SurModics

1999

Annual

Report

BEYOND

Slippery Surfaces

Financial Highlights

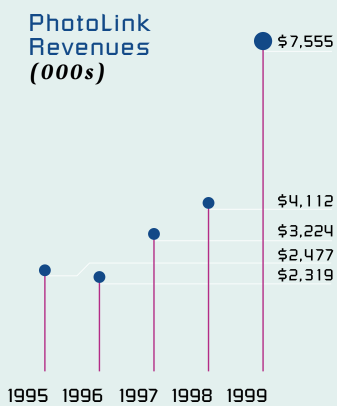
(Dollars in thousands, except per share data)	*Fiscal years ended September 30,*				
	1999	1998	1997	1996	1995
Total revenues	$13,494	$9,779	$7,583	$6,183	$5,956
PhotoLink revenues	$ 7,555	$4,112	$3,224	$2,319	$2,477
PhotoLink royalty revenues	$ 3,912	$2,205	$1,448	$1,052	$ 792
Operating income (loss)	$ 2,419	$ 948	$ 37	$ (415)	$ (455)
Net income (loss)	$ 4,360	$1,637	$ 236	$ (194)	$ (322)
Diluted net income (loss) per share	$ .54	$ .24	$ .04	$ (.04)	$ (.07)
Number of licensees	44	34	32	28	26
Number of licensed applications generating royalties	87	80	58	45	23
Number of licensed applications on the market	43	37	27	22	16

Corporate Profile

SurModics, Inc. is a leading provider of surface modification solutions to the medical device industry. SurModics' primary focus is the commercialization of its patented PhotoLink® process. PhotoLink is a versatile, easily applied, light-activated coating technology that modifies medical device surfaces, providing performance-enhancing characteristics, such as lubricity, hemocompatibility, infection resistance, and drug delivery.

SurModics' strategy is to license this PhotoLink technology to medical device manufacturers who apply the coating to medical devices in their own facilities. Most of these licenses are non-exclusive, which enables SurModics to spread its risk by establishing agreements with multiple companies, often in the same marketplace.

The Company's revenues come from four sources: (1) license fees, (2) royalties received from licensees, (3) sale of chemicals (both reagents used in the PhotoLink process and a line of stabilization products), and (4) research and development revenue.



Entering our 20th year,
SurModics continues its history of
scientific innovation
that has led us to:

DEVELOP

DEVELOP

and innovate

leading surface modification technologies;

DELIVER

DELIVER

surface modification technologies

to select market segments of the
medical device industry; and

LEVERAGE

LEVERAGE

our experience
and scientific expertise

to capitalize on additional high-value opportunities
within the medical marketplace.

To Our Shareholders

Fiscal 1999 was another excellent year for SurModics. We continued to grow the business and reap the benefits of our royalty-based economic model. The Company generated record levels of revenue and earnings, fueled by increasing royalties from our clients' sales of PhotoLink-coated products. Surface modification of medical devices continues to gain acceptance as demonstrated by the 14 new license agreements executed during the year. With a broad spectrum of new coatings under development, we also expect to deliver strong royalty growth in the future.

1999 Financial Review

SurModics produced record financial results in fiscal 1999. Revenues increased 38 percent to $13.5 million. More importantly, PhotoLink revenues increased 84 percent to $7.6 million. All aspects of the PhotoLink business achieved significant growth, led by royalties which increased 77 percent to $3.9 million and reagent chemical sales which increased 136 percent to $1.9 million. As a result of this growth, pro forma fully taxed net income was $2.3 million or $.28 per diluted share in fiscal 1999, up from $1.1 million or $.16 per diluted share in fiscal 1998.

1999 Business Review

A number of significant business events occurred during the year, including:

- Execution of 14 new licensed agreements with 11 different companies;
- Market launch of six new PhotoLink-coated products by licensed clients;
- Being named the 1999 Minnesota Technology Company of the Year;
- Introduction of 3D-Link™ Activated Slides into the emerging genomics market;
- Purchase of our building (previously leased) to provide for future expansion;
- Adoption of a Shareholder Rights Plan to protect shareholders against any hostile takeover attempts.

The heart of the Company's economic model is the licensing of our unique PhotoLink technology. We had a successful year in closing new license agreements in 1999, and the pipeline remains strong for next year. The financial impact of any new license largely rests in the future, as the most important milestone is reached when a client launches a PhotoLink-coated product into the market. Once this occurs, earned royalties begin to flow. In fiscal 1999, our licensees introduced six new products. Two of these applications, cardiovascular catheter products from Cordis and Medtronic AVE, are already producing meaningful royalty revenues for SurModics.

Fiscal 1999 also saw the launch of SurModics' first directly marketed PhotoLink-coated product. 3D-Link Activated Slides are used to make DNA microarrays (also called "gene chips"). The use of DNA microarrays is a small but rapidly developing market, especially in the areas of pharmaceutical and genomics research and diagnostic test development. We believe these high-quality, high-performance slides will be of significant value to genetic researchers as they develop products essential to the evolution of this rapidly growing market.

Expectations For 2000 and Beyond

Fiscal 2000 is expected to bring another year of growing revenues and earnings. We will continue to focus on expanding the use of PhotoLink in the marketplace. Given the strong pipeline of potential licenses, we expect to add another eight to ten new license agreements during the year. Many of these agreements will emphasize lubricity, but a growing number will likely include antimicrobial, drug delivery, and other applications. Royalties should also continue to grow as more PhotoLink-coated products reach the market.

We will continue to focus on advancing the development of new and improved coatings. PhotoLink is very versatile—the same technology can provide a wide array of surface properties. Consequently, broadening PhotoLink's applications is a key corporate objective. Internal projects are currently emphasizing advanced lubricity (i.e. making existing slippery coatings even better), drug delivery, and tissue engineering applications.

Looking even further into the future, we see major opportunities for PhotoLink within the medical device market. An example is the growing awareness of drug delivery coatings. The site-specific delivery of drugs will be an important step in building closer ties between device manufacturers and pharmaceutical companies. We are also expanding our research efforts in tissue engineering to show how PhotoLink can be used to improve the performance of wound healing, bone and cartilage repair, and vascular graft applications.

Throughout its history, SurModics has been known primarily for its capabilities in making medical devices more slippery. Our focus now shifts to expanding the breadth of our product offerings by moving beyond slippery surfaces into areas such as antimicrobial and therapeutic drug delivery and tissue engineering.

Long-Range Objectives

Management recently identified the following targets in its review of SurModics' long-term plans and objectives:

- Generate average annual revenue growth of at least 25 percent;
- Produce annual net income growth of at least 40 percent;
- Finalize a minimum of 50 new PhotoLink license agreements over the next five years;
- Generate one quarter of our annual revenue growth from new products introduced in the previous three-year period;
- Broaden SurModics' revenue base through acquisitions and strategic alliances that add capabilities and strengthen our market presence.

In closing, we thank you, our shareholders, for your continued support and look forward to sharing our successes with you in the future.

Dale R. Olseth
Chairman and Chief Executive Officer

James C. Powell
President and Chief Operating Officer

James C. Powell & Dale R. Olseth

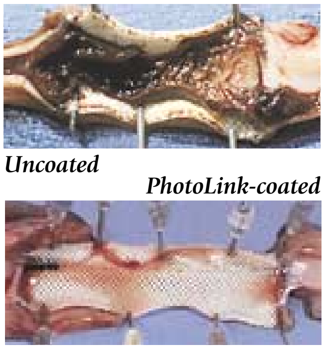
PhotoLink adds a high-quality lubricious coating that enables our customers to access areas of the cardiovascular system that were impossible to reach before.

Dan Bossie, Marketing Manager, Angioplasty Products, Spectranetics Corp.
PhotoLink is used on Spectranetics' Vitesse® line of laser catheters under the trade name Spectraglide®.

As SurModics celebrates its 20th anniversary, we look back with pride at the growth and metamorphosis the Company has experienced to reach its present position as a leader in surface modification.

SurModics' founders initially envisioned a company focused on the development and commercialization of diagnostic and pharmaceutical products.

In performing this research, they developed a method for immobilizing molecules onto a surface through a light-activated chemical process. When the market potential of the surface modification technique became apparent, the Company shifted its strategic direction from diagnostics to developing innovative coating technologies for the medical device industry.



Uncoated and PhotoLink-coated polyurethane was removed from carotid arteries after being implanted for 14 days. Notice how the PhotoLink coating prevented blood clot formation on the artery shown at bottom.

Develop and innovate leading surface modification technologies.

The PhotoLink technology was easily incorporated into a client's manufacturing process. By transferring the coating process to the client's facility, SurModics was able to license the technological know-how rather than become a contract manufacturer. A unique business model was developed to license the technology to medical device manufacturers, customize the process for an individual client, sell the coating reagent, and generate royalties on the sale of coated devices by the client.

Infection-resistant coatings allow ***hydrocephalic shunts*** *to remain in place for longer periods of time.*

Lubricious coatings for ***tympanostomy (ear drain) tubes*** *aid in insertion and in reducing device-centered infections.*

Coatings for ***surgical chest drains*** *prevent blood clotting and make them easier to remove.*

Coatings for ***urinary drainage catheters*** *ease insertion and reduce bacterial infections.*

1979

JUNE
Company incorporated

OCTOBER
First SBIR grant award

1986

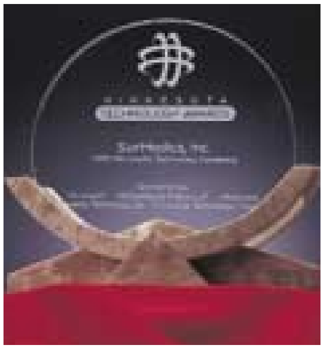
NOVEMBER
Dale Olseth named President and CEO

The coating minimizes friction to such an extent physicians have commented that they can almost 'listen to the lesion' during a procedure.

J. Alex Martin, Vice President, Sales & Marketing, Cordis Cardiology, referring to Cordis' new coronary balloon catheter—NINJA™ the 'Silent Warrior.'

Once the feasibility of PhotoLink technology was proven, license agreements were pursued with medical device manufacturers. Applications to increase the lubricity or slipperiness of devices entering the body were the first to be delivered.

The first PhotoLink license for a lubricious application was signed in June 1990. Since then, applications for PhotoLink have expanded to include blood compatibility, infection resistance, the delivery of drugs from a surface, wettability, DNA immobilization, and multiple tissue engineering approaches. SurModics has now executed license agreements with 44 companies covering more than 100 product applications.



SurModics received the 1999 Minnesota Technology Award for innovative development and commercialization of a successful leading-edge technology, and contributions toward making Minnesota a leading technology center in the United States.

The demand for PhotoLink technology continues to grow as the benefits of surface modification become more evident and acceptance of the technology increases. Clients have 43 medical devices on the market coated with PhotoLink reagents; several are producing substantial royalties. Notable among them are Boston Scientific Target Therapeutics' neuroinfusion catheters, a vascular closure device from Perclose, Inc., and vascular catheters from Cordis Cardiology and Medtronic AVE. As the interest in the coating of medical devices expands, the application and royalty potential for PhotoLink technology continues to grow.

Deliver surface modification technologies to select market segments of the medical device industry.

Anti-adherent coatings reduce protein deposition on ***ophthalmic devices*** *to increase comfort and prolong their use in the body.*

Abdominal aortic aneurysm (AAA) *devices can be coated to help hold the device in place and prevent blood leakage.*

Heparin coatings prevent blood clotting on ***hemodialysis catheters.***

Coatings can help ***orthopedic devices*** *integrate with the body and reduce device-centered infections.*

1990

JUNE
First PhotoLink license signed

AUGUST
StabilCoat introduced to diagnostics market

NOVEMBER
First PhotoLink patent issued

1992

JANUARY
First royalties received from the sale of a coated product

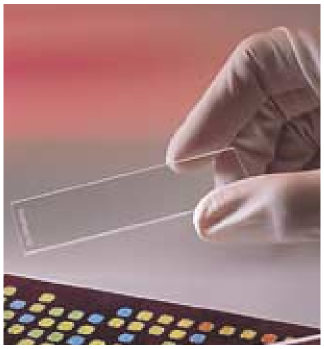
"After testing a number of other surface chemistries, we have decided to use SurModics slides due to their high DNA binding efficiency and increased sensitivity for the detection of low abundance transcripts."

Dr. Tom Freeman, Gene Expression Group, The Sanger Centre, Cambridge, England.

Looking to the next millennium, SurModics will continue to seek new license agreements and expand the utilization of PhotoLink by identifying other high-growth segments of the health care field.

Leverage our experience and scientific expertise to capitalize on additional high-value opportunities within the medical marketplace.

Leveraging its core photoactive chemistry expertise in 1999, SurModics introduced its first coated product: 3D-Link™ Activated Slides. This product is a coated glass slide used by the genomics market to orient DNA strands for analysis. Genomics is still in its infancy, and SurModics has now established a foothold in a market with abundant potential for revenue growth and product-line expansion.



3D-Link Activated Slides, SurModics' first coated product, provide lower background levels and consistent results for reproducible microarrays used in DNA analysis and drug screening.

Research and development is also underway for leveraging PhotoLink technology in areas such as wound healing, bone and cartilage regeneration, vascular grafts, and insulin-producing pancreatic islet cell encapsulation. SurModics recently received a Phase II SBIR award from the National Science Foundation to facilitate the expansion of 3D-Link technology to other genomics product applications.

Everyone at SurModics is excited about the opportunities in front of us as we leverage PhotoLink technology beyond slippery coatings.

*Coatings for **pacemaker leads** aid in insertion and reduce infection rates.*

*Lubricious coatings for **neurovascular catheters** allow surgeons to reach areas of the brain more quickly.*

*Site-specific, drug-delivery coatings on **vascular stents** can prevent restenosis.*

***Angioplasty balloons, guidewires, and guide catheters** benefit from lubricious and heparin coatings to aid in insertion and reduce blood clotting.*

*Lubricious coatings for **vascular closure devices** make insertion easier and reduce trauma.*

1997

JULY
Changed name to SurModics, Inc.

SEPTEMBER
First profitable year

1998

MARCH
Initial public offering

JULY
James Powell named President and COO

1999

MARCH
3D-Link introduced to genomics market

APRIL
Named Minnesota Technology Company of the Year

SEPTEMBER
Record revenues and profits

General

SurModics is a leading provider of surface modification solutions to medical device manufacturers. The Company's revenues are derived from four primary sources: fees from licensing its patented technology to customers; royalties received from licensees; the sale of photo-reactive chemical compounds to licensees and stabilization products to the diagnostics industry; and research and development fees generated on projects for commercial customers and government grants. In March 1998, the Company completed an initial public offering ("IPO") of 2.3 million shares of Common Stock which generated proceeds of approximately $15.5 million, net of related offering expenses.

SurModics' royalty-based economic model once again drove strong financial performance in fiscal 1999. Total revenues increased 38% to $13.5 million in fiscal 1999 from $9.8 million in fiscal 1998. The overall revenue growth was led by an 84% increase in PhotoLink revenues to a record $7.6 million in fiscal 1999. The Company is continuing to see significant increases in the usage of its PhotoLink technology as shown by the growth in royalty revenue and reagent sales. PhotoLink royalties increased 77% to $3.9 million and reagent sales, those chemicals used by licensees in the PhotoLink coating process, increased 136% to $1.9 million. These revenue gains resulted in net income of $4.4 million, or $.54 per diluted share, compared to $1.6 million, or $.24 per diluted share, in fiscal 1998.

Results of Operations

Years Ended September 30, 1999 and 1998

Revenues. The Company's revenues were $13.5 million in fiscal 1999, an increase of 38% over fiscal 1998. The revenue components were as follows:

(Dollars in thousands)	*Fiscal 1999*	*Fiscal 1998*	*Increase (Decrease)*	*% Increase (Decrease)*
PhotoLink revenue:				
Royalties	$ 3,912	$2,205	$1,707	77%
License fees	645	222	423	191%
Reagent sales	1,876	794	1,082	136%
Commercial development	1,122	891	231	26%
Total PhotoLink revenue	7,555	4,112	3,443	84%
Diagnostic royalties	2,758	2,578	180	7%
Stabilization products	2,261	2,004	257	13%
Government research	920	1,085	(165)	(15%)
Total revenues	$13,494	$9,779	$3,715	38%

The revenue growth in fiscal 1999 was mainly due to the 84% increase in PhotoLink revenue between years. PhotoLink royalty revenue increased 77% due to the introduction of six additional coated products as well as increases in the sales of previously introduced coated products by licensees. Two of these new products are already generating meaningful royalties to the Company. SurModics' clients now have 43 PhotoLink-coated products on the market. Reagent sales increased 136% due to increased production of PhotoLink-coated devices by these clients. A single customer purchased 57% of the reagents sold during fiscal 1999, up from 12% in fiscal 1998. It is expected that the reagent purchases by this customer will decrease in the last half of fiscal 2000. During fiscal 1999, SurModics signed 14 new license agreements, compared to three new agreements in fiscal 1998, resulting in a 191% increase in license fees. The Company now has license agreements with 44 companies covering over 100 product applications. Increased customer-funded development projects resulted in a 26% increase in commercial development revenue. Approximately 75% of the development revenue resulted from work on projects for two customers. One of these customers accounted for 50% of the commercial development revenue in fiscal 1998.

The growth of the non-PhotoLink revenues was more moderate in fiscal 1999. The diagnostic royalties grew 7% between years due to increased product sales by the licensee. Sales of stabilization products grew 13% between years as a result of increased market penetration. Finally, revenue from government grants decreased 15% between years, as the Company has begun to internally fund more of its research and development projects rather than relying on these grants.

Product costs. The Company's product costs were $1.5 million for fiscal 1999, an increase of $300,000, or 27%, over fiscal 1998. Overall product margins increased to 63% in fiscal 1999 from 57% in fiscal 1998. The margin improvement was primarily due to cost efficiencies realized in the production of reagent chemicals as a result of increased production volumes. The margins on stabilization product sales remained relatively flat between years.

Research and development expense. Research and development expense was $5.2 million for fiscal 1999, an increase of $700,000, or 16%, over fiscal 1998. Most of this increase was due to compensation and benefit expenses associated with the additional technical personnel hired by the Company during the year. In addition, the Company incurred additional expense on project management training for its technical personnel and increased legal expenses related to the filing of new patents. These cost increases were offset by a reduction in the amount of research performed at external laboratories on government grants.

Sales and marketing expense. Sales and marketing expense was $1.8 million for fiscal 1999, an increase of $400,000, or 25%, over fiscal 1998. This increase was primarily due to compensation and benefit expenses associated with the additional sales and marketing personnel hired during the year, increased incentive compensation as a result of sales growth and increased promotional spending. These cost increases were offset by a reduction in market research costs. An external market study performed last year was not repeated this year.

General and administrative expense. General and administrative expense was $2.5 million for fiscal 1999, an increase of $800,000, or 50%, over fiscal 1998. The increase was primarily due to compensation and benefit costs associated with additional personnel hired during the year, increased expenses associated with being a public company for the full year (such as investor relations costs, Nasdaq fees, and other external reporting expenses) and expenses associated with the shareholder rights plan adopted in fiscal 1999. In addition, a portion of the overall increase was from expenses associated with the Company president, who was appointed in the fourth quarter of fiscal 1998. The overall growth in general and administrative expenses is expected to slow considerably next year.

Other income, net. The Company's net other income was $1.2 million for fiscal 1999, an increase of $400,000 or 59%, over fiscal 1998. The increase in interest income was due to earnings generated on the investments resulting from the $15.5 million of IPO proceeds received in March 1998. The level of investments also increased due to the $4.4 million of cash provided by operating activities in fiscal 1999.

Benefit from income taxes. The Company's net income was benefited by a positive income tax adjustment. During fiscal 1999, management concluded that the Company would generate sufficient taxable income in the future to utilize all of the previously unrecognized tax net operating loss ("NOL") carryforwards prior to their expiration. Therefore, during fiscal 1999, the Company reversed a $2.5 million valuation allowance related to these NOL carryforwards.

Years Ended September 30, 1998 and 1997

Revenues. The Company's revenues were $9.8 million in fiscal 1998, an increase of 29% over fiscal 1997. The revenue components were as follows:

(Dollars in thousands)	***Fiscal 1998***	*Fiscal 1997*	*Increase (Decrease)*	*% Increase (Decrease)*
PhotoLink revenue:				
Royalties	**$2,205**	$1,448	$ 757	52%
License fees	**222**	540	(318)	(59%)
Reagent sales	**794**	494	300	61%
Commercial development	**891**	742	149	20%
Total PhotoLink revenue	**4,112**	3,224	888	28%
Diagnostic royalties	**2,578**	1,465	1,113	76%
Stabilization products	**2,004**	1,665	339	20%
Government research	**1,085**	1,228	(143)	(12%)
Total revenues	**$9,779**	$7,582	$2,197	29%

The fiscal 1998 revenue growth was primarily due to an increase in royalty revenue received from licensed clients. The 52% growth in PhotoLink royalties was due to increases in the minimum royalty payments from certain clients, the introduction of 10 additional coated products by the Company's licensees, and increased earned royalties from greater market penetration of previously launched coated products sold by licensees. The sales of reagent chemicals increased 61% as a result of growing production of PhotoLink-coated devices by SurModics' customers. Commercial development revenue increased 20% between years due to more customer-funded projects related to the development of PhotoLink coatings. Half of this revenue was generated on projects for a single customer. License fees decreased due to the completion of fewer new license agreements during the year. Three new license agreements were signed in fiscal 1998, compared to 10 in fiscal 1997.

The 76% increase in diagnostic royalties was due primarily to the impact of two events in fiscal 1998: a product acquisition by a licensee and the issuance of a new patent to SurModics, both of which resulted in more of the licensee's sales being subject to royalties. The 20% increase in stabilization product sales was the result of greater market penetration due to the Company's sales and marketing efforts.

Product costs. The Company's product costs were $1.2 million for fiscal 1998, a decrease of $200,000, or 17%, from fiscal 1997. Overall product margins increased to 57% in fiscal 1998 from 34% in fiscal 1997. The margin improvement was due to various manufacturing efficiencies achieved during the year as a result of increased production volumes. The most significant factors were: the transfer of stabilization production to a new manufacturing space which increased efficiency; a change to a less costly raw material formulation for the production of some stabilization products; and the increased market demand for some of the Company's products that allowed the Company to establish separate teams for stabilization and reagent production.

Research and development expense. Research and development expense was $4.5 million for fiscal 1998, an increase of $900,000, or 26%, over fiscal 1997. Most of this increase was due to compensation, benefit, and general business expenses associated with the additional technical personnel hired by the Company during the year. In addition, the Company incurred additional depreciation expense associated with the build-out of additional laboratory space. These cost increases were offset by a reduction in the amount of research performed at external laboratories on government grants.

Sales and marketing expense. Sales and marketing expense was $1.4 million for fiscal 1998, an increase of $300,000, or 29%, over fiscal 1997. This increase was primarily due to compensation, benefit, and travel expenses associated with additional sales and marketing personnel hired during the year and the cost of an external market study performed on potential genomics product applications.

General and administrative expense. General and administrative expense was $1.7 million for fiscal 1998, an increase of $300,000, or 20%, over fiscal 1997. The increase was primarily due to the cost of a new directors' and officers' liability insurance policy that was entered into at the time of the IPO; new expenses associated with being a public company (such as investor relations costs, Nasdaq fees, and other external reporting expenses); and additional expenses associated with certain consulting projects.

Other income, net. The Company's net other income was $700,000 for fiscal 1998, an increase of $500,000, or 247%, over fiscal 1997. The increase in interest income was due to the earnings generated on the additional investments resulting from the $15.5 million of proceeds received from the IPO in March.

Net Operating Loss Carryforwards

As of September 30, 1999, the Company had a NOL carryforward of approximately $5.6 million, which expires in varying amounts through 2014. The Company also has $400,000 of capital loss carryforwards at September 30, 1999, which expire in 2001. A valuation allowance of $149,000 has been established due to the uncertainty of realization of the capital loss carryforwards.

Year 2000 Compliance

The Company has evaluated and tested its information technology infrastructure for Year 2000 compliance. The Company has an internal technical infrastructure comprised of client server networks and desktop microcomputers. The applications which run on these computers are primarily purchased software without any significant customized programming. Over the last few years, the Company has routinely upgraded most of its computer hardware, software, and telecommunications systems. As a result of its evaluation, the Company does not anticipate any problems related to Year 2000 compliance with its information technology infrastructure.

The Company has also evaluated and tested its non-information technology systems with regard to Year 2000 compliance, including contacting significant raw material suppliers. This is especially important related to embedded technology such as microcontrollers contained in various lab equipment, and raw material suppliers who support the Company's manufacturing process. Based upon information currently available, the Company does not anticipate any material disruption in its operations as a result of any failure by either non-information technology equipment or one of its suppliers to be in compliance. Compliance should not be an issue with the Company's products, since they are not date-sensitive.

Costs associated with Year 2000 compliance are expensed as incurred. To date, those costs have not been material. Based upon currently available information, the Company does not expect that the costs of addressing any further Year 2000 issues will have a material impact on the Company's financial condition or results of operations.

Although the Company believes it has addressed all Year 2000 issues, there are risks if the Company's evaluation has not been complete. The most severe risk is business interruption. Specific examples of situations that could cause business interruption include, among others, (i) computer hardware or application software processing errors or failures; (ii) failure of lab or manufacturing equipment; (iii) outside suppliers who may not be Year 2000 compliant. Depending on the extent and duration of the business interruption resulting from non-compliant Year 2000 systems, such interruption could have a material adverse effect on the Company's financial condition and results of operations.

Liquidity and Capital Resources

As of September 30, 1999, the Company had working capital of approximately $5.8 million and cash, cash equivalents and investments totaling approximately $21.8 million. The Company generated positive cash flows from operating activities of approximately $4.4 million in fiscal 1999, $2.1 million in fiscal 1998, and $0.5 million in fiscal 1997. The increase in cash flow in fiscal 1999 was primarily due to the increased net income generated during the year.

The significant increase in investing activities over the last two years was primarily due to the activity in the Company's available-for-sale investment portfolio as managed by an independent investment manager. SurModics' investment policy requires investments with high-credit-quality issuers and limits the amount of credit exposure to any one issuer. The Company's investments principally consist of U.S. government and government agency obligations and investment grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are three years or less. A 10% increase in interest rates would result in an approximate $150,000 decrease in the fair value of the Company's available-for-sale securities as of September 30, 1999, but no material impact on the results of operations or cash flows. SurModics does not use derivative instruments in its investment portfolio.

The increase in purchases of property and equipment in fiscal 1999 was primarily due to the Company's purchase of the land and building it currently occupies (which includes additional space for expansion) for approximately $3.2 million. The most significant financing activity over the last three years was the completion of the initial public offering of 2.3 million shares of Common Stock in March 1998, which generated proceeds to the Company of approximately $15.5 million, net of related offering expenses. The exercise of stock options generated an additional $1.3 million of cash during fiscal 1999.

As of September 30, 1999, the Company had no debt, nor did it have any credit agreements. The Company believes that its existing capital resources will be adequate to fund the Company's operations into the foreseeable future.

Forward-Looking Statements

Certain statements contained in this Annual Report and other written and oral statements made from time to time by the Company do not relate strictly to historical or current facts. As such, they are considered "forward-looking statements" which provide current expectations or forecasts of future events. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Reform Act of 1995. Such statements can be identified by the use of terminology such as "anticipate," "believe," "estimate," "expect," "intend," "may," "could," "possible," "plan," "will," "forecast," and similar words or expressions. The Company's forward-looking statements generally relate to its growth strategy, financial results, product development programs, sales efforts, and Year 2000 compliance. One must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions. Consequently, no forward-looking statement can be guaranteed and actual results may vary materially. The Company undertakes no obligation to update any forward-looking statement.

Although it is not possible to create a comprehensive list of all factors that may cause actual results to differ from the Company's forward-looking statements, such factors include, among others, (i) the trend of consolidation in the medical device industry, resulting in more significant, complex and long-term contracts than in the past and potentially greater pricing pressures; (ii) the Company's ability to attract new licensees and to enter into agreements for additional product applications with existing licensees, and the willingness of potential customers to sign license agreements under the terms offered by the Company; (iii) the success of existing licensees in selling products incorporating SurModics' technology and the timing of new product introductions by licensees; (iv) the difficulties and uncertainties associated with the lengthy and costly new product development and foreign and domestic regulatory approval processes, such as delays, difficulties or failures in achieving acceptable clinical results or obtaining foreign or FDA marketing clearances, which may result in lost market opportunities or postpone or preclude product commercialization by licensees; (v) efficacy or safety concerns with respect to products marketed by SurModics and its licensees, whether scientifically justified or not, that may lead to product recalls, withdrawals or declining sales; (vi) the development of new products or technologies by competitors, technological obsolescence and other changes in competitive factors; (vii) the Company's ability to successfully respond to Year 2000 issues, which depends, in part, on the availability of personnel, the Company's ability to identify and resolve issues, both foreseen and unforeseen, and the readiness of third parties to resolve their issues; and (viii) economic factors over which the Company has no control, including changes in inflation and consumer confidence. Investors are advised to consult any further disclosures by the Company on this subject in its filings with the Securities and Exchange Commission.

SurModics, Inc.

Balance Sheets

As of September 30	1999	1998
Assets		
Current Assets		
Cash and cash equivalents	$ 1,975,188	$ 1,343,561
Short-term investments	3,947,273	3,526,493
Accounts receivable, net of allowance of $40,000 and $35,000	1,433,328	1,056,710
Inventories, net	458,888	379,946
Prepaids and other	259,403	255,456
Total current assets	8,074,080	6,562,166
Property and Equipment, net	5,275,165	1,239,548
Long-Term Investments	15,916,538	16,248,914
Deferred Tax Assets	2,465,000	—
Other Assets, net	227,504	254,361
	$31,958,287	$24,304,989
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	$ 710,363	$ 304,706
Accrued liabilities–		
Compensation	783,271	615,264
Other	477,351	334,904
Deferred revenues	268,283	227,725
Total current liabilities	2,239,268	1,482,599
Deferred Revenues, less current portion	—	124,231
Total liabilities	2,239,268	1,606,830
Commitments and Contingencies (Note 6)		
Stockholders' Equity		
Series A Preferred Stock- $.05 par value, 150,000 shares authorized; no shares issued or outstanding	—	—
Common Stock- $.05 par value, 15,000,000 shares authorized; 7,701,921 and 7,214,085 shares issued and outstanding	385,096	360,704
Additional paid-in capital	32,008,996	28,934,732
Unearned compensation	(267,157)	(170,335)
Stock purchase notes receivable	(58,273)	(182,273)
Accumulated other comprehensive income (loss)	(186,502)	278,244
Accumulated deficit	(2,163,141)	(6,522,913)
Total stockholders' equity	29,719,019	22,698,159
	$31,958,287	$24,304,989

The accompanying notes are an integral part of these balance sheets.

SurModics, Inc.

Statements of Operations

For the Years Ended September 30	1999	1998	1997
Revenues			
Royalties	$ 6,670,153	$4,782,626	$2,913,119
License fees	645,000	222,500	540,000
Product sales	4,135,970	2,797,647	2,158,572
Research and development	2,042,417	1,975,888	1,970,174
Total revenues	13,493,540	9,778,661	7,581,865
Operating Costs and Expenses			
Product	1,510,582	1,193,178	1,431,675
Research and development	5,247,647	4,521,689	3,597,061
Sales and marketing	1,768,578	1,419,028	1,098,316
General and administrative	2,547,716	1,696,741	1,417,524
Total operating costs and expenses	11,074,523	8,830,636	7,544,576
Income from Operations	2,419,017	948,025	37,289
Other Income			
Investment income and other, net	1,068,861	698,193	209,204
Gain on sale of investments	88,599	27,634	—
Other income, net	1,157,460	725,827	209,204
Net Income Before Income Taxes	3,576,477	1,673,852	246,493
Provision for (Benefit from) Income Taxes	(783,295)	37,220	10,820
Net Income	$ 4,359,772	$ 1,636,632	$ 235,673
Net Income per Share			
Basic	$ .59	$ .26	$ .05
Diluted	$ .54	$ .24	$ .04
Weighted Average Shares Outstanding			
Basic	7,354,013	6,224,362	4,853,558
Dilutive effect of outstanding stock options	688,064	574,271	531,780
Diluted	8,042,077	6,798,633	5,385,338

The accompanying notes are an integral part of these financial statements.

SurModics, Inc.

Statements of Stockholders' Equity

For the Years Ended September 30, 1999, 1998, and 1997

	Convertible Preferred Stock		Common Stock	
	Shares	Amount	Shares	Amount
Balance, September 30, 1996	376,828	$ 18,841	3,311,480	$165,576
Components of comprehensive income:				
Net income	—	—	—	—
Change in unrealized gain on available-for-sale securities	—	—	—	—
Total comprehensive income				
Common stock options exercised	—	—	45,388	2,268
Restricted stock granted	—	—	44,000	2,200
Amortization of unearned compensation	—	—	—	—
Balance, September 30, 1997	376,828	18,841	3,400,868	170,044
Components of comprehensive income:				
Net income	—	—	—	—
Change in unrealized gain on available-for-sale securities	—	—	—	—
Total comprehensive income				
Common stock options exercised	—	—	25,905	1,296
Conversion of preferred stock to common stock	(376,828)	(18,841)	1,507,312	75,364
Issuance of common stock	—	—	2,300,000	115,000
Restricted stock activity	—	—	(20,000)	(1,000)
Net loan activity	—	—	—	—
Amortization of unearned compensation	—	—	—	—
Balance, September 30, 1998	—	—	7,214,085	360,704
Components of comprehensive income:				
Net income	—	—	—	—
Change in unrealized gain (loss) on available-for-sale securities	—	—	—	—
Total comprehensive income				
Common stock options exercised, net	—	—	482,777	24,139
Tax benefit from exercise of stock options	—	—	—	—
Restricted stock activity	—	—	8,500	425
Net loan activity	—	—	(3,441)	(172)
Amortization of unearned compensation	—	—	—	—
Balance, September 30, 1999	—	$ —	7,701,921	$385,096

The accompanying notes are an integral part of these financial statements.

Additional Paid-In Capital	Unearned Compensation	Stock Purchase Notes Receivable	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders' Equity
$13,093,961	$(142,720)	$ —	$ —	$(8,395,218)	$ 4,740,440
—	—	—	—	235,673	235,673
—	—	—	—	—	—
					235,673
179,904	—	(160,000)	—	—	22,172
217,800	(220,000)	—	—	—	—
—	103,720	—	—	—	103,720
13,491,665	(259,000)	(160,000)	—	(8,159,545)	5,102,005
—	—	—	—	1,636,632	1,636,632
—	—	—	278,244	—	278,244
					1,914,877
111,988	—	—	—	—	113,284
(56,523)	—	—	—	—	—
15,406,102	—	—	—	—	15,521,102
(18,500)	19,500	—	—	—	—
—	—	(22,273)	—	—	(22,273)
—	69,165	—	—	—	69,165
28,934,732	(170,335)	(182,273)	278,244	(6,522,913)	22,698,159
—	—	—	—	4,359,772	4,359,772
—	—	—	(464,746)	—	(464,746)
					3,895,026
1,309,787	—	—	—	—	1,333,926
1,650,000	—	—	—	—	1,650,000
170,305	(170,730)	—	—	—	—
(55,828)	—	124,000	—	—	68,000
—	73,908	—	—	—	73,908
$32,008,996	$(267,157)	$ (58,273)	$(186,502)	$(2,163,141)	$29,719,019

SurModics, Inc.

Statements of Cash Flows

For the Years Ended September 30	1999	1998	1997
Operating Activities			
Net income	$ 4,359,772	$ 1,636,632	$ 235,673
Adjustments to reconcile net income to net cash provided by operating activities—			
Depreciation and amortization	708,937	617,536	460,039
Gain on sale of investments	(88,599)	(27,634)	—
Amortization of unearned compensation, net	73,908	69,165	103,720
Change in deferred rent	(30,481)	(17,742)	(11,104)
Change in deferred tax	(815,000)	—	—
Change in assets and liabilities:			
Accounts receivable	(376,618)	(134,244)	(294,647)
Inventories	(78,942)	(115,938)	(3,240)
Accounts payable and accrued liabilities	716,111	481,739	446,729
Deferred revenue	(53,192)	(205,418)	(393,416)
Prepaids and other	(3,947)	(181,332)	(12,701)
Net cash provided by operating activities	4,411,949	2,122,764	531,053
Investing Activities			
Purchases of property and equipment, net	(4,720,703)	(775,402)	(298,388)
Purchases of available-for-sale investments	(24,436,386)	(33,595,043)	(3,923,184)
Sales/maturities of available-for-sale investments	23,971,835	17,455,608	2,425,000
Repayment (issuance) of stock purchase notes receivable	68,000	(22,273)	—
Other	3,006	31,897	(277,935)
Net cash used in investing activities	(5,114,248)	(16,905,213)	(2,074,507)
Financing Activities			
Issuance of common stock, net of offering costs	1,333,926	15,634,386	22,172
Net cash provided by financing activities	1,333,926	15,634,386	22,172
Net increase (decrease) in cash and cash equivalents	631,627	851,937	(1,521,282)
Cash and Cash Equivalents			
Beginning of year	1,343,561	491,624	2,012,906
End of year	$ 1,975,188	$ 1,343,561	$ 491,624
Supplemental Cash Flow Information			
Interest paid	$ —	$ —	$ 1,700
Non-cash investing and financing activity—			
Issuance of stock purchase notes receivable from exercised stock options	$ —	$ —	$ 160,000
Tax benefit from exercise of stock options	$ 1,650,000	$ —	$ —

The accompanying notes are an integral part of these financial statements.

❶ Description

SurModics, Inc. (the Company) develops, manufactures, and markets innovative surface modification solutions to the medical device industry. The Company also produces and markets a line of proprietary biomolecule stabilization products. Its revenues are derived from the following: fees from licensing its patented technology to customers; royalties received from licensees; the sale of photoreactive chemical compounds to licensees and stabilization products to the diagnostic industry; and research and development fees generated on projects for commercial customers and government grants. The Company markets its products through a direct sales force primarily in the United States and some international markets.

In March 1998, the Company completed an initial public offering of 2.3 million shares of Common Stock, generating proceeds to the Company of approximately $15.5 million, net of offering expenses.

❷ Summary of Significant Accounting Policies

Cash and Cash Equivalents

Cash and cash equivalents consist principally of money market instruments with original maturities of three months or less and are stated at cost which approximates fair value.

Investments

Investments consist principally of U.S. government and government agency obligations and corporate debt securities and are classified as available-for-sale as of September 30, 1999 and 1998. Available-for-sale investments are reported at fair value with unrealized gains and losses excluded from operations and reported as a separate component of stockholders' equity, except for other-than-temporary impairments, which are reported as a charge to current operations and result in a new cost basis for the investment.

The amortized cost, unrealized holding gains and losses, and fair value of investments as of September 30, 1999 and 1998 were as follows:

	Amortized Cost	*Unrealized Gains*	*Unrealized Losses*	*Fair Value*
	September 30, 1999			
U.S. government obligations	$10,422,826	$ 225	$(133,645)	$10,289,406
Corporate bonds	3,457,977	—	(4,521)	3,453,455
Mortgage-backed securities	2,682,899	2,742	(28,455)	2,657,186
Asset-backed securities	2,309,677	447	(7,854)	2,302,271
Municipal bonds	1,176,934	726	(16,167)	1,161,493
Total	$ 20,050,313	$ 4,140	$(190,642)	$19,863,811
	September 30, 1998			
U.S. government obligations	$12,178,480	$243,326	$ —	$12,421,806
Corporate bonds	5,638,397	5,755	(724)	5,643,428
Mortgage-backed securities	1,286,413	28,784	(3,071)	1,312,126
Municipal bonds	200,000	4,174	—	204,174
Other debt securities	193,873	—	—	193,873
Total	$19,497,163	$282,039	$ (3,795)	$19,775,407

The amortized cost and fair value of investments by contractual maturity at September 30, 1999, were as follows:

	Amortized Cost	*Fair Value*
Debt securities due within:		
One year	$ 3,947,273	$ 3,947,273
One to five years	14,534,234	14,356,330
Five years or more	1,568,806	1,560,208
Total	$ 20,050,313	$19,863,811

Inventories

Inventories are stated at the lower of cost or market using the specific identification method and include direct labor, materials, and overhead. Inventories consisted of the following components as of September 30:

	1999	1998
Raw materials	$ 179,205	$ 107,522
Finished products	279,683	272,424
Total	$ 458,888	$ 379,946

Property and Equipment

Property and equipment are stated at cost and are depreciated using the straight-line method over 3 to 20 years, the estimated useful lives of the assets. Upon completion, construction-in-progress will begin depreciation over the estimated useful lives of the assets.

	1999	1998
Laboratory fixtures and equipment	$ 3,009,379	$ 2,313,236
Office furniture and equipment	1,383,197	1,002,210
Building and improvements	4,532,713	1,323,387
Construction-in-progress	408,362	—
Less-Accumulated depreciation and amortization	(4,058,486)	(3,399,285)
Property and equipment, net	$ 5,275,165	$ 1,239,548

Other Assets

Other assets consist principally of patents, which are amortized over 7 to 12 years. Accumulated amortization was $64,000 and $40,000 as of September 30, 1999 and 1998, respectively.

Revenue Recognition

Royalties are recognized as third-party licensees report sales of the licensed product or as minimum royalties become due. Initial nonrefundable license fees are recognized as revenue upon execution of the license agreement and payment of the fee. Certain nonrefundable license and research and development fees are recoverable by the licensees as offsets against a percentage of future earned royalties.

Revenues on product sales are recognized as products are shipped and for research and development as performance progresses under the applicable contract.

Cash received prior to performance is recorded as deferred revenues in the accompanying balance sheets.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Ultimate results could differ from those estimates.

Reclassification

Certain 1998 and 1997 amounts in the accompanying financial statements have been reclassified to conform to the 1999 presentation. These reclassifications had no effect on previously reported net income or stockholders' equity.

New Accounting Pronouncements

SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. Based on its current operations, the Company anticipates that the adoption of SFAS No. 133 in fiscal 2002 will not have a significant impact on its financial statements.

3 Stockholders' Equity

Authorized Shares

The authorized capital stock of the Company consists of 20,000,000 shares of capital stock, $.05 per share par value, of which 15,000,000 shares are Common Stock, 150,000 are Series A Preferred Stock and 4,850,000 shares are undesignated. The Series A Preferred Stock was designated by board action in conjunction with a Shareholder Rights Plan and has certain preferential voting, liquidation and dividend rights as follows:

a. Each share of Series A Preferred Stock is entitled to 100 votes on all matters submitted to a vote of the stockholders of the Company.

b. In the event of liquidation of the Company, the holders of these shares are entitled to receive the greater of $100 per share or 100 times the per share amount to be distributed to holders of shares of Common Stock.

c. Preferred stockholders are entitled to receive a quarterly dividend of the greater of $1.00 per share or 100 times the per share amount of any dividend declared on the Common Stock.

Shareholder Rights Plan

In April 1999, the Company adopted a Shareholder Rights Plan (the "Rights Plan"). Under the Rights Plan, the Board of Directors declared a dividend to stockholders of record on April 5, 1999 of one preferred stock purchase right (the "Rights") for each outstanding share of Common Stock. Each right entitles the holder to purchase one one-hundredth of a share of Series A Preferred Stock from the Company. The Rights issued under the plan will only become exercisable by stockholders, other than a potential acquirer, following an acquisition by the acquirer (without prior approval of the Company's Board of Directors) of 15% or more of the Company's Common Stock, or the announcement of a tender offer for 15% or more of the Common Stock. The Rights will expire in April 2009.

Restricted Stock Awards

The Company has entered into restricted stock agreements with certain key employees, covering the issuance of Common Stock (the Restricted Stock). The Restricted Stock will be released to the key employees if they are employed by the Company at the end of a five-year waiting period. Unearned compensation has been recognized for the estimated fair value of the applicable common shares, reflected as a reduction of stockholders' equity, and is being charged to operations over the five-year waiting period.

Transactions in restricted stock were as follows:

Outstanding at September 30, 1996	82,400
Granted	44,000
Outstanding at September 30, 1997	126,400
Granted	4,000
Canceled	(24,000)
Exercised	(42,400)
Outstanding at September 30, 1998	64,000
Granted	12,500
Canceled	(4,000)
Outstanding at September 30, 1999	72,500

Stock Purchase Notes Receivable

The Company established a loan program during fiscal 1997 to assist employees in purchasing shares of the Company's stock. The loans are collateralized by the employees' purchased shares and require annual interest payments at a rate equal to prime at the date of issuance (8.5%) with principal and any unpaid interest due at the earlier of five years after the date of issuance or three months after termination of employment. The loans may be repaid in either cash or mature shares held by the employee. No further loans are being granted under this program.

4 Stock-Based Compensation Plan

Under the Company's 1997 Incentive Stock Option Plan (the Plan), 600,000 shares of Common Stock were reserved for issuance to employees and officers. The Plan requires that the option price per share must be at least 100% of the fair market value of the Common Stock on the date of the grant of the option or 110% with respect to optionees who own more than 10% of the total combined voting power of all classes of stock. Options expire in five to seven years or upon termination of employment and are exercisable at a rate of 20% per year from the date of grant or 20% per year commencing one year after the date of grant. In addition, options representing a total of 195,350 shares remain outstanding from the Company's 1987 Incentive Stock Option Plan which was replaced by the 1997 Plan.

Under the Company's Nonqualified Stock Option Plan, 972,240 shares of Common Stock were reserved for issuance to outside directors, employees and officers. The options are granted at fair market value. Options expire in seven to ten years and are exercisable at a rate of 20% per year from the date of grant or 20% per year commencing two years after the date of grant.

As of September 30, 1999, there were 420,380 additional shares available for grant under the stock plans. Information regarding stock options under all plans is summarized as follows:

The options outstanding at September 30, 1999 have exercise prices ranging between $5.00 and $16.75, with a weighted average exercise price of $7.53 and a weighted average remaining contractual life of 5.33 years.

The fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1999, 1998, and 1997, respectively: risk-free interest rates of 6.01%, 5.00%, and 6.24%; expected lives of 7.3, 6.4, and 5.6 years; and expected volatility of 71%, 73%, and 73%.

The Company accounts for the options under APB Opinion No. 25, under which no compensation cost has been recognized. Had compensation cost for the options been determined consistent with SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income would have been the following pro forma amounts for the years ended September 30:

	1999	1998	1997
Net income:			
As reported	$4,359,772	$1,636,632	$235,673
Pro forma	$4,119,529	$1,506,492	$155,541
Net income per share:			
As reported	$ .54	$ .24	$ .04
Pro forma	$ .51	$ .22	$ .03

Because the SFAS No. 123 method of accounting has not been applied to options granted prior to October 1, 1995, the resulting pro forma information may not be representative of that to be expected in future periods.

	1999		1998		1997	
Options	*Shares*	*Weighted Average Exercise Price*	*Shares*	*Weighted Average Exercise Price*	*Shares*	*Weighted Average Exercise Price*
Outstanding, beginning of year	1,269,640	$ 4.86	1,204,800	$ 4.60	1,163,600	$ 4.52
Granted	183,700	15.73	137,300	6.98	157,400	5.00
Exercised	(541,030)	4.16	(26,220)	4.47	(45,388)	4.01
Canceled	(38,020)	5.82	(46,240)	4.78	(70,812)	4.51
Outstanding, end of year	874,290	$ 7.53	1,269,640	$ 4.86	1,204,800	$ 4.60
Exercisable, end of year	439,410	$ 5.18	757,860	$ 4.49	589,320	$ 4.42
Weighted average fair value of options granted	$ 11.47		$ 4.91		$ 3.30	

5 Income Taxes

The Company utilizes the liability method to account for income taxes. Deferred taxes are based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Reserves are established on the basis of expected ability to utilize the deferred assets. During fiscal 1999, management concluded that the Company would generate sufficient taxable income in the future to utilize all of the previously unrecognized tax net operating loss ("NOL") carryforwards prior to their expiration.

The deferred income tax provision (benefit) reflects the net change during the year in deferred tax assets and liabilities. Income taxes in the accompanying statements of operations for the years ended September 30 were as follows:

	1999	1998	1997
Current provision:			
Federal	$ —	$33,477	$ 356
State and foreign	16,705	3,743	10,464
Total current provision	16,705	37,220	10,820
Deferred benefit:			
Federal	(735,000)	—	—
State	(65,000)	—	—
Total deferred benefit	(800,000)	—	—
Total provision (benefit)	$ (783,295)	$37,220	$10,820

The reconciliation of the difference between amounts calculated at the statutory federal and state tax rates and the Company's effective tax rate was as follows:

	1999	1998	1997
Amount at statutory federal and state income tax rates	$ 1,323,000	$ 621,000	$ 93,000
Change due to:			
Reversal of tax valuation allowance	(2,466,000)	—	—
Utilization of net operating losses	—	(619,000)	(91,000)
Rate difference for deferred tax assets	180,000	—	—
Other	179,705	35,220	8,820
Income tax provision (benefit)	$ (783,295)	$ 37,220	$ 10,820

The components of deferred income taxes consisted of the following as of September 30:

	1999	1998
Net operating loss carryforwards	$2,048,000	$ 1,875,000
Capital loss carryforwards	149,000	197,000
Depreciation	265,000	247,000
Other	152,000	296,000
Total deferred tax assets	2,614,000	2,615,000
Less–valuation allowance	(149,000)	(2,615,000)
Net deferred tax assets	$2,465,000	$ —

These deferred tax assets result from differences in the recognition of transactions for income tax and financial reporting purposes. The Company's NOL carryforwards of approximately $5.6 million at September 30, 1999 expire in varying amounts through 2014. The Company also has $400,000 of capital loss carryforwards at September 30, 1999, which expire in 2001, on which a 100% valuation allowance has been established.

6 Commitments and Contingencies

Government Contracts

Under provisions contained in the government research contracts, representatives of the government agencies have the right to access and review the Company's underlying records of contract costs. The government retains the right to reject expenses considered unallowable under the terms of the contract. The Defense Contract Audit Agency has reviewed the contracts through 1989. In the opinion of management, future amounts due, if any, with respect to open contract years will not have a material impact on the financial position or results of operations of the Company.

Construction Commitments

The Company has entered into agreements with certain contractors for the construction of additional laboratory and office space totaling approximately $1.0 million, of which $408,000 was recorded in construction-in-progress as of September 30, 1999. This construction is expected to be completed in the first quarter of fiscal 2000.

7 Defined Contribution Plan

The Company has a 401(k) retirement and savings plan for the benefit of qualified employees. Under the plan, qualified employees may elect to defer up to 20% of their compensation, subject to a maximum limit determined by the Internal Revenue Service. Beginning October 1, 1998, the Company matched 50% of each dollar of the first six percent of the tax deferral elected by each employee. In prior years, the Company made discretionary contributions to the plan subject to the approval of the Board of Directors. Company contributions totaling $122,000, $117,000 and $86,000 have been charged to operations for the years ended September 30, 1999, 1998, and 1997, respectively.

8 Operating Segments (Dollars in thousands)

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

The Company manages its business on the basis of three business segments: licensing, manufacturing, and research and development. The licensing segment includes all license fees and royalty revenues generated from the transfer of the Company's technology. No expenses are allocated to the licensing segment. The manufacturing segment includes revenue from the sale of PhotoLink reagents, stabilization products, and DNA slides. The expenses include all production costs, including analytical costs to verify quality of the finished products and certain technical support. The research and development segment includes the revenue generated from development projects for commercial customers and research revenues received from government grants. The expenses include all costs of the Company's technical personnel. Corporate includes all administrative, sales and marketing costs of the Company. These costs, along with interest income and income taxes, are not allocated to the other business segments. The Company's assets are not reviewed by business segment. The accounting policies for segment reporting are the same as for the Company as a whole (see Note 2).

	Licensing	Manufacturing	Research & Development	Corporate	Consolidated
Year Ended September 30, 1999					
Revenues:					
PhotoLink	$4,557	$1,876	$ 1,122	$ —	$7,555
Diagnostic	2,758	—	—	—	2,758
Stabilization	—	2,261	—	—	2,261
Government	—	—	920	—	920
Total revenues	7,315	4,137	2,042	—	13,494
Operating costs and expenses	—	1,511	5,248	4,316	11,075
Operating income (loss)	7,315	2,626	(3,206)	(4,316)	2,419
Other income				1,158	1,158
Income tax benefit				783	783
Net income					$4,360
Year Ended September 30, 1998					
Revenues:					
PhotoLink	$2,427	$ 794	$ 891	$ —	$4,112
Diagnostic	2,578	—	—	—	2,578
Stabilization	—	2,004	—	—	2,004
Government	—	—	1,085	—	1,085
Total revenues	5,005	2,798	1,976	—	9,779
Operating costs and expenses	—	1,193	4,522	3,116	8,831
Operating income (loss)	5,005	1,605	(2,546)	(3,116)	948
Other income				726	726
Income tax expense				(37)	(37)
Net income					$1,637
Year Ended September 30, 1997					
Revenues:					
PhotoLink	$1,988	$ 494	$ 742	$ —	$3,224
Diagnostic	1,465	—	—	—	1,465
Stabilization	—	1,665	—	—	1,665
Government	—	—	1,228	—	1,228
Total revenues	3,453	2,159	1,970	—	7,582
Operating costs and expenses	—	1,432	3,597	2,516	7,545
Operating income (loss)	3,453	727	(1,627)	(2,516)	37
Other income				209	209
Income tax expense				(10)	(10)
Net income					$ 236

Major Customers

Revenues from customers that exceed 10% of total revenues were as follows for the years ended September 30:

	1999	1998	1997
U.S. government	7%	11%	16%
Company A	20%	26%	21%
Company B	12%	2%	—

Revenues from the U.S. government are derived from the research and development segment. Revenues from Company A are derived from the licensing segment. Revenues from Company B are derived from all three segments.

Geographic Revenue

Geographic revenues were as follows for the years ended September 30:

	1999	1998	1997
Domestic	87%	90%	93%
Foreign	13%	10%	7%

9 Quarterly Financial Data

(Unaudited, in thousands except per share data)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Fiscal 1999				
Revenues	$2,639	$3,308	$3,685	$3,862
Income from operations	265	591	755	808
Net income	925	1,105	1,214	1,117
Net income per share:				
Basic	.13	.15	.16	.15
Diluted	.12	.14	.15	.14
Fiscal 1998				
Revenues	$1,909	$2,579	$2,672	$2,619
Income from operations	101	288	330	229
Net income	151	376	566	544
Net income per share:				
Basic	.03	.07	.08	.08
Diluted	.03	.06	.07	.07

Report of Independent Public Accountants

To SurModics, Inc.:

We have audited the accompanying balance sheets of SurModics, Inc. (a Minnesota corporation) as of September 30, 1999 and 1998, and the related statements of operations, stockholders' equity and cash flows for each of the three years in the period ended September 30, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SurModics, Inc. as of September 30, 1999 and 1998, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 1999, in conformity with generally accepted accounting principles.

ARTHUR ANDERSEN LLP

Minneapolis, Minnesota,
October 27, 1999

Report of Management

The management of SurModics, Inc. is responsible for the integrity of the financial statements and other financial information contained in this annual report. The financial statements and related information were prepared in accordance with generally accepted accounting principles and include some amounts that are based on management's best estimates and judgments.

To meet its responsibility, management depends on its accounting systems and related internal accounting controls. These systems are designed to provide reasonable assurance, at an appropriate cost, that financial records are reliable for use in preparing financial statements and that assets are safeguarded. Qualified personnel throughout the organization maintain and monitor these internal accounting controls on an ongoing basis.

The Company's financial statements have been audited by Arthur Andersen LLP, independent public accountants, whose report thereon was based on audits conducted in accordance with generally accepted auditing standards. As part of their audits, the independent public accountants consider the Company's system of internal accounting controls for the purpose of determining the nature, scope and timing of audit tests to be performed.

The Audit Committee of the Board of Directors, composed entirely of directors who are not employees of the Company, meets at least twice per year with the Company's independent public accountants, as well as management, to review accounting, auditing, internal control, financial reporting and other matters.

Dale R. Olseth
Chairman and Chief Executive Officer

Stephen C. Hathaway
Vice President and Chief Financial Officer

Corporate Information

Board of Directors

Dale R. Olseth
Chairman and
Chief Executive Officer
SurModics, Inc.

Donald S. Fredrickson, M.D. (1)
President and Chief Executive Officer
D.S. Fredrickson Associates, Inc.

James J. Grierson (2)
Retired Vice President of
Business Development
Honeywell, Inc.

Patrick E. Guire, Ph.D.
Senior Vice President and
Chief Scientific Officer
SurModics, Inc.

Kenneth H. Keller, Ph.D. (1)(2)
Professor of Science and
Technology Policy
Hubert H. Humphrey Institute
of Public Affairs
University of Minnesota

David A. Koch (1)(2)
Chairman of the Board
Graco Inc.

Kendrick B. Melrose (1)(2)
Chairman of the Board and
Chief Executive Officer
The Toro Company

(1) Member of the Compensation Committee
(2) Member of the Audit Committee

Officers

Dale R. Olseth
Chairman and
Chief Executive Officer

James C. Powell
President and
Chief Operating Officer

Richard C. Carlson
Vice President of Marketing
and Sales

Walter H. Diers, Jr.
Vice President of
Corporate Development

Lise W. Duran, Ph.D.
Vice President of
Product Development

Patrick E. Guire, Ph.D.
Senior Vice President and
Chief Scientific Officer

Stephen C. Hathaway
Vice President and
Chief Financial Officer

Marie J. Versen
Vice President of Quality
Management and Regulatory
Compliance

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Suite 301
Milwaukee, Wisconsin 53212
(800) 637-7549

Legal Counsel
Fredrikson & Byron, P.A.
Minneapolis, Minnesota

Independent Public Accountants
Arthur Andersen LLP
Minneapolis, Minnesota

Investor Relations Counsel
Padilla Speer Beardsley Inc.
Minneapolis, Minnesota

Annual Meeting

The annual meeting of SurModics, Inc. shareholders will take place on Monday, January 24, 2000, beginning at 4:00 p.m. at the Hotel Sofitel in Bloomington, Minnesota.

Information Requests

Shareholders, securities analysts and investors seeking additional information about the Company should contact Stephen C. Hathaway, Vice President and Chief Financial Officer, at (612) 829-2700.

Requests for copies of news releases describing significant company events, quarterly financial results and Form 10-KSB and Form 10-QSB Reports as filed with the Securities and Exchange Commission may be obtained from Investor Relations at the Company's principal address.

You may also learn more about SurModics at our website: www.surmodics.com.

Stock Listing and Price History

SurModics' stock is traded on the Nasdaq National Market under the symbol "SRDX." On March 4, 1998, the Company completed its initial public offering of Common Stock at a price of $7.50 per share. The following table sets forth the range of high and low closing sale prices for the Company's Common Stock, as reported by Nasdaq:

Fiscal Quarter Ended	*High*	*Low*
Sept. 30, 1999	$18 3/4	$14 1/8
June 30, 1999	$16 3/4	$12 3/4
March 31, 1999	$14 1/2	$ 9 7/8
Dec. 31, 1998	$15 1/2	$ 6 1/2
Sept. 30, 1998	$14 1/8	$ 7 3/16
June 30, 1998	$11 3/4	$ 8 1/4
March 31, 1998	$ 9	$ 7 3/4
Dec. 31, 1997	N/A	N/A

According to the records of the Company's transfer agent, as of November 29, 1999, the Company had 227 holders of record of the Company's Common Stock (excluding beneficial owners of shares registered in nominee or street name).

The Company has never paid any cash dividends on its Common Stock and does not anticipate doing so in the foreseeable future.

BEYOND

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