

MII INVESTMENT MEMO

TO: McIntire Investment Institute
FROM: Pete Cobos (Third Year, COMM)
SUBJECT: SFLY – LONG
DATE: November 28, 2007

Shutterfly, Inc. (SFLY)
Recommendation – LONG
November 26, 2007

SFLY sells custom photo products through the internet.

Price (11/24/07):	\$26.78		<u>2004</u>	<u>2005</u>	<u>2006</u>
Market Cap:	660.02M	Customers	900,469	1,219,191	1,724,504
52-Week Range	\$13.20-\$37.00	Orders	1,618,310	3,560,266	5,104,950
P/E (forward):	47.82x	Ave Order Value	\$20.81	\$22.99	\$24.16
PEG Ratio	2.48	% Rev. from Personalized Products	35%	42%	51%
Short % of Float:	9.6%	% Rev. from Prints	65%	58%	49%

Thesis

Shutterfly, Inc. is a long because its well-seasoned, future-oriented management team creates beneficial strategic partnerships in order to increase exposure and sales of its differentiated products at consistently low costs. SFLY operates in an industry with huge growth potential and favorable demographics.

What SFLY Does

Shutterfly is an internet-based producer of photo prints, custom-made photo books, mugs, greeting cards, calendars and other photo-based “memory sharing” goods. Sales and profits are heaviest during the fourth quarter, due to the purchases of both holiday gifts and holiday cards. Their photo products are competitively priced with those of both its main competitors, Kodak’s EasyShare and H-P’s Snapfish.

Internet photo-sharing is a disruptive technology still in its growth stages

There are huge opportunities for growth in internet photo-sharing and printing. As the American population realizes that digital camera-to-internet prints are just as good, if not better, than the old school film-to-store method, photo-takers nationwide will make the transition to the web. Websites like Shutterfly, EasyShare and Snapfish simply provide a better service at a vastly lower cost.

Demographics also support the likelihood of strong growth in the near future. According to the research firm IDC, digital camera and broadband penetration is above 50% in US households. In addition to this, the industry-specific research firm, InfoTrends, states that only 6 percent of the 58 million US households with digital cameras and internet access have purchased photo-based merchandise on the internet. The recent success of Facebook and MySpace are testaments to the public’s desire for personalization and social networking. Bottom line: the untapped market is enormous.

As volume grows, storage costs continue to shrink through technological innovation. Shutterfly is vertically integrated as well. By completely controlling its supply chain, the company can:

- (a) produce goods of a higher quality than its competitors
- (b) innovate and adjust to innovations more rapidly than its competitors
- (c) operate with greater efficiency (production costs and otherwise) than its competitors

Because of these competitive advantages, SFLY will be the best photo printing/publishing company when it comes to increasing capacity and still minimizing costs.

Shutterfly prides itself on viral growth. Because of the high-quality nature of its products, SFLY spends little money on advertising and relies heavily on word of mouth between photo-takers. This has proven successful and has led to approximately 50% sales growth in each of the last two years while keeping costs the same as a percentage of revenue.

Shutterfly's high customer loyalty is proof of a differentiated product

In the last six quarters, 77% of SFLY's revenue came from repeat customers. When that figure is combined with the 50% average sales growth over the last two years, it is clear that SFLY is very good at both attracting customers and retaining them. In my opinion, this high customer retention is a function of the company's viral word-of-mouth growth. People take recommendations from a friend to heart much more than they do an average advertisement. Plus, Shutterfly continues to satisfy its current customers with great products.

Shutterfly's passionate customers place a huge value on quality, especially in the area of personalized photo products, where the fat margins are. After browsing the Shutterfly site, the Kodak EasyShare site, and the H-P Snapfish site, it was clear to me that Kodak and H-P are plain vanilla slackers compared to Shutterfly's personality and breadth of quality custom-printed goods. Consumers are noticing the difference, too. Over the past three years, there has been a steady upward trend of revenue from personalized products to revenue from prints, from 20%:80% in Q1 2004 to 61%:39% in Q4 2006. There is no reason for this not to continue in the future.

The media is also picking up on SFLY's superior goods and services. The company received the Copernican Award for Best Customer Experience earlier this year and the Real Simple Award for Best Online Service for Photo Cards in 2005. In addition, SFLY was the Field Test Winner for Hard Bound Publishing in Money Magazine last January. The company has gotten favorable reviews in Travel & Leisure Magazine, Parents Magazine, Family Circle Magazine and the New York Times. This favorable exposure likely will contribute to increased revenues in the future.

Strategic partnerships give Shutterfly an edge over other companies

SFLY gains a competitive edge by partnering with companies and brands that will complement photo product sales. Among these partners are:

- (a) Target – customers can upload their prints to Shutterfly.com and pick them up in a local target store, usually within an hour.
- (b) Nickelodeon – customers can upload pictures of their children and create custom storybooks of their kids going on adventures with Nick characters, like Dora the Explorer.
- (c) Martha Stewart – customers can choose from a variety of Martha-designed cookbooks with their own recipes and photos.
- (d) Sesame Street – customers can create custom Sesame Street storybooks as well

By choosing partners who share the same values, both companies can benefit.

Shutterfly's partner strategy is simple: choose companies with similar, attractive customer demographics who can add value to SFLY. For example, the Target partnership filled a huge void in Shutterfly's business model. Customers don't have to wait to have their prints shipped via mail anymore if they don't want to. Why did SFLY choose Target? Target's customer also values quality and will pay some premium for it. Target is dedicated to high-quality customer service. Target conducts its business with a brand-emphasis approach. By sustaining these current strategic alliances into the future as well as creating new ones, SFLY can continue to differentiate itself and make it even harder for other companies to compete.

Shutterfly's management team is future-oriented and has brand management experience

SFLY's growth in the future is dependent on management's ability to build the Shutterfly name and to consistently give its customers something they can't get elsewhere. Management at SFLY is 100 percent focused on developing a premium lifestyle brand for personal photo printing and publishing. They don't have to worry about things other companies have to worry about, like digital camera sales (Kodak) or designing new laser printers (H-P).

SFLY's management team is stellar. Many of the executives have had experience managing brands and growing companies. Most importantly, the people running SFLY are genuinely interested in photography and developing the best photo products and services in the world. Heading up SFLY's mission for the complete photo printing solution is CEO Jeffery Housenbold, E&Y Entrepreneur of the Year in June 2006 for retail and consumer products. Mr. Housenbold continues to improve US operations but has been shifting some of his attention toward implementing what he calls "global memory sharing" into countries with high digital camera penetration and broadband connectivity.

At his side is Chief Marketing Officer Kathryn Olson, whose experience in Quaker Oats, Snapple and Gatorade have won her numerous accolades, including the Toy Industry Association's "Most Innovative" "Most Educational" and "Product of the Year" awards in 2005. Ms. Olson is a former executive vice president for Nordstrom and a current trustee in the Association of National Advertisers.

Value-Added Research

For my VAR, I tried to answer three main questions:

- (a) What drives the success and growth of internet companies, specifically SFLY?
- (b) Is word-of-mouth viral growth sustainable?
- (c) What first-hand knowledge can be gained about Shutterfly's products and performance?

My VAR contacts included McIntire Prof. William Kehoe, Comm School grad and CEO of various internet companies Bryan Antler, InfoTrends analyst Matt O'Keefe and numerous Target photo centers.

William Kehoe, a marketing professor here at UVA, was very helpful in determining what drives the success and growth of internet companies. Mr. Kehoe believes that the level of service is most important factor for success, followed by managers' ability to always be thinking about the next step. He also said that recommendations from a friend typically carry much more weight with customers than regular internet advertising. I found these points to be quite encouraging, since I feel SFLY embodies high-quality service, word-of-mouth recommendations and forward-thinking managers.

Mr. Kehoe also referred me to Bryan Antler. Mr. Antler is a McIntire graduate who started his first business, PuppyStock.com, an internet pet supplies store, when he was still in his third year ICE block. He is currently CEO of a startup ringtone company, FriendTones, who partners with Facebook to provide a newer, easier way of making and downloading ringtones. Mr. Antler spoke with me at length about the keys to success for an internet company. The short of it is this: Antler believes management team, product, and timing all contribute to making a company like SFLY successful. He also thinks viral growth is sustainable if the company is tapped into the right social networks, especially when a disruptive technology is involved. Loyalty is built not only by a great product, but by creating high switching costs and the network effect (ex: it is hard to switch from AIM to Yahoo! Messenger when all of your friends are on still using AIM). Lastly, partnerships are important for growth, however each company involved needs to be able to control its core functionality. SFLY's story includes much of what Mr. Antler mentioned, although it seems switching costs between Shutterfly and its competitors would be pretty low.

InfoTrends is a research firm that deals specifically with the imaging industry. Companies within this industry typically pay InfoTrends to do market research and report their findings as it relates to that company. Matt O'Keefe, the InfoTrends representative I spoke with, was nice enough to send me some parts of these

reports, mainly dealing with market growth. The figures in this memo regarding digital camera use and broadband penetration came from InfoTrends information.

My trips to Target stores were extremely encouraging as well. Target PhotoCenter managers at the Charlottesville, VA, Culpeper, VA and Westbury, NY locations all said that Shutterfly online-order products vastly outsell Kodak online-order products. Since the prices for the two companies are very similar, the Target managers attribute this difference to Shutterfly's higher-quality product and creativity-oriented designs. One of the managers showed me numerous samples of both the Kodak products and Shutterfly products, and the Shutterfly's dominance in design and quality was clear.

Target PhotoCenter managers also spoke about the increasing popularity of the online-based photo printing. Typically, Target manages to complete Shutterfly print orders within an hour of receiving them (as long as it is not an overwhelmingly large order), and the quality is just as good as a traditional 35mm print. In fact, so many people are making the transition to online uploading that **the manager in Culpeper said she typically gets close to one hundred online orders in a day, and only about five 35mm rolls of film.**

Risks

Since Shutterfly is a young company and internet-based image sharing is still somewhat in its development stages, there are risks involved with investing in SFLY:

- (a) The reluctance of the American public to switch to online photo services may be detrimental to SFLY's bottom line in the short-term.
- (b) SFLY's competition comes in many different forms: internet (EasyShare and Snapfish), big-box discounters who offer photo services (Wal-Mart), local photo developing stores, and home-printing. This is a constant threat and may affect SFLY's ability to meet earnings expectations in the future.
- (c) SFLY is growing quickly. The company's infrastructure must be able to handle this growth while keeping costs in-line. A failure to do so will cause a decrease in earnings.

SFLY's stock price is also expensive at the moment. I believe the high multiple is justified and earnings will meet/exceed expectations, but any failure to do so will most likely result in a decline in stock value.

Measuring Success and Recommendation

After studying SFLY, I believe the most useful metrics to gauge SFLY's success as it pertains to this long are: sales, number of customers, average orders per customer, revenue mix (personalized products vs. standard prints), revenue source (existing customers vs. new customers), and, obviously, share price.

Although the stock is expensive, I recommend that MII open a long position before year end so as to capture the value when SFLY releases Q4 earnings.

VAR Contacts

William Kehoe, Marketing Professor, UVA

Bryan Antler, Internet Entrepreneur

Matt O'Keefe, Consumer Services, InfoTrends

Valerie Racine, Assistant Editor, PhotoLife Magazine

Tammy, PhotoCenter Manager, Target, Culpeper, VA

Celia, PhotoCenter Manager, Target, Charlottesville, VA

PhotoCenter Employee, Target, Westbury, NY

Investor Relations, Shutterfly, Inc.

Marketing Department, Shutterfly, Inc.

Personal Use: Shutterfly, Kodak EasyShare, HP Snapfish

** I am still awaiting reply from Ms. Racine at PhotoLife and Shutterfly's Marketing Department.*