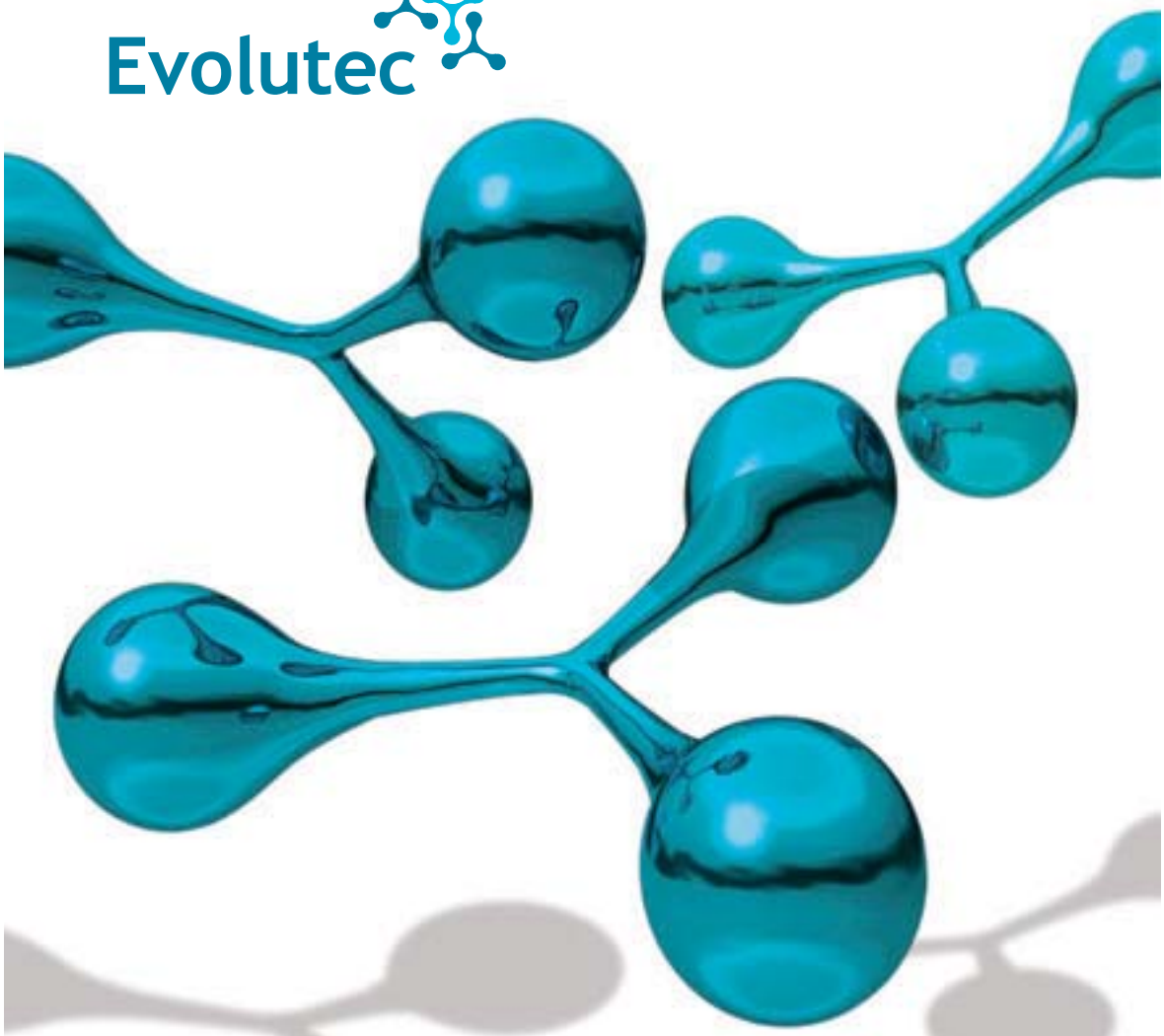
Evolutec



# Evolutec Group plc

Allergy, Inflammation & Autoimmune

## INTERIM REPORT 2006

CONTENTS



# Highlights

## Momentum building

The focus during the first half of 2006 has been on preparation for the intensive clinical programme for rEV131, the Company's lead product development candidate. Two Phase II trials were commenced in June 2006 and will report in 2006 and 2007.

In addition, a preclinical collaboration agreement on rEV576 was signed with Case Western Reserve University ("Case Western") and work to manufacture clinical grade drug substance is underway. Evolutec has generated promising preclinical results with rEV576 in myasthenia gravis, Guillain-Barré Syndrome and asthma. The Company is on track to have two product development candidates in the clinic in 2007.

## Product development portfolio

### rEV131

- Commenced a 300 patient Phase IIb trial in allergic rhinitis. The aim of the trial is to determine the efficacy of rEV131 under a constant pollen challenge. Duration and onset of effect will be determined under these conditions. Patient recruitment is now complete and Evolutec is on track to deliver this result on schedule by the end of 2006.
- Commenced a 150 patient proof of concept Phase II trial in post-cataract eye inflammation. The aim of this trial is to compare the anti-inflamatory efficacy of rEV131 with the corticosteroid, prednisolone, the standard of care in this market, and placebo. The result of this trial is expected in 2007.
- Novel mechanism of action demonstrated.
- Discussions with potential partners for the respiratory rights to rEV131 are progressing ahead of schedule.

### rEV576

- Signed a research collaboration with Case Western under the leadership of Professor Henry J Kaminski to characterise the preclinical efficacy of rEV576 in the severe autoimmune disease, myasthenia gravis.
- Positive preclinical result in myasthenia gravis.
- Positive preclinical results in Guillain-Barré Syndrome, acute myocardial infarction (heart attack), and asthma.

## Vaccine technology

- Signed new option agreement with partner, Merial.

## Financial

- Operating loss increased to £6.1m (2005: £2.5m) reflecting the rising level of development activity.
- Cash resources at 30 June 2006 of £13.2m (2005: £12.2m).

# Chief Executive's Review of Operations

Evolutec is at an important stage of its development with two rEV131 clinical trials underway and partnering discussions progressing ahead of schedule. In addition, preclinical data with rEV576 shows great promise, presenting new commercial options for the Company and the strong prospect of clinical trials in 2007.

In the first six months of 2006 the focus of activities in Evolutec has been on preparatory work for the two rEV131 clinical trials. These trials, in allergic rhinitis and post-cataract eye inflammation, commenced in June and will generate results in 2006 and 2007, respectively. In addition, the preclinical investment made in rEV576 has delivered promising results and a significant research collaboration with Case Western. Over the next 12 months the Company expects to generate no less than four clinical results with rEV131 and, assuming further positive results with rEV576, will have two clinical stage development candidates in 2007.

## rEV131

Allergic rhinitis is the lead indication for our clinical development candidate rEV131. This $6.6 billion market represents a major commercial opportunity for the Company. Evolutec received an unconditional "no objection letter" from Canada Health following its regulatory submission for a multi-dose double blind trial comparing rEV131 with placebo. Previous regulatory submissions had been made via the Food and Drug Administration (FDA) of the United States. The Company now has positive experience of two different regulatory agencies. This 300 patient rhinitis trial is underway in the Environmental Exposure Chamber at Allied Research International ("Allied") in Toronto under the leadership of Dr. Piyush Patel. This study will determine efficacy under a constant high level pollen challenge for up to 12 hours. Duration and onset of action will be determined under these conditions. The trial aims to build on the commercial differentiation of rEV131 from existing therapies and follows the Phase IIa single dose study which demonstrated the rapid onset of action of rEV131 in a nasal allergen challenge format. Allied has an excellent track record of delivering high quality data in a timely fashion. Patient recruitment is complete and Evolutec is on track to deliver this result on schedule by the end of 2006. On the basis of a positive outcome to the trial, the Company intends to license rEV131 in rhinitis to a partner who will develop and commercialise the product worldwide. Partnering discussions are ahead of schedule. A licensing deal of this nature would be a transformational event for Evolutec.

The Company has demonstrated the efficacy of rEV131 in preclinical models of asthma. On the basis of these positive results, the Company intends to commence a Phase I clinical study in asthma, the results of which are expected to be available by the middle of 2007.

The Phase II post-cataract eye inflammation trial is being undertaken at approximately 10 separate clinical sites in the United States. The 150 patient trial is being coordinated by Ophthalmic Research Associates, Inc ("ORA") led by Dr. Mark Abelson. The result of this trial is now anticipated to be in the first half of 2007. This dose ranging trial will evaluate the efficacy of rEV131 in pre-selected patients and compare the anti-inflammatory potential of rEV131 with the commercial steroid standard, prednisolone. Steroids are the dominant therapy in this $500 million market. However, there are concerns about the safety of the steroids and, in particular, their potential to increase intraocular pressure and cause glaucoma. The intended positioning of rEV131 is to produce steroid-like clinical effects with an improved safety profile. The efficacy of rEV131 dosed twice daily will be compared to placebo and prednisolone dosed four times a day. The Company intends to retain the marketing rights in specialised areas, such as ophthalmology, with the intention of establishing its own sales revenue and developing a high quality business.

The rEV131 Phase II trial in dry eye will commence early in 2007 once the long-term safety data is available allowing a six week clinical study. The low humidity at this time of year also favours dry eye symptom reproducibility. These trials are being monitored by our own clinical research manager based in the United States.

rEV131 is now available in two different presentations. For the nasal delivery route, unpreserved product has been prepared in a Pfeiffer multi-dose device. For the eye drop delivery, unpreserved product has been prepared in a Cardinal Health single dose unit. Long-term storage and stability studies are underway with both presentations. Long-term and chronic safety studies via three different routes of administration - ocular, nasal and inhaled - are also underway.

The importance of the novel mechanism of action of rEV131 has long been recognised by Evolutec. However, despite preclinical data to support the effects of rEV131 on the H4 inflammatory cascade, the impact of sequestering histamine and preventing the precise effects of the H4 receptor has been challenging to demonstrate definitively. This has now been resolved. Recent studies undertaken with human eosinophils have shown that rEV131 impacts the important H4 receptor on this cell type. This work is important both scientifically and commercially. Potential partners regard an understanding of the mechanism of action as important in the context of in-licensing novel therapies. This data will be additive to discussions with prospective partners.

## rEV576

The preclinical programme with rEV576, a novel complement inhibitor, is ahead of schedule and new positive results have been generated in preclinical models of myasthenia gravis, Guillain-Barré Syndrome ("GBS") and asthma. Myasthenia gravis and GBS are autoimmune conditions in which disease impacts the peripheral nervous system. These two areas are commercially interesting to the Company as they are not only areas of high unmet clinical need, but also have small patient numbers, potentially allowing the Company to target direct sales rather than depend upon a marketing partner. These are also orphan drug indications which could allow the Company reduced development expenditure and a period of marketing exclusivity. In myasthenia gravis, the preliminary work at Case Western has shown that rEV576 impacts both mild and severe disease in the preclinical models. The models used by Professor Kaminski reflect the chronic disease more closely than those used previously because antibodies are developed *in vivo*. These results are important as they suggest that rEV576 could be used as an acute treatment during myasthenic crises. In the GBS model, rEV576 had a significant effect in reducing moderate levels of disease. On the basis of these results and those previously generated in acute myocardial infarction, a broad range of clinical development options are open to Evolutec. The Company has applied for orphan indication in myasthenia gravis and is in dialogue with the FDA over this application. In a preclinical asthma model, inhaled rEV576 significantly reduced airway hyper-responsiveness with good effect at low doses. Effects were comparable to the commercial standard budesonide. In addition, rEV576 reduced the number of eosinophils in the bronchoalveolar lavage fluid suggesting a reduction in underlying inflammation. Recent evidence suggests that activation of the complement system is associated with the more severe forms of asthma. It is possible that rEV576 could be suited to severe asthma patients. An orphan drug application will now be made for GBS. The process development work required to manufacture rEV576 commercially has progressed well and is on track to deliver the clinical grade material required for clinical studies in 2007. The Company is in a strong position to progress rEV576 to the clinic in 2007, so providing a second clinical development candidate.

## Vaccine technology

The tick-borne disease studies undertaken by Merial have now been completed. However, because the model did not perform as expected, this work will need to be repeated. Merial has indicated its interest in pursuing the work further and discussions are underway over the next steps.

## rEV598

Preclinical work with rEV598 is underway to determine the *in vivo* effect of the development candidate in chemotherapy-induced nausea and vomiting.

## Outlook

During the first half of 2006, Evolutec has commenced two Phase II trials for its lead product development candidate, rEV131. In the next 12 months, Evolutec intends to deliver 4 clinical trial results with rEV131 and progress rEV576 into clinical development. Ongoing rEV131 partnership discussions are progressing well. Assuming positive results, the Board is confident of delivering a strong performance in the next 12 months.

Mark Carnegie Brown
Chief Executive Officer
11 September 2006

# Financial Review

Evolutec reports a net loss of £5.7 million for the first six months of 2006. This reflects increased expenditure on clinical trials with the Company's lead product development candidate rEV131.

Evolutec had cash and held-to-maturity investments of £13.2 million as at 30 June 2006. These funds will be used to complete the rhinitis and post-cataract trials as well as to progress futher clinical work with rEV131 and preclinical work with rEV576 in 2007.

## Implementation of International Financial Reporting Standards

The financial results for the six months ended 30 June 2006 are the first results prepared in accordance with the recognition and measurement principles of International Financial Reporting Standards ("IFRS"). Prior to these results, the Group prepared its audited annual financial statements under UK Generally Accepted Accounting Practices ("UK GAAP").

The results for the six months ended 30 June 2005 and year ended 31 December 2005 included in these interim results have been restated in accordance with IFRS. The impact of the restatement is described in detail in Note 2 to the financial statements.

The principal adjustments relate to:

a. Cash and cash equivalents. Under IFRS cash and cash equivalents include bank deposits and other short-term highly liquid investments with original maturities of three months or less. Under UK GAAP only immediate access deposits were included in cash and cash equivalents.

b. Expenditure on patents. In the 2005 financial statements, Evolutec reclassified expenditure on patents as a research and development expense. Prior to the 2005 financial statements Evolutec classified patent costs as an administrative expense.

c. Foreign exchange gains/(losses). Under IFRS Evolutec has chosen to reclassify foreign exchange gains/(losses) on monetary assets and liabilities under interest payable and similar items. Under UK GAAP, foreign exchange gains/(losses) on monetary assets and liabilities were shown under administrative expenses.

The loss for the six months ended 30 June 2005 and the loss for the year ended 31 December 2005 are unaffected by these adjustments.

Net assets at 1 January 2005, 30 June 2005 and 31 December 2005 are unaffected by these adjustments.

All further comparisons refer to the results reported under IFRS.

## Income statement

Revenue for the six months ended 30 June 2006 was £14 thousand (2005: nil) in respect of revenue recognised under a collaboration agreement with Merial regarding the animal uses of Evolutec's vaccine technology.

Selling and marketing costs for the six months ended 30 June 2006 of £0.1 million (2005: nil) relates mainly to market research.

Research and development expenditure for the six months ended 30 June 2006 increased to £5.1 million (2005: £1.7 million). The increase relates principally to the clinical development of rEV131 in rhinitis and post-cataract eye inflammation. A Phase IIb rhinitis trial and a proof of concept Phase II post-cataract eye inflammation trial commenced during the period. Patient recruitment is already complete for the rhinitis trial.

Administrative expenses for the six months ended 30 June 2006 increased to £1.0 million (2005: £0.8 million). In part this reflects an increase in headcount to 12 full-time employees compared to 7 at 30 June 2005.

Interest receivable and similar income for the six months to 30 June 2006 decreased to £0.3 million (2005: £0.5 million) and comprised interest receivable of £0.3 million (2005: £0.1 million) and no exchange gains (2005: £0.4 million). The increase in interest receivable follows the fundraising in November 2005. Interest payable and similar charges increased to £0.1 million (2005: nil) and entirely comprised unrealised exchange losses on Evolutec's US Dollar denominated deposits.

## Balance sheet

Non-current assets at 30 June 2006 amounted to £0.2 million (2005: £0.1 million) with the principal components being office equipment and leasehold improvements.

Current assets at 30 June 2006 amounted to £14.2 million (2005: £12.5 million) and comprised amounts receivable of £1.0 million and cash resources of £13.2 million. The cash resources comprised £2.7 million on deposits with maturity dates at inception of more than 3 months, and £10.5 million on deposits either with immediate access or with maturities of less than 3 months at inception. The increase in current assets is due to the higher cash balance following the equity fundraising in November 2005 and a higher level of prepayments in respect of the clinical development activity.

Current liabilities at 30 June 2006 amounted to £2.7 million (2005: £1.0 million) and entirely comprised trade payables. The increase in current liabilities reflects higher trade payables and higher accrued expenses in respect of the clinical development activities.

## Cash flow

Net cash outflow from operating activities in the six month period to 30 June 2006 increased to £4.5 million (2005: £1.6 million). The increase relates principally to the increase in development expenses.

The principal cash inflow items were net interest receipts of £0.3 million and the receipt of the research and development tax credit for the prior year of £0.5 million. The principal cash outflow item was capital expenditure of £31 thousand.

## Shareholders' equity

Shareholders' equity at 30 June 2006 was £11.7 million (2005: £11.6 million) and comprised share capital of £24.4 million, other reserves of £9.0 million and the retained deficit of £21.7 million. The increase in share capital reflects the issue of shares in November 2005. The increase in other reserves reflects the fair value of share-based payments to employees.

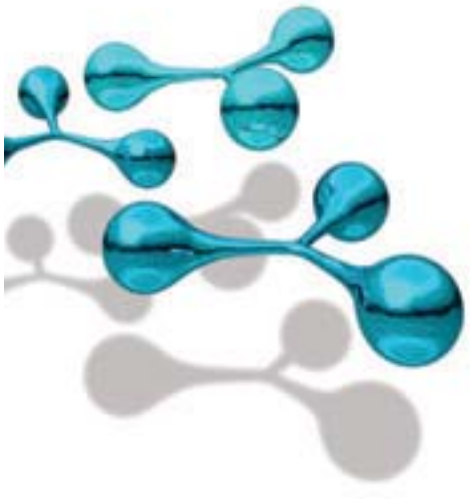
Nicholas Badman
Chief Financial Officer
11 September 2006

# Independent review report to Evolutec Group plc

## Introduction

We have been instructed by the Company to review the financial information for the six months ended 30 June 2006 which comprises the consolidated income statement, consolidated balance sheet, consolidated cash flow statement, consolidated statement of changes in shareholders' equity and the related Notes 1 to 7. We have read the other information contained in the interim report which comprises the Chief Executive's Review of Operations and the Financial Review and considered whether it contains any apparent misstatements or material inconsistencies with the financial information. Our responsibilities do not extend to any other information.

This report is made solely to the Group in accordance with guidance contained in APB Bulletin 1999/4 "Review of Interim Financial Information". Our review work has been undertaken so that we might state to the Group those matters we are required to state to them in a review report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Group, for our review work, for this report, or for the conclusion we have formed.



## Directors' responsibilities

The interim report including the financial information contained therein is the responsibility of, and has been approved by, the Directors. They are responsible for preparing the interim report and ensuring that the accounting policies and presentation applied to the interim figures are consistent with those applied in preparing the annual accounts except where any changes, and the reason for them, are disclosed.

As disclosed in Note 1, the next annual financial statements of the Group will be prepared in accordance with International Financial Reporting Standards as adopted for use in the European Union. This interim report has been prepared in accordance with International Accounting Standard 34 "Interim Financial Reporting" and the requirements of IFRS 1 "First-time Adoption of International Financial Reporting Standards" relevant to interim reports.

The accounting policies are consistent with those that the Directors intend to use in the next annual financial statements.

## Review work performed

We conducted our review in accordance with guidance contained in Bulletin 1999/4 "Review of Interim Financial Information" issued by the Auditing Practices Board for use in the United Kingdom. A review consists principally of making enquiries of management and applying analytical procedures to the financial information and underlying financial data and, based thereon, assessing whether the accounting policies and presentation have been consistently applied unless otherwise disclosed. A review excludes audit procedures such as tests of controls and verification of assets, liabilities and transactions. It is substantially less in scope than an audit performed in accordance with International Standards on Auditing (UK and Ireland) and therefore provides a lower level of assurance than an audit. Accordingly, we do not express an audit opinion on the financial information.

## Review conclusion

On the basis of our review we are not aware of any material modifications that should be made to the financial information as presented for the six months ended 30 June 2006.

GRANT THORNTON UK LLP
CHARTERED ACCOUNTANTS
OXFORD
11 September 2006

1 The maintenance and integrity of the Evolutec Group plc website is the responsibility of the Directors: the interim review does not involve consideration of these matters and, accordingly, the Group's reporting accountants accept no responsibility for any changes that may have occurred to the interim report since it was initially presented on the website.

2 Legislation in the United Kingdom governing the preparation and dissemination of the interim report differs from legislation in other jurisdictions.

## Consolidated income statement

For the six month period ended 30 June 2006

| | Notes | Unaudited Six months ended 30 June 2006 £000 | Unaudited Six months ended 30 June 2005 £000 | Audited Year ended 31 December 2005 £000 |
|---|---|---|---|---|
| Revenue | 3 | 14 | - | 14 |
| Cost of sales | | (1) | - | (6) |
| Gross profit | | 13 | - | 8 |
| Selling and marketing costs | | (52) | - | - |
| Research and development expenditure | | (5,087) | (1,660) | (5,346) |
| Administrative expenses | | (1,007) | (824) | (1,665) |
| Operating loss | | (6,133) | (2,484) | (7,003) |
| Interest receivable and similar income | 4 | 339 | 500 | 870 |
| Interest payable and similar charges | 4 | (137) | - | - |
| Loss before tax | | (5,931) | (1,984) | (6,133) |
| Taxation | | 251 | 170 | 528 |
| Loss for the period | | (5,680) | (1,814) | (5,605) |
| Basic and diluted loss per ordinary share | 7 | (24.1)p | (14.0)p | (34.8)p |

The results for the period are derived from continuing activities.

The notes on pages 16 to 26 form part of these consolidated interim financial statements.

## Consolidated balance sheet

As at 30 June 2006

| | Notes | Unaudited 30 June 2006 £000 | Unaudited 30 June 2005 £000 | Audited 31 December 2005 £000 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Non-current assets** | | | | |
| Property, plant and equipment | | 152 | 67 | 161 |
| | | 152 | 67 | 161 |
| **Current assets** | | | | |
| Research and development tax credits | | 251 | 143 | 502 |
| Trade and other receivables | 5 | 746 | 145 | 819 |
| Held-to-maturity investments | | 2,728 | 10,798 | 15,877 |
| Cash and cash equivalents | | 10,512 | 1,430 | 1,739 |
| | | 14,237 | 12,516 | 18,937 |
| **Total assets** | 3 | 14,389 | 12,583 | 19,098 |
| **EQUITY** | | | | |
| **Capital and reserves attributable to the equity holders of the Company** | | | | |
| Share capital | | 24,402 | 15,146 | 24,402 |
| Other reserves | | 8,948 | 8,699 | 8,793 |
| Retained deficit | | (21,692) | (12,221) | (16,012) |
| **Equity shareholders' funds** | | 11,658 | 11,624 | 17,183 |
| **LIABILITIES** | | | | |
| **Current liabilities** | | | | |
| Trade and other payables | 6 | 2,731 | 959 | 1,915 |
| **Total liabilities** | | 2,731 | 959 | 1,915 |
| **Total equity and liabilities** | | 14,389 | 12,583 | 19,098 |

The notes on pages 16 to 26 form part of these consolidated interim financial statements.

## Consolidated cash flow statement

For the six month period ended 30 June 2006

| | Notes | Unaudited Six months ended 30 June 2006 £000 | Unaudited Six months ended 30 June 2005 £000 | Audited Year ended 31 December 2005 £000 |
|---|---|---|---|---|
| **Cash flows from operating activities** | | | | |
| Loss for the period | | (5,680) | (1,814) | (5,605) |
| Taxation | | (251) | (170) | (528) |
| Depreciation | | 40 | 8 | 29 |
| Interest receivable | | (339) | (149) | (429) |
| Unrealised foreign exchange losses/(gains) | | 138 | (351) | (311) |
| Share options – value of employee services | | 155 | 80 | 275 |
| Decrease/(increase) in trade and other receivables | | 73 | (66) | (741) |
| Increase in trade and other payables | | 816 | 673 | 1,548 |
| Cash used by operations | | (5,048) | (1,789) | (5,762) |
| Taxation received | | 502 | 203 | 203 |
| **Net cash outflow from operating activities** | | (4,546) | (1,586) | (5,559) |
| **Cash flows from investing activities** | | | | |
| Purchase of property, plant and equipment | 3 | (31) | (64) | (179) |
| Interest received | 4 | 339 | 149 | 429 |
| (Decrease)/increase in held-to-maturity investments | | 13,118 | (8,060) | (13,167) |
| **Net cash generated from investing activities** | | 13,426 | (7,975) | (12,917) |
| **Cash flows from financing activities** | | | | |
| Proceeds from issuance of shares | | - | 9,504 | 18,760 |
| Purchase of treasury shares | | - | - | (20) |
| **Net cash generated from financing activities** | | - | 9,504 | 18,740 |
| **Net increase/(decrease) in cash, cash equivalents and bank overdrafts** | | 8,880 | (57) | 264 |
| Cash, cash equivalents and bank overdrafts at the start of the period | | 1,739 | 1,374 | 1,374 |
| Exchange gains/(losses) on cash and bank overdrafts | | (107) | 113 | 101 |
| **Cash, cash equivalents and bank overdrafts at the end of the period** | | 10,512 | 1,430 | 1,739 |

The notes on pages 16 to 26 form part of these consolidated interim financial statements.

## Consolidated statement of changes in shareholders' equity

For the six month period ended 30 June 2006

| | Share capital £000 | Other reserves £000 | Retained deficit £000 | Total £000 |
|---|---|---|---|---|
| **Balance at 1 January 2005** | 10,446 | 3,734 | (10,407) | **3,773** |
| Issue of ordinary shares in April 2005 | 10,000 | - | - | **10,000** |
| Expenses of issue of ordinary shares | (496) | - | - | **(496)** |
| Cancellation of deferred shares | (4,804) | 4,804 | - | **-** |
| Loss for the period | - | - | (1,814) | **(1,814)** |
| Fair value of share-based payments | - | 161 | - | **161** |
| **Balance at 30 June 2005** | 15,146 | 8,699 | (12,221) | **11,624** |
| Issue of ordinary shares in November 2005 | 10,000 | - | - | **10,000** |
| Expenses of issue of ordinary shares | (744) | - | - | **(744)** |
| Purchase of own shares | - | (20) | - | **(20)** |
| Loss for the period | - | - | (3,791) | **(3,791)** |
| Fair value of share-based payments | - | 114 | - | **114** |
| **Balance at 31 December 2005** | 24,402 | 8,793 | (16,012) | **17,183** |
| Loss for the period | - | - | (5,680) | **(5,680)** |
| Fair value of share-based payments | - | 155 | - | **155** |
| **Balance at 30 June 2006** | 24,402 | 8,948 | (21,692) | **11,658** |

The notes on pages 16 to 26 form part of these consolidated interim financial statements.

# Notes to the interim financial statements

For the six month period ended 30 June 2006

## 1. Accounting policies and basis of preparation

Prior to 2006, the Group prepared its audited financial statements under UK GAAP. For the year ended 31 December 2006, the Group has decided to prepare its annual consolidated financial statements in accordance with accounting standards as adopted in the European Union ("EU"). As such, those financial statements will take account of the requirements and options in IFRS 1 "First-time Adoption of International Financial Reporting Standards" as they relate to the 2005 comparatives included therein.

The financial information for the six months ended 30 June 2006 is unaudited and has been prepared in accordance with the Group's accounting policies, based on IFRS, that are expected to apply for 2006. The financial information for the six months ended 30 June 2005 is also unaudited and has been restated under IFRS.

These interim financial statements have been prepared in accordance with IAS 34 and in accordance with the recognition and measurement principles of IFRS that the Group expects to apply in the full year IFRS financial statements for 31 December 2006.

Certain of the requirements and options in IFRS 1 relating to comparative financial information presented on first-time adoption may result in a different application of accounting policies in the 2005 restated financial information to that which would apply if the 2005 financial statements were the first financial statements of the Group prepared in accordance with IFRS. An explanation of how the transition from UK GAAP to IFRS has affected the Group's financial position, income statement and cash flow is set out in Note 2.

The interim financial information has not been audited and does not constitute statutory accounts within the meaning of Section 240 of the Companies Act 1985 but has been reviewed by the auditors in accordance with Bulletin 1999/4 issued by the Auditing Practices Board. The Company's statutory accounts for the year ended 31 December 2005, prepared under UK GAAP, have been delivered to the Registrar of Companies; the report of the auditors on these accounts was unqualified and did not contain a statement under Section 237 (2) or (3) of the Companies Act 1985.

**Accounting policies** The principal accounting policies adopted in the preparation of these interim financial statements are set out below. These policies have been consistently applied to all periods presented, unless otherwise stated.

Evolutec is a research and development based biopharmaceutical business which expects to incur further losses until revenues from royalty income, milestone receipts and product sales exceed expenditure on the product portfolio and its overheads and administrative costs. The Directors believe that the Group has sufficient funds for the foreseeable future, therefore the interim financial statements have been prepared on the going concern basis.

**Basis of consolidation** The consolidated interim financial statements of the Group include the accounts of Evolutec Group plc and all its subsidiary undertakings (together, the "Group"), made up to 30 June 2006. Inter-company transactions are eliminated on consolidation.

**Revenue** The Group generates revenue by licensing its technologies. The recognition of such revenue, including up front and milestone payments, is dependent on the terms of the related arrangement, having regard to the ongoing risks and rewards of the arrangement, and the existence of any performance or repayment obligations with any third party.

Non-refundable access fees, options fees and milestone payments receivable for participation by a third party in development and commercialisation of a product development candidate are recognised when they become contractually binding, provided there are no related commitments of the Group. Where there are related commitments, revenue is recognised on a percentage-of-completion basis in line with the actual levels of expenditure incurred in fulfilling these commitments. All other licence income and contract research fees are recognised over the accounting period to which the relevant services relate. Revenues derived from grants received are recognised in line with the related expenditure. Royalty income is recognised in relation to sales to which the royalty relates.

**Operating leases** Costs in respect of operating leases are charged to the profit and loss account on a straight-line basis over the terms of the leases.

**Share-based payments** The Group makes equity-settled share-based payments to its employees and Directors. Equity-settled share-based payments are measured at fair value at the date of grant and expensed on a straight-line basis over the vesting period of the award. At each balance sheet date, Evolutec revises its estimate of the number of options that are expected to become exercisable.

The value of any shares or options granted is charged to the profit and loss account over the period the shares vest, with a corresponding credit to reserves. When share options are exercised, the proceeds received, net of any transaction costs, are credited to share capital (nominal value) and share premium.

The principal assumptions used to calculate the value of options issued are:

| | |
|---|---|
| Share price volatility | 45% |
| Risk free rate of return | 4.5% |
| Date of exercise | Normally assumed to be the first possible exercise date |

**Employee benefits** All employee benefit costs, notably holiday pay and contributions to personal defined contribution pension plans, are charged to the income statement on an accruals basis. The Group does not offer any other post-retirement benefits.

**Taxation** Current tax, including UK corporation tax and research and development tax credits, is provided (or shown) at amounts expected to be paid (or recovered) using the tax rates or laws that have been enacted, or substantially enacted, by the balance sheet date.

Credit is taken in the accounting period for research and development tax credits, which will be claimed from HM Revenue and Customs in respect of qualifying research and development costs incurred in the same accounting period.

Deferred tax is recognised in respect of all temporary differences identified at the balance sheet date, except to the extent that the deferred tax arises from the initial recognition of goodwill (if amortisation of goodwill is not deductible for tax purposes) or the initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction affects neither accounting profit nor taxable profit and loss. Temporary differences are differences between the carrying amount of the Group's assets and liabilities and their tax base.

Deferred tax liabilities may be offset against deferred tax assets within the same taxable entity or qualifying local tax group. Any remaining deferred tax asset is recognised only when, on the basis of all the available evidence, it can be regarded as probable that there will be suitable taxable profits, within the same jurisdiction, in the foreseeable future against which the deductible temporary difference can be utilised.

Deferred tax is provided on temporary differences arising in subsidiaries, jointly controlled entities or associates, except where the timing of reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax is measured at the average tax rates that are expected to apply in the periods in which the asset is realised or liability settled, based on tax rates and laws that have been enacted or substantially enacted by the balance sheet date. Measurement of deferred tax liabilities and assets reflects the tax consequence expected to follow from the manner in which the asset or liability is recovered or settled.

**Property, plant and equipment** Property, plant and equipment are stated at historic cost less depreciation. Historic cost comprises the purchase price together with any incidental costs of acquisition. Depreciation is calculated to write off the cost, less residual value, of tangible fixed assets in equal annual installments over their estimated useful lives as follows:

Plant and machinery 3-5 years

Fixtures and fittings 3 years

**Internally-generated intangible assets – product research and development** Development expenditure on new or substantially improved products is capitalised as an intangible asset and amortised through cost of sales over the expected useful life of the product concerned. Capitalisation commences from the point at which the technical feasibility and commercial viability of the product can be demonstrated and the Group is satisfied that it is probable that future economic benefit will result from the product once completed. This is usually at the point of regulatory filing in a major market and approval is highly probable. Capitalisation ceases when the product is ready for launch. Where assets are acquired or constructed in order to provide facilities for research and development over a number of years, they are capitalised and depreciated over their useful lives. Expenditure relating to clinical trials is accrued on a percentage-of-completion basis with reference to fee estimates with third parties.

Expenditure on research and development activities which do not meet the above criteria, is charged to the income statement as incurred.

**Held-to-maturity investments** Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity. Assets in this category are held at amortised cost. Held-to-maturity investments include short-term investments with original maturities of more than 3 months.

**Cash and cash equivalents** Cash and cash equivalents include cash in hand, bank deposits repayable on demand and other short-term highly liquid investments with original maturities of 3 months or less.

**Foreign currencies** Transactions in foreign currencies are translated into sterling at the rate of exchange ruling at the transaction date. Monetary assets and liabilities in foreign currencies are retranslated into sterling at the rates of exchange ruling at the balance sheet date. Differences arising due to exchange rate fluctuations are taken to the income statement in the period in which they arise.

**Financial instruments** The Group uses financial instruments, primarily to manage exposures to fluctuations in foreign currency exchange rates and interest rates. Income and expenditure arising on financial instruments is recognised on the accruals basis and credited or charged to the profit and loss account in the financial period to which it relates.

## 2. Explanation of transition to IFRS

**Reconciliation of equity and loss** These interim financial statements have been prepared in accordance with IAS 34 and in accordance with the recognition and measurement principles of IFRS that the Group expects to apply in the full year financial statements for 31 December 2006. The following disclosures are required in the period of transition. For the purpose of this financial information the last interim statements were for the six month period ended 30 June 2005, the last annual financial statements were for the year ended 31 December 2005, and the date of transition to IFRS was 1 January 2005.

IFRS 1 "First-time Adoption of International Financial Reporting Standards" sets out the transition rules which must be applied when IFRS is adopted for the first time. As a result, certain of the requirements and options in IFRS 1 may result in a different application of accounting policies in the 2005 restated financial information from that which would apply if the 2005 financial statements were the first financial statements. The standard sets out certain mandatory exemptions to retrospective application and certain optional exemptions.

The most significant optional exemption available taken by the Group is in respect of business combinations. The Group has elected not to apply IFRS 3 "Business Combinations" retrospectively to business combinations that took place prior to the transition date. Consequently, goodwill arising on business combinations before the transition date remains at its previous UK GAAP carrying value of £nil at the date of transition from the UK GAAP financial statements.

**Reconciliation of equity** There were no adjustments required to either net assets or loss under UK GAAP in order to arrive at net assets or loss under IFRS. As shown in the following tables, there have been adjustments within current assets to reclassify short-term investments with original maturities of 3 months or less as cash and cash equivalents; within equity to reclassify own shares purchased as other reserves; and within the income statement to reclassify exchange gains as interest receivable and similar income.

## Reconciliation of balance sheet presentation at 1 January 2005 (date of transition to IFRS)

| | | UK GAAP £000 | IFRS effect £000 | IFRS £000 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Non-current assets** | | | | |
| Property, plant and equipment | | 11 | - | 11 |
| | | 11 | - | 11 |
| Current assets | | | | |
| Research and development tax credits | | 177 | - | 177 |
| Trade and other receivables | | 78 | - | 78 |
| Held-to-maturity investments | a | 3,761 | (1,261) | 2,500 |
| Cash and cash equivalents | a | 113 | 1,261 | 1,374 |
| | | 4,129 | - | 4,129 |
| Total assets | | 4,140 | - | 4,140 |
| **EQUITY** | | | | |
| **Capital and reserves attributable to the equity holders of the Company** | | | | |
| Share capital | | 5,824 | - | 5,824 |
| Share premium account | | 4,622 | - | 4,622 |
| Other reserves | | 3,734 | - | 3,734 |
| Retained deficit | | (10,407) | - | (10,407) |
| Total equity | | 3,773 | - | 3,773 |
| LIABILITIES | | | | |
| Current liabilities | | | | |
| Trade and other payables | | 367 | - | 367 |
| Total liabilities | | 367 | - | 367 |
| Total equity and liabilities | | 4,140 | - | 4,140 |

## Reconciliation of balance sheet presentation at 30 June 2005

| | | UK GAAP £000 | IFRS effect £000 | IFRS £000 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Non-current assets** | | | | |
| Property, plant and equipment | | 67 | - | 67 |
| | | 67 | - | 67 |
| Current assets | | | | |
| Research and development tax credits | | 143 | - | 143 |
| Trade and other receivables | | 145 | - | 145 |
| Held-to-maturity investments | a | 11,941 | (1,143) | 10,798 |
| Cash and cash equivalents | a | 287 | 1,143 | 1,430 |
| | | 12,516 | - | 12,516 |
| Total assets | | 12,583 | - | 12,583 |
| **EQUITY** | | | | |
| **Capital and reserves attributable to the equity holders of the Company** | | | | |
| Share capital | | 1,734 | - | 1,734 |
| Share premium account | | 13,412 | - | 13,412 |
| Merger reserve | | 3,734 | - | 3,734 |
| Capital redemption reserve | | 4,804 | - | 4,804 |
| Other reserves | | 161 | - | 161 |
| Retained deficit | | (12,221) | - | (12,221) |
| Total equity | | 11,624 | - | 11,624 |
| **LIABILITIES** | | | | |
| **Current liabilities** | | | | |
| Trade and other payables | | 959 | - | 959 |
| Total liabilities | | 959 | - | 959 |
| Total equity and liabilities | | 12,583 | - | 12,583 |

## Reconciliation of balance sheet presentation at 31 December 2005

| | | UK GAAP £000 | IFRS effect £000 | IFRS £000 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| **Non-current assets** | | | | |
| Property, plant and equipment | | 161 | - | 161 |
| | | 161 | - | 161 |
| **Current assets** | | | | |
| Research and development tax credits | | 502 | - | 502 |
| Trade and other receivables | | 819 | - | 819 |
| Held-to-maturity investments | a | 17,013 | (1,136) | 15,877 |
| Cash and cash equivalents | a | 603 | 1,136 | 1,739 |
| | | 18,937 | - | 18,937 |
| **Total assets** | | 19,098 | - | 19,098 |
| **EQUITY** | | | | |
| **Capital and reserves attributable to the equity holders of the Company** | | | | |
| Share capital | | 2,359 | - | 2,359 |
| Share premium account | | 22,043 | - | 22,043 |
| Capital redemption reserve | | 4,804 | - | 4,804 |
| Other reserves | | 3,989 | - | 3,989 |
| Retained deficit | | (16,012) | - | (16,012) |
| **Total equity** | | 17,183 | - | 17,183 |
| **LIABILITIES** | | | | |
| **Current liabilities** | | | | |
| Trade and other payables | | 1,915 | - | 1,915 |
| **Total liabilities** | | 1,915 | - | 1,915 |
| **Total equity and liabilities** | | 19,098 | - | 19,098 |

## Reconciliation of income statement presentation for the six months ended 30 June 2005

| | | UK GAAP £000 | IFRS effect £000 | IFRS £000 |
|---|---|---|---|---|
| Revenue | | - | - | - |
| Cost of sales | | - | - | - |
| Gross profit | | - | - | - |
| Research and development expenditure | b | (1,555) | (105) | (1,660) |
| Administrative expenses | b, c | (578) | (246) | (824) |
| Operating loss | | (2,133) | (351) | (2,484) |
| Interest receivable and similar income | c | 149 | 351 | 500 |
| Loss before income tax | | (1,984) | - | (1,984) |
| Tax credit on loss on ordinary activities | | 170 | - | 170 |
| Loss for the period | | (1,814) | - | (1,814) |

## Reconciliation of income statement presentation for the year ended 31 December 2005

| | | UK GAAP £000 | IFRS effect £000 | IFRS £000 |
|---|---|---|---|---|
| Revenue | | 14 | - | 14 |
| Cost of sales | | (6) | - | (6) |
| Gross profit | | 8 | - | 8 |
| Research and development expenditure | | (5,346) | - | (5,346) |
| Administrative expenses | c | (1,224) | (441) | (1,665) |
| Operating loss | | (6,562) | (441) | (7,003) |
| Interest receivable and similar income | c | 429 | 441 | 870 |
| Loss before income tax | | (6,133) | - | (6,133) |
| Tax credit on loss on ordinary activities | | 528 | - | 528 |
| Loss for the period | | (5,605) | - | (5,605) |

## Notes to the reconciliation of presentation of balance sheets and income statements

**a.** Under IFRS, short-term investments with a maturity of three months or less at the date of acquisition are included in cash and cash equivalents.

**b.** Evolutec has reclassified expenditure on patents as a research and development expense.

**c.** Under IFRS, Evolutec has chosen to reclassify foreign exchange gains and losses within interest receivable and similar items and interest payable and similar items, respectively.

## Explanation of the principal differences between the cash flow statements presented under UK GAAP and the cash flow statements presented under IFRS

The cash flow statement has been prepared in conformity with IAS 7 "Cash Flow Statements". The principal differences between the 2005 cash flow statements presented in accordance with UK GAAP and the cash flow statements presented in accordance with IFRS for the same periods are as follows:

Under UK GAAP, net cash flow from operating activities was determined before considering cash outflows from (a) returns on investments and servicing of finance, (b) taxes paid. Under IFRS, net cash flow from operating activities is determined after these items.

Under UK GAAP, capital expenditure, financial investments and acquisitions were classified separately, while under IFRS they are classified as investing activities.

Under UK GAAP, movements in short-term investments were not included in cash but classified as management of liquid resources. Under IFRS, short-term investments with maturity of 3 months or less at the date of acquisition are included in cash and cash equivalents.

## 3. Segment information

### Primary reporting format – business segments

As at 30 June 2006, the Group operates one business segment, which is the research and development of a range of pharmaceutical product candidates.

| Analysis of revenue by category | Unaudited Six months ended 30 June 2006 £000 | Unaudited Six months ended 30 June 2005 £000 | Audited Year ended 31 December 2005 £000 |
|---|---|---|---|
| Sale of goods | - | - | - |
| Collaborative agreements | 14 | - | 14 |
| Total | 14 | - | 14 |

### Secondary reporting format – geographical segments

The Group operates in four main geographical areas, even though it is managed on a worldwide basis.

The home country of the Company, and of Evolutec Limited - which is the main operating company - is the United Kingdom. The area of operation is primarily research and development of a range of pharmaceutical product candidates.

| Revenue | Unaudited Six months ended 30 June 2006 £000 | Unaudited Six months ended 30 June 2005 £000 | Audited Year ended 31 December 2005 £000 |
|---|---|---|---|
| United Kingdom | - | - | - |
| Rest of Europe | - | - | - |
| North America | 14 | - | 14 |
| Rest of the World | - | - | - |
| Total | 14 | - | 14 |

| Total assets | Unaudited 30 June 2006 £000 | Unaudited 30 June 2005 £000 | Audited 31 December 2005 £000 |
|---|---|---|---|
| United Kingdom | 14,389 | 12,583 | 19,098 |
| Rest of Europe | – | - | - |
| North America | – | - | - |
| Rest of the World | – | - | - |
| Total | 14,389 | 12,583 | 19,098 |

Total assets are allocated based on where the assets are located.

| Capital expenditure | Unaudited Six months ended 30 June 2006 £000 | Unaudited Six months ended 30 June 2005 £000 | Audited Year ended 31 December 2005 £000 |
|---|---|---|---|
| United Kingdom | 31 | 64 | 179 |
| Rest of Europe | – | - | - |
| North America | – | - | - |
| Rest of the World | – | - | - |
| Total | 31 | 64 | 179 |

Capital expenditure is allocated based on where the assets are located.

## 4. Finance income and charges

| | Unaudited Six months ended 30 June 2006 £000 | Unaudited Six months ended 30 June 2005 £000 | Audited Year ended 31 December 2005 £000 |
|---|---|---|---|
| **Interest receivable and other similar income** | | | |
| Interest on cash, cash equivalents and held-to-maturity assets | 339 | 149 | 429 |
| Exchange gains on held-to-maturity assets | – | 351 | 441 |
| Total | 339 | 500 | 870 |
| **Interest payable and other similar charges** | | | |
| Exchange losses on held-to-maturity assets | (137) | - | - |
| Total | (137) | - | - |

## 5. Trade and other receivables

| | Unaudited 30 June 2006 £000 | Unaudited 30 June 2005 £000 | Audited 31 December 2005 £000 |
|---|---|---|---|
| Trade receivables | - | - | 17 |
| Other receivables | 89 | 16 | 21 |
| Prepayments and accrued income | 657 | 129 | 781 |
| Total | 746 | 145 | 819 |

## 6. Trade and other payables

| | Unaudited 30 June 2006 £000 | Unaudited 30 June 2005 £000 | Audited 31 December 2005 £000 |
|---|---|---|---|
| Trade payables | 1,130 | 67 | 599 |
| Taxation and social security payable | 49 | 32 | 109 |
| Accruals | 1,552 | 860 | 1,207 |
| Total | 2,731 | 959 | 1,915 |

## 7. Loss per ordinary share

| | Unaudited Six months ended 30 June 2006 £000 | Unaudited Six months ended 30 June 2005 £000 | Audited Year ended 31 December 2005 £000 |
|---|---|---|---|
| Attributable loss | (5,680) | (1,814) | (5,605) |
| Weighted average number of shares in issue (000) | 23,591 | 13,000 | 16,096 |
| Loss per share (basic and diluted) | (24.1)p | (14.0)p | (34.8)p |

The calculation of earnings per share is based on the weighted average number of ordinary shares in issue during the period. Due to the loss for the period the share options are anti-dilutive.

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