UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2019

or

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

For the transition period from to

Commission file number 001-33031

SHUTTERFLY, INC.

(Exact Name of Registrant as Specified in Its Charter)

DE	**94-3330068**
(State or Other Jurisdiction of Incorporation or Organization)	*(IRS Employer Identification No.)*

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

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

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

Title of Each Class	Trading Symbol(s)	Name of Each Exchange on Which Registered
Common Stock, 0.0001 Par Value Per Share	SFLY	The Nasdaq Global Select Market

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

Indicate by check mark whether the Registrant has submitted electronically every Interactive Data File required to be submitted 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 such files).
Yes ☒ No ☐

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

Large accelerated Filer	☒	Accelerated Filer	☐
Non-accelerated Filer	☐	Smaller reporting company	☐
		Emerging growth company	☐

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

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

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

Class	**Outstanding as of August 2, 2019**
Common stock, $0.0001 par value per share	34,395,673

TABLE OF CONTENTS

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report, including the following Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that are based upon our current expectations. These forward-looking statements include statements related to the timing of the expected closing of our pending acquisition by affiliates of the Apollo Funds, gaining access to Lifetouch customers after our acquisition; the value of integrating customers' photos onto Shutterfly Photos to drive engagement and purchases of our products; the expectation to realize revenue from Lifetouch customers; the expectations of realizing Lifetouch acquisition synergies centered on establishing a common manufacturing platform, achieving greater utilization and leveraging a combined purchasing power and scale; the plan to have Project Aspen serve all of our business segments and result in future benefits to operating expenses; the plan to open a production facility in Texas; the closing of four legacy Lifetouch facilities and related employee considerations; the plan to acquire customers through multiple marketing channels; the plan to attract, retain and grow our leadership team; our expected secured gross leverage ratio; any effect we would experience from a change in interest rates; the anticipation that our current cash balance and cash generated from operations will be sufficient to meet our strategic and other financial requirements; our intent to continue to expand our use of cloud services; our intent to pursue patent coverage in other countries; as well as other statements regarding our future operations, financial condition and prospects and business strategies. In some cases, you can identify forward-looking statements by terminology such as "guidance," "believe," "anticipate," "expect," "estimate," "intend," "seek," "continue," "should," "would," "could," "will," or "may," or the negative of these terms or other 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 parties' inability to consummate the acquisition due to failure to satisfy conditions to the completion of the transaction, including the receipt of stockholder approval, which may not be obtained on the anticipated schedule or at all, the outcome of lawsuits that have been and may be brought by certain stockholders seeking to enjoin us and the Board from proceeding with a stockholder vote or enjoin proceeding with, consummating and closing the acquisition, decreased consumer discretionary spending as a result of general economic conditions; our ability to expand our customer base and increase sales to existing customers; failure to realize the anticipated benefits of the Lifetouch acquisition; recent and ongoing restructuring activities (including but not limited to those relating to manufacturing consolidation, Lifetouch field operations and our single platform migration); our ability to meet production requirements; our ability to attract and retain management and other personnel; our ability to retain and hire necessary employees, including seasonal personnel, and appropriately staff our operations; the impact of seasonality on our business; our ability to develop innovative, new products and services on a timely and cost-effective basis; consumer acceptance of our products and services; our ability to develop additional adjacent lines of business; unforeseen changes in expense levels; a deterioration in the relationship with any of our business partners; refining our promotional strategies; competition and the pricing strategies of our competitors, which could lead to pricing pressure; failure to implement new technology systems; a decline in participation rate in the Lifetouch business; the retention of Lifetouch employees and our ability to successfully integrate the Lifetouch businesses; risks inherent in the achievement of anticipated synergies and the timing thereof; general economic conditions and changes in laws and regulations and the other risks set forth below under "Risk Factors" in Part II, Item 1A of this report. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. We assume no obligation to update any of the forward-looking statements after the date of this report or to compare these forward-looking statements to actual results.

PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	June 30, 2019	December 31, 2018
ASSETS		
Current assets:		
Cash and cash equivalents	$ 105,338	$ 521,567
Short-term investments	19,013	34,011
Accounts receivable, net	60,433	87,023
Inventories	20,916	18,015
Assets held for sale	9,142	1,000
Prepaid expenses and other current assets	114,776	65,961
Total current assets	329,618	727,577
Long-term investments	4,872	10,808
Property and equipment, net	336,655	381,018
Intangible assets, net	291,459	316,154
Goodwill	843,698	843,607
Other assets	84,872	23,045
Total assets	$ 1,891,174	$ 2,302,209
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 5,234	$ 14,203
Accounts payable	45,129	105,407
Accrued liabilities	142,836	226,445
Operating lease liabilities, current portion	21,045	—
Deferred revenue, current portion	38,350	57,319
Total current liabilities	252,594	403,374
Long-term debt	897,985	1,090,442
Operating lease liabilities	59,301	—
Other liabilities	84,707	134,027
Total liabilities	1,294,587	1,627,843
Commitments and contingencies (Note 12)		
Stockholders' equity:		
Common stock, $0.0001 par value; 100,000 shares authorized; 34,382 and 33,673 shares issued and outstanding on June 30, 2019 and December 31, 2018, respectively	3	3
Additional paid-in capital	1,090,694	1,065,531
Accumulated other comprehensive (loss) income	(1,027)	1,592
Accumulated deficit	(493,083)	(392,760)
Total stockholders' equity	596,587	674,366
Total liabilities and stockholders' equity	$ 1,891,174	$ 2,302,209

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	**2018**	**2019**	**2018**
Net revenue	$ 473,416	$ 443,372	$ 798,097	$ 643,097
Cost of net revenue	240,513	233,228	450,912	359,275
Gross profit	232,903	210,144	347,185	283,822
Operating expenses:				
Technology and development	49,606	44,420	97,939	82,924
Sales and marketing	135,468	130,643	254,837	168,363
General and administrative	52,491	55,040	100,878	86,604
Restructuring	3,274	2,952	7,247	2,952
Total operating expenses	240,839	233,055	460,901	340,843
Loss from operations	(7,936)	(22,911)	(113,716)	(57,021)
Interest expense	(13,312)	(17,769)	(31,566)	(27,402)
Interest and other income, net	1,088	1,561	2,266	3,310
Loss before income taxes	(20,160)	(39,119)	(143,016)	(81,113)
Benefit from income taxes	7,428	12,607	46,665	27,436
Net loss	$ (12,732)	$ (26,512)	$ (96,351)	$ (53,677)
Net loss per share - basic and diluted	$ (0.37)	$ (0.80)	$ (2.83)	$ (1.63)
Weighted-average shares outstanding - basic and diluted	34,254	33,234	34,089	32,970

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Net loss	$ (12,732)	$ (26,512)	$ (96,351)	$ (53,677)
Other comprehensive (loss) income, net of reclassification adjustments:				
Foreign currency translation gains (losses)	435	(401)	817	(401)
Unrealized net gains (losses) on investments	64	(16)	164	(46)
Tax (expense) benefit on unrealized net gains (losses) on investments	(15)	4	(41)	11
Unrealized (losses) gains on cash flow hedges	(3,317)	1,000	(5,161)	3,770
Tax benefit (expense) on unrealized (losses) gains on cash flow hedges	753	(249)	1,226	(948)
Impact of adoption of new accounting standard	—	—	376	—
Other comprehensive (loss) income, net of tax	(2,080)	338	(2,619)	2,386
Comprehensive loss	$ (14,812)	$ (26,174)	$ (98,970)	$ (51,291)

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

SHUTTERFLY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)
(Unaudited)

	Three Months Ended June 30, 2019	Three Months Ended June 30, 2018	Six Months Ended June 30, 2019	Six Months Ended June 30, 2018
Common stock (par value)				
Balance, beginning of period	$ 3	$ 3	$ 3	$ 3
Issuance of common stock upon exercise of options and vesting of restricted stock units	—	—	—	—
Balance, end of period	3	3	3	3
Additional paid-in capital				
Balance, beginning of period	1,077,922	1,022,091	1,065,531	996,301
Issuance of common stock upon exercise of options and vesting of restricted stock units	946	2,802	1,007	16,577
Stock-based compensation, net of forfeitures	11,826	12,071	24,156	24,086
Convertible notes settlement	—	(2)	—	(2)
Balance, end of period	1,090,694	1,036,962	1,090,694	1,036,962
Accumulated other comprehensive income				
Balance, beginning of period	1,053	3,826	1,592	1,778
Foreign currency translation gains (losses)	435	(401)	817	(401)
Unrealized gain (loss) on investments, net of tax	49	(12)	123	(35)
Unrealized (loss) gain on cash flow hedges, net of tax	(2,564)	751	(3,935)	2,822
Impact of adoption of new accounting standard	—	—	376	—
Balance, end of period	(1,027)	4,164	(1,027)	4,164
Accumulated deficit				
Balance, beginning of period	(480,351)	(470,321)	(392,760)	(447,358)
Impact of adoption of new accounting standards	—	—	(3,972)	4,202
Net loss	(12,732)	(26,512)	(96,351)	(53,677)
Balance, end of period	(493,083)	(496,833)	(493,083)	(496,833)
Total stockholders' equity	$ 596,587	$ 544,296	$ 596,587	$ 544,296
Number of shares				
Common stock				
Balance, beginning of period	34,181	33,122	33,673	32,297
Issuance of common stock upon exercise of options and vesting of restricted stock units	201	259	709	1,084
Balance, end of period	34,382	33,381	34,382	33,381

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

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

	Six Months Ended June 30, 2019	Six Months Ended June 30, 2018
Cash flows from operating activities:		
Net loss	$ (96,351)	$ (53,677)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	58,967	50,111
Amortization of intangible assets	25,620	15,164
Amortization of debt discount and issuance costs	5,533	7,009
Amortization of operating lease assets	11,150	—
Repayment of convertible senior notes attributable to debt discount	—	(63,510)
Stock-based compensation	23,545	23,389
(Gain) loss on disposal of property and equipment	(426)	154
Deferred income taxes	3,808	17,571
Restructuring	2,301	752
Other	(57)	(272)
Changes in operating assets and liabilities, net of acquisition:		
Accounts receivable	26,605	30,767
Inventories	(2,959)	15,607
Prepaid expenses and other assets	(48,994)	(42,795)
Accounts payable	(60,267)	(69,708)
Accrued and other liabilities	(114,092)	(130,127)
Net cash used in operating activities	(165,617)	(199,565)
Cash flows from investing activities:		
Acquisition of business, net of cash acquired	—	(890,052)
Purchases of property and equipment	(27,129)	(17,692)
Capitalization of software and website development costs	(30,642)	(21,392)
Purchases of investments	—	(9,523)
Proceeds from maturities of investments	21,184	174,329
Proceeds from sales of investments	—	45,106
Proceeds from sales of property and equipment	1,136	1,132
Net cash used in investing activities	(35,451)	(718,092)
Cash flows from financing activities:		
Proceeds from issuance of common stock upon exercise of stock options	1,007	16,577
Principal payments of borrowings	(207,292)	(239,098)
Principal payments of finance lease liabilities and financing obligations	(9,587)	(9,396)
Proceeds from borrowings, net of issuance costs	—	806,652
Net cash (used in) provided by financing activities	(215,872)	574,735
Effect of exchange rate changes on cash and cash equivalents	711	(271)
Net decrease in cash and cash equivalents	(416,229)	(343,193)
Cash and cash equivalents, beginning of period	521,567	489,894
Cash and cash equivalents, end of period	$ 105,338	$ 146,701
Supplemental schedule of non-cash investing / financing activities:		
Net decrease in accrued purchases of property and equipment	$ (1,915)	$ (1,200)
Net increase in accrued capitalized software and website development costs	2,532	1,119
Stock-based compensation capitalized with software and website development costs	612	697
Leased assets obtained in exchange for finance lease liabilities	2,973	2,969

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

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 — The Company and Summary of Significant Accounting Policies

Shutterfly, Inc., (the “Company” or “Shutterfly”) is the leading retailer and manufacturing platform for personalized products and communications. Founded and incorporated in the state of Delaware in 1999, Shutterfly has three segments: Shutterfly Consumer, Lifetouch, and Shutterfly Business Solutions (“SBS”). Shutterfly Consumer and Lifetouch help consumers capture, preserve, and share life’s important moments through professional and personal photography, and personalized products. The Shutterfly brand brings photos to life in photo books, gifts, home décor, and cards and stationery. Lifetouch is the national leader in school photography, built on the enduring tradition of “Picture Day,” and also serves families through portrait studios and other partnerships. SBS delivers digital printing services that enable efficient and effective customer engagement through personalized communications. The Company is headquartered in Redwood City, California.

On April 2, 2018, the Company completed its acquisition of Lifetouch Inc. (“Lifetouch”).

Shutterfly announced in June 2019 that it has entered into a definitive agreement (the "Merger Agreement") with the affiliates of certain funds (the “Apollo Funds”), managed by affiliates of Apollo Global Management, LLC (together with its consolidated subsidiaries, “Apollo”), a leading global alternative investment manager, pursuant to which affiliates of Apollo Funds will acquire all the outstanding shares of Shutterfly for $51.00 per share in cash (the “Transaction”). The Transaction is expected to close by early fourth quarter of fiscal 2019, pending approval by Shutterfly stockholders and satisfaction of certain other closing conditions. Early termination of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 was granted on July 17, 2019, effective immediately.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and, accordingly, do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The accompanying unaudited condensed consolidated financial statements include the accounts of Shutterfly, Inc. and its wholly owned subsidiaries including the financial results of Lifetouch which are included prospectively from the acquisition date of April 2, 2018. In the opinion of management, all adjustments, consisting primarily of normal recurring adjustments, considered necessary for a fair statement of the Company’s results of operations for the interim periods reported and of its financial condition as of the date of the interim balance sheet have been included. Operating results for the three and six months ended June 30, 2019 are not necessarily indicative of the results that may be expected for the year ending December 31, 2019, or for any other period.

The December 31, 2018 condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2018 included in the Company’s Annual Report on Form 10-K.

The Company has evaluated subsequent events through the date that the financial statements were issued.

Revision of Prior Period Amounts

During the third quarter of fiscal year 2018, the Company identified certain amounts attributable to the repayment of accreted interest on its convertible senior notes that should have been classified as cash used in operating activities instead of cash used in financing activities in the condensed consolidated statement of cash flows for the six months ended June 30, 2018. Such error resulted in a $63.5 million understatement of net cash used in operating activities with a corresponding understatement of cash provided by financing activities. The condensed consolidated statement of cash flows for the six months ended June 30, 2018 has been revised to reflect the appropriate classification of such repayment between financing and operating activities.

Additionally, certain reclassifications have been made to the amounts in prior periods in order to conform to the current period’s presentation.

Summary of Significant Accounting Policies

The Company's significant accounting policies are described in Note 2, *Summary of Significant Accounting Policies*, to the consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2018. There have been no material changes to the significant accounting policies during the six months ended June 30, 2019 other than those noted below.

Lease Accounting

The Company determines if an arrangement is or contains a lease at inception. Lease right-of-use ("ROU") assets and lease liabilities for operating and finance leases are recognized based on the present value of the future minimum lease payments over the lease term at commencement date. Operating leases are included in other assets, current operating lease liabilities and operating lease liabilities in the condensed consolidated balance sheets. Finance leases are included in property and equipment, accrued liabilities and other liabilities in the condensed consolidated balance sheets.

As most of the Company's leases do not provide an implicit rate, the Company uses its incremental borrowing rate based on the information available at the lease commencement date in determining the present value of future payments. ROU assets also include any lease payments made and initial direct costs, and exclude lease incentives. Variable lease payments are excluded from the ROU assets and lease liabilities and recognized in the period in which the obligation for those payments is incurred.

Most leases include one or more options to renew. The exercise of lease renewal options is at the Company's sole discretion. Certain leases also include options to terminate or purchase the leased asset. The Company's lease agreements do not contain any material residual value guarantee or material restrictive covenants. Lease cost is recognized on a straight-line basis over the lease term.

The Company elected a short-term lease exception policy, permitting the Company not to apply the recognition requirements of Accounting Standard Codification 842, *Leases*, ("ASC 842") to short-term leases (i.e., leases with terms of 12 months or less). For all leases, the Company accounts for the lease and non-lease components as a single lease component.

Recently Adopted Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-02, *Leases (Topic 842)*, which requires the recognition of ROU assets and corresponding lease liabilities on the balance sheet, measured at present value of the future lease payments. The most significant impact relates to the recognition of lease assets and liabilities for operating leases, while the accounting for finance leases remained unchanged except for recognition of lease assets and liabilities for fixed non-lease components. Accounting for leases by lessors is substantially unchanged from prior practice as lessors will continue to recognize lease revenue as earned.

The Company adopted ASC 842 as of January 1, 2019 (the effective date), using the alternative modified retrospective transition method provided in ASU 2018-11, *Leases (Topic 842)*: *Targeted Improvements*. Under this method, the Company recorded a cumulative-effect adjustment as of the effective date and prior comparative periods were not retrospectively presented in the consolidated financial statements. This adoption approach results in a balance sheet presentation that is not comparable to the prior year period in the first year of adoption. In addition, the Company elected the package of practical expedients permitted under the transition guidance, which among other things allows companies to carry forward their historical lease classification. The Company did not elect the hindsight practical expedient, which permits the use of hindsight when determining the lease term and impairment of ROU assets.

Adoption of ASC 842 resulted in the recording of additional net lease assets and lease liabilities of approximately $37.6 million and $42.4 million, respectively, as of January 1, 2019, for finance lease and operating leases including the impact of the reclassification of the Company's financing obligations related to build-to-suit arrangements to operating leases. The difference between the additional net lease assets and lease liabilities, net of deferred tax impact, was recorded as an adjustment to the opening balance of accumulated deficit. As of December 31, 2018, building assets of $48.4 million and financing obligations of $54.0 million related to build-to-suit arrangements. As of January 1, 2019, these balances were derecognized and these arrangements were accounted for as operating leases. The adoption of ASC 842 did not materially impact the Company's consolidated net loss and had no impact on the consolidated statement of cash flows.

In February 2018, the FASB issued ASU No. 2018-02, *Income Statement, Reporting Comprehensive Income (Topic 220)*: *Reclassification of Certain Effects from Accumulated Other Comprehensive Income* ("ASU 2018-02"), which allows a reclassification of stranded tax effects from accumulated other comprehensive income to retained earnings, as a result of the Tax Cuts and Jobs Act. The Company adopted ASU 2018-02 as of January 1, 2019 using the prospective transition method, which resulted in an immaterial reclassification from accumulated other comprehensive income to the opening balance of accumulated deficit.

The Company adopted Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers (Topic 606)* (“ASC 606”) as of January 1, 2018 using the modified retrospective transition method. Under the modified retrospective method, ASC 606 is only applied to contracts that were not complete as of the adoption date. The cumulative impact of the adoption of ASC 606 resulted in a decrease to the opening balance of accumulated deficit of $4.2 million as of January 1, 2018, which consisted of a decrease in total liabilities of $5.1 million primarily related to deferred revenue and a decrease in total assets of $0.9 million primarily related to deferred costs. Refer to Note 3 in the Company's Form 10-K for the year ended December 31, 2018 for further details.

Recent Accounting Pronouncements Pending Adoption

In August 2018, the FASB issued ASU 2018-15, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract* ("ASU 2018-15"), which clarifies the accounting for implementation costs in cloud computing arrangements. ASU 2018-15 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019, and earlier adoption is permitted including adoption in any interim period. The Company is evaluating the impact of adopting this new accounting guidance on the consolidated financial statements.

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

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which requires measurement and recognition of expected credit losses for financial assets held. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted beginning January 1, 2019. The Company is evaluating the impact of adopting this new accounting guidance on the consolidated financial statements.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 2 — Revenue

Net Revenue by Brand

The following table disaggregates the Company's net revenue by brand for the three and six months ended June 30, 2019 and 2018:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
Shutterfly Consumer net revenue:				
Shutterfly Brand Core	$ 115,583	$ 116,041	$ 220,660	$ 227,708
Shutterfly Brand Personalized Gifts and Home Décor	44,171	38,163	78,756	69,129
Tiny Prints Boutique	1,067	1,374	2,762	3,508
Other	8,763	9,425	16,254	16,717
Shutterfly Consumer net revenue	169,584	165,003	318,432	317,062
Lifetouch net revenue(1)	254,174	228,560	383,481	228,560
Shutterfly Business Solutions net revenue	49,658	49,809	96,184	97,475
Net revenue	$ 473,416	$ 443,372	$ 798,097	$ 643,097

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

Deferred Revenue

The Company records deferred revenue when cash payments are received in advance of the Company's performance and primarily relate to flash deal promotions, gift cards, and yearbooks as well as up-front fees received from SBS or Lifetouch customers. The amount of net revenue recognized during the three and six months ended June 30, 2019 that was included in the deferred revenue balances as of December 31, 2018 was approximately $19.4 million and $32.6 million, respectively.

Note 3 — Acquisition

On April 2, 2018, the Company completed the acquisition of Lifetouch, the leading professional photographer of children and families in the United States and Canada. Lifetouch provides the Company with a highly complementary business.

Under the terms of the Purchase Agreement, the amount of consideration that the Company paid consisted of an all-cash purchase price of $825.0 million subject to certain adjustments based on a determination of Closing Net Working Capital, Transaction Expenses, Cash and Investments, and Indebtedness, as defined by the Stock Purchase Agreement. The total purchase consideration paid by the Company during the second quarter of 2018 was $982.0 million. The Company completed the purchase price allocation as of March 31, 2019 with no material adjustments from those disclosed in the Company's consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2018. In allocating the purchase price based on estimated fair values, the Company recorded approximately $434.9 million of goodwill, $326.3 million of identifiable intangible assets and $220.8 million of net tangible assets. The goodwill recognized represents the assembled workforce of Lifetouch and the value of growth in revenue from future customers of Lifetouch and is deductible for U.S. income tax purposes.

Unaudited Pro Forma Financial Information

The following table summarizes the pro forma consolidated information for the Company for the three and six months ended June 30, 2018 assuming the acquisition of Lifetouch had occurred as of January 1, 2017. The unaudited pro forma information for the periods presented includes the business combination accounting effects resulting from the acquisition, including amortization for intangible assets acquired, depreciation expense for tangible assets acquired, interest expense for the additional indebtedness incurred to complete the acquisition, acquisition-related charges and the impact of adopting ASC 606. The impact of applying ASC 606 to Lifetouch's historical periods as presented below was not material. The pro forma results also include the effects of the purchase accounting adjustments for the fair value of deferred revenue and inventory. The

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

unaudited pro forma financial information as presented below is for informational purposes only and is not necessarily indicative of the results of operations that would have been achieved if the acquisition had taken place at the beginning of fiscal 2017.

(in thousands, except per share data)	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Total net revenue	$ 476,273	$ 810,917
Net income (loss)	$ 14,791	$ (69,359)
Basic earnings per share	$ 0.45	$ (2.10)
Diluted earnings per share	$ 0.41	$ (2.10)

Note 4 — Stock-Based Compensation

Stock-based Compensation Expense

The Company's stock-based compensation expense is allocated as follows in its condensed consolidated statements of operations:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
Cost of net revenue	$ 844	$ 943	$ 1,736	$ 1,942
Technology and development	2,268	2,571	4,566	5,001
Sales and marketing	3,574	2,941	7,039	6,445
General and administrative	4,821	5,242	10,204	10,001
Total stock-based compensation	$ 11,507	$ 11,697	$ 23,545	$ 23,389

Stock Option Activity

A summary of the Company's stock option activity for the six months ended June 30, 2019 is as follows:

	Number of Options Outstanding (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in thousands)
Balance as of December 31, 2018	1,405	$ 53.44		
Granted	—	$ —		
Exercised	(25)	$ 40.04		
Forfeited, cancelled or expired	(63)	$ 51.86		
Balance as of June 30, 2019	1,317	$ 53.77	3.0	$ 3,122
Options vested and expected to vest as of June 30, 2019	1,099	$ 54.09	3.1	$ 2,671
Options vested as of June 30, 2019	679	$ 50.91	1.9	$ 1,791

The total intrinsic value of options exercised during the three months ended June 30, 2019 and 2018 was $0.3 million and $2.8 million, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2019 and 2018 was $0.3 million and $10.7 million, respectively.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Net cash proceeds from the exercise of stock options for the three months ended June 30, 2019 and 2018 were $0.9 million and $2.8 million, respectively. Net cash proceeds from the exercise of stock options for the six months ended June 30, 2019 and 2018 were $1.0 million and $16.6 million, respectively.

Valuation of Stock Options

The Company estimates the fair value of each option award on the date of grant using the Black-Scholes option-pricing model. The Company calculates volatility using an average of its historical and implied volatilities as it has sufficient public trading history to cover the entire expected term. The expected term of options gives consideration to historical exercises, post-vest cancellations and the options' contractual term. The risk-free rate for the expected term of the option is based on the U.S. Treasury Constant Maturity at the time of grant. The assumptions used to value options granted during the six months ended June 30, 2018 are as follows (there were no option awards granted during the three and six months ended June 30, 2019 and the three months ended June 30, 2018):

	Six Months Ended June 30,
	2018
Dividend yield	—
Annual risk-free rate of return	2.6 %
Expected volatility	33.7 %
Expected term (years)	4.1

Restricted Stock Unit Activity

The Company grants restricted stock units (“RSUs”), including service-based restricted stock units, performance-based restricted stock units ("PBRSUs"), and market-based restricted stock units (“MSUs”) to its employees under the provisions of the 2015 Equity Incentive Plan and inducement awards to certain new employees upon hire in accordance with Nasdaq Listing Rule 5635(c)(4). The cost of service-based RSUs and PBRSUs is determined using the fair value of the Company’s common stock on the date of grant. The cost of MSUs is determined using a Monte Carlo simulation model on the date of grant. Service-based RSUs typically vest and are settled annually, based on a four-year total vesting term. Compensation cost associated with service-based RSUs is amortized on a straight-line basis over the requisite service period.

A summary of the Company’s RSU activity, including service-based awards, PBRSUs, and MSUs for the six months ended June 30, 2019, is as follows:

	Number of Units Outstanding (in thousands)	Weighted-Average Grant Date Fair Value
Awarded and unvested as of December 31, 2018	1,941	$ 56.91
Granted	1,357	$ 45.84
Vested	(684)	$ 52.84
Forfeited	(147)	$ 54.02
Awarded and unvested as of June 30, 2019	2,467	$ 52.11
RSUs expected to vest as of June 30, 2019	1,965	

Included in the RSU grants for the six months ended June 30, 2019 are approximately 187,000 RSUs that have both performance criteria tied to the Company’s 2019 financial performance and a three-year service criteria. Compensation expense associated with these PBRSUs is recognized based on the estimated number of shares the Company ultimately expects will vest and amortized on an accelerated basis over the requisite service period as these PBRSUs consist of three tranches. If in the future, situations indicate that the performance criteria is not probable, then no further compensation expense will be recorded and any previous expenses will be reversed.

Included in the RSU grants for the six months ended June 30, 2019, are approximately 187,000 RSUs that have both market criteria over a three-year period and a three-year service criteria (“MSUs”). The grant date fair value of these MSUs was determined using a Monte Carlo simulation model that incorporates the probability that market conditions may not be achieved. Provided that the requisite service is rendered, the total fair value of the MSUs at the date of grant must be recognized as compensation expense even if the market condition is not achieved; the number of shares that ultimately vest can vary depending on the ultimate achievement of the market criteria. Compensation expense associated with these MSUs is recognized on a straight-line basis over the requisite service period as these MSUs consist of one tranche.

Included in the RSU vested shares for the six months ended June 30, 2019, are approximately 58,000 shares related to PBRSUs granted in fiscal years 2015 and 2016. As of June 30, 2019, these PBRSUs are subject only to service vesting conditions as the performance condition has been met in previous years. As of June 30, 2019, approximately 303,000 PBRSUs and 187,000 MSUs remain outstanding (awarded and unvested).

Employee stock-based compensation expense recognized in the three and six months ended June 30, 2019 and 2018 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

At June 30, 2019, the Company had $90.4 million of total unrecognized stock-based compensation cost, net of estimated forfeitures, related to stock options, service-based RSUs, PBRSUs, and MSUs that will be recognized over a weighted-average period of approximately 2.5 years.

Note 5 — Net Loss Per Share

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

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

A summary of the net loss per share for the three and six months ended June 30, 2019 and 2018 is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands, except per share data)			
Net loss per share:				
Numerator				
Net loss	$ (12,732)	$ (26,512)	$ (96,351)	$ (53,677)
Denominator for basic and diluted net loss per share				
Weighted-average common shares outstanding	34,254	33,234	34,089	32,970
Net loss per share - basic and diluted	$ (0.37)	$ (0.80)	$ (2.83)	$ (1.63)

The following weighted-average outstanding stock options and RSUs were excluded from the computation of diluted net loss per common share for the periods presented as the Company had a net loss in the period and including them would have had an anti-dilutive effect:

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
Weighted-average stock options and RSUs that would have been included in the computation of dilutive common equivalent shares outstanding if net income had been reported in the period	1,582	3,337	1,454	3,459
Weighted-average stock options and RSUs that would have been excluded from the computation of dilutive common equivalent shares outstanding if net income had been reported due to their antidilutive effect	1,843	234	1,891	170
Total	3,425	3,571	3,345	3,629

The Company entered into warrant transactions (the "Warrant") in May 2013. The average market value per share of the Company's common stock for the three months ended June 30, 2018, as measured under the Warrant, exceeded the strike price of the Warrant. The dilutive effect of the potential exercise of the Warrant of approximately 345,000 shares was excluded from the computation of diluted net loss per common share for the three months ended June 30, 2018 because including it would have had an anti-dilutive effect. The average market value per share of the Company's common stock for the six months ended June 30, 2018, as measured under the Warrant, did not exceed the strike price of the Warrant.

With respect to the convertible senior notes issued in 2013 and settled in cash upon their maturity in May 2018, the weighted-average impact to dilution for the period that the conversion option was outstanding was 660,000 shares and 690,000 shares for the three and six months ended June 30, 2018, respectively. The potential conversion impact was excluded from the computation of diluted net loss per common share for such periods because including it would have had an anti-dilutive effect.

Note 6 — Investments

At June 30, 2019 and December 31, 2018, the estimated fair value of short-term and long-term debt securities investments, all of which are classified as available-for-sale, was as follows:

	June 30, 2019			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Short-term investments				
Corporate debt securities	$ 11,626	$ 30	$ (1)	$ 11,655
Agency securities	3,867	1	(2)	3,866
U.S. government securities	3,490	3	(1)	3,492
Total short-term investments	$ 18,983	$ 34	$ (4)	$ 19,013
Long-term investments				
Agency securities	$ 1,872	$ 11	$ —	$ 1,883
U.S. government securities	2,969	20	—	2,989
Total long-term investments	$ 4,841	$ 31	$ —	$ 4,872

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	December 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Short-term investments				
Corporate debt securities	$ 24,367	$ —	$ (43)	$ 24,324
Agency securities	5,728	—	(19)	5,709
U.S. government securities	3,986	—	(8)	3,978
Total short-term investments	$ 34,081	$ —	$ (70)	$ 34,011
Long-term investments				
Corporate debt securities	$ 4,283	$ —	$ (13)	$ 4,270
Agency securities	2,113	—	(7)	2,106
U.S. government securities	4,445	—	(13)	4,432
Total long-term investments	$ 10,841	$ —	$ (33)	$ 10,808

The Company had no available-for-sale investments with a significant unrealized loss that have been in a continuous unrealized loss position for more than 12 months as of June 30, 2019, and no impairments were recorded during the three and six months ended June 30, 2019 and 2018. The Company had no material realized gains or losses during the three and six months ended June 30, 2019 and 2018.

The following table summarizes the contractual maturities of the Company's investments as of June 30, 2019 and December 31, 2018:

	June 30, 2019	December 31, 2018
	(in thousands)	
One year or less	$ 19,013	$ 34,011
One year through three years	4,872	10,808
	$ 23,885	$ 44,819

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

Note 7 — Fair Value Measurement

Cash Equivalents and Investments

The Company measures the fair value of money market funds and investments based on quoted prices in active markets for identical assets or liabilities. All other financial instruments were valued either based on recent trades of securities in inactive markets or based on quoted market prices of similar instruments and other significant inputs derived from or corroborated by observable market data. The Company did not hold any cash equivalents or investments categorized as Level 3 as of June 30, 2019 and December 31, 2018.

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

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	Total Estimated Fair Value as of			
	June 30, 2019		December 31, 2018	
	Cash Equivalents	Investments	Cash Equivalents	Investments
	(in thousands)			
Level 1 Securities:				
Money market funds	$ 53,759	$ —	$ 116,212	$ —
Level 2 Securities:				
Corporate debt securities	—	11,655	—	28,594
Agency securities	—	5,749	—	7,815
U.S. government securities	—	6,481	—	8,410
Total cash equivalents and investments	$ 53,759	$ 23,885	$ 116,212	$ 44,819

Derivative (Liabilities) Assets

As of June 30, 2019 and December 31, 2018, the fair value of the interest-rate swap agreements, which were determined based on an income-based valuation model that takes into account the contract terms as well as multiple observable market inputs such as LIBOR-based yield curves, futures, volatility and basis spreads (Level 2), were as follows:

	Total Estimated Fair Value as of	
	June 30, 2019	December 31, 2018
	(in thousands)	
Derivative (liabilities) assets	$ (957)	$ 4,204

Borrowings

As of June 30, 2019 and December 31, 2018, the fair value of the Company's Term Loan borrowings (as described in Note 9 - *Debt*), which was determined based on inputs that are observable in the market or that could be derived from, or corroborated with, observable market data, including the Company's stock price, interest rates and credit spread (Level 2) were as follows:

	Total Estimated Fair Value as of	
	June 30, 2019	December 31, 2018
	(in thousands)	
Term Loans	$ 912,352	$ 1,081,520

As of June 30, 2019 and December 31, 2018, the carrying value of other financial instruments, including accounts receivable, accounts payable and other payables, approximates fair value due to their short maturities.

Note 8 — Balance Sheet Components

Assets Held for Sale

Land and buildings with net book value of $9.1 million are presented as assets held for sale in the condensed consolidated balance sheet as of June 30, 2019. The assets held for sale were comprised primarily of two legacy Lifetouch facilities: Loves Park, Illinois and Bloomington, Minnesota that were vacated with the management's commitment to sell in conjunction with the Company's 2018 Restructuring Plan (refer to Note 14, *Restructuring* for further information). The Loves Park facility consists of 3.4 acres of land and approximately 60,000 square feet of manufacturing, warehousing and administrative space. The Bloomington property consists of 9.25 acres of land and approximately 90,000 square feet of manufacturing and administrative space.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The properties are not depreciated while classified as held for sale. These assets held for sale are measured at the lower of their carrying amount or fair value less cost to sell. Upon meeting the assets held for sale criteria, the Company determined the fair value less costs to sell exceeded the carrying value of the held-for-sales assets based on the estimated sale proceeds. Therefore, no impairment loss has been recorded for assets held for sale as of June 30, 2019. The sale of these facilities is expected to occur within the next 12 months. The Company does not expect to record a significant gain or loss upon completion of these sales.

Prepaid Expenses and Other Current Assets

	June 30, 2019	December 31, 2018
	(in thousands)	
Intra-period income tax asset	$ 50,504	$ —
Restricted certificate of deposit	20,595	18,745
Prepaid service contracts – current portion	14,735	12,562
Other prepaid expenses and current assets	28,942	34,654
	$ 114,776	$ 65,961

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

Property and Equipment, Net

	June 30, 2019	December 31, 2018
	(in thousands)	
Computer equipment and software	$ 389,212	$ 347,032
Plant and equipment	311,967	297,597
Land, buildings and building improvements	46,988	113,048
Leasehold improvements	28,164	27,011
Furniture, fixtures and other	11,509	11,498
	787,840	796,186
Less: Accumulated depreciation and amortization	(451,185)	(415,168)
Property and equipment, net	$ 336,655	$ 381,018

Included within computer equipment and software is approximately $89.9 million and $75.3 million of capitalized software and website development costs, net of accumulated amortization at June 30, 2019 and December 31, 2018, respectively. Amortization of capitalized costs totaled approximately $ 9.7 million and $7.1 million for the three months ended June 30, 2019 and 2018, respectively. Amortization of capitalized costs totaled approximately $ 19.2 million and $13.7 million for the six months ended June 30, 2019 and 2018, respectively.

Plant and equipment includes manufacturing, photography, and rental equipment. Rental equipment includes camera lenses, camera bodies, video equipment and other camera peripherals which are rented through the BorrowLenses website. Included within plant and equipment is approximately $92.7 million and $92.5 million of ROU assets under finance leases for various pieces of manufacturing facility equipment as of June 30, 2019 and December 31, 2018, respectively. As a result of the adoption of ASC 842, the ROU assets under finance leases as of June 30, 2019 include non-lease components whereas the balance as of December 31, 2018 does not. Accumulated amortization of ROU assets under finance leases totaled $41.9 million and $44.9 million at June 30, 2019 and December 31, 2018, respectively.

As of December 31, 2018, land, buildings and building improvements included approximately $56.5 million of build-to-suit arrangements which represented the estimated fair value of buildings under build-to-suit arrangements of which the Company was the "deemed owner" for accounting purposes. As of December 31, 2018, accumulated depreciation for these build-to-suit arrangements was $8.1 million. Upon adoption of ASC 842 on January 1, 2019, the Company derecognized its build-to-suit arrangements as these arrangements no longer qualify for build-to-suit accounting and are instead recognized as operating leases under ASC 842 and included in the operating ROU assets and operating lease liabilities recorded as of the adoption date.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Included in property and equipment is approximately $49.5 million and $26.3 million of assets in construction as of June 30, 2019 and December 31, 2018, respectively, the majority of which relates to computer equipment and software.

Depreciation and amortization expense totaled $29.6 million and $27.5 million for the three months ended June 30, 2019 and 2018, respectively. Depreciation and amortization expense totaled $59.0 million and $50.1 million for the six months ended June 30, 2019 and 2018, respectively.

Intangible Assets

Intangible assets are comprised of the following:

	Weighted Average Useful Life	June 30, 2019	December 31, 2018
		(in thousands)	
Customer relationships	9 years	$ 275,832	$ 275,546
Less: accumulated amortization		(101,132)	(91,087)
		174,700	184,459
Trade name	9 years	112,120	112,120
Less: accumulated amortization		(45,783)	(38,320)
		66,337	73,800
Purchased technology	5 years	121,769	121,769
Less: accumulated amortization		(71,347)	(64,142)
		50,422	57,627
Other	2 years	3,797	4,097
Less: accumulated amortization		(3,797)	(3,829)
		—	268
Total	8 years	$ 291,459	$ 316,154

Intangible asset amortization expense for the three months ended June 30, 2019 and 2018 was $12.5 million and $12.5 million, respectively. Intangible asset amortization expense for the six months ended June 30, 2019 and 2018 was $25.1 million and $14.6 million, respectively. Amortization of existing intangible assets is estimated to be as follows (in thousands):

Year Ending December 31:	
Remainder of 2019	$ 24,599
2020	48,940
2021	48,812
2022	48,121
2023	29,341
Thereafter	91,646
	$ 291,459

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Goodwill

The following table presents the goodwill allocated to the Company's reportable segments as of and during the six months ended June 30, 2019:

	December 31, 2018	Translation Adjustments	June 30, 2019
		(in thousands)	
Shutterfly Consumer	$ 372,072	$ —	$ 372,072
Lifetouch	434,632	91	434,723
Shutterfly Business Solutions	36,903	—	36,903
	$ 843,607	$ 91	$ 843,698

Accrued Liabilities

	June 30, 2019	December 31, 2018
	(in thousands)	
Accrued compensation	$ 55,366	$ 44,720
Accrued production costs	13,830	46,497
Finance lease liabilities, current portion	13,306	14,741
Accrued marketing expenses	9,976	36,428
Accrued income, sales and other taxes	7,546	28,886
Accrued professional services	8,327	11,988
Accrued other	34,485	43,185
	$ 142,836	$ 226,445

Other Liabilities

	June 30, 2019	December 31, 2018
	(in thousands)	
Finance lease liabilities, non-current portion	$ 45,250	$ 38,576
Deferred tax liability	8,236	7,110
Financing obligations	—	51,732
Other liabilities	31,221	36,609
	$ 84,707	$ 134,027

Financing obligations as of December 31, 2018 of $51.7 million related to the Company's build-to-suit arrangements. Upon adoption of ASC 842 on January 1, 2019, the Company derecognized its build-to-suit arrangements as these arrangements no longer qualify for build-to-suit accounting and therefore there was no balance as of June 30, 2019. These arrangements are now recognized as operating leases under ASC 842 and included in the operating lease liability recorded as of the effective date.

Accumulated Other Comprehensive (Loss) Income

The following table summarizes the components of the Company's accumulated other comprehensive (loss) income, net of income taxes:

	June 30, 2019	December 31, 2018
	(in thousands)	
Foreign currency translation losses	$ (297)	$ (1,114)
Unrealized gain (loss) on investments, net of tax	74	(49)
Unrealized (loss) gain on cash flow hedges, net of tax	(1,180)	2,755
Impact of adoption of new accounting standards	376	—
	$ (1,027)	$ 1,592

Note 9 — Debt

The following table summarizes components of the Company's debt:

(in thousands, except percentages)	June 30, 2019	December 31, 2018	Effective Interest Rate
Syndicated Credit Facility			
Initial term loan due August 17, 2024	$ 295,528	$ 297,011	LIBOR plus[(1)]
Incremental term loan due August 17, 2024	617,780	820,880	LIBOR plus[(1)(2)]
Assumed Lifetouch notes payable due at various dates through July 2022	4,761	7,137	0.0 % - 2.2 %
Total principal amount	918,069	1,125,028	
Less: unamortized issuance costs	(14,850)	(20,383)	
Total debt	903,219	1,104,645	
Less: current portion	(5,234)	(14,203)	
Total long-term debt	$ 897,985	$ 1,090,442	

[(1)]As of June 30, 2019 and December 31, 2018, the Initial Term Loan bears interest at a rate equal to one-month LIBOR, plus an applicable margin of 2.50% per annum. As of June 30, 2019 and December 31, 2018, the Incremental Term Loan bears interest at a rate equal to one-month LIBOR, plus an applicable margin of 2.50% and 2.75% per annum, respectively.
[(2)]The applicable margin for the Incremental Term Loan is determined based on a secured leverage ratio as defined by the Incremental Term Loan Amendment dated April 2, 2018.

Syndicated Credit Facility

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

In October 2017, the Company fully drew the $300.0 million Initial Term Loan under the Credit Agreement. On April 2, 2018, the Company entered into an amendment under the Credit Agreement for an incremental term loan in an aggregate principal amount of $825.0 million ("Incremental Term Loan") to finance the acquisition of Lifetouch. The obligations under the Initial Term Loan and Incremental Term Loan rank equally in right of payment. The Credit Agreement requires quarterly principal payments as well as mandatory prepayments under certain conditions as set forth in the Credit Agreement.

The full amount of the $200.0 million Revolving Loan Facility remains undrawn as of June 30, 2019. Borrowings under the Revolving Loan Facility are available through August 17, 2022. The interest rate for the Revolving Loan Facility is based on a formula using certain market rates and the Company's secured leverage ratio as defined by the Incremental Term Loan Amendment dated April 2, 2018. Refer to Note 14 in the Company's Form 10-K for the year ended December 31, 2018 for further details.

In August 2017, the Company entered into certain interest-rate swap agreements with an effective date of October 18, 2017 that have the economic effect of modifying a portion of the variable interest-rate obligations associated with the Initial Term Loan so that the interest payable on such portion becomes fixed (refer to *Note 15 - Derivative Financial Instruments* for further details regarding the interest-rate swap agreements).

The following table sets forth the effective interest rates for the unhedged portion of the Initial Term Loan and the Incremental Term Loan, as well as the principal payments made for the three and six months ended June 30, 2019 and 2018.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
Effective Interest:				
Initial Term Loan Unhedged	4.96 %	4.43 %	4.98 %	4.27 %
Incremental Term Loan	5.07 %	4.68 %	5.17 %	4.68 %
Principal Payments:				
Initial Term Loan	$ 741	$ 750	$ 1,483	$ 1,500
Incremental Term Loan	1,548	—	203,100	—
Total	$ 2,289	$ 750	$ 204,583	$ 1,500

The Credit Agreement contains customary affirmative and negative covenants. The Company is also required to maintain compliance, measured as of the end of each fiscal quarter, with a consolidated secured leverage ratio and a consolidated interest expense coverage ratio. As of June 30, 2019, the Company is in compliance with these covenants.

Principal payments made on the Incremental Term Loan during the six months ended June 30, 2019 includes a $200.0 million principal prepayment the Company made in January 2019. The $200.0 million prepayment is applied to future quarterly principal payments which removes the required quarterly payments until maturity date on August 17, 2024.

The following table sets forth the total interest expense recognized related to the Initial Term Loan and the Incremental Term Loan for the three and six months ended June 30, 2019 and 2018.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
Floating interest (including the effects of cash flow hedges)	$ 11,421	$ 12,849	$ 23,871	$ 16,100
Amortization of debt issuance costs	772	891	5,432	1,063
Total	$ 12,193	$ 13,740	$ 29,303	$ 17,163

Assumed Lifetouch Notes Payable

In connection with the acquisition of Lifetouch in the second quarter of 2018 (refer to Note 3 - *Acquisition*), the Company assumed $9.1 million of legacy Lifetouch notes payable. These notes payable were issued by Lifetouch to finance various acquisitions and represents promissory notes issued to the owners of the acquired companies for an amount equal to the purchase consideration. Payments of principal for these notes payable during the three and six months ended June 30, 2019 were $1.1 million and $2.7 million, respectively.

Debt Principal Payments

As of June 30, 2019, the future principal payments of the Initial Term Loan, Incremental Term Loan and the assumed Lifetouch notes payable are as follows (in thousands):

Year Ending December 31:		
Remainder of 2019	$	2,353
2020		4,940
2021		4,036
2022		3,609
2023		2,843
2024		900,288
Total principal payments	$	918,069

Note 10 — Segment Reporting

The Company reports segment information based on its internal reporting used by management for making decisions and assessing performance as the source of its reportable segments.

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

Segment margin includes technology and development expenses, sales and marketing expenses, and credit card fees, arriving at a margin for the segment. Segment margin excludes corporate expenses, amortization of intangible assets, stock-based compensation expense, restructuring charges, acquisition-related costs and executive transition and strategic review charges. Corporate expenses include activities that are not directly attributable or allocable to a specific segment.

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

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

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

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

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

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The Company's segment results for the three and six months ended June 30, 2019 and 2018 are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in thousands)	**2019**	**2018**	**2019**	**2018**
Shutterfly Consumer:				
Net revenue	$ 169,584	$ 165,003	$ 318,432	$ 317,062
Cost of net revenue[1]	95,261	86,065	185,667	170,909
Technology and development	34,373	29,830	67,896	61,959
Sales and marketing	31,739	29,956	60,863	60,681
Credit card fees	4,346	4,349	8,501	8,548
Margin[1][2]	$ 3,865	$ 14,803	$ (4,495)	$ 14,965
Margin %	2.3 %	9.0 %	(1.4) %	4.7 %
Lifetouch[3]:				
Net revenue[4]	$ 254,174	$ 261,911	$ 384,126	$ 261,911
Cost of net revenue[5]	98,844	91,148	177,172	91,148
Technology and development	8,021	7,109	15,994	7,109
Sales and marketing	89,847	86,960	166,141	86,960
Credit card fees	2,693	1,165	4,920	1,165
Margin[2]	$ 54,769	$ 75,529	$ 19,899	$ 75,529
Margin %	21.5 %	28.8 %	5.2 %	28.8 %
Shutterfly Business Solutions:				
Net revenue	$ 49,658	$ 49,809	$ 96,184	$ 97,475
Cost of net revenue	42,941	41,610	81,092	81,519
Technology and development	3,700	3,049	6,992	6,994
Sales and marketing	1,107	1,619	2,515	3,069
Margin[2]	$ 1,910	$ 3,531	$ 5,585	$ 5,893
Margin %	3.8 %	7.1 %	5.8 %	6.0 %
Consolidated Segments:				
Net revenue[4]	$ 473,416	$ 476,723	$ 798,742	$ 676,448
Cost of net revenue[1][5]	237,046	218,823	443,931	343,576
Technology and development	46,094	39,988	90,882	76,062
Sales and marketing	122,693	118,535	229,519	150,710
Credit card fees	7,039	5,514	13,421	9,713
Margin[1][2]	$ 60,544	$ 93,863	$ 20,989	$ 96,387
Margin %	12.8 %	19.7 %	2.6 %	14.2 %

(1) Six months ended June 30, 2019 includes an immaterial out-of-period adjustment for shipping services provided in the fourth quarter of 2018 of $2.8 million, which increased cost of net revenue and lowered segment margin.

(2) The margins reported reflect only costs that are directly attributable or allocable to a specific segment and exclude purchase accounting adjustments, corporate expenses, amortization of intangible assets, stock-based compensation, restructuring, acquisition-related, and executive transition and strategic review charges.

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

(4) Lifetouch net revenue presented in management reporting related to certain obligations that would have otherwise been recorded by Lifetouch as an independent entity but were not recognized in the Company's condensed consolidated financial statements for the six months ended June 30, 2019 and the three and six months ended June 30, 2018 due to business combination accounting requirements.

(5) Business combination accounting principles require the Company to measure acquired inventory at fair value. The fair value of inventory reflects Lifetouch's cost of manufacturing plus a portion of the expected profit margin. Segment reporting excludes this purchase accounting adjustment from cost of net revenue for the Lifetouch segment for the three and six months ended June 30, 2018.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The following table reconciles total segment margin to total operating loss and loss before income taxes, segment net revenue to net revenue, and segment cost of net revenue to cost of net revenue for the three and six months ended June 30, 2019 and 2018:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
Total segment margin	$ 60,544	$ 93,863	$ 20,989	$ 96,387
Purchase accounting deferred revenue adjustment[1]	—	(33,351)	(645)	(33,351)
Purchase accounting inventory adjustment[2]	—	(10,931)	—	(10,931)
Corporate expenses[3]	(32,459)	(37,012)	(67,549)	(55,036)
Amortization of intangible assets	(12,795)	(12,831)	(25,620)	(15,164)
Stock-based compensation expense	(11,507)	(11,697)	(23,545)	(23,389)
Restructuring	(3,274)	(2,952)	(7,247)	(2,952)
Executive transition and strategic review costs	(8,445)	—	(10,099)	—
Acquisition-related costs	—	(8,000)	—	(12,585)
Loss from operations	$ (7,936)	$ (22,911)	$ (113,716)	$ (57,021)
Loss from operations	$ (7,936)	$ (22,911)	$ (113,716)	$ (57,021)
Interest expense	(13,312)	(17,769)	(31,566)	(27,402)
Interest and other income, net	1,088	1,561	2,266	3,310
Loss before income taxes	$ (20,160)	$ (39,119)	$ (143,016)	$ (81,113)
Total segment net revenue	$ 473,416	$ 476,723	$ 798,742	$ 676,448
Purchase accounting deferred revenue adjustment[1]	—	(33,351)	(645)	(33,351)
Net revenue	$ 473,416	$ 443,372	$ 798,097	$ 643,097
Total segment cost of net revenue	$ 237,046	$ 218,823	$ 443,931	$ 343,576
Purchase accounting inventory adjustment[2]	—	10,931	—	10,931
Stock-based compensation expense for cost of net revenue	844	943	1,736	1,942
Amortization of intangible assets for cost of net revenue	2,623	2,531	5,245	2,826
Cost of net revenue	$ 240,513	$ 233,228	$ 450,912	$ 359,275

(1) Lifetouch net revenue presented in management reporting related to certain obligations that would have otherwise been recorded by Lifetouch as an independent entity but were not recognized in the Company's condensed consolidated financial statements due to business combination accounting requirements.
(2) Business combination accounting principles require the Company to measure acquired inventory at fair value. The fair value of inventory reflects the acquired company's cost of manufacturing plus a portion of the expected profit margin. Management reporting excludes this purchase accounting adjustment from cost of net revenue for the Lifetouch segment.
(3) Corporate expenses include activities that are not directly attributable or allocable to a specific segment. This category consists primarily of expenses related to certain functions performed at the corporate level such as non-manufacturing facilities, human resources, finance and accounting, legal, information technology, integration, etc.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 11 — Leases

The Company leases certain equipment, office space, production and warehouse facilities and several photographic studios under various non-cancelable operating leases that expire on various dates through 2030. The Company's finance leases primarily relate to production equipment.

The following table presents the classification of ROU assets and lease liabilities as of June 30, 2019:

Leases	**Consolidated Balance Sheet Classification**		**June 30, 2019**
			(in thousands)
Assets:			
Operating right-of-use assets	Other assets	$	66,630
Finance right-of-use assets	Property and equipment, net[1]		54,232
Total leased assets		$	120,862
Liabilities:			
Current			
Operating lease liabilities	Operating lease liabilities, current portion	$	21,045
Finance lease liabilities	Accrued liabilities		13,306
Noncurrent			
Operating lease liabilities	Operating lease liabilities		59,301
Finance lease liabilities	Other liabilities		45,250
Total lease liabilities		$	138,902

[1] Finance lease assets are recorded net of accumulated amortization of $41.9 million as of June 30, 2019.

The following table represents the lease cost for the three and six months ended June 30, 2019:

(in thousands)		**Three Months Ended June 30, 2019**		**Six Months Ended June 30, 2019**
Operating lease cost[1]	$	7,579	$	14,860
Finance lease cost				
Amortization of right-of-use-assets		3,896		8,075
Interest on lease liabilities		736		1,503
Variable lease cost		7,855		15,509
Sublease income		(120)		(247)
Net lease cost	$	19,946	$	39,700

[1] Includes short-term lease cost, which is immaterial.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Future minimum lease payments under non-cancelable leases as of June 30, 2019 were as follows:

Year Ended December 31,	Operating Leases (1)	Finance Leases	Total
		(in thousands)	
Remainder of 2019	$ 12,328	$ 8,456	$ 20,784
2020	23,706	14,253	37,959
2021	20,164	13,229	33,393
2022	16,458	12,822	29,280
2023	9,606	10,706	20,312
Thereafter	8,581	6,277	14,858
Total lease payments	$ 90,843	$ 65,743	$ 156,586
Less: Interest	(10,497)	(7,187)	(17,684)
Present value of lease liabilities(2)	$ 80,346	$ 58,556	$ 138,902

(1) Operating lease payments exclude $28.1 million of legally binding minimum lease payments for an operating lease the Company entered into in March 2019 for the Company's new 237,000 square foot facility in Plano, Texas. The lease is expected to commence in early 2020 when construction of the asset is completed with an original lease term of 10 years.
(2) Includes the current portion of $21.0 million for operating leases and $13.3 million for finance leases.

Future minimum lease payments under non-cancelable leases and build-to-suit arrangement as of December 31, 2018 were as follows:

Year Ended December 31,	Operating leases	Build-to-Suit	Finance leases
		(in thousands)	
2019	$ 23,557	$ 6,501	$ 16,853
2020	17,730	6,646	10,582
2021	13,763	6,794	9,908
2022	9,928	6,947	9,820
2023	1,872	6,479	8,237
Thereafter	1,501	6,522	4,023
Total lease payments	$ 68,351	$ 39,889	$ 59,423
Less: Interest			(6,106)
Present value of lease liabilities			$ 53,317

Other information about leases is as follows:

Lease Term and Discount Rate	June 30, 2019
Weighted-average remaining lease term (years)	
Operating leases	4.1
Finance leases	4.1
Weighted-average discount rate	
Operating leases	5.8 %
Finance leases	4.9 %

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Supplemental Cash Flow Information		Six Months Ended June 30, 2019
		(in thousands)
Cash paid for amounts included in the measurement of lease liabilities		
Operating cash flows from operating leases	$	(18,158)
Operating cash flows from finance leases		(1,422)
Financing cash flows from finance leases		(9,587)
ROU assets obtained in exchange for operating lease liabilities		3,541
ROU assets obtained in exchange for finance lease liabilities		2,973

The company has a contract with JCPenney Corporation, Inc. ("JCP") to operate photographic portrait studios at JCP stores. In this contract, the Company pays license fees as defined in the agreement (based on revenue). These amounts are not included in the measurement of the lease liability but are recognized as variable lease cost when incurred. The contract with JCP expires in May 2020 with a three-year wind down period post-expiration date if the contract is not renewed.

Note 12 — Commitments and Contingencies

Purchase Obligations

There have been no material changes to the non-cancelable purchase obligations disclosed in the Company's Form 10-K for the year ended December 31, 2018 except for a new five-year non-cancelable commitment for the Company's enterprise resource planning system of approximately $11.5 million.

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.

Letter of Credit

As of June 30, 2019, the Company has stand-by-letters of credit, totaling approximately $20.6 million, for the benefit of the Company's workers' compensation insurance carriers. There were no amounts drawn against any of the letters of credit at June 30, 2019. The letters of credit are secured by collateral in the form of a certificate of deposit, which is treated as restricted other current asset and is recorded in other current assets on the balance sheet.

Contingencies

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

Legal Matters

The Company is subject to the various legal proceedings and claims discussed below as well as certain other legal proceedings and claims that have not been fully resolved and that have arisen in the ordinary course of business. Although adverse decisions (or settlements) may occur in one or more of these cases, it is not possible to estimate the possible loss or losses from each of these cases. The final resolution of these lawsuits, individually or in the aggregate, is not expected to have a material adverse effect on the Company's business, financial position or results of operations. Cases that previously were disclosed may no longer be described because of rulings in the case, settlements, changes in the Company's business or other developments rendering them, in the Company's judgment, no longer material to the Company's business, financial position or results of operations. One legal proceeding was terminated during April 2019.

Antonio Davis v. Lifetouch, Inc.

On March 10, 2019, Antonio Davis filed a purported class action complaint on behalf of himself and other Lifetouch customers in the U.S. District Court for the District of Kansas. The complaint alleges that Lifetouch violated Kansas consumer protection statutes prohibiting the sale of unsolicited goods. Davis is seeking monetary damages and injunctive relief. The Company believes the suit is without merit and intends to vigorously defend against it.

Miracle-Pond and Paraf v. Shutterfly, Inc.

On June 11, 2019, Vernita Miracle-Pond and Samantha Paraf on behalf of themselves and all other similarly situated Shutterfly and non-Shutterfly customers, filed a complaint against the Company in the Circuit Court of Cook County, Illinois. The complaint asserts that the Company violated the Illinois Biometric Information Privacy Act by extracting their biometric identifiers from photographs and seeks statutory damages and an injunction. The Company removed the case to federal court. Miracle-Pond and Paraf are seeking monetary damages and injunctive relief. The Company believes the suit is without merit and intends to vigorously defend against it.

Monroy v. Shutterfly, Inc.

On November 30, 2016, Alejandro Monroy on behalf of himself and all others similarly situated, filed a complaint against the Company in the U.S. District Court for the Northern District of Illinois. The complaint asserts that the Company violated the Illinois Biometric Information Privacy Act by extracting his and others' biometric identifiers from photographs and seeks statutory damages and an injunction. Monroy was seeking monetary damages and injunctive relief. On April 8, 2019, the U.S. District Court for the Northern District of Illinois dismissed Monroy's claims with prejudice.

Taylor v. Shutterfly, Inc.

On December 12, 2017, Megan Taylor filed a purported class action complaint on behalf of herself and other customers in the U.S. District Court for the Northern District of California. The complaint alleges that the Company misrepresents a deal it currently offers through Groupon because it does not allow purchasers of the Groupon offer to combine or "stack" it with other promotional codes offered by the Company. The Company successfully compelled the matter to private arbitration. On July 11, 2019, the arbitrator ruled that the class action waiver contained in the Company's terms of use was not enforceable and remanded the case back to the U.S. District Court. Taylor is seeking monetary damages and injunctive relief. The Company believes the suit is without merit and intends to vigorously defend against it.

Vigeant v Meek et al.

On March 1, 2018, a purported class action complaint was filed against several directors of Lifetouch, Inc. (which became a direct wholly-owned subsidiary of Shutterfly on April 2, 2018) and the trustee of the Lifetouch Employee Stock Ownership Plan (the "ESOP") in the U.S. District Court for the District of Minnesota. On April 2, 2018, the complaint was amended to include the prior ESOP trustees and plan sponsor (Lifetouch) as additional named defendants. The complaint alleges violations of the Employee Retirement Income Security Act, including that the ESOP should not have been permitted to continue investing in Lifetouch stock during a period in which the Lifetouch stock price was declining. The plaintiffs seek recovery for damages arising from the alleged breaches of fiduciary duty. On November 7, 2018, the District Court granted defendant's motion to dismiss in its entirety and with prejudice. Plaintiffs' counsel filed a timely notice of appeal with the 8th Circuit Court of Appeals. The Company believes the suit is without merit and intends to vigorously defend against it.

Transaction Litigation

On July 22, 2019, a stockholder complaint was filed in the United States District Court, Northern District of California, against the Company and the individual members of the Company's Board of Directors, captioned *Stein v. Shutterfly, Inc.*, et al. (the "Stein Complaint"). Also on July 23, 2019, a stockholder complaint was filed in the United States District Court, Southern District of New York, against the Company and the individual members of the Company's Board of Directors, captioned *Spurlock v. Shutterfly, Inc.*, et al. (the "Spurlock Complaint").

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

On July 26, 2019, a putative stockholder class action complaint was filed in the United States District Court, District of Delaware, against the Company and the individual members of the Company's Board of Directors, captioned *Wolf v. Shutterfly, Inc. et al.,* (the "Wolf Complaint"). On July 29, 2019, a putative stockholder class action complaint was filed in the United States District Court, Northern District of California, against the Company and the individual members of the Company's Board of Directors, captioned *Gordon v. Shutterfly, Inc., et al.,* (the "Gordon Complaint"). On July 31, 2019 and August 5, 2019, a putative stockholder class action complaint was filed in each of the San Mateo County Superior Court and the United States District Court, Northern District of California, respectively, against the Company and the individual members of the Company's Board of Directors, each captioned *Cheung v. Shutterfly, Inc., et al.,* (the "Cheung Complaints" and collectively with the Stein Complaint, Spurlock Complaint, Wolf Complaint and the Gordon Complaint, the "Stockholder Complaints"). Each of the Stockholder Complaints asserts that defendants violated Section 14(a) and 20(a) of the Exchange Act and certain rules and regulations promulgated thereunder by making untrue statements of material fact and omitting certain material facts related to the contemplated Transaction in the relevant proxy statement or in the case of the Cheung complaint filed in San Mateo County, that defendants breached their fiduciary duties in their capacities as officers or directors of the Company.

The Stockholder Complaints seek, among other things, an order enjoining the defendants from consummating the Transaction, money damages and an award of attorneys' and experts' fees. The Company believes that the lawsuits are without merit and intend to vigorously defend those actions. The Company may become subject to similar litigation relating to the Transaction in these or other jurisdictions.

For each of these matters on an individual basis, at each reporting period, the Company evaluates whether or not a potential loss amount or a potential range of loss is probable and reasonably estimable under the provisions of the authoritative guidance that addresses accounting for contingencies. In such cases, the Company accrues for the amount, or if a range, the Company accrues the low end of the range as a component of legal expense. The Company monitors developments in these legal matters that could affect the estimate the Company had previously accrued. There are no material amounts accrued as of December 31, 2018 and June 30, 2019.

Note 13 — Share Repurchase Program

The Company has a share repurchase program originally authorized by the Company's Board of Directors and approved by the Audit Committee to repurchase up to $60.0 million of the Company's common stock. The Company's Board of Directors approved expansions of the share repurchase program in 2014, 2015, 2016 and 2017 by an additional $640.0 million in aggregate to the amounts repurchased as of the date of approval. The Company suspended its share repurchase program as of December 31, 2017. If the Transaction with Apollo does not close as anticipated, the Company will re-evaluate its capital structure and capital return policy.

The share repurchase program is subject to prevailing market conditions and other considerations; does not require the Company to repurchase any dollar amount or number of shares; and may be suspended or discontinued at any time. The share repurchase authorization, when effective, permits the Company to effect repurchases for cash from time to time through the open market, privately negotiated or other transactions, including pursuant to trading plans established in accordance with Rules 10b5-1 and 10b-18 of the Securities Exchange Act of 1934, as amended, or by a combination of such methods.

Note 14 — Restructuring

2018 Restructuring Plan

During the fourth quarter of 2018, the Company's Board of Directors approved a restructuring plan to close four Lifetouch facilities in 2019 ("2018 Restructuring Plan"): Loves Park, Illinois; Bloomington, Minnesota; Chico, California; and Chattanooga, Tennessee and consolidate this volume into other Shutterfly facilities and a new 237,000 square foot facility in Plano, Texas to be completed in the first quarter of 2020. The consolidation involves a mix of moving existing Lifetouch equipment to Shutterfly facilities and migrating Lifetouch volumes to Shutterfly's digital presses.

During the three and six months ended June 30, 2019, the planned exit resulted in restructuring charges of $3.3 million and $7.2 million, respectively. The cumulative charges to date amount to $8.9 million. The Company expects to substantially complete the 2018 Restructuring Plan by the end of 2019. The total estimated restructuring costs associated with the 2018 Restructuring Plan will be approximately $12.5 million and will primarily impact the Company's operating expenses line items within the condensed consolidated statement of operations as these costs are incurred. Any changes to the estimates of executing the 2018 Restructuring Plan will be reflected in the Company's future results of operations.

iMemories Restructuring

The Company completed the acquisition of Lifetouch on April 2, 2018. At the time the Company purchased Lifetouch, it anticipated that it would exit the iMemories business, as Shutterfly Photos was a more complete and advanced solution. The Company decided to accelerate the process of exiting iMemories, which was completed in the second quarter of 2018 and was divested for a nominal amount. The exit resulted in restructuring charges of $3.0 million consisted of lease termination costs of $1.0 million, employee-related costs of $0.8 million and other costs of $1.2 million. Payments of $2.2 million in connection with these charges were made during the second quarter of 2018. The remaining $0.8 million related to non-cash restructuring charges primarily related to write-off of certain assets. The Company does not expect to incur any further charges in connection with this divestiture.

Restructuring Activity

The following table summarizes the restructuring costs recognized during the six months ended June 30, 2019:

Fiscal 2019 Activity	**Balance December 31, 2018** [1]	**Restructuring Charges**	**Cash Payments**	**Non-Cash Adjustments**[2]	**Balance June 30, 2019**[1]
			(in thousands)		
2018 Restructuring Plan:					
Employee costs	$ 861	$ 4,647	$ (1,055)	$ —	$ 4,453
Property and equipment	—	2,232	—	(2,232)	—
Other	—	368	(299)	(69)	—
Total 2018 Restructuring Plan	861	7,247	(1,354)	(2,301)	4,453
Prior year plans	1,271	—	—	(1,271)	—
Total restructuring plans	$ 2,132	$ 7,247	$ (1,354)	$ (3,572)	$ 4,453

[1] Restructuring costs as of June 30, 2019 and December 31, 2018, are recorded in accrued liabilities and other non-current liabilities.
[2] Non-cash adjustments for the 2018 Restructuring include depreciation of property and equipment and other non-cash costs incurred as part of the restructuring.

Note 15 — Derivative Financial Instruments

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

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

The amounts reclassified from other comprehensive loss to interest expense during the three and six months ended June 30, 2019 and 2018 were insignificant. Further, the amounts expected to be reclassified from other comprehensive (loss) income into interest expense in the coming 12 months is also insignificant.

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

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Fair Value of Derivative Instruments Designated as Hedges in the Balance Sheet

	Balance Sheet Location	Total Estimated Fair Value as of June 30, 2019	Total Estimated Fair Value as of December 31, 2018
		(in thousands)	
Swap Agreements	(Other liabilities)/Other assets	$ (957)	$ 4,204

Unrealized Gains (Losses) on Derivative Instruments Designated as Hedges included in Other Comprehensive (Loss) Income

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
Swap Agreements	$ (3,317)	$ 1,000	$ (5,161)	$ 3,770

Interest Expense (Including the Effects of the Cash Flow Hedges) related to the Portion of the Initial Term Loan Subject to the Swap Agreements

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	(in thousands)			
Swap Agreements	$ 1,850	$ 1,632	$ 3,706	$ 3,301

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

Overview

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

On April 2, 2018, we completed our acquisition of Lifetouch Inc. ("Lifetouch") for an all-cash purchase price of $825.0 million. Lifetouch is the national leader in school photography.

We announced in June 2019 that we have entered into a definitive agreement with the affiliates of certain funds (the "Apollo Funds"), managed by affiliates of Apollo Global Management, LLC (together with its consolidated subsidiaries, "Apollo"), a leading global alternative investment manager, pursuant to which affiliates of Apollo Funds will acquire all the outstanding shares of Shutterfly for $51.00 per share in cash (the "Transaction"). The Transaction is expected to close by early fourth quarter 2019, pending approval by Shutterfly stockholders and satisfaction of certain other closing conditions. Early termination of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 was granted on July 17, 2019, effective immediately.

Shutterfly Consumer and Lifetouch help consumers capture, preserve, and share life's important moments through professional and personal photography, and personalized products. The Shutterfly brand brings photos to life in photo books, gifts, home décor, and cards and stationery. Lifetouch is the national leader in school photography, built on the enduring tradition of "Picture Day," and serves families through portrait studios and other partnerships. Shutterfly Business Solutions delivers digital printing services that enable efficient and effective customer engagement through personalized communications.

We also offer Shutterfly Photos, our cloud photo management service, to our customers. During fall picture day season in 2018, Lifetouch school customers who purchased digital images from mylifetouch.com were able to access these pictures directly within Shutterfly Photos; we also deployed this integrated experience for Lifetouch preschool customers during the second quarter of 2019. These customers benefit from free storage for any personal photos they uploaded as well as their Lifetouch photos, and are able to create and purchase personalized products using these photos. Our experience shows that integrating customers' photos onto Shutterfly Photos is the best way to drive customer engagement and purchases of our products.

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

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

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

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

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

Lifetouch is the national leader in school photography, built on the enduring tradition of "Picture Day." **School Photography** captures K-12 portraits and helps high school and college seniors celebrate those graduation milestones and yearbooks. Our P**ortrait Studios** provide professional photographic services for infants, toddlers, families and business professionals throughout the United States under the JCPenney portrait brand at over 400 select retail studios. Lifetouch also captures pictures of infants to toddlers for **Preschools** and daycares nationwide and provides **Churches** and other groups with pictorial directories and images for purchase.

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

We generate most of our revenue by marketing and manufacturing a variety of products such as portraits, cards and stationery, professionally-bound photo books and yearbooks, personalized gifts and home décor, calendars and high-quality prints. We manufacture many of these items in our production facilities located throughout the United States and one in Canada. By operating our own production facilities, we can produce high-quality products, innovate rapidly, maintain a favorable cost structure and ensure timely shipment to customers, even during peak periods of demand. We also operate a network of partners, across which we can seamlessly manage demand. Some of the products that are currently manufactured for us by third-parties include calendars, mugs, ornaments, candles, pillows and blankets.

While Lifetouch is a leading school photographer in Canada, substantially all our revenue is generated from sales originating in the United States. Shutterfly Consumer and Lifetouch sales have historically been highly seasonal. For example, we generated approximately 50% of our net revenue in the fourth quarter during each of the last three years in our Shutterfly consumer business and Lifetouch generated approximately 35% of its net revenue in the fourth calendar quarter during each of the last three years. We have also seen an increase in Lifetouch net revenue during the second quarter in connection with the spring portrait season and yearbooks. Our operations and financial performance depend on general economic conditions in the United States, consumer sentiment, and the levels of consumer discretionary spending. We closely monitor these economic measures as their trends are indicators of the health of the overall economy and are some of the key external factors that impact our business.

Our Lifetouch business is based on securing opportunities at schools, preschools, retailers and other organizations to capture unique images of infants, toddlers, children, teenagers, high school and college seniors, adults and families. Through Lifetouch's arrangements with these "hosts," Lifetouch captures the images of more than 25 million individuals each year and serves over 10 million households. Through our acquisition of Lifetouch, we potentially gain access to these Lifetouch customers for our Shutterfly Consumer business. Lifetouch has over 11 million non-overlapping three-year active customers (defined as customers who have made at least one purchase from Lifetouch in the last three years). Over time, Lifetouch's customers will benefit from Shutterfly's leading cloud-photo management service ("Shutterfly Photos"), product creation capabilities, mobile apps, and broad product range. We expect to realize more revenue from Lifetouch customers within Lifetouch by accelerating the development of Lifetouch's online ordering platforms as well as potentially offering some of Shutterfly's broader product range to customers. We also expect to realize supply chain, manufacturing, and fulfillment synergies over time.

Our plans for cost synergies center on establishing a common manufacturing platform, achieving greater utilization given our adjacent peak periods (the third quarter for Lifetouch and the fourth quarter for Shutterfly Consumer), and leveraging our combined purchasing power and scale. As part of our strategic planning process for 2019, we further developed our long-term plans to establish a single, next-generation manufacturing platform serving Shutterfly Consumer, Lifetouch and SBS. We refer to this initiative as Project Aspen.

In conjunction with Project Aspen, we plan to open a new 237,000 square foot facility in Plano, Texas in the first quarter of 2020, which will serve all of our segments. We will also close four legacy Lifetouch facilities in 2019: Loves Park, Illinois; Bloomington, Minnesota; Chico, California; and Chattanooga, Tennessee, and will consolidate this volume into other Shutterfly facilities and the new facility in Texas. The consolidation involves a mix of moving existing Lifetouch equipment to Shutterfly facilities and migrating Lifetouch volumes to Shutterfly's digital presses. Given the adjacent peak periods of the Shutterfly Consumer and the Lifetouch businesses, this consolidation of facilities will provide an opportunity to reduce our reliance on temporary labor while improving the utilization of existing assets. We plan to retain a portion of the impacted employees in this transition, who will move to other existing Shutterfly or Lifetouch facilities, and we will offer appropriate severance and/or retention packages to other employees. We expect Project Aspen will result in future benefits to operating expenses; however, the expected benefits to operating expenses are not measurable at this point.

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

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

On February 5, 2019, we announced that Christopher North, President and CEO, will be stepping down at the end of August 2019. On June 10, 2019, we announced the appointment of Ryan O'Hara as our next President and Chief Executive Officer and a member of the Board of Directors effective June 24, 2019. Mr. O'Hara has served as Chief Executive Officer of Move, Inc., a real estate portal company, since January 2015. Prior to joining Move, from 2013 to 2014, Mr. O'Hara served as President of Content, Distribution & Sales at The Madison Square Garden Company, the sports and entertainment firm for which he led media assets MSG and Fuse network, as well as technology and marketing partnerships.

On March 8, 2019, we announced the appointment of James Hilt as President, Shutterfly Consumer. On April 4, 2019, we announced that Michael Meek, President and CEO of Lifetouch, will be stepping down in October 2019. On July 30, 2019, we announced the appointment of Greg Hintz as our next President, Lifetouch, effective immediately. Prior to this role, Greg has served as head of Corporate Development, a leader of integration efforts, and Chief of Staff for the Company.

We adopted the new accounting standard for leases effective January 1, 2019. This new lease standard had a material impact on our consolidated balance sheet related to the recording of right-of-use assets and corresponding lease liabilities for operating leases. Further, the change in accounting for our build-to-suit arrangements impacted the classification of associated expenses in the statement of operations. However, the standard did not materially impact our consolidated net loss and had no impact on the consolidated statement of cash flows. Refer to *Note 1 – The Company and Summary of Significant Accounting Policies* of the financial statements for further details regarding the adoption of the new lease standard.

Basis of Presentation

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

Shutterfly Consumer. Our Shutterfly Consumer net revenue includes sales from our brands and are derived from the sale of a variety of products such as, cards and stationery, professionally-bound photo books, personalized gifts and home décor, calendars and prints, and the related shipping revenue as well as rental revenue from our BorrowLenses brand. Revenue from advertising displayed on our websites is also included in Shutterfly Consumer net revenue.

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

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

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

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

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

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

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

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

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

We believe the analysis of these metrics and others described under "Non-GAAP Financial Measures" provides us with important information on our overall net revenue trends and operating results. Fluctuations in these metrics are not unusual and no single factor is determinative of our net revenue and operating results.

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

Shutterfly Consumer. Cost of net revenue for the Shutterfly Consumer segment consists of costs incurred to produce personalized products for all our brands. These costs include direct materials (the majority of which consists of paper, ink, and photo book covers), shipping charges, packing supplies, distribution and fulfillment activities, third-party costs for photo-based merchandise, payroll and related expenses for direct labor and customer service, rent for production facilities, and depreciation of production equipment (primarily digital printing presses and binders) and manufacturing facilities. Cost of net revenue also includes amortization of capitalized website and software development costs, primarily related to adding features and functionality to our website and apps to facilitate product purchases and improve the customer shopping experience. These costs include amortization of third-party software and acquired developed technology as well as patent royalties.

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

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

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

Technology and development expense consists primarily of salaries and benefits for employees and professional fees for contractors engaged in the maintenance and support of our website, developing features and functionality for our free photo storage service, and developing and maintaining internal infrastructure, internal reporting tools and network security and data encryption systems. These expenses include depreciation of computer and network hardware used to run our websites, store user photos and related data, and support our infrastructure, as well as amortization of software used to operate such hardware. Technology and development expense also includes co-location, power and bandwidth costs.

Sales and marketing expense consists of costs incurred for marketing programs, and personnel and related expenses for our customer acquisition, product marketing, business development, and public relations activities. As it relates to the Lifetouch segment, sales and marketing expenses also consist of costs incurred to acquire host accounts (e.g., schools or churches) as well as the costs for marketing programs directed at the end-consumer. These costs include labor costs for sales professionals and account managers who maintain host relationships as well as the personnel and related expenses for product marketing activities. Our marketing efforts consist of various online and offline media programs, such as e-mail and direct mail promotions, flyers distributed by our hosts, social media and online display advertising, radio advertising, television advertising, the purchase of keyword search terms and various strategic alliances. We utilize these efforts to attract customers to our service.

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

Interest Expense. Interest expense primarily consists of interest on our term loans issued in October 2017 and April 2018, interest on our convertible senior notes settled in May 2018 (primarily related to amortization of debt discount), amortization of debt issuance costs, and costs associated with our finance leases and build-to-suit financing obligations.

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

Income Taxes. We account for income taxes under the liability method. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities. We are subject to taxation in the United States, Canada and Israel.

Critical Accounting Policies and Estimates

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

There have been no changes to our critical accounting policies and estimates described in our Annual Report on Form 10-K for the year ended December 31, 2018 that have had a material impact on our condensed consolidated financial statements and related notes.

Recent Accounting Pronouncements

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

Results of Operations

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Net revenue	100 %	100 %	100 %	100 %
Cost of net revenue	51 %	53 %	56 %	56 %
Gross profit	49 %	47 %	44 %	44 %
Operating expenses:				
Technology and development	10 %	10 %	12 %	13 %
Sales and marketing	29 %	29 %	32 %	26 %
General and administrative	11 %	12 %	13 %	14 %
Restructuring	1 %	1 %	1 %	— %
Total operating expenses	51 %	52 %	58 %	53 %
Loss from operations	(2)%	(5)%	(14)%	(9)%
Interest expense	(3)%	(4)%	(4)%	(4)%
Interest and other income, net	— %	— %	— %	—%
Loss before income taxes	(5)%	(9)%	(18)%	(12)%
Benefit from income taxes	2 %	3 %	6 %	4 %
Net loss	(3)%	(6)%	(12)%	(8)%

Comparison of the Three Month Periods Ended June 30, 2019 and 2018

The following table presents the results of operations:

	Three Months Ended June 30,			
	2019	2018	$ Change	% Change
	(dollars in thousands)			
Consolidated:				
Net revenue	$ 473,416	$ 443,372	$ 30,044	7 %
Cost of net revenue	240,513	233,228	7,285	3 %
Gross profit	232,903	210,144	22,759	11 %
Gross margin	49 %	47 %		
Operating expenses:				
Technology and development	49,606	44,420	5,186	12 %
Sales and marketing	135,468	130,643	4,825	4 %
General and administrative[(1)]	52,491	55,040	(2,549)	(5) %
Restructuring	3,274	2,952	322	11 %
Total operating expenses	240,839	233,055	7,784	3 %
Loss from operations	(7,936)	(22,911)	14,975	(65) %
Interest expense	(13,312)	(17,769)	4,457	(25) %
Interest and other income, net	1,088	1,561	(473)	(30) %
Loss before income taxes	(20,160)	(39,119)	18,959	(48) %
Benefit from income taxes	7,428	12,607	(5,179)	(41) %
Net loss	$ (12,732)	$ (26,512)	$ 13,780	(52) %

(1) The General and administrative expenses of $52.5 million for the three months ended June 30, 2019 includes $7.5 million of costs related to executive transition and the strategic review. The General and administrative expenses of $55.0 million for the three months ended June 30, 2018 includes $8.0 million of acquisition-related costs.

Net revenue

Net revenue increased $30.0 million, or 7%, for the three months ended June 30, 2019 as compared to the same period in 2018. Our Shutterfly Consumer, Lifetouch and SBS segments represented 36%, 54% and 10%, respectively, of total net revenue for the three months ended June 30, 2019. Shutterfly Consumer segment revenue increased $4.6 million primarily due to growth in Shutterfly personalized gifts and home décor revenue driven by an increase in paid revenue and new products. Lifetouch segment revenue increased $25.6 million primarily due to a purchase accounting deferred revenue adjustment of $33.4 million that decreased revenue in the three months ended June 30, 2018, which was offset by declines in Schools and Church revenue. Excluding the impact of the purchase accounting deferred revenue adjustment for the three months ended June 30, 2018, Lifetouch segment net revenue decreased $7.7 million for the three months ended June 30, 2019 as compared to the same period in 2018. SBS segment revenue decreased $0.2 million for the three months ended June 30, 2019 as compared to the same period in 2018.

Cost of net revenue

Cost of net revenue increased $7.3 million, or 3%, for the three months ended June 30, 2019 as compared to the same period in 2018. Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase in cost of net revenue as follows:

- Cost of net revenue for our Shutterfly Consumer segment increased $9.2 million;
- Cost of revenue for our Lifetouch segment decreased $3.2 million primarily driven by a purchase accounting inventory adjustment of $10.9 million that increased cost of net revenue in the three months ended June 30, 2018. Excluding the impact of the purchase accounting inventory adjustment for the three months ended June 30, 2018, Lifetouch segment cost of net revenue increased $7.7 million; and
- Cost of net revenue for our SBS segment increased $1.3 million.

Amortization expense of intangible assets for cost of net revenue increased $0.1 million and stock-based compensation expense decreased $0.1 million.

Gross margin increased to 49% in the three months ended June 30, 2019 from 47% in the same period in 2018, primarily due to purchase accounting adjustments for deferred revenue that decreased revenue and increased cost of revenue for the three months ended June 30, 2018. Excluding the effects of the aforementioned purchase accounting adjustments, gross margin decreased to 49% in the three months ended June 30, 2019 from 53% in the same period in 2018, due to declines in gross margins across all three segments.

Technology and development

Our technology and development expense increased $5.2 million, or 12%, for the three months ended June 30, 2019, compared to the same period in 2018. As a percentage of net revenue, technology and development remained flat at 10% in the three months ended June 30, 2019 compared to the three months ended June 30, 2018. Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase in technology and development as follows:

- Technology and development expenses for the Shutterfly Consumer segment increased $4.5 million;
- Technology and development expenses for the Lifetouch segment increased $0.9 million; and
- Technology and development expenses for the SBS segment increased $0.7 million.

Amortization expense of intangible assets for technology and development increased $0.1 million and stock-based compensation decreased $0.3 million.

Sales and marketing

Our sales and marketing expense increased $4.8 million, or 4%, for the three months ended June 30, 2019, compared to the same period in 2018. As a percentage of net revenue, sales and marketing remained flat at 29% in the three months ended June 30, 2019 and 2018. Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase in sales and marketing as follows:

- Sales and marketing expenses for the Shutterfly Consumer segment increased $1.8 million;
- Sales and marketing expenses for the Lifetouch segment increased $2.9 million; and
- Sales and marketing expenses for the SBS segment decreased $0.5 million.

Amortization of intangible assets expense for sales and marketing decreased $0.2 million and stock-based compensation increased $0.6 million.

General and administrative

Our general and administrative expense decreased $2.5 million, or 5%, for the three months ended June 30, 2019, compared to the same period in 2018. As a percentage of net revenue, general and administrative expense decreased to 11% in the three months ended June 30, 2019 from 12% in the three months ended June 30, 2018. The decrease is primarily driven by a decrease in professional fees and stock based compensation which was partially offset by the increase in salaries and benefits primarily due to the onboarding of the new CEO in the second quarter of 2019.

Restructuring

Our restructuring expense increased $0.3 million, or 11%, for the three months ended June 30, 2019, compared to the same period in 2018. The restructuring charges for the three months ended June 30, 2019, primarily consist of $2.2 million in employee-related costs and $0.9 million in depreciation expense of property and equipment in connection with the planned exit of Lifetouch facilities as described in Note 14 - *Restructuring*.

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

Interest expense

Interest expense was $13.3 million for the three months ended June 30, 2019 compared to $17.8 million during the same period in 2018. This decrease is primarily driven by a $200.0 million prepayment of the Incremental Term Loan and a decrease in interest expense for the convertible senior notes paid in May 2018.

Interest and other income, net

Interest and other income, net was $1.1 million for the three months ended June 30, 2019 compared to $1.6 million during the same period in 2018. This decrease is due to lower interest income resulting from lower cash equivalents and investment balances.

Benefit from Income Taxes

We recorded an income tax benefit of $7.4 million and $12.6 million for the three months ended June 30, 2019 and 2018, respectively. Our effective tax rate was 37% for the three months ended June 30, 2019, compared to 32% for the three months ended June 30, 2018. This increase in tax rate was primarily due to the limitation on the deductibility of officer compensation for tax purposes in 2019.

Segment Information

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

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

Shutterfly Consumer Segment

	Three Months Ended June 30,			
	2019	2018	$ Change	% Change
	(dollars in thousands)			
Shutterfly Consumer segment:				
Net revenue	$ 169,584	$ 165,003	$ 4,581	3 %
Cost of net revenue[(1)]	95,261	86,065	9,196	11 %
Technology and development[(1)]	34,373	29,830	4,543	15 %
Sales and marketing[(1)]	31,739	29,956	1,783	6 %
Credit card fees	4,346	4,349	(3)	— %
Margin	$ 3,865	$ 14,803	$ (10,938)	(74) %
Margin %	*2 %*	*9 %*		

(1) Excludes stock-based compensation expense and amortization of intangible assets.

	Three Months Ended June 30,			
	2019	2018	Change	% Change
	(figures in thousands, except AOV amounts)			
Key Shutterfly Consumer Metrics				
Total Customers	3,035	3,140	(105)	(3) %
Total Number of Orders	4,410	4,789	(379)	(8) %
Average order value (AOV)	$ 38.45	$ 34.46	$ 3.99	12 %

Shutterfly Consumer segment net revenue increased $4.6 million, or 3%, in the three months ended June 30, 2019 compared to the same period in 2018. The increase in Shutterfly Consumer segment net revenue was primarily due to growth in personalized gifts and home décor driven by higher performance in paid revenue and new products, partially offset by a slowdown in prints.

Total Shutterfly Consumer segment customers decreased 3% and total number of orders decreased 8%, while AOV increased 12% for the three months ended June 30, 2019 compared to the same period in 2018. These metrics reflect the effect of continuing mix shift away from free promotions and towards paid purchases. Total number of orders decreased primarily due to decline in free orders, and an expected decrease in orders in Groovebook. AOV increased primarily due to mix shift away from free towards paid revenue as well as due to product mix.

Shutterfly Consumer segment cost of net revenue increased $9.2 million, or 11%, for the three months ended June 30, 2019 compared to the same period in 2018 driven primarily by the corresponding increase in net revenue, product mix, higher shipping and material costs, and higher salaries and benefits. Shutterfly Consumer gross margin was 44% for the three months ended June 30, 2019 compared to 48% for the same period in 2018. The decrease in gross margin was driven by an increase in cost of net revenue.

Shutterfly Consumer segment technology and development expense increased $4.5 million, or 15%, for the three months ended June 30, 2019 compared to the same period in 2018. The overall increase is primarily due to an increase of $2.5 million in professional fees and $2.1 million in salaries and benefits. In the three months ended June 30, 2019, we capitalized $11.6 million in eligible salaries and consultant costs, including $0.3 million of stock-based compensation expense, associated with software developed or obtained for internal use, compared to $7.9 million capitalized in the three months ended June 30, 2018, which included $0.3 million of stock-based compensation expense.

Shutterfly Consumer segment sales and marketing expense increased $1.8 million, or 6%, in the three months ended June 30, 2019 compared to the same period in 2018. The increase in the Shutterfly Consumer sales and marketing expense was primarily due to an increase of $0.8 million in salaries and benefits and $0.7 million in marketing campaigns.

Shutterfly Consumer segment margin for the three months ended June 30, 2019 was $3.9 million, a $10.9 million, or 74%, decrease, compared to the same period in 2018, primarily driven by higher cost of net revenue, technology and development and sales and marketing expenses, partially offset by higher net revenue.

Lifetouch Segment

	Three Months Ended June 30,			
	2019	**2018**	**$ Change**	**% Change**
	(dollars in thousands)			
Lifetouch segment:				
Net revenue[1]	$ 254,174	$ 261,911	$ (7,737)	(3) %
Cost of net revenue[2][3]	98,844	91,148	7,696	8 %
Technology and development[2]	8,021	7,109	912	13 %
Sales and marketing[2]	89,847	86,960	2,887	3 %
Credit card fees	2,693	1,165	1,528	131 %
Margin	$ 54,769	$ 75,529	$ (20,760)	(27) %
Margin %	22 %	29 %		

[1] Lifetouch net revenue presented in management reporting related to certain obligations that would have otherwise been recorded by Lifetouch as an independent entity but were not recognized in our condensed consolidated financial statements for the three months ended June 30, 2018 due to business combination accounting requirements.
[2] Excludes stock-based compensation expense and amortization of intangible assets.
[3] Business combination accounting principles require us to measure acquired inventory at fair value. The fair value of inventory reflects the acquired company's cost of manufacturing plus a portion of the expected profit margin. Management reporting excludes this purchase accounting adjustment from cost of net revenue for the Lifetouch segment in the three months ended June 30, 2018.

Lifetouch segment net revenue decreased $7.7 million, or 3%, in the three months ended June 30, 2019 compared to the same period in 2018. The decrease in Lifetouch segment net revenue was primarily driven by declines in Schools and Church net revenue. Schools net revenue decreased primarily driven by lower net revenue from the spring portrait season and special event partially offset by an increase in net revenue from yearbooks. Church net revenue decreased primarily driven by reduction in volume.

Lifetouch segment cost of net revenue increased $7.7 million, or 8% in the three months ended June 30, 2019 compared to the same period in 2018. The increase was primarily driven by higher production costs related to yearbooks during integration in transitioning production from a Lifetouch facility to a Shutterfly facility.

Lifetouch segment technology and development expenses increased $0.9 million, or 13%, in the three months ended June 30, 2019 compared to the same period in 2018. The increase was primarily related to an increase in salaries and benefits and higher maintenance costs.

Lifetouch segment sales and marketing expense increased $2.9 million, or 3% in the three months ended June 30, 2019 compared to the same period in 2018. The increase was primarily related to salaries and benefits and costs incurred to acquire host accounts.

The Lifetouch segment margin for the three months ended June 30, 2019 was $54.8 million, a $20.8 million decrease compared to the same period in 2018, primarily driven by a decrease in net revenue and an increase in cost of net revenue.

Shutterfly Business Solutions (SBS) Segment

	Three Months Ended June 30,			
	2019	2018	$ Change	% Change
	(dollars in thousands)			
SBS segment:				
Net revenue	$ 49,658	$ 49,809	$ (151)	— %
Cost of net revenue(1)	42,941	41,610	1,331	3 %
Technology and development(1)	3,700	3,049	651	21 %
Sales and marketing(1)	1,107	1,619	(512)	(32) %
Margin	$ 1,910	$ 3,531	$ (1,621)	(46) %
Margin %	4 %	7 %		

(1) Excludes stock-based compensation expense and amortization of intangible assets.

SBS segment net revenue decreased $0.2 million in the three months ended June 30, 2019 compared to the same period in 2018.

SBS segment cost of net revenue increased $1.3 million, or 3%, for the three months ended June 30, 2019 compared to the same period in 2018, primarily due to higher lease expense, higher depreciation and an increase in salaries and benefits.

SBS gross margin was 14% for the three months ended June 30, 2019 compared to 16% for the same period in 2018 due to the increase in cost of net revenue.

SBS segment technology and development expenses increased $0.7 million, or 21%, in the three months ended June 30, 2019 compared to the same period in 2018 due to an increase in salaries and benefits. In the three months ended June 30, 2019, we capitalized $1.4 million in eligible salaries and consultant costs, associated with software developed or obtained for internal use, compared to $1.7 million capitalized in the three months ended June 30, 2018.

SBS segment sales and marketing expense decreased $0.5 million, or 32%, in the three months ended June 30, 2019 compared to the same period in 2018 primarily due to an decrease in salaries and benefits.

SBS segment margin in the three months ended June 30, 2019 was $1.9 million, a $1.6 million, or 46%, decrease compared to the same period in 2018 primarily due to the increase in cost of net revenue.

Table of Contents

Comparison of the Six Month Periods Ended June 30, 2019 and 2018

	Six Months Ended June 30,			
	2019	**2018**	**$ Change**	**% Change**
	(dollars in thousands)			
Consolidated:				
Net revenue	$ 798,097	$ 643,097	$ 155,000	24 %
Cost of net revenue	450,912	359,275	91,637	26 %
Gross profit	347,185	283,822	63,363	22 %
Gross margin	44 %	44 %		
Operating expenses:				
Technology and development	97,939	82,924	15,015	18 %
Sales and marketing	254,837	168,363	86,474	51 %
General and administrative[(1)]	100,878	86,604	14,274	16 %
Restructuring	7,247	2,952	4,295	145 %
Total operating expenses	460,901	340,843	120,058	35 %
Loss from operations	(113,716)	(57,021)	(56,695)	99 %
Interest expense	(31,566)	(27,402)	(4,164)	15 %
Interest and other income, net	2,266	3,310	(1,044)	(32) %
Loss before income taxes	(143,016)	(81,113)	(61,903)	76 %
Benefit from income taxes	46,665	27,436	19,229	70 %
Net loss	$ (96,351)	$ (53,677)	$ (42,674)	80 %

[(1)]The general and administrative expense of $100.9 million for the six months ended June 30, 2019 includes $9.7 million of cost related to executive transition and strategic review. The general and administrative expenses of $86.6 million for the six months ended June 30, 2018 include $12.6 million in acquisition-related charges.

Net revenue

Net revenue increased $155.0 million, or 24%, for the six months ended June 30, 2019 as compared to the same period in 2018. Our Shutterfly Consumer, Lifetouch and SBS operating segments represented 40%, 48% and 12%, respectively, of total net revenue for the six months ended June 30, 2019. Of the increase, $129.3 million is related to our Lifetouch segment revenue in the first quarter of 2019 which was absent in the comparable period in 2018 as we acquired Lifetouch on April 2, 2018. The increase was further attributable to Lifetouch segment revenue which increased by $25.6 million for the three months ended June 30, 2019 when compared to same period in prior year primarily due to a purchase accounting deferred revenue adjustment of $33.4 million that decreased revenue in the three months ended June 30, 2018, offset by declines in Schools and Church revenue. Shutterfly Consumer segment net revenue increased $1.4 million while SBS segment net revenue decreased $1.3 million.

Cost of net revenue

Cost of net revenue increased $91.6 million, or 26%, for the six months ended June 30, 2019 as compared to the same period in 2018. Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase in cost of net revenue as follows:

- Cost of net revenue for our Shutterfly Consumer segment increased $14.8 million;
- Cost of revenue for our Lifetouch segment increased $75.1 million. Of the increase, $78.3 million is related to the Lifetouch segment cost of net revenue in the first quarter of 2019 which was absent in the comparable period in 2018 as we acquired Lifetouch on April 2, 2018 and was partially offset by a purchase accounting inventory adjustment of $10.9 million that increased cost of net revenue in the six months ended June 30, 2018; and
- Cost of net revenue for our SBS segment decreased $0.4 million.

Amortization expense of intangible assets for cost of net revenue increased $2.4 million due to the amortization expense for the intangible assets we recorded in the first quarter of 2019 in connection with the acquisition of Lifetouch which was absent in the comparable period in 2018 as we acquired Lifetouch on April 2, 2018. Stock-based compensation expense decreased $0.2 million.

Gross margin remained flat at 44% in the six months ended June 30, 2019 from the same period in 2018. Excluding the effects of purchase accounting adjustments which decreased revenue by $33.4 million and increased cost of revenue by $10.9 million for the six months ended June 30, 2018, gross margin decreased to 44% in the six months ended June 30, 2019 from 49% in the same period in 2018, primarily due to declines in gross margins for the Shutterfly Consumer and the Lifetouch segments.

Technology and development

Our technology and development expense increased $15.0 million, or 18%, for the six months ended June 30, 2019, compared to the same period in 2018. As a percentage of net revenue, technology and development decreased to 12% in the six months ended June 30, 2019 from 13% in the six months ended June 30, 2018. Excluding amortization of intangible assets and stock-based compensation expense, our reportable segments contributed to the increase in technology and development as follows:

- Technology and development expenses for the Shutterfly Consumer segment increased $5.9 million;
- Technology and development expenses for the Lifetouch segment increased $8.9 million; and
- Technology and development expenses for the SBS segment remained flat.

Amortization of intangible assets expense for technology and development increased $1.3 million. Of the increase, $1.2 million relates to the amortization of Lifetouch intangible assets in the first quarter of 2019 which were absent in the comparable period in 2018 as we acquired Lifetouch on April 2, 2018. Stock-based compensation expense decreased $0.4 million.

Sales and marketing

Our sales and marketing expense increased $86.5 million, or 51%, for the six months ended June 30, 2019, compared to the same period in 2018. As a percentage of net revenue, sales and marketing increased to 32% in the six months ended June 30, 2019 from 26% in the six months ended June 30, 2018. The increase in sales and marketing expense as a percentage of net revenue is mainly attributable to our acquisition of Lifetouch on April 2, 2018. The Lifetouch segment has a higher proportion of sales and marketing as a percentage of net revenue as compared to Shutterfly Consumer as Lifetouch relies more on sales professionals and account managers who support and maintain host relationships with schools and churches to reach end customers.

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

- Sales and marketing expenses for the Shutterfly Consumer segment increased $0.2 million;
- Sales and marketing expenses for the Lifetouch segment increased $79.2 million; and
- Sales and marketing expenses for the SBS segment decreased $0.6 million.

Amortization of intangible assets expense for sales and marketing increased $6.7 million. Of the increase, $8.1 million relates to the amortization of Lifetouch intangible assets in the first quarter of 2019 which were absent in the comparable period in 2018 as we acquired Lifetouch on April 2, 1018. The increase in amortization of Lifetouch intangible assets was offset by certain of our intangible assets that became fully amortized in 2018. Stock-based compensation increased $0.6 million. We also recorded $1.0 million in executive transition and strategic review charges during the six months ended June 30, 2019.

General and administrative

Our general and administrative expense increased $14.3 million, or 16%, for the six months ended June 30, 2019, compared to the same period in 2018. As a percentage of net revenue, general and administrative expense decreased to 13% in the six months ended June 30, 2019 from 14% in the six months ended June 30, 2018. Of the increase, $16.3 million relates to general and administrative expenses of Lifetouch in the first quarter of 2019 which were absent in the comparable period in 2018 as we acquired Lifetouch on April 2, 1018. The general and administrative expenses for Lifetouch primarily consist of salaries and benefit expenses and to a lesser extent, professional fees, facilities costs and credit card fees. Further, stock-based compensation expense increased $0.2 million. The increase was partially offset by a decrease in professional fees.

Restructuring expense

Our restructuring expense increased $4.3 million, or 145%, for the six months ended June 30, 2019, compared to the same period in 2018. The restructuring charges for the six months ended June 30, 2019, primarily consist of $4.6 million in employee-related costs and $2.2 million in depreciation expense of property and equipment in connection with the planned exit of Lifetouch facilities as described in Note 14 - *Restructuring*.

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

Interest expense

Interest expense was $31.6 million for the six months ended June 30, 2019 compared to $27.4 million during the same period in 2018. This increase is primarily driven by interest expense for the Incremental Term Loan drawn in April 2018 to finance the acquisition of Lifetouch and additional write-off of debt issuance costs in connection with our prepayment of $200.0 million of principal on the Incremental Term Loan in the first quarter of 2019. These increases are partially offset by a decrease in interest expense driven by a $200.0 million prepayment of the Incremental Term Loan and a decrease in interest expense for the convertible senior notes paid in May 2018.

Interest and other income, net

Interest and other income, net was $2.3 million for the six months ended June 30, 2019 compared to $3.3 million during the same period in 2018. This decrease is due to lower interest income resulting from lower cash equivalents and investment balances.

Benefit from Income Taxes

We recorded an income tax benefit of $46.7 million and $27.4 million for the six months ended June 30, 2019 and 2018, respectively. Our effective tax rate was 33% for the six months ended June 30, 2019, compared to 34% for the six months ended June 30, 2018. This decrease in tax rate was primarily due to a shortfall from stock-based compensation in 2019.

Segment Information

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

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

Shutterfly Consumer Segment

	Six Months Ended June 30,			
	2019	2018	$ Change	% Change
	(dollars in thousands)			
Shutterfly Consumer:				
Net revenue	$ 318,432	$ 317,062	$ 1,370	— %
Cost of net revenue [1][2]	185,667	170,909	14,758	9 %
Technology and development [1]	67,896	61,959	5,937	10 %
Sales and Marketing [1]	60,863	60,681	182	— %
Credit card fees	8,501	8,548	(47)	(1)%
Margin[2]	$ (4,495)	$ 14,965	$ (19,460)	(130)%
Margin %	(1) %	5 %		

(1) Excludes stock-based compensation expense and amortization of intangible assets.
(2) Includes an immaterial out-of-period adjustment for shipping services provided in the fourth quarter of 2018 of $2.8 million, which increased cost of net revenue and lowered segment margin.

Shutterfly Consumer net revenue increased $1.4 million in the six months ended June 30, 2019 compared to the same period in 2018 due to growth in personalized gifts and home décor driven by higher performance in paid revenue and new products. The increase was offset by a slowdown in prints and the continuing mix shift away from free promotions and towards paid purchases, and exiting the fourth quarter of 2018 with a lower year-over-year backlog.

Shutterfly Consumer segment cost of net revenue increased $14.8 million, or 9%, for the six months ended June 30, 2019 compared to the same period in 2018 primarily due to higher shipping costs (largely related to an immaterial out-of-period adjustment for shipping services provided in the fourth quarter of 2018 of $2.8 million), higher material costs, an increase in salaries and benefits, and higher depreciation. Shutterfly Consumer gross margin was 42% for the six months ended June 30, 2019 compared to 46% for the same period in 2018. The decrease in gross margin was primarily driven by an increase in cost of net revenue.

Shutterfly Consumer segment technology and development expense increased $5.9 million, or 10%, for the six months ended June 30, 2019 compared to the same period in 2018. The overall increase is primarily due to an increase of $5.0 million in professional fees and $2.3 million in salaries and benefits, partially offset by a decrease of $2.3 million in depreciation. In the six months ended June 30, 2019, we capitalized $22.2 million in eligible salaries and consultant costs, including $0.5 million of stock-based compensation expense, associated with software developed or obtained for internal use, compared to $15.2 million capitalized in the six months ended June 30, 2018, which included $0.6 million of stock-based compensation expense.

Shutterfly Consumer segment sales and marketing expense remained relatively flat in the six months ended June 30, 2019 compared to the same period in 2018.

Shutterfly Consumer segment margin for the six months ended June 30, 2019 was loss of $4.5 million, a $19.5 million or 130% decrease, compared to the same period in 2018, primarily driven by higher cost of net revenue and technology and development expenses.

Lifetouch Segment

	Six Months Ended June 30,			
	2019	2018	$ Change	% Change
	(dollars in thousands)			
Lifetouch segment:				
Net revenue[1]	$ 384,126	$ 261,911	$ 122,215	47 %
Cost of net revenue[2][3]	177,172	91,148	86,024	94 %
Technology and development[2]	15,994	7,109	8,885	125 %
Sales and marketing[2]	166,141	86,960	79,181	91 %
Credit card fees	4,920	1,165	3,755	322 %
Margin	$ 19,899	$ 75,529	$ (55,630)	(74) %
Margin %	5 %	29 %		

(1) Lifetouch net revenue presented in management reporting related to certain obligations that would have otherwise been recorded by Lifetouch as an independent entity but were not recognized in our condensed consolidated financial statements for the six months ended June 30, 2019 and 2018 due to business combination accounting requirements.
(2) Excludes stock-based compensation expense and amortization of intangible assets.
(3) Business combination accounting principles require us to measure acquired inventory at fair value. The fair value of inventory reflects the acquired company's cost of manufacturing plus a portion of the expected profit margin. Management reporting excludes this purchase accounting adjustment from cost of net revenue for the Lifetouch segment in the six months ended June 30, 2018.

Lifetouch segment net revenue increased $122.2 million, or 47% in the six months ended June 30, 2019 compared to the same period in 2018. Of the increase, $130.0 million was related to our Lifetouch segment net revenue in the first quarter of 2019 which was absent in the comparable period in 2018 as we acquired Lifetouch on April 2, 2018. The increase is offset by the lower Lifetouch segment net revenue of $7.7 million in the three months ended June 30, 2019 compared to the same period in 2018. The decrease in Lifetouch segment net revenue for the three months ended June 30, 2019 compared to the same period in 2018 was primarily driven by declines in Schools and Church net revenue.

Lifetouch segment cost of net revenue increased $86.0 million, or 94% in the six months ended June 30, 2019 compared to the same period in 2018. Of the increase, $78.3 million relates to our Lifetouch segment cost of net revenue in the first quarter of 2019 which was absent in the comparable period in 2018. The remainder of the increase is attributable to increase of Lifetouch segment cost of net revenue of $7.7 million in the three months ended June 30, 2019 compared to the same period in 2018 which was primarily driven by higher production costs related to yearbooks during integration in transitioning production from a Lifetouch facility to a Shutterfly facility.

Lifetouch segment technology and development expense increased $8.9 million, or 125% in the six months ended June 30, 2019 compared to the same period in 2018. Of the increase $8.0 million relates to our Lifetouch segment technology and development expense in the first quarter of 2019 which was absent in the comparable period in 2018. The remainder of the increase is attributable to the increase of Lifetouch segment technology and development expenses of $0.9 million in the three months ended June 30, 2019 compared to the same period in 2018 due to an increase in salaries and benefits and higher maintenance costs.

Lifetouch segment sales and marketing expense increased $79.2 million, or 91% in the six months ended June 30, 2019 compared to the same period in 2018. Of the increase $76.3 million relates to our Lifetouch segment sales and marketing expense in the first quarter of 2019 which was absent in the comparable period in 2018. The remainder of the increase is attributable to increase of Lifetouch segment sales and marketing expense of $2.9 million in the three months ended June 30, 2019 compared to the same period in 2018 which was primarily driven by higher salaries and benefits and costs incurred to acquire host accounts.

The Lifetouch segment margin for the six months ended June 30, 2019 was $19.9 million, a $55.6 million, or 74% decrease compared to same period in 2018. Of the decrease, $34.9 million relates to our Lifetouch segment margin loss in the first quarter of 2019 which was absent in the comparable period in 2018. The decline in segment margin also resulted from the increases in cost of net revenue and sales and marketing expense.

Shutterfly Business Solutions (SBS) Segment

	Six Months Ended June 30,			
	2019	2018	$ Change	% Change
	(dollars in thousands)			
SBS segment:				
Net revenue	$ 96,184	$ 97,475	$ (1,291)	(1) %
Cost of net revenue[1]	81,092	81,519	(427)	(1) %
Technology and development[1]	6,992	6,994	(2)	— %
Sales and marketing[1]	2,515	3,069	(554)	(18) %
Margin	$ 5,585	$ 5,893	$ (308)	(5) %
Margin %	6 %	6 %		

[1] Excludes stock-based compensation expense and amortization of intangible assets

SBS segment net revenue decreased $1.3 million, or 1%, in the six months ended June 30, 2019 compared to the same period in 2018.

SBS segment cost of net revenue decreased $0.4 million, or 1%, for the six months ended June 30, 2019 compared to the same period in 2018 primarily due to the related decrease in revenue. SBS gross margin remained flat at 16% for the six months ended June 30, 2019 compared to the same period in 2018.

SBS segment technology and development expense remained flat in the six months ended June 30, 2019. In the six months ended June 30, 2019, we capitalized $2.8 million in eligible salaries and consultant costs, associated with software developed or obtained for internal use, compared to $3.5 million capitalized in the six months ended June 30, 2018.

SBS segment sales and marketing expense decreased $0.6 million, or 18%, for the six months ended June 30, 2019 compared to the same period in 2018 primarily due to a decrease in salaries and benefits.

SBS segment margin in the six months ended June 30, 2019 was $5.6 million, a $0.3 million, or 5% decrease compared to the same period in 2018 primarily driven by lower net revenue.

Liquidity and Capital Resources

We had $105.3 million and $521.6 million of cash and cash equivalents (including money market funds) as of June 30, 2019, and December 31, 2018, respectively. We had $23.9 million and $44.8 million of investments, primarily corporate debt, U.S. government and agency securities as of June 30, 2019 and December 31, 2018, respectively. The decrease in cash and cash equivalents and investments was primarily due to principal payments of borrowings including a $200.0 million of prepayment on the Incremental Term Loan and use of cash in operating activities due to factors described below.

In August 2017, we entered into a syndicated credit facility (the "Credit Agreement") which provides for (a) a five-year secured revolving loan facility in an aggregate principal amount of up to $200.0 million expiring in August 2022 (the "Revolving Loan Facility") and (b) a seven-year secured delayed draw term loan facility in an initial aggregate principal amount of up to $300.0 million (the "Initial Term Loan"). The Credit Agreement permits us to add one or more incremental term loan facilities and/or increase the commitments for revolving loans subject to certain conditions.

In October 2017, we fully drew the $300.0 million Initial Term Loan under the Credit Agreement. On April 2, 2018, we entered into an amendment under the Credit Agreement for an incremental term loan in an aggregate principal amount of $825.0 million (the "Incremental Term Loan") to finance the acquisition of Lifetouch. The Initial Term Loan and the Incremental Term Loan have a maturity date of August 2024. The Revolving Loan Facility remains undrawn and available to us as of June 30, 2019.

The Credit Agreement fits well with our overall capital structure strategy. We seek to maintain adequate financial capacity to manage our seasonal cash flows, ensure a reasonable degree of operational flexibility and invest in value-creating growth. As part of the strategic review, we had previously affirmed our objective of maintaining gross leverage of 2.5-3.0x Adjusted EBITDA on an annual basis, and to return cash in excess of our operating and financing needs to shareholders in the form of share repurchases, within the parameters of appropriate cash management that meet the needs of our highly seasonal business, where substantially all of our cash flow is generated in the last four months of the year. If the Transaction does not close as anticipated, we will re-evaluate our capital structure and capital return policy.

During the fourth quarter of 2018, our Board of Directors approved a restructuring plan to close four Lifetouch facilities in 2019 ("2018 Restructuring Plan") and consolidate this volume into other Shutterfly facilities and a new 237,000 square foot facility in Plano, Texas to be completed in the first quarter of 2020. The cumulative restructuring charges to date amount to $8.9 million. We expect to substantially complete the 2018 Restructuring Plan by the end of 2019. The total estimated restructuring costs associated with the 2018 Restructuring Plan will be approximately $12.5 million and will primarily impact our operating expenses line items within our condensed consolidated statement of operations as these costs are incurred. Any changes to the estimates of executing the 2018 Restructuring Plan will be reflected in our future results of operations.

Below is our cash flow activity for the six months ended June 30, 2019 and 2018:

	Six Months Ended June 30,	
	2019	2018
	(in thousands)	
Consolidated Statements of Cash Flows Data:		
Purchases of property and equipment	$ (27,129)	$ (17,692)
Capitalization of software and website development costs	(30,642)	(21,392)
Acquisition of business, net of cash acquired	—	(890,052)
Cash flows used in operating activities	(165,617)	(199,565)
Cash flows used in investing activities	(35,451)	(718,092)
Cash flows (used in) provided by financing activities	(215,872)	574,735

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

Operating Activities. For the six months ended June 30, 2019, net cash used in operating activities was $165.6 million, primarily due to our net loss of $96.4 million and the net change in operating assets and liabilities of $199.7 million. The net change in operating assets and liabilities of $199.7 million primarily relates to a decrease in accounts payable of $60.3 million due to timing of payments, a decrease in accrued and other liabilities of $114.1 million primarily due to seasonality, and an increase of $49.0 million in prepaid expenses and other assets primarily due to changes in the intra-period income tax asset, partially offset by a decrease in accounts receivable of $26.6 million due to timing of cash receipts. Net cash used in operating activities was adjusted for non-cash items including primarily $59.0 million of depreciation and amortization expense, $25.6 million of amortization of intangible assets, $23.5 million of stock-based compensation expense, $11.2 million for amortization of operating lease assets, $5.5 million for amortization of debt discount and issuance costs, and $3.8 million provision for deferred income taxes.

For the six months ended June 30, 2018, net cash used in operating activities was $199.6 million, primarily due to our net loss of $53.7 million, the net change in operating assets and liabilities of $196.3 million, and the $63.5 million repayment of convertible senior notes attributable to debt discount. Net cash used in operating activities was adjusted for non-cash items including primarily $50.1 million of depreciation and amortization expense, $23.4 million of stock-based compensation expense, a $17.6 million provision for deferred income taxes, $15.2 million of amortization of intangible assets, and $7.0 million for amortization of debt discount and issuance costs.

Investing Activities. For the six months ended June 30, 2019, net cash used in investing activities was $35.5 million, primarily due to $27.1 million of cash used for capital expenditures, and $30.6 million for capitalized software and website development. This was partially offset by proceeds from the maturities of investments of $21.2 million.

For the six months ended June 30, 2018, net cash used in investing activities was $718.1 million, primarily due to $890.1 million of cash used for the acquisition of Lifetouch, net of cash acquired, $17.7 million cash used for capital expenditures, $21.4 million for capitalized software and website development, and $9.5 million to purchase investments. This was partially offset by proceeds from the maturities of investments of $174.3 million and proceeds from the sales of investments of $45.1 million.

Financing Activities. For the six months ended June 30, 2019, net cash used in financing activities was $215.9 million primarily due to $207.3 million of cash used for principal payments of our borrowings (primarily the prepayment of Incremental Term Loan to finance our acquisition of Lifetouch) and $9.6 million for payments of finance leases.

For the six months ended June 30, 2018, net cash provided by financing activities was $574.7 million, related to proceeds from borrowings, net of issuance costs of $806.7 million and the proceeds from the issuance of common stock from the exercise of stock options of $16.6 million. This was partially offset by $239.1 million of cash used for principal payments of our borrowings (primarily the repayment of $300.0 million in connection with the maturity of our convertible senior notes) and $9.4 million cash used for payments of finance leases and financing obligations.

Contractual Obligations

Except for changes related to the adoption of the new lease accounting standard as described in Note 1 to the Condensed Consolidated Financial Statements, prepayment of $200.0 million of the Incremental Term Loan principal, legally binding minimum obligations of $28.1 million of lease payments for a lease the Company entered into in March 2019 for the Company's new 237,000 square foot facility in Plano, Texas and $11.5 million of a non-cancelable commitment for the Company's new enterprise resource planning system, there have been no material changes in the Company's contractual obligations disclosed in Management's Discussion and Analysis of Financial condition and Results of Operations set forth in Part II, Item 7, of our Annual Report on Form 10-K for the year ended December 31, 2018.

The $200.0 million prepayment of the Incremental Term Loan principal is applied to future quarterly principal payments which removes the required quarterly payments until maturity date on August 17, 2024.

The table below sets forth the contractual obligations related to our Incremental Term Loan at June 30, 2019 but does not update the other line items in the contractual obligations that appear in the section of our Annual Report on Form 10-K described above:

(In thousands)	Total	Remainder of 2019	1-3 Years	3-5 Years	Thereafter
Principal payments on Incremental Term Loan	617,780	—	—	—	617,780
Interest payments on Incremental Term Loan	145,865	15,726	55,266	56,539	18,334

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. To supplement our consolidated financial statements, which are prepared and presented in accordance with U.S. generally accepted accounting principles ("GAAP""), we use certain Non-GAAP financial measures. We closely monitor four financial measures, Non-GAAP revenue, Non-GAAP net loss, Non-GAAP net loss per share and Adjusted EBITDA which meet the definition of Non-GAAP financial measures. We define Non-GAAP net loss and Non-GAAP net loss per share as net loss and net loss per share excluding restructuring, acquisition-related charges, and executive transition and strategic review charges, respectively. We define Adjusted EBITDA as earnings before interest, taxes, depreciation, amortization, stock-based compensation expense, restructuring, acquisition-related charges, and executive transition and strategic review charges.

Management believes 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 revenue, net income (loss), or net income (loss) per share determined in accordance with GAAP.

The table below shows the trend of Non-GAAP net loss, Non-GAAP net loss per share and Adjusted EBITDA as a percentage of net revenue for the three and six months ended June 30, 2019 and 2018 (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Net revenue	$ 473,416	$ 443,372	$ 798,097	$ 643,097
Net loss	$ (12,732)	$ (26,512)	$ (96,351)	$ (53,677)
Net loss % of net revenue	*(3) %*	*(6) %*	*(12) %*	*(8) %*
Net loss per share	$ (0.37)	$ (0.80)	$ (2.83)	$ (1.63)
Non-GAAP net (loss) income	$ (7,951)	$ 13,551	$ (90,669)	$ (10,214)
Non-GAAP net (loss) income % of net revenue	*(2) %*	*3 %*	*(11) %*	*(2) %*
Non-GAAP net (loss) income per share	$ (0.23)	$ 0.38	$ (2.66)	$ (0.31)
Adjusted EBITDA	$ 57,442	$ 84,397	$ 12,131	$ 91,462
Adjusted EBITDA % of net revenue	*12 %*	*19 %*	*2 %*	*14 %*

For the three months ended June 30, 2019 and 2018, our Non-GAAP net (loss) income was $(8.0) million and $13.6 million, respectively. In addition, during the three months ended June 30, 2019 and 2018, Non-GAAP net (loss) income per share was $(0.23) and $0.38, respectively.

For the three months ended June 30, 2019 and 2018, our Adjusted EBITDA was $57.4 million and $84.4 million, respectively.

For the six months ended June 30, 2019 and 2018, our Non-GAAP net loss was $90.7 million and $10.2 million, respectively. In addition, during the six months ended June 30, 2019 and 2018, Non-GAAP net loss per share was $2.66 and $0.31, respectively.

For the six months ended June 30, 2019 and 2018, our Adjusted EBITDA was $12.1 million and $91.5 million, respectively.

The following is a reconciliation of Non-GAAP revenue, Non-GAAP net loss, Non-GAAP net loss per share and Adjusted EBITDA to the most comparable GAAP measure, for the three and six months ended June 30, 2019 and 2018 (in thousands, except per share amounts):

Reconciliation of Net Revenue to Non-GAAP Net Revenue

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Net revenue	$ 473,416	$ 443,372	$ 798,097	$ 643,097
Purchase accounting deferred revenue adjustment	—	33,351	645	33,351
Non-GAAP net revenue	$ 473,416	$ 476,723	$ 798,742	$ 676,448

Reconciliation of Net Loss to Non-GAAP Net Income (Loss) and Non-GAAP Net Income (Loss) per Share

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Net loss	$ (12,732)	$ (26,512)	$ (96,351)	$ (53,677)
Restructuring	3,274	2,952	7,247	2,952
Acquisition-related charges	—	8,000	—	12,585
Purchase accounting adjustments	—	44,282	645	44,282
Executive transition and strategic review charges	8,169	—	10,734	—
Debt repayment impact	—	—	3,886	—
Tax benefit impact of adjustments	(6,662)	(15,171)	(16,830)	(16,356)
Non-GAAP net (loss) income	$ (7,951)	$ 13,551	$ (90,669)	$ (10,214)
Diluted shares outstanding	34,254	33,234	34,089	32,970
Non-GAAP diluted shares outstanding	34,254	35,775	34,089	32,970
Net loss per share	$ (0.37)	$ (0.80)	$ (2.83)	$ (1.63)
Non-GAAP net (loss) income per share	$ (0.23)	$ 0.38	$ (2.66)	$ (0.31)

Reconciliation of Net Loss to Adjusted EBITDA

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Net loss	$ (12,732)	$ (26,512)	$ (96,351)	$ (53,677)
Add back:				
Interest expense	13,312	17,769	31,566	27,402
Interest and other income, net	(1,088)	(1,561)	(2,266)	(3,310)
Benefit from income taxes	(7,428)	(12,607)	(46,665)	(27,436)
Depreciation and amortization	42,428	40,377	84,587	65,275
Stock-based compensation expense	11,507	11,697	22,634	23,389
Restructuring	3,274	2,952	7,247	2,952
Executive transition and strategic review charges	8,169	—	10,734	—
Acquisition-related charges	—	8,000	—	12,585
Purchase accounting adjustments	—	44,282	645	44,282
Non-GAAP Adjusted EBITDA	$ 57,442	$ 84,397	$ 12,131	$ 91,462

Reconciliation of Cash Flow from Operating Activities to Adjusted EBITDA

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Net cash used in operating activities	$ (21,502)	$ (75,233)	$ (165,617)	$ (199,565)
Add back:				
Interest expense	13,312	17,769	31,566	27,402
Interest and other income, net	(1,088)	(1,561)	(2,266)	(3,310)
Benefit from income taxes	(7,428)	(12,607)	(46,665)	(27,436)
Changes in operating assets and liabilities	71,586	53,888	199,707	196,256
Other adjustments	(7,927)	47,659	(20,008)	39,048
Acquisition-related charges	—	8,000	—	12,585
Cash restructuring	2,320	2,200	4,946	2,200
Cash executive transition and strategic review	8,169	—	9,823	—
Purchase accounting adjustments	—	44,282	645	44,282
Non-GAAP Adjusted EBITDA	$ 57,442	$ 84,397	$ 12,131	$ 91,462

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.

As of June 30, 2019, the Company has stand-by-letters of credit, totaling approximately $20.6 million, for the benefit of the Company's workers' compensation insurance carriers. There were no amounts drawn against any of the letters of credit at June 30, 2019. The letters of credit are secured by collateral in the form of a certificate of deposit, which is treated as restricted other current asset and is recorded in other current assets on the balance sheet.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

As of June 30, 2019, we had not borrowed any funds under our Revolving Loan Facility. In October 2017, we fully drew $300.0 million under the Initial Term Loan with a maturity date of August 2024, of which $295.5 million remains outstanding as of June 30, 2019. Further, in April 2018, we entered into an amendment under our existing syndicated credit facility for an Incremental Term Loan in an aggregate principal amount of $825.0 million which has been drawn with a maturity date of August 2024, of which $617.8 million remains outstanding as of June 30, 2019.

In August 2017, in order to mitigate future interest-rate risk, we entered into interest-rate swap agreements (“Swap Agreements”) with an aggregate notional amount of $150.0 million and an effective date of October 18, 2017. These Swap Agreements have the economic effect of modifying a portion of the variable interest-rate obligations associated with our Initial Term Loan so that the interest payable on such portion of the Initial Term Loan became fixed at a rate of 4.27% (refer to Note 9 and Note 15 of Notes to Consolidated Financial Statements for further details regarding the Initial Term Loan and the Swap Agreements). Changes in the overall level of interest rates affect the fair value of the Swap Agreements that we recognize in our consolidated balance sheet. As of June 30, 2019, if LIBOR-based interest rates would have been higher by 100 basis points, the aggregate fair value of the Swap Agreements would have increased by approximately $6.0 million.

If LIBOR-based interest rates increase by 100 basis points, annual interest expense would increase by approximately $7.6 million as it relates to our borrowings that bear variable interest rates (including the new Incremental Term Loan). Further, we do not believe that a 100 basis points change in interest rates would have a significant impact on our interest income.

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

Investment. The primary objective of our investment activities is to preserve principal while at the same time improving yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash equivalents and short-term and long-term investments in a variety of asset types, including bank deposits, money market funds, corporate debt, U.S. government and agency securities. As of June 30, 2019, our investments totaled $23.9 million, which represented approximately 18% of our total investment portfolio.

ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2019. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, ("Exchange Act"), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2019, 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, 2019 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to the various legal proceedings and claims discussed below as well as certain other legal proceedings and claims that have not been fully resolved and that have arisen in the ordinary course of business. Although adverse decisions (or settlements) may occur in one or more of these cases, it is not possible to estimate the possible loss or losses from each of these cases. The final resolution of these lawsuits, individually or in the aggregate, is not expected to have a material adverse effect on our business, financial position or results of operations. Cases that previously were disclosed may no longer be described because of rulings in the case, settlements, changes in our business or other developments rendering them, in our judgment, no longer material to our business, financial position or results of operations. One legal proceeding was terminated during April 2019.

Antonio Davis v. Lifetouch, Inc.

On March 10, 2019, Antonio Davis filed a purported class action complaint on behalf of himself and other Lifetouch customers in the U.S. District Court for the District of Kansas. The complaint alleges that Lifetouch violated Kansas consumer protection statutes prohibiting the sale of unsolicited goods. Davis is seeking monetary damages and injunctive relief. We believe the suit is without merit and intends to vigorously defend against it.

Monroy v. Shutterfly, Inc.

On November 30, 2016, Alejandro Monroy on behalf of himself and all others similarly situated, filed a complaint against us in the U.S. District Court for the Northern District of Illinois. The complaint asserts that we violated the Illinois Biometric Information Privacy Act by extracting his and others' biometric identifiers from photographs and seeks statutory damages and an injunction. Monroy was seeking monetary damages and injunctive relief. On April 8, 2019, the U.S. District Court for the Northern District of Illinois dismissed Monroy's claims with prejudice.

Miracle-Pond and Paraf v. Shutterfly, Inc.

On June 11, 2019, Vernita Miracle-Pond and Samantha Paraf on behalf of themselves and all other similarly situated Shutterfly and non-Shutterfly customers, filed a complaint against us in the Circuit Court of Cook County, Illinois. The complaint asserts that we violated the Illinois Biometric Information Privacy Act by extracting their biometric identifiers from photographs and seeks statutory damages and an injunction. We removed the case to federal court. Miracle-Pond and Paraf are seeking monetary damages and injunctive relief. We believe the suit is without merit and intend to vigorously defend against it.

Taylor v. Shutterfly, Inc.

On December 12, 2017, Megan Taylor filed a purported class action complaint on behalf of herself and other customers in the U.S. District Court for the Northern District of California. The complaint alleges that we misrepresent a deal we currently offer through Groupon because we do not allow purchasers of the Groupon offer to combine or "stack" it with other promotional codes we offer. We successfully compelled the matter to private arbitration. On July 11, 2019, the arbitrator ruled that the class action waiver contained in our terms of use was not enforceable and remanded the case back to the U.S. District Court. Taylor is seeking monetary damages and injunctive relief. We believe the suit is without merit and intend to vigorously defend against it.

Vigeant v Meek et al.

On March 1, 2018, a purported class action complaint was filed against several directors of Lifetouch, Inc. (which became a direct wholly-owned subsidiary of Shutterfly on April 2, 2018) and the trustee of the Lifetouch Employee Stock Ownership Plan (the "ESOP") in the U.S. District Court for the District of Minnesota. On April 2, 2018, the complaint was amended to include the prior ESOP trustees and plan sponsor (Lifetouch) as additional named defendants. The complaint alleges violations of the Employee Retirement Income Security Act, including that the ESOP should not have been permitted to continue investing in Lifetouch stock during a period in which the Lifetouch stock price was declining. The plaintiffs seek recovery for damages arising from the alleged breaches of fiduciary duty. On November 7, 2018, the District Court granted defendant's motion to dismiss in its entirety and with prejudice. Plaintiffs' counsel filed a timely notice of appeal with the 8th Circuit Court of Appeals. We believe the suit is without merit and intend to vigorously defend against it.

Transaction Litigation

On July 22, 2019, a stockholder complaint was filed in the United States District Court, Northern District of California, against us and the individual members of our Board, captioned *Stein v. Shutterfly, Inc.*, et al. (the "Stein Complaint"). Also on July 23, 2019, a stockholder complaint was filed in the United States District Court, Southern District of New York, against us and the individual members of our Board, captioned *Spurlock v. Shutterfly, Inc.*, et al. (the "Spurlock Complaint").

On July 26, 2019, a putative stockholder class action complaint was filed in the United States District Court, District of Delaware, against us and the individual members of our Board, captioned *Wolf v. Shutterfly, Inc. et al.*, (the "Wolf Complaint"). On July 29, 2019, a putative stockholder class action complaint was filed in the United States District Court, Northern District of California, against us and the individual members of our Board, captioned *Gordon v. Shutterfly, Inc., et al.*, (the "Gordon Complaint"). On July 31, 2019 and August 5, 2019, a putative stockholder class action complaint was filed in each of the San Mateo County Superior Court and the United States District Court, Northern District of California, respectively, against us and the individual members of our Board, each captioned *Cheung v. Shutterfly, Inc.*, et al., (the "Cheung Complaints" and collectively with the Stein Complaint, Spurlock Complaint , Wolf Complaint and the Gordon Complaint, the "Stockholder Complaints"). Each of the Stockholder Complaints asserts that defendants violated Section 14(a) and 20(a) of the Exchange Act and certain rules and regulations promulgated thereunder by making untrue statements of material fact and omitting certain material facts related to the contemplated Transaction in our relevant proxy statement or in the case of the Cheung complaint filed in San Mateo County, that defendants breached their fiduciary duties in their capacities as our officers or directors.

The Stockholder Complaints seek, among other things, an order enjoining the defendants from consummating the Transaction, money damages and an award of attorneys' and experts' fees. We believe that the lawsuits are without merit and intend to vigorously defend those actions. We may become subject to similar litigation relating to the Transaction in these or other jurisdictions.

For each of these matters on an individual basis, at each reporting period, we evaluate whether or not a potential loss amount or a potential range of loss is probable and reasonably estimable under the provisions of the authoritative guidance that addresses accounting for contingencies. In such cases, we accrue for the amount, or if a range, we accrue the low end of the range as a component of legal expense. We monitor developments in these legal matters that could affect the estimate we had previously accrued. There are no material amounts accrued as of December 31, 2018 and June 30, 2019.

ITEM 1A. RISK FACTORS

Risks Related to Our Business and Industry

The Transaction, the pendency of the Transaction or our failure to complete the Transaction could have a material adverse effect on our business, results of operations, financial condition and stock price.

On June 10, 2019, we entered into the Merger Agreement with Photo Holdings, LLC and Photo Holdings Merger Sub, Inc., both of which are affiliates of the Apollo Funds, certain funds managed by affiliates of Apollo, a private equity investment firm. Completion of the Transaction is subject to the satisfaction of various conditions, including approval of the Transaction by our stockholders, the absence of certain legal impediments and the absence of a material adverse effect on our business. There is no assurance that all of the various conditions will be satisfied, or that the Transaction will be completed on the proposed terms, within the expected timeframe, or at all. Furthermore, there are additional inherent risks in the Transaction, including the risks detailed below.

During the period prior to the closing of the Transaction, our business is exposed to certain inherent risks due to the effect of the announcement or pendency of the Transaction on our business relationships, financial condition, operating results and business, including:

- potential uncertainty in the marketplace, which could lead current and prospective customers to purchase from other vendors or delay purchasing from us;
- the possibility of disruption to our business and operations, including diversion of management attention and resources, increased transaction costs, and the potentially negative impact on our relationships with our partners and suppliers;
- the inability to attract and retain key personnel, and the possibility that our current employees could be distracted, and their productivity decline as a result, due to uncertainty regarding the Transaction;
- the inability to pursue alternative business opportunities or make changes to our business pending the completion of the Transaction, and other restrictions on our ability to conduct our business;
- the amount of the costs, fees, expenses and charges related to the Merger Agreement and the Transaction; and
- other developments beyond our control, including, but not limited to, changes in domestic or global economic conditions that may affect the timing or success of the Transaction.

The Transaction may be delayed, and may ultimately not be completed, due to a number of factors, including:

- the failure to obtain the approval of the Merger Agreement by our stockholders;
- potential outstanding and future stockholder litigation and other legal and regulatory proceedings, which could delay or prevent the Transaction; and
- the failure to satisfy the other conditions to the completion of the Transaction, including the possibility that a material adverse effect on our business would permit affiliates of the Apollo Funds not to close the Transaction.

If the Transaction does not close, our business and stockholders would be exposed to additional risks, including:

- to the extent that the current market price of our stock reflects an assumption that the Transaction will be completed, the price of our common stock could decrease if the Transaction is not completed;
- investor confidence could decline, stockholder litigation could be brought against us, relationships with existing and prospective customers, suppliers and other business partners may be adversely impacted, we may be unable to retain key personnel, and profitability may be adversely impacted due to costs incurred in connection with the pending Transaction;
- the requirement that we pay a termination fee of $51.2 million to affiliates of the Apollo Funds if we terminate the Merger Agreement under certain circumstances; and
- the requirement that we reimburse up to $5.0 million of affiliates of the Apollo Funds' transaction expenses upon the termination of the Merger Agreement under specified circumstances.

Even if successfully completed, there are certain risks to our stockholders from the Transaction, including:

- the amount of cash to be paid under the Merger Agreement is fixed and will not be adjusted for changes in our business, assets, liabilities, prospects, outlook, financial condition or operating results or in the event of any change in the market price of, analyst estimates of, or projections relating to, our common stock; and
- the fact that, if the Transaction is completed, our stockholders will forego the opportunity to realize the potential long-term value of the successful execution of our current strategy as an independent company.

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

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

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

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

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

Our business is highly seasonal, with a high proportion of our net revenue, net income and operating cash flows generated during the fourth quarter for both our Shutterfly consumer business and our Lifetouch business. For example, we generated approximately 50% of our net revenue in the fourth quarter during each of the last three years in our Shutterfly consumer business and Lifetouch generated approximately 35% of its net revenue in the fourth calendar quarter during each of the last three years. In addition, we incur significant additional expenses in the period leading up to Shutterfly's fourth quarter holiday season and Lifetouch's third quarter fall school portrait season and retail holiday season (our peak times), including expenses related to the hiring and training of temporary workers to meet our seasonal needs, additional inventory and equipment purchases, and increased advertising. We face intense competition for seasonal and temporary workers; with respect to

Lifetouch’s seasonal photographers, this difficulty is exacerbated now that the former Lifetouch ESOP has been terminated. If we are unable to accurately forecast expense levels, our results of operations would likely be negatively impacted. Additionally, if we are unable to accurately forecast and respond to consumer demand for our products during the fourth quarter, or if there is a meaningful decrease in demand for Lifetouch fall school photo day during the third quarter, our financial results, reputation and brands will suffer and the market price of our common stock would likely decline.

We also base our operating expense budgets on expected net revenue trends. A portion of our expenses, such as office, production facility, and various equipment leases and personnel costs, are largely fixed and are based on our expectations of our peak levels of operations. In addition, we must effectively manage the ramp-up and ramp-down of variable labor to achieve our expectations. Failure to accurately forecast or ineffectively manage such spikes can result in unexpected revenue or operating income shortfall. Accordingly, any shortfall in net revenue may cause significant variation in operating results in any quarter, particularly in the third and fourth quarters.

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

We believe that we must continue to upgrade and expand our current production capability to meet our projected net revenue targets. Our capital expenditures were approximately 5%, 6% and 8% of total net revenue for the years ended December 31, 2018, 2017 and 2016, respectively. Operational difficulties, such as a significant interruption in the operations of our production facilities or in facilities operated by third-parties, could delay production or shipment of our products. In addition, inclement weather, particularly heavy rain and snow could impair our production capabilities. Our inability to meet our production requirements, particularly in our peak season, could lead to customer dissatisfaction, impact Lifetouch's account retention, and damage our reputation and brands, which would result in reduced net revenue. Moreover, if the costs of meeting production requirements, including capital expenditures, were to exceed our expectations, our results of operations would be harmed.

In addition, at peak times, we face significant production risks, including the risk of obtaining sufficient qualified seasonal production personnel. Most of our workforce during these periods has historically been comprised of seasonal, temporary personnel. We have had difficulties in the past finding and retaining enough qualified seasonal employees, and our failure to find and retain qualified seasonal production personnel at any of our production facilities could harm our operations.

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

Our financial performance depends on general economic conditions and their impact on levels of consumer spending in the United States, particularly on personalized products and photofinishing services and professional photography and in Canada on Lifetouch's school business. Shutterfly Consumer net revenue as a percentage of total net revenue was 49% in 2018, 84% in 2017 and 88% in 2016; substantially all of Lifetouch’s revenue was derived from consumers during these periods. Some of the macroeconomic conditions that can adversely affect consumer spending levels in the United States include domestic and foreign stock market volatility and its effects on net worth, anticipated economic slowdowns in foreign economies, high consumer debt levels, uncertainty in real estate markets and home values, fluctuating energy and commodity costs, rising or higher than average interest rates, higher than usual unemployment rates, limited credit availability, changes in tax laws, and general uncertainty about the future economic environment. If general economic conditions decline, customers or potential customers could delay, reduce or forego their purchases of our products and services, which are discretionary. Any decrease in the demand for our products and services could impact our business several ways, including lower prices for our products and services and reduced sales. In addition, adverse economic conditions may lead to price increases by our suppliers or increase our operating expenses due to, among other factors, higher costs of labor, energy, equipment and facilities which could in turn lead to additional restructuring actions by us and associated expenses. We may not be able to pass these increased costs on to our customers due to the macroeconomic environment and the resulting increased expenses and/or reduced income could have a material adverse impact our operating results.

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

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

Changes in our pricing strategies have had, and may continue to have, a significant impact on our net revenue and net income. For example, in the last three fiscal quarters we saw a deceleration of revenue associated with free promotions that impacted our top line consumer revenue. As we continue to implement more optimized and targeted pricing strategies, we cannot predict with certainty that these changes will have the expected impacts. From time to time, we have made changes to our pricing structure to remain competitive. Many of our products, including professionally-bound photo books, calendars, cards and stationery and other photo merchandise are also offered by our competitors. Many of our competitors discount those products at significant levels and as a result, we may be compelled to change our discounting strategy, which could impact our acquisition of new customers, average order value, net revenue, gross margin, and Adjusted EBITDA and net income profitability measures. If in the future, due to competitor discounting or other marketing strategies, we significantly reduce our prices on our products without a corresponding increase in volume, it would negatively impact our net revenue and could adversely affect our gross margins and overall profitability.

We generate a significant portion of our net revenue from the fees we collect from shipping and handling of our products. For example, shipping and handling revenue for the Shutterfly website represented approximately 22% of our net revenue in 2018, 23% of our net revenue in 2017 and 19% in 2016. We also offer discounted or free shipping, with a minimum purchase requirement, during promotional periods to acquire and retain customers. If free shipping offers extend beyond a limited number of occasions, are not based upon a minimum purchase requirement or become commonplace, our net revenue and results of operations would be negatively impacted. In addition, we occasionally offer free or discounted products and services to acquire and retain customers. In the future, if we increase these offers to respond to actions taken by our competitors, our results of operations may be harmed.

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

The digital photography products and services industry is intensely competitive, and we expect competition to increase in the future as current competitors improve their offerings, including developing, acquiring and expanding mobile and cloud-based offerings, and as new participants enter the market or as industry consolidation further develops. Competition may result in pricing pressures, reduced profit margins or loss of market share, any of which could substantially harm our business and results of operations. For example, we saw a significantly greater marketing presence and more aggressive promotional activity from competitors in the fourth quarter in 2018 which continued in the first quarter of 2019 as compared to recent years, with competition both at the value and premium ends of the spectrum. We face intense competition from a wide range of companies, including the following:

- Online digital photography services companies such as Snapfish, Vistaprint, EZPrints, and many others;
- Social media companies that host and enable mobile access to and posting of images such as Facebook, Instagram, Twitter, Pinterest, Snapchat and Google+;
- Photo hosting websites that allow users to upload and share images at no cost such as Apple iCloud, Google Photos, and Flickr;
- “Big Box” retailers such as Wal-Mart, Costco, Sam’s Club, Target, and others that offer low cost digital photography products and services. In addition to providing low-cost competitive product offerings on their respective websites, these competitors provide in-store fulfillment and self-service kiosks for printing, and may, among other strategies, offer their customers heavily discounted in-store products and services that compete directly with our offerings;
- Drug stores such as Walgreens, CVS/pharmacy, Rite-Aid and others that offer low-cost photography products and services as well as in-store pick-up from their photo website Internet orders;
- Traditional offline stationery companies such as PaperSource, Crane & Co., and Papyrus;
- Cloud-based storage services and file-syncing services such as Dropbox, Box, Everalbum, Amazon Photos and iCloud;
- Specialized companies in the photo book and stationery business such as Hallmark, Cardstore by American Greetings, Minted, Invitations by Dawn, Picaboo, Blurb, Mixbook, Postable, Artifact Uprising, Printerpix, Pinhole Press, PastBook, Photobook America, Motif and Chatbooks;
- Photo-related software companies such as Apple, Microsoft, and Adobe;
- Online companies specializing in personalized gifts such as UncommonGoods, Moo, Fracture, 4imprint, mpix, MyPhoto.
- Online and offline companies specializing in photo-based merchandise and personalized home décor such as Zazzle, CafePress, Art.Com, Paper Culture, Simply to Impress, Canvas On Demand, CanvasWorld, PhotoAffections, Canvas Champ, MailPix, CanvasPop, Personalization Mall, Personal Creations, Things Remembered, Mark & Graham, CustomInk, Teespring and Etsy.
- Providers of digital alternatives to our products, such as Paperless Post, Evite, Animoto, and PicCollage.

- Home printing service providers such as Hewlett-Packard and Epson that are seeking to expand their printer and ink businesses by gaining market share in the digital photography marketplace;
- Enterprise digital and print communications companies such as RR Donnelley and Sons Company, O'Neil Data Systems, Inc., Quad/Graphics, Inc. and Viatech Publishing Solutions, Inc.;
- Regional photography companies such as Ritz Camera that have established brands and customer bases in existing photography markets;
- Camera and photographic supply companies that rent equipment nationwide both online and in brick-and-mortar stores such as LensRentals.com, Cameralends, AbelCine, and Adorama;
- Picture People and Portrait Innovations in the Lifetouch portrait studio business;
- Independent professional and amateur photographers who enjoy low barriers to entry and can offer flexible business terms and product options in the school photography, church photography and retail studio photography businesses;
- Primarily local and regional players that compete with the Lifetouch School photography business, including Inter-State Studio & Publishing, Barksdale School Portraits, Strawbridge Studios and Dorian Studio in the United States and Artona Group, Edge Imaging, Mountain West Studios and Pegasus School Images in Canada; and
- Jostens, Herff Jones, Balfour and Walsworth Publishing in yearbooks (all of whom have made significant investments in technology) in addition to several online yearbook providers such as Tree Ring and Picaboo.

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

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

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

- demand for our products and services, including seasonal demand;
- our success in executing our pricing, market and general business strategy;
- our ability to attract visitors to our websites and convert those visitors into customers and encourage repeat purchases;
- the amount and timing of our operating and capital expenses;
- our ability to manage our production and fulfillment operations;
- the costs to produce our prints and photo-based products and merchandise to provide our services;
- the costs of expanding or enhancing our technology or websites;
- a significant increase in returns and credits, beyond our estimated allowances, for customers who are not satisfied with our products;
- the slower secular growth of our core-paper based products business, including the increasing commodification in the Prints business;
- decreases in travel, including declines or disruptions to the travel industry and variations in weather, particularly heavy rain and snow which tend to depress travel and picture taking;
- the potential impact of the current U.S political climate on consumer spending;
- the timing of holidays and the duration of the holiday shopping season which will be shorter in 2019 than it was in 2018;
- natural disasters or other events resulting in school closures could lead to cancellations or postponements of scheduled picture days, and could also impact Lifetouch's school business operations in the field and/or production facilities;
- our ability to achieve the expected benefits of strategic partnerships or the loss of any such partnership;
- our ability to address increased shipping delays caused by our third-party shippers' inability to handle the ever-increasing number of consumers ordering goods online, particularly during the holiday shopping season;

- volatility in our stock price, which may lead to higher stock-based compensation expense;
- the deterioration of our business relationships with our Lifetouch hosts, including schools, preschools, and other organizations as well as retailers like JCPenney;
- general economic conditions, including recession and slow economic growth in the United States and worldwide and higher inflation;
- consumer preferences for digital photography services;
- improvements to the quality, cost and convenience of desktop printing of digital pictures and products;
- continued decline in church or house of worship attendance which impact Lifetouch's church division; and
- global and geopolitical events with indirect economic effects such as pandemic disease, hurricane and other natural disasters, war, threat of war or terrorist actions.

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

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

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

Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees and senior executives could hinder our strategic planning and execution. We hired a new Chief Marketing Officer in October 2018. On February 5, 2019, we announced that Christopher North, our President, Chief Executive Officer and member of our Board, will be stepping down at the end of August 2019. On June 10, 2019, we announced the appointment of Ryan O'Hara as our next President and Chief Executive Officer and a member of the Board of Directors effective June 24, 2019. On March 8, 2019 we announced the appointment of James Hilt as President, Shutterfly Consumer. On April 4, 2019, we announced that Michael Meek, President and CEO of Lifetouch, will be stepping down in October 2019 On July 30, 2019, we announced the appointment of Greg Hintz as our next President, Lifetouch, effective immediately. Our ability to execute our business strategies, ensure a cohesive management team, and attract and retain key executives may be adversely affected by the uncertainty associated with the transition to a successor President and Chief Executive Officer as well as the pending closing of the Transaction.

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

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

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

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

- maintain and increase the size of our customer base;
- increase the participation rate at Lifetouch;
- increase the number of schools and preschools Lifetouch serves;
- maintain and enhance our brands;
- enhance and expand our products and services;
- continue to develop and upgrade our technology and information processing systems, including our enterprise resource planning (“ERP”) system;
- maintain and grow our websites, applications and customer operations;
- successfully execute our business and marketing strategy;
- continue to enhance our service to meet the needs of a changing industry;
- provide a high-quality customer experience, including superior customer service and timely product deliveries;
- respond to competitive developments; and
- attract, integrate, retain and motivate qualified personnel.

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

If we are unable to acquire customers, or do so in a cost-effective manner, traffic to our websites would be reduced and our business and results of operations would be harmed.

Our success depends on our ability to attract customers and grow our active customer base, specifically in a cost-effective manner. On a net basis, our active customer base for Shutterfly Consumer has slightly decreased reflecting, among other things, the effect of continuing mix shift away from free promotions and toward paid purchases. We rely on a variety of methods to bring visitors to our websites and mobile applications and promote our products, including paying fees to third parties who drive new customers to our websites and mobile applications, purchasing search results from online search engines, e-mail and direct mail marketing campaigns. We pay providers of online services, search engines, social media, advertising networks, directories and other websites and e-commerce businesses to provide content, advertising/media and other links that direct customers to our websites. We also use e-mail and direct mail to attract customers, and we offer substantial pricing discounts or free products to encourage repeat purchases and trial orders. Through our acquisition of Lifetouch, we also potentially gain access to over 11 million non-overlapping three-year active customers (defined as customers who have made at least one purchase from Lifetouch in the last three years) for our Shutterfly Consumer business. For Lifetouch, our marketing efforts also include flyers distributed by our hosts, radio advertising and television advertising. Our methods of attracting customers, including acquiring customer lists from third parties can involve substantial costs, regardless of whether we acquire new customers as a result of such purchases. Even if we are successful in acquiring and retaining customers, the cost involved in these efforts, and which has increased in recent years, especially as we shift our sales offerings from free to paid products, impacts our results of operations. Customer lists are typically recorded as intangible assets and may be subject to impairment charges if the fair value of that list exceeds its carrying value. These potential impairment charges could harm our results from operations. If we are unable to enhance or maintain the methods we use to reach consumers, if the costs of acquiring customers using these methods significantly increase, or if we are unable to develop new cost-effective methods to obtain customers, our ability to attract new customers would be harmed, traffic to our websites and mobile applications may be reduced and our business and results of operations would be harmed.

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

SBS revenue as a percentage of total net revenue was 12% in 2018, 16% in 2017 and 12% in 2016. SBS gross margins were 19% in 2018, 20% in 2017 and 26% in 2016. The declining gross margins of this segment, coupled with the increasing percentage of total revenue from SBS, may magnify the impact of variations in revenue and operating costs on our operating results. This may have an adverse effect on our overall margins and profitability. Our SBS revenue is highly concentrated in a small number of customers and the loss of, or reduction in volume from, one or more of our SBS customers could decrease SBS revenue and adversely impact our total net revenue. Our SBS customers also come from a variety of industries, often creating regulatory compliance issues for us as well as the need to maintain security for third-party data. These SBS customers also demand strict security requirements and specified service levels. If we fail to meet these service levels, we may not only lose an SBS customer, but may have to pay punitive costs for such failures. As our SBS business grows, issues that impact our sales to SBS customers may have a negative impact on our total sales. Our core business is consumer focused and we have less experience managing sales to SBS customers and may not sell as successfully to SBS customers, who often have long sales cycles, long implementation periods and significant upfront costs. In addition, we had in 2017 and 2018, and may continue to have in the future, low or no gross margins in the early stages of our contracts with SBS customers that often require significant ramp-up periods, which will adversely affect our total net revenue. To compete effectively in the SBS industry, we have in the past, and may in the future, be forced to offer significant discounts to large SBS customers at lower margins or reduce or withdraw from existing relationships with smaller SBS customers, which could negatively impact our net revenue and could adversely affect our gross margins and overall profitability.

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

The primary costs in operating our business are related to producing and shipping products, acquiring customers, compensating our personnel, acquiring equipment and technology, and leasing facilities. Controlling our business costs is challenging because many of the factors that impact these costs are beyond our control. For example, the costs to produce prints, such as the costs of photographic print paper, could increase due to a shortage of silver or an increase in worldwide energy, oil or fuel prices. Higher fuel prices have a corresponding increase in travel-related expenses of our Lifetouch photographers. Changes in federal and state minimum wage laws could raise the wage requirements for certain of our seasonal personnel, which could increase the pressure, particularly on Lifetouch, in hiring seasonal photographers and production workers; we have also experienced and continue to see competitive pressure to increase the wages paid to a large population of our employees resulting from other industry participants increasing wage levels. In addition, we may become subject to increased costs by the third-party shippers that deliver our products to our customers, and we may be unable to pass along any increases in shipping costs to our customers. The costs of online advertising and keyword search could also increase significantly due to increased competition, which would increase our customer acquisition costs. Local land use and other regulations restricting the construction and operation of our production facilities, the adoption of local laws restricting our operations and environmental regulations, may increase the cost of sites and of constructing, leasing and operating our production facilities. If we are unable to keep the costs associated with operating our business aligned with the level of net revenue that we generate, our results of operations would be adversely affected.

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

As a part of our current consumer business model, we offer our customers free unlimited online storage and sharing of images and, as a result, must store and manage many petabytes of data. This policy results in immense system requirements and substantial ongoing technological challenges, both of which are expected to continue to increase over time. We continuously evaluate our short and long-term data storage capacity requirements to enable adequate capacity and management for new and existing customers. We strive to predict the capacity requirements as tightly as possible as overestimating may negatively impact our capital needs and underestimating may impact the level and quality of service we provide to our customers, which could harm customer satisfaction, net revenue, costs and brand reputation.

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

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

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

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

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

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

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

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

This risk is heightened in the fourth quarter, as we experience significantly increased traffic to our websites during the holiday season and significantly higher order volumes. Any interruption that occurs during such time would have a disproportionately negative impact on our results of operations than if it occurred during a different quarter. For example, during the fourth quarter of 2018, a technical issue in our newly built shopping cart service caused a partial outage that prevented some customers from placing orders on Cyber Monday.

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

We could experience operational difficulties in transitioning production from Lifetouch facilities to our other facilities and planned facilities, including the new facility we plan to open in Plano, Texas.

In the second quarter of 2019, various production challenges caused delays in our yearbook deliveries, resulting in higher labor costs and increased expedited shipping costs in order to minimize late deliveries. As our plans for cost synergies from the Lifetouch acquisition center on establishing a common manufacturing platform, we may encounter similar situations as we transition production away from Lifetouch facilities. Any significant complications in the transition of our production may cause us to lose net revenue, which could have a material adverse effect on our results of operations and financial condition.

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

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

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

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

If the third-party vendors who we depend upon to purchase our supplies, market our products, produce many of our products or deliver our product fail to perform under our agreements with them or experience delays or interruptions in service, our customer experience will suffer, which would substantially harm our business, reputation and results of operations.

Our ability to provide a high-quality customer experience depends, in large part, on external factors over which we may have little or no control, including the reliability and performance of our suppliers, third-party product providers and shipping partners. For example, some of our products, such as select photo-based merchandise, are produced and shipped to customers by our third-party vendors, and we rely on these vendors to properly inspect and ship these products. We purchase photo-based and other product supplies and photography equipment from third parties. These parties could increase their prices, reallocate supply to others, including our competitors, or choose to terminate their relationship with us. Furthermore, if any of our third-party suppliers are unable to produce our products, we could have difficulty finding an alternative producer in a timely manner.

In the third quarter of 2018, a third-party supplier unexpectedly shut down, which combined with Hurricane Michael, affected the ability of another third-party supplier that had absorbed the increased capacity to meet our production needs during peak times. In addition, we rely on third-party shippers, including the U.S. Postal Service and UPS to deliver our products to customers. Strikes, furloughs, reduced operations, increased shipping delays particularly during the holiday shopping season, or other service interruptions affecting these shippers could impair our ability to deliver merchandise on a timely basis. We also currently outsource some of our off-line and online marketing, and some of our customer service activities to third parties. In the fourth quarter of 2015, a third-party customer service provider experienced a disruption that affected our operations during peak times. Our failure to provide customers with high-quality products in a timely manner for any reason or a failure to meet customer expectations could substantially harm our reputation and our efforts to develop trusted brands, which would substantially harm our business and results of operations.

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

Substantially all of Lifetouch's studio business is derived from sales in JCPenney stores and is, therefore, materially dependent upon its relationship with JCPenney, the continued goodwill of JCPenney and the integrity of their brand names in the retail marketplace. In January 2019, JCPenney announced it would be closing three stores by the spring with additional closures potentially announced throughout the year. Lifetouch's portrait studios in JCPenney leverage customer traffic generated by the JCPenney retail stores, and if the customer traffic through these stores decreases due to the weakness of the JCPenney business, further store closures, JCPenney chooses not to renew its agreement with us, general economic conditions or for any other reason, Lifetouch's sales could be materially and adversely affected.

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

Our ability to successfully receive and fulfill orders and to provide high-quality customer service depends in part on the efficient and uninterrupted operation of our computer and communications systems. The computer hardware necessary to operate our consumer website is in Las Vegas, Nevada. Lifetouch maintains critical data centers in St. Paul, Minnesota and in Ontario, Canada. We also have computer hardware located in each of our production facilities and operations centers. In addition, we also use third-party public clouds for our system operation. Our systems and operations could suffer damage or interruption from human error, fire, flood, power loss, insufficient power availability, telecommunications failure, break-ins, hacking, distributed denial of service attacks, misuse by spammers, terrorist attacks, acts of war and similar events. In addition, our headquarters are located near a major fault line increasing our susceptibility to the risk that an earthquake could significantly harm our operations. We maintain business interruption insurance; however, this insurance may be insufficient to compensate us for losses that may occur, particularly from interruption due to an earthquake which is not covered under our current policy. We do not presently have redundant systems in multiple locations. In addition, the impact of any of these disasters on our business may be exacerbated by the fact that we are still in the process of developing our formal disaster recovery plan and we do not have a final plan in place.

We may experience difficulties implementing and maintaining our new enterprise resource planning system.

We purchased a new ERP system and are currently beginning its implementation. This system will replace many of our existing operating and financial systems. Such an implementation is a major undertaking, both financially and from a management and personnel perspective. Any disruptions, delays or deficiencies in the design and implementation of our new ERP system could adversely affect our ability to process orders, ship products, provide services and customer support, send invoices and track payments, fulfill contractual obligations or otherwise operate our business.

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

Since 2007, our board of directors has approved inducement equity awards outside of our 2006 Plan and 2015 Plan to select new employees upon hire and in connection with mergers and acquisitions without stockholder approval in accordance with Nasdaq Listing Rule 5635(c) for an aggregate of 3,338,561 shares of our common stock. The use of inducement equity awards may dilute the equity interest of our stockholders, which could in turn adversely affect prevailing market prices for our common stock.

In addition, we may issue equity securities to complete an acquisition, or for other reasons, which would dilute our existing stockholders' ownership, perhaps significantly depending on the terms of such acquisitions or other activities and could adversely affect the price of our common stock. To finance any future acquisitions, it may also be necessary for us to raise additional funds through public or private debt and equity financings. Additional funds may not be available on terms that are favorable to us, and, in the case of equity financings, would result in dilution to our stockholders. Also, the value of our stock may be insufficient to attract acquisition candidates.

If we were to become subject to e-mail blacklisting, traffic to our websites would be reduced and our business and results of operations would be harmed.

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

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

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

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

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

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

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

A decline in participation rate by customers in the Lifetouch school picture business and continued decrease in attendance of church services would have a negative impact on Lifetouch's revenue.

An important element of profitability in the school picture business is the participation rate (percentage of students photographed whose parents purchase the photo). The tradition of families purchasing an annual school photo of their child and/or the school yearbook could erode over time. Likewise, reduction in number of high school seniors who are photographed for the yearbook, combined with the availability of alternative digital platforms for commemorating school achievements, could make the traditional printed yearbook less compelling overall. Similarly, the continued secular decline in people attending church services could reduce the number of participants in our church business. The existence or continuation of such trends would result in the loss of customers as well as lower net revenue.

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

The digital photography industry is rapidly evolving. Professional photography and the tradition of school pictures is subject to continuing disruption from the changes in digital photography and commerce. Changing technologies, intense price competition, additional competitors, evolving industry standards, frequent new service and platform announcements and changing consumer demands and behaviors, including an ongoing trend toward increased video consumption, all impact our business. To the extent that consumer adoption of digital photography does not continue to grow as expected, our revenue growth would likely suffer. A shift in consumer demands toward video would also require additional network infrastructure, including data storage, to continue to satisfy the needs of our customers. Moreover, we face significant risks that, if the industry for digital photography evolves in ways that we are not able to address due to changing technologies or consumer behaviors, pricing pressures, or otherwise, we may find it difficult to create products to accommodate such an evolution or our current products and services may become less attractive, which would result in the loss of customers, as well as lower net revenue and/or increased expenses.

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

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

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

The regulatory framework for privacy issues worldwide is currently evolving and is likely to remain uncertain for the foreseeable future. The occurrence of unanticipated events often rapidly drives the adoption of legislation or regulation affecting the use of data and the way we conduct our business; in fact, there are active discussions among U.S. legislators around adoption of a new U.S. federal privacy law. Restrictions could be placed upon the collection, management, aggregation and use of information, which could result in a material increase in the cost of collecting certain kinds of data. For example, the European Parliament formally adopted the General Data Protection Regulation (the "GDPR"), which established a new framework for data protection in Europe effective as of May 2018. The GDPR imposes more stringent operational requirements for entities processing personal information, such as stronger safeguards for data transfers to countries outside the European Union ("EU"), reliance on express consent from data subjects (as opposed to assumed or implied consent), a right to require data processors to delete personal data, and stronger enforcement authorities and mechanisms. In June of 2018, California enacted the CCPA, which will take effect on January 1, 2020. The CCPA has many similarities to the GDPR and imposes significant new obligations and limitations on businesses, including the Company, that collect and process personal information of California citizens. Complying with CCPA and changing domestic and international requirements may cause the Company to incur substantial costs, require the Company to change its business practices or reduce the overall demand for our business offerings, which could harm our financial condition and results of operations. Noncompliance could result in significant penalties or legal liability.

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

In its role as a service provider to schools, Lifetouch is subject to various privacy laws and regulations including, without limitation, the Family Educational Rights in Privacy Act (FERPA), Connecticut's Act Concerning Student Privacy (Public Act No. 16-189), Colorado's Student Data Transparency and Security Act (16 CRS 22) and Canadian privacy statutes. In recent years (since 2014), numerous student privacy bills have been introduced and laws passed at the federal and state levels. These laws regulate the way Lifetouch collects and handles the school data it relies on to conduct Picture Day, and the way Lifetouch contracts with schools for such services. Lifetouch also historically has relied on schools to distribute portrait packages and access credentials to parents. Newer methods enabling parents to order and receive their child's images online provide many advantages but also entail risks inherent to internet transactions. We cannot guarantee that a person ordering a child's photo has the legal right to receive it. Actual or perceived failure to comply with such laws could lead to significant reputational damage, enforcement actions, penalties and expenses. Additionally, the evolving regulatory environment for student data privacy may make it more difficult for Lifetouch to obtain the data from schools that it requires to conduct an efficient Picture Day, which may result in higher costs and inefficiencies. Increasing compliance and contracting requirements means increasing exposure to liability for breach and rising cost of doing business.

If a change in privacy laws requires Lifetouch to obtain prior express parental consent to photograph children in schools, or if inclusion in a school yearbook requires express parental consent, participation rates may decline. Additionally, if systems failure or human error results in failed delivery or unauthorized access to our images, it could result in harm to our reputation and/or customer and account loss. In either of these instances, our financial results would likely suffer.

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

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

As of June 30, 2019, Shutterfly and Lifetouch had 149 patents issued and more than 20 patent applications pending in the United States. We intend to pursue corresponding patent coverage in other countries to the extent we believe such coverage is appropriate and cost efficient. We cannot ensure that any of our pending applications will be granted. In addition, third parties have in the past and could in the future bring infringement, invalidity, co-inventorship or similar claims with respect to any of our currently issued patents or any patents that may be issued to us in the future. Any such claims, whether or not successful, could be extremely costly to defend, divert management's time and attention, damage our reputation and brands and substantially harm our business and results of operations.

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

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

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

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

From time to time, we have received, and likely will continue to receive, communications from third parties inviting us to license their patents or accusing us of infringement. There can be no assurance that a third party will not take further action, such as filing a patent infringement lawsuit, including a request for injunctive relief to bar the manufacture and sale of our products and services in the United States or elsewhere. We may also choose to defend ourselves by initiating litigation or administrative proceedings to clarify or seek a declaration of our rights. Additionally, from time to time, we have to defend against infringement of our intellectual property by bringing suit against other parties. As competition in our industry grows, the possibility of patent infringement claims against us or litigation we will initiate increases.

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

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

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

We are subject to general business regulations and laws as well as regulations and laws specifically governing the Internet and e-commerce. Existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, restrictions on imports and exports, customs, tariffs, user privacy, data protection, rights of publicity and rights of privacy, pricing, content, copyrights, distribution, electronic contracts and other communications, consumer protection, the provision of online payment services, broadband residential Internet access and the characteristics and quality of products and services. It is not clear how existing laws governing issues such as property use and ownership, sales and other taxes, fraud, libel and personal privacy and the rights of publicity apply to the Internet and e-commerce as the vast majority of these laws were adopted prior to the advent of the Internet and do not contemplate or address the unique issues raised by the Internet or e-commerce. Those laws that do reference the Internet continue to be interpreted by the courts and their applicability and reach are therefore uncertain. For example, and without limitation:

- The Digital Millennium Copyright Act (DMCA) is intended, in part, to limit the liability of eligible online service providers for including (or for listing or linking to third-party websites that include) materials that infringe copyrights or other rights of others. Portions of the Communications Decency Act (CDA) are intended to provide statutory protections to online service providers who distribute third-party content. We rely on the protections provided by both the DMCA and CDA in conducting our business. Any changes in these laws or judicial interpretations narrowing their protections will subject us to greater risk of liability and may increase our costs of compliance with these regulations or limit our ability to operate certain lines of business.

- The Children's Online Protection Act and the Children's Online Privacy Protection Act are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children from Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances.
- The Credit Card Accountability, Responsibility and Disclosure Act (CARD Act) is intended to protect consumers from unfair credit card billing practices and adds new regulations on the use of gift cards, limiting our ability to expire them. Several states are attempting to pass new laws regulating the use of gift cards and amending state escheatment laws to try to pass new laws regulating the use of gift cards and amending state escheatment laws to try and obtain unused gift card balances.
- The Restore Online Shoppers' Confidence Act (ROSCA) prohibits and prevents Internet-based post-transaction third-party sales and imposes specific requirements on negative option features.
- The Personal Information Protection and Electronic Documents Act of 2000 (PIPEDA) and substantially similar provincial laws in Canada govern how private sector organizations collect, use and disclose personal information in the course of commercial activities.
- The California Consumer Privacy Act of 2018 (CCPA), which will come into effect on January 1, 2020, requires companies that process information on California residents to make new disclosures to consumers about their data collection, use and sharing practices, allows consumers to opt out of certain data sharing with third parties and provides a new cause of action for data breaches. The burdens imposed by the CCPA and other similar laws that may be enacted at the federal and state level may require us to modify our data processing practices and policies and how we advertise to our users and to incur substantial expenditure in order to comply.
- The Illinois Biometric Information Privacy Act (IBIPA) regulates the collection, use, safeguarding, and storage of "biometric identifiers" or "biometric information" by private entities. While the statute specifically excludes photographs from its scope, to date there has been no dispositive judicial interpretation of that language.

The costs of compliance with these and other regulations may increase in the future because changes in the regulations or the interpretation of them. Further, any failures on our part to comply with these regulations may subject us to significant liabilities. Those current and future laws and regulations or unfavorable resolution of these issues may substantially harm our business and results of operations.

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

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

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

We regularly offer free products, free shipping or free trials as an inducement for customers to try our products or as part of other promotional photographic programs. Although we believe that we conspicuously and clearly communicate all details and conditions of these offers, for example, that customers are required to pay shipping, handling and/or processing charges to take advantage of a free product offer or that for our spring school photo day, families must return payments along with any prints they do not want under our "family approval model", we have been and, in the future, may be subject to claims from individuals or governmental regulators that our offers are misleading or do not comply with applicable legislation. These claims may be expensive to defend and could divert management's time and attention. If we become subject to such claims in the future or are required or elect to curtail or eliminate our use of free offers, our business and results of operations may be harmed.

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

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

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

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

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

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

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

The online industry for digital photography products and services, including photographic and video equipment rentals, is less developed than the online industry for other consumer products. With the acquisition of Lifetouch, our delivery of photographic products is greatly increased. Our success, and a key synergy anticipated from the acquisition of Lifetouch, will depend in part on our ability to acquire customers who historically have used traditional retail photography services or who have produced photographs and other products using self-service alternatives, such as printing at home. Furthermore, we may have to incur significantly higher and more sustained advertising and promotional expenditures or reduce the prices of our products and services to acquire additional online consumers to our websites and convert them into purchasing customers. Specific factors that could prevent prospective customers from purchasing from us include:

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

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

If our internal controls are not effective or our third-party software systems that we use to assist us in the calculation and reporting of financial data have errors, there may be errors in our financial information that could require a restatement or

delay our SEC filings, and investors may lose confidence in our reported financial information, which could lead to a decline in our stock price.

It is possible that we may discover significant deficiencies or material weaknesses in our internal control over financial reporting in the future. This risk is heightened during the period in which we are integrating Lifetouch, which has not previously been subject to the heightened control standards of a public company. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could cause us to fail to meet our periodic reporting obligations, or result in material misstatements in our financial information. We use numerous third-party licensed software packages, most notably our equity software, leasing software and our SBS resource planning software, which are complex and fully integrated into our financial reporting. Such third-party software may contain errors that we may not identify in a timely manner. If those errors are not identified and addressed timely, our financial reporting may not be in compliance with generally accepted accounting principles. Any such delays, errors or restatements could cause investors to lose confidence in our reported financial information and lead to a decline in our stock price.

Maintaining and improving our financial controls and the requirements of being a public company may strain our resources and divert management's attention.

As a public company, we are subject to the reporting requirements of the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002 and the rules and regulations of The Nasdaq Stock Market. In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 contains various provisions applicable to the corporate governance functions of public companies. Additional or new regulatory requirements may be adopted in the future. The requirements of existing and potential future rules and regulations will likely continue to increase our legal, accounting and financial compliance costs, make some activities more difficult, time-consuming or costly and may also place undue strain on our personnel, systems and resources.

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

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

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

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

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

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

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

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

We are subject to the risks of owning real property.

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

Risks Related to Our Common Stock

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

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

- failure to consummate the Transaction;
- failure to realize the anticipated benefits from the Lifetouch acquisition;
- slow economic growth, and market conditions or trends in our industry or the macro-economy as a whole;
- worldwide economic and market trends and conditions;
- price and volume fluctuations in the overall stock market;
- changes in operating performance and stock market valuations of other technology companies generally, or those in our industry in particular;
- the financial projections we may provide to the public, any changes in those projections or our failure to meet those projections;
- the potential impact of the current U.S. political climate on consumer spending;
- the loss of key personnel;
- changes in financial estimates by any securities analysts who follow our company, our failure to meet these estimates or failure of those analysts to initiate or maintain coverage of our stock;
- ratings downgrades by any securities analysts who follow our company or debt rating agencies;
- business disruptions and costs related to shareholder activism;
- the public's response to our press releases or other public announcements, including our filings with the SEC;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures, acquisitions or capital commitments;
- introduction of technologies or product enhancements that reduce the need for our products;
- lawsuits threatened or filed against us;

- future sales of our common stock by our executive officers, directors and significant stockholders; and
- other events or factors, including those resulting from war, incidents of terrorism or responses to these events.

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

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

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

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

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

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

In April of 2017, our board of directors approved an increase to the share repurchase program of up to $140.0 million in addition to amounts remaining under the board's prior authorizations. Through December 31, 2018, we repurchased $533.2 million in stock under our total authorized amount of $646.0 million. In January 2018, we publicly announced that we had suspended our stock repurchase program, which we expected to reinstate in the fourth quarter of 2019 absent the Transaction. The stock repurchase program may be recontinued or discontinued at any time without prior notice. In the event that we recontinue our stock repurchase program, future repurchases pursuant to our stock repurchase program could affect the price of our common stock and increase its volatility. The existence of our stock repurchase program could also cause the price of our common stock to be higher than it would be in the absence of such a program and could potentially reduce the market liquidity for our common stock. Additionally, repurchases under our stock repurchase program would diminish our cash reserves, which could impact our ability to further develop our technology, access and/or retrofit additional facilities and service our indebtedness. There can be no assurance that any stock repurchases would enhance stockholder value because the market price of our common stock may decline below the levels at which we repurchased such shares. Any failure to repurchase shares after we have announced our intention to do so may negatively impact our reputation and investor confidence in us and may negatively impact our stock price. Although our stock repurchase program is intended to enhance long-term stockholder value, short-term stock price fluctuations could reduce the program’s effectiveness.

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

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

Risks Related to Our Credit Agreement

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

On April 2, 2018, in connection with our acquisition of Lifetouch, we incurred substantial indebtedness pursuant to an incremental term loan facility (the "Incremental Term Loan") in an aggregate principal amount of $825.0 million. The incremental term loan facility is an amendment of our Initial Term Loan of $300.0 million dated as of August 17, 2017 (collectively, the "Credit Agreement"). The Incremental Term Loan Facility was fully funded at close. The Credit Agreement will mature on August 17, 2024 and requires quarterly principal payments, as well as mandatory prepayments due to assets sales or excess cash flow, with the balance payable at maturity. As of June 30, 2019, approximately $295.5 million and $617.8 million of principal amount were outstanding on the Initial Term Loan and the Incremental Term Loan, respectively.

Our substantial indebtedness could have important consequences to us including:

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

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

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

Our Credit Agreement imposes restrictions on our business.

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

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

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

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

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

Issuer Purchases of Equity Securities

The Company suspended its share repurchase program as of December 31, 2017 having publicly committed to maintaining a BB rating profile and repaying the acquisition debt accordingly. If the Transaction does not close as anticipated, we will re-evaluate our capital structure and capital return policy.

As of June 30, 2019, approximately $112.8 million remained available for stock repurchases pursuant to our stock repurchase program.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

Not applicable

ITEM 6. EXHIBITS

Exhibit Number	Description
3.01	Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.03 to our Form S-1 filed June 29, 2006, File No. 333-135426).
3.02	Restated Bylaws (incorporated by reference to Exhibit 3.02 to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, File No. 001-33031).
3.03	Amendment to Restated Bylaws (incorporated by reference to Exhibit 3.1 to our Current Report on Form 8-K filed on June 10, 2019, File No. 001-33031).
10.01	Agreement and Plan of Merger among Photo Holdings, LLC, Photo Holdings Merger Sub, Inc., and Shutterfly, Inc., dated as of June 10, 2019 (incorporated by reference to Exhibit 2.1 to our Current Report on Form 8-K filed on June 10, 2019, File No. 001-33031).
10.02	Offer letter dated June 1, 2019 for Ryan O'Hara (incorporated by reference to Exhibit 99.1 to our Current Report on Form 8-K filed on June 10, 2019, File No. 001-33031).*
31.01	Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
31.02	Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
32.01	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).**
32.02	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).**
101	The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2019, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations, (iii) Condensed Consolidated Statements of Comprehensive Income/(Loss), (iv) Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements, tagged at Level I through IV.

* Represents a management contract or compensatory plan.

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

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 7, 2019	By:	/s/ Ryan O'Hara Ryan O'Hara President and Chief Executive Officer (Principal Executive Officer)
Dated: August 7, 2019	By:	/s/ Michael Pope Michael Pope Senior Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)

Exhibit 31.01

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO RULE 13a-14(a) or 15d-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Ryan O'Hara, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Shutterfly, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant’s other certifying and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of the registrant’s board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Date: August 7, 2019

By: /s/ Ryan O'Hara
Ryan O'Hara
President and Chief Executive Officer

Exhibit 31.02

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(a) or 15d-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Michael Pope, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Shutterfly, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 7, 2019	By:	/s/ Michael Pope
		Michael Pope
		Senior Vice President and Chief Financial Officer
		(Principal Financial Officer and Principal Accounting Officer)

Exhibit 32.01

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

The undersigned, Christopher North, the President and Chief Executive Officer of Shutterfly, Inc. (the “Company”), pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, hereby certifies that:

(i) the Quarterly Report on Form 10-Q for the period ended June 30, 2019 of the Company (the “Report”) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date:	August 7, 2019	By:	/s/ Ryan O'Hara
			Ryan O'Hara
			President and Chief Executive Officer

Exhibit 32.02

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

The undersigned, Michael Pope, Senior Vice President and Chief Financial Officer of Shutterfly, Inc. (the "Company"), pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, hereby certifies that:

(i) the Quarterly Report on Form 10-Q for the period ended June 30, 2019 of the Company (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date:	August 7, 2019	By:	/s/ Michael Pope
			Michael Pope Senior Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)