

Shutterfly Inc.

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Jim Shaughnessy: Good morning, everyone. My name is Jim Shaughnessy. I'm on the Internet research team here at RBC. Very pleased to have Chris North, CEO of Shutterfly, here with us today. Chris, you've been with the company now, I guess, about a year and half or so. Maybe quick summarize sort of where we've been, the journey thus far, actions taken this year, and maybe where you see Shutterfly going forward?

Chris North: Great, Jim, thanks a lot. Thanks to you and the whole RBC team for having us here today. I have to get the safe harbor statement out of the way, so let me read this.

Obviously my comments today are subject to our forward-looking statements safe harbor, which you can read on our website, and while you are there, you can buy a beautiful photo book, for example.

So, where we are today, I think I see ourselves as really executing against a two-phase plan, and we're really right now at that pivot point, where we're coming to the end of the first phase and just beginning the second phase. So in that first phase, what we've been trying to do is really to simplify and refocus the business, particularly the consumer business, to focus our energies on a small number of very large opportunities, right? And in phase one, what we've been doing in the consumer business is we've actually been consolidating and in some cases, even shutting down a set of our smaller brands, and then bringing together our two most important brands, Shutterfly and Tiny Prints, the market leading brands, onto a single technical platform, a single website, in fact, trying to get as many of our past customers onto that website, to have this single flagship Shutterfly.com website going forward in our consumer business.

You know, we've done that by shutting down some of our smallest brands, most of which were shrinking if you go back to 2016, and then seeking to migrate the customers. Now, and the great news there is as of Q3, the technical work, the migration work, platform installation, is complete, and so we're entering our peak Q4 season with this single technical platform for most of our consumer brands. You know, at the same time as we've gone through that work, we went through a significant restructuring as well, and that work is also substantially complete. We've said, and in fact, we affirmed as of Q3, that we expect to save about \$55 million a year on an annual basis as a result of that, which

puts us in a position both to reinvest towards future growth in those consumer end--as I'll come to talk about, in our enterprise business -- but also to significantly improve our profitability. And so, as we look ahead to phase two, as we go into Q4 and look ahead to 2018, all of our energy is really about how we drive reacceleration in the consumer business and continue to grow our enterprise business.

Now, I want to take a moment now and talk about what we saw in Q3. We reported a successful Q3, we beat the high end of our guidance on revenues, we met our guidance on adjusted EBITDA, but subsequent to reporting, we've had a number of questions from investors, trying to get greater clarity both around the trends that we're seeing in the short term in Q3 in the consumer business, but also to try to get some understanding about the confidence that we feel about continued consumer growth and even growth acceleration as we look longer term. And so, I want to really address those questions head-on here today. So I'll talk specifically to the two parts of the question I think we've heard most frequently. One is, what's happening with the core Shutterfly brand growth, and the second is, what's happening in terms of revenue retention from the brands that we either shut down or migrated?

So, I'll start with Shutterfly brand. We really look at two key metrics internally to try to track the underlying growth of our most important consumer businesses, and I want to share both of those. When we look at the Shutterfly brand, we saw revenues in Q4 grow 4% year-over-year compared to the Shutterfly brand the year before. When we look at the Shutterfly.com platform, which is really our flagship going forward, right? One of the points of this re-platforming and platform consolidation was to have a single website which had most of our customers that we can drive all those customers to, cross-sell, upsell, et cetera. We saw the Shutterfly.com platform, which also includes the Tiny Prints boutique, grow 6% year over year as compared to the Shutterfly brand alone last year.

Now, I hasten to add, these are not pure apples-to-apples metrics, right? Those metrics would have benefitted this year from some amount of customers migrating their spend from the brands that were either shut down or consolidated. As a reminder, for those of you who are newer to Shutterfly, we shut down My Publisher in May, we shut down Wedding Paper Divas in September, and we migrated Tiny Prints from a separate website to a tab, the Tiny Prints boutique, on the Shutterfly.com website, at the end of June.

Now, when we look at that Shutterfly brand growth in Q3, there's two other things I really want to add that we think impacted it. We took a set of actions both on the marketing side but also on the pricing and promotion sides within Q3 that we think were the right thing for the business, but will have been additional headwinds to growth in Q3. So, on the marketing side, as we've continued to refine our approach to marketing, we've gotten much better at really understanding the true incremental ROI in a given program or a given channel, and we've been systematically reallocating our marketing spend to the places that we think we get the most bang for our buck. In many cases, if we see a program is not performing as well as we'd like, we will shift that spend to a more effective program. In some cases, we choose to drop those dollars to the bottom line, and that will have contributed to the fact that we're able to drop our total marketing expense as a percentage of revenue by 530 basis points year-over-year, so a pretty significant change in our marketing spend. We think it's the right thing for the business, but there definitely will have been some additional headwinds to Shutterfly brand growth from that.

Now, on the pricing and promotion side, you also will have seen in our Q3 numbers that we had a lower mix of revenue from free promotions, and for those of you newer to Shutterfly, our free promotions are where we give away a product for free but make a margin on the shipping. These free promotions are really useful tactical promotions to drive specific tactical goals and consumer actions, but we're a premium brand and we want to be careful that that mix is appropriate to our premium brand. We think of it as a spice in the recipe; we don't want it to dominate the overall--the final dish. And so that lower mix of free promotions, again, what we think was the right thing for the business for the long term, also will have presented a little bit of an extra headwind for growth to Shutterfly brand in Q3.

Now, if we shift from Shutterfly brand to the question of how we're doing in migrating customers from the brands we shut down, or migrated to the new Shutterfly.com experiences, you know, I want to start by saying, especially for those newer to the Shutterfly story, you know, we've always expected that we would experience a significant revenue loss along the way from the those brands, right? You can't shut down websites completely and make very big changes to websites without losing some of those customers and some of that revenue along the way, and that's always been factored into our forecasts and our guidance. But it is those changes which have allowed us to move forward with greater focus and with a significant cost savings, as well as the ability to have all of our customers or substantially all of our customers, on a single consumer platform. So that expected decline is factored into our guidance.

Now, what we've seen over the course of this migration, and in particular in Q3, really reinforces our beliefs and the beliefs that are built into our guidance around revenue retention in Q4 and beyond. So, internally, the metric that we believe is the best leading indicator for that revenue retention is by looking at past Tiny Prints customers and asking ourselves how many of those customers do we see purchasing somewhere within the Shutterfly.com family, the Shutterfly family, last year in Q3, and how many have we seen in this Q3. And what gives us a lot of optimism is that we saw a very modest decline in that metric, so what that says to us is that customers who shopped in Tiny Prints previously feel comfortable with what they're seeing on the Shutterfly.com website, and that has kind of reinforced our decision to reiterate our guidance for Q4 and for the full year.

Now, I hasten to add that Q4 is very different than Q1 to Q3, right? Particularly for Tiny Prints, where we see most of our revenue in Tiny Prints happening in Q4. 70% of our annual revenue in Tiny Prints has happened in Q4 in the past, and we benefitted from an enormous year-over-year Q4 to Q4 loyalty. We will only be able to know for sure as we go through the peak and really see those customers coming back, but we do think this is the best leading indicator.

Stepping back from all that detail, what I'd say is that we continue to feel good about the underlying health and the potential future growth of the Shutterfly brand and more broadly of our now-Shutterfly.com website. We haven't changed our point of view on overall consumer growth in 2017 or 2018. We've said and we continue to believe that we will experience significant revenue losses from the non-Shutterfly brands, and that's built into our expectation of a mid-single-digit decline in consumer revenue in Q4, but within

that we expect to have healthy growth from Shutterfly and reasonably good revenue retention, as we said, based on the factors we've seen so far.

As we look ahead to 2018, we continue to feel good about our ability--to 2018 and beyond--our ability to reaccelerate consumer growth beginning in the back half of 2018, and of course we also see strong potential in our enterprise business. Coming back to your very original question about how we're going to go about driving accelerated growth, I'll say that just at a high level, there are four areas of focus. We can go deeper on this if you want. Within the consumer business, it's going to be all about how we simplify the process of creating and purchasing a personalized product. It's going to be about how we expand the range of products we sell, a strategy that's served Shutterfly well for 17 years. And it's going to be about how we drive that consumer migration to mobile, something I think we're well underway with a very significant increase in revenue coming from mobile in Q3. And then within our enterprise business, it's really about how we leverage our world-class manufacturing platform to reach an even broader group of businesses.

So that's kind of where I think we are in the journey. Now, we've finished phase one, platform consolidation done, restructuring is substantially done. We're going to have four quarters of tough comps now, and now we're in a position where all of our energy is towards driving the reacceleration of the consumer business and driving the continued success of the enterprise business as we go to 2018 and beyond.

Jim Shaughnessy: Got it. That's helpful. A lot of detail there. And I guess just on a finer point, you mentioned expectations for 2018. Earlier in the year, you put out sort of high-level guidance about your expectations for 2018. Doesn't sound like, with what has happened in 2017, those expectations are changing at all.

Chris North: No, I mean, we gave high-level targets for 2018 and we've reaffirmed those, right? So we're expecting, in very broad numbers, and of course as we come back after Q4 and Q4 earnings, we'll give a lot more detail about our guidance for 2018, so we call these targets that we've reiterated. We're expecting around \$70 million of revenue growth in 2018, with all those tough comps, to generate \$50 million in incremental adjusted EBITDA and \$50 million in incremental operating income.

Jim Shaughnessy: Okay, great. And I want to touch on something that you mentioned, and I think it's been pretty noticeable since the new team has taken over. Just in terms of the product innovation at Shutterfly, maybe talk a little bit about what has gone into that, has that been a key area of focus? I mean, I assume that'll be a big focus going forward, but where does that fit in the overall strategy?

Chris North: Yeah. I mean, that's a great question. Look, I believe really deeply--this would not probably surprise you, given my ten years at Amazon--but I really, really deeply that the way you earn the right to grow and to grow properly over time is primarily through product innovation, right? It's by shipping and products and customer experiences that are better tomorrow than they were yesterday, right? That's how you drive long-term growth.

And for Shutterfly, product innovation really happens on two levels. There's the physical products themselves, but there's also the services, the consumer experiences, and we're focused on both of those. And if you look--if you go back to the consumer growth levers, I think those really speak very strongly to both types of product innovation, so we've continued over the course of this year to introduce new products to our existing categories. We've launched I think 20 new personalized gift and home décor products here today, we've got new formats across photobooks and cards and stationeries and most of our categories, frankly. We've added more than 25 new products to the app just over the last couple quarters, so--continuing to expand the range of products we sell.

I will tell you that, frankly, I find it frustrating in how long it takes us to introduce new physical products at Shutterfly, and something we're working very hard on is how we accelerate that process so our time to market is shorter and the cost of bringing new products to market is faster. And what you should expect from us over time is both that we will increase the pace at which we launch new products, launching more new products every year, but also that we'll begin to enter whole new categories, and we'll share more detail about that in the beginning of 2018.

On a more technical side of products, our interests have gone across the board from how we remove the barriers to customers shopping with us. Quite frankly, at the time I joined the company, our website were slow and not always as stable as we would have liked. And so, we've updated each quarter on 20%-plus, sometimes greater, increases in speed, latency in technical terms. We've driven much more stability on the website and in the app. We've simplified customer experiences across the board. I think the mobile app is a great example of how we've taken the experience of creating, say, a photobook from a 10- or 15-hour process to something you can do in 10 minutes.

You know, aspirationally, where we want to be--and just think about this as something that you approach asymptotically; you don't necessarily get to it tomorrow--is the concept that you can create and purchase a product in just a couple of clicks. We don't think we're going to go out and find the next 10 or 20 million customers who want to spend 15 hours making a photobook. We need to deliver super simple experiences.

But I think you've also seen product innovation in the fact that we're moving to being much more a test-and-run company, right? Running many, many tests simultaneously. We shared in Q3 we're running some tests that we were excited about, ranging from tests around automated product creation and personalized marketing to tests in which very small changes like opting people in by default to have their photos uploaded to the cloud contributed to a very significant increasing number of photos coming into our photo cloud, and very importantly, that those additional photos lead to additional revenue. So I think we are increasingly going to be a product innovation web company. That's a journey we're on. We still have work to do.

Jim Shaugnessy:

Oh, great. And you touched on mobile there, and obviously mobile's been a key focus for the company. What percent, if you can, or maybe ballpark it for us, percent of the

products can you actually create on mobile app versus just having to go to the desktop or use mobile web?

Chris North:

Yeah. So, a couple things on mobile. So, if you go back a year, if you go back 14 months ago, we did not have modern apps. Back in September of last year, we really launched our first modern iOS/Android apps. We've tended to ship new builds of those twice a month since then, sometimes more frequently, sometimes less. Our pace of product (inaudible) innovation in mobile is such that we can see an idea that we really like--we might take inspiration from a whole other industry's app or user interface here, and we could sometimes be testing those in our app within two to four weeks. So we've been driving a lot of improvements to the app, but also, importantly, as you mentioned, adding a lot of our products to the app.

Today, it's still a relatively small set of our products that are purchased in the app. As of Q3, we now have products representing every category. We launched our Android photobooks offer earlier this year. We launched calendars in iOS and android in Q3. Photobooks were in iOS as of last September. A year ago September, excuse me. So while it's still a relatively small subset of products, you can assume we've tended to put the most important ones there first, and we'll continue expanding the range of products that can be built within the app.

I think what's really exciting about the app is two things. One is--let me even step back and just make a higher-level comment. You know, I think we've seen a lot of companies over the last 5 to 10 years really struggle with their business model as their customers went into mobile. They've not always succeeded to make that transition. And I think what's exciting for us is that we are making that transition now, and very successfully.

In Q3, we had 29% of our revenue on the Shutterfly brand in the app. That was a 500 points increase year-over-year. We also said in Q3 that--a metric we revealed for the first time--that while the first year purchases from a customer, or the first 12 month purchases from a customer in the app are somewhat lower in the app than on the website, they are very healthy. And because our cost of acquiring a new customer in the app is cheaper than on the desktop website, the ROI in percentage terms of acquiring customers in the app and then kind of if you look at that CAC to LTV, are superior for us in the app. So we feel like we are set up very well to make that mobile transition successfully, and we're looking forward to the point when app is becoming a significant contributor to our growth rate. We think we're on track for that over time.

The other thing is--maybe this is obvious, but the app and the mobile phone are so important for us, even more so than a typical e-commerce company, because the mobile phone is where you take all your pictures and it's where you store all your pictures, and it's the main place you consume your pictures. So the fact that we are being successful in getting onto millions of downloads a quarter and getting the customer adoption I think is super important for us.

Jim Shaughnessy:

Absolutely. Kind of touching on that topic a little bit, I think there was a recent announcement this quarter with Apple, first-time consumers can actually create a Shutterfly product inside a third party platform.

Chris North:

Yes.

Jim Shaugnessy: This seems like a pretty significant change for the company in that now you don't necessarily need to go to Shutterfly to actually build a book. You actually go to another platform. Are there other opportunities like this that exist out there? Would you consider partnership opportunities with maybe other e-commerce sites to be sort of the backend product creation product equivalent?

Chris North: You know, we think about this really on three levels. So we know that we are not going to be the only game in town about where our customers choose to back up, organize, and consume their photos. In fact, we're unlikely to be the number one. There are some pretty big players in that game. We think we do well at that. We offer a great service for our customers. We revealed the very significant increase in the number of photos being uploaded to our cloud, so clearly, customers use us that way. But customers are going to store their photos across many ecosystems, whether it's Google or Flickr or Amazon or Facebook or Instagram or Snap or some platform we don't know about yet.

So, first of all, it's really important to us that we be agnostic about where photos live. We need to make it super simple for customers to bring those photos in to Shutterfly to create. And that's something we've done for a while, but we've improved--we've made that even easier for customers, both with the Apple integration, but also with an improved Google Photos integration. So that's all about making it simple for people to bring their photos into the Shutterfly ecosystem to create, and we have clear evidence that if you help customers bring more photos in, they purchase more.

Now, what you're referring to with Apple really was a first for us. It's the first time that we've made it possible for customers to create and purchase a Shutterfly product outside of the Shutterfly ecosystem without having to come to Shutterfly in the first place. I think there's a couple of important things to know about that, just to get into the details. One is these are still our customers. They create a Shutterfly account, we have their email address, we have the right to market to them. So we are the seller of record in that situation. And the second thing is their photos do ultimately come back into the Shutterfly ecosystem for them for backup, and for them to use in other cases.

You know, for us, really, Apple was both an almost unique opportunity. We were only one of five companies in the world invited to participate in the phase one launch of the new Apple Photos product for the new Mac desktop operating system. It was also a proof of concept for us, to do the technical work, to be able to take at least the most basic elements of product creation and product discovery and push them into another ecosystem, and we'd love to be able to do that with other ecosystems as well. I mean, to be very blunt, we don't have a billion monthly active users there. Some other platforms do. So if we have other opportunities to do that, we will seize them. These are, as you can imagine, complicated deals, both from a business point of view and from a technical point of view. But we've proven we can do it, we've proven that we have the trust with these major ecosystem players to be the first in the gate.

I think the third angle is when we step back and think about Shutterfly as a whole in our enterprise business, we are the world's largest four-color digital printer. We think we're the best. We think we have very significant advantages from our scale and our expertise in cost and quality and turnaround time, yet we operate at a fairly low utilization of our manufacturing platform for much of the year outside of Q4. So our SBS business has

been one way that we've tried to utilize that excess capacity, and we've seen continued success there. Generally, we want to be an open manufacturing platform that can be used by lots of different types of companies over time, and so we also see long-term opportunities to really make that infrastructure available to others.

Jim Shaugnessy: Yeah. Okay, great. We have a full room here, so I wanted to see if--we have a few minutes left, if anyone has any questions from the audience? Okay, yes. Go ahead.

Unidentified Audience Member: If you look at 2018, that \$70 million in revenue, I think you initially said it was sort of let out roughly 50/50 (inaudible) consumer (inaudible) you're still thinking consumer will be roughly half of that. And if you think about the trajectory, that probably implies fourth quarter next year, something of 6%, 7%, like that. Is that the right way to think about consumer sort of recovery over the next 12 to 18 months?

Chris North: Yeah, Sam, so when we come back after Q4 earnings, we'll go into more detail about our kind of formal guidance for next year. So I'm not going to go beyond what we've said there. I think, like without confirming any specific numbers, I think you're broadly thinking about it the right way in the sense that in Q1 and Q2, we're still going to be comparing to a period before we shut down some of these major--or began the transition of some of these non-Shutterfly brands. In Q3, it's not quite a like-for-like comp. We still have Wedding Paper Divas operating in the prior year for much of the quarter. Q4 is our first like-for-like comp.

But I think broadly speaking, we still have relatively tough comps in the first two quarters, and we will see reacceleration in Q3, but particularly in Q4. So I think that's the right way to think about the shape of it. I'll also add, just beyond the kind of mathematical comps, the set of things that we've been working on, even as we go through the restructuring and the platform consolidation, these things will have had a lot more time to bake in. We think we'll have made continued progress against mobile, against the speed and reliability of our platforms. Again, simplicity. We'll introduce new products. We will by then have shared more details what we're doing in terms of (inaudible) and range expansion. So I do think that's the right way to think about it.

Unidentified Audience Member: When you look at Tiny Prints, especially (inaudible) remained on 3Q, given that 4Q is so much more of a jump-off what with holiday cards, why is that the right assumption? It seems to me that the attach rate, or whatever that metric is, would not (inaudible) 4Q because it is so much more of a holiday card (inaudible).

Chris North: Yeah. So, look, I will broadly agree with you. Like, I don't think there is any data we get--for when we talk about Tiny Prints in particular, which is so Q4-centric. And our business Q1 to Q3 is a completely different business in Tiny Prints than it is in Q4. Q4 and Tiny prints is primarily a loyalty business where customers who bought a year ago in Q4 come back and purchase the next Q4. That's a very different dynamic than we see Q1 to Q3. So, broadly, I will agree with you. There is no perfect leading indicator for Q4 in Tiny Prints.

What gives us a lot of comfort is the fact that both in the anecdotal feedback, so when we look at Tiny Prints customers' qualitative feedback to us, through surveys and through customer service and otherwise, we see customer satisfaction levels level to improving year-over-year. And second, when we actually go look at how people who have

purchased and Tiny Prints customers are coming and purchasing both on Tiny Prints boutique and more broadly across the Shutterfly.com platform, we're seeing very similar levels of engagements. Now, it's not a perfect leading indicator, but it does tell us one thing, which is people who have gone on Tiny Prints previously seem very comfortable with our new experience. So that's why I say that directionally, that gives us more comfort about our assumptions for Q4.

Unidentified Audience Member: Do you see (inaudible) at all? I don't recall when that one was pushed over, but for example, if I clicked on Tiny Prints (inaudible) updated search takes me to a site that the first time I get my head around it, half brand is Shutterfly and half brand is Tiny Prints. Did you see conversion (inaudible) when you first implemented that changeover?

Chris North: Yeah. I think we're at a level of metrics that we don't disclose. I think what I'd say is that we have followed very carefully what's happening to the customers who have previously been Tiny Prints customers, whether it's a year ago or two years ago, and we're looking at how their behavior is changing year-over-year. And what we're seeing, both in terms of the actual visits and purchasing behavior and other type of metrics we'd naturally look at, and the qualitative feedback, sometimes very structured qualitative feedback, makes us feel pretty good that it supports the assumptions that underpin our guidance. To the extent that it's even better, then that'll be a tailwind for Q4.

Jim Shaugnessy: And with that, guys, we're out of time. Thanks a lot.

Chris North: Great. Thank you.

Jim Shaugnessy: Appreciate it, Chris.