VAN DIEN ASSET MANAGEMENT LLC

BUY RECOMMENDATION

SHUTTERFLY (SFLY)
Price: $28.42 (10/12/12)
S&P 500: 1428.59
NASDAQ: 3044.11
Market Cap: $1.08 Bil
Net Cash/Share: $4.00

Shutterfly is a consumer-based online photo storage, photo sharing and photo merchandise ecommerce company well-positioned to "disintermediate" much of the off-line world of photo-sharing, photo-books, greeting cards, scrapbooking, yearbooks, calendars, etc. This is estimated to be a sizable $36 Bil addressable market domestically -- very large for a company of SFLY's size.

Shutterfly has pursued a strategy of building premium brands, providing high-end customer service, delivering strong efficiency by maintaining its own manufacturing facilities, and constantly innovating. All the while, the company has focused on free cash flow, and has delivered very strong financials. Given such, SFLY has emerged as the strongest competitor within the space, and the de facto consolidator. Now with considerable scale (InfoTrends estimates SFLY has almost 50% share of the online market) after acquiring Tiny Prints ($333 million in 2011) and Kodak Gallery ($23.8 million out of Kodak's bankruptcy proceedings earlier in 2012), we believe Shutterfly is in a position to better dictate pricing, and ultimately increase switching costs for consumers, which will improve margins.

Background
On March 21, 2011, SFLY, announced it would acquire Tiny Prints, a private company similar to SFLY in culture and business model, but offering many complementary product lines (for example, greater emphasis on one-to-one greeting cards, stong online wedding announcement/invitations presence with weddingpaperdivas.com, etc.). The match was cheered by investors and the stock briefly traded into the $60s. Unfortunately, SFLY's other competitors (mainly Snapfish, owned by Hewlett Packard, and American Greetings' CardStore.com) reacted defensively, discounting extensively in an effort to grab additional market share during the 2011 holiday season. This resulted in SFLY's cost of acquiring new customers to rise significantly during the fourth quarter. Always focused on delivering free cash flow, SFLY chose not to promote as excessively as its main competitors. Despite the company's disciplined approach, Shutterfly was ultimately forced to preannounce a modest 4Q miss. The CFO then decided to make an abrupt career change.

During the 4Q earnings conference call, management delivered full year guidance for 2013 which incorporated the conservative forecast that the current competitive promotional environment would be ongoing. That said, CEO Jeff Housenbold made two additional sizable purchases of stock on the open market during May, and noted during a conference presentation in June that Snapfish (#2 in market share with ~9%) had indeed reined in some of their promotional efforts.

More recently, Hewlett Packard held an Investor Conference on 10/3 and 10/4 in which CEO Meg Whitman offered a grim outlook and reset the expectations bar. Given HPQ's restructuring, the fact that HPQ stock is down 45% year-to-date, and the fact that Snapfish is a small non-core business within HP's portfolio, we believe that Snapfish will be sold to Shutterfly sometime within the next 12-18 months. Importantly, Housenbold used to work for Whitman at EBAY.

Separately, on September 26th, the CEO of American Greetings (AM--$17.05) introduced a "going private" offer at $17.18/share for his company's Board to consider. These two situations suggest that neither HPQ nor AM appear poised to be chasing market share this year. Finally, we note that SFLY announced on 9/20/12 an agreement to acquire an additional 200,000 square feet of manufacturing space in South Carolina, essentially tripling its space on the east coast. Clearly, this is a move made from strength, that anticipates significant growth in coming years.

Conclusive Remarks
Shutterfly stock was put in the penalty box once it disappointed during last year's 4Q. However, since then the company has (1) acquired and integrated Kodak Gallery, (2) introduced Treat, a one-to-one subscription greeting card service that we believe has significant upside, (3) partnered with Hallmark.com, (4) hired a new CFO, Brian Regan, on July 30, and (5) delivered on its financials both quarters of 2012. Importantly, since it spent much of the year without a CFO, and because 50% of its revenues (and all its profitability) are experienced in the 4Q, management has only made modest upward tweaks to its guidance during the year. Smart management teams, and we would include CEO Housenbold on this list, recognize that once you disappoint (as the company did in 4Q11), you better make sure you don't disappoint again. We believe that Shutterfly's stock still remains a show-me story to many investors concerned about the competitive landscape, and that a strong 4Q beat will force many investors to once again reevaluate the company. If SFLY delivers upside to consensus estimates, delivers a strong outlook, and acquires Snapfish shortly thereafter, investors will begin to recognize SFLY as the owner of this important online vertical and a higher valuation multiple will follow.

The stock, after a very upbeat and impressive presentation by CEO Jeff Housenbold at Citi's Tech Conference on 9/5 and coincident with the market's upward move, had risen about 15% to $34 or so when Cantor's report came out on 9/21. Having established a new upward bar for the stock with the Cantor report, the stock has since retreated to $27-28. Interestingly, Cantor's Squali has subsequently upgraded SFLY on October 10th but with no change to numbers. My feeling is that the stock has limited downside risk from here and is poised for a big 4Q surprise that could send the stock back closer to $40.

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