

Edgar Filing: FAIRMARKET INC - Form 10-Q

FAIRMARKET INC
Form 10-Q
August 02, 2001

=====

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2001

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number 000-29423

FAIRMARKET, INC.
(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

04-3351937
(I.R.S. Employer
Identification No.)

500 UNICORN PARK DRIVE, WOBURN, MA 01801-3341
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (781) 376-5600

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

Yes No

The number of shares outstanding of the registrant's common stock as of July 30, 2001 was 28,898,642.

=====

Edgar Filing: FAIRMARKET INC - Form 10-Q

FAIRMARKET, INC.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2001

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

a) Condensed Consolidated Balance Sheets
as of June 30, 2001 and December 31, 2000.....

b) Condensed Consolidated Statements of Operations
for the Three- and Six-Month Periods Ended June 30, 2001 and 2000.....

c) Condensed Consolidated Statements of Cash Flows
for the Six Months Ended June 30, 2001 and 2000.....

d) Notes to Condensed Consolidated Financial Statements.....

Item 2. Management's Discussion and Analysis of Financial
Condition and Results of Operations.....

Item 3. Quantitative and Qualitative Disclosures About Market Risk.....

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.....

Item 2. Changes in Securities and Use of Proceeds.....

Item 3. Defaults upon Senior Securities.....

Item 4. Submission of Matters to a Vote of Security Holders.....

Item 5. Other Information.....

Item 6. Exhibits and Reports on Form 8-K.....

SIGNATURE.....

FAIRMARKET, FAIRMARKET NETWORK AND THE FAIRMARKET LOGO ARE SERVICE MARKS OF
FAIRMARKET, INC. THE NAMES OF OTHER COMPANIES AND PRODUCTS MENTIONED IN THIS
REPORT MAY BE THE TRADEMARKS OF THEIR RESPECTIVE OWNERS.

Edgar Filing: FAIRMARKET INC - Form 10-Q

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

FAIRMARKET, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

(IN THOUSANDS)

	JUNE 30, 2001 -----	DECEMBER 31, 2000 -----
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 51,958	\$ 61,115
Marketable securities	14,898	14,898
Restricted cash	1,800	1,800
Accounts receivable, net of allowance for doubtful accounts of \$577 and \$540 at June 30, 2001 and December 31, 2000, respectively	1,127	2,127
Prepaid expenses and other current assets	1,966	4,127
Total current assets	71,749	84,067
Property and equipment, net of accumulated depreciation of \$4,815 and \$3,117 at June 30, 2001 and December 31, 2000, respectively	7,810	8,127
Total assets	\$ 79,559 =====	\$ 93,194 =====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 587	\$ 1,127
Accrued expenses	2,548	3,127
Deferred revenue	393	1,127
Current portion of long-term lease obligation	194	194
Total current liabilities	3,722	5,575
Long-term lease obligation	43	43
Other long-term liabilities	423	423
Total liabilities	4,188	6,041
Stockholders' equity:		
Preferred stock	--	--
Common stock	29	29
Additional paid-in capital	189,727	209,727
Deferred compensation and equity-related charges	(20,018)	(51,018)
Accumulated other comprehensive loss, net	(91)	(91)
Accumulated deficit	(94,276)	(69,276)
Total stockholders' equity	75,371	87,152
Total liabilities and stockholders' equity	\$ 79,559	\$ 93,194

See accompanying notes to condensed consolidated financial statements

3

FAIRMARKET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	THREE MONTHS ENDED JUNE 30,		SIX MONTH JUNE
	2001	2000	2001
Revenue	\$ 3,004	\$ 3,013	\$ 5,688
Operating expenses:			
Cost of revenue (exclusive of \$51 and \$115 in 2001 and \$59 and \$121 in 2000, for the three- and six-month periods, respectively, reported below as equity-related charges)	1,259	1,246	2,615
Sales and marketing (exclusive of \$6,148 and \$12,007 in 2001 and \$3,999 and \$7,385 in 2000, for the three- and six-month periods, respectively, reported below as equity-related charges)	2,662	7,167	6,113
Development and engineering (exclusive of \$105 and \$235 in 2001 and \$248 and \$481 in 2000, for the three- and six-month periods, respectively, reported below as equity-related charges)	1,382	2,120	3,102
General and administrative (exclusive of \$171 and \$259 in 2001 and \$176 and \$329 in 2000, for the three- and six-month periods, respectively, reported below as equity-related charges)	3,075	3,363	6,023
Equity-related charges	6,475	4,482	12,616
Restructuring charge	1,650	--	1,650
Total operating expenses	16,503	18,378	32,119
Loss from operations	(13,499)	(15,365)	(26,431)
Interest income, net	788	1,415	1,921
Net loss	\$ (12,711)	\$ (13,950)	\$ (24,510)
Basic and diluted net loss per share	\$ (0.44)	\$ (0.49)	\$ (0.85)
Shares used to compute basic and diluted net loss per share	28,780	28,197	28,760

Edgar Filing: FAIRMARKET INC - Form 10-Q

See accompanying notes to condensed consolidated financial statements.

4

FAIRMARKET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(IN THOUSANDS)

	SIX MONTHS END JUNE 30,	
	2001	2000
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (24,510)	\$ (25,110)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	1,777	1,777
Reserve for uncollectible accounts	37	37
Non-cash advertising expense	--	5
Amortization of email marketing database	3,032	3,032
Amortization of deferred compensation and equity-related charges	12,616	12,616
Changes in operating assets and liabilities:		
Accounts receivable	850	850
Prepaid expenses and other current assets	(330)	(2,100)
Accounts payable	(580)	(580)
Accrued expenses	(596)	1,196
Deferred revenue	(613)	(613)
Other non-current liabilities	(85)	(85)
	-----	-----
Net cash used in operating activities	(8,402)	(12,402)
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property and equipment	(724)	(5,724)
Purchase of marketable securities	(14,898)	(2,898)
Proceeds from maturity of marketable securities	14,978	2,978
	-----	-----
Net cash used in investing activities	(644)	(5,644)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock, net of issuance costs	46	89
Repayment of capital lease	(105)	(105)
Collection of subscription receivable	--	5
	-----	-----
Net cash provided by (used in) financing activities	(59)	94
	-----	-----
Effect of foreign exchange rates on cash and cash equivalents	(63)	(63)
	-----	-----
Net change in cash and cash equivalents	(9,168)	76
Cash and cash equivalents, beginning of period	61,126	11,126
	-----	-----

Edgar Filing: FAIRMARKET INC - Form 10-Q

Cash and cash equivalents, end of period	\$ 51,958	\$ 87
	=====	=====
Supplemental schedule of cash flow information:		
Non-cash financing activity:		
Conversion of preferred stock to common stock	\$ --	70

See accompanying notes to condensed consolidated financial statements.

5

FAIRMARKET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. NATURE OF BUSINESS

FairMarket, Inc. ("FairMarket" or the "Company") develops and delivers e-business selling and marketing solutions for retailers, distributors and manufacturers and for Internet portals and web communities primarily engaged in e-commerce. These hosted, scalable solutions are built upon the Company's proprietary dynamic pricing software. The Company's software is designed for rapid deployment and integrates with existing customer web sites and back office systems.

FairMarket's services are used in four primary areas: (1) retail and discount clearance; (2) business-to-business surplus; (3) promotions and interactive marketing; and (4) outsourced auctions and e-commerce to portals and other web communities. The Company provides a broad suite of dynamic pricing formats to create a comprehensive e-business selling and marketing service offering.

2. BASIS OF PRESENTATION

The accompanying consolidated interim financial statements of FairMarket are unaudited and have been prepared on a basis substantially consistent with the Company's audited financial statements for the year ended December 31, 2000. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Consequently, these statements do not include all disclosures normally required by generally accepted accounting principles for annual financial statements. These consolidated interim financial statements should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2000, which are contained in FairMarket's Annual Report on Form 10-K for the year ended December 31, 2000 filed with the Securities and Exchange Commission. The consolidated interim financial statements, in the opinion of management, reflect all adjustments (including all normal recurring accruals) necessary for a fair presentation of the results of operations and cash flows for the interim periods ended June 30, 2001 and 2000. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the fiscal year. The consolidated interim financial statements include the accounts of FairMarket, Inc. and its wholly owned subsidiaries, FairMarket UK Limited, The FairMarket Network Pty Ltd, FairMarket GmbH and FairMarket Securities Corporation. All intercompany transactions and balances have been eliminated in consolidation.

Edgar Filing: FAIRMARKET INC - Form 10-Q

3. EQUITY-RELATED CHARGES

Equity-related charges consist of the amortization of (i) deferred stock compensation resulting from the grant of stock options to employees at exercise prices subsequently deemed to be less than the fair value of the common stock on the grant date and (ii) the fair value of warrants issued to strategic customers and shares of Series D convertible preferred stock issued to strategic customers at prices below their fair value. At June 30, 2001, deferred stock compensation was \$2.0 million, net of amortization of \$5.6 million and canceled stock options valued at \$5.7 million. This amount is being amortized ratably over the vesting periods of the applicable stock options, typically four years, with 25% vesting on the first anniversary of the grant date and the balance vesting 6.25% quarterly thereafter. For the three and six months ended June 30, 2001 and 2000, related expense recognized was \$747,000 and \$1.2 million, and \$720,000 and \$1.4 million, respectively.

At June 30, 2001, other deferred equity-related charges, which is a component of stockholders' equity, totaled \$18.0 million, net of amortization of \$29.7 million. Included in other deferred equity-related charges is the value of shares of Series D convertible preferred stock issued to Excite, Inc. (now known as At Home Corporation), which converted into shares of the Company's common stock upon the Company's initial public offering. The Company recorded the shares at fair value for a total of \$15.0 million at December 31, 1999. The value of the shares was remeasured at the date of the Company's initial public offering and the Company recorded an additional \$10.5 million in the first quarter of 2000 as a deferred charge to be amortized over the remaining term of the Company's original auction services agreement with Excite. As a result of the termination of the original Excite agreement in December 2000, the remaining term of that agreement has been modified to that of the new auction services agreement entered into by the Company and At Home at that time, which has a term of 18 months.

On June 29, 2001, the Company amended its auction services agreement with Microsoft Corporation which originally provided that, if Microsoft drove more than a specified number of Internet users to the FairMarket Network through its Internet portal site, the Company would guarantee a minimum level of transaction fee revenue

6

regardless of actual transaction fee revenue earned by Microsoft. Under this provision, if Microsoft met its minimum annual traffic guarantee but such increase in traffic did not produce sufficient revenue to meet the minimum guaranteed revenue, the Company would have had a financial obligation to Microsoft equal to the difference between the minimum guaranteed payment and its portion of fees actually collected. The minimum guaranteed revenue was \$5.0 million, \$10.0 million, \$10.0 million, \$15.0 million and \$20.0 million for the first, second, third, fourth and fifth contract years, respectively. Microsoft did not meet its minimum annual traffic guarantee for the first contract year and therefore no payment was required. As part of the June 2001 amendment, this provision was eliminated from the auction services agreement. As a result, the Company will not be required to make any minimum guaranteed revenue payments for any other period. Also under the terms of the amendment, Microsoft relinquished the warrants it held to purchase 4,500,000 shares of FairMarket common stock. In exchange for the above, FairMarket waived its status as "pre-eminent auction services provider" to Microsoft's online properties. However, the Company

Edgar Filing: FAIRMARKET INC - Form 10-Q

continues to provide its online auction services to Microsoft sites. The Company valued these warrants at \$28.5 million at the time of issuance and recorded a deferred charge to be amortized over the term of the Microsoft contract. As of June 2001, the unamortized value of the warrants on the Company's balance sheet was approximately \$18 million which was reversed through equity as a result of the amendment to the auction services agreement. The return of the warrants results in a reduction in quarterly equity-related charges of approximately \$1.4 million beginning with the third quarter of 2001.

Other deferred equity-related charges are being amortized ratably over the terms of the related agreements, from 18 months to three years. For the three and six months ended June 30, 2001 and 2000, related expense recognized was \$5.7 million and \$11.5 million, and \$3.7 million and \$6.9 million, respectively.

4. NET LOSS PER SHARE

Basic net loss per common share excludes potentially dilutive securities and is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Diluted net loss per common share is based upon the weighted average number of common shares outstanding during the period plus the additional weighted average common equivalent shares during the period. Common equivalent shares are not included in the per share calculations where the effect of their inclusion would be anti-dilutive. Common equivalent shares result from the assumed exercises of outstanding stock options and warrants, the proceeds of which are then assumed to have been used to repurchase outstanding common stock using the treasury stock method. For the three and six months ended June 30, 2001 and 2000, basic and diluted net loss per common share is computed based on the weighted-average number of common shares outstanding during the period because the effect of common stock equivalents would be anti-dilutive.

Certain securities were not included in the computation of diluted net loss per share for the quarters ended June 30, 2001 and 2000, because they would have an anti-dilutive effect due to net losses for such periods. These securities include: (i) options to purchase approximately 5,338,000 shares of common stock with exercise prices of \$0.10 to \$9.66 per share at June 30, 2001 and options to purchase 5,318,000 shares of common stock with exercise prices of \$0.10 to \$17.00 per share at June 30, 2000; and (ii) warrants to purchase 5,095,000 shares of common stock with an exercise price of \$1.71 per share at June 30, 2000.

5. COMPREHENSIVE LOSS

For the three months ended March 31, 2001 and 2000, total comprehensive loss was as follows (in thousands):

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	JUNE 30,		JUNE 30,	
	2001	2000	2001	2000
	----	----	----	----
Net loss	\$ (12,711)	\$ (13,950)	\$ (24,510)	\$ (24,510)
Changes in other comprehensive loss:				
Foreign currency translation adjustments	(24)	(40)	(44)	(44)
Unrealized gain (loss) on marketable securities	--	21	(19)	(19)
	-----	-----	-----	-----
Total comprehensive loss	\$ (12,735)	\$ (13,969)	\$ (24,573)	\$ (24,573)
	=====	=====	=====	=====

Edgar Filing: FAIRMARKET INC - Form 10-Q

6. STOCK OPTION EXCHANGE

On January 16, 2001, the Company implemented a one-time employee incentive program under which employees had the opportunity to exchange, on a one-for-one basis, their outstanding employee stock options with exercise prices of \$3.00 or more for new options with an exercise price of \$2.1875, the closing price of the

7

Company's common stock on the January 16, 2001 exchange date. Options held by executive officers and directors were not included in the exchange. Under this program, options covering approximately 1,155,000 shares of the Company's common stock were exchanged for options covering an equal number of shares. Options granted under this program have special terms, with the options vesting quarterly over two years, beginning on the three-month anniversary of the grant date, if the option exchanged was unvested, or vesting on the six-month anniversary of the grant date, if the option exchanged was vested, and having a term of two and one-half years. For accounting purposes, the exchange constituted a repricing of the existing options and will require variable accounting for the new options granted in the exchange. As a result, the Company (i) will recognize a non-cash compensation charge each quarter with respect to vested options if and to the extent that the per share fair market value of the Company's common stock at the end of the quarter exceeds \$2.1875, the per share exercise price of the new options, and (ii) will adjust deferred compensation each quarter for unvested options. There is a potential for such a variable non-cash charge in each quarter until all of the new options are exercised or until the date the options expire (July 16, 2003) or otherwise terminate. The closing price of the Company's common stock on June 30, 2001 was below \$2.1875, therefore no related charge was recognized for the three and six months ended June 30, 2001.

7. REVENUES AND LONG-LIVED ASSETS BY GEOGRAPHIC REGION

The table below presents revenues by principal geographic region for the three and six months ended June 30, 2001 and 2000 (in thousands):

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2001	2000	2001	2000
United States	\$ 2,390	\$ 2,739	\$ 4,488	\$ 4,488
United Kingdom	297	227	727	727
Australia	317	47	473	473
	-----	-----	-----	-----
Total	\$ 3,004	\$ 3,013	\$ 5,688	\$ 5,688

The table below presents long-lived assets by principal geographic region as of June 30, 2001 and December 31, 2000 (in thousands):

Edgar Filing: FAIRMARKET INC - Form 10-Q

	JUNE 30, 2001	DEC
	-----	---
United States	\$ 6,969	\$
United Kingdom	841	
Australia	--	
	-----	---
Total	\$ 7,810	\$
	=====	==

8. RESTRUCTURING CHARGE

On May 14, 2001, as part of the Company's plan to continue to implement cost-cutting measures, the Company eliminated 40 positions at its Massachusetts facility, representing approximately 25% of its total employee base.

On May 14, 2001, the Company also announced its intention to close its office in Australia during the second quarter of 2001, which closing was not completed as of June 30, 2001. The Company expects to complete the closing of its Australia office during the third quarter of 2001. The Company continues to service its Australian customers out of its U.S. operations.

The Company recognized a charge of approximately \$1.7 million in the second quarter of 2001 for the costs related to the workforce reduction, severance payments to certain other employees and other restructuring initiatives, including closing the Australia office. Approximately \$200,000 of the charge relates to non-cash costs associated with the restructuring initiatives. At June 30, 2001, approximately \$1.0 million of the charge remained unpaid, primarily related to severance payments to certain employees; the Company expects to pay substantially all of these remaining expenses during the third quarter of 2001.

9. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2000, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 138, "Accounting for Certain Derivative Instruments," an amendment of SFAS 133 ("Accounting for Derivative Instruments and Hedging Activities"). This statement establishes the accounting

and reporting standards for derivative instruments embedded in other contracts (collectively referred to as "derivatives") and hedging activities. The statement requires companies to recognize all derivatives as either assets or liabilities, with the instruments measured at fair value. The accounting for changes in their value, gains or losses, depends on the intended use of the derivative and its resulting designation. The Company adopted SFAS 138 in 2001, in accordance with SFAS 137, which deferred the effective date of SFAS 133. The adoption of SFAS 138 did not have a material impact on the Company's consolidated financial statements and related disclosures.

In September 2000, the FASB issued SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,

Edgar Filing: FAIRMARKET INC - Form 10-Q

a Replacement of FASB Statement No. 125." This statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities and is effective after March 31, 2001. The Company adopted SFAS 140 in the second quarter of 2001. The adoption of SFAS 140 did not have a material impact on the Company's consolidated financial statements and related disclosures.

In July 2001, the FASB issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS 141 requires that all business combinations be accounted for under the purchase method only and that certain acquired intangible assets in a business combination be recognized as assets apart from goodwill. SFAS 142 requires that ratable amortization of goodwill be replaced with periodic tests of the goodwill's impairment and that intangible assets other than goodwill be amortized over their useful lives. SFAS 141 is effective for all business combinations initiated after June 30, 2001 and for all business combinations accounted for by the purchase method for which the date of acquisition is after June 30, 2001. The provisions of SFAS 142 will be effective for fiscal years beginning after December 15, 2001, and will thus be adopted by the Company, as required, in fiscal year 2002. The impact of SFAS 141 and SFAS 142 on the Company's financial statements has not yet been determined.

10. SUBSEQUENT EVENT

FairMarket has been informed that on or about July 27, 2001, a putative class action lawsuit was filed by an individual shareholder in the U.S. District Court for the Southern District of New York against FairMarket, Scott Randall, John Belchers, U.S. Bancorp Piper Jaffray Inc., Deutsche Bank Securities Inc. and FleetBoston Robertson Stephens, Inc. The lawsuit was filed by the law firm of Bernstein, Liebhard & Lifshitz, LLP on behalf of Ohel Shlomo Dov and purports to seek class action status on behalf of all other similarly situated persons who purchased the common stock of FairMarket between March 14, 2000 and December 6, 2000. The lawsuit alleges that certain underwriters of FairMarket's initial public offering solicited and received excessive and undisclosed fees and commissions in connection with that offering. The lawsuit further alleges that the defendants violated the federal securities laws by issuing a registration statement and prospectus in connection with FairMarket's initial public offering which failed to accurately disclose the amount and nature of the commissions and fees paid to the underwriter defendants. FairMarket obtained a copy of the complaint on August 2, 2001, is reviewing the allegations in the complaint and intends to defend the lawsuit vigorously.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THIS FORM 10-Q 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. YOU CAN IDENTIFY FORWARD-LOOKING STATEMENTS BY THE USE OF THE WORDS "BELIEVE," "EXPECT," "ANTICIPATE," "INTEND," "ESTIMATE," "ASSUME" AND OTHER SIMILAR EXPRESSIONS WHICH PREDICT OR INDICATE FUTURE EVENTS AND TRENDS AND WHICH DO NOT RELATE TO HISTORICAL MATTERS. YOU SHOULD NOT RELY ON FORWARD-LOOKING STATEMENTS, BECAUSE THEY INVOLVE KNOWN AND UNKNOWN RISKS, UNCERTAINTIES AND OTHER FACTORS, SOME OF WHICH ARE BEYOND OUR CONTROL. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE SET FORTH IN THE FORWARD-LOOKING STATEMENTS. CERTAIN FACTORS THAT MIGHT CAUSE SUCH A DIFFERENCE INCLUDE THE FOLLOWING: MARKET ACCEPTANCE OF OUR ONLINE AUCTION AND OTHER

Edgar Filing: FAIRMARKET INC - Form 10-Q

E-COMMERCE SERVICES; GROWTH OF THE MARKET FOR DYNAMIC E-COMMERCE SERVICES; THE COMPETITIVE NATURE OF THE ONLINE MARKETS IN WHICH WE OPERATE; OUR ABILITY TO GENERATE SIGNIFICANT REVENUE TO REACH PROFITABILITY; OUR ABILITY TO ATTRACT AND RETAIN QUALIFIED PERSONNEL; OUR ABILITY TO RETAIN EXISTING CUSTOMERS AND TO OBTAIN NEW CUSTOMERS; THE OPERATION AND CAPACITY OF OUR NETWORK SYSTEM INFRASTRUCTURE; OUR ABILITY TO EXPAND OUR OPERATIONS IN OUR INTERNATIONAL GEOGRAPHIC MARKETS AND THE CURRENCY, REGULATORY AND OTHER RISKS ASSOCIATED WITH DOING BUSINESS IN INTERNATIONAL MARKETS; OUR LIMITED OPERATING HISTORY; AND THE OTHER RISKS AND UNCERTAINTIES DISCUSSED UNDER THE HEADING "FACTORS THAT MAY AFFECT RESULTS OF OPERATIONS AND FINANCIAL CONDITION" ON PAGE 15 OF THIS FORM 10-Q. YOU SHOULD NOT PLACE UNDUE RELIANCE ON OUR FORWARD-LOOKING STATEMENTS, AND WE ASSUME NO OBLIGATION TO UPDATE ANY FORWARD-LOOKING STATEMENTS.

THE FOLLOWING DISCUSSION OF OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS SHOULD BE READ IN CONJUNCTION WITH OUR FINANCIAL STATEMENTS AND THE NOTES TO THOSE STATEMENTS INCLUDED ELSEWHERE IN THIS REPORT AND IN OUR ANNUAL REPORT ON FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2000 AND IN OTHER REPORTS FILED BY US WITH THE SECURITIES AND EXCHANGE COMMISSION.

OVERVIEW, RECENT DEVELOPMENTS

FairMarket develops and delivers e-business selling and marketing solutions for retailers, distributors and manufacturers and for Internet portals and web communities primarily engaged in e-commerce. These hosted, scalable solutions, built upon our proprietary dynamic pricing software, are designed to help clients maximize price yield and promote their brands. We work with customers at any point along the demand chain. Our software is designed for rapid deployment and integrates with existing customer web sites and back office systems.

Our services are used in four primary areas: (1) retail and discount clearance; (2) business-to-business surplus; (3) promotions and interactive marketing; and (4) outsourced auctions and e-commerce to portals and other web communities. We provide a broad suite of dynamic pricing formats, including auctions, our primary format, as well as fixed and falling price formats, and integrated cross-sell and up-sell capability, to create a comprehensive e-business selling and marketing service offering.

Because we host our customer's dynamic pricing sites on our central systems, we have the ability to aggregate listings of goods and services available for sale on our customers' commerce sites and make those listings available for display and sale on other FairMarket customer sites. We refer to this network of customer sites as the FairMarket Network. During the second quarter of 2001, we expanded our auction service in the U.S. to provide customers with the opportunity to list, manage and transact sales through eBay. We may enter into similar relationships with other online service providers.

We believe our success is dependent in large part on increasing our customer base and further developing the breadth and functionality of our service offerings. We intend to continue to invest in the further development of our service offerings and technology and in the marketing and promotion of our service offerings. While it is our stated goal to achieve operating cash flow break-even during the first quarter of 2002, we expect to continue to incur substantial operating losses and significant negative operating cash flows for the third quarter of 2001, which we expect will decrease during the fourth quarter of 2001.

On June 29, 2001, we amended our auction services agreement with Microsoft Corporation. Under the terms of the amendment, Microsoft relinquished the warrants it held to purchase 4,500,000 shares of FairMarket common stock and released FairMarket from our guarantee of a minimum level of transaction fee revenue to Microsoft. In exchange, FairMarket waived its status as "pre-eminent

Edgar Filing: FAIRMARKET INC - Form 10-Q

auction services provider" to Microsoft's online properties. However, we continue to provide our online auction services to Microsoft sites. The unamortized value of the warrants on FairMarket's balance sheet was approximately \$18 million. The return of the warrants results in a reduction in quarterly equity-related charges of approximately \$1.4 million beginning with the third quarter of 2001.

On May 14, 2001, as part of our plan to continue to implement cost-cutting measures, we eliminated 40 positions at our Massachusetts facility, representing approximately 25% of our total employee base. On May 14, 2001, after giving effect to this workforce reduction, we had 119 employees worldwide. Previously, in October

10

2000, we eliminated 35 positions at our Massachusetts facility. We experienced some attrition prior to and following each of these workforce reductions and believe that we may experience additional attrition in the future. At June 30, 2001, we had 112 employees worldwide. Our ability to maintain or increase revenue will depend in part upon our ability to attract and retain qualified personnel.

Also in May 2001, our President and Chief Executive Officer, Eileen Rudden, resigned from the Company and was immediately replaced by our Chief Financial Officer and Treasurer, Janet Smith, who assumed the additional position of interim President. In July 2001, Nanda Krish, a director of FairMarket, was appointed as interim CEO, in which capacity he will direct FairMarket's recruitment of a permanent chief executive officer. In June 2001, Bruce Worrall, former Vice President of Business Development, and Bryan Semple, former Vice President of Corporate Development, resigned from FairMarket. In addition, Scott Randall, the founder of FairMarket, recently resigned as an officer of FairMarket but continues to serve as Chairman of the Board of Directors.

On May 14, 2001, we also announced our intention to close our office in Australia during the second quarter of 2001, which closing was not completed as of June 30, 2001. We expect to complete the closing of our Australia office during the third quarter of 2001. We continue to service our Australian customers out of our U.S. operations.

We recognized a charge of approximately \$1.7 million in the second quarter of 2001 for the costs related to the workforce reduction, severance payments to certain other employees and other restructuring initiatives, including the closing of the Australia office. Approximately \$200,000 of the charge relates to non-cash costs associated with the restructuring initiatives. At June 30, 2001, approximately \$1.0 million of the charge remained unpaid, primarily related to severance payments to certain employees; we expect to pay substantially all of these remaining expenses during the third quarter of 2001.

On January 16, 2001, we implemented a one-time employee incentive program under which employees had the opportunity to exchange, on a one-for-one basis, their outstanding employee stock options with exercise prices of \$3.00 or more for new options with an exercise price of \$2.1875, the closing price of our common stock on the January 16, 2001 exchange date. Options held by executive officers and directors were not included in the exchange. Under this program, options covering approximately 1,155,000 shares of our common stock were exchanged for options covering an equal number of shares. Options granted under this program have special terms, with the options vesting quarterly over two

Edgar Filing: FAIRMARKET INC - Form 10-Q

years, beginning on the three-month anniversary of the grant date, if the option exchanged was unvested, or vesting on the six-month anniversary of the grant date, if the option exchanged was vested, and having a term of two and one-half years. For accounting purposes, the exchange constituted a repricing of the existing options and will require variable accounting for the new options granted in the exchange. As a result, the Company (i) will recognize a non-cash compensation charge each quarter with respect to vested options if and to the extent that the per share fair market value of the Company's common stock at the end of the quarter exceeds \$2.1875, the per share exercise price of the new options, and (ii) will adjust deferred compensation each quarter for unvested options. There is a potential for such a variable non-cash charge in each quarter until all of the new options are exercised or until the date the options expire (July 16, 2003) or otherwise terminate. The closing price of the Company's common stock on June 29, 2001 was below \$2.1875, therefore no related charge was recognized for the three and six months ended June 30, 2001.

Because of our limited operating history, there is limited operating and financial data about our business upon which to base an evaluation of our performance. Period-to-period comparisons of operating results should not be relied upon as an assurance of future operating results.

RESULTS OF OPERATIONS FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2001 AND 2000

For the three and six months ended June 30, 2001, our net loss was \$12.7 million, or \$(0.44) per share, and \$24.5 million, or \$(0.85) per share, respectively. This represented a decrease of \$1.3 million, or 8.9%, compared to our net loss of \$14.0 million, or \$(0.49) per share, for the three months ended June 30, 2000 and a decrease of \$1.1 million, or 4.1%, compared to our net loss of \$25.6 million, or \$(1.35) per share, for the six months ended June 30, 2000. Excluding our one-time restructuring charge of \$1.7 million, our net loss was \$11.1 million, or \$(0.38) per share, for the three months ended June 30, 2001, a decrease of \$2.9 million, or 20.7%, compared to the same period of last year.

The decrease in net loss for the three months ended June 30, 2001 compared to the same period of last year is primarily due to a decrease in total operating expenses of \$3.5 million (excluding our one-time restructuring charge), partially offset by a decrease in interest income, net, of \$627,000. The decrease in net loss for the six months ended June 30, 2001 compared to the same period of last year is primarily due to an increase in revenue of \$667,000 combined with a decrease in total operating expenses of \$1.9 million (excluding our one-time restructuring charge) and an increase in interest income, net, of \$122,000. We expect to see continued improvement each quarter in the

11

net loss for the remainder of the year as we continue our focus on continued cost containment measures in the latter half of the year.

REVENUE

Total revenue was \$3.0 million and \$5.7 million for the three and six months ended June 30, 2001, respectively, which was flat compared to total revenue for the three months ended June 30, 2000, and an increase of \$667,000, or 13.3%, compared to total revenue of \$5.0 million for the six months ended June 30, 2000. The increase in revenue for the six months ended June 30, 2001 compared to same period of last year is primarily due to a general price increase that we effected in early 2000 as well as a shift in business mix offset by a decrease in the number of customers. In addition, during the fourth

Edgar Filing: FAIRMARKET INC - Form 10-Q

quarter of 2000, we formed our Professional Services Group, which contributed approximately 12% to revenue for the three and six months ended June 30, 2001. Also included in revenue for the three months ended June 30, 2001 was hosting, professional service and other revenue from a short-term interactive marketing promotional auction for one customer which represented approximately 14.1% of our revenue for that period; substantially all revenue under this contract has been recognized as of June 30, 2001. We ended the second quarter of 2001 with 61 customers, a net decrease of 35 customers from 96 customers at June 30, 2000. There was no net change in our number of customers from March 31 to June 30, 2001.

International revenue for the three months ended June 30, 2001 was \$614,000, representing 20.4% of total revenue for the quarter. As noted above, we are in the process of closing our office in Australia and continue to service our existing Australian customers out of our U.S. operations. We will continue to assess our strategy of international expansion and investing in our subsidiaries in the U.K. and Germany. There are risks inherent in doing business internationally, including, among others, fluctuating currency exchange rates, differing legal and regulatory requirements and differing accounting practices. We price, invoice and collect fees for our international services primarily in the local currency. To date, currency fluctuations have not had a material effect on our results of operations and financial condition.

The one-time set-up fees we charge for the implementation of our customers' sites are deferred and recorded as revenue over the expected term of the related service contracts. Certain professional service fees are billed over the term the professional service is rendered, recorded as deferred revenue and recognized over the remaining term of the ongoing service contract. At June 30, 2001 and 2000, there was \$393,000 and \$897,000, respectively, of deferred revenue primarily relating to set-up fees and professional service fees.

During the latter half of 2000, we shifted our sales focus away from outsourced e-commerce for portals and traffic building applications for dot-coms to providing demand chain sell-side solutions, such as enabling the web-based sale of retail and discount clearance items and business-to-business surplus and hosting interactive marketing promotions for larger retailers and manufacturers with higher brand awareness and greater financial resources. Because the sales cycle for larger retailers and manufacturers is generally longer than the sales cycle for companies engaged purely in e-commerce, and because the implementation period for larger retailers and manufacturers tends to be longer than the implementation periods we experience with companies engaged purely in e-commerce, we believe that this change in focus has caused the rate of our revenue growth to moderate from prior periods. We also believe that uncertain economic conditions during the first half of 2001 have resulted in a longer decision-making and implementation process with our customers. As a result of this shift in business mix and partially as a result of the general price increase that we effected in early 2000, approximately 75 customer contracts were terminated, either by us or by the customer, during 2000, and an additional 27 customer contracts were terminated during the six months ended June 30, 2001. Also as a result of this shift in business mix and general price increase, average revenue per customer increased to \$49,300 for the second quarter of 2001 from \$31,500 for the second quarter of 2000.

Average revenue per customer for future periods will depend on a number of factors such as our customer mix, the mix of our service offerings, technological changes, our pricing strategies and pricing competition. We believe that revenue for the third quarter of 2001 will be between \$2.1 million and \$2.3 million. We expect total revenue for 2001 will reflect a decrease of between 15% and 20% compared to total revenue for 2000.

OPERATING EXPENSES

Edgar Filing: FAIRMARKET INC - Form 10-Q

COST OF REVENUE consists of costs for direct customer support, end-user customer service, depreciation of network equipment, fees paid to network providers for bandwidth and monthly fees paid to third-party network providers. Cost of revenue was \$1.3 million and \$2.6 million for the three and six months ended June 30, 2001, an increase of \$13,000 and \$407,000, respectively, compared to \$1.2 million and \$2.2 million for the three and six months ended June 30, 2000, respectively. As a percentage of revenue, cost of revenue increased to 41.9% for the three months ended June 30, 2001, compared to 41.4% for the three months ended June 30, 2000. The increase of

12

\$13,000 for the three months ended June 30, 2001 compared to the same period of last year resulted primarily from costs related to the expansion of our U.S. and international data centers during 2000, including depreciation of network equipment and fees paid for bandwidth and third-party network providers, partially offset by a reduction in salaries and related expenses resulting from lower headcount.

Gross margin decreased to 58.1% for the three months ended June 30, 2001 compared to 58.6% for the three months ended June 30, 2000. Gross margin decreased to 54.0% for the six months ended June 30, 2001 compared to 56.0% for the six months ended June 30, 2000. Our cost of revenue components are highly fixed in nature. The decrease in gross margin is primarily attributable to slower revenue growth compared to the costs related to the expansion of our U.S. and international data centers during 2000, including depreciation of network equipment and fees paid for bandwidth and third-party network providers. The gross margins reported above are not necessarily indicative of gross margins for future periods.

SALES AND MARKETING expenses were \$2.7 million and \$6.1 million for the three and six months ended June 30, 2001, a decrease of \$4.5 million, or 62.9%, and \$5.7 million, or 48.4%, compared to sales and marketing expenses of \$7.2 million and \$11.8 million for the three and six months ended June 30, 2000, respectively. These decreases are primarily due to a reduction in amortization of advertising expenses in the amount of \$2.5 million and \$5.0 million related to advertising services purchased from Excite, Inc. (now known as At Home Corporation) during the three and six months ended June 30, 2000, respectively, under our original auction services agreement with Excite, which was terminated in December 2000. This decrease in amortization for each period was partially offset by amortization expense of \$1.1 million and \$3.0 million for the three and six months ended June 30, 2001, respectively, related to an email marketing database which we purchased from At Home in the fourth quarter of 2000 for cash and which is being amortized over its useful life in 2001. Also contributing to the decreases in sales and marketing expenses is a reduction in marketing expenses of approximately \$2.0 million and \$2.4 million for the three and six months ended June 30, 2001, compared to the same periods of last year, primarily relating to the discontinuation of certain advertising programs during the fourth quarter of 2000. Excluding amortization of the email marketing database, we believe that sales and marketing expenses will continue to decrease in absolute dollars during the remainder of 2001.

DEVELOPMENT AND ENGINEERING expenses were \$1.4 million and \$3.1 million for the three and six months ended June, 2001, a decrease of \$738,000, or 34.8%, and \$821,000, or 20.9%, compared to development and engineering expenses of \$2.1 million and \$3.9 million for the three and six months ended June 30, 2000. The decrease in each period is primarily due to decreases in computer related supplies and expenses and contract services expense combined with a reduction in

Edgar Filing: FAIRMARKET INC - Form 10-Q

salaries and related expenses resulting from lower headcount. We believe that development and engineering expenses will continue to decrease in absolute dollars during the remainder of 2001.

GENERAL AND ADMINISTRATIVE expenses were \$3.1 million and \$6.0 million for the three and six months ended June 30, 2001, a decrease of \$288,000, or 8.6%, and \$68,000, or 1.1%, compared to general and administrative expenses of \$3.4 million and \$6.1 million for the three and six months ended June 30, 2000, respectively. The decrease for the three months ended June 30, 2001 is primarily related to decreases in recruiting costs and bad debt expense partially offset by increases in insurance costs and depreciation expense. The decrease for the six months ended June 30, 2001 is primarily related to decreases in recruiting costs, bad debt expense and facility costs partially offset by increases in insurance costs and depreciation expense. We believe that general and administrative expenses will continue to decrease in absolute dollars during the remainder of 2001.

EQUITY-RELATED CHARGES consist of the amortization of (i) deferred stock compensation resulting from the grant of stock options to employees at exercise prices subsequently deemed to be less than the fair value of our common stock on the grant date and (ii) the fair value of warrants issued to certain strategic customers and shares of our Series D convertible preferred stock issued to certain strategic customers at prices below fair value. At June 30, 2001, deferred stock compensation, which is a component of deferred compensation and equity-related charges in stockholders' equity, totaled \$2.0 million, net of amortization of approximately \$5.6 million and canceled stock option grants valued at approximately \$5.7 million. This amount is being amortized ratably over the vesting periods of the applicable stock options, typically four years, with 25% vesting on the first anniversary of the grant date and the balance vesting 6.25% quarterly thereafter.

At June 30, 2001, other deferred equity-related charges, which is a component of deferred compensation and equity-related charges in stockholders' equity, totaled \$18.0 million, net of amortization of \$29.7 million. This amount is being amortized ratably over the terms of the related agreements. Included in other deferred equity-related charges is the value of shares of Series D convertible preferred stock issued to Excite, Inc. (now known as At Home Corporation), which converted into shares of our common stock upon our initial public offering. We recorded the shares at fair value for a total of \$15.0 million at December 31, 1999. The value of the shares was remeasured at the

date of our initial public offering and we recorded an additional \$10.5 million in the first quarter of 2000 as a deferred charge to be amortized over the remaining term of our original auction services agreement with Excite. As a result of the termination of the original Excite agreement in December 2000, the remaining term of that agreement has been modified to that of the new auction services agreement that we entered into with At Home at that time, which has a term of 18 months.

On June 29, 2001, we amended our auction services agreement with Microsoft Corporation which originally provided that, if Microsoft drove more than a specified number of Internet users to the FairMarket Network through its Internet portal site, we would guarantee a minimum level of transaction fee revenue regardless of actual transaction fee revenue earned by Microsoft. Under this provision, if Microsoft met its minimum annual traffic guarantee but such increase in traffic did not produce sufficient revenue to meet the minimum

Edgar Filing: FAIRMARKET INC - Form 10-Q

guaranteed revenue, we would have had a financial obligation to Microsoft equal to the difference between the minimum guaranteed payment and its portion of fees actually collected. The minimum guaranteed revenue was \$5.0 million, \$10.0 million, \$10.0 million, \$15.0 million and \$20.0 million for the first, second, third, fourth and fifth contract years, respectively. Microsoft did not meet its minimum annual traffic guarantee for the first contract year and therefore no payment was required. As part of the June 2001 amendment, this provision was eliminated from the auction services agreement. As a result, we will not be required to make any minimum guaranteed revenue payments for any other period. Also under the terms of the amendment, Microsoft relinquished the warrants it held to purchase 4,500,000 shares of our common stock. In exchange for the above, we waived our status as "pre-eminent auction services provider" to Microsoft's online properties. However, we continue to provide our online auction services to Microsoft sites. We valued these warrants at \$28.5 million at the time of issuance and recorded a deferred charge to be amortized over the term of the Microsoft contract. As of June 2001, the unamortized value of the warrants on our balance sheet was approximately \$18 million which we reversed through equity as a result of the amendment to our auction services agreement. The return of the warrants results in a reduction in quarterly equity-related charges of approximately \$1.4 million beginning with the third quarter of 2001.

INTEREST INCOME, NET

Interest income, net, was \$788,000 for the three months ended June 30, 2001, a decrease of \$627,000 compared to interest income, net, of approximately \$1.4 million for the three months ended June 30, 2000. Interest income, net, was approximately \$1.9 million for the six months ended June 30, 2001, an increase of \$122,000 compared to interest income, net, of approximately \$1.8 million for the six months ended June 30, 2000. The decrease in interest income for the three months ended June 30, 2001 is primarily the result of a lower average balance of cash, cash equivalents and investments and lower interest rates compared to the same period of last year. The increase in interest income for the six months ended June 30, 2001 is the result of a higher average balance of cash, cash equivalents and investments partially offset by lower interest rates compared to the same period of last year. Cash, cash equivalents and investments increased during the second quarter of 2000 as a result of our initial public offering in March 2000 but were lower, on average, during the six months ended June 30, 2000 compared to the same period in 2001.

LIQUIDITY AND CAPITAL RESOURCES

In March 2000, we completed the initial public offering of our common stock and realized net proceeds from the offering of \$89.2 million. Prior to the offering, we had financed our operations primarily through private sales of capital stock, the net proceeds of which totaled \$27.1 million. At June 30, 2001, cash and cash equivalents, marketable securities and restricted cash (related to a lease deposit) totaled \$68.7 million.

Cash used in operating activities was \$8.4 million for the six months ended June 30, 2001 and \$12.0 million for the six months ended June 30, 2000. Net cash flows from operating activities for the six months ended June 30, 2001 reflect a net loss for that period of \$24.5 million combined with an increase in prepaid expenses and other current assets and decreases in current liabilities, deferred revenue and other non-current liabilities, partially offset by depreciation expense, amortization of an email marketing database, amortization of deferred compensation and equity-related charges and a decrease in accounts receivable. The amortization of an email marketing database relates to an email marketing database which we purchased from At Home in the fourth quarter of 2000 for cash and which is being amortized over its useful life in 2001.

Cash used in investing activities was \$644,000 for the six months ended June 30, 2001. Net cash used in investing activities for the six months ended

Edgar Filing: FAIRMARKET INC - Form 10-Q

June 30, 2001 consisted primarily of \$724,000 used for the purchase of property and equipment. For the six months ended June 30, 2000, net cash used in investing activities was \$5.4 million, primarily for purchases of property and equipment.

14

Cash used in financing activities was \$59,000 for the six months ended June 30, 2001. For the six months ended June 30, 2000, cash provided by financing activities was \$94.2 million, consisting of the proceeds of \$89.2 million from our initial public offering of our common stock, net of expenses of \$8.6 million related to the offering. In addition, in connection with our initial public offering, Excite paid us \$5.0 million in accordance with a stock purchase agreement in which Excite purchased 2,500,000 shares of our Series D convertible preferred stock (which converted into shares of our common stock upon our initial public offering) for cash consideration of \$17.5 million in the third quarter of 1999, which payment was withheld as a prepayment against our obligation to purchase advertising from Excite under our former auction services agreement with Excite.

We expect our operating expenses, excluding the one-time charge related to our May 2001 workforce reduction and other restructuring initiatives, to decrease in absolute dollars in the third quarter of 2001, compared to the second quarter of 2001, as a result of cost containment measures and to continue to decrease in the fourth quarter of 2001, and expect to fund these expenses primarily from available cash. In addition, we may utilize our cash resources to fund acquisitions or investments in complementary businesses or technologies. We believe that the net proceeds from our initial public offering and our cash flows from operations will be sufficient to meet our working capital and operating resource expenditure requirements for at least the next year. Thereafter, we may find it necessary to obtain additional equity or debt financing. In the event additional financing is required, we may not be able to raise it on acceptable terms or at all.

We consider all highly liquid investment instruments purchased with an original maturity of three months or less to be cash equivalents. We invest our cash and cash equivalents in an overnight investment account, commercial paper and a money market account. We also invest our cash in marketable securities which are classified as available for sale. These securities are marked to market at each reporting date and any unrealized gain or loss is recorded in accumulated other comprehensive income (loss) as a component of stockholders' equity. We place our cash and temporary cash investments with financial institutions which management believes are of high credit quality.

We have not invested in any financial instruments that expose us to material market risk.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2000, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 138, "Accounting for Certain Derivative Instruments," an amendment of SFAS 133 ("Accounting for Derivative Instruments and Hedging Activities"). This statement establishes the accounting and reporting standards for derivative instruments embedded in other contracts (collectively referred to as "derivatives") and hedging activities. The statement requires companies to recognize all derivatives as either assets or liabilities, with the instruments measured at fair value. The accounting for changes in their value, gains or losses, depends on the intended use of the

Edgar Filing: FAIRMARKET INC - Form 10-Q

derivative and its resulting designation. We adopted SFAS 138 in 2001, in accordance with SFAS 137, which deferred the effective date of SFAS 133. The adoption of SFAS 138 did not have a material impact on our consolidated financial statements and related disclosures.

In September 2000, the FASB issued SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a Replacement of FASB Statement No. 125." This statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities and is effective after March 31, 2001. We adopted SFAS 140 in the second quarter of 2001. The adoption of SFAS 140 did not have a material impact on our consolidated financial statements and related disclosures.

In July 2001, the FASB issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS 141 requires that all business combinations be accounted for under the purchase method only and that certain acquired intangible assets in a business combination be recognized as assets apart from goodwill. SFAS 142 requires that ratable amortization of goodwill be replaced with periodic tests of the goodwill's impairment and that intangible assets other than goodwill be amortized over their useful lives. SFAS 141 is effective for all business combinations initiated after June 30, 2001 and for all business combinations accounted for by the purchase method for which the date of acquisition is after June 30, 2001. The provisions of SFAS 142 will be effective for fiscal years beginning after December 15, 2001, and will thus be adopted by the us, as required, in fiscal year 2002. The impact of SFAS 141 and SFAS 142 on our financial statements has not yet been determined.

FACTORS THAT MAY AFFECT RESULTS OF OPERATIONS AND FINANCIAL CONDITION

THIS FORM 10-Q 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. YOU CAN IDENTIFY FORWARD-LOOKING STATEMENTS BY THE USE OF THE WORDS "BELIEVE," "EXPECT," "ANTICIPATE," "INTEND," "ESTIMATE," "ASSUME" AND OTHER SIMILAR EXPRESSIONS WHICH PREDICT OR INDICATE FUTURE EVENTS AND TRENDS AND WHICH DO NOT RELATE TO HISTORICAL MATTERS. YOU SHOULD NOT RELY

15

ON FORWARD-LOOKING STATEMENTS, BECAUSE THEY INVOLVE KNOWN AND UNKNOWN RISKS, UNCERTAINTIES AND OTHER FACTORS, SOME OF WHICH ARE BEYOND OUR CONTROL. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE SET FORTH IN THE FORWARD-LOOKING STATEMENTS.

SOME OF THE FACTORS THAT MIGHT CAUSE THESE DIFFERENCES INCLUDE THOSE SET FORTH BELOW. YOU SHOULD CAREFULLY REVIEW ALL OF THESE FACTORS, AND YOU SHOULD BE AWARE THAT THERE MAY BE OTHER FACTORS THAT COULD CAUSE THESE DIFFERENCES. THESE FORWARD-LOOKING STATEMENTS WERE BASED ON INFORMATION, PLANS AND ESTIMATES AT THE DATE OF THIS FORM 10-Q, AND WE DO NOT PROMISE TO UPDATE ANY FORWARD-LOOKING STATEMENTS TO REFLECT CHANGES IN UNDERLYING ASSUMPTIONS OR FACTORS, NEW INFORMATION, FUTURE EVENTS OR OTHER CHANGES.

RISKS RELATED TO OUR BUSINESS

BECAUSE WE HAVE ONLY BEEN IN BUSINESS FOR A SHORT TIME, OUR BUSINESS IS DIFFICULT TO EVALUATE, OUR BUSINESS STRATEGY MAY NOT SUCCESSFULLY ADDRESS RISKS WE FACE AND YOUR BASIS FOR EVALUATING US IS LIMITED.

Edgar Filing: FAIRMARKET INC - Form 10-Q

We were formed in February 1997 and we began to execute our current business model involving the offering of outsourced, private-label auction solutions in December 1998, which we have since expanded to include additional transaction pricing and extended marketing and distribution capabilities. While a high percentage of our operating expenses are and will continue to be fixed in the short term, our operating expenses are largely based on unpredictable revenue trends. Because of our limited operating history, our business strategy may not successfully address all of the risks we face, and you have limited operating and financial data about our business upon which to base an evaluation of our performance.

We face the following risks, expenses and difficulties as a company seeking to develop a new Internet-based service:

- o if we fail to attract and retain quality customers we may be unable to generate sufficient revenue to support our business;
- o if we fail to attract and retain qualified sales, engineering and other personnel we may be unable to maintain and expand our business;
- o if we fail to maintain and upgrade our service offerings and technology to keep pace with the rapidly growing Internet market we serve we may be unable to compete effectively; and
- o if we fail to raise additional capital if and when we need it we may be unable to develop or sustain our business.

WE EXPECT TO CONTINUE TO INCUR SUBSTANTIAL OPERATING LOSSES IN THE NEAR FUTURE.

For the quarter ended June 30, 2001, we incurred a net loss of approximately \$12.7 million, which represented approximately 23.6 % of our revenue for the same period. As of June 30, 2001, we had an accumulated deficit of approximately \$94.3 million. We have not achieved profitability and we will continue to incur net losses until we can produce sufficient revenues to cover our costs, which may not occur. While it is our goal to achieve operating cash flow breakeven during the first quarter of 2002, even if we achieve profitability, we may be unable to sustain or increase our profitability in the future because we intend to continue to invest in the further development of our service offerings and technology and in the marketing and promotion of our service offerings. Any such investment will depend on the availability of funds.

WE EXPECT TO CONTINUE TO HAVE NEGATIVE OPERATING CASH FLOW IN THE NEAR FUTURE WHICH MAY REQUIRE US TO SEEK ADDITIONAL FINANCING, WHICH COULD BE DIFFICULT TO OBTAIN.

We expect to continue to experience significant negative operating cash flows for the foreseeable future because we intend to continue to make significant investments in the further development of our service offerings and technology and in the marketing and promotion of our service offerings. We expect that we will fund these expenditures primarily from available cash.

We believe that, with the proceeds of our March 2000 initial public offering, we have sufficient capital to meet our anticipated cash needs for working capital and operating resource expenditure requirements for at least the next 12 months. While it is our goal to achieve operating cash flow breakeven during the first quarter of 2002, we cannot assure you that we will meet that goal or achieve profitable operations. Depending on future cash flow, we may need to raise additional capital in the future to meet our cash requirements. We may not be able to find additional financing, if required, on favorable terms or at all.

WE MAY NOT BE ABLE TO CONTINUE ATTRACTING NEW CUSTOMERS.

The success of our business model depends in large part on our ability to increase our number of customers. The market for our services may grow more slowly than anticipated or become saturated with competitors, many of which may offer lower prices or broader distribution. Some potential customers may not want to join the FairMarket Network because they are concerned about the possibility of their products being listed together with their competitors' products. Beginning in the second half of 2000, we increased our sales focus on larger retailers and manufacturers with higher brand awareness and greater financial resources. The sales cycle for larger retailers and manufacturers is generally longer than the sales cycle for companies engaged purely in e-commerce, and the implementation period for larger retailers and manufacturers tends to be longer than the implementation periods we experience with companies engaged purely in e-commerce. We also believe that uncertain economic conditions during 2001 have resulted in a longer decision-making and implementation process with our customers. If we cannot continue to attract new customers on a timely basis or at all, or if we cannot maintain our existing customer base, we may be unable to offer the benefits of the network model at levels sufficient to attract and retain customers and sustain our business.

BECAUSE OUR INDUSTRY IS HIGHLY COMPETITIVE AND HAS LOW BARRIERS TO ENTRY, WE MAY NOT BE ABLE TO EFFECTIVELY COMPETE.

The U.S. market for e-commerce services is extremely competitive. We expect competition to intensify as current competitors expand their product offerings and new competitors enter the market. In addition to competition from internally-developed solutions by individual organizations, our primary direct competitors are the following providers of hosted auction services: bid.com and Siebel Systems/OpenSite. We also face competition for customers from third party providers in the following areas:

- o software providers and application service providers such as: Ariba, Auction Broker, Commerce One, Moai Technologies and Siebel Systems/OpenSite;
- o destination auction and auction aggregation sites such as: Amazon.com, Andale, AuctionWatch.com, AuctionWorks, eBay, GoTo Auctions and Yahoo! Auctions; and
- o e-commerce vendors such as ATG, Broadvision, IBM and OpenMarket who either have or may extend their offerings to incorporate capabilities similar to those offered by our services.

The principal competitive factors are the quality and breadth of services provided, potential for successful transaction activity and price. E-commerce markets are characterized by rapidly changing technologies and frequent new product and service introductions. We may fail to introduce new online pricing formats and features on a timely basis or at all. If we fail to introduce new service offerings or to improve our existing service offerings in response to industry developments, or if our prices are not competitive, we could lose customers, which could lead to a loss of revenues.

Because there are relatively low barriers to entry in the e-commerce market, competition from other established and emerging companies may develop in

Edgar Filing: FAIRMARKET INC - Form 10-Q

the future. Many of our competitors may also have well-established relationships with our existing and prospective customers. Increased competition is likely to result in fee reductions, reduced margins, longer sales cycles for our services and a decrease or loss of our market share, any of which could harm our business, operating results or financial condition.

Many of our competitors have, and new potential competitors may have, more experience developing Internet-based software applications and integrated purchasing solutions, larger technical staffs, larger customer bases, more established distribution channels, greater brand recognition and greater financial, marketing and other resources than we have. In addition, competitors may be able to develop products and services that are superior to ours or that achieve greater customer acceptance. We cannot assure you that the e-commerce solutions offered by our competitors now or in the future will not be perceived as superior to ours by either businesses or consumers.

OUR RECENT AND PREVIOUS WORKFORCE REDUCTIONS AND CHANGES IN MANAGEMENT MAY IMPACT OUR ABILITY TO ATTRACT OR RETAIN KEY PERSONNEL.

Our future success will depend, in part, on attracting and retaining qualified personnel. In May 2001, we implemented a workforce reduction in which we eliminated 40 positions. Previously, in October 2000, we eliminated 35 positions. We experienced some attrition in personnel prior to each of these workforce reductions and believe that we may experience additional attrition in the future.

Furthermore, in May 2001, our President and Chief Executive Officer, Eileen Rudden, resigned from the Company and was immediately replaced by our Chief Financial Officer and Treasurer, Janet Smith, who assumed the

17

additional position of interim President. In July 2001, Nanda Krish, a director of FairMarket, was appointed as interim CEO, in which capacity he will direct FairMarket's recruitment of a permanent chief executive officer. In June 2001, Bruce Worrall, former Vice President of Business Development, and Bryan Semple, former Vice President of Corporate Development, resigned from FairMarket. In addition, Scott Randall, the founder of FairMarket, recently resigned as an officer of FairMarket but continues to serve as Chairman of the Board of Directors.

We cannot assure you that we will be successful in hiring or retaining qualified personnel. The industry in which we compete has a high level of employee mobility and aggressive recruiting of skilled personnel. Our inability to attract and retain qualified personnel on a timely basis, or the departure of key employees, could harm our existing business and ability to expand our operations.

WE MAY NOT BE ABLE TO SUCCESSFULLY EXPAND IN INTERNATIONAL MARKETS.

A component of our strategy has been to expand internationally by attracting customers outside the U.S. For the three- and six-month periods ended June 30, 2001, revenue under contracts with customers outside the U.S. represented 20% and 21% of our total revenue, respectively. We believe that significant opportunities exist in international markets, and it is our intention to compete in certain of these markets. During 2000, we opened offices in England, Australia and Germany. In May 2001, we announced our intention to close our office in Australia during the second quarter of 2001, which we are in

Edgar Filing: FAIRMARKET INC - Form 10-Q

the process of completing. We continue to service our Australian customers out of our U.S. operations. We may expand our operations to serve other countries in the future. Expansion in our existing international markets and into new international markets requires significant management, financial, development, sales, marketing and other resources. We will continue to assess our strategy of international expansion and investing in our subsidiaries in the U.K. and Germany. We have limited experience in localizing our services, and some of our competitors have expanded or are undertaking expansion into foreign markets. We cannot assure you that we will expand into new international markets or that we will be successful in expanding in international markets.

In addition to the uncertainty regarding our ability to generate revenues from foreign operations and expand our international presence, there are risks inherent in doing business internationally, including, among others:

- o different legal and regulatory requirements;
- o difficulties in staffing and managing foreign operations;
- o longer payment cycles;
- o different accounting practices;
- o fluctuating currency exchange rates;
- o problems in collecting accounts receivable;
- o legal uncertainty regarding liability, ownership and protection of intellectual property;
- o tariffs and other trade barriers;
- o seasonal reductions in business activity;
- o potentially adverse tax consequences; and
- o political instability.

Any of the above factors could adversely affect the success of our international operations. To the extent we expand our international operations, we will become more exposed to the above risks. To the extent we have increasing portions of our revenues denominated in foreign currencies, we will become subject to increased risks relating to foreign currency exchange rate fluctuations. We cannot assure you that one or more of the factors discussed above will not have a material adverse effect on our international operations and, consequently, on our ability to expand our business and increase our revenue.

OUR CUSTOMERS MAY NOT SUCCESSFULLY DRIVE TRAFFIC FROM THEIR MAIN WEB SITES TO THEIR DYNAMIC PRICING SITES.

Our success will also depend in part on increases in the amount of user traffic and the number of transactions on our customers' FairMarket-hosted sites. For this to occur, our existing customers must drive sufficient numbers of users to their FairMarket-hosted auction and other dynamic pricing sites, they must devote sufficient resources to making their sites attractive to buyers and sellers and there must be demand for the products being offered on those

Edgar Filing: FAIRMARKET INC - Form 10-Q

sites. We cannot assure you that our customers will be successful in accomplishing any of these objectives and their failure to do so could impede our growth and adversely affect our business.

BUYERS AND SELLERS MIGHT NOT ADOPT ONLINE AUCTION OR OTHER DYNAMIC PRICING SOLUTIONS AS A MEANS FOR BUYING AND SELLING GOODS AND SERVICES.

Online auction and other dynamic pricing solutions are relatively new methods of buying and selling that market participants may not adopt at levels sufficient to sustain our business. Traditional purchasing is often based on long-standing relationships or familiarity with sellers. For online dynamic pricing solutions to succeed, buyers and sellers must adopt new purchasing practices. Buyers must be willing to rely less upon traditional relationships in making purchasing decisions, and merchants and Internet communities must be willing to offer products for sale through online dynamic pricing solutions. We cannot assure you that buyers, merchants or Internet communities will choose to utilize online dynamic pricing solutions at levels sufficient to sustain our business.

WE MAY ENTER INTO STRATEGIC ALLIANCES OR LICENSE TECHNOLOGIES TO EXPAND OUR BUSINESS OR SERVICE OFFERINGS BUT MAY NOT BE SUCCESSFUL IN DOING SO.

In addition to internal development of new technologies, our future success may depend to a certain degree on our ability to enter into and implement strategic alliances to expand our product and service offerings and our distribution channels and/or to jointly market or gain market awareness for our service offerings. For example, during the second quarter of 2001 we expanded our auction service in the U.S. to provide customers with the opportunity to list, manage and transact sales through eBay. We may enter into similar relationships with other online service providers. We may also expand our service offerings by licensing or purchasing complementary technologies from third parties. For example, during the first quarter of 2001 we announced that we licensed certain real-time e-business infrastructure software from TIBCO Software Inc. to enable us to provide real-time messaging infrastructure. We cannot assure you that we will be successful in identifying, developing or maintaining such alliances and relationships or that such alliances and relationships will achieve their intended purposes.

WE MAY ACQUIRE OTHER BUSINESSES OR TECHNOLOGIES, WHICH COULD RESULT IN DILUTION TO OUR STOCKHOLDERS, OR OPERATIONAL OR INTEGRATION DIFFICULTIES WHICH COULD IMPAIR OUR FINANCIAL PERFORMANCE.

If appropriate opportunities present themselves, we may acquire businesses, technologies, services or products that we believe will be useful in the growth of our business. We do not currently have any commitments or agreements with respect to any acquisition. We may not be able to identify, negotiate or finance any future acquisition successfully. Even if we do succeed in acquiring a business, technology, service or product, the process of integration may produce unforeseen operating difficulties and expenditures and may require significant attention from our management that would otherwise be available for the ongoing development of our business. Moreover, we have not made any acquisitions, have no experience in integrating an acquisition into our business and may never achieve any of the benefits that we might anticipate from a future acquisition. If we make future acquisitions, we may issue shares of stock that dilute other stockholders, incur debt, assume contingent liabilities or create additional expenses related to amortizing goodwill and other intangible assets, any of which might harm our financial results and cause our stock price to decline. Any financing that we might need for future acquisitions may only be available to us on terms that restrict our business or that impose on us costs that reduce our revenue.

Edgar Filing: FAIRMARKET INC - Form 10-Q

OUR BUSINESS MAY SUFFER IF WE ARE NOT ABLE TO PROTECT IMPORTANT INTELLECTUAL PROPERTY.

Our ability to compete effectively against other companies in our industry will depend, in part, on our ability to protect our proprietary technology and systems designs. While we have attempted to safeguard and maintain our proprietary rights, we cannot assure you that we have been or will be completely successful in doing so. Further, our competitors may independently develop or patent technologies that are substantially equivalent or superior to ours.

We have applied for patents on aspects of our technology and processes and those applications are pending with the U.S. Patent and Trademark Office. We cannot assure you that any patents will be issued. Even if some or all of these patents are issued, we cannot assure you that they will not be successfully challenged by others or invalidated, that they will adequately protect our technology and processes or that they will result in commercial advantages for us. We have also applied for trademark registrations for some of our brand names and our marketing materials are copyrighted, but these protections may not be adequate. Effective patent, trademark, service mark, copyright and trade secret protection may not be available in every country where we provide services. We may, at times, have to incur significant legal costs and spend time defending our copyrights and, if issued, our service marks and patents. Any defense efforts, whether successful or not, would divert both time and resources from the operation and growth of our business.

19

WE MAY NOT BE ABLE TO MAINTAIN THE CONFIDENTIALITY OF OUR PROPRIETARY KNOWLEDGE.

We rely, in part, on contractual provisions to protect our trade secrets and proprietary knowledge. These agreements may be breached, and we may not have adequate remedies for any breach. Our trade secrets may also be known without breach of such agreements or may be independently developed by competitors. Our inability to maintain the proprietary nature of our technology could harm our business, results of operations and financial condition by adversely affecting our ability to compete.

OTHERS MAY ASSERT THAT OUR TECHNOLOGY INFRINGES THEIR INTELLECTUAL PROPERTY RIGHTS.

We believe that our technology does not infringe the proprietary rights of others. However, the e-commerce industry is characterized by the existence of a large number of patents and frequent claims and litigation based on allegations of patent infringement and violation of other intellectual property rights. As the e-commerce market and the functionality of products in the industry continues to grow and overlap, we believe that the possibility of an intellectual property claim against us will increase. For example, we may inadvertently infringe a patent of which we are unaware, or there may be patent applications now pending of which we are unaware which we may be infringing when they are issued in the future, or our service or systems may incorporate third party technologies that infringe the intellectual property rights of others. We have been and expect to continue to be subject to alleged infringement claims. The defense of any claims of infringement made against us by third parties, whether or not meritorious, could involve significant legal costs and require our management to divert time from our business operations. Either of these

Edgar Filing: FAIRMARKET INC - Form 10-Q

consequences of an infringement claim could have a material adverse effect on our operating results. If we are unsuccessful in defending any claims of infringement, we may be forced to obtain licenses or to pay royalties to continue to use our technology. We may not be able to obtain any necessary licenses on commercially reasonable terms or at all. If we fail to obtain necessary licenses or other rights, or if these licenses are costly, our operating results may suffer either from reductions in revenues through our inability to serve customers or from increases in costs to license third-party technologies.

OUR BUSINESS MAY BE ADVERSELY AFFECTED IF WE ARE UNABLE TO CONTINUE TO LICENSE SOFTWARE THAT IS NECESSARY FOR OUR SERVICE OFFERING.

Through distributors, we license a variety of commercially-available Microsoft technologies, including our database software and Internet server software, which is used in our services and systems to perform key functions. We also license other third party technology to perform certain functions of our service, such as our search functionality, which utilizes technology from Verity, Inc., technology that we license from TIBCO Software Inc., which we use in certain of our integration solutions, and our wireless service, which is provided by Sentica Corporation. As a result, we are to a certain extent dependent upon those third parties continuing to maintain their technologies. We cannot assure you that we would be able to replace the functionality provided by these third party technologies on commercially reasonable terms or at all. The absence of or any significant delay in the replacement of certain functionalities could have a material adverse effect on our business, financial condition and results of operations.

OUR SYSTEMS INFRASTRUCTURE MAY NOT KEEP PACE WITH THE DEMANDS OF OUR CUSTOMERS.

Interruptions of service as a result of a high volume of traffic and/or transactions could diminish the attractiveness of our services and our ability to attract and retain customers. We cannot assure you that we will be able to accurately project the rate or timing of increases, if any, in the use of our service, or that we will be able to expand and upgrade our systems and infrastructure to accommodate such increases in a timely manner. We currently maintain separate systems in the U.S. for our U.S. and Australia services and a separate system in England. Any failure to expand or upgrade our systems could have a material adverse effect on our results of operations and financial condition by reducing or interrupting revenue flow and by limiting our ability to attract new customers. Any such failure could also have a material adverse effect on the business of our customers, which could damage our reputation and expose us to a risk of loss or litigation and potential liability. The majority of the server capacity of our systems for each of the countries named above is currently not utilized.

A SYSTEM FAILURE COULD CAUSE DELAYS OR INTERRUPTIONS OF SERVICE TO OUR CUSTOMERS.

Service offerings involving complex technology often contain errors or performance problems. Many serious defects are frequently found during the period immediately following introduction and initial implementation of new services or enhancements to existing services. Although we attempt to resolve all errors that we believe would be considered serious by our customers before implementation, our systems are not error-free. Errors or performance problems could result in lost revenues or cancellation of customer agreements and may expose us to litigation and potential liability. We have from time to time discovered errors in our software or software of others used in our operating systems after its incorporation into our systems. We cannot assure you that undetected errors or

performance problems in our existing or future services will not be discovered or that known errors considered minor by us will not be considered serious by our customers. We have experienced periodic minor system interruptions, which may continue to occur from time to time. Most of our contracts provide for the payment or credit to the customer of specified money damages (based on the monthly service fee paid by the customer) if we are unable to maintain specified levels of service based on downtime of either their FairMarket-hosted sites or our centralized service over a specified period, typically one month. The total dollar amount of our potential payment or credit obligations under these provisions if the service levels specified in all of those agreements were not met over the typical one month measurement period could be material. In addition, certain of our contracts also provide the customer with the right to terminate the contract if we are unable to maintain a minimum specified level of service. Performance problems in our technology could also damage our reputation which could reduce market acceptance of our services and lead to a loss of revenues.

THE FUNCTIONING OF OUR SYSTEMS OR THE SYSTEMS OF THIRD PARTIES ON WHICH WE RELY COULD BE DISRUPTED BY FACTORS OUTSIDE OUR CONTROL.

Our success depends on the efficient and uninterrupted operation of our computer and communications hardware systems. Substantially all of our computer hardware for operating our U.S. and Australia services is currently located at the facilities of NaviSite, Inc. in Andover, Massachusetts, and substantially all of our computer hardware for operating our U.K. service is located at a third party hosting center in England. The computer hardware for our end-user customer service system is also hosted by a third party. These systems are vulnerable to damage or interruption from natural disasters, fires, power loss, telecommunication failures, break-ins, sabotage, computer viruses, intentional acts of vandalism and similar events. We do not currently have a backup system in place for any given system; however, any one of our systems could temporarily be utilized as a backup system if a disaster should occur on any of our other systems. Despite any precautions we take or plan to take, the occurrence of a natural disaster or other unanticipated problems at any third party hosting facility could result in interruptions in our services. In addition, if any third party hosting service fails to provide the data communications capacity we require, as a result of human error, natural disaster or other operational disruption, interruptions in our service could result. Any damage to or failure of our systems could result in reductions in, or terminations of, our service, which could have a material adverse effect on our business, results of operations and financial condition.

OUR BUSINESS MAY SUFFER IF BUYERS AND SELLERS DO NOT MAKE PAYMENTS OR DELIVER GOODS.

Our success may depend to some extent upon sellers on customer sites reliably delivering and accurately representing their listed goods and buyers paying the agreed purchase price. Our customers have received in the past, and we anticipate that they will receive in the future, communications from sellers and buyers who did not receive the purchase price or the goods that were to have been exchanged. Neither we nor our customers have the ability to require end-users to make payments or deliver goods or otherwise make end-users whole. Our customers also periodically receive complaints from buyers as to the quality of the goods purchased. We are unaware of any complaints that have materially impacted our customers' businesses in a detrimental manner. Neither we nor our customers have the ability to determine the level of such complaints that are

Edgar Filing: FAIRMARKET INC - Form 10-Q

made directly between buyers and sellers. We expect that both we and our customers will continue to receive requests from end-users requesting reimbursement or threatening legal action against either our customers or us if no reimbursement is made.

WE MAY HAVE TO MONITOR OR CONTROL ACTIVITIES ON CUSTOMER SITES.

The law relating to the liability of providers of online services for the activities of users of their services is currently unsettled in the U.S. and in other countries. Our service automatically screens by key word all listings submitted by end-users for pornographic material. We also have notice and take-down procedures related to infringing and illegal goods. These procedures are not foolproof and goods that may be subject to regulation by U.S. local, state or federal authorities or local foreign authorities could be sold through our service. These goods include, for example, firearms, alcohol and tobacco. We cannot assure you that we will be able to prevent the unlawful exchange of goods on our service or that we will successfully avoid civil or criminal liability for unlawful activities carried out by users through our service. The potential imposition of liability for unlawful activities of end-users of our customers could require us to implement measures to reduce our exposure to such liability, which may require us, among other things, to spend substantial resources and/or to discontinue one or more of our service offerings. Any costs incurred as a result of such liability or asserted liability would harm our results of operations.

FUTURE GOVERNMENT REGULATION OF AUCTIONS AND AUCTIONEERS MAY ADD TO OUR OPERATING COSTS.

Numerous U.S. jurisdictions have laws and regulations regarding the conduct of auctions and the liability of auctioneers, which were enacted for consumer protection many years ago. We believe that the U.S. laws and regulations do not apply to our online auction services. However, little precedent exists in this area, and one or more

21

jurisdictions in the U.S. or in other countries in which we do business are attempting or may attempt to impose these laws and regulations to online auction providers and may attempt to impose these laws and regulations on our operations or the operations of our customers in the future. Certain states are currently considering whether to apply their auctioneer regulations to online auctions and at least one state has recently passed legislation that applies to the conduct of all auctions, including auctions conducted over the Internet. If any such statute or regulation is interpreted to apply to us or to our customers, we and/or those of our customers to whom the statute applies could be required to obtain a license. This could adversely affect our ability to attract and retain customers, could adversely affect our results of operations by decreasing activity on our customers' auction sites and could subject us or our customers to fines if we or our customers are unable to obtain the required licenses. In addition, as the nature of the products listed by our customers or their end-users changes, we may become subject to new regulatory restrictions. If we do become subject to these laws and regulations in the future, it could adversely affect our ability to attract and retain customers and could adversely affect our results of operations by decreasing activity on our customers' auction sites.

RISKS RELATED TO OUR INDUSTRY

Edgar Filing: FAIRMARKET INC - Form 10-Q

OUR SUCCESS DEPENDS ON THE CONTINUED GROWTH OF THE INTERNET AND ONLINE COMMERCE.

Our future revenues and profits depend upon the widespread acceptance and use of the Internet and other online services as a medium for commerce by merchants and consumers. The use of the Internet and e-commerce may not continue to develop at past rates and a sufficiently broad base of business and individual customers may not adopt or continue to use the Internet as a medium of commerce. The market for the sale of goods and services over the Internet is an emerging market. Demand and market acceptance for online services and for the sale of goods and services over the Internet are subject to a high level of uncertainty. Growth in our customer base depends on obtaining businesses and consumers who have historically used traditional means of commerce to purchase goods and services. For us to be successful, these market participants must accept and use novel ways of conducting business and exchanging information.

E-commerce may not prove to be a viable medium for purchasing for the following reasons, any of which could seriously harm our business:

- o the necessary infrastructure for Internet communications may not develop adequately;
- o our potential customers, buyers and suppliers may have security and confidentiality concerns;
- o complementary products, such as high-speed modems and high-speed communication lines, may not be developed;
- o alternative purchasing solutions may be implemented;
- o buyers may dislike the reduction in the human contact inherent in traditional purchasing methods;
- o use of the Internet and other online services may not continue to increase or may increase more slowly than expected;
- o the development or adoption of new technology standards and protocols may be delayed or may not occur; and
- o new and burdensome governmental regulations may be imposed.

OUR SUCCESS DEPENDS ON THE CONTINUED RELIABILITY OF THE INTERNET.

The Internet continues to experience significant growth in the number of users, frequency of use and bandwidth requirements. We cannot assure you that the infrastructure of the Internet and other online services will be able to support the demands placed upon them. Furthermore, the Internet has experienced a variety of outages and other delays as a result of damage to portions of its infrastructure, and could face such outages and delays in the future. These outages and delays could adversely affect the level of Internet usage and also the level of traffic and the processing of transactions. In addition, the Internet or other online services could lose their viability due to delays in the development or adoption of new standards and protocols required to handle increased levels of Internet or other online service activity, or due to increased governmental regulation. Changes in or insufficient availability of telecommunications services or other Internet service providers to support the Internet or other online services also could result in slower response times and adversely affect usage of the Internet and other online services generally and our service in particular. If use of the Internet and other online services does not continue to grow or grows more slowly than expected, if the infrastructure of the Internet and other online services does not effectively support growth that may occur, or if the Internet and other online services do not become a

viable commercial marketplace,

22

we will have to adapt our business model to the new environment, which would materially adversely affect our results of operations and financial condition.

GOVERNMENT REGULATION OF THE INTERNET MAY IMPEDE OUR GROWTH OR ADD TO OUR OPERATING COSTS.

Like many Internet-based businesses, we operate in an environment of tremendous uncertainty as to potential government regulation. The Internet has rapidly emerged as a commerce medium, and governmental agencies have not yet been able to adapt all existing regulations to the Internet environment. Laws and regulations have been introduced or are under consideration and court decisions have been or may be reached in the U.S. and other countries in which we do business that affect the Internet or other online services, covering issues such as pricing, user privacy, freedom of expression, access charges, content and quality of products and services, advertising, intellectual property rights and information security. In addition, it is uncertain how existing laws governing issues such as taxation, property ownership, copyrights and other intellectual property issues, libel, obscenity and personal privacy will be applied to the Internet. The majority of these laws were adopted prior to the introduction of the Internet and, as a result, do not address the unique issues of the Internet. Recent laws that contemplate the Internet, such as the Digital Millennium Copyright Act in the U.S., have not yet been fully interpreted by the courts and their applicability is therefore uncertain. The Digital Millennium Copyright Act provides certain "safe harbors" that limit the risk of copyright infringement liability for service providers such as FairMarket with respect to infringing activities engaged in by users of the service, such as end-users of our customers' auction sites. We have adopted and are further refining our policies and practices to qualify for one or more of these safe harbors, but we cannot assure you that our efforts will be successful since the Digital Millennium Copyright Act has not been fully interpreted by the courts and its interpretation is therefore uncertain. Similarly, the recently enacted Online Services Act in Australia and the Internet Watch Foundation in the U.K. (a body funded by Internet service providers, the U.K. government and U.K. law enforcement agencies) provide or operate notice and take-down procedures with respect to certain types of content, but the extent, if any, to which those procedures provide a safe harbor is uncertain.

In the area of user privacy, several states have proposed legislation that would limit the uses of personal user information gathered online or require online services to establish privacy policies. The Federal Trade Commission also has become increasingly involved in this area, and recently settled an action with one online service regarding the manner in which personal information is collected from users and provided to third parties. The recently adopted European Union Directive on the Protection of Personal Data may affect our ability to expand in Europe if we or our customers do not afford adequate privacy to end-users of our customers' sites. Similar legislation was recently passed in Canada and Australia and may have a similar effect. The Canadian law will be implemented in stages over the next few years, while the Australian Amendment (Privacy Sector) Act 2000 becomes effective in December 2001, with an additional 12 months extended to small businesses. We do not sell personal user information from our customers' sites. Generally, as between FairMarket and our customers, the personal user information belongs to the customer, not FairMarket, and each site is governed by the respective customer's own privacy policy. We do use aggregated data for analyses regarding the FairMarket Network,

Edgar Filing: FAIRMARKET INC - Form 10-Q

and do use personal user information in the performance of our services for our customers. Since we do not control what our customers do with the personal user information they collect, we cannot assure you that our customers' sites will be considered compliant.

As online commerce evolves, we expect that federal, state or foreign agencies will adopt regulations covering issues such as pricing, content, user privacy, and quality of products and services. Any future regulation may have a negative impact on our business by restricting our methods of operation or imposing additional costs. Although many of these regulations may not apply to our business directly, we anticipate that laws regulating the solicitation, collection or processing of personal information could indirectly affect our business.

Title V of the Telecommunications Act of 1996, known as the Communications Decency Act of 1996, prohibits the knowing transmission of any comment, request, suggestion, proposal, image or other communication that is obscene or pornographic to any recipient under the age of 18. The prohibition's scope and the liability associated with a violation are currently unsettled. In addition, although substantial portions of the Communications Decency Act of 1996 have been held to be unconstitutional, we cannot be certain that similar legislation will not be enacted and upheld in the future. It is possible that such legislation could expose companies involved in online commerce to liability, which could limit the growth of online commerce generally. Legislation like the Communications Decency Act could reduce the growth in Internet usage and decrease its acceptance as a communications and commerce medium.

The worldwide availability of Internet web sites often results in sales of goods to buyers outside the jurisdiction in which we or our customers are located, and foreign jurisdictions may claim that we or our customers are required to comply with their laws. As an Internet company, it is unclear which jurisdictions may find that we are conducting business

therein. Our failure to qualify to do business in a jurisdiction that requires us to do so could subject us to fines or penalties and could result in our inability to enforce contracts in that jurisdiction.

NEW TAXES MAY BE IMPOSED ON INTERNET COMMERCE.

In the U.S., we do not collect sales or other similar taxes on goods sold by customers and users through customers' FairMarket-powered sites or service taxes on fees paid by end-users of those sites. The Internet Tax Freedom Act of 1998, which expires on October 21, 2001, prohibits the imposition of taxes on internet access services and new taxes on electronic commerce by U.S. federal and state taxing authorities. However, after the expiration of the Internet Tax Freedom Act, one or more states may seek to impose sales tax collection obligations on out-of-state companies which engage in or facilitate online commerce, and a number of proposals have been made at the state and local level that would impose additional taxes on the sale of goods and services through the Internet. Such proposals, if adopted, could substantially impair the growth of electronic commerce, and could adversely affect our opportunity to derive financial benefit from such activities. Many non-U.S. countries impose service tax (such as value-added tax) collection obligations on companies that engage in or facilitate Internet commerce. We do not collect sales or other similar taxes on goods sold by customers and/or users of our customers' sites in Australia or

Edgar Filing: FAIRMARKET INC - Form 10-Q

the U.K. However, we have modified our systems in each of those countries to enable value-added or goods and services taxes to be charged and collected with respect to site usage fees. A successful assertion by one or more states or any foreign country that we or our customers should collect sales or other taxes on the exchange of merchandise or, in the U.S., site usage fees or that we or our customers should collect Internet-based taxes could impair our revenue and our ability to acquire and retain customers.

THERE MAY BE SIGNIFICANT SECURITY RISKS AND PRIVACY CONCERNS RELATING TO ONLINE COMMERCE.

A significant barrier to online commerce and communications is the secure transmission of confidential information over public networks. A compromise or breach of the technology used to protect our customers' and their end-users' transaction data could result from, among other things, advances in computer capabilities, new discoveries in the field of cryptography, or other events or developments. Any such compromise could have a material adverse effect on our reputation and, therefore, on our business, results of operations and financial condition. Furthermore, a party who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. 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. Concerns over the security of transactions conducted on the Internet and other online services and the privacy of users may also inhibit the growth of the Internet and other online services generally, especially as a means of conducting commercial transactions. We currently have practices and procedures in place to protect the confidentiality of our customers' and their end-users' information. However, our security procedures to protect against the risk of inadvertent disclosure or intentional breaches of security might fail to adequately protect information that we are obligated to keep confidential. We may not be successful in adopting more effective systems for maintaining confidential information, and our exposure to the risk of disclosure of the confidential information of others may grow with increases in the amount of information we possess. To the extent that our activities involve the storage and transmission of proprietary information, such as credit card numbers, security breaches could damage our reputation and expose us to a risk of loss or litigation and possible liability. Our insurance policies may not be adequate to reimburse us for losses caused by security breaches.

WE COULD BE SUBJECT TO POTENTIAL PRODUCT LIABILITY CLAIMS AND THIRD PARTY LIABILITY CLAIMS RELATED TO PRODUCTS AND SERVICES PURCHASED THROUGH OUR CUSTOMERS' SITES.

Any errors, defects or other performance problems in our services and systems could result in financial or other damages to our customers. Although our agreements with our customers typically contain provisions designed to limit our exposure to claims, existing or future laws or unfavorable judicial decisions could negate these limitation of liability provisions.

In addition, we may not be able to successfully avoid civil or criminal liability for problems related to the products and services sold on customer sites. Even if we are successful, any such claims or litigation could still require expenditure of management time and other resources to defend ourselves. Liability of this sort could require us to implement measures to reduce our exposure to this liability, which may require us, among other things, to expend substantial resources or to discontinue service offerings or to take precautions to ensure that products and services are not available on customer sites.

Moreover, deliveries of products purchased on customer sites that are nonconforming, late or are not accompanied by information required by applicable law or regulations, could expose us to liability or result in decreased adoption and use of those sites and therefore our services, which would lead to decreased

revenue.

24

OUR STOCK PRICE IS LIKELY TO BE HIGHLY VOLATILE.

The stock market, and in particular the market for Internet-related stocks, has, from time to time, experienced extreme price and volume fluctuations. Many factors may cause the market price for our common stock to decline, perhaps substantially, including:

- o failure to meet our development plans;
- o the demand for our common stock;
- o downward revisions in securities analysts' estimates or changes in general market conditions;
- o technological innovations by competitors or in competing technologies; and
- o investor perception of our industry or our prospects.

FUTURE SALES OF OUR COMMON STOCK COULD ADVERSELY AFFECT OUR STOCK PRICE.

A substantial portion of our common stock is held by a small number of investors and can be resold or is subject to registration rights. Sales of substantial amounts of our common stock in the public market, or the perception that a large number of shares are available for sale, could cause the market price of our common stock to decline. In addition to the adverse effect a price decline could have on holders of our common stock, such a decline would likely impede our ability to raise capital through the issuance of additional shares of our common stock or other equity securities.

The holders of a substantial portion of our common stock (including at least approximately 12.5 million shares held by former holders of our Series C and D convertible preferred stock) have rights, subject to some conditions, to require us to file registration statements covering their shares, or to include their shares in registration statements that we may file for FairMarket or other stockholders. By exercising their registration rights and selling a large number of shares, these holders could cause the price of our common stock to decline. Furthermore, if we were to include in a FairMarket-initiated registration statement shares held by those holders pursuant to the exercise of their registration rights, those sales could impair our ability to raise needed capital by depressing the price at which we could sell our common stock.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INVESTMENT PORTFOLIO

We do not use derivative financial instruments for investment purposes and only invest in financial instruments that meet high credit quality standards, as specified in our investment policy guidelines. This policy also limits the amount of credit exposure of any one issue, issuer, and type of investment. Due to the conservative nature of our investments, we do not believe that we have a material exposure to interest rate risk.

FOREIGN CURRENCY RISK

Edgar Filing: FAIRMARKET INC - Form 10-Q

International sales are made mostly from FairMarket's foreign sales subsidiaries in the respective countries and are denominated in the local currency of each country. These subsidiaries also incur most of their expenses in the local currency. Accordingly, all foreign subsidiaries use the local currency as their functional currency. Our international business is subject to risks typical of an international business, including, but not limited to differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions, and foreign exchange rate volatility. Accordingly, our future results could be materially adversely impacted by changes in these or other factors. Our intercompany accounts are typically denominated in the functional currency of the foreign subsidiary in order to centralize foreign exchange risk with the parent company in the United States. FairMarket is also exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. As exchange rates vary, these results, when translated, may vary from expectations and adversely impact overall financial results. The effect of foreign exchange rate fluctuations on FairMarket in the quarter ended June 30, 2001 was not significant.

25

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

FairMarket has been informed that on or about July 27, 2001, a putative class action lawsuit was filed by an individual shareholder in the U.S. District Court for the Southern District of New York against FairMarket, Scott Randall, John Belchers, U.S. Bancorp Piper Jaffray Inc., Deutsche Bank Securities Inc. and FleetBoston Robertson Stephens, Inc. The lawsuit was filed by the law firm of Bernstein, Liebhard & Lifshitz, LLP on behalf of Ohel Shlomo Dov and purports to seek class action status on behalf of all other similarly situated persons who purchased the common stock of FairMarket between March 14, 2000 and December 6, 2000. The lawsuit alleges that certain underwriters of FairMarket's initial public offering solicited and received excessive and undisclosed fees and commissions in connection with that offering. The lawsuit further alleges that the defendants violated the federal securities laws by issuing a registration statement and prospectus in connection with FairMarket's initial public offering which failed to accurately disclose the amount and nature of the commissions and fees paid to the underwriter defendants. FairMarket obtained a copy of the complaint on August 2, 2001, is reviewing the allegations in the complaint and intends to defend the lawsuit vigorously.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(d) USE OF PROCEEDS

On March 17, 2000, we completed the initial public offering of our common stock. The shares of the common stock sold in the offering were registered under the Securities Act of 1933 on a Registration Statement on Form S-1 (No. 333-92677). The Securities and Exchange Commission declared the Registration Statement effective on March 13, 2000. We estimate that as of June 30, 2001, of the approximately \$89 million in net proceeds from the initial public offering, approximately \$23 million has been used for working capital purposes, including approximately \$5 million used for the purchase of equipment. At June 30, 2001,

Edgar Filing: FAIRMARKET INC - Form 10-Q

substantially all of the remaining net proceeds (approximately \$66 million) was held in investments in commercial paper, government bonds and other interest-bearing accounts. None of the costs and expenses related to the offering have been paid directly or indirectly to any director, officer or general partner of FairMarket or their associates or persons owning 10% or more of any class of equity securities of FairMarket or an affiliate of FairMarket.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES. Not applicable.

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

On May 23, 2001, we held our 2001 annual meeting of stockholders for the purposes of electing Nanda Krish as a Class I Director, to serve until our 2004 annual meeting of stockholders or until the qualification and election of his successor. The results of the votes were as follows: For: 22,259,948; Withheld: 82,756.

ITEM 5. OTHER INFORMATION. Not applicable.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS

- 10.1 Amendment No. 2 to Auction Services Agreement and Termination of Warrant and Wa dated as of June 29, 2001 between Microsoft Corporation and FairMarket, Inc.
- 10.2 Amended and Restated Agreement Concerning Termination of Employment, Severance Matters dated as of June 21, 2001 between FairMarket, Inc. and Scott Randall
- 10.3 Letter agreement dated May 14, 2001 between FairMarket, Inc. and Eileen Rudden
- 10.4 Letter agreement dated June 20, 2001 between FairMarket, Inc. and Bryan Semple
- 10.5 Amendment to Agreement Concerning Termination of Employment, Severance Pay and dated June 22, 2001 between FairMarket, Inc. and Bruce Worrall
- 10.6 Letter agreement dated July 26, 2001 between FairMarket, Inc. and Nanda Krish

(b) REPORTS ON FORM 8-K

On May 14, 2001, FairMarket filed a Current Report on Form 8-K dated May 14, 2001 with the Securities and Exchange Commission with respect to (1) the resignation of Eileen Rudden as President and Chief Executive Officer and a director of the Company and the resignation of Richard Pallan as a director of the Company and (2) our May 14, 2001 workforce reduction.

On May 22, 2001, FairMarket filed a Current Report on Form 8-K dated May 17, 2001 with the Securities and Exchange Commission with respect to FairMarket's adoption of a shareholder rights plan.

26

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the

Edgar Filing: FAIRMARKET INC - Form 10-Q

undersigned thereunto duly authorized.

FairMarket, Inc.

Date: August 2, 2001

By: /s/ Janet Smith

Janet Smith,
Chief Financial Officer
(PRINCIPAL FINANCIAL AND
ACCOUNTING OFFICER)

27

EXHIBIT INDEX

EXHIBIT NO. -----	TITLE -----
10.1	Amendment No. 2 to Auction Services Agreement and Termination of Warrant and Warrant Agreement dated as of June 29, 2001 between Microsoft Corporation and FairMarket, Inc.
10.2	Amended and Restated Agreement Concerning Termination of Employment, Severance Pay and Related Matters dated as of June 21, 2001 between FairMarket, Inc. and Scott Randall
10.3	Letter agreement dated May 14, 2001 between FairMarket, Inc. and Eileen Rudden
10.4	Letter agreement dated June 20, 2001 between FairMarket, Inc. and Bryan Semple
10.5	Amendment to Agreement Concerning Termination of Employment, Severance Pay and Related Matters dated June 22, 2001 between FairMarket, Inc. and Bruce Worrall
10.6	Letter agreement dated June 26, 2001 between FairMarket, Inc. and Nanda Krish

