

3 rd QUARTER RESULTS

2001



PRESIDENT'S REPORT

Dear Shareholders,

The third quarter of 2001 was a record quarter for Paladin with several important achievements combining to demonstrate the success of our focused business strategy. Paladin's net income for the quarter exceeded net income for fiscal 1998. In fact, our revenues and net income for the first nine months of this year are greater than our revenues and net income for all of last year. Our portfolio of promising new therapeutics continues to perform strongly for Paladin shareholders behind our exceptional sales and marketing team.

Revenues for the third quarter of 2001 totaled \$4.9 million, a 60% increase over the third quarter of 2000. For the first nine months of 2001, revenues are up 46% versus the first nine months of 2000 to \$12.8 million. The significant increase was primarily due to the revenues derived from new or recently launched products, including Androderm™, Canada's first approved testosterone patch, Plan B™, a next generation emergency contraceptive, and MUSE®, an alternative treatment for erectile dysfunction. Gross profit, as a percentage of revenues, improved to 71% in the current quarter from 69% in the same quarter last year.

Net income for the quarter increased 80% to \$1.5 million or \$0.12 per share, compared to \$819,210 or \$0.07 per share in the same period last year. For the 1st nine months of 2001, net income is up 53% to \$2.9 million or \$0.24 per share for the same period.

This quarter, Paladin strengthened its portfolio with the acquisition of Propyl-Thyracil® (propylthiouracil) from Merck Frosst Canada & Co. Propyl-Thyracil® is indicated for the treatment of hyperthyroidism and nicely complements Tapazole® (methimazole), another product indicated to treat hyperthyroidism which was acquired in December of 2000 from Eli Lilly Canada Inc.

IMS Canada reports that prescriptions for the treatment of hyperthyroidism increased at an annual rate of 9% for the past three years. The addition of Propyl-Thyracil® to our product portfolio immediately strengthens our position with Canadian endocrinologists.

In August 2001, the FDA Advisory Committee recommended the approval of Remodulin™ for pulmonary arterial hypertension. Paladin has the Canadian rights to Remodulin™ and expects to file for Canadian approval by the end of this year.

During the past quarter exciting new developments unfolded for Plan B™, our next generation emergency contraceptive. Upon obtaining certification, pharmacists in Quebec will be entitled to prescribe Plan B™, the safest and most effective emergency contraceptive available in Canada, without a prescription. L'Ordre des pharmaciens du Québec just held mandatory training sessions for all Quebec pharmacists, of which Paladin was a proud and prominent sponsor.

Androderm™, the first testosterone patch available in Canada, received formulary approval in Quebec in July, 2001. The testosterone replacement market continues its rapid growth posting a 21% increase during the past twelve months. As the only testosterone patch, we feel that we will be able to carve our place in this fast growing market.

Our pipeline of promising therapeutics remains strong, with six products in Phase III trials and four products in Phase II trials. With over \$22 million of cash and temporary investments, we are well positioned to execute our strategy of acquiring additional innovative pharmaceuticals for the Canadian market. Our current product offering coupled with our rich pipeline will continue to fuel our future growth and further reward those who share our vision.

Sincerely,

“Jonathan Ross Goodman”
(Signed)

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

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

Paladin Labs Inc. (the "Company").

Overview

Paladin continued to experience improved financial results in the third quarter of 2001. Revenues for the quarter increased by 60% over the third quarter of 2000, and net income for the same period grew by 80%. For the nine-month period ending September 30, 2001, revenues were 46% higher than for the same period in fiscal 2000 and net income was 53% over the level achieved in the nine-month period in 2000.

Three months ended September 30, 2001 compared to the three months ended September 30, 2000

Revenues for the third quarter of 2001 were \$4,859,314, an increase of \$1,814,760 or 60% over the third quarter of 2000. The significant increase was primarily due to the revenues derived from new or recently launched products, including Androderm™, Plan B™, MUSE®, Tapazole®, and Oesclim®. Gross profit, as a percentage of revenues, improved to 71% in the current quarter from 69% in the same quarter last year.

Selling and administrative expenses increased to \$1,691,275 from \$1,069,763 in the third quarter of 2000 primarily due to increased marketing spending associated with new product launches 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 \$247,786 in the current quarter, a reduction of \$182,600 from the third quarter last year.

Amortization expense in the third quarter of 2001 was \$166,513 compared to \$47,094 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 \$231,939 in the current quarter from \$375,616 in the third quarter of 2000, reflecting primarily the effect of lower interest rates in the current period.

Net income for the quarter increased by 80% to \$1,473,073 or \$0.12 per share from \$819,210 or \$0.07 per share in the same period last year.

Nine months ended September 30, 2001 compared to the nine months ended September 30, 2000

Revenues for the nine month period ended September 30, 2001 increased by \$4,087,328 or 46% to \$12,858,858 from \$8,791,530 in the nine-month period ended September 30, 2000. The improvement was primarily due to revenues generated by new or recently launched products, primarily including Androderm™, Plan B™, MUSE®, Tapazole®, and Oesclim®. Gross profit, as a percentage of revenues, for the nine-month period ended September 30, 2001 was 68% compared 65% for the same period last year.

Selling and administration expenses amounted to \$5,263,364 during the nine-month period ended September 30, 2001, an increase of \$1,920,586 over the same period last year. The increase reflects increased marketing spending associated with new product launches, together with costs associated with increased staffing levels.

Research and development expenses decreased by \$410,361 to \$492,220 in the current period, from \$902,581 during the nine-month period ended September 30, 2000. This reflected the significant spending in the nine-month period ending September 30, 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 next quarter.

Amortization expense increased to \$475,816 from \$94,525 for the nine-month periods ending September 30, 2000 and 2001, respectively. This increase reflects the significant investment in the acquisition of new products during the past year.

Interest income amounted to \$829,011 for the nine-month period ended September 30, 2001, an increase of \$39,871 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 nine months ended September 30, 2001 increased by 53% to \$2,983,627 or \$0.24 per share from to \$1,949,588 or \$0.17 per share in the same period last year.

Liquidity and Capital Resources

Cash and cash equivalents decreased by \$241,041 for the nine-month period ending September 30, 2001 to \$2,616,487. Cash flow generated by operating activities during the nine-month period ended September 30, 2001 was \$3,245,278, while operating activities utilized cash of \$50,157 during the same period last year. Non-cash working capital declined by \$513,672 in the nine-month period ending September 30, 2001, compared to a decrease of \$2,326,405 in the same period last year.

Expenditures on patents, pharmaceutical product licenses and rights amounted to \$5,126,586 in the nine-month period ending September 30, 2001, compared to \$2,716,148 in the same period last year. The spending in the current period was primarily for the purchase of the Canadian license to Oesclim[®] from Laboratoires Fournier S.A. and the acquisition of Propyl Thyracil[®] from Merck Frosst Canada & Co.

The decrease in temporary investments in the current period of \$1,626,518 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 nine-month-period ending September 30, 2001 generated \$235,634 from the issue of shares primarily related to the exercise of employee stock options. In the corresponding period last year, the Company realized \$18,546,551 (net of share issuance costs) from the proceeds of an equity issue in April 2000.

BALANCE SHEET

	September 30 2001	December 31 2000
	\$	\$
	(unaudited)	
ASSETS		
Current		
Cash and cash equivalents	2,616,487	2,857,528
Temporary investments	19,854,918	21,481,436
Accounts receivable	2,380,127	1,494,527
Inventories	49,785	410,885
Income tax credits receivable	440,446	1,036,374
Future income tax assets	1,520,000	1,520,000
Total current assets	26,861,763	28,800,750
Capital assets, net of accumulated amortization	10,720,607	6,143,770
Investments, at cost	2,770,527	2,366,016
Long term future income tax assets	2,888,871	4,118,321
	43,241,768	41,428,857
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	1,226,706	1,802,581
Income taxes payable	89,188	98,413
Deferred credit	977,760	977,760
Total current liabilities	2,293,654	2,878,754
Balance of sale payable	531,750	495,000
Long term deferred credit	1,428,594	2,286,594
	4,253,998	5,660,348
Shareholders' equity		
Capital stock	36,831,013	36,595,379
Contributed surplus	86,513	86,513
Retained earnings (Deficit)	2,070,244	(913,383)
Total shareholders' equity	39,987,770	35,768,509
	43,241,768	41,428,857

See accompanying notes

STATEMENT OF INCOME

(Unaudited)

	Three months ended September 30		Nine months ended September 30	
	2001	2000	2001	2000
	\$	\$	\$	\$
Revenues	4,859,314	3,044,554	12,858,858	8,791,530
Cost of Sales	1,407,300	951,921	4,112,536	3,059,063
Gross profit	3,452,014	2,092,633	8,746,322	5,732,467
Selling and administrative	1,691,275	1,069,763	5,263,364	3,342,778
Research and development	247,786	430,386	492,220	902,581
Amortization	166,513	47,094	475,816	94,525
Interest income	(231,939)	(375,616)	(829,011)	(789,140)
Gain on disposal of license	(108,694)	–	(108,694)	–
Income before income taxes	1,687,073	921,006	3,452,627	2,181,723
Provision for income taxes				
Current	5,000	–	15,000	–
Future	209,000	101,796	454,000	232,135
	214,000	101,796	469,000	232,135
Net income	1,473,073	819,210	2,983,627	1,949,588
Earnings per share				
Basic	\$0.12	\$0.07	\$0.24	\$0.17
Diluted	\$0.12	\$0.07	\$0.24	\$0.17
Weighted average shares outstanding				
Basic	12,428,420	12,385,909	12,410,020	11,208,676
Diluted	12,486,145	12,486,098	12,476,703	11,349,849

See accompanying notes

STATEMENTS OF RETAINED EARNINGS AND DEFICIT

(Unaudited)

Nine months ended September 30	2001	2000
	\$	\$
		(restated - see note 3)
Balance, beginning of period	(913,383)	(3,710,637)
Net income for the period	2,983,627	1,949,588
Balance, end of period	2,070,244	(1,761,049)

See accompanying notes

STATEMENT OF CASH FLOWS

(Unaudited)

	Three months ended		Nine months ended	
	September 30		September 30	
	2001	2000	2001	2000
	\$	\$	\$	\$
Operating activities				
Net income	1,473,073	819,210	2,983,627	1,949,588
Add items not affecting cash				
Amortization	166,513	47,094	475,817	94,525
Future income taxes	173,450	101,796	371,450	232,135
Gain on disposal of license	(108,694)	–	(108,694)	–
Imputed interest on balance of sale	12,250	–	36,750	–
	1,716,592	968,100	3,758,950	2,276,248
Net change in non-cash balances relating to operations	(518,354)	194,284	(513,672)	(2,326,405)
Cash flows from (used in) operating activities	1,198,238	1,162,384	3,245,278	(50,157)
Investing activities				
Acquisition of capital assets	(459)	(31,089)	(10,836)	(31,089)
Additions to patents, pharmaceutical product licenses and rights	(2,311,107)	(1,982,368)	(5,126,586)	(2,716,148)
Investments	(211,049)	(262,843)	(211,049)	287,157
Net decrease (increase) in temporary investments	(7,399,993)	(17,789,539)	1,626,518	(20,388,728)
Cash flows from (used in) investing activities	(9,922,608)	(20,065,839)	(3,721,953)	(22,848,808)
Financing activities				
Common shares issued for cash	103,134	138,801	235,634	20,436,977
Share issue costs	–	–	–	(1,890,426)
Cash flows from financing activities	103,134	138,801	235,634	18,546,551
Net increase (decrease) in cash and cash equivalents	(8,621,236)	(18,764,654)	(241,041)	(4,352,414)
Cash and cash equivalents, beginning of period	11,237,723	19,297,768	2,857,528	4,885,528
Cash and cash equivalents, end of period	2,616,487	533,114	2,616,487	533,114
Cash and cash equivalents	2,616,487	533,114		
Temporary investments	19,854,918	25,388,733		
	22,471,405	25,921,847		

See accompanying notes

NOTES TO FINANCIAL STATEMENTS

September 30, 2001

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 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 the company.

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 \$172,109 has been amortized to September 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	55,000	214,600
Issued under employee share purchase plan	222	1,034
Employee share purchase loan repayment	—	20,000
Balance at June 30, 2001	12,449,260	\$36,831,012

Options and warrants:

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

As at September 30, 2001, a total of 583,053 stock options were outstanding under the Company's Stock Option Plan, of which 319,585 were exercisable. The weighted average exercise price of these stock options was \$5.03.

6. ASSIGNMENT OF LICENSE TO RELATED PARTY

During the three months ended September 30, 2001, the Company assigned a license for 5% Amlexanox Paste to its sister company, Pharmascience Inc. The Company originally obtained this license with a commitment to royalty and milestone payments based on future sales and through payments to obtain regulatory approval, which were previously expensed. Future royalty and milestone payments have been assigned to Pharmascience Inc. The Company has recorded, at its exchange value, revenue of \$250,000 for the three-month and nine-month periods ended September 30, 2001.

7. CASH AND TEMPORARY INVESTMENTS

Cash and temporary investments decreased by \$241,041 during the third quarter of 2001. During the nine months ended September 30, 2001, cash and temporary investments decreased by \$1,867,559.

Stock Exchange Listing

Toronto Stock Exchange

Trading Symbol: PLB

Transfer Agent

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