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# BLUEFLY.COM: HIGH STYLE GONE HIGH TECH

Ken Seiff paced back and forth as he spoke on his mobile phone by the hotel pool at the Las Ventanas resort in Mexico, while his wife and two young children laughed and played in the water nearby. This was his real first vacation in over 5 years. Despite being thousands of miles away from his midtown Manhattan office, Seiff couldn't escape the demands of being CEO of Bluefly, Inc., the thriving Internet apparel retailer he founded in June 1998. As he discussed the future profitability of his Company with a group of potential investors and members of his board and management team, Seiff reflected on how much his life had changed over the past few years.

## COMPANY HISTORY

### *The Road from Golf to Gucci*

Ken Seiff graduated from The Wharton School of Business's undergraduate program in 1986 and, like many of his classmates, went to work for a strategic consulting firm. He subsequently transferred to another firm where he analyzed leveraged buyout opportunities. While performing due diligence on a deteriorating golf apparel manufacturer, Seiff developed the idea that ultimately became Pivot Rules. Seiff believed that the Company could be an attractive acquisition target because he thought that focusing on younger, more stylish customers could turn the Company around. While the deal fell through, Seiff continued to incubate the idea. He realized that a niche in the golf apparel market was being underexploited. Ultimately he decided to leave the LBO firm and create a Company to serve that niche, and Pivot Rules was born.

Seiff founded Pivot Rules in 1991. For the first few years, Pivot Rules grew rapidly and seemed destined to become a very successful Company. Under Seiff's leadership, Pivot Rules grew from zero sales in 1991 to over $7 million in sales by 1994. But the Company was undercapitalized and, because of this, it didn't get big enough, fast enough. In 1995, the upward trajectory peaked, and growth started to decline at an alarming rate after a host of high profile competitors, including Nike and Polo Ralph Lauren, with superior brand identity and power over retailers, entered Pivot Rules' market. These competitors began to take up the bulk of the shelf space at the same upscale department stores to which Pivot Rules had historically sold its merchandise.

*This case was updated in December, 2003 by Kristin Swenton, MBA' 04, under the supervision of Professor Alan Kane, as the basis for class discussion rather than to illustrate either effective or ineffective handling of a strategic situation. It was originally researched and written by Diana Dreyer-Wagner, Dayle Ellen Hochman, Mine Nisanci, and Patrick Reyno, MBA '00 in May 2000.* 

Although Seiff felt that Pivot Rules still excelled at communicating its message directly to customers, competing against consumer behemoths like Nike and Polo was nearly impossible without additional capital. Seiff took the brand downstream in 1996 in an attempt to fly under the radar of his competitors. While this strategy bought some time, it was not a long-term solution. Seiff turned to the public markets and launched a modest IPO in 1997, raising $5.9 million after expenses.

As he contemplated the changing competitive landscape, Seiff conceived a new structure for Pivot Rules that would capitalize on its strengths and avoid the need to compete for shelf space with larger, better-known companies. Pivot Rules would approach the golf apparel market through three avenues: it would open its own retail stores to serve key regional markets, distribute its own catalog to serve the U.S. market, and launch a Web site to serve its global customers. While researching the online distribution channel, Seiff realized that he had discovered another incredible opportunity. While single-brand retailers such as J. Crew, Lands' End, and The Gap were among the most successful online retailers, there was no Company making a sophisticated effort at selling multiple brands of apparel on the Internet. Recognizing the opportunity to gain first-mover advantage in a huge new market, Seiff knew that he would have to move quickly.

### *Hatching a Winning Business Model*

In evaluating successful online retailers in other markets, Seiff realized that most offered both an enormous breadth of selection and substantial discounts relative to traditional brick and mortar retailers. He knew that the majority of the popular apparel brands did not yet have an Internet strategy. He believed that they would therefore be reluctant to sell their in-season product online, and that this reluctance could turn to outright hostility if he attempted to sell in-season product at the types of discounts that online shoppers were growing to expect. After sizing up the situation, Seiff realized that launching an off-price business that sold end-of-season merchandise would allow him to offer both the discounts and breadth of merchandise necessary to succeed on the Internet.

Both catalog and brick and mortar merchants had neglected the off-price segment for various reasons. Cataloguers had largely ignored the segment because the long lead times and replenishment capability required for a successful catalog operation could not support the small number of units per style typical of an off-price retailer. Traditional retail stores shied away from offering merchandise at deep discounts because they were afraid of alienating their suppliers, who could literally put them out of business by withholding product. Traditional off-price apparel stores, such as T.J. Maxx and Loehmann's, had failed to offer a satisfactory consumer experience and did not offer designer merchandise with a strong fashion point-of-view.

Seiff realized that the Internet enabled an environment in which an off-price retailer could provide the best aspects of all three traditional retail channels. Such a Company could offer high quality brand name apparel at deep discounts, the convenience of catalog shopping and superior customer service. On May 15, 1998, Seiff announced his decision to expand the Company's scope to sell off-price fashion on the Internet. Pivot Rules' shares doubled on the day of the announcement.

### *Bluefly Takes Off…*

This marked the official beginning for Bluefly. Seiff sold the rights to the Pivot Rules brand name and reallocated all of his financial and human resources to building the Bluefly.com Web site. On September 8, 1998, less than three months after hiring its first employee, Bluefly.com opened its virtual doors with huge hopes for success.

Since the Web site's launch, the Company has been in nonstop hyper-growth mode. Its headquarters in Manhattan's fashion district has seen its employee roster grow from 8 employees in June 1998 to 83 in November 2003, including 5 buyers, 20 customer service representatives and 10 information technology specialists.

Bluefly's growth in headcount has coincided with an impressive record of financial results. Net revenues increased more than 15% to $23.9 million for the nine months ending September 30, 2003, from $20.8 million in the corresponding high-growth period the prior year. While the average order size (including shipping and handling) declined slightly from the prior year, the customer acquisition cost was less than half of what it was in the third quarter of 2002, $10.52 per customer vs. $23.07 per customer. (See **Exhibit 1** – Financial Statements.)

### *Financing Bluefly's Future*

As Seiff reflected on all that has happened, his thoughts returned to his desire to secure additional financing. Bluefly raised $5.9 million in its 1997 IPO with an additional $11.2 million of proceeds coming in the first quarter of 1999 from the exercise of warrants associated with the IPO. Another significant cash infusion came in July 1999, when Bluefly issued convertible preferred stock to Soros Private Equity Partners, LLC for $10 million. Affiliates of Soros Private Equity Partners also provided a total of $20 million in financing in 2000. They converted this $20 million of outstanding debt into preferred equity in February 2001, as part of a larger financing exercise that included a $20 million rights offering. Later in 2001, Bluefly entered into an agreement with Rosenthal & Rosenthal, Inc., a leading financial services and factoring firm, to provide cash or credit accommodations. In June and August of 2002, affiliates of the Soros group provided the Company with a total of $4.0 million in financing in exchange for a mixture of Common Stock, warrants to purchase Common Stock, and Series 2002 Convertible Preferred Stock. Soros continued to provide additional funds throughout 2003, including financing in the 2003 months of January, March, May, July, and October. By October 20, 2003, Bluefly had received approximately $55 million from Soros.

While Seiff had secured money up until this point, there was no guarantee that he would continue to receive funds in the months and years ahead. In fact, a $2 million loan to Soros had to be repaid in 2004. Therefore, in addition to determining a long-term financing strategy, he had to address many other challenges on the road to becoming a billion-dollar retailer. He wondered, "How are we going to attract the customers, vendors and employees we need to take Bluefly to the next level? How are we going to convince our current customers to keep coming back and to consider us their store of first choice? How are we going to scale our infrastructure to support the robust sales volume we are expecting for Christmas 2003 and for the years to come? And, how are we going to continue on the same trajectory once more competitors improve their Internet initiatives?" Above all, he reflected on the lessons he learned from Pivot Rules. He knew that Bluefly had an incredible opportunity to seize market leadership as an off-price e-tailer, and he was determined to get big enough, fast enough, and achieve profitability.

## CONCEPT AND BUSINESS MODEL

Bluefly is a leading Internet retailer of high quality designer fashions and home furnishings at discount prices. Via its Web site http://www.bluefly.com, the Company sells over 350 brands of designer apparel and home accessories at discounts up to 75% off of retail prices (See **Exhibit II** – Bluefly.com Website Pages.) It sources its products from traditional retailers' excess inventory, odd lots, and manufacturers' end of season or past season merchandise.

### *Value Proposition to Customers*

Bluefly aims to deliver to its customers the best that department stores (such as Saks Fifth Avenue and Neiman Marcus), catalogs (such as J.Crew and Spiegel) and off-price retailers (such as TJ Maxx, Ross, and Loehmann's) have to offer, without any of the drawbacks. While department stores offer customers a large designer selection and good customer service, they do not offer discounts. While catalogs offer convenience and excellent customer service, they do not offer a designer selection and, they too, do not offer discounts. Finally, while off-price retailers offer attractive discounts, they do not offer customer service and they lack a designer selection of merchandise. Bluefly believes that it can provide customers with the designer selection of department stores, the convenience and customer service of catalogs and the discounts of off-price retailers.

To deliver this optimal online shopping experience, Bluefly.com has employed the following strategies: sell a broad and well-merchandised selection of name brand products, offer significant discounts to full retail prices, provide friendly and available customer service, grant a liberal return policy (90 days), and provide sophisticated search technology that allows customers to quickly locate the items that interest them.

### *Value Proposition to Suppliers*

Historically, traditional off-price retailers had been the primary liquidation vehicles for designers' excess inventory. Many designers were concerned with potential brand dilution that selling to this channel generally entails. By creating an upscale environment on its Web site, Bluefly has prevented the brand dilution vendors have historically experienced in the traditional discount channel. In the world of brick and mortar retailers, it is very expensive to invest in store layout, design, and décor, and since off-price retailers aim to pass along the largest discount possible to their customers, most have elected not to make this investment. Likewise, in order to keep overhead low, off-price retailers minimize the number of sales associates on the selling floor and try to hire the least expensive labor they can find. This hiring practice, not surprisingly, has left much to be desired in terms of customer service. Finally, off-price retailers often ignore the fashion/designer pecking order when displaying apparel to customers. For example, in a store like Daffy's, it would not be uncommon to find a $7 Pierre Cardin T-shirt hanging next to a $400 Giorgio Armani blouse.

Bluefly is committed to protecting its suppliers' brands and to ensuring a high caliber shopping experience. Given the superior economics of online virtual real estate, Bluefly is able to create an upscale, luxurious, and fresh environment at a fraction of the cost a traditional retailer must bear. Finally, Bluefly guarantees its vendors that their merchandise would be tastefully displayed next to designer merchandise of the same caliber. To this end, the Company often chooses not to procure merchandise from vendors who do not match the upscale, exclusive profile that Bluefly is trying to convey. Nevertheless, Bluefly's consistent brand strategy and existing assortments attracted numerous young, up-and-coming designers to contact the Company for inclusion on the Web site. Clearly, with its stylish Web site, emphasis on customer service, and stringent merchandise display standards, Bluefly provides high-end designers with a more appealing environment in which to liquidate inventory than the clearance racks at off-price stores.

***Assortments***

Bluefly's merchandising strategy is an integral element of its branding strategy. Each season, its merchandising team selects products with a particular fashion point-of-view and theme in mind. Unlike many traditional outlet stores and off-price department stores, Bluefly does not sell factory seconds, irregulars, or special-ordered lower quality products. The Company sells only first-quality designer fashions for men and women. These designer fashions tend to be ahead of the fashion trend, catering to specific tastes. Consequently, consumers either like or dislike the design, affecting the Company's return rate. In addition, sizing issues also affect the return rate as well as the Company's 90-day return policy, which is longer than its competitors. (See **Exhibit III** – Return Provisions and **Exhibit IV** – Competitive Return Policy.) Given the particular tastes associated with designer merchandise, it takes considerable markdowns to liquidate any merchandise that does not sell well. This exposure to significant markdowns and the sizeable return rate are points of concern to industry observers.

To facilitate the inventory management of its designer merchandise, the Company established a Clearance category on its web site. Bluefly further broadened its assortment range by introducing two additional categories. The House category includes items such as dinnerware, linens, and bedding products while the Gifts category offers items for birthdays, business associates, congrats / thank you, and housewarming. In spite of its management efforts, however, Bluefly continues to have major problems with customer returns, aging merchandise, and slow inventory turnover. Some industry observers wonder whether a category like designer merchandise, sold over the internet, could ever achieve an economic model that produced a sustainable profit level.

Bluefly has direct supply relationships with approximately 75% of the designers whose products are offered on its Web site. It sources the balance of its inventory from retailers and third-party consolidators. This affords the Company more control over the quality of the merchandise it sells and allows the Company to cherry pick only the best and most fashionable styles available. For the right to purchase only the styles and colors it wants, Bluefly is willing to pay vendors a slight premium compared to other off-price retailers, which generally take the entire lot of garments regardless of their fashion integrity.

The following is a representative sample of the brands featured on Bluefly:

| | | |
|---|---|---|
| A. Testoni | Fendi | Prada |
| Alfred Dunhill | Ferragamo | Ralph Lauren |
| Bvlgari | Giorgio Armani | Sarah Shaw |
| Calvin Klein | Gucci | Sergio Rossi |
| Cesare Paciotti | Helen Wang | Versace |
| Christian Dior | Helmut Lang | Zegna |
| Diesel | Hugo Boss | |
| DKNY | Jill Sander | |
| Dolce & Gabbana | Kenneth Cole | |

Source: Bluefly.com Web site

***Marketing & Advertising***

Early in its history, the Company developed exclusive relationships with popular fashion magazines such as *Vogue*, *Instyle*, and *Harper's Bazaar*. Bluefly leveraged these relationships through co-branded pages and interactive content to help communicate the merchandising team's fashion outlook for each season. In 1999 and 2000, Bluefly was the only off-price retailer advertising in top fashion magazines such as *Vogue*, *Harper's Bazaar*, *Marie Claire*, *Esquire,* and *Metropolitan Home*.

Bluefly's ads depicted its target customer and the lifestyle she leads. She is young, urban, stylish, and up-scale. In the ad campaign, we see her hosting a cocktail party in her downtown loft furnished with retro-modern classics. She is simply "cool" and "hip." What does she want? "Fabulous fashion. Fierce prices," proclaim the Bluefly ads. The customer that Bluefly is targeting is aged 20 – 45, has at least $45,000 in annual income and aspires to be fashionable but does not necessarily want to pay full price. (See **Exhibit V** – Sample Fashion Magazine Advertisement.)

Seiff believed that the primary purpose of the print ads was to build the Company's brand. Furthermore, he believed that building a strong brand name would be essential to winning over a critical mass of customers, which would allow Bluefly to enjoy a superior economics in the future. At the same time, Seiff had to balance the need for marketing dollars with the Company's finances. Consequently, the amount of dollars allocated to marketing declined over time. (See **Exhibit VI** – Operating Expenses.) In 2002, Bluefly, allowed its exclusive relationships with the top fashion magazines to lapse. Simultaneously, the Company employed its dollars more efficiently, and its customer acquisition cost declined over time. (See **Exhibit VII** – Key Operational Metrics.)

In the winter of 2002, Bluefly launched an innovative sweepstakes designed to boost its traffic. From October 1 through December 24, Bluefly offered "fashionistas" the opportunity to win twelve Hermès Kelly and Birkin handbags. (See **Exhibit VIIIa** – Hermès Competition.) Ranging from $4,000 to $80,000, these handbags have an extremely long waiting list, and consequently, are almost impossible to obtain.

Bluefly cut back on its marketing efforts in 2003 by focusing primarily on e-mail, affiliate, and performance-based programs. While continuing to grow its customer base, the

Company spent just $1.2 million in marketing for the nine months ending 2003, compared with $1.5 million for the same period in 2002. Based on the traffic success of the Hermès promotion the prior year, Bluefly launched an equally exciting sweepstakes from October 1 through November 11, 2003. The sweepstakes gave “shoe-obsessed fashionistas” the chance to win a closet full of Manolo Blahniks, the shoes worn by celebrities from Sarah Jessica Parker to Paloma Picasso. Contestants received entries both for visiting the site and for getting friends to register. (See **Exhibit VIIIIb** – Manolo Blahniks Competition.)

***Web Site Re-Design***

After years of focusing on displaying visually appealing merchandise in a uniform way, Bluefly’s strong team of dedicated graphic designers and photographers launched a more fashion-forward website in September 2003. In addition to its more lavish look with a modern, white background, the new site is easier to navigate and makes shopping more enjoyable. The main new features are: (i) *Search For My Size*: Saves time by allowing customers to shop only in their size; (ii) *Shop New Arrivals*: Gives option to see only newest arrivals; (iii) *Shop by Category or Designer*: Similar to *Shop New Arrivals*, gives option to shop only by one category or designer; (iv) *Keyword Search*: Enables search for all items that meet specific criteria; and (v) *Zoom*: Provides close-up view of merchandise.

Excited about the new website, Ken Seiff said:

> With this redesign, we believe our customers will enjoy the easiest and most luxurious shopping experience anywhere on the Web. When you add the service, designer selection and incredible discounts we've always offered, there's no reason to shop for fashion anywhere else.[1]

***Operations***

Bluefly recognizes that perfecting its operations from order placement to delivery is essential to generating repeat purchases and endearing customer loyalty. To ensure rapid execution of customers’ orders, the Company takes title and delivery of its inventory before offering it online. As a result, there are no backorders or out-of-stock situations. Everything displayed on the site is available to be shipped. The Company typically ships orders within twenty-four hours of the order being placed. Bluefly’s standard shipping method is UPS, which usually takes two to three days to arrive at the customer’s premises. The Company can ship items by overnight delivery for an additional charge. This represents a competitive advantage for Bluefly, as other online retailers depend on vendors to direct ship the merchandise to the consumer. By controlling the inventory, Bluefly can live up to its reputation for quality and customer service.

One aspect of customer service that Bluefly chose not to own is order fulfillment. Instead, Bluefly works with a third-party fulfillment provider located near Martinsville, Virginia, who packs and ships the items directly to the customer. Bluefly’s real-time inventory database allows it to ship and pack its orders within 48 hours of receipt of the order. In December 2002, Bluefly shipped approximately 99% of its orders within 24 hours of receipt of the order. As of

[1] Business Wire.

November 2002, the Company could handle processing and fulfilling over 30,000 SKU's of limited quantity merchandise. Although order fulfillment is a key determinant of how a customer views her experience with Bluefly, the Company can not economically justify spending precious capital on warehouses and on developing an in-house packing and shipping capability at this point in its evolution. However, it regularly sends employees from the New York office to the Martinsville warehouse to monitor the fulfillment operations and to help out during critical times like the Christmas holiday season.

Bluefly's management feels that the Company has done a good job managing the process from customer order to actual delivery, although there is clearly room for improvement. In 2003, Bluefly raised the standard ground shipment rate from \$5.95 to \$7.95, thereby increasing its shipping and handling revenue.

***Technology***

An important component of the Bluefly technology is the real-time updating of inventory. Since the Company sells limited quantity items, having real-time inventory is critical. As soon as a customer places an item in his or her virtual shopping cart, the item's locator number is automatically removed from inventory so that duplicate orders for the same exact item are not possible.

***Competition***

Early in its history, Bluefly encountered minimal competition. It now faces a handful of imitators in addition to traditional retailers with websites. (See **Exhibit IX** – Online Competition.)

*Smartbargains.com* positions itself as a virtual shopping arena for customers looking for merchandise at discounted values. Its range of branded products extends to men's, women's and kid's apparel, bed and bath, electronics, home décor, jewelry and watches, kitchen and dining, luggage, and accessories. Smartbargains.com is able to offer discounts between 30 – 80% by sourcing its products from closeouts, canceled orders by retailers and distributors, and overstock merchandise. The Company has Gordon Brothers Group, a provider of customized business solutions for retailers and consumer product companies, as a strategic partner.

*Overstock.com* offers name-brands at a discount between 40 – 80%. Having forged relationships with select manufacturers, wholesalers, and retailers, the Company purchases excess inventory at a discount and passes the savings on to the consumer. It offers products for home and garden; electronics and computers; books, movies, and books; jewelry and apparel; sports, travel, and toys; and worldstock.

*Yoox.com* offers off-season fashion at an average discount of 50 percent. Launched in the fall of 2001 from Italy by a recent Columbia Business School graduate, it focuses on vintage clothing and accessories. Since it sources its products from designers such as Giorgio Armani, Prada, Valentino, and Yves Saint Laurent, Yoox could be considered a direct competitor of Bluefly. After just two years of operation, the Company's bottom line was a brake even, and while most of its business is done in Europe, Yoox recently entered the U.S. and has shown strong results. In the first six months of 2003, the Company's revenue has doubled from the prior year, and Yoox is projecting 2003 revenue at $25 million.

*Designeroutlet.com* offers designer and manufacturer overstocks for men, women, plus size, toddlers and infants, girls, and boys. Designers include Ashworth, Calvin Klein, CHAPS Ralph Lauren, Emporio Armani, and Nicole Miller.

*Amazon.com* announced in November 2002 that it will team up with leading apparel companies to offer more than 400 popular brands in its new Apparel and Accessories Store. Brands include Anne Klein, DKNY, Hugo Boss, La Perla, Polo Ralph Lauren, and Tommy Hilfiger.

*TJX Companies* is the largest off-price retailer of apparel and home fashions in the United States and the world. TJX strives to provide value to its customers by delivering brand names, fashion, quality, and compelling prices. TJX operates 715 T.J. Maxx stores and 615 Marshalls stores in the United States along with 151 Winners store in Canada. TJX also operates HomeGoods, a U.S. off-price home fashion chain with 142 stores, and T.K. Maxx, an off-price family apparel concept with 120 stores in the United Kingdom and Ireland. A.J. Wright, offering brand name family apparel and footwear, and Home Sense, a Canadian equivalent to HomeGoods, round out TJX's stable of companies. Only T.J. Maxx and Marshalls have websites, but neither offers visitors the opportunity to purchase items online. Rather, they provide visitors with store location guides and the chance to purchase gift certificates.

*Ross Stores* is a chain of 507 off-price retail apparel and home accessories stores. It strives to provide in-season brand name and designer merchandise at everyday low prices, generally 20 – 60% below the regular prices of most department and specialty stores. By purchasing later in the merchandise buying cycle than department and specialty stores, Ross capitalizes on imbalances in manufacturer-projected supplies of merchandise. Its target customer is value-conscious men and women between the ages of 25 and 52 in middle-income households. While its Web site offers a store location guide, it does not offer e-commerce functionality.

*Loehmann's*, with 44 stores in 16 states, considers itself to be the only national upscale off-price specialty retailer. Loehmann's is best known for its Back Room, where it offers designer clothing at 30% to 65% lower than department store prices. More recently, Loehmann's has expanded its offerings to include shoes, juniors, fragrances, gifts, and intimate apparel. While Loehmann's has launched its Loehmanns.com Web site, the site only allows visitors to find store locations, to learn about current and upcoming sales, and to join the Insiders Club known as the Loehmann's loyalty card program. Loehmann's ran into financial difficulties in the past few years and voluntarily filed Chapter 11 bankruptcy in May 1999. It formally emerged from Chapter 11 bankruptcy protection in October 2000. The Company has yet to add an e-commerce functionality to its Web site.

*Century 21 Department Store*, also known as "New York's Best Kept Secret®", has more than 15 departments of quality and designer merchandise at 25%-75% off retail prices. Its departments include Men's, Ladies', and Children's Clothing, Men's, Ladies', and Children's Shoes, Lingerie, Linens, Cosmetics, Accessories, Handbags, Luggage, Housewares, Giftwares, and Electronics. Century 21 operates solely in the state of New York and has not expressed any intentions to expand on a national or broader regional basis. The Company's Web site, c21stores.com, offers the same functions as the Loehmann's Web site discussed above.

*Daffy's*, with its tagline "Clothing Bargains for Millionaires" has product offerings similar to Loehmann's and Century 21, with a large inventory of European and American designer clothing sold at discounts to traditional department store prices. Daffys.com offers the same functions as Loehmann's and Century 21.

## MARKET ENVIRONMENT

Despite recent negative press, Internet retailing enjoys and is projected to enjoy phenomenal growth. In January 2003, Jupiter Media Metrix estimated that US online retail sales would increase from $40 billion in 2002 to $52 billion in 2003 and to $105 billion by 2007. Forrester Research, Inc. estimated that 2003 online holiday sales alone would exceed $12 billion, a 42% increase over prior year.

## CURRENT SITUATION

### *Supplier Relationships*

There is an old retailing adage, "you can't sell from an empty basket." With respect to Bluefly's business model, Seiff knows that one of the most important challenges facing Bluefly is to convince high-end fashion designers to allow their merchandise to be sold on Bluefly.com. Only a few of these designers have been selling to Internet retailers, and Bluefly's team of merchants needs to convince the others that they should turn to Bluefly when considering their liquidation strategy. This would not always be easy to do since, in general, many designers are wary of the Internet and of off-price retailers. Other suppliers have never allowed their designs to be liquidated through another party and have always liquidated their products through Company-owned outlet stores or warehouse sales.

Many designers are still trying to determine their own Internet strategy and until they do so, they are hesitant to sell their merchandise through Bluefly.com. Designers need to decide whether they want to have a Company-run Web site or whether they would rather depend on third-party retailers to sell their goods over the Internet. If designers decide on a Company-run Web site strategy, they then have to decide whether to sell current season, full-price designs only or whether to sell past season, liquidation merchandise as well.

Finally, many designers fear the potential backlash and retaliatory consequences of selling their high fashion designs over the Internet. Designers have always had to balance the fine line of eliminating excess inventory, while not alienating their core clients, the national department store chains. If a department store is angered by where a designer decides to sell its goods, the department store may permanently terminate its buying relationship with that designer.

Despite these issues, Bluefly has made the recruitment of top designers one of its highest priorities. Its business model has been designed to provide a better liquidation channel for designers. Bluefly's buying team spends much of its time knocking on doors and preaching this message to designers with whom they worked previously while buying for upscale department stores such as Saks Fifth Avenue and Bergdorf Goodman. Although Bluefly's buying team originally was met with resistance from some brands, Bluefly has managed to open up direct relationships with numerous brands.

### *Positioning*

Bluefly positions itself first and foremost as a fashion destination, even though it also offers value and good service to its customers. In its September 30, 2002 10-Q SEC filing, the Company describes itself as "a leading Internet retailer of designer fashions and home accessories at discount prices." The Company's decision to position itself as a designer retailer first and an outlet store last is indicative of its branding strategy.

Bluefly believes that positioning itself as a fashion Web site as opposed to an online discount retailer gives it a number of advantages. It is a key factor in convincing designers to agree to sell their brands through Bluefly. Also, it allows Bluefly to go after upscale Internet users who may not be accustomed to discount shopping. Rather than targeting traditional off-price shoppers, Bluefly is seeking to convince them to shop off-price. The Company believes that the key to attract these customers is by positioning itself first and foremost as a fashion destination.

While the Company believes it has done a good job in driving traffic to its site, it is not clear whether customers truly understand that Bluefly.com is an off-price store. The strong customer base indicates a successful execution of the Company's branding strategy, but it also makes it more difficult to live up to customer's expectations in that customers may not find every product in the size that they want. Moreover, how Bluefly.com positions itself could have a major impact on the Company's realistic addressable market size.

### *Customer Acquisition and Retention*

Achieving scale will be a key driver of future profitability, and customer acquisition and retention are key to achieving scale. Bluefly acquires customers both through its advertising campaign and through strategic partnerships with leading Internet portals. It is featured in the top two portals: Yahoo.com and AOL.com. In August 1999, Bluefly expanded its marketing agreement with AOL and became an anchor tenant in its Outlet Stores Department. Bluefly has also entered into an agreement with Yahoo! to create a co-branded version of its online store on Yahoo! Shopping.

| Portal | Visitors* | Affiliation |
|---|---|---|
| Yahoo.com | 83.4 mm | Co-branded site |
| AOL.com | 97.9 mm | Anchor Tenant |

* Unique monthly visitors. Traffic numbers based on July 2003 data from comScore Media Metrix.

Bluefly has a number of strategies to help retain customers, but Seiff and his management team recognize that the Company has not taken full advantage of all of the customer information it has collected. They have been asking themselves: "How else can the Company use this information to retain customers? Also, what should we be doing to attract more new customers?"

***Human Resources***

Bluefly has been successful in recruiting top industry talent. Its senior managers have proven track records in the fashion, media, entertainment, and e-commerce industries or as management consultants or lawyers. Additionally, the Company has been growing at breakneck speed. While there were 8 employees when Bluefly was launched in September 1998, the Company now employs 83 people. The working environment at Bluefly's offices in the fashion district in midtown Manhattan is fast-paced and entrepreneurial.

However, management faces two challenges: managing head count in-line with expenses and maintaining the quality of its team. The former saw the Company announce in June 2001 the elimination of approximately 32 jobs, or approximately 34% of its workforce at the time, as part of a larger plan to improve efficiency and reduce the Company's need for additional capital.

Meanwhile, the most potent recruiting weapon Internet companies have to maintain the quality of its team is stock options. Bluefly's stock had been trending down since the beginning of March 2000 from a high of $16 per share at the end of December 1999. In mid-November 2003, however, the stock was trading at $3.85 a share, up 550% from its 52-week low of $.70. The future performance of the Company's stock is likely to have an impact on the Company's ability to attract new talent.

After finding the right people, management has to deal with integration issues. The Company realizes that, sooner or later, it will have to institute more formalized procedures to cope with the larger group of employees. The goal of the management team is to accomplish this without becoming too corporate and bureaucratic. Like most growing companies, Bluefly faces the challenge of maintaining its forward-thinking entrepreneurial culture as it grows.

***Strategic Options***

Seiff knew that Bluefly had many challenges in front of it, but he was confident that he had built a team that was up to the task. The big question remained: will Bluefly achieve the profitability necessary to survive long-term?

For purposes of accessing cash and to achieve more attractive economies of scale, many industry analysts have suggested that Internet retailers may need to consolidate. Furthermore, private investors that were looking at the e-tail space were moving their money into retailers who operate under a clicks-and-mortar model rather than a pure Internet business model.

Industry observers wondered what type of partner would make sense for Bluefly. Should Bluefly form an alliance with or even merge with another Internet retailer, or should it consider partnering with a brick and mortar retailer? Should the partner be an apparel retailer, a discount retailer, or could it operate in a completely different line of business than Bluefly? If Bluefly decides to acquire one of its competitors, who would be the best target? More fundamentally, does it make sense for Bluefly to pursue this type of partnership with anyone, given that its stated goal is to build a brand and business model that is fundamentally different from any of these potential partners? While Seiff had learned first hand the power of strength in the capital markets, he also knew that no good business makes strategic decisions solely at the behest of Wall Street. Part of him said that the best course would be to ride out the current storm in the markets by taking more money from Soros and looking for a recovery in the upcoming year. Soros, in particular, had developed strong ties with Bluefly and had repeatedly made investments. As of October 2003, public records indicated that the Soros group held approximately 90% of Bluefly's outstanding equity excluding options and warrants. There was no assurance, however, that Soros would continue to make additional investments in the Company.

To fully evaluate the situation, Seiff wanted to size up the competitive landscape. He wondered whether Bluefly had achieved a sustainable competitive advantage over its online and offline competitors. If not, how much more time would he need to build that advantage and how much money would it take?

### *Veteran Retailer Named Bluefly President*

Recognizing the need for a merchandising eye in the organization, Bluefly appointed Melissa Payner in September 2003 to a newly created position of President, which will report to Seiff. Payner, former President and CEO of Spiegel catalog, hopes to create a strategy to attract new customers while enhancing Bluefly's relationships with key designers, such as Prada and Gucci. In overseeing the merchandising, marketing, and e-commerce groups, Payner, and the entire Bluefly team believe that her intimate understanding of the business will lead the Company to profitability.

When asked about how quickly the Company would see Payner's impact, Ken Seiff explained:

> We will see some of it right away because of the lack of retail expertise in the business. There's probably a lot of low-hanging fruit.[2]

### *October Milestone*

The Company achieved a 63% year-over-year revenue increase in October 2003. At $4.1 million, this was the second-best net sales month in Bluefly's history, the highest being December 2002, and both an October and 2003 record. Seiff said:

> Because some portion of the more than 63% growth is the result of favorable comparisons to a poor first two weeks in October 2002, I do not expect the Company to maintain this exceptionally strong growth rate in the future. Nevertheless, I am very pleased by these numbers.[3]

[2] The Retailers' Daily Newspaper.
[3] Bluefly.

## CONCLUSION

After three hours had passed, Seiff's phone call was winding down and he could at last get back to vacationing with his family. He had just heard the great news about the stock price. After the press release on October's performance, the stock had reached $5 and closed at $4.52, up 17.4% from the previous day's close and 6.5 times the 52-week low of $.70.

To celebrate the sales performance and stock price, Seiff planned a quiet picnic supper on the beach with his family and a few close friends. As he jumped back in the pool, Seiff was elated about Bluefly's recent success and what his new President would bring to the Company, but he knew that Bluefly's hardest work and toughest decisions were still ahead of him. Specifically, he still faced the task of increasing revenue, controlling expenses, and posting Bluefly's first profit – all while continually refreshing its assortments.

# EXHIBIT I – Financial Statements

**BLUEFLY, INC.**

**Consolidated Balance Sheets**

Nine months ending September 30, 2003, 2002, and 2001
And Years Ending December 31, 2002 and 2001
(Dollars in thousands)

| | 9/30/2003 | 9/30/2002 | 9/30/2001 | 2002 | 2001 |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| Current assets | | | | | |
| Cash and cash equivalents | $2,567 | $3,372 | $4,113 | $1,749 | $5,419 |
| Inventories, net | 12,464 | 10,913 | 7,661 | 10,868 | 6,388 |
| Accounts receivables | 1501 | 640 | 985 | 1,147 | 1,197 |
| Prepaid expenses and other current assets | 382 | 1,089 | 579 | 326 | 474 |
| Total Current Assets | 16,914 | 16,014 | 13,338 | 14,090 | 13,478 |
| Property and equipment, net | 1,919 | 2,802 | 1,095 | 2,604 | 1,155 |
| Other assets | 167 | 293 | 153 | 215 | 193 |
| **Total Assets** | **$2,086** | **$19,109** | **$14,586** | **$16,909** | **$14,826** |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | | | |
| Current liabilities | | | | | |
| Accounts payable | $5,789 | $5,028 | $2,895 | $3,434 | $3,338 |
| Accrued expenses and other current liabilities | 2,648 | 2,100 | 1,910 | 3,067 | 2,213 |
| Deferred revenue | 1412 | 608 | - | 885 | 691 |
| Note payable to shareholders | 2,000 | 2,000 | - | - | - |
| Convertible notes payable, net of unamortized discount | - | - | - | - | - |
| Total Current Liabilities | 11,849 | 9,736 | 4,805 | 7,386 | 6,242 |
| Notes payable to shareholders | 182 | 182 | - | 2182 | 182 |
| Redeemable convertible series A preferred stock | - | - | - | - | - |
| Long-term lease liability | 193 | 447 | - | 257 | - |
| **Total Liabilities** | **$12,224** | **$10,365** | **$4,805** | **$9,825** | **$6,424** |
| **SHAREHOLDERS' EQUITY** | | | | | |
| Series A preferred stock $0.01 par value | 5 | 5 | 5 | 5 | 5 |
| Series B preferred stock $0.01 par value | 89 | 89 | 89 | 89 | 89 |
| Series C preferred stock $0.01 par value | - | - | - | - | - |
| Series 2002 convertible preferred stock $0.01 par value | - | - | - | - | - |
| Common stock $0.01 par value | 111 | 104 | 92 | 104 | 92 |
| Additional paid-in capital | 99,018 | 92,628 | 72,184 | 92,628 | 72,184 |
| Accumulated deficit | -92,447 | -84,082 | -62,589 | -85,742 | -63,968 |
| Total Shareholders' Equity | 6,776 | 8,744 | 9,781 | 7,084 | 8,402 |
| **Total Liabilities and Shareholders' Equity** | **$19,000** | **$19,109** | **$14,586** | **$16,909** | **$14,826** |

Source: Company's 10Q's and 10K's

## EXHIBIT I, cont. – Financial Statements

**BLUEFLY, INC.**
**Consolidated Statement of Operations**
Nine months ending September 30, 2003, 2002 and 2001
And Years Ending December 31, 2003 and 2002
(All dollars in thousands except per share data)

| | 9/30/2003 | 9/30/2002 | 9/30/2001 | 2002 | 2001 |
|---|---|---|---|---|---|
| Net sales | $23,935 | $20,750 | $15,044 | $30,606 | $22,950 |
| Cost of sales | -18,015 | -13,770 | -10,578 | -20,571 | -15,954 |
| Gross profit | 5,920 | 6,980 | 4,466 | 10,035 | 6,996 |
| Selling, marketing and fulfillment expenses | -8,382 | -8,047 | -10,807 | -11,493 | -13,765 |
| General and administrative expenses | -3,778 | -3,546 | -4,178 | -4,740 | -5,098 |
| Total operating expenses | -12,160 | -11,593 | -14,985 | -16,233 | -18,863 |
| Operating loss | -6,240 | -4,613 | -10,519 | -6,198 | -11,867 |
| Interest (expense) / other income | -240 | -206 | -13,108 | -281 | -13,139 |
| Income tax | | - | - | - | - |
| Net loss | -6,480 | -4,819 | -23,627 | -6,479 | -25,006 |
| Deemed dividend related to beneficial conversion feature on Series B preferred stock (1) | -225 | -15,295 | - | -15295 | - |
| Preferred stock dividends | -2,354 | -1,846 | -2,304 | -2,489 | -2,926 |
| Net loss available to common shareholders | ($9,059) | ($21,960) | -25,931 | ($24,263) | ($27,932) |
| Basic and diluted (loss) income per share | ($0.82) | ($2.25) | ($3.31) | ($2.44) | ($3.41) |
| Weighted average shares outstanding | 11,021,829 | 9,770,366 | 7,841,240 | 9,927,027 | 8,185,065 |

(1)
In June 2002, affiliates of the Soros group agreed to provide Bluefly with up to $4.0 million in financing. As a result of this financing agreement, the conversion price of the Company's Series B Preferred Stock automatically decreased from $2.34 to $1.57. This reduction in conversion price resulted in a non-cash charge of approximately $10.2 million, which the Company recorded as part of its second quarter financial results.

In September 2002, affiliates of the Soros group agreed to invest an additional $3.0 million in the Company. As a result of this financing, the conversion price of the Company's Series B Preferred Stock automatically decreased from $1.57 to $0.93, resulting in a non-cash charge of approximately $5.1 million. The Company incorporated this charge in its third quarter financial results.

In March 2003, Bluefly entered into an agreement with Soros in which Soros would provide $2 million in new capital by purchasing 2,000 shares of Series D Preferred Stock. As a result, the conversion price of the Series B and Series C Preferred Stock decreased from $0.93 to $0.76. The Company incorporated a non-cash charge of approximately $225,000 as an adjustment to its first quarter financial results.

Source: Company's 10Q's and 10K's

**EXHIBIT II – Bluefly.com Website Pages: Home Page**

**EXHIBIT II, cont. – Bluefly.com Website Pages: Women's Apparel Page**

**EXHIBIT II, cont. – Bluefly.com Website Pages: Men's Apparel Page**

## EXHIBIT III – Return Provisions (All data in $000's)

| Period Ending | Jun-01 | Sep-01 | Dec-01 | Mar-02 | Jun-02 | Sep-02 | Dec-02 | Mar-03 | Jun-03 | Sep-03 | Year-to-date |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Gross Sales | 7,631 | 7,627 | 12,062 | 11,342 | 10,747 | 10,541 | 14,861 | 13,044 | 11,994 | 13,574 | 38,612 |
| Provision (1) | -2,346 | -2,514 | -4,156 | -3,696 | -3,948 | -4,236 | -5,005 | -4,787 | -4,526 | -5,364 | -14,677 |
| Provision % Gross Sales | -31% | -33% | -34% | -33% | -37% | -40% | -34% | -37% | -38% | -40% | -38% |
| **Net Sales** | **5,285** | **5,113** | **7,906** | **7,646** | **6,799** | **6,305** | **9,856** | **8,257** | **7,468** | **8,210** | **15,725** |

(1) Provision for returns and credit card chargebacks

Source: Company 10Q's and 10K's

## EXHIBIT IV – Competitive Return Policy (A Sample)

| Company | Return Policy |
|---|---|
| Smartbargains.com | Company must receive the product within 30 days of shipment date |
| Overstock.com | Company must receive the product within 30 days of shipment date |
| Yoox.com | Company must receive the product within 30 days of delivery date |
| Designeroutlet.com | Within 30 days of purchase |
| Amazon.com | Within 30 days of delivery (1) |
| Bluefly.com | Within 90 days of purchase |

(1) Extended for the holidays (all orders shipped from Nov. 1, 2003 to Dec. 31, 2003 can be returned until Jan. 31, 2004)

Source: Company websites

**EXHIBIT V – Bluefly.com Fashion Magazine Advertisement (April 2000), page 1**

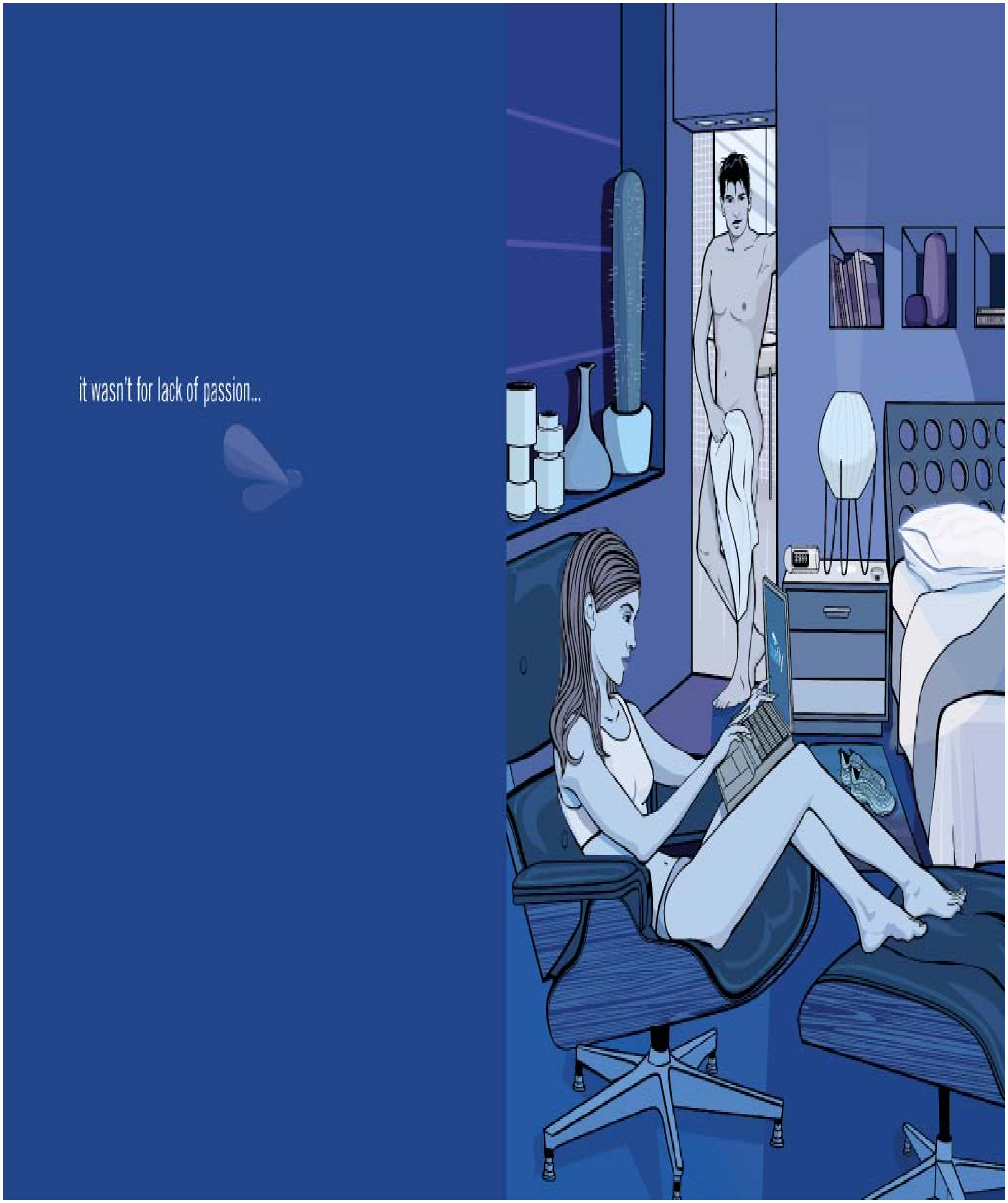


**EXHIBIT V – Bluefly.com Fashion Magazine Advertisement (April 2000), page 2**

## EXHIBIT VI – Operating Expenses (All data in $000's)

| Period Ending | Mar-01 | Jun-01 | Sep-01 | Dec-01 | Mar-02 | Jun-02 | Sep-02 | Dec-02 | Mar-03 | Jun-03 | Sep-03 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Marketing | 1,205 | 2,206 | 664 | 783 | 346 | 491 | 648 | 799 | 260 | 515 | 451 |
| Operating | 865 | 918 | 983 | 1,173 | 1,051 | 1,071 | 1,055 | 1,356 | 1,167 | 1,145 | 1,236 |
| Technology | 1,130 | 1,041 | 840 | 722 | 769 | 810 | 956 | 1017 | 724 | 1047 | 817 |
| Creative | 341 | 370 | 244 | 280 | 239 | 258 | 266 | 318 | n/a | n/a | n/a |
| E-Commerce | n/a | n/a | n/a | n/a | 270 | 287 | 293 | n/a | 302 | 305 | 413 |
| Gen & admin | 1,651 | 1,387 | 1,140 | 920 | 1062 | 1,207 | 1,277 | 1,150 | 1,162 | 1,376 | 1,240 |
| **TOTAL** | **5,192** | **5,922** | **3,871** | **3,878** | **3,737** | **4,124** | **4,495** | **4,640** | **3,615** | **4,388** | **4,157** |

n/a = not available

Source: Company 10Q's and 10K's

## EXHIBIT VII – Key Operational Metrics

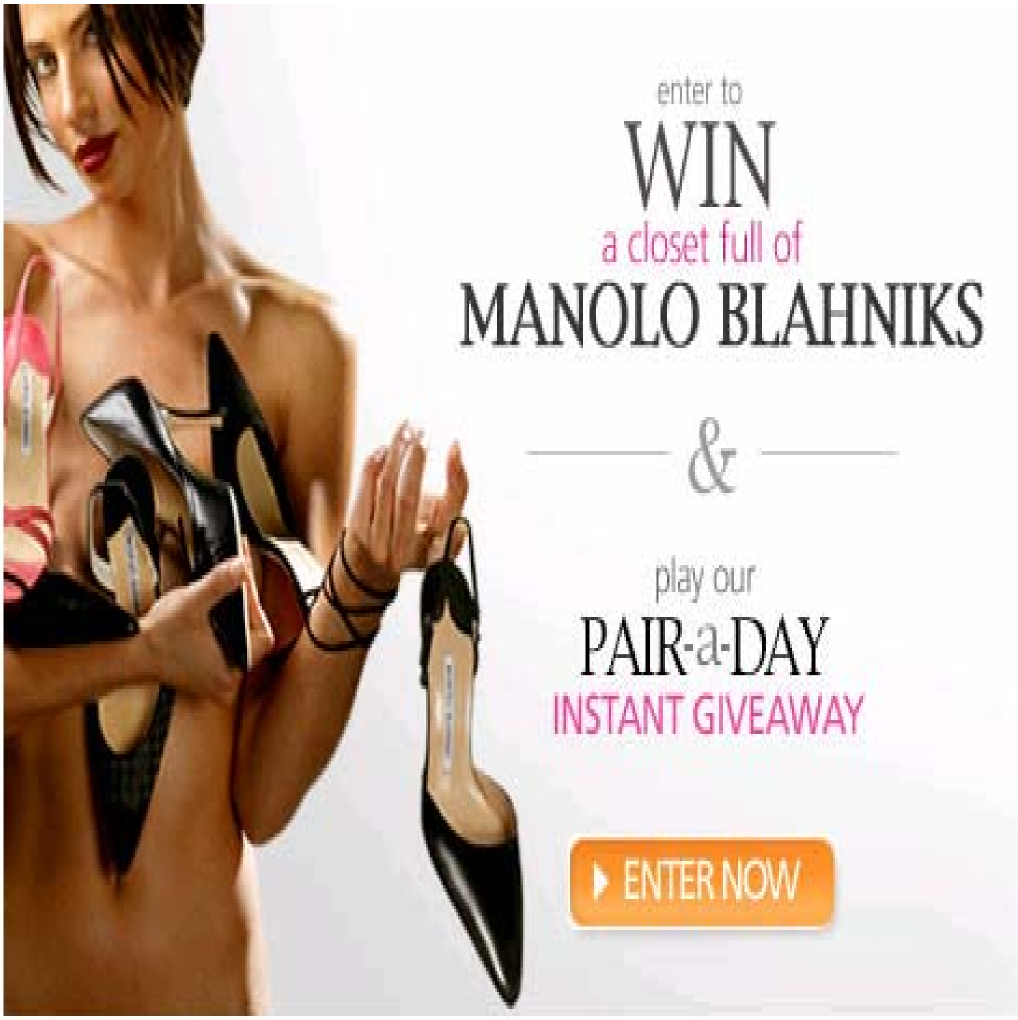
| | Mar-01 | Jun-01 | Sep-01 | Dec-01 | Mar-02 | Jun-02 | Sep-02 | Dec-02 | Mar-03 | Jun-03 | Sep-03 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Customers added during period | 24,257 | 25,988 | 21,113 | 31,039 | 24,873 | 21,057 | 22,393 | 32,840 | 27,031 | 22,581 | 29,522 |
| Avg. order size (1) | $129.11 | $140.29 | $143.84 | $155.84 | $161.76 | $161.65 | $163.64 | $177.53 | $167.20 | $176.70 | $161.87 |
| Avg. order / new customer (1) | $114.79 | $125.92 | $126.74 | $138.96 | $144.73 | $149.01 | $144.03 | $157.78 | $153.01 | $165.15 | $144.69 |
| Avg. order / repeat customer (1) | $143.05 | $154.02 | $155.69 | $167.11 | $171.53 | $167.80 | $174.61 | $190.08 | $175.18 | $182.78 | $171.51 |
| Customer acquisition cost (2) | $40.84 | $75.40 | $23.73 | $18.53 | $9.40 | $16.92 | $23.07 | $19.19 | $5.26 | $15.16 | $10.52 |

(1) Including shipping and handling.
(2) Customer acquisition cost = total advertising expenditures (excluding staff related costs) divided by total new customers added

Source: Company 10Q's and 10K's

**EXHIBIT VIIIa – Bluefly.com Hermes Competition (Winter 2002)**

**EXHIBIT VIIIb – Bluefly.com Manolo Blahniks Competition (Fall 2003)**



## EXHIBIT IX – Online Competition

## EXHIBIT IX, cont. – Online Competition

**EXHIBIT IX, cont. – Online Competition**

## EXHIBIT IX, cont. – Online Competition

## EXHIBIT IX, cont. – Online Competition