



STRENGTH  
THROUGH  
EXECUTION

1<sup>ST</sup> QUARTER RESULTS 2003



# STRENGTH THROUGH EXECUTION

Dear Shareholders,

Late in 2002, we began implementing a significant expansion of our sales and marketing operations in support of Androderm®, Dostinex®, Estrin®<sup>®</sup>, Muse®, Oesclim®, and Plan B™. These key brands are at an early stage in their product life cycles and we are committed to extending more sales and marketing support to fully realize these brands full potential. Many of these growth opportunities lie within the general practitioner market, where we previously had little exposure. I am pleased to report that as of March 31, 2003, we have expanded our sales force from 14 sales representatives focused on urologists and endocrinologists to 48 sales representatives that now cover urologists, endocrinologists, obstetricians/gynaecologists and targeted, high-prescribing general practitioners. As a result, our market reach has grown from 1,375 physicians to more than 7,500 physicians across Canada. This investment in our future growth demonstrates our commitment to strengthening our leadership position in the Canadian specialty pharmaceutical market.

We expect to gradually improve the sales performance of our key brands as we move forward, but effective implementation takes time and the associated benefits will not materialize immediately. While all of our new sales representatives have now been trained on Paladin's key products and have begun the selling process, we do not expect to see the full benefits of our sales force expansion for 12 to 18 months.

Revenues for the three-month period ended March 31, 2003 declined 5% to \$5.1 million, compared to \$5.3 million in the first quarter of 2002. Decreased year-over-year sales in the period resulted primarily from a 71% decline in Urispas® sales due to the product's genericization, and suspended sales of Valtaxin® related to ongoing supplier manufacturing difficulties. Our declining sales resulting from the aforementioned issues with Urispas® and Valtaxin® were partially offset by sales gains in other product segments.

Selling and marketing expenses for the three-month period ended March 31, 2003 increased to \$2.7 million from \$1.4 million in the first quarter a year ago.

Net income for the quarter was \$672,000 or \$0.05 per share, compared to net income of \$1.4 million or \$0.11 per share in the first quarter of 2002. Our 2003 first quarter net income includes a gain on disposal of \$278,000 related to the assignment and sale of licenses for certain over-the-counter products to

Pharmascience Inc. and other income of \$341,000 which includes a one-time compensation payment for lost revenues of Dalacin® Vaginal Cream and other payments related to Paladin's license agreements.

Paladin acquired the distribution rights to Dalacin®, along with four other products, from Pharmacia Canada Inc. in January 2002. We have worked closely with Pharmacia to resolve the manufacturing issues related to Dalacin® and we believe that these issues have now been resolved.

At March 31, 2003, Paladin's cash, cash equivalents and investments in both short-term and long-term marketable securities totalled \$46.1 million, compared to \$45.6 million as at March 31, 2002. From this strong cash position, we are actively pursuing acquisitions of innovative products for the Canadian market that meet our disciplined investment criteria. Foremost, each acquisition must be regarded as having the potential to support our profitable growth. We are committed to strengthening our product pipeline and leveraging our sales and marketing capabilities. We are confident in our strategy and remain focused on creating long-term value for our shareholders.

On behalf of our Board of Directors, thank you for your continued support.

Sincerely,

*"Jonathan Ross Goodman"*  
*(signed)*

Jonathan Ross Goodman, B.A., LL.B., M.B.A.  
President & CEO

# STRENGTH THROUGH EXECUTION

## Management Discussion And Analysis:

*All numbers are in thousands of Canadian dollars*

The following analysis explains the variations in the results of operations, financial position and cash flows for Paladin Labs Inc. (“Paladin” or the “Company”). This discussion should be read in conjunction with the information contained in the Company’s interim and annual financial statements and the related notes to these financial statements.

### Overview

Paladin is a leading speciality pharmaceutical company focused on acquiring or in-licensing innovative pharmaceutical products for the Canadian market. Through a national sales force, the Company markets its pharmaceutical products to Canadian physicians.

#### First quarter highlights:

- Revenues reached \$5,065, a decrease of 5% over the same period last year.
- Net income was \$672, a decrease of 52% over the same period last year.
- Transferred rights to certain over-the-counter products.
- Launched sales and marketing initiatives behind key products, including Androderm®, Dostinex®, Estring® Muse®, Oesclim® and Plan B™.

As is common in the specialty drug industry, Paladin’s revenue and profitability growth may vary from one quarter to another. These fluctuations result from, among other things, the timing of TPD approvals, the timing of new product launches and the timing of listing of new drugs on Formularies.

### Results of Operations

#### Revenues

Revenues decreased \$279 or 5%, to \$5,065 for the three-month period ended March 31, 2003 from \$5,344 for the three-month period ended March 31, 2002. This is primarily due to decline in Urispas® sales as a result of the product’s genericization, and a decline in sales of Valtaxin® related to the manufacturing difficulties at Anthra Pharmaceuticals, Inc (“Anthra”). During the second quarter of fiscal 2002, Anthra advised the Company that it was having difficulties manufacturing Valtaxin™, a treatment for BCG-refractory bladder cancer, and that it is not able to determine when it will resume production. Paladin acquired the exclusive license for Valtaxin™ from Anthra in September 1999 and recorded its first sale in May 2001.

### **Gross Profit**

Total gross profit increased \$93 or 2% to \$3,828 for the three-month period ended March 31, 2003 from \$3,735 for the three-month period ended March 31, 2002. Gross profit, as a percentage of revenues, improved to 76% for the three-month period ended March 31, 2003 from 70% for the three-month period ended March 31, 2002. This increase resulted primarily from a higher proportion of products sold for which the Company earns a distribution fee and consequently does not incur costs of sales related to these products.

### **Selling and Marketing Expense**

Selling and marketing expense increased \$1,234 or 87% to \$2,654 for the three-month period ended March 31, 2003 from \$1,420 for the three-month period ended March 31, 2002. Selling and marketing expense, as percentage of revenues, increased to 52% for the three-month period ended March 31, 2003 from 27% for the three-month period ended March 31, 2002. This increase was primarily attributed to increased spending associated with the expansion of the sales and marketing infrastructure behind Androderm®, Dostinex®, Estring®, Muse®, Oesclim®, and Plan B™. The Company has expanded its sales force from 14 sales representatives focused on urologists and endocrinologists to 48 sales representatives focused on urologists, endocrinologists, obstetricians/gynaecologists and targeted high prescribing general practitioners. This sales force includes 26 full time contract sales representatives. As at March 31, 2003, all sales representatives had been trained on the Company's key products and had begun the selling process. Given the long selling cycle associated with the pharmaceutical industry, the Company does not expect to see the full impact of the sales force expansion for twelve to eighteen months.

### **General and Administrative Expense**

General and administrative expense decreased \$97 or 15% to \$549 for the three-month period ended March 31, 2003 from \$646 for the three-month period ended March 31, 2002. General and administrative expense, as a percentage of revenues, decreased to 11% for the three-month period ended March 31, 2003 from 12% for the three-month period ended March 31, 2002.

### **Research and Development Expense**

Research and development expense decreased \$46 or 12% to \$1,084 for the three-month period ended March 31, 2003 from \$383 for the three-month period ended March 31, 2002. This decrease is primarily due to the timing of research and development projects and related expenditures. Research and development expense consists of staffing costs and associated costs required to support DHEA and other products in various stages of development, including further Canadian regulatory expense for currently marketed products.

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## Amortization Expense

Amortization expense increased \$20 or 5% to \$442 for the three-month period ended March 31, 2003 from \$422 for the three-month period ended March 31, 2002. This increase reflects the impact of amortization expense related to the Company's additions to licenses, rights, and intellectual property during fiscal 2002.

## Interest Income

Interest income increased \$259 or 336% to \$336 for the three-month period ended March 31, 2003 from \$77 for the three-month period ended March 31, 2002. This increase reflects the impact of increased cash available for investment during the three-month period March 31, 2003 compared to the same period last year.

## Other Income

Other income decreased \$341 or 49% to \$354 for the three-month period ended March 31, 2003 from \$695 for the three-month period ended March 31, 2002. Other income includes a one-time compensation payment for lost revenues of Dalacin® Vaginal Cream and other payments related to certain license and trademark license agreements.

## Gain of Disposal

During the three month period ended March 31, 2003, the Company recorded gain on disposal of \$278 related to assignment and sale of licenses to certain over-the-counter products.

## Income Tax Expense

Income tax expense decreased \$93 or 40% to \$142 for the three-month period ended March 31, 2003 from \$235 for the three-month period ended March 31, 2002. The effective tax rate was 17% for the three-month period ended March 31, 2003 compared to 14% for the three-month period ended March 31, 2002.

## Net Income

Due to the factors set forth above, net income decreased \$729 or 52% to \$672 for the three-month period ended March 31, 2003 from \$1,401 for the three-month period ended March 31, 2002.

## Liquidity and Capital Resources

The Company believes that its existing cash and cash equivalents, short-term and long-term marketable securities, as well as cash generated from operations are sufficient to finance its current operations and working capital needs and future product acquisitions. At present, the Company is actively pursuing product

acquisitions that may require the use of substantial capital resources. There are no present agreements or commitments with respect to any such acquisitions.

Cash flows from operating activities were \$727 and \$1,823 for the three-month periods ended March 31, 2003 and 2002, respectively. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, write-down of intellectual property, future income taxes, gain on disposal of licenses, and imputed interest.

The cash flows from operating activities for the three-month period ended March 31, 2003 was due to net income, amortization, and future income taxes, offset by a gain on disposal of license and a decrease in net change in non-cash balances relating to operations. For the three-month period ended March 31, 2002, the cash flows from operating activities was mainly due to net income, and amortization offset by future income taxes and a decrease in net change in non-cash balances relating to operations.

Cash flow from investing activities was \$7,290 for the three-month period ended March 31, 2003. For the three-month period ended March 31, 2002, the Company's investing activities used cash of \$12,206. During the three-month period ended March 31, 2003, the Company invested \$519 in acquisitions of patents, pharmaceutical product licenses and rights and intellectual property and received \$340 related to the assignment and sale of certain over-the-counter products. In addition, the Company had a \$7,494 net decrease in short-term marketable securities during the three-month period ended March 31, 2003. For the three-month period ended March 31, 2002, the Company invested \$2,089 in acquisitions of patents, pharmaceutical product licenses and rights and intellectual property and had a net increase in short-term marketable securities of \$11,285. This was offset by \$1,179 in accounts payable related to the above-mentioned acquisitions.

Cash flows from financing activities were \$10 and \$19,986 for the three-month periods ended March 31, 2003 and 2002, respectively. For the three-month period ended March 31, 2003, \$10 was provided from issuance of common shares under the Company's stock purchase plan. For the three-month period ended March 31, 2002, \$19,895 was raised from the issuance of special warrants less related issuance costs. In addition, \$91 was provided from common stock option exercises and the issuance of common shares under the Company's stock purchase plan.

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The Company owns common shares of Anthra Pharmaceuticals, Inc. (“Anthra”) with a carrying value of \$1,500. Anthra is a private corporation based in the United States and it is not practicable within constraints of timeliness or cost to determine the fair value of the common shares. However, the Company’s assessment of the carrying value of the investment in Anthra has indicated that there were a number of factors which could result in a near term impairment of the value of the Company’s investment which could be material.

## Forward-Looking Statements

This document contains forward-looking statements, which reflect the Company’s current expectations regarding future events. The forward-looking statements involve risk and uncertainties, including the difficulty in predicting product approvals, acceptance and demand for new pharmaceutical products, the impact of competitive products and pricing, new product development and launch, availability of raw materials, the regulatory environment, fluctuations in operating results and other risks. Many risks are inherent in the pharmaceutical industry; others are more specific to Paladin. Investors should consult the Company’s ongoing quarterly filings, annual reports and Annual Information Form for additional information on risks and uncertainties relating to these forward-looking statements.

## BALANCE SHEET

[In thousands of Canadian dollars]

	March 31 2003 \$ (unaudited)	December 31 2002 \$
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents <i>[note 3]</i>	10,047	2,020
Short-term marketable securities <i>[note 3]</i>	32,077	36,572
Accounts receivable and other assets	2,539	2,586
Inventories	8	21
Income tax credits receivable	363	325
Future income tax assets	1,221	1,221
<b>Total current assets</b>	<b>46,255</b>	<b>42,745</b>
Long-term marketable securities <i>[note 3]</i>	4,020	7,020
Property plant and equipment	84	72
Intangible assets	12,401	12,703
Deferred charges	1,832	1,515
Investments, at cost	2,771	2,771
Future income tax credits receivable	470	470
Future income tax assets	1,171	1,359
	<b>69,004</b>	<b>68,655</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	3,456	3,658
Income taxes payable	99	109
Balance of sale payable	610	597
Deferred credit	979	1,113
<b>Total current liabilities</b>	<b>5,144</b>	<b>5,477</b>
<b>Shareholders' equity <i>[note 4]</i></b>		
Capital stock	57,344	57,334
Contributed surplus	87	87
Other paid-in capital	23	23
Retained earnings	6,406	5,734
<b>Total shareholders' equity</b>	<b>63,860</b>	<b>63,178</b>
	<b>69,004</b>	<b>68,655</b>

See accompanying notes

# STRENGTH THROUGH EXECUTION

## STATEMENTS OF INCOME AND RETAINED EARNINGS

[In thousands of Canadian dollars except for share and per share amounts]

	Three-month period ended March 31	
	2003	2002
	\$	\$
	(unaudited)	(unaudited)
Revenues	5,065	5,344
Cost of sales	1,237	1,609
<b>Gross profit</b>	<b>3,828</b>	<b>3,735</b>
Selling and marketing	2,654	1,420
General and administrative	549	646
Research and development	337	383
Amortization	442	422
Interest income, net	(336)	(77)
Other income	(354)	(695)
<b>Income before under noted items</b>	<b>536</b>	<b>1,636</b>
Gain on disposal of license <i>[note 6]</i>	278	-
<b>Income before income taxes</b>	<b>814</b>	<b>1,636</b>
Provision for income taxes		
Current	30	21
Future	112	214
	142	235
<b>Net income</b>	<b>672</b>	<b>1,401</b>
<b>Retained earnings, beginning of period</b>	<b>5,734</b>	<b>572</b>
Retained earnings end of period	6,406	1,973
<b>Earnings per share</b>		
Basic	0.05	0.11
Diluted	0.05	0.11
<b>Weighted average number of shares outstanding</b> <i>[note 5]</i>		
Basic	14,781,784	12,549,760
Diluted	14,784,285	12,833,496

See accompanying notes

## STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]

	Three-month period ended	
	2003	March 31
	\$	\$
	(unaudited)	(unaudited)
<b>Operating activities</b>		
Net income	672	1,401
Add items not affecting cash		
Amortization	455	427
Future income taxes	54	(387)
Imputed interest on balance of sale	13	13
Gain on disposal of license	(278)	-
	916	1,454
Net change in non-cash balances relating to operations	(189)	369
Cash flows from operating activities	727	1,823
<b>Investing activities</b>		
Additions to pharmaceutical product licenses and rights	(519)	(2,089)
Accounts payable related to the acquisition of intellectual property	-	1,179
Acquisition of property plant and equipment	(25)	(11)
Purchases of short-term marketable securities	(4,421)	(26,095)
Maturities of short-term marketable securities	11,915	14,810
Proceeds from disposal of pharmaceutical licences	340	-
Cash flows from (used in) financing activities	7,290	(12,206)
<b>Financing activities</b>		
Common shares issued for cash	10	91
Issuance of special warrants	-	20,952
Share issue costs, net of tax	-	(1,057)
Cash flows from financing activities	10	19,986
<b>Net change in cash and cash equivalents during the period</b>	<b>8,027</b>	<b>9,603</b>
Cash and cash equivalents, beginning of period	2,020	1,978
<b>Cash and cash equivalents, end of period</b>	<b>10,047</b>	<b>11,581</b>
Cash and cash equivalents	10,047	11,581
Short-term marketable securities	32,077	31,755
Long-term marketable securities	4,020	-
	46,144	43,336

See accompanying notes

# STRENGTH THROUGH EXECUTION

## NOTES TO FINANCIAL STATEMENTS

[In thousands of Canadian dollars except for share and per share amounts]

### 1. BASIS OF PRESENTATION

Information with respect to the December 31, 2002 balance sheet is derived from the Company's complete audited financial statements. These unaudited interim financial statements should be read in conjunction with the audited financial statements and the notes thereto in the Company's Annual Report for the year ended December 31, 2002.

### 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, 2002.

### 3. CASH AND MARKETABLE SECURITIES

Cash, short-term marketable securities and long-term marketable securities increased by \$532 during the three-month period ended March 31, 2003.

### 4. CAPITAL STOCK

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

Issued and outstanding:

	Number of shares	Amount
Balance at December 31, 2002	14,780,205	\$57,334
Issued under employee share purchase plan	2,408	10
Balance at March 31, 2003	14,782,613	\$57,344

## Stock option plan

The changes to the number of stock options granted by the Company and their weighted average exercise price are as follows:

	2003		2002	
	#	Weighted average exercise price	#	Weighted average exercise price
		\$		\$
Balance at December 31	706,524	6.18	694,833	5.71
Granted	149,318	4.25	68,258	9.86
Exercised	—	—	(13,419)	6.00
Expired or forfeited	—	—	(5,000)	6.35
Balance at March 31	855,842	5.84	744,672	6.08
Options exercisable at March 31	349,032	5.66	274,244	5.53

The company applies the intrinsic value based method of accounting for stock-based compensation awards granted to employees. Accordingly, no compensation cost has been recognized for stock options granted to employees and directors. Had compensation cost been determined based on the fair value at the date of grant of options, the fair value of the options would have been amortized over the vesting period of the options and the Company's net income and income per common share would have been amended as follow:

	Three-month period ended March 31, 2003 \$
Net income as reported	672
Less: Amortization of fair value related to option grants	(138)
Amortization of fair value related to option life amendment in fiscal 2002	(28)
<b>Pro-forma net income</b>	<b>506</b>
<b>Basic Earnings per share</b>	
As reported	0.05
Pro-forma	0.03
<b>Diluted Earnings per share</b>	
As reported	0.05
Pro-forma	0.03

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## 5. EARNINGS PER SHARE

The following summarizes the reconciliation of the basic weighted average number of shares outstanding and the diluted weighted average number of shares outstanding used in the diluted earnings per share calculations:

	Three-month period ended	
	2003	March 31 2002
Basic weighted average number of shares outstanding	14,781,784	12,549,760
Dilutive effect of options	2,501	273,150
Dilutive effect of warrants	–	10,586
Diluted weighted average number of shares outstanding	14,784,285	12,833,496

There was no adjustment to net income for purposes of calculating diluted earnings per share.

## 6. RELATED PARTY TRANSACTION

Effective January 1, 2003, the Company assigned the licenses to Sialor® and the Baker Cummins line of dermatology products and sold the MoiStir® trademark to a related party for net proceeds of \$340. The Company recorded a gain of \$278 representing the difference between the value of the consideration received and the net carrying value of the intellectual property of \$90 less accumulated amortization of \$28. The Company will receive no further consideration for these products.

## 7. COMMITMENTS

In the normal course of business, the Company secures Canadian sales and marketing rights to innovative drug products and has entered into various agreements, which include contractual obligations extending beyond the current year. These obligations are classified into three major categories: revenue based, milestone based and purchase based commitments.

### Revenue based commitments

Most pharmaceutical product license agreements require that the Company make royalty payments; ranging from 5% to 10% of sales, or require payments for products at rates ranging from 40% to 50% of the net selling price, or 60% of the net profit on sales.

In addition, the Company may have to pay up to \$4,481 [US\$3,050] if the Company achieves specific sales volumes on specific products in the future. Payments related to sales volume may be due over the next 10 years.

#### **Milestone based commitments**

The Company has also committed to fund certain research and development expenditures of third parties for \$220 [US\$150] over the next two years. In addition, specific payments are required under these agreements if milestones are met, such as regulatory approval in Canada. Based on the outcome of these milestones, the Company may have to pay up to \$2,535 including US\$1,668.

#### **Purchase and service based commitments**

The Company is committed to making minimum spending related to inventory purchases, regulatory, sales and marketing expenditures in the amount of \$13,335 in order to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual amounts are as follows:

	\$
April 1, 2003 to December 31, 2003	2,534
2004	3,295
2005	1,786
2006	1,792
2007	851
2008-2011	3,077

## **8. COMPARATIVE FIGURES**

Certain of the comparative figures have been reclassified to conform to the presentation adopted in the current year.

## Stock Exchange Listing

Toronto Stock Exchange

Trading Symbol: PLB

## Transfer Agent

Computershare Trust Company of Canada

1500 University St.

Suite 700

Montreal, Quebec

H3A 3S8

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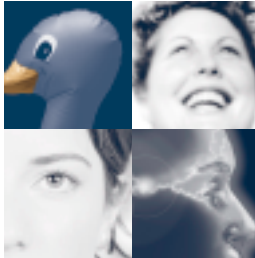
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