KARO BIO

Press Release

October 15, 2004

# QUARTERLY REPORT JULY - SEPTEMBER 2004

- **Preclinical development of the KB3305 compound for treatment of type 2 diabetes has progressed with the aim to initiate clinical trials.**
- **Cost savings initiatives, including a staff reduction, have been implemented to free resources for drug development activities.**
- **New share issue successfully completed in October 2004, generating in total MSEK 119.6 before transaction costs.**
- **Net sales amounted to MSEK 8.8 (10.5).**
- **The loss for the period amounted to MSEK 24.9 (34.3).**
- **Cash flows from operating activities amounted to MSEK -24.8 (-38.2).**
- **Cash and cash equivalents and short-term investments amounted to MSEK 100.8 (234.6) at the end of the period.**
- **Loss per share for the period amounted to SEK 1.48 (2.03).**

## Operations

Karo Bio is a leading drug discovery company in the field of nuclear receptors. The Company discovers and develops receptor-selective and tissue-selective pharmaceuticals for treatment of major disorders.

Karo Bio has two strategic collaborations with international pharmaceutical companies for development of innovative therapies for the treatment of common diseases. Karo Bio also has several internal projects in various clinical areas where the Company's competitive advantages are utilized for discovery and development of new pharmaceuticals that target nuclear receptors. To maintain a strong pipeline, exploratory studies are conducted, often in collaboration with leading academic groups, in clinically important areas.

## Strategic Collaborations

### Estrogen Receptors - Merck & Co., Inc.

In October 1997 Karo Bio and Merck & Co., Inc. initiated a drug discovery collaboration in the field of estrogen receptors. The joint collaboration phase was completed in October 2002 and the program has successfully reached its primary drug discovery objectives, the identification of estrogen receptor subtype selective compounds with potential for multiple clinical indications. Merck & Co., Inc. is in the process of completing preclinical evaluation of a selected compound that was identified as a candidate drug in May 2003, to determine suitability for progression into clinical trials. Further, additional compounds that were discovered in the research collaboration continue to be evaluated as candidates for selected potential clinical indications.

#### Atherosclerosis - Wyeth Pharmaceuticals

Karo Bio entered into a three-year collaboration with Wyeth Pharmaceuticals in September 2001. The parties collaborate in the drug discovery phase with the liver X receptor (LXR) as a target for treatment of atherosclerosis. Progress has continued and one compound has advanced into predevelopment stage. The event was linked to a milestone payment. The collaboration is successful as predevelopment stage has been reached in less than three years from the initiation of the collaboration. Earlier in the year, research terms for the collaboration were extended with one year until September 1, 2005. Presently, novel LXR acting compounds are evaluated for suitability as leads to treat atherosclerosis.

## Drug Development Projects

#### Type 2 diabetes and the KB3305 compound

The compound KB3305 was discovered in a joint collaboration with Abbott Laboratories and represents a first-in-class therapeutic approach for the treatment of type 2 diabetes. All rights to KB3305 were returned to Karo Bio by Abbott Laboratories in November 2003.

KB3305 has a favourable pharmacological profile in animal diabetes models and acts by antagonizing the action of specific hormones called glucocorticoids, so named because of their key role in glucose metabolism. Karo Bio's strategy to selectively address the metabolic effects on glucose turnover and to avoid side effects is to identify compounds that are liver selective. The compound KB3305 is the first known example of such a liver selective GR antagonist. It demonstrates significant anti-diabetic effects in three separate animal disease models. Karo Bio has shown that KB3305 effectively restores glucose control in diabetic mice by decreasing glucose production from the liver and as a consequence normalizes the hyperglycemia associated with type 2 diabetes. In addition to this beneficial effect of KB3305 and its potential use as an anti-diabetic agent, KB3305 significantly improves several measures of blood lipid levels in these animals. High blood cholesterol levels in patients with type 2 diabetes severely increase the risk for serious cardiovascular events such as heart infarction and stroke.

Clinical concerns related to GR antagonism have been greatly reduced in KB3305 through a chemical modification that elevates hepatic drug levels and minimizes other systemic GR responses associated with unwanted side-effects. Preclinical safety and toxicity studies suggest that KB3305 is a safe and well tolerated drug with a 100-fold safety margin over the expected clinical dose.

Work is currently ongoing to take KB3305 through preclinical development into proof-of-concept in man. In the period, we have focused on the major remaining preclinical development challenges of KB3305; formulation of the compound to improve bioavailability and on large scale synthesis of the compound to be able to complete the toxicology studies. These are necessary before bringing KB3305 into clinical trials.

#### Dyslipidemia, obesity and the KB2115 compound

Karo Bio is developing drugs that regulate the activity of one specific group of nuclear receptors, thyroid receptors (TRs), to which thyroid hormones normally bind. Thyroid hormones are known to play important roles in the regulation of body weight, blood

cholesterol levels and glucose metabolism. Therefore, chemical compounds acting on TR have the potential to become important agents for treatment of many aspects of the metabolic syndrome. However, in addition to the beneficial effects of thyroid hormone on metabolism, these hormones also have unwanted side effects, particularly on heart rate and bone and muscle turnover.

Karo Bio has shown that unwanted side effects can be avoided by designing compounds that, in relation to the natural thyroid hormone, have an improved safety profile. The most advanced lead compound, KB2115, is a tissue and TR selective agonist developed as an anti-obesity agent increasing the metabolic rate. KB2115 comes from the program that Bristol-Myers Squibb returned to Karo Bio in April 2004. The compound has an affinity for TR that is higher than that of naturally occurring thyroid hormones, and furthermore has a broad therapeutic dose range (>100-fold) of efficacy versus undesired effects. KB2115 has passed the first part of a phase I study conducted by Bristol-Myers Squibb. It is Karo Bio's plan to bring KB2115 back into clinical trials. During the period a new development plan has been established specifically addressing further characterization of the food induced reaction product of KB2115.

Karo Bio has also since May 2003 internally run a new and alternative indication TR agonist project for treatment of dyslipidemia. The project is currently at the lead selection stage.

## Drug Discovery Projects & Exploratory Studies

The cost and staff reduction program in the period has mainly affected Drug Discovery Projects & Exploratory Studies. Therefore, resources allocated into these projects have been reduced compared to the situation earlier in the year. This reduction has mainly an effect on the Prostate Cancer program, but also on the other early stage projects and activities described below.

#### Prostate Cancer

Karo Bio targets the androgen receptor (AR) for the treatment of prostate cancer. Karo Bio believes that new, potent, non-steroidal antagonists with reduced side effects will be important for the future management of hormone refractory prostate cancer. During the period, new X-ray structures of the androgen receptor in complex with proprietary compounds have been solved and these structures suggest the mechanism of action of the market leading drug Casodex (bicalutamide). These findings are predicted to open up for the design of new and improved prostate cancer drugs.

#### Estrogen Receptors

Estrogen receptors are important targets for a wide range of disorders with unmet clinical needs. While estrogens have beneficial effects on a variety of disease conditions they may be associated with undesirable side effects. Therefore, future drugs targeting estrogen receptors will have to be more selective at the tissue and subtype receptor level in order to obtain desired effects and avoid side effects. Karo Bio is currently addressing CNS disorders but other indications are also explored. In the period, design of new and more selective compounds has continued.

**Exploratory Studies**

Karo Bio conducts exploratory studies upon the glucocorticoid, estrogen and mineralocorticoid receptors, aiming to discover new medical concepts that may lead to novel applications for its nuclear receptor focused compound libraries. These libraries continue to be refined and have continued to be expanded in the period. In addition to Karo Bio's in-house scientists, parts of these studies are conducted in collaboration with the Company's scientific network. Such studies are important for next generation of innovative Karo Bio drug discovery projects.

## Organization

In September, Karo Bio announced a cost savings initiative to make available financial resources to bring selected projects into clinical trials. The savings initiative includes the reduction of the organization by 20 persons, of which most of whom have left the Company. The reduction affects primarily staff involved in activities in the early phase of drug discovery, but also in the organization outside the research operations. The savings amounts to approximately MSEK 30 on an annual basis.

By the end of the period, Karo Bio had 79 (119) employees, of which 63 (95) are engaged in research.

## Nomination Committee

A nomination committee has been appointed in accordance with the decision at the shareholders' meeting in April 2004. The committee consists of Thomas Ehlin, representing Nordea Bank, Björn Franzon, Fourth Swedish National Pension Fund, Carl Rosén, Second Swedish National Pension Fund, and Per-Olof Mårtensson, chairman of the Karo Bio board of directors.

## New share issue

Karo Bio's new share issue has been completed in October. The rights issue of 11 260 043 shares generated MSEK 95.7 to the Company excluding transaction costs, and 99.0 percent were subscribed with preferential right for shareholders. The Karo Bio board of directors allocated remaining shares to shareholders. The board has decided to use the authorization granted at the special general meeting August 30, 2004 in full to issue 2 815 010 additional new shares. Allocation of shares has been made to those who have applied for shares and were shareholder on the record date September 8, 2004. Thereby, additionally MSEK 23.9 excluding transaction costs was raised. The new share issues generate in total approximately MSEK 113 after transaction costs.

## Result

Net sales for the quarter amounted to MSEK 8.8 as compared to MSEK 10.5 for the same period last year. Revenues in the third quarter 2004 consist of research funding from the research collaboration with Wyeth Pharmaceuticals and the period's share of

upfront payment, which in this quarter is for the last month of the originally agreed research funding period of three years.

Expenses decreased by MSEK 11.9 to MSEK 35.2 (47.1), primarily as the result of the consolidation of research operations to Sweden in November 2003 and other cost savings initiatives. A provision for the costs related to the reduction of the number of employees implemented in September is included in the expenses for the third quarter 2004. Operating expenses were affected positively by the lower amortization and depreciation cost relating to goodwill and licenses and similar rights.

Operating loss amounted to MSEK 26.4 (36.5). The operating loss excluding goodwill amortization amounted to MSEK 26.4 (35.2). Financial income amounted to MSEK 1.5 (2.2), including currency gains of MSEK 0.7 (0.9) relating to financial items. The reported loss for the period amounted to MSEK 24.9 (34.3).

## Cash Flow

Cash flows from operating activities amounted to MSEK -24.8 (-38.2). Cash flows were affected positively by the decrease in cash-based expenses.

Cash and cash equivalents and short-term investments amounted to MSEK 100.8 (234.6) at the end of the period, while the corresponding amount for previous quarter was MSEK 126.0.

## Capital investments

Capital investments in equipment amounted to MSEK 0.1 (0.8) including equipment financed with capital leases.

## Shareholders' Equity and Per Share Data

At period-end, warrants representing 611 419 shares were outstanding. The warrants were issued in conjunction with the acquisition of Karo Bio USA, Inc. in 2000 (warrants representing 3 219 shares), the implementation of the Stock Option Programs 2001 and 2003 (warrants representing 367 200 and 241 000 shares, respectively). The number of corresponding shares regarding the Stock Option Programs 2001 and 2003, updated for the effect of the rights issue completed in October 2004, in accordance with the terms for the option programs, are 447 984 and 281 970. The subscription price for warrants relating to the program 2001 has been updated from SEK 297.80 to SEK 254.30 and the program 2003 from SEK 33, 36, 39 and 44 to SEK 28, 31, 34 and 37, respectively.

The share capital at the end of the period amounted to kSEK 84 450. The total number of shares amounted to 16 890 065 shares at a par value of SEK 5. Total consolidated shareholders' equity amounted to MSEK 91.8 after taking into account the loss for the period.

Loss per share for the period, based on the weighted average number of shares outstanding, amounted to SEK 1.48 (2.03). The Group's equity ratio as of period-end was 70.8 percent (80.4) and equity per share at period-end was SEK 5.44 (13.74).

## Accounting and Valuation Principles

This quarterly report has been prepared in accordance with the Swedish Financial Accounting Standards Council's (the Council) standard RR 20 for interim reports. The accounting and valuation principles applied are unchanged compared to what was applied in the Annual Report for 2003.

Amounts are expressed in kSEK (thousands of Swedish Kronor) unless otherwise indicated. MSEK is an abbreviation for millions of SEK. Amounts or figures in parentheses indicate comparative figures for the corresponding period last year.

## Scheduled Releases of Financial Information

Karo Bio intends to distribute financial reports as follows:

- Quarterly Report October - December and Earnings Report 2004 February 8, 2005

Financial reports, press releases and other information are available on Karo Bio's web site www.karobio.com Karo Bio's financial reports and press releases may be downloaded and subscribed to on the web site at www.karobio.com/finance Financial reports are available on the web site upon release.

## CONDENSED CONSOLIDATED INCOME STATEMENTS (kSEK)

| | July - September | | January - September | |
|---|---|---|---|---|
| | **2004** | **2003** | **2004** | **2003** |
| Net sales | 8 779 | 10 530 | 32 938 | 74 072 |
| ***Operating expenses*** | | | | |
| Administrative expenses | -6 167 | -10 789 | -26 680 | -32 551 |
| Research and development expenses | -29 092 | -36 502 | -94 582 | -121 761 |
| Amortization of goodwill | - | -1 289 | - | -82 747 |
| Other operating income and expenses | 83 | 1 529 | 2 272 | 1 961 |
| | -35 176 | -47 051 | -118 990 | -235 098 |
| **Operating loss** | **-26 397** | **-36 521** | **-86 052** | **-161 026** |
| Financial net | 1 474 | 2 237 | 2 669 | 8 295 |
| **Loss after financial items** | **-24 923** | **-34 284** | **-83 383** | **-152 731** |
| Tax | - | - | - | - |
| **LOSS FOR THE PERIOD** | **-24 923** | **-34 284** | **-83 383** | **-152 731** |
| *Other depreciation included in operating expenses* | *-2 162* | *-5 090* | *-10 238* | *-15 180* |
| **Loss per share (SEK)** [*)] | | | | |
| - weighted average number of shares outstanding | -1.48 | -2.03 | -4.94 | -10.46 |
| **Number of shares outstanding (000)** | | | | |
| - weighted average during period | 16 890 | 16 878 | 16 888 | 14 600 |
| - weighted average during period, including warrants | 17 501 | 17 501 | 17 501 | 15 111 |
| - at end of period | 16 890 | 16 878 | 16 890 | 16 878 |
| - at end of period, including warrants | 17 501 | 17 501 | 17 501 | 17 501 |

[*)] The outstanding warrants lead to no dilution of earnings per share, as a conversion to shares would lead to an improvement of earnings per share.

## CONDENSED CONSOLIDATED BALANCE SHEETS (kSEK)

| | September 30 | | December 31 |
|---|---|---|---|
| | **2004** | **2003** | **2003** |
| **Assets** | | | |
| Licenses and similar rights | 104 | 6 449 | 3 983 |
| Goodwill | - | 11 602 | - |
| Equipment | 20 427 | 25 020 | 23 916 |
| Other current assets | 8 227 | 10 814 | 17 081 |
| Cash, cash equivalents and short-term investments | 100 835 | 234 627 | 184 047 |
| **TOTAL ASSETS** | **129 593** | **288 512** | **229 027** |
| **Shareholders' equity and liabilities** | | | |
| Shareholders' equity | 91 808 | 231 923 | 174 850 |
| Non-current liabilities | 2 798 | 3 797 | 4 768 |
| Deferred revenue | 6 015 | 22 374 | 17 154 |
| Other current liabilities | 28 972 | 30 418 | 32 255 |
| **TOTAL SHAREHOLDERS' EQUITY AND LIABILITIES** | **129 593** | **288 512** | **229 027** |

## CONDENSED CONSOLIDATED CASH FLOW STATEMENTS (kSEK)

| | July - September | | January - September | |
|---|---|---|---|---|
| | **2004** | **2003** | **2004** | **2003** |
| ***Operating activities*** | | | | |
| Operating loss before financial items | -26 397 | -36 521 | -86 052 | -161 026 |
| Amortization and depreciation | 2 162 | 6 380 | 10 238 | 97 928 |
| Other items not affecting cash flows | 27 | - | -222 | - |
| | **-24 208** | **-30 141** | **-76 036** | **-63 098** |
| Financial income received and expenses paid | 789 | 820 | 3 802 | 2 451 |
| **Cash flow from operating activities before changes in working capital** | **-23 419** | **-29 321** | **-72 234** | **-60 647** |
| Changes in working capital | -1 361 | -8 829 | -6 622 | -17 825 |
| **Cash flow from operating activities** | **-24 780** | **-38 150** | **-78 856** | **-78 472** |
| ***Investing activities*** | | | | |
| Investment in licenses and similar rights | - | - | -3 775 | -3 884 |
| Investment in equipment | -371 | -829 | -2 003 | -2 775 |
| Sale of equipment | 30 | - | 1 362 | - |
| **Cash flow from investing activities** | **-341** | **-829** | **-4 416** | **-6 659** |
| **Cash flow from operations** | **-25 121** | **-38 979** | **-83 272** | **-85 131** |
| ***Financing activities*** | | | | |
| Proceeds from new share issues | - | 2 | 60 | 118 596 |
| **Cash flow from financing activities** | **-** | **2** | **60** | **118 596** |
| **Cash flow for the period** | **-25 121** | **-38 977** | **-83 212** | **33 465** |
| **Liquid assets at the end of the period** | **100 835** | **234 627** | **100 835** | **234 627** |

## CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY (kSEK)

| | July - September | | January - September | |
|---|---|---|---|---|
| | **2004** | **2003** | **2004** | **2003** |
| **Amount at beginning of period** | **117 348** | **267 547** | **174 850** | **269 060** |
| Currency translation difference | -617 | -1 342 | 281 | -3 657 |
| New issues of shares | | | | |
| - rights issue | - | - | - | 118 578 |
| - warrants exercise | - | 2 | 60 | 18 |
| Issue of warrants | - | - | - | 655 |
| Loss for the period | -24 923 | -34 284 | -83 383 | -152 731 |
| **Amount at end of period** | **91 808** | **231 923** | **91 808** | **231 923** |

## EQUITY DATA

| | September 30 | | December 31 |
|---|---|---|---|
| | **2004** | **2003** | **2003** |
| Equity ratio | 70.8% | 80.4% | 76.3% |
| Equity per share at the end of period, SEK | 5.44 | 13.74 | 10.36 |
| Equity per share at the of period, including warrants, SEK | 5.25 | 13.25 | 9.99 |

Huddinge, October 15, 2004

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**Legal disclaimer**

This financial report includes statements that are forward looking and actual results may differ materially from those stated. In addition to the factors discussed, among other factors that may affect results are developments within research programs, including development in pre-clinical and clinical trials, the impact of competing research programs, the effect of economic conditions, the effectiveness of the Company's intellectual property rights and preclusions of potential third party's intellectual property rights, technological development, exchange rate and interest rate fluctuations, and political risks.

This report has not been subject to review by the Company's independent auditor.

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