MAGIC SOFTWARE ENTERPRISES LTD
Form 20-F
June 30, 2003

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

[X] **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2002

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

(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, nominal value 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: 29,555,240

(as of December 31, 2002)

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 [X] No [-]

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 [-] Item 18 [x]

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The statements contained in this annual report that are not purely historical are forward-looking statements. Such forward-looking statements also include statements in Item 4 Information on the Company and Item 5 Operating and Financial Review and Prospects. These statements involve risks and uncertainties and actual results could differ materially from such results discussed in these statements as a result of the risk factors set forth in this annual report. All forward-looking statements included in this annual report are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements.

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, 2000, 2001 and 2002, and the consolidated balance sheet data as of December 31, 2001 and 2002 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, 1998 and 1999 and the consolidated balance sheet data as of December 31, 1998, 1999 and 2000 from our audited consolidated financial statements that are not included in this annual report.

Income Statement Data:

	Year ended December 31,				
	1998	**1999**	**2000**	**2001**	**2002**
	(U.S. dollars in thousands, except share and per share data)				
Revenues:					
Software(1)	$20,479	$32,596	$26,904	$19,110	$15,136
Applications		4,428	14,416	11,212	7,355
Maintenance and technical support	5,780	9,218	11,347	10,956	10,882
Professional services	12,501	17,750	37,589	35,284	26,631
Total revenues	38,760	63,992	90,256	76,562	60,004

Cost of revenues:					
Software(1)	2,994	3,231	3,635	4,187	3,318
Applications		741	2,007	2,399	2,334
Maintenance and technical support	3,306	3,450	4,200	4,334	4,100
Professional services	9,046	11,365	24,014	25,622	19,239
Total cost of revenues	15,346	18,787	33,856	36,542	28,991
Gross profit	23,414	45,205	56,400	40,020	31,013
Operating expenses:					
Research and development, net	2,797	2,953	5,947	7,547	5,336
Sales, marketing, general and administrative	23,890	31,176	47,458	46,598	30,694
Restructuring and other non-recurring costs	2,677		2,466	6,613	1,123
Impairment expenses				20,081	
Operating income (loss)	(5,950)	11,076	529	(40,819)	(6,140)
Financial (expense) income, net	(322)	175	2,419	575	958
Capital loss			(623)	(2,199)	
Income (loss) before income taxes	(6,272)	11,251	2,325	(42,443)	(5,182)
Income taxes	50	2	523	(167)	(384)

	(6,322)	11,249	1,802	(42,610)	(5,566)
Equity in earnings (losses) of affiliates	(149)	52	(57)		(108)
Minority interest in losses (earnings) of consolidated subsidiaries	12	(394)	(825)	(176)	11
Net income (loss)	$(6,459)	$10,907	$920	$(42,786)	$(5,663)
Basic earnings (loss) per share	$(0.37)	$0.45	$0.03	$(1.45)	$(0.19)
Diluted earnings (loss) per share	$(0.37)	$0.43	$0.03	$(1.45)	$(0.19)
Shares used to compute basic earnings (loss) per share	17,610	24,281	29,084	29,604	29,690
Shares used to compute diluted earnings (loss) per share	17,610	25,391	30,232	29,604	29,690

(1)

In 1998 software revenues included applications revenues and cost of software revenues included cost of revenues for applications.

Balance Sheet Data:

	At December 31,				
	1998	**1999**	**2000**	**2001**	**2002**
	(U.S. dollars in thousands)				
Working capital	$ 5,269	$ 9,608	$48,968	$28,007	$23,200
Cash and cash equivalents	5,828	8,298	42,627	27,900	24,785
Total assets	32,381	56,894	137,995	94,612	84,522

Shareholders' equity	17,136	33,794	109,405	66,893	61,021

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.

We incurred net losses of approximately $42.8 million and $5.66 million for the years ended December 31, 2001 and December 31, 2002, respectively. We cannot assure you that we will be profitable 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 may continue to experience in the future 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. 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 ordinarily 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, manufacturing, 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 Magic technology, applications and services.

Many companies compete with us in the software development and deployment technology and applications and services markets in which we operate. We expect that competition will increase in the future, both with respect to the Magic technology, applications and services which we currently offer and applications and services which other members of the Magic community and we 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 we have. 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 those of our competitors. Failure to do so could adversely affect our business, financial condition and results of operations.

We may not succeed in penetrating the e-Business, CRM and other enterprise application markets.

Our revenues from e-Business, CRM and other applications licenses decreased by 34.4% to $7.4 million in the year ended December 31, 2002 from $11.2 million in the year ended December 31, 2001. We cannot assure you that we will be able to reverse this decline in the future.

We may not have the resources, skills and product offerings that will be required to successfully increase our market share for e-Business, CRM and other enterprise applications. To succeed in these markets, we will need to:

- develop and improve expertise in marketing and selling Internet-based applications;

- develop and cultivate new sales channels to market our applications to prospective customers;

- hire, train and integrate new technical and sales personnel; and

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effectively establish and support relationships with end-users, with whom we have had limited interaction to date.

Our future efforts to enter additional enterprise applications markets may still not succeed. The e-Business, CRM, and other enterprise applications markets that we may attempt to penetrate may not become substantial commercial markets for our applications or may not evolve in a manner that will enable our applications to achieve market acceptance.

Our future success will be largely dependent on the acceptance of Magic eDeveloper.

Our future success will be in great measure dependent on the acceptance of Magic e-Developer. The acceptance of this product will be dependent in part on the continued acceptance and growth of the Internet as a commercial marketplace. Because the use of the Internet for e-Business and other applications is evolving, we cannot predict with any certainty that the Internet will continue to grow as a commercial marketplace in the long term. If the Internet does not continue to grow as a commercial marketplace, the marketing of our Internet-based applications will not succeed.

We may not succeed in penetrating the Enterprise Application Integration market with our new iBolt integration family

The Enterprise Application Integration, or AEI, market in which we compete is extremely competitive and subject to rapid change. We compete with companies that utilize varying approaches to providing technology for application integration and business process management. We do not have a long history of selling products in the EAI market 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 to convince 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.

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

In 2000, our revenues from services increased at a greater rate than our revenues from software licenses and adversely affected our gross profit margin. 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 continued to have 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 continues to have an adverse affect on gross profit margins. 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. We extend credit to our independent distributors and there is no assurance that such credit will be paid back to us. Our results of operations could be materially adversely affected by changes in the financial condition, business, marketing strategies 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, including our Magic applications, 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 North America, especially in the United States, and in Europe. Our efforts to increase our penetration of the North American and European markets is subject to risks inherent to these markets including the high cost of doing business in the United States, which has historically caused our United States operations to incur operating losses.

Our products have a lengthy sales cycle.

Our customers typically use our Magic technology to develop and deploy applications that are critical to their business. As a result, the licensing and implementation of our Magic 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. We have recently encountered a longer sales cycle for our Magic Application products, which may cause significant fluctuations in our quarterly operating results.

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.

Delay in the release of Windows versions of our products negatively impacted our sales and profitability in the mid-1990s. 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 will grow, 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 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 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 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 protecting our proprietary technology. We rely on a combination of trade secret and copyright law 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 on 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, over 80% of our sales in 2000, 93% of our sales in 2001 and 94% of our sales in 2002 were generated from the other countries in which we operate. This subjects us to many risks inherent in 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;
- 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 16,345,369 or 55.5% of our currently 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 ability generally to direct our affairs. Such concentration of ownership may have the effect of delaying or preventing a change in control.

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 affected by the political, economic and military conditions affecting Israel. Any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our business, financial condition and results of operations. Since the establishment of the State of Israel in 1948, a state of hostility has existed, varying in degree and intensity, between Israel and the Arab countries. While Israel has entered into peace agreements with both Egypt and Jordan and several other countries have announced their intentions to establish trade and other relations with Israel, Israel has not entered into any additional peace agreements with such countries or with Syria or Lebanon. Since October 2001, there has been a marked acceleration in the number and frequency of hostile incidents, which culminated in numerous lethal suicide attacks in Israel. In response, the Israeli Army made incursions into Palestinian-controlled cities, towns and refugee camps. Since then, acts of terrorism have continued to occur in various locations in Israel. The continued hostilities between the Palestinian community and Israel and the failure to settle the conflict has had and continues to have a material adverse effect on the Israeli economy and a material adverse effect on our business and us. Further expansion of hostilities might require more widespread military reserve service by some of our employees, which may have a material adverse effect on our business.

Our directors, officers and employees who are male adult citizens and permanent residents of Israel under the age of 48 are, unless exempt, obligated to perform annual military reserve duty and are subject to being called to active duty at any time under emergency circumstances. We cannot assess the full impact of these requirements on our workforce or business if conditions should change, and we cannot predict the effect on us of any expansion or reduction of these obligations.

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, 2000, the rate of inflation exceeded the rate of devaluation of the NIS against the U.S. dollar. We cannot assure you that we will not be materially 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 may be adversely affected by the recently enacted tax reform in Israel.

On January 1, 2003, a comprehensive tax reform took effect in Israel. Pursuant to the reform, resident companies are subject to Israeli tax on income accrued or derived in Israel or abroad. In addition, the concept of "controlled foreign corporation" was introduced according to which an Israeli company may become subject to Israeli taxes on certain income of a non-Israeli subsidiary if the subsidiary's primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains). The tax reform also substantially changed the system of taxation of capital gains.

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.

Risk Factors Related to Our Ordinary Shares

Holders of our ordinary shares who are United States residents face income tax risks.

There is a substantial risk that we will be classified as a passive foreign investment company, or PFIC. Our treatment as a PFIC could result in a reduction in the after-tax return to the holders of our ordinary shares and would likely cause a reduction in the value of such shares. For U.S. federal income tax purposes, we will be classified as a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, passive income includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets which produce passive income. If we were determined to be a PFIC for U.S. federal income tax purposes, highly complex rules would apply to U.S. Holders owning our ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of such rules.

As a result of our substantial cash position and the decline in the value of our stock, there is a substantial risk that we will be classified as a PFIC under the asset test described in the preceding paragraph. However, because the determination of whether we are a PFIC is based upon the composition of our income and assets from time to time, this determination can not be made with certainty until the end of the calendar year.

United States residents should carefully read Item 10E. Taxation - United States Federal Income Tax Consequences for a more complete discussion of the U.S. federal income tax risks related to owning and disposing of 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:

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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; and

- stock market price and volume fluctuations.

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 target of similar litigation. Securities litigation could result in substantial costs and divert management's attention and resources.

Anti-takeover provisions ***could negatively impact our shareholders.***

Some of the provisions of Israeli law could:

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discourage potential acquisition proposals;

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delay or prevent a change in control over us; and

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limit the price that investors might be willing to pay in the future for our ordinary shares.

Generally, under Israeli corporate law, a merger must be approved by the board of directors and the shareholders of each of the merging companies. If the share capital of the non-surviving company consisted of more than one class of shares, the approval of each class is also required. Further, if the company was incorporated before February 1, 2000, as we were, the approval of the merger requires a majority of 75% of the shareholders present and voting at a meeting. In certain cases, court approval is also required. Under the Companies Law, a merger may be completed only after 70 days have elapsed from the date all the necessary approvals and the merger proposals have been submitted to the Israeli Companies Registrar. The Companies Law also provides that an acquisition of shares of a public company must be made by means of a tender offer if, as a result of such acquisition, the purchaser would become a 25% or more shareholder of the company. This rule does not apply if there is already another 25% shareholder of the company. Similarly, the Companies Law provides that an acquisition of shares in a public company must be made by means of tender offer if, as a result of the acquisition, the purchaser would become a 45% shareholder of the company, unless someone else already holds a majority of the voting power of the company. These rules do not apply if the acquisition is made by way of a merger. Regulations promulgated under the Companies Law provide that, generally, these provisions do not apply to companies whose shares are listed for trading outside of Israel. The requirements of Israeli corporate law generally make these forms of acquisition significantly more difficult than under United States corporate laws.

Other potential means of acquiring a public Israeli company might involve significant obstacles, such as a requirement for court approval for the acquisition. In addition, a body of case law has not yet developed with respect to the Companies Law. Until this happens, uncertainties will exist regarding its interpretation.

Finally, Israeli tax law treats some acquisitions, particularly stock-for-stock swaps between an Israeli company and a foreign company, less favorably than United States tax law. Israeli tax law may, for instance, subject a shareholder who exchanges his or her shares in us for shares in a foreign corporation to immediate taxation.

These provisions of Israeli corporate and tax law and the uncertainties surrounding such law may have the effect of delaying, preventing or making more difficult a merger or acquisition involving our company. This could prevent a change of control in our company and depress the market price of our ordinary shares that might otherwise rise as a result of such change of control.

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 $11,882,474 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.

ITEM 4

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 for an indefinite term. 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 Magic software development and deployment technology and business solutions. Our Magic technology enables enterprises to accelerate the process of building and deploying business software applications that can be rapidly customized and integrated with existing systems. Since 1999, we also sell applications developed using Magic technology. These applications are designed for e-Business, customer relationship management, or CRM, and other enterprise uses. 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.

On February 25, 2000 we completed a public offering of 3,500,000 ordinary shares, resulting in net proceeds to our company of approximately $79.6 million. We used a substantial portion of the proceeds to purchase interests in several business solution providers and providers of consulting services. The economic downturn and the downturn in the technology market severely impacted our acquisition strategy.

In 2000, 2001 and 2002 we incurred approximately $2.5 million, $6.6 million and $1.1 million in implementing a restructuring plan with respect to our operations. In 2001 we announced that we were implementing a series of strategic initiatives intended to further reduce costs, increase efficiencies and focus on key business areas. In addition during 2001 we incurred a $20.1 million impairment charge attributable to goodwill and other intangible assets. On March 31st 2003 we sold our holdings in Access Data (Magic) Inc. and on February 28th 2003 we sold our holdings in Magic Thailand.

In September 2002, we established CoreTech Consulting Group, LLC to assume the operating activities of our subsidiary CoreTech Consulting Group, Inc. CoreTech is a leading provider of consulting services and solutions to the pharmaceutical and financial services industries. CoreTech provides consulting and services in the areas of internetworking, platforms, security, business intelligence, project management, project staff augmentation, and support/help desk services, to its Fortune 50 client base. The newly created organizational structure will more closely resemble a consulting model that aligns the interests of CoreTech, its key consulting management and thought leaders, and its customer base. The new LLC structure provides CoreTech with the flexibility to have as many partners as warranted by its business, while enabling us to maintain a material ownership interest in the consulting group.

In March 2003 we launched the iBolt Integration Suite. iBolt is a new product family that will provide affordable enterprise application integration to mid-sized businesses and system integrators. As a comprehensive suite for application integration, iBolt allows the simple integration and interoperability of diverse solutions, including legacy applications in a quick and efficient manner.

B.

BUSINESS OVERVIEW

General

We develop, market and support our award winning eDeveloper, software development and deployment technology and our iBolt technology for enterprise application integration. 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.

Our technology and solutions are especially in demand when time-to-market considerations are critical, budgets are tight, integration if 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.

Magic Technology Benefits

Our eDeveloper and iBolt technologies offer software developers and end-users of deployed applications the following:

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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, which 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.

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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 quickly be 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 can also 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. The eDeveloper technology architecture allows 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 worldwide leadership position in the markets for software development, integration and deployment technology. In particular, we intend to become a leading supplier of application development and enterprise integration technology with a strong focus on customers utilizing IBM eServer systems in heterogeneous environments. 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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maintain technological leadership and become the leading provider of development and integration technology for customers;

- increase penetration and revenue by working with our existing partners, customer accounts and markets;

- cultivate and expand the Magic community by recruiting new software partners; and

- maintain and develop new alliance and development partners.

iBOLT Market Penetration Strategy

Our three-point integration strategy was developed to help customers overcome current business challenges by enabling enterprises to extend their business process automation, management and integration efforts and will offer increased efficiencies to our current and new customers worldwide.

- New Integration Products Based On Our Core Technology. The focus of the iBOLT integration product family will be to serve the needs of medium and small enterprises implementing applications that require connectivity to and reuse of existing enterprise assets. iBOLT illustrates our commitment to providing enterprise-class development and customization tools, performance and scalability, with a heightened focus on providing affordable application integration solutions including extensions to disparate systems such as legacy, ERP, CRM, and SCM, multiple data sources and other home grown solutions. The new framework is specifically designed to meet demanding application integration requirements of current and future applications and directly builds on our substantial experience and track record in this field.

- Increase Strategic Relationships with Integration Specialists. Leading consulting companies and systems integrators are refocusing their efforts toward helping customers extend their business systems by leveraging integration technologies. We offer these firms the integration and development technology that enterprises are demanding. We will intend to join forces with system integrators who focus on the mid-market and to enter into reseller partnerships with complementary technology vendors to provide integration functionality to a broader customer base.

- Enhance Global Team Providing Support. We will continue to enhance our worldwide service team so that customers will receive immediate access to technical support during disparate business hours around the world to ensure efficient problem recovery and the continuity of business. The support mechanism is transparent to customers, as incoming queries are automatically routed to the most appropriate support center.

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 then 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 an enterprise application integration platform targeted at mid-sized organizations, a considerably underserved market in today's hot EAI 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 EAI 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 EAI 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 catalogs available to customers via Web interfaces, to subscribe to investment funds via the Web, and to integrate seven 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 responding to changing business requirements with 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 and 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.

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.

Magic Applications

Magic eMerchant. Magic eMerchant is a customizable business platform that combines business solutions for supply chain management with a powerful virtual order center. Magic eMerchant delivers enterprise-level processing power and security along with rapid integration with back-end systems, and can be easily customized to fit an organization's business rules. Magic eMerchant enables customization to specific business logic and processes, personalized pricing, order templates and catalogs, and robust security. It provides sophisticated product configuration capabilities and a multi-tiered architecture to support multiple business units, stores, outlets and branches features that are unique in its price category.

CRM 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.

- *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.

- *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.

Hermes (formerly Magic eCargo). Designed expressly for the cargo industry, Hermes 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 charging, collecting fees and invoicing.

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.

Magic Rental Technologies Ltd. develops, markets, and sells Carpro Systems™, a solution that includes more than 90% of the functions usually required by multi-facility car- and truck-rental and leasing companies worldwide. Carpro Systems can manage such varied functions as purchasing and selling vehicles, reservations management, leasing and rental arrangements, and fleet control and management.

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

Access Data (Magic) Inc. provides a comprehensive software suite for managing law enforcement, fire, communications, corrections/detention, emergency service and judicial agencies throughout the United States. On March 31st 2003 we sold our holdings in Access Data (Magic) Inc.

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.

Services

Professional Services. We provide a broad range of consulting and software development project management services to customers developing and deploying distributed and Internet applications with the eDeveloper technology. 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 know-how 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, each of which includes trainer and student guidebooks. 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.

In 2002 we launched a free web based training initiative for eDeveloper. The web training provides developers with a free evaluation version of eDeveloper, a 40-hour web based training course "Fundamentals of eDeveloper Programming" as well as three months of free technical support.

Customers, End-Users and Markets

We market and sell our products and services in approximately 50 countries worldwide. Industries that are significantly represented in our Magic community base include finance, retail, media, telecommunications, manufacturing, tourism, 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 of our eDeveloper technology are the following organizations: Merrill Lynch, American Express, Mutual of Omaha, Allstate Insurance, Bank of France, Carey International, Cap Gemini Finance, JP Morgan, Club Med, Financial Times, Hitachi, Hutchison Telecom, Kodak, Matsushita, McKesson HBOC, Minolta, Nestle, Philip Morris, Steelcase, Adidas-Salomon, State of Washington, John Menzies Distribution and World Cargo, Athlon Group, Marconi, Compass Group PLC, United Utilities, Phoenix Police Department, the Hungarian Government and the United Nations.

Sales, Marketing and Distribution

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

Sales. We maintain a direct sales force in the field for pursuing large accounts. They carry out strategic sales with a direct approach to decision makers, managing a constantly monitored consultative type of sales cycle. At March 31, 2003 we had approximately 86 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 telesales staff to sell to small and medium sized accounts and to generate and qualify leads for larger accounts.

Some larger Magic solution providers may also resell development systems when selling sophisticated 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 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 35 distributors, most 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 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 sponsor periodic 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. *Magic Magazine,* a publication that has been developed as a public relations activity, is produced quarterly and distributed to the Magic community and potential customers, includes articles that highlight our Magic solution providers.

Strategic Alliances

The important strategic alliances formed by us to date include:

IBM. During 2002, 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. eDeveloper and iBolt support application development and deployment for the IBM iSeries and AS/400, xSeries, pSeries and zSeries platforms.

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.

During 2002 we carried out various campaigns in conjunction with IBM including a campaign to provide users with a smooth migration path from the HP e3000 to IBM eServer platforms. We carried out a channel expansion campaign and enhanced our Magic Solution Partners program to recruit new partners. During 2002 we also signed an agreement with IBM according to which we will market and sell IBM s DB2 database environment, in conjunction with eDeveloper.

Oracle. As an Oracle Alliance member, we work closely with Oracle to provide gateways from our Magic technology to Oracle's database. As part of our relationship, we have the ability to obtain special development and marketing support including licenses, technical assistance and cooperative marketing.

Pervasive Software. We have a strategic alliance with Pervasive Software to develop and market a bundled product comprised of Pervasive's Scalable SQL and database engines and our eDeveloper technology. The alliance provides for joint technical development and product integration, international co-marketing and channel development programs.

Software AG. During 2002 we initiated a partnership with Software AG to enable XML connectivity for iSeries applications. Software AG is Europe's largest systems software provider and a pioneer in XML technologies. The combination of the strength of eDeveloper with the power of Software AG's Tamino XML Server, provides a powerful technological environment for building and enabling iSeries applications to take advantage of XML and cross-platform data transfer. In addition, existing iSeries applications can be upgraded, modernized and XML-enabled, increasing the value and life span of existing applications.

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), 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 WenMethods, Tibco, Seeburger, Microsoft BizTalk (although we also complement this environment), Axway and Mercator. 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 the case of large accounts, site license agreements are often required to be signed by the end-users. Generally, a "shrink wrap&