BLUE NILE INC
Form 10-Q
August 06, 2004

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended July 4, 2004

OR

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

For the transition period from to

Commission file number 000-50763

BLUE NILE, INC.

(Exact name of registrant as specified in its charter)

Delaware *(State or other jurisdiction of incorporation or organization)*	91-1963165 *(I.R.S. Employer Identification No.)*

705 Fifth Avenue South, Suite 900
Seattle, Washington 98104
(Address of principal executive offices)

Registrant s telephone number, including area code: (206) 336-6700

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ( ) No (**X**)

As of July 26, 2004, the registrant had 17,656,265 shares of common stock outstanding.

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Cautionary Note Regarding Forward-Looking Statements

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

Blue Nile, Inc.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

BLUE NILE, INC.

Consolidated Balance Sheets

	July 4, 2004	December 31, 2003
	(Unaudited) (in thousands, except par value)	
Assets		
Current assets:		
Cash and cash equivalents	$ 52,646	$ 30,383
Restricted cash	60	400
Marketable securities	15,928	
Accounts receivable	517	843
Inventories	6,681	10,204
Deferred income taxes	5,250	5,300
Prepaids and other current assets	1,212	465
Total current assets	82,294	47,595
Property and equipment, net	3,671	3,979
Deferred income taxes	8,687	10,654
Other assets	77	77
Total assets	$ 94,729	$ 62,305
Liabilities and Stockholders Equity (Deficit)		
Current liabilities:		
Accounts payable	$ 13,786	$ 26,288
Accrued liabilities	2,981	4,467
Current portion of deferred rent	176	173
Total current liabilities	16,943	30,928
Deferred rent, less current portion	1,028	1,130
Commitments and contingencies		
Mandatorily redeemable convertible preferred stock, $0.001 par value; 25,856 shares authorized; no shares and 10,000 shares outstanding at July 4, 2004 and December 31, 2003, respectively; aggregate liquidation preference of $0 and		57,485

$78,664 at July 4, 2004 and December 31, 2003, respectively		
Stockholders equity (deficit):		
Preferred stock, $0.001 par value; no shares authorized, issued and outstanding as of December 31, 2003; 5,000 shares authorized, none issued and outstanding as of July 4, 2004		
Common stock, $0.001 par value; 300,000 shares and 48,000 shares authorized as of July 4, 2004 and December 31, 2003, respectively; 18,406 shares and 5,128 shares issued as of July 4, 2004 and December 31, 2003, respectively; 17,656 shares and 4,378 shares outstanding as of July 4, 2004 and December 31, 2003, respectively	18	5
Additional paid-in capital	104,276	4,247
Deferred compensation	(1,166)	(1,352)
Accumulated deficit	(25,734)	(29,502)
Treasury stock, at cost; 750 shares outstanding at July 4, 2004 and December 31, 2003	(636)	(636)
Total stockholders equity (deficit)	76,758	(27,238)
Total liabilities and stockholders equity (deficit)	$ 94,729	$ 62,305

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

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BLUE NILE, INC.

Consolidated Statements of Operations

	Quarter Ended		Year to Date Ended	
	July 4, 2004	June 30, 2003	July 4, 2004	June 30, 2003
	(Unaudited)		(Unaudited)	
	(in thousands, except per share data)			
Net sales	$35,022	$ 27,254	$ 70,806	$51,882
Cost of sales	27,095	21,147	54,667	39,622
Gross profit	7,927	6,107	16,139	12,260
Operating expenses:				
Selling, general and administrative	5,111	3,890	10,419	8,207
	5,111	3,890	10,419	8,207
Operating income	2,816	2,217	5,720	4,053
Other income (expense) net:				
Interest income	97	21	139	55
Interest expense		(11)		(209)
Other income	14	16	38	35
	111	26	177	(119)
Income before income taxes	2,927	2,243	5,897	3,934
Income tax expense	1,063		2,129	
Net income	$ 1,864	$ 2,243	$ 3,768	$ 3,934
Basic net income per share	$ 0.18	$ 0.65	$ 0.51	$ 1.15
Diluted net income per share	$ 0.11	$ 0.14	$ 0.22	$ 0.24

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

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BLUE NILE, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN MANDATORILY REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)
Unaudited

	Mandatorily Redeemable Convertible Preferred Stock		Stockholders Equity (Deficit)						
			Common Stock						
	Shares	Amount	Shares	Amount	Additional Paid-in Capital	Deferred Compensation	Accumulated Deficit	Treasury Stock	Total
					(in thousands)				
Balance, December 31, 2003	10,000	$ 57,485	5,128	$ 5	$ 4,247	$ (1,352)	$ (29,502)	$ (636)	$ (27,238)
Sale of common stock, net of offering expenses			2,301	2	42,491				42,493
Conversion of mandatorily redeemable convertible preferred stock to common stock	(10,000)	(57,485)	10,920	11	57,474				57,485
Deferred stock compensation on issuance of stock options					228	(228)			
Amortization of deferred stock compensation						188			188
Reversal of deferred compensation relating to cancelled options					(226)	226			
Exercise of common stock options and warrants			57		62				62
Net income and comprehensive income							3,768		3,768
Balance, July 4, 2004		$	18,406	$ 18	$ 104,276	$ (1,166)	$ (25,734)	$ (636)	$ 76,758

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

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BLUE NILE, INC.

Consolidated Statements of Cash Flows

	Year to date Ended	
	July 4, 2004	June 30, 2003
	(Unaudited) (in thousands)	
Operating activities:		
Net income	$ 3,768	$ 3,934
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	734	694
Stock-based compensation	188	
Warrant-based interest expense		87
Deferred income taxes	2,017	
Changes in assets and liabilities:		
Receivables, net	326	218
Inventories	3,523	925
Prepaid expenses and other assets	(748)	(77)
Accounts payable	(12,502)	(4,864)
Accrued liabilities	(1,486)	(787)
Deferred rent	(99)	12
Net cash (used in) provided by operating activities	(4,279)	142
Investing activities:		
Purchases of property and equipment	(425)	(756)
Transfers of restricted cash	340	
Purchases of marketable securities	(15,928)	
Net cash used in investing activities	(16,013)	(756)
Financing activities:		
Proceeds from sale of common stock, net of issuance costs	42,493	
Repurchase of restricted and common stock		(8)
Payments on subordinated notes payable		(6,638)
Payments on capital lease obligations		(995)
Payments on note payable to related party		(1,140)
Proceeds from warrant and stock option exercises	62	16
Net cash provided by (used in) financing activities	42,555	(8,765)

Net increase (decrease) in cash and cash equivalents	22,263	(9,379)
Cash and cash equivalents, beginning of period	30,383	22,597
Cash and cash equivalents, end of period	$ 52,646	$ 13,218
Supplemental disclosure of cash flow information:		
Non-cash financing activities:		
Conversion of mandatorily redeemable preferred stock to common stock	$ 57,485	$

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

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BLUE NILE, INC.

Notes to Consolidated Financial Statements

Note 1. Description of the Company and Summary of Significant Accounting Policies

The Company

Blue Nile, Inc. (the Company) is a leading online retailer of high quality diamonds and fine jewelry. In addition to sales of diamonds, fine jewelry and watches, the Company provides guidance and support to enable customers to more effectively learn about and purchase diamonds as well as classically styled fine jewelry. The Company, a Delaware corporation, based in Seattle, Washington, was formed in March 1999. The Company maintains its primary web site at www.bluenile.com.

Change in Fiscal Year

On January 1, 2004, the Company s fiscal year-end changed from December 31 to the Sunday closest to December 31. Each fiscal year consists of four 13-week quarters, with an extra week added onto the fourth quarter every five to six years. Because of the transition, year to date 2004 results include three additional days of operations.

Reclassifications

Certain reclassifications of prior year balances have been made for consistent presentation with the current year.

Basis of Presentation

The accompanying unaudited consolidated financial statements should be read in conjunction with the Notes to Consolidated Financial Statements contained in Amendment No. 4 of the Company s registration statement on Form S-1, declared effective by the Securities and Exchange Commission on May 19, 2004. The same accounting policies are followed for preparing quarterly and annual financial statements. In the opinion of management, all adjustments necessary for the fair presentation of the results of operations, financial position and cash flows have been included and are of a normal, recurring nature.

Due to the seasonal nature of the retail industry, quarterly results are not necessarily indicative of the results for the full fiscal year.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates include the allowance for sales returns, the reserve for estimated fraud losses and the deferred tax valuation reserve. Actual results could differ from those estimates.

Stock-Based Compensation

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations including Financial Accounting Standards Board Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB Opinion No. 25. The Company has elected to apply the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation. Had compensation cost for the Company s stock options been determined based on the fair value of the options at the date of grant, the Company s pro forma net income would have been as shown below (in thousands, except per share data):

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BLUE NILE, INC.

Notes to Consolidated Financial Statements

	Quarter Ended		Year to Date Ended	
	July 4, 2004	**June 30, 2003**	**July 4, 2004**	**June 30, 2003**
Net income, as reported	$1,864	$ 2,243	$3,768	$ 3,934
Add: Stock-based compensation expense, as reported	82		188	
Deduct: Stock-based employee compensation expense determined under fair-value-based method, net of tax	(140)	(66)	(307)	(131)
Pro forma net income	$1,806	$ 2,177	$3,649	$ 3,803
Income per share:				
Basic as reported	$ 0.18	$ 0.65	$ 0.51	$ 1.15
Basic pro forma	$ 0.17	$ 0.63	$ 0.50	$ 1.11
Diluted as reported	$ 0.11	$ 0.14	$ 0.22	$ 0.24
Diluted pro forma	$ 0.10	$ 0.13	$ 0.21	$ 0.23

Note 2. Inventories

Inventories are stated at cost and consist of the following (in thousands):

	July 4, 2004	**December 31, 2003**
Loose diamonds	$ 77	$ 124
Fine jewelry, watches and other	6,604	10,080
	$6,681	$10,204

Note 3. Marketable Securities

The Company s marketable securities are classified as available-for-sale as defined by Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. At July 4, 2004, marketable securities consist of U.S. government and agencies securities maturing in 2004. The securities are carried at fair value, which approximates cost. Interest on marketable securities is included in interest income in the consolidated statements of operations. There were no sales of marketable securities during the periods presented.

Note 4. Net Income Per Share

Basic net income per share is based on the weighted average number of common shares outstanding, excluding unvested common shares issued to employees upon early exercise of options, which are subject to repurchase by the Company. Diluted net income per share is based on the weighted average number of common shares and equivalents outstanding. Common share equivalents included in the computation represent common shares issued upon early exercise of options which are subject to repurchase rights, shares issuable upon assumed exercise of outstanding stock options, warrants and mandatorily redeemable convertible preferred stock except when the effect of their inclusion would be antidilutive.

The following tables sets forth the computation of basic and diluted net income (loss) per share (in thousands, except per share data):

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BLUE NILE, INC.

Notes to Consolidated Financial Statements

	Quarter Ended		Year to Date Ended	
	July 4, 2004	June 30, 2003	July 4, 2004	June 30, 2003
Net income	$ 1,864	$ 2,243	$ 3,768	$ 3,934
Weighted average common shares outstanding	10,388	3,433	7,329	3,419
Basic net income per share	$ 0.18	$ 0.65	$ 0.51	$ 1.15
Dilutive effect of stock options and warrants	1,228	2,043	1,179	2,048
Dilutive effect of mandatorily redeemable convertible preferred stock	6,000	10,920	8,513	10,850
Common stock and common stock equivalents	17,616	16,396	17,021	16,317
Diluted net income per share	$ 0.11	$ 0.14	$ 0.22	$ 0.24

For the quarter ended June 30, 2003, there were 2,994 preferred stock warrants and 2,517 stock option shares excluded from the computation of net income per diluted share due to their antidilutive effect. For the year to date ended June 30, 2003, there were 2,994 preferred stock warrants and 1,311 stock option shares excluded from the computation of net income per diluted share due to their antidilutive effect.

Note 5. Initial Public Offering

On May 19, 2004, the Company s registration statement on Form S-1 was declared effective for its initial public offering, pursuant to which the Company sold 2,300,910 million shares of common stock at $20.50 per share. The Company s common stock commenced trading on May 20, 2004. The offering closed on May 25, 2004, and, as a result, the Company received net proceeds of approximately $43.9 million (after underwriters discounts of $3.3 million). The Company incurred additional, estimated related expenses of approximately $1.4 million.

On April 30, 2004, the Company effected a 1 for 2.5 reverse split of its common stock and mandatorily redeemable convertible preferred stock. All shares and per share amounts and any other references to shares included in the accompanying unaudited consolidated financial statements have been adjusted to reflect this split on a retroactive basis.

Simultaneous with the closing of this offering, the Company s 10.0 million outstanding shares of mandatorily redeemable convertible preferred stock were automatically converted into approximately 10.9 million shares of common stock.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with our Consolidated Financial Statements and the related notes contained elsewhere in this quarterly report on Form 10-Q. All statements in the following discussion that are not reports of historical information or descriptions of current accounting policy are forward-looking statements. Please consider our forward-looking statements in light of the factors that may affect operating results set forth herein.

Overview

Net income in the second quarter of 2004 was $1.9 million, or $0.11 per diluted share. In the second quarter of 2003, net income and net income per diluted share were $2.2 million and $0.14, respectively. There was no income tax expense in the second quarter of 2003 as a valuation allowance was recorded against deferred tax assets. Income before income taxes in the second quarter of 2004 was $2.9 million, compared to $2.2 million in the second quarter of 2003. The significant growth in sales drove the 30.4% increase in income before income taxes for the quarter.

Year to date net income and net income per diluted share for the period ended July 4, 2004 were $3.8 million and $0.22 respectively, compared to net income and net income per diluted share of $3.9 million and $0.24 for the six months ended June 30, 2003. Income before income taxes was $5.9 million for the year to date period ended July 4, 2004, compared to $3.9 million for the six months ended June 30, 2003.

Results of Operations

Comparison of Quarter Ended July 4, 2004 to Quarter Ended June 30, 2003

Net Sales

Net sales increased 28.5% to $35.0 million for the second quarter of 2004 compared to $27.3 million for the second quarter of 2003. The increase in net sales was primarily due to an increase in net sales of engagement rings and loose diamonds.

Gross Profit

Gross profit increased 29.8% to $7.9 million in the second quarter of 2004 from $6.1 million in the comparable period in 2003. The increase in gross profit was due to the increase in sales volume. Gross profit as a percentage of net sales was 22.6% and 22.4% in the quarters ended July 4, 2004 and June 30, 2003, respectively. The increase in gross profit as a percentage of net sales was primarily due to merchandise mix, with higher gross margin jewelry items making up a larger percentage of net sales in the second quarter of 2004 compared to the comparable period in 2003.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 31.4% to $5.1 million in the second quarter of 2004 from $3.9 million in the second quarter of 2003. As a percentage of net sales, selling, general and administrative expenses were 14.6% in the second quarter of 2004 compared to 14.3% in the second quarter of 2003. The increase in selling, general and administrative expenses in the second quarter of 2004 was due to several factors. Marketing expenses increased by approximately $566,000 due primarily to increased advertising costs from higher sales volume. Payroll and payroll related expenses increased approximately $190,000 resulting primarily from the addition of new employees. Legal and accounting fees increased approximately $139,000, primarily due to higher costs associated with being a public company. Insurance costs increased approximately $130,000, primarily due to higher director and officer insurance premiums as a result of becoming a public company, and credit card processing fees increased approximately $97,000 due to higher sales volumes. Additionally, in the second quarter of 2004, we recorded approximately $80,000 of stock-based compensation expense for which there was no corresponding amount in the second quarter of 2003.

Interest Income

Interest income was approximately $97,000 for the second quarter of 2004, compared to approximately $21,000 in the second quarter of 2003. The increase in interest income is primarily due to an increase in our cash and cash equivalents and marketable securities as a result of our initial public stock offering completed in May 2004, resulting in net proceeds of $42.5 million.

Income Taxes

Income tax expense was $1.1 million in the second quarter of 2004 compared to $0 in the second quarter of 2003. In the second quarter of 2004, we recognized income tax expenses at the federal statutory rate. There was no income tax expense for the comparable period in 2003 as a result of a valuation allowance against deferred tax assets.

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Comparison of Year to Date Ended July 4, 2004 to Year to Date Ended June 30, 2003

Net Sales

Net sales increased 36.5% to $70.8 million year to date ended July 4, 2004 compared to $51.9 million in the six months ended June 30, 2003. The increase in net sales was primarily due to an increase in net sales of engagement rings and loose diamonds.

Net sales in the year to date ended July 4, 2004 were positively impacted by our transition to a 4-4-5 retail calendar on January 1, 2004 that added three days of sales compared to the six months ended June 30, 2003. Sales in the additional days contributed approximately $1.2 million to the quarter ended April 4, 2004 net sales.

Gross Profit

Gross profit increased 31.6% to $16.1 million year to date ended July 4, 2004 from $12.3 million in the comparable period in 2003. The increase in gross profit primarily resulted from increases in sales volume. Gross profit as a percentage of net sales declined to 22.8% year to date ended July 4, 2004 from 23.6% in the six months ended June 30, 2003. The decrease in gross profit as a percentage of net sales resulted primarily from retail price reductions that were instituted beginning in the second quarter of 2003. This decrease was partially offset by a change in merchandise mix. Jewelry, which has historically generated higher gross profit margin than engagement products, represented a larger percentage of our net sales in the year to date July 4, 2004 compared to the six months ended June 30, 2003.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 27.0% to $10.4 million year to date ended July 4, 2004 from $8.2 million in the six months ended June 30, 2003. Several factors contributed to the increase in selling, general and administrative expenses year to date ended July 4, 2004. Marketing expenses increased approximately $777,000 due to increased advertising costs from higher sales volume. Payroll and payroll related expenses increased approximately $493,000 resulting primarily from the addition of new employees. Legal and accounting fees increased approximately $343,000 due to higher costs associated with being a public company. Credit card processing fees increased approximately $304,000 due to higher sales volumes. Insurance costs increased approximately $152,000 primarily due to higher director and officer premiums as a result of becoming a public company. Additionally, year to date ended July 4, 2004 we recorded approximately $182,000 of stock-based compensation expense for which there was no corresponding amount in the six months ended June 30, 2003.

As a percentage of net sales, selling, general and administrative expenses were 14.7% year to date ended July 4, 2004 compared to 15.8% in the six months ended June 30, 2003. The decrease in these expenses as a percentage of net sales year to date ended July 4, 2004 resulted primarily from our ability to grow sales at a greater pace than selling, general and administrative expenses.

Interest Income

Interest income was approximately $139,000 for the year to date ended July 4, 2004, compared to approximately $55,000 in the six months ended June 30, 2003. The increase in interest income is primarily due to an increase in our cash and cash equivalents and marketable securities as a result of our initial public stock offering completed in May 2004, resulting in net proceeds of $42.5 million.

Interest Expense

Interest expense was $0 year to date ended July 4, 2004 compared to approximately $209,000 in the six months ended June 30, 2003. The decrease was due to the repayment of the outstanding balances on our notes payable and capital lease obligations in March 2003 and April 2003.

Income Taxes

Income tax expense was $2.1 million year to date ended July 4, 2004 compared to $0 in the six months ended June 30, 2003. Year to date ended July 4, 2004 we recognized income tax expenses at the federal statutory rate. In the six months ended June 30, 2003 we did not recognize income tax expense as a result of a valuation allowance against deferred tax assets.

Liquidity and Capital Resources

As of July 4, 2004, we had working capital of $65.4 million, including cash and cash equivalents of $52.6 million, partially offset by accounts payable of $13.8 million. We believe that our current cash and cash equivalents as well as cash flows from operations will be sufficient to continue our operations and meet our capital needs for the foreseeable future.

Net cash of $4.3 million was used for operating activities year to date July 4, 2004 compared to cash provided by operating activities of $142,000 in the six months ended June 30, 2003. Cash was provided by earnings of $3.8 million and $3.9 million year to date July 4, 2004 and the six months ended June 30, 2003, respectively. Additionally, inventory decreased by $3.5 million year to date July 4, 2004 due to the seasonal decrease in inventory of settings and jewelry from the fourth quarter of 2003. However, these amounts were offset by net payments of payables totaling $12.5 million for the year to date July 4, 2004 and $4.9 million for the six months ended June 30, 2003 due to the normal payment of vendors in the first quarter for inventory sold in the fourth quarter.

Net cash used in investing activities was $16.0 million year to date July 4, 2004 and $756,000 for the six months ended June 30, 2003. Cash used in 2004 was primarily for the purchase of marketable securities of $15.9 million. Cash used in 2003 was primarily related to capital expenditures

Net cash provided by financing activities year to date July 4, 2004 were $42.6 million resulting from the net proceeds of our initial public offering completed in May 2004. Cash used in financing activities in the six months ended June 30, 2003 was $8.8 million and was primarily related to payments of notes payable, capital leases, and a related party note payable.

Factors that May Affect Future Operating Results

You should carefully consider the risks described below and elsewhere in this report, which could materially and adversely affect our business, results of operations or financial condition. In those cases, the trading price of our common stock could decline and you may lose all or part of your investment.

Our limited operating history makes it difficult for us to accurately forecast net sales and appropriately plan our expenses.

We were formed in March 1999 and have a limited operating history. As a result, it is difficult to accurately forecast our net sales and plan our operating expenses. We base our current and future expense levels on our operating forecasts and estimates of future net sales. Net sales and operating results are difficult to forecast because they generally depend on the volume and timing of the orders we receive, which are uncertain. Some of our expenses are fixed, and, as a result, we may be unable to adjust our spending in a timely manner to compensate for any unexpected shortfall in net sales. This inability could cause our net income in a given quarter to be lower than expected.

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

We experienced significant operating losses in each quarter from our inception in 1999 through the second quarter of 2002. As a result, our business has a limited record of profitability and may not continue to be profitable or increase in profitability. If we are unable to acquire diamonds and fine jewelry at commercially reasonable prices, if net sales decline or if our expenses otherwise exceed our expectations, we may not be able to sustain or increase profitability on a quarterly or annual basis.

As a result of our significant operating losses in prior periods, we have accrued substantial net operating loss carryforwards. If we are unsuccessful in generating sufficient net income in future periods, these assets may expire before they are utilized.

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

We expect our net sales and operating results to vary significantly from quarter to quarter due to a number of factors, including changes in:

demand for our products;

our ability to attract visitors to our web site and convert those visitors into customers;

our ability to retain existing customers or encourage repeat purchases;

our ability to manage our product mix and inventory;

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- consumer tastes and preferences for diamonds and fine jewelry;
- our ability to manage our fulfillment operations;
- general economic conditions;
- advertising and other marketing costs;
- the costs to acquire diamonds and precious metals;
- our, or our competitors , pricing and marketing strategies;
- conditions or trends in the diamond and fine jewelry industry;
- conditions or trends in the Internet and e-commerce industry; and
- costs of expanding or enhancing our technology or web site.

As a result of the variability of these and other factors, our operating results in future quarters may be below the expectations of public market analysts and investors. In this event, the price of our common stock may decline.

As a result of seasonal fluctuations in our net sales, our quarterly results may fluctuate and could be below expectations.

We have experienced and expect to continue to experience seasonal fluctuations in our net sales. In particular, a disproportionate amount of our net sales has been realized during the fourth quarter as a result of the December holiday season, and we expect this seasonality to continue in the future. Over 35%, 42% and 38% of our net sales in 2001, 2002 and 2003, respectively, were generated during the fourth quarter. In anticipation of increased sales activity during