

## MII SHORT FUND ELECTION MEMO – BLUE NILE

**TO:** MII Managers  
**FROM:** Hunter Armistead  
**SUBJECT:** Blue Nile (NASDAQ: NILE)  
**DATE:** April 19, 2009



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### Selected Financial Metrics:

#### Valuation Measures

|                       |         |
|-----------------------|---------|
| Market Capitalization | 613.51M |
| Enterprise Value      | 559.96M |
| Trailing P/E Ratio    | 56.43   |
| Forward P/E Ratio     | 50.99   |
| PEG Ratio (5 yr)      | 3.18    |
| Price/Sales           | 1.93    |
| Price/Book            | 29.57   |

#### Other Financial Data

|                        |         |
|------------------------|---------|
| Profit Margin          | 3.94%   |
| Return on Assets       | 7.99%   |
| Return on Equity       | 28.10%  |
| Operating Cash Flow    | -2.93M  |
| Levered Free Cash Flow | -12.35M |
| Short % of Float       | 44.20%  |
| Current Ratio          | 1.791   |

BLUE NILE INC  
as of 17-Apr-2009



52wk Range: 18.34 – 55.95

## Business Description:

Services | Jewelry Stores

Blue Nile is the largest online diamond retailer in the world. The company specializes in custom diamond jewelry with a focus on engagement rings. Its primary business is in the United States, but it also operates websites in the United Kingdom and Canada. In addition, Blue Nile ships products to over 30 countries worldwide. By being exclusively an online retailer, the company is able to sell its products at a discount compared to traditional brick and mortar stores. Sales in the engagement category (diamonds, ring settings and wedding bands) represented approximately 69% of the company's revenue in 2008.

The company was formerly known as Internet Diamonds, Inc. and changed its name to Blue Nile, Inc. in November 1999. Blue Nile, Inc. was founded in March 1999 by Marc Vadon and is headquartered in Seattle, Washington.

### Blue Nile's Products

Blue Nile sells the following products on its website:

- Build Your Own Diamond Jewelry: A proprietary "Build Your Own" function that consumers can use to customize diamond rings, earrings, pendants, three stone rings, three stone pendants and five stone rings.
- Proprietary Diamond Search: An interactive diamond search function that allows consumers



to search through an inventory of over 55,000 diamonds independently certified to find jewelry based on individual criteria.

- **Blue Nile Signature Diamonds:** A collection of diamonds that are hand-selected and cut to the most exacting standards, providing perfect symmetry and proportions for maximum brilliance.
- **Diamond and Jewelry Consultants:** Trained customer service team offering advice and guidance to help customers make purchasing decisions.
- **Fine Jewelry:** Finely-crafted diamond, gold, pearl, sterling silver, platinum and gemstone jewelry in classic and modern designs.
- **Fancy Colored Diamonds:** An exclusive collection of rare fancy colored diamonds, including extremely rare diamonds in red and pink hues.

## Thesis Points:

### **Recession Will Hurt Blue Nile's Core Customer Base**

In the current macroeconomic environment, consumer expenditures are falling rapidly. With much less disposable income, customers are trading down from expensive jewelry to less costly alternatives. Tight credit conditions and weak consumer confidence are also causing consumers to purchase less expensive jewelry from Blue Nile and other jewelers.

Being a high-end jewelry retailer would lead many investors to think Blue Nile is supposed to appeal to customers in the upper-income bracket whose absolute spending power is not significantly affected by economic downturns. Yet despite this categorization, the majority of purchases made on Blue Nile's site are below \$5,000. Items in this category carry much lower margins than their ultra-expensive counterparts. In an interview with *Investors Business Daily* last November, Blue Nile's CEO commented that consumers that many of the company's customers were having trouble getting credit, and nearly all of Blue Nile's sales comes through credit card purchases. This problem will be exacerbated in the near future as card issuers continue to pull back limits on outstanding cards and decline to issue new cards to potential buyers. Blue Nile has tried to ease its pains with consumer credit by offering third party financing on its website. However, tighter credit standards have led to approval rates dropping recently.

Even though some sectors in the economy are showing signs of recovery, I don't think the jewelry business will be out of trouble until next year. In the wake of the financial crisis, consumers are much more likely to save more and spend less on big discretionary items like diamonds and jewelry. In those cases that they do, the purchases will be subject to much tighter budget constraints.

*VAR: Zachary Scheidt, CIO, Sound Counsel Investment Advisors*

- The company has no debt and posted third quarter profits, as opposed to many retailers which showed losses. The company actually saw sales come in near the same levels as last year, which has some bulls optimistic that stability will remain with this diamond retailer.



- The typical NILE customer is a 25 to 35 year old male purchasing an engagement ring.
- Unfortunately, this is one of the hardest hit demographic categories.
- At this time the typical buyer is opting for a smaller diamond, a less sophisticated band, and in general, a lower priced item.
- Bullish investors have long argued that the jewelry business caters to the wealthy and affluent, and should be relatively immune to an economic downtrend.
- Since NILE focuses on the lower-end engagement type jewelry, the company's customers are actually very sensitive to economic cycles.

*VAR: April 2009 Jewelry Consumer Opinion Counsel Study (Subsidiary of MVI Marketing Ltd) on Consumer Spending*

- When asked when they will start purchasing non-essential products and services again, such as fine jewelry, new cars and vacation/personal travel, 58 % said they don't know when this will occur, while 15 % said it would be more than a year before they start buying such items again.
- 10 % of respondents said they would start buying non-essential products and services in the next six to 12 months
- The main reason consumers are holding back on non-essential spending is because they are worried about the economy (24 %), while 20 % cited uncertain cash flow and another 16 % said they had too much debt
- Unfortunately for retail jewelers, the survey shows that when consumers do loosen up their pocketbooks, fine jewelry is not the first thing on their to-buy lists.
  - According to the survey, 19 % of respondents will spend first on vacations, followed by home furnishings and dining out (13 %). Buying fine jewelry, high definition televisions and items for their children all came in at 5 %, while 1 % or less will opt to buy fine or fashion watches

### **The Jewelry Industry Is Highly Competitive and Blue Nile Competes with Lots of Larger, Powerful Competitors**

Overall, the jewelry industry is highly competitive. Current or potential competitors include the following:

- Independent jewelry stores
- Retail jewelry store chains
- Other online retailers that sell jewelry
- Department stores, chain stores and mass retailers
- Online auction sites
- Catalog and television shopping retailers
- Discount superstores and wholesale clubs.

There is tremendous competition from small, local jewelers (who may have strong ties to their communities), as well as from big names like Wal-Mart and Costco, and from other online retailers, including Amazon.com, eBay and Overstock.com. Recently, DeBeers, who controls approximately 40% of the diamond trade, began selling its diamonds online.

As Blue Nile says in their Annual Report, “[they] believe that the principal competitive factors in our



market are product selection and quality, customer service and support, price, brand recognition, reputation, reliability and trust, website features and functionality, convenience, and delivery performance.” I agree with Blue Nile, however, I don’t see the company becoming a decided leader in any of those categories in the near future. Many of Blue Nile's current and potential competitors have advantages over the company, including longer operating histories, greater brand recognition, existing customer and supplier relationships, and significantly greater financial, marketing and other resources. In addition, traditional store-based retailers offer consumers the ability to physically handle and examine products in a manner that is not possible over the Internet. They also offer a more convenient means of returning and exchanging purchased products.

Especially in the current market, Blue Nile will have trouble gaining any brand recognition as its ad budgets are cut while its larger competitors still continue to market a lot more relatively. With only about 191 employees and little inventory, the company is a low cost provider of services, but it has very low margins too. Therefore, its profitability is highly sensitive to both average price and units sold. Should Blue Nile’s sales volume decline because of low demand or its average price falls because of lower diamond prices, one of the only material cost the company could cut is its marketing expenditure.

DeBeers and other large competitors seeking to establish an online presence can devote substantially more resources to website systems Internet and other online services increases. Blue Nile's online competitors can duplicate many of its products, services and content.

Because of its relatively small size in the overall market, Blue Nile’s suppliers have a lot of power. Most of its supply of rough diamonds is controlled by a small number of mining firms: about 25% of payments to suppliers last year went to its top three providers. As these contracts run out beginning this year, Blue Nile’s suppliers could move their businesses to larger, more recognizable jewelers.

*VAR: Nicholas White, White & Co. (Customer Jewelry Retailer)*

- Blue Nile continues to demonstrate that it understands how to use the Internet’s strengths to market luxury items like diamonds and other fine jewelry.
- Blue Nile cut deals with loose diamond suppliers to provide large diamonds on a consignment and proceeded to design a site that offered Internet savvy consumers an information intense environment from which to shop.
- Blue Nile has less than 1/2 % of the US jewelry market and about 1.3% of the diamond market.
- To continue to grow, Blue Nile will not only have to take more business from traditional jewelers, but greater market share from luxury brands also... not that easy to do.
- Most luxury consumers don’t buy diamonds because of price alone and are willing to pay a premium to own a Tiffany or Winston diamond.
- Tiffany and other fine jewelry brands are expanding into more America urban markets.
  - This provides local consumers greater choice, knowledgeable service, convenience, and a personal touch too when shopping for fine jewelry; a powerful combination that Blue Nile technology can’t match.

### **Many Customers Not Comfortable Purchasing Diamonds Online**



The online retail jewelry business is relatively new compared to the centuries old brick and mortar retailers. Purchasing diamonds and jewelry is not a frequent occurrence, and many customers value the in-person counseling and education as opposed to reading material online. Though the detail of pictures and descriptions is quite good online, it is simply not an adequate substitute for many consumers.

Returns and product problems are also big deterrents for online customers. The potential for the jewelry to be lost in the mail and having to deal with customer service over the phone can be too much. Another large drawback to online shopping is that there is no side-by-side comparison of the gems.

*VAR: September 2008 Jewelry Consumer Opinion Counsel Study (Subsidiary of MVI Marketing Ltd) on Online Jewelry Purchasing*

- 84 % of respondents were satisfied or extremely satisfied with the quality of their online jewelry purchases
- Of those who purchased fine jewelry online, 31 % prefer shopping from a well-known fine-jewelry retailer's Web site, while more than two-thirds prefer shopping at that retailer's store
- 80 % of respondents believe that shopping online is more convenient than shopping at the retail store
- 28 % of the engagement-age group (18-39 years of age) indicated they shop online and are more likely than other age groups to prefer shopping at Amazon.com, Blue Nile and eBay.
- The 60-plus age group showed that when purchasing from a well-known retailer, only 38 % prefer purchasing from that retail store's Web site as opposed to their physical store

*VAR: Personal Experience*

- I actually purchased a David Yurman ring (don't worry, it's not an engagement) off of eBay in October and some earrings off of Tiffany.com in February
- The bad:
  - With the ring, I had a really tough time gauging what the stone's size would be in real life
  - Though the sites gave all the measurements, I had a really hard time trying to figure out what a 2mm difference would look like on the person I was giving it to just by seeing a picture of the ring
  - I did worry about buying a fake ring, but the user rating of the seller helped to assuage some of my concerns
  - With the earrings, I also had a really tough time gauging what they would look like on a person (again, mainly a size issue)
- The good:
  - I saved nearly 30% by buying the ring offline
  - The convenience of shopping from my computer couldn't be beat
  - Experience at Tiffany.com was great
    - Easy to track my order, and I got everything perfectly packaged with no problems whatsoever
- Overall:
  - I would definitely shop online again because of the cost savings and convenience

- Because these were my first two times buying jewelry, I could have used a lot more helpful information in my selection process
  - Mainly informative pictures on the sizing / pictures of jewelry on models
  - Items popular within certain age demographics
  - I ended up having to ask other girls what was popular with them
- My mother and grandmother thought that I was crazy
  - I interpreted this to mean older generations are much more skeptical of buying big ticket items off the internet

## Risks:

### Short Squeeze

The short interest as a % of float is currently is a staggering 44.2%. If we short Blue Nile and a short squeeze occurs, we might be forced to cover and face a huge loss.

### Economic Downturn Ends Sooner Than Expected

If consumer spending and credit start to improve much sooner than expected, Blue Nile could experience a huge boost in profits and stock price.

### Online Diamond Purchasing Quickly Becomes the Norm

With its lower costs and tax benefits, purchasing diamonds online has the potential to gain enormous popularity among consumers who at the moment strapped for cash. Reviews of Blue Nile on Yahoo!, BizRate, and other sites reveal positive consumer experiences. Word of mouth and blogging could help Blue Nile a much-needed marketing boost and increase sales.

## Summary:

I think that Blue Nile would be a good addition to the Short Portfolio of MII. The company is operating in a highly competitive industry with dismal prospects for the near future. Blue Nile is particularly vulnerable to a prolonged downturn due to its small size and relatively narrow range of products. I think that MII should look for a possible entry point when the short interest as a % of float falls to limit the risk of getting caught in a short squeeze. A possible exit point could occur when consumer credit begins to thaw and spending on jewelry starts to pick up.

## Ideas for MII:

I think that MII has taken a lot of very good steps in improving the club over the past three years that I've been a member. I like how the communication has improved between the managers and the other members of the club, particularly concerning the selection of stocks. After the success of the analyst training session, I think that MII should get guest speakers who focus on teaching members how to invest rather than recounting their own experiences. Having an alumni network for analysts and managers to use would benefit the club greatly. I think that it might also be fun to have an alumnus from Wall Street who was in MII come back and talk to us about his work once a semester. I think that taking a trip (rather somewhere close by like Richmond or somewhere far away New York) to see a venture capital firm, investment bank, etc. would also be a great experience for members.