

BLUE MARTINI SOFTWARE INC

Form 10-K

March 30, 2005

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the year ended December 31, 2004

OR

.. Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number: 0-30925

BLUE MARTINI SOFTWARE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

incorporation or organization)

94-3319751
(I.R.S. Employer

Identification No.)

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2600 Campus Drive

San Mateo, California 94403

(Address of principal executive offices)

Telephone Number (650) 356-4000

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: Common Stock

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

The aggregate market value of the voting stock held by non-affiliates of the registrant, based on the closing sale price of the Common Stock on June 30, 2004 as reported on the Nasdaq National Market was approximately \$29,983,000. Shares of Common Stock held by each current executive officer and director and by each person who is known by the registrant to own 5% or more of the outstanding Common Stock have been excluded from this computation in that such persons may be deemed to be affiliates of the registrant. Share ownership information of certain persons known by the registrant to own greater than 5% of the outstanding common stock for purposes of the preceding calculation is based solely on information on Schedule 13G filed with the Commission and is as of June 30, 2004. This determination of affiliate status is not a conclusive determination for other purposes.

The number of shares outstanding of the registrant's Common Stock as of March 1, 2005 was approximately 13,075,413.

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ANNUAL REPORT

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PART I

In addition to historical information, this annual report on Form 10-K contains 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, including statements using terminology such as can, may, believe, designed to, will, expect, plan, anticipate, estimate, potential, or continue, or the ne comparable terminology regarding beliefs, plans, expectations or intentions regarding the future. Forward-looking statements involve risks and uncertainties and actual results could differ materially from those discussed in the forward-looking statements. All forward-looking statements and risk factors included in this document are made as of the date hereof, based on information available to Blue Martini Software, Inc. (the Company, Blue Martini, or we) as of the date thereof, and the Company assumes no obligation to update any forward-looking statement or risk factors.

ITEM 1. BUSINESS

Recent Developments

On March 1, 2005, Blue Martini entered into an Agreement and Plan of Merger dated as of February 28, 2005 with Multi-Channel Holdings, Inc., or Multi-Channel, and BMS Merger Corporation, or Merger Sub, a wholly owned subsidiary of Multi-Channel, pursuant to which, subject to satisfaction or waiver of the conditions therein, Merger Sub will merge with and into Blue Martini, and Multi-Channel will acquire all of the outstanding common stock of Blue Martini. Upon the consummation of the merger, or the Effective Time, Blue Martini will become a wholly owned subsidiary of Multi-Channel. See Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources for a more detailed discussion of the proposed merger.

Overview

Blue Martini LLC, a Delaware limited liability company, was founded in June 1998 and was succeeded in January 1999 by Blue Martini Software, Inc.

Blue Martini provides software designed to help companies increase revenues, or optimize sales, by proactively guiding sales people, partners, and customers through sales interactions. Companies can incorporate their specific sales and marketing expertise into our application software. The combination of this expertise along with the intelligence embedded in our applications allows our customers to automate important sales and marketing processes that otherwise would require significant time and effort from their product, marketing and sales experts. Our applications are designed to proactively guide sales interactions online, on the phone and in the store, resulting in higher revenues and allowing companies to extend their selling expertise throughout their entire sales force as well as to their partners and end customers.

Our software applications can help our customers increase sales and improve customer loyalty by:

Recommending to sales people when they should contact customers, what products they should suggest, and what they should say;

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Guiding sales people, partners, and customers to the best solutions to meet their needs;

Providing customers with a unified customer experience across multiple channels including the website, call center, e-mail campaigns, and in the store;

Providing customers with web-based self-service; and

Making it easier for marketers to analyze, segment, and target customers for multi-step, multi-channel customer interactions that deliver relevant and timely messages.

Leading companies throughout the world have implemented our software, including AOL, Carrefour, Debenhams, DuPont, Harrah's, Kohl's, Lanier, and Saks Fifth Avenue.

Products

Our software offerings include products for sales, marketing, and commerce.

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Blue Martini Sales. We provide sales applications for retailers and other companies that sell to consumers that help them maximize customer revenue. Blue Martini guided selling provides a web-based application that guides sales people, partners, and customers towards the best products or solutions for their needs. Our customers can use our software to take into account their users' needs and preferences and guide them through an interactive product recommendation and selection process to zero in on the right product. Our customers can also use our software to make it easier for their own customers to understand and compare features, get expert advice, find gifts for the right occasion, and select or configure products and services.

Retailers seek to maximize their revenue from their key customers. Our retail customers can use our Clienteling application to recommend to sales people which prospective customers they should contact and what they should communicate in order to bring them back to the store more often and increase the size of their orders. For this purpose, the application draws on insights about the customer to recommend products, reminds sales associates of relevant events for each customer, and helps a company maintain information about top customers as they transition between sales associates. Our customers can also use our applications to provide their sales people with real-time information about their key clients, including contact information, customer preferences, buying history and recent transactions, holds, service tickets and alterations, wish lists, events, and relevant reports. Sales people can access our applications in the store, online, at the point-of-sale, or via wireless devices.

Blue Martini Marketing. Blue Martini Marketing includes customer analytic and messaging applications. Our customers can use our analytics applications to analyze multi-channel customer information and make informed decisions about how to target and interact with customers. Our customers' business users can use our analytics applications to do reporting, data mining, and online analytical processing (OLAP). Our customers' marketing teams can use our messaging applications to enable marketers to define multi-step, multi-channel interactions with customers; for example, a retailer might use our messaging application for a coordinated launch of a new product involving e-mails, calls, and personalized website content aimed at key customers.

Blue Martini Commerce. Blue Martini Commerce helps companies address the challenge of deploying complex, multi-brand, multi-national websites. Blue Martini Commerce provides massive scalability, is highly extensible and supports all languages, currencies and virtually any payment methodology. Our customers' business users work within the application's intuitive environment to manage their websites and can leverage powerful merchandising, catalog and content management, and integrated analytics capabilities to provide customers with compelling interactions across all channels. We also offer an integrated contact center with Commerce.

Solution Benefits and Differentiating Factors

Our solutions are designed to deliver unique competitive advantages and benefits to our customers:

Intelligence. Our intelligent selling systems are powered by a suite of intelligent engines that uniquely differentiate us from traditional database applications. Where database applications are useful in tracking and presenting information, our intelligent engines enable companies to automate key sales and marketing processes to reduce sales cycles and sell more effectively by gathering and collecting information from the customer's internal experts. Our intelligent engines include:

An analytics engine that employs machine learning to segment customers and discover patterns of customer behavior;

A constraint engine that can model complex needs analysis, configuration, and pricing knowledge; and

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A process-modeling engine that can interact intelligently with a customer over time and across multiple channels (e.g., email, a website, and a retail store).

We believe that the breadth and depth of the intelligent systems embedded in our applications provides Blue Martini with a unique competitive advantage. By continuing to focus research and development on extending these core intelligent systems, as well as the applications that leverage this intelligence, we hope to be able to compete effectively in the marketplace against larger vendors that offer more basic customer-tracking functionality.

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Flexible Architecture. Our J2EE (Java 2 Platform, Enterprise Edition) architecture is modular, allowing customers to implement point solutions today to solve critical business issues, and later easily add other modules without extensive time-consuming integration. With our focus on enabling business users to operate applications, companies can easily and rapidly customize our applications to fit their particular business needs, rather than forcing changing their business processes to suit the software.

Easy Deployment and Integration. Our applications are designed for our customers to implement quickly and efficiently and to fit easily within existing IT environments. Our applications can work stand-alone, as integrated into a disparate applications environment, or as extensions of existing customer relationship management (CRM) applications, such as sales force automation and campaign management.

Scalable Operations. Our application suite architecture is designed to support a large number of concurrent users, and our performance has undergone benchmark tests with excellent results. Our applications can be installed across any number of web and application servers, making it possible to support large amounts of content, products and concurrent users.

Vertical Expertise. Blue Martini has deployed solutions for leading retailers worldwide. Designed by retail experts in collaboration with customers, Blue Martini retail solutions for retail are modular point solutions that include retail-specific functionality, starter templates, and best practices. Applications can be deployed individually or as a complete package, so companies have the flexibility to address their most pressing issues quickly, with a roadmap to a future integrated solution. Blue Martini retail solutions are tailored to meet the unique competitive requirements inherent in the retail market.

Services

While our business model focuses on the development and licensing of software, we also offer a comprehensive selection of services to our customers, including professional, technical support and training services, as well as value-added data analysis services. In 2004, 2003 and 2002, revenues derived from these services accounted for 74%, 65% and 82% of our total revenues, respectively.

Blue Martini Consulting. We offer professional services to our customers for the deployment of our application suite and its integration with third-party software such as traditional call centers, sales force automation, merchandising, enterprise resource planning and supply chain management systems. Our service professionals work directly with our customers as well as with third-party systems integrators and regional consulting organizations.

Blue Martini Managed Services. We have recently begun to offer our products on both a hosted basis and an on-demand basis. These new offerings are intended to allow our customers to deploy Blue Martini software more quickly without requiring significant internal IT resources.

Blue Martini Support. We offer comprehensive technical support, designed to allow companies to quickly and effectively address technical issues as they arise and to provide updates and upgrades to our customers.

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Blue Martini Training. We offer a comprehensive training curriculum designed for systems integrators and customers. Our courses not only train professionals in the use and implementation of our application suite but also educate business users on key concepts such as personalization and data mining. We have training facilities in San Mateo, California and also conduct training in multiple locations in Europe and Asia.

Alliances

Blue Martini maintains alliances with consulting and system integrator firms, independent software vendors, and platform and infrastructure providers. Many of these alliances can be terminated by either party upon thirty days' notice.

Consulting and System Integrators (CSI). CSI alliance members typically manage the integration projects at our customer sites. We offer CSI alliance members partner program benefits such as discounted training fees, participation in joint marketing activities, access to our software, and the opportunity to participate in joint

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development projects within related industries. In addition, we have active customer referral programs. Our CSI alliance members help us develop customer relationships, and similarly we recommend our CSI alliance members to our customers. Our customers pay us directly for our application suite and pay our CSI alliance members directly for their services. By recruiting, training, and managing personnel deploying our software, CSI alliance members permit us to focus on our core competencies, such as developing and distributing our software application suite and providing additional product-specific technical expertise during consulting service engagements.

Independent Software Vendors (ISV). Our ISV alliance members deliver software products that complement our application suite. Their offerings include fulfillment, transportation management, content enhancement, enterprise application integration, marketplace infrastructure and CRM. In addition, we partner with ISVs focused on specific market segments to enhance our market penetration opportunities in the retail and manufacturing markets. Our ISV alliance members help us to develop customer relationships, and similarly we recommend our ISV alliance members to our customers. Our customers pay directly for our application suite and typically pay our ISV alliance members directly for their products; however, we pay royalties to some alliance members where their technology is embedded in or bundled with our solutions. Our ISV program facilitates the delivery of our pre-packaged adapters that connect the Blue Martini application suite to our alliance members' software, or competitor software in place. Delivery of packaged adapters requires software development at the outset as well as validation of the packaged software for each release of our application suite.

Platform and Infrastructure (PI). Our PI alliance members provide our customers with the hardware and software infrastructure used for the deployment of our application suite. Our PI alliance members sell hardware, operating systems, database products, and software services. We perform the software development work necessary to ensure that our software supports the platforms of our PI alliance members. Our customers pay us directly for our software application suite and pay our PI alliance members directly for their products and services; however, we pay royalties to some alliance members where their technology is embedded in or bundled with our solutions.

Technology

Our software application suite is built upon a three-tiered architecture designed to deliver consistent, high performance operation in an uncertain environment where demand imbalances and hardware failures are common. A layer of web servers handles Website requests. These web servers return and cache static content, but forward dynamic web requests to a layer of application servers. These application servers execute business logic that typically requires access to data stored in read-only catalog databases. To improve performance, our architecture automatically caches catalog and session data in memory to avoid slow database access. These catalog databases can also be replicated to further improve support for large numbers of customers without interruption. Customers can easily handle increased website volume by adding any combination of web, application or database servers. Read-write transaction databases record customer transactions as well as updates to end-customer profiles. Optionally, business logic for some functions can be executed as Java applets on the client to further enhance performance and scalability.

Our software is developed in the Java programming language to take advantage of the graphical user interface and functional libraries available in Java, as well as the speed of development made possible by other Java features such as pointer-less references and automatic memory management.

Our application suite incorporates technologies including a Java application server, full-text retrieval software, constraint engine, UI generation software, rules induction software, rules execution software, a workflow system, data transformation software, and visualization libraries. Our application suite provides integrated data analysis, visualization, personalization, product configurations, solution design, and workflow.

Research and development expenses totaled \$7.5 million, \$9.7 million and \$13.4 million for 2004, 2003 and 2002, respectively.

Sales Capabilities

We currently have sales offices in France and the United States. Our sales and marketing headcount is 16 at December 31, 2004. In 2004, one customer, Masco Corporation, accounted for 12% of our total revenues or \$3.3

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million of revenues. In 2003, two customers each accounted for 13% of total revenues. Masco Corporation and America Online, Inc. accounted for \$4.3 million and \$4.2 million, respectively, of 2003 total revenues. In 2002, no individual customer accounted for more than 10% of total revenues. Our total revenues were \$28.3 million, \$32.6 million, and \$33.6 million for 2004, 2003 and 2002, respectively. International revenues for 2004, 2003 and 2002 were \$8.2 million, \$7.6 million and \$7.7 million, respectively, representing 29% of total revenues in 2004 and 23% in 2003 and 2002.

Acquisitions

In April 2002, we acquired The Cybrant Corporation (Cybrant) through the merger of a wholly owned subsidiary of Blue Martini with and into Cybrant, with Cybrant surviving as a wholly owned subsidiary of Blue Martini (the Merger). The Cybrant products enable customers to sell complex products and services.

Competition

The market for our product is intensely competitive, rapidly evolving, and subject to rapid technological change. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any one of which could reduce our future revenues or earnings. We expect the intensity of competition to increase in the future. We face competition primarily from the following:

Internally Developed Systems. Information technology, or IT, departments of potential customers have developed or may develop systems that provide for some or all of the functionality of our product. We expect that internally developed application integration and process automation efforts will continue to be a principal source of competition for the foreseeable future. In particular, it can be difficult to license our product to a potential customer whose internal development group has already invested substantially in, and made progress towards completion of, the systems that our product is intended to replace.

Point Applications. Our products compete with stand-alone point solutions offered by providers such as BroadVision, Inc., Firepond, Inc., Selectica, Inc., Trilogy Software, Inc., Unica Corporation, and Vignette Corporation.

Components. Our products compete with components offered by vendors such as Art Technology Group, Inc., Microsoft Corporation and IBM Corporation.

Traditional Retail Applications. Our products compete with the retail suite vendors who continue to push outside of their traditional areas of comfort with new add-on products and they are: GERS, JDA and Retek.

Traditional CRM Software. Our products compete with CRM products offered by vendors such as E.piphany, Inc., Oracle Corp., PeopleSoft, Inc. (a subsidiary of Oracle Corp.), SAP AG, NCR and Siebel Systems, Inc.

E-Commerce On Demand. Blue Martini has recently released selected solutions available on demand. We are now competing with existing on demand solutions from companies such as Amazon and GSI, and recently, ATG announced an on demand version of its product.

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Many of our competitors have greater resources and broader alliance and customer relationships than we do. In addition, many of these competitors have extensive knowledge of our industry. Current and potential competitors have established, or may establish, cooperative relationships among themselves or with third parties to offer a single solution and increase the ability of their products to address customer needs. Furthermore, our competitors may combine with each other and other companies may enter our markets by acquiring or entering into strategic relationships with our competitors.

We believe that the principal competitive factors affecting our market include:

vertical domain expertise;

product functionality and features;

product architecture and technology;

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incumbency of vendors;

availability of global support;

relationship with system integrators;

coverage of direct sales force;

ease and speed of product implementation;

vendor and product reputation;

financial condition of similar vendors;

ability of products to support large numbers of concurrent users; and

price of the solution

flexibility in delivering the solution (premise, hosted and on-demand); we have recently introduced hosted and on-demand solutions;

customer referenceability;

measurable value (top and bottom line) to the customer; and

implementation complexity and time requirement.

We believe that our primary competitive advantages are our vertical domain expertise, the breadth and depth of our product's functionality and features, measurable value, breadth of delivery options and our product architecture and technology. We may not be able to compete effectively against current and potential competitors, especially those with greater financial, sales, marketing, professional services, technical support, training and other resources.

Intellectual Property and Other Proprietary Rights

Our success depends in part on the development and protection of the proprietary aspects of our technology as well as our ability to operate without infringing on the proprietary rights of others. To protect our proprietary technology, we rely primarily on a combination of trade secret, copyright, trademark and patent laws, as well as confidentiality procedures and contractual restrictions.

We license technologies from several software providers that are incorporated in our product. We anticipate that we will continue to license technology from third parties in the future. In particular, we license application server technology from BEA Systems, Inc. and IBM Corporation, we license a rules engine from Blaze Software Inc. that automates the execution of business processes according to criteria set by our customers, and we license configuration technology from Array Technologies that is incorporated in our interactive selling applications. The arrangement with IBM is comprised of a marketing agreement that expires December 2006, and an OEM license for IBM's WebSphere server that expires in December 2005. The license agreement with Blaze expires in June 2007, the license agreement with BEA expires in July 2007, and the license agreement with Array Technologies is indefinite in term. We may not be able to renew our licenses for these technologies on commercially reasonable terms, if at all. The loss of these technologies or other technologies that we license could prevent sales of our product and increase our costs until substitute technologies, if available, are developed or identified, licensed and successfully integrated into our product. Even if substitute technologies are available, there can be no guarantee that we will be able to license these technologies on commercially reasonable terms, if at all.

We license the modules of our application suite and require our customers to enter into license agreements that impose restrictions on their ability to reproduce, distribute and utilize the modules. In addition, we seek to avoid disclosure of our trade secrets through a number of means, including but not limited to, generally restricting access to our source code and object code and requiring those entities and persons with access to our proprietary information to agree to confidentiality terms which restrict their use and disclosure. We seek to protect our software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. We cannot assure that any of our proprietary rights with respect to our applications will be viable, or of value, in the future since the validity, enforceability and type of protection of proprietary rights in Internet-related industries are uncertain and still evolving.

We have one issued patent relating to our configuration products, issued on June 11, 2002 and expiring on December 30, 2019, and have several United States patent applications pending. It is possible that some or all of the patents that we have applied for will not be issued, and even if issued, that some or all may not be successfully

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defended. It is also possible that we may not develop proprietary products or technologies that are patentable, that any patent issued to us may not provide us with any competitive advantages or that the patents of others will harm our ability to do business.

Despite our efforts to protect our proprietary rights and technology, unauthorized parties may attempt to copy aspects of our products or obtain the source code to our software or use other information that we regard as proprietary or could develop software competitive to ours. Policing unauthorized use of our products is difficult, and while we are unable to determine the extent to which piracy of our software exists, software piracy may be or become a problem. Our means of protecting our proprietary rights may not be adequate, and our competitors may independently develop similar technology or duplicate our product. Litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement or invalidity. Any such resulting litigation could result in substantial costs and diversion of resources that could have a material adverse effect on our business, operating results and financial condition.

In the future, a third party may bring suit claiming that we or our current or future products infringe their patents, trade secrets or copyrights. Any claims, with or without merit, could be costly and time-consuming to defend, divert our management's attention or cause product delays. We may not have patents that we could use defensively against a company bringing such a claim. If our product was found to infringe a third party's proprietary rights, we could be required to enter into royalty or licensing agreements to be able to sell our product. Royalty and licensing agreements, if required, may not be available on terms acceptable to us, if at all, which could harm our business.

Employees

As of December 31, 2004, we had 95 employees, of whom 80 were based in North America, 14 were based in Europe, and 1 was based in Asia. Of these employees, 16 were in sales and marketing, 25 were in product development, 39 were in professional services, technical support and training and 15 were in finance, human resources, legal, information systems and administrative functions. Our employees are not represented by any collective bargaining agreements (other than one French employee subject to the Syntec collective bargaining agreement), and we have never experienced a significant work stoppage. We believe our employee relations are good.

Availability of this Report

Our annual report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed or furnished pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are available free of charge on our web site at www.bluemartini.com shortly after we electronically file such material with the SEC. The public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling 1-800-SEC-0330. The SEC also maintains a web site at www.sec.gov that contains reports, proxy, and information statements, and other information regarding issues that file electronically. We assume no obligation to update or revise any forward looking statement in this annual report, whether as a result of new information, future events or otherwise, unless it is required to do so by law.

ITEM 2. PROPERTIES

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Our principal administrative, research and development, sales, consulting and marketing activities are conducted in approximately 19,000 square feet of leased space in San Mateo, California. The lease covering this space expires in April 2006. In addition, we have a lease covering approximately 8,000 square feet in Boca Raton, Florida that expires in September 2006. We also lease office space in France, Japan and the United Kingdom on a short-term basis to support our worldwide sales and professional services organizations.

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Beginning in July 2001, Blue Martini, Monte Zweben, William Zuendt, certain of our former officers and directors and Goldman Sachs and the other underwriters of our initial public offering, or IPO, were named as defendants in several class action shareholder complaints filed in the United States District Court for the Southern District of New York, consolidated under the title *In re Blue Martini Initial Public Offering Securities Litigation*. Plaintiffs claim that the defendants violated the federal securities laws because our IPO registration statement and prospectus allegedly contained untrue statements of material fact or omitted material facts regarding the compensation to be received by, and the stock allocation practices of, the IPO underwriters. The plaintiffs seek unspecified monetary damages and other relief. Similar complaints were filed in the same Court against hundreds of other public companies that conducted IPOs of their common stock since the mid-1990s. On August 8, 2001, all IPO-related lawsuits were consolidated for pretrial purposes before United States Judge Shira Scheindlin of the Southern District of New York. In accordance with Judge Scheindlin's orders, we did not answer the complaint, and no discovery was served. Also in accordance with Judge Scheindlin's orders, plaintiffs filed amended consolidated complaints on April 19, 2002. We joined in a global motion to dismiss the IPO Lawsuits on July 15, 2002. On or about October 9, 2002, our directors and officers were dismissed without prejudice pursuant to a stipulated dismissal and tolling agreement between the plaintiffs and certain individual defendants. On November 1, 2002 Judge Scheindlin presided over an all-day hearing on the global motions to dismiss. On February 19, 2003, Judge Scheindlin issued a ruling on the global motion to dismiss; with respect to us, the motion was granted in part and denied in part. In June 2003, we joined in a tentative global settlement that would, among other things, result in the dismissal with prejudice of all claims against all issuers and their officers and directors in the IPO-related lawsuits, and the assignment to plaintiffs of certain potential claims that the issuers may have against their IPO underwriters. The tentative settlement provides that, in the event that the plaintiffs ultimately recover less than \$1 billion in settlement or judgment against the underwriter defendants in the IPO-related lawsuits, the plaintiffs would be entitled to payment by each participating Issuer's insurer of a pro rata share of any shortfall in the plaintiffs' guaranteed recovery. The tentative settlement does not involve any payment or admission of wrongdoing by us. In July 2003, pursuant to the authorization of a special litigation committee of our Board of Directors, we entered into a non-binding memorandum of understanding reflecting the settlement terms described above. In September 2003, in connection with the possible settlement, our officers and directors described above who had entered tolling agreements with plaintiffs agreed to extend those agreements so that they would not expire prior to any settlement being finalized. In June 2004, Blue Martini executed a final settlement agreement with the plaintiffs. On February 15, 2005, the Court issued a decision certifying a class action for settlement purposes and granting preliminary approval of the settlement, subject to modification of one aspect of the settlement. The settlement remains subject to a number of procedural conditions, as well as final approval by the court.

On or about July 24, 2002, a complaint was filed against Blue Martini in the Supreme Court of the State of New York, County of Queens. The complaint, captioned *Fresh Direct, Inc. v. Blue Martini Software, Inc.*, was filed by a customer that had licensed our products and engaged us to perform related services. The complaint was amended on or about August 26, 2002, to change the plaintiff to Fresh Direct, LLC as successor to Fresh Direct, Inc.. The amended complaint asserts claims for breach of contract, breach of warranty, negligent misrepresentation, fraud, and unjust enrichment. On or about September 18, 2002, we filed a motion to dismiss the amended complaint. On or about October 23, 2002, Fresh Direct opposed the motion to dismiss and filed a cross-motion for leave to file a second amended complaint, which we subsequently opposed. On or about March 24, 2003, the Court issued an order which granted in part and denied in part our motion to dismiss and granted Fresh Direct's motion for leave to file the second amended complaint. In April 2003, we appealed the denial of the motion to dismiss, and in May 2003, we filed our answer to the second amended complaint and counterclaims for breach of contract and fraud. In May 2004, the appellate court affirmed the lower court's decision respecting the motion to dismiss. The parties entered into a confidential settlement agreement (the Settlement Agreement), with no admission of liability, dated as of February 28, 2005. Pursuant to the Settlement Agreement, among other things, the parties will cause a stipulation of discontinuance to be filed in the Supreme Court of the State of New York, Queens County, and as of the Effective Date of the Settlement Agreement, as that term is defined therein, will release each other from any claims that each has against the other.

In November 2004, our customer, Harley-Davidson, Inc. (Harley-Davidson) notified Blue Martini by letter that a complaint had been filed in August 2004 in the United States District Court for the Eastern District of Texas by Orion IP, LLC (Orion) asserting claims against Harley-Davidson and others for patent infringement. In the letter, Harley-Davidson asserted claims for warranty and/or indemnification and defense of the litigation purportedly arising under the Software License and Services Agreement between Harley-Davidson and Blue Martini.

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Harley-Davidson has filed an answer denying infringement and a counterclaim for declaratory judgment of noninfringement, invalidity, and/or unenforceability of the patents. Blue Martini is currently investigating Harley-Davidson's claim for indemnification and warranty. We believe that we have meritorious defenses against this claim for indemnification and intend to pursue them vigorously.

On or about March 1, 2005, a complaint was filed against the Company in the Court of Common Pleas of the State of South Carolina, County of Greenville. The complaint, captioned ScanSource, Inc. v. Blue Martini Software, Inc., was filed by a customer that had licensed certain products and engaged the Company to perform related services. The complaint asserts claims for breach of contract, breach of warranties, negligence, negligent misrepresentation, fraud, breach of contract accompanied by fraudulent acts, unfair or deceptive trade practices, and privacy. The Company believes that it has meritorious defenses against this lawsuit and intends to pursue them vigorously.

In addition, we may be subject to additional legal proceedings and claims, asserted or unasserted, that are in the ordinary course of business. We cannot predict the outcome of these proceedings and claims or their possible impact Blue Martini.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our security holders during the fourth quarter of 2004.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

(a) Our common stock is listed on the Nasdaq National Market under the symbol BLUE. The following high and low sales prices were reported by Nasdaq in each quarter during the last two years.

	High	Low
Year Ended December 31, 2004:		
Fourth quarter	\$ 3.40	\$ 2.50
Third quarter	\$ 4.44	\$ 2.40
Second quarter	\$ 5.55	\$ 4.00
First quarter	\$ 5.95	\$ 3.80
Year Ended December 31, 2003:		
Fourth quarter	\$ 6.05	\$ 4.34
Third quarter	\$ 5.48	\$ 3.50
Second quarter	\$ 4.00	\$ 2.56
First quarter	\$ 3.14	\$ 2.66

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The reported last sale price of our common stock on the Nasdaq National Market on March 15, 2005 was \$3.90, which reflects the effect of the merger announcement discussed in Item 7 and elsewhere in the document. The approximate number of holders of record of the shares of our common stock was 260 as of March 15, 2005. This number does not include stockholders whose shares are held in trust by other entities or stockholders who hold our shares beneficially, or in street name. We estimate that the number of beneficial stockholders of the shares of our common stock as of March 15, 2005 was approximately 9,200.

We have sold and issued no unregistered securities during the period covered by this report. We have never paid any cash dividends on our capital stock. For the foreseeable future, we intend to retain our earnings to fund the development and growth of our business and, therefore, do not anticipate paying any cash dividends. See Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

Table of Contents**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

The following selected consolidated financial data is derived from our consolidated financial statements. This data should be read in conjunction with Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements of Blue Martini Software, Inc. and the notes to consolidated financial statements included elsewhere in this annual report. The consolidated statement of operations data set forth below for each of the years in the three-year period ended December 31, 2004 and the consolidated balance sheet data as of December 31, 2004 and 2003, are derived from, and qualified by reference to, the audited financial statements appearing elsewhere in this annual report. The statement of operations data for the periods ended December 31, 2001 and 2000, and the balance sheet data as of December 31, 2002, 2001 and 2000, are derived from audited financial statements not included herein. All references to earnings per share and the number of common shares reflect the one-for-seven reverse stock split of our outstanding shares of common stock, effected on November 13, 2002.

	Year Ended December 31,				
	2004	2003	2002	2001	2000
(In thousands, except per share data)					
Consolidated Statement of Operations Data:					
Revenues:					
License	\$ 7,321	\$ 11,479	\$ 5,915	\$ 20,438	\$ 42,650
Professional services	11,791	12,795	19,330	28,419	26,520
Maintenance	9,174	8,321	8,378	11,057	5,081
Total revenues	28,286	32,595	33,623	59,914	74,251
Cost of revenues:					
License	846	1,607	3,812	4,122	3,754
Professional services	9,398	10,636	16,046	30,405	29,051
Maintenance	2,613	3,049	4,118	6,954	5,625
Total cost of revenues	12,857	15,292	23,976	41,481	38,430
Gross profit	15,429	17,303	9,647	18,433	35,821
Operating expenses:					
Sales and marketing	13,846	18,714	26,920	46,661	45,962
Research and development	7,541	9,713	13,380	18,623	14,671
General and administrative	5,037	6,786	7,590	10,900	11,449
Amortization of deferred stock compensation	188	1,336	(794)	12,014	30,571
Impairment of long-lived assets and goodwill		(673)	16,678		
In-process research and development			800		
Restructuring charges	1,678	180	6,363	6,257	
Total operating expenses	28,290	36,056	70,937	94,455	102,653
Loss from operations	(12,861)	(18,753)	(61,290)	(76,022)	(66,832)
Interest income and other, net	710	1,184	2,438	6,418	4,745
Net loss before provision for income taxes	\$ (12,151)	\$ (17,569)	\$ (58,852)	\$ (69,604)	\$ (62,087)
Provision for income taxes	52	18			

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Net loss	\$ (12,203)	\$ (17,587)	\$ (58,852)	\$ (69,604)	\$ (62,087)
Basic and diluted net loss per common share	\$ (1.00)	\$ (1.61)	\$ (5.80)	\$ (7.62)	\$ (10.63)
Shares used in computing basic and diluted net loss per common share	12,200	10,950	10,140	9,136	5,839

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	December 31,				
	2004	2003	2002	2001	2000
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short-term investments	\$ 32,326	\$ 45,226	\$ 59,433	\$ 95,827	\$ 156,341
Restricted cash	264	314	355	355	
Working capital	26,615	37,287	51,073	84,151	129,676
Restricted cash, less current portion	358	648	962	1,317	
Total assets	37,258	52,080	69,592	122,421	199,824
Long-term obligations					117
Total stockholders' equity	26,987	36,719	51,105	102,462	156,171

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Blue Martini has entered into an Agreement and Plan of Merger dated as of February 28, 2005, or, the Merger Agreement, with Multi-Channel and Merger Sub, a wholly owned subsidiary of Multi-Channel, pursuant to which, subject to satisfaction or waiver of the conditions therein, Merger Sub will merge with and into Blue Martini and Multi-Channel will acquire all of the outstanding common stock of Blue Martini. Upon the consummation of the merger, or the Effective Time, Blue Martini will become a wholly owned subsidiary of Multi-Channel.

Under the terms of the Merger Agreement, the holders of shares of common stock of Blue Martini (other than stockholders who exercise appraisal rights under Delaware law) that are outstanding immediately prior to the Effective Time will receive \$4.00 in cash for each share of Blue Martini common stock at the Effective Time. In addition, at the Effective Time, all stock options held by then-current employees and directors of Blue Martini will be accelerated in accordance with the terms of our stock option plans (unless lesser acceleration is provided for in the grant document related to such option) and cancelled, and the holder of each vested Blue Martini stock option that is outstanding immediately prior to the consummation of the Merger will receive into an amount in cash equal to, for each share of common stock of Blue Martini underlying such option, the excess, if any, of \$4.00 over the exercise price per share of such option in consideration of such cancellation. At the Effective Time, all restricted stock awards held by then-current employees will immediately vest (unless lesser acceleration is provided for in the grant document related to such restricted stock award). The total value of the transaction is approximately \$54 million.

The consummation of the Merger is conditioned upon, among other things, the adoption of the Merger Agreement by the holders of a majority in interest of Blue Martini's outstanding common stock, customary regulatory approvals and other closing conditions. In order to induce Multi-Channel to enter into the Merger Agreement, certain directors and officers of Blue Martini who own in the aggregate approximately 28% of Blue Martini's outstanding common stock have entered into voting agreements with Multi-Channel pursuant to which they have agreed, among other things, to vote in favor of the adoption of the Merger Agreement. The Merger is expected to close in the second quarter of 2005; however, there can be no assurances that the Merger will be consummated in that time period or at all.

This description of certain terms of the Merger Agreement and the transactions contemplated by the Merger Agreement is qualified in its entirety by reference to the full text of the Merger Agreement, a copy of which was filed as Exhibit 10.1 to the Form 8-K filed by us on March 4, 2005.

In connection with execution and delivery of the Merger Agreement, Golden Gate Private Equity, Inc. and Golden Gate Capital Investment Fund II, L.P. (collectively, the Golden Gate Entities) entered into a letter agreement in favor of Multi-Channel and Blue Martini (the Commitment Letter), pursuant to which the Golden Gate Entities

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committed to invest an amount in cash in Multi-Channel as a source of funding for the Merger that, together with the amount of cash that Multi-Channel may cause the surviving corporation to deposit with the paying agent, is equal to the aggregate merger consideration. The Golden Gate Entities' commitment to invest such amount is conditioned only upon the prior fulfillment or waiver in writing by Multi-Channel of each and all of the conditions precedent to Multi-Channel's and Merger Sub's obligations to consummate the merger under the merger agreement.

The Golden Gate Entities further agreed that in the event that a court renders a judgment in a legal proceeding in which we claim or allege that Multi-Channel or Merger Sub has breached or committed a default under the merger agreement, and the terms of such judgment require that Multi-Channel or Merger Sub make a cash payment to Blue Martini, then the Golden Gate Entities will invest in Multi-Channel for the purpose of funding such judgment an amount in cash that is equal to the lesser of \$5,000,000 or the cash payment required by the judgment. In addition, Multi-Channel and the Golden Gate Entities agreed not to cause or permit the redemption or repurchase by Multi-Channel of any securities of Multi-Channel held by the Golden Gate Entities until the cash payment required by such judgment has been paid in full by Multi-Channel and/or Merger Sub to Blue Martini.

The description of certain terms of the Commitment Letter and the transactions contemplated by the Commitment Letter is qualified in its entirety by reference to the full text of the Commitment Letter, a copy of which was filed as Exhibit 10.28 to this Annual Report on Form 10-K.

The following reflects management discussion and analysis of results and operations and financial position on a standalone basis without reflecting any changes resulting from the merger.

Overview of Operations

The following discussion of our financial condition and results of operations should be read in conjunction with the section below in the Item 7 entitled "Risk Factors" and our consolidated financial statements and notes thereto.

We provide sales optimization systems designed to enable companies to increase revenues by guiding salespeople, channel partners, and customers through sales interactions. Our revenues are derived from the licensing of our software, and the sale of related services, including hosted and on-demand use of our software. The license agreement for our software typically provides for an initial fee for use of the software in perpetuity, with use limited by the number of servers (CPUs), business unit, geographic area, brand or other similar limitations. Service revenues are principally derived from consulting services, maintenance and to a lesser extent, training. We started offering our software in hosted and on-demand environments in the fourth quarter of 2004. Revenues from these arrangements are recognized ratably during the term of the contract and were immaterial for 2004. Our maintenance agreements are typically payable in advance, entitle customers to receive software updates, maintenance releases, and technical support, and typically have a one-year term. Consulting services and training are generally sold on a time-and-materials basis.

We market our application suite primarily through a direct sales force; we have recently entered into agreements with a limited number of resellers, but these agreements have not yet generated revenues. We also engage in alliances with systems integrators and technology vendors to assist us in marketing and selling our software and related services. Some of our customers use systems integrators to implement our product, and systems integrators are a significant influence in our customers' purchasing decisions. We primarily target our products to customers competing in the retail and retail-like markets.

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While the majority of our revenues to date have been derived from customers in the United States, international revenues accounted for 29% of our revenues for 2004 and 23% for 2003 and 2002. We believe that international revenues will fluctuate as a percentage of revenues in the near term. Our quarterly operating results have experienced seasonal fluctuations in the past. Quarterly results fluctuate based on several factors, including our customers' fiscal years, budgeting cycles, sales incentive plans, slow summer purchasing patterns and general economic conditions in markets where we conduct business.

To date, we have derived a significant portion of our revenues from a small number of customers. In 2004, one customer, Masco Corporation, accounted for \$3.3 million of revenues or 12% of consolidated revenues. In 2003,

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two customers each accounted for 13% of total revenues. Masco Corporation and America Online, Inc. accounted for \$4.3 million and \$4.2 million, respectively, of total revenues in 2003. In 2002 no single customer accounted for more than 10% of our revenues. We expect that a small number of customers will continue to account for a substantial portion of our quarterly total revenues. Sales to our ten largest customers accounted for 50%, 54% and 42% of total revenues in 2004, 2003 and 2002, respectively. The loss of a major potential or existing customer or the delay or cancellation of anticipated significant license contracts would adversely affect our revenues and operating results in a particular quarter. Failure to obtain a significant number of new customers or additional orders from existing customers in any period would adversely affect our business and operating results.

Our operating expenses are based in part on our expectations of future revenues over the long term, and are largely fixed in the short term. As such, a delay in completion of new customer license contracts or the recognition of revenues from one or more license contracts could cause significant variations in our operating results from quarter to quarter and could result in significant variation in our quarterly results of operations. Our expectation is that this potential for variation may be reduced as we enter into more hosted and on-demand agreements, due to the ratable recognition of revenues from such arrangements. In addition, there is a risk that the introduction of hosted and on-demand transactions may result in the reduction of revenues in the short term.

Overview of 2004

In 2004, our license and total revenues were significantly below our expectations primarily due to the continued uncertainty surrounding information technology (IT) spending by both current and prospective customers. We believe this uncertainty will continue in the near term. In our experience, many of our target customers have reduced their budgets for IT projects and streamlined their IT organizations, thus limiting their capacity to execute new projects; many are maintaining their current IT systems rather than investing in system upgrades or replacements. In this environment, sales transactions require a prolonged and expensive evaluation process, as customers are cautious to commit their resources. As a result, we have sought to refine our marketing strategy to address the cautious spending environment and its commensurate IT resource constraints.

In the fourth quarter of 2004, we introduced modular solution packs and made our software available in hosted and on-demand environments. These marketing initiatives were taken to help our existing and prospective customers overcome their IT budget and resource limitations and to lower the perceived risk of investing in a new IT solution. We believe our hosted and on-demand offerings will allow our customers to use our software more quickly without placing a high demand on their IT departments. Our solution packs are intended to allow customers to implement certain product functionality in a packaged implementation that is less expensive and faster to implement than a broader enterprise software solution. We booked one hosted software transaction in the fourth quarter of 2004 resulting in immaterial revenues from this transaction in 2004. We did not generate any revenues in 2004 from modular solution packs.

Despite difficulties in achieving revenue growth, we have continued to manage our cost structure and cash burn. During 2004, our headcount decreased 55% from 210 on December 31, 2003 to 95 on December 31, 2004 and cash burn decreased from \$14.6 million for the twelve months ended 2003 to \$13.2 million for the twelve months ended 2004. As a partial offset to the reductions in force, we supplemented our direct headcount with outsourced offshore and onshore teams in the quality assurance, product development and IT functions. Average Days Sales Outstanding, or DSOs, calculated on an annual basis, decreased from 55 days in 2003 to 33 days in 2004.

We believe that our greatest challenges as a company are to close sales transactions more expeditiously, and to increase our sales pipeline. During 2004, our ability to sell was harmed by turnover in the leadership and staffing of our sales force. In 2005, we need to increase our sales force productivity and ensure that new members of our sales team become productive within a reasonable period. We also need to communicate better to our customers the value we believe our solutions offer, including our new modular solution packs and our managed services offerings. We continue to strive to improve our overall performance by strengthening our competitive position (which we intend to accomplish by

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strengthening the salesforce, narrowing our market focus, leveraging partners and resellers and offering hosted and on-demand solutions), controlling costs, effectively managing our cash flow and better aligning our management and organizational structure to support our sales efforts.

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The Results of Operations section below discusses our 2004 results in more detail.

Results of Operations**Revenues*****License***

	<u>2004</u>	<u>% Change 2004 to 2003</u>	<u>2003</u>	<u>% Change 2003 to 2002</u>	<u>2002</u>
License revenue (in thousands)	\$ 7,321	(36)%	\$ 11,479	94%	\$ 5,915
Percentage of total revenues	26%		35%		18%

The decrease in license revenues in dollar terms in 2004 as compared to 2003 was due to a decrease in the average selling price of our software license transactions and a decrease in the number of transactions in 2004 as compared to 2003. 2003 marked an improvement in our Company in that license revenues increased significantly from 2002. The increase in license revenues in dollar terms in 2003 as compared to 2002 was due to an increase in the average selling price of our software license transactions.

We began offering software products acquired from the Cybrant acquisition in the second quarter of 2002. Because our professional services related to these arrangements were deemed essential to the functionality of the software, we initially accounted for license revenues from the Cybrant software products using the percentage-of-completion method under Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. In the fourth quarter of 2002, upon repeated successful implementations of the Cybrant application, we determined that our professional services were not essential to the functionality of the software, and as such, in the fourth quarter of 2002, we began to recognize license transactions relating to the Cybrant software products upon delivery, instead of using the percentage-of-completion method, subject to meeting all other revenue recognition criteria.

Professional Services

	<u>2004</u>	<u>% Change 2004 to 2003</u>	<u>2003</u>	<u>% Change 2003 to 2002</u>	<u>2002</u>
Professional services revenue (in thousands)	\$ 11,791	(8)%	\$ 12,795	(34)%	\$ 19,330
Percentage of total revenues	42%		39%		57%

Service revenues include revenues from consulting (professional services), and to a lesser extent training activities. In addition, we also included \$17,000 of revenues related to our managed services/hosted software offering in the fourth quarter of 2004. In dollar terms, the decrease in professional services revenue in 2004 from 2003 and in 2003 from 2002 was primarily a result of the reduced software licensing activity and secondarily the result of driving more of the consulting services to our partners.

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The hosted/on-demand offering, as discussed in the Overview above, is new in 2004. The offering is aimed at lowering potential customers perceived risk of investing in our software and eliminating lengthy and costly implementation cycles.

Maintenance

	<u>2004</u>	<u>% Change 2004 to 2003</u>	<u>2003</u>	<u>% Change 2003 to 2002</u>	<u>2002</u>
Maintenance revenue (in thousands)	\$ 9,174	10%	\$ 8,321	(1)%	\$ 8,378
Percentage of total revenues	32%		26%		25%

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Maintenance revenues are derived from maintenance agreements, which are typically payable in advance and entitle customers to receive software updates, maintenance releases and technical support. The agreements generally have a one-year term. The increase in maintenance revenues in 2004 from 2003 was due to the increase over time of maintenance agreements from additional customers and increases in the maintenance rates, somewhat offset by customers who discontinue maintenance or reduce the rate of their maintenance fee. Maintenance revenues remained at the same levels in 2003 and 2002.

Cost of Revenues***License***

	<u>2004</u>	<u>% Change 2004 to 2003</u>	<u>2003</u>	<u>% Change 2003 to 2002</u>	<u>2002</u>
Cost of license (in thousands)	\$ 846	(47)%	\$ 1,607	(58)%	\$ 3,812
Percentage of total revenues	3%		5%		11%
Percentage of license revenues	12%		14%		64%

Cost of license revenues generally consists of royalty payments to third parties, amortization of prepaid royalties and amortization of purchased intangible assets for technology that is either embedded in or bundled with our software.

In dollar terms, the decline in cost of license revenues in 2004 as compared to 2003 was due to the full amortization and the write-off of purchased intangibles in 2003, which did not occur in 2004. The decrease in costs of license revenues in dollar terms in 2003 from 2002 was due to the decrease in the amortization of purchased intangible assets as we wrote-off the majority of these assets as part of an impairment evaluation in 2002. See impairment discussion below under the heading *Impairment of Long-lived Assets and Goodwill*. In addition, cost of license revenues for 2002 included amortization of intangible assets acquired in the Cybrant acquisition as well as accelerated amortization totaling \$638,000 related to technology rights in the form of prepaid royalties for which we reduced the estimated useful lives.

Based on agreements currently in place, we expect the cost of license revenues in 2005 to consist of a fixed amount of \$110,000 per quarter and a variable amount estimated to be between 5% and 10% of license revenues for payments required under technology license arrangements.

Professional Services

	<u>2004</u>	<u>% Change 2004 to 2003</u>	<u>2003</u>	<u>% Change 2003 to 2002</u>	<u>2002</u>
Cost of professional services (in thousands)	\$ 9,398	(12)%	\$ 10,636	(34)%	\$ 16,046
Percentage of total revenues	33%		33%		48%
Percentage of professional services revenue	80%		83%		83%

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Cost of professional service revenues consists primarily of salaries and other personnel-related expenses, costs of services provided by third-party subcontractors engaged by us, allocated overhead costs, and depreciation of equipment used to provide consulting services and training and \$31,000 of hosting costs related to our hosted/on demand service offering. Allocated overhead costs for costs of services and other expense categories include facilities, information systems, and other corporate infrastructure costs. The decrease in cost of professional services revenues in dollar terms in 2004 as compared to 2003 and in 2003 as compared to 2002 resulted primarily from reductions in force and other cost-saving actions implemented in these periods. We reduced our professional services workforce 46% in 2004 from 2003 and 32% in 2003 from 2002. In addition, in 2003, as part of the allocation of the total credit of \$2.1 million arising from the expiration of a potential reimbursement obligation related to a prior executive officer, we recorded a credit of \$609,000 to cost of professional services. (See Note 7 of the Consolidated Financial Statements included elsewhere in this annual report for further discussion.) Our cost of service revenues are relatively fixed in the short-term. We target to keep our professional services costs at approximately 80% of our professional services revenues by adjusting the use of subcontractors and if needed, by adjusting the headcount.

Table of Contents***Cost of Maintenance Revenues***

	<u>2004</u>	<u>% Change 2004 to 2003</u>	<u>2003</u>	<u>% Change 2003 to 2002</u>	<u>2002</u>
Cost of maintenance (in thousands)	\$ 2,613	(14)%	\$ 3,049	(26)%	\$ 4,118
Percentage of total revenues	9%		9%		12%
Percentage of maintenance revenue	28%		37%		49%

Cost of maintenance revenues consists primarily of salaries and other personnel-related expenses, costs of services provided by third-party subcontractors engaged by us, royalties related to maintenance services, and allocated overhead costs and depreciation of equipment. The decrease in cost of maintenance revenues in dollar terms in 2004 as compared to 2003 was due primarily to a 20% decrease in our maintenance headcount. The decrease in dollar terms in 2003 as compared in 2002 was primarily due a 7% decrease in average headcount in 2003 from 2002 and a decrease in allocated overhead costs due to the decrease in headcount. We target to keep our costs of maintenance at approximately 30% of our maintenance revenues.

Operating Expenses***Sales and Marketing***

	<u>2004</u>	<u>% Change 2004 to 2003</u>	<u>2003</u>	<u>% Change 2003 to 2002</u>	<u>2002</u>
Sales and marketing (in thousands)	\$ 13,846	(26)%	\$ 18,714	(30)%	\$ 26,920
Percentage of total revenues	49%		57%		80%

Sales and marketing expenses consist primarily of salaries, commissions, and other personnel-related expenses associated with our direct sales and marketing personnel, allocated overhead costs, and costs of marketing programs including trade shows, advertisements, promotional activities and media events. The 2002 expense also included amortization of deferred marketing costs of \$2.3 million, related to warrants issued to a marketing partner. The decrease in sales and marketing expenses in 2004 from 2003 was due primarily to a 38% reduction in our average sales and marketing headcount in 2004 from 2003. The decrease in 2003 from 2002 was due primarily to the reduction in the deferred marketing amortization expense, lower spending on marketing and advertising programs and lower personnel-related expenses resulting from reductions in force and other cost-saving actions. Further, in 2003, as part of the total credit of \$2.1 million arising from the expiration of a potential reimbursement obligation related to a prior executive officer, we recorded a credit of \$667,000 to sales and marketing expense. (See Note 7 of the Consolidated Financial Statements included elsewhere in this annual report for further discussion.) In addition, the unamortized balance of deferred marketing costs of \$638,000 was written off as part of the impairment evaluation in 2002. We expect that sales and marketing expenses in 2005 will be lower than 2004 reflecting the reduction of sales and marketing resources and spending in the second half 2004.

Research and Development

2004

2003

2002

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		<u>% Change</u> <u>2004 to 2003</u>		<u>% Change</u> <u>2003 to 2002</u>	
Research and development (in thousands)	\$ 7,541	(22)%	\$ 9,713	(27)%	\$ 13,380
Percentage of total revenues	27%		30%		40%

Research and development expenses consist primarily of salaries and other personnel-related expenses for engineering personnel, allocated overhead costs, costs of contractors, and depreciation of equipment used in the development of our software products. Development costs incurred in the research and development of new software products are expensed as incurred until technological feasibility has been established, at which time such

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costs are capitalized, subject to recoverability. To date, all costs related to the development of our software have been expensed as incurred. The decrease in research and development costs in 2004 from 2003 was mainly attributable to the 27% decrease in our average research and development headcount in 2004 from 2003. The decrease in 2003 from 2002 was primarily due to the decrease in average headcount in 2003 by 57% and a credit of \$551,000 arising from the expiration of a potential reimbursement obligation related to a prior executive officer in 2003. The credit of \$551,000 is an allocation to research and development of the \$2.1 million credit. (See Note 7 of the Consolidated Financial Statements included elsewhere in this annual report for further discussion.) We expect that research and development expenses in 2005 will be at a level lower than 2004 reflecting the reduction of research and development resources in the second half 2004.

General and Administrative

	<u>2004</u>	<u>% Change 2004 to 2003</u>	<u>2003</u>	<u>% Change 2003 to 2002</u>	<u>2002</u>
General and administrative (in thousands)	\$ 5,037	(26)%	\$ 6,786	(11)%	\$ 7,590
Percentage of total revenues	18%		21%		23%

General and administrative expenses include costs associated with our finance, human resources, legal, and other administrative functions. These costs consist principally of salaries and other personnel-related expenses, professional fees, insurance premiums, provision for doubtful accounts, equipment depreciation, and allocated facilities and information technology overhead costs. The decrease in general and administrative expenses in 2004 from 2003 resulted from a reduction in our average general and administrative headcount by 25% in 2004 from 2003 a \$290,000 credit in the provision for bad debt due to the revised estimates of potential losses in certain receivables, the reduction of compensation-related accruals related to reduced headcount and general activity levels and other cost savings from lower insurance premiums and reduction in outside services costs offset by approximately \$485,000 of legal related costs. The decrease in 2003 from 2002 was primarily due to the reductions in force and a credit of \$232,000 arising from the expiration of a potential reimbursement obligation related to a prior executive officer and other cost-saving actions. The credit of \$232,000 is an allocation to general and administrative of the \$2.1 million total credit. (See Note 7 of the Consolidated Financial Statements included elsewhere in this annual report for further discussion.)

Stock-Based Compensation

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Stock-based compensation (in thousands)	\$ 188	\$ 1,336	\$ (794)

Stock-based compensation consists of the net amortization of deferred stock compensation relating to stock options that vest over time and the stock-based compensation expense associated with immediately vested stock options and warrants granted to non-employees. Deferred stock compensation represented the difference between the exercise price of stock option grants to employees and the deemed fair market value of our common stock at the time of grant. Deferred stock-based compensation was amortized to expense over the period during which the common stock and stock options vest using an accelerated method allowed by generally accepted accounting principles. The reported expense is net of the reversal of previously recognized compensation expense related to stock options granted to employees who were later terminated before the options vested.

On December 9, 2004, we granted stock awards to employees, valued at \$2.80 per share, the price at which our shares of Common Stock closed on the Nasdaq National Market on December 8, 2004, the last trading day preceding the grant date. The shares vest over an approximately two-year period with 20% vesting on May 1, 2005, 12.5% vesting quarterly thereafter for five quarters, and the final 17.5% vesting in November

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2006. We recorded deferred compensation of \$1.1 million relating to the transaction and amortized approximately \$93,000 in December 2004. In addition, in March 2004, we recorded a charge of \$95,000 due to the accelerated vesting of options in connection with a termination agreement relating to a former Company executive.

Deferred stock compensation expense in 2003 included a charge of \$319,000 for the variable plan accounting associated with a stock option exchange program initiated in 2002, under which 602,000 outstanding employee

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stock options with exercise prices at or above \$12.39 per share (approximately 92% of the total eligible options) were exchanged for replacement stock options at the fair market value of \$3.60 per share, which vested over a five-month period ending in May 2003 and expired in September 2003. The charge reflected the net increase in our stock market price above the option exercise price through the date the underlying options were exercised or expired.

We recorded deferred stock compensation of \$590,000 in 2002 using the intrinsic value method, which was based on the difference between the exercise price of stock option grants to employees and the deemed fair market value of our common stock at the time of grant.

Impairment of Long-Lived Assets and Goodwill. In September 2002, a sharp decline in our stock price resulted in our market capitalization being significantly below our net asset value. We determined that this circumstance triggered a review of our long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Accordingly, we performed an impairment analysis of our property and equipment, intangible assets and other long-lived assets, other than goodwill, and determined that the carrying amount of property and equipment, intangible assets and other long-lived assets exceeded their respective fair values. As a result, we recorded an impairment charge of approximately \$11.1 million. The remaining balances in property and equipment and acquisition-related technology and intangibles were depreciated and amortized, respectively, over their remaining estimated lives, in 2003.

SFAS No. 142, *Goodwill and Other Intangible Assets*, requires that goodwill be tested for impairment if a SFAS No. 144 triggering event has occurred. Accordingly, we performed an impairment analysis of goodwill arising from the Cybrant acquisition. As we have determined that we operate in a single segment with one reporting unit, the fair value of our reporting unit was determined based on our market capitalization on the date of the impairment testing. As a result of this analysis, we wrote off all \$5.6 million of goodwill in 2002.

We estimated the fair value of our long-lived assets based on a combination of the market, income and replacement cost approaches. In the application of the impairment testing, we were required to make estimates of future operating trends and resulting cash flows and judgments on discount rates and other variables. Actual future results and other assumed variables could differ from these estimates.

The impairment charge to goodwill, other intangible assets and other long-lived assets from the impairment review resulted in a write-off of the net book value as follows (in thousands):

Goodwill	\$ 5,608
Acquisition-related technology	1,350
Other intangible assets	8,220
Property and equipment	1,500
	<hr/>
Total	\$ 16,678
	<hr/>

Further, in September 2003, we recorded a benefit of \$673,000 representing purchase price adjustments resulting from the final resolution of acquisition related costs, acquired liabilities and the retirement of shares held in escrow relating to the Cybrant acquisition.

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In-Process Research and Development. Approximately \$800,000 of the purchase price in the Cybrant acquisition in April 2002 represented the estimated fair value of acquired in-process research and development projects that had not yet reached technological feasibility and had no alternative future use. Accordingly, this amount was charged to expense upon the acquisition date. The value assigned to purchased in-process research and development comprises development projects that were labeled at the acquisition time as versions 4.2 and 5.0 of the Cybrant product that were valued by employment of a discounted cash flow model using discount rate of 35%. Version 4.2 was commercialized in 2002; version 5.0 was commercialized in 2003.

Table of Contents**Restructuring Charges**

	2004	2003	2002
Restructuring charges (in 000s)	\$ 1,678	\$ 180	\$ 6,363
Decrease in headcount from restructuring	63	10	120

During 2004, 2003 and 2002, we implemented restructuring plans intended to strengthen our future operating performance and competitive position by preserving cash and reducing costs. As part of these restructurings, we reduced our employee force and vacated certain office facilities in the United States.

As of December 31, 2004, the Company has accrued restructuring charges of \$3.2 million related to excess facilities, which will be paid through 2006. These accrued charges reflect estimates with respect to the time it will take to sublease the facilities, sublease terms, and sublease rates. Should there be changes in real estate market conditions or should it take longer than expected to find a suitable tenant to sublease the remaining vacant facilities, adjustments to the idle facilities lease losses reserve may be necessary in future periods based upon then current actual events and circumstances. The following tables summarize the activity related to restructuring activities in 2004 and 2003 (in thousands):

	Accrued at December 31, 2003	Total Expense	Cash Payments	Accrued at December 31, 2004
Lease cancellations - prior to 2004 restructuring	\$ 2,431	\$	\$ (947)	\$ 1,484
Lease cancellations - 2004 restructuring	\$	271	(194)	77
Severance and related charges - 2004 restructuring		1,407	(1,317)	90
	<u>\$ 2,431</u>	<u>\$ 1,678</u>	<u>\$ (2,458)</u>	<u>\$ 1,651</u>

	Accrued at December 31, 2002	Total Expense	Non-cash Charges	Cash Payments	Accrued at December 31, 2003
Lease cancellations - prior to 2003 restructuring	\$ 3,418	\$	\$ (173)	\$ (814)	\$ 2,431
Severance and related charges - prior to 2003 restructuring	\$ 58	\$	\$	\$ (58)	
Severance and related charges - 2003 restructuring		180		(180)	
	<u>\$ 3,476</u>	<u>\$ 180</u>	<u>\$ (173)</u>	<u>\$ (1,052)</u>	<u>\$ 2,431</u>

Interest Income and Other, Net

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Interest income and other, net consists of interest income from cash, cash equivalents and short-term investments partially offset by interest expense associated with capital leases and foreign currency transaction gains and losses. Interest income and other, net was \$710,000, \$1.2 million and \$2.4 million in 2004, 2003 and 2002, respectively. The decline in interest income in the three year period from 2002 to 2004 was primarily due to lower interest rates and the decline in balances of cash, cash equivalents and short-term investments. Foreign currency transaction losses were approximately \$154,000 in 2004, \$260,000 in 2003 and immaterial in 2002. We expect interest income to decrease as the amount of cash and cash equivalents available for investment decreases as cash is used in operations.

Table of Contents**Income Taxes**

From inception to December 31, 2004, we incurred net losses, on a consolidated basis, for federal and state tax purposes and have not recognized any tax provision or benefit; however, we recorded a tax provision in 2004 in the amount of \$52,000 for a subsidiary resulting from our intercompany agreement with Blue Martini Software KK. In addition, we reclassified from sales and marketing expenses tax provision relating to the subsidiary for 2002. As of December 31, 2004, we had approximately \$148 million of federal and \$84 million of California state net operating loss carryforwards to offset future taxable income. The federal net operating loss carryforwards will expire in 2019 through 2024. The California net operating loss carryforwards will expire in 2007 through 2014. Because of our limited operating history, our losses incurred to date and the difficulty in forecasting our future results, management does not believe that the realization of the related deferred income tax asset is more likely than not. Therefore, we have recorded a valuation allowance against the net deferred income tax assets.

Quarterly Results of Operations

The following tables set forth consolidated statement of operations data for each of the quarters in the two-year period ended December 31, 2004 (in thousands, except per share data).

	Three Months Ended			
	Mar. 31, 2004	Jun. 30, 2004	Sep. 30, 2004	Dec. 31, 2004
(In thousands, except per share data)				
Consolidated Statement of Operations Data:				
Revenues:				
License	\$ 3,350	\$ 1,582	\$ 1,585	\$ 804
Professional services	3,274	3,267	2,965	2,285
Maintenance	2,270	2,333	2,246	2,325
Total revenues	\$ 8,894	\$ 7,182	\$ 6,796	\$ 5,414
Gross profit	\$ 5,538	\$ 3,737	\$ 3,623	\$ 2,531
Net loss	\$ (3,311)	\$ (4,073)	\$ (3,079)	\$ (1,740)
Basic and diluted net loss per common share	\$ (0.28)	\$ (0.34)	\$ (0.25)	\$ (0.14)
Shares used in computing basic and diluted net loss per common share	11,780	12,100	12,370	12,500

Three Months Ended			
Mar. 31, 2003	Jun. 30, 2003	Sep. 30, 2003	Dec. 31, 2003
(In thousands, except per share data)			

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Consolidated Statement of Operations Data:

Revenues:

License	\$ 1,756	\$ 2,510	\$ 4,203	\$ 3,010
Professional services	4,001	3,360	2,711	2,723
Maintenance	1,900	2,003	2,140	2,278
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total revenues	7,657	7,873	9,054	8,011
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Gross profit	3,222	3,843	5,258	4,980
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net loss	\$ (5,431)	\$ (4,749)	\$ (4,467)	\$ (2,940)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Basic and diluted net loss per common share	\$ (0.51)	\$ (0.45)	\$ (0.40)	\$ (0.26)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Shares used in computing basic and diluted net loss per common share	10,550	10,640	11,110	11,490
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

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The above quarterly information has been derived from our unaudited quarterly consolidated financial statements that, in the opinion of our management, include all adjustments necessary for a fair presentation of this information. We have experienced and expect to continue to experience fluctuations in operating results from quarter to quarter. We incurred net losses in each quarter since inception and may continue to incur losses in the foreseeable future. No conclusions about our future results should be drawn based on the results of our operations for any quarter, as quarterly results are not indicative of the results for a full fiscal year or any other period.

Liquidity and Capital Resources

(in thousands)	2004	2003	2002
Cash and cash equivalents and short term investments	\$ 32,326	\$ 45,226	\$ 59,433
Working capital	26,615	37,287	51,073
Restricted cash	622	962	1,317
Stockholders' equity	26,987	36,719	51,105

As of December 31, 2004, we had cash, cash equivalents and short-term investments of \$32.3 million, down from \$45.2 million as of December 31, 2003. Our cash and cash equivalents consist primarily of money market funds, commercial paper and U.S. treasury and government agency securities. All of our investments are classified as available-for-sale and carried at fair value based on quoted market prices in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

During 2004, net cash used in operating activities was \$15.4 million compared to \$15.9 million in 2003 and \$35.6 million in 2002. Cash used in operating activities decreased slightly in 2004 from 2003 due to lower net loss arising from headcount reductions and other cost control measures, a decrease in receivables arising from lower sales levels offset by the decrease in accrued restructuring and other liabilities. The decreases in net cash used in operating activities in 2003 from 2002 was primarily due to the decrease in our net losses resulting from headcount reductions and other cost saving actions. These reductions in net losses were partially offset by the reduction of non-cash charges such as depreciation, amortization of deferred stock compensation, restructuring and impairment of long-lived assets and goodwill. Our accounts receivables decreased in 2004 as we proactively managed collections of outstanding balances. Our days sales outstanding in 2004, 2003 and 2002 were 33, 55 and 63 days, respectively.

Net cash provided by investing activities were \$1.4 million, \$21.4 million and \$31.1 million in 2004, 2003 and 2002, respectively, principally related to the net sale of short-term investments partially offset by fixed asset purchases.

Net cash provided by financing activities were \$2.8 million and \$3.3 million in 2004 and 2003, respectively, resulting from proceeds from the issuance of common stock under our employee stock option and stock purchase plans. Most of the proceeds from the 2003 stock options exercises were related to options from the stock option exchange program instituted in December 2002 that expired in September 2003. (See discussion in Note 10 of the Consolidated Financial Statements included elsewhere herein.) In 2002, net cash used in financing activities was \$39,000 consisting of repayments of debt and capital lease obligations offset by proceeds from the issuance of common stock. In addition, we reclassified cash pledged to a financial institution as restricted cash and the decrease in restricted cash from 2002 to 2004 increased cash provided by financing activities. Depending on the level of employee stock option and purchase activity and the prevailing market price for our stock and the movement in restricted cash, net cash provided by or used in financing activities may vary in the near term.

In June 2002, our board of directors authorized the repurchase of up to 5% of our outstanding common stock. As of December 31, 2002, we had repurchased and retired approximately 91,000 shares of our common stock in open market transactions at prevailing market prices for a total

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cost of approximately \$558,000, including commissions. If we repurchase our outstanding common stock, additional cash will be used. Based on current conditions, we do not anticipate repurchasing additional shares under this program in the near term.

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We expect that for the foreseeable future, our operating costs and expenses will continue to constitute a significant use of our cash resources. In addition, we may use our cash resources to fund acquisitions or invest in other businesses, technologies or product lines. We currently anticipate that our existing cash resources will be sufficient to meet our presently anticipated operating requirements for at least the next 12 months. Either within this time period or at some future date, if our current financial performance continues, we may need to raise additional funds in the future through public or private debt or equity financing. There can be no assurance that this additional financing will be available, or if available, will be on reasonable terms. If adequate funds are not available on acceptable terms, we may have to accept financing on terms we view as unreasonable or that are dilutive to our stockholders, or to cease operations. If we were to seek additional financing today, we do not believe it would be available on reasonable terms.

The existence or even the anticipation of an uncertain economic environment and the hesitation to spend on IT projects by potential and existing customers in the markets in which we operate have affected the demand for our applications, caused pricing pressures for our products, increased customer requests for extended payment terms, and impacted our sales activity during 2004, 2003 and 2002, and may continue to do so in future periods, which could in turn affect our liquidity.

Commitments

Our principal commitments as of December 31, 2004 consisted of obligations under operating leases, letter of credit agreements, and royalty agreements. We expect to fulfill our commitments through our working capital.

Letters of Credit. At December 31, 2004, \$622,000 is held in trust as security for letters of credit for guarantee of lease payments for leased office space and commitments relating to a foreign tax agency. Amount pledged of \$582,000 for leased office space will be restricted and released in stages until the expiration of the lease term in 2006 and amount pledged of \$40,000 relating to a foreign tax agency requirement will be restricted until its expiration in 2009.

Royalties. We license and incorporate into our products technologies from third party software providers. Under the terms of these license agreements, which expire at various dates up to July 2007, we pay royalties at various rates and amounts, generally based on unit sales or revenues. Royalty expense was \$979,000, \$1.1 million and \$1.5 million for 2004, 2003 and 2002, respectively.

Aggregate Contractual Obligations. The Company leases certain facilities, including its corporate headquarters, under non-cancelable operating leases. Rent expense for 2004, 2003 and 2002 was \$2.9 million, \$3.2 million and \$4.2 million respectively. Future minimum lease payments under operating lease with non-cancelable terms of more than one year as of December 31, 2004 are as follows (including lease commitments reflected in accrued restructuring liabilities on the consolidated balance sheet):

(in thousands)	Payments Due by Period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating leases	\$ 4,948	\$ 3,653	\$ 1,295	\$	\$
Total contractual obligations	\$ 4,948	\$ 3,653	\$ 1,295	\$	\$

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Of the net lease commitment of \$4.9 million, \$1.6 million is recorded on the balance sheet under accrued restructuring charges, \$537,000 is recorded on the balance sheet as deferred rent liability included in other current liabilities and \$2.8 million is the unrecorded liability to be expensed through April 30, 2006.

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Use of Estimates and Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States, or GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures. We evaluate our estimates on an ongoing basis, including those related to revenue recognition, allowances for doubtful accounts and accrued liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our accounting policies are described in the notes to our financial statements. We have identified the following as critical estimates employed in applying critical accounting policies:

Revenue Recognition. We recognize revenue in accordance with Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended, and recognize revenue when all of the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable and (4) collectibility is probable. We allocate revenue on software arrangements involving multiple elements to each element based on the residual method prescribed by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. Our determination of fair value of each element in multiple-element arrangements is based on vendor-specific objective evidence (VSOE) for all undelivered elements in the arrangement and the residual value is allocated to the license. We limit our assessment of VSOE for each element, including maintenance, to the price charged when the same element is sold separately. VSOE for maintenance is determined based upon the customer's annual renewal rates.

We identified two critical accounting estimates with respect to applying our revenue recognition policy in 2003 and in the near future. The first critical accounting estimate relate to determining whether an option provided to the customer to purchase specified software products in the future represents an element of the present arrangement or is a separate arrangement. We evaluate whether these options provide the customer with significant incremental discounts to the optional software. We primarily consider the discount of the optional products relative to the discount of the delivered software products and the price paid by other customers for the same software in similar configurations; however, there is judgment involved in determining whether discounted prices on the optional software are incremental and significant. In cases where the optional software is discounted at a higher rate than the delivered element, we defer some of the revenue related to the delivered element and recognize the deferred revenue when the optional software is delivered or when the option expires. To date, we did not have to defer any such revenues.

The second critical accounting estimate with respect to our revenue recognition policy related to estimating percentage of completion for certain services transactions that require such estimation. We review each transaction at quarter-end and apply an estimate of percentage of completion to the contract amount to determine the appropriate revenue recognition. We calculate the percentage based on contractual milestones met or, when the contract does not involve milestones, on hours incurred relative to total estimated hours to complete a project. We evaluate the reasonableness of our estimates based on the type of services we render and our overall role in a project. In cases where the percentage of completion method is appropriate, the license revenue will be deferred and recognized based on the percentage completion of the project.

In the fourth quarter of 2004, we introduced a new offering, which included on-demand and hosting solutions to enable our customers to use our software more quickly without placing a high demand on their IT departments. The solution may be sold bundled with license, maintenance, hosting and professional services or professional services may be sold separately. With the bundled solution, we allocate total revenue over the term of the contract as we do not have VSOE for each of the separate elements. In 2004, revenue from the on-demand arrangement was minimal and combined with professional services revenue.

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Allowance for Doubtful Accounts Receivable. Accounts receivable is recorded net of allowance for doubtful accounts and sales return reserve. We regularly review the adequacy of our accounts receivable allowance and sales return reserve by considering the accounts receivable aging, customer concentrations, the customer's expected ability to pay, our collection history with each customer, available information regarding customer satisfaction and current economic trends. We review any outstanding past due balances to determine if an allowance is appropriate based on the risk category using the factors discussed above. In addition, we maintain a general allowance for doubtful accounts for all invoices by applying a percentage based on the age category. The allowance for doubtful accounts and the realization reserve represent our best estimate, but changes in circumstances relating to accounts receivable may result in a requirement for additional allowance or reserve in the future.

Accrued Liabilities. The idle facility lease losses were based on our lease commitments offset by our best estimate expected sublease income and related costs. These estimates are based upon management's estimate of the time required to sublet the facility and the amount of sublease income that will be generated once the facility is sublet. Should there be changes in real estate market conditions or should it take longer than expected to find a suitable tenant to sublease the remaining vacant facilities, adjustments to the idle facilities lease losses reserve may be necessary in future periods. As of December 31, 2004, we had contractual commitments of \$2.1 million for vacated office facilities. Our accrual for vacated facility leases was net of \$280,000 of expected sublease income based on sublease payments due under noncancelable subleases as of December 31, 2004. Actual future sublease income may not be realized if sublessees default under the sublease agreements.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS 123R *Share-Based Payment*. SFAS 123R requires entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This cost is recognized over the period during which the employee is required to provide service in exchange for the award (usually the vesting period). The accounting guidance provided in SFAS 123R is effective for the Company as of the beginning of the first interim reporting period that begins after June 15, 2005. The Company expects to apply the modified prospective approach for the transition period beginning July 1, 2005. The Company's stock option plan and Employee Stock Purchase Plan will be subject to the fair value provisions under SFAS 123R. Adoption of the pronouncement may have a material impact on the Company's reported net income (loss) in future periods.

In December 2004, the FASB also issued Staff Position SFAS No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision* (FSP No. 109-2) within the American Jobs Creation Act of 2004. The Act provides for a one-time deduction of 85 percent of certain foreign earnings that are repatriated in either an enterprise's last tax year that began before the date of enactment, or the first tax year that begins during the one year period beginning on the date of enactment. FSP No. 109-2 allows companies additional time to evaluate whether foreign earnings will be repatriated under the repatriation provisions of the new tax law and requires specified disclosures for companies needing the additional time to complete the evaluation. The Company does not expect this pronouncement to have a significant effect on operations.

Factors That May Impact Future Operating Results

Risks Related to the Proposed Acquisition of Blue Martini Software by Multi-Channel Holdings

If the proposed merger with Multi-Channel is not completed, our business could be materially and adversely affected and our stock price could decline. We have entered into an Agreement and Plan of Merger, or Merger Agreement, dated as of February 28, 2005 with Multi-Channel, under which Multi-Channel would acquire us through the merger of a wholly owned subsidiary of Multi-Channel with and into Blue Martini. Upon the closing of the merger, the holders of our outstanding common stock will receive \$4.00 per share in cash. The merger is

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subject to customary closing conditions, including the approval of a majority in interest of our outstanding common stock, customary regulatory approvals and other closing conditions. Therefore, the merger may not be completed or may not be completed in the expected time period. If the merger agreement is terminated, the market price of our common stock will likely decline, as we believe that our market price reflects an assumption that the merger will be completed. In addition, our stock price may be adversely affected as a result of the fact that we have incurred and will continue to incur significant expenses related to the merger prior to its closing that will not be recovered if the

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merger is not completed. If the Merger Agreement is terminated under certain circumstances, we may be obligated to pay Multi-Channel a termination fee of \$1,622,000 or reimburse Multi-Channel for its expenses in connection with the merger, up to a maximum of \$500,000. As a consequence of the failure of the merger to be completed, as well as of some or all of these potential effects of the termination of the merger agreement, our business could be materially and adversely affected in that concerns about our viability are likely to increase, making it more difficult to retain employees and existing customers and to generate new business. Our business is not and has not been profitable; see **Risks Related To Our Financial Condition**, below.

The fact that there is a merger pending could have an adverse effect on our business, revenue and results of operations. While the merger is pending, it creates uncertainty about Blue Martini's future. As a result of this uncertainty, customers may decide to delay, defer, or cancel purchases of our products pending completion of the merger or termination of the Merger Agreement. If these decisions represent a significant portion of our anticipated revenue, our results of operations and quarterly revenues could be substantially below the expectations of market analysts.

In addition, while the merger is pending, we are subject to a number of risks that may adversely affect our business, revenue and results of operations, including:

the diversion of management and employee attention and the unavoidable disruption to our relationships with customers and vendors may detract from our ability to grow revenues and minimize costs;

we have and will continue to incur significant expenses related to the merger prior to its closing; and

we may be unable to respond effectively to competitive pressures, industry developments and future opportunities.

In connection with the proposed merger, we have filed a preliminary proxy statement with the Securities and Exchange Commission. After we file the definitive proxy statement, it will be mailed to all holders of Blue Martini common stock and will contain important information about Blue Martini, the proposed merger and related matters. We urge all of our stockholders to read the definitive proxy statement when it becomes available.

Risks Related To Our Financial Condition

We have incurred losses throughout our operating history. These losses may continue for the foreseeable future, and we may not achieve profitability. In 2004, we incurred net losses of \$12.2 million; as of December 31, 2004, we had an accumulated deficit of \$232.8 million. We expect to continue to incur losses on both a quarterly and annual basis, and may continue to do so for the foreseeable future. Moreover, we expect to continue to incur significant costs of services and substantial operating expenses. We have entered into an Agreement and Plan of Merger with Multi-Channel as discussed in more detail under **Risks Related to the Proposed Acquisition of Blue Martini Software by Multi-Channel Holdings**. However, if the proposed merger is not completed, we will need to significantly increase our revenues to achieve and maintain profitability and a positive cash flow. We may not be able to generate sufficient revenues to achieve profitability. In that event, we may need to consider other alternatives, including a financing transaction (to the extent available) or other actions, including a sale or liquidation of the Company or its assets.

Our declining cash balance and volatile stock price have affected our potential and current customers and partners' perception of our viability, which in turn could affect our ability to close sales and partnership transactions. Concerns about our perceived financial viability were a factor in multiple potential and actual customer transactions and partner relationships. We attribute these concerns primarily to the following: we are not yet profitable and thus must use our cash balance (offset by revenues) to fund our operations; our stock price experienced a dramatic decline in 2002; our stock price has been, and continues to be, volatile; and many of our competitors are better funded, more established, or significantly larger than we are. We have entered into an Agreement and Plan of Merger with Multi-Channel as discussed in more detail under **Risks Related to the Proposed Acquisition of Blue Martini Software by Multi-Channel Holdings.** However, if the proposed merger is not completed, we will continue to use our cash balance (offset by revenues) to fund our operations until we achieve profitability (which may not occur); thus, we expect our cash balance will continue to decline during 2005, though at a lower rate than 2004. Therefore, if these conditions do not improve significantly in the next year, we expect these

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concerns about our perceived viability to continue. In that event, we may need to consider other alternatives, including a financing transaction (to the extent available) or other actions, including a sale or liquidation of the Company or its assets.

Cost-reduction efforts may harm our productivity and service levels. Beginning in 2001, we instituted various cost-control measures affecting various aspects of our business operations. We reduced our workforce by approximately 200 employees in 2001, approximately 120 employees in 2002, approximately 10 in 2003, and approximately 63 in 2004. Given current economic conditions and our declining revenues over the last several quarters, we may in the future be required to take additional reductions in force and other cost-saving actions to reduce our losses and to conserve cash. The failure to achieve such future cost savings could have a material adverse effect on our financial condition. Moreover, even if we are successful with these efforts and generate the anticipated cost savings, there is no assurance that these actions will not adversely impact our employees' morale and productivity, the competitiveness of our products and business, and the results of our operations.

Risks Related To Our Products

If we fail to keep pace with technological innovation, improve our existing products, or develop new products, our application suite could become obsolete and our revenues would decline. The market for our application suite is marked by rapid technological change, frequent new product introductions, Internet-related technology enhancements, uncertain product life cycles, changes in client demands and evolving industry standards. New products based on new technologies or new industry standards can render existing products obsolete and unmarketable. To succeed, we will need to enhance our current application suite and develop new products on a timely basis to keep pace with developments related to Internet technology and to satisfy the increasingly sophisticated requirements of our clients.

Enterprise application software technology is complex, and new products and product enhancements can require long development and testing periods; we cannot be certain that we will successfully develop and market new products, new product enhancements or new products compliant with present or emerging Internet technology standards. Our future revenues will depend, in significant part, on our ability to successfully develop and license new and enhanced versions of our application suite, and our ability to continue diversifying our offerings by developing and licensing new products. If we are not able to successfully improve our existing products and develop new products, or if we develop new products and they do not achieve market acceptance, or if we were to experience delays in either, our revenues are likely to decline.

Our new product offerings may not succeed in increasing revenues from our customers. We have recently introduced new solution packs and hosted and on-demand service offerings, which are intended to help customers overcome resource limitations and the perceived risk of IT investment. There can be no assurance that these new offerings will result in increased revenues for us or when, if ever, they may do so.

If we fail to release new versions and upgrades of our application suite in a timely manner, customers may license competing products and our revenues may decline. We may fail to introduce or deliver new products on a timely basis, if at all. In the past, we have experienced delays in the commencement of commercial shipments of enhancements to our application suite. To date, these delays have not had a material impact on our revenues. If we are unable to ship or implement new products or enhancements to our application suite when planned or at all, or fail to achieve timely market acceptance of these new products or enhancements, we may suffer lost sales and thus reduce our revenues. Our future operating results will depend on demand for our application suite, including new and enhanced releases that are subsequently introduced.

If our application suite does not successfully function for customers with large numbers of transactions, customers or product offerings, we may lose sales and suffer decreased revenues. Our application suite must be able to accommodate a large number of transactions, customers and product offerings. Large-scale usage presents significant technical challenges that are difficult or impossible to predict. To date, our application suite has been deployed on a large scale by only a limited number of customers and, therefore, we can make no assurances that our

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application suite is able to meet our customers' demands for large-scale usage. If our customers experience difficulty with our application suite during periods of high traffic or usage, the reputation of our products would suffer and our revenues would be likely to decline accordingly.

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Our interactive selling application may not be capable of handling our customers' needs. Our interactive selling system is based on a powerful configuration engine that has proven successful for a number of customers. Nonetheless, it is possible that our system could fail to successfully meet a customer's needs if the customer's configuration requirements are extremely complex, exceptionally broad in scope, or not fully understood by us.

Our applications may be implemented in a way that does not capture our customers' business processes or address their needs. Successful implementations of our applications reflect our customers' business processes and address their needs. Whether an implementation is performed by the customer, by a third-party system integrator, or by our consulting services, it is possible to implement our applications in a way that fails to capture our customers' business processes or to address their needs in a satisfactory fashion. Consequently, the customer involved in such an implementation may become dissatisfied, and may direct its dissatisfaction at the Company and its software, rather than at the party responsible for the implementation.

Loss or unavailability of key technologies licensed to us by third parties could affect our ability to license our product. Our products incorporate technologies licensed from third-party software providers. In particular, we license array database modeling and configuration technology from Array Technology A/S, and we license a rules engine from Blaze Software Inc. that automates the execution of business processes according to criteria set by our customers. We may not be able to maintain or renew our license agreements for these technologies on terms that are acceptable to us (or at all). The loss of these technologies could harm our ability to license our products and increase our costs until we identify or develop substitute technologies, license them, and integrate them into our product; even if substitute technologies are available, we may not be able to license those technologies on terms that are acceptable to us (or at all).

If our product does not operate with the wide variety of hardware, software and operating systems used by our current and potential customers, our revenues would be harmed. We currently serve a customer base that uses a wide variety of constantly changing hardware, software applications and operating systems. Our application suite will gain broad market acceptance only if it can support a wide variety of hardware, software applications, systems, and standards, including those developed in the future.

Defects in our application suite could diminish demand for our application suite and result in loss of revenues, decreased market acceptance, injury to our reputation and product liability claims. We have in the past discovered software errors and performance problems with various versions of our application suite after release, and, as a result, have experienced injury to our reputation, increased expenses, delays in the shipment of our application suite and our customers have experienced difficulty in deploying and operating our application suite.

Errors in our application suite may be caused by defects in third-party software incorporated into our application suite. If so, we may not be able to fix these defects without the cooperation of these software providers. Since these defects may not be as significant to our software providers as they are to us, we may not receive the rapid cooperation that we may require. We may not have the contractual right to access the source code of third-party software and, even if we access the source code, we may not be able to fix the defect.

Since our customers use our application suite for critical business applications such as e-commerce, any errors, defects or other performance problems of our application suite could damage our customers' businesses. Consequently, these customers could delay or withhold payment to us for our software and services, which could result in an increase in our provision for doubtful accounts or an increase in collection cycles for accounts receivable. In addition, these customers could seek significant compensation from us for their losses. Even if unsuccessful, a product liability claim brought against us would likely be time consuming and costly and harm our reputation, and thus our ability to license to new customers. Even if a suit is not brought, correcting errors in our application suite could increase our expenses. A customer suit is pending against us alleging that our products failed to perform as represented. The Company believes that it has meritorious defenses against these allegations and intends to defend itself vigorously. See Part I, Item 3, Legal Proceedings.

If we are unable to protect our intellectual property or become subject to intellectual property infringement claims, we may lose a valuable asset or incur costly and time-consuming litigation. Our success depends in part on the development and protection of the proprietary aspects of our technology as well as our ability to operate

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without infringing on the proprietary rights of others. To protect our proprietary technology, we rely primarily on a combination of trade secret, copyright, trademark, and patent laws, as well as confidentiality procedures and contractual restrictions. Despite our efforts to protect our proprietary rights and technology, unauthorized parties may attempt to copy aspects of our products or obtain the source code to our software or use other information that we regard as proprietary or could develop software competitive to ours. Our means of protecting our proprietary rights may not be adequate, and our competitors may independently develop similar technology or duplicate our product. Litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Any such litigation could result in substantial costs and diversion of resources that could have a material adverse effect on our business, operating results, and financial condition.

We have one issued patent and several pending patent applications. It is possible that some of the patents that we have applied for will not be issued, and even if issued, that some or all may be successfully challenged. It is also possible that we may not develop additional proprietary products or technologies that are patentable, that any patent issued to us may fail to provide us with competitive advantage, and that the patents of others may materially harm our ability to do business.

In the future, a third party may bring suit claiming that our current or future products infringe its patents, trade secrets or copyrights. Any claims, with or without merit, could be costly and time-consuming to defend, divert our management's attention, or cause product delays. We have only one currently issued patent that we could use defensively against any company bringing such a claim. If our product was found to infringe a third party's proprietary rights, we could be required to enter into royalty or licensing agreements to be able to sell our product. Royalty and licensing agreements, if required, may not be available on terms that are acceptable to us (or at all), which could materially harm our business.

We intend to shift some aspects of the development of our products to offshore resources, which may affect the quality of our products and the speed and cost of our development costs. We have recently entered into agreements with offshore service providers to assist us in the development of our products. Our intention is to maintain current quality standards at a lower rate of expense. However, there can be no assurance that these arrangements will produce the desired results; it is possible that these arrangements may present quality or productivity problems that could affect the timing or quality of our product releases.

Risks Related to Our Market and Our Ability to Sell

See the risk factor entitled "The fact that there is a merger pending could have an adverse effect on our business, revenue and results of operations above."

The economic downturn and related caution in IT spending have significantly affected demand for our products and services and may continue to adversely impact future revenues. The existence of economic downturns in the markets in which we operate has decreased the demand for our applications, caused pricing pressures for our products, and affected our sales activity during 2002, 2003 and 2004. In 2002, 2003 and 2004, we signed 21, 20 and 9 new licenses, respectively, as customers reduced their information technology budgets and postponed or cancelled planned projects, including the evaluation and purchase of new applications, upgrades to existing applications, and purchase of related services. As a result, our revenues have been negatively impacted, and may continue to be in the future.

The existence or even the anticipation of an uncertain economic environment by potential customers in the markets in which we operate affected the demand for our applications, caused pricing pressures for our products, increased customer request for extended payment terms, substantially reduced our sales activity during 2002 and 2003, and continued to affect sales in 2004. We expect it will continue to do so in future periods, which could in turn materially reduce our liquidity. In addition, ongoing financial, political, economic, and other uncertainties have further

weakened the global economy. Additional terrorist attacks, continued war or increased outsourcing of technology projects overseas could adversely affect our business, including revenues, financial condition, and results of operations.

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Our budgeting and forecasting depend on estimates of revenue growth in our target markets. Thus, the prevailing economic and political uncertainty makes it difficult to estimate anticipated license contract signings and future revenues. The future performance of the overall domestic and global economies and the resolution of current international tension involving the United States will likely have a significant impact on our overall performance. To the extent that the current downturn continues or increases in severity or scope, we believe demand for our products and services, and therefore future revenues, could be further reduced.

We may not be able to compete effectively with current and potential competitors. We compete in the highly competitive CRM market, which is subject to rapid technological change. We believe that our products, which are externally focused on increasing our customers' sales to their own customers, are fundamentally different from traditional CRM offerings, which focus internally on managing and reporting a customer's sales efforts and opportunities. We may not be able to articulate the value we believe we offer with sufficient clarity and distinctiveness to generate interest in our target markets. A principal source of competition is the internal information technology departments at potential customers, which may develop systems that provide for some or all of the functionality of our applications. Our products also compete with products, components, or solutions offered by Art Technology Group, Inc., BroadVision, Inc., E. Philip, Inc., Firepond, Inc., Microsoft Corporation, Oracle Corp., SAP AG, Selectica, Inc., Siebel Systems, Inc., Trilogy Software, Inc., Unica Corporation and Vignette Corporation.

Compared to us, many of these competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial resources. This may place us at a disadvantage in responding to our competitors' pricing strategies, technological advances, advertising campaigns, strategic partnerships and other initiatives. Competitive pressures and our perceived viability in this market may make it difficult for us to acquire and retain customers, and may require us to reduce the price of our products which could reduce our revenues and result in increased operating losses.

The sales cycle for our products is long and variable, which makes it difficult to predict our future revenues and may cause our operating results to vary significantly. Our revenues and results of operations are difficult to predict and may fluctuate substantially from quarter to quarter. For example, certain indicators that we relied upon in developing our license revenue forecasts, such as our historical pattern of transaction timing and anticipated sales cycles, did not prove reliable during 2002, 2003 or 2004. During these periods, we continued to see extended sales cycles; our average sales period was six to twelve months in 2002, 2003, and 2004.

The period between initial contact with a prospective customer and the licensing of our application suite varies and can range from three to more than twelve months. Because of this variable sales cycle, the timing of revenues from the licensing of our application suite is difficult to forecast. Factors affecting our sales cycle, many of which are beyond our control, include:

Many of our license agreements close within the last few weeks of each quarter;

Customers consider a number of factors related to our products and services, as well as our financial condition, before committing to purchase our application suite. As a result, we spend significant time and resources informing prospective customers about our company, application suite, and other offerings, which may not result in a completed transaction but may nonetheless impact our operating margins;

The licensing of our application suite is often an enterprise-wide decision by our customers that involves many factors and decision-makers; thus, if our customer's management, budget, or strategy changes, our ability to conclude license agreements may be affected;

Because a substantial portion of our quarterly revenues are derived from a small number of customers, delays in the signing of one or more large license agreements or the loss of a significant customer order may materially affect revenues and our operating results;

Due in part to macroeconomic conditions, customers remain cautious about spending, and have increased requests for contract terms that affect our ability to recognize revenue. These conditions may persist in the future;

Customer approval processes are unpredictable; delays in approvals, even after selection of a vendor, could impact the timing and amount of revenues recognized in a quarterly period;

We have recently changed several aspects of our sales leadership, strategy and process with the intention of improving our sales pipeline and results, including changes in the way we generate leads, hiring of additional

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salespeople and changes in the way we target and approach accounts. We expect that it may take up to twelve months to see positive results from these changes, although these changes may not show positive results during that period or at all. As a result of these changes, our ability to market and license our software may be limited accordingly; and

The number, timing and significance of enhancements to our application suite, and the introduction by us or our competitors, of new software may affect customers' purchasing decisions.

Because of this variation in sales cycle length, it is difficult for us to predict revenues and thus our operating results could be hard to estimate. For example, if our license results do not meet our internal expectations, our service offerings would be affected (since service revenue lags licenses) and our services revenues would be reduced, which would harm our overall results since service expenses are relatively fixed in the short term.

A small number of customers have accounted for a substantial portion of our revenues, and this pattern is likely to continue for the foreseeable future; as a result, our revenues could decline due to the loss or delay of a single customer order, the delay in recognizing revenue associated with a single customer order, or the failure to collect revenue associated with a single customer. Each quarter during our operating history, a relatively small number of customers has accounted for a significant portion of that quarter's total revenues. We expect this to continue in the future. Thus, the loss or delay of individual orders could have a significant impact on revenues and operating results.

The timing of recognition of customer revenue may also affect our results. Customer payments that do not meet our revenue recognition policy requirements are recorded as deferred revenue. Although new agreements may not result in revenues in the quarter in which the agreement was signed, commissions and royalties may nonetheless become payable on such agreements during that quarter, which would impact our operating results.

We may not successfully establish ourselves in international markets or generate significant revenues abroad, which could result in slower revenue growth and harm our business. In 2004, we generated approximately 29% of our total revenues from sales outside the United States. We have sales offices in France and have also generated sales in other countries. We may add others in the future. If we are not successful in continuing to license our application suite in international markets, or if we do not increase sales from outside the United States, we could experience slower revenue growth and our business could be harmed. We anticipate devoting additional resources and management attention to expanding international opportunities. Our international expansion carries with it a number of additional challenges, including:

greater difficulty in staffing and managing foreign operations;

expenses associated with foreign operations and compliance with applicable laws;

difficulty and costs of managing a global technical support service that provides around the clock support;

political or economic changes or instability in a specific country or region;

expenses associated with localizing our product for foreign countries;

differing intellectual property rights and the enforcement of such rights;

protectionist laws and business practices that favor local competitors;

different sales cycles and collection periods or seasonal reductions in business activity;

multiple, conflicting and changing governmental laws and regulations; and

foreign currency restrictions and exchange rate fluctuations.

Increasing government regulation of personal data, the Internet, imposition of sales and other taxes on products sold by our customers over the Internet and privacy concerns could reduce the license of our application suite and harm our business. Federal, state or foreign agencies may adopt laws or regulations affecting personal data or the use of the Internet as a commercial medium. We expect that laws and regulations relating to user privacy, pricing, content and quality of products and services could indirectly affect our business.

Current federal legislation limits the imposition of state and local taxes on Internet-related sales at this time. Congress may choose not to renew this legislation, in which case state and local governments would be free to impose taxes on electronically purchased goods. The imposition of new sales or other taxes could limit the growth of Internet commerce in general and, as a result, the demand for our application suite and services.

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Businesses use our application suite to capture information regarding their customers when those customers contact them on-line with customer service inquiries. Privacy concerns may cause visitors to withhold personal data, which would limit the effectiveness of our application suite. More importantly, even the perception of privacy concerns, whether or not valid, may indirectly inhibit market acceptance of our application suite.

Our indirect sales channel may not produce the revenues desired. We have recently sought to expand our indirect sales channel by entering into agreements with a limited number of resellers, and are working to enter into agreements with others. These reseller relationships may take significant time and effort. We cannot predict with certainty whether this channel will produce significant revenue, or how long it will take to do so.

Risks Related To System Integrators

Our failure to develop and maintain strong relationships with consulting and system integrator firms (CSIs) would harm our ability to market and implement our application suite, which could reduce future revenues and increase our expenses. An increasing portion of our sales are influenced by the recommendation of our application suite by systems integrators, consulting firms and other third parties that help deploy our application suite for our customers. Losing the support of these third parties may limit our ability to penetrate our existing or potential markets or harm our ability to implement our application suite. These third parties are under no obligation to recommend or support our application suite and could recommend or give higher priority to their own products and services or those of other companies. Systems integrators assist our customers with the installation and deployment of our application suite, in addition to those products of our competitors, and perform custom integration of computer systems and software. If we are unable to develop and maintain relationships with systems integrators, we would be required to hire additional personnel to install and maintain our application suite, which would result in higher expenses and delays in our ability to recognize revenue. Our inability to gain the support of CSIs or a shift by these companies toward favoring competing products could negatively affect our software license and service revenues.

Some CSIs also engage in joint marketing and sales efforts with us. If our relationships with these CSIs fail, we will have to devote substantially more resources to the sales and marketing and the installation and maintenance of our application suite, which would result in higher expenses and delays in our ability to recognize revenue. In many cases, these parties have extensive relationships with our existing and potential customers and influence the decisions of these customers. A number of our competitors have longer and more established relationships with these CSIs than we do, and as a result those CSIs may be more likely to recommend competitors' products and services and increase our expenses.

Other Risks

Changes in accounting policies created and interpreted by authoritative agencies can have a significant effect on our reported results and may even affect the reporting of transactions completed before a change is announced. We prepare our financial statements in conformity with accounting principles generally accepted in the United States of America or GAAP. These principles are subject to interpretation by the Securities and Exchange Commission and various bodies formed to interpret and create accounting policies. A change in these policies can have a significant effect on our reported results and may even affect the reporting of transactions completed before a change is announced. Our accounting policies that may be affected by changes in the accounting rules are as follows:

revenue recognition

accounting for business combinations

stock-based compensation

goodwill and other intangible assets accounting

Changes to these or other rules or the questioning of current practices may have a significant adverse effect on our reported financial results or in the way in which we conduct our business. See the discussion under "Use of Estimates and Critical Accounting Policies" in this annual report for additional information about our critical accounting policies and some risks associated with these policies.

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We may enter into mergers and acquisitions in the future; our business could be affected by the distraction and challenges of such transactions. We may merge with, or acquire technologies or companies in the future. Entering into any business combination entails many risks, any of which could materially harm our business, including

diversion of the attention of management or key technical employees from other business concerns;

failure to assimilate the combined companies with the pre-existing business;

failure to integrate the acquired technology with our existing technologies;

delays in our product releases caused by the integration of the acquired technology with our existing technologies;

potential loss of key employees from either our pre-existing business or the combined business;

increasing our cost structure and thus our use of existing cash resources;

dilution of our existing stockholders as a result of issuing equity securities; and

assumption of liabilities of the merged or acquired company.

We may not be able to identify suitable merger or acquisition candidates, and even if we do identify suitable candidates, we may not be able to make these transactions on commercially acceptable terms (if at all). If we do merge with or acquire other companies, we may not be able to realize the benefits we expected to achieve at the time of entering into the transaction. In any future merger or acquisition, we will likely face the same risks as those discussed above. Further, we may have to use our cash reserves, incur debt, or issue equity securities to pay for any future merger or acquisition. Each of these financing alternatives could have negative consequences, by decreasing our cash reserves, increasing our debt burden, or diluting our existing stockholders.

We have entered into an Agreement and Plan of Merger with Multi-Channel as discussed in more detail under **Risks Related to the Proposed Acquisition of Blue Martini Software by Multi-Channel Holdings**.

We may be at risk of future securities litigation, which could result in substantial costs and divert management attention and resource. The purported shareholders' derivative complaint against us relating to our IPO has been favorably resolved, and we have agreed in principle to a tentative global settlement (subject to a number of procedural conditions and formal approval by the court) of the securities class action claims against us and other companies relating to our collective IPOs. Nonetheless, as a technology company with a volatile stock price, we may in the future be the target of additional securities class action litigation. In the past, other types of securities class action litigation have been brought against companies following a decline in the market price of their securities. This risk is especially acute for us because technology companies have experienced greater than average stock price volatility in recent years, particularly since mid-2000, and, as a result, technology companies have been subject to a greater number of securities class action claims than companies in other industries. In addition, we have entered into an Agreement and Plan of Merger with Multi-Channel as discussed in more detail under **Risks Related to the Proposed Acquisition of Blue Martini Software by Multi-Channel Holdings**; our entry into this Agreement may also trigger litigation. There can be no assurance that the Company will not be subject to these or other securities or class action claims. Such litigation could result in substantial costs and divert management's attention

and resources, which could harm our business.

We may have difficulty retaining or recruiting qualified personnel, which could impact the development and license of our application suite. Difficulty in hiring or retaining qualified personnel, or failure by newly hired personnel to develop necessary skills or reach expected levels of productivity, may weaken our ability to develop and market our application suite. Our success also depends on the continued contributions of key engineering, sales and marketing, management, and professional services personnel. In particular, losing the services of Monte Zweben, our Chairman and Chief Executive Officer, would be difficult to replace.

Our ability to increase our sales will depend on our ability to recruit, train and retain top-quality sales people who can target prospective customers senior management and generate and service large accounts. In our industry, competition for qualified sales personnel is intense.

Our Chairman and CEO maintains significant control over Blue Martini Software, which may lead to conflicts with other stockholders over corporate strategy and other issues. Our directors, executive officers, and holders of

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5% or more of our outstanding common stock owned approximately 42% of our outstanding common stock as of December 31, 2004. Monte Zweben, our Chairman and Chief Executive Officer, together with related entities, owned approximately 26% of our common stock as of this date. These stockholders, acting together, and Mr. Zweben, individually, will be able to significantly influence all matters requiring approval by our stockholders, including the election of directors and significant corporate transactions such as mergers or other business combination transactions. This control may delay or prevent a third party from acquiring or merging with us.

We have implemented anti-takeover provisions that could discourage or prevent a takeover. Provisions of our amended and restated certificate of incorporation and bylaws, as well as provisions of Delaware law, could make it more difficult for a third party to acquire us. These provisions include:

establishment of a classified board of directors such that not all members of the board may be elected at one time;

authorizing the issuance of blank check preferred stock that could be issued by our board of directors to increase the number of outstanding shares and thwart a takeover attempt;

prohibiting cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;

limitations on the ability of stockholders to call special meetings of stockholders;

prohibiting stockholder action by written consent and requiring all stockholder actions to be taken at a meeting of our stockholders; and

establishing advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporations Law and the terms of our stock option plans may discourage, delay or prevent a change in control of the Company.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Exchange

Through December 31, 2004, approximately 71% of our revenues were denominated in United States dollars and were primarily from customers in the United States and Canada, and approximately 29% of our revenues were in various international currencies from various international customers. We expect that future license and service revenues will continue to be derived from international markets and may be denominated in the currency of the applicable market. Through December 31, 2004, we have continued our international operations and continued to have personnel in Europe and Asia Pacific. Our future operating results may become subject to significant fluctuations based upon changes in the exchange rates of foreign currencies in relation to the United States dollar. In the future, we expect to engage in international sales denominated in both the United States dollar and in foreign currencies. An increase in the value of the United States dollar relative to foreign currencies could make our products less competitive in international markets. Although we will continue to monitor our exposure to currency fluctuations and, when appropriate, may use economic hedging techniques in the future to minimize the effect of these fluctuations, we can make no assurances that exchange rate fluctuations will not adversely affect our financial results in the future. Through December 31, 2004, the Company did not engage in foreign currency hedging activities.

Fixed Income Securities

At December 31, 2004, we had an investment portfolio of fixed income securities, including those classified as cash equivalents, of \$32.9 million compared to \$46.2 million at December 31, 2003 of which \$622,000 and \$962,000 in 2004 and 2003, respectively were pledged as collateral primarily relating to our office lease and a small amount relating to compliance with a foreign taxing agency. Our exposure to financial market risk, including changes in interest rates, relates primarily to our investment portfolio. Our general policy is to limit the risk of principal loss and ensure the safety of invested funds by limiting market and credit risk. This exposure is limited by the establishment and monitoring of compliance with our investment policy that provides for investments in fixed income securities with maturities not exceeding 18 months. This policy also establishes credit quality standards and limits investment exposure to any one issuer. We do not invest in any derivative instruments. Due mainly to the relatively short-term nature of our available-for-sale investment portfolio, the fair value of our investment portfolio or related income would not be significantly impacted by a 100 basis point increase or decrease in interest rates.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements required by this item are submitted as a separate section of this annual report on Form 10-K. See Item 15.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Quarterly Evaluation of Our Disclosure Controls and Internal Controls: As of December 31, 2004 (the Evaluation Date), we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (the Disclosure Controls), as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934, as amended, and our internal controls and procedures for financial reporting (the Internal Controls). This evaluation (the Controls Evaluation) was done under the supervision and with the participation of management, including our CEO and CFO. Rules adopted by the SEC require that we present the conclusions of the CEO and the CFO about the effectiveness of our Disclosure Controls and Internal Controls based on and as of the date of the Controls Evaluation.

Certifications: Attached as Exhibits 31.1, 31.2 and 32.1 are two separate forms of certifications of the CEO and the CFO. The certifications attached as Exhibits 31.1 and 31.2 are required in accordance with Section 302 of the

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Sarbanes-Oxley Act of 2002 (the "Section 302 Certifications"). The information contained in this Item 4 relates to the Controls Evaluation referred to in the Section 302 Certifications, and should be read with the Section 302 Certifications for a more complete understanding of the topics presented.

Disclosure Controls and Internal Controls over Financial Reporting: Our management, including the CEO and the CFO, is responsible for establishing and maintaining adequate disclosure and internal controls over our financial reporting. Disclosure Controls are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms. Disclosure Controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including the CEO and the CFO, as appropriate to allow timely decisions regarding required disclosure. Internal Controls are procedures that are designed with the objective of providing reasonable assurance regarding the reliability of financial reporting and include those policies and procedures that provide reasonable assurances that our transactions are properly authorized, our assets are safeguarded against unauthorized or improper use, and our transactions and dispositions of assets are properly recorded and reported, all to permit the preparation of our financial statements in conformity with GAAP.

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

Scope of the Controls Evaluation: The CEO and CFO evaluation of our Disclosure Controls and our Internal Controls included a review of the controls' objectives and design, our controls' implementation and the effect of the controls on the information generated for use in this Quarterly Report on Form 10-Q. In the course of the Controls Evaluation, we sought to identify data errors, control problems or acts of fraud and to confirm that appropriate corrective actions, including process improvements, were being undertaken. We will perform this type of evaluation on a quarterly basis so that the conclusions concerning controls effectiveness can be reported in our Quarterly Reports on Form 10-Q and Annual Report on Form 10-K. The overall goals of these various evaluation activities are to monitor our Disclosure Controls and our Internal Controls and to make modifications as necessary. Our intent in this regard is that the Disclosure Controls and the Internal Controls will be maintained as dynamic systems that change (including with improvements and corrections) as conditions warrant.

Among other matters, we sought in our evaluation to determine whether there were any "significant deficiencies" or "material weaknesses" in our Internal Controls, or whether we have identified any acts of fraud involving personnel who have a significant role in our Internal Controls. This information was important both for the Controls Evaluation generally and because item 5 in the Section 302 Certifications require that the CEO and CFO disclose such information to the Audit Committee of our Board of Directors and to our independent auditors and to report on related matters in this section of the Quarterly Report on Form 10-Q. In the professional auditing literature, "significant deficiencies" are referred to as "reportable conditions," which are control issues that could have a significant adverse effect on the ability to record, process, summarize and report financial data in the financial statements. A "material weakness" is defined in the auditing literature as a particularly serious reportable condition where the internal control does not reduce to a relatively low level the risk that misstatements caused by error or fraud may occur in amounts that would be material in relation to the financial statements and not be detected within a timely period by employees in the normal course of performing their assigned functions. We also sought to deal with other controls matters in the Controls Evaluation, and in each case if a problem was identified, we considered what revision, improvement or correction to make in accordance with our on-going procedures.

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Conclusions: Based upon the Controls Evaluation, our CEO and our CFO have concluded that, subject to the limitations noted above, our Disclosure Controls and Internal Controls and procedures are effective in alerting them on a timely basis to material information related to us (including our consolidated subsidiaries) that is required to be included in our reports filed or submitted under the Securities and Exchange Act of 1934, as amended.

Changes in Internal Controls over Financial Reporting: In accordance with SEC requirements, our CEO and CFO note that, during the quarter ended December 31, 2004, there have been no changes in Internal Controls or in other factors that could materially affect or are reasonably likely to materially affect such controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

ITEM 9B. OTHER INFORMATION

None.

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The following table sets forth certain information regarding our executive officers as of March 15, 2005 and their ages as of such date:

Name	Age	Office(s)
Monte Zweben	41	Chairman and Chief Executive Officer
Eran Pilovsky	44	Chief Financial Officer
Eugene Davis	42	Vice President, Product Development
Russell Gunderson	51	Vice President, Global Marketing and Business Development

Monte Zweben has served as our Chairman and Chief Executive Officer since June 1998. From November 1997 to June 1998, Mr. Zweben was an Entrepreneur in Residence at Matrix Partners and Institutional Venture Partners, two venture capital firms. From October 1996 to November 1997, Mr. Zweben was Vice President and General Manager at PeopleSoft, Inc., a provider of enterprise applications. From 1992 to December 1996, Mr. Zweben was Chairman, President and Chief Executive Officer of Red Pepper Software Company. From September 1986 to December 1992, Mr. Zweben was the Deputy Branch Chief of the NASA Ames Research Center's Artificial Intelligence Branch. Mr. Zweben serves on the board of directors of Advent Software, Inc. and the School of Computer Science at Carnegie-Mellon University. Mr. Zweben has a master's degree in computer science from Stanford University and a bachelor's degree in computer science and industrial management from Carnegie-Mellon University.

Eran Pilovsky has served as our Chief Financial Officer since August 2003, having joined the Company as Vice President of Finance in March 2002. Prior to joining Blue Martini Software, from January 2000 to October 2001, Mr. Pilovsky served as Chief Financial Officer of Vyvo, Inc., a NASDAQ-listed supplier of broadband wireless systems. From October 1997 to January 2000, he was a partner with Ernst & Young LLP, having joined Ernst & Young's audit practice in September 1985. Mr. Pilovsky is a cum laude graduate of the University of San Francisco with a B.S. in Business Administration, and is also a Certified Public Accountant in California.

Eugene Davis has served as our Vice President of Product Development since August 2004. From August 2001 to August 2004, Mr. Davis served as Vice President of Engineering at Fogbreak Software. From December 1999 to June 2001, Mr. Davis was Vice President of Engineering at TeaLeaf Technology. From December 1996 to December 1999, Mr. Davis held successive positions as Engineering Manager, Engineering Director and Vice President of Engineering at Red Pepper Software Company. Mr. Davis has a master's degree in Computer Science from the University of Toronto and bachelor's degrees in chemical engineering and music from Stanford University.

Russell Gunderson has served as our Vice President of Global Marketing and Business Development since June 2004. Prior to joining Blue Martini Software, from November 2003 to May 2004, Mr. Gunderson served as Senior Vice President of Marketing and Business Development at Descartes Systems Group. From February 2001 to October 2003, Mr. Gunderson served as Chief Executive Officer of Vigilance Software. From December 1999 to January 2001, Mr. Gunderson served as Chief Operating Officer at CrossLogix. From April 1994 to November 1999,

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Mr. Gunderson served as Senior Vice President at Baan. From 1980, to 1994, Mr. Gunderson held various executive positions in the systems and application software group at Hewlett Packard. Mr. Gunderson has an MBA from the University of California in Los Angeles, a master's degree in Engineering from Stanford University, and a B.S. degree in Engineering from the University of California, Berkeley.

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The following table sets forth certain information regarding our Board of Directors as of March 15, 2005, and their ages as of such date:

Name	Age	Position
Monte Zweben	41	Chairman
Dennis Carey (1)	58	Director
Mel Friedman (1)(2)(3)(4)(5)	66	Director
Dominic Gallelo (3)(4)(5)	50	Director
Amal Johnson (2)	52	Director
Gary A. Wetsel (1)	59	Director
William Zuendt (1)(3)(5)	58	Director

- (1) Member of the Audit Committee of the Board of Directors.
- (2) Member of the Compensation Committee of the Board of Directors.
- (3) Member of the Nominating Committee of the Board of Directors.
- (4) Member of the Litigation Committee of the Board of Directors.
- (5) Member of the Corporate Governance Committee of the Board of Directors.

Set forth below is biographical information of the Company's board of directors, other than Mr. Zweben who is an officer of Blue Martini as well as a director and whose biographical information may be found in the section entitled "Executive Officers" above:

Dennis Carey has served as a director since July 2002. Mr. Carey is executive vice president of Motorola. Previously, Mr. Carey served as executive vice president of business development, strategy and corporate operations for The Home Depot, Inc. ("Home Depot") from May 2001 to March 2002. He joined Home Depot in May 1998 as executive vice president and chief financial officer and served in that capacity until May 2001. From 1994 to 1998, Mr. Carey was employed by AT&T Corp. ("AT&T") in several roles, most recently as vice president and general manager, corporate productivity and mergers and acquisitions from December 1996 to May 1998 and, prior to that, as vice president and chief financial officer for international operations from January 1996 to December 1996.

Mel Friedman has served as director since May 2002. Mr. Friedman retired as Senior Vice President, Customer Advocacy for Sun Microsystems, Inc. Mr. Friedman had previously held several other executive roles during 1989-2002 at Sun, including President of Sun's Microelectronics division, VP of Worldwide Operations, VP of West Coast Operations, and VP of Supply Management. Before joining Sun, Mr. Friedman held senior positions at Prime Computer, from 1985-1989, where he ran Worldwide Operations and Customer Service. At Apollo Computer he was responsible for International Operations and Worldwide facilities. At Polaroid, he was granted 13 patents and was responsible for international hardware manufacturing. He also co-founded Tabor Corporation, a microfloppy disc drive company. Mr. Friedman holds a B.S.M.E. with honor society leadership from the City College of New York and conducted graduate work in mechanical engineering and industrial management at MIT. Mr. Friedman also serves on the board of directors of Volterra Semiconductor Corporation, a manufacturer of power management semiconductors and Electroglas Inc., a supplier of innovative probers, prober-based test handlers, test floor management software and services.

Dominic Gallelo has served as a director since April 2003. Since September 2003, Mr. Gallelo has served as chief executive officer of Graphisoft. From October 2002 to April 2003, Mr. Gallelo served as executive vice president, Corporate Development for Macromedia, Inc. Mr. Gallelo joined Macromedia in October 2001, initially responsible for Macromedia's Rich Media Division and serving as executive vice president of Products from June 2002 until October 2002. Before joining Macromedia, Mr. Gallelo served as chief executive officer of

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RedSpark, Inc., a provider of enterprise supply chain software, from its May 2000 inception as a spinoff of Autodesk Inc. to October 2001. Mr. Gallelo joined Autodesk in 1992 and served in a number of executive positions there, including vice president of Asia-Pacific, vice president of the Manufacturing Solutions Group, and executive vice president of the Design Solutions Group.

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Amal Johnson has served as a Director since January 2004. Ms. Johnson is currently a venture partner of ComVentures. Prior to joining Com Ventures, Ms. Johnson was a venture partner of Lightspeed Venture Partners, focusing on enterprise software and infrastructure, having joined as a general partner in 1999. Previously, Ms. Johnson was president of Baan Supply Chain Solutions from January 1998 to December 1998, president of Baan Affiliates from January 1997 to December 1997, and president of Baan Americas from October 1994 to December 1996. Prior to that, Ms. Johnson served as president of ASK Manufacturing Systems from August 1993 to July 1994 and held executive positions at IBM from 1977 to June 1993. Ms. Johnson also serves on the board of directors of Alibris.

Gary A. Wetsel has served as a director since March 2004. In December 2004, Mr. Wetsel announced his retirement from Aspect Communications Corp. where he served as executive vice president, chief financial officer and chief administrative officer since April 2002. From February 2000 to April 2002, Mr. Wetsel served as vice president and chief financial officer for Zhone Technologies, Inc. From 1998 to February 2000, Mr. Wetsel served as president and chief executive officer of Warpspeed Communication Corp. Before Warpspeed, Mr. Wetsel held senior executive positions with several high tech companies, including Wyse Technologies, Inc., Borland International, Inc., Octel Communications Corporation, Ungermann-Bass, Inc., and Rolm Corporation. Mr. Wetsel also serves on the board of directors of Looksmart.

William Zuendt has served as a director since August 1998. Mr. Zuendt retired as president and chief operating officer of Wells Fargo & Company, a bank holding company, and its principal subsidiary, Wells Fargo Bank in 1997 after serving in that position since 1994. Mr. Zuendt currently serves on the board of directors of Advent Software, Inc.

Audit Committee

The Audit Committee currently consists of Dennis Carey, Mel Friedman, Gary A. Wetsel, and William Zuendt, each of whom is independent under current listing standards of The Nasdaq Stock Market. In addition, the board of directors has reviewed the qualifications and experience of Mr. Carey and Mr. Wetsel, including their experience in supervising and evaluating the preparation of audited financial statements, and has determined that Mr. Carey and Mr. Wetsel each qualify as an audit committee financial expert within the meaning of the current rules of the Securities and Exchange Commission. Each of the current Audit Committee members served throughout fiscal 2004 (except for Mr. Wetsel, who joined the Audit Committee in March 2004 and served throughout the balance of fiscal 2004). The Audit Committee:

meets with our independent auditors at least annually to review the results of the annual audit and to discuss the financial statements;

hires and has the power to terminate the independent auditors;

oversees the independence of the independent auditors;

evaluates the independent auditors' performance; and

receives and considers the independent auditors' comments as to internal controls, accounting and operational matters, management performance, and procedures in connection with audits and reviews.

Compensation Committee

The Compensation Committee reviews and approves the overall compensation strategy and policies for Blue Martini. The Compensation Committee reviews and approves corporate performance goals and objectives relevant to the compensation of our executive officers and other senior management; reviews and approves the compensation and other terms of employment of our Chief Executive Officer, recommends to the Board, in consultation with the Nominating Committee, the compensation for independent Board members; and has full power and authority to administer our stock option and purchase plans, pension and profit sharing plans, stock bonus plans, deferred compensation plans and other similar programs. We also have a Non-Officer Stock Option Committee that may award stock options to employees who are not officers. Two directors currently comprise the Compensation Committee: Mr. Friedman and Ms. Johnson. All members of the Compensation Committee are independent (as independence is currently defined in Rule 4200(a)(15) of the Nasdaq listing standards). During 2004, the Compensation Committee met nine times and acted by unanimous written consent four times.

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Nominating Committee

The Nominating Committee is responsible for identifying, reviewing and evaluating candidates to serve as directors of Blue Martini, reviewing and evaluating incumbent directors, selecting candidates for election to the Board of Directors and making recommendations to the Board regarding the membership of the committees of the Board. Our Nominating Committee charter can be found on the investor relations section of our corporate website at www.bluemartini.com. Three directors comprise the Nominating Committee: Mr. Friedman, Mr. Gallello and Mr. Zuendt. All members of the Nominating Committee are independent (as independence is currently defined in Rule 4200(a)(15) of the Nasdaq listing standards). During 2004, the Nominating Committee met one time.

The Nominating Committee believes that candidates for director should have certain minimum qualifications, including being able to read and understand basic financial statements, being over 21 years of age and having the highest personal integrity and ethics. The Committee also intends to consider such factors as possessing relevant expertise upon which to be able to offer advice and guidance to management, having sufficient time to devote to our affairs, demonstrated excellence in the director's field, having the ability to exercise sound business judgment and having the commitment to rigorously represent the long-term interests of our stockholders. However, the Committee retains the right to modify these qualifications from time to time in consultation with the Board. Candidates for director nominees are reviewed in the context of the current composition of the Board, our operating requirements and the long-term interests of stockholders. In conducting this assessment, the Committee considers diversity, age, skills, and such other factors as it deems appropriate given the current needs of the Board and Blue Martini, to maintain a balance of knowledge, experience and capability. In the case of incumbent directors whose terms of office are set to expire, the Nominating Committee reviews such directors' overall service to us during their term, including the number of meetings attended, level of participation, quality of performance, and any other relationships and transactions that might impair such directors' independence. In the case of new director candidates, the committee also determines whether the nominee must be independent for Nasdaq purposes, which determination is based upon applicable Nasdaq listing standards, applicable SEC rules and regulations and the advice of counsel, if necessary. The Committee then uses its network of contacts, a professional search firm, or both to compile a list of potential candidates, but may also engage, if it deems appropriate, a professional search firm. The Committee conducts any appropriate and necessary inquiries into the backgrounds and qualifications of possible candidates after considering the function and needs of the Board. The Committee meets to discuss and consider such candidates' qualifications and then selects a nominee by majority vote. The Nominating Committee has retained the services of Christian & Timbers to assist in the process of identifying or evaluating director candidates, including Gary A. Wetsel. To date, the Nominating Committee has not rejected a timely director nominee from any stockholder(s) holding more than 5% of our voting stock.

Litigation Committee

The Litigation Committee reviews and directs our decisions regarding currently pending litigation filed in connection with our IPO, including reviewing any settlement proposals and investigating any claims, and the merits of such claims, brought in our name. Two independent directors who were not members of our Board of Directors at the time of our IPO comprise the Litigation Committee: Mr. Friedman and Mr. Gallello. During 2004, the Litigation Committee did not meet and acted by written consent one time.

Corporate Governance Committee

The Corporate Governance Committee is responsible for developing a set of corporate governance principles for us, overseeing and reviewing the processes and procedures used by Blue Martini to provide information to the Board and its committees, assessing the performance of the Board and establishing procedures to consider stockholder recommendations and proposals. Three directors comprise the Corporate Governance Committee: Mr. Friedman, Mr. Gallello and Mr. Zuendt. All members of the Corporate Governance Committee are independent (as independence is currently defined in Rule 4200(a)(15) of the Nasdaq listing standards). During 2004, the Corporate Governance Committee did not meet.

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SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires our directors and executive officers, and persons who own more than ten percent of a registered class of our equity securities, to file with the SEC initial reports of ownership and reports of changes in ownership of common stock and other equity securities of Blue Martini. Officers, directors and greater than ten percent stockholders are required by SEC regulation to furnish us with copies of all Section 16(a) forms they file.

To our knowledge, based solely on a review of the copies of such reports furnished to us and written representations that no other reports were required, during the fiscal year ended December 31, 2004, all Section 16(a) filing requirements applicable to our officers, directors and greater than ten percent beneficial owners were complied with.

Code of Conduct

We have adopted a code of conduct that applies to all members of our board of directors and all of our employees, including our principal executive officer and principal financial officer. A copy of this code is available on the Corporate Governance section of our website at www.bluemartini.com. We intend to disclose any changes in or waivers from our code of ethics required to be publicly disclosed by posting such information on our website or by filing a Form 8-K.

ITEM 11. EXECUTIVE COMPENSATION

Compensation of Directors

Directors who are not employees of Blue Martini receive cash compensation for service on our Board of Directors and our committees of the Board. Each non-employee director serving on our Board receives an annual retainer of \$25,000 following the close of our annual meeting, plus \$2,000 for each meeting of the Board and \$1,000 for each meeting of a committee of the Board they attend, payable quarterly. In addition, our directors are eligible for reimbursement for expenses incurred in connection with attendance at Board of Directors and committee meetings.

Each of our non-employee directors also receives stock option grants under our 2000 Non-Employee Directors' Stock Option Plan (which shall be referred to as the Directors' Plan). Only non-employee directors or an affiliate of such directors (as defined in the U.S. Internal Revenue Code) are eligible to receive options under the Directors' Plan. Options granted under the Directors' Plan are intended by us not to qualify as incentive stock options under the U.S. Internal Revenue Code. Option grants under the Directors' Plan are non-discretionary.

Pursuant to the Directors' Plan, new non-employee directors joining our Board of Directors following our 2003 Annual Meeting are automatically granted an option to purchase 50,000 shares of our common stock (the Initial Grants). New non-employee directors who joined our Board in 2003 before our 2003 Annual Meeting were automatically granted an option to purchase 3,571 shares of our common stock on the same terms as the Initial Grants. On the day after each annual meeting of our stockholders, each non-employee director on our Board of Directors as of the annual meeting is automatically granted an option to purchase 20,000 shares of our common stock (the Annual Grants). The

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exercise price per share of each new option granted under the Directors' Plan is the fair market value of a share of our common stock on the date of the option grant. The Initial Grants may be exercised immediately but vest as follows: after one year of continuous service to us following the date of grant of such option, 1/3rd of the shares subject to the grant vest and 1/36th of the shares subject to the grant vest each month thereafter. The Annual Grants may be exercised immediately but vest 1/12th each month after the date of the grant. The term of options granted under the Directors' Plan is ten years. In the event of a merger of Blue Martini with or into another corporation or a consolidation, acquisition of assets or other change-in-control transaction involving Blue Martini, the vesting of each option granted under the Directors' Plan will accelerate 50% and the option will terminate if not exercised prior to the consummation of the transaction.

In addition to the non-discretionary grants under the Directors' Plan, non-employee directors who joined our Board of Directors before our 2003 Annual Meeting were granted an additional option under our 2000 Equity Incentive Plan during 2003. Mr. Carey, Mr. Friedman, Mr. Gallelo, Mr. Verhalen and Mr. Zuendt were granted, respectively, an option to purchase up to 43,000, 41,000, 46,000, 42,000 and 42,000 shares of our common stock, at an exercise price of the fair market value of a share of our common stock on the date of the option grant. Such options vest 1/3rd after one year of service and 1/36th per month thereafter.

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Named Executive Officer Compensation

The following table shows for the fiscal years ended December 31, 2004, 2003 and 2002, compensation awarded or paid to our Chief Executive Officer and our other four most highly compensated executive officers at December 31, 2004:

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SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Annual Compensation			Long-Term Compensation Awards	
		Salary(1)	Bonus	Other Compensation(1)	Securities	
					Underlying	
					Restricted Stock Awards	Options (2)(3)(#)
Monte Zweben Chairman and Chief Executive Officer	2004	\$ 300,000	\$			
	2003	300,000	35,000			
	2002	225,000				