

BLACKHAWK NETWORK HOLDINGS, INC  
Form 10-Q  
October 14, 2014  
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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 September 6, 2014

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: 001-35882

BLACKHAWK NETWORK HOLDINGS, INC.  
(Exact Name of Registrant as Specified in Its Charter)

Delaware 43-2099257  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

6220 Stoneridge Mall Road 94588  
Pleasanton, CA  
(Address of Principal Executive Offices) (Zip Code)

(925) 226-9990  
(Registrant's Telephone Number, Including Area Code)

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 checkmark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter time period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

As of October 7, 2014, there were 12,677,000 shares of the Registrant's Class A common stock outstanding and 40,320,000 shares of the Registrant's Class B common stock outstanding.

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PART I. FINANCIAL INFORMATION  
ITEM 1. FINANCIAL STATEMENTS  
BLACKHAWK NETWORK HOLDINGS, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(In thousands, except par value)  
(Unaudited)

	September 6, 2014	December 28, 2013	September 7, 2013
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents	\$ 219,851	\$ 550,380	\$ 103,453
Restricted cash	5,000	—	—
Overnight cash advances to Safeway	—	—	9,000
Settlement receivables, net	272,912	813,448	167,945
Accounts receivable, net	125,976	126,369	91,634
Deferred income taxes	20,145	20,145	10,499
Prepaid expenses and other current assets	71,802	67,474	57,674
Total current assets	715,686	1,577,816	440,205
Property, equipment and technology, net	95,368	79,663	71,384
Intangible assets, net	85,083	98,689	22,198
Goodwill	172,866	133,521	42,729
Deferred income taxes	727	727	983
Other assets	86,590	90,678	70,473
<b>TOTAL ASSETS</b>	<b>\$ 1,156,320</b>	<b>\$ 1,981,094</b>	<b>\$ 647,972</b>

See accompanying notes to condensed consolidated financial statements

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BLACKHAWK NETWORK HOLDINGS, INC.  
 CONDENSED CONSOLIDATED BALANCE SHEETS (continued)  
 (In thousands, except par value)

	September 6, 2014	December 28, 2013	September 7, 2013
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
Current liabilities:			
Settlement payables	\$ 472,629	\$ 1,484,047	\$ 351,938
Consumer and customer deposits	65,607	54,915	8,670
Accounts payable and accrued operating expenses	89,633	99,499	59,448
Current portion of note payable	8,708	—	—
Note payable to Safeway	8,473	—	—
Other current liabilities	49,695	81,270	41,817
Total current liabilities	694,745	1,719,731	461,873
Deferred income taxes	23,312	24,488	9,959
Note payable	165,446	—	—
Other liabilities	29,115	8,711	15,986
Total liabilities	912,618	1,752,930	487,818
Commitments and contingencies (see Note 8)	—	—	—
Stockholders' equity:			
Preferred stock: \$0.001 par value; 10,000 shares authorized; no shares outstanding	—	—	—
Class A common stock: \$0.001 par value; 125,000 shares authorized; 12,678, 12,188, and 11,550 shares outstanding, respectively	13	12	11
Class B common stock: \$0.001 par value; 125,000 shares authorized; 40,297, 40,252, and 40,429 shares outstanding, respectively	41	41	41
Additional paid-in capital	125,267	107,139	95,225
Treasury stock	(508)	(126)	(50)
Accumulated other comprehensive loss	(7,556)	(2,873)	(2,930)
Retained earnings	119,730	116,975	67,713
Total Blackhawk Network Holdings, Inc. equity	236,987	221,168	160,010
Non-controlling interests	6,715	6,996	144
Total stockholders' equity	243,702	228,164	160,154
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 1,156,320</b>	<b>\$ 1,981,094</b>	<b>\$ 647,972</b>
See accompanying notes to condensed consolidated financial statements			

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except for per share amounts)

(Unaudited)

	12 Weeks Ended		36 Weeks Ended	
	September 6, 2014	September 7, 2013	September 6, 2014	September 7, 2013
<b>OPERATING REVENUES:</b>				
Commissions and fees	\$201,888	\$ 158,270	\$596,324	\$ 479,564
Program, interchange, marketing and other fees	43,895	25,352	119,981	78,617
Product sales	23,244	22,374	69,781	58,727
Total operating revenues	269,027	205,996	786,086	616,908
<b>OPERATING EXPENSES:</b>				
Distribution partner commissions	137,506	105,361	400,123	319,496
Processing and services	46,715	34,927	133,654	101,321
Sales and marketing	41,704	30,486	126,274	98,743
Costs of products sold	21,946	21,423	66,745	55,782
General and administrative	16,163	10,320	41,700	33,115
Business acquisition expense (benefit) and amortization of acquisition intangibles	3,330	(255 )	11,199	(962 )
Total operating expenses	267,364	202,262	779,695	607,495
<b>OPERATING INCOME</b>	1,663	3,734	6,391	9,413
<b>OTHER INCOME (EXPENSE):</b>				
Interest income and other income (expense), net	182	59	126	432
Interest expense	(1,080 )	—	(2,081 )	—
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	765	3,793	4,436	9,845
<b>INCOME TAX EXPENSE</b>	352	1,544	1,844	5,332
<b>NET INCOME BEFORE ALLOCATION TO NON-CONTROLLING INTERESTS</b>	413	2,249	2,592	4,513
Add: Net loss attributable to non-controlling interests (net of tax)	142	106	238	319
<b>NET INCOME ATTRIBUTABLE TO BLACKHAWK NETWORK HOLDINGS, INC.</b>	\$555	\$ 2,355	\$2,830	\$ 4,832
<b>EARNINGS PER SHARE:</b>				
Basic – Class A and Class B	\$0.01	\$ 0.05	\$0.05	\$ 0.09
Diluted – Class A and Class B	\$0.01	\$ 0.04	\$0.05	\$ 0.09
Weighted average shares outstanding—basic	52,609	51,615	52,450	50,811
Weighted average shares outstanding—diluted	54,304	53,074	54,035	51,982
See accompanying notes to condensed consolidated financial statements				

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

	12 Weeks Ended		36 Weeks Ended	
	September 6, 2014	September 7, 2013	September 6, 2014	September 7, 2013
NET INCOME BEFORE ALLOCATION TO NON-CONTROLLING INTERESTS	\$413	\$2,249	\$2,592	\$4,513
Other comprehensive income (loss):				
Currency translation adjustments	(4,163	) (1,413	) (4,682	) (3,228
COMPREHENSIVE INCOME (LOSS) BEFORE ALLOCATION TO NON-CONTROLLING INTERESTS	(3,750	) 836	(2,090	) 1,285
Add: Comprehensive loss attributable to non-controlling interests (net of tax)	145	106	237	319
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO BLACKHAWK NETWORK HOLDINGS, INC.	\$(3,605	) \$942	\$(1,853	) \$1,604

See accompanying notes to condensed consolidated financial statements

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BLACKHAWK NETWORK HOLDINGS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (In thousands)  
 (Unaudited)

	36 Weeks Ended	
	September 6, 2014	September 7, 2013
<b>OPERATING ACTIVITIES:</b>		
Net income before allocation to non-controlling interests	\$2,592	\$4,513
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	32,153	16,963
Program development cost amortization	17,779	13,259
Provision for doubtful accounts and sales adjustments	2,678	2,764
Employee stock-based compensation expense	9,769	5,279
Distribution partner mark-to-market expense	(88	) 6,961
Change in fair value of contingent consideration	—	(1,255 )
Reversal of reserve for patent litigation	(3,852	) —
Excess tax benefit from stock-based awards	(1,364	) (588 )
Other	1,174	80
Changes in operating assets and liabilities:		
Settlement receivables	535,183	338,568
Settlement payables	(1,006,128	) (877,287 )
Accounts receivable, current and long-term	8,721	15,132
Prepaid expenses and other current assets	1,450	(4,624 )
Other assets	(21,466	) (19,894 )
Consumer and customer deposits	6,542	(294 )
Accounts payable and accrued operating expenses	(13,345	) (4,767 )
Other current and long-term liabilities	(12,733	) (16,803 )
Income taxes, net	(22,474	) (15,596 )
Net cash used in operating activities	(463,409	) (537,589 )
<b>INVESTING ACTIVITIES:</b>		
Change in overnight cash advances to Safeway	—	486,000
Expenditures for property, equipment and technology	(25,960	) (21,349 )
Business acquisitions, net of cash received	(16,710	) —
Payment for working capital adjustment for business acquisitions, net	(1,366	) —
Cash received for assumption of liabilities from prior business acquisition	3,917	—
Change in restricted cash	(5,000	) 8,968
Other	—	(250 )
Net cash provided by (used in) investing activities	(45,119	) 473,369

See accompanying notes to condensed consolidated financial statements



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BLACKHAWK NETWORK HOLDINGS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)  
 (In thousands)  
 (Unaudited)

	36 Weeks Ended	
	September 6, 2014	September 7, 2013
<b>FINANCING ACTIVITIES:</b>		
Proceeds from issuance of note payable	175,000	—
Payments of costs for issuance of note payable	(2,451)	) —
Proceeds from note payable to Safeway	8,473	—
Repayment of debt assumed in business acquisition	(7,474)	) —
Payments for acquisition liability	—	(2,281)
Payments for initial public offering costs	—	(4,694)
Reimbursements for initial public offering costs	—	5,540
Proceeds from issuance of common stock from exercise of employee stock options and employee stock purchase plans	5,895	359
Excess tax benefit from stock-based awards	1,364	588
Other	(778)	) (872)
Net cash provided by (used in) financing activities	180,029	(1,360)
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS</b>	(2,030)	) (3,632)
<b>DECREASE IN CASH AND CASH EQUIVALENTS</b>	(330,529)	) (69,212)
<b>CASH AND CASH EQUIVALENTS—Beginning of year</b>	<b>550,380</b>	<b>172,665</b>
<b>CASH AND CASH EQUIVALENTS—End of period</b>	<b>\$219,851</b>	<b>\$103,453</b>
<b>Noncash investing and financing activities:</b>		
Financing of business acquisition with stock	\$1,595	\$—
Financing of business acquisition with contingent consideration	\$24,100	\$—
Reclassification of warrant and common stock liabilities to additional paid-in capital upon initial public offering	\$—	\$27,121
Reclassification of redeemable equity to stockholders' equity upon initial public offering	\$—	\$36,171
Intangible assets recognized for the issuance of fully vested warrants	\$—	\$22,183
See accompanying notes to condensed consolidated financial statements		

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BLACKHAWK NETWORK HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. The Company and Significant Accounting Policies

The Company

Blackhawk Network Holdings, Inc., together with its subsidiaries (we, us, our), is a leading prepaid payment network utilizing proprietary technology to offer a broad range of prepaid gift, telecom and debit cards, in physical and digital forms, as well as related prepaid products and payment services in the United States and 21 other countries. Our payment network supports our key constituents: consumers who purchase or receive the products and services we offer, content providers who offer branded gift cards and other prepaid products that are redeemable for goods and services, distribution partners who sell those products and business partners that distribute our products as incentives and rewards. Our product offerings include gift cards, prepaid telecom products and prepaid financial services products, including general purpose reloadable (GPR) cards and our reload network (collectively, prepaid products). We offer gift cards from leading consumer brands (known as closed loop) as well as branded gift and incentive cards from leading payment network card associations such as American Express, Discover, MasterCard and Visa (known as open loop) and prepaid telecom products offered by prepaid wireless telecom carriers. We also distribute GPR cards, including Green Dot and NetSpend branded cards, as well as PayPower, our proprietary GPR card. We operate a proprietary reload network named Reloadit, which allows consumers to reload funds onto their previously purchased GPR cards. We distribute products across multiple high-traffic channels such as grocery, convenience, specialty and online retailers (referred to as distribution partners) in the Americas, Europe, Africa, Australia and Asia.

Spin-Off

Prior to April 14, 2014, we were a majority-owned subsidiary of Safeway Inc. (Safeway). On April 14, 2014, Safeway distributed its remaining 37.8 million shares of our Class B common stock to Safeway stockholders (the Spin-Off). As a result of the Spin-Off, we became a stand-alone entity separate from Safeway. See Note 7—Income Taxes and Note 9—Related Party Transactions for disclosures regarding this relationship.

Basis of Presentation

The accompanying condensed consolidated financial statements of Blackhawk Network Holdings, Inc. are unaudited. We have prepared our unaudited interim condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP) and applicable rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. We have condensed or omitted certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP pursuant to such rules and regulations. Accordingly, our interim condensed consolidated financial statements should be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K, filed with the SEC on March 17, 2014 (the Annual Report). We have prepared our condensed consolidated financial statements on the same basis as our annual audited consolidated financial statements and, in the opinion of management, have reflected all adjustments, which include only normal recurring adjustments, necessary to present fairly our financial position and results of operations for the interim periods presented. Our results for the interim periods are not necessarily reflective of the results to be expected for the year ending January 3, 2015 or for any other interim period or other future year. Our condensed consolidated balance sheet as of December 28, 2013, included herein was derived from our audited consolidated financial statements as of that date but does not include all disclosures required by GAAP, including notes to the financial statements.

Our condensed consolidated financial statements include Blackhawk Network Holdings, Inc., a Delaware corporation, and its wholly- or majority-owned domestic and foreign subsidiaries. All intercompany transactions and balances among us and our subsidiaries have been eliminated in consolidation. Our condensed consolidated financial statements have been prepared as if we existed on a stand-alone basis for the periods presented, but may not necessarily reflect the results of operations, financial position or cash flows that would have been achieved if we had existed on a stand-alone basis separate from Safeway during the periods presented.

Prior to the Spin-Off, our condensed consolidated financial statements included an allocation of expenses arising from certain shared services and infrastructure provided by Safeway. These expenses primarily related to facilities rental

and tax services and were allocated using actual costs or estimates based on the portion of services used by us. Management believes that the allocation methodology was reasonable and considers the charges to be a reasonable reflection of the cost of benefits received. Following the Spin-Off, Safeway continues to rent facilities to us and provide certain tax services (related to tax periods through the Spin-Off) based on similar pricing terms as prior to the Spin-Off.

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### Significant Accounting Policies

There have been no material changes to our significant accounting policies, as compared to the significant accounting policies described in the audited consolidated financial statements and related notes included in the Annual Report.

### Use of Estimates

The preparation of our condensed consolidated financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and the accompanying notes to the condensed consolidated financial statements. We generally base our estimates and assumptions on a combination of historical factors, current circumstances, and the experience and judgment of management. Significant estimates and assumptions include, among other things, allowances for doubtful accounts and sales adjustments, useful lives of assets, card redemption patterns and lives, delivery timing for product sales and valuation assumptions with respect to acquisition liabilities, goodwill, other intangible assets, common stock and income taxes. Actual results could differ from our estimates.

### Seasonality

A significant portion of gift card sales occurs in late December of each year during the holiday selling season. As a result, we earn a significant portion of revenues, net income and cash inflows during the fourth fiscal quarter of each year and remit the majority of the cash, less commissions, to our content providers in January of the following year. The timing of our fiscal year-end, December holiday sales and the related January cash settlement with content providers significantly increases our Cash and cash equivalents, Overnight cash advances to Safeway, Settlement receivables and Settlement payables balances at the end of each fiscal year relative to normal daily balances. The cash settlement with our content providers in January accounts for the majority of the use of cash from operating activities in our condensed consolidated statements of cash flows during our first three fiscal quarters. Additionally, our operating income may fluctuate significantly during our first three fiscal quarters due to lower revenues and timing of certain expenses during such fiscal periods. As a result, quarterly financial results are not necessarily reflective of the results to be expected for the year, any other interim period or other future year.

### Restatement

Subsequent to the issuance of our third quarter 2013 condensed consolidated financial statements, we identified certain IRS limitations related to stock-based compensation as a result of our initial public offering in that quarter that should have been considered in our reported income tax expense for that quarter. Therefore, we have corrected previously issued condensed consolidated financial statements for the 36 weeks ended September 7, 2013 for a \$1.4 million increase in income tax expense, decrease to Net income attributable to Blackhawk Network Holdings, Inc. and related impacts to our condensed consolidated balance sheets and statements of comprehensive income and cash flows. We have also corrected Basic and Diluted Earnings per Share – Class A and Class B from previously reported amounts of \$0.12 and \$0.12, respectively, for the 36 weeks ended September 7, 2013. Management does not consider these amounts to be material to our previously issued unaudited condensed consolidated financial statements.

### Reclassification

In the accompanying condensed consolidated balance sheets, we have reclassified amounts previously reported as Accounts payable and accrued liabilities into Consumer and customer deposits, Accounts payable and accrued expenses and Other current liabilities. We have made the corresponding reclassifications in the condensed consolidated statements of cash flows and have combined the changes of Other current liabilities and Other liabilities as Other current and long-term liabilities. Additionally, we have reclassified the Change in the provision for doubtful accounts and sales adjustments from previously reported amounts to (i) the Provision for doubtful accounts and sales adjustments, (ii) changes in operating assets and liabilities for Settlement receivables and (iii) changes in operating assets and liabilities for Accounts receivable, current and long-term.

In the accompanying consolidated statements of operations, we have reclassified certain amounts from previously reported amounts in various Operating expenses, including the change in fair value of contingent consideration and acquisition-related expenses previously reported in General and administrative expense, to Business acquisition expense (benefit) and amortization of acquisition intangibles.

### Restricted Cash

Restricted cash represents funds held in an escrow account related to one of our acquisitions. See Note 2—Business Acquisitions.

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## Financing Costs

We incurred debt issuance costs and paid certain costs to the group of banks in conjunction with entering into our credit agreement, which included a note payable and revolving credit facility (see Note 4—Financing). We allocated the costs paid to the group of banks between the note payable and revolving credit facility based on their relative fair values and recognized them as discount on note payable and deferred revolving credit facility costs, respectively. We present the deferred revolving credit facility costs and debt issuance costs (collectively, deferred financing costs) in Other assets and the discount on the note payable as a reduction of the carrying value of the Note payable in our accompanying condensed consolidated balance sheets. We amortize the deferred financing costs and discount on note payable on a straight-line basis over the term of the credit agreement as the difference between the straight-line method and effective interest method is immaterial to our consolidated financial statements.

## Revenue Recognition

Post-Activation Program Management Fees—During the 36 weeks ended September 6, 2014, pursuant to contract amendments with certain of our card-issuing banks of our open loop Visa gift and incentive cards, the issuing banks agreed to replace certain account service fees and fund expiration fees with a program management fee, defined as a contractually-determined percentage of load value. We recognize these fees in the same manner as our other program management fees described in our Annual Report. Certain of these issuing banks agreed to compensate us under this arrangement for cards activated from January 1, 2014 or other prior periods. Certain of these amendments also provide that, in addition to the program management fee, the issuing banks will compensate us in the same amount that the issuing bank would have paid to us as account service fees and fund expiration fees on such cards to the extent that such fees exceed the program management fees previously paid to us.

## Recent Accounting Pronouncement

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2014-09 Revenue from Contracts with Customers (Topic 606). ASU 2014-09 supersedes all previous revenue recognition guidance with a single revenue recognition model. This new guidance is to be applied retrospectively either to each reporting period presented or with the cumulative effect of initially applying the guidance at the date of initial application for reporting periods beginning after December 15, 2016. Early adoption is not permitted. Management is still evaluating the impact of this guidance.

## 2. Business Acquisitions

## 2014 Acquisitions

## Parago, Inc.

On September 24, 2014, we entered into a definitive agreement to acquire Parago, Inc. and its subsidiaries, a leader in providing global incentive and engagement solutions, for approximately \$291 million, consisting of cash purchase consideration of approximately \$256 million, subject to certain adjustments for working capital, and debt assumed of approximately \$35 million. The acquisition is expected to close by the end of October 2014, subject to certain conditions, including receipt of certain regulatory approvals. If consummated, this acquisition will allow us to deliver expanded capabilities and products in the consumer and corporate incentives markets. We plan to finance the purchase using cash on hand and approximately \$200 million in new borrowings under an expansion of our current credit facility.

## Other 2014 Acquisitions

During the 36 weeks ended September 6, 2014, we acquired CardLab, Inc. and its subsidiaries (CardLab), a leading online provider of customizable prepaid incentive and rewards cards, and Incentec Solutions, Inc. (Incentec), which provides cloud-based software solutions in the incentives and rewards industry, for total purchase consideration of \$44.6 million. These acquisitions have enhanced our product and service offerings in our incentives business. We accounted for these acquisitions as business combinations and have included their results of operations in our accompanying condensed consolidated financial statements starting on the acquisition dates. The following table summarizes the components of the purchase consideration based on their fair values at the acquisition dates (in thousands):

Cash paid at closing	\$18,898
Stock consideration	1,595

Contingent consideration	24,100
Total purchase consideration	\$44,593

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Stock consideration consists of 61,840 shares of our Class A common stock. Contingent consideration resulting from our acquisition of CardLab consists of three cash payments: i) up to \$2.5 million based on CardLab's 2014 financial results, ii) \$0, \$1.25 million or \$2.5 million dependent upon the contract execution and subsequent launch of a certain incentive program by certain specified dates and iii) up to \$46.5 million based on CardLab's 2015 financial results for certain incentive programs. We estimated the fair value of the contingent consideration based on our estimates of the probability of achieving these targets and discount rates ranging from 4.6% to 15.0%, reflecting the risk profiles of meeting these targets (see Note 3—Fair Value Measurements) and present such amounts in Other current liabilities or Other liabilities in our condensed consolidated balance sheets. We placed \$5.0 million in an escrow account for the contingent consideration related to the 2014 financial results and the execution and launch of the incentive program and present such amounts as Restricted cash in the accompanying condensed consolidated balance sheets.

We allocated the total purchase consideration to tangible net assets and identifiable technology and intangible assets based on the estimated fair value of each asset and liability and recorded the excess purchase price over the fair value of the net assets as goodwill. Goodwill represents the value of the future cash flows from new customers and the launch of new incentive programs, our prior relationship with Incentec and the value of the assembled workforce. Goodwill is not expected to be deductible for income tax purposes. The following table summarizes the initial purchase price allocation, and we may make adjustments to these amounts through the one year measurement period to finalize information regarding forecasting assumptions, other relevant valuation assumptions, working capital, amounts due to or from us regarding working capital and income taxes (in thousands):

Tangible liabilities, net	\$(1,112 )
Debt assumed	(7,474 )
Deferred taxes	756
Identifiable technology and intangible assets	11,123
Goodwill	41,300
Total purchase consideration	\$44,593

We repaid all of CardLab's outstanding debt of \$7.5 million on the acquisition date and present such payments as Repayment of debt assumed in business acquisition in our condensed consolidated statements of cash flows.

The following table summarizes the components of the identifiable technology and intangible assets and their estimated useful lives at the acquisition date (dollars in thousands):

	Fair Value	Useful Life
Customer relationships	\$1,250	5 years
Back-log	1,610	4 months
Technology	8,180	5 years
Trade name	83	3 years
Total identifiable technology and intangible assets	\$11,123	

Customer relationships represent the estimated fair value of the underlying relationships and agreements with the acquirees' customers. Back-log represents the estimated fair value resulting from cards issued prior to the acquisition date, resulting from revenues, including interchange and account service fees. Technology consists of Incentec's cloud-based software solutions and CardLab's internal-use software used for the order, fulfillment and management of customer orders. Trade name represents the fair value of the brand and name recognition associated with the acquirees.

We valued customer relationships, back-log, trade name and Incentec's technology using the income approach and CardLab's technology using the cost approach. Significant assumptions include forecasts of revenues, costs of revenue, development costs and sales, general and administrative expenses and estimated attrition rates for customers. We discounted the cash flows at various rates reflecting the different risk profiles of the assets.

Acquisition related costs totaled \$0.4 million and are included in Business acquisition expense (benefit) and amortization of acquisition intangibles expense. Revenues and earnings from closing and pro forma financial information are not presented, as amounts are not material to our condensed consolidated financial statements.





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## 2013 Acquisitions

As discussed in our Annual Report, in the fourth quarter of 2013, we acquired Retailo AG and its subsidiaries (collectively, Retailo) and substantially all of the net assets of InteliSpend Prepaid Solutions, LLC, and its subsidiaries (collectively, InteliSpend). We have included the results of Retailo and InteliSpend in our consolidated financial statements since the acquisition dates.

The following pro forma financial information summarizes the combined results of operations of us, Retailo and InteliSpend as though we had been combined as of the beginning of fiscal 2012 (in thousands):

	12 Weeks Ended September 7, 2013	36 Weeks Ended September 7, 2013
Total revenues	\$222,624	\$665,545
Net income attributable to Blackhawk Network Holdings, Inc.	1,556	2,824

The pro forma financial information includes adjustments to amortize the identifiable technology and intangible assets starting at the beginning of 2012. The pro forma financial information is for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of 2012.

As discussed in our Annual Report, we had not assumed certain cardholder liabilities nor acquired the related cash for our acquisition of InteliSpend due to requirements for a state regulatory approval. In May 2014, we received such approval and subsequently assumed such liabilities and related cash of \$3.9 million, which we present as Cash received for assumption of liabilities from prior business acquisition in the accompanying condensed consolidated statements of cash flows.

## 3. Fair Value Measurements

We measure certain assets and liabilities at fair value on a recurring basis. The table below summarizes the fair value of these assets and liabilities as of September 6, 2014, December 28, 2013 and September 7, 2013 (in thousands):

	September 6, 2014			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents				
Money market mutual funds	\$86,100	\$—	\$—	\$86,100
Liabilities				
Contingent consideration	\$—	\$—	\$24,100	\$24,100
	December 28, 2013			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents				
Money market mutual funds	\$379,000	\$—	\$—	\$379,000
Liabilities				
Contingent consideration	\$—	\$—	\$—	\$—
	September 7, 2013			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents				
Money market mutual funds	\$28,000	\$—	\$—	\$28,000
Liabilities				
Contingent consideration	\$—	\$—	\$13,485	\$13,485

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Level 1— Unadjusted quoted prices in active markets for identical assets or liabilities. Level 1 investments include money market mutual funds.

Level 2— Inputs other than quoted prices included in Level 1 that are either directly or indirectly observable. Level 2 investments include commercial paper. We did not classify any amounts within Level 2 as of September 6, 2014, December 28, 2013 or September 7, 2013.

In the 36 weeks ended September 6, 2014, there were no transfers between Level 1 and Level 2.

Level 3— Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the inputs that market participants would use in pricing. Level 3 includes the estimated fair value of our contingent consideration liability.

Contingent Consideration—We estimate the fair value of the contingent consideration based on our estimates of the probability of achieving the relevant targets and discount rates reflecting the risk profiles of meeting these targets. A significant increase (decrease) in our estimate of the probability of achieving the relevant targets or a significant decrease (increase) in the discount rate could materially increase (decrease) the fair value of contingent consideration. The change in fair value of contingent consideration classified as Level 3 for the 36 weeks ended September 6, 2014 and September 7, 2013 is as follows (in thousands):

	36 Weeks Ended	
	September 6, 2014	September 7, 2013
Contingent Consideration		
Balance – Year-end	\$—	\$18,947
Decrease in fair value of contingent consideration	—	(1,255 )
Issuance of contingent consideration for acquisition of CardLab	24,100	—
Settlements	—	(4,207 )
Balance – End of period	\$24,100	\$13,485

The decrease in the fair value of contingent consideration is recognized in Business acquisition expense (benefit) and amortization of acquisition intangibles, is presented as a non-cash adjustment to net income in our accompanying condensed consolidated statements of cash flows and reflects the changes in the passage of time, expected timing of the contingent payments, our estimate of the probability of achieving the relevant targets and the discount rate.

Settlements reflect the resolution of the contingency based on achievement of the relevant targets.

As of year-end 2013, we estimated the fair value of contingent consideration from our acquisition of Cardpool to be \$0. As of September 6, 2014, the final measurement period for the Cardpool contingent consideration was concluded, and no amounts were payable based on such measurement period. As a result of our acquisition of CardLab during the 36 weeks ended September 6, 2014, we recognized the fair value of contingent consideration at its acquisition date (see Note 2—Business Acquisitions), and there was no change in the fair value from the acquisition date through September 6, 2014. We estimated the fair value of the contingent consideration based on our estimates of the probability of achieving the relevant targets and discount rates ranging from 4.6% to 15.0%, reflecting the risk profiles of meeting these targets. A significant increase (decrease) in our estimates of achieving the relevant targets or a significant decrease (increase) in the discount rates used could materially increase (decrease) the fair value of the contingent consideration liability.

As of September 7, 2013, settlements of \$3.3 million were payable, and, during the 36 weeks ended September 7, 2013, we paid settlements of \$2.3 million, of which \$1.4 million resulted from fiscal 2012 financial and operational results, which we present as Payments for acquisition liability in our accompanying condensed consolidated statements of cash flows.

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## 4. Financing

On March 28, 2014, we entered into a credit agreement with a group of banks (the Credit Agreement). The Credit Agreement includes a \$175 million 4-year term loan, with an option to increase such loan to \$225 million, and a revolving credit facility of up to \$200 million with up to an additional \$100 million during the year-end holiday period for specific settlement related requirements. The revolving credit facility includes a \$100 million subfacility for the issuance of letters of credit. On September 26, 2014, we exercised the option for the additional \$50 million under the term loan and increased our term loan to \$225 million. Borrowings under the Credit Agreement are secured by a pledge of the assets of Blackhawk Network Holdings, Inc.; substantially all of the assets of certain of its U.S. subsidiaries, including Blackhawk Network, Inc., the primary U.S. operating subsidiary; and 65% of the shares in certain foreign subsidiaries.

Loans borrowed under the Credit Agreement bear interest, in the case of LIBOR rate loans, at a per annum rate equal to the LIBOR rate plus the Applicable Margin (as defined in the Credit Agreement), which may range from 1.25% to 2.00%, based on our Consolidated Total Leverage Ratio (as defined in the Credit Agreement). Loans that are borrowed under the Credit Agreement that are not LIBOR rate loans bear interest at a per annum rate equal to (i) the highest of (A) the rate of interest announced, from time to time, by Wells Fargo Bank, National Association as its “prime rate,” (B) the Federal Funds Rate plus 0.50% and (C) one-month LIBOR plus 1.00%, plus (ii) the Applicable Margin, which may range from 0.25% to 1.00%, based on our Consolidated Total Leverage Ratio. During the 36 weeks ended September 6, 2014, our interest rate for our Note payable ranged from 1.73% to 1.75%.

A letter of credit commission on the daily amount available to be drawn under letters of credit issued under the Credit Agreement is payable by us at the rate per annum equal to the Applicable Margin with respect to LIBOR rate loans, which Applicable Margin may range from 1.25% to 2.00% per annum, based on our Consolidated Total Leverage Ratio; provided, however, that the commission on letters of credit secured by cash is payable at the rate of 0.75% per annum. During the 36 weeks ended September 6, 2014, our interest rate for our letter of credit commission was 1.75%.

A commitment fee on the average daily unused portion of the revolving credit facility is payable by us at the rate per annum equal to the Applicable Margin for that fee, which may range from 0.20% to 0.35%, based on our Consolidated Total Leverage Ratio. Other fees are also payable by us, as referenced in the Credit Agreement. During the 36 weeks ended September 6, 2014, our interest rate for our commitment fee was 0.25%.

The Credit Agreement contains various loan covenants that restrict our ability to take certain actions and contains financial covenants that require us periodically to meet certain financial tests, which limit our ability to declare and pay cash dividends.

As of September 6, 2014, we had no amounts outstanding under our revolving credit facility, \$44.9 million in outstanding letters of credit and \$155.1 million available under our revolving credit facility.

As of September 6, 2014, we estimate the fair value of our Note payable to be approximately \$175 million.

The following table presents the amounts due by maturity date, unamortized discount and net carrying amount of our Note payable as of September 6, 2014 and amounts due by maturity date as of September 26, 2014 pursuant to our exercise of our option to increase our loan to \$225 million (in thousands):

	September 6, 2014	September 26, 2014
Due March 21, 2015	\$8,750	\$11,250
Due March 21, 2016	17,500	22,500
Due March 21, 2017	26,250	33,750
Due March 28, 2018	122,500	157,500
Total amount due	\$175,000	\$225,000
Unamortized discount	(846 )	
Note payable, net of discount	\$174,154	



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## 5. Condensed Consolidated Financial Statement Details

## Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets as of September 6, 2014, December 28, 2013 and September 7, 2013 consisted of the following (in thousands):

	September 6, 2014	December 28, 2013	September 7, 2013
Card stock	\$ 19,104	\$ 13,342	\$ 12,230
Deferred expenses	6,970	10,126	3,416
Program development costs	3,041	5,767	7,016
Prepaid load value	6,399	10,631	10,174
Income tax receivables	14,292	8,344	2,811
Other prepaids	21,996	19,264	22,027
Total prepaid expenses and other current assets	\$ 71,802	\$ 67,474	\$ 57,674

## Goodwill

A summary of changes in our goodwill during the 36 weeks ended September 6, 2014 is as follows (in thousands):

Balance – December 28, 2013		\$ 133,521
Retailo purchase price adjustment		78
Business acquisitions		41,300
Foreign currency translation adjustments		(2,033 )
Balance – September 6, 2014		\$ 172,866

We have finalized our information regarding working capital for our acquisitions of IntelliSpend and Retailo and have settled amounts due to or from us for working capital adjustments, which we present as Payment for working capital adjustment for business acquisitions, net in the accompanying condensed consolidated statements of cash flows.

## Other Assets

Other assets as of September 6, 2014, December 28, 2013 and September 7, 2013 consisted of the following (in thousands):

	September 6, 2014	December 28, 2013	September 7, 2013
Program development costs	\$ 59,729	\$ 58,029	\$ 46,738
Other receivables	9,737	19,905	10,901
Income taxes receivable	6,376	5,555	4,962
Deferred financing costs	1,330	—	—
Other	9,418	7,189	7,872
Total other assets	\$ 86,590	\$ 90,678	\$ 70,473

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## Other Current Liabilities

Other current liabilities as of September 6, 2014, December 28, 2013 and September 7, 2013 consisted of the following (in thousands):

	September 6, 2014	December 28, 2013	September 7, 2013
Deferred revenue	\$ 23,934	\$ 30,540	\$ 15,262
Income taxes payable	3,269	21,167	4,939
Payroll and related liabilities	15,398	20,949	10,096
Acquisition liabilities	4,350	2,279	6,867
Other payables and accrued liabilities	2,744	6,335	4,653
Total other current liabilities	\$ 49,695	\$ 81,270	\$ 41,817

## Other Liabilities

Other liabilities as of September 6, 2014, December 28, 2013 and September 7, 2013 consisted of the following (in thousands):

	September 6, 2014	December 28, 2013	September 7, 2013
Acquisition liabilities	\$ 19,750	\$ —	\$ 9,930
Payable to content provider	6,718	6,664	4,360
Income taxes payable	906	—	—
Deferred income and other liabilities	1,741	2,047	1,696
Total other liabilities	\$ 29,115	\$ 8,711	\$ 15,986

## Business Acquisition Expense (Benefit) and Amortization of Acquisition Intangibles

Business acquisition expense (benefit) and amortization of acquisition intangibles for the 12 and 36 weeks ended September 6, 2014 and September 7, 2013 consisted of the following (in thousands):

	12 Weeks Ended		36 Weeks Ended	
	September 6, 2014	September 7, 2013	September 6, 2014	September 7, 2013
Change in fair value of contingent consideration liability (See Note 3—Fair Value Measurements)	\$—	\$(352)	\$—	\$(1,255)
Amortization of intangible assets acquired in business combination	3,005	97	10,839	293
Acquisition related expenses	325	—	360	—
Total business acquisition expense (benefit) and amortization of acquisition intangibles	\$3,330	\$(255)	\$11,199	\$(962)

## 6. Stock Based Compensation

During the 36 weeks ended September 6, 2014 our Board of Directors granted 26,250 restricted stock awards, 886,450 restricted stock units, 88,900 performance stock units and 559,500 stock options at a weighted-average exercise price of \$26.65 per share.

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## 7. Income Taxes

Our effective tax rates were 46.0% and 40.7% for the 12 weeks ended September 6, 2014 and September 7, 2013, respectively and were 41.6% and 54.2% for the 36 weeks ended September 6, 2014 and September 7, 2013, respectively. The effective rate for the 12 weeks ended September 6, 2014 was higher primarily due to operating losses of certain foreign subsidiaries for which we did not recognize an income tax benefit and jurisdictional mix of income partially offset by benefits related to return-to-provision adjustments that we recorded in the 12 weeks ended September 6, 2014. The effective rate for the 36 weeks ended September 6, 2014 was lower primarily due to lower amounts of nondeductible equity based compensation expense for certain executives, which, as a result of our initial public offering, became subject to IRS limitations.

## Second Amended and Restated Tax Sharing Agreement

In April 2014, we and Safeway executed the second Amended and Restated Tax Sharing Agreement (the SARTSA), which superseded the previous tax sharing agreements, with respect to the matters addressed by the SARTSA. Under the terms of the SARTSA, if the Spin-Off is treated as taxable, we and Safeway intend to continue to file a consolidated federal tax return and certain state and local tax returns through the date of the Spin-Off, rather than through the date of our initial public offering in April 2013, as discussed in the Annual Report, subject to Safeway's ultimate determination as to whether such consolidated treatment is appropriate.

Safeway previously announced that it had entered into the Agreement and Plan of Merger with AB Acquisition LLC dated March 6, 2014, which was subsequently amended on April 7, 2014 pursuant to Amendment No. 1 and on June 13, 2014 pursuant to Amendment No. 2 (as amended, the Merger Agreement). Assuming that the acquisition of Safeway by AB Acquisition LLC (the Merger) is completed as contemplated by the Merger Agreement, the Spin-Off is expected to be taxable to Safeway and Safeway's stockholders. Under the SARTSA, any corporate-level income tax incurred as a result of the Spin-Off in the event that the Merger is completed will be borne by Safeway, except that, pursuant to a separate letter agreement entered into by Safeway and us in August 2014, we will bear any incremental taxes that result from certain elections requested by us with respect to certain of our subsidiaries in connection with the Spin-Off.

The SARTSA provides that Safeway and we will make an election that is intended to give rise to a step-up in the tax basis of Blackhawk's assets if the Spin-Off is taxable (the Section 336(e) Election). The actual benefit realized by us from the step-up will depend on, among other things, our value at the time of the Spin-Off and whether we generate adequate taxable income over time to fully utilize deductions associated with any increased tax basis resulting from the Section 336(e) Election.

If the Merger is not completed, and certain other conditions are satisfied, it is intended that the Spin-Off qualify as a tax-free transaction to Safeway and its stockholders. The SARTSA provides for certain continuing restrictions and covenants applicable to both Safeway and us that are intended to preserve the ability for the Spin-Off to qualify as a tax-free spin-off. Among the restrictions on us are that (i) for up to two years following the termination of the Merger Agreement, subject to certain exceptions, we will not dispose of all or substantially all of our assets, merge with another entity, issue an amount of our stock (or securities convertible or exchangeable into our stock) in one or more transactions that would comprise 40% or more of our value or voting power, facilitate any person becoming the owner of 5% or more of our stock, or cease conducting our current business and (ii) for up to five years from the date of our initial public offering in April 2013, we will not seek to convert any class of our stock into a different class of our stock or change the absolute or relative voting rights of our classes of stock. The SARTSA provides these restrictions will lapse in certain circumstances, including the completion of the Merger or the completion of certain alternative transactions. If the Merger is not completed, each of Safeway and we would be responsible for any taxes resulting from the failure of the Spin-Off to qualify as a tax-free transaction to the extent such taxes are attributable to, or result from, any act or failure to act by Safeway or us, as applicable, or certain transactions involving Safeway or us, as applicable, following the Spin-Off. Safeway and we each would be responsible for 50 percent of taxes from the Spin-Off to the extent such taxes are not attributable to, or do not result from, any act or failure to act by either Safeway or us.

The SARTSA provides that, in the event that (i) the Merger does not occur, (ii) the Spin-Off is taxable, (iii) Safeway bears the liability for any Spin-Off taxes and (iv) certain other conditions are met, we will make payments to Safeway



over time equal to 85 percent of the amount of the tax benefits, if any, that we are deemed to realize as a result of the Section 336(e) Election. The tax benefit deemed realized will be computed by comparing our actual income tax liability (calculated based on certain assumptions) to the amount of income taxes we would have been required to pay had the Section 336(e) Election not been made. Such payments will be made by us to Safeway as we recognize the benefit of the basis step-up, or upon the occurrence of certain events, such as certain changes of control of us or material breaches by us of the provisions in the SARTSA regarding such payments.

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For any states in which we are required under state law to remit Spin-Off taxes (because Safeway does not file combined returns with us in those states), Safeway is responsible for funding the amount of such taxes; however, the SARTSA permits Safeway to determine how such taxes will be remitted to the applicable state taxing authority. To date, Safeway has determined to fund these amounts to us in exchange for promissory notes. Pursuant to the terms of the notes, Safeway will contribute the notes to us as paid-in capital when the Merger is completed (and also will do so if the Merger is not completed but the Spin-Off is nonetheless taxable as a result of the negotiation of the Merger (or an alternative acquisition)). If the Merger is not completed and certain other considerations are satisfied, it is intended that the Spin-Off qualify as a tax-free transaction. In that event, we intend to file for refunds of the Spin-Off taxes paid to these states and then repay the notes with the refunded amounts.

As of September 6, 2014, Safeway has funded approximately \$8.5 million to us in exchange for promissory notes for Spin-Off taxes we directly remitted to certain state taxing authorities. The promissory notes bear interest at a per annum rate equal to the short-term applicable federal rates. We present the corresponding Spin-Off tax payments that we remitted to various state taxing authorities in Prepaid expenses and other current assets in our condensed consolidated balance sheets. On September 11, 2014, Safeway funded an additional \$16.1 million in exchange for a promissory note for Spin-Off taxes that we directly remitted to various state taxing authorities.

### 8. Commitments and Contingencies

#### Legal Matters

On October 19, 2009, e2Interactive and Interactive Communications International, Inc. (collectively, InComm) filed a lawsuit against us in the United States District Court for the Western District of Wisconsin (the District Court), alleging that we infringed a recently issued patent (the Patent). InComm claimed the rights to “methods, systems and computer programs for processing a store-value card transaction request in a card data management system.” InComm sought injunctive relief, damages and attorneys’ fees. On December 2, 2009, we answered InComm’s complaint and filed counterclaims asserting, among other things, that the Patent was invalid and that InComm engaged in inequitable conduct before the U.S. Patent and Trademark Office in securing the Patent. We sought a declaration of noninfringement, invalidity and unenforceability of the Patent. On February 28, 2012, the jury found that we had infringed the Patent and awarded damages of \$3.5 million plus interest to InComm for such infringement. On February 21, 2013, the District Court awarded InComm costs, such that the total damages outstanding at year end 2013 totaled \$3.7 million. We appealed to the United States Court of Appeals for the Federal Circuit (the Federal Circuit). On March 12, 2014, the Federal Circuit reversed the judgment of infringement on the grounds that the asserted claims in the Patent were limited “to require use of the terminal identifier for determining if a terminal is authorized to make the requested transaction” and that we did not make such use of a terminal identifier. InComm requested rehearing en banc at the Federal Circuit. On April 29, 2014, the Federal Circuit denied InComm’s request. We filed a motion with the District Court seeking to have the previous award of damages vacated and also for discharge of the injunction, release of the bond, and for a reversal of costs. The District Court ruled in our favor, vacating the damages award, discharging the injunction, releasing the bond and reversing the costs award. All appeal deadlines have passed regarding liability. Accordingly, we reversed our previously recorded reserve of \$3.9 million (including interest) during the 36 weeks ended September 6, 2014 to General and administrative expense.

There are various claims and lawsuits arising in the normal course of business pending against us, some of which seek damages and other relief which, if granted, may require future cash expenditures. Management does not believe that it is probable that the resolution of these matters would result in any liability that would materially affect our results of operations or financial condition.

#### Commitments

From time to time, we enter into contracts containing provisions that require us to indemnify various parties against certain potential claims from third parties. Under contracts with certain issuing banks, we are responsible to the banks for any unrecovered overdrafts on cardholders’ accounts. Under contracts with certain content and distribution partners, we are responsible for potential losses resulting from certain claims from third parties. Because the indemnity amounts associated with these agreements are not explicitly stated, the maximum amount of the obligation cannot be reasonably estimated. Historically, we have paid limited amounts pursuant to these indemnification provisions.

Contingencies

We are subject to audit related to various indirect taxes, including, but not limited to, sales and use taxes, value-added tax, and goods and services tax, in various foreign and state jurisdictions. We evaluate our exposure related to these audits and potential audits and do not believe that it is probable that any audit would hold us liable for any material amounts due.

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## 9. Related-Party Transactions

## Intercompany Revenues and Expenses

As discussed in Note 1, until April 14, 2014, Safeway was our Parent. The following table presents the amounts of Operating revenues and Other income (expense) from (to) Safeway and Operating expenses to (from) Safeway through the Spin-Off date of April 14, 2014 included in the accompanying consolidated statements of operations (in thousands). Although we are no longer a related party with Safeway, we continue to recognize Operating revenues from Safeway and Operating expense to (from) Safeway following the Spin-Off.

	12 Weeks Ended		36 Weeks Ended	
	September 6, 2014	September 7, 2013	September 6, 2014	September 7, 2013
<b>OPERATING REVENUES:</b>				
Commissions and fees	\$—	\$376	\$710	\$1,493
Program, interchange, marketing and other fees	—	321	383	1,053
Product sales	—	1,669	863	3,552
Total operating revenues	—	2,366	1,956	6,098
<b>OPERATING EXPENSES:</b>				
Distribution partner commissions	—	9,887	11,821	30,973
Processing and services	—	(1,105	) (212	) (1,453
Sales and marketing	—	27	—	90
Costs of products sold	—	—	—	—
General and administrative	—	611	786	1,949
Total operating expenses	—	9,420	12,395	31,559
<b>OTHER INCOME (EXPENSE):</b>				
Interest income and other income (expense), net	—	25	—	201
Interest expense	—	—	(50	) —

## Intercompany Assets and Liabilities

The following table presents the amounts of assets and liabilities with Safeway as a related party included in the accompanying consolidated balance sheet as of December 28, 2013 (in thousands). As of April 14, 2014, Safeway was no longer a related party, and therefore we no longer separately report assets and liabilities with Safeway as related party transactions.

	December 28, 2013	September 7, 2013
<b>ASSETS</b>		
Overnight cash advances	\$—	\$9,000
Settlement receivables, net	95,317	18,011
Accounts receivable, net	1,833	2,061
Prepaid expenses and other current assets	8,268	—
Other assets	5,555	4,962
<b>LIABILITIES</b>		
Settlement payables	1,636	2,213
Accounts payable and accrued operating expenses	3,554	484

## Cash Management and Treasury Services Agreement and Guarantees

In March 2014, Safeway and we terminated our Cash Management and Treasury Services Agreement (the CMATSA). Under the CMATSA, pursuant to unsecured promissory notes, Safeway borrowed available excess cash from us, and we borrowed from Safeway to meet our working capital and capital expenditure requirements (the Note Payable to Safeway). In conjunction with such termination, on March 28, 2014, we fully repaid amounts outstanding under the Note Payable to Safeway, which totaled \$103.1 million.



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As a result of the Spin-Off, Safeway no longer provides guarantees to any of our content providers. We have replaced the Note Payable to Safeway with a credit agreement with a group of banks. See Note 4—Financing.

Pursuant to our second Amended and Restated Tax Sharing Agreement and in exchange for promissory notes issued by us, Safeway provides us funding for Spin-Off taxes that we directly remitted to certain state taxing authorities, which we present as Note payable to Safeway in our accompanying condensed consolidated balance sheets. See Note 7—Income Taxes for additional information.

## 10. Earnings Per Share

We compute basic earnings per share (EPS) by dividing net income available to common stockholders by the weighted average common shares outstanding during the period and compute diluted EPS by dividing earnings available to common stockholders by the weighted average shares outstanding during the period and the impact of securities that if exercised, would have a dilutive effect on EPS.

We compute EPS under the two-class method, which is a method of computing EPS when an entity has both common stock and participating securities. We consider nonvested stock as a participating security if it contains rights to receive nonforfeitable dividends at the same rate as common stock. Under the two-class method, we exclude the income and distributions attributable to participating securities from the calculation of basic and diluted EPS and exclude the participating securities from the weighted average shares outstanding.

Class A and Class B common stock have equal rights to dividends as declared by the Board. As a result, basic and diluted EPS are equivalent for Class A and Class B common stock.

The following table provides reconciliations of net income and shares used in calculating Basic EPS to those used in calculating Diluted EPS (in thousands except per share amounts):

	12 Weeks Ended September 6, 2014		12 Weeks Ended September 7, 2013	
	Basic	Diluted	Basic	Diluted
Net income attributable to Blackhawk Network Holdings, Inc.	\$555	\$555	\$2,355	\$2,355
Distributed and undistributed earnings allocated to participating securities	(1	) (1	) (14	) (14
Net income attributable to common stockholders	\$554	\$554	\$2,341	\$2,341
Weighted-average common shares outstanding	52,609	52,609	51,615	51,615
Common share equivalents		1,695		1,459
Weighted-average shares outstanding		54,304		53,074
Earnings per share— Class A and Class B	\$0.01	\$0.01	\$0.05	\$0.04
	36 Weeks Ended September 6, 2014		36 Weeks Ended September 7, 2013	
	Basic	Diluted	Basic	Diluted
Net income attributable to Blackhawk Network Holdings, Inc.	\$2,830	\$2,830	\$4,832	\$4,832
Distributed and undistributed earnings allocated to participating securities	(47	) (47	) (153	) (151
Net income attributable to common stockholders	\$2,783	\$2,783	\$4,679	\$4,681
Weighted-average common shares outstanding	52,450	52,450	50,811	50,811
Common share equivalents		1,585		1,171
Weighted-average shares outstanding		54,035		51,982
Earnings per share— Class A and Class B	\$0.05	\$0.05	\$0.09	\$0.09

The weighted-average common shares outstanding for diluted EPS excluded approximately 569,000 and 1,806,000 potential common stock outstanding for the 12 weeks ended September 6, 2014 and September 7, 2013, respectively, and 488,000 and 1,573,000 potential common stock outstanding for the 36 weeks ended September 6, 2014 and September 7, 2013 because the effect would have been anti-dilutive. Potential common stock outstanding results in fewer common share equivalents as a result of the treasury stock method.



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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q (the Quarterly Report) and our Annual Report filed on Form 10-K filed with the Securities and Exchange Commission on March 17, 2014 (the Annual Report). The following discussion has been updated to reflect the effects of the restatement to the 36 weeks ended September 7, 2013 disclosed in Note 1 to our condensed consolidated financial statements. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed below. You should review the "Risk Factors" and "Special Note regarding Forward-Looking Statements" sections of the Annual Report and the "Risk Factors" section of this Quarterly Report for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in the following discussion and analysis.

Forward Looking Information

This Quarterly Report contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). Forward-looking statements are often identified by the use of words such as, but not limited to, "anticipate," "believe," "can," "continue," "could," "estimate," "expect," "intend," "plan," "project," "seek," "should," "target," "will," "would" and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed or referenced in the section titled "Risk Factors" included under Part II, Item 1A below. Furthermore, such forward-looking statements speak only as of the date of this Quarterly Report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Company Overview

Blackhawk Network Holdings, Inc., together with its subsidiaries (we, us or our) is a leading prepaid payment network utilizing proprietary technology to offer a broad range of prepaid gift, telecom and debit cards, in physical and digital forms, as well as related prepaid products and payment services in the United States and 21 other countries. Our extensive prepaid network provides significant benefits to our key constituents: consumers who purchase or receive the products and services we offer; content providers who offer branded gift cards and other prepaid products that are redeemable for goods and services; distribution partners who sell those products; and business partners that distribute our products as incentives or rewards. For consumers, we provide convenience by offering a broad variety of quality brands and content through retail and online distribution locations or through loyalty, incentive and reward programs offered by our business customers. For our content providers, we drive incremental sales by providing access to millions of consumers and creating new customer relationships. For our retail distribution partners, we provide a significant, high-growth and highly productive product category that drives incremental store traffic and customer loyalty. And for our business partners, we provide a wide array of prepaid products to enhance their customer incentives and employee rewards programs. Our technology platform allows us to efficiently and seamlessly connect our network participants and offer new products and services as payment technologies evolve. We believe the breadth of our distribution network and product content, combined with our consumer reach and technology platform, creates powerful network effects that enhance value for our constituents and drive growth in our business.

Prior to April 14, 2014, we were a majority-owned subsidiary of Safeway Inc. (Safeway). On April 14, 2014, Safeway distributed its remaining 37.8 million shares of our Class B common stock to Safeway stockholders (the Spin-Off). As a result of the Spin-Off, we became a stand-alone entity separate from Safeway.





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Quarterly Results of Operations and Seasonality

Seasonal consumer spending habits, which are most pronounced in December of each year as a result of the holiday selling season, significantly affect our business. We believe this seasonality is important to understanding our quarterly operating results. A significant portion of gift card sales occurs in late December of each year during the holiday selling season. As a result, we earn a significant portion of our revenues, net income and cash flows during the fourth quarter of each year. We also experience an increase in revenues, net income and cash flows during the second quarter of each year, which we primarily attribute to the Mother's Day, Father's Day and graduation gifting season and the Easter holiday. Depending on when the Easter holiday occurs, the associated increase could occur in either the first or second quarter. Additionally, operating income may fluctuate significantly during the first three fiscal quarters due to lower revenues and timing of certain expenses during such fiscal periods. As a result, quarterly financial results are not necessarily reflective of the results to be expected for the year, any other interim period or other future year.

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## Description of Our Revenues

**Commissions and Fees**—Commissions and fees consist of content provider commissions, consumer purchase fees, GPR load and reload fees and other transaction-based commissions. We account for total commissions and fees as revenues. The portion of commissions and fees that we pay to our distribution partners is accounted for as Distribution partner commissions in operating expenses.

**Content Provider Commissions**—We earn the majority of our revenues from commissions paid by content providers for the marketing and distribution of their prepaid cards, which we refer to as closed loop gift cards. For closed loop gift cards and prepaid telecom cards, our commissions are based on a contractual percentage of the aggregate load value of the cards recognized during a defined period. This contractual percentage is individually negotiated with each content provider and is generally a fixed percentage. After a closed loop gift card or telecom card is activated, we have no further service obligations and recognize the commissions received as revenue at the time of activation.

**Purchase Fees**—We generate a portion of our revenue from fees related to open loop gift cards, including our proprietary Visa gift card, American Express and MasterCard network-branded gift cards and GPR cards provided by Green Dot and NetSpend, the industry leaders in this product category, as well as PayPower, our own GPR card. The consumer pays a purchase fee upon activation of a network-branded card or the initial load to the GPR cards. These purchase fees vary based on the type of card purchased and the dollar amount of the load transaction. We serve as the program manager, in conjunction with the issuing banks, for our proprietary Visa gift card and PayPower GPR card and have ongoing customer service obligations after card activation. We recognize revenue for our proprietary Visa gift card purchase fee ratably in proportion to the historical redemption patterns of the card portfolio over the estimated life of the card (currently 12 months), which presently results in the recognition of approximately 90% of the purchase fee within four months of card activation. We recognize the initial load fee on the PayPower GPR card on a straight-line basis over the estimated life of the card (currently four months). For the American Express and MasterCard network-branded gift cards and the Green Dot and NetSpend branded GPR cards, we receive a contractual percentage of the consumer purchase fee, which is recognized as revenue at the time of card activation as we have no future customer service obligations.

**Reload Fees**—The consumer pays a purchase fee and we earn the fee when consumers reload funds onto their PayPower GPR card or another GPR card through our Reloadit network. Revenue is recognized when the reload is processed.

**Incentive Program Fees**—We receive fees from our business partners for the activation of incentive cards and the overall management of our incentives and rewards business. Incentive cards include Visa and MasterCard network-branded cards, for which we serve as program manager in conjunction with issuing banks, and Discover network-branded cards that we issue. We defer initial program fees for incentive cards ratably over the estimated card life for single use cards (currently nine months) and on a straight-line basis for reloadable cards (currently 24 months), and we recognize fees for reloading cards when the reload is processed. We may grant price concessions to certain business partners for the purchase of incentive cards. Such concessions are presented as a reduction of Commissions and fees revenue. If such concessions exceed the revenues received from the business partner, we present the net amounts in Operating expenses in Distribution partner commissions

**Merchant Commissions**—Certain open-loop incentive cards are redeemable only at certain merchants utilizing our proprietary restricted authorization network technology. We receive commissions from such merchants based on a contractual percentage of the amount redeemed. Revenue is recognized when the cardholders make purchases.

**Transaction-Based and Other Fees**—We receive transaction-based fees from certain telecom partners related to the use of our proprietary network. These fees vary with usage or volumes and are recognized at the time our network is accessed. We also receive fees for certain services related to our local, regional and sports team card programs such as balance tracking, customer service calls and financial settlement. Revenue is recognized in the period the services are performed.

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Program, Interchange, Marketing and Other Fees—Program, interchange, marketing and other fees consist of post-activation program management fees, settlement network interchange fees, marketing revenues from our content providers, account service fees, fund expiration fees, fund expiration revenues and other fees.

Post-Activation Program Management Fees—We receive a program management fee from certain of our issuing banks related to our proprietary Visa gift card and certain open-loop incentive cards. This fee is based on a contractually stated percentage of load value and represents a portion of our compensation for the overall management and customer support of our proprietary Visa gift and incentive card programs. The fees are deferred and recognized over the estimated life of the card in proportion to historical redemption patterns. The fee percentages are subject to quarterly adjustment based on changes in the underlying redemption patterns, escheat obligations, regulations and other factors that change the underlying economics of the card portfolio.

Interchange Fees—We earn payment network fees related to the cardholder’s usage of our proprietary Visa gift, PayPower GPR and open loop incentive cards. Merchants are charged at varying rates established by Visa, MasterCard and Discover. These fees are contractually passed through to us by the issuing banks net of any fees paid to Visa or MasterCard, or paid directly to us by Discover for the cards that we issue. We recognize revenues when cardholders make purchases.

Marketing Revenue—We receive funds from our content providers to promote their prepaid cards throughout our retail distribution partner network. We generally recognize revenue ratably over the period of the related marketing campaign.

Account Service Fees—We earn a monthly fee and other transaction-based service fees on the PayPower GPR card and earn monthly fees for certain Visa gift and incentive cards, which we charge only after a predetermined amount of time has transpired since card activation. These consumer-paid service fees are collected by reducing card balances and are recognized as revenue at the time the card balance is reduced. For certain incentive cards, we earn these fees only to the extent that the fees exceed post-activation program management fees paid to us for such cards.

Fund Expiration Revenue—We serve as issuer of Discover network-branded incentive cards and present the cardholder liability in Consumer and Customer Deposits in our consolidated balance sheets. When funds expire, we recognize revenue and derecognize the liability.

Fund Expiration Fees—We receive fees from our issuing banks for certain Visa gift and Visa and MasterCard incentive cards, based on a contractual percentage of the unredeemed funds when the funds expire. We recognize revenue when the funds expire. For certain incentive cards, we earn these fees only to the extent that the fees exceed post-activation program management fees paid to us for such cards.

Other Fees—In some instances, we may receive a portion of other fees such as account maintenance, interchange or referral fees for open loop cards and GPR cards other than our proprietary Visa gift card and PayPower GPR card. We also receive fees related to Safeway-branded gift cards and local, regional and sports team card programs. Typically, these fees are recognized when earned and determinable. For one open loop content provider, we receive a fee, under deferred payment terms, based on a percentage of load value and pay the content provider a fee (a portion of which is also under deferred payment terms) for meeting certain activation targets. We recognize the net amount of these fees upon activation.

Product Sales—Product sales consist of our card production sales, secondary card market sales and telecom handset sales.

Card Production—We provide card design, development and third-party production services for certain content providers that are separate from the standard content provider contract. We outsource the physical card production to a third party and charge the content provider actual cost plus a margin for managing this process. Revenue is recognized when the cards are received by our content providers, at our distribution partners’ locations or by us at our third-party warehouse.

Secondary Card Market—We generate revenue through our wholly owned subsidiary, Cardpool, by acquiring previously owned closed loop gift cards at a discount from the remaining value on the card and then selling them at a mark-up over our costs (but still at a discount to the value on the card) to consumers. Revenue is recognized when the cards are delivered to the purchaser.



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Telecom Handsets—We earn revenue from the sale of telecom handsets to our distribution partners to facilitate and supplement the sale of our prepaid telecom content providers' airtime cards. Revenue is generally recognized upon handset shipment to or receipt by the distribution partner based upon the shipping terms, net of estimated returns. We may grant price discounts to distribution partners to increase sales of the distribution partners' remaining inventory, which we recognize as a reduction of revenue.

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## Description of Our Expenses

**Distribution Partner Commissions**—Distribution partner commissions represent the amounts paid to members of our distribution partner network for their distribution services related to our content providers' cards and our proprietary Visa gift card and PayPower GPR card. We compensate our distribution partners by paying them a negotiated share of the commission we receive from our content providers or the consumer purchase fee associated with open loop cards. The percentage shared is generally fixed, but may vary based on annual load value per store location. We recognize pricing concessions in excess of revenue from incentive business partners in Distribution partner commission expense. Distribution partner commission expense is recognized upon card activation, except for Visa gift, PayPower GPR and incentive cards where commission expense is capitalized and then amortized based on the same redemption pattern as the related revenue.

**Processing and Services**—Processing and services costs are the direct costs of generating commissions and fees, and program, interchange, marketing and other fees and include costs of development, integration, maintenance, depreciation and amortization of technology platforms and related hardware; card distribution, fulfillment, merchandising and fixture display amortization; card production for our Visa gift, PayPower GPR and incentive cards and certain other content providers' cards, data communication costs, customer support services, third-party processing, data center facilities costs and compensation costs for processing and services personnel. These costs are expensed as incurred. However, for the Visa gift, incentive and PayPower GPR cards, card production costs and upfront transaction processing fees are capitalized and expensed based on the same redemption pattern as the related revenue. We also incur significant costs to develop new technology platforms and to add functionality to our existing technology platforms. Those costs are capitalized and included in Property, equipment and technology, net and amortized to Processing and services expense over the project's estimated useful life, which is typically five years. Some costs related to operating our technology platform, including certain technology personnel costs and the cost of our in-store displays and merchandising, are fixed in nature, not increasing directly with increasing prepaid product sales, but certain costs will increase based on expected general growth of our business.

**Sales and Marketing**—We incur costs, both discretionary and contractual, in the form of marketing allowances, direct advertising campaigns, general marketing and trade promotions to promote content providers' prepaid cards and our Visa gift card and PayPower GPR card at our distribution partner locations. Sales and marketing expenses consist of program marketing and advertising costs, distribution partner program development expenses, compensation and travel costs for marketing and sales personnel, communication costs, mark-to-market charges and intangible amortization expense resulting from equity instruments issued to certain distribution partners, facilities costs and outside consulting fees. Additionally, sales and marketing expenses include additional compensation to certain distribution partners for the sale of certain prepaid products, for which we earn revenues included in Program, interchange, marketing and other fees. Program development expenses are generally contractually fixed and do not increase based on volume of prepaid product sales. Other sales and marketing costs do not vary directly with the volume of prepaid product sales, but certain costs will increase based on expected general growth of our business.

**Costs of Products Sold**—Costs of products sold include the direct costs of card production efforts, the costs to acquire previously issued prepaid cards and other direct costs related to our Cardpool secondary gift card market business and costs to acquire telecom handsets. We may receive pricing concessions from our telecom handset vendors to increase sales of remaining inventory at distribution partners, which we recognize as a reduction of expense and pass onto our distribution partners as a reduction of revenue. Most costs of products sold are variable based on the volume of product sales.

**General and Administrative**—General and administrative expenses include compensation and benefits for administrative staff, facilities costs, telecommunications costs and professional service fees. These costs do not vary directly with the volume of prepaid product sales, but certain costs will increase based on general growth of our business. General and administrative expenses may also include bad debt and legal expenses, which may cause significant fluctuations from period to period.

**Business acquisition expense (benefit) and amortization of acquisition intangibles**— Business acquisition expense (benefit) and amortization of acquisition intangibles includes the change in the estimated fair value of the Cardpool contingent consideration liability, amortization of intangible assets acquired in a business acquisition and

acquisition-related costs, such as legal, tax, audit and valuation services.

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## Key Operating Statistics

The following table sets forth key operating statistics that directly affect our financial performance for the 12 and 36 weeks ended September 6, 2014 and September 7, 2013:

	12 Weeks Ended		36 Weeks Ended		
	September 6, 2014	September 7, 2013	September 6, 2014	September 7, 2013	
	(in thousands, except percentages and average load transaction value)				
Load value	\$2,514,561	\$1,727,753	\$7,321,923	\$5,256,978	
Commissions and fees as a % of load value	8.0	% 9.2	% 8.1	% 9.1	%
Distribution partner commissions paid as a % of commissions and fees	68.1	% 66.6	% 67.1	% 66.6	%
Number of load transactions	52,380	40,929	154,556	124,375	
Average load transaction value	\$48.01	\$42.21	\$47.37	\$42.27	
Adjusted operating revenues (1)	\$130,428	\$100,635	\$385,963	\$297,412	
Adjusted EBITDA (1)	\$14,714	\$11,477	\$48,225	\$37,361	
Adjusted EBITDA margin (1)	11.3	% 11.4	% 12.5	% 12.6	%
Adjusted net income (1)	\$4,688	\$4,005	\$17,693	\$14,703	
Adjusted diluted earnings per share (1)	\$0.09	\$0.08	\$0.33	\$0.28	

Our Adjusted operating revenues, EBITDA, Adjusted EBITDA, Adjusted EBITDA margin, Adjusted net income and Adjusted diluted earnings per share are non-GAAP financial measures. Generally, a non-GAAP financial measure is a numerical measure of a company's performance, financial position or cash flow that either excludes or (1) includes amounts that are not normally excluded or included in the most directly comparable measure calculated and presented in accordance with GAAP. These measures, however, should be considered in addition to, and not as a substitute for or superior to, operating revenues, operating income, operating margin, cash flows, or other measures of the financial performance prepared in accordance with GAAP.

**Load Value**—Represents the total dollar amount of value loaded onto any of our prepaid products during the period. The dollar amount and volume of card sales directly affect the amount of our revenues and direct costs. We measure and monitor Load value by distribution partner channel and content provider program. The significant growth in Load value over the past two years has been driven by increased consumer use of prepaid products, partly in response to distribution partner loyalty and incentive programs, expansion of product content and services we offer, our acquisitions of IntelliSpend and Retailo and expansion of selling stores in our distribution partner network in the United States and internationally.

**Commissions and Fees as a Percentage of Load Value**—Represents the total amount of Commissions and fees recognized during the period as a percentage of Load value for the same period. Commissions as a percentage of load value is generally higher for closed loop and telecom products than the purchase, load and incentive program fees as a percentage of load value for open loop, financial services and incentive products. As a result, overall Commissions and fees as a percentage of load value is directly affected by the mix of Load value among our product offerings. This metric helps us understand and manage overall margins from our product offerings.

**Distribution Partner Commissions Paid as a Percentage of Commissions and Fees**—Represents Distribution partner commissions expense divided by Commissions and fees revenue during the period. This metric represents the expense recognized for the share of content provider commissions and purchase or load fees we pay to our distribution partners as a percentage of total Commissions and fees revenue recognized during the period. Distribution partner commission share percentages are individually negotiated with our distribution partners and are independent of the commission rates negotiated between us and our content providers. The distribution partner commissions paid percentage is affected by changes in the proportion of Load value and resulting Commissions and fees revenue between distribution partners with differing share percentages.

Number of Load Transactions—Represents the total number of load transactions (including reloads) for all of our prepaid products during the period.

Average Load Transaction Value—Represents Load value divided by the Number of load transactions during the period.

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We regard Adjusted operating revenues, EBITDA, Adjusted EBITDA, Adjusted EBITDA margin, Adjusted net income and Adjusted diluted earnings per share as useful measures of operational and financial performance of the business. We regard Adjusted EBITDA margin as an important financial metric that we use to evaluate the operating efficiency of our business. Adjusted EBITDA, Adjusted net income and Adjusted diluted earnings per share measures are prepared and presented to eliminate the effect of items from EBITDA, Net income and Diluted earnings per share that we do not consider indicative of our core operating performance within the period presented. Adjusted operating revenues are prepared and presented to offset the commissions paid to our distribution partners. Adjusted EBITDA margin represents Adjusted EBITDA as a percentage of Adjusted operating revenues. Our Adjusted operating revenues, Adjusted EBITDA, Adjusted EBITDA margin, Adjusted net income and Adjusted diluted earnings per share may not be comparable to similarly titled measures of other organizations because other organizations may not calculate these measures in the same manner as we do. You are encouraged to evaluate our adjustments and the reasons we consider them appropriate.

We believe Adjusted operating revenues, EBITDA, Adjusted EBITDA, Adjusted EBITDA margin, Adjusted net income and Adjusted diluted earnings per share are useful to evaluate our operating performance for the following reasons:

adjusting our operating revenues for the issuing bank contract amendment and the commissions paid to our distribution partners is useful to understanding our operating margin;

- EBITDA and Adjusted EBITDA are widely used by investors and securities analysts to measure a company's operating performance without regard to items that can vary substantially from company to company and from period to period depending upon their financing, accounting and tax methods, the book value of their assets, their capital structures and the method by which their assets were acquired;

Adjusted EBITDA margin provides a measure of operating efficiency based on Adjusted operating revenues and without regard to items that can vary substantially from company to company and from period to period depending upon their financing, accounting and tax methods, the book value of their assets, their capital structures and the method by which their assets were acquired;

non-cash equity grants made to employees and distribution partners at a certain price and point in time do not necessarily reflect how our business is performing at any particular time and the related expenses are not key measures of our core operating performance;

the issuing bank contract amendment fee adjustments are necessary to adjust operating revenues, EBITDA and Net income to recognize the revenues from these fees as if the contract amendments had been in place as of the beginning of the fiscal year, which we believe better reflects our core operating performance during those periods;

intangible asset amortization expenses can vary substantially from company to company and from period to period depending upon the applicable financing and accounting methods, the fair value and average expected life of the acquired intangible assets, the capital structure and the method by which the intangible assets were acquired and, as such, we do not believe that these adjustments are reflective of our core operating performance; and

non-cash fair value adjustments to contingent business acquisition liability do not directly reflect how our business is performing at any particular time and the related expense adjustment amounts are not key measures of our core operating performance.

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## Reconciliation of Non-GAAP Measures:

The following tables present a reconciliation of Total operating revenues to Adjusted operating revenues, a reconciliation of Net income to EBITDA and Adjusted EBITDA, a reconciliation of Operating income margin to Adjusted EBITDA margin, a reconciliation of Net income to Adjusted net income and a reconciliation of Diluted earnings per share to Adjusted diluted earnings per share, in each case reconciling the most comparable GAAP measure to the adjusted measure, for each of the periods indicated.

	12 Weeks Ended		36 Weeks Ended		
	September 6, 2014	September 7, 2013	September 6, 2014	September 7, 2013	
	(in thousands, except percentages and per share amounts)				
Adjusted operating revenues:					
Total operating revenues	\$269,027	\$205,996	\$786,086	\$616,908	
Issuing bank contract amendment fee adjustment (b)	(1,093)	—	—	—	
Distribution partner commissions	(137,506)	(105,361)	(400,123)	(319,496)	)
Adjusted operating revenues	\$130,428	\$100,635	\$385,963	\$297,412	
Adjusted EBITDA:					
Net income before allocation to non-controlling interests	\$413	\$2,249	\$2,592	\$4,513	
Interest income and other income (expense), net	(182)	(59)	(126)	(432)	)
Interest expense	1,080	—	2,081	—	
Income tax expense	352	1,544	1,844	5,332	
Depreciation and amortization	10,465	6,312	32,153	16,963	
EBITDA	12,128	10,046	38,544	26,376	
Adjustments to EBITDA:					
Employee stock-based compensation	3,679	1,817	9,769	5,279	
Distribution partner mark-to-market expense (a)	—	(34)	(88)	6,961	)
Issuing bank contract amendment fee adjustment (b)	(1,093)	—	—	—	
Change in fair value of contingent consideration (c)	—	(352)	—	(1,255)	)
Adjusted EBITDA	\$14,714	\$11,477	\$48,225	\$37,361	
Adjusted EBITDA margin:					
Total operating revenues	\$269,027	\$205,996	\$786,086	\$616,908	
Operating income	\$1,663	\$3,734	\$6,391	\$9,413	
Operating margin	0.6	% 1.8	% 0.8	% 1.5	%
Adjusted operating revenues	\$130,428	\$100,635	\$385,963	\$297,412	
Adjusted EBITDA	\$14,714	\$11,477	\$48,225	\$37,361	
Adjusted EBITDA margin	11.3	% 11.4	% 12.5	% 12.6	%
Adjusted net income:					
Income before income tax expense	\$765	\$3,793	\$4,436	\$9,845	
Employee stock-based compensation	3,679	1,817	9,769	5,279	
Distribution partner mark-to-market expense (a)	—	(34)	(88)	6,961	)
Issuing bank contract amendment fee adjustment (b)	(1,093)	—	—	—	
Change in fair value of contingent consideration (c)	—	(352)	—	(1,255)	)
Amortization of intangibles (d)	4,085	1,206	14,202	2,284	
Adjusted income before income tax expense	7,436	6,430	28,319	23,114	
Income tax expense	352	1,544	1,844	5,332	
Tax expense on adjustments (e)	2,538	987	9,020	3,398	
Adjusted income tax expense	2,890	2,531	10,864	8,730	
Adjusted net income before allocation to non-controlling interests	4,546	3,899	17,455	14,384	

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Add: Net loss attributable to non-controlling interests (net of tax)	142	106	238	319
Adjusted net income attributable to Blackhawk Network Holdings, Inc.	\$4,688	\$4,005	\$17,693	\$14,703

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	12 Weeks Ended		36 Weeks Ended	
	September 6, 2014	September 7, 2013	September 6, 2014	September 7, 2013
	(in thousands, except percentages and per share amounts)			
Adjusted diluted earnings per share:				
Net income attributable to Blackhawk Network Holdings, Inc.	\$555	\$2,355	\$2,830	\$4,832
Distributed and undistributed income allocated to participating securities	(1	) (14	) (47	) (151
Net income attributable to common shareholders	\$554	\$2,341	\$2,783	\$4,681
Diluted weighted-average shares outstanding	54,304	53,074	54,035	51,982
Diluted earnings per share	\$0.01	\$0.04	\$0.05	\$0.09
Adjusted net income attributable to Blackhawk Network Holdings, Inc.	\$4,688	\$4,005	\$17,693	\$14,703
Adjusted distributed and undistributed income allocated to participating securities	(7	) (24	) (74	) (312
Adjusted net income attributable to common shareholders	\$4,681	\$3,981	\$17,619	\$14,391
Diluted weighted average shares outstanding	54,304	53,074	54,035	51,982
Adjusted diluted earnings per share	\$0.09	\$0.08	\$0.33	\$0.28

(a) Distribution partner equity instruments are generally marked to market at each reporting date to fair value until the instrument is vested.

During 2014, we entered into contractual amendments with certain of our issuing banks that substituted a program management fee for account service fees or card expiration fees for certain open-loop gift and incentive cards. A

(b) portion of the fees related to cards sold in prior periods. Adjusted operating revenues, Adjusted EBITDA and Adjusted net income for the 12 weeks ended September 6, 2014 have been adjusted to recognized the revenues as if the contract amendment had been in force at the beginning of the fiscal year.

(c) Adjustments to reflect a contingent business acquisition liability at its estimated fair value.

(d) Non-cash expense resulting from the amortization of intangible assets, including the amortization of distribution partner relationships resulting from the issuance of fully vested warrants, recorded in Sales and marketing expense, and the amortization of intangible assets from business acquisitions, recorded in Business acquisition expense (benefit) and amortization of acquisition intangibles.

(e) Assumes our statutory tax rate adjusted for certain amounts that are not deductible for tax purposes.

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## Results of Operations

Comparison of the 12 Weeks Ended September 6, 2014 and September 7, 2013

The fiscal periods presented in the accompanying tables below and throughout this Results of Operations section consist of the 12-week periods ended September 6, 2014 and September 7, 2013.

The following table sets forth the revenue and expense amounts as a percentage of total operating revenues by the line items in our condensed consolidated statements of income for the 12 weeks ended September 6, 2014 and September 7, 2013.

	12 Weeks Ended September 6, 2014	% of Total Operating Revenues	12 Weeks Ended September 7, 2013	% of Total Operating Revenues	
(in thousands, except percentages)					
<b>OPERATING REVENUES:</b>					
Commissions and fees	\$201,888	75.0	% \$158,270	76.8	%
Program, interchange, marketing and other fees	43,895	16.3	% 25,352	12.3	%
Product sales	23,244	8.6	% 22,374	10.9	%
Total operating revenues	269,027	100.0	% 205,996	100.0	%
<b>OPERATING EXPENSES:</b>					
Distribution partner commissions	137,506	51.1	% 105,361	51.1	%
Processing and services	46,715	17.4	% 34,927	17.0	%
Sales and marketing	41,704	15.5	% 30,486	14.8	%
Costs of products sold	21,946	8.2	% 21,423	10.4	%
General and administrative	16,163	6.0	% 10,320	5.0	%
Business acquisition expense (benefit) and amortization of acquisition intangibles	3,330	1.2	% (255 )	(0.1 )	%
Total operating expenses	267,364	99.4	% 202,262	98.2	%
OPERATING INCOME	1,663	0.6	% 3,734	1.8	%
<b>OTHER INCOME (EXPENSE):</b>					
Interest income and other income (expense), net	182	0.1	% 59	—	%
Interest expense	(1,080 )	(0.4 )	% —	—	%
INCOME BEFORE INCOME TAX EXPENSE	765	0.3	% 3,793	1.8	%
INCOME TAX EXPENSE	352	0.1	% 1,544	0.7	%
NET INCOME BEFORE ALLOCATION TO NON-CONTROLLING INTERESTS	413	0.2	% 2,249	1.1	%
Add: Net loss attributable to non-controlling interests (net of tax)	142	—	% 106	—	%
NET INCOME ATTRIBUTABLE TO BLACKHAWK	\$555	0.2	% \$2,355	1.1	%

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12 Weeks Ended September 6, 2014 and September 7, 2013:

## Operating Revenues

The following table sets forth our consolidated operating revenues for the 12 weeks ended September 6, 2014 and September 7, 2013.

	12 Weeks Ended		Change		
	September 6, 2014	September 7, 2013			
	(in thousands, except percentages)				
<b>OPERATING REVENUES:</b>					
Commissions and fees	\$201,888	\$158,270	\$43,618	27.6	%
Program, interchange, marketing and other fees	43,895	25,352	18,543	73.1	%
Product sales	23,244	22,374	870	3.9	%
Total operating revenues	\$269,027	\$205,996	\$63,031	30.6	%

## Commissions and Fees

Commissions and fees revenue increased primarily due to a 45.5%, or \$786.8 million, increase in Load value, partially offset by a decrease in Commissions and fees as a percentage of load value of 120 basis points, to 8.0% for the 12 weeks ended September 6, 2014 from 9.2% for the 12 weeks ended September 7, 2013. The increase in Load value was primarily due to a 28.0% increase in the Number of load transactions and a 13.7% increase in the Average load transaction value. The increase in Number of load transactions reflects our acquisitions of InteliSpend and Retailo in the fourth quarter of 2013; improved store productivity in certain parts of our distribution network, including significant increases in Japan; the addition of new distribution partners, including our expansion into South Africa; and increases in products sold through our online and digital distribution channels. Increases in open loop, financial services and incentive products sold as a proportion of total Load Value resulted in increased Average load transaction value and decreased Commissions and fees as a percentage of load value as these products generally have higher load values with lower Commissions and fees revenue but generate higher amounts of revenues included in Program, interchange, marketing and other fees. Commissions and fees as a percentage of load value also decreased due to mix of closed loop products sold.

## Program, Interchange, Marketing and Other Fees

Program, interchange, marketing and other fees increased primarily due to increases in our program-managed Visa gift and PayPower GPR cards sold, our acquisition of InteliSpend and contract amendments with certain of our issuing banks of our Visa gift cards, which collectively resulted in a 112.7%, or \$10.4 million, increase in post-activation program management fees and a 133.5%, or \$5.3 million, increase in net interchange fees, card expiration fees and account service fees. Additionally, program, interchange, marketing and other fees increased due to a 12.5%, or \$1.3 million, increase in marketing revenues, and a \$1.5 million increase in other revenues, primarily from our acquisitions of Incentec and InteliSpend.

## Product Sales

Product sales increased primarily due to a 34.5%, or \$4.8 million, increase in sales from Cardpool and a 8.3%, or \$0.4 million, increase in card production sales, partially offset by a 106.7%, or \$4.3 million, decrease in telecom handset and other product sales, primarily the result of vendor-funded pricing discounts which we passed on to our distribution partners to promote the sale of telecom handsets to end consumers.



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## Operating Expenses

The following table sets forth our consolidated operating expenses for the 12 weeks ended September 6, 2014 and September 7, 2013.

	12 Weeks Ended		Change		
	September 6, 2014	September 7, 2013			
(in thousands, except percentages)					
<b>OPERATING EXPENSES:</b>					
Distribution partner commissions	\$ 137,506	\$ 105,361	\$ 32,145	30.5	%
Processing and services	46,715	34,927	11,788	33.8	%
Sales and marketing	41,704	30,486	11,218	36.8	%
Costs of products sold	21,946	21,423	523	2.4	%
General and administrative	16,163	10,320	5,843	56.6	%
Business acquisition expense (benefit) and amortization of acquisition intangibles	3,330	(255)	3,585	(1,405.9)	)%
Total operating expenses	\$ 267,364	\$ 202,262	\$ 65,102	32.2	%

**Distribution Partner Commissions**

Distribution partner commissions expense increased 30.5% primarily due to a 27.6% increase in Commissions and fees revenue. Distribution partner commissions expense as a percentage of commissions and fees revenue increased from 66.6% in the 12 weeks ended September 7, 2013 to 68.1% for the 12 weeks ended September 6, 2014 primarily due to an increased portion of our prepaid products sold in Japan and South Africa under distributor agreements and certain other international areas which share a higher portion of commissions with distribution partners, partially offset by favorable changes in our U.S. distribution partner mix and our acquisition of Retailo, which shares a lower portion of commissions with distribution partners.

**Processing and Services**

Processing and services expenses increased 33.8% primarily due to a 28.0% increase in Number of load transactions and an increase in the proportion of our program-managed Visa gift and incentives cards sold, which have higher Processing and services expense but also generate the majority of our revenues included in Program, interchange, marketing and other fees. The \$11.8 million increase includes increases of \$4.2 million for personnel costs, including employee and contractor compensation, benefits and travel related costs; \$3.6 million for our card program management services, including card production, redemption transaction processing and customer care primarily for our Visa gift, PayPower GPR and incentive cards; \$2.9 million for our technology infrastructure, including depreciation of capitalized software and related hardware, data center lease, data connectivity, activation transaction processing and other equipment costs; \$0.5 million for maintaining our distribution partner network, including in-store fixture amortization and merchandising and supply chain costs; and \$0.6 million net increase in other costs.

Processing and services expenses increased as a percentage of Total operating revenues to 17.4% in the 12 weeks ended September 6, 2014 from 17.0% in the 12 weeks ended September 7, 2013 primarily due to our acquisition of IntelliSpend, which has higher Processing and services expenses but substantially lower Distribution partner commissions expense.

**Sales and Marketing**

Sales and marketing expenses increased due to a \$5.4 million increase in program marketing and development expenses, which partially resulted from the \$1.3 million increase in marketing revenue in Program, interchange, marketing and other fees as well as the enhancement and expansion of our distribution network and related marketing programs. Sales and marketing expenses also increased due to a \$4.9 million increase in employee compensation, benefits and travel related costs, primarily from our acquisition of IntelliSpend, and a \$0.9 million net increase in other costs.

**Costs of Products Sold**

Costs of products sold increased due to \$4.4 million increase in Cardpool costs, partially offset by a \$4.0 million decrease in telecom handsets and other product costs, primarily the result of vendor-funded pricing discounts which

we passed on to our distribution partners to promote the sale of telecom handsets to end consumers. Costs of products sold decreased to 94.4% of product sales in the 12 weeks ended September 6, 2014 compared to 95.7% in the 12 weeks ended September 7, 2013 primarily due to an increase in the gross margin percentage for Cardpool and card production sales.

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## General and Administrative

General and administrative expenses increased primarily due to a \$3.2 million increase in employee compensation, benefits and travel related costs, primarily as a result of our acquisitions of IntelliSpend. General and administrative expense also increased by \$2.6 million other net costs, primarily resulting from rent expense and other operating costs from IntelliSpend, tax and legal costs related to our Spin-Off and bad debt expense.

Business acquisition expense (benefit) and amortization of acquisition intangibles

Business acquisition expense (benefit) and amortization of acquisition intangibles for the 12 weeks ended September 6, 2014 and September 7, 2013 consisted of the following (in thousands):

	12 Weeks Ended	
	September 6, 2014	September 7, 2013
Change in fair value of contingent consideration liability (See Note 3—Fair Value Measurements in the notes to our condensed consolidated financial statements)	\$—	\$(352)
Amortization of intangible assets acquired in business combination	3,005	97
Acquisition related expenses	325	—
Total business acquisition expense (benefit) and amortization of acquisition intangibles	\$3,330	\$(255)

Business acquisition expense (benefit) and amortization of acquisition intangibles increased \$2.9 million due to the amortization of intangible assets resulting from our acquisitions of IntelliSpend and Retailo in the fourth quarter of 2013, \$0.3 million due to our acquisitions of CardLab and Incentec and \$0.4 million due to the non-cash benefit in the 12 weeks ended September 7, 2013 related to the change in the estimated fair value of the Cardpool contingent consideration liability.

## Other Income (Expense) and Income Tax Expense

The following table sets forth our consolidated other income (expense), and income tax expense and effective tax rates for the 12 weeks ended September 6, 2014 and September 7, 2013.

	12 Weeks Ended			Change
	September 6, 2014	September 7, 2013		
	(in thousands, except percentages)			
<b>OTHER INCOME (EXPENSE):</b>				
Interest income and other income (expense), net	\$ 182	\$ 59	\$ 123	208.5 %
Interest expense	(1,080)	—	(1,080)	— %
Total other income (expense)	\$(898)	\$ 59	\$(957)	(1,622.0) %
<b>INCOME TAX EXPENSE</b>	\$ 352	\$ 1,544	\$(1,192)	(77.2) %
<b>EFFECTIVE TAX RATE</b>	46.0	% 40.7	% 5.3	%

## Other Income (Expense)

Other income (expense) consists of Interest income and other income (expense), net and Interest expense. Interest income and other income (expense), net includes interest income earned primarily on short-term cash investments and Overnight cash advances to Safeway balances, as well as foreign currency transaction gains and losses and other non-operating gains and losses. During the 12 weeks ended September 6, 2014, interest income consisted solely of short-term cash investments since Safeway did not borrow any of our cash balances. Interest income has fluctuated with the amount and duration of the short-term cash investments and Overnight cash advances to Safeway balances and changes in interest and commercial paper rates. Interest expense includes interest charged under our Note payable and the amortization of deferred financing costs and the discount on the Note payable (see Note 4—Financing in the accompanying notes to our condensed consolidated financial statements).

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In late March 2014, we terminated our Cash Management and Treasury Services Agreement with Safeway (the CMATSA). Under the CMATSA, pursuant to unsecured promissory notes, Safeway borrowed available excess cash from us, and we borrowed from Safeway to meet our working capital and capital expenditure requirements (See Note 9—Related Party Transactions in the accompanying notes to our condensed consolidated financial statements). In conjunction with such termination, we entered into a credit agreement with a group of banks. We expect interest expense related to the credit agreement to total approximately \$5.9 million for fiscal 2014, including interest on additional borrowings to finance our acquisition of Parago, Inc. See Note 4—Financing in the notes to our condensed consolidated financial statements and “—Liquidity and Capital Resources—Acquisition of Parago, Inc.” for additional information.

**Income Tax Expense**

Our effective tax rates were 46.0% and 40.7% for the 12 weeks ended September 6, 2014 and September 7, 2013, respectively. The effective rate for the 12 weeks ended September 6, 2014 was higher primarily due to operating losses of certain foreign subsidiaries for which we did not recognize an income tax benefit and the jurisdictional mix of income, partially offset by benefits related to return-to-provision adjustments that we recorded in the 12 weeks ended September 6, 2014.

In April 2014, we and Safeway executed the second Amended and Restated Tax Sharing Agreement (the SARTSA). See Note 7—Income Taxes in the notes to our condensed consolidated financial statements for information regarding this agreement.

**Adjusted Effective Income Tax Rate**

Our Adjusted net income adjusts Net income for certain noncash items, including certain amounts that are nontaxable or nondeductible for income tax purposes, including i) the change in the fair value of contingent consideration, ii) certain amounts of distribution partner mark-to-market expense and iii) certain amounts of stock-based compensation for certain executives that are subject to IRS limitations as a result of our initial public offering. As such, we have presented in the table below reconciliations from our effective income tax rate to our Adjusted effective income tax rate used in the determination of our Adjusted net income for the 12 weeks ended September 6, 2014 and September 7, 2013, which we believe provides a clearer understanding of our operational performance by removing the impact of such nontaxable or nondeductible items that we do not consider indicative of our core operating performance within the period presented.

	12 Weeks Ended			
	September 6, 2014	September 7, 2013		
	(in thousands, except percentages)			
Income before income tax expense	\$765	\$3,793		
Income tax expense	\$352	\$1,544		
Effective income tax rate	46.0	% 40.7		%
Adjusted income before income tax expense	\$7,436	\$6,430		
Adjusted income tax expense	\$2,890	\$2,531		
Adjusted effective income tax rate	38.9	% 39.4		%

Our Adjusted effective income tax rates were 38.9% and 39.4% for the 12 weeks ended September 6, 2014 and September 7, 2013, respectively. This decrease reflects benefits related to return-to-provision adjustments that we recorded in the 12 weeks ended September 6, 2014, partially offset by the jurisdictional mix of income.

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Comparison of the 36 Weeks Ended September 6, 2014 and September 7, 2013

The fiscal periods presented in the accompanying tables below and throughout this Results of Operations section consist of the 36-week periods ended September 6, 2014 and September 7, 2013.

The following table sets forth the revenue and expense amounts as a percentage of total operating revenues by the line items in our condensed consolidated statements of income for the 36 weeks ended September 6, 2014 and September 7, 2013.

	36 Weeks Ended September 6, 2014	% of Total Operating Revenues	36 Weeks Ended September 7, 2013	% of Total Operating Revenues	
	(in thousands, except percentages)				
<b>OPERATING REVENUES:</b>					
Commissions and fees	\$596,324	75.9	% \$479,564	77.7	%
Program, interchange, marketing and other fees	119,981	15.3	% 78,617	12.7	%
Product sales	69,781	8.9	% 58,727	9.5	%
Total operating revenues	786,086	100.0	% 616,908	100.0	%
<b>OPERATING EXPENSES:</b>					
Distribution partner commissions	400,123	50.9	% 319,496	51.8	%
Processing and services	133,654	17.0	% 101,321	16.4	%
Sales and marketing	126,274	16.1	% 98,743	16.0	%
Costs of products sold	66,745	8.5	% 55,782	9.0	%
General and administrative	41,700	5.3	% 33,115	5.4	%
Business acquisition expense (benefit) and amortization of acquisition intangibles	11,199	1.4	% (962	) (0.2	)%
Total operating expenses	779,695	99.2	% 607,495	98.5	%
OPERATING INCOME	6,391	0.8	% 9,413	1.5	%
<b>OTHER INCOME (EXPENSE):</b>					
Interest income and other income (expense), net	126	—	% 432	0.1	%
Interest expense	(2,081	) (0.3	)% —	—	%
INCOME BEFORE INCOME TAX EXPENSE	4,436	0.6	% 9,845	1.6	%
INCOME TAX EXPENSE	1,844	0.2	% 5,332	0.9	%
NET INCOME BEFORE ALLOCATION TO NON-CONTROLLING INTERESTS	2,592	0.3	% 4,513	0.7	%
Add: Net loss attributable to non-controlling interests (net of tax)	238	—	% 319	—	%
NET INCOME ATTRIBUTABLE TO BLACKHAWK	\$2,830	0.4	% \$4,832	0.8	%

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36 Weeks Ended September 6, 2014 and September 7, 2013:

## Operating Revenues

The following table sets forth our consolidated operating revenues for the 36 weeks ended September 6, 2014 and September 7, 2013.

	36 Weeks Ended		Change		
	September 6, 2014	September 7, 2013			
(in thousands, except percentages)					
<b>OPERATING REVENUES:</b>					
Commissions and fees	\$596,324	\$479,564	\$116,760	24.3	%
Program, interchange, marketing and other fees	119,981	78,617	41,364	52.6	%
Product sales	69,781	58,727	11,054	18.8	%
Total operating revenues	\$786,086	\$616,908	\$169,178	27.4	%

## Commissions and Fees

Commissions and fees revenue increased primarily due to a 39.3%, or \$2.1 billion, increase in Load value, partially offset by a decrease in Commissions and fees as a percentage of load value of 100 basis points, to 8.1% for the 36 weeks ended September 6, 2014 from 9.1% for the 36 weeks ended September 7, 2013. The increase in Load value was primarily due to a 24.3% increase in the Number of load transactions and an 12.1% increase in the Average load transaction value. The increase in Number of load transactions reflects our acquisitions of InteliSpend and Retailo in the fourth quarter of 2013; improved store productivity in certain parts of our distribution network, including significant increases in Japan; the addition of new distribution partners, including our expansion into South Africa; and increases in products sold through our online and digital distribution channels. Increases in open loop, financial services and incentive products sold as a proportion of total Load Value increased Average load transaction value and decreased Commissions and fees as a percentage of load value as these products generally have higher load values with lower Commissions and fees revenue but generate higher amounts of revenues included in Program, interchange, marketing and other fees. Commissions and fees as a percentage of load value also decreased due to mix of closed loop products sold.

## Program, Interchange, Marketing and Other Fees

Program, interchange, marketing and other fees increased primarily due to increases in our program-managed Visa gift PayPower GPR cards, our acquisition of InteliSpend, contract amendments with certain of our issuing banks of our Visa gift and incentive cards, which collectively resulted in a 65.8%, or \$19.5 million, increase in post-activation program management fees and a 78.3%, or \$12.9 million, increase in net interchange fees, card expiration fees and account service fees. Program, interchange, marketing and other fees also increased due to a 27.2%, or \$7.0 million, increase in marketing revenues, and a \$2.0 million increase in other revenues, primarily from our acquisitions of Incentec and InteliSpend.

## Product Sales

Product sales increased primarily due to a 30.1%, or \$11.6 million, increase in sales from Cardpool and a 27.2%, or \$3.4 million, increase in card production sales, partially offset by a 50.6%, or \$3.9 million, decrease in telecom handset and other product sales, primarily the result of vendor-funded pricing discounts which we passed on to our distribution partners to promote the sale of telecom handsets to end consumers.

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## Operating Expenses

The following table sets forth our consolidated operating expenses for the 36 weeks ended September 6, 2014 and September 7, 2013.

	36 Weeks Ended		Change		
	September 6, 2014	September 7, 2013			
(in thousands, except percentages)					
<b>OPERATING EXPENSES:</b>					
Distribution partner commissions	\$400,123	\$319,496	\$80,627	25.2	%
Processing and services	133,654	101,321	32,333	31.9	%
Sales and marketing	126,274	98,743	27,531	27.9	%
Costs of products sold	66,745	55,782	10,963	19.7	%
General and administrative	41,700	33,115	8,585	25.9	%
Business acquisition expense (benefit) and amortization of acquisition intangibles	11,199	(962)	) 12,161	(1,264.1)	)%
Total operating expenses	\$779,695	\$607,495	\$172,200	28.3	%

**Distribution Partner Commissions**

Distribution partner commissions expense increased 25.2% primarily due to a 24.3% increase in Commissions and fees revenue. Distribution partner commissions expense as a percentage of commissions and fees revenue increased from 66.6% in the 36 weeks ended September 7, 2013 to 67.1% for the 36 weeks ended September 6, 2014 primarily due to an increased portion of our prepaid products sold in Japan and South Africa under distributor agreements and certain other international areas which share a higher portion of commissions with distribution partners, partially offset by favorable changes in our U.S. distribution partner mix and our acquisition of Retailo, which shares a lower portion of commissions with distribution partners.

**Processing and Services**

Processing and services expenses increased 31.9% primarily due to a 24.3% increase in Number of load transactions and an increase in the proportion of our program-managed Visa gift and incentives cards sold, which have higher Processing and services expense but also generate the majority of our revenues included in Program, interchange, marketing and other fees revenue. The \$32.3 million increase includes increases of \$10.2 million for our card program management services, including card production, redemption transaction processing and customer care primarily for our Visa gift, PayPower GPR and incentive cards; \$8.0 million for personnel costs, including employee and contractor compensation, benefits and travel related costs; \$7.2 million for our technology infrastructure, including depreciation of capitalized software and related hardware, data center lease, data connectivity, activation transaction processing and other equipment costs; \$4.4 million for maintaining our distribution partner network, including in-store fixture amortization and merchandising and supply chain costs; and \$2.5 million net increase in other costs. Processing and services expenses increased as a percentage of Total operating revenues to 17.0% in the 36 weeks ended September 6, 2014 from 16.4% in the 36 weeks ended September 7, 2013 primarily due to our acquisition of InteliSpend, which has higher Processing and services expenses but substantially lower Distribution partner commissions expense.

**Sales and Marketing**

Sales and marketing expenses increased due to a \$18.4 million increase in program marketing and development expenses, which partly resulted from the \$7.0 million increase in marketing revenue in Program, interchange, marketing and other fees as well as the enhancement and expansion of our distribution network and related marketing programs. Sales and marketing expenses also increased due to a \$12.8 million increase in employee compensation, benefits and travel related costs, primarily from our acquisition of InteliSpend, and a \$2.0 million net increase in other costs. These increases were partially offset by a \$5.7 million decrease in mark-to-market and amortization expense for equity instruments held by distribution partners, primarily as a result of the accelerated mark-to-market expense that we recorded due to our initial public offering in April 2013.





Table of Contents**Costs of Products Sold**

Costs of products sold increased due to an \$11.4 million increase in Cardpool costs and a \$2.9 million increase in card production costs, partially offset by a \$3.3 million decrease in telecom handset and other product costs, primarily the result of vendor-funded pricing discounts which we passed on to our distribution partners to promote the sale of telecom handsets to end consumers. Costs of products sold increased to 95.6% of product sales in the 36 weeks ended September 6, 2014 compared to 95.0% in the 36 weeks ended September 7, 2013 primarily due to a decrease in the gross margin percentage for telecom handsets, partially offset by an increase in the gross margin percentage for Cardpool.

**General and Administrative**

General and administrative expenses increased primarily due to a \$8.3 million increase in employee compensation, benefits and travel related costs, primarily as a result of our acquisitions of InteliSpend, and \$4.2 million increase in other net costs, primarily resulting from professional services related to our Spin-Off, rent expense and other operating costs from InteliSpend, tax and legal costs related to our Spin-Off and bad debt expense. These increases were partially offset by a \$3.9 million benefit for the reversal of our previously recorded reserve (including interest) for patent infringement litigation with e2interactive and Interactive Communications International, Inc. (see Note 8—Commitments and Contingencies in the notes to our condensed consolidated financial statements).

**Business acquisition expense (benefit) and amortization of acquisition intangibles**

Business acquisition expense and amortization of acquisition intangibles for the 36 weeks ended September 6, 2014 and September 7, 2013 consisted of the following (in thousands):

	36 Weeks Ended	
	September 6, 2014	September 7, 2013
Change in fair value of contingent consideration liability (See Note 3 – Fair Value Measurements in the notes to our condensed consolidated financial statements)	\$—	\$(1,255 )
Amortization of intangible assets acquired in business combination	10,839	293
Acquisition related expenses	360	—
Total business acquisition expense (benefit) and amortization of acquisition intangibles	\$11,199	\$(962 )

Business acquisition expense (benefit) and amortization of acquisition intangibles increased \$10.5 million due to the amortization of intangible assets resulting from our acquisitions of InteliSpend and Retailo in the fourth quarter of 2013, \$0.4 million due to our acquisitions of CardLab and Incentec and a \$1.3 million benefit due to the non-cash adjustment in the 36 weeks ended September 7, 2013 related to the change in the estimated fair value of the Cardpool contingent consideration liability.

**Other Income (Expense) and Income Tax Expense**

The following table sets forth our consolidated other income (expense), and income tax expense and effective tax rates for the 36 weeks ended September 6, 2014 and September 7, 2013.

	36 Weeks Ended					
	September 6, 2014	September 7, 2013	Change			
	(in thousands, except percentages)					
<b>OTHER INCOME (EXPENSE):</b>						
Interest income and other income (expense), net	\$126	\$432	\$(306 )	(70.8 )	%	
Interest expense	(2,081 )	—	(2,081 )	—	%	
Total other income (expense)	\$(1,955 )	\$432	\$(2,387 )	(552.5 )	%	
<b>INCOME TAX EXPENSE</b>	\$1,844	\$5,332	\$(3,488 )	(65.4 )	%	
<b>EFFECTIVE TAX RATE</b>	41.6	% 54.2	% (12.6 )	%		

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## Other Income (Expense)

Other income (expense) consists of Interest income and other income (expense), net and Interest expense. Interest income and other income (expense), net includes interest income earned primarily on short-term cash investments and Overnight cash advances to Safeway balances, as well as foreign currency transaction gains and losses and other non-operating gains and losses. During the 36 weeks ended September 6, 2014, interest income consisted solely of short-term cash investments since Safeway did not borrow any of our cash balances. Interest income has fluctuated with the amount and duration of the short-term cash investments and Overnight cash advances to Safeway balances and changes in interest and commercial paper rates. Such investments were significantly lower during the 36 weeks ended September 6, 2014 due to our acquisitions of IntelliSpend and Retailo in the fourth quarter of 2013.

Additionally, in the 36 weeks ended September 6, 2014, we recognized \$0.4 million in losses on intercompany foreign currency transactions, and we had no such expense in the 36 weeks ended September 7, 2013. Interest expense includes interest charged under our Note payable and the amortization of deferred financing costs and the discount on the Note payable (see Note 4—Financing in the accompanying notes to our condensed consolidated financial statements).

In late March 2014, we terminated our Cash Management and Treasury Services Agreement with Safeway (the CMATSA). Under the CMATSA, pursuant to unsecured promissory notes, Safeway borrowed available excess cash from us, and we borrowed from Safeway to meet our working capital and capital expenditure requirements (See Note 9—Related Party Transactions in the accompanying notes to our condensed consolidated financial statements). In conjunction with such termination, we entered into a credit agreement with a group of banks. We expect interest expense related to the credit agreement to total approximately \$5.9 million for fiscal 2014, including interest on additional borrowings to finance our acquisition of Parago, Inc. See Note 4—Financing in the notes to our condensed consolidated financial statements and “—Liquidity and Capital Resources—Acquisition of Parago, Inc.” for additional information.

## Income Tax Expense

Our effective tax rates were 41.6% and 54.2% for the 36 weeks ended September 6, 2014 and September 7, 2013, respectively. The effective rate for the 36 weeks ended September 6, 2014 was lower primarily due to lower amounts of nondeductible equity based compensation expense for certain executives, which, as a result of our initial public offering, became subject to IRS limitations.

In April 2014, we and Safeway executed the second Amended and Restated Tax Sharing Agreement (the SARTSA). See Note 7—Income Taxes in the notes to our condensed consolidated financial statements for information regarding this agreement.

## Adjusted Effective Income Tax Rate

Our Adjusted net income adjusts Net income for certain noncash items, including certain amounts that are nontaxable or nondeductible for income tax purposes, including i) the change in the fair value of contingent consideration, ii) certain amounts of distribution partner mark-to-market expense and iii) certain amounts of stock-based compensation for certain executives that are subject to IRS limitations as a result of our initial public offering. As such, we have presented in the table below reconciliations from our effective income tax rate to our Adjusted effective income tax rate used in the determination of our Adjusted net income for the 36 weeks ended September 6, 2014 and September 7, 2013, which we believe provides a clearer understanding of our operational performance by removing the impact of such nontaxable or nondeductible items that we do not consider indicative of our core operating performance within the period presented.

	36 Weeks Ended		
	September 6, 2014	September 7, 2013	
	(in thousands, except percentages)		
Income before income tax expense	\$4,436	\$9,845	
Income tax expense	\$1,844	\$5,332	
Effective income tax rate	41.6	% 54.2	%

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Adjusted income before income tax expense	\$28,319	\$23,114	
Adjusted income tax expense	\$10,864	\$8,730	
Adjusted effective income tax rate	38.4	% 37.8	%

Our Adjusted effective income tax rates were 38.4% and 37.8% for the 36 weeks ended September 6, 2014 and September 7, 2013, respectively. The adjusted effective rate for the 36 weeks ended September 6, 2014 was higher primarily due to the jurisdictional mix of income.

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## Liquidity and Capital Resources

The following table sets forth the major sources and uses of cash for the 36 weeks ended September 6, 2014 and September 7, 2013.

	36 Weeks Ended	
	September 6, 2014	September 7, 2013
	(in thousands)	
Net cash used in operating activities	\$(463,409 )	\$(537,589 )
Net cash provided by (used in) investing activities	(45,119 )	473,369
Net cash provided by (used in) financing activities	180,029	(1,360 )
Effect of exchange rates on cash	(2,030 )	(3,632 )
Net decrease in cash and cash equivalents	\$(330,529 )	\$(69,212 )
Adjusted for Change in overnight cash advances to Safeway	—	(486,000 )
Net decrease in cash and cash equivalents and overnight cash advances to Safeway	\$(330,529 )	\$(555,212 )

In March 2014, Safeway announced that it had entered into a definitive agreement to merge with Albertsons. If the merger is completed, it is expected that the distribution of our shares in the Spin-Off will be taxable to Safeway and its shareholders. If the merger is completed, it is also anticipated that there will be a step-up in the tax basis of our assets that would be amortized as a tax deduction that could result in an estimated \$27 million in cash tax savings per year for us, assuming a 15-year recovery period and our U.S. statutory rate. We could realize an estimated \$18 million related to fiscal 2014 as a result of the recovery period beginning at our Spin-Off in April 2014. We are currently finalizing the allocation of the basis step-up between our U.S. and international entities which will determine the final benefit that we will realize. Our ability to realize these benefits will be dependent upon, among other things, our ability to generate adequate taxable income to fully utilize the deductions and the value of our common stock at the time of the distribution. See Note 7—Income Taxes in the notes to our condensed consolidated financial statements for additional information.

## Adjusted Net Cash Provided by (Used in) Operating Activities and Free Cash Flow

Adjusted net cash provided by (used in) operating activities is calculated as the net cash used in operating activities adjusted to exclude the impact from changes in Settlement receivables and Settlement payables. Free cash flow is calculated as Adjusted net cash provided by (used in) operating activities, less Expenditures for property, equipment and technology. Cash from the sale of prepaid products is held for a short period of time and then remitted, less our commissions, to our content providers, and is significantly impacted by the portion of gift card sales that occur in late December. Because this cash flow is temporary and highly seasonal, it is not available for other uses is therefore excluded from our calculation of free cash flow. Free cash flow provides information regarding the cash that our business generates without the fluctuations resulting from the timing of cash inflows and outflows from gift card sales in late December, which we believe is useful to understanding our business. Please see “—Cash Flows from Operating Activities” for additional information. The following table sets forth our Adjusted net cash flow provided by (used in) operating activities and Free cash flow for the 36 weeks ended September 6, 2014 and September 7, 2013.

	36 Weeks Ended	
	September 6, 2014	September 7, 2013
	(in thousands)	
Net cash used in operating activities	\$(463,409 )	\$(537,589 )
Decrease in settlement payables, net of settlement receivables	470,945	538,719
Adjusted net cash provided by operating activities (1)	7,536	1,130
Expenditures for property, equipment and technology	(25,960 )	(21,349 )
Free cash flow (1)	\$(18,424 )	\$(20,219 )

(1) Our Adjusted net cash flow provided by (used in) operating activities and Free cash flow are non-GAAP financial measures. Generally, a non-GAAP financial measure is a numerical measure of a company's performance, financial position or cash flow that either excludes or includes amounts that are not normally

excluded or included in the most directly comparable measure calculated and presented in accordance with GAAP. This measure, however, should be considered in addition to, and not as a substitute for or superior to, cash flows or other measures of the financial performance prepared in accordance with GAAP.

Table of Contents**Cash Flows from Operating Activities**

Our Adjusted net cash provided by (used in) operating activities, which removes the impact on operating cash flow from the timing of cash settlement of Settlement receivables and Settlement payables, increased primarily due to a 26.8%, or \$12.8 million, increase in net income adjusted for noncash reconciling items to \$60.8 million in the 36 weeks ended September 6, 2014 from \$48.0 million in the 36 weeks ended September 7, 2013. This increase primarily reflects a 27.4% increase in our operating revenues. This increase was partially offset by a \$6.5 million decrease in cash flows from changes in operating assets and liabilities (excluding Settlement receivables and Settlement payables). This decrease reflects \$8.5 million in payments to certain state tax authorities for Spin-Off taxes. Safeway has funded these payments pursuant to promissory notes which we reflect within financing activities. See Note 7—Income Taxes in the notes to our condensed consolidated financial statements for additional information.

**Cash Flows from Investing Activities**

The net cash used in investing activities for the 36 weeks ended September 6, 2014 totaled \$45.1 million, which included \$26.0 million for expenditures for property, equipment and technology and \$21.7 million for our acquisitions of CardLab and Incentec, which included \$16.7 million paid at closing and \$5.0 million placed in escrow for certain portions of contingent consideration. Additionally, at closing, we repaid \$7.5 million of debt that we assumed from these acquisitions (which we present in financing activities, below), and we are liable for up to \$46.5 million in additional contingent consideration based on 2015 financial results of CardLab. See Note 2—Business Acquisitions in the notes to our condensed consolidated financial statements for additional information. These payments were partially offset by a net cash receipt of \$2.6 million for the subsequent assumption of cardholder liabilities and purchase price adjustments related to our acquisitions of Retailo and IntelliSpend (see Note 2—Business Acquisitions and Note 5—Condensed Consolidated Financial Statement Details in the notes to our condensed consolidated financial statements). During the 36 weeks ended September 7, 2013, we advanced a portion of our U.S. cash balances at the end of every day to Safeway, which invested these amounts in overnight investments. The net cash provided by investing activities for the 36 weeks ended September 7, 2013 totaled \$473.4 million, which included \$486.0 million for the change in overnight cash advances to Safeway and \$9.0 million for the release of restricted cash upon our initial public offering in April 2013, partially offset by \$21.3 million for expenditures for property, equipment and technology.

**Cash Flows from Financing Activities**

The net cash provided by financing activities for the 36 weeks ended September 6, 2014 totaled \$180.0 million, which included \$172.5 million in proceeds from our Note payable under our credit agreement with a group of banks, net of deferred financing costs (see below under Credit Agreements), \$8.5 million from promissory notes to Safeway for funding our Spin-Off taxes (see Note 7—Income Taxes in the notes to our condensed consolidated financial statements) and \$5.9 million from the proceeds from the issuance of common stock from the exercise of employee stock options and our employee stock purchase program. These proceeds were partially offset by our repayment of \$7.5 million of debt assumed from our acquisition of CardLab. The net cash used in financing activities for the 36 weeks ended September 7, 2013 totaled \$1.4 million, primarily consisting of a payment of \$2.3 million for our Cardpool acquisition liability, partially offset by a \$0.8 million for reimbursement, net of payments, for costs related to our initial public offering.

**Credit Agreements**

In conjunction with our entry into a new credit agreement (see below), we and Safeway terminated the Cash Management and Treasury Services Agreement (the CMATSA). Under the CMATSA, we borrowed from Safeway to meet our working capital and capital expenditure requirements. In conjunction with such termination, on March 28, 2014, we repaid \$103.1 million of amounts outstanding under the Note payable to Safeway. Additionally, as a result of the Spin-Off, Safeway no longer provides guarantees to any of our content providers.

On March 28, 2014, in conjunction with the termination of the CMATSA, we entered into a credit agreement with a group of banks (the Credit Agreement). The Credit Agreement includes a \$175 million 4-year term loan (which we present as Note payable in our condensed consolidated financial statements), with an option to increase such loan to \$225 million, and a revolving credit facility of up to \$200 million with up to an additional \$100 million during the year-end holiday period for specific settlement related requirements. The revolving credit facility includes a \$100

million subfacility for the issuance of letters of credit. On September 26, 2014, we exercised the option for the additional \$50 million under the loan and increased our term loan to \$225 million.

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Loans borrowed under the Credit Agreement bear interest, in the case of LIBOR rate loans, at a per annum rate equal to the LIBOR rate plus the Applicable Margin (as defined in the Credit Agreement), which may range from 1.25% to 2.00%, based on our Consolidated Total Leverage Ratio (as defined in the Credit Agreement). Loans that are borrowed under the Credit Agreement that are not LIBOR rate loans bear interest at a per annum rate equal to (i) the highest of (A) the rate of interest announced, from time to time, by Wells Fargo Bank, National Association as its “prime rate,” (B) the Federal Funds Rate plus 0.50% and (C) one-month LIBOR plus 1.00%, plus (ii) the Applicable Margin, which may range from 0.25% to 1.00%, based on our Consolidated Total Leverage Ratio.

A letter of credit commission on the daily amount available to be drawn under letters of credit issued under the Credit Agreement is payable by us at the rate per annum equal to the Applicable Margin with respect to LIBOR rate loans, which Applicable Margin may range from 1.25% to 2.00% per annum, based on our Consolidated Total Leverage Ratio; provided, however, that the commission on letters of credit secured by cash is payable at the rate of 0.75% per annum.

A commitment fee on the average daily unused portion of the Revolving Credit Facility is payable by us at the rate per annum equal to the Applicable Margin for that fee, which may range from 0.20% to 0.35%, based on the Company’s Consolidated Total Leverage Ratio. Other fees are also payable by us, as referenced in the Credit Agreement.

As of September 6, 2014, we had \$175 million outstanding under our Note payable (which we increased to \$225 million on September 26, 2014, as described above), no amounts outstanding under our revolving credit facility, \$44.9 million in outstanding letters of credit and and \$155.1 million available under our revolving credit facility.

Other than for our acquisition of Parago, Inc. (see below), we believe that our Cash and cash equivalents, projected cash flow from operations and our Credit Agreement provides sufficient liquidity to meet our expected needs, including working capital and capital expenditure requirements, for the next 12 months.

For the maturity dates of our Note payable, see Note 4—Financing in the notes to our condensed consolidated financial statements.

The Credit Agreement contains various loan covenants that restrict our ability to take certain actions and contains financial covenants that require us periodically to meet certain financial tests, which limit our ability to declare and pay cash dividends. Please see “Part II, Item 1A—Risk Factors—Risk Factors Related to Our Business or Industry—Our credit and collateral agreements with Wells Fargo Bank, National Association, and other financial institutions contain certain restrictions that limit our flexibility in operating our business and, in the event of a default, could have a material adverse impact on our business and results of operations” for additional information.

Acquisition of Parago, Inc.

On September 24, 2014, we entered into a definitive agreement to acquire Parago, Inc. and its subsidiaries, a leader in providing global incentive and engagement solutions, for approximately \$291 million, consisting of cash purchase consideration of approximately \$256 million, subject to certain adjustments for working capital, and debt assumed of approximately \$35 million. To finance this acquisition, we intend to use cash on hand and approximately \$200 million in new borrowings under an expansion of our current credit facility, of which \$150 million is already committed by four lead participating banks representing a voting majority of the bank syndicate.

As a result of the expansion of our current credit facility, we expect that (1) the range of our Applicable Margin on LIBOR rate loans will increase from (i) 1.25% to 2.00% to (ii) 1.25% to 2.50%, (2) the range of our Applicable Margin on loans that are not LIBOR rate loans will increase from (i) 0.25% to 1.00% to (ii) 0.25% to 1.50% and (3) the range of our Applicable Margin on our commitment fee on the unused portion of our Revolving Credit Facility will increase from (i) 0.20% to 0.35% to (ii) 0.20% to 0.45%.



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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes to our market risk position from the information provided under “Part II, Item 7A. Quantitative and Qualitative Disclosures About Market Risk,” in our Annual Report, except as noted below.

Interest Rate Risk

On March 28, 2014, we completed the Credit Agreement with a group of banks. Interest expense under the Credit Agreement for interest on loans, letter of credit commissions and commitment fees will be determined based on LIBOR interest rates, the Wells Fargo Bank, NA “prime rate” and/or Federal Funds Rate, and we will be exposed to changes in such rates. See “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Cash Flows from Financing Activities” for additional information.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 6, 2014. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the 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 financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of September 6, 2014, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

In November 2013, we completed the acquisitions of IntelliSpend and Retailo. We are in the process of integrating internal controls at IntelliSpend and Retailo into our control structure. We consider the ongoing integrations of IntelliSpend and Retailo to represent material changes in our internal control over financial reporting. With the exception of these changes, there was no change in our internal control over financial reporting identified in connection with the evaluation required by Rules 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

Our management, including our Chief Executive Officer and Chief Financial Officer, believes that our disclosure controls and procedures and internal control over financial reporting are designed to provide reasonable assurance of achieving their objectives and are effective at the reasonable assurance level. However, our management does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more persons or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.



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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are involved from time to time in various legal proceedings arising in the ordinary course of business, including the matters described below. Although the outcome of any pending matters, including the matters described below, and the amount, if any, of our ultimate liability and any other forms of remedies with respect to these matters, cannot be determined or predicted with certainty, we currently do not believe that it is probable that the resolution of these matters would have a material adverse effect on our business, results of operations or financial condition.

We have been the subject of other claims and litigation in the past, and could be the subject of additional litigation and regulatory or judicial proceedings or investigations in the future.

Other than as disclosed in Note 8—Commitments and Contingencies in the notes to our condensed consolidated financial statements, there have not been any changes to the information previously disclosed in “Part I, Item 3. Legal Proceedings” in our Annual Report.

ITEM 1A. RISK FACTORS

You should carefully consider the risks described below and the other information in this Quarterly Report on Form 10-Q and the risk factors previously disclosed in “Part I, Item 1A. Risk Factors” in our Annual Report. The occurrence of any of the events or circumstances described below or other adverse events could have a material adverse effect on our business, results of operations and financial condition. Additional risks or uncertainties not presently known to us or that we currently deem immaterial may also harm our business.

There have not been any material changes to the information previously disclosed in “Part I, Item 1A. Risk Factors” in our Annual Report, other than as disclosed in this Item 1A.

Risks Related to Our Business and Industry

We rely on relationships with card issuing banks for services related to products for which we act as program manager, and our business, results of operations and financial condition could be materially and adversely affected if we fail to maintain these relationships or if we maintain them under new terms that are less favorable to us.

We rely on issuing banks for critical services, such as membership in the Visa card association and provision of FDIC-insured depository accounts tied to our program-managed GPR cards. MetaBank is one of the issuing banks for our proprietary GPR products and open loop products and, in 2013, was the issuing bank for the substantial majority of our proprietary open loop gift and GPR products. If our relationship with MetaBank deteriorates, it could hinder our ability to grow our business and have a material adverse effect on our business, results of operations and financial condition.

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A Supervisory Directive issued in 2010 by the Office of Thrift Supervision, or the OTS, now the Office of the Comptroller of the Currency (the OCC), and a Cease and Desist Order issued in July 2011, relating to MetaBank limited or prevented our ability to offer MetaBank-issued cards to new distribution partners, necessitating that we enter into agreements with Sunrise Bank, N.A. as a second issuing bank for proprietary Visa gift cards and with The Bancorp Bank (Bancorp) as a second issuing bank for Visa-branded GPR cards. The Order was terminated by the OCC effective August 7, 2014. Nonetheless, there can be no assurance that we will be able to reduce the risk associated with our reliance on MetaBank. We continue to use MetaBank as the issuing bank for a substantial majority of our proprietary Visa gift cards, and we cannot provide any assurance that we will continue to achieve comparable financial terms related to these programs if we are required, or elect, to reduce or eliminate our issuances through MetaBank. Further, we may not be able to renew our existing agreements with issuing banks or enter into relationships with additional banks on acceptable terms, or at all, in which case we would incur significant transition and other costs and expenses, and users of our products and services could be significantly affected. In addition, there has been increased regulatory scrutiny of products and services that are offered by issuing banks (including our issuing banks) in conjunction with third parties. For example, Bancorp entered into a Stipulation and Consent to the Issuance of a Consent Order with the Federal Deposit Insurance Corporation (the FDIC) which became effective on June 5, 2014. While Bancorp took that action without admitting or denying any charges of unsafe or unsound banking practices or violations of law or regulation relating to its Bank Secrecy Act (BSA) Compliance Program, the Stipulation and Order may limit our ability to rely on Bancorp as a secondary issuing bank for new distribution. As a result of the increased regulatory scrutiny, generally, we have also faced increased compliance costs. To the extent that our issuing banks continue to face increased regulatory pressure, we may face further increased compliance costs and limits on our product offerings, among other consequences. If any material adverse event were to affect MetaBank, Sunrise Bank, N.A., Bancorp or any other issuing bank with whom we have a relationship, including a decline in their financial condition, a decline in the quality of their services, loss of their deposits, their failure or inability to comply with applicable banking and financial regulatory requirements, a systems failure or their inability to pay us fees or outstanding receivable balances, then our business, results of operations and financial condition could be materially and adversely affected.

Changes in laws and regulations to which we are subject, or to which we may become subject in the future, may materially increase our costs of operation, decrease our operating revenues and disrupt our business.

Changes in laws and regulations may occur that could:

- impair or eliminate our ability to conduct certain aspects of our business;
- increase our compliance and other costs of doing business;
- require significant product redesign or systems redevelopment;
- render our products or services less profitable, obsolete or less attractive compared to competing products;
- affect our distribution partners' or content providers' willingness to do business with us or operate in our industry;
- reduce the amount of revenues that we derive from unredeemed prepaid products; and
- discourage distribution partners from offering, and consumers from purchasing, our prepaid products.

Any of these events could have a material adverse effect on our business, results of operations and financial condition. In light of current economic conditions, legislators and regulators have increased their focus on the banking and consumer financial services industry. As a result, in recent years there has been a significant increase in the regulation of the prepaid industry that is intended to protect consumers and help detect and prevent money laundering, terrorist financing and other illicit activities.

At both the federal and state level, there are recent changes and proposed changes to existing laws and regulations that would limit the fees or interchange rates that can be charged or refine the disclosures that must be provided with respect to our products and services or expand the point-of-sale data collection that is required when prepaid cards are sold, all of which have increased, and may in the future increase, our costs and decrease our operating revenues.

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For example, the provisions of the Dodd–Frank Act known as the Durbin Amendment gave the Federal Reserve Bank (the FRB) the power to regulate debit card interchange fees. On June 29, 2011, the FRB issued its final rule that set a cap, which took effect on October 1, 2011, on the interchange fee an issuer can receive from a single debit card transaction (21 cents plus 5 basis points multiplied by the amount of the transaction); and the rule allows an issuer to raise its interchange fees by as much as one cent if it implements certain fraud-prevention measures. GPR cards, including certain of our GPR products, and smaller issuing banks, including some of our issuing banks, are exempt from the rule. However, to the extent that one or more of our GPR products or issuing banks lose their exempt status, the interchange rates applicable to transactions involving those GPR products or issuing banks could be affected, which would decrease our revenues and profit and could have a material adverse effect on our financial condition and results of operations. Please see the risk factor titled “We rely on relationships with card issuing banks for services related to products for which we act as program manager, and our business, results of operations and financial condition could be materially and adversely affected if we fail to maintain these relationships or if we maintain them under new terms that are less favorable to us.”

Additionally, the Durbin Amendment requires that certain prepaid access products be accessible through two unaffiliated payment networks, which we refer to as the network exclusivity requirement. The compliance deadline for the network exclusivity requirement for open loop gift and GPR cards was April 1, 2013, subject to certain exceptions with respect to reloads on GPR cards that were issued prior to April 1, 2013. We and the issuing banks and program managers for these open-loop gift and CPR cards made changes in response to the requirement, which increased certain of our costs. However, on March 13, 2013, the Staff of the Board of Governors of the Federal Reserve System, or the Staff, issued certain “frequently asked questions”, or FAQs, relating to the network exclusivity requirement. We and the issuing banks and program managers made further changes to address the FAQs, and we believe that the open loop gift and GPR cards that we distribute are in compliance with the network exclusivity requirement, as PINs are enabled on such products at the time of their activation. We and others in the prepaid industry requested clarification from the Staff that our changes complied with the network exclusivity requirement. On May 31, 2013, the Staff issued an update to the FAQs, specifying that the issuer of such products complies with the requirement by providing a PIN to the cardholder or having the cardholder select a PIN before or at the time a merchant first prompts the cardholder to enter a PIN. We and the issuing banks and program managers are making further changes to address the updated FAQs. Although these additional changes may increase our costs and potentially could make these cards less attractive to our distribution partners or consumers, we do not presently believe that such changes will have a material adverse effect on our business, results of operations and financial condition.

On July 31, 2013, the U.S. District Court for the District of Columbia overturned the FRB’s rules regarding interchange fees and network exclusivity, holding that (1) those rules violated the Durbin Amendment’s provisions concerning which costs are allowed to be taken into account for purposes of setting fees that are “reasonable and proportional to the costs incurred by the issuer”; and (2) the rule’s network exclusivity provisions also violated the Durbin Amendment, because the statutory language requires each card to have two unaffiliated networks enabled for each method of authentication (i.e., both signature and PIN) possible using the card. The Court vacated the rules, but stayed its ruling to allow the FRB to replace the invalidated portions. On August 21, 2013, the FRB announced that it would seek an expedited appeal for the ruling by the U.S. Court of Appeals for the D.C. Circuit. On September 19, 2013, the Court of Appeals granted an expedited briefing schedule, and the District Court stayed enforcement of its ruling during the appeal, thereby keeping in place the 2011 rules enacting the Durbin Amendment’s cap in debit fees and the network exclusivity provisions pending the D.C. Circuit Court of Appeals review. On January 17, 2014 the D.C. Circuit Court of Appeals heard oral arguments for the appeal.

On March 21, 2014, the D.C. Circuit Court of Appeals reversed the District Court’s ruling that FRB had set too high a cap on interchange fees in 2011 and also overturned a network-routing rule requiring card issuers to provide merchants with up to four routing options for debit and prepaid cards, thus upholding FRB’s “two unaffiliated networks” rule. The D.C. Circuit Court of Appeals also remanded the case to the District Court for further proceedings with respect to FRB’s election to exempt the transaction-monitoring part of allowable interchange from the fraud-prevention adjustment requirements. On August 18, 2014, a group of merchants and merchant associations filed a petition for a writ of certiorari, requesting that the U.S. Supreme Court review that portion of the Court of Appeals decision with

respect to interchange fees. The petitioners did not seek review of the Court of Appeals decision regarding network routing requirements.

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On June 26, 2013, Consumer Financial Protection Bureau (the CFPB) issued a final rule (Nonbank Supervisory Rule) that establishes procedures to implement Section 1024(a)(1)(C) of the Dodd-Frank Act, by which the CFPB will supervise certain nonbank entities that offer or provide consumer financial products or services. The CFPB is authorized to supervise nonbank entities for purposes of: (1) assessing compliance with federal consumer financial law; (2) obtaining information about the activities and compliance systems or procedures of nonbank entities; and (3) detecting and assessing risks to consumers and markets. The Nonbank Supervisory Rule establishes the procedures the CFPB will use to determine whether a nonbank entity will be subject to the CFPB's supervisory authority. Regardless of whether nonbank entities providing consumer financial products or services are subject to the CFPB's supervisory authority, the CFPB affirmed in the Nonbank Supervisory Rule that such entities are subject to the CFPB's regulatory and enforcement authority and that the CFPB may conduct examinations or request information from supervised entities. If the CFPB determines that there is a need to examine us, it could increase our costs of operation or disrupt our business.

In addition, recent changes and proposed changes to other laws and regulations may materially increase our costs of operation, decrease our operating revenues and disrupt our business.

Assertions by third parties of infringement by us, our distribution partners or our content providers of their intellectual property rights could result in significant costs and substantially harm our business and operating results.

The technologies used in the payments industry are protected by a wide array of patents and other intellectual property rights. As a result, third parties have in the past and may in the future assert infringement and misappropriation claims against us, our distribution partners or our content providers from time to time.

For example, on October 19, 2009, e2Interactive, Inc. and InComm (collectively, e2Interactive) filed a lawsuit against our subsidiary, Blackhawk Network, Inc., in Federal District Court in Wisconsin, asserting that Blackhawk infringed a patent held by e2Interactive relating to "methods, systems and computer programs for processing a stored-value-card transaction request in a card data-management system," and seeking injunctive relief, damages in an unspecified amount and recovery of costs and attorneys' fees. Although we believed the e2Interactive allegations were meritless, as ultimately decided in the appeals court, the jury found infringement and awarded damages to e2Interactive in the amount of \$3.5 million for the period from August 2009 through February 2012, with no further payments due as the result of Blackhawk's removal of certain lines of code in a computer program. We fully accrued for this award in fiscal 2011. In December 2012, the trial court rendered its final post-trial rulings, entering judgment for approximately \$3.7 million, including interest and costs, and entering a permanent injunction prohibiting use of the removed code. While the damages represent an immaterial impact to Blackhawk's financial results for the referenced periods, Blackhawk appealed. On March 12, 2014, the Court of Appeals for the Federal Circuit (the Federal Circuit) reversed the lower court and ruled that Blackhawk had not infringed. e2Interactive requested rehearing en banc at the Federal Circuit. On April 29, 2014, the Federal Circuit denied e2Interactive's request. We filed a motion seeking to have the previous award of damages vacated and also for discharge of the injunction, release of the bond, and for a reversal of costs. The District Court ruled in our favor, vacating the damages award, discharging the injunction, releasing the bond and reversing the cost award awarding Blackhawk \$0.2 million. All appeal deadlines have passed, other than for e2Interactive's recent request to reduce the amount of the cost award.

In addition, in the past, we have received letters from various other parties claiming to have enforceable patent rights and asserting infringement of them by us. There can be no assurance that these assertions, or any such future assertions, will not result in liability or damages payable by us. For example, on July 31, 2014, Protegrity Corporation asserted that Blackhawk's PayPower product may infringe the claims of ten patents owned by Protegrity. While we have evaluated Protegrity's assertions and believe them to be meritless, Protegrity has filed litigations against other parties, primarily banks. Consequently, there can be no assurance that these assertions will not lead to litigation, liability or damages payable by us.

Our distribution partners may be subject to infringement or misappropriation claims that, if successful, could preclude the distribution partner from distributing our products and services. In addition, some of our agreements require that if claims related to our products and services are made against our distribution partners or content providers, we are required to indemnify them against any losses. For example, we are currently defending a number of our partners in connection with the matter *Alexsam, Inc. v. Best Buy Co., Inc. et al.*, filed in the United States District Court for the

Eastern District of Texas, alleging patent infringement in connection with activation of prepaid cards. Alexsam was successful in other patent litigation in 2011. The defendants in our case have denied the claims and vigorously defended the infringement allegations. The trial court in the initial consolidated trial upheld the validity and enforceability of the Alexsam patents in late April 2013 and early May 2013. Separate infringement trials started in May 2013. The first litigation was settled in May 2013, and the next two trials resulted in verdicts of non-infringement by the defendants in June 2013. The remaining four cases were dismissed with prejudice, with no right of appeal. Though Alexsam has preserved its ability to appeal one case, it did not appeal - relating to subject matter involving Blackhawk transactions by the August 18, 2014 deadline. Accordingly, all Alexsam matters involving Blackhawk-related transactions have been finally resolved with no infringement.



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Whether or not an infringement or misappropriation claim is valid or successful, it could adversely affect our business by diverting management’s attention or involving us in costly and time-consuming litigation. If we are not successful in defending any such claim, we may be required to pay past and future royalties to use technology or other intellectual property rights then in use, we may be required to enter into a license agreement and pay license fees or we may be required to stop using the technology or other intellectual property rights then in use. Any of these results could have a material adverse effect on our business, results of operations and financial condition.

Recent and future acquisitions or investments could disrupt our business and harm our financial condition.

On August 27, 2014, we acquired the stock of CardLab, Inc. (CardLab), an online provider of customizable prepaid incentive and rewards cards. Prior to the acquisition of CardLab, on June 19, 2014, we acquired the stock of Incentec Solutions, Inc. (Incentec), a provider of a software platform that supports the incentives business. On November 12, 2013, we acquired substantially all of the assets and liabilities of a business-to-business card sales company called InteliSpend Prepaid Solutions, LLC and its subsidiaries, or InteliSpend, that involves corporate incentives and consumer promotions. As a result, Blackhawk Network California issues Discover-branded prepaid products and consequently has registered with FinCEN as a provider of prepaid access. For additional information, please see the risk factor titled “We are increasingly facing more stringent anti-money laundering rules and regulations, compliance with which may increase our costs of operation, decrease our operating revenues and disrupt our business.” Also in the fourth quarter of 2013, we acquired the stock of Retailo AG, a German company engaged in a prepaid card distribution business in Germany, Switzerland and Austria. Most recently, on September 24, 2014, we signed a definitive agreement under which we intend to acquire the stock of Parago, Inc. (Parago), a provider of global incentive and engagement solutions. And in the future, we may pursue other acquisitions or investments that we believe will help us achieve our strategic objectives.

The process of integrating an acquired business, product or technology can create unforeseen operating difficulties, expenditures and other challenges such as:

- potentially increased regulatory and compliance requirements;
- implementation or remediation of controls, procedures and policies at the acquired company;
- diversion of management time and focus from operation of our then-existing business to acquisition integration challenges;
- coordination of product, sales, marketing and program and systems management functions;
- transition of the acquired company’s users and customers onto our systems;
- retention of employees from the acquired company;
- integration of employees from the acquired company into our organization;
- integration of the acquired company’s accounting, information management, human resources and other administrative systems and operations into our systems and operations;
- liability for activities of the acquired company prior to the acquisition, including violations of law, commercial disputes and tax and other known and unknown liabilities; and
- litigation or other claims in connection with the acquired company, including claims brought by terminated employees, customers, former stockholders or other third parties.

If we are unable to address these difficulties and challenges or other problems encountered in connection with our acquisition of CardLab, Incentec, InteliSpend, Retailo or any future acquisition or investment, including the pending acquisition of Parago, we might not realize the anticipated benefits of that acquisition or investment and we might incur unanticipated liabilities or otherwise suffer harm to our business generally. The difficulties and challenges of successful integration of any acquired company are increased when the integration involves multiple acquired companies. Consequently, we may not be able successfully to integrate our recently acquired companies, particularly our multiple incentives businesses acquired over the last year, or to achieve anticipated cost saving across channels and infrastructure.

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To the extent that we pay the consideration for any future acquisitions or investments in cash, or any potential earn outs (e.g., the CardLab acquisition), it would reduce the amount of cash available to us for other purposes. Such payments also may increase our cash flow and liquidity risk and, in the case of the pending Parago acquisition, will result in increased borrowings under our credit agreement. For additional information, please see the risk factor titled “Our debt could adversely impact our operating income and growth prospects and make us vulnerable to adverse economic and industry conditions.” Future acquisitions or investments could also result in dilutive issuances of our equity securities or the incurrence of debt, contingent liabilities, amortization expenses or impairment charges against goodwill on our balance sheet, any of which could have a material adverse effect on our business, results of operations and financial condition.

Our credit and collateral agreements with Wells Fargo Bank, National Association, and other financial institutions contain certain restrictions that limit our flexibility in operating our business and, in the event of a default, could have a material adverse impact on our business and results of operations.

Effective on March 28, 2014, we terminated the cash management and treasury services agreement with Safeway and entered into a credit agreement (the Credit Agreement) with a group of lenders led by Wells Fargo Bank, National Association in an aggregate principal amount of up to \$525,000,000, consisting of a combination of revolving credit loans, letters of credit and a term loan. The Credit Agreement and other related agreements contain customary restrictions on us or our subsidiaries. Subject to a number of important exceptions, these limitations include covenants that limit or restrict us or our subsidiaries, as the case may be, from:

- incurring additional indebtedness or modifying subordinated indebtedness;
- granting liens on or with respect to any of our property or that of certain of our subsidiaries;
- making investments;
- consolidating or merging with, or acquiring, another business;
- selling or disposing of our assets;
- paying dividends and making other distributions to our stockholders;