

SHUTTERFLY INC

Form 10-Q

November 07, 2018

SHUTTERFLY INC--12-31Large Accelerated Filer2018Q310-QFALSESeptember 30,

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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, 2018**

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 94-3330068**

*(State or Other*

*Jurisdiction of (IRS Employer*

*Incorporation Identification*

*or No.)*

*Organization)*

**2800 Bridge  
Parkway  
Redwood 94065  
City,  
California**

*(Address of  
Principal (Zip  
Executive Code)  
Offices)*

Registrant's Telephone Number, Including Area Code  
**(650) 610-5200**

**Securities registered pursuant to Section 12(b) of the Act:**

| <b>Title of<br/>Each<br/>Class</b>                     | <b>Name of<br/>Each<br/>Exchange<br/>on Which<br/>Registered</b> |
|--|--|
| Common<br>Stock,<br>\$0.0001<br>Par Value<br>Per Share | The Nasdaq<br>Global Select<br>Market                            |

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, a smaller reporting company, or an emerging growth 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   
Emerging

growth  
company o

(Do not check if a  
smaller reporting  
company)

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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

| <b>Class</b>   | <b>Outstanding<br/>as of<br/>November 5,<br/>2018</b> |
|--|---|
| Common<br>stock,<br>\$0.0001<br>par value<br>per share | 33,604,472  |

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## 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, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that are based upon our current expectations. These forward-looking statements include statements related to expanding our product range to Lifetouch customers; accelerating the development of Lifetouch's online order-taking platform; the impact on us of general economic conditions, trends in key metrics such as total number of customers, total number of orders and average order value; our business strategy and plans; the seasonality of and growth of our business; growing and strengthening our talented leadership team; realizing significant supply chain, manufacturing and fulfillment synergies over time; technology initiatives; expected SBS gross margins in the short and longer term; our capital expenditures for 2018; the sufficiency of our cash and cash equivalents and cash generated from operations for the next twelve months; our manufacturing capabilities; effective tax rates; the incremental term loan; continued expansion of reliance on public cloud services; our intention to net settle warrants; anticipation of paying down our acquisition debt and maintaining a BB rating profile; continued focus on optimizing capital allocation; 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 "guidance," "believe," "anticipate," "expect," "estimate," "intend," "seek," "continue," "should," "would," "could," "will," or "may," or the negative of these terms or other 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, decreased consumer discretionary spending as a result of general economic conditions; our ability to expand our customer base and increase sales to existing customers; our ability to meet production requirements; our ability to retain and hire necessary employees, including seasonal personnel, and appropriately staff our operations; the impact of seasonality on our business; our ability to develop innovative, new products and services on a timely and cost-effective basis; failure to realize the anticipated benefits of our 2017 restructuring activities; the retention of Lifetouch employees and our ability to successfully integrate the Lifetouch businesses; consumer acceptance of our products and services; our ability to develop additional adjacent lines of business and successfully launch new product categories; successfully acquire businesses and technologies and to successfully integrate and operate these acquired businesses and technologies; unforeseen changes in expense levels; refinement of our promotional strategy; competition and the pricing strategies of our competitors, which could lead to pricing pressure; the anticipated benefits of expanding the portions of our public cloud infrastructure; risks inherent in the achievement of anticipated synergies from the Lifetouch acquisition and the timing thereof; changes in laws and regulations 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.*

**PART I — FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****SHUTTERFLY, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except par value amounts)****(Unaudited)**

|   | <b>September 30, 2018</b> | <b>December 31, 2017</b> |
|---|---------------------------|--------------------------|
| <b>ASSETS</b>                               |                           |                          |
| Current assets:                             |                           |                          |
| Cash and cash equivalents                   | \$ 165,929                | \$ 489,894               |
| Short-term investments                      | 38,915                    | 178,021                  |
| Accounts receivable, net                    | 75,224                    | 82,317                   |
| Inventories                                 | 18,081                    | 11,019                   |
| Prepaid expenses and other current assets   | 144,853                   | 41,383                   |
| Total current assets                        | 443,002                   | 802,634                  |
| Long-term investments                       | 18,626                    | 9,242                    |
| Property and equipment, net                 | 388,862                   | 266,860                  |
| Intangible assets, net                      | 328,756                   | 29,671                   |
| Goodwill                                    | 842,917                   | 408,975                  |
| Other assets                                | 24,253                    | 17,418                   |
| Total assets                                | \$ 2,046,416              | \$ 1,534,800             |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                           |                          |
| Current liabilities:                        |                           |                          |
| Current portion of long-term debt           | \$ 14,407                 | \$ 297,054               |
| Accounts payable                            | 33,271                    | 91,473                   |
| Accrued liabilities                         | 159,783                   | 159,248                  |
| Deferred revenue                            | 110,736                   | 24,649                   |
| Total current liabilities                   | 318,197                   | 572,424                  |
| Long-term debt                              | 1,092,084                 | 292,457                  |
| Other liabilities                           | 148,932                   | 119,195                  |
| Total liabilities                           | 1,559,213                 | 984,076                  |



Commitments and contingencies (Note 11)

Stockholders' equity:

Common stock, \$0.0001 par value; 100,000 shares authorized; 33,534 and 32,297 shares issued and outstanding on September 30, 2018 and December 31, 2017, respectively

|  |              |  |              |
|--|--------------|--|--------------|
|  | 3            |  | 3            |
| Additional paid-in capital                 | 1,052,383    |  | 996,301      |
| Accumulated other comprehensive income     | 5,193        |  | 1,778        |
| Accumulated deficit                        | (570,376)    |  | (447,358)    |
| Total stockholders' equity                 | 487,203      |  | 550,724      |
| Total liabilities and stockholders' equity | \$ 2,046,416 |  | \$ 1,534,800 |

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

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**SHUTTERFLY, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except per share amounts)  
(Unaudited)

|   | <b>Three Months Ended</b> |             |              | <b>Nine Months Ended</b> |  |
|---|---------------------------|-------------|--------------|--------------------------|--|
|   | <b>September 30,</b>      |             |              | <b>September 30,</b>     |  |
|   | <b>2018</b>               | <b>2017</b> | <b>2018</b>  | <b>2017</b>              |  |
| Net revenue   | \$ 368,757                | \$ 195,443  | \$ 1,011,853 | \$ 596,447               |  |
| Cost of net revenue                                     | 224,738                   | 131,108     | 584,012      | 365,432                  |  |
| Restructuring   | —                         | 39          | —            | 1,475                    |  |
| Gross profit  | 144,019                   | 64,296      | 427,841      | 229,540                  |  |
| Operating expenses:                                     |                           |             |              |                          |  |
| Technology and development                              | 44,735                    | 39,614      | 127,659      | 124,968                  |  |
| Sales and marketing                                     | 135,375                   | 33,331      | 303,737      | 119,205                  |  |
| General and administrative                              | 50,445                    | 23,894      | 137,050      | 79,200                   |  |
| Capital lease termination                               | —                         | —           | —            | 8,098                    |  |
| Restructuring   | —                         | 3,278       | 2,952        | 15,491                   |  |
| Total operating expenses                                | 230,555                   | 100,117     | 571,398      | 346,962                  |  |
| Loss from operations                                    | (86,536)                  | (35,821)    | (143,557)    | (117,422)                |  |
| Interest expense  | (16,660)                  | (6,699)     | (44,063)     | (18,617)                 |  |
| Interest and other income, net                          | 856                       | 253         | 4,166        | 687                      |  |
| Loss before income taxes                                | (102,340)                 | (42,267)    | (183,454)    | (135,352)                |  |
| Benefit from income taxes                               | 28,797                    | 16,660      | 56,234       | 53,713                   |  |
| Net loss  | \$ (73,543)               | \$ (25,607) | \$ (127,220) | \$ (81,639)              |  |
| Net loss per share - basic and diluted                  | \$ (2.20)                 | \$ (0.78)   | \$ (3.84)    | \$ (2.45)                |  |
| Weighted-average shares outstanding - basic and diluted | 33,470                    | 32,878      | 33,139       | 33,363                   |  |
| Stock-based compensation expense is                     |                           |             |              |                          |  |

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allocated as follows (Note 4):

|                            |        |          |          |          |
|----------------------------|--------|----------|----------|----------|
| Cost of net revenue        | \$ 909 | \$ 1,041 | \$ 2,851 | \$ 3,284 |
| Technology and development | 2,545  | 2,512    | 7,546    | 7,388    |
| Sales and marketing        | 3,057  | 2,864    | 9,502    | 9,017    |
| General and administrative | 5,420  | 4,319    | 15,422   | 13,021   |
| Restructuring              | —      | —        | —        | 814      |

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

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**SHUTTERFLY, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
(In thousands)  
(Unaudited)

|  | <b>Three Months Ended</b> |             |              | <b>Nine Months Ended</b> |  |
|--|---------------------------|-------------|--------------|--------------------------|--|
|  | <b>September 30,</b>      |             |              | <b>September 30,</b>     |  |
|  | <b>2018</b>               | <b>2017</b> | <b>2018</b>  | <b>2017</b>              |  |
| Net loss   | \$ (73,543)               | \$ (25,607) | \$ (127,220) | \$ (81,639)              |  |
| Other comprehensive income, net of reclassification adjustments: |                           |             |              |                          |  |
| Foreign currency translation gains (losses)                      | 363                       | —           | (38)         | —                        |  |
| Unrealized gains (losses) on investments, net                    | 9                         | 21          | (37)         | (7)                      |  |
| Tax benefit on unrealized gains (losses) on investments, net     | (2)                       | (8)         | 9            | 8                        |  |
| Unrealized gains on cash flow hedges                             | 867                       | 1,402       | 4,637        | 1,402                    |  |
| Tax expense on unrealized gains on cash flow hedges              | (208)                     | (543)       | (1,156)      | (543)                    |  |
| Other comprehensive income, net of tax                           | 1,029                     | 872         | 3,415        | 860                      |  |
| Comprehensive loss   | \$ (72,514)               | \$ (24,735) | \$ (123,805) | \$ (80,779)              |  |

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

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

|   | Nine Months Ended |             |
|---|-------------------|-------------|
|   | September 30,     |             |
|   | 2018              | 2017        |
| <b>Cash flows from operating activities:</b>                                |                   |             |
| Net loss  | \$ (127,220)      | \$ (81,639) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                   |             |
| Depreciation and amortization   | 79,522            | 66,367      |
| Amortization of intangible assets   | 27,723            | 11,770      |
| Amortization of debt discount and issuance costs                            | 7,901             | 11,365      |
| Repayment of convertible senior notes attributable to debt discount         | (63,510)          | —           |
| Stock-based compensation  | 35,321            | 32,710      |
| (Gain) loss on disposal of property and equipment                           | (175)             | 705         |
| Deferred income taxes   | 17,656            | (8,607)     |
| Restructuring   | 752               | 11,636      |
| Other   | 208               | —           |
| Changes in operating assets and liabilities, net of acquisition:            |                   |             |
| Accounts receivable   | 14,121            | (4,103)     |
| Inventories   | 12,795            | (1,782)     |
| Prepaid expenses and other assets   | (73,462)          | (34,064)    |

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|   |           |          |
|---|-----------|----------|
| Accounts payable  | (68,060)  | (35,819) |
| Accrued and other liabilities   | (36,096)  | (49,198) |
| Net cash used in operating activities                                 | (172,524) | (80,659) |
| <b>Cash flows from investing activities:</b>                          |           |          |
| Acquisition of business, net of cash acquired                         | (889,587) | —        |
| Purchases of property and equipment                                   | (28,984)  | (22,960) |
| Capitalization of software and website development costs              | (34,602)  | (25,977) |
| Purchases of investments  | (9,523)   | (44,381) |
| Proceeds from the maturities of investments                           | 193,399   | 28,456   |
| Proceeds from the sales of investments                                | 46,879    | —        |
| Proceeds from sale of property and equipment                          | 2,088     | 21,232   |
| Net cash used in investing activities                                 | (720,330) | (43,630) |
| <b>Cash flows from financing activities:</b>                          |           |          |
| Proceeds from issuance of common stock upon exercise of stock options | 19,698    | 626      |
| Repurchases of common stock   | —         | (80,000) |
| Principal payments of capital lease and financing obligations         | (14,222)  | (24,813) |
| Principal payments of borrowings                                      | (243,018) | —        |
| Payment of debt issuance costs  | —         | (4,789)  |

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|  |            |           |
|--|------------|-----------|
| Proceeds from borrowings, net of issuance costs              | 806,652    | —         |
| Net cash provided by (used in) financing activities          | 569,110    | (108,976) |
| Effect of exchange rate changes on cash and cash equivalents | (221)      | —         |
| Net decrease in cash and cash equivalents                    | (323,965)  | (233,265) |
| Cash and cash equivalents, beginning of period               | 489,894    | 289,224   |
| Cash and cash equivalents, end of period                     | \$ 165,929 | \$ 55,959 |

**Supplemental schedule of non-cash investing / financing activities:**

|   |            |          |
|---|------------|----------|
| Net (decrease) increase in accrued purchases of property and equipment                | \$ (1,450) | \$ 4,263 |
| Net increase (decrease) in accrued capitalized software and website development costs | 241        | (161)    |
| Stock-based compensation capitalized with software and website development costs      | 1,065      | 1,084    |
| Property and equipment acquired under capital leases                                  | 5,611      | 18,224   |

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**

On April 2, 2018, the Company completed its acquisition of Lifetouch Inc. ("Lifetouch"). As a result of the acquisition, the Company has a new operating segment for the Lifetouch business (refer to Note 10 - *Segment Reporting* for further details).

***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 ("U.S. GAAP") for interim financial information and, accordingly, do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The accompanying unaudited condensed consolidated financial statements include the accounts of Shutterfly, Inc. and its wholly owned subsidiaries including the financial results of Lifetouch which are included prospectively from the acquisition date of April 2, 2018. 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, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018, or for any other period.

The December 31, 2017 condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP. 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, 2017 included in the Company's Annual Report on Form 10-K.

***Revision of Prior Period Amounts***



Table of Contents**SHUTTERFLY, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

|   | <b>Six Months Ended</b>           |                   |                   |
|---|-----------------------------------|-------------------|-------------------|
|   | <b>June 30, 2018</b>              |                   |                   |
|   | <b>As previously<br/>reported</b> | <b>Adjustment</b> | <b>As revised</b> |
| <b>Condensed Consolidated Statement of Cash Flows:</b>              |                                   |                   |                   |
| Repayment of convertible senior notes attributable to debt discount | \$ —                              | \$ (63,510)       | \$ (63,510)       |
| Net cash used in operating activities                               | (136,055)                         | (63,510)          | (199,565)         |
| Principal payments of borrowings                                    | (302,608)                         | 63,510            | (239,098)         |
| Net cash provided by financing activities                           | \$ 511,225                        | \$ 63,510         | \$ 574,735        |

There was no impact of the above matter on the Company's Condensed Consolidated Balance Sheets, Statements of Operations or Statements of Comprehensive Income (Loss).

***Tax Cuts and Jobs Act***

As of December 31, 2017, the Company recorded provisional estimates of the tax impacts of the enactment of the Tax Cuts and Jobs Act (the "Tax Act"). The Company provisionally recorded an income tax benefit related to the Tax Act primarily for the impact of the remeasurement of its deferred tax assets and liabilities at the newly enacted 21% tax rate, the enhanced accelerated depreciation deductions available on qualified property, and estimates of other elements of the Tax Act. The Company's accounting for the Tax Act as of December 31, 2017 was incomplete due to the complexity involved and the absence of regulatory guidance, and therefore its provisional accounting was based on reasonable estimates. In accordance with SAB 118, the measurement period extends up to one year from the enactment date. As the Company completes its analysis of regulatory guidance, adjustments to its provisional amounts may have a material impact to the Company's provision for income taxes in the period they are recognized. For the three and nine months ended September 30, 2018, the Company did not record any adjustments to its provisional amounts. The Company expects to complete its analysis by the fourth quarter of 2018.

***Foreign Currency Translation Policy***

As a result of the acquisition of Lifetouch, the Company has subsidiaries in Canada for which the functional currency is the local currency. As such, exchange rate fluctuations for these subsidiaries are included in stockholders' equity as a component of accumulated other comprehensive income (loss). Prior to the acquisition of Lifetouch, the Company

only had one foreign subsidiary in Israel for which the functional currency is the U.S. Dollar and exchange rate fluctuations are recorded as part of earnings.

***Recently Adopted Accounting Pronouncements***

In 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers (Topic 606)* (“ASC 606”). This new standard replaces all current GAAP guidance on this topic and eliminates all industry-specific guidance. The new revenue recognition guidance provides a unified model to determine when and how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration for which the entity expects to be entitled in exchange of those goods or services. The Company adopted ASC 606 as of January 1, 2018 using the modified retrospective transition method. Refer to Note 2 - *Revenue* for further details.

In August 2016, the FASB issued ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. The Company adopted ASU 2016-15 as of January 1, 2018 on a retrospective basis with no material impact to the consolidated statements of cash flows for the nine months ended September 30, 2018 and 2017.

***Recent Accounting Pronouncements Pending Adoption***

In August 2018, the FASB issued ASU 2018-15, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract* (“ASU 2018-15”), which clarifies the accounting for implementation costs in cloud computing arrangements. ASU 2018-15 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019, and earlier

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**SHUTTERFLY, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

adoption is permitted including adoption in any interim period. The Company is evaluating the impact of adopting this new accounting guidance on the consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-02, *Income Statement, Reporting Comprehensive Income (Topic 220): Reclassification of Certain Effects from Accumulated Other Comprehensive Income* (“ASU 2018-02”), which allows a reclassification of stranded tax effects from accumulated other comprehensive income to retained earnings, as a result of the Tax Act. ASU 2018-02 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, with early adoption permitted and can be applied either in the period of adoption or retrospectively to all applicable periods. The Company does not expect that the pending adoption of ASU 2018-02 will have a material impact on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, *Intangibles - Goodwill and Other (Topic 350)*. The updated guidance simplifies the measurement of goodwill impairment by removing step two of the goodwill impairment test, which requires the determination of the fair value of individual assets and liabilities of a reporting unit. The new guidance requires goodwill impairment to be measured as the amount by which a reporting unit’s carrying value exceeds its fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The amendments should be applied on a prospective basis. The new standard is effective for annual or any interim goodwill impairment tests performed in fiscal years beginning after December 15, 2019 with early adoption permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company is evaluating the impact this new accounting guidance will have on the consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which requires measurement and recognition of expected credit losses for financial assets held. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Earlier adoption is permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is evaluating the impact of adopting this new accounting guidance on the consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The new guidance requires the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous guidance. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018 on a modified retrospective basis, and earlier adoption is permitted. The Company anticipates that most of its operating lease commitments will be subject to the new standard and recognized as lease liabilities and right-of-use assets upon adoption, which will increase the total assets and total liabilities. The Company is currently evaluating the accounting transition and disclosure requirements of this standard, and due to the magnitude of leases assumed in the recent acquisition of Lifetouch, the Company cannot currently estimate the financial statement impact of adoption.

**Note 2 — Revenue**

***Adoption of ASC 606, Revenue from Contracts with Customers***

The Company adopted ASC 606 as of January 1, 2018 using the modified retrospective transition method. Under the modified retrospective method, ASC 606 is only applied to contracts that were not complete as of the adoption date. Results for reporting periods beginning after January 1, 2018 are presented under ASC 606, while prior period amounts are not adjusted and continue to be reported in accordance with our historic accounting under ASC 605, *Revenue Recognition*.

As a result of the adoption of ASC 606, the Company identified an impact related to timing and measurement of breakage revenue for the Shutterfly consumer and the Lifetouch businesses and for one of the Company's significant multiple-element arrangements in connection with the SBS business. Upon adoption of ASC 606, the Company recognized the expected breakage amounts as revenue in proportion to the pattern of rights exercised by the customer, rather than the previous method of recognizing breakage revenue when the Company believed the redemption was remote. As it relates to timing and measurement of one of the Company's multiple-element arrangements in connection with the SBS business, deferred revenue was previously recognized over the stated term of the contract. Upon adoption of ASC 606, deferred revenue for this particular arrangement is now recognized ratably over a period of time that is shorter than the stated contract term, as this arrangement does not contain substantive termination penalties after a certain initial number of years within the contractual term.

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**SHUTTERFLY, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

The cumulative impact of the adoption of ASC 606 resulted in a decrease to opening accumulated deficit of \$4.2 million as of January 1, 2018, which consisted of a decrease in total liabilities of \$5.1 million primarily related to deferred revenue and a decrease in total assets of \$0.9 million primarily related to deferred costs.

***Revenue Recognition Policy***

The Company derives its revenue from Shutterfly Consumer, Lifetouch and SBS product sales, net of applicable sales tax and allowances for returns. Revenue is recognized when control of the promised products or services is transferred to its customers in an amount that reflects the consideration it expects to be entitled to in exchange for those products or services. Shipping charged to its customers is recognized as revenue upon shipment and the related shipping costs are recognized as cost of net revenue.





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**SHUTTERFLY, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

*SBS.* The Company's SBS revenue is derived from personalized direct marketing and other end-consumer communications as well as just-in-time, inventory-free printing for its business customers. The services that the Company promises to its SBS customers are typically composed of a series of services that are performed over time. The Company accounts for these series of services as one performance obligation which represents a series of distinct services that are substantially the same and have the same pattern of transfer.

The Company recognizes revenue from the satisfaction of performance obligations when it invoices its customers (that is, when it has the contractual right to bill under the contract). The Company has the contractual right to consideration from its customers in an amount that corresponds directly with the value to the customer of the services it has performed to date. For contracts that do not contain a significant non-refundable up-front fee, the Company applies the "right to invoice" practical expedient as it has the right to consideration from its customers in an amount that corresponds directly with the value to the customer of the services it has performed to date. For contracts that contain a significant non-refundable up-front fee, the Company considers whether these fees are related to the transfer of a promised good or service to the customer, and therefore represent a performance obligation. When the up-front fees do not represent a distinct performance obligation, the Company recognizes revenue ratably over the period for which there is a significant termination contractual penalty.

The Company's incremental direct costs of obtaining a contract consist of Lifetouch and SBS sales commissions. The Company does not defer such incremental direct costs as the related performance obligations are satisfied within a short period of time and the Company elected to apply the practical expedient per ASC 340-40-25-4 related to expensing contract acquisition costs with the amortization period of less than one year. The Company does not provide any financing services to its customers.

***Deferred Revenue***

***Net Revenue by Brand***

The following table disaggregates the Company's net revenue by brand for the three and nine months ended September 30, 2018 and 2017 (in thousands):

Table of Contents**SHUTTERFLY, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|   | <b>2018</b>               | <b>2017</b> | <b>2018</b>              | <b>2017</b> |
| Shutterfly consumer net revenue:          |                           |             |                          |             |
| Shutterfly brand                          | \$ 115,464                | \$ 115,883  | \$ 412,309               | \$ 379,694  |
| Tiny Prints Boutique <sup>(1)</sup>       | 1,490                     | 1,942       | 4,990                    | 1,942       |
| Tiny Prints <sup>(1)</sup>                | —                         | —           | —                        | 23,382      |
| Wedding Paper Divas <sup>(2)</sup>        | —                         | 8,523       | —                        | 34,178      |
| MyPublisher <sup>(3)</sup>                | —                         | —           | —                        | 10,992      |
| Other                                     | 9,934                     | 9,070       | 26,651                   | 24,965      |
| Shutterfly consumer net revenue           | 126,888                   | 135,418     | 443,950                  | 475,153     |
| Lifetouch net revenue <sup>(4)</sup>      | 183,113                   | —           | 411,673                  | —           |
| Shutterfly Business Solutions net revenue | 58,756                    | 60,025      | 156,230                  | 121,294     |
| Net revenue                               | \$ 368,757                | \$ 195,443  | \$ 1,011,853             | \$ 596,447  |

<sup>(1)</sup> On June 28, 2017, the Company created a Tiny Prints boutique on a dedicated tab on Shutterfly.com and shut down the legacy Tiny Prints website.

<sup>(2)</sup> On September 13, 2017, the Company launched the new Shutterfly Wedding Shop and shut down the Wedding Paper Divas legacy website.

<sup>(3)</sup> The MyPublisher brand was shut down on May 15, 2017.

<sup>(4)</sup> On April 2, 2018, the Company acquired Lifetouch.

**Note 3 — Acquisition**

On January 30, 2018, the Company entered into a Stock Purchase Agreement (the “Purchase Agreement”) with Lifetouch and Lifetouch Inc. Employee Stock Ownership Trust (collectively, the “Seller”). On April 2, 2018, pursuant to the Purchase Agreement, the Company completed the acquisition of 100% of the issued and outstanding shares of common stock of Lifetouch from the Seller. Under the terms of the Purchase Agreement, the consideration for the acquisition consisted of an all-cash purchase price of \$825.0 million subject to certain adjustments based on a determination of Closing Net Working Capital, Transaction Expenses, Cash and Investments, and Closing Indebtedness, as defined in the Purchase Agreement. The Company financed the all-cash purchase price with an incremental \$825.0 million term loan issuance under its existing credit agreement, which closed simultaneous with the acquisition (refer to Note 9 - *Debt* for further details).

Lifetouch provides the Company with a highly complementary business. Lifetouch will be able to offer Shutterfly’s broader product range to Lifetouch customers, as well as to accelerate the development of Lifetouch’s online

order-taking platform. The Company expects to gain access to many Lifetouch customers as Shutterfly customers, where they will benefit from Shutterfly's leading cloud-based photo management service, product creation capabilities, mobile apps, and broad product range.

The Company elected to treat the acquisition of Lifetouch as an asset acquisition under section 338(h)(10) of the U.S. Internal Revenue Service tax code. As such, the goodwill that the Company recognizes as part of the Lifetouch acquisition will be deductible for U.S. income tax purposes. The goodwill recognized represents the assembled workforce of Lifetouch and the value of growth in revenue from future customers of Lifetouch.

During the three and nine months ended September 30, 2018, the Company recorded approximately \$2.4 million and \$15.0 million, respectively, of direct and incremental costs associated with acquisition-related activities. These costs were incurred primarily for banking, legal, professional fees and personnel-related costs for transitional employees associated with the Lifetouch acquisition. These costs were recorded in general and administrative expenses in the consolidated statement of operations.

During the three and nine months ended September 30, 2018, Lifetouch contributed to \$183.1 million and \$411.7 million, respectively, to net revenue, and \$86.6 million and \$210.8 million to gross profit, respectively.

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Under the terms of the Purchase Agreement, the amount of consideration that the Company paid consisted of an all-cash purchase price of \$825.0 million subject to certain adjustments based on a determination of Closing Net Working Capital, Transaction Expenses, Cash and Investments, and Indebtedness, as defined by the Purchase Agreement. The total purchase consideration paid by the Company during the second quarter of 2018 was \$982.0 million. The following table shows the calculation of how the purchase consideration paid by the Company was determined in accordance with the Purchase Agreement (in thousands):

|   |           |                |
|---|-----------|----------------|
| Cash consideration at closing                       | \$        | 825,000        |
| Less: Closing Indebtedness <sup>(1)</sup>           | (27,742)  |                |
| Less: Net Working Capital Adjustment <sup>(1)</sup> | (10,559)  |                |
| Less: Transaction Expenses <sup>(1)(2)</sup>        | (17,614)  |                |
| Add: Closing Cash and Investments <sup>(1)</sup>    | 212,872   |                |
| Purchase price adjustments                          | 156,957   |                |
| <b>Total purchase consideration</b>                 | <b>\$</b> | <b>981,957</b> |

<sup>(1)</sup> As defined in the Purchase Agreement.

<sup>(2)</sup> Transaction expenses incurred by Lifetouch in connection with the transaction as defined by the Purchase Agreement.

In accordance with ASC 805, *Business Combinations*, the Company has recorded the acquired assets (including identifiable intangible assets) and liabilities assumed at the acquisition date fair values. The purchase price allocation for the Lifetouch acquisition is preliminary and subject to revision as additional information about fair value of assets acquired and liabilities assumed becomes available. Additional information that existed as of the acquisition date but at that time was unknown may become known during the remainder of the measurement period, a period not to exceed 12 months from the acquisition date.

The following table shows the preliminary allocation of the total purchase price to the net assets acquired based on their estimated fair values as of April 2, 2018 (in thousands):

|                           |         |        |
|---------------------------|---------|--------|
| Cash and cash equivalents | \$      | 92,370 |
| Investments               | 101,269 |        |
| Accounts receivable, net  | 7,410   |        |

|                                   |                   |
|-----------------------------------|-------------------|
| Inventories                       | 19,857            |
| Property and equipment            | 135,968           |
| Intangible assets                 | 326,000           |
| Goodwill                          | 433,942           |
| Prepaid expenses and other assets | 34,793            |
| Accounts payable                  | (15,331)          |
| Deferred revenue, current portion | (30,934)          |
| Notes payable                     | (8,963)           |
| Accrued and other liabilities     | (114,424)         |
| <b>Total</b>                      | <b>\$ 981,957</b> |

The following table shows the valuation of the intangible assets acquired from Lifetouch along with their estimated remaining useful lives:

|  | <b>Approximate Fair Value<br/>(in thousands)</b> | <b>Weighted Average Life<br/>(in years)</b> |
|--|--|---|
| Customer contracts and related relationships | \$ 200,100                                       | 10  |
| Developed technology                         | 68,000   | 5   |
| Trade names / trademarks / domain name       | 57,600   | 5   |
| Favorable/unfavorable leases                 | 300  | 7   |
| Total intangible assets                      | \$ 326,000                                       |   |

Table of Contents**SHUTTERFLY, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS*****Identifiable Intangible Assets***

*Customer contracts and related relationships.* These assets primarily relate to the existing relationships that Lifetouch has developed with a number of schools and preschools. These relationships provide economic value to the Company and therefore were valued separately from goodwill. The Company valued these assets utilizing a form of the income approach known as the "Multi-Period Excess Earnings Method" ("MPEEM") since these customer assets were identified as the primary asset. Under the MPEEM, the value of these assets was estimated based on the expected future economic earnings attributable to the assets. The key assumptions used in the valuation of these assets include future revenue from existing customers and estimated expenses forecast, contributory asset charges (such as cash-free debt-free working capital, fixed assets, brand assets and assembled workforce), the discount rate, expected tax rate(s) and tax amortization benefit.

*Developed technology.* Lifetouch has a number of developed technology platforms that are internally-used (e.g., field operations management and production management systems) and customer-facing (e.g., order management and yearbook design systems). These technologies will continue to be used by the Company. Given that the technologies are specific to Lifetouch and have minimal possibility of being licensed out to third parties, the "Cost to Recreate Method" under the Cost approach was used to value these assets. The key assumptions used in the valuation of these assets include direct and indirect developer costs, developer's profit, and opportunity cost.

*Trade names / trademarks / domain name.* Lifetouch is the leading provider of school photography services in the U.S. and has a number of registered trade names, trademarks and domain names that are recognized and well known in the marketplace. These brand names are expected to continue to be used, providing economic value to the Company, and therefore were valued separately from goodwill. The "Relief from Royalty Method" of the income approach was used in the valuation of trade names, trademarks and domain names.

***Unaudited Pro Forma Financial Information***

The following table summarizes the pro forma consolidated information for the Company assuming the acquisition of Lifetouch had occurred as of January 1, 2017. The unaudited pro forma information for all periods presented includes the business combination accounting effects resulting from the acquisition, including amortization for intangible assets acquired, depreciation expense for tangible assets acquired, interest expense for the additional indebtedness incurred to complete the acquisition, acquisition-related charges and the impact of adopting ASC 606. The impact of applying ASC 606 to Lifetouch's historical periods as presented below was not material. The pro forma results also include the effects of the purchase accounting adjustments for the fair value of deferred revenue and inventory. The unaudited pro forma financial information as presented below is for informational purposes only and is not necessarily indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of fiscal 2017.

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |              |
|--|---------------------------|-------------|--------------------------|--------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |              |
| <i>(in thousands, except per share data)</i> | <b>2018</b>               | <b>2017</b> | <b>2018</b>              | <b>2017</b>  |
| Total net revenue                            | \$ 372,715                | \$ 399,769  | \$ 1,183,631             | \$ 1,189,214 |
| Net loss                                     | \$ (68,527)               | \$ (62,631) | \$ (137,885)             | \$ (179,374) |
| Basic loss per share                         | \$ (2.05)                 | \$ (1.90)   | \$ (4.16)                | \$ (5.38)    |
| Diluted loss per share                       | \$ (2.05)                 | \$ (1.90)   | \$ (4.16)                | \$ (5.38)    |

**Note 4 — Stock-Based Compensation**

*Stock Option Activity*

A summary of the Company's stock option activity for the nine months ended September 30, 2018 is as follows (share numbers and aggregate intrinsic values in thousands):

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|   | <b>Number of<br/>Options<br/>Outstanding<br/>(in<br/>thousands)</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Term (years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(in thousands)</b> |
|---|---|--|--|---|
| Balance as<br>of<br>December<br>31, 2017                                    | 1,529   | \$ 46.77   |  |   |
| Granted   | 228   | \$ 76.73   |  |   |
| Exercised   | (428)   | \$ 45.93   |  |   |
| Forfeited,<br>cancelled or<br>expired                                       | (28)  | \$ 45.49   |  |   |
| Balance as<br>of<br>September<br>30, 2018                                   | 1,301   | \$ 52.33   | 5.2  | \$ 20,112   |
| Options<br>vested and<br>expected to<br>vest as of<br>September<br>30, 2018 | 1,213   | \$ 51.84   | 5.1  | \$ 19,100   |
| Options<br>vested as of<br>September<br>30, 2018                            | 360   | \$ 47.32   | 4.6  | \$ 6,676  |

During the nine months ended September 30, 2018, the Company granted options to purchase an aggregate of approximately 228,000 shares of common stock with an estimated weighted-average grant-date fair value of \$23.57. The total intrinsic value of options exercised during the three months ended September 30, 2018 and 2017 was \$2.6 million and \$0.1 million, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2018 and 2017 was \$13.3 million and \$0.8 million, respectively.

Net cash proceeds from the exercise of stock options for the three months ended September 30, 2018 and 2017 were \$3.1 million and \$0.1 million, respectively. Net cash proceeds from the exercise of stock options for the nine months ended September 30, 2018 and 2017 were \$19.7 million and \$0.6 million, respectively.

***Valuation of Stock Options***

The Company estimates the fair value of each option award on the date of grant using the Black-Scholes option-pricing model. The Company calculates volatility using an average of its historical and implied volatilities as it has sufficient public trading history to cover the entire expected term. The expected term of options gives consideration to historical exercises, post-vest 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 nine months ended September 30, 2018 and 2017 are as follows (there were no option awards granted during the three months ended September 30, 2018 and 2017):

|                                 | <b>Nine Months<br/>Ended<br/>September 30,<br/>2018    2017</b> |                 |
|---------------------------------|---|-----------------|
| Dividend yield                  | —   | —               |
| Annual risk-free rate of return | 2% <del>6</del>   | 1% <del>8</del> |
| Expected volatility             | 3% <del>7</del>   | 2% <del>8</del> |
| Expected term (years)           | 4.1   | 4.1             |

#### ***Restricted Stock Unit Activity***

The Company grants restricted stock units ("RSUs") and performance-based restricted stock units ("PBRsUs") to its employees under the provisions of the 2015 Equity Incentive Plan and inducement awards to certain new employees upon hire in accordance with Nasdaq Listing Rule 5635(c)(4). The cost of RSUs and PBRsUs 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 four-year total vesting term. Compensation cost associated with RSUs is amortized on a straight-line basis over the requisite service period.

A summary of the Company's RSU activity, including service-based awards and performance-based awards, for the nine months ended September 30, 2018, is as follows (share numbers in thousands):

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|  | <b>Number of<br/>Units<br/>Outstanding</b> |    | <b>Weighted<br/>Average<br/>Grant Date<br/>Fair Value</b> |
|--|--|----|---|
| Awarded<br>and<br>unvested as<br>of<br>December<br>31, 2017  | 2,293                                      | \$ | 44.64   |
| Granted  | 748  | \$ | 76.65   |
| Vested   | (805)                                      | \$ | 45.12   |
| Forfeited  | (177)                                      | \$ | 47.47   |
| Awarded<br>and<br>unvested as<br>of<br>September<br>30, 2018 | 2,059                                      | \$ | 55.83   |
| RSUs<br>expected to<br>vest as of<br>September<br>30, 2018   | 1,769                                      |    |   |

Employee stock-based compensation expense recognized in the three and nine months ended September 30, 2018 and 2017 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.

At September 30, 2018, the Company had \$83.6 million of total unrecognized stock-based compensation expense, net of estimated forfeitures, related to stock options, RSUs and PBRSUs that will be recognized over a weighted-average period of approximately two years.

**Note 5 — Net Loss Per Share**

Basic 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 shares outstanding during the period.

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 RSUs and incremental shares of common stock issuable upon the exercise of stock options, and conversion of warrants.

A summary of the net loss per share for the three and nine months ended September 30, 2018 and 2017 is as follows (in thousands, except per share amounts):

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|  | <b>2018</b>               | <b>2017</b> | <b>2018</b>              | <b>2017</b> |
| <b>Net loss per share:</b>                           |                           |             |                          |             |
| Numerator  |                           |             |                          |             |
| Net loss   | \$ (73,543)               | \$ (25,607) | \$ (127,220)             | \$ (81,639) |
| Denominator for basic and diluted net loss per share |                           |             |                          |             |
| Weighted-average common shares outstanding           | 33,470                    | 32,878      | 33,139                   | 33,363      |
| Net loss per share - basic and diluted               | \$ (2.20)                 | \$ (0.78)   | \$ (3.84)                | \$ (2.45)   |

The following weighted-average outstanding stock options and RSUs 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):

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## SHUTTERFLY, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

|                        | Three Months Ended |       | Nine Months Ended |       |
|------------------------|--------------------|-------|-------------------|-------|
|                        | September 30,      |       | September 30,     |       |
|                        | 2018               | 2017  | 2018              | 2017  |
| Stock options and RSUs | 3,350              | 4,070 | 3,535             | 4,026 |

With respect to the convertible senior notes issued in 2013 as described in Note 9 - *Debt*, the Company settled the principal of the convertible senior notes in cash upon their maturity in May 2018. The weighted-average impact to dilution for the period that the conversion option was outstanding was 451,000 shares for the nine months ended September 30, 2018. The potential conversion impact was excluded from the computation of diluted net loss per common share for such periods because including it would have had an anti-dilutive effect.

**Note 6 — Investments**

At September 30, 2018 and December 31, 2017, the estimated fair value of short-term and long-term debt securities investments, all of which are classified as available-for-sale, was as follows (in thousands):

|                                      | September 30, 2018 |                        |                         |                      |
|--------------------------------------|--------------------|------------------------|-------------------------|----------------------|
|                                      | Amortized Cost     | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| <b>Short-term investments</b>        |                    |                        |                         |                      |
| Corporate debt securities            | \$ 30,000          | \$ 2                   | \$ (31)                 | \$ 29,971            |
| Agency securities                    | 3,871              | —                      | (16)                    | 3,855                |
| U.S. government securities and other | 5,104              | —                      | (15)                    | 5,089                |
| Total short-term investments         | \$ 38,975          | \$ 2                   | \$ (62)                 | \$ 38,915            |
| <b>Long-term investments</b>         |                    |                        |                         |                      |
| Corporate debt securities            | \$ 9,701           | \$ 3                   | \$ (28)                 | \$ 9,676             |
| Agency securities                    | 4,582              | —                      | (30)                    | 4,552                |
| U.S. government                      | 4,437              | —                      | (39)                    | 4,398                |

securities

|                             |           |      |         |           |
|-----------------------------|-----------|------|---------|-----------|
| Total long-term investments | \$ 18,720 | \$ 3 | \$ (97) | \$ 18,626 |
|-----------------------------|-----------|------|---------|-----------|

**December 31, 2017**

|                               | <b>Amortized Cost</b> | <b>Gross Unrealized Gains</b> | <b>Gross Unrealized Losses</b> | <b>Estimated Fair Value</b> |
|-------------------------------|-----------------------|-------------------------------|--------------------------------|-----------------------------|
| <b>Short-term investments</b> |                       |                               |                                |                             |
| Corporate debt securities     | \$ 54,911             | \$ 3                          | \$ (52)                        | \$ 54,862                   |
| Agency securities             | 10,781                | —                             | (14)                           | 10,767                      |
| Commercial paper              | 101,546               | —                             | —                              | 101,546                     |
| U.S. government securities    | 10,857                | —                             | (11)                           | 10,846                      |
| Total short-term investments  | \$ 178,095            | \$ 3                          | \$ (77)                        | \$ 178,021                  |
| <b>Long-term investments</b>  |                       |                               |                                |                             |
| Corporate debt securities     | \$ 6,287              | \$ —                          | \$ (25)                        | \$ 6,262                    |
| Agency securities             | 2,000                 | —                             | (17)                           | 1,983                       |
| U.S. government securities    | 998                   | —                             | (1)                            | 997                         |
| Total long-term investments   | \$ 9,285              | \$ —                          | \$ (43)                        | \$ 9,242                    |

The Company had no available-for-sale investments with a significant unrealized loss that have been in a continuous unrealized loss position for more than 12 months as of September 30, 2018, and no impairments were recorded during the three and nine months ended September 30, 2018 and 2017. The Company had no material realized gains or losses during the three and nine months ended September 30, 2018 and 2017.

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The following table summarizes the contractual maturities of the Company's investments as of September 30, 2018 and December 31, 2017 (in thousands):

|                              | <b>September 30,<br/>2018</b> |       | <b>December 31, 2017</b> |
|------------------------------|-------------------------------|-------|--------------------------|
| One year or less             | \$ 38,915                     | \$    | 178,021                  |
| One year through three years | 18,626                        | 9,242 |                          |
|                              | \$ 57,541                     | \$    | 187,263                  |

**Note 7 — Fair Value Measurement*****Cash Equivalents and Investments***

The Company measures the fair value of money market funds and investments based on quoted prices in active markets for identical assets or liabilities. All other financial instruments were valued either based on recent trades of securities in inactive markets or based on quoted market prices of similar instruments and other significant inputs derived from or corroborated by observable market data. The Company did not hold any cash equivalents or investments categorized as Level 3 as of September 30, 2018 and December 31, 2017.

|                            | <b>Total Estimated Fair Value as of</b> |                    |                          |                    |
|----------------------------|---|--------------------|--------------------------|--------------------|
|                            | <b>September 30, 2018</b>               |                    | <b>December 31, 2017</b> |                    |
|                            | <b>Cash<br/>Equivalents</b>             | <b>Investments</b> | <b>Cash Equivalents</b>  | <b>Investments</b> |
| <b>Level 1 Securities:</b> |   |                    |                          |                    |
| Money market funds         | \$ 62,580                               | \$ —               | \$ 151,071               | \$ —               |
| <b>Level 2 Securities:</b> |   |                    |                          |                    |
| Corporate debt securities  | —                                       | 39,647             | 21,592                   | 61,124             |
| Agency securities          | —                                       | 8,407              | 6,444                    | 12,750             |
| Commercial                 | —                                       | —                  | 85,599                   | 101,546            |

|   |           |           |            |    |         |
|---|-----------|-----------|------------|----|---------|
| paper   |           |           |            |    |         |
| U.S.  |           |           |            |    |         |
| government securities and other               | —         | 9,487     | —          |    | 11,843  |
| <b>Total cash equivalents and investments</b> | \$ 62,580 | \$ 57,541 | \$ 264,706 | \$ | 187,263 |

*Derivative Assets*

As of September 30, 2018 and December 31, 2017, the fair value of certain of the Company's term loans interest-rate swap agreements, which were determined based on an income-based valuation model that takes into account the contract terms as well as multiple observable market inputs such as LIBOR-based yield curves, futures, volatilities and basis spreads (Level 2), were as follows (in thousands):

|                   | <b>Total Estimated Fair Value as of</b> |                          |
|-------------------|---|--------------------------|
|                   | <b>September 30, 2018</b>               | <b>December 31, 2017</b> |
| Derivative assets | \$ 7,616                                | \$ 2,979                 |

As of September 30, 2018 and December 31, 2017, the fair value of the Company's borrowings, which was determined based on inputs that are observable in the market or that could be derived from, or corroborated with, observable market data, including the Company's stock price, interest rates and credit spread (Level 2) were as follows (in thousands):

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|                          | <b>Total Estimated Fair Value as of</b> |                          |
|--------------------------|---|--------------------------|
|                          | <b>September 30,<br/>2018</b>           | <b>December 31, 2017</b> |
| Convertible senior notes | \$ —                                    | \$ 296,550               |
| Term Loans               | \$ 1,132,176                            | \$ 300,000               |

As of September 30, 2018 and December 31, 2017, the carrying value of other financial instruments, including accounts receivable, accounts payable and other payables, approximates fair value due to their short maturities.

**Note 8 — Balance Sheet Components***Prepaid Expenses and Other Current Assets*

|   | <b>September 30,<br/>2018</b> | <b>December 31,<br/>2017</b> |
|---|-------------------------------|------------------------------|
|   | <i>(in thousands)</i>         |                              |
| Intra-period deferred tax asset           | \$ 73,022                     | \$ —                         |
| Other prepaid expenses and current assets | 71,831                        | 41,383                       |
|   | \$ 144,853                    | \$ 41,383                    |

Intra-period income 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.

*Property and Equipment, Net*

|  | <b>September 30,<br/>2018</b> | <b>December 31, 2017</b> |
|--|-------------------------------|--------------------------|
|  | <i>(in thousands)</i>         |                          |
| Manufacturing equipment                            | \$ 224,945                    | \$ 192,494               |
| Computer equipment and software                    | 173,240                       | 188,593                  |
| Capitalized software and website development costs | 164,612                       | 134,585                  |



|   |            |            |
|---|------------|------------|
| Buildings under build-to-suit leases      | 56,468     | 56,468     |
| Photography equipment                     | 54,797     | —          |
| Owned buildings and building improvements | 38,488     | —          |
| Leasehold improvements                    | 27,815     | 22,145     |
| Rental equipment                          | 18,424     | 19,208     |
| Land                                      | 17,000     | —          |
| Furniture and fixtures and other          | 11,442     | 8,255      |
|   | 787,231    | 621,748    |
| Less:                                     |            |            |
| Accumulated depreciation and amortization | (398,369)  | (354,888)  |
| Property and equipment, net               | \$ 388,862 | \$ 266,860 |

Included within manufacturing equipment is approximately \$95.7 million and \$89.9 million of capital lease obligations for various manufacturing facility equipment as of September 30, 2018 and December 31, 2017, respectively. Accumulated depreciation of assets under capital leases totaled \$43.7 million and \$32.4 million at September 30, 2018 and December 31, 2017, respectively.

Rental equipment includes camera lenses, camera bodies, video equipment and other camera peripherals which are rented through the BorrowLenses website.

Depreciation and amortization expense totaled \$29.4 million and \$21.2 million for the three months ended September 30, 2018 and 2017, respectively. Depreciation and amortization expense totaled \$79.5 million and \$66.4 million for the nine months ended September 30, 2018 and 2017, respectively.

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Included in property and equipment is approximately \$21.0 million and \$15.8 million of assets in construction as of September 30, 2018 and December 31, 2017, respectively, the majority of which relates to capitalized software and website development costs.

|                                   | <b>Weighted<br/>Average<br/>Useful<br/>Life</b> | <b>September 30,<br/>2018</b> | <b>December 31, 2017</b> |
|-----------------------------------|---|-------------------------------|--------------------------|
|                                   |   | <i>(in thousands)</i>         |                          |
| Purchased technology              | 8 years   | \$ 172,869                    | \$ 104,869               |
| Less:<br>accumulated amortization |   | (85,989)                      | (76,585)                 |
|                                   |   | 86,880                        | 28,284                   |
| Customer relationships            | 9 years   | 275,246                       | 75,146                   |
| Less:<br>accumulated amortization |   | (85,474)                      | (73,759)                 |
|                                   |   | 189,772                       | 1,387                    |
| Other <sup>(1)</sup>              | 5 years   | 65,102                        | 7,202                    |
| Less:<br>accumulated amortization |   | (12,998)                      | (7,202)                  |
|                                   |   | 52,104                        | —                        |
| Total                             |   | \$ 328,756                    | \$ 29,671                |

<sup>(1)</sup> The unamortized balance for other intangible assets primarily relate to the trade name, trademarks and domain name assets acquired as part of the acquisition of Lifetouch during the second quarter of 2018.

Intangible asset amortization expense for the three months ended September 30, 2018 and September 30, 2017 was \$12.3 million and \$3.3 million, respectively. Intangible asset amortization expense for the nine months ended September 30, 2018 and September 30, 2017 was \$26.9 million and \$10.9 million, respectively. Amortization of existing intangible assets is estimated to be as follows (in thousands):

**Year  
Ending  
December  
31:**

|                      |    |         |
|----------------------|----|---------|
| Remainder<br>of 2018 | \$ | 12,307  |
| 2019                 |    | 49,226  |
| 2020                 |    | 49,000  |
| 2021                 |    | 48,925  |
| 2022                 |    | 48,418  |
| Thereafter           |    | 120,880 |
|                      | \$ | 328,756 |

**Goodwill**

The following table presents the goodwill allocated to the Company's reportable segments as of and during the nine months ended September 30, 2018 (in thousands):

|                                     | <b>December 31, 2017</b> | <b>Acquisitions</b> | <b>September 30, 2018</b> |
|-------------------------------------|--------------------------|---------------------|---------------------------|
| Shutterfly<br>Consumer              | \$ 372,072               | \$ —                | \$ 372,072                |
| Lifetouch                           | —                        | 433,942             | 433,942                   |
| Shutterfly<br>Business<br>Solutions | 36,903                   | —                   | 36,903                    |
|                                     | \$ 408,975               | \$ 433,942          | \$ 842,917                |

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The allocation of goodwill from the acquisition of Lifetouch to the Company's reporting units has not been finalized and will be allocated based upon the finalization of the valuation.

***Accrued Liabilities***

|  | <b>September 30,<br/>2018</b> | <b>December 31, 2017</b> |
|--|-------------------------------|--------------------------|
|  | <i>(in thousands)</i>         |                          |
| Accrued compensation                       | \$ 46,566                     | \$ 31,331                |
| Accrued marketing expenses                 | 22,542                        | 22,874                   |
| Accrued production costs                   | 21,141                        | 37,552                   |
| Capital lease obligations, current portion | 16,681                        | 16,859                   |
| Accrued other                              | 52,853                        | 50,632                   |
|  | \$ 159,783                    | \$ 159,248               |

***Other Liabilities***

|  | <b>September 30,<br/>2018</b> | <b>December 31, 2017</b> |
|--|-------------------------------|--------------------------|
|  | <i>(in thousands)</i>         |                          |
| Financing obligations                          | \$ 52,252                     | \$ 53,682                |
| Capital lease obligations, non-current portion | 41,698                        | 48,620                   |
| Other liabilities                              | 54,982                        | 16,893                   |
|  | \$ 148,932                    | \$ 119,195               |

Financing obligations relate to the Company's build-to-suit leases.

**Note 9 — Debt*****2017 Syndicated Credit Facility***

On August 17, 2017 ("Closing Date"), the Company entered into a credit agreement ("Credit Agreement") with certain lenders and Morgan Stanley Senior Funding, Inc., as administrative agent and collateral agent. The Credit Agreement provides for (a) a secured revolving loan facility in an aggregate principal amount of up to \$200.0 million ("Revolving Loan Facility") and (b) a secured delayed draw term loan facility ("Initial Term Loan") in an aggregate principal amount of up to \$300.0 million. The Credit Agreement permits the Company to add one or more incremental term loan facilities and/or increase the commitments for revolving loans subject to certain conditions.

In October 2017, the Company fully drew the \$300.0 million Initial Term Loan under the Credit Agreement. On April 2, 2018, the Company entered into an amendment under the Credit Agreement for an incremental term loan in an aggregate principal amount of \$825.0 million ("Incremental Term Loan") to finance the acquisition of Lifetouch, Inc. The full amount of the \$200.0 million Revolving Loan Facility remains undrawn as of September 30, 2018.

Upon funding of the Initial Term Loan, the Company elected to bear interest at a rate of one-month LIBOR, subject to a floor of 0.0%, plus an applicable margin of 2.50% per annum. Upon funding of the Incremental Term Loan, the Company elected to bear interest at a rate of one-month LIBOR, subject to a floor of 0.0%, plus an applicable margin of 2.75% per annum. The applicable margin of 2.75% for the Incremental Term Loan is determined based on a secured leverage ratio as defined by the Incremental Term Loan Amendment dated April 2, 2018.

The effective interest rates for the unhedged portion of the Initial Term Loan for three and nine months ended September 30, 2018 were 4.59% and 4.38%, respectively. The effective interest rates for the Incremental Term Loan for the three and nine months ended September 30, 2018 were 4.84% and 4.76% respectively.

The revolving loans under the Credit Agreement bear interest, at the election of the Company, at either (a) the base rate (the "Base Rate"), which is defined as a fluctuating rate per annum equal to the greatest of (1) the prime rate then in effect, (2) the federal funds rate then in effect, plus 0.50%, and (3) an adjusted LIBOR rate determined on the basis of a one-month interest

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period, plus 1.0% or (b) an adjusted LIBOR Rate, subject to a floor of 0.0% (the "LIBOR Rate"), in each case, plus an applicable margin of (1) initially, 0.75% per annum in the case of Base Rate loans and 1.75% per annum in the case of LIBOR Rate loans or (2) following the Company's delivery of financial statements for the first full fiscal quarter following the Closing Date, 0.50% to 0.75% per annum in the case of Base Rate loans and 1.50% to 1.75% per annum in the case of LIBOR Rate loans, in each case based on the Company's consolidated secured net leverage ratio, measured as of the end of the most recently ended fiscal quarter. In connection with the Credit Agreement, the Company is also required to pay commitment fees, closing fees, arrangement fees, ticking fees and administration fees, and other customary fees and costs.

Both the Initial Term Loan and the Incremental Term Loan have a maturity date of August 17, 2024. Commencing on the respective last day of the first full fiscal quarter following the Company's respective borrowings of the Initial Term Loan and the Incremental Term Loan, the respective Initial Term Loan and Incremental Term Loan amortize in equal quarterly installments of 0.25% of the outstanding principal balance for each loan, with the remaining respective principal balances payable on the maturity date. Amounts drawn on the Revolving Loan Facility, if any, mature on August 17, 2022. Further, the Company has the right to prepay its borrowings under the Credit Agreement in whole or in part at any time without a premium or penalty, subject to certain limitations. The Credit Agreement also contains certain customary mandatory prepayments under certain conditions as set forth in the Credit Agreement.

The Credit Agreement contains customary affirmative and negative covenants, including covenants that limit or restrict the Company's and its subsidiaries' ability to, among other things, incur indebtedness, grant liens, undergo certain fundamental changes, dispose of assets, make investments, enter into transactions with affiliates, and make certain restricted payments (including declaration and payment of dividends), in each case subject to limitations and exceptions set forth in the Credit Agreement. The Company is also required to maintain compliance, measured as of the end of each fiscal quarter, with a consolidated secured net leverage ratio and a consolidated interest expense coverage ratio. As of September 30, 2018, the Company is in compliance with these covenants.

In August 2017, the Company entered into certain interest-rate swap agreements with an effective date of October 18, 2017 that have the economic effect of modifying a portion of the variable interest-rate obligations associated with the Initial Term Loan so that the interest payable on such portion become fixed (refer to *Note 14 - Derivative Financial Instruments* for further details regarding the interest-rate swap agreements).

The Company incurred \$5.6 million in credit facility origination costs during the year ended December 31, 2017 related to the Credit Agreement and \$18.3 million in origination costs during the nine months ended September 30, 2018 related to the Incremental Term Loan. The origination costs attributable to the Revolving Loan Facility were capitalized within prepaid expenses for the current portion and other assets for the non-current portion. The origination costs attributable to the Initial Term Loan and the Incremental Term Loan are presented as a reduction to the carrying value of the debt in the consolidated balance sheet. Fees attributable to the Revolving Loan Facility of \$0.8 million are being amortized over five years as component of interest expense. The fees attributable to the Initial Term Loan of \$4.8 million and the Incremental Term Loan of \$18.3 million are being amortized over the term of the loans, both as a component of interest expense.

The Initial Term Loan and Incremental Term Loan consist of the following (in thousands):

|  | <b>September 30, 2018</b> | <b>December 31, 2017</b> |
|--|---------------------------|--------------------------|
| Principal borrowings                           | \$ 1,125,000              | \$ 300,000               |
| Less: principal payments                       | (4,309)                   | —                        |
| Less: debt issuance costs, net of amortization | (20,936)                  | (4,543)                  |

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|                         |    |           |    |         |
|-------------------------|----|-----------|----|---------|
| Net carrying amount     | \$ | 1,099,755 | \$ | 295,457 |
| Term loans, current     | \$ | 11,165    | \$ | 3,000   |
| Term loans, non-current | \$ | 1,088,590 | \$ | 292,457 |

The following table sets forth the total interest expense recognized related to the Initial Term Loan and the Incremental Term Loan for the three and nine months ended September 30, 2018 (in thousands). The Initial Term Loan was drawn in October 2017 and the Incremental Term Loan was drawn in April 2018. Therefore, there was no interest expense for the three and nine months ended September 30, 2017 associated with these loans.

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|   | <b>Three Months Ended</b> |             |             | <b>Nine Months Ended</b> |  |
|---|---------------------------|-------------|-------------|--------------------------|--|
|   | <b>September 30,</b>      |             |             | <b>September 30,</b>     |  |
|   | <b>2018</b>               | <b>2017</b> | <b>2018</b> | <b>2017</b>              |  |
| Floating interest (including the effects of cash flow hedges) | \$ 13,701                 | \$ —        | \$ 29,801   | \$ —                     |  |
| Amortization of debt issuance costs                           | 891                       | —           | 1,955       | —                        |  |
|   | \$ 14,592                 | \$ —        | \$ 31,756   | \$ —                     |  |

***Assumed Notes Payable from the Acquisition of Lifetouch***

In connection with the acquisition of Lifetouch in the second quarter of 2018 (refer to Note 3 - *Acquisition*), the Company assumed \$9.0 million of legacy Lifetouch notes payable (of which \$4.0 million was classified as current), which is payable in varying principal payments plus interest rates ranging from 0% to 2.2% with maturities at various dates through July 2022. These notes payable were issued by Lifetouch to finance various acquisitions and represents promissory notes issued to the owners of the acquired companies for an amount equal to the purchase consideration. Payments of principal for these notes payable during the three and nine months ended September 30, 2018 were \$1.1 million and \$2.2 million respectively.

As of September 30, 2018, the estimated future principal and interest payments of these assumed notes payable is as follows (in thousands):

| <b>Year Ending December 31:</b>       |          |
|---------------------------------------|----------|
| Remainder of 2018                     | \$ 240   |
| 2019                                  | 3,337    |
| 2020                                  | 2,060    |
| 2021                                  | 1,164    |
| 2022                                  | 742      |
| Total principal and interest payments | \$ 7,543 |

***0.25% Convertible Senior Notes Due and Paid May 15, 2018***

In May 2013, the Company issued \$300.0 million aggregate principal amount of 0.25% convertible senior notes (the



"Notes") which were due and paid on May 15, 2018. Upon maturity, the Company paid the aggregate principal amount of \$300.0 million and delivered 1,108,000 shares of the Company's common stock. The Company also received 1,108,000 shares of the Company's common stock from a note hedge transaction that was entered into in May 2013 to minimize the potential economic dilution upon the aforementioned conversion of the Notes.

In accounting for the issuance of the Notes, the Company separated the Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was determined by deducting the fair value of the liability component from the face value of the Notes as a whole. The excess of the principal amount of the liability component over its carrying amount ("debt discount") was amortized to interest expense over the term of the Notes.

In accounting for the transaction costs related to the Note issuance, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Issuance costs attributable to the liability component, totaling \$6.4 million, were amortized to expense over the term of the Notes, and issuance costs attributable to the equity component, totaling \$1.7 million, were netted with the equity component in stockholders' equity. Additionally, the Company recorded a deferred tax asset of \$0.6 million on a portion of the equity component transaction costs which are deductible for tax purposes.

Concurrently with the Note issuance, the Company repurchased 0.6 million shares of common stock for approximately \$30.0 million.

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The Notes were paid in May 2018. As of December 31, 2017, the Notes consist of the following (in thousands):

| <b>December 31, 2017</b>                                      |                   |
|---|-------------------|
| Liability component:  |                   |
| Principal   | \$ 300,000        |
| Less: debt issuance costs, debt discount, net of amortization | (5,946)           |
| <b>Net carrying amount (classified as current)</b>            | <b>\$ 294,054</b> |
| Equity Component <sup>(1)</sup>                               | \$ 63,510         |

<sup>(1)</sup> Recorded in the consolidated balance sheets within additional paid-in capital, net of the \$1.7 million of issuance costs in equity.

The following table sets forth total interest expense recognized related to the Notes (in thousands):

|                                     | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|-------------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                     | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                                     | <b>2018</b>               | <b>2017</b> | <b>2018</b>              | <b>2017</b> |
| 0.25% coupon                        | \$ —                      | \$ 187      | \$ 281                   | \$ 562      |
| Amortization of debt issuance costs | —                         | 351         | 543                      | 1,039       |
| Amortization of debt discount       | —                         | 3,490       | 5,403                    | 10,326      |
|                                     | \$ —                      | \$ 4,028    | \$ 6,227                 | \$ 11,927   |

**Note Hedge**

To minimize the impact of potential economic dilution upon conversion of the Notes, the Company entered into convertible note hedge transactions with respect to its common stock (the "Note Hedge"). In May 2013, the Company paid an aggregate amount of \$63.5 million for the Note Hedge. The Note Hedge expired upon maturity of the Notes in May 2018. The Note Hedge was intended to offset the potential dilution upon conversion of the Notes and/or offset any cash payments the Company is required to make in excess of the principal amount upon conversion of the Notes in the event that the market value per share of the Company's common stock, as measured under the Notes, is greater than the strike price of the Note Hedge, which initially corresponds to the conversion price of the Notes and is subject to anti-dilution adjustments substantially similar to those applicable to the conversion rate of the Notes. Upon expiration of the Note Hedge in May 2018, the Company received 1,108,000 shares of the Company's common stock from the Note Hedge counterparties.

*Warrant*

common stock for the reporting period, as measured under the Warrant, exceeds the strike price of the Warrant, the Warrant will have a dilutive effect on the Company's earnings per share. The Warrant is a separate transaction, entered into by the Company and is not part of the Notes or the Note Hedge, and has been accounted for as part of additional paid-in capital. Holders of the Notes and Note Hedge will not have any rights with respect to the Warrant.

**Note 10 — Segment Reporting**

The Company reports segment information based on its internal reporting used by management for making decisions and assessing performance as the source of its reportable segments. As a result of the acquisition of Lifetouch in the second quarter of 2018, the Company entered into a new business and as a result, the Company has a new reportable and operating segment described further below.

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**SHUTTERFLY, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

The Chief Operating Decision Maker ("CODM") function uses segment margin to evaluate the performance of the segments and allocate resources. Management considers segment margin to be the appropriate metric to evaluate and compare the ongoing performance of each reportable segment as it is the level at which direct costs associated with the performance of the segment are monitored.

During the second quarter of 2018, the Company expanded its segment reporting. As a result, the profitability metric by which the Company's CODM measures segment performance and allocates resources changed from segment gross profit to segment margin. Segment margin includes technology and development expenses, sales and marketing expenses, and credit card fees, arriving at a margin for the segment. Segment margin excludes corporate expenses, amortization of intangible assets, stock-based compensation expense, and other non-recurring items including restructuring charges and acquisition-related costs. Corporate expenses include activities that are not directly attributable or allocable to a specific segment.

The Company's segments are determined based on the products and services each segment provides and how the CODM evaluates the business. The Company has the following reportable segments:

Shutterfly Consumer - Includes sales from the Company's brands and are derived from the sale of a variety of products such as, professionally-bound photo books, cards and stationery, custom home décor products and unique photo gifts, calendars and prints, and related shipping revenue, as well as rental revenue from its BorrowLenses brand. Revenue from advertising displayed on the Company's website is also included in Shutterfly Consumer revenue.

Lifetouch - Includes revenue from professional photography services for schools, preschools and churches, as well as retail studios operated by Lifetouch under the JCPenney Portrait brand.

Shutterfly Business Solutions - Includes revenue from personalized direct marketing and other end-consumer communications as well as just-in-time, inventory-free printing for the Company's business customers.

Segment assets are not reported to, or used by, the CODM to allocate resources or assess performance of the Company's segments. Accordingly, the Company has not disclosed asset information by segment. Substantially all of the Company's revenue is generated from sales originating in the United States.

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The Company's segment results for the three and nine months ended September 30, 2018 and 2017 were as follows (dollars in thousands):

|                                       | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---------------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                       | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                                       | <b>2018</b>               | <b>2017</b> | <b>2018</b>              | <b>2017</b> |
| <b>Shutterfly Consumer:</b>           |                           |             |                          |             |
| Net revenue                           | \$ 126,888                | \$ 135,418  | \$ 443,950               | \$ 475,153  |
| Cost of net revenue                   | 81,031                    | 81,439      | 251,940                  | 263,345     |
| Technology and development            | 29,971                    | 32,712      | 91,930                   | 104,679     |
| Sales and marketing                   | 28,819                    | 26,811      | 89,500                   | 98,955      |
| Credit card fees                      | 3,527                     | 3,766       | 12,075                   | 12,709      |
| Margin <sup>(1)</sup>                 | \$ (16,460)               | \$ (9,310)  | \$ (1,495)               | \$ (4,535)  |
| Margin %                              | (13)%                     | (7) %       | — %                      | (1) %       |
| <b>Lifetouch<sup>(2)</sup>:</b>       |                           |             |                          |             |
| Net revenue <sup>(3)</sup>            | \$ 187,071                | \$ —        | \$ 448,982               | \$ —        |
| Cost of net revenue <sup>(4)</sup>    | 94,188                    | —           | 185,336                  | —           |
| Technology and development            | 7,142                     | —           | 14,251                   | —           |
| Sales and marketing                   | 92,693                    | —           | 179,653                  | —           |
| Credit card fees                      | 3,316                     | —           | 4,481                    | —           |
| Margin <sup>(1)</sup>                 | \$ (10,268)               | \$ —        | \$ 65,261                | \$ —        |
| Margin %                              | (5) %                     | — %         | 15 %                     | — %         |
| <b>Shutterfly Business Solutions:</b> |                           |             |                          |             |
| Net revenue                           | \$ 58,756                 | \$ 60,025   | \$ 156,230               | \$ 121,294  |
| Cost of net revenue                   | 45,973                    | 47,520      | 127,493                  | 95,256      |
| Technology and development            | 3,190                     | 4,390       | 10,184                   | 12,901      |

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|                       |          |          |           |           |
|-----------------------|----------|----------|-----------|-----------|
| Sales and marketing   | 1,473    | 1,193    | 4,542     | 3,032     |
| Margin <sup>(1)</sup> | \$ 8,120 | \$ 6,922 | \$ 14,011 | \$ 10,105 |
| Margin %              | 14 %     | 12 %     | 9 %       | 8 %       |

**Consolidated Segments:**

|                                    |             |            |              |            |
|------------------------------------|-------------|------------|--------------|------------|
| Net revenue <sup>(3)</sup>         | \$ 372,715  | \$ 195,443 | \$ 1,049,162 | \$ 596,447 |
| Cost of net revenue <sup>(4)</sup> | 221,192     | 128,959    | 564,769      | 358,601    |
| Technology and development         | 40,303      | 37,102     | 116,365      | 117,580    |
| Sales and marketing                | 122,985     | 28,004     | 273,695      | 101,987    |
| Credit card fees                   | 6,843       | 3,766      | 16,556       | 12,709     |
| Margin <sup>(1)</sup>              | \$ (18,608) | \$ (2,388) | \$ 77,777    | \$ 5,570   |
| Margin %                           | (5) %       | (1) %      | 7 %          | 1 %        |

(1) The margins reported reflect only costs that are directly attributable or allocable to a specific segment and exclude corporate expenses, amortization of intangible assets, stock-based compensation expense and other one-time charges.

(2) The Company acquired Lifetouch on April 2, 2018.

(3) Yearbook sales and collections for the Lifetouch segment are made throughout the school year, whereas yearbooks are typically delivered toward the end of the school year in the second quarter of the fiscal year. Business combination accounting principles require the Company to record the assumed deferred revenue at fair value on the acquisition date measured based on the cost to manufacture and deliver the yearbooks, plus a profit margin. Segment reporting includes this purchase accounting adjustment which primarily relates to yearbook sales in net revenue for the Lifetouch segment.

(4) Business combination accounting principles require the Company to measure acquired inventory at fair value. The fair value of inventory reflects Lifetouch's cost of manufacturing plus a portion of the expected profit margin. Segment reporting excludes this purchase accounting adjustment from cost of net revenue for the Lifetouch segment.

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The following table reconciles operating segment margin to total operating loss and loss before income taxes, operating segment net revenue to total net revenue, and operating segment cost of net revenue to total cost of net revenue (in thousands):

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |              |
|--|---------------------------|-------------|--------------------------|--------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |              |
|  | <b>2018</b>               | <b>2017</b> | <b>2018</b>              | <b>2017</b>  |
| Total margin for operating segments                            | \$ (18,608)               | \$ (2,388)  | \$ 77,777                | \$ 5,570     |
| Purchase accounting deferred revenue adjustment <sup>(1)</sup> | (3,958)                   | —           | (37,309)                 | —            |
| Purchase accounting inventory adjustment <sup>(2)</sup>        | —                         | —           | (10,931)                 | —            |
| Corporate expenses <sup>(3)</sup>                              | (37,088)                  | (15,810)    | (92,121)                 | (52,634)     |
| Amortization of intangible assets                              | (12,559)                  | (3,570)     | (27,723)                 | (11,770)     |
| Stock-based compensation expense for operating segments        | (11,931)                  | (10,736)    | (35,321)                 | (33,524)     |
| Restructuring  | —                         | (3,317)     | (2,952)                  | (16,966)     |
| Acquisition-related costs                                      | (2,392)                   | —           | (14,977)                 | —            |
| Capital lease termination                                      | —                         | —           | —                        | (8,098)      |
| Loss from operations   | \$ (86,536)               | \$ (35,821) | \$ (143,557)             | \$ (117,422) |
| Loss from operations   | \$ (86,536)               | \$ (35,821) | \$ (143,557)             | \$ (117,422) |
| Interest expense   | (16,660)                  | (6,699)     | (44,063)                 | (18,617)     |
| Interest and other income, net                                 | 856                       | 253         | 4,166                    | 687          |
| Loss before income taxes                                       | \$ (102,340)              | \$ (42,267) | \$ (183,454)             | \$ (135,352) |
| Total net revenue for all operating segments                   | \$ 372,715                | \$ 195,443  | \$ 1,049,162             | \$ 596,447   |
| Purchase accounting deferred                                   | (3,958)                   | —           | (37,309)                 | —            |

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|   |            |            |              |            |  |
|---|------------|------------|--------------|------------|--|
| revenue<br>adjustment <sup>(1)</sup>                              |            |            |              |            |  |
| Total net revenue   | \$ 368,757 | \$ 195,443 | \$ 1,011,853 | \$ 596,447 |  |
| Total cost of net<br>revenue for all<br>operating segments        | \$ 221,192 | \$ 128,959 | \$ 564,769   | \$ 358,601 |  |
| Purchase<br>accounting<br>inventory<br>adjustment <sup>(2)</sup>  | —          | —          | 10,931       | —          |  |
| Stock-based<br>compensation<br>expense for cost of<br>net revenue | 909        | 1,041      | 2,851        | 3,284      |  |
| Amortization of<br>intangible assets for<br>cost of net revenue   | 2,637      | 1,108      | 5,461        | 3,547      |  |
| Total cost of net<br>revenue                                      | \$ 224,738 | \$ 131,108 | \$ 584,012   | \$ 365,432 |  |

(1) Yearbook sales and collections for the Lifetouch segment are made throughout the school year, whereas yearbooks are typically delivered toward the end of the school year in the second quarter of the fiscal year. Business combination accounting principles require the Company to record the assumed deferred revenue at fair value on the acquisition date measured based on the cost to manufacture and deliver the yearbooks, plus a profit margin. Segment reporting includes this purchase accounting adjustment which primarily relates to yearbook sales in net revenue for the Lifetouch segment.

(2) Business combination accounting principles require the Company to measure acquired inventory at fair value. The fair value of inventory reflects the acquired company's cost of manufacturing plus a portion of the expected profit margin. Management reporting excludes this purchase accounting adjustment from cost of net revenue for the Lifetouch segment.

(3) Corporate expenses include activities that are not directly attributable or allocable to a specific segment. This category consists primarily of expenses related to certain functions performed at the corporate level such as non-manufacturing facilities, human resources, finance and accounting, legal, information technology, integration, etc.



Table of Contents**SHUTTERFLY, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****Note 11 — Commitments and Contingencies*****Leases Assumed from the Acquisition of Lifetouch***

There have been no significant changes to the minimum lease payments schedule disclosed in the Company's Form 10-K for the year ended December 31, 2017. However, the Company assumed leases in connection with the acquisition of Lifetouch. As part of this acquisition, the Company assumed leases for office facilities, production and warehouse facilities, several photographic studios, and a portion of office equipment under operating agreements, which expire beginning in 2018 through 2030. Rent expense in connection with these assumed leases for the three and nine months ended September 30, 2018 was \$4.9 million and \$9.7 million respectively.

As of September 30, 2018, the total future minimum payments under these assumed non-cancelable operating leases from the acquisition of Lifetouch are as follows (in thousands):

| <b>Year<br/>Ending<br/>December<br/>31:</b> |           |
|---|-----------|
| Remainder<br>of 2018                        | \$ 4,341  |
| 2019  | 14,676    |
| 2020  | 9,766     |
| 2021  | 5,945     |
| 2022  | 3,380     |
| 2023  | 1,633     |
| Thereafter                                  | 1,462     |
| Total<br>minimum<br>lease<br>payments       | \$ 41,203 |

Total minimum lease payments for capital leases assumed as part of the acquisition of Lifetouch are not significant to the financial statements.

***Purchase Obligations Assumed from the Acquisition of Lifetouch***

There have been no significant changes to the non-cancelable purchase obligations disclosed in the Company's Form 10-K for the year ended December 31, 2017. However, the Company assumed certain non-cancelable purchase obligations in connection with the acquisition of Lifetouch primarily related to non-cancelable service agreements that expire through 2021.

As of September 30, 2018, the total non-cancelable future minimum purchase obligations from the acquisition of Lifetouch are as follows (in thousands):

**Year Ending  
December  
31:**

|   |    |        |
|---|----|--------|
| Remainder of<br>2018                        | \$ | 1,839  |
| 2019  |    | 6,501  |
| 2020  |    | 2,057  |
| 2021  |    | 101    |
| Total<br>minimum<br>purchase<br>obligations | \$ | 10,498 |

***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.

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**SHUTTERFLY, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

***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***

The Company is subject to the various legal proceedings and claims discussed below as well as certain other legal proceedings and claims that have not been fully resolved and that have arisen in the ordinary course of business. Although adverse decisions (or settlements) may occur in one or more of these cases, it is not possible to estimate the possible loss or losses from each of these cases. The final resolution of these lawsuits, individually or in the aggregate, is not expected to have a material adverse effect on the Company's business, financial position or results of operations. Cases that previously were disclosed may no longer be described because of rulings in the case, settlements, changes in the Company's business or other developments rendering them, in the Company's judgment, no longer material to the Company's business, financial position or results of operations. One material legal proceeding was terminated during the third quarter of 2018.

*The State of Delaware v. Shutterfly, Inc.*

On May 1, 2014, the State of Delaware filed a complaint against Shutterfly for alleged violations of the Delaware False Claims and Reporting Act, 6 Del C. § 1203(b)(2). The complaint asserts that Shutterfly failed to report and remit to Delaware cash equal to the balances on unused gift cards under the Delaware Escheats Law, 12 Del. C. § 1101 et seq. The Company entered into an agreement to settle this matter and did not admit any liability or wrongdoing. The case was dismissed with prejudice by order dated August 31, 2018.

*Monroy v. Shutterfly, Inc.*

On November 30, 2016, Alejandro Monroy on behalf of himself and all others similarly situated, filed a complaint against us in the U.S. District Court for the Northern District of Illinois. The complaint asserts that the Company violated the Illinois Biometric Information Privacy Act by extracting his and others' biometric identifiers from photographs and seeks statutory damages and an injunction. The Company believes the suit is without merit and intends to vigorously defend against it.

*Taylor v. Shutterfly, Inc.*

On December 12, 2017, Megan Taylor filed a purported class action complaint on behalf of herself and other customers in the U.S. District Court for the Northern District of California. Taylor alleges that the Company misrepresents a deal it currently offers through Groupon because it does not allow purchasers of the Groupon offer to combine or "stack" it with other promotional codes offered by the Company. Taylor is seeking monetary damages and injunctive relief. The Company believes the suit is without merit and intends to vigorously defend against it.

*Vigeant v Meek et al.*

On March 1, 2018, a purported class action complaint was filed against several directors of Lifetouch, Inc. (which became a direct wholly-owned subsidiary of Shutterfly on April 2, 2018) and the trustee of the Lifetouch Employee Stock Ownership Plan (the "ESOP") in the U.S. District Court for the District of Minnesota. On April 2, 2018, the complaint was amended to include the prior ESOP trustees and plan sponsor (Lifetouch) as additional named

defendants. The complaint alleges violations of the Employee Retirement Income Security Act, including that the ESOP should not have been permitted to continue investing in Lifetouch stock during a period in which the Lifetouch stock price was declining. The plaintiffs seek recovery for damages arising from the alleged breaches of fiduciary duty. The Company believes this suit is without merit and intends to vigorously defend against it.

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 the Company had 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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Table of Contents**SHUTTERFLY, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****Note 12 — Share Repurchase Program**

On October 24, 2012, the Company's Board of Directors (the "Board") conditionally authorized and the Audit Committee subsequently approved a share repurchase program for up to \$60.0 million of the Company's common stock. As of September 30, 2018, the Company's Board of Directors had approved increases to the program on the following dates:

- On February 6, 2014, the Board approved an increase of \$100.0 million in addition to any amounts repurchased as of that date.
- On February 9, 2015, the Board approved an increase of \$300.0 million in addition to any amounts repurchased as of that date.
- On April 21, 2016, the Board approved an increase of \$100.0 million in addition to any amounts repurchased as of that date.
- On April 18, 2017, the Board approved an increase of \$140.0 million in addition to any amounts repurchased as of that date.

The Company suspended its share repurchase program as of December 31, 2017 and the Company has publicly committed to maintaining a BB rating profile, and repaying acquisition debt, accordingly.

The share repurchase program is subject to prevailing market conditions and other considerations; does not require the Company to repurchase any dollar amount or number of shares; and may be suspended or discontinued at any time.

The share repurchase authorization, which was effective immediately, permits the Company to effect repurchases for cash from time to time through the 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 following table provides information about our repurchase of shares of our common stock for fiscal years 2016, 2017, and 2018:

| <b>Period<sup>(1)</sup></b> | <b>Total<br/>Number of<br/>Shares<br/>Purchased</b> | <b>Average Price<br/>Paid per Share</b> | <b>Total Dollar Value<br/>Spent on Repurchases<br/>(in thousands)</b> |
|-----------------------------|---|---|---|
| 2016<br>Repurchases         | 2,524,752   | \$ 44.55                                | \$ 112,488  |
| 2017<br>Repurchases         | 2,325,825   | \$ 47.29                                | \$ 110,000  |
| 2018<br>Repurchases         | —   | —                                       | —   |

<sup>(1)</sup> All shares were purchased pursuant to the publicly announced share repurchase program described above. Shares are reported in a period based on the settlement date of the applicable repurchase. All repurchased shares of common stock have been retired.

**Note 13 — Restructuring*****iMemories Restructuring***

The Company completed the acquisition of Lifetouch on April 2, 2018. At the time the Company purchased Lifetouch, it anticipated that it would exit the iMemories business, as Shutterfly Photos was a more complete and advanced solution. The Company decided to accelerate the process of exiting iMemories, which was completed in the

second quarter of 2018 and was divested for a nominal amount. The exit resulted in restructuring charges of \$3.0 million consisted of lease termination costs of \$1.0 million, employee-related costs of \$0.8 million and other costs of \$1.2 million. Payments of \$2.2 million in connection with these charges were made during the second quarter of 2018. The remaining \$0.8 million relates to non-cash restructuring charges primarily related to write-off of certain assets. The Company does not expect to incur any further charges in connection with this divestiture.

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**SHUTTERFLY, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 14 — Derivative Financial Instruments**

In August 2017, the Company entered into certain interest-rate swap agreements (“Swap Agreements”) with an aggregate notional amount of \$150.0 million and an effective date of October 18, 2017. The Swap Agreements have the economic effect of modifying a portion of the variable interest-rate obligations associated with the Company’s Initial Term Loan drawn in October 2017 so that the interest payable on such portion of the Initial Term Loan become fixed at a rate of 4.27% (refer to Note 9 - *Debt* for further details regarding the term loan facility). The Swap Agreements have a maturity date of August 17, 2023 as compared to August 17, 2024 for the Initial Term Loan. Further, the Initial Term Loan has an interest-rate floor, whereas the Swap Agreements do not include a floor. All other critical terms of the Swap Agreements correspond to the Initial Term Loan, including interest-rate reset dates and underlying market indices. The Company fully drew the Initial Term Loan on October 18, 2017 which is also the effective date of the Swap Agreements. The Company has asserted that it is probable that it will have sufficient outstanding debt throughout the life of the Swap Agreements.

The Company has designated the aforementioned Swap Agreements as qualifying hedging instruments and is accounting for them as cash flow hedges pursuant to ASC 815 (as amended by ASU 2017-12).

The fair value of the Swap Agreements was \$7.6 million and \$3.0 million as of September 30, 2018 and December 31, 2017, respectively, and were classified as other assets in the balance sheet. The unrealized gains recognized in other comprehensive income (loss) were \$0.9 million and \$4.6 million for the three and nine months ended September 30, 2018, respectively. The amounts reclassified from other comprehensive income (loss) to interest expense during the three and nine months ended September 30, 2018 were insignificant. Amounts expected to be reclassified from other comprehensive income into interest expense in the coming 12 months is \$1.2 million. Interest expense (including the effects of the cash flow hedges) related to the portion of the Initial Term Loan subject to the aforementioned interest-rate swap agreements was \$1.8 million and \$5.1 million for the three and nine months ended September 30, 2018, respectively.

The Company does not use derivative financial instruments for trading purposes.

**Note 15 — Subsequent Events**

In October 2018, the Company announced that it will be closing two Lifetouch facilities in 2019: Loves Park, Illinois and Bloomington, Minnesota, and will consolidate this volume into existing Shutterfly facilities. The consolidation involves a mix of moving existing Lifetouch equipment to Shutterfly facilities, and migrating Lifetouch volumes to Shutterfly's digital presses. Given the adjacent peak periods of the Shutterfly Consumer and the Lifetouch businesses, this consolidation of facilities will further reduce the Company's reliance on temporary labor while improving the utilization of existing assets.

The Company plans to retain a portion of the impacted employees in this transaction, who will move to other existing Shutterfly or Lifetouch facilities, and the Company will offer appropriate severance and/or retention packages to other employees. The Company is currently in the process of estimating the impact of the financial effect the closing of these two facilities will have on its financial statements.

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

**Overview**

Shutterfly, Inc. was incorporated in the state of Delaware in 1999. In September 2006, we completed our initial public offering and our common stock is listed on The Nasdaq Global Select Market under the symbol "SFLY." Our principal corporate offices are in Redwood City, California.

We are the leading retailer and manufacturing platform for personalized products and communications.

On April 2, 2018, we completed our acquisition of Lifetouch Inc. ("Lifetouch"). Lifetouch is the national leader in school photography, built on the enduring tradition of "Picture Day," and also serves families through portrait studios and other partnerships.

Our high-quality products and services and the compelling 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 trusted premium brands are:

**Shutterfly** leads the industry in personalized photo products and services. Shutterfly helps our customers turn their precious memories into lasting keepsakes with award-winning professionally-bound photo books, cards and stationery, custom home décor products and unique photo gifts as well as calendars and prints.

The **Tiny Prints boutique** offers premium cards and stationery, stylish announcements, invitations and personal stationery. The Tiny Prints boutique provides customers exclusive luxe designs curated from top stationery designers. Customers seek us out for our industry-leading designs and exceptional service.

**BorrowLenses** is the premier online marketplace for high-quality photographic and video equipment rentals.

**Groovebook** is an iPhone and Android app and subscription service that prints up to 100 mobile phone photos in a Groovebook and mails it to customers every month.

Professional photographers at **Lifetouch** capture the classic images of school-age children under the **Lifetouch** brand. In addition, **Prestige Portraits** help high school and college seniors celebrate those graduation milestones. **Lifetouch** also provides schools with yearbooks and memory books and churches and other groups with pictorial directories and images for purchase. Over 400 retail studios operated by Lifetouch under the **JCPenney Portrait** brand also provide



professional photographic services for infants, toddlers, families and business professionals throughout the United States.

In addition to these consumer brands, **Shutterfly Business Solutions (SBS)** provides personalized direct marketing and other end-consumer communications as well as just-in-time, inventory-free printing for our business customers.

We generate most of our revenue by capturing, marketing and manufacturing a variety of products such as high-quality prints, cards and stationery, professionally-bound photo books and yearbooks, personalized gifts and home décor, and calendars. We manufacture many of these items in 11 production facilities located throughout the United States and one in Canada. By operating our own production facilities, we can produce high-quality products, innovate rapidly, maintain a favorable cost structure and ensure timely shipment to customers, even during peak periods of demand. We also operate a network of partners

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and can seamlessly manage demand across it. Some of the products that are currently manufactured for us by third parties include calendars, mugs, ornaments, candles, pillows and blankets.

While Lifetouch is a leading school photographer in Canada, substantially all our revenue is generated from sales originating in the United States. Shutterfly and Lifetouch sales have historically been highly seasonal. For example, approximately 50% of our Shutterfly brand net revenue occurs during our fiscal fourth quarter. In the fourth quarter, the traditional fall school and holiday portraits generate approximately 35% of Lifetouch's annual revenue. We also see an increase in Lifetouch net revenue during the second quarter in connection with the spring portrait season and yearbooks. Our operations and financial performance depend on general economic conditions in the United States, consumer sentiment, and the levels of 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.

Our customers are a central part of our business model. They generate most of the content for our Shutterfly consumer business 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 network of new users and customers.

In addition to the customer acquisition opportunities made possible through our acquisition of Lifetouch, we will continue to acquire customers through multiple marketing channels. Close, frequent customer interactions, coupled with significant investments in sophisticated integrated marketing programs, enable us to obtain user input on new features, functionalities and products. We continue to fine-tune and tailor our promotions and website presentation to specific customer segments. Consequently, our Shutterfly customers are presented with a highly personalized shopping experience, which helps foster a unique and deep relationship with our Shutterfly consumer business.

To successfully execute our strategies, we require a talented leadership team. This is even more critical as we integrate our acquisition of Lifetouch. As a result, we intend to continue our focus to attract, retain, and grow our team; and to build continuity and pursue executional excellence in our daily operations everywhere. Lifetouch is also highly dependent on its field sales and photo operations teams, which have a core year-round employee base, supplemented by a large number of seasonal employees. By providing our employees with a great place to work, we believe that we continue to strengthen our high-performance culture.

In October 2018, we announced that we will be closing two Lifetouch facilities in 2019: Loves Park, Illinois and Bloomington, Minnesota, and will consolidate this volume into existing Shutterfly facilities. The consolidation involves a mix of moving existing Lifetouch equipment to Shutterfly facilities, and migrating Lifetouch volumes to Shutterfly's digital presses. Given the adjacent peak periods of the Shutterfly Consumer and the Lifetouch businesses, this consolidation of facilities will further reduce our reliance on temporary labor while improving the utilization of existing assets. We plan to retain a portion of the impacted employees in this transaction, who will move to other existing Shutterfly or Lifetouch facilities, and we will offer appropriate severance and/or retention packages to other

employees. We are currently in the process of estimating the impact of the financial effect the closing of these two facilities will have on our financial statements.

**Basis of Presentation**

*Net Revenue.* Our net revenue is comprised of sales generated from the Shutterfly Consumer, Lifetouch and SBS segments.

*Shutterfly Consumer.* Our Shutterfly Consumer revenue includes sales from our brands and are derived from the sale of a variety of products such as, professionally-bound photo books, cards and stationery, custom home décor products

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and unique photo gifts, calendars and prints, and related shipping revenue, as well as rental revenue from our BorrowLenses brand. Revenue from advertising displayed on our website is also included in Shutterfly Consumer revenue.

*Lifetouch.* Our Lifetouch revenue is primarily from professional photography services for schools, preschools and churches, as well as retail studios operated by Lifetouch under the JCPenney Portrait brand.

*SBS.* Our SBS revenue is primarily from personalized direct marketing and other end-consumer communications as well as just-in-time, inventory-free printing for our business customers. We continue to focus our efforts in expanding our presence in this industry.

Our Shutterfly Consumer segment is subject to seasonal fluctuations. In particular, we generate a substantial portion of our Shutterfly Consumer segment revenue during the holiday season in the fourth quarter. We also typically experience increases in Shutterfly Consumer segment net revenue during other shopping-related seasonal events, such as Easter, Mother's Day, Father's Day and Halloween. We generally experience lower Shutterfly Consumer segment net revenue 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, Shutterfly Consumer segment order backlog is not material to our business.

To further understand net revenue trends in our Shutterfly Consumer segment, we monitor several key metrics including, total customers, total number of orders, and average order value.

*Total Customers.* We closely monitor total customers as a key indicator of demand. Total customers represent the number of transacting customers in a given period. An active customer is defined as one that has transacted in the last trailing twelve months. We seek to expand our customer base by empowering our existing customers with sharing and collaboration services, and by conducting integrated marketing and advertising programs. We also acquire new customers through customer list acquisitions.

*Total Number of Orders.* We closely monitor total number of orders as a leading indicator of net revenue trends. We recognize net revenue 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 in approximately three business days after a customer places an order.

*Average Order Value.* Average order value ("AOV") is Shutterfly Consumer net revenue for a given period divided by the total number of customer orders recorded during that same period. AOV is impacted by product sales mix and pricing and promotional strategies, including our promotions and competitor promotional activity. As a result, our AOV may fluctuate on a quarterly and annual basis.

Our Lifetouch segment is also subject to seasonal fluctuations. In particular, we generate a substantial portion of our Lifetouch segment revenue in the fourth quarter during the traditional fall school and holiday portraits season. The Lifetouch segment also typically experiences increases in net revenue during the second quarter due to the spring school portrait and yearbook season.

Our SBS segment revenue is generated from personalized direct marketing and other end-consumer communications as well as just-in-time, inventory-free printing for our business customers.

We believe the analysis of these metrics and others described under "Non-GAAP Financial Measures" 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 revenue and operating results.

*Cost of Net Revenue.* Our cost of net revenue is split between our Shutterfly Consumer, Lifetouch and SBS segments.

*Shutterfly Consumer.* Cost of net revenue for the Shutterfly Consumer segment consists of costs incurred to produce personalized products for all our brands. These costs include direct materials (the majority of which consists of paper, ink, and photo book covers), shipping charges, packing supplies, distribution and fulfillment activities, third-party costs for photo-based merchandise, payroll and related expenses for direct labor and customer service, rent for production facilities, and depreciation of production equipment (primarily digital printing presses and binders) and manufacturing facilities. Cost of net revenue also includes amortization of capitalized website and

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software development costs, primarily related to adding features and functionality to the Shutterfly website and apps to facilitate product purchases and improve the customer shopping experience. These costs include amortization of third-party software and acquired developed technology as well as patent royalties. Cost of net revenue also includes inventory markdowns that are part of restructuring activities.

*Lifetouch.* Cost of net revenue for the Lifetouch segment consists of costs incurred to capture and produce photography products. These costs include direct materials (the majority of which consists of paper, ink, and yearbook covers), shipping charges, packing supplies, distribution and fulfillment activities, payroll and related expenses for direct labor (including photographers) and customer service, and depreciation of production and photography equipment and manufacturing facilities. Cost of net revenue also includes amortization of capitalized website and software development costs, primarily related to adding features and functionality to the Lifetouch website to facilitate product purchases and improve the customer shopping experience. These costs include amortization of third-party software and acquired developed technology.

*SBS.* Cost of net revenue for the SBS segment consists of costs which are direct and incremental to the SBS business. These include production costs of SBS products, such as materials, labor and printing costs, shipping costs, indirect overhead and depreciation as well as costs associated with third-party production of goods.

*Operating Expenses.* Operating expenses consist of technology and development, sales and marketing, general and administrative and restructuring expenses.

Technology and development expense consists primarily of salaries and benefits for employees and professional fees for contractors engaged in the maintenance and support of our websites, developing features and functionality for our free photo storage service, and developing and maintaining internal infrastructure such as our ERP, internal reporting tools and network security and data encryption systems. These expenses include depreciation of computer and network hardware used to run our websites, store user photos and related data, and support our infrastructure, as well as amortization of software used to operate such hardware. 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. As it relates to the Lifetouch segment, sales and marketing expenses also consist of cost incurred to acquire host accounts (e.g., schools or churches) as well as the costs for marketing programs directed at the end-consumer. These costs include labor costs for sales professionals and account managers that maintain the relationships with the hosts as well as the personnel and related expenses for product marketing activities. Our marketing efforts consist of various online and offline media programs, such as e-mail and direct mail promotions, flyers distributed by our hosts, social media and online display advertising, radio advertising, television advertising, the purchase of keyword search terms and various strategic alliances. We utilize 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 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 revenue during the period. All 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 interest on our convertible senior notes arising from amortization of debt discount, amortization of debt issuance costs and our 0.25% coupon payment up until its settlement in May 2018,

interest on our term loans issued in October 2017 and April 2018, costs associated with our syndicated credit facilities, and costs associated with our capital leases and build-to-suit lease financing obligations.

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

*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. We are subject to taxation in the United States, Canada and Israel.

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**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, revenue 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.

Except for the accounting policy for revenue recognition that was updated as a result of the adoption of Accounting Standards Update No. ASU 2014-09, there have been no changes to our critical accounting policies and estimates described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 that have had a material impact on our condensed consolidated financial statements and related notes.

***Revenue Recognition Policy***

We derive our revenue primarily from Shutterfly Consumer, Lifetouch and SBS product sales, net of applicable sales tax and allowances for returns. Revenue is recognized when control of the promised products or services is transferred to our customers in an amount that reflects the consideration we expect to be entitled to in exchange for those products or services. Shipping charged to our customers is recognized as revenue upon shipment and the related shipping costs are recognized as cost of net revenue.





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*SBS.* SBS revenue is derived from personalized direct marketing and other end-consumer communications as well as just-in-time, inventory-free printing for our business customers. The services that we promise to our SBS customers are typically composed of a series of services that are performed over time. We account for these series of services as one performance obligation which represents a series of distinct services that are substantially the same and have the same pattern of transfer.

We recognize revenue from the satisfaction of performance obligations when we invoice our customers (that is, when we have the contractual right to bill under the contract). We have the contractual right to consideration from our customers in an amount that corresponds directly with the value to the customer of the services we have performed to date. For contracts that do not contain a significant non-refundable up-front fee, we apply the “right to invoice” practical expedient as we have the right to consideration from our customers in an amount that corresponds directly with the value to the customer of the services we have performed to date. For contracts that contain a significant non-refundable up-front fee, we consider whether these fees are related to the transfer of a promised good or service to the customer, and therefore represent a performance obligation. When the up-front fees do not represent a distinct performance obligation, we recognize revenue ratably over the period for which there is a significant termination contractual penalty.

Incremental direct costs of obtaining a contract consist of Lifetouch and SBS sales commissions. We do not defer such incremental direct costs as the related performance obligations are satisfied within a short period of time and we elected to apply the practical expedient per ASC 340-40-25-4 related to expensing contract acquisition costs with the amortization period of less than one year. We do not provide any financing services to our customers.

**Recent Accounting Pronouncements**

Refer to *Note 1 - The Company and Summary of Significant Accounting Policies* of the financial statements for a discussion of the recent accounting pronouncements.

Table of Contents**Results of Operations**

The following table presents the components of our statement of operations as a percentage of net revenue:

|                                | <b>Three Months<br/>Ended<br/>September 30,</b> |             | <b>Nine Months<br/>Ended<br/>September 30,</b> |             |
|--------------------------------|---|-------------|--|-------------|
|                                | <b>2018</b>                                     | <b>2017</b> | <b>2018</b>                                    | <b>2017</b> |
| Net revenue                    | 100   | 100         | 100  | 100         |
| Cost of net revenue            | 61%   | 67%         | 58%  | 62%         |
| Restructuring                  | —%  | —%          | —%   | —%          |
| Gross profit                   | 39%   | 33%         | 42%  | 38%         |
| Operating expenses:            |   |             |  |             |
| Technology and development     | 12%   | 20%         | 13%  | 21%         |
| Sales and marketing            | 3%  | 1%          | 30%  | 20%         |
| General and administrative     | 14%   | 12%         | 13%  | 13%         |
| Capital lease termination      | —%  | —%          | —%   | 1%          |
| Restructuring                  | —%  | 2%          | —%   | 3%          |
| Total operating expenses       | 63%   | 51%         | 56%  | 58%         |
| Loss from operations           | (24)  | (18)        | (14)   | (20)        |
| Interest expense               | (4)   | (4)         | (4)  | (3)         |
| Interest and other income, net | —%  | —%          | —%   | —%          |
| Loss before income taxes       | (28)  | (22)        | (18)   | (23)        |
| Benefit from income taxes      | 8%  | 9%          | 5%   | 9%          |
| Net loss                       | (20)  | (13)        | (13)   | (14)        |

Table of Contents**Comparison of the Three Month Periods Ended September 30, 2018 and 2017**

The following table presents the results of operations:

|                                   | <b>Three Months Ended September 30,</b> |             |                  | <b>%<br/>Change</b> |
|-----------------------------------|---|-------------|------------------|---------------------|
|                                   | <b>2018</b>                             | <b>2017</b> | <b>\$ Change</b> |                     |
|                                   | <i>(dollars in thousands)</i>           |             |                  |                     |
| <b>Consolidated:</b>              |   |             |                  |                     |
| Net revenue                       | \$ 368,757                              | \$ 195,443  | \$ 173,314       | 89%                 |
| Cost of net revenue               | 224,738                                 | 131,108     | 93,630           | 71%                 |
| Restructuring                     | —                                       | 39          | (39)             | (100)               |
| Gross profit                      | 144,019                                 | 64,296      | 79,723           | 124%                |
| Gross margin                      | 39 %                                    | 33 %        |                  |                     |
| Operating expenses:               |   |             |                  |                     |
| Technology and development        | 44,735                                  | 39,614      | 5,121            | 13%                 |
| Sales and marketing               | 135,375                                 | 33,331      | 102,044          | 306%                |
| General and administrative<br>(1) | 50,445                                  | 23,894      | 26,551           | 111%                |
| Restructuring                     | —                                       | 3,278       | (3,278)          | (100)               |
| Total operating expenses          | 230,555                                 | 100,117     | 130,438          | 130%                |
| Loss from operations              | (86,536)                                | (35,821)    | (50,715)         | 142%                |
| Interest expense                  | (16,660)                                | (6,699)     | (9,961)          | 149%                |
| Interest and other income, net    | 856                                     | 253         | 603              | 238%                |
| Loss before income taxes          | (102,340)                               | (42,267)    | (60,073)         | 142%                |
| Benefit from income taxes         | 28,797                                  | 16,660      | 12,137           | 73%                 |
| Net loss                          | \$ (73,543)                             | \$ (25,607) | \$ (47,936)      | 187%                |

(1) The general and administrative expenses of \$50.4 million for the three months ended September 30, 2018 include \$2.4 million in acquisition-related charges related to the acquisition of Lifetouch.

*Net revenue*

Net revenue increased \$173.3 million, or 89%, for the three months ended September 30, 2018 as compared to the same period in 2017. Our Shutterfly Consumer, Lifetouch and SBS operating segments represented 30%, 50% and 20%, respectively, of total net revenue for the three months ended September 30, 2018. The acquisition of Lifetouch contributed to \$183.1 million of the revenue growth for three months ended September 30, 2018 offset by a decrease in revenue from the SBS segment of \$1.3 million and revenue declines in the Shutterfly Consumer segment of \$8.5 million resulting from lower than expected Shutterfly brand revenue and anticipated revenue declines from the Wedding Paper Divas website, which was shut down in the third quarter of 2017.

*Cost of net revenue*

Cost of net revenue increased \$93.6 million, or 71%, for the three months ended September 30, 2018 as compared to the same period in 2017.

Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase in cost of net revenue as follows:

- The Lifetouch segment contributed \$94.2 million to the increase in cost of net revenue as we acquired Lifetouch during the second quarter of 2018;
- Cost of net revenue for our SBS segment decreased \$1.5 million, primarily driven by the related decrease in revenue; and
- Cost of net revenue for our Shutterfly Consumer segment decreased \$0.4 million.

Amortization of intangible assets expense for cost of net revenue increased \$1.5 million and stock-based compensation expense decreased \$0.1 million. The increase in amortization of intangible assets expense is due to amortization expense for the

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intangible assets we recorded in connection with the acquisition of Lifetouch of \$2.3 million offset by certain of our intangible assets that became fully amortized.

Gross margin increased to 39% in the three months ended September 30, 2018 from 33% in the same period in 2017, primarily related to business mix and an increase in margin in the SBS segment.

As it relates to business mix, we acquired Lifetouch in April 2018 which has higher gross margins as compared to Shutterfly Consumer and SBS. The increase in the SBS segment gross margin is attributable to increased margins following the one-year anniversary of a deal we signed with an existing technology client in the third quarter of 2017, which had lower gross margins during the initial ramp up period.

*Technology and development*

Our technology and development expense increased \$5.1 million, or 13%, for the three months ended September 30, 2018, compared to the same period in 2017. As a percentage of net revenue, technology and development decreased to 12% in the three months ended September 30, 2018 from 20% in the three months ended September 30, 2017.

Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase technology and development as follows:

- The Lifetouch segment contributed \$7.1 million to the increase in technology and development expenses;
- Technology and development expenses for the Shutterfly Consumer segment decreased \$2.7 million; and
- Technology and development expenses for the SBS segment decreased \$1.2 million.

Due to the acquisition of Lifetouch, amortization of intangible assets expense for technology and development increased \$1.0 million. Stock-based compensation expense remained flat. Additionally, we recorded \$0.9 million related to integration costs in connection with the acquisition of Lifetouch.

*Sales and marketing*

Our sales and marketing expense increased \$102.0 million, or 306%, for the three months ended September 30, 2018, compared to the same period in 2017. As a percentage of net revenue, sales and marketing increased to 37% in the three months ended September 30, 2018 from 17% in the three months ended September 30, 2017. Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase in sales and marketing as follows:

- The Lifetouch segment contributed \$92.7 million to the increase in sales and marketing expenses;
- Sales and marketing expenses for the Shutterfly Consumer segment increased \$2.0 million; and
- Sales and marketing expenses for the SBS segment increased \$0.3 million.

Amortization of intangible assets expense for sales and marketing increased \$6.5 million due to amortization expense for the intangible assets we recorded in connection with the acquisition of Lifetouch of \$8.1 million offset by certain of our intangible assets that became fully amortized. Additionally, we recorded \$0.4 million related to integration costs in connection with the acquisition of Lifetouch and stock-based compensation increased \$0.2 million.

*General and administrative*

Our general and administrative expense increased \$26.6 million, or 111%, for the three months ended September 30, 2018, compared to the same period in 2017. As a percentage of net revenue, general and administrative expense increased to 14% in the three months ended September 30, 2018 from 12% in the three months ended September 30, 2017. The acquisition of Lifetouch contributed \$21.4 million to the increase in general and administrative expenses which primarily consist of salaries and benefit expenses and to a lesser extent, professional fees, facilities costs and credit card fees. As it relates to the Shutterfly Consumer and SBS segments, professional fees increased \$3.3 million and salaries and benefit expenses increased \$1.4 million. Further, stock-based compensation expense increased \$1.1 million.

Table of Contents*Interest expense*

Interest expense was \$16.7 million for the three months ended September 30, 2018 compared to \$6.7 million during the same period in 2017. This increase is primarily driven by interest expense for the initial term loan drawn in October 2017 and the incremental term loan drawn in April 2018 to finance the acquisition of Lifetouch. These increases are offset by decrease in interest expense for the convertible senior notes paid in May 2018.

*Interest and other income, net*

Interest and other income, net was \$0.9 million for the three months ended September 30, 2018 compared to \$0.3 million during the same period in 2017. This increase is due to higher interest income resulting from higher cash equivalents and investment balances and higher interest rates.

*Benefit from Income Taxes*

We recorded an income tax benefit of \$28.8 million and \$16.7 million for the three months ended September 30, 2018 and 2017, respectively. Our effective tax rate was 28% for the three months ended September 30, 2018, compared to 39% for the three months ended September 30, 2017. This decrease was due to the new baseline effective tax rate primarily attributable to tax reform resulting from the Tax Cuts and Jobs Act partially offset by incremental tax deductions from stock-based compensation expense.

**Segment Information**

We report our financial performance based on the following reportable segments: Shutterfly Consumer, Lifetouch and SBS. The segment amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations are presented on a basis consistent with our internal management reporting.

Additional information on our reportable segments is contained in Note 10 - *Segment Reporting* of the Notes to the Financial Statements (Part 1, Item 1 of this Form 10-Q).

*Shutterfly Consumer Segment*

|   | <b>Three Months Ended September 30,</b> |             |                  |                     |
|---|---|-------------|------------------|---------------------|
|   | <b>2018</b>                             | <b>2017</b> | <b>\$ Change</b> | <b>%<br/>Change</b> |
|   | <i>(dollars in thousands)</i>           |             |                  |                     |
| <b>Shutterfly<br/>Consumer<br/>segment:</b> |   |             |                  |                     |
| Net revenue                                 | \$ 126,888                              | \$ 135,418  | \$ (8,530)       | (6)%                |
| Cost of net<br>revenue <sup>(1)</sup>       | 81,031                                  | 81,439      | (408)            | (1)%                |
|   | 29,971                                  | 32,712      | (2,741)          | (8)%                |

Technology and  
development<sup>(1)</sup>

|                                       |                  |            |            |                 |
|---------------------------------------|------------------|------------|------------|-----------------|
| Sales and<br>marketing <sup>(1)</sup> | 28,819           | 26,811     | 2,008      | 7%              |
| Credit card fees                      | 3,527            | 3,766      | (239)      | <del>(6%)</del> |
| Margin                                | \$ (16,460)      | \$ (9,310) | \$ (7,150) | 7%              |
| Margin %                              | <del>(13%)</del> | (7) %      |            |                 |

<sup>(1)</sup> Excludes stock-based compensation expense and amortization of intangible assets.

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|  | Three Months Ended September 30,                  |          |         |          |
|--|---|----------|---------|----------|
|  | 2018  | 2017     | Change  | % Change |
|  | <i>(dollars in thousands, except AOV amounts)</i> |          |         |          |
| <b>Key Shutterfly Consumer Metrics</b> |   |          |         |          |
| Total Customers                        | 2,777   | 2,969    | (192)   | (6%)     |
| Total Number of Orders                 | 4,274   | 4,861    | (587)   | (12%)    |
| Average order value (AOV)              | \$ 29.69  | \$ 27.86 | \$ 1.83 | 7%       |

Shutterfly Consumer segment net revenue decreased \$8.5 million, or 6%, in the three months ended September 30, 2018 compared to the same period in 2017. The overall Shutterfly Consumer segment revenue decline was driven by promotional weakness, slow customer growth and by the anticipated revenue declines from the Wedding Paper Divas website, which was shut down in the third quarter of 2017. Further, revenue declined due to a continuing mix shift away from free promotions, where customers receive the product for free but pay for shipping and handling, and towards paid purchases and from less effective paid promotions.

Total Shutterfly Consumer segment customers decreased 6% and total number of orders decreased 12%, while AOV increased 7% for the three months ended September 30, 2018 compared to the same period in 2017. These metrics reflect a combination of the effects of the platform consolidation, weak performance on promotions, the changing mix away from free and towards paid revenues, and soft new customer growth. AOV increased primarily due to mix shift away from free towards paid revenues.

Shutterfly.com revenue from free products (revenue recognized for shipping and handling) in the third quarter of 2018 declined 10% year-over-year, while revenue from paid products increased 2% (these figures are for Shutterfly.com as a whole, and include the Tiny Prints Boutique and incremental revenue from shutterfly.com). We regard this as a positive shift in that it reduces our reliance on our most aggressive promotions, improves the quality of our revenue, and protects our premium brand position; however, it does have a near-term impact on revenue growth in the third quarter of 2018 and we expect this impact again to a smaller extent in the fourth quarter of 2018 given the seasonal nature of our business.

Shutterfly Consumer segment cost of net revenue decreased \$0.4 million, or 1%, for the three months ended September 30, 2018 compared to the same period in 2017. Shutterfly Consumer gross margin was 36% for the three months ended September 30, 2018 compared to 40% for the same period in 2017. The decrease in gross margin was due to lower volumes, product mix, and an increase in amortization cost of revenue from capitalized technology expenses related to our strategic initiatives, partially offset by our higher AOV and the mix shift away from free toward paid revenues.

Shutterfly Consumer segment technology and development expense decreased \$2.7 million, or 8%, for the three months ended September 30, 2018 compared to the same period in 2017. The overall decrease is primarily due to a decrease of \$1.5 million due to lower depreciation, a decrease of \$0.7 million in salaries and benefits, and a decrease

of \$0.6 million in facilities costs primarily related to co-location services. In the three months ended September 30, 2018, we capitalized \$8.2 million in eligible salary and consultant costs, including \$0.3 million of stock-based compensation expense, associated with software developed or obtained for internal use, compared to \$6.6 million capitalized in the three months ended September 30, 2017, which included \$0.3 million of stock-based compensation expense.

Shutterfly Consumer segment sales and marketing expense increased \$2.0 million, or 7%, in the three months ended September 30, 2018 compared to the same period in 2017. The increase in the Shutterfly Consumer sales and marketing expense was due to an increase of \$2.9 million in marketing campaigns largely driven by working marketing investment offset by a decrease of \$0.6 million in salaries and benefits.

Shutterfly Consumer segment margin loss for the three months ended September 30, 2018 was \$16.5 million, a \$7.2 million, or a 77% increase, compared to the same period in 2017, due to decrease in revenue and gross margin and an increase in sales and marketing expenses.

Table of ContentsLifetouch Segment

|   | <b>Three Months Ended September 30,</b> |             |                  |                     |
|---|---|-------------|------------------|---------------------|
|   | <b>2018</b>                             | <b>2017</b> | <b>\$ Change</b> | <b>%<br/>Change</b> |
|   | <i>(dollars in thousands)</i>           |             |                  |                     |
| <b>Lifetouch segment:</b>                 |   |             |                  |                     |
| Net revenue <sup>(1)</sup>                | \$ 187,071                              | \$ —        | \$ 187,071       | <del>100</del>      |
| Cost of net revenue <sup>(2)</sup>        | 94,188                                  | —           | 94,188           | <del>100</del>      |
| Technology and development <sup>(2)</sup> | 7,142                                   | —           | 7,142            | <del>100</del>      |
| Sales and marketing <sup>(2)</sup>        | 92,693                                  | —           | 92,693           | <del>100</del>      |
| Credit card fees                          | 3,316                                   | —           | 3,316            | <del>100</del>      |
| Margin                                    | \$ (10,268)                             | \$ —        | \$ (10,268)      | <del>100</del>      |
| Margin %                                  | (5)%                                    | — %         |                  |                     |

<sup>(1)</sup> Yearbook sales and collections for the Lifetouch segment are made throughout the school year, whereas yearbooks are typically delivered toward the end of the school year in the second quarter of the fiscal year. Business combination accounting principles require us to record the acquired deferred revenue at fair value on the acquisition date measured based on the cost to manufacture and deliver the yearbooks, plus a profit margin. Management reporting includes this purchase accounting adjustment which primarily relates to yearbook sales in net revenue for the Lifetouch segment.

<sup>(2)</sup> Excludes stock-based compensation expense and amortization of intangible assets.

We acquired Lifetouch on April 2, 2018. In the third quarter of 2018, Lifetouch commenced its peak season with the Fall School picture day tradition, the cornerstone program in the Schools business. Strong performances in both the Schools and Pre-School businesses in third quarter of 2018 were supported by good account retention and solid growth in new accounts, leading to net account growth. Revenue in the Specialty business, including Church and Studios, was also slightly better than expected in the quarter, with strong Studio performance offsetting the Church business which continues to decline.

Cost of net revenue for the three months ended September 30, 2018 of \$94.2 million primarily relates to salaries and benefit expenses for costs incurred to capture and produce photography products, and to a lesser extent, direct materials and depreciation of production and photography equipment and manufacturing facilities.

Technology and development expenses for the three months ended September 30, 2018 of \$7.1 million primarily relates to salaries and benefit expenses for employees. Sales and marketing expenses for the three months ended September 30, 2018 of \$92.7 million primarily relates to costs incurred for marketing programs and personnel and related expenses to acquire host accounts (schools or churches) as well as the costs for marketing programs directed at the end-customer.

The Lifetouch segment margin loss for the three months ended September 30, 2018 was \$10.3 million.

Shutterfly Business Solutions (SBS) Segment

|   | <b>Three Months Ended September 30,</b> |             |                  |                     |
|---|---|-------------|------------------|---------------------|
|   | <b>2018</b>                             | <b>2017</b> | <b>\$ Change</b> | <b>%<br/>Change</b> |
|   | <i>(dollars in thousands)</i>           |             |                  |                     |
| <b>SBS segment:</b>                       |   |             |                  |                     |
| Net revenue                               | \$ 58,756                               | \$ 60,025   | \$ (1,269)       | <del>(2%)</del>     |
| Cost of net revenue <sup>(1)</sup>        | 45,973                                  | 47,520      | (1,547)          | <del>(3%)</del>     |
| Technology and development <sup>(1)</sup> | 3,190                                   | 4,390       | (1,200)          | <del>(2%)</del>     |
| Sales and marketing <sup>(1)</sup>        | 1,473                                   | 1,193       | 280              | 2%                  |
| Margin                                    | \$ 8,120                                | \$ 6,922    | \$ 1,198         | 17%                 |
| Margin %                                  | 14 %                                    | 12 %        |                  |                     |

<sup>(1)</sup> Excludes stock-based compensation expense and amortization of intangible assets.

SBS segment net revenue decreased \$1.3 million, or 2%, in the three months ended September 30, 2018 compared to the same period in 2017.

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SBS segment cost of net revenue decreased \$1.5 million, or 3%, for the three months ended September 30, 2018 compared to the same period in 2017 due to lower revenue. SBS gross margin was 22% for the three months ended September 30, 2018 compared to 21% for the same period in 2017. The increase in the SBS segment gross margin is attributable to increased margins following the one-year anniversary of a deal we signed with an existing technology client in the third quarter of 2017, which had lower gross margins during the initial ramp up period. The gross margin increase reflects the improved profitability of this client.

SBS segment technology and development expenses decreased \$1.2 million, or 27%, in the three months ended September 30, 2018 compared to the same period in 2017. The overall decrease is primarily due to a decrease of \$0.9 million for professional fees and \$0.3 million in salaries and benefits. In the three months ended September 30, 2018, we capitalized \$1.7 million in eligible salary and consultant costs, associated with software developed or obtained for internal use, compared to \$1.8 million capitalized in the three months ended September 30, 2017.

SBS segment sales and marketing expense increased \$0.3 million, or 23%, in the three months ended September 30, 2018 compared to the same period in 2017. The increase is primarily due to an increase of \$0.3 million in salaries and benefits.

SBS segment margin in the three months ended September 30, 2018 was \$8.1 million, a \$1.2 million increase compared to the same period in 2017, driven by higher gross margin and a reduction in technology-related expenses.

Table of Contents**Comparison of the Nine Month Periods Ended September 30, 2018 and 2017**

|                                   | <b>Nine Months Ended September 30,</b> |             |                  |                     |
|-----------------------------------|--|-------------|------------------|---------------------|
|                                   | <b>2018</b>                            | <b>2017</b> | <b>\$ Change</b> | <b>%<br/>Change</b> |
|                                   | <i>(dollars in thousands)</i>          |             |                  |                     |
| <b>Consolidated:</b>              |  |             |                  |                     |
| Net revenue                       | \$ 1,011,853                           | \$ 596,447  | \$ 415,406       | <del>7%</del>       |
| Cost of net revenue               | 584,012                                | 365,432     | 218,580          | <del>6%</del>       |
| Restructuring                     | —                                      | 1,475       | (1,475)          | <del>(1%)</del>     |
| Gross profit                      | 427,841                                | 229,540     | 198,301          | <del>8%</del>       |
| Gross margin                      | 42 %                                   | 38 %        |                  |                     |
| Operating expenses:               |  |             |                  |                     |
| Technology and development        | 127,659                                | 124,968     | 2,691            | 2%                  |
| Sales and marketing               | 303,737                                | 119,205     | 184,532          | <del>1%</del>       |
| General and administrative<br>(1) | 137,050                                | 79,200      | 57,850           | <del>7%</del>       |
| Capital lease termination         | —                                      | 8,098       | (8,098)          | <del>(1%)</del>     |
| Restructuring                     | 2,952                                  | 15,491      | (12,539)         | <del>(8%)</del>     |
| Total operating expenses          | 571,398                                | 346,962     | 224,436          | <del>6%</del>       |
| Loss from operations              | (143,557)                              | (117,422)   | (26,135)         | <del>2%</del>       |
| Interest expense                  | (44,063)                               | (18,617)    | (25,446)         | <del>1%</del>       |
| Interest and other income, net    | 4,166                                  | 687         | 3,479            | <del>5%</del>       |
| Loss before income taxes          | (183,454)                              | (135,352)   | (48,102)         | <del>3%</del>       |
| Benefit from income taxes         | 56,234                                 | 53,713      | 2,521            | 5%                  |
| Net loss                          | \$ (127,220)                           | \$ (81,639) | \$ (45,581)      | <del>5%</del>       |

(1) The general and administrative expenses of \$137.1 million for the nine months ended September 30, 2018 include \$15.0 million in acquisition-related charges related to the acquisition of Lifetouch.

*Net revenue:*

Net revenue increased \$415.4 million, or 70%, for the nine months ended September 30, 2018 as compared to the same period in 2017. Our Shutterfly Consumer, Lifetouch and SBS operating segments represented 40%, 40% and 20%, respectively, of total net revenue for the nine months ended September 30, 2018. The acquisition of Lifetouch contributed \$411.7 million of the revenue growth for nine months ended September 30, 2018. The remaining revenue growth was attributable to an increase in revenue from the SBS segment of \$34.9 million offset by revenue declines in the Shutterfly Consumer segment of \$31.2 million resulting primarily from anticipated declines in the non-Shutterfly brands due to the platform consolidation and the brand shutdowns over the course of the past year.

*Cost of net revenue:*

Cost of net revenues increased \$218.6 million, or 60%, for the nine months ended September 30, 2018 as compared to the same period in 2017.

Excluding amortization of intangible assets, stock-based compensation expense and purchase accounting adjustments, our reportable segments contributed to the increase in cost of net revenue as follows:

- The Lifetouch segment contributed \$196.3 million to the increase in cost of net revenue as we acquired Lifetouch during the second quarter of 2018;
- Cost of net revenue for our SBS segment increased \$32.2 million primarily driven by the related increase in revenue;

and

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• Cost of net revenue for our Shutterfly Consumer segment decreased \$11.4 million driven by the corresponding decrease in revenue.

Amortization of intangible assets expense for cost of net revenue increased \$1.9 million and stock-based compensation expense decreased \$0.4 million. The increase in amortization of intangible assets expense is due to amortization expense for the intangible assets we recorded in connection with the acquisition of Lifetouch of \$4.6 million offset by certain of our intangible assets that became fully amortized.

Gross margin increased to 42% in the nine months ended September 30, 2018 from 38% in the same period in 2017 primarily related to business mix as we acquired Lifetouch in April 2018 and Lifetouch has higher gross margins as compared to Shutterfly Consumer and SBS.

In the nine months ended September 30, 2018, no restructuring charges were recognized.

*Technology and development*

Our technology and development expense increased \$2.7 million, or 2%, for the nine months ended September 30, 2018, compared to the same period in 2017. As a percentage of net revenue, technology and development decreased to 13% in the nine months ended September 30, 2018 from 21% in the nine months ended September 30, 2017.

Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase in cost of net revenue as follows:

- The Lifetouch segment contributed \$14.3 million to the increase in technology and development expenses;
- Technology and development expenses for the Shutterfly Consumer segment decreased \$12.7 million; and
- Technology and development expenses for the SBS segment decreased \$2.7 million.

Due to the acquisition of Lifetouch, amortization of intangible assets expense for technology and development increased \$2.2 million. Stock-based compensation expense increased \$0.2 million and we also

*Sales and marketing*

Our sales and marketing expense increased \$184.5 million, or 155%, for the nine months ended September 30, 2018, compared to the same period in 2017. As a percentage of net revenue, sales and marketing increased to 30% in the nine months ended September 30, 2018 from 20% in the nine months ended September 30, 2017. Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase in sales and marketing as follows:

- The Lifetouch segment contributed \$179.7 million to the increase in sales and marketing expenses;
- Sales and marketing expenses for the Shutterfly Consumer segment decreased \$9.5 million; and
- Sales and marketing expenses for the SBS segment increased \$1.5 million.

Amortization of intangible assets expense for sales and marketing increased \$11.9 million due to amortization expense for the intangible assets we recorded in connection with the acquisition of Lifetouch of \$16.1 million offset by certain of our intangible assets that became fully amortized. Stock-based compensation expense increased \$0.5 million and we also recorded \$0.5 million in integration costs in sales and marketing expenses.

*General and administrative*

Our general and administrative expense increased \$57.9 million, or 73%, for the nine months ended September 30, 2018, compared to the same period in 2017. As a percentage of net revenue, general and administrative expense remained flat at 13% for the nine months ended September 30, 2018 and 2017. The acquisition of Lifetouch contributed \$39.9 million to the increase in general and administrative expenses which primarily consists of salaries and benefits expenses and to a lesser extent, professional fees, facilities costs and credit card fees. During the nine months ended September 30, 2018, we recorded \$15.0 million in acquisition-related charges in connection with the acquisition of Lifetouch and there was also an increase in stock-based compensation expense of \$2.4 million.





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*Capital lease termination*

In the nine months ended September 30, 2017, there was \$8.1 million capital lease termination charges within operating expenses. These charges related to leased equipment from an existing vendor which we purchased and subsequently resold to HP during the second quarter of fiscal 2017.

*Restructuring expense*

In the nine months ended September 30, 2018, there were \$3.0 million of restructuring charges within operating expenses in connection with the exit of Lifetouch's iMemories business which was completed during the second quarter of 2018. These restructuring charges primarily consist of \$1.0 million in lease termination costs, \$0.8 million in employee-related costs and \$1.2 million in other costs.

In the nine months ended September 30, 2017, there were \$15.5 million of restructuring charges within operating expenses. These restructuring charges primarily consist of \$8.4 million in depreciation expense of disposed assets and facility closures, and \$5.9 million in employee-related costs such as severance and retention expense, and \$1.2 million related to other costs.

*Interest expense*

Interest expense was \$44.1 million for the nine months ended September 30, 2018 compared to \$18.6 million during the same period in 2017. This increase is primarily driven by interest expense for the initial term loan drawn in October 2017 and the incremental term loan drawn in April 2018 to finance the acquisition of Lifetouch. These increases are offset by decrease in interest expense for the convertible senior notes paid in May 2018.

*Interest and other income, net*

Interest and other income, net was \$4.2 million for the nine months ended September 30, 2018 compared to \$0.7 million during the same period in 2017. This increase is due to higher interest income resulting from higher cash equivalents and investment balances and higher interest rates.

*Benefit from Income Taxes*

We recorded an income tax benefit of \$56.2 million and \$53.7 million for the nine months ended September 30, 2018 and 2017, respectively. Our effective tax rate was 31% for the nine months ended September 30, 2018, compared to 40% for the nine months ended September 30, 2017. This decrease was due to the new baseline effective tax rate primarily attributable to tax reform resulting from the Tax Cuts and Jobs Act partially offset by incremental tax deductions from stock-based compensation expense.

**Segment Information**

We report our financial performance based on the following reportable segments: Shutterfly Consumer, Lifetouch and SBS. The segment amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations are presented on a basis consistent with our internal management reporting.

Additional information on our reportable segments is contained in Note 10 - *Segment Reporting* of the Notes to the Financial Statements (Part 1, Item 1 of this Form 10-Q).



Table of ContentsShutterfly Consumer Segment

|   | <b>Nine Months Ended September 30,</b> |             |                  |                     |
|---|--|-------------|------------------|---------------------|
|   | <b>2018</b>                            | <b>2017</b> | <b>\$ Change</b> | <b>%<br/>Change</b> |
|   | <i>(dollars in thousands)</i>          |             |                  |                     |
| <b>Shutterfly Consumer:</b>               |  |             |                  |                     |
| Net revenue                               | \$ 443,950                             | \$ 475,153  | \$ (31,203)      | <del>(7%)</del>     |
| Cost of net revenue <sup>(1)</sup>        | 251,940                                | 263,345     | (11,405)         | <del>(4%)</del>     |
| Technology and development <sup>(1)</sup> | 91,930                                 | 104,679     | (12,749)         | <del>(12%)</del>    |
| Sales and Marketing <sup>(1)</sup>        | 89,500                                 | 98,955      | (9,455)          | <del>(10%)</del>    |
| Credit card fees                          | 12,075                                 | 12,709      | (634)            | <del>(5%)</del>     |
| Margin                                    | \$ (1,495)                             | \$ (4,535)  | \$ 3,040         | <del>(6%)</del>     |
| Margin %                                  | — %                                    | (1) %       |                  |                     |

<sup>(1)</sup> Excludes stock-based compensation expense and amortization of intangible assets.

Shutterfly Consumer net revenue decreased \$31.2 million, or 7%, in the nine months ended September 30, 2018 compared to the same period in 2017. The overall Shutterfly Consumer segment revenue decline was driven by the loss of revenue from the three websites we shut down in 2017: Tiny Prints, Wedding Paper Divas, and MyPublisher. Further, revenue declined due to a continuing mix shift away from free promotions, where customers receive the product for free but pay for shipping and handling, towards paid purchases.

Shutterfly Consumer segment cost of net revenue decreased \$11.4 million, or 4%, for the nine months ended September 30, 2018 compared to the same period in 2017 due to corresponding decrease in net revenue. Shutterfly Consumer gross margin, excluding restructuring, was 43% for the nine months ended September 30, 2018 compared to 45% for the same period in 2017. The decrease in gross margin was due to lower volumes, product mix, and an increase in amortization cost of revenue from capitalized technology expenses related to our strategic initiatives, partially offset by our higher AOV and the mix shift away from free revenues.

Shutterfly Consumer segment technology and development expense decreased \$12.7 million, or 12%, for the nine months ended September 30, 2018 compared to the same period in 2017. The overall decrease is primarily due to a decrease of \$5.6 million in salaries and benefits relating to reduced headcount resulting from the Shutterfly consumer platform consolidation, a decrease of \$4.4 million due to lower depreciation, and a decrease of \$1.9 million in facilities costs. In the nine months ended September 30, 2018, we capitalized \$23.3 million in eligible salary and consultant costs, including \$0.9 million of stock-based compensation expense, associated with software developed or obtained for internal use, compared to \$19.3 million capitalized in the nine months ended September 30, 2017, which included \$1.0 million of stock-based compensation expense.

Shutterfly Consumer segment sales and marketing expense decreased \$9.5 million, or 10%, in the nine months ended

September 30, 2018 compared to the same period in 2017. The decrease in the Shutterfly Consumer sales and marketing expense was due to a decrease of \$4.9 million in marketing campaigns largely driven by decreased external marketing spend as we migrated our smaller brands to the Shutterfly platform as part of the Shutterfly consumer platform consolidation during 2017. There was also a decrease of \$4.2 million in salaries and benefits because of lower headcount.

Shutterfly Consumer segment margin loss for the nine months ended September 30, 2018 was \$1.5 million, a \$3 million or 67% improvement, compared to the same period in 2017, driven by lower expenses primarily resulting from the Shutterfly consumer platform consolidation in 2017.

Table of ContentsLifetouch Segment

|   | <b>Nine Months Ended September 30,</b> |             |                  |                     |
|---|--|-------------|------------------|---------------------|
|   | <b>2018</b>                            | <b>2017</b> | <b>\$ Change</b> | <b>%<br/>Change</b> |
|   | <i>(dollars in thousands)</i>          |             |                  |                     |
| <b>Lifetouch segment:</b>                 |  |             |                  |                     |
| Net revenue <sup>(1)</sup>                | \$ 448,982                             | \$ —        | \$ 448,982       | 100                 |
| Cost of net revenue <sup>(2)(3)</sup>     | 185,336                                | —           | 185,336          | 100                 |
| Technology and development <sup>(3)</sup> | 14,251                                 | —           | 14,251           | 100                 |
| Sales and marketing <sup>(3)</sup>        | 179,653                                | —           | 179,653          | 100                 |
| Credit card fees                          | 4,481                                  | —           | 4,481            | 100                 |
| Margin                                    | \$ 65,261                              | \$ —        | \$ 65,261        | 100                 |
| Margin %                                  | 15 %                                   | — %         |                  |                     |

<sup>(1)</sup> Yearbook sales and collections for the Lifetouch segment are made throughout the school year, whereas yearbooks are typically delivered toward the end of the school year in the second quarter of the fiscal year. Business combination accounting principles require us to record the acquired deferred revenue at fair value on the acquisition date measured based on the cost to manufacture and deliver the yearbooks, plus a profit margin. Management reporting includes this purchase accounting adjustment which primarily relates to yearbook sales in net revenue for the Lifetouch segment.

<sup>(2)</sup> Business combination accounting principles require us to measure acquired inventory at fair value. The fair value of inventory reflects the acquired company's cost of manufacturing plus a portion of the expected profit margin. Management reporting excludes this purchase accounting adjustment from cost of net revenue for the Lifetouch segment.

<sup>(3)</sup> Excludes stock-based compensation expense and amortization of intangible assets.

We acquired Lifetouch on April 2, 2018. In the second quarter of 2018, Lifetouch has seasonality as the Schools business focuses on providing spring photography for grades K-8, as well as sports photography, yearbooks, and senior graduation photography. In the third quarter of 2018, Lifetouch commenced its peak season with the Fall School picture day tradition, the cornerstone program in the Schools business. Strong performances in both the Schools and Pre-School businesses in second and third quarters of 2018 were supported by good account retention and solid growth in new accounts, leading to net account growth. This growth was partially offset by the Church business, which continues to decline.

Cost of net revenue for the nine months ended September 30, 2018 of \$185.3 million primarily relates to salaries and benefits costs incurred to capture and produce photography products, and to a lesser extent, cost of net revenue expense relate to direct materials and depreciation of production and photography equipment and manufacturing facilities.

Technology and development expenses for the nine months ended September 30, 2018 of \$14.3 million primarily relates to salaries and benefit expenses for employees. Sales and marketing expenses for the nine months ended September 30, 2018 of \$179.7 million primarily relates to costs incurred for marketing programs and personnel and related expenses to acquire host accounts (schools or churches) as well as the costs for marketing programs directed at

the end-customer.

The Lifetouch segment margin for the nine months ended September 30, 2018 was \$65.3 million. Lifetouch profits were driven primarily by the Schools business as noted above.

Shutterfly Business Solutions (SBS) Segment

|   | <b>Nine Months Ended September 30,</b> |             |                  |                     |
|---|--|-------------|------------------|---------------------|
|   | <b>2018</b>                            | <b>2017</b> | <b>\$ Change</b> | <b>%<br/>Change</b> |
|   | <i>(dollars in thousands)</i>          |             |                  |                     |
| <b>SBS segment:</b>                       |  |             |                  |                     |
| Net revenue                               | \$ 156,230                             | \$ 121,294  | \$ 34,936        | 29%                 |
| Cost of net revenue <sup>(1)</sup>        | 127,493                                | 95,256      | 32,237           | 34%                 |
| Technology and development <sup>(1)</sup> | 10,184                                 | 12,901      | (2,717)          | (21)                |
| Sales and marketing <sup>(1)</sup>        | 4,542                                  | 3,032       | 1,510            | 50%                 |
| Margin                                    | \$ 14,011                              | \$ 10,105   | \$ 3,906         | 39%                 |
| Margin %                                  | 9 %                                    | 8 %         |                  |                     |

<sup>(1)</sup> Excludes stock-based compensation expense and amortization of intangible assets

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SBS segment net revenue increased \$34.9 million, or 29%, in the nine months ended September 30, 2018 compared to the same period in 2017. SBS segment revenue growth was driven by a multi-year deal we signed in the third quarter of 2017 with an existing technology client, where volumes ramped more rapidly than planned in the nine months ended September 30, 2018.

SBS segment cost of net revenue increased \$32.2 million, or 34%, for the nine months ended September 30, 2018 compared to the same period in 2017 due to higher revenue. SBS gross margin was 18% for the nine months ended September 30, 2018 compared to 21% for the same period in 2017. The gross margin decrease is due to the new deal signed in the third quarter of 2017, which had lower margins during the client's initial ramp period.

SBS segment technology and development expenses decreased \$2.7 million, or 21%, in the nine months ended September 30, 2018 compared to the same period in 2017. The overall decrease is primarily due to a decrease of \$2.2 million for professional fees and a decrease of \$0.3 million in salaries and benefits. In the nine months ended September 30, 2018, we capitalized \$5.1 million in eligible salary and consultant costs, associated with software developed or obtained for internal use, compared to \$6.0 million capitalized in the nine months ended September 30, 2017.

SBS segment sales and marketing expense increased \$1.5 million, or 50%, in the nine months ended September 30, 2018 compared to the same period in 2017. The increase is primarily due to an increase of \$1.5 million in salaries and benefits.

SBS segment margin in the nine months ended September 30, 2018 was \$14.0 million, a \$3.9 million, or 39%, increase compared to the same period in 2017, driven by growth from the multi-year deal signed in the third quarter of 2017 as well as growth from other client wins.



Table of Contents**Liquidity and Capital Resources**

At September 30, 2018, we had \$165.9 million of cash and cash equivalents (including money market funds) and \$57.5 million of investments, primarily corporate debt, U.S. government and agency securities. In May 2013, we issued \$300.0 million of 0.25% convertible senior notes due May 15, 2018 (the "Senior Notes") which were due and paid in May 2018. In August 2017, we entered into a syndicated credit facility (the "Credit Agreement") which provides for (a) a five-year secured revolving loan facility in an aggregate principal amount of up to \$200.0 million expiring in August 2022 (the "Revolving Loan Facility") and (b) a seven-year secured delayed draw term loan facility in an initial aggregate principal amount of up to \$300.0 million (the "Initial Term Loan"). The Credit Agreement permits us to add one or more incremental term loan facilities and/or increase the commitments for revolving loans subject to certain conditions.

In October 2017, we fully drew the \$300.0 million Initial Term Loan under the Credit Agreement and used the proceeds to repay the Senior Notes due in May 2018. On April 2, 2018, we entered into an amendment under the Credit Agreement for an incremental term loan in an aggregate principal amount of \$825.0 million (the "Incremental Term Loan") to finance the acquisition of Lifetouch. The Initial Term Loan and the Incremental Term Loan have a maturity date of August 2024. The Revolving Loan Facility remains undrawn and available to us as of September 30, 2018.

The Credit Agreement fits well with our overall capital structure strategy. We seek to maintain adequate financial capacity to manage our seasonal cash flows, ensure a reasonable degree of operational flexibility and invest in value-creating growth. We anticipate using free cash flow to pay down the debt in the near term, and maintaining a BB rating profile. From there, we will continue to focus on optimizing capital allocation across organic re-investment in the business, further acquisitions, and returning excess capital to shareholders.

Below is our cash flow activity for the nine months ended September 30, 2018 and 2017:

**Nine Months Ended September 30,****2018                      2017***(in thousands)***Consolidated  
Statements of  
Cash Flows  
Data:**

|  |             |             |
|--|-------------|-------------|
| Purchases of property and equipment                      | \$ (28,984) | \$ (22,960) |
| Capitalization of software and website development costs | (34,602)    | (25,977)    |
| Cash flows used in operating activities                  | (172,524)   | (80,659)    |
| Cash flows used in investing                             | (720,330)   | (43,630)    |

activities

Cash flows  
provided by  
(used in)  
financing  
activities

|         |           |
|---------|-----------|
| 569,110 | (108,976) |
|---------|-----------|

We anticipate that our current cash balance and cash generated from operations will be sufficient to meet our strategic and working capital requirements, lease obligations, technology development projects, and quarterly payments for the Initial Term Loan and Incremental Term Loan 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 additional equity. The sale of additional equity or convertible debt could result in significant dilution to our stockholders. Financing arrangements may not be available to us, or may not be in amounts or on terms acceptable to us.

*Operating Activities.* For the nine months ended September 30, 2018, net cash used in operating activities was \$172.5 million, primarily due to our net loss of \$127.2 million, the net change in operating assets and liabilities of \$150.7 million, and the repayment of convertible senior notes attributable to debt discount of \$63.5 million. The net change in operating assets and liabilities of \$150.7 million primarily relate to an increase of \$73.5 million in prepaid expenses and other assets due to changes in the intra-period income tax asset, and a decrease in accounts payable of \$68.1 million due to timing of payments. Net cash used in operating activities was adjusted for non-cash items including \$79.5 million of depreciation and amortization expense, \$35.3 million of stock-based compensation expense, \$27.7 million of amortization of intangible assets, \$17.7 million provision from deferred income taxes, and \$7.9 million for amortization of debt discount and issuance costs.

For the nine months ended September 30, 2017, net cash used in operating activities was \$80.7 million, primarily due to our net loss of \$81.6 million and the net change in operating assets and liabilities of \$125.0 million. The net change in operating assets and liabilities of \$125.0 million primarily relate to decrease in accrued and other liabilities of \$49.2 million primarily related to sales tax, accrued marketing expenses and accrued production costs, a decrease in accounts payable of \$35.8 million

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due to timing of payments, and an increase in prepaid and other assets of \$34.1 million due to changes in the intra-period income tax asset. Net cash used in operating activities was adjusted for non-cash items including \$66.4 million of depreciation and amortization expense, \$32.7 million of stock-based compensation expense, \$11.6 million of non-cash restructuring, \$11.8 million of amortization of intangible assets, \$11.4 million for amortization of debt discount and issuance costs, and \$8.6 million provision from deferred income taxes.

*Investing Activities.* For the nine months ended September 30, 2018, net cash used in investing activities was \$720.3 million, primarily due to \$889.6 million for cash used for acquisitions, net of cash acquired, \$29.0 million cash used for capital expenditures, \$34.6 million for capitalized software and website development, and \$9.5 million to purchase investments. This was offset by proceeds from the maturities of investments of \$193.4 million, proceeds from the sales of investments of \$46.9 million, and proceeds from sale of property and equipment of \$2.1 million.

For the nine months ended September 30, 2017, net cash used in investing activities was \$43.6 million. We used \$23.0 million for capital expenditures for computer and network hardware to support our website infrastructure and information technology systems and production equipment for our manufacturing and production operations. We also used \$26.0 million for capitalized software and website development and \$44.4 million to purchase investments. This was offset by proceeds from the maturities of investments of \$28.5 million and proceeds from sale of property and equipment of \$21.2 million.

*Financing Activities.* For the nine months ended September 30, 2018, net cash provided by financing activities was \$569.1 million, related to proceeds from borrowings, net of issuance costs of \$806.7 million and the proceeds from the issuance of common stock from the exercise of stock options of \$19.7 million. This was offset by \$243.0 million of cash used for principal payments of our borrowings (primarily the repayment in connection with the maturity of our Senior Notes) and \$14.2 million cash used for payments of capital leases and financing obligations.

For the nine months ended September 30, 2017, net cash used in financing activities was \$109.0 million. We used \$80.0 million to repurchase shares of our common stock. We also used \$24.8 million for payments of capital leases and financing obligations, which includes \$12.2 million of payments made in connection with certain capital leases that were terminated as part of the upgrade of our color printer fleet during the second quarter of 2017. We also used \$4.8 million for the payment of credit agreement issuance costs. This was offset by \$0.6 million of proceeds from the issuance of common stock from the exercise of stock options.

**Contractual Obligations Assumed from the Acquisition of Lifetouch**

There have been no significant changes to the contractual obligations disclosed in our Form 10-K for the year ended December 31, 2017. However, we assumed leases in connection with the acquisition of Lifetouch. As part of this acquisition, we assumed operating lease obligations and certain purchase obligations as follows (in thousands):

|  | <b>Total</b> | <b>Remainder of<br/>fiscal year 2018</b> | <b>1-3 Years</b> | <b>3-5 Years</b> | <b>Thereafter</b> |
|--|--------------|--|------------------|------------------|-------------------|
| <b>Contractual<br/>Obligations</b>         |              |  |                  |                  |                   |
| Operating lease obligations <sup>(1)</sup> | \$ 41,203    | \$ 4,341                                 | \$ 30,387        | \$ 5,013         | \$ 1,462          |
| Purchase obligations <sup>(2)</sup>        | \$ 10,498    | \$ 1,839                                 | \$ 8,659         | \$ —             | \$ —              |
| Principal and interest                     | \$ 7,543     | \$ 240                                   | \$ 6,561         | \$ 742           | \$ —              |

payments of  
borrowings

(1) Includes leases in connection with the acquisition of Lifetouch. As part of this acquisition, we assumed leases for office facilities, production and warehouse facilities, several photographic studios, and a portion of office equipment under operating agreements, which expire beginning in 2018 and through 2030.

(2) Includes non-cancelable service agreements that expire through 2021.

Total minimum lease payments for capital leases assumed as part of the acquisition of Lifetouch are not significant to the financial statements.

### **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 three financial measures, Non-GAAP net loss, Non-GAAP net loss per share and adjusted EBITDA which meet the definition of Non-GAAP financial measures. We define Non-GAAP net loss and Non-GAAP net loss per share as net loss and

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net loss per share excluding restructuring and acquisition-related charges, respectively. We define adjusted EBITDA as earnings before interest, taxes, depreciation, amortization, stock-based compensation expense, restructuring, acquisition-related charges, capital lease termination charges and purchase accounting adjustments. Management believes these Non-GAAP financial measures reflect an additional way of viewing our 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 Non-GAAP net loss, Non-GAAP net loss per share and adjusted EBITDA 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 loss or net 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 Non-GAAP net loss, Non-GAAP net loss per share and Non-GAAP adjusted EBITDA as a percentage of net revenue for the three and nine months ended September 30, 2018 and 2017 (in thousands, except per share amounts):

|   | <b>Three Months Ended</b> |              | <b>Nine Months Ended</b> |               |
|---|---------------------------|--------------|--------------------------|---------------|
|   | <b>September 30,</b>      |              | <b>September 30,</b>     |               |
|   | <b>2018</b>               | <b>2017</b>  | <b>2018</b>              | <b>2017</b>   |
| Net revenue                               | \$ 368,757                | \$ 195,443   | \$ 1,011,853             | \$ 596,447    |
| GAAP net loss                             | \$ (73,543)               | \$ (25,607)  | \$ (127,220)             | \$ (81,639)   |
| <i>GAAP net loss % of net revenue</i>     | <i>(20)%</i>              | <i>(13)%</i> | <i>(13)%</i>             | <i>(14) %</i> |
| GAAP net loss per share                   | \$ (2.20)                 | \$ (0.78)    | \$ (3.84)                | \$ (2.45)     |
| Non-GAAP net loss                         | \$ (70,796)               | \$ (23,959)  | \$ (81,011)              | \$ (67,021)   |
| <i>Non-GAAP net loss % of net revenue</i> | <i>(19)%</i>              | <i>(12)%</i> | <i>(8) %</i>             | <i>(11) %</i> |
| Non-GAAP net loss per share               | \$ (2.12)                 | \$ (0.73)    | \$ (2.44)                | \$ (2.01)     |
| Non-GAAP adjusted EBITDA                  | \$ (26,285)               | \$ 3,047     | \$ 65,178                | \$ 18,489     |
|   | <i>(7) %</i>              | <i>2 %</i>   | <i>6 %</i>               | <i>3 %</i>    |

*Non-GAAP  
adjusted  
EBITDA %  
of net  
revenue*

For the three months ended September 30, 2018 and 2017, our Non-GAAP net loss was \$70.8 million and \$24.0 million, respectively. In addition, during the three months ended September 30, 2018 and 2017, Non-GAAP net loss per share was \$2.12 and \$0.73, respectively.

For the three months ended September 30, 2018 and 2017, our Non-GAAP adjusted EBITDA loss and Non-GAAP adjusted EBITDA was \$26.3 million and \$3.0 million, respectively.

For the nine months ended September 30, 2018 and 2017, our Non-GAAP net loss was \$81.0 million and \$67.0 million, respectively. In addition, during the nine months ended September 30, 2018 and 2017, Non-GAAP net loss per share was \$2.44 and \$2.01, respectively.

For the nine months ended September 30, 2018 and 2017, our Non-GAAP adjusted EBITDA was \$65.2 million and \$18.5 million, respectively.

The following is a reconciliation of Non-GAAP net loss, Non-GAAP net loss per share and Non-GAAP adjusted EBITDA to the most comparable GAAP measure, for the three and nine months ended September 30, 2018 and 2017 (in thousands, except per share amounts):

Table of Contents**Reconciliation of Net Loss to Non-GAAP Net Loss and Non-GAAP Net Loss per Share**

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|   | <b>2018</b>               | <b>2017</b> | <b>2018</b>              | <b>2017</b> |
| <b>GAAP net loss</b>                      | (73,543)                  | \$ (25,607) | \$ (127,220)             | \$ (81,639) |
| Capital lease termination                 | —                         | —           | —                        | 8,098       |
| Restructuring                             | 3,317                     | —           | 2,952                    | 16,966      |
| Acquisition-related charges               | 2,392                     | —           | 14,977                   | —           |
| Purchase accounting adjustments           | 3,058                     | —           | 48,240                   | —           |
| Tax benefit impact of non-recurring items | (3,603)                   | (1,669)     | (19,960)                 | (10,446)    |
| <b>Non-GAAP net loss</b>                  | (70,796)                  | \$ (23,959) | \$ (81,011)              | \$ (67,021) |
| GAAP diluted shares outstanding           | 33,470                    | 32,878      | 33,139                   | 33,363      |
| Non-GAAP diluted shares outstanding       | 33,470                    | 32,878      | 33,139                   | 33,363      |
| <b>GAAP net loss per share</b>            | (2.20)                    | \$ (0.78)   | \$ (3.84)                | \$ (2.45)   |
| <b>Non-GAAP net loss per share</b>        | (2.12)                    | \$ (0.73)   | \$ (2.44)                | \$ (2.01)   |

**Reconciliation of Net Loss to Non-GAAP  
Adjusted EBITDA**

|                                  | <b>Three Months Ended</b> |             |              | <b>Nine Months Ended</b> |             |             |
|----------------------------------|---------------------------|-------------|--------------|--------------------------|-------------|-------------|
|                                  | <b>September 30,</b>      |             |              | <b>September 30,</b>     |             |             |
|                                  | <b>2018</b>               | <b>2017</b> | <b>2018</b>  | <b>2017</b>              | <b>2018</b> | <b>2017</b> |
| <b>Net loss</b>                  | (73,543)                  | \$ (25,607) | \$ (127,220) | \$ (81,639)              |             |             |
| Add back:                        |                           |             |              |                          |             |             |
| Interest expense                 | 16,660                    | 6,699       | 44,063       | 18,617                   |             |             |
| Interest and other income, net   | (856)                     | (253)       | (4,166)      | (687)                    |             |             |
| Benefit from income taxes        | (28,797)                  | (16,660)    | (56,234)     | (53,713)                 |             |             |
| Depreciation and amortization    | 41,970                    | 24,815      | 107,245      | 78,137                   |             |             |
| Stock-based compensation expense | 11,031                    | 10,736      | 35,321       | 32,710                   |             |             |
| Acquisition-related charges      | 2,392                     | —           | 14,977       | —                        |             |             |
| Restructuring                    | 3,317                     | 3,317       | 2,952        | 16,966                   |             |             |
| Capital lease termination        | —                         | —           | —            | 8,098                    |             |             |
| Purchase accounting adjustments  | 3,058                     | —           | 48,240       | —                        |             |             |
| <b>Non-GAAP Adjusted EBITDA</b>  | (26,285)                  | \$ 3,047    | \$ 65,178    | \$ 18,489                |             |             |



Table of Contents**Reconciliation of Cash Flow from Operating Activities to Non-GAAP Adjusted EBITDA and Non-GAAP Adjusted EBITDA**

|  | <b>Three Months Ended</b> |                 | <b>Nine Months Ended</b> |                  |
|--|---------------------------|-----------------|--------------------------|------------------|
|  | <b>September 30,</b>      |                 | <b>September 30,</b>     |                  |
|  | <b>2018</b>               | <b>2017</b>     | <b>2018</b>              | <b>2017</b>      |
| <b>Net cash provided by (used in) operating activities</b> | \$ 27,041                 | \$ (21,945)     | \$ (172,524)             | \$ (80,659)      |
| Add back:  |                           |                 |                          |                  |
| Interest expense   | 16,660                    | 6,699           | 44,063                   | 18,617           |
| Interest and other income, net                             | (856)                     | (253)           | (4,166)                  | (687)            |
| Benefit from income taxes                                  | (28,797)                  | (16,660)        | (56,234)                 | (53,713)         |
| Changes in operating assets and liabilities                | (45,554)                  | 35,336          | 150,702                  | 124,966          |
| Other adjustments  | (1,129)                   | (2,575)         | 37,920                   | (3,463)          |
| Acquisition-related charges                                | 2,392                     | —               | 14,977                   | —                |
| Cash restructuring   | —                         | 2,445           | 2,200                    | 5,330            |
| Capital lease termination                                  | —                         | —               | —                        | 8,098            |
| Purchasing adjustments                                     | 3,058                     | —               | 48,240                   | —                |
| <b>Non-GAAP Adjusted</b>                                   | <b>(20,285)</b>           | <b>\$ 3,047</b> | <b>\$ 65,178</b>         | <b>\$ 18,489</b> |

**EBITDA**

**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.

Table of Contents**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 and our borrowings that bear variable interest rates under our syndicated credit facility. We maintain our portfolio of cash equivalents and investments in a variety of money market funds, corporate debt, U.S. government and agency securities. All of our cash equivalents are carried at market value. Our syndicated credit facility provides for (a) a five-year secured revolving loan facility in an aggregate principal amount of up to \$200.0 million ("Revolving Loan Facility") and (b) a seven-year delayed draw secured term loan facility with an initial aggregate principal amount of up to \$300.0 million ("Initial Term Loan") with the option for an amendment to enter into an incremental term loan facility ("Incremental Term Loan"). We may draw funds from our syndicated credit facility under interest rates based on either the Federal Funds Rate or the Adjusted London Interbank Offered Rate ("LIBOR rate"). If these rates increase significantly, our costs to borrow these funds will also increase.

As of September 30, 2018, we had not borrowed any funds under our Revolving Loan Facility. In October 2017, we fully drew \$300.0 million under the Initial Term Loan with a maturity date of August 2024, of which \$297.8 million remains outstanding as of September 30, 2018. Further, in April 2018, we entered into an amendment under our existing syndicated credit facility for an Incremental Term Loan in an aggregate principal amount of \$825.0 million which has been drawn with a maturity date of August 2024, of which \$822.9 million remains outstanding as of September 30, 2018.

In August 2017, in order to mitigate future interest-rate risk, we entered into interest-rate swap agreements ("Swap Agreements") with an aggregate notional amount of \$150.0 million and an effective date of October 18, 2017. These Swap Agreements have the economic effect of modifying a portion of the variable interest-rate obligations associated with our Initial Term Loan so that the interest payable on such portion of the Initial Term Loan became fixed at a rate of 4.27% (refer to Note 9 and Note 14 of Notes to Consolidated Financial Statements for further details regarding the Initial Term Loan and the Swap Agreements). Changes in the overall level of interest rates affect the fair value of the Swap Agreements that we recognize in our consolidated balance sheet. As of September 30, 2018, if LIBOR-based interest rates would have been higher by 100 basis points, the aggregate fair value of the Swap Agreements would have increased by approximately \$6.8 million.

If LIBOR-based interest rates increase by 100 basis points, annual interest expense would increase by approximately \$9.7 million as it relates to our borrowings that bear variable interest rates (including the new Incremental Term Loan). Further, we do not believe that a 100 basis points change in interest rates would have a significant impact on our interest income.

*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.

*Investment.* The primary objective of our investment activities is to preserve principal while at the same time improving yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash equivalents and short-term and long-term investments in a variety of asset types, including bank deposits, money market funds, corporate debt, U.S. government and agency securities. As of September 30, 2018, our investments totaled \$57.5 million, which represented approximately 48% of our total investment portfolio.

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**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, 2018. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, (“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, 2018, 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, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting except that on April 2, 2018, the Company acquired Lifetouch Inc. ("Lifetouch"). As a result, the Company is currently integrating Lifetouch's operations into its overall internal control over financial reporting. Under the guidelines established by the Securities and Exchange Commission, companies are permitted to exclude acquisitions from their assessment of internal control over financial reporting during the first year of an acquisition. Accordingly, we expect to exclude Lifetouch from the assessment of internal control over financial reporting for the year ending December 31, 2018.

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**PART II — OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

We are subject to the various legal proceedings and claims discussed below as well as certain other legal proceedings and claims that have not been fully resolved and that have arisen in the ordinary course of business. Although adverse decisions (or settlements) may occur in one or more of these cases, it is not possible to estimate the possible loss or losses from each of these cases. The final resolution of these lawsuits, individually or in the aggregate, is not expected to have a material adverse effect on our business, financial position or results of operations. Cases that previously were disclosed may no longer be described because of rulings in the case, settlements, changes in our business or other developments rendering them, in our judgment, no longer material to our business, financial position or results of operations. One material legal proceeding was terminated during the third quarter of 2018.

*The State of Delaware v. Shutterfly, Inc.*

On May 1, 2014, the State of Delaware filed a complaint against Shutterfly for alleged violations of the Delaware False Claims and Reporting Act, 6 Del C. § 1203(b)(2). The complaint asserts that Shutterfly failed to report and remit to Delaware cash equal to the balances on unused gift cards under the Delaware Escheats Law, 12 Del. C. § 1101 et seq. We entered into an agreement to settle this matter and did not admit to any liability or wrongdoing. The case was dismissed with prejudice by order dated August 31, 2018.

*Monroy v. Shutterfly, Inc.*

On November 30, 2016, Alejandro Monroy on behalf of himself and all others similarly situated, filed a complaint against the Company in the U.S. District Court for the Northern District of Illinois. The complaint asserts that we violated the Illinois Biometric Information Privacy Act by extracting his and others' biometric identifiers from photographs and seeks statutory damages and an injunction. We believe the suit is without merit and intend to vigorously defend against it.

*Taylor v. Shutterfly, Inc.*

On December 12, 2017, Megan Taylor filed a purported class action complaint on behalf of herself and other customers in the U.S. District Court for the Northern District of California. Taylor alleges that Shutterfly misrepresents a deal it currently offers through Groupon because it does not allow purchasers of the Groupon offer to combine or "stack" it with other promotional codes offered by Shutterfly. Taylor is seeking monetary damages and injunctive relief. We believe the suit is without merit and intend to vigorously defend against it.

*Vigeant v Meek et al.*

On March 1, 2018, a purported class action complaint was filed against several directors of Lifetouch, Inc. (which became a direct wholly-owned subsidiary of Shutterfly on April 2, 2018) and the trustee of the Lifetouch Employee Stock Ownership Plan (the "ESOP") in the U.S. District Court for the District of Minnesota. On April 2, 2018, the complaint was amended to include the prior ESOP trustees and plan sponsor (Lifetouch) as additional named defendants. The complaint alleges violations of the Employee Retirement Income Security Act, including that the ESOP should not have been permitted to continue investing in Lifetouch stock during a period in which the Lifetouch stock price was declining. The plaintiffs seek recovery for damages arising from the alleged breaches of fiduciary duty. We believe this suit is without merit and intend to vigorously defend against it.

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 had previously accrued. There are no amounts accrued that we believe would be material to our financial position and results of operations.

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**ITEM 1A. RISK FACTORS**

**Risks Related to Our Business and Industry**

*The recently completed acquisition of Lifetouch, Inc. ("Lifetouch") presents many risks and we may not realize our anticipated financial and strategic goals.*

On April 2, 2018, we completed our acquisition of Lifetouch, the national leader in school photography. Risks we may face in connection with the acquisition of Lifetouch include:

- We may not realize the benefits we expect to receive from the transaction, such as anticipated synergies, increasing revenue and enhanced financial position;
- We may have difficulties (1) managing the acquired company's technologies and lines of business; (2) entering into a new business where we have no or limited direct prior experience; or (3) retaining key personnel from Lifetouch;
- The acquisition may not further our business strategy as we expected, we may not successfully integrate Lifetouch as planned, there could be unanticipated adverse impacts on Lifetouch's business, or we may not otherwise realize the expected return on our investments, which could adversely affect our business or operating results and potentially cause impairment to assets that we record as a part of an acquisition including intangible assets and goodwill;
- Our operating results or financial condition may be adversely impacted by (1) claims or liabilities that we assume from Lifetouch including, among others, claims from government agencies, terminated employees, current or former customers or business partners, former employee stock ownership plan (ESOP Plan) participants or other third parties; (2) pre-existing contractual relationships of Lifetouch that we would not have otherwise entered into, the termination or modification of which may be costly or disruptive to our business; (3) unfavorable accounting treatment as a result of Lifetouch's practices; and (4) intellectual property claims or disputes;
- Our ability to successfully manage the various Lifetouch businesses, which operate in more decentralized manner than Shutterfly, and in particular the sales territory organization structure;
- Lifetouch was a privately-held company and has not been required to maintain an internal control infrastructure that would meet the standards of a public company, including the requirements of the Sarbanes-Oxley Act of 2002. The implementation of such controls may impair business operations, the costs that we may incur to implement such controls and procedures may be substantial and we could encounter unexpected delays and challenges in this implementation. In addition, we may discover significant deficiencies or material weaknesses in the quality of Lifetouch's financial and disclosure controls and procedures and any of these things could impact our ability to timely file our periodic reports;
- Lifetouch's large workforce means greater compliance burden and increased risks of class action lawsuits, regulatory actions and potential claims or audits from governmental agencies;
- We may fail to identify or assess the magnitude of certain liabilities, shortcomings or other circumstances existing prior to acquiring Lifetouch, which could result in unexpected litigation or regulatory exposure, unfavorable accounting treatment, unexpected increases in taxes due, a loss of anticipated tax benefits or other adverse effects on our business, operating results or financial condition; and
- We may have difficulty incorporating Lifetouch's related supply chain operations with our existing supply chain infrastructure and maintaining uniform standards, controls, procedures and policies.

The occurrence of any of these risks could have a material adverse effect on our business, results of operations, financial condition or cash flows.

*Our net revenue, 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 revenue, net income and operating cash flows generated during the fourth quarter for both our Shutterfly consumer business and our Lifetouch business. For example, we generated approximately 50% of our net revenue in the fourth quarter during each of the last three years

in our Shutterfly consumer business, and Lifetouch generated approximately 35% of its net revenue in the fourth calendar quarter during each of the last three years. In addition, we incur significant additional expenses in the period leading up to Shutterfly's fourth quarter holiday season and Lifetouch's third quarter fall school portrait season and retail 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. We face intense competition for seasonal and temporary workers; with respect to Lifetouch's seasonal photographers, this difficulty may be exacerbated now that the ESOP has been terminated. If we are unable to accurately forecast expense levels, our results of operations would likely be negatively impacted. Additionally, if we are unable to accurately forecast and respond to consumer demand for our products during the fourth quarter, if there is a meaningful

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decrease in demand for Lifetouch fall school photo day during the third 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. In addition, we must effectively manage the ramp up and ramp down of variable labor to achieve our expectations. Failure to accurately forecast or ineffectively manage such spikes can result in unexpected revenue or operating income shortfall. Accordingly, any shortfall in net revenue may cause significant variation in operating results in any quarter, particularly in the third and fourth quarters.

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

We believe that we must continue to upgrade and expand our current production capability to meet our projected net revenue targets. Our capital expenditures were approximately 6%, 8% and 8% of total net revenue for the years ended December 31, 2017, 2016 and 2015, respectively. The expenditures will increase with the Lifetouch acquisition. Operational difficulties, such as a significant interruption in the operations of our production facilities or in facilities operated by third-parties, could delay production or shipment of our products. In addition, inclement weather, particularly heavy rain and snow could impair our production capabilities. Our inability to meet our production requirements, particularly in our peak season, could lead to school and customer dissatisfaction, impact Lifetouch's account retention, and damage our reputation and brands, which would result in reduced net revenue. 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, at peak times (including the fourth quarter and other holidays for the Shutterfly consumer business and the Lifetouch retail business, and the fall school portrait and spring yearbook seasons for Lifetouch), we face significant production risks, including the risk of obtaining sufficient qualified seasonal production personnel. A majority of our workforce during these periods has historically been comprised of seasonal, temporary personnel. We have had difficulties in the past finding and retaining a sufficient number of qualified seasonal employees, and our failure to find and retain qualified seasonal production personnel at any of our production facilities could harm our operations.

***Uncertainties in general economic conditions and their impact on consumer spending patterns, particularly in the personalized products and photofinishing services categories, could adversely impact our operating results.***

Our financial performance depends on general economic conditions and their impact on levels of consumer spending in the United States, particularly on personalized products, photofinishing services and professional photography and in Canada on Lifetouch's school business. Shutterfly Consumer net revenue as a percentage of Shutterfly's total net revenue was 84% in 2017, 88% in 2016 and 91% in 2015; substantially all of Lifetouch's revenue was derived from consumers during these periods. Some of the macroeconomic conditions that can adversely affect consumer spending levels in the United States include domestic and foreign stock market volatility and its effects on net worth, anticipated economic slowdowns in foreign economies, high consumer debt levels, uncertainty in real estate markets and home values, fluctuating energy and commodity costs, rising or higher than average interest rates, higher than usual unemployment rates, limited credit availability, changes in tax laws, and general uncertainty about the future economic environment. If general economic conditions decline, customers or potential customers could delay, reduce or forego their purchases of our products and services, which are discretionary. Any decrease in the demand for our products and services 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 other factors, higher costs of labor, energy, equipment and facilities which could in turn lead to additional restructuring actions by us and associated expenses. We may not be able to pass these increased costs on to our customers due to the macroeconomic environment and the resulting increased expenses and/or reduced income could have a material adverse impact our operating results.

***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 slow or uncertain economic growth and consumer conservatism. Many factors can significantly impact our pricing strategies, including production and personnel costs, and others outside our control, such as consumer sentiment and our competitors' pricing and marketing strategies. If we fail to meet our customers' price expectations, we could lose customers, which would harm our business and results of operations.

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Changes in our pricing strategies have had, and may continue to have, a significant impact on our net revenue and net income. For example, in the second and third quarters of 2018 we saw a deceleration of revenue associated with free promotions that impacted our top line consumer revenue. As we continue to implement more optimized and targeted pricing strategies, we cannot predict with certainty that these changes will have the expected impacts. From time to time, we have made changes to our pricing structure in order to remain competitive. Many of our products, including professionally-bound photo books, calendars, cards and stationery and other photo merchandise are also offered by our competitors. Many of our competitors discount those products at significant levels and as a result, we may be compelled to change our discounting strategy, which could impact our acquisition of new customers, average order value, net revenue, gross margin, and 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 revenue and could adversely affect our gross margins and overall profitability.

We generate a significant portion of our net revenue from the fees we collect from shipping and handling of our products. For example, shipping and handling revenue for the Shutterfly brand website represented approximately 23% of our net revenue in 2017, 19% of our net revenue in 2016 and 20% in 2015. We offer discounted or free shipping, with a minimum purchase requirement, during promotional periods to acquire 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 revenue and results of operations would be negatively impacted. In addition, we occasionally offer free or discounted products and services to acquire 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 industry is intensely competitive, and we expect competition to increase in the future as current competitors improve their offerings, including developing, acquiring and expanding mobile and cloud-based 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, Vistaprint, and many others;
- Social media companies that host and enable mobile access to and posting of images such as Facebook, Instagram, Twitter, Pinterest, Snapchat and Google+;
- Photo hosting websites that allow users to upload and share images at no cost such as Apple iCloud, Google Photos, and Flickr;
- “Big Box” retailers such as Wal-Mart, Costco, Sam’s Club, Target, and others that offer low cost digital photography products and services. In addition to providing low-cost competitive product offerings on their respective websites, 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 low-cost photography products and services as well as in-store pick-up from their photo website Internet orders;
- Traditional offline stationery companies such as PaperSource, Crane & Co., and Papyrus;
- Cloud-based storage services and file-syncing services such as Dropbox, Box, Everalbum, Amazon Photos and iCloud;
- Specialized companies in the photo book and stationery business such as Hallmark, Cardstore by American Greetings, Minted, Invitations by Dawn, Picaboo, Blurb, Mixbook, Postable, Artifact Uprising and Chatbooks;
- Photo-related software companies such as Apple, Microsoft, and Adobe;

- Online and offline companies specializing in photo-based merchandise and personalized home décor such as Zazzle, CafePress, Art.Com, Canvas On Demand, Personalization Mall, Personal Creations, Things Remembered, Mark & Graham, CustomInk, Teespring and Etsy.
- Providers of digital alternatives to our products, such as Paperless Post, Evite, Animoto, and PicCollage.
- Home printing service providers such as Hewlett-Packard and Epson that are seeking to expand their printer and ink businesses by gaining market share in the digital photography marketplace;
- Enterprise digital and print communications companies such as RR Donnelley and Sons Company, O'Neil Data Systems, Inc., Quad/Graphics, Inc. and Viatech Publishing Solutions, Inc.;
- Regional photography companies such as Ritz Camera that have established brands and customer bases in existing photography markets;
- Camera and photographic supply companies that rent equipment nationwide both online and in brick-and-mortar stores such as LensRentals.com, Cameralends, AbelCine, and Adorama;

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- Picture People and Portrait Innovations in the Lifetouch portrait studio business;
- The Lifetouch School photography and retail studio photography businesses face competitive pressure from independent professional and amateur photographers who enjoy low barriers to entry and can offer flexible business terms and product options;
- The Lifetouch School photography competitors are primarily local and regional players, including Strawbridge and Inter-State Studio in the United States and Canadian competitors, Edge Imaging and 36Pix; and
- Jostens, Herff Jones and Balfour in the yearbook market (all of whom have made significant investments in technology).

Many of our competitors, in the Shutterfly consumer and SBS segments in particular, have significantly longer operating histories, larger and broader customer bases, greater brand and name recognition, 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 industry 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 revenue 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:

- 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 websites and convert those visitors into customers;
- the potential impact of the current U.S. political climate on consumer spending;
- 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 websites;
- a significant increase in returns and credits, beyond our estimated allowances, for customers who are not satisfied with our products;
- our ability to achieve the expected benefits of strategic partnerships or the loss of any such partnership;
- declines or disruptions to the travel industry;
- variations in weather, particularly heavy rain and snow which tend to depress travel and picture taking;
- natural disasters or other events resulting in school closures could lead to cancellations or postponements of scheduled picture days, and could also impact Lifetouch's school business operations in the field and/or production facilities;
- the timing of holidays and the duration of the holiday shopping season;
- general economic conditions, including recession and slow economic growth in the United States and worldwide and higher inflation;

- our ability to address increased shipping delays caused by our third-party shippers' inability to handle the ever-increasing number of consumers ordering goods online, particularly during the holiday shopping season;
- volatility in our stock price, which may lead to higher stock-based compensation expense;
- consumer preferences for digital photography services;
- improvements to the quality, cost and convenience of desktop printing of digital pictures and products;
- continued decline in church or house of worship attendance which impact Lifetouch's church division; 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, and in light of the seasonal nature of our business, 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

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future quarters, our operating results may be below the expectations of public 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 consumer demand decreases and net revenue 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;
- increase the number of schools and preschools we serve;
- maintain and enhance our brands;
- enhance and expand our products and services;
- continue to develop and upgrade our technology and information processing systems;
- maintain and grow our websites, applications and customer operations;
- successfully execute our business and marketing strategy;
- continue to enhance our service to meet the needs of a changing industry;
- provide a high-quality customer experience, including superior customer service and timely product deliveries;
- 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 unable to acquire customers in a cost-effective manner, traffic to our websites 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 websites and mobile applications and promote our products, including paying fees to third parties who drive new customers to our websites and mobile applications, purchasing search results from online search engines, e-mail and direct mail marketing campaigns. We pay providers of online services, search engines, social media, advertising networks, directories and other websites and e-commerce businesses to provide content, advertising/media and other links that direct customers to our websites. We also use e-mail and direct mail to attract customers, and we offer substantial pricing discounts or free products to encourage repeat purchases and trial orders. Our methods of attracting customers, including acquiring customer lists from third parties can involve substantial costs, regardless of whether we acquire new customers as a result of such purchases. Even if we are successful in acquiring and retaining customers, the cost involved in these efforts, and which has increased in recent years, 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 acquiring customers using these methods significantly increase, or if we are unable to develop new cost-effective

methods to obtain customers, our ability to attract new customers would be harmed, traffic to our websites and mobile applications may be reduced and our business and results of operations would be harmed.

***Our sales to SBS customers can be unpredictable, can require significant ramp-up periods in the early stages of SBS contracts, and a decrease in SBS revenue or an increase in costs of SBS net revenue could adversely impact total net revenue and profit levels.***

SBS revenue as a percentage of total net revenue was 16% in 2017, 12% in 2016 and 9% in 2015. SBS gross margins were 20% in 2017, 26% in 2016 and 19% in 2015. The declining gross margins of this segment, coupled with the increasing percentage of total revenue from SBS, may magnify the impact of variations in revenue and operating costs on our operating

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results. This may have an adverse effect on our overall margins and profitability. Our SBS revenue is highly concentrated in a small number of customers and the loss of, or reduction in volume from, one or more of our SBS customers could decrease SBS revenue and adversely impact our total net revenue. Our SBS customers also come from a variety of industries, often creating regulatory compliance issues for us as well as the need to maintain security for third-party data. These SBS customers also demand strict security requirements and specified service levels. If we fail to meet these service levels, we may not only lose an SBS customer, but may have to pay punitive costs for such failures. As our SBS business grows, issues that impact our sales to SBS customers may have a negative impact on our total sales. Our core business is consumer focused and we have less experience managing sales to SBS customers and may not sell as successfully to SBS customers, who often have long sales cycles, long implementation periods and significant upfront costs. In addition, we have had in 2017 and 2018, and may continue to have in the future, low or no gross margins in the early stages of our contracts with SBS customers that often require significant ramp-up periods, which will adversely affect our total net revenue. To compete effectively in the SBS industry, we have in the past, and may in the future, be forced to offer significant discounts to large SBS customers at lower margins or reduce or withdraw from existing relationships with smaller SBS customers, which could negatively impact our net revenue and could adversely affect our gross margins and overall profitability.

***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. 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, oil or fuel prices. Higher fuel prices have a corresponding increase in travel-related expenses of our Lifetouch photographers. Changes in federal and state minimum wage laws could raise the wage requirements for certain of our seasonal personnel, which could increase the pressure, particularly on Lifetouch, in hiring seasonal photographers and production workers; we may also experience competitive pressure to increase the wages paid to a large population of our employees resulting from other industry participants increasing wage levels. 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. If we are unable to keep the costs associated with operating our business aligned with the level of net revenue that we generate, our results of operations would be adversely affected.

***If we are not able to reliably meet our technology, data storage and management requirements, it may harm customer satisfaction, net revenue, costs and brand reputation.***

As a part of our current consumer business model, we offer our customers free unlimited online storage and sharing of images 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. We continuously evaluate our short and long-term data storage capacity requirements to enable adequate capacity and management for new and existing customers. We strive to predict the capacity requirements as tightly as possible as overestimating may negatively impact our capital needs and underestimating may impact the level and quality of service we provide to our customers, which could harm customer satisfaction, net revenue, costs and brand reputation.

***An increasing number of our customers are using smartphones, tablets and other mobile devices to order products and access services. If we are unable to develop mobile applications that are adopted by our customers or if we are unable to generate net revenue from our mobile applications, our results of operations and business could be adversely affected.***

The number of people who access information about our services and our websites through mobile devices, including smartphones and handheld tablets or computers, has increased significantly in recent years and is expected to continue increasing. As part of our multichannel strategy, we are making technology investments in our mobile websites and our iOS and Android applications. If customers do not adopt our applications and mobile website as expected, or if we are generally unable to make, improve, or develop relevant customer-facing mobile technology in a timely manner, our ability to compete could be adversely affected and may result in the loss of market share, which could harm our results of operations. In addition, if our technology systems do not function as designed, we may experience a loss of confidence, data security breaches or lost sales, which could adversely affect our reputation and results of operations. As new mobile devices and platforms are released, it is difficult to predict the problems we may encounter in developing products and applications for these alternative devices and platforms, and we may need to devote significant resources to the creation, support, and maintenance of such products and applications. If we experience difficulties providing satisfactory access to our services via our mobile applications and mobile websites, such as, problems with our relationships with providers of mobile operating systems (e.g., Apple or Google and their

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application stores) our growth and customer acquisition and retention capabilities may be impaired. In addition, increased distribution costs of the applications may impact net revenue growth and negative reviews due to our software and user experience may damage our brand reputation and lead to customer churn.

***Computer system capacity constraints and system failures could significantly degrade the quality of our services, such as access to our websites or mobile applications, and in-turn cause customer loss, damage to our reputation and negatively affect our net revenue.***

Our business requires that we have adequate capacity in our computer systems to cope with the periodic high volume of visits to our websites and mobile applications. As our operations grow in size and scope, we continually need to improve and upgrade our computer systems, data storage, and network infrastructure to enable reliable access to our websites and mobile applications, 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 revenue will increase to offset these additional expenses.

Portions of our infrastructure, especially our photos domain for Shutterfly Photos, have run on a public cloud service (Amazon Web Services, Inc. or "AWS") for several years. Since third quarter of 2017, Shutterfly has added additional workloads to AWS thereby expanding the portions of our infrastructure which run on a public cloud service, and we intend to continue to expand our use of AWS. Any disturbances in the AWS system may create unforeseen technical issues, which would negatively influence our business and reputation. Although we leverage the redundancy features available from our public cloud service provider, any outage to their infrastructure could adversely impact our site availability, potentially leading to poor customer experience and data loss. For instance, in December 2017, researchers identified significant CPU architecture vulnerabilities commonly known as "Spectre" and "Meltdown" that required AWS software updates and patches to mitigate such vulnerabilities and such updates and patches required AWS servers to be offline and potentially slow their performance.

Our ability to provide high-quality products and service depends on the efficient and uninterrupted operation of our computer and communications, data storage and network infrastructure systems. If our systems cannot be scaled in a timely manner to cope with increased website and mobile applications 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 revenue to decline.

***Full or partial outages to our websites, mobile applications, computer systems, print production processes or customer service operations could damage our brand reputation and substantially harm our business and results of operations.***

The satisfactory performance, reliability and availability of our websites and mobile applications, information technology systems, printing production processes and customer service operations are critical to our service delivery, customer acquisition and retention and brand reputation growth. Any service interruptions that degrade the satisfactory use of our websites and mobile applications due to undetected bugs, design faults or poor scalability, may impact customer growth and retention, net revenue and costs. These include (but are not limited to) our product creation experience, order fulfillment performance, customer service operations and security of our systems.

This risk is heightened in the fourth quarter, as we experience significantly increased traffic to our websites during the holiday season and significantly higher order volumes. Any interruption that occurs during such time would have a disproportionately negative impact on our results of operations than if it occurred during a different quarter. For example, during the fourth quarter of 2014, unusually high seasonal traffic combined with system misconfigurations arising from our data center migration resulted in some days when customers could not place orders from our Tiny Prints brand. Even after the issue was identified and corrected, many of those orders were not received by customers

within the expected time frame. As a result, we refunded many of those orders which reduced net revenue, recognized excess costs related to expedited shipping upgrades, and increased customer service costs which negatively impacted our gross margins and our brand.

We depend in part on third parties to implement and maintain certain aspects of our Internet and communications infrastructure 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 net revenue we may lose.

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***Any failure by us to protect student photos and the confidential information of our customers and employees, and our 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 e-commerce and communications is the secure transmission of confidential information over public networks. We may be subject to cyber-attacks, phishing attacks, malicious software programs, and other attacks in the future. These attacks may come from individual hackers, criminal groups, and state-sponsored organizations. In addition to these threats, the security, integrity, and availability of student photos, as well as our and our customers' and employees' data, could be compromised by employee negligence, error or malfeasance, and technology defects. Our failure to prevent security breaches could damage our reputation and brands and substantially harm our business and results of operations. For example, even though we do not store customer credit cards on our computer system and use third-party systems to clear transactions, in case of an outage to a third-party system, we will temporarily store and bill our customers' credit card accounts directly; orders are then shipped to a customer's address and customers log on using their e-mail address. We rely on encryption and authentication technologies licensed from third parties to affect the secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, new discoveries in the field of cryptography, hacking or other developments may result in a compromise or breach of the technology used by us to protect customer transaction data. In addition, any party who is able to illicitly obtain a user's password could access the user's transaction data, personal information or stored images.

Our expanded use of cloud-based services could also increase the risk of security breaches as cyber-attacks on cloud environments are increasing to almost the same level as attacks on traditional information technology systems. For example, in 2014, we experienced a cyber-attack on our Tiny Prints, Treat and Wedding Paper Divas websites, which may have exposed the email addresses and encrypted passwords used by our customers to login to their accounts. We encrypt customer credit and debit card information, and we have no evidence that such information was compromised; however, any compromise of our security could damage our reputation and brands and expose us to a risk of loss or litigation and potential 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. Additionally, in 2018, we discovered that there had been unauthorized access to an internal testing environment, which could have resulted in exposure of employee confidential data. Although we discovered no evidence to indicate exposure of this data, we cannot determine that it did not occur; while we have taken remediation and precautionary measures to prevent this type of situation from occurring again, we cannot guarantee that these measures will be effective.

In addition, contractors we hire as well as other employees have access to confidential information, including credit card and employee 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 would damage our reputation and brands, and substantially harm our business and result of operations.

***If the third-party vendors who we depend upon to produce many of our products or those that deliver our product experience delays or interruptions in service, our customer experience will suffer, which would substantially harm our business, reputation and results of operations.***

Our ability to provide a high-quality customer experience depends, in large part, on external factors over which we may have little or no control, including the reliability and performance of our suppliers, third-party product providers and shipping partners. 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. If any of our third-party suppliers are unable to produce our products, we could have difficulty finding an alternative producer in a timely manner. In addition, we rely on third-party shippers, including the U.S. Postal Service and UPS to deliver our products to customers. Strikes, furloughs, reduced operations, increased shipping delays particularly during the holiday shopping season, or other service interruptions affecting these shippers could impair our ability to deliver merchandise on a timely basis. 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, which would substantially harm our business and results of operations.

*Lifetouch's studio business is materially dependent upon JCPenney and any deterioration in Lifetouch's relationships with JCPenney or in JCPenney's business could have a material adverse effect on Lifetouch's revenue*

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Substantially all of Lifetouch's studio business is derived from sales in JCPenney stores and is, therefore, materially dependent upon its relationship with JCPenney, the continued goodwill of JCPenney and the integrity of their brand names in the retail marketplace. Lifetouch's portrait studios in JCPenney leverage customer traffic generated by the JCPenney retail stores, and if the customer traffic through these stores decreases due to the weakness of the JCPenney business, general economic conditions or for any other reason, Lifetouch's sales could be materially and adversely affected.

***If the facility where our computer and communications hardware is located fails or if any of our production facilities fail, our business and results of operations would be harmed and our reputation could be damaged.***

Our ability to successfully receive and fulfill orders and to provide high-quality customer service depends in part on the efficient and uninterrupted operation of our computer and communications systems. The computer hardware necessary to operate our consumer website is in Las Vegas, Nevada. Lifetouch maintains critical data centers in St. Paul, Minnesota and in Ontario, Canada. We also have computer hardware located in each of our production facilities and operations centers. In addition, we also use third-party public clouds for our system operation. Our systems and operations could suffer damage or interruption from human error, fire, flood, power loss, insufficient power availability, telecommunications failure, break-ins, hacking, distributed denial of service attacks, misuse by spammers, terrorist attacks, acts of war and similar events. In addition, our headquarters are located near a major fault line increasing our susceptibility to the risk that an earthquake could significantly harm our operations. 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.

***In order to be successful, we must attract, engage, retain and integrate key employees and have adequate succession plans in place, and failure to do so could have an adverse effect on our ability to manage our business.***

Our success depends, in large part, on our ability to identify, hire, integrate, retain and motivate qualified executives and other key employees throughout all areas of our business. Identifying, developing internally or hiring externally, training and retaining highly-skilled senior management, technical, marketing and production personnel are critical to our future, and competition for experienced employees can be intense. And, the current uncertainty around U.S. immigration rules could impact our ability to attract and retain qualified employees. We face significant competition for qualified personnel in all locations where we operate, including in the San Francisco Bay Area, where our headquarters are located. We may be unable to attract and retain suitably qualified individuals who can meet our growing operational and managerial requirements, or we may be required to pay increased compensation in order to do so. Failure to successfully hire executives and key employees or the loss of any executives and key employees could have a significant impact on our operations. Further, a lack of management continuity could result in operational, technological, 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.

Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees and senior executives could hinder our strategic planning and execution.

***In order to attract new personnel, we may need to grant inducement equity awards outside of our 2015 Equity Incentive Plan, which dilutes the ownership of our existing stockholders.***

Since 2007, our board of directors has approved inducement equity awards outside of our 2006 Plan and 2015 Plan to select new employees upon hire and in connection with mergers and acquisitions without stockholder approval in

accordance with Nasdaq Listing Rule 5635(c) for an aggregate of 3,338,561 shares of our common stock. The use of inducement equity awards may dilute the equity interest of our stockholders, which could in turn adversely affect prevailing market prices for our common stock.

In addition, we may issue equity securities to complete an acquisition, or for other reasons, which would dilute our existing stockholders' ownership, perhaps significantly depending on the terms of such acquisitions or other activities and could adversely affect the price of our common stock. 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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***If we were to become subject to e-mail blacklisting, traffic to our websites would be reduced and our business and results of operations would be harmed.***

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 sell 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.

***Our business and financial performance could be adversely affected by changes in search engine algorithms and dynamics, or search engine disintermediation.***

We rely on Internet search engines such as Google, Yahoo! and Bing, including through the purchase of keywords related to photo-based products, to generate traffic to our websites. We obtain a significant amount of traffic via search engines and, therefore, utilize techniques such as search engine optimization (“SEO”) and search engine marketing (“SEM”) to improve our placement in relevant search queries. Search engines, including Google, Yahoo! and Bing, frequently update and change the logic that determines the placement and display of results of a user's search, such that the purchased or algorithmic placement of links to our websites can be negatively affected. Moreover, a search engine could, for competitive or other purposes, alter its search algorithms or results causing our websites to place lower in search query results. If a major search engine changes its algorithms in a manner that negatively affects our paid or unpaid search ranking, or if competitive dynamics impact the effectiveness of SEO or SEM in a negative manner, including but not limited to increased costs for desired search queries, our business and financial performance would be adversely affected, potentially to a material extent.

***We may not succeed in promoting and strengthening our brands, which would prevent us from acquiring new customers and increasing net revenue.***

A component of our business strategy is the continued promotion and strengthening of the Shutterfly, Lifetouch, Prestige Portraits, Tiny Prints, Groovebook and BorrowLenses brands. Due to the competitive nature of the digital photography products and services industry, if we are unable to successfully promote our brands, we may fail to acquire new customers, increase the engagement of existing customers with our brands or substantially increase our net revenue. 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. The failure of our brand promotion activities could adversely affect our ability to acquire 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 earlier in our history we have focused our business on consumer industry for silver halide prints, we have consistently evolved and broadened our offering to include other photo-based products, such as professionally-bound

photo books, cards and stationery, calendars and other photo merchandise. We continually evaluate the demand for new products and services and the need to address trends in consumer demand and opportunities in the marketplace. For example, we have expanded in recent years into statement gifts and home décor, including wall art, ornaments and pillows, and video equipment rentals through the BorrowLenses brand, and we launched kids and pets categories in the second half of 2018. In the future, we may need to address additional segments and expand our customer demographic to grow our business. Our efforts to expand our existing services, create new products and services, address new segments or develop a significantly broader customer base may not be successful. Any failure to address additional opportunities could result in loss of market share, which would harm our business, financial condition and results of operations.

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***We currently outsource some of our off-line and online marketing, and some of our customer service activities 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 off-line and online marketing, and some of our customer service activities 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. In the fourth quarter of 2015, a third-party customer service provider experienced a disruption that affected our operations during peak times.

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

We purchase photo-based and other product supplies and photography equipment from third parties. These parties could increase their prices, reallocate supply to others, including our competitors, or choose to terminate their relationship with us. If one of these third parties chooses not to renew their agreements or fails to perform in accordance with the terms of their agreements and we are not able to secure supplies and services from a different source in a timely manner, we could fail to meet customer expectations, which could damage our reputation and harm our business. 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 or other products and photography equipment, we may incur delays and incremental costs, which could harm our operating results.

***A decline in participation rate by customers in the Lifetouch school picture business would have a negative impact on Lifetouch's revenue.***

An important element of profitability in the school picture business is the participation rate (percentage of students photographed whose parents purchase the photo). The tradition of families purchasing an annual school photo of their child and/or the school yearbook could erode over time. Likewise, reduction in number of high school seniors who are photographed for the yearbook, combined with the availability of alternative digital platforms for commemorating school achievements, could make the traditional printed yearbook less compelling overall.

***Providing access to school photos extends inherent risks that could result in reputational harm or loss of business.***

In the school photography segment, Lifetouch historically has relied on schools to distribute portrait packages, and/or access credentials to parents. Newer methods enabling parents to order and receive their child's images online provide many advantages but also entail risks inherent to internet transactions. We cannot guarantee that a person ordering a child's photo has the legal right to receive it. Additionally, if systems failure or human error results in failed delivery or unauthorized access to our images, it could result in harm to our reputation and/or customer and account loss.

***Failure to comply with privacy laws and regulations and failure to adequately protect customer data could harm our business, damage our reputation and result in a loss of customers.***

Federal, state and international laws and regulations may govern the collection, use, sharing and security of data that we receive from our customers as well as school photos. In addition, we have and post on our websites 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, U.S. 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.

***The regulatory framework is constantly evolving, and privacy concerns could adversely affect our operation results.***

The regulatory framework for privacy issues worldwide is currently evolving and is likely to remain uncertain for the foreseeable future. The occurrence of unanticipated events often rapidly drives the adoption of legislation or regulation affecting the use of data and the manner in which we conduct our business; in fact, there are active discussions among U.S. legislators around adoption of a new U.S. federal privacy law. Restrictions could be placed upon the collection, management, aggregation and use of information, which could result in a material increase in the cost of collecting certain kinds of data. For example, the European Parliament formally adopted the General Data Protection Regulation (the “GDPR”), which established a

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new framework for data protection in Europe effective as of May 2018. The GDPR imposes more stringent operational requirements for entities processing personal information, such as stronger safeguards for data transfers to countries outside the European Union (“EU”), reliance on express consent from data subjects (as opposed to assumed or implied consent), a right to require data processors to delete personal data, and stronger enforcement authorities and mechanisms. In June of 2018, California enacted the California Consumer Privacy Act (the “CCPA”), which will take effect on January 1, 2020. The CCPA has many similarities to the GDPR and imposes significant new obligations and limitations on businesses, including the Company, that collect and process personal information of California citizens. Complying with CCPA and changing domestic and international requirements may cause the Company to incur substantial costs, require the Company to change its business practices or reduce the overall demand for our business offerings, which could harm our financial condition and results of operations. Noncompliance could result in significant penalties or legal liability.

***Lifetouch is uniquely subject to a number of student data privacy laws; any adverse publicity stemming from a data breach or failure to protect personal data (whether valid or perceived) could adversely affect Lifetouch’s relationship with schools, districts, education associations and parent groups, leading to loss of future business.***

In its role as a service provider to schools, Lifetouch is subject to various privacy laws and regulations including, without limitation, the Family Educational Rights in Privacy Act (FERPA), Connecticut’s Act Concerning Student Privacy (Public Act No. 16-189), Colorado’s Student Data Transparency and Security Act (16 CRS 22) and Canadian privacy statutes. In recent years (since 2014), numerous student privacy bills have been introduced and laws passed at the federal and state levels. These laws regulate the manner in which Lifetouch collects and handles the school data it relies on to conduct Picture Day, and the way Lifetouch contracts with schools for such services. Actual or perceived failure to comply with such laws could lead to significant reputational damage, enforcement actions, penalties and expenses. Additionally, the evolving regulatory environment for student data privacy may make it more difficult for Lifetouch to obtain the data from schools that it requires to conduct an efficient Picture Day, which may result in higher costs and inefficiencies. Increasing compliance and contracting requirements means increasing exposure to liability for breach and rising cost of doing business.

If a change in privacy laws requires Lifetouch to obtain prior express parental consent to photograph children in schools, or if inclusion in a school yearbook requires express parental consent, participation rates may decline. In either of these instances, our financial results would likely suffer.

***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 websites, our production operations and our trademarks.

As of September 30, 2018, Shutterfly and Lifetouch had 142 patents issued and more than 30 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,” “Lifetouch,” “Prestige Portraits,” “Tiny Prints,” “Wedding Paper Divas,” and “BorrowLenses.” We hold applications and/or registrations for the Shutterfly, Lifetouch, Prestige Portraits, Tiny Prints, Wedding Paper Divas, BorrowLenses and Groovebook trademarks in our major territories of the United States and Canada as well as in the European Community. Our marks are critical components of our marketing programs. If we lose the ability to use these marks in any particular sector, we could be forced to either incur significant additional marketing expenses within that sector, or elect not to sell products in that sector.

From time to time, third parties have adopted names similar to ours, applied to register trademarks similar to ours, and we believe have infringed or misappropriated our intellectual property rights and impeded our ability to build brand identity, possibly leading to customer confusion. In addition, we have been and may continue to be subject to potential trade name or trademark infringement claims brought by owners of marks that are similar to Shutterfly, Lifetouch, Tiny Prints, Wedding Paper Divas, BorrowLenses, or one of our other marks.

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We respond on a case-by-case basis and where appropriate may send cease and desist letters or commence opposition actions and litigation. However, we cannot ensure that the steps we have taken to protect our intellectual property rights are adequate, that our intellectual property rights can be successfully defended and asserted in the future or that third parties will not infringe upon or misappropriate any such rights. In addition, our trademark rights and related registrations may be challenged in the future and could be canceled or narrowed. Failure to protect our trademark rights could prevent us in the future from challenging third parties who use names and logos similar to our trademarks, which may in turn cause consumer confusion or negatively affect consumers' perception of our brands, products, and services. Any claims or consumer 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 industry grows, the possibility of patent infringement claims against us or litigation we will initiate increases.

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 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 revenue and harm our results of operations and possibly prevent us from generating revenue sufficient to sustain our operations.

***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, rights of publicity and rights of privacy, 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 how existing laws governing issues such as property use and ownership, sales and other taxes, fraud, libel and personal privacy and the rights of publicity 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 continue to be interpreted by the courts and their applicability and reach are therefore uncertain. For example, and without limitation:

- The Digital Millennium Copyright Act (“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 (“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.



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- 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. Several states are attempting to pass new laws regulating the use of gift cards and amending state escheatment laws to try 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 Illinois Biometric Information Privacy Act (“IBIPA”) regulates the collection, use, safeguarding, and storage of "biometric identifiers" or "biometric information" by private entities. While the statute specifically excludes photographs from its scope, to date there has been no dispositive judicial interpretation of that language.

The costs of compliance with these and other 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 review could impose complex and costly constraints on our business model.***

Although our websites' terms of use specifically require customers to represent that they have the right and authority to provide and submit to us and to reproduce the content they provide and submit and that the content is in full compliance with all relevant laws and regulations and does not infringe on any third-party intellectual property or other proprietary rights or rights of publicity or rights of privacy, 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 another party's right of privacy or right of publicity, 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 which could substantially harm our business and results of operations.

Lifetouch often contracts with schools to provide spring portraits that feature a variety of looks and media different from the traditional fall headshot and that offer schools an opportunity for fundraising. In some markets, Lifetouch offers spring portraits under a “Family Approval” model whereby portrait products are distributed by the school to parents for review. Parents are asked to pay for the products they elect to keep (if any) and to return any products they do not wish to purchase to the school. Lifetouch has been and in the future may be subject to claims from individuals that these products qualify as “gifts” and/or that the program does not comply with legislation pertaining to “unsolicited goods.” While we do not believe that such legislation is applicable to school photography, if Lifetouch becomes subject to such claims and is required or elect to curtail the use of the Family Approval model, its business and revenue may

be negatively impacted.

***Our marketing practices could be subject to judicial or regulatory challenge.***

We regularly offer free products or free shipping as an inducement for customers to try our products or as part of other promotional photographic programs. 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 have been and in the future 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 business and results of operations may be harmed.

***We may be subject to product liability claims if people or property are harmed by the products we sell.***

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Some of the products we sell may expose us to product liability claims relating to issues such as personal injury, death, or property damage, and may require product recalls or other actions. Any claims, litigation, or recalls relating to product liability could be costly to us and damage our brands and reputation.

***The failure of our suppliers and manufacturing fulfillers to use legal and ethical business practices could negatively impact our business.***

We source the raw materials for the products we sell from an expanding number of suppliers in an increasing number of jurisdictions worldwide, and we contract with third-party manufacturers to fulfill customer orders. Although we require our suppliers and fulfillers to operate in compliance with all applicable laws, including those regarding corruption, working conditions, employment practices, safety and health, and environmental compliance, we cannot control their business practices, and we may not be able to adequately vet, monitor, and audit our many suppliers and fulfillers (or their suppliers) throughout the world. If any of them violates labor, environmental, or other laws or implements business practices that are regarded as unethical, our reputation could be severely damaged, and our supply chain and order fulfillment process could be interrupted, which could harm our sales and results of operations.

***We are subject to safety, health, and environmental laws and regulations, which could result in liabilities, cost increases or restrictions on our operations.***

We are subject to a variety of safety, health and environmental laws and regulations in each of the jurisdictions in which we operate. These laws and regulations govern, among other things, air emissions, wastewater discharges, the storage, handling and disposal of hazardous and other regulated substances and wastes, soil and groundwater contamination and employee health and safety. We use regulated substances such as inks and solvents, and generate air emissions and other discharges at our manufacturing facilities, and some of our facilities are required to hold environmental permits. If we fail to comply with existing safety, health and environmental laws and regulations, or new, more stringent safety, health and environmental laws and regulations applicable to us are imposed, we may be subject to monetary fines, civil or criminal sanctions, third-party claims, or the limitation or suspension of our operations. In addition, if we are found to be responsible for hazardous substances at any location (including, for example, offsite waste disposal facilities or facilities at which we formerly operated), we may be responsible for the cost of cleaning up contamination, regardless of fault, as well as to claims for harm to health or property or for natural resource damages arising out of contamination or exposure to hazardous substances.

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

The digital photography industry is rapidly evolving. Professional photography and in particular the tradition of school pictures is subject to continuing disruption from the changes in digital photography and commerce. Changing technologies, intense price competition, additional competitors, evolving industry standards, frequent new service and platform announcements and changing consumer demands and behaviors all impact our business. 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 industry for digital photography evolves in ways that we are not 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 revenue and/or increased expenses.

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

The online industry for digital photography products and services, including photographic and video equipment rentals, is less developed than the online industry for other consumer products. With the acquisition of Lifetouch, our delivery of photographic products is greatly increased. Our success, and a key synergy anticipated from the

acquisition of Lifetouch, will depend in part on our ability to acquire 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 acquire additional online consumers to our websites 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;
- costs associated with shipping and handling;

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- 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 or rent online, our net revenue and results of operations would be harmed.

***If our internal controls are not effective or our third-party software systems that we use to assist us in the calculation and reporting of financial data have errors, 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.***

It is possible that we may discover significant deficiencies or material weaknesses in our internal control over financial reporting in the future. This risk is heightened during the period in which we are integrating Lifetouch, who has not previously been subject to the heightened control standards of a public company. 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. We use numerous third-party licensed software packages, most notably our equity software and our SBS resource planning 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. Any such delays, errors or restatements could cause investors to lose confidence in our reported financial 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 and divert management's attention.***

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 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 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 Select Market.

***Our effective tax rate may be subject to fluctuation from federal and state audits, changes in U.S. tax laws and stock-based compensation activity.***

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.

Our effective tax rate is subject to fluctuations under current tax regulations as a result of stock-based compensation activity. This activity includes items such as windfalls and 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 exercise or cancellation of vested non-qualified stock options.

Additionally, in December 2017, the current U.S. administration signed an act referred to as the “Tax Cuts and Jobs Act” (the "TCJA"), generally effective for taxable years beginning after December 31, 2017. The TCJA is complex and includes significant amendments to the Internal Revenue Code of 1986, as amended (the “Code”), including amendments that significantly change the taxation of offshore earnings and the deductibility of interest. We are currently assessing the impact of the TCJA on our business and consolidated financial statements.

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***Uncertainties in the interpretation and application of the 2017 Tax Cuts and Jobs Act could materially affect our tax obligations and effective tax rate.***

The TCJA was enacted on December 22, 2017, and significantly affected U.S. tax law by changing how the U.S. imposes income tax on multinational corporations. The U.S. Department of Treasury has broad authority to issue regulations and interpretative guidance that may significantly impact how we will apply the law and impact our results of operations in the period issued.

The TCJA requires complex computations not previously provided in U.S. tax law. As such, the application of accounting guidance for such items is currently uncertain. Further, compliance with the TCJA and the accounting for such provisions require accumulation of information not previously required or regularly produced. As a result, we have provided a provisional estimate on the effect of the TCJA in our financial statements. As additional regulatory guidance is issued by the applicable taxing authorities, as accounting treatment is clarified, as we perform additional analysis on the application of the law, and as we refine estimates in calculating the effect, our final analysis, which will be recorded in the period completed, may be different from our current provisional amounts, which could materially affect our tax obligations and effective tax rate.

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

A key component of our business strategy includes strengthening our competitive position and refining the customer experience on our websites and mobile applications through internal development. However, from time to time, we may selectively pursue acquisitions of complementary businesses. The identification of suitable acquisition candidates can be time-consuming and expensive, and we may not be able to successfully complete identified acquisitions. Furthermore, even if we successfully complete an acquisition, we may not achieve the anticipated benefits and synergies we expect due to a number of factors including the loss of management focus on and the diversion of resources from existing businesses; difficulty retaining key personnel of the acquired company; cultural challenges associated with integrating employees from an acquired company into our organization; difficulty integrating acquired technologies into our existing systems; entry into a business or industry with which we have historically had little experience; difficulty and increased costs of integrating data systems; the need to implement or remediate the controls, procedures or policies of the acquired company; and increased risk of litigation. While we have actively sought to control increases in costs that may stem from such acquisitions, there can be no assurance that we will succeed in limiting future cost increases. Failure to achieve the anticipated benefits of such acquisitions or the incurrence of debt, contingent liabilities, amortization expenses, or write-offs of goodwill in connection with such acquisitions could harm our operating results.

***International expansion would 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 may in the future decide to expand into international industries 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 industry 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 industries. We do not have experience establishing, acquiring or operating such facilities overseas. We may not be successful in expanding into any international industries or in generating revenue from foreign operations. In addition, different privacy, censorship and liability standards and regulations and different intellectual property laws in foreign countries may result in additional expenses, diversion of resources, including the attention of our management team.

*We are subject to the risks of owning real property.*

We own real property as of the acquisition of Lifetouch, including the land and buildings at ten of the Lifetouch facilities. The ownership of real property subjects us to risks, including: the possibility of environmental contamination and the costs associated with fixing any environmental problems and the risk of damages resulting from such contamination; adverse changes in the value of the property due to interest rate changes, changes in the neighborhood in which the property is located or other factors; ongoing maintenance expenses and costs of improvements; the possible need for structural improvements in order to comply with zoning, seismic, disability act or other requirements; and possible disputes with neighboring owners or others.

**Risks Related to Our Common Stock**

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***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. In addition, our stock price increased significantly after we announced our intention to acquire Lifetouch. Factors that could cause our stock price to fluctuate include:

- failure to realize the anticipated benefits from the planned Lifetouch acquisition after it has closed;
- slow economic growth, and market conditions or trends in our industry or the macro-economy as a whole;
- worldwide economic and market trends and conditions;
- 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 those projections or our failure to meet those projections;
- the potential impact of the current U.S. political climate on consumer spending;
- the loss of key personnel;
- 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 or debt rating agencies;
- business disruptions and costs related to shareholder activism;
- 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, acquisitions or capital commitments;
- introduction of technologies or product enhancements that reduce the need for our products;
- 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.

***We may be obligated to issue additional shares of common stock pursuant to outstanding warrants that we issued in connection with our Senior Convertible Senior Notes that were retired in May 2018.***

In connection with the issuance of our Senior Convertible Senior Notes that were retired in May 2018 (the "Notes"), we sold warrants to purchase shares of our common stock. The warrants could have a dilutive effect to the extent that the market price per share of our common stock exceeds the strike price of the warrants, which is \$83.1775.

***Provisions of 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 president and chief executive officer or a majority of our board of directors are 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.

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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.

***Our stock repurchase program could affect the price of our common stock and increase volatility and may be suspended or terminated at any time, which may result in a decrease in the trading price of our common stock.***

In April of 2017, our board of directors approved an increase to the share repurchase program of up to \$140.0 million in addition to amounts remaining under the board's prior authorizations. Through September 30, 2018, we have repurchased \$533.2 million in stock under our total authorized amount of \$646.0 million. The timing and actual number of shares repurchased will depend on a variety of factors including the timing of open trading windows, price, corporate and regulatory requirements, an assessment by management and our board of directors of cash availability and other market conditions. The stock repurchase program may be suspended or discontinued at any time without prior notice. In January 2018, we publicly announced that we suspended our stock repurchase program for an undetermined period of time as we are committed to de-levering. Future repurchases pursuant to our stock repurchase program could affect the price of our common stock and increase its volatility. The existence of our stock repurchase program could also cause the price of our common stock to be higher than it would be in the absence of such a program and could potentially reduce the market liquidity for our common stock. Additionally, repurchases under our stock repurchase program will diminish our cash reserves, which could impact our ability to further develop our technology, access and/or retrofit additional facilities and service our indebtedness. There can be no assurance that any stock repurchases will enhance stockholder value because the market price of our common stock may decline below the levels at which we repurchased such shares. Any failure to repurchase shares after we have announced our intention to do so may negatively impact our reputation and investor confidence in us and may negatively impact our stock price. Although our stock repurchase program is intended to enhance long-term stockholder value, short-term stock price fluctuations could reduce the program's effectiveness.

***We do not intend to pay dividends on our common stock for the foreseeable future.***

We have never declared or paid cash dividends on our common stock. In addition, we must comply with the covenants in our credit facilities if we want to pay cash dividends. We currently intend to retain our future earnings, if any, to finance the further development and expansion of our business and do not intend to pay cash dividends in the foreseeable future. Any future determination to pay dividends will be at the discretion of our board of directors and will depend upon our financial condition, results of operations, capital requirements, restrictions contained in current or future financing instruments and such other factors as our board of directors deems relevant.

**Risks Related to Our Credit Agreement**

***Our indebtedness could adversely affect our financial condition and our ability to raise additional capital to fund our operations and limit our ability to react to changes in the economy or our industry.***

On April 2, 2018, in connection with our acquisition of Lifetouch, we incurred substantial indebtedness pursuant to an incremental term loan facility (the "Incremental Term Loan Facility") in an aggregate principal amount of \$825.0 million. The incremental term loan facility is an amendment of our initial term loan facility of \$300.0 million dated as of August 17, 2017 (collectively, the "Credit Agreement"). The Incremental Term Loan Facility was fully funded at close. The Credit Agreement will mature on August 17, 2024 and requires quarterly principal payments, as well as mandatory prepayments as a result of assets sales or excess cash flow, with the balance payable at maturity.

Our substantial indebtedness could have important consequences to us including:

- increasing our vulnerability to adverse general economic and industry conditions;
- requiring us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital expenditures, research and development efforts, execution of our business strategy, acquisitions and other general corporate purposes;
- limiting our flexibility in planning for, or reacting to, changes in the economy and our industry;
- our ability to refinance our debt;
- exposing us to interest rate risk to the extent of our variable rate indebtedness; and

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- making it more difficult to borrow additional funds in the future to fund growth, acquisitions, working capital, capital expenditures and other purposes.

The Credit Agreement contains customary events of default upon the occurrence of which, after any applicable grace period, the lenders would have the ability to immediately declare the loans due and payable in whole or in part. In such event, we may not have sufficient available cash to repay such debt at the time it becomes due, or be able to refinance such debt on acceptable terms or at all. Any of the foregoing could materially and adversely affect our financial condition and results of operations.

We receive debt ratings from the major credit rating agencies in the United States. Factors that may impact our credit ratings include debt levels, leverage ratios, planned asset purchases or sales and near-term and long-term production growth opportunities. Liquidity, asset quality, cost structure, reserve mix and commodity pricing levels could also be considered by the rating agencies. A ratings downgrade could adversely impact our ability to access debt markets in the future and increase the cost of current or future debt and may adversely affect our share price.

***Our Credit Agreement imposes restrictions on our business.***

The Credit Agreement contains a number of covenants imposing restrictions on our business. These restrictions may affect our ability to operate our business and may limit our ability to take advantage of potential business opportunities as they arise. The restrictions, among other things, restrict our ability to create or incur certain liens, incur or guarantee additional indebtedness, merge or consolidate with other companies, payment of dividends, transfer or sell assets and make restricted payments. These restrictions are subject to a number of limitations and exceptions set forth in the Credit Agreement. Our ability to meet the liquidity covenant may be affected by events beyond our control.

The foregoing restrictions could limit our ability to plan for, or react to, changes in market conditions or our capital needs. We do not know whether we will be granted waivers under, or amendments to, our Credit Agreement if for any reason we are unable to meet these requirements, or whether we will be able to refinance our indebtedness on terms acceptable to us, or at all.

***Servicing our debt requires a significant amount of cash, and we may not have sufficient cash flow from our business to pay our substantial debt.***

Our ability to make scheduled payments of the principal of, to pay interest on, and to refinance our debt, depends on our future performance, which is subject to financial, competitive, economic, and other factors beyond our control. Our business may not continue to generate cash flow from operations in the future sufficient to make necessary capital expenditures or to satisfy our obligations under the Credit Agreement and any future indebtedness that we may incur. If we are unable to generate such cash flow, we may be required to adopt one or more alternatives, such as reducing or delaying investments or capital expenditures, selling assets, refinancing or obtaining additional equity capital on terms that may be onerous or highly dilutive. We may not be able to engage in any of these activities or engage in these activities on desirable terms when needed, which could result in a default on our indebtedness.

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

**Issuer Purchases of Equity Securities**

The Company suspended its share repurchase program as of December 31, 2017 having publicly committed to maintaining a BB rating profile and repaying the acquisition debt accordingly.

As of September 30, 2018, approximately \$112.8 million remained available for stock repurchases pursuant to our stock repurchase program.

**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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Table of Contents**ITEM 6. EXHIBITS**

| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 10.01                 | <u>Performance-Based Restricted Stock Unit Award for Christopher North</u>   |
| 10.02                 | <u>Performance-Based Restricted Stock Unit Award for Michael Meek</u>  |
| 31.01                 | <u>Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).</u>  |
| 31.02                 | <u>Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).</u>  |
| 32.01                 | <u>Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*</u>  |
| 32.02                 | <u>Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*</u>  |
| 101                   | The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated |

Balance Sheets, (ii)  
Condensed  
Consolidated  
Statements of  
Operations, (iii)  
Condensed  
Consolidated  
Statements of  
Comprehensive  
Income/(Loss), (iv)  
Condensed  
Consolidated  
Statements of Cash  
Flows, and (v) 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, as amended, 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, as amended, or the Securities Exchange Act of 1934, as amended, 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: /s/  
November 7, 2018 By: Christopher North  
Christopher North  
President and Chief Executive Officer  
(Principal Executive Officer)

Dated: /s/ Michael Pope  
November 7, 2018 By: Pope  
Michael Pope  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)