

MAGIC SOFTWARE ENTERPRISES LTD
Form 20-F
March 30, 2005

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR

(g) OF THE SECURITIES EXCHANGE ACT OF 1934

or

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2004

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: 0-19415

MAGIC SOFTWARE ENTERPRISES LTD.

(Exact Name of Registrant as Specified in Its Charter
and Translation of Registrant's Name Into English)

Israel

(Jurisdiction of

Incorporation or Organization)

5 Haplada Street, Or Yehuda 60218, Israel

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(Address of Principal Executive Offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

None

Securities registered or to be registered pursuant to Section 12(g) of the Act:

Ordinary Shares, NIS 0.1 Par Value

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

Ordinary Shares, par value NIS 0.1

31,180,275

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 check mark which financial statement item the registrant has elected to follow:

Item 17 Item 18

INTRODUCTION

Magic Software Enterprises Ltd. develops, markets and supports software development, deployment and integration technologies that enable enterprises to accelerate the process of building and deploying applications that can be rapidly customized and integrated with existing systems. Our core technology, eDeveloper, is based on a revolutionary programming paradigm that eliminates wasted time and repetition from the development cycle, significantly reducing development, deployment and maintenance time and costs. eDeveloper is built around the concept of a smart application engine that provides platform and database independence for the development of composite applications that bridge computing architectures, such as Java, .Net and other diverse standards.

In mid-2002, we embarked on the development of a suite of integration products targeted toward mid-size and large organizations that have multiple computing environments, limited budgets and time to market challenges. In May 2003, we launched the iBOLT Integration Suite, which enables companies to utilize their existing business processes and legacy investments, and rapidly customize solutions to meet specific enterprise needs, at an affordable price. iBOLT has become a major focus of ours. In October 2004 we launched iBOLT Version 2.0, which offers enhanced functionality and further increases the power of the integration project manager.

In August 1991, we completed an initial public offering and in February 2000, we completed a public offering of additional ordinary shares. Our ordinary shares trade on the NASDAQ National Market and on the Tel Aviv Stock Exchange under the symbol MGIC.

Except for the historical information contained in this annual report, the statements contained in this annual report are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995, as amended, with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results. We urge you to consider that statements which use the terms anticipate, believe, do not believe, expect, plan, intend, estimate, anticipate and similar expressions are intended to identify forward-looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to publicly release any update or revision to any forward-looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3.D. Key Information- Risk Factors.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with U.S. generally accepted accounting principles, or U.S. GAAP. All references in this annual report to dollars or \$ are to U.S. dollars and all references in this annual report to NIS are to New Israeli Shekels. The representative exchange rate between the NIS and the dollar as published by the Bank of Israel on March 29, 2005 was NIS 4.37 per \$1.00.

As used in this annual report, the terms we, us and our refer to Magic Software Enterprises Ltd. and its subsidiaries, unless otherwise indicated.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we

filed any of these documents as an exhibit to this annual report or to any registration statement or annual report that we previously filed, you may read the document itself for a complete description of its terms.

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PART I

ITEM 1.

IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2.

OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3.

KEY INFORMATION

A.

SELECTED FINANCIAL DATA

We derived the following income statement data for the years ended December 31, 2002, 2003 and 2004 and the consolidated balance sheet data as of December 31, 2003 and 2004 from our audited consolidated financial statements and notes included elsewhere in this annual report. We derived the consolidated income statement data for the years ended December 31, 2000 and 2001 and the consolidated balance sheet data as of December 31, 2000, 2001 and 2002 from our audited consolidated financial statements that are not included in this annual report.

Income Statement Data:

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Year ended December 31,

2000 2001 2002 2003 2004

(U.S. dollars in thousands, except share and per share data)

| | | | | | |
|--|----------|------------|-----------|----------|----------|
| Revenues: | | | | | |
| Software | \$26,904 | \$19,110 | \$15,136 | \$19,712 | \$20,614 |
| Applications | 14,416 | 11,212 | 7,355 | 7,277 | 7,408 |
| Maintenance and technical support | 11,347 | 10,956 | 10,882 | 10,853 | 12,555 |
| Consulting services | 37,589 | 35,284 | 26,631 | 25,548 | 24,590 |
| Total revenues | 90,256 | 76,562 | 60,004 | 63,390 | 65,167 |
| Cost of revenues: | | | | | |
| Software | 3,635 | 4,187 | 3,318 | 3,943 | 4,742 |
| Applications | 2,007 | 2,399 | 2,334 | 1,162 | 1,720 |
| Maintenance and technical support | 4,200 | 4,334 | 4,100 | 2,580 | 3,199 |
| Consulting services | 24,014 | 25,622 | 19,239 | 16,454 | 15,818 |
| Total cost of revenues | 33,856 | 36,542 | 28,991 | 24,139 | 25,479 |
| Gross profit | 56,400 | 40,020 | 31,013 | 39,251 | 39,688 |
| Operating expenses: | | | | | |
| Research and development, net | 5,947 | 7,547 | 5,336 | 4,775 | 3,845 |
| Sales, marketing, general and administrative | 47,458 | 46,598 | 30,694 | 30,814 | 32,541 |
| Restructuring and other non-recurring costs | 2,466 | 6,613 | 1,123 | | |
| Impairment expenses | | 20,081 | | | |
| Operating income (loss) | 529 | (40,819) | (6,140) | 3,662 | 3,302 |
| Financial (expense) income, net | 2,419 | 575 | 958 | 307 | 912 |
| Other expenses | (623) | (2,199) | | 42 | |
| Income (loss) before taxes on income | 2,325 | (42,443) | (5,182) | 3,927 | 4,214 |
| Income taxes | 523 | (167) | (384) | 230 | 281 |
| | 1,802 | (42,610) | (5,566) | 3,697 | 3,933 |
| Equity in earnings (losses) of affiliates | (57) | | (108) | (36) | 79 |
| Minority interest in losses (earnings) of subsidiaries | (825) | (176) | 11 | (594) | 78 |
| Net income (loss) | \$920 | \$(42,786) | \$(5,663) | \$3,067 | \$ 4,090 |
| | | | | \$0.10 | \$ 0.13 |
| Basic net earnings (loss) per share | \$0.03 | \$(1.45) | \$(0.19) | | |
| | | | | \$0.10 | \$0.13 |
| Diluted net earnings (loss) per share | \$0.03 | \$(1.45) | \$(0.19) | | |

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| | | | | | |
|--|--------|--------|--------|--------|--------|
| Shares used to compute basic earnings (loss) per share | 29,084 | 29,604 | 29,690 | 29,624 | 31,029 |
| Shares used to compute diluted earnings (loss) per share | 30,232 | 29,604 | 29,690 | 29,909 | 32,426 |

Balance Sheet Data:

| | At December 31, | | | | |
|--|------------------------------------|-------------|-------------|-------------|-------------|
| | 2000 | 2001 | 2002 | 2003 | 2004 |
| | (U.S. dollars in thousands) | | | | |
| Working capital | \$48,968 | \$28,007 | \$23,200 | \$16,798 | \$19,852 |
| Cash, cash equivalents and marketable securities | 42,627 | 27,900 | 24,785 | 13,581 | 12,803 |
| Total assets | 137,995 | 94,612 | 84,522 | 77,800 | 80,285 |
| Shareholders' equity | 109,405 | 66,893 | 61,021 | 53,924 | 59,547 |

B.

CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C.

REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D.

RISK FACTORS

Investing in our ordinary shares involves a high degree of risk and uncertainty. You should carefully consider the risks and uncertainties described below before investing in our ordinary shares. Our business, prospects, financial condition and results of operations could be adversely affected due to any of the following risks. In that case, the

value of our ordinary shares could decline, and you could lose all or part of your investment.

Risks Related to Our Business and Our Industry

We have a recent history of losses and may not be able to maintain profitable operations in the future.

Although we reported net profit of approximately \$4 million and \$3 million for the fiscal years ended December 31, 2004 and 2003, respectively, we incurred net losses of \$5.7 million and \$42.8 million for the years ended December 31, 2002 and 2001, respectively. No assurance can be given that we will be able to maintain our current level of revenues and profitability in the future.

We have a history of quarterly fluctuations in our results of operations and expect these fluctuations to continue.

We have experienced and in the future may continue to experience significant fluctuations in our quarterly results of operations and we expect these fluctuations to continue. Factors that may contribute to fluctuations in our quarterly results of operations include:

-

The size and timing of orders;

-

The high level of competition that we encounter;

-

The timing of our product introductions or enhancements or those of our competitors or of providers of complementary products;

-

Market acceptance of our new products, applications and services;

-

The purchasing patterns and budget cycles of our customers and end-users;

-

Seasonality, including the relatively low level of general business activity during the summer months in Europe;

-

The mix of product sales;

-

Exchange rate fluctuations; and

-

General economic conditions.

Our customers ordinarily require the delivery of products promptly after we accept their orders. With the exception of contracts for services, we usually do not have a significant backlog of orders for our products. Consequently, revenues from our products in any quarter depend on orders received and accepted by the customers in that quarter. The deferral of the placing and acceptance of any large order from one quarter to another could materially adversely affect our results of operations for the former quarter. Our customers sometimes require an acceptance test for services we provide and as a result, we might have a significant backlog of orders for our services. Our revenues from services depend on orders received and services provided by us and accepted by our customers in that quarter. In addition, we anticipate that our operating expenses will continue to increase significantly. If sales in any quarter do not increase correspondingly or if we do not reduce our expenses in response to level or declining revenues in a timely fashion, our financial results for that quarter would be materially adversely affected. For these reasons, quarter-to-quarter comparisons of our results of operations are not necessarily meaningful and you should not rely on the results of our operations in any particular quarter as an indication of future performance.

Currency exchange rate fluctuations in the world markets in which we conduct business could have a material adverse affect on our business, results of operations and financial condition.

Our financial statements are stated in U.S. dollars, our functional currency. Nevertheless, a majority of our sales are made, and a majority of our expenses are incurred, in other currencies, particularly Euros, Japanese yen, NIS and U.K. pounds sterling. We maintain substantial non-U.S. dollar balances of assets, including cash and accounts receivable, and liabilities, including accounts payable. Fluctuations in the value of the currencies in which we do business relative to the U.S. dollar could have a material adverse effect on our business, results of operations and financial condition, by decreasing the U.S. dollar value of assets held in other currencies and increasing the U.S. dollar amount of liabilities payable in other currencies. Generally, we do not use derivative instruments or hedge to cover all exposures.

Our widespread operations may strain our management, operational and financial resources.

Our widespread operations have significantly strained our management, operational and financial resources in the past. Any future growth may increase this strain. To manage future growth effectively, we must:

-

Expand our operational, management, financial, marketing and research and development functions;

-

Train, motivate, manage and retain qualified employees; and

-

Hire additional personnel.

We may not succeed in managing future growth.

We face intense competition in the markets for our application development and integration technologies, applications and services.

Many companies compete with us in the areas of software development tools, business integration and business process management, or BPM, tools, and in the applications and services markets in which we operate. We expect that competition will increase in the future, both with respect to our technology, applications and services which we currently offer and applications and services which we and other members of the Magic community are developing. Increased competition, direct and indirect, could adversely affect our business, financial condition and results of operations.

Many of our existing and potential competitors are far larger, have substantially greater resources including financial, technological, marketing, skilled human resources and distribution capabilities, and enjoy greater market recognition than us. We may not be able to differentiate our products from those of our competitors, offer our products as part of integrated systems or solutions to the same extent as our competitors, or successfully develop or introduce new products that are more cost-effective, or offer better performance than our competitors. Failure to do so could adversely affect our business, financial condition and results of operations.

We may not succeed in increasing our market share in the business integration and process management markets with our iBOLT products.

During 2003, we launched the iBOLT Integration Suite, which provides business integration and process management solutions to mid-size and large organizations. In October 2004 we launched iBOLT Version 2.0, which offers new functions. iBOLT has been positively endorsed by customers, business partners and by leading technology analysts.

The business integration and BPM markets in which we compete are extremely competitive and subject to rapid changes. Our competitors utilize varying approaches to the provision of technology to business integration and BPM markets. Although we have managed to increase both our presence and our performance in these markets since iBOLT was launched, we may not have the resources, skills and product variety required to successfully increase our market share in these markets. We do not have a long history of selling products in the business integration and process management markets and we will have to devote substantial resources to educating prospective customers and the market about our products' benefits. In addition, even if we succeed in convincing prospective customers and the market that our products are effective and provide real business benefits, our target customers may not choose them for technical, cost, support or other reasons.

To succeed in these markets, we will need to:

-

Further develop and improve our expertise in marketing and selling integration technology;

-

Recruit, develop and cultivate additional system integrators who will serve as market and sales channels of integration projects for prospective customers;

-

Effectively establish and enhance relationships with technological partners and application vendors, which will extend our value proposition and assist us in reaching more customers.

Our future success will be largely dependent on the acceptance of future releases of our eDeveloper application development and deployment product.

Our future success will be in great measure dependent on the acceptance of future releases of eDeveloper application development and deployment environment. The acceptance of this product relies in part on the continued acceptance and growth of diverse platforms, systems and databases, where eDeveloper operates as the bridge for creating composite applications. We cannot predict with any certainty that organizations will continue to implement multiple environments to serve their computing needs.

Changes in the ratio of revenues from software licenses to revenues from services may adversely affect our gross profit margins.

Historically, our revenues from software licenses have had a higher gross profit margin than our revenues from services. In 2001, our revenues from software licenses decreased at a greater rate than our revenues from services and had an adverse effect on our gross profit margin. In 2002, our revenues from services decreased at a greater rate than our revenues from software license and continued to have an adverse affect on gross profit margins. In 2003, our software license revenues increased while our revenues from services decreased. In 2004 our software licenses revenues and our revenues from services remained the same as in 2003 and our gross profit increased slightly. Any future decrease in the percentage of revenues derived from software licenses as compared to revenues from services may adversely affect our gross profit margin.

We derive a portion of our revenues, and a greater percentage of our operating profit, from independent distributors who are under no obligation to purchase our products.

We sell our products through our direct sales representatives and through Magic solution providers and independent distributors. These independent distributors then resell our products to end-users. We are dependent upon the acceptance of our products by our independent distributors and their active marketing and sales efforts. Typically, our arrangements with our independent distributors do not require them to purchase specified amounts of products or prevent them from selling non-competitive products. The independent distributors may not continue, or may not give a high priority to, marketing and supporting our products. Our results of operations could be materially adversely affected by changes in the financial condition, business, marketing strategies, local and global economic conditions, or results of our independent distributors.

We may lose independent distributors on which we currently depend and we may not succeed in developing new distribution channels.

If any of our distribution relationships are terminated, we may not be successful in replacing them on a timely basis, or at all. In addition, we will need to develop new sales channels for new products, and we may not succeed in doing so. Any changes in our distribution and sales channels, particularly the loss of a major distributor or our inability to establish effective distribution and sales channels for new markets, will impact our ability to sell our products and result in a loss of revenues and profits.

Our efforts to increase our presence in the United States and Europe may not be profitable.

Our success in becoming a stronger competitor in the sale of software development and deployment technology and a leading provider of applications is dependent upon our ability to increase our sales in the U.S. and in Europe. Our efforts to increase our penetration of the U.S. and European markets is subject to risks inherent to these markets including the high cost of doing business there.

Our products have a lengthy sales cycle.

Our customers typically use our technology to develop, deploy and integrate applications that are critical to their businesses. As a result, the licensing and implementation of our technology generally involves a significant commitment of attention and resources by prospective customers. Because of the long approval process that typically accompanies strategic initiatives or capital expenditures by companies, our sales process is often delayed, with little or no control over any delays encountered by us. Our sales cycle can be further extended for sales made through third party distributors.

Rapid technological change may adversely affect the market acceptance of our products and services.

We compete in a market that is characterized by rapid technological change. The introduction of new technologies could render existing products and services obsolete and unmarketable and could exert price pressures on our products and services. Our future success will depend upon our ability to address the increasingly sophisticated needs of our customers by:

-

Supporting existing and emerging hardware, software, databases and networking platforms; and

-

Developing and introducing new and enhanced software development technology and applications that keep pace with such technological developments, emerging new markets and changing customer requirements.

If release dates of any future products or enhancements are delayed or if, when released, fail to achieve market acceptance, our business, financial condition and results of operations would be materially adversely affected.

We may be unable to attract, train and retain qualified engineering, administrative, operational, sales and technical support personnel.

In the event our business grows, we will need to hire additional qualified engineering, administrative, operational, sales and technical support personnel. The process of locating, training and successfully integrating qualified personnel into our operations can be lengthy and expensive. We may not be able to compete effectively for the personnel we need. Competition for these employees in the industry in which we operate is intense around the world, especially in Israel, India and the United States. Any loss of members of senior management or key technical personnel, or any failure to attract or retain highly qualified employees as needed, could have a material adverse effect on our business, financial condition and results of operations.

Our products may contain defects that may be costly to correct, delay market acceptance of our products and expose us to difficulties in the collection of receivables and to litigation.

Despite quality assurance testing done by us, by Magic solution providers and by end-users, errors may be found in our software products or in applications developed with Magic technology. This risk is exacerbated by the fact that a significant percentage of the applications developed with Magic technology were and are likely to continue to be developed by Magic solution providers over whom we exercise no supervision or control. If defects are discovered, we may not be able to successfully correct them in a timely manner or at all. Defects and failures in our products could result in a loss of, or delay in, market acceptance of our products, as well as difficulties in the collection of receivables and litigation, and could damage our reputation.

Although our standard license agreement with our customers contains provisions designed to limit our exposure to potential product liability claims, it is possible that these provisions may not be effective or enforceable under the laws of some jurisdictions, and we could fail to realize revenues and suffer damage to our reputation as a result of, or in

defense of, a substantial claim.

We rely on third party technology licenses.

We incorporate software that we license from third parties in our Magic technology. If we lose, or are unable to maintain any software licenses, we could suffer harm until equivalent software can be developed, identified, licensed and integrated. Loss of third party software licensing would materially adversely affect our business, financial condition and results of operations.

Our proprietary technology is difficult to protect and unauthorized use of our proprietary technology by third parties may impair our ability to compete effectively.

Our success and ability to compete depend in large part upon our ability to protect our proprietary technology. We rely on a combination of trade secret and copyright laws and confidentiality, non-disclosure and assignment-of-inventions agreements to protect our proprietary technology. We do not have any patents. Our policy is to require employees and consultants to execute confidentiality agreements upon the commencement of their relationships with us. These measures may not be adequate to protect our technology from third-party infringement, and our competitors might independently develop technologies that are substantially equivalent or superior to ours. Additionally, our products may be sold in foreign countries that provide less protection for intellectual property rights than that provided under U.S. or Israeli laws.

Our products may infringe the intellectual property rights of others.

Third parties may assert infringement claims against us or claims that we have violated a patent or infringed on a copyright, trademark or other proprietary right belonging to them. In addition, any infringement claim, even one without merit, could result in the expenditure of significant financial and managerial resources to defend.

We may encounter difficulties with our international operations and sales.

While our principal executive offices are located in Israel, 94% of our sales in both 2002 and 2003 and 95% of our sales in 2004 were generated from other countries. This subjects us to many risks inherent to international business activities, including:

- Limitations and disruptions resulting from the imposition of government controls;
- Changes in regulatory requirements;
- Export license requirements;
- Economic or political instability;
-

Trade restrictions;

-

Changes in tariffs;

-

Currency fluctuations;

-

Difficulties in the collection of receivables;

-

Greater difficulty in safeguarding intellectual property; and

-

Difficulties in managing overseas subsidiaries and international operations.

We may encounter significant difficulties in connection with the sale of our products in international markets as a result of one or more of these factors.

Formula Systems (1985) Ltd. may continue to control us.

Formula Systems (1985) Ltd., whose shares trade on the NASDAQ National Market and the Tel Aviv Stock Exchange, or TASE, directly owns 15,620,348 or 50.18% of our outstanding ordinary shares. Formula Systems is and may continue to be in a position to exercise control over most matters requiring shareholder approval, including the election of our directors, approval of significant corporate transactions and the general ability to direct our affairs. Such concentration of ownership may have the effect of delaying or preventing a change in control.

Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new Securities and Exchange Commission regulations and NASDAQ Stock Market rules, are creating uncertainty for companies such as ours. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we intend to invest reasonably necessary resources to comply with evolving standards, and this investment may result in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities, which could harm our operating results and business prospects.

The implementation of SFAS No. 123(R), which will require us to record compensation expense in connection with equity share based compensation as of the third quarter of 2005, will reduce our profitability.

On December 16, 2004, the Financial Accounting Standards Board, or FASB issued Statement No. 123 (revised 2004), Share-Based Payment, or SFAS No. 123(R), which is a revision of SFAS No. 123. Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123. However, SFAS No. 123 permitted, but did not require, share-based payments to employees to be recognized based on their fair values while SFAS No. 123(R) requires, as of the third quarter of 2005, all share-based payments to employees to be recognized based on their fair values. SFAS No. 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The adoption of SFAS No. 123(R) may have a significant effect on our company's results of operations in the future. In addition, such adoption could also limit our ability to use stock options as an incentive and retention tool, which could, in turn, hurt our ability to recruit employees and retain existing employees.

Risk Factors Related to Our Ordinary Shares

Our share price has been very volatile in the past and may continue to be susceptible to significant market price and volume fluctuations in the future.

Our ordinary shares have experienced significant market price and volume fluctuations in the past and may experience significant market price and volume fluctuations in the future in response to factors such as the following, some of which are beyond our control:

-

Quarterly variations in our operating results;

-

Operating results that vary from the expectations of securities analysts and investors;

-

Changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;

-

Announcements of technological innovations or new products by us or our competitors;

-

Announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;

-

Changes in the status of our intellectual property rights;

-

Announcements by third parties of significant claims or proceedings against us;

-

Additions or departures of key personnel;

-

Future sales of our ordinary shares;

-

Stock market price and volume fluctuations; and

-

General trends of the stock markets.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our ordinary shares.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We may in the future be the targets of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

We do not anticipate paying cash dividends in the foreseeable future and, therefore, it may be difficult for you to earn a positive return on your investment.

Although we paid a one-time cash dividend of \$11,844,713 in February 2003, we currently intend to retain all future earnings to fund the growth of our business and do not anticipate paying any further cash dividends in the foreseeable future. As a result, investors will only be able to earn a positive return on their investment from selling their shares in higher price than purchased.

Risks Relating to Our Location in Israel

Conducting business in Israel entails special risks.

We are incorporated under the laws of, and our executive offices and research and development facilities are located in, the State of Israel. Although most of our sales are made to customers outside Israel, we are nonetheless directly influenced by the political, economic and military conditions affecting Israel. Specifically, we could be adversely affected by any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Since September 2000, there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. There is no indication as to how long the current hostilities will last or whether there will be any further escalation. Any further escalation in these hostilities or any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price. Furthermore, there are a number of countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed

towards Israel or Israeli businesses had, and may in the future continue to have, an adverse impact on our operations, our financial results or the expansion of our business. No predictions can be made as to whether or when a final resolution of the area's problems will be achieved or the nature thereof and to what extent the situation will impact Israel's economic development or our operations.

Our results of operations may be negatively affected by the obligation of our personnel to perform military service.

Many of our executive officers and employees in Israel are obligated to perform up to 30 days, depending on rank and position, of military reserve duty annually and are subject to being called for active duty under emergency circumstances. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence of one or more of our executive officers or key employees or a significant number of other employees for a significant period due to military service. Any disruption in our operations could adversely affect our business.

The economic conditions in Israel have not been stable in recent years.

In recent years Israel has been going through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel continue to deteriorate. In addition, due to significant economic measures proposed by the Israeli Government, there have been several general strikes and work stoppages in 2003 and 2004, affecting all banks, airports and ports. These strikes have had an adverse effect on the Israeli economy and on business, including our ability to deliver products to our customers. Following the passage by the Israeli Parliament of laws to implement the economic measures, the Israeli trade unions have threatened further strikes or work stoppages, and these may have a material adverse effect on the Israeli economy and on us.

We may be adversely affected if the rate of inflation in Israel exceeds the rate of devaluation of the New Israeli Shekel against the U.S. dollar.

A portion of our expenses, primarily labor expenses, is incurred in New Israeli Shekels, or NIS. As a result, we are exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the U.S. dollar or that the timing of this devaluation lags behind inflation in Israel. In 1997, 1998, 2001 and 2002, the rate of devaluation of the NIS against the dollar exceeded the rate of inflation in Israel, a reversal from prior years that benefited us. In 1999 and 2000, the rate of inflation exceeded the rate of devaluation of the NIS against the U.S. dollar. In 2004, the inflation rate in Israel was 1.2%. We cannot assure that we will not be materially and adversely affected in the future if the rate of inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of this devaluation lags behind increases in inflation in Israel.

We currently benefit from government tax benefits, which may be discontinued or reduced in the future.

We are currently eligible to receive tax benefits under Government of Israel programs. In order to maintain our eligibility for these tax benefits, we must continue to meet specific conditions, including making specified investments in fixed assets. If we fail to comply with these conditions in the future, the tax benefits received could be canceled and we could also be required to pay significantly increased taxes for prior years and for the future.

Service and enforcement of legal process on us and our directors and officers may be difficult to obtain.

Service of process upon our directors and officers and the Israeli experts named herein, all of whom reside outside the United States, may be difficult to obtain within the United States. Furthermore, since substantially all of our assets, all of our directors and officers and the Israeli experts named in this annual report are located outside the United States, any judgment obtained in the United States against us or these individuals or entities may not be collectible within the United States.

There is doubt as to the enforceability of civil liabilities under the Securities Act and the Securities Exchange Act in original actions instituted in Israel. However, subject to certain time limitations and other conditions, Israeli courts may enforce final judgments of United States courts for liquidated amounts in civil matters, including judgments based upon the civil liability provisions of those Acts.

Provisions of Israeli law may delay, prevent or make difficult an acquisition of us, which could prevent a change of control and therefore depress the price of our shares.

Provisions of Israeli corporate and tax law may have the effect of delaying, preventing or making more difficult a merger with, or other acquisition of, us. This could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain control of us. Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unable or unwilling to do so because of these provisions of Israeli law.

Your rights and responsibilities as a shareholder will be governed by Israeli law and differ in some respects from the rights and responsibilities of shareholders under U.S. law.

We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, our articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In particular, a shareholder of an Israeli company has a duty to act in good faith toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law provides that these duties are applicable in shareholder votes on, among other things, amendments to a company's articles of association, increases in a company's authorized share capital, mergers and interested party transactions requiring shareholder approval. In addition, a shareholder who knows that it possesses the power to determine the outcome of a shareholder vote or to appoint or prevent the appointment of a director or executive officer in the company has a duty of fairness toward the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revision in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

ITEM 1.

INFORMATION ON THE COMPANY

A.

HISTORY AND DEVELOPMENT OF THE COMPANY

We were incorporated under the laws of the State of Israel on February 1983 as Magic Software (1983) Ltd. for an indefinite term. We changed our name to Magic Software Enterprises Ltd. in 1991. We are a public limited liability company and operate under the Israeli Companies Law 1999 and associated legislation. Our registered offices and principal place of business are located at 5 Haplada Street, Or Yehuda 60218, Israel, and our telephone number is 972-3-538-9292. Our address on the Internet is www.magicsoftware.com. The information on our website is not incorporated by reference into this annual report.

We develop, market and support software development, deployment and integration technologies and business solutions that enable enterprises to accelerate the process of building and deploying applications that can be rapidly customized and integrated with existing systems.

Magic technology and Magic-based applications are used by over 2,500 software solution providers and thousands of enterprises in approximately 40 countries. We refer to these software solution providers and enterprises as the Magic community. We also provide maintenance and technical support as well as professional services to the Magic community.

We also market and sell the iBOLT Business Integration Suite. In 2004 we released iBOLT Version 2.0. iBOLT provides affordable business integration solutions to mid-sized and large enterprises and system integrators. As a comprehensive suite, iBOLT allows the simple integration and interoperability of diverse solutions, including legacy applications in a quick and efficient manner.

During 2004, we entered into a number of partnerships for the purpose of enhancing iBOLT. The most notable of these was a new marketing agreement with SAP America, Inc., the North American subsidiary of SAP AG (NYSE: SAP), pursuant to which we introduced a specially designed iBOLT Integration Suite for SAP Business One and achieved access to the qualified group of SAP Business One partners.

We entered into a marketing agreement with IDS Scheer AG. Under the terms of this agreement, we will work with IDS Scheer to market IDS software products from its ARIS product line for business process management.

We also entered into an agreement with Enformia Software Ltd., a company in which Mr. David Assia, chairman of our board of directors is a shareholder, to integrate their portal technology into the iBOLT Integration family of products. The product, to be known as iBOLT Portal, enables corporations to deliver customized information and applications to a wide range of users, customers, employees, partners and suppliers, using an architecturally superior approach to provide improved customer service and retention, enhanced communication and increased productivity. iBOLT Portal sales in 2004 helped introduce iBOLT to a number of customers worldwide, including Israel's Electricity Company and Vodafone UK.

In February 2004, we increased our holdings in CarPro Systems Ltd. to 87.5%. In addition, during the first quarter of 2004, we increased our holdings in Advanced Answers on Demand Holding Corp. to 84%.

In July 2004, we acquired the remaining 26% minority interest in our Hungarian subsidiary, Onyx Szoftverhaz Korlatolt Felelossegu Tarsasag, from its minority shareholders and increased our holdings in this company to 100%.

In 2002, we established a joint venture company in the UK, known as Hermes Logistics Technologies Ltd. together with Menzies Aviation Group plc, or Menzies. In the second half of 2004 we purchased Menzies' interest in Hermes, and increased our interest in Hermes to 100%, also including the purchase of Menzies intellectual property rights in the Hermes software. Pursuant to the agreement with Menzies, we agreed to pay Menzies 1.75% of the gross sales of the Hermes business, including license fees and service fees, until July 2009.

B.

BUSINESS OVERVIEW

General

We develop, market and support eDeveloper, a software development and deployment technology, and iBOLT, a technology for business integration and BPM. Our technology enables enterprises to accelerate the process of building and deploying business software applications that can be rapidly customized to meet current and future

needs.

Our development and integration products empower customers to dramatically improve their business performance and return on investment by enabling the affordable and rapid integration of diverse applications, systems and databases to streamline business processes from within one comprehensive framework.

Our technology and solutions are especially in demand when time-to-market considerations are critical, budgets are tight, integration is required with multiple platforms, databases or existing systems and business processes, or a high degree of application maintenance and customization is anticipated.

We address the critical business needs for companies to be able to quickly respond to changing market forces and demands. Robust business solutions are created, deployed and maintained with unrivaled productivity and time-to-market results. Our proprietary development methodology enables developers to create better solutions in less time and with fewer resources.

Development communities have become increasingly disjointed, creating an even greater need for a development environment that provides open interfaces to leading technologies and standards. eDeveloper and iBOLT provide developers with the ability to rapidly build integrated applications in a more productive manner, lowering IT maintenance costs and decreasing time-to-market.

The Magic Solution

Our eDeveloper and iBOLT technologies offer system integrators, software developers and end-users of deployed applications the following benefits:

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Time to Market. We believe that the methodology of our technologies allow enterprises to prototype and develop, integrate and deploy complex, mission-critical components and applications rapidly and in a cost-effective manner. Most program functionality that usually requires repetitive, tedious coding is provided by our underlying core development technology, eDeveloper. In today's dynamic and competitive business environment, the development community is under pressure to produce and integrate applications faster and with more meaningful business processes and information than ever before, while reducing costs. Both eDeveloper and iBOLT enable organizations to meet these needs.

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Scalability and Adaptability. Applications developed and integrated with eDeveloper and iBOLT can be easily modified as business requirements change, computing environments evolve and end-user usage and transaction volumes increase. As a result, implementations of our technology can be quickly adapted to support increased functionality and wider use throughout an organization. Applications developed with the eDeveloper technology can grow within an enterprise from the departmental level to the enterprise level by accommodating additional platforms, databases and operating systems and increased usage and application complexity. Our eDeveloper technology also enables partitioning of applications by allowing application logic to be distributed across a system in order to achieve optimal system performance and flexibility. Our iBOLT eDeveloper and iBOLT technologies enable enterprises to respond quickly to unanticipated changes in their business requirements to protect their investments in software and hardware.

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Portability. We designed our eDeveloper and iBOLT technologies to enable enterprises to develop and integrate applications that can be used with most hardware platforms, operating systems and databases. Applications developed with our technology for one platform also can be deployed on other supported platforms. Simply changing the relevant parameters in an application and initiating the file conversion of the application accomplish porting an application developed with our technology from one platform to another. As a result, porting applications can be accomplished without the lengthy coding, compiling, linking and testing phases typically required with other development methodologies. Applications developed with our technology can also be partitioned across multiple platforms. Developers can therefore take advantage of the flexibility and performance advantages inherent in multi-tiered architectures. The portability of applications developed with our software development technology enables enterprises to migrate quickly to new computing environments without having to rewrite their applications.

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Database Access and Technology Independence. eDeveloper and iBOLT allow enterprises to access and manipulate data from multiple databases, each based on a different technology, into a single integrated application. Developers and end-users can access multiple legacy and relational databases across the enterprise from within the same application and from within the same data view. Our technology can easily move data across platforms and convert the data from one database format to another.

Strategy

Our goal is to achieve a leadership position in the software development and business integration and deployment technology markets. We focus on providing technology, applications and services that enable enterprises to meet their business needs on time and budget. The key elements of our strategy to achieve this goal are:

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Target mid-size enterprises, with focus on organizations that require rapid solutions for critical projects at an affordable price;

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Enhance strategic relationships with integration specialists and Magic solution partners for vertical market penetration;

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Form partnerships with complementary technology vendors to increase license sales and overall transactions value;

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Form new partnerships with new system integrators, who specialize in implementing business integration and process management projects; and

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Form new partnerships with global and local application vendors, who lack integration capabilities that can be provided by the iBOLT technology.

We intend to promote the growth of iBOLT sales through market development, acquisition of new businesses and partner recruitment. With respect to eDeveloper, we will concentrate on increasing market penetration, as well as

consolidating our existing position in the market. We intend to focus on the continued cultivation of our customer base and increase our customer care and retention capabilities, with an emphasis on realizing new business from existing customers through upgrades, maintenance, education and development projects.

Products

Magic Technologies

eDeveloper. Our core technology, eDeveloper, is based on a revolutionary programming paradigm that eliminates wasted time and repetition from the development cycle. This paradigm maximizes manpower productivity and other resources that enable developers to easily and rapidly create highly functional, scalable and portable business applications tailored to meet the most demanding requirements.

Based on a visual table-driven programming methodology, eDeveloper allows developers to quickly create and easily modify applications by filling in forms and tables that define data structures, business rules and program logic. This methodology does not require developers to write any program code, significantly reducing development time and programming errors.

eDeveloper is built around the concept of a smart application engine that provides unique platform and database independence for Web and client/server development. eDeveloper integrates with standard computing architectures, including J2EE and .Net and can act as the bridge between these and other diverse standards such as XML and Web Services. Applications developed with eDeveloper interact and integrate with advanced J2EE application servers, such as IBM's WebSphere. eDeveloper enables these applications to also be deployed as Web Services. We released eDeveloper Version 9.2 in December 2001, Version 9.3 in July 2002 and Version 9.4 in March 2003.

Customer results have proven that eDeveloper can deliver solutions over 50% quicker than standard development environments, greatly increasing time-to-market and return on investment, or ROI, from the development effort. In addition, eDeveloper significantly reduces maintenance time and costs. Our research and development teams continue to develop and integrate new technologies into eDeveloper to ensure that our customers have the best development environment available on the market today.

iBOLT Integration Suite. Our iBOLT Integration Suite is a business integration platform targeted at mid-sized organizations, a considerably unserved market in today's hot business integration space. iBOLT is based on existing eDeveloper and connectivity technology. When we realized that most of our customers were using our development environment for application development and integration, we began to add the necessary components to make our solution a stand-alone business integration environment.

iBOLT Integration Suite provides mid-sized organizations with an affordable platform for integrating many of their existing business-critical applications. In most cases, companies can purchase licenses for iBOLT Integration Suite that include development, staging, and production environments for less than \$100,000, an important differentiation from other business integration environments that are cost-prohibitive for the mid-sized organization. Companies in vertical markets ranging from manufacturing to insurance and financial services can use iBOLT technology to market their product via Web interfaces, to connect to their suppliers' systems, and to integrate multiple separate applications (including legacy) that comprise a distribution system.

As a comprehensive suite for application integration, iBOLT includes a robust set of capabilities for handling integration and exchanging transactions in a heterogeneous environment. It includes support for business process management, monitoring and real time reporting. In addition, iBOLT is able to directly tackle the challenge of rapidly changing business requirements with the use of our eDeveloper technology.

iBOLT provides integration and connectivity capabilities that include database interoperability, the ability to work with multiple databases in the same process, and the capacity to deploy on a range of systems on varied platforms. iBOLT also includes an assortment of smart connectors and adapters and ready-to-use components.

Seamless interfaces are provided with iBOLT for messaging to and from middleware technologies, such as XML, Web services, Websphere, MQ, JMS, MSMQ, J2EE and .NET platforms. iBOLT integration solutions can be deployed on Windows, most UNIX platforms including AIX, HP-UX and Solaris, Linux, and on the IBM iSeries. We released iBOLT Version 1.5 in November 2003 and version 2.0 in October 2004.

iBOLT supports most combinations of integration architectures such as network, bus or hub and spoke, with messaging models including publish and subscribe, request and reply and transaction integrity. iBOLT supports the use of Java and .NET Framework components.

In 2003 iBOLT received confirmation of compliance within Giga Group's Application Integration Framework (AIF) model. In November 2004 the Gartner Group published a report indicating that iBOLT is a rich and easy-to-use platform. In December 2004 the Forrester Research published a report stating that, Magic Software's iBOLT product offers strong integration capability at a reasonable price.

Magic Applications

We have developed CRM applications for online customer service and content center management, which will assist companies to provide superior service and information flow in acquiring, developing and retaining their customer base. Superior customer experience will be provided by our comprehensive solutions, which will allow users to provide customers with consistent, accurate and relevant information.

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Magic eContact. Magic eContact manages all aspects of a contact center, from sales and marketing to customer care and support. We believe that Magic eContact is one of the most rapid-to-implement contact center systems available on the market. Magic eContact provides contact center agents with the professional tools needed to efficiently and cost-effectively manage customer interactions, including the ability to drive targeted marketing campaigns in rapid response to market changes. We released Magic eContact Version 2.5 in May 2002.

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Magic eService. Magic eService is an Internet-based customer service management system. With Magic eService, customers are able to find solutions on their own, using a sophisticated scripted online help-desk or the knowledge base of tech notes and previously offered customer solutions, or they can interact with customer service agents by opening a service request directly on the Internet site and tracking it to completion. Customers are able to track their service requests via the Internet site or via automatic notification by e-mail. Communications between customers and service agents are saved in the Magic eService system. Magic eService is wireless application protocol-enabled.

Magic Software Vertical Solutions

Some of our subsidiaries develop, market, and support vertical applications, including long-term care, criminal justice, and multi-facility car and truck rental management solutions.

Advanced Answers on Demand, Inc. develops and markets application software targeted at the long-term care industry. Its comprehensive solution is designed to meet the management information needs of retirement homes,

nursing homes, assisted living facilities, continuing care retirement communities, and home health and rehabilitation agencies. In March 2004, we increased our holdings in Advanced Answers on Demand from 63% to 84%.

CarPro Systems Ltd. develops, markets and sells CarPro™, a solution that includes more than 90% of the functions usually required by multi-facility car and truck rental companies worldwide. CarPro can manage such varied functions as purchasing and selling vehicles, reservations management, leasing and rental arrangements, and fleet control and management. In February 2004, we increased our holdings in CarPro Systems Ltd. from 75 to 87.5%.

Nextstep Infotech PVT. Ltd. develops and markets Cheq Mate™, a banking application that provides most of the functionality needed to run a retail bank branch, including support for various deposit types, advances, time deposits, bank guarantees, letters of credit and portfolio management. We currently hold a 40% interest in Nextstep Infotech.

CoreTech Consulting Group LLC is an information technology consulting firm offering flexible and creative solutions in the areas of infrastructure design and delivery; application development; technology planning and implementation services; and supplemental staffing. CoreTech is our wholly owned subsidiary.

Hermes (formerly Magic eCargo) is designed expressly for the cargo industry and is a comprehensive solution for cargo handling and inventory control that is designed to increase productivity, improve efficiency, and reduce costs.

Hermes handles many aspects of a cargo operation including inventory control, automated build-up of flights/manifesting, messaging to CARGO-IMP standards, customs clearance, weight and balance DCS interfacing, scanning and verification of cargo, secured tracking and a comprehensive financial package for all aspects of billing and collecting fees. We hold 100% of the company that owns the intellectual property rights in the Hermes software.

Services

Professional Services. We provide a broad range of consulting and software development project management services to customers developing, deploying and integrating distributed applications. We believe that the availability of effective consulting services is an important factor in achieving widespread market acceptance.

We offer fee-based consulting services in connection with installation assurance, application audits and performance enhancement, application migration and application prototyping and design. Consulting services are aimed at both generating additional revenues and ensuring successful implementation of eDeveloper and iBOLT projects through knowledge transfer. Our consultants provide a value-added service on large development projects supporting existing teams in the design or implementation cycle, and maximizing the utilization of resources in large development environments. The consultants help developers design prototype applications. Program components written by our consultants may also be added onto existing programs or programs in development. We also offer consulting services in rapid prototyping, multi-platform integration and migration to more efficient environments. Specialized consultants are also available to assist customers in all facets of migration from host character-based applications to distributed and Internet applications.

Services are offered as separately purchased add-on packages or as part of an overall software development and deployment technology framework. Over the last several years, we have built upon our established global presence to form joint ventures with our Magic solution providers and distributors to deliver successful solutions in focused market sectors. We promote these solutions and help tailor them to enterprises. An integration of the acquired technology from a particular market sector with local expertise has proven to both save time and enable building solutions that better meet customers' needs.

Maintenance. We offer our customers annual maintenance contracts providing for upgrades and new versions of our products for an annual fee.

Technical Support. We believe that a high level of customer support is important to the successful marketing and sale of our products. Our in-house technical support group provides training and post-sale support. We believe that effective technical support during product evaluation as well as after the sale has substantially contributed to product acceptance and customer satisfaction and will continue to do so in the future.

We instituted an online support system for the Magic community in the United States and Canada, which provides members of the Magic community with the ability to instantaneously enter, confirm and track support requests via the Internet. Magic eService was implemented by our technical support organization as a virtual support center which provides support to Magic solution providers and end-users worldwide.

Training. We conduct formal and organized training through our Magic University. Magic University staff members have developed several courses, pertaining to our principal products including our eDeveloper and iBOLT. Each of these courses includes trainer and student guidebooks. Course materials are available both in traditional, classroom courses and as Web-Based Training modules, which can be downloaded and studied at the student's own pace and location. The courses and course materials are designed to accelerate the learning process, using an intensive technical curriculum in an atmosphere conducive to productive training.

Magic University also assists our professional services managers in designing and implementing custom-made client-site courses. These courses are conducted by certified instructors who are either our employees or employees of our distributors. In addition, we have been utilizing web-based training and demos more frequently for our employee training and customer demos.

Customers, End-Users and Markets

We market and sell our products and services in approximately 40 countries worldwide.

The following table presents our revenues by revenue type and geographical market for the periods indicated:

| | Year ended December 31, | | |
|-----------------------------------|--------------------------------|-------------|-------------|
| | 2002 | 2003 | 2004 |
| | In thousands | | |
| Revenues: | | | |
| Software sales | \$ 22,491 | \$ 26,989 | \$ 28,022 |
| Maintenance and technical support | 10,882 | 10,853 | |
| Consulting services | 26,631 | 25,548 | 12,555 |
| | | | 24,590 |
| Total revenues | \$ 60,004 | \$ 63,390 | \$ 65,167 |

| Geographical Market | Year ended December 31, | | |
|---------------------|-------------------------|--------|-----------|
| | 2002 | 2003 | 2004 |
| | In thousands | | |
| Israel | \$ | \$ | \$ 3,354 |
| | 3,417 | 3,643 | |
| Europe | 16,136 | 24,934 | 25,698 |
| U.S. | 22,044 | 21,050 | 21,090 |
| Japan | 9,563 | 9,444 | 11,450 |
| Other | 8,844 | 4,319 | 3,575 |
| Total | \$ | \$ | \$ 65,167 |
| | 60,004 | 63,390 | |

Industries that are significantly represented in our Magic community base include finance, retail, media, telecommunications, logistics, health care, manufacturing and government agencies. Our eDeveloper technology is used by a wide variety of developers that can be generally divided into two distinct segments: those performing in-house development (corporate information technology departments) and Magic solution providers that perform development for third parties. Magic solution providers include large system integrators that use our eDeveloper technology in large customized system projects and smaller independent Magic solution providers that generally perform development work for small to medium sized business clients. Magic solution providers that are packaged software publishers use our Magic technology to write standard packaged software products that are sold to multiple clients, typically within a vertical industry segment or a horizontal business function.

Among the thousands of end-users running their business systems with Magic technology are the following: Adidas-Solomon, Allstate, Athlon Group, Bank of France, Burger King, Chase Manhattan Bank, Club Med, Compass Group PLC, Deka Bank, Fiat, Financial Times, Hitachi, John Menzies, Kodak, Marconi Mobile, NEC, Merrill Lynch, Matsushita, McDonalds, McKesson HBOC, Minolta, Nestle Nespresso, Nintendo, Philip Morris, GAP, the -State of Washington, Vodafone, the United Nations and Victorinox.

Sales, Marketing and Distribution

We market and support our products through our own direct sales force in Europe, India, Israel, Japan and the United States and through a network of distributors, Magic solution providers and system integrators in those countries and various other countries in Asia, Europe, Africa and Latin America. We sell and support our products directly through our subsidiaries in Israel, France, Germany, Hungary, India, Italy, Japan, the Netherlands, the United Kingdom and the United States, and through local distributors elsewhere.

Sales. We maintain a direct sales force in the field for pursuing local accounts and software solution providers (VAR s). They carry out strategic sales with a direct approach to decision makers, managing a constantly monitored consultative type of sales cycle. On March 21, 2005, we had approximately 94 direct sales personnel in the field and a group of sales engineers who provide pre-sale technical support, presentations and demonstrations in order to support most of these sales persons. Sales efforts are targeted to large enterprises performing internal application development and Magic solution providers that use Magic technology to develop solutions for their customers. We also employ an in-house and external telesales staff to sell to prospect accounts and to generate and qualify leads.

Some larger Magic solution providers may also resell development systems when selling applications requiring on-site development, maintenance, and diagnostics. We carry out marketing activities with our Magic solution providers, such as publishing solutions directories and newsletters. We have a marketing program that supports Magic solution providers by providing a wide range of features and advantages in the areas of application development, sales and marketing to them.

Distributors. In general, we distribute our products through local distributors in those countries where we do not have a sales subsidiary. A local distributor is typically a software marketing organization with the capability to add value with consulting, training, and support. Distributors are generally responsible for the localization of our software development technology and applications into their native language. The distributors also translate our marketing literature and technical documentation. Distributors must undergo our program of sales and technical training. Marketing, sales, training, consulting, product and client support are provided by the local distributor. We are available for backup support for the distributor and for end-users. In coordination with the local subsidiaries and distributors, we also provide sales support for large and multinational accounts. We have approximately 30 distributors in Europe, Latin America and Asia, many of whom also act as Magic solution providers.

Marketing Activities. We carry out a wide range of marketing activities aimed at generating awareness of our products and sales leads, including an extensive program of Internet-based Webcasts, exhibitions, advertising and public relations, attendance at trade shows and exhibitions, direct mail, response mail, telemarketing campaigns and user and distributor conferences and seminars. We also devote substantial efforts to marketing our products on the Internet. We regularly advertise our products in prominent trade publications. These activities are intended both to maintain the general public awareness of the products and to generate sales leads. We participate in many major industry trade shows and fairs worldwide. We conduct the distributor and user conferences to update our worldwide affiliates and user base concerning our new releases, marketing strategies, pricing, technical information and the like. These events are conducted approximately once a year.

In order to foster improved relationships with our Magic solution providers, we periodically sponsor local events and other marketing programs and activities. On our corporate Internet site, we host an online solutions directory which highlights applications developed by our Magic solution providers, and an information sharing section which enables our Magic solution providers to participate alongside our representatives at trade shows and conferences. The Magic eNewsletter, an online publication that was developed as a public relations activity, is produced twice each month and distributed to the Magic community and to potential customers. It includes articles that highlight our Magic solution providers.

Strategic Alliances

The important strategic alliances formed by us to date include:

SAP. In 2004 we entered into a partnership with SAP, that focused on providing a special edition of iBOLT as a Collaboration Platform for the SAP Business One product. While the formal agreement was signed between Magic Software Enterprises Inc., or MSE Inc., and SAP America, the cooperation took place worldwide, in all the locations where the SAP Business One product has a significant presence. Our cooperation model is to be introduced to the regional SAP Business One management, who will consequently help us qualify and approach SAP Business Partners.

We offer these partners the opportunity to resell and implement the iBOLT Special Edition in conjunction with the SAP Business One product. This activity started in the last quarter of 2004 in the U.S. on a trial basis and was expanded and intensified as of January 2005 worldwide. Beyond the direct economic impact of iBOLT sales, we are experiencing the following advantages that arise from this partnership: (i) recognition and validation of our technology as a mainstream player in the Business Integration and Composite Application Development domains; (ii) privileged access to a pre-qualified partner community that can also employ iBOLT in non-SAP related projects; and (iii) revitalization of the Magic Solution Partners, MSP, community, offering our traditional partners access to the SAP Partner Program and branding of their existing applications.

IBM. During 2004 we continued to work closely with IBM as an Advanced Partner of IBM Partnerworld for Developer business partner program and as a Member Partner of IBM Partnerworld for Software. In the past, we have received the highest approval rating from IBM Alliance Shareholder/400 technical teams in Rochester for our adherence to IBM's e-business framework. The Level Four certification signifies that we are one of few elite companies able to demonstrate our support for several different servers using standards established by IBM. This key accomplishment helps foster our continued business relationship with IBM throughout the world. IBM has also awarded us with its ServerProven® certification for our eDeveloper product following a rigorous testing and evaluation process. Only those products that are validated by IBM to install quickly, start up easily and run reliably on IBM servers are awarded this certification, designed by IBM to help its customers easily identify complete solutions for their business-critical e-business needs.

In March 2004, we initiated the iBOLT Integration Partner plan for IBM business partners. The iBOLT Integration Partner program offers standard and platinum levels of partner participation. Both programs deliver technical training, sales training, sales support, technical support, implementation services and other vital vendor services.

During 2004, iBOLT was qualified as an industry Advanced IBM ISV Business Partner and was qualified for additional benefits and joint marketing activities. As a result, in 2004 we expanded our alliance initiatives with IBM in North America. In addition, cooperative marketing activities utilizing direct mail and telemarketing tactics were performed by IBM to promote iBOLT alongside IBM solutions in the health care industry, specifically to hospitals in need of HIPAA compliant solutions. Winslow Indian Health Center is an example of a new iBOLT customer gained in 2004 through our IBM relationship activities.

In 2004, IBM reorganized its partner programs around vertical industries. Our U.S. subsidiary, MSE Inc., is an advanced member of the IBM Partner World ISV Banking Network and is one of the only vendors that was certified for IBM's optimized status in that program. This certification supports our focused marketing efforts in the vertical financial market. This relationship also resulted in joint selling activity with IBM Global Services for the first time in North America, and IBM Global Services and MSE Inc. are jointly seeking new business opportunities and potential customers.

Magic Software Japan signed an OEM agreement with IBM Japan for the sale of IBM's DB2 UDB. The product fits very well with Magic Software Japan's market, supports Linux, UNIX, Windows and IBM business servers (eServer iSeries) and is widely accepted as a standard of SQL. IBM Japan's interest was fueled by Magic Software Japan's strong experience in the midrange market.

IDS Scheer. In August 2004, we signed a marketing partnership with IDS Scheer, a world leader in business process modeling and monitoring software. This partnership complements and extends iBOLT in the areas of process modeling and process performance management, and provides IDS Scheer with a powerful technology (iBOLT) to enable their ARIS PPM product especially in the small to medium business markets. PPM is a new alternative to business intelligence, which is, according to leading market research, expected to be one of the top growth markets for the next few years. We have developed an initial prototype linking iBOLT with ARIS PPM, and will start field activities with selected IDS Scheer offices in 2005.

Pervasive Software. We have a strategic alliance with Pervasive Software to develop and market a bundled product comprised of Pervasive's Scalable SQL database engines and our eDeveloper technology. The alliance provides for joint technical development, product integration channel and development programs. In 2004 we expanded and improved our cooperation with Pervasive Software by signing an OEM agreement that enables us to directly issue Pervasive licenses.

iWay Software. During 2003 we initiated a partnership with iWay Software to provide intelligent, prepackaged adapters for the iBOLT Integration Suite. iWay Software is an information builder company and a leading adapter vendor, engaged in acceleration of business integration. The availability of over 250 iWay Software adapters to the iBOLT Integration Suite enables organizations to connect to virtually any packaged application, mainframe and legacy system, traditional database, and to external data sources. iWay adapters interface seamlessly into the iBOLT environment without requiring complex coding or application modifications. The combination of iBOLT and iWay Software adapters allows enterprises to integrate their disparate proprietary applications and middleware, while supporting emerging messaging and business standards. This agreement expands our ability to deliver comprehensive cost-effective business integration solutions to our customers. During 2004 we resold and implemented projects using iWay adaptors.

Sabratech. In February 2003, we signed an OEM agreement with Sabratech, a company for which one of our directors, Jacob Tenenboem, serves as chairman of the board of directors, to market and sell its ApplinX product. Sabratech develops and provides advanced enterprise integration solutions which allow a rapid and flexible approach to the development of legacy-based services. Sabratech was recently acquired by Software AG, who competes with iBOLT. While Sabratech agreed to maintain their relationship and service level with us, we are examining alternative products from other vendors.

Enformia Software Ltd. In May 2003, we entered into an agreement with Enformia, a company in which Mr. David Assia, chairman of our board of directors, is a shareholder, to integrate their portal technology into the iBOLT Integration family of products. The product, iBOLT Portal, enables corporations to deliver customized information and applications to a wide range of users, customers, employees, partners and suppliers, using an architecturally superior approach to provide improved customer service and retention, enhanced communication and increased productivity. iBOLT Portal sales in 2004 helped introduce iBOLT to a number of leading customers worldwide, including the Israel Electric Company, the Israel Open University, Amsterdam Arena, Diehl and Vodafone Europe.

During 2004 we initiated strategic partnerships with a number of system integrators worldwide, to help deliver business integration services using our iBOLT application integration framework. Among those system integrators are:

-

Mphasis, a rapidly growing global information technology, IT, and business process outsourcing, service provider to global 2000 enterprises worldwide, partnered with MSE Inc. to jointly deliver technology and services for BPM and regulatory compliance to financial services customers.

-

Ineum, formerly Deloitte Touche Consulting in France, is a top tier system integrator in the French market. We are working together with Ineum to provide joint solutions and services to the Retail and Financial Services markets, using vertical expertise and solutions provided by Magic Solution Providers. Other partnership initiatives along the same model are being developed in several locations, where we bring together a top-tier system integrators and a vertical solution provider to form a three-tiered partnership providing advanced solutions to specific needs.

-

Copenhagen-based VM-Line, a leading Danish software developer and systems integrator that counts among its customers Denmark's Ministry of Economy & Business Affairs, the Danish Telecom Agency, the United Nations, Deutsche Bank and PA Consulting Group, is now responsible for supporting our existing partner and corporate customer base and for driving sales of iBOLT. As part of the agreement, VM Line made an initial purchase of iBOLT and eDeveloper licenses having a value of \$400,000.

•

Avesta, in the fourth quarter of 2003, we entered into an agreement with Avesta Computer Services Ltd., a global system integrator based in Jersey City, N.J., to become an iBOLT Integration partner. With offices in New Jersey, Pennsylvania, California, Hong Kong and India, Avesta is a systems integrator and outsourcer specializing in solutions for large and mid-sized organizations such as the Bank of New York, Cisco Systems, Merrill Lynch, EDS, Pfizer and HSBC Bank. While the commercial cooperation between Magic and Avesta is aimed towards the U.S. market, the technical cooperation took place essentially in India where a contingent from Avesta received training on Magic technologies. One of the first tangible results of the cooperation was the implementation of an integration project at a major mobile phone operator in the U.S. After an initial assessment and pilot implementation, the customer is now expanding the use of iBOLT at a rate of two new processes per month.

Competition

The markets for our eDeveloper and iBOLT technologies and applications are characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and rapidly changing customer requirements. These markets are therefore highly competitive and we expect competition to intensify in the future. We may not be able to compete effectively in these markets and may lose market share to our competitors.

The principal competitors in the market for our eDeveloper technology are: Visual Basic (Microsoft), Progress, Delphi and Jbuilder (Borland), Java, Oracle, Compuware, Lansa and packaged applications such as SAP and PeopleSoft.

The principal competitors in the market for our iBOLT Integration Suite are companies such as WebMethods, Tibco, Vitria, Seeburger, IBM's WebSphere, Microsoft's BizTalk, Seebeyond and Sonic Software (Progress). Additional competitors may enter each of our markets at any time. Moreover, our customers may seek to develop internally the products that we currently sell to them and thereafter compete with us.

Most of our competitors have greater financial, personnel and other resources than we do, which may limit our ability to compete effectively with them. These competitors may be able to respond more quickly to new or emerging technologies or changes in customer requirements. These competitors may also benefit from greater economies of scale, offer more aggressive pricing, devote greater resources to the promotion of their products or bundle their products into existing products in a manner that renders our technology partially or fully obsolete, thereby discouraging customers from purchasing our technology or applications.

We believe that the principal competitive factors affecting the market for our products include developer productivity, rapid results, product functionality, performance, reliability, portability, interoperability, ease-of-use, demonstrable economic benefits for developers and users relative to cost, quality of customer support and documentation, ease of installation, vendor reputation and experience, financial stability and, to a lesser degree, price.

Intellectual Property

We do not hold any patents and rely upon a combination of copyright, trademark, trade secret laws and contractual restrictions to protect our rights in our software products. Our policy has been to pursue copyright protection for our

software and related documentation and trademark registration of our product names. Also, our key employees and independent contractors and distributors are required to sign non-disclosure and secrecy agreements.

We provide our products to customers under a non-exclusive, non-transferable license. Usually, we have not required end-users of our products to sign license agreements. However, in some accounts license agreements are required to be signed by the end-users. Generally, a "shrink wrap" license agreement is included in the product packaging which explains that by opening the package seal, the user is agreeing to the terms contained therein. It is uncertain whether license agreements of this type are legally enforceable in all of the countries in which the software is marketed.

Our trademark rights include rights associated with our use of our trademarks, and rights obtained by registration of our trademarks. We have obtained trademark registrations in Canada, France, Germany, Israel, Italy, Luxembourg, the Netherlands, Poland, Portugal, Romania, Slovakia, South Africa, Spain, Switzerland, Thailand, Austria, Czech Republic, Hungary, China, Bulgaria, the United Kingdom, Australia, Chile and the United States. Our use and registration of our trademarks do not ensure that we have superior rights to others that may have registered or used identical or related marks on related goods or services. We do not believe that patent laws are a significant source of protection for our products. Copyright registration for software is available in the United States. We have registered a copyright for our software in the United States and Japan. Also, we have registered copyrights for some of our manuals in the United States and have acquired ISBN numbers for some of our manuals. Our copyrights expire 70 years from date of first publication. The initial terms of the registration of our trademarks range from 10 to 20 years and are renewable thereafter.

Since the software industry is characterized by rapid technological changes, the policing of the unauthorized use of software is a difficult task and software piracy is expected to continue to be a persistent problem for the packaged software industry. As there can be no assurance that the above-mentioned means of legal protection will be effective against piracy of our products, and since policing unauthorized use of software is rather difficult, software piracy can be expected to be a persistent potential problem.

We believe that because of the rapid pace of technological change in the software industry, the legal protections for our products are less significant factors in our success than the knowledge, ability and experience of our employees, the frequency of product enhancements and the timeliness and quality of our support services.

A.

ORGANIZATIONAL STRUCTURE

We are a member of the Formula Systems (1985) Ltd. Group (NASDAQ: FORTY). Formula Systems is an international information technology company principally engaged, through its subsidiaries and affiliates, in providing software consulting services, developing proprietary software products and producing computer-based solutions. In addition, Formula Systems manages a venture capital fund, which invests in early stage companies that develop software products for the international market. Formula Systems, an Israeli corporation, beneficially owns a 50.18% equity interest in our ordinary shares.

The following table sets forth the legal name, location and country of incorporation and percentage ownership of each of our subsidiaries, as of March 2005:

| Subsidiary Name | Country of Incorporation | Ownership Percentage |
|---------------------------------|-----------------------------|---------------------------------|
| Magic Software Enterprises Inc. | U.S. | 100% |

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| | | |
|---|-------------|------|
| CoreTech Consulting Group, LLC | U.S. | 100% |
| CoreTech Consulting Group, Inc. | U.S. | 100% |
| MSE Holdings, Inc. | U.S. | 100% |
| Magic Software Enterprises (UK) Ltd. | U.K. | 100% |
| Hermes Logistics Technologies Limited | U.K. | 100% |
| Magic Beheer B.V | Netherlands | 100% |
| Magic Software Enterprises Netherlands B.V. | Netherlands | 100% |
| Magic Software Enterprises Spain Ltd. | Spain | 100% |
| Magic Software Enterprises GmbH | Germany | 100% |
| Magic Software Enterprises France | France | 100% |
| Magic Benelux B.V. | Netherlands | 100% |
| Magic Software Enterprises (Israel) Ltd. | Israel | 100% |
| Magic Software Enterprises Italy S.r.l | Italy | 100% |
| Magic Software Japan K.K. | Japan | 100% |
| Magic Software Enterprises India Pvt. Ltd. | India | 100% |
| Onyx Szoftverhaz Korlatolt Felelossegu Tarsasag | Hungary | 100% |

| | | |
|--|--------|-------|
| CarPro Systems Ltd. | Israel | 87.5% |
| Advanced Answers on Demand Holding Corporation | U.S. | 84% |
| Nextstep Infotech Pvt. Ltd. | India | 40% |

B.

PROPERTY, PLANTS AND EQUIPMENT

Facilities

Our headquarters and principal administrative, finance, sales, marketing and research and development operations are located in an office building of approximately 34,000 square feet that we own in Or Yehuda, Israel, a suburb of Tel Aviv. The building was constructed on a parcel of land leased from the Israel Land Authority. The lease expires in 2040 and can be renewed for an additional period of 49 years.

Our Hungarian subsidiary owns a 9,830 square foot office in Budapest, Hungary.

Our U.S. subsidiaries lease approximately 24,150 square feet of office space in Irvine, California, King of Prussia, Pennsylvania, Fort Lauderdale and Florida. In addition, our subsidiaries also lease office space aggregating approximately 51,000 square feet in Paris, France; Munich, Germany; Pune, India; Bangalore, India; Milan, Italy; Tokyo, Japan; Houten, the Netherlands; Madrid, Spain, and Bracknell, U.K.

In the year ended December 31, 2004, we invested \$1million in capital assets, mainly in computers and peripheral equipment.

ITEM 2.

OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A.

OPERATING RESULTS

The following discussion and analysis is based on and should be read in conjunction with our consolidated financial statements and notes thereto and the other financial information included elsewhere in this annual report.

Overview

We develop, market and support our Magic software development and deployment technology called eDeveloper, and technology for business integration and process management called iBOLT. Our technology enables enterprises to accelerate the process of building, deploying and integrating business software applications that can be rapidly customized to meet current and future needs. Magic technology and Magic-based applications are used by over 2,500 software solution providers and thousands of enterprises in approximately 50 countries. We also provide maintenance

and technical support as well as professional services to the Magic community.

We began operations in 1986 and completed an initial public offering of our ordinary shares in the United States in August 1991. In the first quarter of 2000, we completed a follow-on offering of 4,000,000 of our ordinary shares in the United States at \$25.00 per share. Of these shares, 3,500,000 ordinary shares were offered by us and 500,000 ordinary shares were offered by our major shareholder, Formula Group (1985) Ltd. Our net proceeds from the offering, after deducting the underwriting discount and expenses, were \$79.6 million.

We paid a one-time cash dividend of \$11,844,713 in February 2003.

Critical Accounting Policies

We have identified the policies below as critical to the understanding of our financial statements. The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions in certain circumstances that affect the amounts reported in the accompanying financial statements and the related footnotes. Actual results may differ from these estimates. To facilitate the understanding of our business activities, certain of our accounting policies that are more important to the portrayal of its financial condition and results of operations and that require management's subjective judgments are described below. We base our judgments on our experience and various assumptions that we believe are reasonable.

Our consolidated financial statements are stated in U.S. dollars, the currency of our primary economic environment and our functional and reporting currency, and prepared in accordance with generally accepted accounting principles in the United States. Nevertheless, we conduct our operations in the local currencies of the countries in which many of our subsidiaries are located. Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Transactions and balances in other currencies are re-measured into U.S. dollars in accordance with the principles set forth in Financial Accounting Standards Board Statement No. 52. Gains and losses arising from conversion are included in accumulated other comprehensive loss in shareholders' equity.

The significant accounting policies that we believe are the most critical to aid in fully understanding and evaluating our financial condition and results of operations under generally accepted accounting principles, are discussed below.

Other Intangible Assets. Intangible assets are comprised of capitalized software development costs as well as distribution rights, acquired technology and customer relations. Distribution rights, acquired technology and customer relations, are amortized over their useful life using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up. Distribution rights, acquired technology and customer relations are amortized on a straight line basis over a period of five, eight and five years, respectively.

Research and development costs are capitalized subsequent to the establishment of technological feasibility. Based on ours and our subsidiaries product development process, technological feasibility is established upon completion of a detailed program design.

Research and development costs incurred in the process of developing product improvements or new products, are generally charged to expenses as incurred.

Significant costs incurred by us and our subsidiaries between completion of the detailed program design and the point at which the product is ready for general release, have been capitalized.

Capitalized software costs are amortized by the greater of the amount computed using the: (i) ratio that current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (three to five years). We assess the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. As of December 31, 2003 and 2004, no impairment losses have been identified.

Goodwill. Goodwill represents the excess of the costs over the net assets of businesses acquired. Goodwill is not amortized as of January 1, 2002.

Goodwill is tested for impairment at least annually or between annual tests in certain circumstances, and written down when impaired. Goodwill attributable to each of the reporting units is tested for impairment by comparing the fair value of each reporting unit with its carrying value. Fair value is determined using discounted cash flows. Significant estimates used in the methodologies include estimates of future cash flows, future short-term and long-term growth rates and weighted average cost of capital for each of the reportable units. As of December 31, 2003 and 2004, no indications for impairment were identified.

Revenue Recognition. To date, we have derived our revenues from licensing the rights to use our software, maintenance and technical support and providing professional services. We sell our products primarily through our direct sales force and indirectly through distributors.

Revenue earned in software arrangements involving multiple elements are allocated to each element based on the relative fair value of the elements. Since January 1, 2000, we recognize revenues under the residual method when vendor specific objective evidence (VSOE) of fair value exists for all undelivered elements and VSOE does not exist for all of the delivered elements.

Revenue from license fees is recognized when persuasive evidence of an arrangement exists, delivery of the product has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable, and collectibility is probable. We do not grant a right of return to our customers. When a right of return exists, we defer revenue until the right of return expires, at which time the revenue is recognized provided that all other revenue recognition criteria are met.

Maintenance and technical support revenue included in multiple element arrangements is deferred and recognized on a straight-line basis over the term of the maintenance and support agreement. The VSOE of fair value of the undelivered elements (maintenance, support and services) is determined based on the price charged for the undelivered element when sold separately.

Revenue from consulting services consists of billable hours for services provided, and are recognized as the services are rendered.

Arrangements that include consulting services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are considered essential, revenue under the

arrangement is recognized using contract accounting. When consulting services are not considered essential, the revenue allocable to the consulting services is recognized as the services are performed. To date, we had determined that the services are not considered essential to the functionality of other elements of the arrangement.

Revenues from software licenses that require significant customization, integration and installation are recognized using contract accounting on a percentage of completion method, based on inputs. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss on the entire contract. As of December 31, 2004 no such estimated losses were identified.

Deferred revenues include unearned amounts received under maintenance and support contracts, and amounts received from customers but not recognized as revenues.

Concentration of Credit Risk. Financial instruments, which potentially subject our company and our subsidiaries to concentration of credit risk, consist principally of cash and cash equivalents, trade receivables and marketable securities. Our cash and cash equivalents are invested primarily in deposits with major banks world-wide, however, such cash and cash equivalents in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold our investments are financially solid, and accordingly, minimal credit risk exists with respect to these investments. Our trade receivables are derived from sales to customers located primarily in the United States, Europe, Japan and Israel. We perform ongoing credit evaluations of our customers and to date have not experienced any material losses. An allowance for doubtful accounts is determined with respect to those amounts that we have determined to be doubtful of collection.

Impact of recently issued Accounting Standards. On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"), which is a revision of SFAS 123 Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123 permitted, but not required, share-based payments to employees to be recognized based on their fair values while SFAS 123(R) requires all share-based payments to employees to be recognized based on their fair values. SFAS 123(R) also revises, clarifies and expands guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. The new standard will be effective for us commencing July 1, 2005.

SFAS 123(R) permits companies to adopt its requirements using one of the following two methods:

1.

The "modified prospective" method, in which compensation cost is recognized commencing with the effective date (i) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (ii) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested at the effective date.

2.

The "modified retrospective" method, which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123, for purposes of pro forma disclosures either (i) all prior periods presented or (ii) the prior interim period of the year of adoption.

As permitted by SFAS 123, we currently account for share-based payments to employees using APB 25, the intrinsic value method, and, as such, recognizes no compensation cost for employee stock options. Accordingly, the adoption of the SFAS 123(R) fair value method will have significant impact on our results of operations, although it will have no impact on our overall financial position. The impact of the adoption of SFAS 123(R) cannot be predicted at this time, as it depends on levels of share-based payments for future grant. However, had we adopted SFAS 123(R) in

prior periods, the impact of that Standard would have approximated the impact of SFAS 123, as described in the disclosure of the pro forma net loss and net loss per share in the footnote to our financial statements.

Significant Expenses

Cost of Revenues. Cost of revenues for software sales consist primarily of software production costs royalties and licenses payable to third parties, and amortization of capitalized software. Cost of revenues for maintenance and technical support and professional services consists primarily of personnel expenses and other related costs.

Research and Development Expenses, Net. Research and development costs consist primarily of salaries of employees engaged in on-going research and development activities and other related expenses. The capitalization of software development costs are applied as reductions to gross research and development costs to calculate net research and development expenses.

The following table sets forth the gross research and development costs, capitalized software development costs, and the net research and development expenses for the periods indicated:

| | Year ended December 31 | | |
|---|-----------------------------|----------------|-----------------|
| | 2002 | 2003 | 2004 |
| | (U.S. dollars in thousands) | | |
| Gross research and development costs | \$ 6,629 | \$7,086 | \$7,317 |
| Less capitalization of software development costs | <u>(1,293)</u> | <u>(2,311)</u> | <u>(3,472)</u> |
| Research and development expenses, net | <u>\$5,336</u> | <u>\$4,775</u> | <u>\$ 3,845</u> |

Selling and Marketing Expenses. Selling and marketing expenses consist primarily of compensation and related expenses for sales and marketing personnel, sales commissions, marketing programs, web site related expenses, public relations, promotional materials, travel expenses and trade show exhibit expenses.

General and Administrative Expenses. General and administrative expenses consist primarily of salaries and related expenses for executive, accounting, human resources and administrative personnel, professional fees, provisions for doubtful accounts, and other general corporate expenses.

Financial Income, Net. Financial income consists of interest on cash and cash equivalent balances and currency translation gains. This income is offset in part by financial expenses consisting of interest expense and currency translation expense adjustments.

Results of Operations

The following table presents selected consolidated statement of operations data for the periods indicated:

| | Year ended December 31, | | |
|--|-------------------------|------|------|
| | 2002 | 2003 | 2004 |

(U.S. dollars in thousands, except share and per share data)

| | | | |
|--|----------|----------|----------|
| Revenues: | | | |
| Software | \$15,136 | \$19,712 | \$20,614 |
| Applications | 7,355 | 7,277 | 7,408 |
| Maintenance and technical support | 10,882 | 10,853 | 12,555 |
| Consulting services | 26,631 | 25,548 | 24,590 |
| Total revenues | 60,004 | 63,390 | 65,167 |
| Cost of revenues: | | | |
| Software | 3,318 | 3,943 | 4,742 |
| Applications | 2,334 | 1,162 | 1,720 |
| Maintenance and technical support | 4,100 | 2,580 | 3,199 |
| Consulting services | 19,239 | 16,454 | 15,818 |
| Total cost of revenues | 28,991 | 24,139 | 25,479 |
| Gross profit | 31,013 | 39,251 | 39,688 |
| Operating expenses: | | | |
| Research and development, net | 5,336 | 4,775 | 3,845 |
| Sales, marketing, general and administrative | 30,694 | 30,814 | 32,541 |
| Restructuring and other non-recurring costs | 1,123 | | |

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| | | | |
|---|-----------|----------|---------|
| Operating income (loss) | (6,140) | 3,662 | 3,302 |
| Financial income, net | 958 | 307 | 912 |
| Other expenses | | 42 | - |
| Income (loss) before taxes on income | (5,182) | 3,927 | 4,214 |
| Income taxes | (384) | 230 | 281 |
| | (5,566) | 3,697 | 3,933 |
| Equity in earnings (losses) of affiliates | (108) | (36) | 79 |
| Minority interest in losses (earnings) of consolidated subsidiaries | 11 | (594) | 78 |
| Net income (loss) | \$(5,663) | \$3,067 | \$4,090 |
| Basic earnings (loss) per share | \$(0.19) | \$(0.10) | \$ 0.13 |
| Diluted earnings (loss) per share | \$(0.19) | \$(0.10) | \$ 0.13 |
| Shares used to compute basic earnings (loss) per share | 29,690 | 29,624 | 31,029 |
| Shares used to compute diluted earnings (loss) per share | 29,690 | 29,909 | 32,426 |

The following table presents selected consolidated statement of operations data for the periods indicated as a percentage of total revenues:

| | Year ended December 31, | | |
|-----------------------------------|--------------------------------|-------------|-------------|
| | 2002 | 2003 | 2004 |
| Revenues: | | | |
| Software | 25.2% | 31.1% | 31.6% |
| Applications | 12.3 | 11.5 | 11.4 |
| Maintenance and technical support | 18.1 | 17.1 | 19.3 |
| Consulting services | 44.4 | 40.3 | 37.7 |
| Total revenues | 100.0% | 100.0% | 100.0% |
| Cost of revenues: | | | |
| Software | 5.5 | 6.2 | 7.3 |
| Applications | 3.9 | 1.8 | 2.6 |
| Maintenance and technical support | 6.8 | 4.1 | 4.9 |
| Consulting services | 32.1 | 26.0 | 24.3 |
| Total cost of revenues | 48.3 | 38.1 | 39.1 |
| Gross profit | 51.7 | 61.9 | 60.9 |
| Operating expenses: | | | |
| Research and development, net | 8.9 | 7.5 | 5.9 |
| Selling and marketing, net | 22.9 | 23.9 | 26.3 |

| | | | |
|---|--------|-------|------|
| General and administrative | 28.2 | 24.7 | 23.6 |
| Restructuring and other non-recurring costs | 1.9 | - | - |
| Total operating expenses | 61.9 | 56.1 | 55.8 |
| Operating income (loss) | (10.2) | 5.8 | 5.1 |
| Other expenses | - | 0.1 | - |
| Financial income, net | 1.6 | 0.5 | 1.4 |
| Income (loss) before taxes on income | (8.6) | 6.2 | 6.5 |
| Income taxes | 0.6 | 0.4 | 0.4 |
| Equity in earnings (losses) of affiliates | (0.2) | (0.1) | 0.1 |
| Minority interest in (earnings) losses of consolidated subsidiaries | 0.0 | (0.9) | 0.1 |
| Net income (loss) | (9.4)% | 4.8% | 6.3% |

Year Ended December 31, 2004 Compared With Year Ended December 31, 2003

Revenues. Total revenues increased 3% to \$65.2 million in 2004 from \$63.4 million in 2003. Software sales increased 5% to \$20.6 million in 2004 from \$19.7 million in 2003. This increase was principally attributable to an increase in iBOLT license sales. Revenues from applications increased slightly to \$7.4 million in 2004 from \$7.3 million in 2003. Revenues from maintenance and technical support increased 16% to \$12.6 million in 2004, from \$10.9 million in 2003 as a result of a new program for total customer care we introduced during 2004. Revenues from professional services decreased 4% to \$24.6 million in 2004 from \$25.5 million in 2003, reflecting a reduction in demand for such services. We expect a stable or moderate increase in our total revenues in 2005, principally from an increase in iBOLT sales.

Cost of Revenues. Cost of revenues increased 6% to \$25.5 million in 2004 from \$24.1 million in 2003. Cost of revenues for software sales increased 21% to \$4.7 million in 2004 from \$3.9 million in 2003. This increase was partly due to higher amortization costs related to capitalized research and development. Cost of revenues for applications increased 42% to \$1.7 million in 2004 from \$1.2 million in 2003, principally as a result of a change in our product mix, with an increase in 2004 of sales of products having lower gross margins. Cost of revenues for maintenance and technical support increased 23% to \$3.2 million in 2004 from \$2.6 million in 2003. Cost of revenues for professional services decreased 4% to \$15.8 million in 2004 from \$16.4 million in 2003. The decrease is attributable to our lower professional services revenues in 2004 compared to 2003.

Gross Profit. Gross profit increased slightly by 1% to \$39.7 million in 2004 from \$39.3 million in 2003. Our gross margin (gross profit as a percentage of total revenues) on software sales decreased to 77% in 2004 from 80% in 2003. Our gross margin on applications decreased to 77% in 2004 from 84% in 2003 principally as a result of a change in our product mix. Our gross margin on maintenance and technical support decreased slightly to 75% in 2004 compared to 76% in 2003, and our gross margin on professional services remained at 36% in 2004, the same as in 2003.

Research and Development Expenses, Net. Total research and development expenses increased 3% to \$7.3 million in 2004 from \$7.1 million in 2003. Net research and development expenses decreased 21% to \$3.8 million in 2004 from \$4.8 million in 2003. In 2004 we capitalized \$3.48 million of software development costs, as compared to \$2.3 million capitalized in 2003. The increase is due to higher capitalization related to the eDeveloper product line (a major version expected to be released during 2005), as well as the iBOLT and Hermes products. On December 31, 2004, we employed 149 persons in research and development, of which 61 persons were in Israel, 68 persons were based in our research and development facility in India and the rest in Japan and the United States. Net research and development expenses as a percentage of revenues decreased to 6% in 2004 from 8% in 2003.

Selling and Marketing Expenses, Net. Selling and marketing expenses increased 14% to \$17.2 million in 2004 from \$15.1 million in 2003 reflecting the overall growth in our 2004 revenues and investments in the introduction of the new iBOLT product. Selling and marketing expenses as a percentage of revenues increased slightly to 26% in 2004 from 24% in 2003. We intend to continue to support our iBOLT sales initiatives in 2005.

General and Administrative Expenses. General and administrative expenses decreased slightly by 2% to \$15.4 million in 2004 from \$15.7 million in 2003.

Financial Income, Net. Our financial income increased to \$0.9 million in 2004 from \$0.3 million in 2003, principally as a result of the devaluation of the dollar against the Euro and the Yen.

Income Taxes. We incurred income taxes of \$0.3 million in 2004, out of which \$0.1 million were incurred in prior years, and \$0.2 million were incurred in 2004. These taxes are primarily attributable to taxes accrued in the U.S. and Israel.

Equity in Gains (Losses) of Affiliates. In 2004, we recognized a gain of \$0.08 million, while we recognized a loss of \$0.04 million in 2003.

Minority Interest in Profits (Losses) of Consolidated Subsidiaries. Minority interest in the profits of our consolidated subsidiaries represents the minority shareholders' share of the profits (losses) of some of our majority owned subsidiaries. In 2004, we recognized income of \$0.08 million as compared to expenses of \$0.59 million in 2003.

Year Ended December 31, 2003 Compared With Year Ended December 31, 2002

Revenues. Total revenues increased 5.7% to \$63.4 million in 2003 from \$60.0 million in 2002. Software sales increased 30.5% to \$19.7 million in 2003 from \$15.1 million in 2002. This increase was principally attributable to an

increase in revenues from sales of eDeveloper and iBOLT Integration Suite. Revenues from applications decreased slightly to \$7.3 million in 2003 from \$7.4 million in 2002. Revenues from maintenance and technical support remained at approximately \$10.9 million in 2003, similar to 2002. Revenues from professional services decreased 4.1% to \$25.5 million in 2003 from \$26.6 million in 2002.

Cost of Revenues. Cost of revenues decreased 17.2% to \$24 million in 2003 from \$29 million in 2002. Cost of revenues for software sales increased 18.2% to \$3.9 million in 2003 from \$3.3 million in 2002. Cost of revenues for applications decreased 47.8% to \$1.2 million in 2003 from \$2.3 million in 2002. Cost of revenues for maintenance and technical support decreased 36.6% to \$2.6 million in 2003 from \$4.1 million in 2002. Cost of revenues for professional services decreased 14.6% to \$16.4 million in 2003 from \$19.2 million in 2002. The decrease was attributable to our ongoing efforts to cut costs and be more efficient, which efforts are continuing in 2004.

Gross Profit. Gross profit increased 26.5% to \$39.2 million in 2003 from \$31.0 million in 2002, as a result of the higher revenues and lower expenses in 2003 compared to 2002. Our gross margin, or gross profit as a percentage of total revenues, on software sales increased to 80.0% in 2003 from 78.1% in 2002. Our gross margin on applications increased to 84.0% in 2003 from 68.3% in 2002. Our gross margin on maintenance and technical support was increased to 76.2% in 2003 compared to 62.3% in 2002, and our gross margin on professional services increased to 35.6% in 2003 from 27.8% in 2002.

Research and Development Expenses, Net. Total research and development expenses increased 7.6% to \$7.1 million in 2003 from \$6.6 million in 2002. Net research and development expenses decreased 9.4% to \$4.8 million in 2003 from \$5.3 million in 2002. In 2003 we capitalized \$2.3 million of software development costs mainly relating to our iBOLT product, as compared to \$1.3 million capitalized in 2002. We did not receive any grants from the Israeli Office of the Chief Scientist in either 2003 or 2002, nor did we accrue any grants from BIRD-F. See - Research and Development, Patents and Licenses. On December 31, 2003, we employed 134 persons in research and development, of which 74 persons were based in our research and development facility in India. Net research and development expenses as a percentage of revenues decreased to 7.5% in 2003 from 8.9% in 2002.

Selling and Marketing Expenses, Net. Selling and marketing expenses increased 9.4% to \$15.1 million in 2003 from \$13.8 million in 2002 reflecting the overall growth in our 2003 revenues. Selling and marketing expenses as a percentage of revenues increased slightly to 23.9% in 2003 from 22.9% in 2002. Our sales and marketing expenses have increased with the launch of the new iBOLT Integration Suite to market. In particular, we invested in new sales personal with relevant expertise, new and appropriate sales tools for selling iBOLT and increased marketing campaigns and programs to generate new leads and increase the awareness of iBOLT in the market.

General and Administrative Expenses. General and administrative expenses decreased 7.1% to \$ 15.7 million in 2003 from \$16.9 million in 2002. The decrease was primarily attributable to our efforts to be more effective and to cut expenses.

Restructuring and Other Non-Recurring Costs, Net. We did not incur any net restructuring costs in 2003 compared to \$1.1 million that was incurred in 2002 in connection with the world wide restructuring of our company.

Financial Income, Net. Our financial income decreased to \$0.3 million in 2003 from \$1 million in 2002, principally as a result of our distribution of \$11.8 million as a dividend in fiscal 2003, lower interest rates and a significant decrease in currency exchange rate gains in 2003, compared to 2002.

Income Taxes. We incurred income taxes of \$0.2 million in 2003 and \$0.4 million in 2002. These taxes are primarily attributable to taxes paid in the United States.

Equity in Losses of Affiliates. In 2003, we recognized a loss of \$0.04 million, while we recognized a loss of \$0.11 million in 2002.

Minority Interest in Profits (Losses) of Consolidated Subsidiaries. Minority interest in the profits of our consolidated subsidiaries represents the minority shareholders' share of the profits of some of our majority owned subsidiaries. In 2003, we recognized losses of \$0.59 million as compared to earnings of \$0.01 million in 2002.

Quarterly Results of Operations

The following tables set forth unaudited quarterly results of operations in U.S. dollars and as a percentage of revenues for each of the eight fiscal quarters ended December 31, 2004. We have prepared this information on a basis consistent with our audited consolidated financial statements included in this annual report and include all necessary adjustments, consisting only of normal recurring accruals that we consider necessary for a fair presentation of the information for the periods indicated. The results of operations for any quarter are not necessarily indicative of results for any future periods.

Three months ended

**Mar. 31,
2003**

**June 30,
2003**

**Sep. 30,
2003**

**Dec. 31,
2003**

**Mar. 31,
2004**

**June 30,
2004**

**Sep. 30,
2004**

**Dec. 31,
2004**

(U.S. dollars in thousands)

Revenues:

Software

\$4,077

\$4,525

\$4,750

\$6,360

\$5,461

\$ 5,481

\$4,712

\$4,960

Applications

1,664

1,661

1,700

2,252

52

1,664

1,778

1,317

2,649

Maintenance and technical support

2,579

2,666

2,756

2,852

2,795

3,070

3,213

3,477

Consulting services

6,806

6,449

6,462

5,831

6,534

6,338

5,773

5,945

Total revenues

15,126

15,301

15,668

17,295

16,454

16,667

15,015

17,031

Cost of revenues:

Software

816

1,128

904

1,095

1,248

1,099

1,113

1,282

Applications

245

220

246

451

54

| | |
|-----------------------------------|-------|
| | 620 |
| | 416 |
| | 197 |
| | 487 |
| Maintenance and technical support | |
| | 591 |
| | 664 |
| | 651 |
| | 674 |
| | 803 |
| | 892 |
| | 698 |
| | 806 |
| Consulting services | |
| | 4,583 |
| | 3,867 |
| | 4,039 |
| | 3,965 |
| | 3,769 |
| | 4,074 |
| | 3,704 |
| | 4,271 |
| Total cost of revenues | |

6,235

5,879

5,840

6,185

6,440

6,481

5,712

6,846

Gross profit

8,891

9,422

9,828

11,110

10,014

10,186

9,303

10,185

Operating expenses:

Research and development, net

1,006

1,142

1,242

1,385

56

1,205

869

736

1,035

Selling and marketing

3,530

3,862

3,897

3,850

4,350

4,451

3,897

4,459

General and administrative

4,103

3,660

3,533

4,379

3,866

3,971

3,758

3,789

Total operating expenses

| | |
|----------------------------------|-------|
| | 8,639 |
| | 8,664 |
| | 8,672 |
| | 9,613 |
| | 9,421 |
| | 9,291 |
| | 8,391 |
| | 9,283 |
| Operating income (loss) | |
| | 252 |
| | 758 |
| | 1,156 |
| | 1,496 |
| | 593 |
| | 895 |
| | 912 |
| | 902 |
| Financial income (expenses), net | |
| | 45 |
| | 185 |
| | (31) |
| | 108 |
| | (114) |
| | (41) |
| | 58 |

| | |
|--------------------------------------|-------|
| | 44 |
| | 1,023 |
| Other expenses | |
| | - |
| | - |
| | 35 |
| | 7 |
| | - |
| | - |
| | - |
| Income (loss) before taxes on income | |
| | 297 |
| | 943 |
| | 1,090 |
| | 1,597 |
| | 479 |
| | 854 |
| | 956 |
| | 1,925 |
| Income taxes | |
| | (82) |
| | 95 |
| | 111 |
| | 59 |

| | |
|--|------|
| | 106 |
| | - |
| | - |
| | 67 |
| | 214 |
| Equity in earnings (losses) of affiliates | |
| | - |
| | - |
| | - |
| | (36) |
| | - |
| | 90 |
| | (17) |
| | 6 |
| Minority interest in earnings (losses) of subsidiaries | |
| | 60 |

| | | | | | | | | | |
|-------------------|--|--|--|--|--|--|--|--|---------|
| | | | | | | | | | 107 |
| | | | | | | | | | 96 |
| | | | | | | | | | (166) |
| | | | | | | | | | 225 |
| | | | | | | | | | (239) |
| | | | | | | | | | 30 |
| | | | | | | | | | 126 |
| | | | | | | | | | 5 |
| Net income (loss) | | | | | | | | | |
| | | | | | | | | | \$272 |
| | | | | | | | | | \$752 |
| | | | | | | | | | \$813 |
| | | | | | | | | | \$1,230 |
| | | | | | | | | | \$718 |
| | | | | | | | | | \$914 |
| | | | | | | | | | \$746 |
| | | | | | | | | | \$1,712 |

| | | | | | | | | |
|--|-----------------|---------------------------|-----------------|-----------------|-------------|-----------------|-----------------|-----------------|
| | | Three months ended | | | | | | |
| | Mar. 31, | Jun. | Sep. 30, | Dec. 31, | Mar. | Jun. 30, | Sep. 30, | Dec. 31, |
| | 2003 | 30, | 2003 | 2003 | 31, | 2004 | 2004 | 2004 |
| | | 2003 | | | 2004 | | | |

(As percentage of total revenues)

Revenues:

Software

27.0% 29.6% 30.3% 36.8% 33.2% 32.9% 31.4% 29.1%

Applications

11.0% 10.9% 10.9% 13.0% 10.1% 10.7% 8.8% 15.6%

Maintenance and technical support

17.0%

17.4%

17.6%

16.5%

17.0%

18.4%

21.4%

20.4%

Consulting services

45.0%

42.1%

41.2%

33.7%

39.7%

38.0%

38.4%

34.9%

Total revenues

100.0%

100.0%

100.0%

100.0%

100.0%

100.0%

100.0%

100.0%

Cost of revenues:
Software

5.4%

7.4%

5.8%

6.3%

7.6%

6.6%

7.4%

7.5%

Applications

1.6%

1.4%

1.6%

2.7%

3.8%

2.5%

1.3%

2.9%

Maintenance and technical support

3.9%

4.3%

4.2%

3.9%

4.9%

5.4%

4.6%

4.7%

Consulting services

30.3%

25.3%

25.7%

22.9%

22.8%

24.4%

24.7%

25.1%

Total cost of revenues

41.2%

38.4%

37.3%

35.8%

39.1%

38.9%

38.0%

40.2%

Gross profit

58.8%

61.6%

62.7%

64.2%

60.9%

61.1%

62.0%

59.8%

Operating expenses:

Research and development,
net

6.7%

7.5%

7.9%

8.0%

7.3%

5.2%

4.9%

6.1%

Selling and marketing, net

23.3%

25.2%

24.9%

22.3%

26.4%

26.7%

26.0%

26.2%

General and administrative

27.1%

23.9%

22.5%

25.3%

23.6%

23.8%

25.0%

22.2%

Total operating expenses

57.1%

56.6%

55.3%

55.6%

57.3%

55.7%

55.9%

54.5%

Operating income (loss)

1.7%

5.0%

7.4%

8.6%

3.6%

5.4%

6.1%

5.3%

Financial income (expenses),
net

0.3%

1.3%

(0.2)%

0.7%

(0.7)%

(0.3)%

0.3%

6.0%

Other expenses

-

-

0.2%

0.1%

-

-

-

-

Income (loss) before
taxes on income

2.0%

6.2%

7.0%

9.2%

2.9%

5.1%

6.4%

11.3%

Income taxes

(0.5)%

0.6%

0.7%

0.6%

-

-

0.4%

1.2%

Equity in earnings (losses) of
affiliates

-

-

-

(0.2)%

-

0.5%

(0.2)%

0.0%

Minority interest in losses (earnings)
of subsidiaries

(0.7)%

(0.6)%

(1.1)%

(1.3)%

(1.5)%

0.1%

0.8%

0.0%

Net income (loss)

1.8%

4.9%

5.2%

7.1%

4.4%

5.5%

5.0%

10.1%

Our quarterly results of operations have varied significantly in the past as a result of various factors, part of which are beyond our control. Accordingly, revenues and net income, if any, in any particular period may be lower than revenues and net income, if any, in a preceding or comparable period. Period-to-period comparisons of our result of operations may not be meaningful, and you should not rely upon them as indications of our future performance.

Conditions in Israel

We are incorporated under the laws of, and our principal executive offices and manufacturing and research and development facilities are located in, the State of Israel. Accordingly, we are directly affected by political, economic and military conditions in Israel.

Political Conditions

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, and a state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Since September 2000, there has been a marked increase in violence, civil unrest and hostility, including armed clashes, between the State of Israel and the Palestinians, and acts of terror have been committed inside Israel and against Israeli targets in the West Bank and Gaza. There is no indication as to how long the current hostilities will last or whether there will be any further escalation. Any further escalation in these hostilities or any future armed conflict, political instability or violence in the region may have a negative effect on our business condition, harm our results of operations and adversely affect our share price. Furthermore, there are a number of

countries that restrict business with Israel or Israeli companies. Restrictive laws or policies of those countries directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

Many of our executive officers and employees in Israel are obligated to perform up to 30 days, depending on rank and position, of military reserve duty annually and are subject to being called for active duty under emergency circumstances. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

Economic Conditions

In recent years Israel has been going through a period of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel continue to deteriorate. In addition, due to significant economic measures proposed by the Israeli Government, there have been several general strikes and work stoppages in 2003 and 2004, affecting all banks, airports and ports. These strikes have had an adverse effect on the Israeli economy and on business, including our ability to deliver products to our customers. Following the passage by the Israeli Parliament of laws to implement the economic measures, the Israeli trade unions have threatened further strikes or work-stoppages, and these may have a material adverse effect on the Israeli economy and on us.

Trade Relations

Israel is a member of the United Nations, the International Monetary Fund, the International Bank for Reconstruction and Development and the International Finance Corporation. Israel is a member of the World Trade Organization and is a signatory to the General Agreement on Tariffs and Trade. In addition, Israel has been granted preferences under the Generalized System of Preferences from the United States, Australia, Canada and Japan. These preferences allow Israel to export the products covered by such programs either duty-free or at reduced tariffs.

Israel and the EEC, known now as the European Union, concluded a Free Trade Agreement in July 1975 that confers some advantages with respect to Israeli exports to most European countries and obligates Israel to lower its tariffs with respect to imports from these countries over a number of years. In 1985, Israel and the United States entered into an agreement to establish a Free Trade Area. The Free Trade Area has eliminated all tariff and some non-tariff barriers on most trade between the two countries. On January 1, 1993, an agreement between Israel and the European Free Trade Association, known as the EFTA, established a free-trade zone between Israel and the EFTA nations. In November 1995, Israel entered into a new agreement with the European Union, which includes re-definement of rules of origin and other improvements, such as allowing Israel to become a member of the Research and Technology programs of the European Union. In recent years, Israel has established commercial and trade relations with a number of other nations, including Russia, China, India, Turkey and other nations in Eastern Europe and Asia.

Corporate Tax Rate

Israeli companies are generally subject to income tax at the corporate tax rate of 35% of taxable income. However, eight investment programs at our facility in Or Yehuda have been granted "approved enterprise" status under the Law for Encouragement of Capital Investments, 1959 and we are, therefore, eligible for some tax benefits. Subject to compliance with applicable requirements, the portion of our income derived from the approved enterprise programs will be tax-exempt for a period of two to four years commencing in the first year in which an approved enterprise generates taxable income and will be subject, for a period of five to eight years, to a reduced corporate tax of 25%.

However, these benefits will not be available to us with respect to any income derived by our non-Israeli subsidiaries. The Investment Law has been extended to March 31, 2005, and no assurance can be given that it will be extended further. A failure to extend the Investment Law will result in a significant increase in our corporate tax rate.

As of December 31, 2004, our net operating loss carry-forwards for Israeli tax purposes was approximately \$21.0 million and the net operating loss carry-forwards of our U.S. subsidiaries for U.S. tax purposes amounted to approximately \$17.2 million. Our U.S. net operating loss carry-forwards can be carried forward and offset against taxable income for 15 to 20 years and will expire in the years 2009 through 2024.

In the end of 2003, we received final tax assessments for the years 1997 to 2000, from the Israeli tax authorities and have appealed to the District Court of Tel Aviv with respect to such tax assessments. As of March 2005, one open issue remains to be settled by the court (which management believes will result in a maximum tax payment of no more than \$1.0 million), while all other issues were resolved with no additional taxes to be paid by us. Our management, based on its the advice of our legal advisors, believes that the probability of an unfavorable outcome for our company on this matter is remote. Accordingly, no provision was provided in the financial statements in respect of this matter.

Impact of Currency Fluctuations and of Inflation

Our financial statements are denominated in U.S. dollars, our functional currency. Nevertheless, a majority of our sales are made, and a majority of our expenses are incurred, in other currencies, particularly Euros, Japanese yen, NIS and U.K. pounds sterling. We maintain substantial non-U.S. dollar balances of assets, including cash and accounts receivable, and liabilities, including accounts payable. Fluctuations in the value of the currencies in which we do business relative to the U.S. dollar could have a material adverse effect on our business, results of operations and financial condition by decreasing the U.S. dollar value of assets held in other currencies and increasing the U.S. dollar amount of liabilities payable in other currencies.

The U.S. dollar cost of our operations in Israel is influenced by the extent to which any increase in the rate of inflation in Israel is (or is not) offset, or is offset on a lagging basis, by the devaluation of the NIS in relation to the U.S. dollar. Unless offset by a devaluation of the NIS, inflation in Israel will have a negative effect on our profitability as we incur expenses, principally salaries and related personnel expenses, in NIS. For several years prior to 1997, the rate of inflation in Israel exceeded the rate of devaluation of the NIS against the U.S. dollar and companies experienced increases in the U.S. dollar cost of their operations in Israel. This trend was reversed during 1997 and 1998. In 1999 and 2000, the rate of inflation exceeded the rate of devaluation of the NIS against the U.S. dollar. In 2001 and 2002, the devaluation rate again exceeded the inflation rate in Israel. In 2003, the rate of inflation was negative and the NIS was revalued vis-à-vis the dollar. In 2004, the inflation rate in Israel was 1.2%. We cannot assure you that we will not be materially and adversely affected in the future if inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of such devaluation lags behind inflation in Israel.

The following table sets forth, for the periods indicated, information with respect to the rate of inflation in Israel, the rate of devaluation of the NIS against the U.S. dollar, and the rate of inflation in Israel adjusted for such devaluation:

| | Israeli inflation | | | |
|----------------------------|---------------------------|--------------------------|----------------------------|-----------------------------|
| Year ended | Israeli consumer | Israeli inflation | Israeli devaluation | adjusted for |
| <u>December 31,</u> | <u>price index</u> | <u>rate %</u> | <u>rate %</u> | <u>devaluation %</u> |

| | | | | |
|------|-------|-------|-------|-------|
| 2001 | 101.6 | 1.4 | 9.3 | (7.8) |
| 2002 | 108.2 | 6.5 | 7.3 | (0.7) |
| 2003 | 106.2 | (1.6) | (9.2) | (7.6) |
| 2004 | 107.4 | 1.2 | (1.6) | 2.8 |

A devaluation of the NIS in relation to the U.S. dollar has the effect of reducing the U.S. dollar amount of any of our expenses or liabilities which are payable in NIS (unless such expenses or payables are linked to the U.S. dollar). Such devaluation also has the effect of decreasing the U.S. dollar value of any asset, which consists of NIS or receivables payable in NIS (unless such receivables are linked to the U.S. dollar). Conversely, any increase in the value of the NIS in relation to the U.S. dollar has the effect of increasing the U.S. dollar value of any unlinked NIS assets and the U.S. dollar amounts of any unlinked NIS liabilities and expenses.

Because exchange rates between the NIS and the U.S. dollar fluctuate continuously (albeit with a historically declining trend in the value of the NIS), exchange rate fluctuations and especially larger periodic devaluations will have an impact on our profitability and period-to-period comparisons of our results. The effects of foreign currency re-measurements are reported in our consolidated financial statements in current operations.

B.

LIQUIDITY AND CAPITAL RESOURCES

Historically, we have financed our operations through cash generated by operations, funds generated by our public offerings in 1991 (approximately \$8.5 million), 1996 (approximately \$5.0 million) and 2000 (approximately \$79.6 million), private equity investments in 1998 (approximately \$12.2 million), as well as from research and development and marketing grants primarily from the Government of Israel. In addition, we have also financed our operations through short-term loans and borrowings under available credit facilities.

Our principal commitments consist of outstanding obligations under operating leases, as well as from credit facilities granted to us by financial institutions.

We made approximately \$1.0 million of capital expenditures in 2004 and \$1.3 million in 2003. In both 2003 and 2004, the majority of our capital expenditures were attributable to the purchase of computers, peripheral equipment and software. We currently do not have significant capital spending or purchase commitments. However, we anticipate an increase in capital expenditures and lease commitments consistent with our anticipated growth in operations, infrastructure and personnel.

As of December 31, 2004, we had approximately \$7.6 million in cash and cash equivalents and working capital of approximately \$19.9 million as compared to \$13.6 million in cash and cash equivalents and working capital of \$16.8 million at December 31, 2003.

Net cash resulting from operating activities was \$5.0 million in 2004 compared to \$4.3 million used in operating activities in 2003. These amounts were primarily attributable to our net profit these years. Net cash used in investing activities was approximately \$11.6 million in 2004 and \$3.2 million in 2003, mainly a result of investments in fixed assets and affiliated companies, as well as the capitalization of software research and development activities. In addition, in 2004 we have invested a net of \$5.2 million in marketable securities and \$1.6 million in increasing our percentage of ownership in several of our partially owned subsidiaries.

Net cash provided by financing activities was approximately \$0.8 million in 2004, resulting mainly from the exercise of stock options in the amount of \$1.3 million, while net cash used in financing activities was approximately \$12.1 million in 2003, mainly as a result of a one-time \$11.8 million dividend distribution.

As of December 31, 2004, we used \$2.0 million of our credit facility with the First International Bank of Israel Ltd. The short-term bank credit is secured by a first priority floating charge on all our assets.

On February 24, 2003, we paid a \$0.40 per share cash dividend to our shareholders, which amounted to \$11.8 million. The dividend was declared by our board of directors after considering alternative means of increasing shareholder value, including a major stock buyback program that would have reduced the float of our ordinary shares. The board determined that the dividend would be more beneficial for our company and its shareholders.

As of December 31, 2004, we had repurchased 1,084,988 shares of our ordinary shares at an aggregate purchase price of \$5.88 million. We plan to repurchase additional shares from time to time in the open market subject to, among other things, general market conditions and the market price of our ordinary shares, as well as the provisions of Israeli corporate law and U.S. securities law. In 2004 we repurchased 31,600 shares at an aggregate purchase price of \$102,000.

We believe our existing cash and cash equivalents will be sufficient to support our current operating plan at least through March 31, 2006; however, we have based this estimate on assumptions that may prove to be incorrect. Therefore, if we do not generate sufficient cash from operations, we may be required to obtain additional financing. There can be no assurance that such financing will be available in the future, or, if available, will be on terms satisfactory to us.

C.

RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES

Research and Development

The software industry is characterized by rapid technological change and is highly competitive with respect to timely product innovation. We must maintain compatibility and competitiveness in the face of ongoing changes in industry standards.

We place considerable emphasis on research and development to improve and expand the functionality of our Magic technology and to develop new applications. We believe that our future success will depend upon our ability to maintain our technological leadership, to enhance our existing products and to introduce new commercially viable products addressing the needs of our customers on a timely basis. We also intend to support emerging technologies as they are introduced in the same way we have supported new technologies in the past. We will continue to devote a significant portion of our resources to research and development. We believe that internal development of our Magic technology is the most effective means of achieving our strategic objective of providing an extensive, integrated and feature-rich development technology.

During the three years ended December 31, 2004, we invested our resources in three main areas:

1.

A new version of eDeveloper, is expected to be released in 2005. This version of the eDeveloper will provide enhanced support in industry standards, improved functionality and a composite application development environment.

2.

We have also invested a large amount in specifying, designing, developing, testing and releasing the second version of iBOLT, iBOLT Version 2.0 (released in 2004), which provides unique mapping capabilities and components access as well as facilitates rapid integration projects.

3.

We have continued to invest in the development of our unique browser client technology and the iBOLT portal capabilities.

In a lesser degree, we have continued to develop the Hermes software. Hermes has recently been ported to the eDeveloper 9.4 version.

The above statement does not constitute the commitment to deliver these products and new versions will be released if and when available.

Our research and development and support personnel work closely with our customers and prospective customers to determine their requirements and to design enhancements and new releases to meet their needs. We periodically release enhancements and upgrades to our core products. In the years ended December 31, 2002, 2003 and 2004, we invested \$6.6 million, \$7.1 million and \$ 7.3 million, respectively, in research and development. Research and development activities take place in our facilities in Israel, India, Japan, the United States and Europe.

On December 31, 2004, we employed 149 employees in R&D activities of which 61 persons were located in Israel, 68 persons in India, 8 persons in Japan and 12 persons in the U.S. As part of our product development team, we employ technical writers who prepare user documentation for our products and have employed subcontractors in connection with the documentation and some development work.

A.

TREND INFORMATION

In order to improve our results in 2004, we implemented a long-term business model and product strategy that we believe will bring consistent revenue growth and profitability as well as growth in software license sales.

We have focused on launching the iBOLT Version 2.0, Integration Suite to market and positioned ourselves in a leading position in the business integration and process management market segments, a position which has been acknowledged by the leading industry analyst groups. We have focused on growing our partner base of system integrators for iBOLT in the development community and our base of solution partners for eDeveloper.

We continued our stringent cost-cutting actions, reducing administrative overhead as possible, throughout our company. We also continued our efforts to increase the effectiveness of our professional services organization by increasing overall utilization. We intend to continue to increase the effectiveness of our professional services organization to realize better margins from projects implemented around the world and to build and improve the efficiency of our distribution channels. We expect that our revenues and operating results will improve during the remainder of 2005.

B.

OFF-BALANCE SHEET ARRANGEMENTS

We are not a party to any off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

C.

TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table summarizes our minimum contractual obligations and commercial commitments, including obligations of discontinued operations, as of December 31, 2004 and the effect we expect them to have on our liquidity and cash flow in future periods.

| Contractual Obligations | Payments due by Period | | | |
|-------------------------------------|------------------------|---------------------|-----------|-----------|
| | Total | less than 1 year | 1-3 Years | 3-5 Years |
| Operating lease obligations | \$ 5.8 | \$ 1.9 | \$ 2.7 | \$ 1.2 |
| Long-term debt obligations | - | - | - | - |
| Capital (finance) lease obligations | - | - | - | - |
| Purchase obligations | - | - | - | - |