

## Evotec OAI AG, Second Quarter Report 2003

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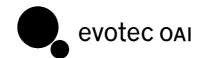
Evotec OAI AG Schnackenburgallee 114 D-22525 Hamburg www.evotecoai.com

### Dear shareholders,

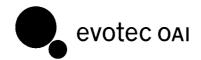
We are delighted to report sales growth of 5% in the second quarter, resulting in a sound growth rate of 5% for the first six months of 2003. At constant exchange rates, sales growth in the first half of the year was 16%. Given the continued tough market environment and exchange rate pressures from the strong Euro against the US-Dollar and Sterling, this is a very satisfactory result. We are also pleased to announce that EBITDA was positive for the first six months of 2003, and we are on track to be EBITDA positive for the full year.

Above average growth in Discovery Biology resulted from our newly established biology service contract with Novartis. Evotec Technologies' performance under our three-year contract with Pfizer also contributed positively. Cost reductions in SG&A and the refocusing of R&D activities initiated last year led to a decline in our R&D spending of 34% and SG&A expenses of 13%. Solid revenue growth in concert with these cost savings led to a 33% improvement in operating loss and to positive EBITDA for the first six months. Our liquidity position stands at EUR 16.3 million due to an anticipated inventory build up during the second quarter. This short-term effect will be reversed by instrument deliveries in the second half of 2003.

We also made excellent progress with regard to our new Discovery Programs Division by closing a major partnership recently: We signed an agreement with Takeda with a contract value of up to EUR 20 million,



strongly endorsing our investment in target identification and validation in Alzheimer's Disease performed over the past four years and our strategy to become actively involved in selected fields of drug discovery alongside a partner.



### **Highlights**

Continued track record in Discovery and Development Services

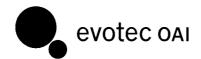
Our core business, Discovery and Development Services, continued to deliver excellent results for customers, outperforming most of our peers in the current challenging environment:

Our main focus in *Discovery Biology* was our hit-finding programs for **Novartis.** We successfully completed the first target screening, for the first time running an adherent cellular assay on EVOscreen® Mark III in miniaturised formats and ultra-high throughput, performing close to 100,000 tests per day. In our collaboration with **Oxagen** our scientists implemented a highly complex sensitive cellular assay, which has been screened on our new medium throughput screening platform. Further activities included several hit-finding and profiling projects for **Elixir**, **Infinity Pharmaceuticals and KeyNeurotek/Institute of Medical Technology Magdeburg** as well as our assay development project with **Pfizer**.

In *Discovery Chemistry*, we successfully continued our multi-year programmes with companies like **Merck**, **Amgen**, **Pharmacia**, **Roche and Solvay**. New contracts have been signed with **Axxima**, **Oxagen** and **Artesian**. We have continued our lead optimisation collaboration with **Curis** and have been rewarded with a milestone payment for delivery of a drug candidate to them. Scientists from British Biotech were successfully integrated into our medicinal chemistry team after our acquisition of British Biotech's research unit.

Key customers in *Development Chemistry* included **GlaxoSmithKline**, **AstraZeneca**, **Elan**, **Serono**, **Celgene and UCB**. Several have filed substantial new orders for delivery in the second half of the year across all disciplines, ranging from custom preparations through process research and development (PRD) to pilot plant production. Capacity utilisation in our pilot plant is better than anticipated, partially driven through PRD work carried out during Q2 2003. Following a voluntary inspection by the UK-based MHRA (Medicines and Healthcare Products Regulatory Agency) we have received a Certificate of GMP Compliance for our plant in June.

New contracts in medicinal chemistry signed with Axxima and Artesian In addition to several new orders in discovery and development we signed two substantial partnerships in the second quarter, in which our partners capitalise on our leading medicinal chemistry expertise. In May we announced the fourth agreement under the innovative umbrella contract with venture capitalist Oxford Bioscience Partners (OBP). **Artesian Therapeutics** entered a three-year drug discovery service agreement with us to optimise small molecule therapeutics for the treatment of congestive heart failure, initially focussing on medicinal chemistry. In June, **Axxima** selected Evotec OAI as their partner to design and synthesise small molecule lead structures for one of their leading kinase projects.



Evotec Technologies will significantly contribute to 2003 growth

As expected, the new contract with Pfizer signed in October 2002 will contribute significantly to a strong 2003 performance by Evotec Technologies (ET). After achieving site acceptance testing of EVOscreen® Mark III at Pfizer's research site in Sandwich, UK, in Q1, an extension of this system for cellular screening has now been installed during Q2. In addition to the related revenue recognition, a milestone was achieved.

ET also signed an after-sales service and maintenance agreement with GSK for the Evotec technology platform installed at their sites. All EVOscreen® partners are now under contract, creating steady after sales service revenues for the company.

In May, ET announced the European launch of its CellProcessor<sup>TM</sup> instrument Elektra for cell cloning at the MipTec Conference 2003 in Basel, Switzerland. A distribution agreement with Quantum Design for Cytoman, a semi-automated core module of Elektra, has been signed for Japan and contributed to our order book in Q2.

#### Important events after the end of the second quarter

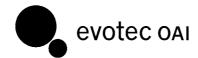
Equity participation of Pfizer in Evotec Technologies became effective in July

Evotec signed a significant discovery contract with Takeda in Alzheimer's Disease After a successful three-year collaboration, **Pfizer** entered into a new three-year agreement with Evotec Technologies (ET) in October 2002. As part of this transaction, Pfizer committed to make an equity investment in ET. This investment became effective 22 July 2003, with Pfizer becoming a 10% shareholder in the company.

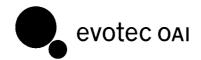
On 1 August 2003, Evotec OAI, Evotec Neurosciences (ENS) and **Takeda** announced a four-year collaboration in the area of Alzheimer's disease (AD). Together the companies aim to identify and validate novel targets relating to different aspects of the causes and progression of AD, with the goal of developing innovative therapeutics.

ENS will receive payments from Takeda of up to EUR 20 million, covering access fees to ENS' target database, research funding and milestone payments relating to the selection of targets for further drug discovery. Substantial milestones would also be payable on the successful clinical development of compounds acting on selected targets.

This agreement is an important validation of Evotec OAI's strategy adopted in 1999 of focussing increasingly on drug discovery and selectively investing in high-value indication-specific research programmes together with leading academic institutions in order to cover a large part of the discovery value chain.



Bernard Questier will join Evotec OAI as new Chief Business Officer On 6 August we announced the appointment of Bernard Questier as Chief Business Officer. Bernard Questier, 49, will join Evotec OAI with effect from 6 October 2003, leading the Company's business development functions as a member of the Management Board. Mr. Questier brings more than 20 years' of international experience in various management positions. He is joining Evotec OAI following a successful career in Ventana Medical Systems, where he was responsible for most of the company's business outside the United States.



#### **Financial Report**

#### Revenue

Evotec OAI achieved a sound growth of 5% in the first six months of 2003. Revenues amounted to EUR 34.8 million (2002: EUR 33.2 million). At constant exchange rates revenue growth was 16%. Despite the adverse impact of currency, we maintain our Euro growth target of 10 to 15% for the full year 2003.

Third-party revenues in our **Discovery and Development Services Division** (DDS) amounted to EUR 28.0 million (2002 actual: EUR 28.8 million; 2003 adjusted for currency effects: EUR 31.7 million) in the first six months of 2003. Sales fell in the first quarter due to the one-off impact of revenues being deferred from Q4 2001 into Q1 2002, but in the second quarter revenues in the division grew by 5%, at constant exchange rates by 20%. This was supported by strong sales in Discovery Biology, partly because of a significant new hit-finding and profiling contract with Novartis. Sales performance of Development Chemistry services was slightly below expectation only due to deferred revenues from a delay in despatch of pilot plant material to a customer until 1 July.

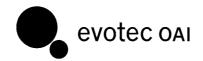
As anticipated, third-party revenues in our **Tools and Technologies Segment "Evotec Technologies"** rose strongly, up by 58% to EUR 6.9 million (2002: EUR 4.4 million). This growth over the first half of 2002 is mainly attributable to the successful installation of the first EVOscreen® Mark III system at Pfizer in the first quarter and the extension of the system for cellular screening in the second quarter 2003.

In Euro currency terms, Evotec OAI recorded 56% of total revenues in Europe, 40% in the United States, and 4% in Japan and Rest of World.

Research and development and other cost

For two reasons **R&D expenses** fell significantly compared to the previous year, down 34% to EUR 8.0 million (2002: EUR 12.1 million). On the one hand, it is a consequence of the restructuring programme announced in October last year. We started to reduce R&D significantly in technology development without impairing our core capabilities. On the other hand, income from FTE-based technology R&D services performed for Pfizer were netted against actual R&D cost as their equity participation in Evotec Technologies makes them a "related party" under US GAAP (FAS 68).

Cost of revenues amounted to EUR 20.7 million (2002: EUR 18.5 million). Gross margins improved to 40.5% compared to Q1 2003 (38.3%) due to a favourable sales mix in our Services Division. Compared to the same period last year (gross margin 2002: 44.3%) it was impacted by adverse movements in the US-Dollar, which accounts for a deterioration of gross margin of approximately EUR 1.4 million. Adjusted for these exchange rate



movements, gross margins were maintained at last year's levels (44.4% vs. 44.3%).

**SG&A** costs for the first six months totalled EUR 9.4 million (2002: EUR 10.8 million), down 13%, mainly as a result of planned cost reduction initiatives.

Result

The reduction in R&D and SG&A expenses led to a significant improvement in the Company's **operating loss.** For the first six months of 2003 it fell by 33% to EUR (10.3) million (2002: EUR (15.3) million). Excluding amortisation charges, operating losses almost halved (-47%) to EUR (4.9) million (2002: EUR (9.2) million).

**Net loss** improved by 40% to EUR (8.2) million (2002: EUR (13.7) million). In addition to the improvement in the operating result, an R&D tax credit under the new tax regime in the UK contributed positively to net result. Net income tax benefits totalled EUR 1.7 million. Deferred tax benefits in the UK (EUR 0.3 million) and current taxes worldwide (EUR (0.1) million) added to deferred tax benefits from the amortisation of merger-related non-goodwill intangible assets (EUR 1.5 million).

Net income per share amounted to EUR (0.23) (2002: EUR (0.39)).

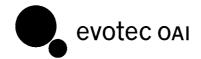
**Earnings before interest and taxes, depreciation and amortisation** (**EBITDA**) was positive. It improved from EUR (3.1) million to EUR 0.6 million.

### Capital expenditure

Investments in fixed assets amounted to EUR 5.3 million. They included the purchase of chemical development and laboratory/analytical equipment, partially transferred from British Biotech to Evotec OAI, and investments for the fitting out of our new Discovery Chemistry laboratory building in Abingdon, UK. The new building will be completed early in 2004.

## Cash flow and cash equivalents

Cash flow from operating activities amounted to EUR (2.2) million, a significant improvement over 2002 (EUR (4.8) million). This includes a net increase in working capital of EUR 3.0 million. The strong build up of inventories (EUR 3.9 million) is only a short-term effect in our instrumentation business, which will be reversed by sizeable planned instrument sales to Pfizer and additional customers in the second half of the year. Net cash flow from financing activities amount to EUR 3.1 million (2002: EUR (0.1) million). We have drawn down loan financing to match the capital expenditure for the fit out of the new laboratory building in Abingdon. Cash, cash equivalents and marketable securities as of 30 June 2003 amounted to EUR 16.3 million. Cash consumption in Q2 therefore was driven by investments and the build-up of instrument inventory for Pfizer.



## Employees and management

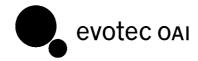
Evotec OAI employed 664 people at the end of June 2003. Growth from the first quarter of 2003 is mainly due to the transfer of 17 research scientists from British Biotech, who in response to growing market demand will further strengthen our capacity and expertise in medicinal chemistry and biology.

## Stock option programme

As stated in our first quarter report, we issued 46,000 stock options to new employees at exercise prices of EUR 1.66, 1.93 and 2.03 in the first three months of the year. In the second quarter, stock options were neither granted nor exercised. As of June 30, 2003, the total number of options that are available for future exercise amounts to 2,112,361, or approximately 6% of currently issued shares.

#### Outlook

Although today's market environment and, in particular, considerable exchange rate movements have adversely impacted Evotec OAI's financial performance in the first half of 2003, it has been outstanding compared to most of our peers. Thanks to our broad and well balanced business portfolio and our strong market presence we have achieved a continued actual growth of 5% YTD, and 16% adjusted for currency effects. Our sales and order book as of July amounted to EUR 67 million for 2003, covering 86% of analysts' revenue expectations for the full year (consensus: EUR 78 million). We expect this to result in a strong third guarter. In addition to continued good growth in our Discovery and Development Services Division, significant instrument deliveries to Pfizer are scheduled for September. On this basis we maintain our guidance for 2003, despite the continued strong Euro and overall business environment in the industry. Based on current prospects, we are confident of achieving our revenue growth target of 10 to 15% for the year. By delivering on our cost containment programme, Evotec OAI has achieved positive EBITDA in the first half of the year and is on track for positive EBITDA for the full year 2003.



## Shareholdings of the Boards of Evotec OAI AG

	Number of shares	Share options
Management Board		
Joern Aldag	286,556	132,600
Dr Dirk H. Ehlers	0	60,000
Dr Ian M. Hunneyball	0	40,000
Dr Timm-H. Jessen	136,172	83,232
Supervisory Board		
Prof Dr Heinz Riesenhuber	110,400	0
Peer Schatz	3,892	0
Dr Pol Bamelis	1,500	0
Dr Karsten Henco	1,306,356	26,732
Dr Edwin Moses	313,058	15,000
Michael Redmond	1,000	0

<sup>30</sup> June 2003

Pursuant to §15a of the German Securities Trading Act (Wertpapierhandelsgesetz), the above table lists separately for each member of our Management and Supervisory Board, the number of Company shares held, and rights for such shares granted to each board member as of 30 June 2003.

## Segment reporting according to US GAAP

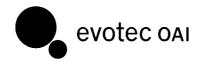
### **Evotec OAI AG and Subsidiaries**

Euro in thousands except share data	Discovery and	Discovery	Tools and	Consolidation	
	Development Services	Programs <sup>1</sup>	Technologies		
Revenue:					
- Drug discovery products & development of technologies	9	-	7,234	(334)	
- Drug discovery services	28,809	10	-	(891)	
Total revenue	28,818	10	7,234	(1,225)	
- Cost of revenues	17,526	6	3,652	(473)	
Gross Profit	11,292	4	3,582	(752)	
-Selling, general and administrative expenses	6,949	932	1,482	(12)	
- Research and development expenses	3,787	2,570	2,453	(833)	
- Other operating expenses	1,672	-	-	-	
-Amortisation of goodwill amongst other things	5,244	34	507	(397)	
Operating income (loss)	(6,360)	(3,532)	(860)	490	

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<sup>&</sup>lt;sup>1</sup> In 2002 included in Discovery and Development Services



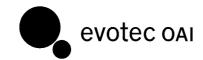
## Condensed consolidated statements of operations according to US GAAP

**Evotec OAI AG and Subsidiaries** 

Euro in thousands except share data	04.00/0000	04.00/0000	A : 0/	04.00/0000	04.00/0000	A : 0/
	01-06/2003	01-06/2002	∆ in %	04-06/2003	04-06/2002	∆ in %
Revenues:						
<ul><li>Drug discovery products &amp; development of technologies</li></ul>	6,909	4,777	44.6	2,439	2,489	(2.0)
-Drug discovery services	27,928	28,424	(1.8)	14,578	13,768	5.9
Total revenues	34,837	33,201	4.9	17,017	16,257	4.7
- Cost of revenue	20,711	18,490	12.0	9,715	8,400	15.7
Gross profit	14,126	14,711	(4.0)	7,302	7,857	(7.1)
-Selling, general and administrative expenses	9,351	10,795	(13.4)	4,769	5,560	(14.2)
- Research and development expense	7,977	12,131	(34.2)	3,548	6,660	(46.7)
- Other operating expenses	1,672	996	67.9	823	996	(17.4)
<ul> <li>Amortisation of goodwill amongst other things</li> </ul>	5,388	6,106	(11.8)	2,634	2,999	(12.2)
Operating income (loss)	(10,262)	(15,317)	(33.0)	(4,472)	(8,358)	(46.5)
- Interest income (expense)	3	325	(99.1)	(43)	177	(124.3)
- Income from investments and participations	-	-	-	-	-	
- Income (expense) from associated companies	(51)	-	(100.0)	(15)	-	(100.0)
- Foreign currency exchange gain (loss), net	(3)	144	(102.1)	93	(2)	
- Other income (expense)	374	502	(25.5)	64	102	(37.3)
Result before income taxes and minority interests	(9,939)	(14,346)	(30.7)	(4,373)	(8,081)	(45.9)
Income tax	1,749	591	195.9	1,135	45	
Extraordinary income (expenses)	-	-	-	-	-	
Result before minority interests	(8,190)	(13,755)	(40.5)	(3,238)	(8,036)	(59.7)
Minority interests	3	22	(86.4)	49	7	600.0
Net income / loss	(8,187)	(13,733)	(40.4)	(3,189)	(8,029)	(60.3)
Net loss per share (basic)	(0.23)	(0.39)		(0.09)	(0.23)	
Net loss per share (diluted) <sup>2</sup>	-	-		-	-	
Weighted average common share outstanding (basic)	35,510,130	35,508,427		35,510,130	35,508,427	
Weighted average common share outstanding (diluted)	-	-		-	-	
Depreciation of property, plant and equipment included in total operating expense	5,127	5,434	(5.7)	2,571	2,816	(8.7)

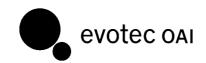
<sup>2</sup> According to US GAAP the definition of net income per share does not allow to report diluted net income per share as long as the Company shows a net loss.

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# Condensed consolidated balance sheets according to US GAAP Evotec OAI AG and Subsidiaries

Euro in thousands	30/06/2003	31/12/2002	$\Delta$ in %
Assets			
Current assets:			
- Cash and cash equivalents	13,406	21,308	(37.1)
-Marketable securities, at fair value	2,887	-	100.0
- Trade accounts receivable	8,702	10,166	(14.4)
- Accounts receivable due from related parties	509	244	108.6
- Inventories, at cost	12,157	8,408	44.6
- Deferred tax assets	42	45	(6.7)
- Current tax receivables	2,392	2,665	(10.2)
- Prepaid expenses and other current assets	3,671	3,196	14.9
Total current assets	43,766	46,032	(4.9)
Long-term investments	640	560	14.3
Property, plant and equipment, net	59,251	61,951	(4.4)
Intangible assets, excluding goodwill, net	22,670	29,601	(23.4)
Notes receivable / loans	-	-	-
Goodwill, net	98,228	102,851	(4.5)
Deferred taxes	-	-	-
Other non-current assets	47	47	-
Total assets	224,602	241,042	(6.8)
Liabilities and stockholders' equity			
Current liabilities:			
-Current portion of capital lease obligation	357	386	(7.5)
- Current maturities of long-term loans	1,569	1,067	47.1
- Trade accounts payable	5,026	4,565	10.1
- Accounts payable to related parties	119	8	
- Advanced payments received	3,961	5,703	(30.6)
- Accrued expenses	5,845	5,552	5.3
- Deferred revenues	3,389	2,695	25.8
- Current tax payables	55	80	(31.3)
- Deferred taxes	-	-	-
- Other current liabilities	1,745	1,404	24.3
Total current liabilities	22,066	21,460	2.8
Long-term loans	8,870	6,820	30.1
Long-term capital lease obligations	1,595	1,113	43.3
Deferred taxes	12,895	15,544	(17.0)
Other non-current liabilities	53	53	-
Minority interests	641		

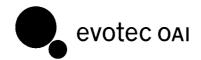


Stockholders' equity:			
- Share capital	35,510	35,510	-
- Additional paid-in capital	536,911	536,908	-
- Treasury stock	-	-	-
- Retained earning/accumulated deficit	(357,192)	(349,006)	(2.4)
- Accumulated other comprehensive income/loss	(36,747)	(28,005)	(31.2)
Total liabilities and stockholders' equity	224,602	241,042	(6.8)

# Condensed consolidated statements of cash flows according to US GAAP

Evotec OAI AG and Subsidiary

Euro in thousands	30/06/2003	30/06/2002
Cash flows from operating activities:		
Net loss	(8,187)	(13,733)
Adjustments to reconcile net loss to		
net cash used in operating activities	8,912	10,930 (1,963)
Change in assets and liabilities	(2,957) (2,232) (2,805)	
Net cash (used in) provided by operating activities	(2,232)	(4,766)
Cash flows from investing activities:		
Purchase of marketable securities	(2,805)	(1,923)
Purchase of investment	-	(3)
Purchase of property, plant and equipment	(5,302)	(4,358)
Purchase of intangible assets	(1)	(23)
Proceeds from sale of property, plant and equipment	15	4
Proceeds from sale of investments	-	219
Proceeds from sale of marketable securities	-	11,095
Net cash (used in) provided by investing activities	(8,093)	5,011
Cash flows from financing activities:		
Net proceeds from capital increase	-	22
Net proceeds from increase of bank loan	3,552	-
Repayment of bank loan	(425)	(88)
Net cash flow (used in) provided by financing activities	3,127	(66)
Net increase in cash and cash equivalents	(7,198)	179
Exchange rate difference	(704)	(538)
Cash and cash equivalents at beginning of year	21,308	18,651
Cash and cash equivalents at end of the second quarter	13,406	18,292
Cash, cash equivalents and marketable securities at end of the second quarter	16,293	18,292



## Consolidated statements of changes in stockholders' equity

Evotec OAI AG and Subsidiaries

Euro in thousands except sha	are data				Foreign			Total
			Additional	Unearned	currency	Unrealised	Accumu-	stock-
		capital	paid-in	compen-	translation	gains (losses)	lated	holders
	Shares	Amount	capital	sation	adjustment	on securities	deficit	equity
Balance at								
31 December 2001	35,507,047	35,507	536,857	(635)	(6,914)	152	(217,376)	347,591
Share capital increase	3,083	3	17	-	-	-	-	20
Stock option plan	-	-	34	290	-	-	-	324
Comprehensive loss:								
- Foreign currency								
translation	-	-	-	-	(20,746)	-	-	(20,746)
- Unrealised holding gains								
on available-for-sale								
securities	-	-	-	-	-	(152)	-	(152)
- Net loss	-	-	-	-	-	-	(131,630)	(131,630)
Total comprehensive loss	-	-	-	-	-	-	-	(152,528)
Balance at								
31 December 2002	35,510,130	35,510	536,908	(345)	(27,660)	-	(349,006)	195,407
Share capital increase	-	-	-	-	-	-	-	-
Stock option plan	-	-	3	147	-	-	-	150
Comprehensive loss:								
Foreign currency translation	-	-	-	-	(8,889)	-	-	(8,889)
<ul> <li>Unrealised holding gains on available-for-sale</li> </ul>								
securities	-	-	-	-	-	-	-	-
- Net loss	-	-	-	-	-	-	(8,186)	(8,186)
Total comprehensive loss	-	-	-	-	-	-	-	(17,075)
Balance at 30 June 2003	35,510,130	35,510	536,911	(198)	(36,549)		(357,192)	178,482

The financial statements of the reported period were prepared using the same accounting policies as for the year 2002.