

SHUTTERFLY INC  
Form 10-Q  
November 04, 2016

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, 2016

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 Incorporation or Organization) (IRS Employer Identification No.)

2800 Bridge Parkway  
Redwood City, California 94065  
(Address of Principal Executive Offices) (Zip Code)

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

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).

Yes ☒ No ☐

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

Large accelerated Filer ☒ Accelerated Filer ☐

Non-accelerated Filer ☐ Smaller reporting company ☐

(Do not check if a smaller reporting company)

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

Yes ☐ No ☒

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

Class	Outstanding as at November 2, 2016
Common stock, \$0.0001 par value per share	33,945,139

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## PART I — FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## SHUTTERFLY, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)

(Unaudited)

	September 30, 2016	December 31, 2015
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 60,212	\$ 288,863
Short-term investments	32,643	22,918
Accounts receivable, net	44,759	55,222
Inventories	11,351	13,466
Prepaid expenses and other current assets	90,047	31,828
Total current assets	239,012	412,297
Long-term investments	16,114	29,005
Property and equipment, net	292,782	281,779
Intangible assets, net	47,501	62,323
Goodwill	408,975	408,975
Other assets	13,554	10,948
Total assets	\$ 1,017,938	\$ 1,205,327
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 17,865	\$ 35,329
Accrued liabilities	88,233	149,134
Deferred revenue, current portion	22,082	27,329
Total current liabilities	128,180	211,792
Convertible senior notes, net	275,108	264,361
Other liabilities	137,603	123,112
Total liabilities	540,891	599,265
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Common stock, \$0.0001 par value; 100,000 shares authorized; 33,865 and 34,777 shares issued and outstanding on September 30, 2016 and December 31, 2015, respectively	3	4
Additional paid-in capital	937,026	900,218
Accumulated other comprehensive income (loss)	24	(68 )
Accumulated deficit	(460,006 )	(294,092 )
Total stockholders' equity	477,047	606,062
Total liabilities and stockholders' equity	\$ 1,017,938	\$ 1,205,327

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)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net revenues	\$187,328	\$167,492	\$572,998	\$511,349
Cost of net revenues	117,754	107,991	336,069	299,345
Gross profit	69,574	59,501	236,929	212,004
Operating expenses:				
Technology and development	43,284	38,066	122,866	111,928
Sales and marketing	41,903	43,052	135,284	138,028
General and administrative	26,181	27,449	83,462	85,730
Total operating expenses	111,368	108,567	341,612	335,686
Loss from operations	(41,794 )	(49,066 )	(104,683 )	(123,682 )
Interest expense	(5,726 )	(5,613 )	(17,062 )	(15,334 )
Interest and other income, net	130	433	379	655
Loss before income taxes	(47,390 )	(54,246 )	(121,366 )	(138,361 )
Benefit from (provision for) income taxes	18,235	(8,831 )	46,290	6,404
Net loss	\$(29,155 )	\$(63,077 )	\$(75,076 )	\$(131,957)
Net loss per share - basic and diluted	\$(0.86 )	\$(1.73 )	\$(2.19 )	\$(3.54 )
Weighted-average shares outstanding - basic and diluted	33,932	36,369	34,235	37,291
Stock-based compensation is allocated as follows (Note 2):				
Cost of net revenues	\$1,131	\$952	\$3,436	\$3,145
Technology and development	2,725	2,443	5,696	7,744
Sales and marketing	3,664	5,329	11,697	17,202
General and administrative	4,694	7,032	12,459	21,740

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)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net loss	\$(29,155)	\$(63,077)	\$(75,076)	\$(131,957)
Other comprehensive income (loss), net of reclassification adjustments:				
Unrealized gains (losses) on investments, net	(59	) 31	149	134
Tax benefit (expense) on unrealized gain / loss on investments, net	23	(12	) (57	) (51
Other comprehensive income (loss), net of tax	(36	) 19	92	83
Comprehensive loss	\$(29,191)	\$(63,058)	\$(74,984)	\$(131,874)

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

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## SHUTTERFLY, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net loss	\$(75,076)	\$(131,957)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	69,314	63,435
Amortization of intangible assets	15,744	20,798
Amortization of debt discount and transaction costs	10,747	10,163
Stock-based compensation	33,288	49,831
Loss on disposal of property and equipment	378	1,475
Deferred income taxes	5,786	(14,414 )
Tax benefit from stock-based compensation	263	13,041
Excess tax benefits from stock-based compensation	(886 )	(13,666 )
Changes in operating assets and liabilities:		
Accounts receivable	10,463	(17,797 )
Inventories	2,115	1,406
Prepaid expenses and other assets	(61,113 )	(12,146 )
Accounts payable	(15,105 )	(14,157 )
Accrued and other liabilities	(67,806 )	(63,712 )
Net cash used in operating activities	(71,888 )	(107,700 )
Cash flows from investing activities:		
Purchases of property and equipment	(43,733 )	(46,448 )
Capitalization of software and website development costs	(27,136 )	(15,448 )
Purchases of investments	(21,891 )	(4,400 )
Proceeds from the maturities and sales of investments	25,070	52,460
Proceeds from sale of property and equipment	14,071	1,128
Acquisition of business and intangible assets, net of cash acquired	—	(127 )
Net cash used in investing activities	(53,619 )	(12,835 )
Cash flows from financing activities:		
Proceeds from issuance of common stock upon exercise of stock options	1,935	2,670
Repurchases of common stock	(90,837 )	(134,084 )
Prepayment of accelerated share repurchase	—	(75,000 )
Refund of accelerated share repurchase	—	38,179
Excess tax benefits from stock-based compensation	886	13,666
Principal payments of capital lease and financing obligations	(15,128 )	(8,988 )
Net cash used in financing activities	(103,144 )	(163,557 )
Net decrease in cash and cash equivalents	(228,651 )	(284,092 )
Cash and cash equivalents, beginning of period	288,863	380,543
Cash and cash equivalents, end of period	\$60,212	\$96,451
Supplemental schedule of non-cash investing / financing activities:		
Net decrease in accrued purchases of property and equipment	\$(1,274 )	\$(154 )
Net increase (decrease) in accrued capitalized software and website development costs	(97 )	363
Stock-based compensation capitalized with software and website development costs	1,322	1,001

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Increase in estimated fair market value of buildings under build-to-suit leases	—	17,161
Property and equipment acquired under capital leases	23,946	29,097

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



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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — The Company and Summary of Significant Accounting Policies

Shutterfly, Inc., (the “Company” or “Shutterfly”) was incorporated in the state of Delaware in 1999 and began its services in December 1999. The Company is the leading manufacturer and digital retailer of high-quality personalized products and services offered through a family of lifestyle brands. The Company provides customers a full range of products and services to organize and archive digital images; share pictures; order prints and create an assortment of personalized items such as photo books, greeting cards and stationery and calendars. Shutterfly also operates a premier online marketplace for high-quality photographic and video equipment rentals. The Company provides Enterprise services: printing and shipping of direct marketing and other variable data print products and formats. The Company's Enterprise brand is called Shutterfly Business Solutions ("SBS") and is referred to as such in this document. The Company is headquartered in Redwood City, California.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and, accordingly, do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The accompanying unaudited condensed consolidated financial statements include the accounts of Shutterfly, Inc. and its wholly owned subsidiaries. In the opinion of management, all adjustments, consisting primarily of normal recurring accruals, considered necessary for a fair statement of the Company's results of operations for the interim periods reported and of its financial condition as of the date of the interim balance sheet have been included. Operating results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016, or for any other period.

The December 31, 2015 condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2015 included in the Company's Annual Report on Form 10-K.

Recent Accounting Pronouncements

In August 2014, the FASB issued new guidance related to the disclosures around going concern. The new standard provides guidance around management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The new standard is effective for the annual period ending December 15, 2016, and for annual periods and interim periods thereafter. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

In April 2015, the FASB issued new guidance related to presentation of debt issuance costs. The new standard requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. The Company adopted this guidance beginning January 1, 2016. This guidance requires retrospective application to all prior periods presented. The effect of this change was to reduce the previously reported amounts within the accompanying condensed consolidated balance sheets as of December 31, 2015 for prepaid expenses and other current assets, other assets, and convertible senior notes, net by \$1.3 million, \$1.9 million, and \$3.3 million, respectively. Adoption of this guidance did not affect the Company's

condensed consolidated statements of operations and condensed consolidated statements of cash flows.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (ASU 2016-09). The updated guidance changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The amendments in this update are effective for reporting periods beginning after December 15, 2016. The Company plans to adopt this pronouncement beginning January 1, 2017.

In 2014, the FASB issued new accounting guidance related to revenue recognition. This new standard will replace all current GAAP guidance on this topic and eliminate 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 for those goods or services. This guidance can be applied either retrospectively to each period

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

presented or as a cumulative-effect adjustment as of the date of adoption. In 2015, the FASB issued guidance to defer the effective date to fiscal years beginning after December 15, 2017 with early adoption for fiscal years. In 2016, the FASB issued additional guidance to clarify the implementation guidance. Presently, the Company is not yet in a position to assess the application date. The Company has not yet completed its final review of the impact of this guidance, although the Company currently does not anticipate a material impact on its revenue recognition practices. The Company will continue to review variable consideration, potential disclosures, and the method of adoption to complete the evaluation of the impact on the consolidated financial statements. In addition, the Company will continue to monitor additional changes, modifications, clarifications or interpretations being undertaken by the FASB, which may impact its current conclusions.

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. The Company is evaluating the impact, if any, of adopting this new accounting guidance on its financial statements.

In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments. The new guidance clarifies the classification of certain cash receipts and cash payments in the statement of cash flows, including debt prepayment or extinguishment costs, settlement of contingent consideration arising from a business combination, insurance settlement proceeds, and distributions from certain equity method investees. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. The Company is evaluating the impact of adopting this new accounting guidance on the consolidated financial statements.

## Out-of-period Correction

In the third quarter of 2016, the Company recorded an out-of-period correction to increase revenue \$0.8 million relating to prepaid plan breakage and \$0.5 million relating to other errors. These amounts were incorrectly deferred and should have been recorded in prior periods. Management believes this correction is not material to the current period financial statements or any previously issued financial statements.

## Note 2 — Stock-Based Compensation

## Stock Option Activity

A summary of the Company's stock option activity for the nine months ended September 30, 2016 is as follows (share numbers and aggregate intrinsic values in thousands):

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Term (Years)	Aggregate Intrinsic Value
Balance as of December 31, 2015	206	\$ 27.08		
Granted	850	48.30		
Exercised	(93 )	20.69		
Forfeited, cancelled or expired	(4 )	42.94		
Balance as of September 30, 2016	959	\$ 46.44	6.3	\$ 1,633
Options vested and expected to vest at September 30, 2016	959	\$ 46.44	6.3	\$ 1,633

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Options vested at September 30, 2016	108	\$ 31.95	3.3	\$ 1,623
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During the nine months ended September 30, 2016, the Company granted options to the Chief Executive Officer to purchase an aggregate of 850,000 shares of common stock at a exercise price of \$48.30, with an estimated weighted-average grant-date fair value of \$13.50. The total intrinsic value of options exercised during the three months ended September 30, 2016 and 2015 was \$1.9 million and \$0.7 million, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2016 and 2015 was \$2.6 million and \$3.6 million, respectively.

Net cash proceeds from the exercise of stock options for the three months ended September 30, 2016 and 2015 were \$1.2 million and \$0.4 million, respectively. Net cash proceeds from the exercise of stock options for the nine months ended September 30, 2016 and 2015 were \$1.9 million and \$2.7 million, respectively.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## 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 had 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.

## Restricted Stock Unit Activity

The Company grants restricted stock units ("RSUs") to its employees under the provisions of the 2015 Plan and inducement awards to certain new employees upon hire in accordance with NASDAQ Listing Rule 5635(c)(4). The cost of RSUs is determined using the fair value of the Company's common stock on the date of grant. RSUs typically vest and are settled annually, based on a 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 for the nine months ended September 30, 2016, is as follows (share numbers in thousands):

	Number of Units Outstanding	Weighted Average Grant Date Fair Value
Awarded and unvested as of December 31, 2015	3,150	\$ 44.28
Granted	1,261	41.73
Vested	(1,056)	) 43.69
Forfeited	(292)	) 45.07
Awarded and unvested as of September 30, 2016	3,063	\$ 43.36
RSUs expected to vest after September 30, 2016	2,493	

Included in the RSU grants for the nine months ended September 30, 2016, are 185,000 performance-based RSUs ("PBRsUs") that have both performance criteria tied to the Company's 2016 financial performance and four year service criteria. Compensation cost associated with these PBRsUs is recognized on an accelerated attribution model and ultimately based on whether or not satisfaction of the performance criteria is probable. If in the future, situations indicate that the performance criteria are not probable, then no further compensation cost will be recorded and any previous costs will be reversed.

Employee stock-based compensation expense recognized in the three and nine months ended September 30, 2016 and 2015, 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, 2016, the Company had \$94.6 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 three years.

Note 3 — 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, conversion of warrants, and the impact of convertible senior notes.

A summary of the net loss per share for the three and nine months ended September 30, 2016 and 2015 is as follows (in thousands, except per share amounts):

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net loss per share:				
Numerator				
Net loss	\$(29,155)	\$(63,077)	\$(75,076)	\$(131,957)
Denominator for basic and diluted net loss per share				
Weighted-average common shares outstanding	33,932	36,369	34,235	37,291
Net loss per share - basic and diluted	\$(0.86 )	\$(1.73 )	\$(2.19 )	\$(3.54 )

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Stock options and restricted stock units	3,923	3,330	3,666	3,457

## Note 4 — Investments

At September 30, 2016 and December 31, 2015, the estimated fair value of short-term and long-term investments classified as available for sale are as follows (in thousands):

	September 30, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Short-term investments				
Corporate debt securities	\$ 15,074	\$ 4	\$ (4 )	\$ 15,074
Agency securities	10,750	16	—	10,766
Commercial paper	3,399	—	—	3,399
US Government securities	3,398	6	—	3,404
Total short-term investments	\$ 32,621	\$ 26	\$ (4 )	\$ 32,643
Long-term investments				
Corporate debt securities	\$ 6,599	\$ 4	\$ (5 )	\$ 6,598
Agency securities	6,373	11	(1 )	6,383
US Government securities	3,126	7	—	3,133
Total long-term investments	\$ 16,098	\$ 22	\$ (6 )	\$ 16,114



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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Short-term investments				
Corporate debt securities	\$16,187	\$ 2	\$ (14 )	\$ 16,175
Agency securities	6,246	—	(2 )	6,244
Commercial paper	499	—	—	499
Total short-term investments	\$22,932	\$ 2	\$ (16 )	\$ 22,918
Long-term investments				
Corporate debt securities	\$10,132	\$ —	\$ (37 )	\$ 10,095
Agency securities	13,421	1	(43 )	13,379
US Government securities	5,549	—	(18 )	5,531
Total long-term investments	\$29,102	\$ 1	\$ (98 )	\$ 29,005

The Company had no short-term or long-term investments that have been in a continuous unrealized loss position for more than 12 months as of September 30, 2016 and no impairments were recorded in the period. The Company had no material realized gains or losses during the nine months ended September 30, 2016.

The following table summarizes the contractual maturities of the Company's investments as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, December 31,	
	2016	2015
One year or less	\$ 32,643	\$ 22,918
One year through three years	16,114	29,005
	\$ 48,757	\$ 51,923

Actual maturities may differ from the contractual maturities because borrowers may have certain prepayment conditions.

## Note 5 — 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, 2016.

The following table summarizes, by major security type, the Company's cash equivalents and investments that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy (in thousands):

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Total Estimated Fair Value as of			
	September 30, 2016		December 31, 2015	
	Cash Equivalents	Investments	Cash Equivalents	Investments
Level 1 Securities:				
Money market funds	\$20,808	\$ —	\$24,577	\$ —
Level 2 Securities:				
Corporate debt securities	—	21,672	850	26,270
Agency securities	—	17,149	—	19,623
US Government securities	—	6,537	—	5,531
Commercial Paper	—	3,399	—	499
Total cash equivalents and investments	\$20,808	\$ 48,757	\$25,427	\$ 51,923

## Convertible Senior Notes

As of September 30, 2016, the fair value of the convertible senior notes, 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 our stock price, interest rates and credit spread (Level 2) were as follows (in thousands):

	Total Estimated Fair Value as of	
	September 30, 2016	December 31, 2015
Convertible senior notes	\$284,796	\$ 270,192

The carrying value of other financial instruments, including accounts receivable, accounts payable and other payables, approximates fair value due to their short maturities.

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## Note 6 — Balance Sheet Components

## Prepaid Expenses and Other Current Assets

	September 30, 2016	December 31, 2015
	(in thousands)	
Intra-period income tax asset	\$52,787	\$ —
Prepaid service contracts	8,883	12,539
Other prepaid expenses and current assets	28,377	19,289
	\$90,047	\$ 31,828

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

	September 30, 2016	December 31, 2015
	(in thousands)	
Computer equipment and software	\$183,918	\$ 172,048
Manufacturing equipment	182,977	148,820
Capitalized software and website development costs	133,197	108,837
Buildings under build-to-suit leases	56,468	56,468
Leasehold improvements	22,456	21,519
Rental equipment	18,604	17,414
Furniture and fixtures	11,762	11,351
	609,382	536,457
Less: Accumulated depreciation and amortization	(316,600 )	(254,678 )
Net property and equipment	\$292,782	\$ 281,779

Included within manufacturing equipment is approximately \$90.0 million and \$72.9 million of capital lease obligations for various pieces of manufacturing facility equipment as of September 30, 2016 and December 31, 2015, respectively. Accumulated depreciation of assets under capital lease totaled \$21.2 million at September 30, 2016 compared to \$14.1 million at December 31, 2015.

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 \$23.0 million and \$22.6 million for the three months ended September 30, 2016 and 2015, respectively. Depreciation and amortization expense totaled \$69.3 million and \$63.4 million for the nine months ended September 30, 2016 and 2015, respectively.

Included in property and equipment is approximately \$12.7 million and \$17.2 million of assets in construction as of September 30, 2016 and December 31, 2015, respectively, the majority of which relates to internal-use software.

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## Accrued Liabilities

	September 30, 2016	December 31, 2015
	(in thousands)	
Accrued production costs	\$21,613	\$ 44,825
Accrued compensation	16,658	20,703
Capital lease obligations, current portion	15,971	14,090
Accrued marketing expenses	7,623	26,793
Accrued income and sales tax	3,938	17,843
Accrued other	22,430	24,880
	\$88,233	\$ 149,134

## Other Liabilities

	September 30, 2016	December 31, 2015
	(in thousands)	
Financing obligations	\$55,736	\$ 56,771
Capital lease obligations, non-current portion	54,263	44,428
Deferred tax liability	18,789	12,447
Deferred revenue, non-current portion	5,641	6,564
Other liabilities	3,174	2,902
	\$137,603	\$ 123,112

Financing obligations represents the build-to-suit leases for the Company's manufacturing facilities in Fort Mill, South Carolina; Shakopee, Minnesota; and Tempe, Arizona.

## Note 7 — Convertible Senior Notes

## 0.25% Convertible Senior Notes Due May 15, 2018

In May 2013, the Company issued \$300.0 million aggregate principal amount of 0.25% convertible senior notes (the "Notes") due May 15, 2018, unless earlier purchased by the Company or converted. Interest is payable semiannually in arrears on May 15 and November 15 of each year, commencing on November 15, 2013.

The Notes are governed by an Indenture between the Company, as issuer, and Wells Fargo Bank, National Association, as trustee. The Notes are unsecured and rank senior in right of payment to the Company's future indebtedness that is expressly subordinated in right of payment to the Notes and rank equal in right of payment to the Company's existing and future liabilities that are not so subordinated and are effectively subordinated in right of payment to any of the Company's cash equal to the principal amount of the Notes, and secured indebtedness to the extent of the value of the assets securing such indebtedness and are structurally subordinated to all existing and future indebtedness and liabilities incurred by the Company's subsidiaries.

Upon conversion, the Company will pay or deliver, as the case may be, cash, shares of the Company's common stock or a combination of cash and shares of common stock, at the Company's election.

The initial conversion rate is 15.5847 shares of common stock per \$1,000 principal amount of Notes. The initial conversion price is \$64.17 per share of common stock. Throughout the term of the Notes, the conversion rate may be adjusted upon the occurrence of certain events. Holders of the Notes will not receive any cash payment representing accrued and unpaid interest upon conversion of a Note. Accrued but unpaid interest will be deemed to be paid in full upon conversion rather than cancelled, extinguished or forfeited. Holders may convert their Notes only under the following circumstances:

during any calendar quarter commencing after the calendar quarter ending on September 30, 2013 (and only during such calendar quarter), if the last reported sale price of the Company's common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day;

during the five business day period after any ten consecutive trading day period (the "Notes Measurement Period") in which the "trading price" (as the term is defined in the Indenture) per \$1,000 principal amount of notes for each trading day of such Notes Measurement Period was less than 98% of the product of the last reported sale price of the Company's common stock on such trading day and the conversion rate on each such trading day;

upon the occurrence of specified corporate events; or

at any time on or after December 15, 2017 until the close of business on the second scheduled trading immediately preceding the maturity date.

As of September 30, 2016, the Notes are not yet convertible.

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") is amortized to interest expense over the term of the Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

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, are being 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.

The Notes consist of the following (in thousands):

	September 30, December 31, 2016 2015	
Liability component:		
Principal	\$ 300,000	\$ 300,000
Less: debt issuance costs, debt discount, net of amortization (1)	(24,892 )	(35,639 )
Net carrying amount	\$ 275,108	\$ 264,361
Equity component (2)	\$ 63,510	\$ 63,510

(1) In April 2015, the FASB issued new guidance related to presentation of debt issuance costs. Effective January 1, 2016 the Company has adopted the guidance and applied it on a retrospective basis.

(2) 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):

	Three Months Ended September 30, 2016 2015		Nine Months Ended September 30, 2016 2015	
0.25% coupon	\$188	\$188	\$562	\$563
Amortization of debt issuance costs	332	314	982	929
Amortization of debt discount	3,300	3,120	9,765	9,233

\$3,820 \$3,622 \$11,309 \$10,725

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## 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 will expire upon maturity of the Notes. The Note Hedge is 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.

## Warrant

Separately, in May 2013, the Company entered into warrant transactions (the "Warrant"), whereby the Company sold warrants to acquire shares of the Company's common stock at a strike price of \$83.18 per share. The Company received aggregate proceeds of \$43.6 million from the sale of the Warrant. If the average market value per share of the Company's 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 8 — Share Repurchase Program

On October 24, 2012, the Company's Board of Directors 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, 2016, the Company's Board of Directors has approved increases to the program on the following dates:

• On February 6, 2014, the Company's Board of Directors approved an increase of \$100.0 million in addition to any amounts repurchased as of that date.

• On February 9, 2015, the Company's Board of Directors approved an increase of \$300.0 million in addition to any amounts repurchased as of that date.

• On April 21, 2016, the Company's Board of Directors approved an increase of \$100.0 million in addition to any amounts repurchased as of that date.

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 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 2014, 2015, and 2016:

Period <sup>(1)</sup>	Total Number of Shares Purchased	Average Price Paid per Share	Total Dollar Value Spent on Repurchases (in thousands)
2014 Repurchases	1,961,085	\$ 45.29	\$ 88,815
2015 Repurchases <sup>(2)</sup>	4,907,675	\$ 43.99	\$ 215,911



2016 Repurchases to date <sup>(3)</sup> 2,060,901 \$ 44.08 \$ 90,837

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

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(2) The Company entered into an accelerated share repurchase ("ASR") in the second quarter of 2015 under which a prepayment of \$75 million was made. Final settlement of the ASR occurred on August 3, 2015, resulting in the delivery to the Company of 0.8 million shares of the Company's common stock and a return of cash for the remaining amount not settled in shares of \$38.2 million. In total, approximately 0.8 million shares of common stock were repurchased under the ASR for \$36.8 million, resulting in an average price paid per share of \$46.49 under the ASR.

(3) Represents repurchases for the nine months ended September 30, 2016.

Note 9 — 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.

The Chief Operating Decision Maker ("CODM") function uses gross profit to evaluate the performance of the segments and allocate resources. Management considers gross margin to be the appropriate metric to evaluate and compare the ongoing performance of each reportable segment as it is the level which direct costs associated with the performance of the segment are monitored. Cost of revenue for the Consumer segment consists of costs directly attributable to the production of personalized products for all of the Company's brands, including direct materials, shipping charges, and payroll and related expenses for direct labor; rent for production facilities, and depreciation of production equipment and facilities where the Company is the deemed owner. Cost of net revenues for the SBS segment consists of costs which are direct and incremental to the SBS segment. These include production costs of SBS products, such as materials, labor and printing costs and costs associated with third-party production of goods. They also include shipping costs and indirect overhead.

Due to the nature of the Company's operations, a majority of its assets are utilized across all segments. In addition, 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.

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

Consumer - Includes sales from the Company's brands and are derived from the sale of photo-based products, such as photo books, stationery and greeting cards, other photo-based merchandise, photo prints, statement gifts and the related shipping revenues as well as rental revenue from its BorrowLenses brand.

SBS - Includes revenues primarily from variable, direct marketing collateral manufactured and fulfilled for business customers.

In addition to the above reportable segments, the Company has a corporate category that includes activities that are not directly attributable or allocable to a specific segment. This category consists of stock-based compensation expense and amortization of intangible assets.

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SHUTTERFLY, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2016	2015	2016	2015	
<b>Consumer</b>					
Net revenues	\$144,074	\$138,025	\$476,072	\$458,087	
Cost of net revenues	84,825	82,760	256,438	246,925	
Gross profit	\$59,249	\$55,265	\$219,634	\$211,162	
Gross profit as a percentage of net revenues	41	% 40	% 46	% 46	%
<b>Shutterfly Business Solutions (SBS)</b>					
Net revenues	\$43,254	\$29,467	\$96,926	\$53,262	
Cost of net revenues	30,389	22,566	71,909	42,699	
Gross profit	\$12,865	\$6,901	\$25,017	\$10,563	
Gross profit as a percentage of net revenues	30	% 23	% 26	% 20	%
<b>Corporate</b>					
Net revenues	\$—	\$—	\$—	\$—	
Cost of net revenues	2,540	2,665	7,722	9,721	
Gross profit	\$(2,540 )	\$(2,665 )	\$(7,722 )	\$(9,721 )	
<b>Consolidated</b>					
Net revenues	\$187,328	\$167,492	\$572,998	\$511,349	
Cost of net revenues	117,754	107,991	336,069	299,345	
Gross profit	\$69,574	\$59,501	\$236,929	\$212,004	
Gross profit as a percentage of net revenues	37	% 36	% 41	% 41	%

## Note 10 — Commitments and Contingencies

## Indemnifications

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

## Contingencies

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

## Syndicated Credit Facility

On November 22, 2011, the Company entered into a credit agreement ("Credit Agreement") with J.P. Morgan Securities LLC, Wells Fargo Securities, LLC, Fifth Third Bank, Silicon Valley Bank, US Bank and Citibank, N.A. ("the Banks").

JPMorgan Chase Bank, N.A. acted as administrative agent in the Credit Agreement. The Credit Agreement is for five years and provides for a \$125.0 million senior secured revolving credit facility (the “credit facility”) and if requested by the Company, the Banks may increase the credit facility by \$75.0 million subject to certain conditions. In December 2013, the Company requested and received the entire incremental amount for a total credit facility of \$200.0 million. As part of the expansion in May 2013, Bank of America, N.A. and

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SHUTTERFLY, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Morgan Stanley Bank, N.A. joined the syndicate. From inception through September 30, 2016, the Company has not drawn on the credit facility.

At the Company's option, loans under the Facility will bear stated interest based on the Base Rate or Adjusted LIBO Rate, in each case plus the Applicable Rate (respectively, as defined in the Credit Agreement). The Base Rate will be, for any day, the highest of (a) 1/2 of 1% per annum above the Federal Funds Effective Rate (as defined in the Credit Agreement), (b) JPMorgan Chase Bank's prime rate and (c) the Adjusted LIBO Rate for a term of one month plus 1.00%. Eurodollar borrowings may be for one, two, three or six months (or such period that is 12 months or less, requested by Intersil and consented to by all the Lenders) and will be at an annual rate equal to the period-applicable Eurodollar Rate plus the Applicable Rate. The Applicable Rate for all revolving loans is based on a pricing grid ranging from 0.05% to 1.25% per annum for Base Rate loans and 1.50% to 2.25% for Adjusted LIBO Rate loans based on the Company's Leverage Ratio (as defined in the Credit Agreement).

On May 10, 2013, the Company amended the Credit Agreement by and among the Company and the Banks to (i) permit the issuance of the Notes and the related Note Hedge and Warrant, (ii) amend certain of the restrictive covenants set forth in the Credit Agreement, (iii) increase the Leverage Ratio (as defined the Credit Agreement) to be maintained by the Company to be at or below 3.50 to 1.00, and (iv) add a covenant requiring that the Company not permit its Senior Secured Leverage Ratio (as defined in the Credit Agreement) to exceed 1.60 to 1.00. Unchanged from the initial credit agreement, the Credit Agreement contains customary representations and warranties, affirmative and negative covenants, and events of default. Also, the Company may not permit the ratio of its Consolidated EBITDA for any period of four consecutive fiscal quarters to its interest and rental expense and the amount of scheduled principal payments on long-term debt, for the same period, to be less than 2.50 to 1.00.

On June 10, 2016, the Company renewed the Credit Agreement with the Banks. As part of this renewal, Fifth Third Bank, Silicon Valley Bank, US Bank and Citibank, N.A. left the syndicate and SunTrust Bank and BMO Harris Bank N.A. joined the syndicate. The Credit Agreement is for five years and provides for a \$200.0 million senior secured revolving credit facility. As part of the renewal, the Company amended the Credit Agreement by and among the Company and the Banks to increase the Leverage Ratio (as defined the Credit Agreement) to be maintained by the Company to be at or below 3.50 to 1.00 for the fiscal quarter ended June 30, 2016 through March 31, 2017, at or below 3.25 to 1.00 for the fiscal quarter ending June 30, 2017 through March 31, 2018, and at or below 3.00 to 1.00 for the fiscal quarter ended June 30, 2018 and thereafter. Unchanged from the initial credit agreement, the Credit Agreement contains customary representations and warranties, affirmative and negative covenants, and events of default. Also, the Company may not permit the ratio of its Consolidated EBITDA for any period of four consecutive fiscal quarters to its interest and rental expense and the amount of scheduled principal payments on long-term debt, for the same period, to be less than 2.50 to 1.00. As of September 30, 2016, the Company is in compliance with these covenants.

Amounts repaid under the Facility may be reborrowed. The revolving loan facility matures on the fifth anniversary of its closing and is payable in full upon maturity. The Company intends to use the new Facility from time to time for general corporate purposes, working capital and potential acquisitions.

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 proceedings, it is not possible to estimate the possible loss or losses from each of these proceedings. The final resolution of these proceedings,

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 our business or other developments rendering them, in our judgment, no longer material to our business, financial position or results of operations.

The State of Delaware v. Shutterfly, Inc.

On May 1, 2014, the state of Delaware filed a complaint against the Company for alleged violations of the Delaware False Claims and Reporting Act, 6 Del C. § 1203(b)(2). The complaint asserts that the Company 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 believes the suit is without merit.

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

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

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report, including the following Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are based upon our current expectations. These forward-looking statements include statements related to our business strategy and plans, restructuring activities, technology initiatives, the seasonality of and growth of our business, 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 capital expenditures for 2016, the sufficiency of our cash and cash equivalents and cash generated from operations for the next 12 months, our operating expenses remaining a consistent percentage of our net revenues, our manufacturing capabilities, our new production facilities, effective tax rates, outstanding convertible senior notes, stock repurchase program 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 "believe," "anticipate," "expect," "estimate," "intend," "seek," "continue," "should," "would," "could," "will," or "may," or the negative of these terms or comparable terminology. Forward-looking statements involve risks and uncertainties. Our actual results and the timing of events could differ materially from those anticipated in our forward-looking statements as a result of many factors, including but not limited to, economic downturns and the general state of the economy; changes in consumer discretionary spending as a result of the macroeconomic environment; competition, which could lead to pricing pressure; our ability to expand our customer base, increase sales to existing customers and 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 and implement innovative, new products and services on a timely and cost-effective basis, including our next generation Shutterfly platform; consumer acceptance of our products and services; our ability to successfully acquire businesses and technologies and to successfully integrate and operate these acquired businesses and technologies; our ability to achieve and maintain expected benefits of our partnerships; our ability to develop additional adjacent lines of business; unforeseen changes in expense levels; and our ability to timely upgrade and develop our infrastructure and facilities and the other risks set forth below under "Risk Factors" in Part II, Item 1A of this report. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. We assume no obligation to update any of the forward-looking statements after the date of this report or to compare these forward-looking statements to actual results.

Overview

We are the leading manufacturer and digital retailer of high-quality personalized products and services offered through a family of lifestyle brands. Our vision is to make the world a better place by helping people share life's joy. Our mission is to build an unrivaled service that enables deeper, more personal relationships between our customers and those who matter most in their lives. Our primary focus is on helping consumers manage their memories through the powerful medium of photography. We provide a full range of personalized photo-based products and services that make it easy, convenient and fun for consumers to upload, edit, enhance, organize, find, share, create, print, and preserve their memories in a creative and thoughtful manner through our premium lifestyle brands: Shutterfly, Tiny Prints, Wedding Paper Divas, MyPublisher, BorrowLenses and Groovebook.

We generate the majority of our Consumer revenues by producing and selling professionally-bound photo books, greeting and stationery cards, personalized calendars, other photo-based merchandise and high-quality prints ranging in size from wallet-sized to jumbo-sized 20x30 enlargements. We generate the majority of our Shutterfly Business Solutions ("SBS") revenues by printing and shipping direct marketing and other variable data print products and



formats. We manufacture most of these items in our Fort Mill, South Carolina; Shakopee, Minnesota; and Tempe, Arizona production facilities. By controlling the production process in our own production facilities, we are able to produce high-quality products, innovate rapidly, maintain a favorable cost structure, and enable timely shipment to customers, even during peak periods of demand. Additionally, we sell a variety of photo-based merchandise that is currently manufactured for us by third parties, such as calendars, mugs, magnets, pillows and blankets. We generate substantially all of our revenue from sales originating in the United States and our sales cycle has historically been highly seasonal as we generate more than 50% of our total net revenues during our fiscal fourth quarter. Our 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.

We reached key milestones on our Shutterfly 3.0 initiative which is our long term vision for creating a platform and device-agnostic memory management and personalized e-commerce solution. Our goals for 2016 were two-fold: first, completing the

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migration of our most active customers to the All New Shutterfly Photos, and second, launching new Shutterfly mobile apps on iOS and Android. We delivered both of these projects in the third quarter.

Firstly, we integrated the ThisLife photo management service, referred to as the All New Shutterfly Photos, in to Shutterfly.com. In the third quarter we reached our full-year goal of migrating our most active customers to this service. We believe that our photo management service will deepen our relationship with customers by inspiring them to upload more photographs and by driving greater engagement, thereby creating more opportunities to present them with contextually relevant products. Coupled with our ability to use our machine learning capabilities to present personalized, pre-created products featuring customers' more relevant photos, we expect the All New Shutterfly Photos to drive increased sales over time. All New Shutterfly Photos customers now have the ability to view all of their photos on a timeline, organize them with albums, tags, places or favorites, identify and find people they care about in their pictures using our facial recognition technology, and easily create products from their favorite photos.

Secondly, our goal was to launch new Shutterfly mobile apps on iOS and Android. Both apps went live in September, well ahead of the fourth quarter peak season. The relaunched apps now include the ability to create and purchase cards and stationery, our largest category by annual revenue, and also feature a new, intuitive, easy-to-use creation experience that allows customers to create a card in as little as a minute. Our iOS app also adds a new photo book creation experience, where customers can create a photo book in just a few minutes. Both apps allow customers to automatically upload their photos and to easily create personalized products. The new mobile apps have been built using our new service-oriented architecture which means that the features and improvements we launch in the apps will be reusable elsewhere in Shutterfly. Over time we expect to only have one identity service, rather than building and maintaining login functionality separately across multiple websites and apps. This is a critical step forward towards reducing technical debt, enabling faster innovation, and moving to a build-once approach in which our customers across multiple brands benefit from new feature launches.

We also continue to innovate on new products and below are a few we launched in this third quarter:

• In Cards and Stationery, we introduced pop-out cards, which feature photos that pop out of the card and can be displayed long after the occasion.

• In Photo Books, we introduced standard layflat pages, featuring a hinge with new higher quality paper, allowing images on both sides of a page without a gap in the middle of the book.

Earlier this year, we launched our new Statement Gifts category on Shutterfly, leveraging the strength of the Shutterfly brand to expand our product range to personalized non-photo based gifts, increasing our ability to serve a wider range of our customers' gifting needs. In the third quarter, we expanded the Statement Gifts line to include etched glass vases, flasks, wine bags, and garden stones.

• We also expanded our Home Decor category with the launch of our exclusive Drew Barrymore collection.

On the marketing front, we have launched our major holiday season campaign spanning mobile, online, direct mail, television and other channels. In addition, we launched a multi-channel campaign featuring the All New Shutterfly Photos. Our long-standing philanthropic partnership with the Ellen DeGeneres show recently entered its fifth season, continuing to help change the lives of those in need while increasing awareness for Shutterfly. These programs along with our many partnerships and robust holiday campaign will help drive awareness and engagement in the fourth quarter.

On the SBS side, we were successful in winning follow-on contracts from our existing key clients where our ability to execute on personalized print and digital communications at scale resulted in additional programs and volumes. We continue to develop deeper relationships with our existing customer base, while carefully building our sales pipeline with a target set of high-potential prospects.

## Basis of Presentation

Net Revenues. Our net revenues are comprised of sales generated from Consumer and SBS segments.

Consumer. Our Consumer revenues include sales from all of our brands and are derived from the sale of photo-based products, such as photo books, stationery and greeting cards, other photo-based merchandise, photo prints, and the related shipping revenues as well as rental revenue from our BorrowLenses brand. Included in our photo-based merchandise are items such as mugs, iPhone cases, desktop plaques, candles, pillows, canvas prints and blankets. Photo prints consist of wallet, 4x6, 5x7, 8x10, and large format sizes. Revenue from advertising displayed on our websites is also included in Consumer revenues.

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

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In addition to the two reportable segments, we also have a corporate category that includes activities that are not directly attributable or allocable to a specific segment. This category consists of stock-based compensation and amortization of intangible assets.

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

To further understand net revenue trends in our Consumer 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 represents 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 customers have increased on an annual basis for each year since inception.

**Total Number of Orders.** We closely monitor total number of orders as a leading indicator of net revenue trends. We recognize net revenues associated with an order when the products have been shipped and all other revenue recognition criteria have been met. Orders are typically processed and shipped in approximately three business days after a customer places an order. Total number of orders has increased on an annual basis for each year since 2000, and we anticipate this trend to continue in the future.

**Average Order Value.** Average order value ("AOV") is Consumer net revenues 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, we expect that our AOV may fluctuate on an annual basis.

Our SBS segment revenues are generated from the printing and shipping of direct marketing and other variable data print products and formats.

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 revenues and operating results.

**Cost of Net Revenues.** Our cost of net revenues is split between our Consumer and SBS segments and our Corporate category.

**Consumer.** Cost of net revenues for the Consumer segment consists of costs directly attributable to the production of personalized products for all of our brands, including 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 and facilities where we are the deemed owner. Cost of net revenues also includes any third-party software or patents licensed, as well as the amortization of acquired developed

technology, capitalized website and software development costs, and patent royalties. Cost of net revenues also includes certain costs associated with facility closures and restructuring.

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

**Corporate.** Our corporate category includes activities that are not directly attributable or allocable to a specific segment. This category consists of stock-based compensation expense and amortization of intangible assets.

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

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

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

General and administrative expense includes general corporate costs, including rent for our corporate offices, insurance, depreciation on information technology equipment, and legal and accounting fees. Transaction costs are also included in general and administrative expense. In addition, general and administrative expense includes personnel expenses of employees involved in executive, finance, accounting, human resources, information technology and legal roles. Third-party payment processor and credit card fees are also included in general and administrative expense and have historically fluctuated based on revenues during the period. All of the payments we have received from our intellectual property license agreements have been included as an offset to general and administrative expense.

**Interest Expense.** Interest expense consists of interest on our convertible senior notes arising from amortization of debt discount, amortization of debt issuance costs and our 0.25% coupon payment, costs associated with our five-year syndicated credit facility that was renewed in June 2016, 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 and Israel.

## Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

#### 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.

#### Results of Operations

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

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	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net revenues	100 %	100 %	100 %	100 %
Cost of net revenues	63 %	64 %	59 %	59 %
Gross profit	37 %	36 %	41 %	41 %
Operating expenses:				
Technology and development	23 %	23 %	21 %	22 %
Sales and marketing	22 %	26 %	24 %	27 %
General and administrative	14 %	16 %	15 %	17 %
Total operating expenses	59 %	65 %	60 %	66 %
Loss from operations	(22 )%	(29 )%	(19 )%	(25 )%
Interest expense	(3 )%	(3 )%	(2 )%	(3 )%
Interest and other income, net	— %	— %	— %	— %
Loss before income taxes	(25 )%	(32 )%	(21 )%	(28 )%
Benefit from/(provision for) income taxes	10 %	(5 )%	8 %	1 %
Net loss	(15 )%	(37 )%	(13 )%	(27 )%



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## Comparison of the Three Month Periods Ended September 30, 2016 and 2015

	Three Months Ended September 30,			
	2016	2015	\$	%
			Change	Change
	(in thousands)			
Consolidated				
Net revenues	\$187,328	\$167,492	\$19,836	12 %
Cost of net revenues	117,754	107,991	9,763	9 %
Gross profit	\$69,574	\$59,501	\$10,073	17 %
Gross profit as a percentage of net revenues	37	% 36	%	

Net revenues increased \$19.8 million, or 12%, for the three months ended September 30, 2016 as compared to the same period in 2015. Cost of net revenues increased \$9.8 million, or 9%, for the three months ended September 30, 2016 as compared to the same period in 2015. As a percentage of net revenues, cost of net revenues decreased to 63% in the three months ended September 30, 2016 from 64% in the same period in 2015, which increased gross margin to 37% in the three months ended September 30, 2016 from 36% in the same period in 2015.

	Three Months Ended September 30,			
	2016	2015	\$	%
			Change	Change
	(in thousands)			
Consumer				
Net revenues	\$144,074	\$138,025	\$6,049	4 %
Cost of net revenues	84,825	82,760	2,065	2 %
Gross profit	\$59,249	\$55,265	\$3,984	7 %
Gross profit as a percentage of net revenues	41	% 40	%	

	Three Months Ended September 30,			
	2016	2015	Change	% Change
	(in thousands)			

Key Consumer Metrics				
Total Customers	3,151	3,112	39	1 %
Total Number of Orders	5,395	5,344	51	1 %
Average order value (AOV)	\$26.71	\$25.83	\$0.88	3 %

## Consumer Segment

Consumer net revenues increased \$6.0 million, or 4%, in the three months ended September 30, 2016 compared to the same period in 2015. The increase in Consumer net revenues was primarily a result of increased sales of photo gifts and mobile revenue. The increase is also reflected in the increases in customers and orders in three months ended September 30, 2016, as compared to the same period in 2015. AOV increased 3% primarily due to favorable product mix.

Consumer cost of net revenues increased \$2.1 million, or 2%, for the three months ended September 30, 2016 as compared to the same period in 2015. Consumer gross margin increased to 41% in the three months ended September 30, 2016 from 40% in the same period in 2015. The increase in Consumer gross margin percentage from the same period a year ago is primarily driven by manufacturing efficiencies, resulting from facility consolidation and manufacturing automation efficiencies.



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	Three Months Ended September 30,			
	2016	2015	\$	%
			Change	Change
	(in thousands)			
Shutterfly Business Solutions (SBS)				
Net revenues	\$43,254	\$29,467	\$13,787	47 %
Cost of net revenues	30,389	22,566	7,823	35 %
Gross profit	\$12,865	\$6,901	\$5,964	86 %
Gross profit as a percentage of net revenues	30	% 23	%	

## SBS Segment

SBS net revenues increased \$13.8 million, or 47%, in the three months ended September 30, 2016 compared to the same period in 2015. The increase in SBS net revenues is primarily due to the expansion of projects, higher revenue volumes with existing customers, and our ability to execute on personalized print and digital communications at scale resulted in additional programs and volumes.

SBS cost of net revenues increased 7.8 million, or 35%, for the three months ended September 30, 2016 as compared to the same period in 2015. SBS gross margin increased to 30% in the three months ended September 30, 2016 from 23% in the same period in 2015. The increase in SBS gross margin is primarily due to improved customer targeting and favorable product mix as a result of expansion of projects with our existing customers.

	Three Months Ended September 30,			
	2016	2015	\$	%
			Change	Change
	(in thousands)			
Corporate				
Net revenues	\$—	\$—	\$ —	— %
Cost of net revenues	2,540	2,665	(125 )	(5 )%
Gross profit	\$(2,540)	\$(2,665)	\$ 125	(5 )%

## Corporate Segment

Corporate cost of net revenues decreased \$0.1 million, or 5% in the three months ended September 30, 2016 compared to the same period in 2015. The decrease in corporate cost of net revenues was primarily a result of fully amortized intangible assets relating to our business acquisitions in prior years.

	Three Months Ended September 30,			
	2016	2015	\$	%
			Change	Change
	(in thousands)			
Technology and development	\$43,284	\$38,066	\$5,218	14 %
Percentage of net revenues	23	% 23	% —	—
Sales and marketing	\$41,903	\$43,052	\$(1,149)	(3 )%
Percentage of net revenues	22	% 26	% —	—
General and administrative	\$26,181	\$27,449	\$(1,268)	(5 )%
Percentage of net revenues	14	% 16	% —	—

Our technology and development expense increased \$5.2 million, or 14%, for the three months ended September 30, 2016, compared to the same period in 2015. As a percentage of net revenues, technology and development remained

flat at 23% in the three months ended September 30, 2016 and 2015. The overall increase in expense was primarily due to an increase of \$3.0 million in personnel and related costs due to increased headcount, an increase of \$2.6 million in professional fees, an increase of \$1.3 million in facilities costs primarily resulting from additional network operations and security support, and an increase in stock-based compensation expense of \$0.3 million. These factors were partially offset by an increase of \$1.7 million in software and website development costs capitalized and by a decrease of \$0.3 million in depreciation and amortization expense.

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At September 30, 2016, headcount in technology and development increased by 13% compared to September 30, 2015, reflecting our strategic focus on increasing the rate of innovation in our product and services offerings, to generate greater differentiation from our competitors, and improve our long-term operating efficiency. In the three months ended September 30, 2016, we capitalized \$7.7 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 \$5.9 million capitalized in the three months ended September 30, 2015, which included \$0.3 million of stock-based compensation expense.

Our sales and marketing expense decreased \$1.1 million, or 3%, in the three months ended September 30, 2016 compared to the same period in 2015. As a percentage of net revenues, total sales and marketing expense decreased to 22% in the three months ended September 30, 2016 from 26% in the three months ended September 30, 2015. The decrease in our sales and marketing expense was due to a decrease of \$1.7 million of stock-based compensation expense due to executive departures in the first quarter of 2016 and full vesting of prior acquisition grants and a decrease of \$1.6 million in depreciation and amortization expense. These factors were partially offset by an increase of \$1.2 million related to our integrated marketing campaigns which included increased marketing partnerships and increased brand development costs. There was also an increase of \$0.9 million in personnel costs due to increased headcount.

Our general and administrative expense decreased \$1.3 million, or 5%, in the three months ended September 30, 2016 as compared to the same period in 2015. As a percentage of net revenues, general and administrative expense decreased to 14% in the three months ended September 30, 2016 from 16% in the three months ended September 30, 2015. The decrease in general and administrative expense was primarily due to a decrease of \$2.3 million in stock-based compensation expense from the departure of our former Chief Executive Officer, a decrease of loss on asset disposition of \$0.6 million, and a decrease of \$0.2 million in depreciation and amortization expense. The decrease in general and administrative expense was partially offset by an increase of \$1.0 million in professional fees, an increase of \$0.6 million in facilities costs, and an increase of \$0.4 million in personnel related costs.

	Three Months Ended September 30,		
	2016	2015	Change
	(in thousands)		
Interest expense	\$(5,726)	\$(5,613)	\$(113)
Interest and other income, net	130	433	(303)

Interest expense consists of interest on our convertible senior notes, amortization of the issuance costs associated with our convertible senior notes and credit facility, capital leases, and our financing obligation associated with our production facilities in Fort Mill, South Carolina; Shakopee, Minnesota; and Tempe, Arizona. Interest expense was \$5.7 million for the three months ended September 30, 2016 compared to \$5.6 million during the same period a year ago. This increase in interest expense was primarily driven by an increase of \$0.2 million in interest expense from our convertible debt compared to prior year.

	Three Months Ended September 30,	
	2016	2015
	(in thousands)	
Benefit from (provision for) income taxes	\$18,235	\$(8,831)
Effective tax rate	38	% (16)%

We recorded an income tax benefit of \$18.2 million and an income tax provision of \$8.8 million for the three months ended September 30, 2016 and 2015, respectively. Our effective tax rate was 38% for the three months ended September 30, 2016, compared to (16)% for the three months ended September 30, 2015. Factors that impacted the

effective tax rate include the federal research and development credit, limitations on executive compensation, and disqualifying dispositions of employee incentive stock options. The tax expense related to the three months ended September 30, 2015 was highly sensitive to changes to our estimated effective tax rate for the prior year due to the near break-even taxable income.

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## Comparison of the Nine Month Periods Ended September 30, 2016 and 2015

	Nine Months Ended September 30,			
	2016	2015	\$ Change	% Change
	(in thousands)			
Consolidated				
Net revenues	\$572,998	\$511,349	\$61,649	12 %
Cost of net revenues	336,069	299,345	36,724	12 %
Gross profit	\$236,929	\$212,004	\$24,925	12 %
Gross profit as a percentage of net revenues	41	% 41	%	

Net revenues increased \$61.6 million, or 12%, for the nine months ended September 30, 2016 as compared to the same period in 2015. Cost of net revenues increased \$36.7 million, or 12%, for the nine months ended September 30, 2016 as compared to the same period in 2015. As a percentage of net revenues, cost of net revenues remained flat at 59% in the nine months ended September 30, 2016 and 2015. Gross margin also remained flat at 41% in the nine months ended September 30, 2016 and 2015.

	Nine Months Ended September 30,			
	2016	2015	\$ Change	% Change
	(in thousands)			
Consumer				
Net revenues	\$476,072	\$458,087	\$17,985	4 %
Cost of net revenues	256,438	246,925	9,513	4 %
Gross profit	\$219,634	\$211,162	\$8,472	4 %
Gross profit as a percentage of net revenues	46	% 46	%	

## Consumer Segment

Consumer net revenues increased \$18.0 million, or 4%, in the nine months ended September 30, 2016 compared to the same period in 2015. The increase in Consumer net revenues was primarily a result of increased sales of cards and stationery, photo gifts, and mobile revenue. The increase is also reflected in the increases in customers and orders in the nine months ended September 30, 2016, as compared to the same period in 2015.

Consumer cost of net revenues increased \$9.5 million, or 4%, for the nine months ended September 30, 2016 as compared to the same period in 2015. Consumer gross margin remained flat at 46% in the nine months ended September 30, 2016 and 2015.

	Nine Months Ended September 30,			
	2016	2015	\$ Change	% Change
	(in thousands)			
Shutterfly Business Solutions (SBS)				
Net revenues	\$96,926	\$53,262	\$43,664	82 %
Cost of net revenues	71,909	42,699	29,210	68 %
Gross profit	\$25,017	\$10,563	\$14,454	137 %
Gross profit as a percentage of net revenues	26	% 20	%	

SBS Segment

SBS net revenues increased \$43.7 million, or 82%, in the nine months ended September 30, 2016 compared to the same period in 2015. The increase in SBS net revenues is due to the expansion of projects, higher revenue volumes with existing customers, and our ability to execute on personalized print and digital communications at scale resulted in additional programs and volumes.

SBS cost of net revenues increased \$29.2 million, or 68%, for the nine months ended September 30, 2016 as compared to the same period in 2015. SBS gross margin increased to 26% in the nine months ended September 30, 2016 from 20% in the same



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period in 2015. The increase in SBS gross margin is primarily due to improved customer targeting and favorable product mix as a result of expansion of projects with our existing customers.

	Nine Months Ended September 30,			
	2016	2015	\$ Change	% Change
	(in thousands)			
Corporate				
Net revenues	\$—	\$—	\$—	— %
Cost of net revenues	7,722	9,721	(1,999 )	(21 )%
Gross profit	\$(7,722)	\$(9,721)	\$1,999	(21 )%

## Corporate Segment

Corporate cost of net revenues decreased \$2.0 million, or 21% in the nine months ended September 30, 2016 compared to the same period in 2015. The decrease in corporate cost of net revenues was primarily a result of fully amortized intangible assets relating to our business acquisitions in prior years.

	Nine Months Ended September 30,			
	2016	2015	\$ Change	% Change
	(in thousands)			
Technology and development	\$122,866	\$111,928	\$10,938	10 %
Percentage of net revenues	21	% 22	% —	—
Sales and marketing	\$135,284	\$138,028	\$(2,744 )	(2 )%
Percentage of net revenues	24	% 27	% —	—
General and administrative	\$83,462	\$85,730	\$(2,268 )	(3 )%
Percentage of net revenues	15	% 17	% —	—

Our technology and development expense increased \$10.9 million, or 10%, for the nine months ended September 30, 2016, compared to the same period in 2015. As a percentage of net revenues, technology and development expense decreased to 21% in the nine months ended September 30, 2016 from 22% in the nine months ended September 30, 2015. The overall increase in expense was primarily due to an increase of \$8.7 million in personnel and related costs due to increased headcount, an increase of \$5.7 million in professional fees, and an increase of \$4.2 million in facilities costs primarily resulting from additional network operations and security support. The increase in technology and development expense was also due to an increase of \$0.7 million in depreciation and amortization expense. These factors were partially offset by an increase of \$6.7 million in software and website development costs capitalized and by a decrease in stock-based compensation expense of \$1.9 million.

In the nine months ended September 30, 2016, we capitalized \$22.2 million in eligible salary and consultant costs, including \$1.2 million of stock-based compensation expense, associated with software developed or obtained for internal use, compared to \$15.5 million capitalized in the nine months ended September 30, 2015, which included \$1.0 million of stock-based compensation expense.

Our sales and marketing expense decreased \$2.7 million, or 2%, in the nine months ended September 30, 2016 compared to the same period in 2015. As a percentage of net revenues, total sales and marketing expense decreased to 24% in the nine months ended September 30, 2016 from 27% in the nine months ended September 30, 2015. The decrease in our sales and marketing expense was primarily driven by a decrease of \$5.5 million in stock-based compensation expense due to executive departures in the first quarter of 2016 and full vesting of prior acquisition grants. There was also a decrease of \$2.8 million in depreciation and amortization expense compared to the prior year.

These factors were partially offset by an increase of \$3.8 million in personnel and related costs due to an increase in headcount, an increase of \$1.2 million in related to our integrated marketing campaigns which included increased marketing partnerships and online advertising, as well as an increase of \$0.8 million in professional fees.

Our general and administrative expense decreased \$2.3 million, or 3%, in the nine months ended September 30, 2016 as compared to the same period in 2015. As a percentage of net revenues, general and administrative expense decreased to 15% in the nine months ended September 30, 2016 from 17% in the nine months ended September 30, 2015. The decrease in general and administrative expense was primarily due to a decrease of \$9.3 million in stock-based compensation expense from the departure

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of our former Chief Executive Officer, a decrease in loss on asset disposition of \$0.9 million, and a decrease in taxes and miscellaneous fees of \$0.5 million. The decrease in general and administrative expense was partially offset by an increase of \$3.8 million in personnel related costs as a result of executive severance in the first quarter of 2016, an increase of \$2.1 million in professional fees, and an increase of \$1.5 million in facility costs. There was also an increase of \$0.3 million in credit card fees due to increased revenue, an increase of \$0.2 million in depreciation and amortization expense, and a decrease of \$0.2 million in proceeds from intellectual property license agreements.

	Nine Months Ended September 30,		
	2016	2015	Change
	(in thousands)		
Interest expense	\$(17,062)	\$(15,334)	\$(1,728)
Interest and other income, net	379	655	(276 )

Interest expense consists of interest on our convertible senior notes, amortization of the issuance costs associated with our convertible senior notes and credit facility, capital leases, and our financing obligation associated with our production facilities in Fort Mill, South Carolina; Shakopee, Minnesota; and Tempe, Arizona. Interest expense was \$17.1 million for the nine months ended September 30, 2016 compared to \$15.3 million during the same period a year ago. This increase in interest expense was primarily driven by \$0.9 million of financing obligations relating to our Tempe, Arizona facility that became operational in the second quarter of 2015 and an increase of \$0.6 million in interest expense from our convertible debt compared to prior year.

	Nine Months Ended September 30,		
	2016	2015	
	(in thousands)		
Income tax benefit	\$46,290	\$6,404	
Effective tax rate	38 %	5 %	%

We recorded an income tax benefit of \$46.3 million and \$6.4 million for the nine months ended September 30, 2016 and 2015, respectively. Our effective tax rate was 38% for the nine months ended September 30, 2016, compared to 5% for the nine months ended September 30, 2015. Factors that impacted the effective tax rate include the federal research and development credit, limitations on executive compensation, a discrete tax expense related to the Israel Tax Authority settlement in the second quarter of 2016, and disqualifying dispositions of employee incentive stock options.

During the second quarter of 2016 the Israel Tax Authority, as part of the 2012 to 2014 audit, issued an assessment for taxes due. The assessment resulted in a discrete tax expense of \$0.3 million during the prior quarter.

### Liquidity and Capital Resources

At September 30, 2016, we had \$60.2 million of cash and cash equivalents and \$48.8 million of investments, primarily agency securities and corporate bonds. To supplement our overall liquidity position, in May 2013 we issued \$300.0 million of 0.25% convertible senior notes due May 15, 2018. We also have access to a five-year senior secured syndicated credit facility expiring in June 2021 to provide up to \$200.0 million in additional capital resources. As of September 30, 2016, no amounts have been drawn against this facility.

Below is our cash flow activity for the nine months ended September 30, 2016:



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Nine Months Ended  
September 30,  
2016      2015  
(in thousands)

## Consolidated Statements of Cash Flows Data:

Purchases of property and equipment	\$(43,733)	\$(46,448)
Capitalization of software and website development costs	(27,136 )	(15,448 )
Cash flows used in operating activities	(71,888 )	(107,700 )
Cash flows used in investing activities	(53,619 )	(12,835 )
Cash flows used in financing activities	(103,144 )	(163,557 )

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, share repurchase program, technology development projects, and coupon payments for our 0.25% convertible senior notes 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.

We anticipate that total 2016 capital expenditures will be approximately 7% of our expected net revenues in 2016. These expenditures will be used to make developments to Shutterfly 3.0, improve mobile capabilities, develop the SBS platform, purchase technology and equipment to support the growth in our business, increase our production capacity, and help enable us to respond more quickly and efficiently to customer demand. This range of capital expenditures is not outside the ordinary course of our business or materially different from how we have expanded our business in the past.

The following table shows total capital expenditures including amounts accrued but not yet paid by category for the nine months ended September 30, 2016 and 2015:

Nine Months Ended  
September 30,  
2016      2015  
(in thousands)

Technology equipment and software	\$11,912	\$29,469
Percentage of total capital expenditures	17 %	47 %
Manufacturing equipment and building improvements	28,527	13,137
Percentage of total capital expenditures	41 %	21 %
Capitalized technology and development costs	27,039	15,811
Percentage of total capital expenditures	39 %	26 %
Rental equipment	2,020	3,688
Percentage of total capital expenditures	3 %	6 %
Total capital expenditures	\$69,498	\$62,105
Total capital expenditures percentage of net revenues	12 %	12 %

Operating Activities. For the nine months ended September 30, 2016, net cash used in operating activities was \$71.9 million, primarily due to our net loss of \$75.1 million and the net change in operating assets and liabilities of \$131.4 million. Net cash used in operating activities was adjusted for non-cash items including \$69.3 million of depreciation and amortization expense, \$33.3 million of stock-based compensation expense, \$15.7 million of amortization of

intangible assets, \$10.7 million for amortization of debt discount and \$5.8 million provision from deferred income taxes.

For the nine months ended September 30, 2015, net cash used in operating activities was \$107.7 million, primarily due to our net loss of \$132.0 million and the net change in operating assets and liabilities of \$106.4 million. Net cash used in operating activities was adjusted for non-cash items including \$63.4 million of depreciation and amortization expense, \$49.8 million of stock-based compensation expense, \$20.8 million of amortization of intangible assets, \$10.2 million for amortization of debt discount and \$14.4 million benefit from deferred income taxes.

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**Investing Activities.** For the nine months ended September 30, 2016, net cash used in investing activities was \$53.6 million. We used \$43.7 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 \$27.1 million for capitalized software and website development and \$21.9 million to purchase investments. This was partially offset by proceeds from the maturities and sales of investments of \$25.1 million and proceeds from sale of property and equipment of \$14.1 million.

For the nine months ended September 30, 2015, net cash used in investing activities was \$12.8 million. We used \$46.4 million for capital expenditures for computer and network hardware to support our website infrastructure and information technology systems and for production equipment for our manufacturing and production operations, \$15.4 million for capitalized software and website development, and \$4.4 million to purchase investments. This was partially offset by proceeds from the sale of investments of \$52.5 million.

**Financing Activities.** For the nine months ended September 30, 2016, net cash used in financing activities was \$103.1 million. We used \$90.8 million to repurchase shares of our common stock. We also used \$15.1 million for payments of capital leases and financing obligations. This was partially offset by \$0.9 million in excess tax benefit from stock-based compensation expense and \$1.9 million of proceeds from the issuance of common stock from the exercise of stock options.

For the nine months ended September 30, 2015, net cash used in financing activities was \$163.6 million. We used \$134.1 million to repurchase shares of common stock including a prepayment of \$75.0 million under an accelerated share repurchase agreement in the second quarter of 2015 and \$38.2 million refund received upon final settlement of the accelerated share repurchase in the third quarter of 2015. We also used \$9.0 million for payments of capital leases and financing obligations. This was partially offset by \$13.7 million in excess tax benefit from stock-based compensation expense and \$2.7 million of proceeds from the issuance of common stock from the exercise of stock options.

## Non-GAAP Financial Measures

Regulation G, conditions for use of Non-Generally Accepted Accounting Principles ("Non-GAAP") financial measures, and other SEC regulations define and prescribe the conditions for use of certain Non-GAAP financial information. We closely monitor two financial measures, adjusted EBITDA, and free cash flow which meet the definition of Non-GAAP financial measures. We define adjusted EBITDA as earnings before interest, taxes, depreciation, amortization, and stock-based compensation. Free cash flow is defined as adjusted EBITDA less purchases of property and equipment and capitalization of software and website development costs. Free cash flow has limitations due to the fact that it does not represent the residual cash flow for discretionary expenditures. For example, free cash flow does not incorporate payments made on capital lease obligations or cash requirements to comply with debt covenants. 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 adjusted EBITDA and free cash flow to the most comparable GAAP measure.

To supplement our consolidated financial statements presented on a GAAP basis, we believe that these Non-GAAP measures provide useful information about our core operating results and thus are appropriate to enhance the overall understanding of our past financial performance and our prospects for the future. These adjustments to our GAAP results are made with the intent of providing both management and investors a more complete understanding of our underlying operational results and trends and performance. Management uses these Non-GAAP measures to evaluate our financial results, develop budgets, manage expenditures, and determine employee compensation. The presentation

of additional information is not meant to be considered in isolation or as a substitute for or superior to net income (loss) determined in accordance with GAAP. We believe that it is important to view free cash flow as a complement to our reported consolidated financial statements. Management strongly encourages shareholders to review our financial statements and publicly-filed reports in their entirety and not to rely on any single financial measure.

The table below shows the trend of adjusted EBITDA and free cash flow as a percentage of net revenues for the three and nine months ended September 30, 2016 and 2015 (in thousands):

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net revenues	\$187,328	\$167,492	\$572,998	\$511,349
Non-GAAP adjusted EBITDA	\$(1,993 )	\$(4,377 )	\$13,663	\$10,382
EBITDA % of net revenues	(1 )%	(3 )%	2 %	2 %
Free cash flow	\$(25,769 )	\$(25,847 )	\$(46,008 )	\$(51,723 )
Free cash flow % of net revenues	(14 )%	(15 )%	(8 )%	(10 )%

For the three months ended September 30, 2016 and 2015, our adjusted EBITDA loss was \$2.0 million and \$4.4 million, respectively. In addition, during the three months ended September 30, 2016 and 2015, we experienced negative free cash flows of \$25.8 million and \$25.8 million, respectively.

For the nine months ended September 30, 2016 and 2015, our adjusted EBITDA was \$13.7 million and \$10.4 million, respectively. In addition, during the nine months ended September 30, 2016 and 2015, we experienced negative free cash flows of \$46.0 million and \$51.7 million, respectively.

By carefully managing our operating costs and capital expenditures, we are able to make the strategic investments we believe are necessary to grow and strengthen our business while maintaining the opportunity for full year adjusted EBITDA profitability and positive free cash flows.

The following is a reconciliation of adjusted EBITDA and free cash flow to the most comparable GAAP measure, for the three and nine months ended September 30, 2016 and 2015 (in thousands):

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net loss	\$(29,155)	\$(63,077)	\$(75,076)	\$(131,957)
Add back:				
Interest expense	5,726	5,613	17,062	15,334
Interest and other income, net	(130 )	(433 )	(379 )	(655 )
(Benefit from) provision for income taxes	(18,235 )	8,831	(46,290 )	(6,404 )
Depreciation and amortization	27,587	28,933	85,058	84,233
Stock-based compensation expense	12,214	15,756	33,288	49,831
Non-GAAP Adjusted EBITDA	\$(1,993 )	\$(4,377 )	\$13,663	\$10,382

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## Reconciliation of Cash Flow from Operating Activities to Non-GAAP Adjusted EBITDA and Free Cash Flow

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net cash provided by (used in) operating activities	\$(4,881 )		\$(22,140 )	
Add back:				
Interest expense	5,726	5,613	17,062	15,334
Interest and other income, net	(130 )	(433 )	(379 )	(655 )
(Benefit from) provision for income taxes	(18,235 )	8,831	(46,290 )	(6,404 )
Changes in operating assets and liabilities	29,155	134	131,446	106,406
Other adjustments	(13,628 )	3,618	(16,288 )	3,401
Non-GAAP Adjusted EBITDA	(1,993 )	(4,377 )	13,663	10,382
Less:				
Purchases of property and equipment, including accrued amounts	(14,957 )	(15,117 )	(42,459 )	(46,294 )
Capitalized software and website development costs, including accrued amounts	(8,819 )	(6,353 )	(27,039 )	(15,811 )
Capex adjustments [1]	—	—	9,827	—
Free cash flow	\$(25,769 )		\$(25,847 )	

[1] In the second quarter of 2016, the Company acquired and subsequently sold \$9.8 million of printers.

## 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.

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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 syndicated credit facility. We maintain our portfolio of cash equivalents and investments in a variety of agency bonds and corporate debt securities. All of our cash equivalents are carried at market value. 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 (“LIBO rate”). If these rates increase significantly, our costs to borrow these funds will also increase. To date, we have not borrowed any funds under our syndicated credit facility. We do not believe that a 10% change in interest rates would have a significant impact on our interest income and expense, operating results, or liquidity.

**Market Risk and Market Interest Risk.** In May 2013, we issued \$300.0 million of 0.25% convertible senior notes due May 15, 2018. We carry this instrument at face value less unamortized discount on our balance sheet. Since this instrument bears interest at fixed rates, we have no financial statement risk associated with changes in interest rates. However, the fair value of these instruments fluctuates when interest rates change, and in the case of convertible notes, when the market price of our stock fluctuates.

**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, agency bonds and corporate debt securities. As of September 30, 2016, our investments totaled \$48.8 million, which represented approximately 70% of our total investment portfolio.

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, 2016. 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, 2016, 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, 2016 that has materially affected, or is reasonably

likely to materially affect, our internal control over financial reporting.

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PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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 proceedings, it is not possible to estimate the possible loss or losses from each of these proceedings. The final resolution of these proceedings, 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. No material legal proceeding was terminated during the third quarter of 2016.

The State of Delaware v. Shutterfly, Inc.

On May 1, 2014, the State of Delaware filed a complaint against us for alleged violations of the Delaware False Claims and Reporting Act, 6 Del C. § 1203(b)(2). The complaint asserts that we 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 believe the suit is without merit.

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.

ITEM 1A. RISK FACTORS

Risks Related to Our Business and Industry

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

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

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

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

We believe that we must continue to grow our current production capability to meet our projected net revenue targets. Our capital expenditures were approximately 8%, 10% and 10% of total net revenues for the years ended December 31, 2015, 2014 and 2013, respectively. We anticipate that total capital expenditures for the year ending December 31, 2016 will be approximately 7% of 2016 net revenues. Operational difficulties, such as a significant interruption in the operations of our Fort Mill, South Carolina; Tempe, Arizona; or Shakopee, Minnesota production facilities, 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 customer dissatisfaction and damage our reputation and brands, which would result in reduced net revenues. Moreover, if the costs of meeting production requirements, including capital expenditures, were to exceed our expectations, our results of operations would be harmed.

In addition, at peak holiday seasons, and in particular during the fourth quarter, we face significant production risks, including the risk of obtaining sufficient qualified seasonal production personnel. A majority of our workforce during the fourth quarter of 2015 was seasonal, temporary personnel. We have had difficulties in the past finding a sufficient number of qualified seasonal

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employees, and our failure to obtain 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 in the United States and their impact on levels of consumer spending, particularly spending on personalized products and photofinishing services. Consumer revenue as a percentage of total revenue was 91% in 2015, 95% in 2014 and 95% in 2013. 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 and general uncertainty about the future economic environment. If general economic conditions do not improve or continue to improve slowly, customers or potential customers could delay, reduce or forego their purchases of our products and services, which are often 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 ones outside of 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.

Changes in our pricing strategies have had, and may continue to have, a significant impact on our net revenues and net income. From time to time, we have made changes to our pricing structure in order to remain competitive. Most of our other products, including photo books, calendars, cards and stationery and other photo merchandise are also offered by our competitors. 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 revenues, 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 revenues and could adversely affect our gross margins and overall profitability.

We generate a significant portion of our net revenues from the fees we collect from shipping our products. For example, shipping revenue for the Shutterfly brand website represented approximately 20% of our net revenues in 2015 and 16% of our net revenues in 2014 and 2013. We offer discounted or free shipping, with a minimum purchase requirement, during promotional periods to attract and retain customers. If free shipping offers extend beyond a limited number of occasions, are not based upon a minimum purchase requirement or become commonplace, our net revenues and results of operations would be negatively impacted. In addition, we occasionally offer free or discounted products and services to attract and retain customers. In the future, if we increase these offers to respond to actions

taken by our competitors, our results of operations may be harmed.

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

The digital photography products and services 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, Amazon Prints, and many others;
- Social media companies that host and enable mobile access to and posting of images such as Facebook, Instagram, Twitter, Snapchat and Google+;



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Photo hosting websites that allow users to upload and share images at no cost such as Flickr;

“Big Box” retailers such as Wal-Mart, Costco, Sam’s Club, Target, and others that offer low cost digital photography products and services. These competitors provide in-store fulfillment and self-service kiosks for printing, and may, among other strategies, offer their customers heavily discounted in-store products and services that compete directly with our offerings;

Drug stores such as Walgreens, CVS/pharmacy, and others that offer low-cost photography products and services as well as in-store pick-up from their photo website internet orders;

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

Cloud-based storage services and file-syncing services such as Dropbox, Box, Amazon Cloud Drive, and iCloud;

Specialized companies in the photo book and stationery business such as Hallmark, Cardstore by American Greetings, Minted, Picaboo, Blurb, and Mixbook;

Photo-related software companies such as Apple, Microsoft, and Adobe;

Internet portals and search engines such as Yahoo! and Google that offer broad-reaching digital photography uploading and storage as well as related products and services to their large user bases;

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 Viatch Publishing Solutions, Inc.;

Regional photography companies such as Ritz Camera that have established brands and customer bases in existing photography markets; and

- Camera and photographic supply companies that rent equipment nationwide both online and in brick-and-mortar stores such as LensRentals.com, LensProToGo, Cameralends, AbelCine, and Adorama.

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

- general economic conditions, including recession and slow economic growth in the U.S. and worldwide and higher inflation;
- 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;
- our ability to retain customers and encourage repeat purchases;
- the costs of customer acquisition;



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- 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;
- the timing of holidays and the duration of the holiday shopping season;
- 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; 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. For example, we have significant engineering resources in Haifa, Israel and any military actions in that part of the world may impact those resources.

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 future quarters, our operating results may be below the expectations of public market analysts and investors. In that event, the trading price of our common stock may decline.

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

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

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

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

- maintain and increase the size of our customer base;
- maintain and enhance our brands;
- enhance and expand our products and services;
- maintain and grow our websites and customer operations;
- successfully execute our business and marketing strategy;
- continue to develop and upgrade our technology and information processing systems;
- continue to enhance our service to meet the needs of a changing market;
- provide a high quality customer experience, including superior customer service and timely product deliveries;



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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.

Our sales to SBS customers can be unpredictable and a decrease in SBS revenue could adversely impact total net revenue.

SBS revenue as a percentage of total net revenue was 9% in 2015, 5% in 2014 and 5% in 2013. Our SBS revenue is highly concentrated in a few customers and the loss of 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 wide variety of industries, creating new 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. To compete effectively in the SBS market, we have in the past, and may in the future, be forced to offer significant discounts to large SBS customers at lower margins and/or reduce or withdraw from existing relationships with smaller SBS customers, which could negatively impact our net revenues and could adversely affect our gross margins and overall profitability.

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

As a part of our current 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 impact customer satisfaction, revenue, costs and brand reputation.

If we do not successfully develop and implement Shutterfly 3.0 in a timely manner or if Shutterfly 3.0 is not accepted by our customers, our results of operations may suffer.

We have made progress toward creating a memory management service connected to smart, personalized, customer-friendly, scalable e-commerce solutions ("Shutterfly 3.0"). With Shutterfly 3.0, we aim to address the friction points caused by multiple devices, fragmented storage options and limited organization and search capabilities for interacting with photos and videos. Shutterfly 3.0 is intended to deliver a better overall user experience with more products and innovations for our customers. Phase one, integrating ThisLife into Shutterfly has been completed. We have also completed the migration of our most active customers to the new, integrated platform.

If we are unable to develop and implement Shutterfly 3.0 in a timely manner, or if it is not accepted by our customers, our ability to compete could be adversely affected and may result in the loss of market share, which would harm our results of operations. In addition, if Shutterfly 3.0 does not function as designed, we may experience a loss of confidence or lost sales from customers who are dissatisfied with the changes to our platform, which would adversely affect our reputation and results of operations.

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 revenues.

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 revenues will increase to offset these additional expenses.

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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 revenues 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, 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 revenues, 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 revenues we may lose.

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 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 website 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 websites and recently launched new mobile applications on iOS and Android. If we are unable to make, improve, or develop relevant customer-facing 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 for these alternative devices and platforms, and we may need to devote significant resources to the creation, support, and maintenance of such products. If we experience difficulties providing satisfactory access to our services via our mobile applications, such as, problems with our relationships with providers of mobile operating systems (e.g. Apple or Google and their 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.

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

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



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technologies licensed from third parties to effect the secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, new discoveries in the field of cryptography, 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 use of our own as third-party provided (such as Amazon) 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.

In addition, contractors we hire as well as other employees have access to confidential information, including credit card data. Although we take steps to limit this access, this data could be compromised by these contractors or other employee personnel. Under current credit card practices, we are liable for fraudulent credit card transactions because we do not obtain a cardholder's signature. We do not currently carry insurance against this risk. To date, we have experienced minimal losses from credit card fraud, but we continue to face the risk of significant losses from this type of fraud. Our failure to adequately control fraudulent credit card transactions and use of confidential information would damage our reputation and brands, and substantially harm our business and result of operations.

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

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

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. 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.

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

We have website operations, offices and customer support centers in Redwood City, California, Santa Clara, California, and Tempe, Arizona and production facilities in Fort Mill, South Carolina, Shakopee, Minnesota and a new facility in Tempe, Arizona which became operational in the second quarter of 2015. Our growth has placed, and will continue to place, a strain on our administrative and operational infrastructure. Our ability to manage our operations and growth will require us to continue to refine our operational, financial and management controls, human resource policies and reporting systems.

If we are unable to manage future expansion, we may not be able to implement improvements to our controls, policies and systems in an efficient or timely manner and may discover deficiencies in existing systems and controls. Our ability to provide a

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high-quality customer experience could be compromised, which would damage our reputation and brands and substantially harm our business and results of operations.

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. 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 are capable of meeting 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. Changes in key management positions may temporarily affect our financial performance and results of operations as new management becomes familiar with our business.

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 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 3,216,061 shares of our common stock. In December 2015, we replaced the 2006 Plan with our 2015 Plan. We may continue making inducement equity awards outside of the 2015 Plan as we did with the 2006 Plan. 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.

If we are unable to acquire customers in a cost-effective manner, or 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.

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 promote our products, including paying fees to third parties who drive new customers to our websites, 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 and/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 may be reduced and our business and results of operations would be harmed.

In addition, various private entities attempt to regulate the use of e-mail for commercial solicitation. These entities often advocate standards of conduct or practice that significantly exceed current legal requirements and classify certain e-mail solicitations

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

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 and search engine marketing 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 search engine optimization or search engine marketing 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 revenues.

A component of our business strategy is the continued promotion and strengthening of the Shutterfly, Tiny Prints, Wedding Paper Divas, BorrowLenses, MyPublisher, and Groovebook brands. Due to the competitive nature of the digital photography products and services markets, if we are unable to successfully promote our brands, we may fail to attract new customers, increase the engagement of existing customers with our brands or substantially increase our net revenues. Customer awareness and the perceived value of our brands will depend largely on the success of our marketing efforts and our ability to provide a consistent, high-quality customer experience. To promote our brands, we have incurred, and will continue to incur, substantial expense related to advertising and other marketing efforts. The failure of our brand promotion activities could adversely affect our ability to attract new customers and maintain customer relationships, which would substantially harm our business and results of operations.

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

Although earlier in our history we have focused our business on consumer markets for silver halide prints, we have consistently evolved and broadened our offering to include other photo-based products, such as photo books, stationery cards, calendars, and photo merchandise such as mugs and magnets. 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 decor, including wall art, ornaments and pillows. In 2013, we began to offer online photography and video equipment rentals through the BorrowLenses brand. In the future, we may need to address additional markets and expand our customer demographic to grow our business. Our efforts to expand our existing services, create new products and services, address new

market segments or develop a significantly broader customer base may not be successful. Any failure to address additional market opportunities could result in loss of market share, which would harm our business, financial condition and results of operations.

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, such as our 2014 acquisition of selected assets of Dot Copy, Inc. ("Groovebook") and our 2013 acquisitions of BorrowLenses LLC, R&R Images, Inc. and MyPublisher, Inc. The identification of suitable acquisition candidates can be time-consuming and expensive, and we may not be able to successfully complete identified acquisitions.

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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 market with which we have historically had little experience; difficulty integrating data systems; the need to implement or remediate the controls, procedures or policies of the acquired company; and increased risk of litigation. 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.

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.

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 website is in Las Vegas, Nevada. We also have computer hardware located in our production facilities in Fort Mill, South Carolina; Shakopee, Minnesota; and Tempe, Arizona. Our systems and operations could suffer damage or interruption from human error, fire, flood, power loss, insufficient power availability, telecommunications failure, break-ins, terrorist attacks, acts of war and similar events. In addition, 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.

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

We purchase photo-based and other product supplies 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, we may incur delays and incremental costs, which could harm our operating results.

We currently outsource some of our off-line and on-line 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 on-line 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.

Changes in regulations or customer concerns regarding privacy and protection of 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. 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.

Failure to adequately protect our intellectual property could substantially harm our business and results of operations.



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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, 2016, Shutterfly had 97 patents issued, and had 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," "Tiny Prints," "Wedding Paper Divas," and "BorrowLenses." We hold applications and/or registrations for the Shutterfly, Tiny Prints, Wedding Paper Divas, BorrowLenses, Groovebook, MyPublisher, and ThisLife trademarks in our major markets 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 market, we could be forced to either incur significant additional marketing expenses within that market, or elect not to sell products in that market.

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, Tiny Prints, Wedding Paper Divas, BorrowLenses, ThisLife or one of our other marks.

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

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

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We may be subject to investigations or audits by governmental authorities and regulatory agencies, which can occur in the ordinary course of business or which can result from increased scrutiny from a particular agency towards an industry, country or practice. The resolution of such proceedings, investigations or audits could require us to pay substantial amounts of money or take actions that adversely affect our operations. In addition, defending against these claims may involve significant time and expense. Given the visibility of our brands, we may regularly be involved in legal proceedings, government investigations or audits that could adversely affect our business and financial performance.

Our effective tax rate may be subject to fluctuation from federal and state audits, 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 shortfalls associated with the vesting of restricted stock units and restricted stock awards, disqualifying dispositions when employees exercise and sell their incentive stock options within a two year period, and cancellation of vested non-qualified stock options.

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

We are subject to general business regulations and laws as well as regulations and laws specifically governing the Internet and e-commerce. Existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, restrictions on imports and exports, customs, tariffs, user privacy, data protection, 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.

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 judicial interpretation of that language.

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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.

Because of our focus on automation and high volumes, our operations do not involve, for the vast majority of our sales, any human-based review of content. Although our 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.

Our practice of offering free products and services 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. 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.

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 markets in order to grow our business. These expansion plans will require significant management attention and resources and may be unsuccessful. We have limited experience adapting our products to conform to local cultures, standards and policies. We may have to compete with established local or regional companies which understand the local market better than we do. In addition, to achieve satisfactory performance for consumers in international locations it may be necessary to locate physical facilities, such as production facilities, in the foreign market. We do not have experience establishing, acquiring or operating such facilities overseas. We may not be successful in expanding into any international markets or in generating revenues from foreign operations. In addition, different privacy, censorship and liability standards and regulations and different intellectual property laws in foreign countries may result in additional expenses, diversion of resources, including the attention of our management team.

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

The digital photography market is rapidly evolving, characterized by changing technologies, intense price competition, additional competitors, evolving industry standards, frequent new service and platform announcements and changing consumer demands and behaviors. To the extent that consumer adoption of digital photography does not continue to grow as expected, our revenue growth would likely suffer. Moreover, we face significant risks that, if the market for digital photography evolves in ways that we are not able to address due to changing technologies or consumer behaviors, pricing pressures, or otherwise, our current products and services may become less attractive, which would result in the loss of customers, as well as lower net revenues and/or increased expenses.

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

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The online market for digital photography products and services, including photographic and video equipment rentals, is less developed than the online market for other consumer products. If this market does not gain widespread acceptance, our business may suffer. Our success will depend in part on our ability to attract customers who historically have used traditional retail photography services or who have produced photographs and other products using self-service alternatives, such as printing at home. Furthermore, we may have to incur significantly higher and more sustained advertising and promotional expenditures or reduce the prices of our products and services in order to attract additional online consumers to our 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;
- 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 revenues 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. 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.

#### Risks Related to Our Common Stock

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



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affected the market price of many technology companies in ways that may have been unrelated to those companies' operating performance. Factors that could cause our stock price to fluctuate include:

- slow economic growth, and market conditions or trends in our industry or the macro-economy as a whole;
- 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 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;
- 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.

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

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

In addition, we are subject to Section 203 of the Delaware General Corporation Law, which, subject to some exceptions, prohibits "business combinations" between a Delaware corporation and an "interested stockholder," which is generally defined as

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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 2016, our board of directors approved an increase to the share repurchase program of up to \$100.0 million in addition to amounts remaining. Through September 30, 2016, we have repurchased \$401.6 million in stock under our total authorized amount of \$506.0 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. 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 0.25% Senior Convertible Senior Notes Due in 2018 (the "Notes")

Although the notes are referred to as convertible senior notes, they are effectively subordinated to any of our secured debt and any liabilities of our subsidiaries.

The notes will rank senior in right of payment to any of our indebtedness that is expressly subordinated in right of payment to the notes; equal in right of payment to any of our liabilities that are not so subordinated; effectively junior in right of payment to any of our secured indebtedness to the extent of the value of the assets securing such indebtedness; and structurally junior to all indebtedness and other liabilities (including trade payables) of our subsidiaries. In the event of our bankruptcy, liquidation, reorganization or other winding up, our assets that secure debt ranking senior in right of payment to the notes will be available to pay obligations on the notes only after the secured debt has been repaid in full from these assets, and the assets of our subsidiaries will be available to pay obligations on the notes only after all claims senior to the notes (including any amounts drawn under our credit facility) have been repaid in full. There may not be sufficient assets remaining to pay amounts due on any or all of the notes then outstanding. The indenture governing the notes does not prohibit us from incurring additional senior debt or

secured debt, nor does it prohibit any of our subsidiaries from incurring additional liabilities.

Recent and future regulatory actions and other events may adversely affect the trading price and liquidity of the notes.

We expect that many investors in, and potential purchasers of, the notes will employ, or seek to employ, a convertible arbitrage strategy with respect to the notes. Investors would typically implement such a strategy by selling short the common stock underlying the notes and dynamically adjusting their short position while continuing to hold the notes. Investors may also implement this type of strategy by entering into swaps on our common stock in lieu of or in addition to short selling the common stock. The Securities and Exchange Commission ("SEC") and other regulatory and self-regulatory authorities have implemented various rules and taken certain actions, and may in the future adopt additional rules and take other actions, that may impact those engaging in short selling activity involving equity securities (including our common stock). Such rules and actions include Rule 201 of SEC Regulation SHO, the adoption by the Financial Industry Regulatory Authority, Inc. and the national securities exchanges of a "Limit Up-Limit Down" program, the imposition of market-wide circuit breakers that halt trading of securities for certain periods

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following specific market declines, and the implementation of certain regulatory reforms required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Any governmental or regulatory action that restricts the ability of investors in, or potential purchasers of, the notes to effect short sales of our common stock or enter into swaps on our common stock could adversely affect the trading price and the liquidity of the notes.

In addition, if investors and potential purchasers seeking to employ a convertible arbitrage strategy are unable to borrow or enter into swaps on our common stock, in each case on commercially reasonable terms, the trading price and liquidity of the notes may be adversely affected.

Volatility in the market price and trading volume of our common stock could adversely impact the trading price of the notes.

The stock market in recent years has experienced significant price and volume fluctuations that have often been unrelated to the operating performance of companies. The market price of our common stock could fluctuate significantly for many reasons, including in response to the risks described in this section, or for reasons unrelated to our operations, such as reports by industry analysts, investor perceptions or negative announcements by our customers, competitors or suppliers regarding their own performance, as well as industry conditions and general financial, economic and political instability. A decrease in the market price of our common stock would likely adversely impact the trading price of the notes. The price of our common stock could also be affected by possible sales of our common stock by investors who view the notes as a more attractive means of equity participation in us and by hedging or arbitrage trading activity that we expect to develop involving our common stock. This trading activity could, in turn, affect the trading prices of the notes.

We may still incur substantially more debt or take other actions which would intensify the risks discussed above.

We and our subsidiaries may be able to incur substantial additional debt in the future, subject to the restrictions contained in our debt instruments, some of which may be secured debt. We will not be restricted under the terms of the indenture governing the notes from incurring additional debt, securing existing or future debt, recapitalizing our debt or taking a number of other actions that are not limited by the terms of the indenture governing the notes that could have the effect of diminishing our ability to make payments on the notes when due. Our existing credit facility restricts our ability to incur additional indebtedness, including secured indebtedness, but if the facility matures or is repaid, we may not be subject to such restrictions under the terms of any subsequent indebtedness.

We may not have the ability to raise the funds necessary to settle conversions of our notes in cash or to repurchase the notes upon a fundamental change, and our current debt contains, and our future debt may contain, limitations on our ability to pay cash on conversion or repurchase the notes.

Holders of the notes have the right to require us to repurchase their notes upon the occurrence of a fundamental change at a repurchase price equal to 100% of their principal amount, plus accrued and unpaid interest, if any. In addition, upon conversion of the notes, unless we elect to deliver solely shares of our common stock to settle such conversion (other than paying cash in lieu of delivering any fractional share), we will be required to make cash payments in respect of the notes being converted. However, we may not have enough available cash or be able to obtain financing at the time we are required to make repurchases of notes surrendered therefor or notes being converted.

In addition, our ability to repurchase the notes and settle conversions in cash is limited by our credit facility and may be limited by law, by regulatory authority or by agreements governing our future indebtedness. Our failure to repurchase notes at a time when the repurchase is required by the indenture would constitute a default under the indenture. A default under the indenture or the fundamental change itself could also lead to a default under the credit

facility agreements governing our future indebtedness. Moreover, the occurrence of a fundamental change under the indenture would constitute an event of default under our credit facility. If the payment of the related indebtedness were to be accelerated after any applicable notice or grace periods, we may not have sufficient funds to repay the indebtedness and repurchase the notes or to pay cash upon conversion of the notes.

The conditional conversion feature of the notes, if triggered, may adversely affect our financial condition and operating results.

In the event the conditional conversion feature of the notes is triggered, holders of notes will be entitled to convert the notes at any time during specified periods at their option. If one or more holders elect to convert their notes, unless we elect to satisfy our conversion obligation by delivering solely shares of our common stock (other than paying cash in lieu of delivering any fractional share), we would be required to settle a portion or all of our conversion obligation in cash, which could adversely affect our liquidity. In addition, even if holders do not elect to convert their notes, we could be required under applicable accounting rules to reclassify all or a portion of the outstanding principal of the notes as a current rather than long-term liability, which would result in a material reduction of our net working capital.

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The accounting method for convertible debt securities that may be settled in cash, such as the notes, could have a material effect on our reported financial results.

In May 2008, the Financial Accounting Standards Board, which we refer to as FASB, issued FASB Staff Position No. APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement), which has subsequently been codified as Accounting Standards Codification 470-20, Debt with Conversion and Other Options, which we refer to as ASC 470-20. Under ASC 470-20, an entity must separately account for the liability and equity components of the convertible debt instruments (such as the notes) that may be settled entirely or partially in cash upon conversion in a manner that reflects the issuer's economic interest cost. The effect of ASC 470-20 on the accounting for the notes is that the equity component is required to be included in the additional paid-in capital section of stockholders' equity on our consolidated balance sheet and the value of the equity component would be treated as original issue discount for purposes of accounting for the debt component of the notes. As a result, we will be required to record a greater amount of non-cash interest expense in current periods presented as a result of the amortization of the discounted carrying value of the notes to their face amount over the term of the notes. We will report lower net income in our financial results because ASC 470-20 will require interest to include both the current period's amortization of the debt discount and the instrument's coupon interest, which could adversely affect our reported or future financial results, the trading price of our common stock and the trading price of the notes. In addition, under certain circumstances, convertible debt instruments (such as the notes) that may be settled entirely or partly in cash are currently accounted for utilizing the treasury stock method, the effect of which is that any shares issuable upon conversion of the notes are not included in the calculation of diluted earnings per share except to the extent that the conversion value of the notes exceeds their principal amount. Under the treasury stock method, for diluted earnings per share purposes, the transaction is accounted for as if the number of shares of common stock that would be necessary to settle such excess, if we elected to settle such excess in shares, are issued. We cannot be sure that the accounting standards in the future will continue to permit the use of the treasury stock method. If we are unable to use the treasury stock method in accounting for the shares issuable upon conversion of the notes, then our diluted earnings per share would be adversely affected.

Future sales of our common stock in the public market could lower the market price for our common stock and adversely impact the trading price of the notes.

In the future, we may sell additional shares of our common stock to raise capital. In addition, a substantial number of shares of our common stock is reserved for issuance upon the exercise of stock options, the vesting of restricted stock units and other equity awards pursuant to our employee benefit plans, upon conversion of the notes, and in relation to the convertible note hedge and warrant transactions entered into in connection with the pricing of the notes. We cannot predict the size of future issuances or the effect, if any, that they may have on the market price for our common stock. The issuance and sale of substantial amounts of common stock, or the perception that such issuances and sales may occur, could adversely affect the trading price of the notes and the market price of our common stock and impair our ability to raise capital through the sale of additional equity securities.

Holders of notes will not be entitled to any rights with respect to our common stock, but they will be subject to all changes made with respect to them to the extent our conversion obligation includes shares of our common stock.

Holders of notes will not be entitled to any rights with respect to our common stock (including, without limitation, voting rights and rights to receive any dividends or other distributions on our common stock) prior to the conversion date relating to such notes (if we elect to settle the relevant conversion by delivering solely shares of our common stock (other than paying cash in lieu of delivering any fractional share)) or the last trading day of the relevant observation period (if we elect to pay and deliver, as the case may be, a combination of cash and shares of our common stock in respect of the relevant conversion), but holders of notes will be subject to all changes affecting our

common stock. For example, if an amendment is proposed to our certificate of incorporation or bylaws requiring stockholder approval and the record date for determining the stockholders of record entitled to vote on the amendment occurs prior to the conversion date related to a holder's conversion of its notes (if we have elected to settle the relevant conversion by delivering solely shares of our common stock (other than paying cash in lieu of delivering any fractional share)) or the last trading day of the relevant observation period (if we elect to pay and deliver, as the case may be, a combination of cash and shares of our common stock in respect of the relevant conversion), such holder will not be entitled to vote on the amendment, although such holder will nevertheless be subject to any changes affecting our common stock.

The conditional conversion feature of the notes could result in holders receiving less than the value of our common stock into which the notes would otherwise be convertible.

Holders of notes may convert their notes only if specified conditions are met. If the specific conditions for conversion are not met, holders will not be able to convert their notes, and may not be able to receive the value of the cash, common stock or a combination of cash and common stock, as applicable, into which the notes would otherwise be convertible.

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Upon conversion of the notes, holders may receive less valuable consideration than expected because the value of our common stock may decline after holders exercise their conversion rights but before we settle our conversion obligation.

Under the notes, a converting holder will be exposed to fluctuations in the value of our common stock during the period from the date such holder surrenders notes for conversion until the date we settle our conversion obligation. Upon conversion of the notes, we have the option to pay or deliver, as the case may be, cash, shares of our common stock, or a combination of cash and shares of our common stock. If we elect to satisfy our conversion obligation in cash or a combination of cash and shares of our common stock, the amount of consideration that holders will receive upon conversion of their notes will be determined by reference to the volume weighted average prices of our common stock for each trading day in a 30 trading-day observation period. Accordingly, if the price of our common stock decreases during such observation period, the amount and/or value of consideration holders receive will be adversely affected. In addition, if the market price of our common stock at the end of such period is below the average of the volume weighted average price of our common stock during such period, the value of any shares of our common stock that holders will receive in satisfaction of our conversion obligation will be less than the value used to determine the number of shares that holders will receive.

If we elect to satisfy our conversion obligation solely in shares of our common stock upon conversion of the notes, we will be required to deliver the shares of our common stock, together with cash for any fractional share, three business days after the relevant conversion date. Accordingly, if the price of our common stock decreases during this period, the value of the shares that holders receive will be adversely affected and would be less than the conversion value of the notes on the conversion date.

The notes are not protected by restrictive covenants.

The indenture governing the notes does not contain any financial or operating covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by us or any of our subsidiaries. The indenture contains no covenants or other provisions to afford protection to holders of the notes in the event of a fundamental change or other corporate transaction involving us except under limited circumstances.

The increase in the conversion rate for notes converted in connection with a make-whole fundamental change may not adequately compensate holders for any lost value of their notes as a result of such transaction.

If a make-whole fundamental change occurs prior to the maturity date, under certain circumstances, we will increase the conversion rate by a number of additional shares of our common stock for notes converted in connection with such make-whole fundamental change. The increase in the conversion rate will be determined based on the date on which the specified corporate transaction becomes effective and the price paid (or deemed to be paid) per share of our common stock in such transaction. The increase in the conversion rate for notes converted in connection with a make-whole fundamental change may not adequately compensate holders for any lost value of their notes as a result of such transaction. Our obligation to increase the conversion rate for notes converted in connection with a make-whole fundamental change could be considered a penalty, in which case the enforceability thereof would be subject to general principles of reasonableness and equitable remedies.

The conversion rate of the notes may not be adjusted for all dilutive events.

The conversion rate of the notes is subject to adjustment for certain events, including, but not limited to, the issuance of certain stock dividends on our common stock, the issuance of certain rights or warrants, subdivisions, combinations, distributions of capital stock, indebtedness, or assets, cash dividends and certain issuer tender or



exchange offers. However, the conversion rate will not be adjusted for other events, such as a third-party tender or exchange offer or an issuance of common stock for cash that may adversely affect the trading price of the notes or our common stock. An event that adversely affects the value of the notes may occur, and that event may not result in an adjustment to the conversion rate.

Provisions in the indenture for the notes may deter or prevent a business combination that may be favorable to holders of the notes.

If a fundamental change occurs prior to the maturity date of the notes, holders of the notes will have the right, at their option, to require us to repurchase all or a portion of their notes. In addition, if a make-whole fundamental change occurs prior to the maturity date of the notes, we will in some cases be required to increase the conversion rate for a holder that elects to convert its notes in connection with such fundamental change. Furthermore, the indenture for the notes prohibits us from engaging in certain mergers or acquisitions unless, among other things, the surviving entity assumes our obligations under the notes. These and other provisions in the indenture could deter or prevent a third party from acquiring us even when the acquisition may be favorable to holders of the notes.

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Some significant restructuring transactions may not constitute a fundamental change, in which case we would not be obligated to offer to repurchase the notes.

Upon the occurrence of a fundamental change, holders have the right to require us to repurchase their notes. However, the fundamental change provisions will not afford protection to holders of notes in the event of other transactions that could adversely affect the notes. For example, transactions such as leveraged recapitalizations, refinancings, restructurings, or acquisitions initiated by us may not constitute a fundamental change requiring us to repurchase the notes. In the event of any such transaction, the holders would not have the right to require us to repurchase the notes, even though each of these transactions could increase the amount of our indebtedness, or otherwise adversely affect our capital structure or any credit ratings, thereby adversely affecting the holders of notes.

We have not registered the notes or the common stock issuable upon conversion, if any, which will limit holders' ability to resell them.

The notes and the shares of common stock issuable upon conversion of the notes, if any, have not been registered under the Securities Act of 1933, as amended, or the Securities Act, or any state securities laws. Unless the notes and any shares of common stock issuable upon conversion of the notes have been registered, they may not be transferred or resold except in a transaction exempt from or not subject to the registration requirements of the Securities Act and applicable state securities laws. We do not intend to file a registration statement for the resale of the notes and the common stock, if any, into which the notes are convertible.

An active trading market may not develop for the notes.

Prior to our issuance of the notes, there had been no trading market for the notes. We do not intend to apply to list the notes on any securities exchange or to arrange for quotation on any automated dealer quotation system. The liquidity of the trading market in the notes, and the market price quoted for the notes, may be adversely affected by changes in the overall market for this type of security and by changes in our financial performance or prospects or in the prospects for companies in our industry generally. As a result, we cannot assure holders that an active trading market will develop for the notes. If an active trading market does not develop or is not maintained, the market price and liquidity of the notes may be adversely affected. In that case holders may not be able to sell their notes at a particular time or holders may not be able to sell their notes at a favorable price.

Any adverse rating of the notes may cause their trading price to fall.

We do not intend to seek a rating on the notes. However, if a rating service were to rate the notes and if such rating service were to lower its rating on the notes below the rating initially assigned to the notes or otherwise announces its intention to put the notes on credit watch, the trading price of the notes could decline.

Holders of the notes may be subject to tax if we make or fail to make certain adjustments to the conversion rate of the notes even though such holders do not receive a corresponding cash distribution.

The conversion rate of the notes will be adjusted in certain circumstances. Under Section 305(c) of the Internal Revenue Code of 1986, or the Code, adjustments (or failures to make adjustments) that have the effect of increasing the holders' proportionate interest in our assets or earnings may in some circumstances result in a deemed distribution to the holders. Certain of the conversion rate adjustments with respect to the notes (including, without limitation, adjustments in respect of taxable dividends to holders of our common stock) will result in deemed distributions to the holders of notes even though they have not received any cash or property as a result of such adjustments. In addition, an adjustment to the conversion rate in connection with a make-whole fundamental change may be treated as a

deemed distribution. Any deemed distributions will be taxable as a dividend, return of capital, or capital gain. If holders are a “non-U.S. holder” under the Code any deemed dividend may be subject to U.S. withholding tax at a 30% rate or such lower rate as may be specified by an applicable tax treaty, which may be set off against subsequent payments on the notes (or in certain circumstances, on the common stock). Under proposed regulations relating to certain “dividend equivalent” payments, an adjustment to the conversion rate of the notes as a result of a dividend on our common stock may be subject to withholding tax at a different time or in a different amount than the withholding tax otherwise imposed on dividends and constructive dividends.

The convertible note hedge and warrant transactions may affect the value of the notes and our common stock.

In connection with the pricing of the notes, we entered into convertible note hedge transactions with Morgan Stanley & Co. International plc, Credit Suisse International, Citibank, N.A., and Bank of America, N.A., or the option counterparties. We also entered into warrant transactions with the option counterparties pursuant to which we will sell warrants for the purchase of our

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common stock. The convertible note hedge transactions are expected generally to reduce the potential dilution upon any conversion of notes and/or offset any cash payments we are required to make in excess of the principal amount upon conversion of the notes. The warrant transactions could separately have a dilutive effect to the extent that the market price per share of our common stock exceeds the strike price of the warrants. However, subject to certain conditions, we may elect to settle the warrant transactions in cash.

The option counterparties and/or their respective affiliates may modify their hedge positions by entering into or unwinding various derivatives with respect to our common stock and/or purchasing or selling our common stock in secondary market transactions following the pricing of the notes and prior to the maturity of the notes (and are likely to do so during any observation period related to a conversion of notes or following any repurchase of notes by us on any fundamental change repurchase date or otherwise). This activity could also cause or avoid an increase or a decrease in the market price of our common stock or the notes, which could affect holders' ability to convert the notes and, to the extent the activity occurs during any observation period related to a conversion of notes, it could affect the amount and value of the consideration that holders will receive upon conversion of the notes.

In addition, if any such convertible note hedge and warrant transactions fail to become effective, the option counterparties may unwind their hedge positions with respect to our common stock, which could adversely affect the value of our common stock and the value of the notes. The potential effect, if any, of these transactions and activities on the market price of our common stock or the notes will depend in part on market conditions and cannot be ascertained at this time. Any of these activities could adversely affect the value of our common stock and the value of the notes (and as a result, the value of the consideration, the amount of cash and/or the number of shares, if any, that holders would receive upon the conversion of the notes) and, under certain circumstances, holders' ability to convert the notes. The convertible note hedge transactions and the warrant transactions are separate transactions (in each case entered into between us and the option counterparties), are not part of the terms of the notes and will not affect the holders' rights under the notes. Holders of the notes will not have any rights with respect to the convertible note hedge transactions or the warrant transactions.

We do not make any representation or prediction as to the direction or magnitude of any potential effect that the transactions described above may have on the price of the notes or our common stock. In addition, we do not make any representation that the option counterparties will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

We are subject to counterparty risk with respect to the convertible note hedge transactions.

The option counterparties are financial institutions, and we will be subject to the risk that any or all of them might default under the convertible note hedge transactions. Our exposure to the credit risk of the option counterparties will not be secured by any collateral. Recent global economic conditions have resulted in the actual or perceived failure or financial difficulties of many financial institutions. If an option counterparty becomes subject to insolvency proceedings, we will become an unsecured creditor in those proceedings, with a claim equal to our exposure at that time under our transactions with that option counterparty. Our exposure will depend on many factors but, generally, an increase in our exposure will be correlated to an increase in the market price and in the volatility of our common stock. In addition, upon a default by an option counterparty, we may suffer adverse tax consequences and more dilution than we currently anticipate with respect to our common stock. We can provide no assurances as to the financial stability or viability of the option counterparties.

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

## Issuer Purchases of Equity Securities

The following table provides information about our repurchase of shares of our common stock during the third quarter of the fiscal year 2016:

Period (1)	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased Under Publicly Announced Plans or Programs (2)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans Or Programs (in thousands) (2) (3)
July 1, 2016 to July 31, 2016	64,042	46.33	64,042	114,136
August 1, 2016 to August 31, 2016	55,716	50.10	55,716	111,345
September 1, 2016 to September 30, 2016	143,694	48.07	143,694	104,437
	263,452	\$ 48.08	263,452	\$ 104,437

(1) All shares were purchased pursuant to the publicly announced share repurchase program described in footnote 2 below. Shares are reported in a period based on the settlement date of the applicable repurchase. All repurchased shares of common stock have been retired.

(2) On November 1, 2012, we announced a share repurchase program authorized by our Board of Directors and approved by our Audit Committee to repurchase up to \$60.0 million of our common stock. On February 6, 2014, our Board of Directors approved an increase to the share repurchase program to allow for repurchases of up to an additional \$100.0 million of shares in addition to any amounts repurchased as of the approval date. On February 9, 2015, our Board of Directors approved an increase to the share repurchase program to allow for repurchases of up to an additional \$300 million of shares in addition to any amounts repurchased as of the approval date.

(3) On April 21, 2016, the Company's Board of Directors approved an increase to repurchase up to \$100.0 million in addition to amounts authorized to date. The share repurchase authorization, which is effective immediately, permits the Company to effect repurchases for cash from time to time through open market, privately negotiated or other transactions, including pursuant to trading plans established in accordance with Rules 10b5-1 and 10b-18 of the Securities Exchange Act of 1934, as amended, or by a combination of such methods. The share repurchase program is subject to prevailing market conditions and other considerations; does not require Shutterfly to repurchase any dollar amount or number of shares; and may be suspended or discontinued at any time.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

Not applicable

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ITEM 6. EXHIBITS

Exhibit Number	Description
31.01	Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
31.02	Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
32.01	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*
32.02	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).*
101	The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, 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: November 3, 2016 By: /s/ Christopher North  
Christopher North  
President and Chief Executive Officer  
(Principal Executive Officer)

Dated: November 3, 2016 By: /s/ Michael Pope  
Michael Pope  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)

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