SHUTTERFLY INC
Form 10-Q
August 02, 2011

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-Q

(Mark One)

x	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarterly period ended June 30, 2011
	or
o	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from to

Commission file number 001-33031

SHUTTERFLY, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	94-3330068 (IRS Employer Identification No.)
2800 Bridge Parkway Redwood City, California (Address of Principal Executive Offices)	94065 (Zip Code)

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

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 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 x No o

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

Large accelerated Filer o Accelerated Filer x

Non-accelerated Filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

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

Class	Outstanding at July 29, 2011
Common stock, $0.0001 par value per share	34,559,003

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PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Item 1. Condensed Consolidated Financial Statements

SHUTTERFLY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value amounts)
(Unaudited)

	June 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 75,935	$ 252,244
Accounts receivable, net	5,606	4,845
Inventories	3,181	3,580
Deferred tax asset, current portion	327	3,582
Prepaid expenses and other current assets	46,631	6,934
Total current assets	131,680	271,185
Property and equipment, net	46,531	39,726
Intangible assets, net	102,376	5,672
Goodwill	342,730	11,163
Deferred tax asset, net of current portion	-	11,314
Other assets	5,330	4,770
Total assets	$ 628,647	$ 343,830
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,678	$ 22,341
Accrued liabilities	24,733	38,831
Deferred revenue	10,431	9,731
Total current liabilities	39,842	70,903
Deferred tax liability	17,681	-
Other liabilities	5,159	3,320
Total liabilities	62,682	74,223
Commitments and contingencies (Note 6)		
Stockholders' equity		
Common stock, $0.0001 par value; 100,000 shares authorized; 34,414 and 27,957 shares issued and outstanding on June 30, 2011 and December 31, 2010, respectively	3	3
Additional paid-in capital	571,494	263,726
Accumulated earnings (deficit)	(5,532)	5,878
Total stockholders' equity	565,965	269,607
Total liabilities and stockholders' equity	$ 628,647	$ 343,830

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 June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Net revenues	$ 75,764	$ 46,807	$ 132,993	$ 92,549
Cost of net revenues	39,881	23,179	69,427	45,757
Gross profit	35,883	23,628	63,566	46,792
Operating expenses:				
Technology and development	16,971	12,477	30,084	24,646
Sales and marketing	24,930	11,311	39,195	21,468
General and administrative	15,522	9,620	28,813	18,421
Total operating expenses	57,423	33,408	98,092	64,535
Loss from operations	(21,540)	(9,780)	(34,526)	(17,743)
Interest expense	-	(21)	-	(42)
Interest and other income, net	6	194	20	436
Loss before income taxes	(21,534)	(9,607)	(34,506)	(17,349)
Benefit from income taxes	17,884	3,722	23,096	6,733
Net loss	$ (3,650)	$ (5,885)	$ (11,410)	$ (10,616)
Net loss per share - basic and diluted	$ (0.11)	$ (0.22)	$ (0.37)	$ (0.40)
Weighted-average shares outstanding - basic and diluted	33,160	26,952	30,917	26,595
Stock-based compensation is allocated as follows:				
Cost of net revenues	$ 754	$ 129	$ 929	$ 260
Technology and development	2,752	756	3,666	1,557
Sales and marketing	4,156	966	5,517	2,068
General and administrative	4,437	2,208	7,222	4,548

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)

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Cash flows from operating activities:		
Net loss	$ (11,410)	$ (10,616)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	10,786	12,680
Amortization of intangible assets	4,206	1,289
Stock-based compensation, net of forfeitures	17,334	8,433
Loss/(gain) on disposal of property and equipment	11	(88)
Deferred income taxes	-	(3,285)
Tax benefit from stock-based compensation	11,585	3,710
Excess tax benefits from stock-based compensation	(11,607)	(4,102)
Changes in operating assets and liabilities:		
Accounts receivable, net	185	2,575
Inventories	1,311	484
Prepaid expenses and other current assets	(38,149)	(7,905)
Other assets	(887)	(58)
Accounts payable	(20,786)	(6,727)
Accrued and other liabilities	(20,787)	(19,207)
Deferred revenue	194	(346)
Net cash used in operating activities	(58,014)	(23,163)
Cash flows from investing activities:		
Acquisition of business and intangibles, net of cash acquired	(134,036)	-
Purchases of property and equipment	(9,064)	(8,630)
Capitalization of software and website development costs	(5,044)	(2,049)
Proceeds from sale of equipment	20	77
Proceeds from the sale of auction rate securities	-	21,575
Net cash provided by (used in) investing activities	(148,124)	10,973
Cash flows from financing activities:		
Principal payments of capital lease obligations	(5)	(6)
Proceeds from issuance of common stock upon exercise of stock options	18,227	7,884
Excess tax benefits from stock-based compensation	11,607	4,102
Net cash provided by financing activities	29,829	11,980
Net decrease in cash and cash equivalents	(176,309)	(210)
Cash and cash equivalents, beginning of period	252,244	132,812
Cash and cash equivalents, end of period	$ 75,935	$ 132,602
Supplemental schedule of non-cash investing activities		
Net change in accrued purchases of property and equipment	$ 193	$ 914
Amount due from adjustment of net working capital from acquired business	426	-

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

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SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — The Company and Summary of Significant Accounting Policies

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

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and, accordingly, do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The accompanying unaudited condensed consolidated financial statements include the accounts of Shutterfly, Inc. and its wholly owned subsidiaries. In the opinion of management, all adjustments, consisting primarily of normal recurring accruals, considered necessary for a fair statement of the Company's results of operations for the interim periods reported and of its financial position as of the date of the interim balance sheets have been included. Operating results for the three and six months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011, or for any other period.

The December 31, 2010 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, 2010 included in the Company's Annual Report on Form 10-K.

Fair Value

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

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

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

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

Income Taxes

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

The Company reports a liability for unrecognized tax benefits resulting from uncertain tax positions taken or expected to be taken in a tax return. The application of income tax law is inherently complex. Laws and regulations in this area are voluminous and are often ambiguous. The Company is required to make subjective assumptions and judgments regarding its income tax exposures. Interpretations and guidance surrounding income tax laws and regulations change over time. As such, changes in the Company's subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of operations.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The Company's policy is to recognize interest and /or penalties related to all tax positions in income tax expense. To the extent that accrued interest and penalties do not ultimately become payable, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision in the period that such determination is made. No interest and penalties were accrued as of December 31, 2010 and June 30, 2011.

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

Recent Accounting Pronouncements

No new accounting standards have been adopted since the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010 was filed. Management does not believe that any new accounting pronouncements not yet effective will have a material impact on the Company's financial statements once adopted.

Note 2 — Stock-Based Compensation

Stock Option Activity

A summary of the Company's stock option activity for the three and six months ended June 30, 2011 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
Balances, December 31, 2010	3,357	$ 15.33		
Granted	75	44.70		
Exercised	(813)	9.15		
Forfeited, cancelled or expired	(12)	19.17		
Balances, March 31, 2011	2,607	$ 18.09	6.4	$ 89,346
Granted	16	52.72		
Exercised	(911)	11.83		
Forfeited, cancelled or expired	(41)	18.72		
Increase due to acquisition	1,345	5.35		
Balances, June 30, 2011	3,016	$ 14.48	6.9	$ 129,502
Options vested and expected to vest at June 30, 2011	2,828	$ 14.35	6.8	$ 121,814
Options vested at June 30, 2011	2,177	$ 13.51	6.3	$ 95,566

During the three months ended June 30, 2011, the Company granted options to purchase an aggregate of 16,000 shares of common stock with an estimated weighted-average grant-date fair value of $23.59 per share. The total intrinsic value of options exercised during the three months ended June 30, 2011, was $42,243,000. Net cash proceeds from the exercise of stock options were $10,782,000 for the three months ended June 30, 2011.

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SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Valuation of Stock Options

The Company estimated the fair value of each option award on the date of grant using the Black-Scholes option-pricing model and the assumptions noted in the following table. In the three and six months ended June 30, 2011, the Company calculated volatility using an average of its historical and implied volatilities as it had sufficient public trading history to cover the entire expected term. In all prior periods, expected volatility also included historical and implied volatility of a peer group of publicly traded entities. The expected term of options gave consideration to historical exercises, post-vesting cancellations and the options' contractual term. The risk-free rate for the expected term of the option is based on the U.S. Treasury Constant Maturity at the time of grant. The assumptions used to value options granted during the three and six months ended June 30, 2011 and 2010 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Dividend yield	—	—	—	—
Annual risk free rate of return	1.9%	2.3%	2.1%	2.3%
Expected volatility	53.9%	51.7%	49.1%	50.4%
Expected term (years)	4.3	4.5	4.4	4.6

Employee stock-based compensation expense recognized in the three and six months ended June 30, 2011 and 2010, was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. Accounting standards require forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Restricted Stock Units

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

Restricted Stock Unit Activity

A summary of the Company's restricted stock unit activity for the three and six months ended June 30, 2011, is as follows (share numbers in thousands):

	Number of Units Outstanding	Weighted Average Grant Date Fair Value
Awarded and unvested, December 31, 2010	2,019	$ 15.76
Granted	723	45.13
Vested	(547)	13.62
Forfeited	(41)	23.16
Awarded and unvested, March 31, 2011	2,154	$ 26.02
Granted	98	53.39

Vested	(169)		15.50
Forfeited	(106)		25.22
Increase due to acquisition	64		55.36
Awarded and unvested, June 30, 2011	2,041	$	29.17
Restricted stock units expected to vest, June 30, 2011	1,590		

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Included in the RSU grants for the six months ended June 30, 2011, are 155,000 RSUs that have both performance and service vesting criteria (“PBRSU”). The performance criteria are tied to the Company’s 2011 financial performance and the service criteria are consistent with vesting described in the Company's 2006 Equity Incentive Plan. Compensation cost associated with these PBRSUs is recognized on an accelerated attribution model and ultimately based on whether or not satisfaction of the performance criteria is probable. If in the future, situations indicate that the performance criteria are not probable, then no further compensation cost will be recorded and any previous costs will be reversed.

At June 30, 2011, the Company had $67,079,000 of total unrecognized compensation expense, net of estimated forfeitures, related to stock options and RSUs that will be recognized over a weighted-average period of approximately two years.

Note 3 — Net Loss Per Share

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

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

A summary of the net loss per share for the three and six months ended June 30, 2011 and 2010 is as follows (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net loss per share:				
Numerator				
Net loss	$ (3,650)	$ (5,885)	$ (11,410)	$ (10,616)
Denominator for basic and diluted net loss per share				
Weighted-average common shares outstanding	33,160	26,952	30,917	26,595
Net loss per share — basic and diluted	$ (0.11)	$ (0.22)	$ (0.37)	$ (0.40)

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 June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Stock options and restricted stock units	5,605	5,981	5,966	6,213

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SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 4 — Fair Value Measurement

The following table represents the Company's fair value hierarchy for its financial assets as of June 30, 2011 and December 31, 2010 (in thousands):

	June 30, 2011	
	Fair Value	Level 1
Cash equivalents:		
Money market funds	$ 68,705	$ 68,705
Total financial assets	$ 68,705	$ 68,705

	December 31, 2010	
	Fair Value	Level 1
Cash equivalents:		
Money market funds	$ 211,385	$ 211,385
Total financial assets	$ 211,385	$ 211,385

As of June 30, 2011 and December 31, 2010, the Company held Level 1 financial assets which were all invested in money market funds, primarily in U.S. Treasury and U.S. agency securities.

Note 5 — Balance Sheet Components

Prepaid Expenses and Other Current Assets

	June 30, 2011	December 31, 2010
	(in thousands)	
Intra-period deferred tax asset	$ 34,681	$ -
Prepaid service contracts – current portion	4,129	3,189
Prepaid income taxes	1,231	611
Other prepaid expenses and current assets	6,590	3,134
	$ 46,631	$ 6,934

Intra-period deferred tax asset includes $11.6 million in excess tax benefits from stock-based compensation, that will offset against taxes payable on a full year basis.

Property and Equipment

	June 30, 2011	December 31, 2010
	(in thousands)	
Computer and other equipment	$ 95,819	$ 87,531
Software	10,349	9,124
Leasehold improvements	8,723	7,133
Furniture and fixtures	3,682	3,006

Capitalized software and website development costs		30,593		25,173
		149,166		131,967
Less: Accumulated depreciation and amortization		(102,635)		(92,241)
Net property and equipment	$	46,531	$	39,726

Depreciation and amortization expense totaled $5,672,000 and $6,307,000 for the three months ended June 30, 2011 and 2010, respectively. Depreciation and amortization expense totaled $10,786,000 and $12,680,000 for the six months ended June 30, 2011 and 2010, respectively.

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SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Accrued Liabilities

	June 30, 2011	December 31, 2010
	(in thousands)	
Accrued marketing expenses	$ 6,587	$ 11,766
Accrued compensation	5,249	5,701
Accrued production costs	3,803	8,551
Accrued income and sales taxes	3,037	7,342
Accrued consulting	1,370	1,750
Accrued other	4,687	3,721
	$ 24,733	$ 38,831

Note 6 — 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.

Legal Matters

On October 1, 2010, Express Card Systems, LLC filed a complaint for alleged patent infringement against the Company and four other defendants in Express Card Systems, LLC. v. Shutterfly, Inc. et. al., Civ. No. 6:10-cv-514, in the Eastern District of Texas, Tyler Division. The complaint asserts infringement of U.S. Patent No. 5,751,590, which claims, among other things, a method related to processing images to define social expression cards in a computer database. The Complaint asserts that the Company directly or indirectly infringes the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages and injunctive relief. On December 27, 2010, the Company filed an answer and counterclaims against Express Card Systems. On May 20, 2011, the court for the Eastern District of Texas, Tyler Division, granted Express Card Systems, LLC's Stipulation of Joint Dismissal without Prejudice of all claims and counterclaims between Express Card and Shutterfly.

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

On January 31, 2011, the Company filed a complaint for patent infringement against Eastman Kodak Company and Kodak Imaging Network, Inc. ("Kodak") in Shutterfly, Inc. v. Eastman Kodak Company and Kodak Imaging Network, Inc., C.A. No. 11-099-SLR, in the U.S. District Court for the District of Delaware. The complaint asserts infringement of U.S. Patents Nos. 6,583,799; 7,269,800; 6,587,596; 6,973,222; 7,474,801; 7,016,869; and 7,395,229, which claim among other things, methods for image uploading, image cropping, automatic generation of photo albums, and changing attributes of an image-based product. The Complaint asserts that Kodak directly or indirectly infringes the patents, and it seeks unspecified damages and injunctive relief. On March 24, 2011, Kodak filed an answer and counterclaims against the Company.

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SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

In addition to the above cases, from time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. 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.

Note 7 — Acquisition

On April 25, 2011, the Company acquired Tiny Prints, Inc. ("Tiny Prints"), a privately-held ecommerce company. Pursuant to the terms of the agreement, all of the outstanding shares of capital stock of Tiny Prints, together with vested and unvested Tiny Prints equity awards, were acquired by the Company for aggregate consideration comprised of (i) approximately $146.5 million in cash, and approximately 4.0 million shares of the Company's common stock issuable in exchange for shares of Tiny Prints capital stock and (ii) Company equity awards for approximately 1.4 million shares of common stock in exchange for vested and unvested Tiny Prints' equity awards assumed by the Company, in each case pursuant and subject to the terms of the Merger Agreement. The 5.4 million shares of Shutterfly common stock issuable pursuant to the agreement equal approximately 18.5% of the Company's outstanding common stock as of March 30, 2011.

During the three months ended June 30, 2011, the Company finalized the Net Working Capital, Net Cash, and Net Debt amounts resulting in a reduction of purchase price of approximately $1.1 million. In accordance with the merger agreement, this amount will be repaid from the consideration held in escrow in the same proportion of cash and stock as was made in the initial escrow contribution. As of June 30, 2011, the cash proceeds due from escrow have been accrued as a component of other current assets.

Purchase Price

The total purchase price, after adjusting for changes in Net Working Capital, Net Cash, and Net Debt, is as follows (in thousands):

Cash consideration	$ 146,119
Fair value of common stock issued	218,677
Fair value of vested stock awards assumed	41,766
Total fair value of consideration transferred	$ 406,562

Tiny Prints operates tinyprints.com and weddingpaperdivas.com which offer cards, invitations, personalized stationery and photo books. With the acquisition and combined resources, the Company expects to incur significant revenue and cost synergies through the Tiny Prints brands, customer base and workforce.

Estimated Fair Value of Stock Awards Assumed

In connection with the acquisition, each Tiny Prints stock option that was outstanding and unexercised was assumed and converted into an option to purchase the Company's common stock based on a conversion ratio of 0.327, which was calculated as the consideration price per share of $12.44 divided by a fixed per share value of $38. The Company assumed the stock options in accordance with the terms of the applicable Tiny Prints stock option plan and the stock option agreement. Based on Tiny Prints' stock options outstanding at April 25, 2011, the Company converted options to purchase approximately 4.1 million shares of Tiny Prints common stock into options to purchase approximately 1.3

million shares of the Company’s common stock. The Company also assumed and converted approximately 196,896 unvested shares of outstanding Tiny Prints restricted stock units into approximately 64,386 shares of the Company’s restricted stock units, using the same conversion ratios stated above.

The fair value of stock options assumed was calculated using a Black-Scholes valuation model with the following assumptions: closing date market price of $54.64 per share; expected term of 4.5 years; risk-free interest rate of 2.1%; expected volatility of 48.1%; and no dividend yield. The fair value of restricted stock units assumed was calculated using the closing date market price of $54.64 per share for the Company’s common stock. The Company included the fair value of vested stock options assumed of $41.8 million in the consideration transferred for the acquisition. The estimated fair value of unvested stock options and restricted stock units assumed by the Company of $25.8 million was not included in the consideration transferred and is being recognized as stock-based compensation expense over the weighted average remaining vesting period of approximately two years. In addition, the Company determined that $2.9 million of incremental fair value was associated with vested awards at the acquisition date, and has recognized this additional amount in its post-combination financial statements.

Purchase Price Allocation

Under the purchase accounting method, the total purchase price was allocated to Tiny Prints’ tangible and identifiable intangible assets acquired and liabilities assumed based upon their estimated fair values as of the April 25, 2011 closing date of the acquisition. The excess purchase price over the value of the net assets acquired is recorded as goodwill.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The purchase price of Tiny Prints is allocated as follows (in thousands):

	Amount	Estimated Useful Life (in years)
Total assets acquired	$ 19,235	N/A
Total liabilities assumed	(44,218)	N/A
Identifiable intangible assets:		
Trade Name	51,100	15
Customer Base	33,300	7
Developed Technology	12,500	4
Other	3,080	2-3
Goodwill	331,565	N/A
Total purchase price	$ 406,562	

Included in the total liabilities assumed is a net deferred tax liability balance of $32.2 million, primarily comprised of the difference between the assigned values of the tangible and intangible assets acquired and the tax basis of those assets. This amount is net of deferred tax assets related to vested non-qualified stock options included in the purchase price, as well as other deferred tax assets acquired in the transaction.

Total amortizable intangible assets total $100.0 million and consist of trade name, customer base, developed technology, and other contractual agreements with useful lives that range from 2 to 15 years.

Goodwill of $331.6 million represents the excess of the purchase price over the fair value of the underlying net tangible and identifiable intangible assets, and represents the expected synergistic benefits of the transaction and the knowledge and experience of the workforce in place. In accordance with applicable accounting standards, goodwill will not be amortized but instead will be tested for impairment at least annually, or, more frequently if certain indicators are present. In the event that the management of the combined company determined that the value of goodwill has become impaired, the combined company will incur an accounting charge for the amount of the impairment during the fiscal quarter in which the determination is made.

The following table presents the pro forma statements of operations obtained by combining the historical consolidated operations of the Company and Tiny Prints for the three and six months ended June 30, 2011 and 2010, giving effect to the merger as if it occurred on January 1, 2011 and 2010, respectively (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Pro forma net revenues	$ 81,508	$ 61,017	$ 158,771	$ 119,969
Pro forma net loss	(4,537)	(6,889)	(14,369)	(11,104)
Pro forma basic and diluted net loss per share	$ (0.14)	$ (0.26)	$ (0.46)	$ (0.42)

Included in net revenues for the three and six months ended June 30, 2011 is $14.7 million of net revenues from sales of Tiny Prints products from the acquisition date of April 25, 2011 through June 30, 2011.

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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 document, including the following Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are based upon our current expectations. These forward-looking statements include statements related to our expectations regarding the seasonality and growth of our business, the impact on us of general economic conditions, trends in key metrics such as number of customers and orders and average order value, the decline in average selling prices for prints, our capital expenditures for 2011, the sufficiency of our cash and cash equivalents and cash generated from operations for the next 12 months, our ability to grow our personalized products and services as a percentage of our total revenues, our operating expenses remaining a consistent percentage of our net revenues, as well as other statements regarding our future operations, financial condition and prospects and business strategies. In some cases, you can identify forward-looking statements by terminology such as "project," "believe," "anticipate," "plan," "expect," "estimate," "intend," "continue," "should," "w "potentially," "will," or "may," or the negative of these terms or other comparable terminology. Forward-looking statements involve risks and uncertainties. Our actual results and the timing of events could differ materially from those anticipated in our forward-looking statements as a result of many factors, including but not limited to, the seasonality of our business, whether we are able to expand our customer base and increase our product and service offering, competition in our marketplace and the other risks set forth below under "Risk Factors" in Part II, Item 1A of this report. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. We assume no obligation to update any of the forward-looking statements after the date of this report or to compare these forward-looking statements to actual results.

Overview

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

On April 25, 2011, we acquired Tiny Prints, Inc. a privately-held company based in Sunnyvale, California that operates tinyprints.com and weddingpaperdivas.com, two growing ecommerce brands offering stylish cards, invitations, personalized stationary and photo books. We believe the acquisition will accelerate growth in our cards and stationery offering and will also provide the opportunity for significant synergies through vertical integration.

We currently generate the majority of our revenues by producing and selling professionally-bound photo books, greeting and stationery cards, personalized calendars, other photo-based merchandise and high-quality prints ranging in size from wallet-sized to jumbo-sized 20x30 enlargements. We manufacture most of these items in our Charlotte, North Carolina and Phoenix, Arizona production facilities. By controlling the production process in our own production facilities, we are able to produce high-quality products, innovate rapidly, maintain a favorable cost structure and ensure timely shipment to customers, even during peak periods of demand. Additionally, we sell a variety of photo-based merchandise that is currently manufactured for us by third parties, such as calendars, mugs, canvas prints, mouse pads, magnets, and puzzles. We generate substantially all of our revenue from sales originating in the United States and our sales cycle has historically been highly seasonal as we generate more than 50% of our revenue during our fiscal fourth quarter.

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

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

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

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

Basis of Presentation

Net Revenues. Our net revenues are comprised of sales generated from personalized products and services ("PPS"), prints and commercial print services.

Personalized products and services

Our personalized products and services revenues are derived from the sale of photo-based products, such as photo books, greeting and stationery cards, calendars and other photo-based merchandise and the related shipping revenues. Greeting and stationery card revenue includes all products sold by Tiny Prints. Included in our photo-based merchandise are items such as mugs, mouse pads, desktop plaques and puzzles. Revenue from advertising displayed on our website and referral fees are also included in PPS revenue. Our referral fees were approximately 0.7%, 2.5% and 3.1% of our net annual revenues for 2010, 2009 and 2008. Our referral fee program was discontinued effective March 31, 2010, and no referral fee revenue has been recorded subsequent to that date.

Prints

We also generate revenue from photo prints and the associated shipping revenue. Photo prints consist of wallet, 2x3, 4x6, 5x7, 8x10, and large format sizes. Also included in print revenues are photocards, which are personalized silver halide photo prints with designed content, used for greeting card occasions ranging from holidays to birthday cards and thank you notes.

Commercial print services

In order to use available print capacity during low volume periods and to leverage our large installed base of existing digital presses, we began providing commercial printing services in 2008 to the direct marketing industry. We continue to focus our efforts in expanding our presence in this market.

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

Our business is subject to seasonal fluctuations. In particular, we generate a substantial portion of our revenues during the holiday season in the calendar 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, we monitor several key metrics including:

Total Customers. We closely monitor total customers as a key indicator of demand. Total customers include the number of transacting customers in a given period. We seek to expand our customer base by empowering our existing customers with sharing and collaboration services (such as Shutterfly Gallery and Shutterfly Share Sites), and by conducting integrated marketing and advertising programs. Total customers have increased on an annual basis for each year since inception and while we expect this trend to continue, the number of customers is dependent on whether we are successful in executing our strategy in addition to the conditions of the overall economic environment.

Total Number of Orders. We closely monitor the total number of orders as a leading indicator of net revenue trends. We recognize the net revenues associated with an order when the products have been shipped and all other revenue recognition criteria have been met. Orders are typically processed and shipped within two business days after a customer places an order. Total number of orders has increased on an annual basis for each year since 2000, and while we anticipate this trend to continue in the future, the number of orders is dependent on whether we are successful in executing our strategy in addition to the conditions of the overall economic environment.

Average Order Value. For Shutterfly, average order value is net revenues, excluding revenues from our commercial print services, for a given period divided by the total number of customer orders recorded during that same period. For Tiny Prints, average order value excludes the impact of orders and net revenues related to sales of individual greeting cards, referred to as one-to-one greeting cards. We seek to increase average order value as a means of increasing net revenues. Average order value has increased on an annual basis for each year since 2000, and we anticipate that this trend will continue in the future as consumers shift from prints into personalized products and services.

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Personalized Products and Services Revenues as Percentage of Net Revenues. We continue to innovate and improve our personalized products and services and expect the net revenues from these products and services to increase as a percentage of total net revenues as we continue to diversify our product offerings. Personalized products and services as a percentage of total net revenue was 71% in 2010, 66% in 2009 and 61% in 2008. We believe that this trend results, in part, from the shift of consumer spending from offline to online outlets, as well as the increasing adoption of personalized, designed content.

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

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

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

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

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

General and administrative expense includes general corporate costs, such as rent for our corporate offices, insurance, depreciation on information technology equipment, and legal and accounting fees. Transaction costs related to our acquisition of Tiny Prints 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. We recognized a final payment due from one of the agreements in the first quarter of fiscal year 2010.

Interest Expense. Interest expense consists of interest costs recognized under our capital lease obligations as well as costs associated with our line of credit facility that expired in June 2010 and was not renewed.

Interest and other income, net. Interest and other income, net primarily consists of the interest earned on our cash and investment accounts. In 2010, this also included gains and losses on our trading securities, our auction-rate securities ("ARS") investment, which we liquidated in July 2010.

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. Historically, we have only been subject to taxation in the United States because we only operate within the United States.

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, 2010.

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Results of Operations

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net revenues	100%	100%	100%	100%
Cost of net revenues	53%	50%	52%	49%
Gross profit	47%	50%	48%	51%
Operating expenses:				
Technology and development	22%	27%	23%	27%
Sales and marketing	33%	24%	29%	23%
General and administrative	20%	21%	22%	20%
Loss from operations	(28)%	(22)%	(26)%	(19)%
Interest expense	0%	0%	0%	0%
Interest and other income, net	0%	1%	0%	1%
Loss before income taxes	(28)%	(21)%	(26)%	(18)%
Benefit from income taxes	23%	8%	17%	7%
Net loss	(5)%	(13)%	(9)%	(11)%

Comparison of the Three Month Periods Ended June 30, 2011 and 2010

	Three Months Ended June 30,			
	2011	2010	$ Change	% Change
	(in thousands)			
Net revenues				
Personalized products and services	$ 58,531	$ 31,676	$ 26,855	85%
Prints	14,491	14,371	120	1
Commercial printing services	2,742	760	1,982	261
Total net revenues	75,764	46,807	28,957	62
Cost of net revenues	39,881	23,179	16,702	72
Gross profit	$ 35,883	$ 23,628	$ 12,255	52%
Percentage of net revenues	47%	50%	—	—

Net revenues increased $29.0 million, or 62%, for the three months ended June 30, 2011 as compared to the same period in 2010. Revenue growth was attributable to increases in all revenue categories. PPS revenues increased $26.9 million, or 85%, to $58.5 million in the three months ended June 30, 2011 compared to the same period in 2010. The increase in PPS is primarily a result of increased sales of photo books and greeting and stationery cards. In addition, PPS includes $14.7 million of revenues from sales of Tiny Prints greeting card and stationery products from the acquisition date of April 25, 2011 through June 30, 2011. Print revenue increased $0.1 million, or 1%, to $14.5 million in the three months ended June 30, 2011 compared to the same period in 2010. Print revenues from sales of 4x6 prints represented 9% of total net revenues for the three months ended June 30, 2011, versus 16% in the prior year. In terms of product mix, PPS represented 77% and Prints represented 19% of revenue in the three months ended June 30, 2011. This compares to 68% and 31% in the same period in 2010. Revenue from our commercial print services increased $2.0 million, or 261%, to $2.7 million for the three months ended June 30, 2011, representing 4% of our total net revenues in the three months ended June 30, 2011.

For Shutterfly, excluding commercial print revenues, net revenue increases were also the result of year-over-year increases in all of our key metrics: customers, orders and average order value, as noted below:

	Three Months Ended June 30,			
	2011	2010	$ Change	% Change
Shutterfly	(in thousands, except AOV amounts)			
Customers	1,413	1,118	295	26%
Orders	2,235	1,802	433	24%
Average order value	$ 26.10	$ 25.56	$ 0.54	2%

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On a pro forma basis, comparing the full three months ended June 30, 2011 to the three months ended June 30, 2010, Tiny Prints key metrics, also increased, as noted below:

	Three Months Ended June 30,			
	2011	2010	$ Change	% Change
Tiny Prints	(in thousands, except AOV amounts)			
Customers	224	134	90	67%
Orders	362	162	200	124%
Average order value (excluding one-to-one greeting cards)	$ 112.13	$ 100.17	$ 11.96	12%

Cost of net revenues increased $16.7 million, or 72%, for the three months ended June 30, 2011 as compared to the same period in 2010. As a percentage of net revenues, cost of net revenues increased to 53% in 2011 from 50% in 2010, which decreased gross margin to 47% in the three months ended June 30, 2011 from 50% in the same period in 2010. Overall, the increase in cost of net revenues was primarily the result of the increased volume of shipped products, increased headcount and greater third-party fulfillment costs associated with Tiny Prints products. These costs were partially offset by favorable improvements from product mix.

	Three Months Ended June 30,			
	2011	2010	$ Change	% Change
	(in thousands)			
Technology and development	$ 16,971	$ 12,477	$ 4,494	36%
Percentage of net revenues	22%	27%	-	-
Sales and marketing	$ 24,930	$ 11,311	$ 13,619	120%
Percentage of net revenues	33%	24%	-	-
General and administrative	$ 15,522	$ 9,620	$ 5,902	61%
Percentage of net revenues	20%	21%	-	-

Our technology and development expense increased $4.5 million, or 36%, for the three months ended June 30, 2011, as compared to the same period in 2010. As a percentage of net revenues, technology and development expense decreased to 22% for the three months ended June 30, 2011 from 27% for the same period in 2010. The increase in technology and development expense was primarily due to an increase of $2.6 million related to personnel and related costs for employees, $2.0 million of stock-based compensation, $1.2 million related to professional and outside services consultants involved with website development and website infrastructure support teams and $0.4 million related to facilities costs. These factors were partially offset by a decrease in depreciation expense of $0.7 million and higher website development costs capitalized in the current period compared to the same period in the prior year.

At June 30, 2011, headcount in technology and development increased by 55% compared to June 30, 2010 reflecting our strategic focus to increase the rate of innovation in our product and services offerings, to generate greater differentiation from our competitors, and improve our long-term operating efficiency. In addition, the increase in headcount is also the result of the completion of the Tiny Prints acquisition during the period. As a result, in the three months ended June 30, 2011, we capitalized $2.4 million in eligible salary and consultant costs, including $0.1 million of stock based compensation, associated with software developed or obtained for internal use, compared to $1.3 million, which included $0.1 million of stock based compensation capitalized in the three months ended June 30, 2010. We expect this trend to continue in 2011, further increasing capitalized website and software development costs as a percentage of our total capital expenditures.

Our sales and marketing expense increased $13.6 million, or 120%, in the three months ended June 30, 2011 compared to the same period in 2010. As a percentage of net revenues, total sales and marketing expense increased to 33% in the three months ended June 30, 2011 from 24% in the three months ended June 30, 2010. The increase in sales and marketing expense was primarily due to an increase of $5.8 million related to expanded online marketing and partner marketing campaigns, as well as an increase of $3.2 million in stock-based compensation, and $2.1 million for depreciation. Personnel and related costs increased $2.3 million due to the additional headcount from our acquisition of Tiny Prints as well as the expansion of our existing marketing team.

Our general and administrative expense increased $5.9 million, or 61%, in the three months ended June 30, 2011 as compared to the same period in 2010. As a percentage of net revenues, total general and administrative expense decreased slightly to 20% for the three months ended June 30, 2011 from 21% in the three months ended June 30, 2010. The increase in general and administrative expense is primarily due to an increase in stock-based compensation of $2.2 million, an increase in personnel related costs of $1.6 million as a result of increased headcount, $0.9 million in transaction costs and $0.3 million related to facility costs. In the three months ended June 30, 2011, we also incurred an increase in credit card fees of $0.7 million which was driven by the increase in consumer product revenue as compared to the same period in 2010.

	Three Months Ended June 30,		
	2011	2010	Change
		(in thousands)	
Interest expense	$ -	$ (21)	$ (21)
Interest and other income, net	$ 6	$ 194	$ (188)

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Interest expense decreased in the three months ended June 30, 2011 as compared to the same period in 2010 primarily due to the expiration of our $20.0 million line of credit facility with Silicon Valley Bank on June 23, 2010, which we did not renew.

Interest and other income, net decreased by $0.2 million for the three months ended June 30, 2011 compared to the same period in 2010. The decrease was primarily due to the liquidation of our ARS investments on July 1, 2010, which yielded higher returns and were subsequently invested in Treasury securities, which yielded lower returns.

	Three Months Ended June 30,	
	2011	2010
	(in thousands)	
Income tax benefit	$ 17,884	$ 3,722
Effective tax rate	83%	39%

The benefit for income taxes was $17.9 million for the three months ended June 30, 2011, compared to a benefit of $3.7 million for the three months ended June 30, 2010. Our effective tax rate was 83% in the three months ended June 30, 2011, compared to 39% in the same period in 2010, primarily reflecting non-deductible stock-based compensation and transaction expenses, offset by tax benefits resulting from disqualifying dispositions of employee incentive stock options during the period.

	Three Months Ended June 30,			
	2011	2010	$ Change	% Change
	(in thousands)			
Loss before income taxes	$ (21,534)	$ (9,607)	$ (11,927)	124%
Net loss	$ (3,650)	$ (5,885)	$ 2,235	(38)%
Percentage of net revenues	(5) %	(13) %	—	—

Net loss decreased by $2.2 million for the three months ended June 30, 2011 as compared to the same period in 2010. As a percentage of net revenue, net loss was 5% and 13% for the three months ended June 30, 2011 and June 30, 2010, respectively.

Comparison of the Six Month Period Ended June 30, 2011 and 2010

	Six Months Ended June 30,			
	2011	2010	$ Change	% Change
	(in thousands)			
Net revenues				
Personalized products and services	$ 99,330	$ 62,170	$ 37,160	60%
Prints	28,644	28,107	537	2
Commercial printing services	5,019	2,272	2,747	121
Total net revenues	132,993	92,549	40,444	44
Cost of net revenues	69,427	45,757	23,670	52
Gross profit	$ 63,566	$ 46,792	$ 16,774	36%
Percentage of net revenues	48%	51%	—	—

Net revenues increased $40.4 million, or 44%, for the six months ended June 30, 2011 as compared to the same period in 2010. Revenue growth was attributable to increases in all revenue categories. PPS revenues increased $37.2 million, or 60%, to $99.3 million in the six months ended June 30, 2011 compared to the same period in 2010. The increase in PPS is primarily a result of increased sales of photo books and greeting and stationery cards. In addition, PPS includes $14.7 million of revenues from sales of Tiny Prints greeting card and stationery products from the acquisition date of April 25, 2011 through June 30, 2011. Print revenue increased $0.5 million, or 2%, to $28.6 million in the six months ended June 30, 2011 compared to the same period in 2010. The overall increase in print revenue was primarily due to an increase in large format prints offset by a decrease in photocard revenue and 4x6 print revenue, which represented 11% of total net revenues versus 16% in the prior year. In terms of product mix, PPS represented 77% and Prints represented 19% of revenue in the three months ended June 30, 2011. This compares to 67% and 31% in the same period in 2010. Revenue from our commercial print services increased $2.7 million, or 121%, to $5.0 million for the six months ended June 30, 2011, compared to the same period in 2010, and represented 4% of our total net revenues in the six months ended June 30, 2011.

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Cost of net revenues increased $23.7 million, or 52%, for the six months ended June 30, 2011 as compared to the same period in 2010. As a percentage of net revenues, cost of net revenues increased slightly to 52% in 2011 from 49% in 2010, which decreased gross margin to 48% in the six months ended June 30, 2011 from 51% in the same period in 2010. Overall, the increase in cost of net revenues was primarily the result of the increased volume of shipped products and increased headcount, as well as additional third party fulfillment costs associated with Tiny Prints products. These costs were partially offset by favorable improvements from product mix.

	Six Months Ended June 30,			
	2011	2010	$ Change	% Change
		(in thousands)		
Technology and development	$ 30,084	$ 24,646	$ 5,438	22%
Percentage of net revenues	23%	27%	-	-
Sales and marketing	$ 39,195	$ 21,468	$ 17,727	83%
Percentage of net revenues	29%	23%	-	-
General and administrative	$ 28,813	$ 18,421	$ 10,392	56%
Percentage of net revenues	22%	20%	-	-

Our technology and development expense increased $5.4 million, or 22%, for the six months ended June 30, 2011, as compared to the same period in 2010. As a percentage of net revenues, technology and development expense decreased to 23% for the six months ended June 30, 2011 from 27% for the same period in 2010. The increase in technology and development expense was primarily due to an increase of $3.9 million related to personnel and related costs for employees, an increase of $2.4 million related to professional and outside services consultants involved with website development and website infrastructure support teams, $2.1 million of stock-based compensation and $0.9 million related to facilities costs. These factors were partially offset by a decrease in depreciation expense of $1.6 million and higher website development costs capitalized in the current period compared to the same period in the prior year.

In the six months ended June 30, 2011, we capitalized $4.7 million in eligible salary and consultant costs, including $0.2 million of stock based compensation, associated with software developed or obtained for internal use, compared to $2.2 million, which included $0.1 million of stock based compensation capitalized in the six months ended June 30, 2010. We expect this trend to continue in 2011, further increasing capitalized website and software development costs as a percentage of our total capital expenditures.

Our sales and marketing expense increased $17.7 million, or 83%, in the six months ended June 30, 2011 compared to the same period in 2010. As a percentage of net revenues, total sales and marketing expense increased to 29% from 23%. The increase in sales and marketing expense was primarily due to an increase of $8.4 million related to expanded online marketing and partner marketing campaigns. The increase is also attributable to an increase of $3.4 million in personnel and related costs associated with our acquisition of Tiny Prints as well as the expansion of our internal marketing team, an increase of $3.4 million in stock based compensation, $2.1 million in depreciation and $0.4 million for professional fees.

Our general and administrative expense increased $10.4 million, or 56%, in the six months ended June 30, 2011 as compared to the same period in 2010. As a percentage of net revenues, total general and administrative expense increased to 22% in the six months ended June 30, 2011 from 20% for the comparable period in 2010. The increase in general and administrative expense is primarily due to an increase in personnel related costs of $3.1 million as a result of increased headcount, $2.7 million in stock-based compensation, $2.2 million in transaction costs related to our acquisition of Tiny Prints and $0.4 million for facility costs offset by a decrease in professional fees of $0.9 million. In the six months ended June 30, 2011, we also incurred an increase in credit card fees of $1.1 million which was driven by the increase in consumer product revenue as compared to the same period in 2010. During the six months ended June 30, 2010, we received the final installment from a cross-licensing agreement, while in the current period we received no installments. These payments were recognized as reductions of general and administrative expense.

	Six Months Ended June 30,		
	2011	2010	Change
		(in thousands)	
Interest expense	$ -	$ (42)	$ (42)
Interest and other income, net	$ 20	$ 436	$ (416)

Interest expense decreased in the six months ended June 30, 2011 as compared to the same period in 2010 primarily due to the expiration of our $20.0 million line of credit facility with Silicon Valley Bank on June 23, 2010, which we did not renew.

Interest and other income, net decreased by $0.4 million for the six months ended June 30, 2011 compared to the same period in 2010. The decrease was primarily due to the liquidation of our ARS investments on July 1, 2010, which yielded higher returns and were subsequently invested in Treasury securities, which yielded lower returns.

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	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
	(in thousands)	
Income tax benefit	$ 23,096	$ 6,733
Effective tax rate	67%	39%

The benefit for income taxes was $23.1 million for the six months ended June 30, 2011, compared to a benefit of $6.7 million for the six months ended June 30, 2010. Our effective tax rate was 67% in the six months ended June 30, 2011, compared to 39% in the same period in 2010, primarily reflecting non-deductible stock-based compensation and transaction expenses, offset by tax benefits resulting from disqualifying dispositions of employee incentive stock options during the period.

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010	$ Change	% Change
	(in thousands)			
Loss before income taxes	$ (34,506)	$ (17,349)	$ (17,157)	99%
Net loss	$ (11,410)	$ (10,616)	$ (794)	7%
Percentage of net revenues	(9) %	(11) %	—	—

Net loss increased by $0.8 million for the six months ended June 30, 2011 as compared to the same period in 2010. As a percentage of net revenue, net loss was 9% and 11% for the six months ended June 30, 2011 and June 30, 2010, respectively.

Liquidity and Capital Resources

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
	(in thousands)	
Consolidated Statements of Cash Flows Data:		
Purchases of property and equipment	$ 9,064	$ 8,630
Capitalization of software and website development costs	5,044	2,049
Depreciation and amortization	14,992	13,969
Cash flows used in operating activities	(58,014)	(23,163)
Cash flows provided by (used in) investing activities	(148,124)	10,973
Cash flows provided by financing activities	29,829	11,980

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

We anticipate that total 2011 capital expenditures will range from 7.0% to 7.5% of our expected net revenues in 2011. These expenditures will be used to purchase technology and equipment to support the growth in our business and to increase our production capacity and help enable us to respond more quickly and efficiently to customer demand. An increasing component of these expenditures includes costs associated with capitalized software and website development, as we continue to support our innovative engineering and product development strategies.

The following table shows total capital expenditures by category for the six months ended June 30, 2011 and 2010 (in thousands):

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Technology equipment and software	$ 5,665	$ 7,688
Percentage of total capital expenditures	40%	66%
Manufacturing equipment and building improvements	3,591	1,856
Percentage of total capital expenditures	25%	16%
Capitalized technology and development costs	5,045	2,049
Percentage of total capital expenditures	35%	18%
Total Capital Expenditures	$ 14,301	$ 11,593
Total Capital Expenditures percentage of net revenues	11%	13%

During the six months ended June 30, 2011, as we continued to increase the rate of innovation in our product and services offerings, to generate greater differentiation from our competitors, and improve our long-term operating efficiency, the percentage of total capital expenditures associated with website and product development has increased to 35% in the six months ended June 30, 2011 from 18% in the comparable period in 2010.

Also in the six months ended June 30, 2011, we incurred approximately $1.9 million in capital expenditures associated with building improvements to our headquarters facility. We expect these leasehold improvements to be reimbursed under our current lease, which was renewed in March 2010. Reimbursements under this provision have been recorded as a deferred lease incentive and will reduce rent expense over the remaining lease term. We expect to utilize the remaining reimbursement allowance during 2011.

Operating Activities. For the six months ended June 30, 2011, net cash used in operating activities was $58.0 million, primarily due to our net loss of $11.4 million and the net change in operating assets and liabilities of $78.9 million largely due to payments of year-end obligations. Net cash used in operating activities was adjusted for non-cash items including $10.8 million of depreciation and amortization expense and $17.3 million of stock-based compensation. Another non-cash item included in operating activities is $4.2 million of amortization of intangible assets which includes $0.2 million of amortization of prepaid royalties associated with intellectual property licenses that were entered into since 2009.

For the six months ended June 30, 2010, net cash used in operating activities was $23.2 million, primarily due to our net loss of $10.6 million and the net change in operating assets and liabilities of $31.2 million. Net cash used in operating activities was adjusted for non-cash items including $12.7 million of depreciation and amortization expense, $3.3 million benefit from deferred income taxes and $8.4 million of stock-based compensation. Another non-cash item included in operating activities is $1.3 million of amortization of intangible assets which includes $0.3 million of amortization of prepaid royalties associated with intellectual property licenses that were entered into during 2009.

Investing Activities. For the six months ended June 30, 2011, net cash used in investing activities was $148.1 million. We used $146.5 million in the acquisition of Tiny Prints net of cash acquired, $9.1 million for capital expenditures for computer and network hardware to support our website infrastructure and information technology systems, capital expenditures for production equipment for our manufacturing and production operations, and $5.0 million of capitalized software and website development.

For the six months ended June 30, 2010, net cash provided by investing activities was $11.0 million. We used $8.6 million for capital expenditures for computer and network hardware to support our website infrastructure and information technology systems, capital expenditures for production equipment for our manufacturing and production operations, and $2.0 million of capitalized software and website development. The use of cash was offset by cash provided from the liquidation of $21.6 million (at par value) of our ARS investments that were called by various issuers at par.

Financing Activities. For the six months ended June 30, 2011, net cash provided by financing activities was $29.8 million, primarily from $18.2 million of proceeds from issuance of common stock from the exercise of options and $11.6 million from excess tax benefits from stock-based compensation.

For the six months ended June 30, 2010, net cash provided by financing activities was $12.0 million, primarily from $7.9 million of proceeds from issuance of common stock from the exercise of options and $4.1 million from excess tax benefits from stock-based compensation.

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Non-GAAP Financial Measures

Regulation G, conditions for use of Non-Generally Accepted Accounting Principles ("Non-GAAP") financial measures, and other SEC regulations define and prescribe the conditions for use of certain Non-GAAP financial information. We closely monitor two financial measures, adjusted EBITDA and free cash flow which meet the definition of Non-GAAP financial measures. We define adjusted EBITDA as earnings before interest, taxes, depreciation, amortization and stock-based compensation. Free cash flow is defined as adjusted EBITDA less purchases of property and equipment and capitalization of software and website development costs. Management believes these Non-GAAP financial measures reflect an additional way of viewing our profitability and liquidity that, when viewed with our GAAP results, provides a more complete understanding of factors and trends affecting our earnings and cash flows. Refer below for a reconciliation of both adjusted EBITDA and free cash flow to the most comparable GAAP measure.

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

The table below shows the trend of adjusted EBITDA and free cash flow as a percentage of net revenues for the three and six months ended June 30, 2011 and 2010 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net revenues	$ 75,764	$ 46,807	$ 132,993	$ 92,549
Non-GAAP Adjusted EBITDA	$ (282)	$ 1,228	$ (2,200)	$ 4,659
EBITDA % of Net revenues	0 %	3 %	(2)%	5 %
Free cash flow	$ (6,819)	$ (4,029)	$ (16,501)	$ (6,934)
Free cash flow % of Net revenues	(9)%	(9)%	(12)%	(7)%

By carefully managing our operating costs and capital expenditures, we were able to make the strategic investments we believe are necessary to grow and strengthen our business. For the three and six months ended June 30, 2011, our adjusted EBITDA was ($0.3) million and ($2.2) million, respectively, as compared to $1.2 million and $4.7 million in the same periods in 2010. This adjusted EBITDA decline resulted from various discrete items, including intellectual property licensing and referral fees of $4.1 million in the six months ended June 30, 2010, and acquisition costs of $2.2 million and incremental payroll taxes related to employee equity awards of $1.1 million in the six months ended June 30, 2011. After adjusting for these discrete items, for the six months ended June 30, 2011, adjusted EBITDA would have increased $0.5 million compared to the prior year.

During the six months ended June 30, 2011 and 2010, we experienced negative free cash flows of $16.5 million and $6.9 million, respectively. However, during the fiscal year, we take steps designed to preserve the opportunity to achieve full year positive free cash flows. For example, on an annual basis, our capital expenditures have decreased each year from 2008 to 2010, as we continue to make strategic capital investments to support our overall growth as a business, improve efficiencies in our production and satisfy our customer needs while improving our cost imperatives.

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. Therefore, we believe that it is important to view free cash flow as a complement to our reported consolidated financial statements.

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The following is a reconciliation of adjusted EBITDA and free cash flow to the most comparable GAAP measure, for the three and six months ended June 30, 2011 and 2010 (in thousands):

Reconciliation of Net Loss to Non-GAAP Adjusted EBITDA	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net loss	$ (3,650)	$ (5,885)	$ (11,410)	$ (10,616)
Add back:				
Interest expense	-	21	-	42
Interest and other income, net	(6)	(194)	(20)	(436)
Tax benefit	(17,884)	(3,722)	(23,096)	(6,733)
Depreciation and amortization	9,159	6,949	14,992	13,969
Stock-based compensation expense	12,099	4,059	17,334	8,433
Non-GAAP Adjusted EBITDA	$ (282)	$ 1,228	$ (2,200)	$ 4,659

Reconciliation of Cash Flow from Operating Activities to Non-GAAP Adjusted EBITDA and Free Cash Flow	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net cash used in operating activities	$ (5,165)	$ 5,101	$ (58,014)	$ (23,163)
Add back:				
Interest expense	-	21	-	42
Interest and other income, net	(6)	(194)	(20)	(436)
Tax benefit	(17,884)	(3,722)	(23,096)	(6,733)
Changes in operating assets and liabilities	23,217	(1,969)	78,919	31,184
Other adjustments	(444)	1,991	11	3,765
Non-GAAP Adjusted EBITDA	(282)	1,228	(2,200)	4,659
Less:				
Purchases of property and equipment, including accrued amounts	(3,811)	(4,010)	(9,257)	(9,544)
Capitalized technology & development costs	(2,726)	(1,247)	(5,044)	(2,049)
Free cash flow	$ (6,819)	$ (4,029)	$ (16,501)	$ (6,934)

Off-Balance Sheet Arrangements

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

Recent Accounting Pronouncements

No new accounting standards have been adopted since our Annual Report on Form 10-K for the fiscal year ended December 31, 2010 was filed. We do not believe that any new accounting pronouncements not yet effective will have a material impact on our financial statements once adopted.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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.

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ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2011. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2011, 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 June 30, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On October 1, 2010, Express Card Systems, LLC filed a complaint for alleged patent infringement against us and four other defendants in Express Card Systems, LLC. v. Shutterfly, Inc. et. al., Civ. No. 6:10-cv-514, in the Eastern District of Texas, Tyler Division. The complaint asserts infringement of U.S. Patent No. 5,751,590, which claims, among other things, a method related to processing images to define social expression cards in a computer database. The Complaint asserts that we directly or indirectly infringe the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages and injunctive relief. On December 27, 2010, we filed an answer and counterclaims against Express Card Systems. On May 20, 2011, the court for the Eastern District of Texas, Tyler Division, granted Express Card Systems, LLC's Stipulation of Joint Dismissal without Prejudice of all claims and counterclaims between Express Card and us.

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

On January 31, 2011, we filed a complaint for patent infringement against Eastman Kodak Company and Kodak Imaging Network, Inc. ("Kodak") in Shutterfly, Inc. v. Eastman Kodak Company and Kodak Imaging Network, Inc., C.A. No. 11-099-SLR, in the U.S. District Court for the District of Delaware. The complaint asserts infringement of U.S. Patents Nos. 6,583,799; 7,269,800; 6,587,596; 6,973,222; 7,474,801; 7,016,869; and 7,395,229, which claim among other things, methods for image uploading, image cropping, automatic generation of photo albums, and changing attributes of an image-based product. The Complaint asserts that Kodak directly or indirectly infringes the patents, and it seeks unspecified damages and injunctive relief. On March 24, 2011, Kodak filed an answer and counterclaims against us.

In addition to the above cases, from time to time, we may be involved in various legal proceedings arising in the ordinary course of business. 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.

ITEM 1A. RISK FACTORS

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

Our business is highly seasonal, with a high proportion of our net revenues, net income and operating cash flows generated during the fourth quarter. For example, we generated more than 50% of our 2010 net revenues in the fourth quarter of 2010, and the net income that we generated during the fourth quarter of 2010 was necessary for us to achieve profitability on an annual basis. In addition, we incur significant additional expenses in the period leading up to the fourth quarter holiday season including expenses related to the hiring and training of temporary workers to meet our seasonal needs, additional inventory and equipment purchases and increased advertising. If we are unable to accurately forecast and respond to consumer demand for our products during the fourth quarter, our financial results, reputation and brand will suffer and the market price of our common stock would likely decline.

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

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

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

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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. We anticipate that total 2011 capital expenditures will range from 7.0% to 7.5% of 2011 net revenues. Operational difficulties, such as a significant interruption in the operations of either our Charlotte, North Carolina or Phoenix, Arizona production facilities could delay production or shipment of our products. Our inability to meet our production requirements could lead to customer dissatisfaction and damage our reputation and brand, which would result in reduced net revenues. Moreover, if the costs of meeting production requirements, including capital expenditures, were to exceed our expectations, our results of operations would be harmed.

In addition, we face significant production risks at peak holiday seasons, including the risks of obtaining sufficient qualified seasonal production personnel. A majority of our workforce during the fourth quarter of 2010 was seasonal, temporary personnel. We have had difficulties in the past finding a sufficient number of qualified seasonal employees, and our failure to obtain qualified seasonal production personnel at any of our production facilities could harm our operations.

Economic trends could adversely affect our financial performance.

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

Weak economic conditions, low consumer spending and decreased consumption may harm our operating results. Purchases of our products are often discretionary. If the economic climate does not improve, customers or potential customers could delay, reduce or forego their purchases of our products and services, which could impact our business in a number of ways, including lower prices for our products and services and reduced sales. In addition, adverse economic conditions may lead to price increases by our suppliers or increase our operating expenses due to, among others, higher costs of labor, energy, equipment and facilities. A prolonged and slow economic recovery or a renewed recession may also lead to additional restructuring actions and associated expenses. For example, during the first quarter of 2009, we reduced our headcount by 5%. Due to reduced consumer spending and increased competitive pressures in the current economic environment, we may not be able to pass these increased costs on to our customers. The resulting increased expenses and/or reduced income would negatively impact our operating results.

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

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

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

- general economic conditions, including recession and slow economic growth in the U.S. and worldwide and higher inflation, as well as those economic conditions specific to the Internet and e-commerce industries;
- demand for our products and services, including seasonal demand;
- our pricing and marketing strategies and those of our competitors;

our ability to attract visitors to our website and convert those visitors into customers;

our ability to retain customers and encourage repeat purchases;

our ability to sustain our profit margins, and our ability to diversify our product offerings, promote our new products and services and sell to consumers photo-based products such as photo books, calendars and cards;

the costs of customer acquisition;

our ability to manage our production and fulfillment operations;

the costs to produce our prints and photo-based products and merchandise and to provide our services;

the costs of expanding or enhancing our technology or website;

a significant increase in returns and credits, beyond our estimated allowances, for customers who are not satisfied with our products;

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- declines or disruptions to the travel industry;
- variations in weather, particularly heavy rain and snow which tend to depress travel and picture taking;
- the timing of holidays;
- volatility in our stock price, which may lead to higher stock-based compensation expense;
- 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, war, threat of war or terrorist actions.

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

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

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

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

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

- maintain and increase the size of our customer base;
- maintain and enhance our brand;
- enhance and expand our products and services;
- maintain and grow our website and customer operations;
- successfully execute our business and marketing strategy;
- continue to develop and upgrade our technology and information processing systems;
- continue to enhance our service to meet the needs of a changing market;

- provide superior customer service;
- respond to competitive developments; and
- attract, integrate, retain and motivate qualified personnel.

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

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

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

Our data storage system could suffer damage or interruption from human error, fire, flood, power loss, telecommunications failure, break-ins, terrorist attacks, acts of war and similar events. In addition, our primary storage facilities are located near a major fault line, increasing our susceptibility to the risk that an earthquake could significantly harm our data storage system. If we experience disruption to our redundant systems located at our data storage center, such disruption could result in the deletion or corruption of customer stored images.

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

The satisfactory performance, reliability and availability of our website, information technology systems, printing production processes and customer service operations are critical to our reputation, and our ability to attract and retain customers and maintain adequate customer satisfaction. Any interruptions that result in the unavailability of our website or reduced order fulfillment performance or customer service could result in negative publicity, damage our reputation and brand and cause our business and results of operations to suffer. For example, in the second quarter of 2008, we experienced website performance issues in conjunction with a large release of additional website functionality which impacted our key metrics and revenue. This risk is heightened in the fourth quarter, as we experience significantly increased traffic to our website during the holiday season. Any interruption that occurs during such time would have a disproportionately negative impact than if it occurred during a different quarter.

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

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

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

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

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

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

Changes in our pricing strategies have had, and may continue to have, a significant impact on our net revenues and net income. From time to time, we have made changes to our pricing structure, specifically for 4x6 prints, in order to remain competitive. Like 4x6 prints, most of our other products are also offered by our competitors. If in the future, due to competitor activities 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, these fees represented approximately 14%, 14% and 17% of our net revenues in 2010, 2009 and 2008 respectively. We offer discounted or free shipping, with a minimum purchase requirement, during promotional periods to attract and retain customers. If free shipping offers extend beyond a limited number of occasions, are not based upon a minimum purchase requirement or become commonplace, our net revenues and results of operations would be negatively impacted. In addition, we occasionally offer free or discounted products and services to attract and retain customers. In the future, if we increase these offers to respond to actions taken by our competitors, our results of operations may be harmed.

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

The digital photography products and services industries are intensely competitive, and we expect competition to increase in the future as current competitors improve their offerings 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 Kodak EasyShare Gallery, Snapfish, which is a service of Hewlett-Packard, Webshots, Vistaprint, SmugMug, SeeHere and others;

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

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

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

Social media companies that host images such as Facebook, Twitter, and MySpace;

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

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

Home printing service providers such as Hewlett-Packard, Epson, Canon, Kodak and Fuji that are seeking to expand their printer and ink businesses by gaining market share in the digital photography marketplace;

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

Self-publishing companies and services such as Lulu, CafePress, Amazon's CreateSpace and Zazzle; and

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

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

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

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

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

A key component of our business strategy includes strengthening our competitive position and refining the customer experience on our website through internal development. However, from time to time, we may selectively pursue acquisitions of businesses, such as our 2011 acquisition of Tiny Prints, Inc., our 2010 acquisition of WMSG, Inc., and our 2009 acquisition of TinyPictures. Integrating any newly acquired businesses, technologies or services is likely to be expensive and time consuming. For example, in connection with our Tiny Prints acquisition, we issued approximately 5.4 million shares of our common stock as transaction consideration. We may continue to issue equity securities for future acquisitions, which would dilute existing stockholders, perhaps significantly depending on the terms of such acquisitions. To finance any future acquisitions, it may also be necessary for us to raise additional funds through public or private debt and equity financings. Additional funds may not be available on terms that are favorable to us, and, in the case of equity financings, would result in dilution to our stockholders. Also, the value of our stock may be insufficient to attract acquisition candidates.

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

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

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

We are highly dependent upon the continued service and performance of our senior management team and key technical, marketing and production personnel. The loss of these key employees, each of whom is “at will” and may terminate his or her employment relationship with us at any time, may significantly delay or prevent the achievement of our business objectives.

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

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

At the 2010 annual meeting, our stockholders approved an amendment to our 2006 Equity Incentive Plan (the “2006 Plan”) to renew its “evergreen” provision. According to the amendment, the number of shares available for issuance under the 2006 Plan will automatically increase as follows: (i) on January 1, 2011 by 3.5% of the number of the Company’s common stock issued and outstanding on December 31, 2010; (ii) on January 1, 2012 by 3.3% of the number of the Company’s common stock issued and outstanding on December 31, 2011, and (iii) on January 1, 2013 by 3.1% of the number of the Company’s common stock issued and outstanding on December 31, 2012. In addition, in order to attract key personnel, the Board authorized 380,000, 135,100 and 200,000 additional inducement stock option grants and restricted stock awards to supplement our 2006 Plan, which were granted in 2007, 2008 and 2009, respectively. Inducement stock options and awards are granted to certain employees upon hire and do not require shareholder approval. In the future, attracting key personnel may require a level of option grants in excess of the amount available in our 2006 Plan. The increase of the shares available for issuance under the 2006 Plan and grants of awards from it, as well as further inducement equity awards outside of the 2006 Plan, will cause dilution to our stockholders.

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

Our success depends on our ability to attract customers in a cost-effective manner. We rely on a variety of methods to bring visitors to our website and promote our products, including paying fees to third parties who drive new customers to our website, purchasing search results from online search engines, e-mail and direct mail. We pay providers of online services, search engines, directories and other website and e-commerce businesses to provide content, advertising banners and other links that direct customers to our website. We also use e-mail and direct mail to offer free products and services to attract customers, and we offer substantial pricing discounts to encourage repeat purchases. Our methods of attracting customers, including acquiring customer lists from third parties, can involve substantial costs, regardless of whether we acquire new customers. Even if we are successful in acquiring and retaining customers, the cost involved in these efforts impacts our results of operations. Customer lists are typically recorded as intangible assets and may be subject to impairment charges if the fair value of that list exceeds its carrying value. These potential impairment charges could harm our results from operations. If we are unable to enhance or maintain the methods we use to reach consumers, if the costs of attracting customers using these methods significantly increase, or if we are unable to develop new cost-effective means to obtain customers, our ability to attract new customers would be harmed, traffic to our website would be reduced and our business and results of operations would be harmed.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We have historically relied on an exclusive supply relationship with Fuji Photo Film U.S.A. to supply all of our photographic paper for silver halide print production, such as 4x6 prints. In March 2010, we renewed our supply agreement with Fuji which expires in March 2013. If that agreement is not renewed before it expires in March 2013, or if Fuji fails to perform in accordance with the terms of our agreement and if we are unable to secure a paper supply from a different source in a timely manner, we would likely fail to meet customer expectations, which could result in negative publicity, damage our reputation and brand and harm our business and results of operations. We purchase other photo-based supplies from third parties on a purchase order basis, and, as a result, these parties could increase their prices, reallocate supply to others, including our competitors, or choose to terminate their relationship with us. In addition, we purchase or rent a substantial portion of the machines used to produce certain of our photo-based products from Hewlett-Packard, which is one of our primary competitors in the area of online digital photography services. This competition may influence their willingness to provide us with additional products or services. If we were required to switch vendors of machines for photo-based products, we may incur delays and incremental costs, which could harm our operating results.

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

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

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

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

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

We rely on a combination of patent, trademark, trade secret and copyright law and contractual restrictions to protect our intellectual property. These protective measures afford only limited protection. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our website features and functionalities or to obtain and use information that we consider proprietary, such as the technology used to operate our website, our production operations and our trademarks.

As of June 30, 2011, Shutterfly had 38 patents issued, and had more than 20 patent applications pending in the United States. With the acquisition of Tiny Prints on April 25, 2011, Shutterfly acquired more than 20 Tiny Prints patent applications that were 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 brand and substantially harm our business and results of operations.

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

For example, in 2009, we settled three patent infringement lawsuits against us. In 2010, two more patent infringement lawsuits were filed against us, one of which is currently pending. The other, filed by Express Card Systems, LLC on October 1, 2010, was recently dismissed. On May 20, 2011, the court for the Eastern District of Texas, Tyler Division, granted Express Card Systems, LLC's Stipulation of Joint Dismissal without Prejudice of all claims and counterclaims between Express Card and Shutterfly. On December 10, 2010, Eastman Kodak Company ("Kodak") filed a complaint for alleged patent infringement against Shutterfly in the District of Delaware. On January 31, 2011, we filed a patent infringement complaint against Kodak and Kodak Imaging Network, Inc. in the United

States District Court of Delaware.

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.

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

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

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

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

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

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

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

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

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

We are subject to general business regulations and laws as well as regulations and laws specifically governing the Internet and e-commerce. Existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, restrictions on imports and exports, customs, tariffs, user privacy, data protection, pricing, content, copyrights, distribution, electronic contracts and other communications, consumer protection, the provision of online payment services, broadband residential Internet access and the characteristics and quality of products and services. It is not clear how existing laws governing issues such as property use and ownership, sales and other taxes, fraud, libel and personal privacy apply to the Internet and e-commerce as the vast majority of these laws were adopted prior to the advent of the Internet and do not contemplate or address the unique issues raised by the Internet or e-commerce. Those laws that do reference the Internet are only beginning to be interpreted by the courts and their applicability and reach are therefore uncertain. For example, the Digital Millennium Copyright Act, or DMCA, is intended, in part, to limit the liability of eligible online service providers for including (or for listing or linking to third-party websites that include) materials that infringe copyrights or other rights of others.

Portions of the Communications Decency Act, or CDA, are intended to provide statutory protections to online service providers who distribute third-party content. We rely on the protections provided by both the DMCA and CDA in conducting our business. Any changes in these laws or judicial interpretations narrowing their protections will subject us to greater risk of liability and may increase our costs of compliance with these regulations or limit our ability to operate certain lines of business. The Children's Online Protection Act and the Children's Online Privacy Protection Act are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children From Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances. The Credit Card Accountability, Responsibility and Disclosure Act ("CARD Act") is intended to protect consumers from unfair credit card billing practices and adds new regulations on the use of gift cards, limiting our ability to expire them. In addition, several states are also attempting to pass new laws regulating the use of gift cards and amending state escheatment laws to try and obtain unused gift card balances. The Restore Online Shoppers' Confidence Act ("ROSCA") prohibits and prevents Internet-based post-transaction third party sales and imposes specific requirements on negative option features. The costs of compliance with these regulations may increase in the future as a result of changes in the regulations or the interpretation of them. Further, any failures on our part to comply with these regulations may subject us to significant liabilities. Those current and future laws and regulations or unfavorable resolution of these issues may substantially harm our business and results of operations.

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

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

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

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

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

A significant prerequisite to online commerce and communications is the secure transmission of confidential information over public networks. Our failure to prevent security breaches could damage our reputation and brand and substantially harm our business and results of operations. For example, a majority of our sales are billed to our customers' credit card accounts directly, orders are shipped to a customer's address, and customers log on using their e-mail address. We rely on encryption and authentication technology licensed from third parties to effect the secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, new discoveries in the field of cryptography or other developments may result in a compromise or breach of the technology used by us to protect customer transaction data. In addition, any party who is able to illicitly obtain a user's password could access the user's transaction data, personal information or stored images. Any compromise of our security could damage our reputation and brand and expose us to a risk of loss or litigation and possible liability, which would substantially harm our business and results of operations. In addition, anyone who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. We may need to devote significant resources to protect against security breaches or to address problems caused by breaches.

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

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

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

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

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

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

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

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

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

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

The online market for digital photography products and services is less developed than the online market for other consumer products. If this market does not gain widespread acceptance, our business may suffer. Our success will depend in part on our ability to attract customers who have historically used traditional retail photography services or who have produced photographs and other products using self-service alternatives, such as printing at home. Furthermore, we may have to incur significantly higher and more sustained advertising and promotional expenditures or reduce the prices of our products and services in order to attract additional online consumers to our website and convert them into purchasing customers. Specific factors that could prevent prospective customers from purchasing from us include:

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

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

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

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

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

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

In October 2009, in connection with the restatement of our financial statements related to our accounting for stock-based compensation expense, we determined that we had a material weakness in our internal controls, which pertained to controls to ensure the completeness and accuracy of stock-based compensation expense. This weakness resulted in the restatement of our consolidated balance sheets at December 31, 2008 and December 31, 2007, our consolidated statements of operations, stockholders' equity and cash flows for the fiscal years ended December 31, 2008 and December 31, 2007, and the related notes thereto to correct an error in our stock-based compensation expense.

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

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

As a public company, we are subject to the reporting requirements of the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002 and the rules and regulations of The NASDAQ Stock Market. Additional or new regulatory requirements may be adopted in the future. The requirements of existing and potential future rules and regulations will likely continue to increase our legal, accounting and financial compliance costs, make some activities more difficult, time-consuming or costly and may also place undue strain on our personnel, systems and resources.

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

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

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

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

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

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

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

price and volume fluctuations in the overall stock market;

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changes in operating performance and stock market valuations of other technology companies generally, or those in our industry in particular;

the financial projections we may provide to the public, any changes in these projections or our failure to meet these projections;

changes in financial estimates by any securities analysts who follow our company, our failure to meet these estimates or failure of those analysts to initiate or maintain coverage of our stock;

ratings downgrades by any securities analysts who follow our company;

the public's response to our press releases or other public announcements, including our filings with the SEC;

announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;

introduction of technologies or product enhancements that reduce the need for our products;

impairment or loss in value of our investments in auction rate securities;

the loss of key personnel;

lawsuits threatened or filed against us;

future sales of our common stock by our executive officers, directors and significant stockholders; and

other events or factors, including those resulting from war, incidents of terrorism or responses to these events.

Some provisions in our restated certificate of incorporation and restated bylaws and Delaware law may deter third parties from acquiring us.

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

our board is classified into three classes of directors, each with staggered three-year terms;

only our chairman, our chief executive officer, our president, or a majority of our board of directors is authorized to call a special meeting of stockholders;

our stockholders may take action only at a meeting of stockholders and not by written consent;

vacancies on our board of directors may be filled only by our board of directors and not by stockholders;

our certificate of incorporation authorizes undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval; and

advance notice procedures apply for stockholders to nominate candidates for election as directors or to bring matters before an annual meeting of stockholders.

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

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

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

Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

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 Shutterfly, Inc's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Satements of Operations, (iii) Condensed Consolidated Satements of Cash Flows, and (iv) Notes to Unaudited Condensed Consolidated Financial Statements.

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

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SHUTTERFLY, INC.
(Registrant)

Dated: August 2, 2011	By: /s/ Jeffrey T. Housenbold Jeffrey T. Housenbold President and Chief Executive Officer (Principal Executive Officer)
Dated: August 2, 2011	By: /s/ Mark J. Rubash Mark J. Rubash Senior Vice President and Chief Financial Officer (Principal Financial Officer)

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