MAGIC SOFTWARE ENTERPRISES LTD
Form 20-F
May 16, 2008

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 20-F

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2007

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Date of event requiring this shell company report ____________

Commission file number: 0-19415

MAGIC SOFTWARE ENTERPRISES LTD.

(Exact Name of Registrant as specified in its charter
and translation of Registrant s name into English)
Israel
(Jurisdiction of incorporation or organization)

5 Haplada Street, Or Yehuda 60218, Israel
(Address of principal executive offices)

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

Title of each class	Name of each exchange on which registered
Ordinary Shares, NIS 0.1 Par Value	**NASDAQ Global Market**

Securities registered or to be registered pursuant to Section 12(g) of the Act: **None**

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: **None**

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

Ordinary Shares, par value NIS 0.01 per share 31,542,050
(as of December 31, 2007)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No x

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

Item 17 o Item 18 x

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

This annual report on Form 20-F is incorporated by reference into the registrant s Registration Statements on Form S-8, Registration Nos. 333-13270, 333-11220, 333-1946, 333-10794, 333-113552, 333-132221 and 333-149553

INTRODUCTION

Magic Software Enterprises Ltd. develops, markets, sells and supports composite application development and deployment platforms with a service-oriented architecture, or SOA, including application integration and business process management, or BPM, with existing and legacy systems. Our products and services are available through a global network of subsidiaries, distributors, value-added resellers and software solution providers in approximately 50 countries. As used in this annual report, the terms we, us, our, and Magic mean Magic Software Enterprises Ltd. and its subsidiaries, unless otherwise indicated.

Over the last twenty-four years we have developed an application development and deployment technology, which facilitates change and empowers business users to take an active part in the development process. Our technology is a metadata driven, rule based platform and development framework. During that period, a broad community of independent software vendors, or ISVs, and customers worldwide, have been using our rapid application development and deployment technology and products. In 2002, we recognized that the software application market was changing. Organizations had built up a wide array of systems that needed to communicate with each other more efficiently in order to streamline business processes, improve productivity and ultimately reduce costs and increase business revenues. The demand for technology enablement was no longer coming exclusively from the information technology, or IT, department, but from businesses charged with improving operations. In order to address the needs of both developers and business users, we added to our eDeveloper two additional layers, orchestration and graphical process design, as well as an activity monitoring service, and created iBOLT - a single, unified and highly scalable development and business integration suite. iBOLT allows our customers to implement application integration layers, create service oriented architectures and manage end-to-end processes.

We have obtained trademark registrations for Magic® in the United States as well as in Canada, Israel, the Netherlands (Benelux), Switzerland, Thailand and the United Kingdom. All other trademarks and trade names appearing in this annual report are owned by their respective holders.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. All references in this annual report to dollars or $ are to U.S. dollars and all references in this annual report to NIS are to New Israeli Shekels.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any previous filling with the Securities and Exchange Commission, you may read the document itself for a complete recitation of its terms.

This annual report on Form 20-F contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995, as amended, with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results. Statements which use the terms anticipate, believe, expect, plan, intend, est anticipate and similar expressions are intended to identify forward looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to publicly release any update or revision to any forward looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3D. Key Information - Risk Factors

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. Selected Financial Data

The following table presents selected consolidated financial data as of the dates and for each of the periods indicated. This data includes discontinued operation for all presented periods (see note 1b and 1g to the financial statements). You should read the selected consolidated financial data set forth below together with Item 5. Operating and Financial Review and Prospects as well as our consolidated financial statements and notes thereto appearing elsewhere in this annual report.

We have derived the following consolidated income statement data for the years ended December 31, 2005, 2006 and 2007 and the consolidated balance sheet data as of December 31, 2006 and 2007 from our audited consolidated financial statements and notes included elsewhere in this annual report with the relevant adjustments due to the discontinued operation. We have derived the consolidated income statement data for the years ended December 31, 2003 and 2004 and the consolidated balance sheet data as of December 31, 2003, 2004 and 2005 from our audited consolidated financial statements that are not included in this annual report with the relevant adjustments due to the discontinued operation.

Income Statement Data:

	Year ended December 31,				
	2003	**2004**	**2005**	**2006**	**2007**

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

Revenues:					
Software	$ 22,327	$ 24,861	$ 21,503	$ 18,788	$ 17,707
Maintenance and technical support	9,495	11,233	11,238	11,531	12,605
Consulting services	23,620	21,119	19,096	22,252	28,116
Total revenues	55,442	57,213	51,836	52,571	58,428
Cost of revenues:					
Software	4,794	4,814	6,965	5,433	4,558
Maintenance and technical support	2,424	3,072	2,179	2,873	1,602
Consulting services	15,296	14,403	14,123	16,862	21,181
Total cost of revenues	22,514	22,289	23,267	25,168	27,340
Gross profit	32,928	34,924	28,569	27,403	31,088
Operating expenses:					
Research and development, net	3,573	2,545	2,413	2,462	2,716
Sales, marketing, general and administrative	27,842	29,685	31,707	29,496	27,090
Restructuring and impairment and other non-recurring costs				2,157	
Operating income (loss)	1,513	2,694	(5,551)	(6,712)	1,282
Financial income (expense), net	338	917	(809)	332	161
Other income (expenses)	(42)			278	170
Income (loss) before taxes on income	1,809	3,611	(6,360)	(6,102)	1,613
Income taxes	(36)	254	462	310	362
Income (loss) after taxes on income	1,845	3,357	(6,822)	(6,412)	1,251
Equity in earnings (losses) of affiliates	(36)	79	19	15	(86)
Minority interest in losses (earnings) of subsidiaries	(162)	67	(8)	71	$ (22)
Net income (loss) before discontinued operation	$ 1,647	$ 3,369	$ (6,811)	$ (6,326)	$ 1,143
Net income from discontinued operation	1,420	721	2,204	1,320	11,465
Net income (loss) after discontinued operation	3,067	4,090	(4,607)	(5,006)	12,608
Basic net earnings (loss) per share	$ 0.10	$ 0.13	$ (0.15)	$ (0.16)	$ 0.40
Diluted net earnings (loss) per share	$ 0.10	$ 0.13	$ (0.15)	$ (0.16)	$ 0.39
Shares used to compute basic earnings (loss) per share	29,624	31,029	31,124	31,184	31,443
Shares used to compute diluted earnings (loss) per share	29,909	32,426	31,124	31,184	32,023

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Balance Sheet Data:

	At December 31,				
	2003	2004	2005	2006	2007
	(U.S. dollars in thousands)				
Working capital	$ 23,008	$ 25,934	$ 19,052	$ 15,584	$ 28,743
Cash, cash equivalents, short term deposits and marketable securities	11,233	10,982	10,173	11,653	16,357
Total assets including discontinued operation	77,799	80,285	73,722	71,172	82,298
Shareholders equity	53,924	59,547	52,305	47,644	61,244

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

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

Risks Related to Our Business and Our Industry

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

Although we reported net income of $12.6 million in the year ended December 31, 2007, we incurred losses in the pervious two years. No assurance can be given that we will be able to maintain our current level of revenues or profitability in the future.

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

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

- The size and timing of orders;
- The high level of competition that we encounter;
- The timing of our product introductions or enhancements or those of our competitors or of providers of complementary products;
- Market acceptance of our new products, applications and services;
- The purchasing patterns and budget cycles of our customers and end-users;
- The mix of product sales;
- Exchange rate fluctuations; and
- General economic conditions.

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

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

Our financial statements are stated in U.S. dollars, our functional currency. Nevertheless, a substantial portion of our revenues and expenses are incurred in other currencies, particularly Euros, Japanese yen, NIS and the British pound**.** We maintain substantial non-U.S. dollar balances of assets, including cash and accounts receivable, and liabilities, including accounts payable. Fluctuations in the value of the currencies in which we do business relative to the U.S. dollar may have a material adverse effect on our business, results of operations and financial condition, by decreasing the U.S. dollar value of assets held in other currencies and increasing the U.S. dollar amount of liabilities payable in other currencies, or by decreasing the U.S. dollar value of our revenues in other currencies and increasing the U.S. dollar amount of our expenses in other currencies. From time to time we use derivative or other instruments to hedge against part or all of our exposures.

Our widespread operations may strain our management, operational and financial resources and could have a material adverse affect on our business, results of operations and financial condition.

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

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

- Train, motivate, manage and retain qualified employees; and
- Hire additional personnel.

We may not succeed in managing future growth.

We face intense competition in the markets for our application development and integration technologies and services, which are evolving into a new unified market for composite applications development and deployment, which competition could adversely affect our business, results of operations and financial condition.

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

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

We may not succeed in increasing our market share in the business integration and process management markets with our iBOLT products, or leverage our experience in the composite applications field which could adversely affect our business, results of operations and financial condition.

During 2003, we launched the iBOLT Integration Suite, which provides business integration and process management solutions to mid-size and large organizations. As a comprehensive suite, iBOLT allows the seamless integration and interoperability of diverse solutions, including legacy applications, in a quick and efficient manner. We continued to develop this product and enhance it, releasing successive versions in 2004 and 2005 (the current version is 2.5). In 2005 we also started a line of special editions of iBOLT tailored for specific application packages, and to date we have released three such special editions, for SAP, for Oracle JD Edwards, and for Salesforce.com. We are currently developing the next release of iBOLT, which we intend to release during the second half of 2008.

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

Our future success will be largely dependent on the acceptance of future releases of our eDeveloper application development and deployment product and if we are unsuccessful our business, results of operations and financial condition will be adversely affected.

Our future success will be in great measure dependent on the acceptance of future releases of our eDeveloper application development and deployment product. The acceptance of this product relies in part on the continued acceptance and growth of diverse platforms, systems and databases, where eDeveloper operates as the bridge for creating composite applications. In the future, organizations may not implement multiple environments to serve their computing needs. If this product is not accepted, our business, results of operations and financial condition will be adversely affected.

Changes in the ratio of our revenues generated from different revenue elements may adversely affect our gross profit margins.

We derive our revenues from the sale of software licenses, applications, maintenance and technical support and consulting services. Our gross margin is affected by the proportion of our revenues generated from the sale of each of those elements of our revenues. Our revenues from the sale of our software licenses and maintenance and technical support have higher gross margins than our revenues from the sale of consulting services. If the relative proportion of our revenues from the sale of consulting services increases as a percentage of our total revenues, our gross profit margins will decline. Our software licenses revenues include the sale of the third party software license sales, which have a lower gross margin than the sales of our software products. Any increase in the portion of third party software license sales out of total license sales will decrease our gross profit margin.

We derive a significant portion of our revenues from independent distributors who are under no obligation to purchase our products and the loss of such independent distributors could adversely affect our business, results of operations and financial condition.

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

We may lose independent distributors on whom we currently depend and we may not succeed in developing new distribution channels which could adversely affect our business, results of operations and financial condition.

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

Our efforts to increase our presence worldwide, including the United States, Europe and Asia may not be profitable, which could adversely affect our business, results of operations and financial condition.

Our success in becoming a stronger competitor in the sale of software development and deployment technology and a leading provider of applications is dependent upon our ability to increase our sales in all our markets, including, but not limited to the United States, Europe and Japan. Our efforts to increase our penetration to these markets are subject to risks inherent to such markets, including the high cost of doing business in such locations. Our efforts may be costly and the may not result in profits, which could adversely affect our business, results of operations and financial condition.

Our products have a lengthy sales cycle which could adversely affect our revenues.

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

Rapid technological changes may adversely affect the market acceptance of our products and services, and our business, results of operations and financial condition could be adversely affected.

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

- Supporting existing and emerging hardware, software, databases and networking platforms; and
- Developing and introducing new and enhanced software development technology and applications that keep pace with such technological developments, emerging new markets and changing customer requirements.

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

We may be unable to attract, train and retain qualified persona, which could adversely affect our business, results of operations and financial condition.

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

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

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

Our standard license agreement with our customers contains provisions designed to limit our exposure to potential product liability claims that may not be effective or enforceable under the laws of some jurisdictions. Accordingly, we could fail to realize revenues and suffer damage to our reputation as a result of, or in defense of, a substantial claim.

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

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

We are dependent on a limited number of product families and a decrease in revenues from these products would adversely affect our business, results of operations and financial condition.

Currently, we derive most of our revenues from sales of developments and integration products primarily under our eDeveloper and iBolt brands, as well as related revenues from software maintenance and support and other services. We do not expect our revenue structure to change in the foreseeable future. Our future growth depends heavily on our ability to effectively develop and sell new and acquired products as well as add new features to existing products. A decrease in revenues from our primary products would adversely affect our business, results of operations and financial condition.

Third parties may claim that we infringe upon their intellectual property rights and could harm our business.

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

We may encounter difficulties with our international operations and sales which could adversely affect our business, results of operations and financial condition.

While our principal executive offices are located in Israel, 92% of our sales in 2005, 2006 and 2007 were generated from other countries. This subjects us to many risks inherent to international business activities, including:

- Limitations and disruptions resulting from the imposition of government controls;
- Changes in regulatory requirements;
- Export license requirements;
- Economic or political instability;
- Trade restrictions;
- Changes in tariffs;
- Currency fluctuations;
- Difficulties in the collection of receivables;
- Greater difficulty in safeguarding intellectual property; and
- Difficulties in managing overseas subsidiaries and international operations.

We may encounter significant difficulties in connection with the sale of our products in international markets as a result of one or more of these factors and our business, results of operations and financial condition could be adversely affected.

Because we are controlled by Formula Systems (1985) Ltd., investors will not be able to affect the outcome of shareholder votes.

Formula Systems (1985) Ltd., whose shares trade on the NASDAQ Global Market and the Tel Aviv Stock Exchange, or TASE, directly owns 17,036,018 or 53.3% of our outstanding ordinary shares. Formula Systems Ltd. is and may continue to be in a position to exercise control over most matters requiring shareholder approval, including the election of our directors, approval of significant corporate transactions and the general ability to direct our affairs. Such concentration of ownership may have the effect of delaying or preventing a change in control.

If we are unable to maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act of 2002, the reliability of our financial statements may be questioned and our share price may suffer.

The Sarbanes-Oxley Act of 2002 imposes certain duties on us and our executives and directors. Our efforts to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 governing internal controls and procedures for financial reporting, which started in connection with this Annual Report on Form 20-F have resulted in increased general and administrative expense and a diversion of management time and attention, and we expect these efforts to require the continued commitment of significant resources. We may identify material weaknesses or significant deficiencies in our assessments of our internal controls over financial reporting. Failure to maintain effective internal controls over financial reporting could result in investigation or sanctions by regulatory authorities, and could have a material adverse effect on our operating results, investor confidence in our reported financial information, and the market price of our ordinary shares.

Risk Factors Related to Our Ordinary Shares

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

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

- Quarterly variations in our operating results;
- Operating results that vary from the expectations of securities analysts and investors;
- Changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- Announcements of technological innovations or new products by us or our competitors;
- Announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- Changes in the status of our intellectual property rights;
- Announcements by third parties of significant claims or proceedings against us;
- Additions or departures of key personnel;
- Future sales of our ordinary shares;
- Stock market price and volume fluctuations; and
- General trends of the stock markets.

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

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

We have not paid any cash dividends on our ordinary shares in the last four fiscal years and may not do so in the future.

Although we paid a dividend in 2003 we did not pay any cash dividends on our ordinary shares in the last four fiscal years. Future dividend distributions are subject to the discretion of our board of directors and will depend on various factors, including our operating results, future earnings, capital requirements, financial condition, tax implications of dividend distributions on our income, future prospects and any other factors deemed relevant by our board of directors. The distribution of dividends also may be limited by Israeli law, which permits the distribution of dividends only out of profits (as defined by Israeli law) or otherwise upon the permission of the court. You should not rely on an investment in our company if you require dividend income from your investment. The success of your investment will likely depend entirely upon any future appreciation of the market price of our ordinary shares, which is uncertain and unpredictable. There is no guarantee that our ordinary shares will appreciate in value or even maintain the price at which you purchased your ordinary shares.

Our ordinary shares are traded on more than one market and this may result in price variations.

Our ordinary shares are traded primarily on the NASDAQ Global Market and on the Tel Aviv Stock Exchange. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on the NASDAQ Global Market, and New Israeli Shekels, or NIS, on the Tel Aviv Stock Exchange), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Consequently, the trading prices of our ordinary shares on these two markets may differ. Any decrease in the trading price of our ordinary shares on one of these markets could cause a decrease in the trading price of our ordinary shares on the other market.

Risks Relating to Our Location in Israel

Political, economic and military instability in Israel may disrupt our operations and negatively affect our business condition, harm our results of operations and adversely affect our share price.

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

Since the establishment of the State of Israel in 1948, Israel and its Arab neighbors have engaged in a number of armed conflicts. A state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. Major hostilities between Israel and its neighbors may hinder Israel s international trade and lead to economic downturn. This, in turn, could have a material adverse effect on our operations and business. There has been an increase in unrest and terrorist activity in Israel, which began in September 2000 and which has continued with varying levels of severity through 2007. The future effect of this deterioration and violence on the Israeli economy and our operations is unclear. Recently, there was an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups, as well as extensive hostilities along Israel s northern border with Lebanon in the summer of 2006, and extensive hostilities along Israel s border with the Gaza Strip since June 2007 when the Hamas effectively took control of the Gaza Strip, which have intensified since February 2008. Ongoing violence between Israel and the Palestinians as well as tension between Israel and the neighboring Syria and Lebanon may have a material adverse effect on our business, financial conditions and results of operations.

Furthermore, there are a number of countries, primarily in the Middle East, as well as Malaysia and Indonesia, that restrict business with Israel or Israeli companies, and we are precluded from marketing our products to these countries. Restrictive laws or policies directed towards Israel or Israeli businesses may have an adverse impact on our operations, our financial results or the expansion of our business.

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

Many of our executive officers and employees in Israel are obligated to perform annual reserve duty in the Israeli Defense Forces and may be called for active duty under emergency circumstances at any time. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of other employees due to military service. Any disruption in our operations could adversely affect our business.

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

A substantial portion of our expenses, primarily labor expenses, are incurred in NIS. As a result, we are exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the U.S. dollar or that the timing of this devaluation lags behind inflation in Israel. During 2007, the NIS appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our NIS expenses. We may be materially and adversely affected in the future if the rate of inflation in Israel continues to exceed the devaluation of the NIS against the U.S. dollar or if the timing of this devaluation lags behind increases in inflation in Israel.

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

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

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

We are incorporated in Israel and some of our directors, executive officers and the Israeli experts named in this annual report reside outside the United States. Service of process upon them may be difficult to effect within the United States. Furthermore, most of our assets and the assets of some of our executive officers and directors and some of the experts named in this annual report are located outside the United States. Therefore, a judgment obtained against us or any of them in the United States, including one based on the civil liability provisions of the U.S. federal securities laws, may not be collectible in the United States and may not be enforced by an Israeli court. It also may be difficult for you to assert U.S. securities law claims in original actions instituted in Israel. For more information regarding the enforceability of civil liabilities against us, our directors and executive officers and the Israeli experts named in this prospectus, including the terms under which certain judgments may be enforced by an Israeli court, please see Enforceability of Civil Liabilities.

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

Israeli corporate law regulates mergers, requires tender offers for acquisitions of shares above specified thresholds, requires special approvals for transactions involving directors, officers or significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israeli tax considerations may make potential transactions unappealing to us or to some of our shareholders. These provisions of Israeli corporate and tax law may have the effect of delaying, preventing or complicating a merger with, or other acquisition of, us. This could cause our ordinary shares to trade at prices below the price for which third parties might be willing to pay to gain control of us. Third parties who are otherwise willing to pay a premium over prevailing market prices to gain control of us may be unable or unwilling to do so because of these provisions of Israeli law.

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

We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In particular, a shareholder of an Israeli company has a duty to act in good faith in exercising his or her rights and fulfilling his or her obligations toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law provides that these duties are applicable in shareholder votes at the general meeting with respect to, among other things, amendments to a company s articles of association, increases in a company s authorized share capital, mergers and actions and transactions involving interests of officers, directors or other interested parties which require the shareholders general meeting s approval. In addition, a controlling shareholder of an Israeli company or a shareholder who knows that he or she possesses the power to determine the outcome of a vote at a meeting of our shareholders, or who has, by virtue of the company s articles of association, the power to appoint or prevent the appointment of an office holder in the company, or any other power with respect to the company, has a duty of fairness toward the company. The Israeli Companies Law does not establish criteria for determining whether or not a shareholder has acted in good faith. Moreover, the law is relatively new and there is no case law available on the duty of a non-controlling shareholder to act in good faith.

As a foreign private issuer whose shares are listed on the NASDAQ Global Market, we may follow certain home country corporate governance practices instead of certain NASDAQ requirements.

As a foreign private issuer whose shares are listed on The NASDAQ Global Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Marketplace Rules. A foreign private issuer that elects to follow a home country practice instead of such requirements, must submit to NASDAQ in advance a written statement from an independent counsel in such issuer s home country certifying that the issuer s practices are not prohibited by the home country s laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission or on its website each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. As a foreign private issuer listed on The NASDAQ Global Market, we may follow home country practice with regard to, among other things, composition of our board of directors, director nomination procedure, compensation of officers, and quorum at shareholders meetings. In addition, we may follow our home country law, instead of the NASDAQ Marketplace Rules, which require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company.

ITEM 4. INFORMATION ON THE COMPANY

A. History and Development of the Company

We were incorporated under the laws of the State of Israel in February 1983 as Mashov Software Export (1983) Ltd. and we changed our name to Magic Software Enterprises Ltd. in 1991. We are a public limited liability company and operate under the Israeli Companies Law 1999 and associated legislation. Our registered offices and principal place of business are located at 5 Haplada Street, Or Yehuda 60218, Israel, and our telephone number is +972-3-538-9292. Our U.S. subsidiary, Magic Software Enterprises Inc., is located at 23046 Avenida de la Carlota, suite 300, Laguna Hills, CA 926653. Our address on the Internet is www.magicsoftware.com. The information on our website is not incorporated by reference into this annual report.

We develop, market and support eDeveloper, an application platform for software development and deployment, with SOA, and iBOLT, a technology for business integration and business process management, or BPM. The eDeveloper and the iBOLT enable enterprises to accelerate the process of building and deploying applications that can be rapidly customized and integrated with existing systems.

Our application platform, the eDeveloper, is used by thousands of enterprises and independent software vendors that use our technology to develop solutions for their customers in approximately 50 countries. We refer to the independent software vendors as Magic Software Partners. We also provide maintenance and technical support as well as professional services to our enterprise customers and to Magic Software Partners. In addition, we sell our technology for business integration, the iBOLT, to customers of specific popular software applications, such as SAP, Salesforce.com or Oracle JD Edwards via such entities. We refer to these vendor centered market segments as ecosystems.

eDeveloper enables the rapid development and deployment of business applications. The eDeveloper technology can be deployed on multiple platforms operating with interoperability under various information technology, or IT, architectures and can operate on multiple databases. During 2006, we released eDeveloper Version 10, which highlights SOA. eDeveloper Version 10 supports enhanced compliance with industry standards, provides improved functionality in comparison to prior versions and provides a composite application development environment. In February 2007, we released two new editions of eDeveloper Version 10, the Discovery edition and Xpress edition, which target different developer needs. The Discovery edition is targeted at students, new developers and those developing basic Windows client and web applications for personal use. The Xpress edition is designed to meet the needs of users developing and deploying small- to mid-scale desktop and web applications that are based on either Pervasive or MySQL tables. eDeveloper Xpress is affordable for small- and home-office developers.

In 2007, recognizing the growing market demand for rich internet applications, or RIA, and software-as-a-service, or SaaS, we engaged in developing new functionality and extensions to our application platform, with the objective of enabling the development of RIA and SaaS applications. SaaS is a new business and technical model for delivering software applications, similar to a phone or cable TV model, in which the software applications are installed and operated in dedicated data centers and users subscribe to these centers and use the applications over an internet connection. This model requires the ability to deliver RIA. We currently support function-rich applications in a client-server architecture, necessitating that users dispose of a powerful PC to install and run these applications. The new development is aimed at providing a similar level of functionality to users who only have an internet connection and a light device, such as a mobile device or an internet terminal, without having to install the application locally. We intend to develop a new product, packaged as a SEAP, available later this year, initially for Japanese clients. Following the development, we intend to extend the availability of this product worldwide. This new product will include, among other features, the functionality of the current eDeveloper platform in addition to rich internet client functionality. As of December 31, 2007, no revenues from SaaS were recognized.

iBOLT provides affordable business integration solutions to mid-sized and large enterprises and system integrators. As a comprehensive suite, iBOLT allows the seamless integration and interoperability of diverse solutions, including legacy applications, in a quick and efficient manner. In 2005, we released iBOLT Version 2.5 and since then we have continued to develop the iBOLT channel and entered into agreements with additional system integrators, consultancies and service providers, who acquired iBOLT skills and offer iBOLT licenses and related services to their customers. During the last two years we have developed a new version of iBOLT, Version 3, which we expect to release during 2008.

During 2004, we entered into a partnership with SAP, an international provider of business software solutions. The agreement focused on providing a special edition of iBOLT as a collaborative platform for the SAP Business One product, an integrated business management solution designed specifically for small and midsize businesses. In January 2005, we launched iBOLT Special Edition for the SAP Business One product and subsequently expanded and intensified our joint activities with SAP worldwide. The iBOLT Special Edition was accepted by the SAP community with enthusiasm, and SAP awarded our company its ISV Partner Leadership in Innovation 2005 Award.

During 2006, our software was recognized by SAP for the best overall achievement in quality and excellence among SAP Business One software solution partners with the SAP Software Solution Partner Quality Excellence Award. Our iBOLT Special Edition partner program was endorsed by over 150 SAP Business One resellers across the globe who have signed a partnership agreement with us and became a significant new addition to the Magic partner community. In the beginning of 2007, we expanded our portfolio to include iBOLT Special Edition for SAP ERP R/3 for mid-size businesses and organizations. In the beginning of 2007, we also received SAP s xAPPS certification. During the third quarter of 2007, we completed several successful new deployments of iBOLT Special Edition for SAP ERP R3.

As of December 2007, more than 230 SAP business partners in 27 countries worldwide were part of our iBOLT for SAP Partner Program. We have also received certification in Japan for the iBOLT for SAP product. A significant addition to the international certifications we had already received, it reinforced and expanded SAP s level of co-operation with us.

During 2006, we continued to work closely with IBM as an Advanced Partner of the IBM Partnerworld for Developer business partner program and as a Member Partner of IBM Partnerworld for Software. IBM has awarded us with its ServerProven® certification for our eDeveloper and iBOLT products following a rigorous testing and evaluation process. Only those products that are validated by IBM to install quickly, start up easily and run reliably on IBM servers are awarded this certification, designed by IBM to assist its customers to easily identify complete solutions for their business-critical e-business needs. During 2006, we also became part of IBM s System i Tools Innovation Program. As part of our activities with the IBM System i customers and business partners, we released our JDE Connect, a fully functional version of our iBOLT integration technology targeted to users of JD Edwards Enterprise One Oracle enterprise resource planning, or ERP, software on the IBM System i platform.

In January 2007, we sold the intellectual property relating to the technology known as iBOLT Portal to Axcepia Technologies Ltd. Under the agreement, in consideration for the transfer and assignment of our rights in and to the technology, Axcepia agreed to pay us a commission equal to 50% of its revenues derived from sales to customers who held licenses to use the iBOLT Portal technology for a period of five years as of the date of the agreement. In addition, commencing as of six months from the date of the agreement, Axcepia agreed to pay us a commission equal to 20% of the revenues it derived from the provision of maintenance and support services relating to the iBOLT Portal technology for a period of five years from the date of the agreement.

In December 30, 2007, we sold our wholly-owned subsidiary, Advanced Answers on Demand Holding Corporation, or AAOD, a Florida corporation that develops and markets application software targeted at the long-term care industry to Fortissimo Capital for $17 million. Fortissimo paid us $1 million of the sale price in December 2007 and the remaining $16 million in the beginning of 2008. In addition, as part of the transaction, we entered into a three years license agreement with AAOD according to which AAOD will continue to sell our products, as an OEM partner, in consideration for $3 million, to be paid quarterly over three years starting in 2008.

The sales described above were part of our strategy to focus on our core products. In the fourth quarter of 2006, we announced a restructuring and impairment plan designed to increase our profitability by focusing on the marketing and sale of our flagship products. The restructuring and impairment plan included the appointment of three new members to our board of directors in January 2007, the appointment of a new chief executive officer who began to serve in such capacity on July 1, 2007, and the appointment of a new chief financial officer on July 26, 2007. In November 2007, Mr. Guy Bernstein replaced David Assia as chairman of our board of directors. The organizational restructuring was completed at the beginning of 2008, with the formation of a dedicated product group, and the rationalization of our territorial structure.

Our capital expenditures totaled $0.8 million in the year ended December 31, 2007 and $1.0 million, in the years ended December 31, 2006 and 2005. Of the $0.8 million of capital expenditures in 2007, $0.6 million, was invested in network equipment and computers, $0.1 million was invested in furniture and office equipment and $0.1 million, was invested in leasehold improvements.

B. Business Overview

Industry Overview

In recent years the multiplication of enterprise applications has lead to a level of complexity in enterprises information system that is actually obstructing business progress and evolution, reducing business agility and is often resulting in multiple versions of similar data objects such as customer records. We believe that one of the main challenges the modern enterprise faces today is creating a single view of the truth , which is the better way to make effective and relevant business decisions. Business integration is employed to facilitate this. Traditionally, given their cost and complexity, business integration solutions were targeted at large enterprises. Consequently, business integration tools are mostly complex, require significant implementation resources, take a long time to implement and are costly. This constituted a barrier to small and medium enterprises, who could not afford to embark on such projects. Yet, given the critical need for business integration across the demand and supply chain, enterprises of all sizes require such solutions. We recognized this trend and emerging need when we designed iBOLT, and are one of the first vendors to provide business integration solutions to small and medium enterprises.

Another major evolution in enterprises is the trend of reusing information technology, or IT, assets, such as enterprise applications, driving the move towards SOA. Due to the large investments in enterprise applications, such as ERP (enterprise resource planning) and CRM (customer relationship management), on the one hand, and the accelerating business change, on the other, organizations need to find a way to continue to leverage and amortize their IT investments while increasing their ability to change business processes and support new ones. The software industry s response is a new SOA, a new paradigm of application development, service oriented development of applications, or SODA, and composite applications. Most of these involve metadata (which is data that describes other data, similar to a table of content describing a book), rather than traditional programming. We have developed and enhanced this paradigm over the last twenty years, and we believe that we have the one of the largest installed base of products employing such technology.

Additionally, SaaS is becoming a well-established phenomenon in some areas of enterprise IT. It is growing into a mainstream option for software-based business solutions and will affect most of enterprise IT departments in the next three years in one way or another. SaaS enabled application platform, or SEAP, seems to become a dominant player in the SaaS growing application industry. We are developing our technology to provide the functionality of a SEAP, as a result of the growing demand from application vendors to repackage their applications as a SaaS offering.

General

We develop, market and support eDeveloper, an application platform for software development and deployment, and iBOLT, a technology for business integration and BPM. Our technology enables enterprises to accelerate the process of building and deploying business software applications that can be rapidly customized to meet current and future needs. Our development and integration products empower customers to dramatically improve their business performance and return on investment by enabling the affordable and rapid integration of diverse applications, systems and databases to streamline business processes from within one comprehensive framework.

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

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

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

- With the launch of iBOLT, we started a process of expanding from the application development field to the business integration and process management fields, which are, presently converging, from a technology perspective, to the composite application field. Products for these fields require service-oriented architecture, application integration capabilities, process management, orchestration capabilities, and information delivery capabilities. Our technology and products provide all of these capabilities.

- With the impending introduction of our SEAP, we expect to strengthen our position a leading application platform provider opening the path for us to address the top-tier segment of the market. The increasing adoption of the SaaS delivery and business model requires the use of a new generation application platforms, which support the relevant functions required for SaaS deployment. We are one of the first vendors to offer such a platform, which is based on the combined features of our iBOLT and eDeveloper products. By leveraging the easy migration of applications between the different versions of each of the iBOLT and eDeveloper, our Magic Software Partners have the potential to become among the first and most versatile sources of SaaS applications. Industry analysts as well as several of our major Magic Software Partners have recognized this, and we have begun to work with some of them in this context.

Our Solution

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

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

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

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

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

- *Comprehensiveness*. Our technology delivers what enterprises need to achieve business integration into a single product stack, including a composite application framework, SODA, enterprise service bus (ESB, or also referred to as a message broker), enterprise application integration, BPM, and service and business activity monitoring. Our single product stack provides small and medium enterprises as well as large enterprises with top tier power, which is simple to learn and fast to deliver value even with small business budgets.

- *Innovation and experience*. We provide a service oriented platform which includes application integration, business process management and composite applications, to rapidly develop, change and deploy solutions integrated with existing and legacy systems. We enable enterprises to increase their agility and rapidly adapt to business changes, by aligning their IT with their business operations, accelerating the evolution to a SOA through application integration and BPM. Our customers develop and deploy applications that are rapidly customized and integrated with existing and legacy systems. Our products are built on twenty years of research and development, as well as customer experience.

Our Strategy

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

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

- Focus our sales efforts on our core products iBOLT and eDeveloper;

- Focus our efforts on building a strong partner base of system integrators and resellers of our core technologies;

- Increase the number of software houses and independent software vendors using eDeveloper to build their applications;

- Strengthen our alliance with SAP. The SAP solutions for small businesses (such as the SAP Business One products) and midsize companies (such as the SAP ERP R/3 solution and SAP Business All-in-One solution) address a broad horizontal market. As a result of our alliance with SAP, our offerings and resources (such as sales, marketing and research and development) more effectively address the SAP market;

- Develop additional alliances with leading application vendors and develop offerings and partner programs in their ecosystems, such as Oracle s JD Edwards and Salesforce.com; and

- Focus on recruiting OEM partners who will incorporate our iBOLT integration technology into their product offerings.

Our Products

The driving principles behind our technology are:

- Abstraction - to hide complexity and facilitate change;

- Automation of mundane tasks - to accelerate development and maintenance and reduce risk; and

- Interoperability - to support business logic across multiple hardware and software platforms, operating systems and geographies.

We design our tools for use by system architects, business analysts and consultants rather than by programmers. Over the years, we have enriched our technology with emerging features such as messaging, application partitioning, browser based rich client, graphical design studio for business processes, event and service provision and consumption, orchestration and many more.

We offer two complementary products that address the wide spectrum of composite applications.

eDeveloper is an interactive composite applications toolset, delivering an extremely productive, state-of-the-art technology for developing and deploying web and client/server applications across and beyond the enterprise. eDeveloper automates the mundane repetitive tasks of the software development cycle, drastically shortening the process, reducing project risk and minimizing human errors.

In February 2007, we released two new editions of eDeveloper Version 10, the Discovery edition and Xpress edition, which target different developer needs. The Discovery edition is targeted at students, new developers and those developing basic Windows client and web applications for personal use. The Xpress edition is designed to meet the needs of users developing and deploying small- to mid-scale desktop and web applications that are based on either Pervasive or MySQL tables. eDeveloper Xpress is affordable for small- and home-office developers.

eDeveloper Version 10 highlights SOA architecture, supports enhanced compliance with industry standards, provides improved functionality in comparison to prior versions and provides a composite application development environment. In this product version we made a significant paradigm shift, facilitating and shortening significantly the learning and mastering of the tool while maintaining and enhancing its key productivity features. eDeveloper Version 10 further enhances our position as provider of service oriented development of applications (SODA) technology and the feature set provided by our iBOLT and eDeveloper product lines fully complies with the prevailing industry requirements of a comprehensive composite applications and SOA platform. Gartner, a leading global information technology industry research and analyst firm, defines an integrated services environment, or ISE, as an integrated development platform or framework that is focused on developing applications using a composite (assemble-first) metaphor based on SOA and process centricity through a lightweight BPM. According to Gartner, ISEs should have a productivity layer that makes developers more productive through hiding complexity (such as frameworks or prepackaged functions), automation (or code-generation or parameterization), and simplification (such as visual modeling), and forms the basic value proposition of an ISE. Gartner further describes ISE as intended to be used by developers and business analysts alike together, but is targeted at process-centric developers. Through these products, the focus of the user shifts from writing code to assembling and managing business processes. Through these processes, flexible business solutions can be assembled or composed. In the beginning of 2006, Gartner recognized us as a visionary ISE vendor.

iBOLT Business Integration Suite is a flow oriented composite applications toolset, delivering a comprehensive, business-driven integration framework that empowers enterprises to dramatically improve business performance. iBOLT enables customers to easily design, develop and deploy automated business processes, including BPM and business activity monitoring. Increasing the usability and life span of existing legacy and other IT systems, iBOLT allows fast enterprise application integration, development and customization of diverse applications, systems and databases, assuring rapid return on invested capital and time-to-market, increased profitability, and customer satisfaction. We also offer special editions of iBOLT targeted at specific enterprise application vendor ecosystems, such as SAP, JD Edwards or Salesforce.com. These special editions contain specific features and pricing tailored for these market segments.

Our technology, comprised of both iBOLT and eDeveloper, is a comprehensive and proven ISE in the market. It can be applied to the full range of software development market, from the implementation of micro-vertical solutions, through tactical application renovation and process automation solutions, to enterprise spanning SOA migrations and composite applications initiatives. Unlike most competing ISEs, we offer a coherent and unified toolset stemming from the same proven metadata driven and rules based declarative technology, resulting in unprecedented cost savings through fast and easy implementation and reduced project risk.

Product Development

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

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

During 2007, we invested mainly in the development of the following products:

- eDeveloper Version 10.1. During 2007, in response to customers needs and service requests, we released eDeveloper Version 10.1 as well as service packs for the eDeveloper Version 10.1. The eDeveloper Version 10.1 service packs include many new features such as Report Generator, Hebrew Support, XML views enhancements, UDDI and others. In addition we issued numerous bug fixes.

- *Rich Intranet Application Technology*. This is a new technology for eDeveloper Intranet solution. Based on eDeveloper browser client engine, we developed a Java-based client module that provides full thin-client functionality using standard widget toolkit open source technology. The advantage of the new technology is its ability to run on any platform, significantly reducing the cost of maintenance. We are continuing to develop the technology targeting the SaaS market. We plan to release a version of the eDeveloper that will include the RIA technology for the use of Japanese customers during the first quarter of 2008.

- *A new version of iBOLT*. iBOLT Version 3 was the main focus of the iBOLT development in 2007. The new version delivers a full range of new functionalities for the mid size integration market as well as a massive performance improvements. Some of the main functionalities include new data mapper, expression editor, user defined storages, resource management and component software development kit. We plan controlled and limited release of the first version of iBOLT Version 3 during the second quarter of 2008.

- *Intercompany iBOLT solution.* We developed a generic solution for inter-company synchronization with iBOLT Version 2.5. Some of the main functionalities include mail and HTTP synchronization, object management, synchronization process monitoring and more. We released the first version during the fourth quarter of 2007 and continue to improve the functionality of this product.
- *The Hermes software*. In 2007 we continued to develop the Hermes software. HERMES Releases 3.1 and 3.2 incorporate new and advanced functionalities. HERMES Release 3.1 software is operating in full production at Amsterdam Schiphol Airport, with KLM Cargo, and HERMES 3.2 is being launched by HERMES users in India. During the second half of 2008, HERMES Release 3.2 is expected to be deployed at major air cargo centers in Europe, such as in Frankfurt.

Vertical Solutions

Some of our subsidiaries develop, market, and support vertical applications, including for long-term care, banking and cargo handling solutions.

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

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

Hermes Logistics Technologies Ltd., (formerly Magic eCargo), our wholly-owned subsidiary, develops and markets a comprehensive solution for cargo handling and inventory control that is designed to increase productivity, improve efficiency, and reduce costs. Hermes handles many aspects of a cargo operation including inventory control, automated build-up of flights/manifesting, messaging to CARGO-IMP standards, customs clearance, weight and balance departure control systems, interfacing, scanning and verification of cargo, secured tracking and a comprehensive financial package for all aspects of billing and collecting fees.

Services

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

We offer fee-based consulting services in connection with installation assurance, application audits and performance enhancement, application migration and application prototyping and design. Consulting services are aimed at both generating additional revenues and ensuring successful implementation of eDeveloper and iBOLT projects through knowledge transfer. As part of our restructuring and impairment plan to focus on license sales, our goal is to provide such activities as a complementary service to our customers and partners.

Services are offered as separately purchased add-on packages or as part of an overall software development and deployment technology framework. Over the last several years, we have built upon our established global presence to form joint ventures with our Magic Software Partners who use our technology to develop solutions for their customers, and distributors to deliver successful solutions in focused market sectors.

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

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

We offer an online support system for the Magic Software Partners, which provides members of the Magic Software Partners with the ability to instantaneously enter, confirm and track support requests via the Internet. It provides support to Magic Software Partners and end-users worldwide.

Training. We conduct formal and organized training on our development tools through the Magic University International. We develop courses, pertaining to our principal products, eDeveloper and iBOLT and provide trainer and student guidebooks. Course materials are available both in traditional, classroom courses and as web-based training modules, which can be downloaded and studied at the student s own pace and location. The courses and course materials are designed to accelerate the learning process, using an intensive technical curriculum in an atmosphere conducive to productive training

Customers, End-Users and Markets

We market and sell our products and services in more than 50 countries worldwide. The following table presents our revenues by revenue type and geographical market for the periods indicated:

	Year ended December 31,		
	2005	2006	2007
		(In thousands)	
Software sales	$ 21,503	$ 18,788	$ 17,707
Maintenance and technical support	11,238	11,531	12,605
Consulting services	19,095	22,252	28,116
Total revenues	$ 51,836	$ 52,571	$ 58,428

	Year ended December 31,		
	2005	2006	2007
		(In thousands)	
Israel	$ 4,013	$ 4,307	$ 4,471
Europe	22,636	21,713	24,916
United States	11,529	13,995	18,612
Japan	10,107	10,223	9,080
Other	3,551	2,333	1,349
Total revenues	$ 51,836	$ 52,571	$ 58,428

Industries that are significantly represented in our Magic Software Partners base include finance, government, health care, logistics, manufacturing media, retail and telecommunications. Our eDeveloper and iBOLT technologies are used by a wide variety of developers, integrators and solution providers who can be generally divided into two segments: in the first segment are those performing in-house development (corporate IT departments) and in the second segment are Magic Software Partners, including large system integrators and smaller independent developers, and value added resellers, or VARs, that use our technology to develop or provide solutions to their customers. Magic Software Partners who are packaged software publishers use our technology to write standard packaged software products that are sold to multiple clients, typically within a vertical industry segment or a horizontal business function.

Among the thousands of end-users running their business systems with our technology are the following: Adidas-Solomon, Allstate, Athlon Group, Burger King, Club Med, Compass Group PLC, Danish Ministry of Economic, Deka Bank, Euroclear, Financial Times, FMRP, Fraport AG, GAP, Hitachi, Johnson & Johnson, John Menzies, Kodak, Marconi Mobile, Merrill Lynch, Matsushita, Minolta, NEC, Nestle Nespresso, Nintendo, Philip Morris, TEVA, the State of Washington, Vodafone, the United Nations, UPS and Victorinox.

Sales, Marketing and Distribution

We market and support our products through our own direct sales force, a network of distributors, Magic Software Partners and system integrators. We sell and support our products directly through our subsidiaries in the United States, Japan, the United Kingdom, France, Germany, the Netherlands, Hungary, India and Israel, and through local distributors elsewhere.

Direct Sales. We maintain a direct sales force that pursues local accounts and software solution providers. Our sales personnel carry out strategic sales with a direct approach to decision makers, managing a constantly monitored consultative type of sales cycle. At March 31, 2008, we had approximately 67 sales personnel including a team of 14 sales engineers who provide pre-sale technical support, presentations and demonstrations in order to support our sales force. Sales efforts are targeted at large enterprises performing internal application development and Magic Software Partners who use our technology to develop solutions for their customers. We also employ an in-house and external telemarketing staff to generate and qualify leads.

Indirect Sales. We maintain an indirect sales channel for iBOLT, through system integrators, value added distributors and resellers, OEM partners, as well as consultancies and service providers. We carry out marketing activities with our Magic Software Partners and indirect channels, such as publishing solutions directories and newsletters. We have a marketing program that supports Magic Software Partners and supports iBOLT general partners, and special partner program for those that are also SAP and IBM reseller/partners by providing a wide range of features and advantages in the areas of sales and marketing and technical knowledge transfer.

Distributors. In general, we distribute our products through local distributors in those countries where we do not have a sales subsidiary. A local distributor is typically a software marketing organization with the capability to add value with consulting, training, and support. Distributors are generally responsible for the localization of our software development technology and applications into their native language. The distributors also translate our marketing literature and technical documentation. Distributors must undergo our program of sales and technical training. Marketing, sales, training, consulting, product and client support are provided by the local distributor. We are available for backup support for the distributor and for end-users. In coordination with the local subsidiaries and distributors, we also provide sales support for large and multinational accounts. We have approximately 25 distributors in Europe, Latin America and Asia, many of whom are also Magic Software Partners.

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

In order to foster improved relationships with our iBOLT channel partners, we periodically sponsor local events and other marketing programs and activities. On our corporate Internet website, we host an online solutions directory, which highlights applications developed by our Magic Software Partners, and an information sharing section, which enables our Magic Software Partners to participate alongside our representatives at trade shows and conferences. Strategic Alliances

The important strategic alliances formed by us to date include:

SAP. During 2004, we entered into a partnership with SAP that focused on providing a special edition of iBOLT as a collaboration platform for the SAP Business One product, an integrated business management solution designed specifically for small and midsize businesses. Our iBOLT Special Edition was accepted by the SAP community with enthusiasm, and our company was awarded by SAP the ISV Partner Leadership in Innovation 2005 award and in 2006 we were awarded the SAP Software Solution Partner Quality Excellence Award. Our iBOLT Special Edition partner program is endorsed by over 230 SAP Business One partners across the globe who have signed a partnership agreement with us and became a significant new addition to the Magic partner community. In the beginning of 2007, we announced a new iBOLT Special Edition for SAP R/3 ERP software and we received SAP s xAPPS certification. In addition to the direct economic impact of iBOLT sales, we are experiencing the following benefits that arise from our partnership with SAP: (i) recognition and validation of our technology as a mainstream player in the business integration and composite application development domains; (ii) privileged access to a pre-qualified partner community that can also employ iBOLT in non-SAP related projects; and (iii) revitalization of our Magic Software Partners community, by offering them access to the SAP Partner Program and branding of their existing applications.

IBM. In March 2007, we qualified for the IBM Business Partner SOA Specialty. For this specialty, IBM selects business partners who market SOA content, services, or both that demonstrate compatibility with or complement the IBM SOA Foundation products, who endorse the IBM SOA strategy, and whose marketing activities IBM determines to be in agreement with its own. We offer SOA capabilities in the System i (iSeries / AS/400) market] and we qualified for this specialty with respect to one of our SOA projects that was performed in France during 2006.

W4. In 2005, we entered into agreements with W4, a leading European provider of BPM software for human resources related processes. W4 s BPM technology has over nine years of proven use by hundreds of customers. W4 has embedded iBOLT into its BPM platform, W4 BPMSuite V6, which was launched in December 2005. We have added the W4 BPM engine to our extensive list of components, which enables iBOLT developers to seamlessly integrate human resources related activities as a component of any composite applications developed with the iBOLT Integration Suite. In 2007, Forrester Research recognized W4 as a strong performer in the Human Centric BPM Suites industry, pointing out the partnership between us and W4 as a strong element. This alliance extends our exposure to BPM areas in which we are less active directly, and in particular the Human Centric and Workflow Oriented areas.

iWay Software. During 2003, we initiated a partnership with iWay Software to provide intelligent, prepackaged adapters for the iBOLT Integration Suite. iWay Software is an information builder company and a leading adapter vendor, engaged in acceleration of business integration. The availability of over 250 iWay Software adapters to the iBOLT Integration Suite enables organizations to connect to virtually any packaged application, mainframe and legacy system, traditional database, and to external data sources. iWay Software adapters interface seamlessly into the iBOLT environment without requiring complex coding or application modifications.

In late 2007, we joined the partner program of Salesforce.com and became an AppExchange certified. This enables us to address the Salesforce.com ecosystem and introduce our iBOLT Special Edition for Salesforce.com to its partners and customers.

Competition

The markets for our eDeveloper and iBOLT technologies and applications are characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and rapidly changing customer requirements. These markets are therefore highly competitive and we expect competition to intensify in the future. We constantly follow and analyze the market trends and our peers in order to effectively compete in these markets and avoid losing market share to other players and to our competitors.

With the introduction of eDeveloper Version 10 in mid 2006, we further shifted our activities from the integrated development environment market, in which we were competing with eDeveloper in the past, towards the service oriented architecture market, which we entered into with iBOLT. Our current competitors include Above All, Agentis, Appian, BEA, Bowstreet, Broadvision, ClearNova, Computer Associates, Cordys, FileNet, GT Software, IBM, Microsoft, OutSystems, Oracle, Pegasytems, Progress, Skyway, Sun (SeeBeyond), TIBCO, Ultimus, Unify, and Software AG. Additional competitors may enter each of our markets at any time. Moreover, our customers may seek to develop internally the products that we currently sell to them and thereafter compete with us.

Our goal is to maintain our technology superiority, time to market and worldwide channel network, as well as our constant market analysis to quickly address changing market dynamics. We believe that the principal competitive factors affecting the market for our products include developer productivity, rapid results, product functionality, performance, reliability, portability, interoperability, ease-of-use, demonstrable economic benefits for developers and users relative to cost, quality of customer support and documentation, ease of installation, vendor reputation and experience, financial stability as well as intuitive and out of the box solutions to extend the capabilities of ERP and/or CRM and other application vendors for enterprise integration.

Intellectual Property

We do not hold any patents and rely upon a combination of copyright, trademark, trade secret laws and contractual restrictions to protect our rights in our software products. Our policy has been to pursue copyright protection for our software and related documentation and trademark registration of our product names. Also, our key employees and independent contractors and distributors are required to sign non-disclosure and secrecy agreements.

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

Our trademark rights include rights associated with our use of our trademarks, and rights obtained by registration of our trademarks. We have obtained trademark registrations in South Africa, Canada, Chile, China, Israel, the Netherlands (Benelux), Switzerland, Thailand, the United Kingdom and the United States. The initial terms of the registration of our trademarks range from 10 to 20 years and are renewable thereafter. Our use and registration of our trademarks do not ensure that we have superior rights to others that may have registered or used identical or related marks on related goods or services. We do not believe that patent laws are a significant source of protection for our products. We have registered a copyright for our software in the United States and Japan. Also, we have registered copyrights for some of our manuals in the United States and have acquired an International Standard Book Number (ISBN) for some of our manuals. Our copyrights expire 70 years from date of first publication.

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

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

C. Organizational Structure

We are a member of the Formula Systems (1985) Ltd. (NASDAQ: FORTY), or Formula Systems, group. Formula Systems is an international IT company principally engaged, through its subsidiaries and affiliates, in providing software consulting services, developing proprietary software products and producing computer-based solutions. In addition, Formula Systems manages a venture capital fund, which invests in early stage companies that develop software products for the international market. Formula Systems, an Israeli corporation, beneficially owns a 53.3% equity interest in our ordinary shares.

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

Subsidiary/Affiliate Name	Country of Incorporation	Ownership Percentage
Magic Software Enterprises Inc.	United States	100%
CoreTech Consulting Group, LLC	United States	100%
CoreTech Consulting Group, Inc.	United States	100%
Magic Software Enterprises (UK) Ltd.	United Kingdom	100%
Hermes Logistics Technologies Limited	United Kingdom	100%
Magic Beheer B.V	Netherlands	100%
Magic Software Enterprises Netherlands B.V.	Netherlands	100%
Magic Software Enterprises Spain Ltd.	Spain	100%
Magic Software Enterprises GmbH	Germany	100%
Magic Software Enterprises France S.A.R.L.	France	100%
Magic Benelux B.V.	Netherlands	100%
Magic Software Enterprises (Israel) Ltd.	Israel	100%
Magic Software Enterprises Italy S.r.l	Italy	100%
Magic Software Japan K.K.	Japan	100%
Magic Software Enterprises India Pvt. Ltd.	India	100%
Onyx Magyarorszag Szsoftverhaz	Hungary	100%
CarPro Systems Ltd.	Israel	90.48%
Nextstep Infotech Prt. Ltd.	India	40%

D. Property, Plants and Equipment

Facilities

Our headquarters and principal administrative, finance, sales, marketing and research and development operations are located in an office building of approximately 39,321 square feet that we own in Or Yehuda, Israel, a suburb of Tel Aviv. The building was constructed on a parcel of land leased from the Israel Land Authority. The lease expires in 2040 and can be renewed for an additional period of 49 years.

Our Hungarian subsidiary owns a 4,850 square foot office facility in Budapest, Hungary.

Our U.S. subsidiaries lease approximately 12,796 square feet of office space in Laguna Hills, California; and King of Prussia, Pennsylvania. In addition, our subsidiaries also lease office spaces in Paris, France; Munich, Germany; Pune, India; Bangalore, India; Tokyo, Japan; Houten, the Netherlands; and Bracknell, United Kingdom. The aggregate annual cost for such facilities was $1,401,000 in the year ended December 31, 2007.

In the year ended December 31, 2007, we invested approximately $0.8 million in capital assets, mainly in computers and peripheral equipment.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. Results of Operations

The following discussion of our results of operations should be read together with our consolidated financial statements and the related notes, which appear elsewhere in this annual report. The following discussion contains forward-looking statements that reflect our current plans, estimates and beliefs and involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include those discussed below and elsewhere in this annual report.

Background

We develop, market and support software development, deployment and integration technologies and business solutions that enable enterprises to accelerate the process of building and deploying applications that can be rapidly customized and integrated with existing systems. We were incorporated under the laws of Israel in February 1983. We have 17 wholly-owned subsidiaries and one controlled subsidiary, incorporated in the United States, Europe, Asia and Israel. Our subsidiaries are engaged in developing, marketing and supporting vertical applications, as well as in selling and supporting our products. One of our subsidiaries provides software consulting services. Our ordinary shares are traded on the NASDAQ Global Market under the symbol MGIC and on the Tel Aviv Stock Exchange.

Overview

We develop, market and support our software development and deployment technology called eDeveloper, and technology for business integration and process management called iBOLT. Our technology enables enterprises to accelerate the process of building, deploying and integrating business software applications that can be rapidly customized to meet current and future needs. Our technology and applications based on our technology are used by software solution providers and thousands of enterprises in approximately 100 countries. We refer to these vendors and enterprises as the Magic Software Partners. We also provide maintenance and technical support as well as professional services to the Magic Software Partners.

We began operations in 1986 and completed an initial public offering of our ordinary shares in the United States in August 1991. In the first quarter of 2000, we completed a follow-on offering of 4,000,000 of our ordinary shares in the United States at $25.00 per share. Of these shares, 3,500,000 ordinary shares were offered by us and 500,000 ordinary shares were offered by our major shareholder, Formula Group (1985) Ltd. Our net proceeds from the offering, after deducting the underwriting discount and expenses, were $79.6 million. We paid a one-time cash dividend of approximately $11.8 million in February 2003.

General

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. All references in this annual report to dollars or $ are to U.S. dollars and all references in this annual report to NIS are to New Israeli Shekels. Transactions and balances originally denominated in dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into dollars in accordance with the principles set forth in Financial Accounting Standards Board Statement No. 52. The majority of our sales are made outside Israel and a substantial part of them are in dollars. In addition, substantial portions of our costs are incurred in dollars. Since the dollar is the primary currency of the economic environment in which we and certain of our subsidiaries operate, the dollar is our functional and reporting currency and, accordingly, monetary accounts maintained in currencies other than the dollar are remeasured using the foreign exchange rate at the balance sheet date. Operational accounts and non monetary balance sheet accounts are measured and recorded at the exchange rate in effect at the date of the transaction. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Statement of operations amounts have been translated using the average exchange rate for the period. The resulting translation adjustments are reported as a component of shareholders equity in accumulated other comprehensive income (loss).

Discussion of Critical Accounting Policies and Estimations

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

Revenue Recognition

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

We account for software sales in accordance with Statement of Position, or SOP, No. 97-2, Software Revenue Recognition, as amended by Statement of Position 98-9, Modifications of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions, or SOP No. 97-2. Revenue is recognized when the following four criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the fee is fixed or determinable; and (iv) collectibility is probable.

SOP No. 97-2 generally requires revenue earned from software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements determined by the vendor s specific objective evidence, or VSOE, of fair value. Revenue is recognized under the residual method when VSOE of fair value exists for all undelivered elements and VSOE of fair value does not exist for all of the delivered elements, and when all SOP No. 97-2 criteria for revenue recognition are met, as described above. The VSOE of fair value of the undelivered elements included in multiple element arrangement (maintenance, support and services) is determined based on the price charged for the undelivered element when sold separately.

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

Maintenance and technical support revenue is deferred and recognized on a straight-line basis over the term of the maintenance and support agreement. Revenue from consulting services consists of billable hours for services provided, and is recognized as the services are rendered.

Arrangements that include consulting services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangement. When services are considered essential, revenue under the arrangement is recognized using contract accounting based on Statement of Position No. 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, or SOP 81-1, on a percentage of completion method based on input measures. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are first determined, in the amount of the estimated loss for the entire contract. As of December 31, 2007, no such estimated losses were identified.

When consulting services are not considered essential, the revenue allocable to the consulting services is recognized as the services are performed. In most cases to date, we have determined that the services are not considered essential to the functionality of other elements of the arrangement.

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

Capitalization of Software development costs

Certain software development costs are capitalized subsequent to the establishment of technological feasibility in accordance with Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standard, or SFAS, No. 86 Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed. Based on our product development process and that of our subsidiaries, technological feasibility is established upon completion of a detailed program design and a working model.

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

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

Capitalized software costs are amortized by the greater of the amount computed using the: (i) ratio that current gross revenues from sales of the software to the total of current and anticipated future gross revenues from sales of that software, or (ii) the straight-line method over the estimated useful life of the product (three to five years). We assess the recoverability of this intangible asset on a regular basis by determining whether the amortization of the asset over its remaining life can be recovered through undiscounted future operating cash flows from the specific software product sold. As of December 31, 2005, 2006 and 2007, no impairment losses have been identified.

Goodwill

Goodwill and intangible assets with an identifiable useful life are no longer amortized but are subject to annual impairment tests based on estimated fair value in accordance with SFAS No. 142 Goodwill and Other Intangible Assets, or SFAS No. 142. We conduct our annual test of impairment for goodwill in December of each year. In addition we test for impairment periodically whenever events or circumstances occur subsequent to our annual impairment tests that indicate that the asset might be impaired. Indicators we consider important which could trigger an impairment include, but are not limited to, significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of acquired assets or the strategy for our overall business, significant negative industry or economic trends, a significant decline in our stock price for a sustained period and our market capitalization relative to net book value.

As of December 31, 2007, we had two reporting units. Goodwill attributable to each of the reporting unit is measured separately. The first step of the goodwill impairment test compares the carrying value of each reporting unit with its fair value on that date. Since the fair value of the reporting units exceeded their carrying amount, no impairment was identified in 2005, 2006 and 2007.

Other Intangible Assets

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

Impairment of long-lived assets

We review our long-lived assets for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, or SFAS No. 144, whenever a sale event or change in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying value of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the fair value of the assets. In 2006 we identified impairment (see Note 1 (e) inour Financial Statements). As of December 31, 2007 and 2005, no impairment indicators have been identified.

Marketable Securities

We account for investments in marketable securities in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, or SFAS No. 115. Our management determines the appropriate classification of its investments in marketable debt securities at the time of purchase and reevaluates such determinations at each balance sheet date. Debt securities are classified as available for sale and reported at fair value.

Debt securities that are designated as available-for-sale are stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income (loss), a separate component of shareholders equity. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in financial income, net. No impairment has been identified as of December 31, 2007.

FASB Staff Position (FSP) No. 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investment (FSP 115-1) and SAB Topic 5M Other Than Temporary Impairment Of Certain Investments In Debt And Equity Securities provides guidance for determining when an investment is considered impaired, whether impairment is other-than temporary, and measurement of an impairment loss. An investment is considered impaired if the fair value of the investment is less than its carrying amount. If, after consideration of all available evidence to evaluate the realizable value of its investment, impairment is determined to be other than- temporary, then an impairment loss should be recognized equal to the difference between the investment s carrying amount and its fair value. FSP 115-1 nullifies certain provisions of Emerging Issues Task Force (EITF) Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (EITF 03-1) while retaining the disclosure requirements of EITF 03-1 which we adopted in 2003. No other temporary loss has been recognized as of December 31, 2007.

Stock-based compensation

FASB SFAS No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123(R), requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in our consolidated income statement. Prior to the adoption of SFAS 123(R), we accounted for equity-based awards to employees and directors using the intrinsic value method in accordance with Accounting Principles Board No. 25, or APB 25, as allowed under SFAS No. 123, *Accounting for Stock-Based Compensation.*

We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard starting from January 1, 2006, the first day of our fiscal year 2006. Under the transition method, since all the unvested options had been accelerated prior to the adoption of SFAS 123(R) (see Note 12 to the consolidated financial statements), compensation cost recognized in the year ended December 31, 2007 includes compensation cost for all share-based payments granted subsequent to January 1, 2007, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). Results for prior periods have not been restated.

We recognize compensation expenses for the value of our awards, which have graded vesting based on the straight line method over the requisite service period of each of the awards, net of estimated forfeitures. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

We used the Black-Scholes option-pricing model through December 31, 2006 and the Cox, Ross and Rubinstein s Binomial model for options granted thereafter.

Discontinued Operation

We recorded the results of the sale of AAOD and the liquidation of one of our subsidiaries as discontinued operation, according to Exhibit 03-13A of EITF 03-13, which applies to FAS 144 par. 42, or the Exhibit. The Exhibit generally requires that in order to record the disposal s group results as a discontinued operation, the disposal group must meet all of the following criteria:

1. The activity needs to be qualified as a component of an entity .

2. The results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations if both of the following conditions are met:

   a. The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction

   b. The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

According to Exhibit 03-13A of EITF 03-13 the above mentioned activities are classified as a discontinued operation for all presented periods.

Accounting for income tax

On January 1, 2007, we adopted FIN 48, Accounting for Uncertainty in Income Taxes, which contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with Statement 109, Accounting for Income Taxes. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. Prior to January 1, 2007, we estimated our uncertain income tax obligations in accordance with SFAS No. 109, Accounting for Income Taxes (SFAS No. 109) and SFAS No. 5 Accounting for Contingencies (SFAS No. 5).

We recognize accrued interest related to unrecognized tax benefits in tax expense. Accounting for tax positions requires judgments, including estimating reserves for potential uncertainties. We also assess our ability to utilize tax attributes, including those in the form of carry forwards, for which the benefits have already been reflected in the financial statements. We do not record valuation allowances for deferred tax assets that we believe are more likely than not to be realized in future periods. While we believe the resulting tax balances as of December 31, 2007 and 2006 are appropriately accounted for in accordance with FIN 48, SFAS No. 5 and SFAS No. 109 as applicable, the ultimate outcome of such matters could result in favorable or unfavorable adjustments to our consolidated financial statements and such adjustments could be material. See Note 11 to Consolidated Financial Statements for further information regarding income taxes. We have filed or are in the process of filing local and foreign tax returns that are subject to audit by the respective tax authorities. The amount of income tax we pay is subject to ongoing audits by the tax authorities, which often result in proposed assessments. Our estimate of the potential outcome for any uncertain tax issue is highly judgmental. We believe that we adequately provided for any reasonably foreseeable outcomes related to tax audits and settlement. However, our future results may include favorable or unfavorable adjustments to our estimated tax liabilities in the period the assessments are made or resolved, audits are closed or when statutes of limitation on potential assessments expire. As a result of the adoption of FIN 48, we recorded a change of $530,000 in our shareholder s equity and a change of $50,000 in our tax expenses.

Interest associated with uncertain income tax positions and penalties expense are classified as income tax expenses. We have not recorded any material interest or penalties during the years 2005, 2006 and 2007.

Significant Expenses

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

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

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

	Year ended December 31		
	2005	**2006**	**2007**
	(U.S. dollars in thousands)		
Gross research and development costs	$ 6,322	$ 5,944	$ 5,743
Less capitalization of software development costs	(3,909)	(3,482)	(3,027)
Research and development expenses, net	$ 2,413	$ 2,462	$ 2,716

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

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

Financial income (expenses), net. Net financial income (expenses) consists primarily of interest earned on cash equivalents and marketable securities, interested paid on loans received and currency translation adjustments.

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

	Year ended December 31		
	2005	**2006**	**2007**
	(U.S. dollars in thousands, except share and per share data)		
Revenues:			
Software	$ 21,503	$ 18,788	$ 17,707
Maintenance and technical support	11,238	11,531	12,605
Consulting services	19,095	22,252	28,116
Total revenues	51,836	52,571	58,428
Cost of revenues:			
Software	6,965	5,433	4,558
Maintenance and technical support	2,179	2,873	1,602
Consulting services	14,123	16,862	21,181
Total cost of revenues	23,267	25,168	27,340
Gross profit	28,569	27,403	31,088
Operating expenses:			

Research and development, net	2,413	2,462	2,716
Sales and marketing, net	17,197	15,712	15,558
General and administrative	14,510	13,784	11,532
Restructuring and impairment expenses	-	2,157	-
Total operating expenses	$ 34,120	34,115	29,806
Operating income (loss)	(5,551)	(6,712)	1,282
Financial income (expenses), net	(809)	332	161
Other income	-	278	170
Income (loss) before taxes on income	(6,360)	(6,102)	1,613
Income taxes	462	310	362
Income (loss) after taxes on income	(6,822)	(6,412)	1,251
Equity in earnings (losses) of affiliates	19	15	(86)
Minority interest in losses (earnings) of consolidated subsidiaries	(8)	71	(22)
Net income (loss) before discontinued operation	$ (6,811)	$ (6,326)	$ 1,143
Net income from discontinued operation	2,204	1,320	11,465
Net income (loss) after discontinued operation	(4,607)	(5,006)	12,608
Basic earnings (loss) per share	$ (0.15)	$ (0.16)	$ 0.40
Diluted earnings (loss) per share	$ (0.15)	$ (0.16)	$ 0.39
Shares used to compute basic earnings (loss) per share	31,124	31,184	31,443
Shares used to compute diluted earnings (loss) per share	31,124	31,184	32,023

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

	Year ended December 31,		
	2005	2006	2007
Revenues:			
Software	41.5%	35.7%	30.3%
Maintenance and technical support	21.7	21.9	21.6
Consulting services	36.8	42.4	48.1
Total revenues	100.0%	100.0%	100.0%
Cost of revenues:			
Software	13.5	10.3	7.8
Maintenance and technical support	4.2	5.5	2.7
Consulting services	27.2	32.1	36.3
Total cost of revenues	44.9	47.9	46.8
Gross profit	55.1	52.1	53.2
Operating expenses:			
Research and development, net	4.6	4.7	4.7
Selling and marketing, net	33.2	29.9	26.6
General and administrative	28.0	26.2	19.7
Restructuring and impairment expenses	-	4.1	-
Total operating expenses	65.8	64.9	51.0
Operating income (loss)	(10.7)	(12.8)	2.2
Other income (expenses)	-	0.5	0.3
Financial income (expenses), net	(1.6)	0.7	0.3
Income (loss) before taxes on income	(12.3)	(11.6)	2.8
Income taxes	0.8	0.6	0.6
Equity in earnings (losses) of affiliates	0.0	(0.0)	(0.2)
Minority interest in (earnings) losses of consolidated subsidiaries	0.0	0.2	0.0
Net income (loss) before discontinued operation	(13.1)	(12.0)	2.0
Net income from discontinued operation	4.2	2.5	19.6
Net income (loss) after discontinued operation	(8.9)	(9.5)	21.6

Year Ended December 31, 2007 Compared With Year Ended December 31, 2006

Revenues. Total revenues increased by 11% to $58.4 million in 2007 from $52.6 million in 2006. License revenues decreased by 5% to $15.0 million in 2007 from $15.8 million in 2006. Application revenues decreased by 7% to $2.7 million in 2007 from $2.9 million in 2006 primarily due to our efforts to decrease sales to third parties. Revenues from maintenance and technical support increased by 10% to $12.6 million in 2007 from $11.5 million in 2006.as a result of the broad maintenance and support services that we provide to our existing customers. Revenues from consulting and other services increased by 27% to $28.1 million in 2007 from $22.2 million in 2006, as a result of customers upgrading to eDeveloper V10 and due to the growth of our information technology consulting firm.

Cost of Revenues. Cost of revenues increased by 8% to $27.3 million in 2007 from $25.2 million in 2006. Cost of revenues for licenses decreased by 6% to $3.3 million in 2007 from $3.5 million in 2006 in line with the decrease in licenses sales. These costs includes the amortization of capitalized software development assets in the amount of $2.5 million in 2007 and $3.6 million in 2006. Cost of revenues for applications decreased by 32% to $1.3 million in 2007 from $1.9 million in 2006, primarily as a result of decrease in sales to third parties. Cost of revenues for maintenance and technical support decreased by 45% to $1.6 million in 2007 from $2.9 million in 2006 primarily due to cost saving following the implementation of our restructuring plan. Cost of revenues for consulting and other services increased by 25% to $21.2 million in 2007 from $16.9 million in 2006, consistent with the increase in consulting and other services revenues. We expect that our cost of revenues as a percentage of revenues will improve in 2008.

Gross Profit. Gross Profit in 2007 was 53.2% as compared with gross profit of 52.1% in 2006. The improvement in our gross profit was a result of the cost saving resulting from the implementation of our restructuring plan and from improved sales margins from professional services.

Research and Development Expenses, Net. Total research and development expenses decreased by 3% to $5.7 million in 2007 from $5.9 million in 2006. Net research and development expenses increased by 8% to $2.7 million in 2007 from $2.5 million in 2006. In 2007, we capitalized $3.0 million of software development costs, as compared to $3.5 million in 2006. The decrease in total research and development expenses in 2007 was due to a decrease in the number of employees in our research and development department. Net research a