BLUEFLY INC
Form 10-K
March 03, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2004

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______

Commission File Number: 001-14498

BLUEFLY, INC.
(Name of registrant as specified in its charter)

Delaware	13-3612110
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
42 West 39th Street, New York, NY	10018
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number: (212) 944-8000

Securities registered under Section 12(b) of the Exchange Act: Common Stock, par value $.01 per share

Securities registered under Section 12(g) of the Exchange Act: Common Stock, par value $.01 per share

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark whether disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained in this form, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K [ ]

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

As of February 24, 2005, there were 15,329,097 shares of Common Stock, $.01 par value, of the registrant outstanding. The aggregate market value of the voting and non-voting common equity held by non-affiliates as of June 30, 2004, based upon the last sale price of such equity reported on the National Associated of

Securities Dealers Automated Quotation SmallCap Market, was approximately $9,933,000.

PART I

ITEM 1. DESCRIPTION OF BUSINESS

GENERAL

Bluefly, Inc. is a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home products at discounts up to 75% off retail value. During 2004, we offered over 27,000 different styles for sale in categories such as men's, women's and accessories as well as house and home accessories. We launched the Bluefly.com Web site (the "Web site") in September 1998. Since its inception, www.bluefly.com has served over 640,000 customers and shipped to over 20 countries.

Our common stock is listed on the Nasdaq SmallCap Market under the symbol "BFLY" and on the Boston Stock Exchange under the symbol "BFL" and we are incorporated in Delaware. Our executive offices are located at 42 West 39th Street, New York, New York 10018, and our telephone number is (212) 944-8000. Our Internet address is www.bluefly.com. We make available, free of charge, through our Web site, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

In this report, the terms "we," "us," "Bluefly" and the "Company" refer to Bluefly, Inc. and its predecessors and subsidiaries, unless the context indicates otherwise.

RECENT DEVELOPMENTS

In February 2005, we extended the maturity dates on the Convertible Promissory Notes issued to affiliates of Soros Private Equity Partners, LLC (collectively, "Soros") that collectively own a majority of our capital stock in July and October 2003 (the "Notes"). The maturity dates of the Notes were each extended for one year, from May 1, 2005 to May 1, 2006. Also in February 2005, we renewed our credit facility (the "Loan Facility") with Rosenthal & Rosenthal, Inc. ("Rosenthal") for an additional year, from March 30, 2005 to March 30, 2006.

BUSINESS STRATEGY

Our goal is to offer our customers the best designer brands, hottest fashion trends and superior values. We strive to offer the same types of on trend and in-season designer merchandise as are sold in luxury department stores such as Saks Fifth Avenue and Bergdorf Goodman at discounts normally found only at outlet stores and off-price stores such as T.J. Maxx and Ross Stores. We are able to acquire our products at significantly lower prices than a luxury department store (and pass these discounts on to our customers) because we purchase our inventory slightly later in the season than a typical full price retailer, at a time when vendors consider it to be excess inventory. Similarly, we are able to offer an upscale shopping experience not available at off-price stores or outlet malls because of our merchandise selection and the presentation and product search capabilities offered by our Web site.

Our business is also designed to provide a compelling value proposition for our suppliers and, in particular, the more than 350 top designer brands that we offer on our Web site. We recognize that liquidating excess inventory can be a "necessary evil" and that brand dilution can occur when a brand's product is offered in a traditional discount environment. We would like to make the liquidation of excess inventory a positive experience for our vendors rather than a distasteful one. We intend to do this by treating our suppliers with honesty and respect and by creating a high-end retail environment that offers only the best designer brands and the most current trends. In doing so, we hope to support our vendors' brands, rather than diluting them as traditional off-price channels do.

We do not believe that we can accomplish these goals without using the Internet as a platform. The direct marketing of products that are available in limited quantities and sizes, and that are not replenishable, requires a cost-effective medium that can display a large number of products, many of which are in limited supply, and some of which are neither available in all sizes nor easily replenished. We believe print catalogs are not well suited to this task. The paper, printing, mailing and other production costs of a print catalog can be significant and the lead times required to print a catalog make them significantly inflexible in addressing inventory sell outs, price changes and new styles. To work around these limitations, a traditional cataloger typically requires products that are replenishable, available in a full range of sizes and in substantial quantities. Similarly, retailing on television is costly and requires substantial quantities of products that are available in all sizes in order

for it to be an economical medium. In addition, the number of items that can be displayed on television is limited, and television does not allow viewers to search for products that interest them.

The Internet, however, can be a far less expensive and far more effective medium. By using the Internet as our platform, the number of items that we offer is not limited by the high costs of printing and mailing catalogs. With the Internet, we can automatically update product images as new products arrive and other items sell out. By using a real-time inventory database, we can create a personalized shopping environment and allow our customers to search for the products that specifically interest them and are available in their size. In addition, we believe that we are able to more economically and consistently maintain an upscale environment through the design of a single online storefront.

We believe that we have created a customer experience that is fundamentally better than that offered by traditional off-price retailers. Similarly, we believe that our upscale atmosphere, professional photography and premium merchandise offering create a superior distribution channel for designers who wish to liquidate their end-of-season and excess merchandise without suffering the brand dilution inherent in traditional off-price channels.

E-COMMERCE AND THE ONLINE APPAREL MARKET

The dramatic growth of e-commerce has been widely reported and is expected to continue. According to the ComScore Networks, online sales grew in 2004 by 26% over the $93.2 billion spent in 2003. During the holiday shopping season alone, consumers spent $23.6 billion, a 28% increase over the $18.3 billion spent in the previous year, according to ComScore. We believe that a number of factors will contribute to the growth of e-commerce, including (i) shoppers' growing familiarity and comfort with shopping online, (ii) the proliferation of devices to access the Internet, and (iii) technological advances that make navigating the Internet faster and easier.

Forrester Research predicts that online sales of apparel will top $13.8 billion in 2004, which makes it the single largest category of merchandise sold online.

According to Forrester, 12% of all apparel sales will be made online by 2010, up from 7% in 2004. We believe that the market for online sales of apparel is growing faster than many other retail categories as a result of a confluence of trends, including (i) the growth of the number of women online, who account for a larger share of retail apparel purchases, (ii) the expansion of online traffic from technology oriented users to users with mainstream demographic, (iii) the development of sophisticated tools to search complex product categories such as apparel and (iv) the growing adoption of high speed access of cable modems and DSL, which makes viewing large numbers of photos much faster. Of course, there can be no assurance that such expectations will prove to be correct or that they will have a positive effect on our business.

MARKETING

Our marketing efforts are focused both on acquiring new customers and retaining existing customers. During the past several years, we have acquired new customers primarily through online advertising, word-of-mouth, sweepstakes and our affiliate program. Although we have not allocated significant resources to branding or to more traditional advertising channels such as print during this time, we may begin to do so as we seek to more aggressively promote the growth of our business. A significant portion of our sales to existing customers are driven by our customer emails, which highlight new promotions and products and provide special previews to customers who have asked to be included in our email list. In addition, we believe that our sales to existing customers are driven by all aspects of our customer experience, including our Web site design, packaging, delivery and customer service.

MERCHANDISING

We buy merchandise directly from designers as well as from retailers and other third party, indirect resources. Currently, we offer products from more than 350 name brand designers, which we believe to be the widest selection of designers available from any online store. We have established direct supply relationships with over 200 such designers. We believe that we have been successful in opening up over 200 direct supply relationships, in part because we have devoted substantial resources to establishing Bluefly.com as a high-end retail environment. We are committed to displaying all of our merchandise in an attractive manner, offering superior customer service and gearing all aspects of our business towards creating a better channel for top designers.

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During 2004, we re-focused our merchandising strategy to offer more in-season merchandise and to cover the latest trends, while continuing to offer a premium selection of brands. As a result of this merchandise strategy, we were able to increase our gross margins to their highest levels ever - 37.5%, from 29.9%, 32.8% and 30.5% in 2003, 2002 and 2001, respectively.

WAREHOUSING AND FULFILLMENT

When we receive an order, the information is transmitted to our third party warehouse and fulfillment center located in Virginia, where the items included in the order are picked, packed and shipped directly to the customer. Our inventory database is updated on a real-time basis, allowing us to display on our Web site only those styles, sizes and colors of product available for sale.

We focus on customer satisfaction throughout our organization. In December 2004, during our peak weeks of the holiday season, the vast majority of our orders were shipped within one business day from receipt of the customer's order.

CUSTOMER SERVICE

We believe that a high level of customer service and support is critical to differentiating ourselves from traditional off-price retailers and maximizing customer acquisition and retention efforts. Our customer service effort starts with our Web site, which is designed to provide an intuitive shopping experience. An easy to use help center is available on the Web site and is designed to answer many of our customers' most frequently asked questions. For customers who prefer e-mail or telephone assistance, customer service representatives are available seven days a week to provide assistance. We utilize customer representatives from a third party call center that has a team dedicated to our business. We also maintain a team of premiere representatives in our New York office, who provide special services and assist in the training and management of the other representatives. To insure that customers are satisfied with their shopping experience, we generally allow returns for any reason within 90 days of the sale for a full refund.

TECHNOLOGY

We have implemented a broad array of state-of-the-art technologies that facilitate Web site management, complex database search functionality, customer interaction and personalization, transaction processing, fulfillment and customer service functionality. Such technologies include a combination of proprietary technology and commercially available, licensed technology. To address the critical issues of privacy and security on the Internet, we incorporate, for transmission of confidential personal information between customers and our Web server, Secure Socket Layer Technology ("SSL") such that all data is transmitted via a 128-bit encrypted session. The computer and communications equipment on which our Web site is hosted are currently located at a single third party co-location facility in New Jersey. During the first half of 2005 we intend to move to a new co-location facility owned by a different third party located in New York.

COMPETITION

Electronic commerce generally, and, in particular, the online retail apparel and fashion accessories market, is a relatively new, dynamic, high-growth market. Our competition for online customers comes from a variety of sources, including existing land-based retailers such as Neiman Marcus, Saks Fifth Avenue, Bergdorf Goodman, The Gap, Nordstrom, and Macy's that are using the Internet to expand their channels of distribution, established Internet companies such as Amazon.com, Overstock.com and ebay.com and less established companies such as eLuxury and Yoox. In addition, our competition for customers comes from traditional direct marketers such as L.L. Bean, Lands' End, and J.Crew, designer brands that may attempt to sell their products directly to consumers through the Internet and land-based off-price retail stores, such as T.J. Maxx, Marshalls, Filene's Basement and Loehmanns, which may or may not use the Internet in the future to grow their customer base. Many of these competitors have longer operating histories, significantly greater resources, greater brand recognition and more firmly established supply relationships. Moreover, we expect additional competitors to emerge in the future.

We believe that the principal competitive factors in our market include: brand recognition, merchandise selection, price, convenience, customer service, order delivery performance and site features. Although we believe that we compare favorably with our competitors, we recognize that this market is relatively new and is evolving rapidly, and, accordingly, there can be no assurance that this will continue to be the case.

INTELLECTUAL PROPERTY

We rely on various intellectual property laws and contractual restrictions to protect our proprietary rights in services and technology, including confidentiality, invention assignment and nondisclosure agreements with employees and contractors. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our intellectual property without our authorization. In addition, we pursue the registration of our trademarks and service marks in the U.S. and internationally and the registration of our domain name and variations thereon. However, effective intellectual property protection may not be available in every country in which the services are made available online.

We rely on technologies that we license from third parties. These licenses may not continue to be available to us on commercially reasonable terms in the future. As a result, we may be required to obtain substitute technology of lower quality or at greater cost, which could materially adversely effect our business, financial condition, results of operations and cash flows.

We do not believe that our business, sales policies or technologies infringe the proprietary rights of third parties. However, third parties have in the past and may in the future claim that our business, sales policies or technologies infringe their rights. We expect that participants in the e-commerce market will be increasingly subject to infringement claims as the number of services and competitors in the industry grows. Any such claim, with or without merit, could be time consuming, result in costly litigation or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements might not be available on terms acceptable to us, or at all. As a result, any such claim of infringement against us could have a material adverse effect upon our business, financial condition, results of operations and cash flows.

GOVERNMENTAL APPROVALS AND REGULATIONS

We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, and laws or regulations directly applicable to online commerce. We are not aware of any permits or licenses that are required in order for us, generally, to sell apparel and fashion accessories on the Internet, although licenses are sometimes required to sell products made from specific materials. In addition, permits or licenses may be required from international, federal, state or local governmental authorities to operate or to sell certain other products on the Internet in the future. No assurances can be given that we will be able to obtain such permits or licenses. We may be required to comply with future national and/or international legislation and statutes regarding conducting commerce on the Internet in all or specific countries throughout the world. No assurance can be made that we will be able to comply with such legislation or statutes. Our Internet operations are not currently impacted by federal, state, local and foreign environmental protection laws and regulations.

EMPLOYEES

As of February 18, 2005, we had 73 full-time employees and 4 part-time employees, as compared to 89 full-time and 3 part-time employees as of February 18, 2004. None of our employees are represented by a labor union and we consider our relations with our employees to be good.

RISK FACTORS

We Have A History Of Losses And Expect That Losses Will Continue In The Future. As of December 31, 2004, we had an accumulated deficit of $96,127,000. We incurred net losses of $3,791,000, $6,369,000 and $6,479,000 for the years ended December 31, 2004, 2003 and 2002, respectively. We have incurred substantial costs to develop our Web site and infrastructure. In order to expand our business, we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. We therefore expect to continue to incur substantial operating losses for the foreseeable future. Our ability to become profitable depends on our ability to generate and sustain substantially higher net sales while maintaining reasonable expense levels, both of which are uncertain. If we do achieve profitability, we cannot be certain that we would be able to sustain or increase profitability on a quarterly or annual basis in the future.

We Are Making A Substantial Investment In Our Business And May Need To Raise Additional Funds. We may need additional financing to effect our business plan and accelerate our customer acquisition. The environment for raising investment

capital has been difficult and there can be no assurance that additional financing or other capital will be available upon terms acceptable to us, or at all. In the event that we are unable to obtain additional financing, if needed, we could be forced to decrease expenses that we believe are necessary for us to realize on our long-term prospects for growth and profitability and/or liquidate inventory in order to generate cash. Moreover, any additional equity financing that we may raise could result in significant dilution of the existing holders of common stock. See "Risk Factors - Certain Events Could Result In Significant Dilution Of Your Ownership Of Common Stock."

Our Lenders Have Liens On Substantially All Of Our Assets And Could Foreclose In The Event That We Default Under Our Loan Facility. Under the terms of the Loan Facility, Rosenthal provides us with certain credit accommodations, including loans and advances, factor-to-factor guarantees, letters of credit in favor of suppliers or factors and purchases of payables owed to our suppliers. Pursuant to the Loan Facility, we gave a first priority lien to Rosenthal on substantially all of our assets, including our cash balances. If we default under the Loan Facility, Rosenthal would be entitled, among other things, to foreclose on our assets in order to satisfy our obligations under the Loan Facility.

Our Ability To Comply With Our Financial Covenants And Pay Our Indebtedness Under Our Loan Facility Is Dependent Upon Meeting Our Business Plan. We are required to pay interest under our Loan Facility on a monthly basis. In addition, we are required, under the facility, to maintain working capital of at least $6.0 million and net tangible worth of at least $7.0 million as of the end of each fiscal year. Assuming we meet our business plan, we will satisfy these covenants. To a certain extent, however, our ability to meet our business plan, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control, and therefore we cannot assure you that based on our business plan we will generate sufficient cash flow from operations to enable us to pay our indebtedness under the Loan Facility and maintain compliance with our net working capital covenant throughout the term of the agreement or that we will be able to maintain compliance with the net worth covenant. If we fall short of our business plan and are unable to raise additional capital, we could default under our Loan Facility. In the event of a default under the Loan Facility, Rosenthal would be entitled, among other things, to foreclose on our assets (whether inside or outside a bankruptcy proceeding) in order to satisfy our obligations under the Loan Facility. See "Risk Factors - Our Lenders Have Liens On Substantially All Of Our Assets And Could Foreclose In The Event That We Default Under Our Loan Facility."

Certain Events Could Result In Significant Dilution Of Your Ownership Of Our Common Stock. Stockholders could be subject to significant dilution to the extent that we raise additional equity financing, as a result of both the issuance of additional equity securities, the potential conversion of the convertible promissory notes described below and the anti-dilution provisions of our Series B, C, D and E preferred stock described below, which provide for the issuance of additional securities to the holders thereof, under certain circumstances, to the extent that the Preferred Stock is converted at any time after a sale of Common Stock at less than $0.76 per share.

Moreover, as of February 18, 2005, there were outstanding options to purchase 8,750,680 shares of our Common Stock issued under our Stock Option Plans, warrants to purchase 981,644 shares of our Common Stock issued to Soros, and additional warrants and options to purchase 723,301 shares of our Common Stock. In addition, as of such date, our outstanding Preferred Stock was convertible into an aggregate of 43,323,430 shares of our Common Stock (plus any shares of our Common Stock issued upon conversion in payment of any accrued and unpaid dividends). The exercise of our outstanding options and warrants and/or the conversion of our outstanding Preferred Stock would dilute the then existing stockholders' percentage ownership of our common stock, and any sales in the public market of our Common Stock underlying such securities, could adversely affect prevailing market price of our Common Stock. In the event that all of the securities described above were converted to Common Stock, the holders of the Common Stock immediately prior to such conversion would own approximately 22% of the outstanding Common Stock immediately after such conversion, excluding the effect of accrued dividends on Preferred Stock.

As described above, our Series B, C, D and E Preferred Stock contain anti-dilution provisions pursuant to which, subject to certain exceptions, in the event that we issue or sell our Common Stock or new securities convertible into our Common Stock in the future for less than $0.76 per share, the number of shares of our Common Stock to be issued upon the conversion of such Preferred Stock would be increased to a number equal to the face amount of such Preferred Stock divided by the price at which such Common Stock or other new securities are sold.

In addition, Soros owns $4 million of convertible promissory notes issued by us that bear interest at the rate of 12% per annum and are convertible, at Soros' option, into our equity securities sold in any subsequent round of financing at a price that is equal

to the lowest price per share accepted by any investor (including Soros or any of its affiliates) in such subsequent round of financing.

Soros Owns A Majority Of Our Stock And Therefore Effectively Controls Our Management And Policies. As of February 18, 2005, through its holdings of our common stock, as well as our preferred stock, and warrants convertible into our common stock, Soros beneficially owned, in the aggregate, approximately 84% of our common stock. The holders of our preferred stock vote on an "as converted" basis with the holders of our common stock. By virtue of its ownership of our preferred stock, Soros has the right to appoint two designees to our Board of Directors, each of whom has seven votes on any matter voted upon by our Board of Directors. Collectively, these two designees have 14 out of 19 possible votes on each matter voted upon by our Board of Directors. In addition, we are required to obtain the approval of holders of our preferred stock prior to taking certain actions. The holders of our preferred stock have certain pre-emptive rights to participate in future equity financings and certain anti-dilution rights that could result in the issuance of additional securities to such holders. In view of their large percentage of ownership and rights as the holders of our preferred stock, Soros effectively controls our management and policies, such as the election of our directors, the appointment of new management and the approval of any other action requiring the approval of our stockholders, including any amendments to our certificate of incorporation, a sale of all or substantially all of our assets or a merger. In addition, Soros has demand registration rights with respect to the shares of our common stock that it beneficially owns. Any decision by Soros to exercise such registration rights and to sell a significant amount of our shares in the public market could have an adverse effect on the price of our common stock. See "Risk Factors - Certain Events Could Result In Significant Dilution of Your Ownership Of Common Stock."

If We Are Not Accurate In Forecasting Our Revenues, We May Be Unable To Adjust Our Operating Plans In A Timely Manner. Because our business has not yet reached a mature stage, it is difficult for us to forecast our revenues accurately. We base our current and future expense levels and operating plans on expected revenues, but in the short term a significant portion of our expenses are fixed. Accordingly, we may be unable to adjust our spending in a timely manner to compensate for any unexpected revenue shortfall. This inability could cause our operating results in some future quarter to fall below the expectations of securities analysts and investors. In that event, the trading price of our common stock could decline significantly. In addition any such unexpected revenue shortfall could significantly affect our short-term cash flow and our net worth, which could require us to seek additional financing and/or cause a default under our credit facility. See "Risk Factors - We Are Making A Substantial Investment In Our Business And May Need To Raise Additional Funds" and "Risk Factors -Our Ability To Comply With Our Financial Covenants And Pay Our Indebtedness Under Our Loan Facility Is Dependent Upon Meeting Our Business Plan."

Unexpected Changes In Fashion Trends Could Cause Us To Have Either Excess or Insufficient Inventory. Fashion trends can change rapidly, and our business is sensitive to such changes. There can be no assurance that we will accurately anticipate shifts in fashion trends and adjust our merchandise mix to appeal to changing consumer tastes in a timely manner. If we misjudge the market for our products or are unsuccessful in responding to changes in fashion trends or in market demand, we could experience insufficient or excess inventory levels or higher markdowns, either of which would have a material adverse effect on our business, financial condition and results of operations.

We Will Be Subject To Cyclical Variations In The Apparel And E-Commerce Markets. The apparel industry historically has been subject to substantial cyclical variations. Furthermore, Internet usage slows down in the summer months. We and other apparel vendors rely on the expenditure of discretionary income for most, if not all, sales. In the first three quarters of 2003, the retail apparel market experienced sluggish growth, requiring many retailers to significantly reduce prices and discount merchandise. We lowered our prices during the first quarter of 2003, in part, as the result of this sluggish growth, and maintained lower pricing levels in the second and third quarters of 2003 in order to generate cash from excess out-of-season inventory. While the retail apparel market improved modestly during the fourth quarter of 2003 and the 2004 calendar year, any future decrease in growth rates or downturn, whether real or perceived, in economic conditions or prospects could adversely affect consumer spending habits and, therefore, have a material adverse effect on our revenue, cash flow and results of operations. Alternatively, any improvement, whether real or perceived, in economic conditions or prospects could adversely impact our ability to acquire merchandise and, therefore, have a material adverse effect on our business, prospects, financial condition and results of operations, as our supply of merchandise is dependent on the inability of designers and retailers to sell their merchandise in full-price venues. See "Risk Factors - We Do Not Have Long Term Contracts With The Majority Of Our Vendors And Therefore The Availability of Merchandise Is At Risk."

We Purchase Product From Some Indirect Supply Sources, Which Increases Our Risk of Litigation Involving The Sale Of Non-Authentic Or Damaged Goods. We purchase merchandise both directly from brand owners and indirectly from retailers and third party distributors. The purchase of merchandise from parties other than the brand owners increases the risk that we will mistakenly purchase and sell non-authentic or damaged goods, which could result in potential liability under applicable laws, regulations, agreements and orders. Moreover, any claims by a brand owner, with or without merit, could be time consuming, result in costly litigation, generate bad publicity for us, and have a material adverse impact on our business, prospects, financial condition and results of operations.

If Our Co-Location Facility, Third Party Distribution Center Or Third Party Call Center Fails, Our Business Could Be Interrupted For A Significant Period Of Time. Our ability to receive and fulfill orders successfully and provide high-quality customer service, largely depends on the efficient and uninterrupted operation of our computer and communications hardware systems and fulfillment center. Substantially all of our computer and communications hardware is located at a single co-location facility owned by a third party in New Jersey, and during the first half of 2005, we intend to move to a new co-location facility owned by a different third party in New York. Primarily all of our inventory is held, and our customer orders are filled, at a third party distribution center located in Virginia, and a large majority of our customer service representatives are employees of a third party call center in Ohio. These operations are vulnerable to damage or interruption from fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, earthquake and similar events. We do not presently have redundant systems in multiple locations or a formal disaster recovery plan. Accordingly, a failure at one of these facilities could interrupt our business for a significant period of time, and our business interruption insurance may be insufficient to compensate us for losses that may occur. Any such interruption would negatively impact our sales, results of operations and cash flows for the period in which it occurred, and could have a long-term adverse effect on our relationships with our customers and suppliers.

Security Breaches To Our Systems And Database Could Cause Interruptions to Our Business And Impact Our Reputation With Customers, And We May Incur Significant Expenses to Protect Against Such Breaches. A fundamental requirement for online commerce and communications is the secure transmission of confidential information over public networks. There can be no assurance that advances in computer capabilities, new discoveries in the field of cryptography, or other events or developments will not result in a compromise or breach of the algorithms we use to protect customer transaction and personal data contained in our customer database. A party who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. If any such compromise of our security were to occur, it could have a material adverse effect on our reputation with customers, thereby affecting our long-term growth prospects. In addition, we may be required to expend significant capital and other resources to protect against such security breaches or to alleviate problems caused by such breaches.

Brand Owners Could Establish Procedures To Limit Our Ability To Purchase Products Indirectly. Brand owners have implemented, and are likely to continue to implement, procedures to limit or control off-price retailers' ability to purchase products indirectly. In addition, several brand owners in the U.S. have distinctive legal rights rendering them the only legal importer of their respective brands into the U.S. If we acquire such product indirectly from distributors and other third parties who may not have complied with applicable customs laws and regulations, such goods could be subject to seizure from our inventory by U.S. Customs Service, and the importer may have a civil action for damages against us. See "Risk Factors - We Do Not Have Long Term Contracts With The Majority of Our Vendors And Therefore The Availability Of Merchandise Is At Risk."

Our Growth May Place A Significant Strain On Our Management And Administrative Resources And Cause Disruptions In Our Business. Our historical growth has placed, and any further growth is likely to continue to place, a significant strain on our management and administrative resources. To be successful, we must continue to implement information management systems and improve our operating, administrative, financial and accounting systems and controls. We will also need to train new employees and maintain close coordination among our executive, accounting, finance, marketing, merchandising, operations and technology functions. Any failure to implement such systems and training, and to maintain such coordination, could affect our ability to plan for, and react quickly to, changes in our business and, accordingly, could cause an adverse impact on our cash flow and results of operations in the periods during which such changes occur. In addition, as our workforce grows, our exposure to potential employment liability issues increases, and we will need to continue to improve our human resources functions in order to protect against such increased exposure. Moreover, our business is dependent upon our ability to expand our third-party fulfillment operations, customer service operations, technology infrastructure, and inventory levels to accommodate increases in demand, particularly during the peak holiday selling season.

Our planned expansion efforts in these areas could cause disruptions in our business. Any failure to expand our third-party fulfillment operations, customer service operations, technology infrastructure or inventory levels at the pace needed to support customer demand could have a material adverse effect on our cash flow and results of operations during the period in which such failures occur and could have a long-term effect on our reputation with our customers.

We Are Heavily Dependent On Third-Party Relationships, And Failures By A Third Party Could Cause Interruptions To Our Business. We are heavily dependent upon our relationships with our fulfillment operations provider, third party call center and Web hosting provider, delivery companies like UPS and the United States Postal Service, and credit card processing companies such as Paymentech and Cybersource to service our customers' needs. To the extent that there is a slowdown in mail service or package delivery services, whether as a result of labor difficulties, terrorist activity or otherwise, our cash flow and results of operations would be negatively impacted during such slowdown, and the results of such slowdown could have a long-term negative effect on our reputation with our customers. The failure of our fulfillment operations provider, third party call center, credit card processors or Web hosting provider to properly perform their services for us could cause similar effects. Our business is also generally dependent upon our ability to obtain the services of other persons and entities necessary for the development and maintenance of our business. If we fail to obtain the services of any such person or entities upon which we are dependent on satisfactory terms, or we are unable to replace such relationship, we would have to expend additional resources to develop such capabilities ourselves, which could have a material adverse impact on our short-term cash flow and results of operations and our long-term prospects.

We Are In Competition With Companies Much Larger Than Ourselves. Electronic commerce generally and, in particular, the online retail apparel and fashion accessories market, is a new, dynamic, high-growth market and is rapidly changing and intensely competitive. Our competition for customers comes from a variety of sources including:

- existing land-based, full price retailers, such as Neiman Marcus, Saks Fifth Avenue, Bergdorf Goodman, Nordstrom, The Gap, and Macy's that are using the Internet to expand their channels of distribution;

- less established online companies, such as eLuxury and Yoox;

- internet sites such as Amazon.com, Overstock.com and ebay.com
- traditional direct marketers, such as L.L. Bean, Lands' End and J. Crew; and
- traditional off-price retail stores such as T.J. Maxx, Marshalls, Ross, Filene's Basement and Loehmanns, which may or may not use the Internet to grow their customer base.

We expect competition in our industry to intensify and believe that the list of our competitors will grow. Many of our competitors and potential competitors have longer operating histories, significantly greater resources, greater brand name recognition and more firmly established supply relationships. We believe that the principal competitive factors in our market include:

- brand recognition;
- merchandise selection;
- price;
- convenience;
- customer service;
- order delivery performance; and
- site features.

There can be no assurance that we will be able to compete successfully against competitors and future competitors, and competitive pressures faced by us could force us to increase expenses and/or decrease our prices at some point in the future.

We Do Not Have Long Term Contracts With Our Vendors And Therefore The Availability Of Merchandise Is At Risk. We have few agreements controlling the long-term availability of merchandise or the continuation of particular pricing

practices. Our contracts with suppliers typically do not restrict such suppliers from selling products to other buyers. There can be no assurance that our current suppliers will continue to sell products to us on current terms or that we will be able to establish new or otherwise extend current supply relationships to ensure product acquisitions in a timely and efficient manner and on acceptable commercial terms. Our ability to develop and maintain relationships with reputable suppliers and obtain high quality merchandise is critical to our success. If we are unable to develop and maintain relationships with suppliers that would allow us to obtain a sufficient amount and variety of quality merchandise on acceptable commercial terms, our ability to satisfy our customer's needs, and therefore our long-term growth prospects, would be materially adversely affected. See "Risk Factors - Brand Owners Could Establish Procedures to Limit Our Ability to Purchase Products Indirectly."

We Need To Further Establish Brand Name Recognition. We believe that further establishing, maintaining and enhancing our brand is a critical aspect of our efforts to attract and expand our online traffic. The number of Internet sites that offer competing services, many of which already have well established brands in online services or the retail apparel industry generally, increases the importance of establishing and maintaining brand name recognition. Promotion of Bluefly.com will depend largely on our success in providing a high quality online experience supported by a high level of customer service, which cannot be assured. In addition, to attract and retain online users, and to promote and maintain Bluefly.com in response to competitive pressures, we may find it necessary to increase substantially our advertising and marketing expenditures. If we are unable to provide high quality online services or customer support, or otherwise fail to promote and maintain Bluefly.com, or if we incur excessive expenses in an attempt to promote and maintain Bluefly.com, our long-term growth prospects, would be materially adversely affected.

There Can Be No Assurance That Our Technology Systems Will Be Able To Handle Increased Traffic; Implementation Of Changes To Web Site. A key element of our strategy is to generate a high volume of traffic on, and use of, Bluefly.com. Accordingly, the satisfactory performance, reliability and availability of Bluefly.com, transaction processing systems and network infrastructure are critical to our reputation and our ability to attract and retain customers, as well as maintain adequate customer service levels. Our revenues will depend on the number of visitors who shop on Bluefly.com and the volume of orders we can handle. Unavailability of our Web site or reduced order fulfillment performance would reduce the volume of goods sold and could also adversely affect consumer perception of our brand name. We may experience periodic system interruptions from time to time. If there is a substantial increase in the volume of traffic on Bluefly.com or the number of orders placed by customers, we will be required to expand and upgrade further our technology, transaction processing systems and network infrastructure. There can be no assurance that we will be able to accurately project the rate or timing of increases, if any, in the use of Bluefly.com or expand and upgrade our systems and infrastructure to accommodate such increases on a timely basis. In order to remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of Bluefly.com, which is particularly challenging given the rapid rate at which new technologies, customer preferences and expectations and industry standards and practices are evolving in the online commerce industry. Accordingly, we redesign and enhance various functions on our Web site on a regular basis, and we may experience instability and performance issues as a result of these changes. In addition, during the first half of 2005, we plan to move to a new co-location facility and in connection with the move will need to rebuild our systems with new hardware at the new co-location facility. This move may also result in short-term instability and performance issues, although in the long term we believe that it will provide us a more robust and stable environment.

We May Be Subject To Higher Return Rates. We recognize that purchases of apparel and fashion accessories over the Internet may be subject to higher return rates than traditional store bought merchandise. We have established a liberal return policy in order to accommodate our customers and overcome any hesitancy they may have with shopping via the Internet. If return rates are higher than expected, our business, prospects, financial condition, cash flows and results of operations could be materially adversely affected.

Our Success Is Largely Dependent Upon Our Executive Personnel. We believe our success will depend to a significant extent on the efforts and abilities of our executive personnel. In particular, we rely upon their strategic guidance, their relationships and credibility in the vendor and financial communities and their ability to recruit key operating personnel. The loss of the services of any of our executive officers could have a material adverse effect on our credibility in the vendor communities and our ability to recruit new key operating personnel.

Our Success Is Dependent Upon Our Ability To Attract New Key Personnel. Our operations will also depend to a great extent on our ability to attract new key personnel with relevant experience and retain existing key personnel in the future. The market for qualified personnel is extremely competitive. Our failure to attract additional qualified employees could have a material adverse effect on our prospects for long-term growth.

There Are Inherent Risks Involved In Expanding Our Operations. We may choose to expand our operations by developing new Web sites, promoting new or complementary products or sales formats, expanding the breadth and depth of products and services offered, expanding our market presence through relationships with third parties, adopting non-Internet based channels for distributing our products, or consummating acquisitions or investments. Expansion of our operations in this manner would require significant additional expenses and development, operations and editorial resources and would strain our management, financial and operational resources. For example, we have historically expended significant internal resources in connection with the redesign of our Web site and the implementation of our online strategic alliances. Moreover, in the event that we expand upon our efforts to open brick-and-mortar outlet stores, we will be required to devote significant internal resources and capital to such efforts. There can be no assurance that we would be able to expand our efforts and operations in a cost-effective or timely manner or that any such efforts would increase overall market acceptance. Furthermore, any new business or Web site that is not favorably received by consumer or trade customers could damage our reputation.

We May Be Liable For Infringing The Intellectual Property Rights Of Others. Third parties may assert infringement claims against us. From time to time in the ordinary course of business we have been, and we expect to continue to be, subject to claims alleging infringement of the trademarks and other intellectual property rights of third parties. These claims and any resulting litigation, if it occurs, could subject us to significant liability for damages. In addition, even if we prevail, litigation could be time-consuming and expensive and could result in the diversion of our time and attention. Any claims from third parties may also result in limitations on our ability to use the intellectual property subject to these claims unless we are able to enter into agreements with the third parties making these claims.

We May Be Liable for Product Liability Claims. We sell products manufactured by third parties, some of which may be defective. If any product that we sell were to cause physical injury or injury to property, the injured party or parties could bring claims against us as the retailer of the product. Our insurance coverage may not be adequate to cover every claim that could be asserted. If a successful claim were brought against the Company in excess of our insurance coverage, it could have a material adverse effect on our cash flow and on our reputation with customers. Unsuccessful claims could result in the expenditure of funds and management time and could have a negative impact on our business.

We Cannot Guarantee The Protection Of Our Intellectual Property. Our intellectual property is critical to our success, and we rely on trademark, copyright, domain names and trade secret protection to protect our proprietary rights. Third parties may infringe or misappropriate our trademarks or other proprietary rights, which could have a material adverse effect on our business, prospects, results of operations or financial condition. While we enter into confidentiality agreements with our employees, consultants and strategic partners and generally control access to and distribution of our proprietary information, the steps we have taken to protect our proprietary rights may not prevent misappropriation. We are pursuing registration of various trademarks, service marks and domain names in the United States and abroad. Effective trademark, copyright and trade secret protection may not be available in every country, and there can be no assurance that the United States or foreign jurisdictions will afford us any protection for our intellectual property. There also can be no assurance that any of our intellectual property rights will not be challenged, invalidated or circumvented. In addition, we do not know whether we will be able to defend our proprietary rights since the validity, enforceability and scope of protection of proprietary rights in Internet-related industries is uncertain and still evolving. Moreover, even to the extent that we are successful in defending our rights, we could incur substantial costs in doing so.

Our Business Could Be Harmed By Consumers' Concerns About The Security Of Transactions Over The Internet. Concerns over the security of transactions conducted on the Internet and commercial online services, the increase in identity theft and the privacy of users may also inhibit the growth of the Internet and commercial online services, especially as a means of conducting commercial transactions. Moreover, although we have developed systems and processes that are designed to protect consumer information and prevent fraudulent credit card transactions and other security breaches, failure to mitigate such fraud or breaches could have a material adverse effect on our business, prospects, financial condition and results of operations.

We Face Legal Uncertainties Relating To The Internet In General And To Our Industry In Particular And May Become Subject To Costly Government Regulation. We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, and laws or regulations directly applicable to

online commerce. However, it is possible that laws and regulations may be adopted that would apply to the Internet and other online services. Furthermore, the growth and development of the market for online commerce may prompt calls for more stringent consumer protection laws that may impose additional burdens on those companies conducting business online. The adoption of any additional laws or regulations may increase our cost of doing business and/or decrease the demand for our products and services and increase our cost of doing business.

The applicability to the Internet of existing laws in various jurisdictions governing issues such as property ownership, sales and other taxes, libel and personal privacy is uncertain and may take years to resolve. Any such new legislation or regulation, the application of laws and regulations from jurisdictions whose laws do not currently apply to our business, or the application of existing laws and regulations to the Internet and online commerce could also increase our cost of doing business. In addition, if we were alleged to have violated federal, state or foreign, civil or criminal law, we could face material liability and damage to our reputation and, even if we successfully defend any such claim, we incur significant costs in connection with such defense.

We Face Uncertainties Relating To Sales And Other Taxes. We are not currently required to pay sales or other similar taxes in respect of shipments of goods into states other than Virginia, Ohio, New Jersey and New York. However, one or more states may seek to impose sales tax collection obligations on out-of-state companies such as our company that engage in online commerce. In addition, any new operation in states outside Virginia, Ohio, New Jersey and New York could subject shipments into such states to state sales taxes under current or future laws. A successful assertion by one or more states or any foreign country that the sale of merchandise by us is subject to sales or other taxes, could subject us to material liabilities and, to the extent that we pass such costs on to our customers, could decrease our sales.

Change Of Control Covenant And Liquidation Preference Of Preferred Stock. We have agreed with Soros, that for so long as any shares of their Preferred Stock are outstanding, we will not take any action to approve or otherwise facilitate any merger, consolidation or change of control, unless provisions have been made for the holders of such Preferred Stock to receive from the acquirer an amount in cash equal to the respective aggregate liquidation preferences of such Preferred Stock. The aggregate liquidation preference of the Preferred Stock is equal to the greater of (i) approximately $49,100,000 (plus any accrued and unpaid dividends) and (ii) the amount that the holders of shares of Preferred Stock would receive if they were to convert such shares of Common Stock immediately prior to liquidation.

The Holders Of Our Common Stock May Be Adversely Affected By The Rights Of Holders Of Preferred Stock That May Be Issued In The Future. Our certificate of incorporation and by-laws, as amended, contain certain provisions that may delay, defer or prevent a takeover. Our Board of Directors has the authority to issue up to 15,486,250 additional shares of preferred stock, and to determine the price, rights, preferences and restrictions, including voting rights, of those shares, without any further vote or action by the stockholders. Accordingly, our Board of Directors is empowered, without approval of the holders of Common Stock, to issue preferred stock, for any reason and at any time, with such rates of dividends, redemption provisions, liquidation preferences, voting rights, conversion privileges and other characteristics as they may deem necessary. The rights of holders of Common Stock will be subject to, and may be adversely affected by, the rights of holders of any preferred stock that may be issued in the future.

We Rely On The Effectiveness Of Our Internal Controls. Section 404 of the Sarbanes-Oxley Act of 2002 requires that we establish and maintain an adequate internal control structure and procedures for financial reporting and assess on an on-going basis the design and operating effectiveness of our internal control structure and procedures for financial reporting. Our independent registered accounting firm will be required to audit both the design and operating effectiveness of our internal controls and management's assessment of the design and the effectiveness of its internal controls for the year ended December 31, 2005. It is possible that, in preparation for this audit, we could discover certain deficiencies in the design and/or operation of our internal controls that could adversely affect our ability to record, process, summarize and report financial data. We have invested and will continue to invest significant resources in this process. Because management's assessment of internal controls has not been required to be reported in the past, we are uncertain as to what impact a conclusion that deficiencies exist in our internal controls over financial reporting would have on the trading price of our common stock.

Forward-Looking Statements and Associated Risks. This Annual Report contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate, or imply future results, performance, or achievements, and may contain the words "believe," "anticipate," "expect," "estimate," "project," "will be," "will continue," "will likely result," or words or phrases of similar meaning. Forward-looking statements involve risks and

uncertainties that may cause actual results to differ materially from the forward-looking statements ("Cautionary Statements"). The risks and uncertainties include, but are not limited to those matters addressed herein under "Risk Factors." All subsequent written and oral forward-looking statements attributable to the Company or persons acting on the Company's behalf are expressly qualified in their entirety by the Cautionary Statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their dates. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

ITEM 2. PROPERTIES

We lease approximately 26,000 square feet of office space in New York City. The property is in good operating condition. The lease expires in 2010. Our total lease expense for the current office space during 2004 was approximately $442,000.

ITEM 3. LEGAL PROCEEDINGS

We currently, and from time to time, are involved in litigation incidental to the conduct of our business. However, we are not party to any lawsuit or proceeding which in the opinion of management is likely to have a material adverse effect on us.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

MARKET INFORMATION

The Company's common stock, par value $.01 per share ("Common Stock"), is quoted on The Nasdaq SmallCap Market and the Boston Stock Exchange. The following table sets forth the high and low bid prices for the Common Stock for the periods indicated, as reported by the Nasdaq SmallCap Market:

FISCAL 2004	HIGH	LOW
First Quarter	$ 4.93	$ 3.07
Second Quarter	$ 3.44	$ 1.92
Third Quarter	$ 2.30	$ 1.40
Fourth Quarter	$ 3.56	$ 1.75

FISCAL 2003	HIGH	LOW
First Quarter	$ 1.69	$ 0.67
Second Quarter	$ 1.60	$ 0.72
Third Quarter	$ 1.80	$ 0.76
Fourth Quarter	$ 5.96	$ 1.20

HOLDERS

As of February 18, 2005, there were approximately 109 holders of record of the Common Stock. We believe that there were more than 5,000 beneficial holders of the Common Stock as of such date.

DIVIDENDS

We have never declared or paid cash dividends on our Common Stock. We currently intend to retain any future earnings to finance future growth and, therefore, do not anticipate paying any cash dividends in the foreseeable future.

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

EQUITY COMPENSATION PLAN INFORMATION (AS OF DECEMBER 31, 2004)

PLAN CATEGORY	NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS(a)	WEIGHTED-AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS (b)	NUMBER REMAIN FUTURE EQUITY (EXCLU REFLEC (c)
Equity compensation plans approved by security holders	8,911,789	$ 2.35	
Equity compensation plans not approved by security holders	901,590	$ 1.60	
Total	9,813,379	$ 2.28	

The following is a summary of the material provisions of the Bluefly, Inc. 2000 Plan Stock Option Plan (the "2000 Plan"), our only equity compensation plan that has not been approved by our stockholders.

Eligibility. Key employees of the Company who are not officers or directors of the Company and its affiliates and consultants to the Company are eligible to be granted options.

Administration of the 2000 Plan. The Option Plan/Compensation Committee administers the 2000 Plan. The Option Plan/Compensation Committee has the full power and authority, subject to the provisions of the 2000 Plan, to designate participants, grant options and determine the terms of all options. The 2000 Plan provides that no participant may be granted options to purchase more than 1,000,000 shares of Common Stock in a fiscal year. The Option Plan/Compensation Committee is required to make adjustments with respect to options granted under the 2000 Plan in order to prevent dilution or expansion of the rights of any holder. The 2000 Plan requires that the Option Plan/Compensation Committee be composed of at least two directors.

Amendment. The 2000 Plan may be wholly or partially amended or otherwise modified, suspended or terminated at any time or from time to time by the Board of Directors, but no amendment without the approval of our stockholders shall be made if stockholder approval would be required under any law or rule of any governmental authority, stock exchange or other self-regulatory organization to which we are subject. Neither the amendment, suspension or termination of the 2000 Plan shall, without the consent of the holder of an option under the 2000 Plan, alter or impair any rights or obligations under any option theretofore granted.

Options Issued Under 2000 Plan. The Option Plan/Compensation Committee determines the term and exercise price of each option under the 2000 Plan and the time or times at which such option may be exercised in whole or in part, and the method or methods by which, and the form or forms in which, payment of the exercise price may be paid.

Upon the exercise of an option under the 2000 Plan, the option holder shall pay us the exercise price plus the amount of the required federal and state withholding taxes, if any. The 2000 Plan also allows participants to elect to have shares withheld upon exercise for the payment of withholding taxes.

The unexercised portion of any option granted to a key employee under the 2000 Plan generally will be terminated (i) 30 days after the date on which the optionee's employment is terminated for any reason other than (a) Cause (as defined in the 2000 Plan), (b) retirement or mental or physical disability, or (c) death; (ii) immediately upon the termination of the optionee's employment for Cause; (iii) three months after the date on which the optionee's employment is terminated by reason of retirement or mental or physical disability; or (iv) (A) 12 months after the date on which the optionee's employment is terminated by reason of his death or (B) three months after the date on which the optionee shall die if such death occurs during the three-month period following the termination of the optionee's employment by reason of retirement or mental or physical

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disability. The Option Plan/Compensation Committee has in the past, and may in the future, extend the period of time during which an optionee may exercise options following the termination of his or her employment.

Under the 2000 Plan, an option generally may not be transferred by the optionee other than by will or by the laws of descent and distribution. During the lifetime of an optionee, an option under the 2000 Plan may be exercised only by the optionee or, in certain instances, by the optionee's guardian or legal representative, if any.

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ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with the consolidated financial statements and the notes thereto and the information contained in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations." Historical results are not necessarily indicative of future results. All data is in thousands, except share data:

STATEMENT OF OPERATIONS DATA:

	Year Ended December		
	2004	2003	2002
Net sales	$ 43,799	$ 37,928	$ 30,606
Cost of sales	27,393	26,603	20,571
Gross profit	16,406	11,325	10,035
Selling, marketing and fulfillment expenses	13,996	12,061	11,547
General and administrative expenses	6,333	5,239	4,686
Total operating expenses	20,329	17,300	16,233
Operating loss	(3,923)	(5,975)	(6,198)
Interest (expense)/other income	132	(394)	(281)
Net loss	(3,791)	(6,369)	(6,479)
Basic and diluted loss per share:	$ (0.55)	$ (0.88)	$ (2.44)
Basic and diluted weighted average number of common shares outstanding available to common			

stockholders	14,586,752	11,171,018	9,927,027

BALANCE SHEET DATA:

	As of December 31,		
	2004	2003	2002
Cash and cash equivalents	$ 7,938/(1)/	$ 7,721	$ 1,749
Inventories, net	12,958	11,340	10,868
Other current assets	2,559	1,863	1,159
Total assets	25,541	22,998	16,595
Current liabilities	9,413	8,459	7,072
Short-term convertible notes payable, net		-	-
Long term liabilities	4,739	4,260	2,439
Redeemable preferred stock	-	-	-
Shareholders' equity (deficit)	11,389	10,279	7,084

/(1)/ Includes restricted cash of $1,253

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

This discussion and analysis of our financial condition and results of operations contains forward-looking statements that involve risks and uncertainties. We have based these forward-looking statements on our current expectations and projections of future events. However, our actual results could differ materially from those discussed herein as a result of the risks that we face, including but not limited to those risks stated in "Risk Factors," or faulty assumptions on our part. In addition, the following discussion should be read in conjunction with the audited consolidated financial statements and the related notes thereto included elsewhere in this report.

OVERVIEW

We are a leading Internet retailer that sells over 350 brands of designer apparel, accessories and home products at discounts up to 75% off retail value. The Bluefly.com Web site was launched in September 1998.

Our gross profit increased by approximately 45% to $16,406,000 in 2004, from $11,325,000 in 2003. This growth was driven by increases in both net sales and gross margins, and allowed us to decrease our net loss by approximately 40%, to $3,791,000 in 2004, from $6,369,000 in 2003.

Our net sales increased approximately 15% to $43,799,000 for the year ended December 31, 2004 from $37,928,000 for the year ended December 31, 2003. For the first three quarters of 2004, our net sales increased by approximately 35%, 27% and 6%, respectively, as compared to the same periods in 2003. For the entire fourth quarter of 2004, our net sales increased by approximately 4% to $14,515,000 from $13,993,000 in the fourth quarter of 2003. Our net sales actually decreased in October 2004, but rebounded strongly in November and December 2004, which resulted in net sales growth for the quarter.

Net sales attributable to the Company's Web site increased by approximately 7%

during the quarter, to $14,230,000 in the fourth quarter of 2004 from $13,356,000 in the fourth quarter of 2003, while net sales attributable to the Company's temporary Manhattan store, which opened in late November, decreased to approximately $251,000 compared to $465,000 for the same period in 2003.

Our gross margin increased to 37.5% from 29.9% in 2003, 32.8% in 2002 and 30.5% in 2001. The increase in 2004 was driven by a merchandising strategy that focused on negotiating better prices with vendors as well as selling more in-season product which has more value to our customer and therefore demands higher margins. In 2003 the lower margins resulted from our decision to turn more of our out-of-season merchandise, as well as inventory items that we were particularly deep in, into cash that could be used to purchase new inventory, rather than holding the inventory for the next season.

For the fourth quarter of 2004, we had net income of $7,000 as compared to net income of $111,000 in the fourth quarter of 2003. The decrease in net income was partly the result of the Company's temporary Manhattan store, which contributed significantly to our profitability during the fourth quarter of 2003, but did not contribute to our profit in any material respect during the fourth quarter of 2004. We believe that the store did not perform as well financially in 2004 as it did in 2003 because we tested pricing and branding strategies that were more in line with those of our Web site. While the performance of the store was not as strong during 2004 as it was during 2003, we believe that the relatively small investment provided us with valuable experience that we can use in the future in an effort to build a store strategy that is in line with our brand strategy and offers stronger financial performance.

Our reserve for returns and credit card chargebacks decreased slightly to 36.6% in 2004 from 37.1% in 2003 and it had been 35.5% in 2002. We believe that the slight improvement in the return rate is attributable to more detailed analysis on customer purchase and return habits as well as initiatives related to the way we photograph and describe our product and improved buying by the merchant team. The increase in return rates in prior years was primarily driven by shifts in our merchandise mix towards products that generate higher return rates, but also higher gross margins and average order sizes. While we are testing initiatives to reduce our return rates, we believe that the overall shift in merchandise mix has been beneficial to the overall gross profit realized per order. Accordingly, we do not expect return rates to decrease to 2002 levels in the near term.

At December 31, 2004, we had an accumulated deficit of $96,127,000. The net losses and accumulated deficit resulted primarily from the costs associated with developing and marketing our Web site, building our infrastructure and non-cash charges in connection with automatic decreases in the conversion price of our Preferred Stock. In order to expand our business,

we intend to invest in sales, marketing, merchandising, operations, information systems, site development and additional personnel to support these activities. We therefore expect to continue to incur substantial operating losses for the foreseeable future. Although we have experienced revenue growth in recent years, this growth may not be sustainable and therefore should not be considered indicative of future performance.

CRITICAL ACCOUNTING POLICIES

MANAGEMENT ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates and assumptions relate to the adequacy of the allowances for sales returns, recoverability of inventories, useful lives of property and equipment and the realization of deferred tax assets. Actual amounts could differ significantly from these estimates.

REVENUE RECOGNITION

We recognize revenue in accordance with Staff Accounting Bulletin ("SAB") No. 101 "Revenue Recognition in the Financial Statements" as amended. Gross sales consists primarily of revenue from product sales and shipping and handling charges and is net of promotional discounts. Net sales represent gross sales, less provisions for returns, credit card chargebacks, and adjustments for uncollected sales taxes. Revenue is recognized when all the following criteria are met:

- A customer executes an order.
- The product price and the shipping and handling fee have been determined.
- Credit card authorization has occurred and collection is reasonably assured.
- The product has been shipped and received by the customer.

Shipping and handling billed to customers are classified as revenue in accordance with Financial Accounting Standards Board ("FASB") Task Force's Emerging Issues Task Force ("EITF") No. 00-10, "Accounting for Shipping and Handling Fees and Costs" ("EITF No. 00-10").

PROVISION FOR RETURNS AND DOUBTFUL ACCOUNTS

We generally permit returns for any reason within 90 days of the sale. Accordingly, we establish a reserve for estimated future returns and bad debt at the time of shipment based primarily on historical data. We perform credit card authorizations and check the verification of our customers prior to shipment of merchandise. However, our future return and bad debt rates could differ from historical patterns, and, to the extent that these rates increase significantly, it could have a material adverse effect on our business, prospects, cash flows, financial condition and results of operations.

INVENTORY VALUATION

Inventories, which consist of finished goods, are stated at the lower of cost or market value. Cost is determined by the first-in, first-out ("FIFO") method. We review our inventory levels in order to identify slow-moving merchandise and establish a reserve for such merchandise.

DEFERRED TAX VALUATION ALLOWANCE

We recognize deferred income tax assets and liabilities on the differences between the financial statement and tax bases of assets and liabilities using enacted statutory rates in effect for the years in which the differences are expected to reverse. The effect on deferred taxes of a change in tax rates is realized in income or loss in the period that included the enactment date. We have assessed the future taxable income and determined that a 100% deferred tax valuation allowance is deemed necessary. In the event that we were to determine that we would be able to realize our deferred tax assets, an adjustment to the deferred tax valuation allowance would increase income in the period such determination is made.

RESULTS OF OPERATIONS

The following table sets forth our statement of operations data for the years ended December 31st. All data is in thousands except as indicated below:

	2004		2003	
		AS A % OF NET SALES		AS A % OF NET SALES
Net sales	$ 43,799	100.0%	$ 37,928	100.0%
Cost of sales	27,393	62.5%	26,603	70.1%
Gross profit	16,406	37.5%	11,325	29.9%
Selling, marketing and fulfillment expenses	13,996	32.0%	12,061	31.8%
General and administrative expenses	6,333	14.4%	5,239	13.8%
Total operating expenses	20,329	46.4%	17,300	45.7%
Operating loss	(3,923)	(8.9)%	(5,975)	(15.8)%
Interest (expense) other income	132	0.3%	(394)	(1.0)%
Net loss	$ (3,791)	(8.6)%	$ (6,369)	(16.8)%

We also measure and evaluate ourselves against certain other key operational metrics. The following table sets forth our actual results based on these other metrics for the years ended December 31st, as indicated below:

	2004	2003
Average Order Size (including shipping & handling)	$ 188.51	$ 17
Average Order Size Per New Customer (including shipping & handling)	$ 159.38	$ 15
Average Order Size Per Repeat Customer (including shipping & handling)	$ 205.10	$ 18
Total Customers	640,125	512
Customers Added during the Year	127,177	124
Revenue from Repeat Customers as a % of total Revenue	70%	
Customer Acquisition Costs	$ 11.41	$ 1

We define a "repeat customer" as a person who has bought more than once from us during their lifetime. We calculate customer acquisition cost by dividing total advertising expenditures (excluding staff related costs) during a given time period by total new customers added during that period. All measures of the number of customers are based on unique email addresses.

FOR THE YEAR ENDED DECEMBER 31, 2004 COMPARED TO THE YEAR ENDED DECEMBER 31, 2003

Net sales: Gross sales for the year ended December 31, 2004 increased by approximately 15% to $69,032,000, from $60,279,000 for the year ended December 31, 2003. The provision for returns and credit card chargebacks and other discounts was approximately 37% for both 2004 and 2003, resulting in a provision of $25,233,000 for the year ended December 31, 2004 and $22,351,000 for the year ended December 31, 2003.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the year ended December 31, 2004 were $43,799,000. This represents an increase of approximately 15% compared to the year ended

December 31, 2003, in which net sales totaled $37,928,000. The growth in net sales was largely driven by the increase in gross average order size (approximately 8% higher than the full year 2003) and a slight increase in the number of new customers acquired (approximately 2% higher than the full year 2003). Shipping and handling revenue (which is included in net sales) increased by 14% to $3,353,000 for the year ended December 31, 2004, from $2,939,000 for the year ended December 31, 2003.

Cost of sales: Cost of sales consists of the cost of product sold to customers, in-bound and out-bound shipping costs, inventory reserves, commissions and packing materials. Cost of sales for the year ended December 31, 2004 totaled $27,393,000, resulting in gross margin of approximately 38%. Cost of sales for the year ended December 31, 2003 totaled $26,603,000, resulting in gross margin of 30%. The increase in gross margin was driven by a merchandising strategy that focused on negotiating better prices with vendors as well as selling more in-season product, which has more value to our customer and therefore demands higher margins. The gross margin in 2003 was impacted negatively by our decision to reduce our product margin during the first three quarters of 2003 on certain merchandise in an effort to reduce prior season inventory levels.

Gross Profit: As a result of the increases in net sales and gross margin, gross profit increased by 45%, to $16,406,000 for the year ended December 31, 2004, from $11,325,000 for the year ended December 31, 2003.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by approximately 16% for the year 2004 compared to the year ended 2003. As a percentage of net sales, our selling, marketing and fulfillment expenses remained relatively unchanged at approximately 32% for both 2004 and 2003. The selling, marketing and fulfillment expenses were comprised of the following:

	YEAR ENDED DECEMBER 31, 2004	YEAR ENDED DECEMBER 31, 2003	PERCENTAGE DIFFERENCE INCREASE (DECREASE)
Marketing	$ 2,213,000	$ 1,898,000	16.6%
Operating	5,848,000	5,223,000	12.0%
Technology	4,086,000	3,420,000	19.5%
E-Commerce	1,849,000	1,520,000	21.6%
	$ 13,996,000	$ 12,061,000	16.0%

Marketing expenses include expenses related to online and print advertising, direct mail campaigns as well as staff related costs. The increase in marketing expenses of approximately 17% was primarily driven by the donation of the net proceeds from the sale of "hope." collection products to St. Jude Children's Research Hospital ("St. Jude"). Pursuant to a charitable program with St. Jude, we were the exclusive retailer of the "hope." t-shirt and agreed to donate the net proceeds (i.e., the revenue less the cost of goods sold and the costs of processing and filling the orders) from the sale of all "hope." collection products on our Web site to St. Jude. For the year ended December 31, 2004, approximately $141,000 was donated and has been recorded as a marketing expense in our financial statements. A portion of the increase also resulted from increased consulting expenses, which were offset slightly by a decrease in staff related expenses. In the event that we attempt to accelerate revenue growth, it may be necessary to utilize less cost efficient methods of customer acquisition, and accordingly there can be no assurance that customer acquisition costs will not increase further in the future.

Operating expenses include all costs related to inventory management, fulfillment, customer service, credit card processing and during the fourth quarters, the costs associated with the Company's temporary Manhattan store. Operating expenses increased in 2004 by approximately 12% compared to 2003 as a result of variable costs associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees) as well as the overhead costs associated with the store.

Technology expenses consist primarily of Web site hosting and staff related costs. For the year ended December 31, 2004, technology expenses increased by approximately 20% compared to the year ended December 31, 2003. This increase was related to an increase in headcount, overall web hosting costs and consulting costs and was slightly offset by a decrease in depreciation expense. The department employed an average of 18 people per month in 2004 compared to 12 people per month in 2003.

E-Commerce expenses include expenses related to our photo studio, image processing, and Web site design. For the year ended December 31, 2004, this amount increased by approximately 22% as compared to the year ended December 31, 2003. This increase is to the result of an increase in staff related costs, temporary help and the purchase of licenses for new search functionality and Web site analytics.

General and administrative expenses: General and administrative expenses include merchandising, finance and administrative salaries and related expenses, insurance costs, accounting and legal fees, depreciation and other office related expenses. General and administrative expenses for the year ended December 31, 2004 increased by approximately 21% to $6,333,000 as compared to $5,239,000 for the year ended December 31, 2003. As a percentage of net sales, general and administrative expenses increased to 14.4% in 2004 from 13.8% in 2003. The increase in general and administrative expenses was the result of increased salary and benefit expenses of approximately 45% (including $325,000 of expenses incurred in connection with the Separation Agreement that we entered into with our former CEO) as well as an increase in public company fees. These increases were slightly offset by a reduction in consulting and professional fees. Due to the cost of compliance of Sarbanes-Oxley we anticipate that professional and public company fees will continue to increase in 2005.

Loss from operations: Operating loss decreased by approximately 34% in 2004, to $3,923,000 from $5,975,000 in 2003 as a result of the increase in gross profit.

Interest expense and Interest and other income, net: Interest and other income for year ended December 31, 2004 increased to $847,000 from $38,000 for the year ended December 31, 2003. The increase resulted from $564,000 recognized to adjust a liability associated with warrants issued by us to their fair value as of June 17, 2004 (at which time the warrants were re-classified as equity as described in Note 3 to our financial statements), the $169,000 realized in connection with the judgment we received in the Breider Moore litigation and an increase in interest income earned on our cash balance.

Interest expense for the year ended 2004 totaled $715,000, and related primarily to fees paid in connection with the Loan Facility and interest expense on Convertible Notes held by Soros. Interest expense for the year ended December 31, 2003 totaled $432,000, and related to fees paid in connection with our Loan Facility as well as amortization of warrants issued in connection with the January 2003 Financing.

FOR THE YEAR ENDED DECEMBER 31, 2003 COMPARED TO THE YEAR ENDED DECEMBER 31, 2002

Net sales: Gross sales for the year ended December 31, 2003 increased by approximately 27% to $60,279,000, from $47,491,000 for the year ended December 31, 2002. For the year ended December 31, 2003, we recorded a provision for returns and credit card chargebacks and other discounts of $22,351,000, or approximately 37% of gross sales. For the year ended December 31, 2002, the provision for returns and credit card chargebacks and other discounts was $16,885,000, or approximately 36% of gross sales. The increase in this provision as a percentage of gross sales was related primarily to an increase in the return rate. We believe that the increase in return rate was partly the result of a shift in our merchandise mix towards certain product categories that historically have generated higher return rates, but also higher gross margins and average order size.

After the necessary provisions for returns, credit card chargebacks and adjustments for uncollected sales taxes, our net sales for the year ended December 31, 2003 were $37,928,000. This represents an increase of approximately 24% compared to the year ended December 31, 2002, in which net sales totaled $30,606,000. The growth in net sales was largely driven by the increase in the numbers of new customers acquired (approximately 23% higher than the full year 2002) and the increase in gross average order size (approximately 5% higher than the full year 2002). In addition, our shipping and handling revenue increased as we raised our standard shipping rate from $5.95 per order to $7.95 per order in the first quarter of 2003. For the year ended December 31, 2003, revenue from shipping and handling (which is included in net sales) increased by 44% to $2,939,000 from $2,048,000 for the year ended December 31, 2002.

Cost of sales: Cost of sales for the year ended December 31, 2003 totaled $26,603,000, resulting in gross margin of approximately 30%. Cost of sales for the year ended December 30, 2002 totaled $20,571,000, resulting in gross margin of 33%. The decrease in gross margin resulted primarily from our decision to reduce our product margin during the first three quarters of 2003 on certain merchandise in an effort to reduce prior season inventory levels.

Gross Profit: Gross profit increased by 13%, to $11,325,000 for the year ended December 31, 2003, compared to $10,035,000 for the year ended December 31, 2002. The increase in gross profit was the result of net sales growth, partially offset by the decrease in gross margin.

Selling, marketing and fulfillment expenses: Selling, marketing and fulfillment expenses increased by approximately 5% for the year 2003 compared to the year ended 2002. As a percentage of net sales, our selling, marketing and fulfillment expenses

decreased to 32% in 2003 from approximately 37.7% in 2002. The decrease resulted primarily from refinements to our marketing strategy that allowed us to better target potential new customers and convert repeat customers, as well as the cost savings we derived from our move to a new web hosting facility. Selling, marketing and fulfillment expenses were comprised of the following:

	YEAR ENDED DECEMBER 31, 2003	YEAR ENDED DECEMBER 31, 2002	PERCENTAGE DIFFERENCE INCREASE (DECREASE)
Marketing	$ 1,898,000	$ 2,275,000	(16.6)%
Operating	5,223,000	4,533,000	15.2%
Technology	3,420,000	3,552,000	(3.7)%
E-Commerce	1,520,000	1,187,000	28.1%
	$ 12,061,000	$ 11,547,000	4.5%

Marketing expenses include expenses related to online and print advertising, direct mail campaigns as well as staff related costs. The decrease in marketing expenses of approximately 17% was largely related to a shift in our customer acquisition strategy. We reduced our advertising expenditures and focused more on email, affiliate programs and other performance based programs. Primarily as a result of this shift, we were able to decrease our customer acquisition costs for the year ended December 31, 2003 by approximately 40% to $10.22 per new customer from $17.04 per new customer for the year ended December 31, 2002.

Operating expenses include all costs related to inventory management, fulfillment, customer service, credit card processing and during the fourth quarter of 2003, the costs associated with the Company's temporary Manhattan store. Operating expenses increased in 2003 by approximately 15% compared to 2002 as a result of variable costs associated with the increased sales volume (e.g., picking and packing orders, processing returns and credit card fees).

Technology expenses consist primarily of Web site hosting and staff related costs. For the year ended December 31, 2003, technology expenses decreased by approximately 4% compared to the year ended December 31, 2002. This decrease was related to a decrease in overall web hosting costs offset by accelerated depreciation of equipment acquired under a capital lease due to a change in the estimated useful life, along with increased amortization expense incurred as a result of capitalized costs incurred in connection with the upgraded version of the Web Site. Depreciation and amortization for the year ended December 31, 2003 represented approximately 40% of the total technology expense, while depreciation and amortization for the year ended December 31, 2002 represented approximately 17% of the total technology expense. These amounts were partially offset by a reduction of approximately 61% in our Web Site hosting costs in connection with our move to a new web hosting facility.

E-Commerce expenses include expenses related to our photo studio, image processing, and Web Site design. For the year ended December 31, 2003, this amount increased by approximately 28% as compared to the year ended December 31, 2002, primarily due to the creation of an Online Retail Group within the E-Commerce department. The department employed an average of 17 employees per month in 2003, compared to an average of 13 per month in 2002. The Online Retail Group is, among other things, responsible for leveraging the Web Site technology to improve the on-site customer experience. In September 2003, we launched a redesigned Web Site. The redesigned Web Site provided a new look and, we believe, more intuitive navigation. The costs of the new site were primarily included in E-Commerce and expensed as incurred.

General and administrative expenses: General and administrative expenses include merchandising, finance and administrative salaries and related expenses, insurance costs, accounting and legal fees, depreciation and other office related expenses. General and administrative expenses for the year ended December 31, 2003 increased by approximately 12% to $5,239,000 as compared to $4,686,000 for the year ended December 31, 2002. As a percentage of net sales, general and administrative expenses decreased to 13.8% in 2003 from 15.3% in 2002. The increase in general and administrative expenses was the result of increased salary and benefit expenses of approximately 7% as well as an increase in professional fees of 50%.

Loss from operations: Operating loss decreased by approximately 4% in 2003, to $5,975,000 from $6,198,000 in 2002 as a result of the increase in sales and gross margin dollars and decreases in selling, marketing and fulfillment expenses and general and administrative expenses as a percentage of net sales.

Interest expense and other income, net: Interest expense for the year ended December 31, 2003 totaled $432,000, and related to fees paid in connection with our Loan Facility, amortization of warrants issued in connection with the January 2003

Financing, and interest on the notes issued in connection with the July 2003 Financing. For the year ended December 31, 2002, interest expense totaled $349,000, and related primarily to fees paid in connection with the Loan Facility.

Interest income for the year ended December 31, 2003 decreased to $38,000 from $68,000 for the year ended December 31, 2002. The decrease is related to the decrease in our cash balance as interest income primarily represents interest earned on our cash balance.

LIQUIDITY AND CAPITAL RESOURCES

GENERAL

At December 31, 2004, we had approximately $6.7 million of liquid assets, entirely in the form of cash and cash equivalents, and working capital of approximately $12.8 million (both amounts exclude the $1.25 million of restricted cash). In addition, as of December 31, 2004, we had approximately $2.3 million of borrowings committed under the Loan Facility, leaving approximately $1.2 million of availability. At December 31, 2003, we had approximately $2.3 million of borrowings committed, leaving $2.1 million of availability.

In February 2005, we extended the maturity dates on the Convertible Promissory Notes issued to Soros in July and October 2003. The maturity dates of the Notes, which were originally January and April 2004, respectively, were each extended for one year, from May 1, 2005 to May 1, 2006. Also in February 2005, we renewed the Loan Facility with Rosenthal for an additional year, from March 30, 2005 to March 30, 2006.

We fund our operations through cash on hand, operating cash flow, as well as the proceeds of any equity or debt financing. Operating cash flow is affected by revenue and gross margin levels, as well as return rates, and any deterioration in our performance on these financial measures would have a negative impact on our liquidity. Total availability under the Loan Facility is based upon our inventory levels and is dependent, among other things, on the Company having at least $7.0 million of tangible net worth and $6.0 million of working capital and cash balances of at least $750,000 (exclusive of the $1.25 million cash collateral pledged to Rosenthal to secure our obligations under the Loan Facility). In addition, both availability under the Loan Facility and our operating cash flows are affected by the payment terms that we receive from suppliers and service providers, and the extent to which suppliers require us to request Rosenthal to provide credit support under the Loan Facility. We believe that our suppliers' decision-making with respect to payment terms and/or the type of credit support requested is largely driven by their perception of our credit rating, which is affected by information reported in the industry and financial press and elsewhere as to our financial strength. Accordingly, negative perceptions as to our financial strength could have a negative impact on our liquidity.

We anticipate that our existing resources and working capital should be sufficient to satisfy our cash requirements through the end of fiscal 2005. Of course, there can be no assurance that such expectations will prove to be correct. If we do not achieve our operating plan, and additional financing is not available, future operations may need to be modified, scaled back or discontinued. Moreover, we may seek additional debt and/or equity financing in order to maximize the growth of our business and accelerate customer acquisition. There can be no assurance that any additional financing or other sources of capital will be available to us upon acceptable terms, or at all.

LOAN FACILITY

Pursuant to the Loan Facility, Rosenthal provides us with certain credit accommodations, including loans and advances, factor-to-factor guarantees, letters of credit in favor of suppliers or factors and purchases of payables owed to our suppliers. The Rosenthal Financing Agreement was amended in April 2004 to: (i) extend the term until March 30, 2005 (later extended further, as described below); (ii) substitute $1.25 million of cash collateral pledged by the Company for the $2.0 million standby letter of credit previously provided by Soros as collateral security for the Company's obligations under the Loan Facility; (iii) decrease the maximum amount available under the Loan Facility from $4.5 million to $4.0 million; (iv) increase the tangible net worth requirement to $7.0 million; (v) increase the working capital requirement to $6.0 million; and (vi) increase the minimum cash balance that the Company is required to maintain to $750,000 (exclusive of the $1.25 million in cash collateral). Because we removed the requirement that Soros provide a standby letter of credit to secure the Loan Facility, we are no longer subject to an agreement with Soros that previously required us to issue additional warrants to Soros with an exercise price equal to 75% of

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market price in the event that Rosenthal were to draw on Soros' letter of credit. In February 2005, the Rosenthal Financing Agreement was further extended to March 30, 2006. All other terms of the Rosenthal Financing Agreement remained the same.

Interest accrues monthly on the average daily amount outstanding under the Loan Facility during the preceding month at a per annum rate equal to the prime rate plus 1%. We pay an annual facility fee equal to 1.5% of the portion of the Loan Facility that is provided on the basis of our inventory level. This formula currently results in an annual facility fee of $33,750. We also pay Rosenthal certain fees to open letters of credit and guarantees in an amount equal to a certain percentage of the face amount of the letter of credit for each thirty (30) days such letter of credit, or a portion thereof, remains open.

In consideration for the Loan Facility, among other things, we granted to Rosenthal a first priority lien on substantially all of our assets, including control of all of our cash accounts (including the $1.25 million of cash collateral, which has been placed in a segregated, restricted account) upon an event of default and certain of our cash accounts in the event that the total amount of funded debt loaned to us under the Loan Facility exceeds 90% of the maximum amount available under the Loan Facility for more than 10 days.

Under the terms of the Loan Facility, Soros has the right to purchase all of our obligations from Rosenthal at any time during its term.

COMMITMENTS AND LONG TERM OBLIGATIONS

As of December 31, 2004, we had the following commitments and long term obligations:

	2005	2006	2007	2008	THER
Marketing and Advertising	$ 150,000	--	--	--	
Operating Leases	462,000	469,000	481,000	441,000	
Capital Leases	139,000	54,000	27,000	--	
Employment Contracts	1,219,000	1,030,000	324,000	--	
Notes payable to shareholders	--	4,000,000 *	--	--	
Grand total	$ 1,970,000	$ 5,553,000	$ 832,000	$ 441,000	$

* Notes were reclassified to long term in February 2005, See "Recent Developments"

We believe that in order to grow the business, we will need to make additional marketing and advertising commitments in the future. In addition, we expect to hire and train additional employees for the operations and development of Bluefly.com. However, our marketing budget and our ability to hire such employees is subject to a number of factors, including our results of operations as well as the amount of additional capital that we raise.

In order to continue to expand our product offerings, we intend to expand our relationships with suppliers of end-of-season and excess name brand apparel and fashion accessories. We expect that our suppliers will continue to include designers and retail stores that sell excess inventory as well as third-party end-of-season apparel aggregators. To achieve our goal of offering a wide selection of top name brand designer clothing and fashion accessories, we may acquire certain goods on consignment and may explore leasing or partnering select departments with strategic partners and distributors,

RECENT ACCOUNTING PRONOUNCEMENTS

In March, 2004, the Emerging Issues Task Force issued EITF 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128". This statement provides additional guidance on the calculation and disclosure requirements for earnings per share. The FASB concluded in EITF 03-6 that companies with multiple classes of common stock or participating securities, as defined by SFAS No. 128, calculate and disclose earnings per share based on the two-class method. The adoption of this statement does not have an impact to the Company's financial statement presentation as the Company is currently in a loss position.

In December 2004, the FASB issued Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"), which replaces SFAS 123 and supersedes APB No. 25. Under the new standard, companies will no longer be able to account for stock-based compensation transactions using the intrinsic value method in accordance with APB No. 25. Instead, companies will be

required to account for such transactions using a fair-value method and to recognize the expense in the statements of income. The adoption of SFAS 123R will also require additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. SFAS 123R will be effective for periods beginning after June 15, 2005 and allows, but does not require, companies to restate prior periods. We are evaluating the impact of adopting SFAS 123R and expect that we will record substantial non-cash stock compensation expenses. The adoption of SFAS 123R is not expected to have a significant effect on our financial condition or cash flows but the non-cash charges associated therewith are expected to have a significant, adverse effect on our results of operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have assessed our vulnerability to certain market risks, including interest rate risk associated with financial instruments included in cash and cash equivalents and our notes payable. Due to the short-term nature of these investments we have determined that the risks associated with interest rate fluctuations related to these financial instruments do not pose a material risk to us.

ITEM 8. FINANCIAL STATEMENTS

(a) Index to the Financial Statements

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Consolidated Balance Sheets as of December 31, 2004 and 2003	F-2
Consolidated Statements of Operations for the three years ended December 31, 2004, 2003 and 2002	F-3
Consolidated Statements of Changes in Shareholders' Equity for the three years ended December 31, 2004, 2003 and 2002	F-4
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
of Bluefly, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Bluefly, Inc. and its subsidiary at December 31, 2004 and December 31, 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

New York, New York
February 18, 2005

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BLUEFLY, INC.
CONSOLIDATED BALANCE SHEETS
December 31, 2004 and 2003
(dollars rounded to the nearest thousand)

	2004
ASSETS	
Current assets	
Cash and cash equivalents	$ 6,685,00
Restricted cash	1,253,00
Inventories, net	12,958,00
Accounts receivable, net of allowance for doubtful accounts	1,206,00
Prepaid expenses and other current assets	1,353,00
Total current assets	23,455,00
Property and equipment, net	1,933,00
Other assets	153,00
Total assets	$ 25,541,00
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities	
Accounts payable	$ 4,190,00
Accrued expenses and other current liabilities	3,526,00
Deferred revenue	1,697,00
Notes payable to related party shareholders	
Total current liabilities	9,413,00
Notes payable to related party shareholders	4,000,00
Long-term interest payable to related party shareholders	658,00
Long-term obligations under capital lease	81,00
Total liabilities	14,152,00
Commitments and contingencies (Note 8)	
Shareholders' equity	
Series A Preferred Stock - $.01 par value; 500,000 shares authorized, 460,000 shares issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: $9.2 million plus accrued dividends of $5.0 million)	5,00

Series B Preferred Stock - $.01 par value; 9,000,000 shares authorized, 8,889,414 shares issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: $30 million plus accrued dividends of $7.3 million)	89,00
Series C Preferred Stock - $.01 par value; 3,500 shares authorized, 1,000 shares issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: $1 million plus accrued dividends of $191,000)	
Series D Preferred Stock - $.01 par value; 7,150 shares authorized, 7,136.548 shares issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: $7.1 million plus accrued dividends of $1.6 million)	
Series E Preferred Stock - $.01 par value; 1,000 shares authorized, issued and outstanding as of December 31, 2004 and 2003, respectively (liquidation preference: $1.0 million plus accrued dividends of $202,000)	
Common Stock - $.01 par value; 92,000,000 shares authorized, 15,241,756 and 12,894,166 shares issued and outstanding as of December 31, 2004 and 2003, respectively	152,00
Additional paid-in capital	107,270,00
Accumulated deficit	(96,127,00
Total shareholders' equity	11,389,00
Total liabilities and shareholders' equity	$ 25,541,00

The accompanying notes are an integral part of these consolidated financial statements.

BLUEFLY, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
Years Ended December 31, 2004, 2003 and 2002
(dollars rounded to the nearest thousand)

	2004	2003
Net sales	$ 43,799,000	$ 37,928,000
Cost of sales	27,393,000	26,603,000
Gross profit	16,406,000	11,325,000
Selling, marketing and fulfillment expenses	13,996,000	12,061,000
General and administrative expenses	6,333,000	5,239,000
Total operating expenses	20,329,000	17,300,000
Operating loss	(3,923,000)	(5,975,000)
Interest expense	(715,000)	(432,000)
Interest income	114,000	38,000
Other income (Note 6)	733,000	-

Net loss	(3,791,000)	(6,369,000)	
Preferred stock dividends	(4,275,000)	(3,225,000)	
Deemed dividend related to beneficial conversion feature on Series B and C Preferred Stock	-	(225,000)	(
Net loss available to common shareholders	$ (8,066,000)	$ (9,819,000)	$ (
Basic and diluted loss per common share	$ (0.55)	$ (0.88)	$
Weighted average number of shares outstanding used in calculating basic and diluted loss per common share	14,586,752	11,171,018	

The accompanying notes are an integral part of these consolidated financial statements.

BLUEFLY, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years Ended December 31, 2004, 2003 and 2002
(Dollars rounded to the nearest thousand)

	SERIES A PREFERRED STOCK $.01 PAR VALUE	
	NUMBER OF SHARES	AMOUNT