



# **Paladin Labs Inc.**

## **2004 Third Quarter Report**

**Paladin Labs Inc.**  
**Laboratoires Paladin Inc.**

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## 2004 THIRD QUARTER BUSINESS UPDATE

Paladin achieved record revenue for the third quarter and nine months ended September 30, 2004, and remains on track to meet its financial guidance for 2004.

### Q3 2004 Highlights

- Revenue totaled a record \$7.9 million, a 46% increase compared to Q3 2003
- Net income increased to \$1.0 million from net income of \$356,000 in Q3 2003
- Filed new drug submissions for GlucaGen<sup>®</sup> and Histrelin Hydrogel Implant with Health Canada
- Signed exclusive Canadian marketing and promotion agreement with Duramed Pharmaceuticals, Inc., for Loestrin<sup>®</sup> and Minestrin<sup>®</sup>

“We are pleased with our progress and financial results to date in 2004. Our recent market launch of OXYTROL<sup>®</sup> significantly strengthens our urology franchise and will drive strong organic sales growth,” said Jonathan Ross Goodman, President & CEO of Paladin Labs.

### Product Developments

During the third quarter, Paladin filed, on behalf of Novo Nordisk Canada Inc., a new drug submission for GlucaGen<sup>®</sup> (recombinant glucagon for injection) with the Biologics and Genetic Therapies Directorate of Health Canada. GlucaGen<sup>®</sup> is chemically identical to human glucagon, a naturally occurring peptide that selectively converts liver glycogen to glucose, relaxes smooth muscle, and increases the strength of cardiac contractions. Glucagon is indicated for emergency treatment of hypoglycemia in insulin-dependent diabetics. According to IMS Canada, in 2003, the annual market for glucagon was \$4.1 million, and grew by 28% over the previous year.

Paladin filed a new drug submission for Histrelin Hydrogel Implant with the Therapeutic Products Directorate of Health Canada. Histrelin Hydrogel Implant is a unique, once-yearly luteinizing hormone-releasing hormone (LHRH) implant indicated for the treatment of prostate cancer, the most prevalent form of cancer afflicting Canadian men. According to IMS Canada, in 2003, the total LHRH agonist market for the treatment of prostate cancer was \$108 million, and had a compound annual growth rate of 15% since 1998.

Paladin entered into an exclusive Canadian marketing and promotion agreement with Duramed Pharmaceuticals, Inc., a wholly-owned subsidiary of Barr Pharmaceuticals, Inc., for Loestrin<sup>®</sup> (norethindrone acetate 1.5mg/ ethinyl estradiol 0.03mg) and Minestrin<sup>®</sup> (norethindrone acetate 1.0mg/ ethinyl estradiol 0.02mg), two oral contraceptive pharmaceutical products that are currently available in Canada. Under the terms of the agreement, Paladin will assume responsibility for all marketing and promotion in Canada in exchange for a service fee. Duramed will continue to maintain control of manufacturing, distribution and logistical support.

Due to changes in market conditions, Paladin announced that it will no longer pursue its new drug submission for Statex<sup>®</sup> SR (sustained-release morphine sulfate tablets) with the Therapeutic Products Directorate of Health Canada. Paladin also announced that as a result of Health Canada's recent classification of melatonin as a natural health product, Circadin<sup>®</sup> (controlled release melatonin tablets) no longer fits within its sales and marketing strategy and will not be commercialized.

Subsequent to the end of the third quarter, on October 18, 2004, Paladin announced the Canadian launch of OXYTROL<sup>®</sup> (oxybutynin transdermal system), a unique patch medication indicated for the treatment of overactive bladder (OAB), with symptoms of urge urinary incontinence, urgency, and

frequency. By bypassing initial metabolism in the liver and the gastrointestinal tract that occurs with oral medications, OXYTROL<sup>®</sup> provides relief of overactive bladder symptoms for up to four days with anticholinergic side effects comparable to placebo. According to The Canadian Continence Foundation (TCCF), approximately three million Canadians suffer from an overactive bladder and, according to IMS Canada, the total Canadian prescription market for overactive bladder exceeded \$46 million in 2003.

#### **Financial Guidance**

For the year ended December 31, 2004, Paladin expects to generate \$26.5 million in revenue, EBITDA<sup>1</sup> in the range of \$6.4 million to \$7.0 million, and net income in the range of \$1.9 million to \$2.1 million. This forecast excludes the impact of acquisitions that may be made by the Company between now and the end of 2004.

*(1) EBITDA does not have any standardized meaning prescribed by generally accepted accounting principles (GAAP) and therefore may not be comparable to similar measures presented by other public issuers. EBITDA performance and guidance is presented herein because Paladin management believes that, in addition to net income, EBITDA is a useful supplemental measure of the Company's financial performance.*

# Management Discussion And Analysis:

*All numbers are in thousands of Canadian dollars except for share and per share amounts*

The following analysis explains the variations in the results of operations, financial position and cash flows for Paladin Labs Inc. ("Paladin" or the "Company") and is current as at October 27, 2004. 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.

## 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.

## Overview

Paladin is a specialty pharmaceutical company focused on selling and marketing innovative pharmaceutical products for the Canadian market. Through a national sales force, the Company markets its pharmaceutical products to Canadian physicians.

Paladin's strategy is to acquire promotion-sensitive products with existing sales and to increase sales of these products through focused marketing and promotion. The Company also in-licenses late-stage development products, obtains regulatory approval for them and then launches them in the Canadian market.

### Third quarter highlights:

- Revenues reached \$7,938 an increase of 46% over the same period last year.
- Net income was \$1,038, an increase of 192% from a \$356 in the same period last year.
- Submitted new drug submission for Glucagen<sup>®</sup>, on behalf of Novo Nordisk Canada Inc., with Health Canada.
- Submitted new drug submission for Hisdrolin Hydrogel Implant was filed with Health Canada.
- Realigned product pipeline to no longer pursue its new drug submissions for Statex<sup>®</sup> SR and Circadin<sup>®</sup> with Health Canada.
- Announced change in management team.
- Signed marketing agreement with Duramed Pharmaceuticals for Loestrin<sup>®</sup> and Minestrin<sup>®</sup>.
- Donated more than \$400 in medication to Health Partners International of Canada (HPIC).

Paladin's annual and quarterly operating results are primarily affected by: (1) the level of acceptance of Paladin's products by physicians and their patients; and, (2) wholesaler buying patterns. The level of patient and physician acceptance of Paladin's products, as well as the availability of similar therapies, impact Paladin's revenues by driving the level and timing of prescriptions for its products. Wholesaler buying patterns, including a tendency to increase inventory levels prior to anticipated or announced price increases, affect the Company's operating results by shifting revenue between quarters. To ensure that Paladin maintains good relations with wholesalers, Paladin typically gives wholesalers prior notice of price increases to enable them to purchase products that they will later sell at higher prices.

## Critical Accounting Estimates

Paladin's financial statements are prepared in accordance with Canadian generally accepted accounting principles, applied in a consistent basis. Paladin's critical accounting estimates include revenue recognition, the recording of research and development expenses, the useful lives and fair value of intangible assets and stock based compensation expense. For a more detailed discussion of the Company's critical accounting, please refer to the Management Discussion & Analysis included in the Company's 2003 Annual Report. There have been no material changes to accounting estimates since December 31, 2003.

## Results of Operations

Three-month period ended September 30, 2004 compared to three-month period ended September 30, 2003, and nine-month period ended September 30, 2004 compared to nine-month period ended September 30, 2003.

### Revenues

Revenues increased \$2,518 or 46% to \$7,938 for the nine-month period ended September 30, 2004 from \$5,420 for the nine-month period ended September 30, 2003. For the three-month period ended September 30, 2004, revenues increased \$2,994 or 18% to \$19,932 from \$16,938 for the three-month period ended September 30, 2003. The increase in revenues for the three month period ended September 30, 2004 was due to growth from the Company's key promoted products, including Androderm<sup>®</sup>, Dostinex<sup>®</sup>, Dalacin<sup>®</sup>, Estring<sup>®</sup> and Plan B<sup>®</sup>, which increased by 19% compared to the three-month period ended September 30, 2003. The increase in revenues for the nine-month period ended September 30, 2004 was due to growth from the Company's key promoted products including Androderm<sup>®</sup>, Dostinex<sup>®</sup>, Dalacin<sup>®</sup>, Estring<sup>®</sup> and Plan B<sup>®</sup>, which increased by 15% compared to the nine-month period ended September 30, 2003. The increase in revenues of promoted products was offset by continued declines in sales of Urispas<sup>®</sup>, due to generic competition; a decline in sales of Oesclim<sup>®</sup>, due to the recent medical concerns relating to female hormone replacement therapies.

### Gross Profit

Total gross profit increased \$1,677 or 42% to \$5,679 for the three-month period ended September 30, 2004 from \$4,002 for the three-month period ended September 30, 2003. For the nine-month period ended September 30, 2004, gross profit increased \$1,971 or 15% to \$14,721 from \$12,750 for the nine-month period September 30, 2003. Gross profit, as a percentage of revenues, declined to 72% for the three-month period ended September 30, 2004 from 74% for the three-month period ended September 30, 2003. Gross profit, as a percentage of revenues, declined to 74% for the nine-month period ended September 30, 2004 from 75% for the nine-month period ended September 30, 2003.

### Selling and Marketing Expense

Selling and marketing expense decreased \$676 or 26% to \$1,898 for the three-month period ended September 30, 2004 from \$2,574 for the three-month period ended September 30, 2003. For the nine-month period ended September 30, 2004, selling and marketing expense decreased \$2,832 or 36% to \$5,115 from \$7,947 for the nine-month period September 30, 2003. Selling and marketing expense, as percentage of revenues, decreased to 24% for the three-month period ended September 30, 2004 from 47% for the three-month period ended September 30, 2003. Selling and marketing expense, as percentage of revenues, decreased to 26% for the nine-month period ended September 30, 2004 from 47% for the nine-month period ended September 30, 2003. This decrease was primarily attributed to decreased promotion activities on Androderm<sup>®</sup>. It is expected that selling and marketing expense, as a percentage of revenues, will be between 30% and 35% for the year ended December 31, 2004.

### General and Administrative Expense

General and administrative expense increased \$75 or 13% to \$655 for the three-month period ended September 30, 2004 from \$580 for the three-month period ended September 30, 2003. For the nine-month period ended September 30, 2004, general and administrative expense increased \$287 or 16% to \$2,124 from \$1,837 for the nine-month period September 30, 2003. General and administrative expense, as a percentage of revenues, decreased to 8% for the three-month period ended September 30, 2004 from 11% for the three-month period ended September 30, 2003. General and administrative expense, as a percentage of revenues, was 11% for the nine-month period ended September 30, 2004 and for the nine-month period ended September 30, 2003.

### Research and Development Expense

Research and development expense increased \$383 or 98% to \$774 for the three-month period ended September 30, 2004 from \$391 for the three-month period ended September 30, 2003. For the nine-month period ended September 30, 2004, research and development expense increased \$1,579 or 181% to \$2,452 from \$873 for the nine-month period September 30, 2003. This increase in research and development expense for the three-month and nine-month periods ended September 30, 2004 was due to: expenses related to the submissions of New Drug Submissions for Histrelin Hydrogel Implant and GlucaGen<sup>®</sup>; an increased number of research and development projects in fiscal 2004; and, \$353 related to certain license payments for unapproved products.

**Amortization Expense**

Amortization expense increased \$667 or 151% to \$1,109 for the three-month period ended September 30, 2004 from \$442 for the three-month period ended September 2003. For the nine-month period ended September 30, 2004, amortization expense increased \$1,633 or 119% to \$3,011 from \$1,377 for the nine-month period September 30, 2003. This increase in amortization expense is a result of the Company's decision to reduce the estimated useful life of the carrying value of the intellectual property associated with products which may be genericized as well as the impact of amortization expense related to the Company's acquisitions of licenses, rights and intellectual property during fiscal 2003.

**Interest Income**

Interest income decreased \$145 or 35% to \$267 for the three-month period ended September 30, 2004 from \$412 for the three-month period ended September 30, 2003. For the nine-month period ended September 30, 2004, interest income decreased \$247 or 22% to \$866 from \$1,113 for the nine-month period September 30, 2003. This decrease reflects the impact of lower interest rates and lower average cash balance during the three and nine-month period ended September 30, 2004 compared to the three and nine-month period ended September 30, 2003.

**Other Income**

Other income was \$0 for the three and nine-month period ended September 30, 2004. Other income in the three and nine-month periods ended September 30, 2003 includes a one-time compensation payment for lost revenues of Dalacin<sup>®</sup> and other payments related to certain license and trademark license agreements.

**Gain on Disposal**

Gain on disposal was \$0 for the three and nine-month period ended September 30, 2004. During the nine-month period ended September 30, 2003, the Company recorded a gain on disposal of \$504 related to assignment and sale of licenses to certain over-the-counter products to a related party and the sale of its investment in Connetics Corporation.

**Write-down of Investments**

In June 2003, Anthra Pharmaceuticals, Inc. ("Anthra") advised the Company that it had disposed of virtually all of its assets and was unable to determine when it will be able to resume production of its marketed product, Valtaxin<sup>™</sup>. The Company determined that there had been a permanent impairment in the carrying value of the investment in Anthra. Anthra is a private corporation based in the United States and it is not practicable within constraints of timeliness and cost to determine the fair value of the common shares. Consequently, the Company recorded a write-down of \$1,497, representing the full amount of its carrying value of its investment in Anthra.

**Income Tax Expense**

Income tax expense increased \$390 or 476% to \$472 for the three-month period ended September 30, 2004 from \$82 for the three-month period ended September 30, 2003. For the nine-month period ended September 30, 2004, income tax expense increased \$382 or 87% to \$823 from \$441 for the nine-month period September 30, 2003. For the three and nine-month periods ended September 30, 2003, the Company did not record any tax benefit related to the write-down of its investment in Anthra. The effective tax rate was 31% for the three-month period ended September 30, 2004 compared to 19% for the three-month period ended September 30, 2003. The effective tax rate was 29% for the for the nine-month period ended September 30, 2004 compared to 36% for the nine-month period ended September 30, 2003.

**Net Income**

Due to the factors set forth above, net income increased \$682 to a net income of \$1,038 for the three-month period ended September 30, 2004 from a net income of \$356 for the three-month period ended September 30, 2003 and increased \$1,276 or 162% to \$2,063 for the nine-month period ended September 30, 2004 from \$787 for the nine-month period ended September 30, 2003.

**Liquidity and Capital Resources**

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

Paladin's cash, cash equivalents, and short-term and long-term marketable securities decreased \$8,202 to \$39,446 at September 30, 2003 from \$47,648 at December 31, 2003. This decrease in cash, cash equivalents, and short-term and long-term marketable securities was primarily due to an increase in accounts receivable and inventory. On February 1, 2004, the Company amended its distribution agreement with its affiliate (see Related Party Transactions). As a result of this amendment, Paladin has taken ownership of inventory and accounts receivables related to products distributed by Paladin. Consequently, on February 1, 2004, Paladin purchased \$4.1 million of accounts receivables and \$2.9 million of inventory from this affiliate.

Working capital decreased \$9 to \$39,914 at September 30, 2004 from \$39,923 at December 31, 2003. This decrease is primarily due to an increase in long-term marketable securities and a decrease in short-term liabilities.

Cash flows from operating activities were \$2,493 and \$1,523 for the three-month periods ended September 30, 2004 and 2003, respectively. Cash flows used in operating activities was \$598 for the nine-month period ended September 30, 2004. For the nine-month period ended September 30, 2003, cash flows from operating activities were \$4,185. Cash flows from operating activities represent the cash flows from net earnings, excluding revenues and expenses not affecting cash, principally amortization, future income taxes, option compensation expense and imputed interest.

Cash flows from investing activities were \$2,136 for the three-month period ended September 30, 2004 and cash flows used in investing activities were \$1,433 for the three-month periods ended September 30, 2003. During the three-month period ended September 30, 2004, the Company invested \$519 in acquisitions of pharmaceutical product licenses and rights and intellectual property, and had a \$1,615 net increase in short-term and long-term marketable securities. For the three-month period ended September 30, 2003, the Company invested \$519 in acquisitions of pharmaceutical product licenses and rights and intellectual property and had a \$912 net increase in short-term and long-term marketable securities.

Cash flows from investing activities were \$5,058 for the nine-month period ended September 30, 2004 and cash flows used in investing activities were \$4,745 for the nine-month periods ended September 30, 2003. During the nine-month period ended September 30, 2004, the Company invested \$2,460 in acquisitions of pharmaceutical product licenses and rights and intellectual property. In addition, the Company had a \$7,522 net decrease in short-term and long-term marketable securities. For the nine-month period ended September 30, 2003, the Company invested \$1,606 in acquisitions of pharmaceutical product licenses and rights and intellectual property and \$1,434 in other companies. In addition, the Company received \$869 related to the sale of its investment in Connetics Corporation and certain over-the-counter products and had a \$2,523 net increase in short-term and long-term marketable securities.

Cash flows used in financing activities were \$1,025 and \$3,235 for the three and nine-month periods ended September 30, 2004 respectively. For the three and nine month periods ended September 30, 2004, \$14 and \$267 was provided from common stock option exercises and the issuance of common shares under the stock purchase plan. In addition, the Company had a decrease of \$1,039 and \$3,522 in accounts payable related to pharmaceutical product licenses for the three and nine-month periods ended September 30, 2004 respectively.

Cash flows used in financing activities were \$12 and \$73 for the three and nine-month periods ended September 30, 2003 respectively. For the three-month period and nine-month period ended September 30, 2003, \$12 and \$53 were provided from the issuance of common shares under the stock purchase plan.

### **Related Party Transactions**

JODDES Limited ("JODDES"), a private Canadian corporation, is a significant shareholder, holding approximately 45% of the outstanding shares of the Company, and one director of the Company, the Company's President and CEO, is related to JODDES.

In June 1998, the Company entered into a number of ten-year agreements each with five-year renewal options with a wholly owned subsidiary of JODDES. Under these agreements, this affiliate provides manufacturing and logistics services including, customer service, warehousing and shipping, invoicing and collection services on behalf of the Company. Effective February 1, 2004, Paladin amended the distribution agreement with this affiliate. As a result of this amendment, Paladin has begun to invoice customers and collect accounts receivables and has taken title to the inventory and accounts receivables related to the products distributed by Paladin. Consequently, on February 1,

2004, Paladin purchased \$4.1 million of accounts receivable and \$2.9 million of inventory from this affiliate. The related party will continue to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services.

The Company also engages this affiliate to perform certain research and development services. These service contracts are on a pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of JODDES. This lease is for a period of two years and includes minimum payments of \$133. On November 5, 2003, the Company purchased a three-year license and distribution agreement from PanGeo Pharmaceutical (Canada) Inc. ("PanGeo"). On November 6, 2003, PanGeo was purchased by JODDES.

All transactions with affiliated companies are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount.

The table below reflects all transactions and services with affiliates, including those referred to in the agreements described above:

	Three-month period ended		Nine-month period ended	
	2004	2003	2004	2003
	\$	\$	\$	\$
Revenues	805	314	1,308	1,766
Purchases	244	1,267	4,426	3,874
Research and development expenses	96	104	318	202
Sales and marketing expenses	436	299	1,115	910
General and administrative expenses	64	60	212	197

Effective January 1, 2003, the Company sold the MoiStir<sup>®</sup> trademark and assigned the licenses of Sialor<sup>®</sup> and the Baker Cummins line of dermatology products to a related party, a subsidiary of JODDES, and recorded a gain of \$278. The Company will receive no further consideration for these products.

### Subsequent Event

Subsequent to September 30, 2004, the Company disposed all of its common shares of BioSante Pharmaceuticals, Inc. The Company recorded a gain of \$577 representing the difference between the proceeds received of \$1,020 and the carrying value of \$444.

### Risk Factors

For a more detailed discussion of the risk factors that could materially affect the results of operations and the financial condition of the Company, please refer to the Company's Annual Information Form.

### Contractual Obligations and Commitments

In the normal course of business, Paladin secures Canadian development, sales, marketing and distribution rights to innovative drug products and has entered into various agreements, which include contractual obligations extending beyond the current year. In addition, under certain agreements, Paladin may have to pay additional consideration should the Company achieve certain sales volumes or if certain milestones are met, such as regulatory approval in Canada. The Company has the following contractual obligations and commitments related to product license, trademark and distribution agreements:

	Contractual Obligations		Commitments	
	Purchase and service based commitments	Milestone based commitments	Revenue based commitments	
	\$	\$	\$	\$
July 1, 2004 – December 31, 2004	758	—	—	—
Fiscal 2005 – fiscal 2006	6,788	1,664	379	
Fiscal 2007 – fiscal 2008	3,232	—	537	
After fiscal 2009	2,221	2,044	3,892	
<b>Total</b>	<b>12,999</b>	<b>3,707</b>	<b>4,808</b>	

## NOTICE TO READER OF THE INTERIM FINANCIAL STATEMENTS

The financial statements of Paladin Labs Inc. (the “**Company**”) and the accompanying interim balance sheet as at September 30, 2004 and the interim statements of income, retained earnings and cash flows for the three and six month periods then ended are the responsibility of the Company’s management. These financial statements have not been audited or reviewed on behalf of the shareholders by the independent external auditors, Ernst & Young LLP.

The interim financial statements have been prepared by management and include the selection of appropriate accounting principles, judgments and estimates necessary to prepare these financial statements in accordance with Canadian generally accepted accounting principles. Readers are cautioned that these interim statements may not be appropriate for their purposes.

Jonathan Ross Goodman, B.A., LL.B, M.B.A.  
President and Chief Executive Officer  
Montreal, Canada  
October 27, 2004

Samira Sakhia C.A., M.B.A.  
Chief Financial Officer  
Montreal, Canada  
October 27, 2004

## BALANCE SHEET

[In thousands of Canadian dollars]

	September 30 2004 \$	December 31 2003 \$
	(unaudited)	
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	4,412	1,991
Short-term marketable securities	30,948	42,556
Accounts receivable	5,553	248
Inventories	2,780	—
Other current assets	520	2,541
Investment tax credits receivable	176	256
Future income tax assets	1,969	1,969
<b>Total current assets</b>	<b>46,358</b>	<b>49,561</b>
Long-term marketable securities	4,086	—
Property, plant and equipment	89	132
Intangible assets	10,731	12,359
Deferred charges	3,859	2,781
Investments	1,877	1,877
Future income tax credits recoverable	659	659
Future income tax assets	743	1,601
	<b>68,402</b>	<b>68,970</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	4,010	4,546
Accounts payable to related parties	640	170
Income taxes payable	159	85
Balance of license agreements payable	1,635	4,537
Deferred credit	—	300
<b>Total current liabilities</b>	<b>6,444</b>	<b>9,638</b>
<b>Shareholders' equity [note 4]</b>		
Capital stock	57,727	57,440
Contributed surplus	87	87
Other paid-in capital	519	243
Retained earnings	3,625	1,562
<b>Total shareholders' equity</b>	<b>61,958</b>	<b>59,332</b>
	<b>68,402</b>	<b>68,970</b>

See accompanying notes

## STATEMENTS OF INCOME AND RETAINED EARNINGS

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

	Three-month period ended September 30		Nine-month period ended September 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
		(restated – see note 3)		(restated – see note 3)
Revenues	7,938	5,420	19,932	16,938
Cost of sales	2,259	1,418	5,211	4,188
<b>Gross profit</b>	<b>5,679</b>	<b>4,002</b>	<b>14,721</b>	<b>12,750</b>
Selling and marketing	1,898	2,574	5,115	7,947
General and administrative <i>[note 3]</i>	655	580	2,124	1,837
Research and development	774	391	2,452	873
Amortization	1,109	442	3,010	1,377
Interest income, net	(267)	(412)	(866)	(1,113)
Other income	—	(11)	—	(392)
<b>Income before under noted items</b>	<b>1,510</b>	<b>438</b>	<b>2,886</b>	<b>2,221</b>
Gain on disposal of license <i>[note 6]</i>	—	—	—	(504)
Write-down of long-term investments <i>[note 7]</i>	—	—	—	1,497
<b>Income before income taxes</b>	<b>1,510</b>	<b>438</b>	<b>2,886</b>	<b>1,228</b>
Provision for income taxes				
Current	25	15	75	75
Future	447	67	748	366
	472	82	823	441
<b>Net income (loss) <i>[note 3]</i></b>	<b>1,038</b>	<b>356</b>	<b>2,063</b>	<b>787</b>
<b>Retained earnings, beginning of period</b>	<b>2,587</b>	<b>6,165</b>	<b>1,562</b>	<b>5,734</b>
<b>Retained earnings, end of period</b>	<b>3,625</b>	<b>6,521</b>	<b>3,625</b>	<b>6,521</b>
<b>Earnings per share</b>				
Basic	0.07	0.02	0.14	0.05
Diluted	0.07	0.02	0.14	0.05
<b>Weighted average number of shares outstanding <i>[note 5]</i></b>				
Basic	14,851,775	14,789,827	14,828,278	14,785,069
Diluted	14,909,415	14,824,569	14,908,867	14,802,981

*See accompanying notes*

## STATEMENTS OF CASH FLOWS

[In thousands of Canadian dollars]  
[unaudited]

	Three-month period ended September 30		Nine-month period ended September 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
		(restated – see note 3)		(restated – see note 3)
<b>Operating activities</b>				
Net income (loss) [note 3]	1,038	356	2,063	787
Add items not affecting cash				
Amortization	1,124	452	3,057	1,416
Stock based compensation expense [note 3]	62	30	280	188
Future income taxes	408	8	558	235
Write-down of long-term investment	—	—	—	1,497
Imputed interest on balance of sale	—	13	—	40
Gain on disposal of license	—	—	—	(504)
	2,632	859	5,958	3,659
Net change in non-cash balances relating to operations	(139)	664	(5,360)	526
Cash flows from (used in) operating activities	2,493	1,523	598	4,185
<b>Investing activities</b>				
Additions to pharmaceutical product licenses and rights and intellectual property and deferred charges	(519)	(519)	(2,460)	(1,606)
Investment in other companies	—	—	—	(1,434)
Acquisition of property, plant and equipment	(2)	(2)	(4)	(51)
Purchases of short-term marketable securities	(7,895)	(8,382)	(24,664)	(39,219)
Maturities of short-term marketable securities	7,748	14,153	36,272	44,632
Purchases of long-term marketable securities	(1,736)	(6,683)	(5,435)	(7,936)
Maturities of long-term marketable securities	268	—	1,349	—
Proceeds from disposal of assets	—	—	—	869
Cash flows from (used in) investing activities	(2,136)	(1,433)	5,058	(4,745)
<b>Financing activities</b>				
Common shares issued for cash	14	12	267	53
Account payable related to the acquisition of intellectual property	(1,039)	—	(3,522)	—
Repayment of share purchase loan	—	—	20	20
Cash flows from (used in) financing activities	(1,025)	12	(3,235)	73
<b>Net change in cash and cash equivalents during the period</b>	<b>(668)</b>	<b>102</b>	<b>2,421</b>	<b>(487)</b>
Cash and cash equivalents, beginning of period	5,080	1,431	1,991	2,020
<b>Cash and cash equivalents, end of period</b>	<b>4,412</b>	<b>1,533</b>	<b>4,412</b>	<b>1,533</b>
Cash and cash equivalents	4,412	1,533		
Short-term marketable securities	30,948	39,432		
Long-term marketable securities	4,086	6,683		
	39,446	47,648		

See accompanying notes

## 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, 2003 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, 2003.

### 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, 2003.

### 3. Restatement

As reported in note 3 of the audited financial statements for the year ended December 31, 2003, the Company changed its accounting policy for the stock-based compensation plans in the fourth quarter of 2003. Consequently, the Company has applied fair value based method to expense employee options awarded since January 1, 2003. This change in accounting policy has resulted in restatement of general and administrative expenses and net income for the three-month and nine-month periods ended September 30, 2003.

### 4. Capital Stock

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

**Issued and outstanding:**

	<b>Number of shares</b>	<b>Amount</b>
<b>Balance at beginning of year</b>	<b>14,799,588</b>	<b>57,440</b>
Issued on exercise of stock options	47,590	230
Issued under employee share purchase plan	6,808	37
Employee share purchase loan	—	20
Other	5	—
<b>Balance at September 30, 2004</b>	<b>14,853,991</b>	<b>57,727</b>

### Stock option plan

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

	2004		2003	
	#	Weighted average exercise price \$	#	Weighted average exercise price \$
Balance at beginning of year	873,984	5.57	706,524	6.18
Granted	101,869	5.22	195,318	4.29
Exercised	(47,590)	4.84	(5,000)	4.25
Expired or forfeited	(80,966)	6.08	(80,338)	6.31
Balance at September 30	847,297	5.52	816,504	5.73
Options exercisable at September 30	451,453	5.59	361,816	5.61

During 2003, the Company adopted the fair value based method of accounting for employee stock compensation on a prospective basis for options awarded since January 1, 2003. Consequently, the Company records a charge against income with a corresponding credit against paid-in-capital. For options, which were granted or modified during fiscal 2002, the Company will continue to present pro forma net income as if the fair value had been applied to those awards. The Company uses the Black-Scholes option-pricing model to determine the fair value of stock options.

The Company recorded option compensation expense and determined the fair value of stock options as follows:

	Three-month period ended September 30		Nine-month period ended September 30	
	2004	2003	2004	2003
Option compensation expense	60	25	276	183
Weighted average fair value of stock options	\$5.40	\$3.16	\$3.54	\$3.02
Weighted average risk-free interest rate	4.45%	4.23%	3.95%	4.60%
Dividend yield	Nil	Nil	Nil	Nil
Weighted average volatility factor	63%	69%	66%	71%
Weighted average expected life	7 years	7 years	7 years	7 years

For purposes of pro forma disclosures, the estimated fair value of the options granted prior to 2003 will continue to be disclosed as an expense on a straight-line basis over the option's vesting period. The fair value of option grants during 2002 was estimated at the date of grant using the following assumptions: weighted average risk-free interest rate of 5.02%; dividend yield of nil; weighted average volatility factor of the expected market price of the Company's common shares of 76%; and a weighted average expected life of the options of 7 years. The weighted average fair value of stock options granted during 2002, under the Black-Scholes option-pricing model and above assumptions, was \$6.05.

For options for which the option term was amended from five years to seven years, the fair value was estimated at the date of amendment using the following assumptions: weighted average risk-free interest rate of 4.06%; dividend yield of nil; weighted average volatility factor of the expected market price of the Company's common shares of 72%; and a weighted average expected life of the options of 3.5 years. The weighted average fair value of stock options amended on December 4, 2002, under the Black-Scholes option-pricing model and above assumptions, was \$4.06.

	Three-month period ended September 30		Nine-month period ended September 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
Net income (loss) as reported	1,038	356	2,063	787
Less:				
Amortization of fair value related to option grants	(16)	(34)	(54)	(105)
Amortization of fair value related option life amendment in fiscal 2002	(7)	(27)	(44)	(82)
<b>Pro-forma net income</b>	<b>1,015</b>	<b>295</b>	<b>1,965</b>	<b>600</b>
Basic Earnings per share				
As reported	0.07	0.02	0.14	0.05
Pro-forma	0.07	0.02	0.13	0.04
Diluted Earnings per share				
As reported	0.07	0.02	0.14	0.05
Pro-forma	0.07	0.02	0.13	0.04

## 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:

Earnings per share	Three-month period ended September 30		Nine-month period ended September 30	
	2004	2003	2004	2003
Basic weighted average number of shares outstanding	14,851,775	14,789,827	14,828,278	14,785,069
Dilutive effect of options	57,640	34,742	80,590	17,912
Diluted weighted average number of shares outstanding	14,909,415	14,824,569	14,908,868	14,802,981

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

## 6. Related party transactions

JODDES Limited ("JODDES"), a private Canadian corporation, is a significant shareholder holding approximately 45% of the outstanding shares of the Company, and one director of the Company, the Company's President and CEO, is related to JODDES.

In June 1998, the Company entered into a number of ten-year agreements each with five-year renewal options with a wholly owned subsidiary of JODDES. Under these agreements, this affiliate provides manufacturing and logistics services including, customer service, warehousing and shipping, invoicing and collection services on behalf of the Company. Effective February 1, 2004, Paladin amended the distribution agreement with this affiliate. As a result of this amendment, Paladin has begun to invoice customers and collect accounts receivable and has taken title to the inventory and accounts receivables related to the products distributed by Paladin. Consequently, on February 1, 2004, Paladin purchased \$4.1 million of account receivable and \$2.9 million of inventory from this affiliate. The related party will continue to provide logistics services, including customer service, warehousing and shipping, invoicing and collection services.

The Company also engages this affiliate to perform certain research and development services. These service contracts are on a pay-for-use basis. The Company also leases its office facilities from another wholly owned subsidiary of JODDES. This lease is for a period of 2 years and includes minimum payments of \$133. On November 5, 2003, the Company purchased a three-year license and distribution agreement from PanGeo Pharmaceutical (Canada) Inc. ("PanGeo"). On November 6, 2003, PanGeo was purchased by JODDES.

All transactions with affiliated companies are carried out in the normal course of operations, and are recorded at an agreed upon exchange amount.

The table below reflects all transactions and services with affiliates, including those referred to in the agreements described above:

	Three-month period ended September 30		Nine-month period ended September 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
Revenues	805	314	1,308	1,766
Purchases	244	1,267	4,426	3,874
Research and development expenses	96	104	318	202
Sales and marketing expenses	436	299	1,115	910
General and administrative expenses	64	60	212	197

Effective January 1, 2003, the Company sold the MoiStir<sup>®</sup> trademark and assigned the licenses of Sialor<sup>®</sup> and the Baker Cummins line of dermatology products to a related party, a subsidiary of JODDES, and recorded a gain of \$278. The Company will receive no further consideration for these products.

## 7. Write-down of investments

In June 2003, Anthra advised the Company that it had disposed of virtually all of its assets and was unable to determine when it will be able to resume production of its marketed product, Valtaxin™. The Company considers that there has been a permanent impairment in the carrying value of the investment in Anthra. Anthra is a private corporation based in the United States and it is not practicable within constraints of timeliness and cost to determine the fair value of the common shares. Consequently, the Company recorded a write-down of \$1,497, representing the full amount of its carrying value of its investment in Anthra.

## 8. Commitments

In the normal course of business, the Company secures Canadian development, sales, marketing and distribution 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 2.5% to 20% of sales, or require payments for products at rates ranging from 26% 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 \$4,708 [US\$3,725] and \$100 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 \$316 [US\$250] over the next two years. Additional payments may be 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 \$3,393, including US\$2,618, over a maximum period of 15 years.

### 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 \$12,999 including US\$125 in order to retain exclusive distribution agreements for certain products. These commitments end in 2011 and annual amounts are as follows:

	\$
October 1, 2004 - December 31, 2004	758
2005	3,472
2006	3,316
2007	2,376
2008	856
2009-2011	2,221

## **9. Subsequent Event**

Subsequent to September 30, 2004, the Company disposed all of its common shares of BioSante Pharmaceuticals, Inc. The Company recoded a gain of \$577 representing the difference between the proceeds received of \$1,020 and the carrying value of \$444.

## **10. Comparative figures**

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

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