

2 nd QUARTER RESULTS

2001



## PRESIDENT'S REPORT

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### **Dear Shareholders,**

Paladin Labs' sales and marketing activities drove strong growth during the second quarter of fiscal 2001. Robust sales increases coupled with increased profitability demonstrate the success of our focused business strategy.

### **Increasing Value**

The continued strength of established products such as Tapazole®, plus the recent launch of innovative brands such as MUSE®, Plan B™, Valtaxin™ and Androderm™, enabled the Company to achieve record results in both sales and earnings.

Androderm™, the only approved testosterone patch in Canada to treat hypogonadism in males, gained first formulary approval in June 2001 for reimbursement and has begun generating strong initial sales. According to IMS Canada, over the past 12 months the market for testosterone replacement therapy in Canada increased 54% to \$12 million. With encouraging initial sales, we look forward to the third quarter as the first full quarter of sales for Androderm™.

Plan B™, a new generation emergency contraceptive for Canadian women is the first progestin-only pill developed to prevent pregnancy after a contraceptive failure. This new prescription product is the most effective emergency contraceptive available and boasts a significantly better safety and side effect profile than existing emergency contraceptives. Record sales of Plan B™ in the second quarter underscores Paladin's commitment to deploy significant resources to ensure the successful launch of our products. A video news release reached more than 750,000 viewers and a direct marketing campaign targeting over 10,000 physicians were an integral part of our successful launch.

Our growing track record of results positions Paladin to attract new and significant product licensing and acquisitions opportunities. We have already targeted high profile products to add to our portfolio by the end of this fiscal year.

## Financial Highlights

Revenues for the second quarter of 2001 were \$4.5 million, an increase of \$1.45 million or 47% over the second quarter of 2000. This significant increase was primarily due to revenues generated by new and recently launched products, including Tapazole®, Oesclim®, MUSE®, Valtaxin™, Androderm™, and Plan B™. For the six month period ended June 30, 2001 revenues increased by \$2.3 million or 39% to \$8.0 million from \$5.7 million in the first half of 2000.

Net income for the quarter amounted to \$995,000 or \$0.08 per share compared to \$832,000 or \$0.07 per share in the same period last year. Net income for the six months ended June 30, 2001 amounted to \$1.5 million or \$0.12 per share, compared to \$1.1 million or \$0.11 per share in the same period last year.

I have never been more optimistic about Paladin's future as I examine our pristine balance sheet. With more than \$20 million of current assets and virtually no debt, Paladin is well positioned to invest in promising drugs that will power the engine of future growth.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Jonathan Goodman', is positioned above the printed name.

Jonathan Goodman  
President & CEO

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## **Paladin Labs Inc. ( the "Company").**

Paladin continued to experience improved financial results in the second quarter of 2001. Revenues for the quarter increased by 47% over the second quarter of 2000, while net income grew by 20%. For the first half of 2001, revenues were 39% higher than in the first half of 2000 and net income was 34% over the level achieved in the first half of 2000.

### ***Three months ended June 30, 2001 compared to the three months ended June 30, 2000***

Revenues for the second quarter of 2001 were \$4,514,795, an increase of \$1,450,894 or 47% over the second quarter of 2000. The significant increase was primarily due to the revenues derived from new or recently launched products, including Tapazole®, Oesclim®, MUSE®, Androderm™, Plan B™. Gross profit as a percentage of revenues improved to 69% in the current quarter from 65% in the same quarter last year.

Selling and administrative expenses increased to \$1,977,369 from \$1,228,112 in the second quarter of 2000, primarily due to increased spending on direct brand marketing support associated with new products and to higher staffing costs related to the expanded infrastructure necessitated by the Company's product line growth during the past year.

Research and development expenses amounted to \$119,648 in the current quarter, a reduction of \$29,000 from the second quarter last year.

Amortization expense in the second quarter of 2001 was \$155,240, compared to \$23,895 in the corresponding quarter last year. The increase reflected the Company's success in acquiring new products during the past year.

Interest income decreased to \$302,533 in the current quarter from \$321,892 in the second quarter of 2000, reflecting primarily the effect of lower interest rates in the current period.

Net income for the quarter amounted to \$995,071 or \$0.08 per share compared to \$831,716 or \$0.07 per share in the same period last year.

### ***Six months ended June 30, 2001 compared to the six months ended June 30, 2000***

Revenues for the first half of 2001 increased by \$2,252,568 or 39% to \$7,999,544 from the level of \$5,746,976 in the first half of 2000. The improvement was primarily due to revenues generated by new or recently launched products, primarily Tapazole®, Oesclim®, MUSE®, Androderm™ and Plan B™. Gross profit as a percentage of revenues increased to 66% from 63% in the first half of last year.

Selling and administration expenses amounted to \$3,572,089 in the six months ended June 30, 2001, an increase of \$1,299,074 over the same period last year. The increase reflects higher spending on direct brand marketing support for new products, together with costs associated with increased staffing levels.

Research and development expenses decreased by \$227,761 to \$244,434 in the current period, from \$472,195 in the first half of 2000. This reflected the significant spending in the first half of 2000 on the development of a sustained release version of Statex, (sustained release morphine sulfate), which is expected to complete Phase III clinical testing during the current year.

Amortization expense increased to \$309,303 from \$47,431 in the first half of last year, reflecting the significant investment in the acquisition of new products during the past year.

Interest income amounted to \$597,072 in the first half of 2001, an increase of \$183,548 over the corresponding period last year. The increase reflects the full effect of investment of the proceeds from the April 2000 equity issue.

Net income for the six months ended June 30, 2001 amounted to \$1,510,554 or \$0.12 per share, compared to \$1,130,378 or \$0.11 per share in the same period last year.

### **Financial Condition**

Cash and cash equivalents increased by \$8,380,195 in the first half of 2001 to \$11,237,723. Cash flow generated by operating activities during the period amounted to \$2,047,041, while during the first half of 2000 operating activities utilized cash of \$662,543. Non-cash working capital declined by \$4,684 in the first half of 2001, compared to an increase of \$1,970,691 in the same period last year. The increase in the first half of 2000 was primarily due to an increase in accounts receivables (\$658,100), a decrease in accounts payables (\$873,847) and a decrease in income taxes payable (\$627,730). In the first six months of 2001, a reduction of \$1,018,596 in payables was more than offset by decreases in inventories (\$358,853), income tax credits receivable (\$557,914) and accounts receivable (\$110,352).

Expenditures on patents, pharmaceutical product licenses and rights amounted to \$2,815,480 in the first half of 2001, compared to \$733,778 in the same period last year. The spending in the current period was primarily for the purchase of the Canadian license to Oesclim®.

The decrease in temporary investments in the current period of \$9,026,511 reflected the transfer of marketable securities into bankers' acceptances with maturities of three months or less, which are classified on the balance sheet as cash equivalents.

Financing activities in the first half of 2001 generated \$132,500 from the issue of shares, primarily related to the exercise of employee stock options. In the corresponding period last year, the Company realized \$18,407,750 (net of share issuance costs) from the proceeds of an equity issue in April 2000.

# BALANCE SHEET

	June 30 2001	December 31 2000
	\$	\$
	(unaudited)	
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	11,237,723	2,857,528
Temporary investments	12,454,925	21,481,436
Accounts receivable	1,384,175	1,494,527
Inventories	52,032	410,885
Income tax credits receivable	478,460	1,036,374
Income taxes recoverable	-	-
Future income tax assets	1,520,000	1,520,000
<b>Total current assets</b>	<b>27,127,315</b>	<b>28,800,750</b>
Capital assets, net of accumulated amortization	8,660,324	6,143,770
Investments, at cost	2,366,016	2,366,016
Future income tax assets	3,494,321	4,118,321
	<b>41,647,976</b>	<b>41,428,857</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	783,985	1,802,581
Income taxes payable	94,574	98,413
Deferred credit	977,760	977,760
<b>Total current liabilities</b>	<b>1,856,319</b>	<b>2,878,754</b>
Balance of sale payable	519,500	495,000
Deferred credit	1,860,594	2,286,594
	<b>4,236,413</b>	<b>5,660,348</b>
<b>Shareholders' equity</b>		
Capital stock	36,727,879	36,595,379
Contributed surplus	86,513	86,513
Retained earnings (Deficit)	597,171	(913,383)
<b>Total shareholders' equity</b>	<b>37,411,563</b>	<b>35,768,509</b>
	<b>41,647,976</b>	<b>41,428,857</b>

*See accompanying notes*

# STATEMENT OF INCOME

(Unaudited)

	Three months ended June 30		Six months ended June 30	
	2001	2000	2001	2000
	\$	\$	\$	\$
Revenues	<b>4,514,795</b>	3,063,901	<b>7,999,544</b>	5,746,976
Cost of sales	<b>1,414,000</b>	1,058,809	<b>2,705,236</b>	2,107,142
<b>Gross profit</b>	<b>3,100,795</b>	2,005,092	<b>5,294,308</b>	3,639,834
Selling and administrative	<b>1,977,369</b>	1,228,112	<b>3,572,089</b>	2,273,015
Research and development	<b>119,648</b>	148,648	<b>244,434</b>	472,195
Amortization	<b>155,240</b>	23,895	<b>309,303</b>	47,431
Interest income	<b>(302,533)</b>	(321,892)	<b>(597,072)</b>	(413,524)
<b>Income before income taxes</b>	<b>1,151,071</b>	926,329	<b>1,765,554</b>	1,260,717
Provision for income taxes				
Current	<b>5,000</b>	-	<b>10,000</b>	-
Future	<b>151,000</b>	94,613	<b>245,000</b>	130,339
	<b>156,000</b>	94,613	<b>255,000</b>	130,339
<b>Net Income</b>	<b>995,071</b>	831,716	<b>1,510,554</b>	1,130,378
<b>Earnings per share</b>				
Basic	<b>\$0.08</b>	\$0.07	<b>\$0.12</b>	\$0.11
Diluted	<b>\$0.08</b>	\$0.07	<b>\$0.12</b>	\$0.10

*See accompanying notes*

# STATEMENT OF DEFICIT

(Unaudited)

<b>Three months ended March 31</b>	<b>2001</b>	2000
	\$	\$
		(restated - see note 3)
Balance, beginning of period	(913,383)	<b>(3,710,637)</b>
Net income for the period	<b>1,510,554</b>	1,130,378
Balance, end of period	<b>597,171</b>	(2,580,259)

*See accompanying notes*

# STATEMENT OF CASH FLOWS

(Unaudited)

	Three months ended June 30		Six months ended June 30	
	2001	2000	2001	2000
	\$	\$	\$	\$
<b>Operating activities</b>				
Net income	995,071	831,716	1,510,554	1,130,378
Add items not affecting cash				
Amortization	155,240	23,895	309,303	47,431
Future income taxes	128,000	94,613	198,000	130,339
Imputed interest on balance of sale	12,250	-	24,500	-
	<b>1,290,561</b>	950,224	<b>2,042,357</b>	1,308,148
Net change in non-cash balances relating to operations	(22,234)	260,243	4,684	(1,970,691)
Cash flows from (used in) operating activities	<b>1,268,327</b>	1,210,467	<b>2,047,041</b>	(662,543)
<b>Investing activities</b>				
Acquisition of capital assets	(3,849)	-	(10,377)	-
Additions to patents, pharmaceutical product licenses and rights	(246,215)	(369,780)	(2,815,480)	(733,778)
Net decrease (increase) in temporary investments	(2,061,259)	(100,113)	9,026,511	(2,599,189)
Cash flows from (used in) investing activities	<b>(2,311,323)</b>	(469,893)	<b>6,200,654</b>	(3,332,967)
<b>Financing activities</b>				
Common shares issued for cash	132,500	20,300,000	132,500	20,300,000
Share issue costs	-	(1,776,628)	-	(1,892,250)
Cash flows used in financing activities	<b>132,500</b>	18,523,372	<b>132,500</b>	18,407,750
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(910,496)</b>	19,263,946	<b>8,380,195</b>	14,412,240
Cash and cash equivalents, beginning of period	<b>12,148,219</b>	33,822	<b>2,857,528</b>	4,885,528
<b>Cash and cash equivalents, end of period</b>	<b>11,237,723</b>	19,297,768	<b>11,237,723</b>	19,297,768

See accompanying notes

# NOTES TO FINANCIAL STATEMENTS

## 1. BASIS OF PRESENTATION

Information with respect to the December 31, 2000 balance sheet is derived from the Company's complete audited financial statements. These unaudited interim financial statements should be read in conjunction with the notes appearing in the Company's audited financial statements for the year ended December 31, 2000 and the accompanying notes.

## 2. ACCOUNTING POLICIES

The accounting policies underlying these interim financial statements are those set forth in note 2 of the audited financial statements for the year ended December 31, 2000, except that effective January 1, 2001 the Company has adopted the new recommendations of the Canadian Institute of Chartered Accountants regarding the preparation of interim financial statements. The adoption of the new recommendations did not have a significant effect on the Company's financial position or results of operations.

## 3. RESTATEMENT

As reported in note 3 of the audited financial statements for the year ended December 31, 2000, the Company changed its accounting policy for share issue costs retroactively, resulting in a restatement of capital stock and the deficit.

## 4. CONTINGENCIES

The Company entered into a Development, Commercialization and License Agreement with Connetics Corporation ("Connetics") on July 7, 1999, relating to the development of relaxin, a product for the treatment of peripheral vascular disease. As a result, the Company has an investment in Connetics of \$303,918 and licenses of \$1,875,103, of which a total of \$144,534 has been amortized to June 30, 2001.

On May 23, 2001, Connetics announced that it will pursue a license or other strategic alternative for its relaxin program and is reducing its investment in the development of relaxin in favor of focusing its resources on expanding its dermatology business.

In the event that Connetics is unable to conclude a satisfactory arrangement for the continuing development of relaxin within a reasonable period of time, the Company will be required to write off the unamortized balance of its licenses and will also have to review the carrying value of its investment.

## 5. CAPITAL STOCK

**Authorized:** 100,000,000 common shares without nominal or par value.

### Issued and outstanding:

	Number of shares	Amount
Balance at December 31, 2000	12,394,038	\$ 36,595,379
Issued on exercise of stock options	25,000	112,500
Employee share purchase loan repayment	-	20,000
Balance at June 30, 2001	12,419,038	\$ 36,727,879

### Options and warrants

In 1999, the Corporation issued 1,450 warrants to purchase 1,450 common shares at \$7.94 per share. These warrants expire in December 2001.

As at June 30, 2001, a total of 558,350 stock options were outstanding under the Corporation's Stock Option Plan, of which 338,265 were exercisable. The weighted average exercise price of these stock options was \$4.95.

## 6. CASH AND TEMPORARY INVESTMENTS

Cash and temporary investments in total increased by \$1,150,763 during the second quarter of 2001. During the six months ended June 30, 2001, cash and temporary investments decreased by \$646,316.

## **Stock Exchange Listing**

Toronto Stock Exchange

Trading Symbol: PLB

## **Transfer Agent**

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