

2005 Annual Report and Shareholder Letter

To Our Shareholders:

I am pleased to report another impressive year of financial and operational achievements for fiscal year 2005.

In last year's letter to you we reflected on the significant strategic and operational changes made through our business reorganization earlier in fiscal year 2004. These changes were designed to both improve our operating results by instilling a greater sense of urgency and more accountability through the newly formed business units, and accelerate our technology leadership by focusing on the creation and acquisition of value added technology. I am pleased to report that in fiscal year 2005 our organization made significant progress in both of these important areas aided by our new strategic direction and our entrepreneurial, customer focused and technology centered business units.

Delivering Operating Results That Matter Most

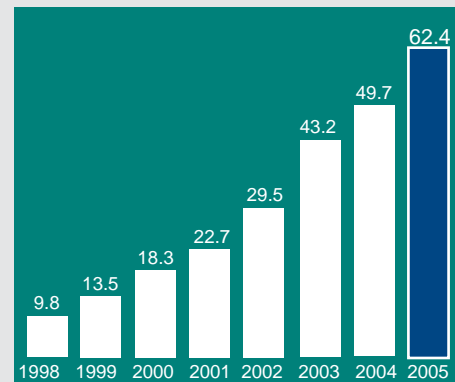
Strong Financial Results

Since our IPO, we have delivered record revenue for eight consecutive years and have demonstrated our proven leadership in surface modification and site specific drug delivery. We also produced many other highly successful fiscal year 2005 results including records for number of licenses signed with our customers, number of patent applications filed, and earnings before non-cash charges. Total revenue increased 25% to \$62.4 million, and excluding certain non-cash charges*, operating income increased 33% and net income was \$23.6 million, or \$1.27 per diluted share, up 34% from \$17.6 million, or \$0.99 per diluted share, in fiscal year 2004. Our operating margin increased to 57.3%.

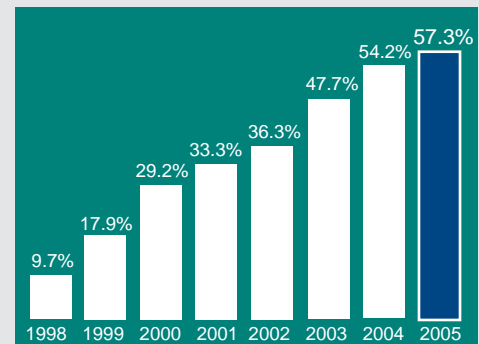
Strong CYPHER® Stent Results . . . But Our Diversification Strategy is Working

The CYPHER® Sirolimus-eluting Coronary Stent from Cordis Corporation, a Johnson & Johnson company, continues to benefit from a growing body of clinical data published in prestigious cardiology journals suggesting superior safety and efficacy. J&J reported the CYPHER stent's share of the U.S. market has grown to 46% for the quarter ended September 30, 2005, up from 35% in the year earlier period. We are pleased to be associated with the success of the CYPHER stent.

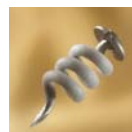
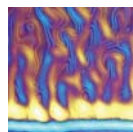
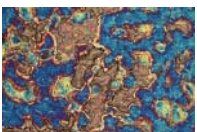
TOTAL REVENUE
(dollars in millions)

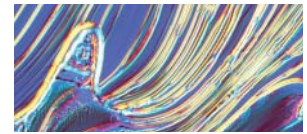
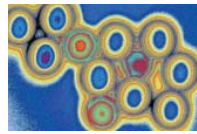
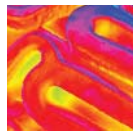


OPERATING MARGIN
(excluding certain charges)



DILUTED EPS
(excluding certain charges)





We are also aggressively diversifying our business. One measure of the progress we have made toward our diversification goals is the increasing percentage of non-Cordis related revenue. In fiscal year 2004, non-Cordis represented 48% of total revenue, but despite year-over-year growth in Cordis revenue, the non-Cordis contribution increased to 54% in 2005. Looking at it in another way, total revenue from Cordis grew 11% from fiscal year 2004 to fiscal year 2005, while non-Cordis revenue grew 41% during the same period.

We are focused on maintaining a balanced revenue stream by growing our customer base and portfolio of products and technologies. The breadth and depth of our pipeline is increasing, and products are expected from each of our distinct business units. At fiscal year end, 80 products utilizing SurModics technology were on the market generating royalty revenue, with 72 licensed products awaiting launch, and an additional 64 non-licensed opportunities in the pipeline. Our efforts to optimize the portfolio have made us even more confident in the revenue potential and partnering promise of the projects employing SurModics technology under development today.

Enhancing the Business Model

Throughout fiscal year 2005, we focused on execution and implementation of our seven point revenue growth strategy designed to maintain long-term sustainable growth by: (1) exploiting the convergence of drugs and devices, (2) capturing more elements of the value chain, (3) expanding the portfolio of technology offerings, (4) leveraging our technology in new markets, (5) efficiently managing our product portfolio, (6) expanding our distribution capabilities, and (7) putting the balance sheet to work. For example:

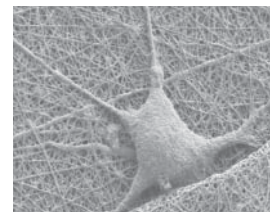
- The January acquisition of InnoRx, Inc. provided us with a platform technology, which in combination with our drug delivery polymers, provides the foundation for our new ophthalmology division. The InnoRx technology platform



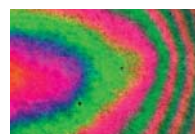
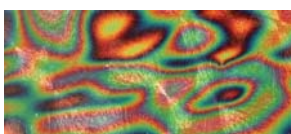
addresses two of the leading causes of blindness: age-related macular degeneration (AMD) and diabetic macular edema (DME). Industry experts anticipate this market will reach \$2.5 billion to \$7.0 billion within six years. Our **STRIDE** (Sustained Triamcinolone Release for Inhibition of Diabetic Macular Edema) Phase I clinical trial of the I-vation™ Intravitreal Implant was initiated in June, and we expect to have six-month follow-up data available in 2006. By delivering both the coating and device platform along with relevant clinical data to potential partners, we expect to capture more components of the value chain. We believe that doing so gives us the potential to dramatically increase the royalty rates we can earn.

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- In May, we entered into a joint development agreement with the Donaldson Company to improve cell culture performance by combining their nanofibers with our surface modification technology. Some industry experts estimate the targeted cell culture research market to be as large as \$100 million and the drug discovery high throughput screening market to total \$500 million. Because no FDA approval process is necessary for these products, we expect to be able to launch a new offering soon.



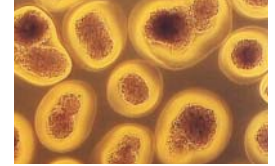
- We are leveraging multiple avenues to participate in the dynamic drug eluting stent (DES) market. Currently, we have three business units serving the cardiology field: Drug Delivery, Regenerative Technologies, and Hydrophilic Technologies. Our Drug Delivery unit offers eight polymers to provide site-specific controlled release drug delivery. Regenerative Technologies is introducing antithrombotic and pro-healing technologies into the market, which could play a significant role in future generations of





DES products. Hydrophilic Technologies offers advanced lubricity, hydrophilic coatings on DES delivery catheters. The experience gained during the development of our coating for the CYPHER stent, our strong track record and reputation, and our broad portfolio of technologies uniquely position us to exploit the convergence of drugs and devices.

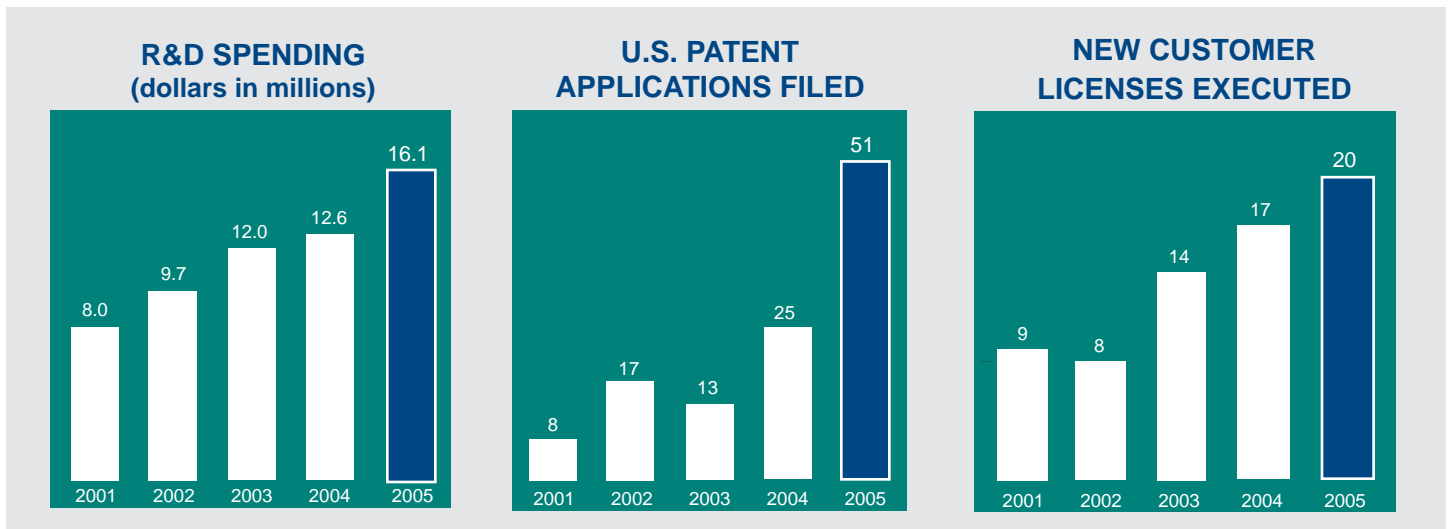
- Lastly, we are encouraged by the positive steps taken by Novocell to develop a potential treatment for diabetes. Novocell has received FDA approval of its IND application and expects to commence its first-in-man Phase I/II trial soon. Our equity investment in Novocell and the role our technology plays in their offering positions us to greatly benefit from a technology with the potential to revolutionize the treatment of diabetes.



Accelerating Our Technology Leadership

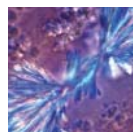
Increasing Our Investment in Research and Development

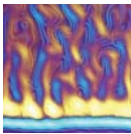
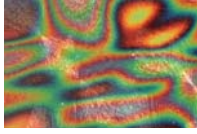
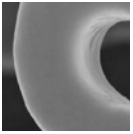
To keep our pipeline brimming with new technologies, we must remain deeply committed to R&D investment. We made significant investments in research and development to ensure that we stay on the cutting edge of science and technology. In fiscal year 2005, we dedicated \$16.1 million to R&D, a record amount representing 26% of revenue, and a 27% increase from the prior year period. As a result of this increased investment and to protect our innovations, we filed 51 new U.S. patent applications in fiscal year 2005, a record number for SurModics. As evidenced by our record number of customer licenses, we continue to develop technologies that are valued in the marketplace today.



Acquiring External Technologies

We also put our balance sheet to work to expand our pipeline and increase the value we bring to our partners and customers. I have already mentioned our acquisition of InnoRx – one that we believe has the potential to create value for years to come. In addition, we gained rights to several other exciting technologies, including our licensing of the Rutgers biodegradable polymers and our equity investments in OctoPlus and ThermoPeutiX. We are also very excited about our relationship with the University of Arizona and Dr. Stu Williams to develop a promising approach to address the problem of stent thrombosis through novel prohealing technology.





Delivering Sustainable, Long-Term Shareholder Value

As much as we are pleased with our results to date, SurModics remains committed to continually enhancing our market position. Innovation will continue to thrive at SurModics as our product development capabilities grow ever stronger – both in developing proprietary technology and working in collaboration with our customers. We believe our future at the forefront of the convergence of drugs and devices looks bright, and we will continue to make good use of the wealth of opportunities that are afforded to us as a result of our unique position in the market. The core tenets of innovation and integrity that have been part of our company for over a quarter century remain steadfast as our business continues to evolve and improve. We will continue to be a results-driven company that follows ethical business practices.

Our future at the forefront of the convergence of drugs and devices looks bright . . .

Our employees have worked hard to create our leadership position in the surface modification and drug delivery area, and I thank them for their dedication and commitment. I would also like to thank our customers and shareholders for their loyalty and support. I look forward to reporting additional achievements from SurModics throughout the year.

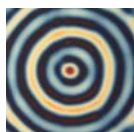
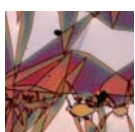
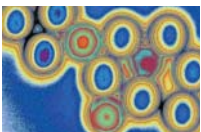
Bruce J Barclay
President and CEO



SurModics Corporate Officers: Standing (left to right): Charlie Olson, Paul Lopez, Greg Yung, Steve Keough, Phil Ankeny, Loren Miller, Doug Astry, Dave Wood. Seated: Aron Anderson, Bruce Barclay, Lise Duran.

* Non-cash charges for fiscal year 2005 included a \$30.3 million charge to write-off in-process research and development in connection with the acquisition of InnoRx in January 2005, and a \$2.5 million asset impairment charge related to the sale of our Bloomington, Minnesota facility in September 2005. Including these non-cash charges, operating income was \$3.0 million, and our net loss was \$(8.2) million, or \$(0.45) per diluted share. Fiscal year 2004 results included a non-cash asset impairment charge of \$16.5 million against the Bloomington facility. Including the charge, operating income was \$10.5 million, and net income was \$7.2 million, or \$0.41 per diluted share.

Forward-Looking Statements. Certain statements contained in this communication may be deemed to be forward-looking statements under federal securities laws, and SurModics intends that such forward-looking statements be subject to the safe harbor created thereby.



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