# 2006 Annual Report and Shareholder Letter

## To Our Shareholders:

*Fiscal 2006 was another successful year for SurModics. We achieved record financial results, and accomplished a number of significant operating milestones which strengthened our foundation for growth well into the future.*

We made tremendous strides delivering on the strategic initiatives outlined in last year's letter to you. Notably, our focus on diversification yielded a string of successes relating to new customer agreements, broadening our opportunities in existing markets and penetrating exciting new markets. We made excellent progress in enhancing our unique business model to "climb the value chain" and command greater value for our technologies. And, knowing that our leadership position must be earned every day, we made significant investments to strengthen our position as experts in the development of surface modification, biomaterials and drug delivery technologies, most notably in research and development.

Healthcare remains an attractive market, and SurModics is deeply committed to its mission of providing the world's foremost, innovative surface modification and drug delivery technologies and products to enhance the well-being of patients. The demand by our customers for new technologies and products has never been higher, and our accomplishments have earned us a growing reputation in the healthcare community. Our achievements this year would not have been possible without the dedication and hard work of our talented employees, and we are deeply grateful for their contributions. Looking forward to 2007, our entire organization remains committed to our mission and focused on continuing our track record of success.

## Financial Review

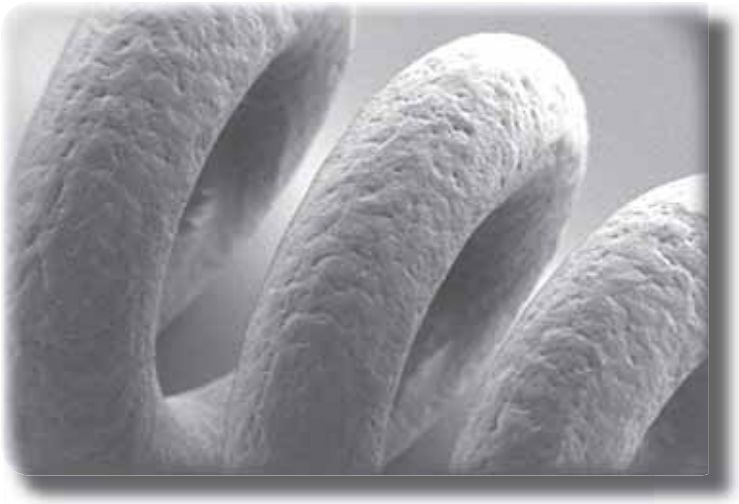
In fiscal 2006, SurModics achieved record revenue and earnings. We delivered record revenue from both Cordis and Non-Cordis sources, and record revenue in all three operating segments. The company's total revenue increased 12% to $69.9 million, helping drive a 15% increase in fiscal 2006 operating income*. Excluding certain non-cash charges*, net income increased 18% to $28.2 million, and diluted earnings per share increased 16% to $1.49. Both were records. Profitability continues to be excellent, as we produced an operating margin (excluding certain non-cash charges*) of 60%. In fiscal 2006 our cash flow was the strongest it has ever been. Our cash and investment balance at the end of the year stood at $106.6 million, a 45% increase from a year ago. We have no debt.

## Strategic Plan for Sustainable Growth

Our strategy is working, and these results are but one example of that. Additional highlights of our progress on key elements of our strategy include:

## Climbing the Value Chain

By providing multiple components of the final product, additional data demonstrating the potential utility of the product, or both, we believe we can enhance the royalty rates and licensing terms that SurModics earns on future product offerings. One application of "Climbing the Value Chain" is in ophthalmology, where our I-vation™ intravitreal implant serves as an enabling technology in the market for retinal disease. The I-vation implant combines the device from SurModics' ophthalmology division with one of our drug delivery polymers as a potential treatment for two of the leading causes of blindness – age-related macular degeneration (AMD) and diabetic macular edema (DME). In fiscal 2006, we completed enrollment of the first clinical trial with our first product, a Phase I study in patients with DME using I-vation™ TA – a version of our implant coated with a steroid called triamcinolone acetonide. We are pleased with the results from the six-month patient follow-up. The safety profile of our I-vation implant was exceptional. We are highly encouraged with the trend toward positive efficacy outcomes and that 100% of the patients with the implant maintained or improved their vision. Our ophthalmology division is very active, managing multiple paid feasibility and development programs evaluating both our drug delivery platforms and polymer matrix technologies. These projects are currently generating R&D revenue. Should they move forward to licenses, they could potentially drive significant R&D revenue, milestone payments and royalties. In addition, we granted Bausch & Lomb an exclusive license to patents relating to the use of Genistein in the treatment and prevention of retinal diseases.

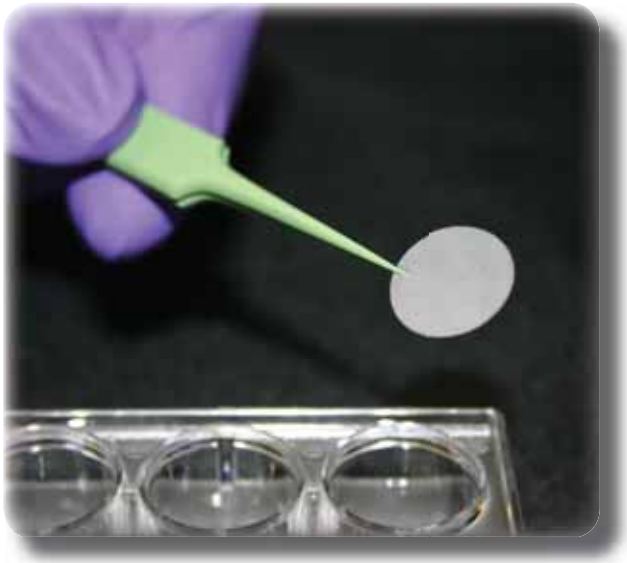


**Above:** Scanning electron microscopic image of an I-vation intravitreal implant coated with a SurModics drug-eluting polymer matrix. The coating is uniform and exhibits no cracking or peeling away from the surface.

*"Today, more than ever, the pharmaceutical pipeline for treatment of ophthalmic diseases looks extremely promising. The challenge ahead, especially for many of the chronic eye conditions, will be to provide site specific delivery of these compounds for periods ranging from months to years. The I-vation™ sustained drug delivery system provides an ideal platform for achieving optimal therapeutic drug treatment levels and eliminating the need for frequent intravitreal bolus injections."*

Pravin Dugel, MD
Retinal Consultants of Arizona
Phoenix, AZ
A principal investigator in the
I-vation™ TA Phase I study

Another area where we are capturing more elements of the value chain is in our re-branded and re-positioned In Vitro Technologies business unit, formerly known as Diagnostics & Drug Discovery. The focus of this business unit is to develop and apply SurModics' technologies to *in vitro* markets. Currently, SurModics' In Vitro Technologies include our stabilization product family, GE Healthcare genomics slides, Abbott diagnostics royalties and our synthetic extracellular matrix (ECM) products developed in collaboration with the Donaldson Company. This collaboration combines Donaldson's nanofibers with SurModics' surface modification technology. The resulting Ultra-Web™ Synthetic ECM products provide cell growth conditions that more closely resemble those found in the body. This has led to improved outcomes in cell culture, cell-based bioassays and other *in vitro* cell-related applications. In May, we announced that Corning Life Sciences will provide worldwide marketing and distribution for the expanding product line. The new agreement enables us to take advantage of Corning's market leading position in plastic and glass labware to address cell culture and drug discovery applications. We are poised to capitalize on the full potential of this platform technology in the near term. Also in 2006, we announced the expansion of our relationship with Diarect AG, allowing us to sell exclusively the company's genetically engineered antigen products used in diagnostic test kits to the same *in vitro* diagnostics manufacturers that currently purchase our stabilization products. This product synergy with our customers could be significant, and this is an exciting new way to increase our participation in the *in vitro* market.



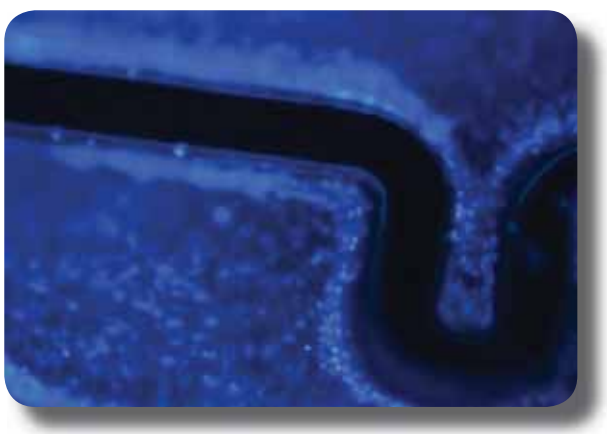
**Right:** SurModics developed the surface modification for the Ultra-Web™ Synthetic ECM. The coated nanofibrillar surface more closely resembles that found in the body for improved cell culture growth conditions, leading to more biologically accurate results.

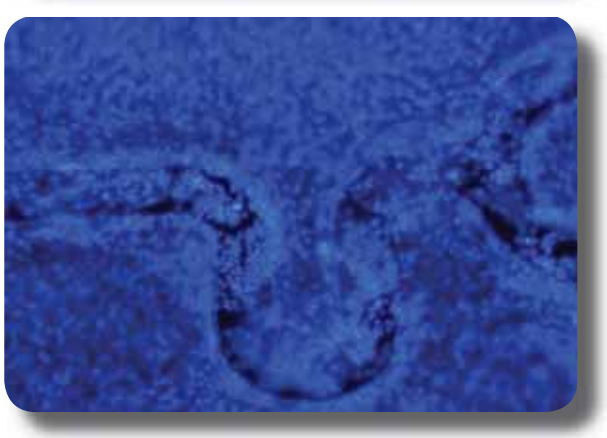
## Continued Diversification As We Pursue Exciting Opportunities in the Drug Eluting Stent Market

Building upon our successful collaboration with Cordis Corporation, a Johnson & Johnson company, we have developed further advances in drug eluting stent (DES) related technologies that have allowed us to participate in multiple ways and with multiple partners in the overall DES market. Currently, we have three business units serving the cardiology field: Drug Delivery, Regenerative Technologies and Hydrophilic Technologies. Our Drug Delivery business unit offers polymer systems to provide site-specific controlled release drug delivery; the Regenerative Technologies business unit is developing antithrombotic and prohealing technologies, which could play a significant role in future generations of drug eluting stents; and our Hydrophilic Technologies business unit offers advanced hydrophilic coatings on drug eluting stent delivery catheters to improve deliverability and ease of use for physicians.

We have disclosed five customers that have licensed SurModics' hydrophilic coating technology for the delivery systems of their drug eluting stent platforms. During fiscal 2006, we were proud to publicly announce drug eluting stent delivery system licensing agreements with Cordis, Medtronic, Devax, Xtent and Conor Medsystems. Indeed, revenue in our Hydrophilic and Other segment grew 17% in fiscal 2006, making it our fastest growing segment. In addition, we have announced drug delivery polymer relationships with three different companies – Cordis, CardioMind and X-Cell Medical.

The ability to provide solutions for late stent thrombosis represents another substantial opportunity. Thrombosis, or clotting, remains a challenge for both bare metal stents and drug eluting stents and is an issue for which the medical community and the device industry are actively seeking solutions. Incomplete or delayed re-growth of healthy endothelial cells following the placement of stents may be a factor in late thrombosis events. With our partner, Stuart Williams, Ph.D. and his staff at the University of Arizona, we have identified certain extracellular matrix (ECM) proteins that encourage the healing process following stent-induced vascular injury. ECM proteins promote the re-establishment of a normal endothelial cell layer in the blood vessel. Using our PhotoLink® technology, SurModics can attach those ECM proteins to the stent. As we reported in October at a key interventional cardiology conference, animal studies we recently sponsored showed that this technology has successfully produced normal endothelial cell growth – even in as little as one or two weeks after implantation. Evidence suggests the growth of healthy endothelial cells after stent implantation, whether it is a drug eluting or bare metal stent, could help prevent stent thrombosis.





## Diversify into New Markets

We have been able to leverage our expertise in the convergence of drugs and devices within the cardiovascular space to penetrate new markets. In particular, we have extended our reach to address the site specific drug delivery needs of our customers in the ophthalmology, urology, orthopedics and potentially oncology markets.

Dale Olseth retired as Executive Chairman of the Board on July 31st. We would like to express the gratitude of the entire SurModics family to Dale for his 20 years of leadership of our company. Without the tireless efforts of Dale in raising the early capital, recruiting such an effective Board and scientific team, and providing strategic insight and direction, SurModics would not be the success it has become today. Everyone at SurModics has been touched by his warmth, charm, sense of humor, and above all, visionary and values-based leadership. We are fortunate and grateful that Dale will continue to serve on the Board. His guidance and wisdom are highly valued.

**Top Left:** Microscopic image of a portion of a drug eluting stent (black) after two weeks in a live vessel. Note the lack of cell coverage (lighter blue areas) on the stent strut.

**Bottom Left:** Microscopic image of a portion of a drug eluting stent coated with SurModics' prohealing coating after two weeks in a live vessel. Note the cell growth over the surface of the stent strut.

We are honored to be associated with the success of the CYPHER® stent, and are pleased to have a second licensed technology on Cordis' recently released CYPHER SELECT™ Plus stent. Because we have continued to aggressively take action to further diversify our revenue concentration, the non-CYPHER portion of our business continues to grow more rapidly than our CYPHER revenue. At fiscal year end, 83 SurModics coated products were generating royalty revenue, with 84 licensed products awaiting launch, and an additional 69 non-licensed opportunities in the queue. The expansion of our pipeline has been both robust and broad based, as we signed 21 new license agreements with customers in 2006, representing five of our six business units.

We are pleased with the progress we and our partners are making in diverse markets. In diabetes, developments at Novocell are encouraging. In June, Novocell presented favorable preliminary data from its Phase I/II proof-of-principle clinical trial in patients with Type I diabetes. With those encouraging results in hand, Novocell is focusing on its stem cell development activities. In fact, Novocell announced in October the development of a process that efficiently converts human embryonic stem cells into insulin-producing pancreatic endocrine cells. Once it has achieved sufficient insulin production from those cells, it plans to encapsulate them using our licensed technology and move forward into animal studies and clinical trials.

## Increase Participation in the Convergence of Drugs and Devices

A key component of our plan is facilitating the convergence of drugs and devices. As noted above, we have extended our reach to address the site specific drug delivery needs of our customers in the ophthalmology, urology, orthopedics and potentially oncology markets. SurModics announced a relationship with AbbeyMoor Medical for the use of our technology in the urology market, and we have undertaken a major effort in combining drugs and devices for use in orthopedic applications which we hope to announce soon.

## Accelerate our Technology Leadership

To accelerate our technology leadership, we have increased our focus on customer and clinical needs. We continue to add to the number and variety of technologies and products we make available to our customers through both internal innovation and external acquisition.

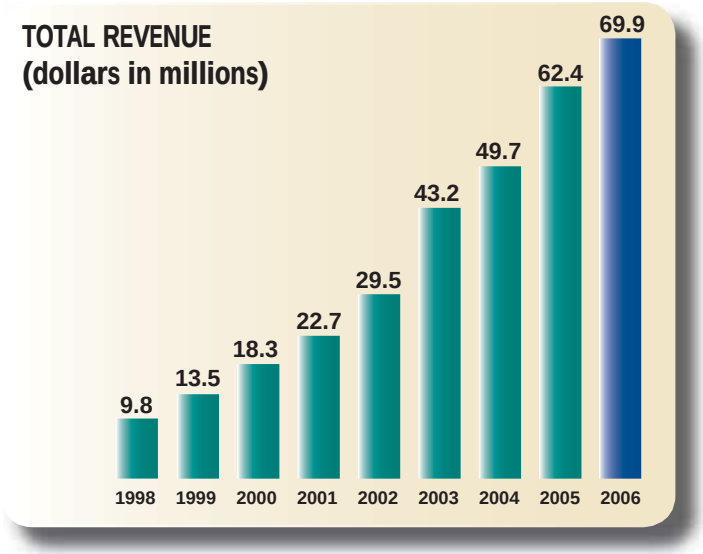
SurModics' business model allows us to invest aggressively in R&D while delivering exceptional profitability; and from that investment, innovation continues to flourish at SurModics. We dedicated $17.9 million to R&D during fiscal year 2006, which represents 26% of total revenue, and is an 11% increase from the prior year period.* Further, R&D expense for the period constituted 72% of total operating expenses, excluding product costs. In addition, to protect the results of our pioneering work, the company has incurred larger patent related legal costs that have contributed to higher R&D expenses. In 2006, SurModics filed 56 U.S. patent applications, compared with 51 in the prior year. Allocating funds to patent protection is consistent with our strategy to vigilantly protect our product innovations, intellectual property and technology portfolio, which serve as the foundation of our unique technology licensing business model.

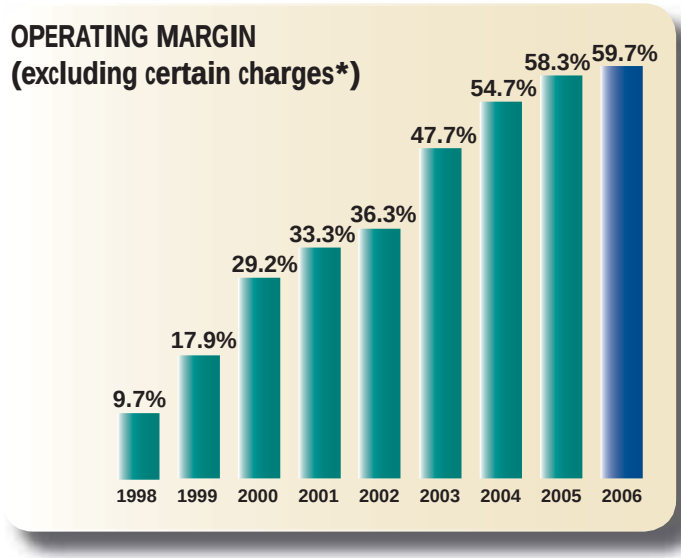
Ken Melrose was elected Chairman of the Board effective August 1st. Ken has a long history with SurModics having been a director of the company since 1988. We are delighted that the Board has elected such a capable, thoughtful and professional individual as Ken to serve as Chairman. Ken has had a long and distinguished career as the chairman and chief executive of The Toro Company, presiding over a period of tremendous diversification and growth at Toro. SurModics is fortunate to have Ken in this key leadership position.

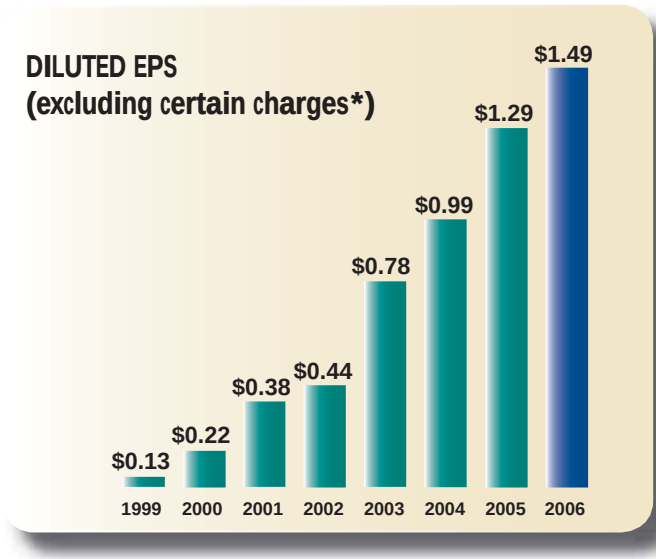
## Share Repurchase – the First in SurModics History

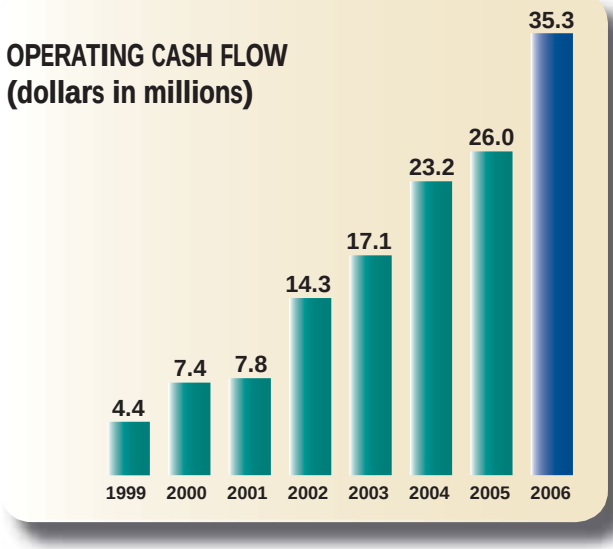
Despite our continued focus on investing for future growth, our ability to generate significant cash flow provides us the opportunity to return capital to shareholders and further enhance long-term shareholder value. In November, SurModics commenced a share repurchase program, the first in its history. We believe that our growth prospects are substantial and the repurchase of common stock presents an attractive investment opportunity.

# Financial Highlights* (see footnotes on back page)

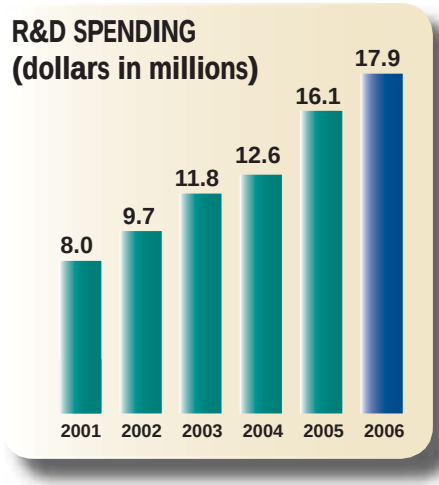


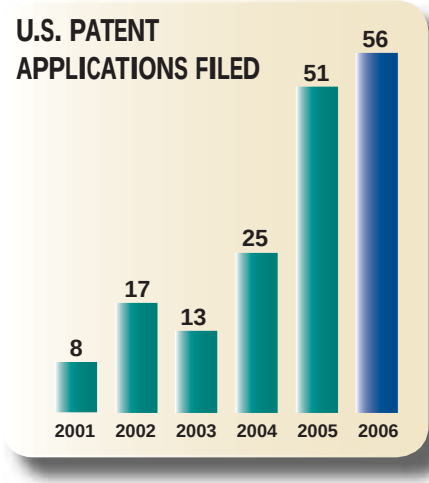







## Pursue Business Development Opportunities

In addition to internal innovation, we have aggressively pursued business development opportunities to gain access to technology developed outside the company to accelerate our technology leadership. For example, we expanded our portfolio of biodegradable polymers by licensing technology from InnoCore and acquiring intellectual property from Intralytix. We also made an additional equity investment in OctoPlus. Our business development group is actively evaluating additional opportunities that will advance our revenue growth strategy. SurModics' focus has been, and will continue to be, pursuing opportunities that support our growth strategy and enhance our market position.

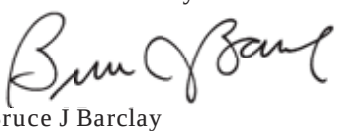
## Attract and Retain Top Talent

SurModics' greatest asset is our team of talented, dedicated and committed employees who deliver exceptional service to our customers every day. None of what we have outlined for you would be possible if we did not focus our efforts on creating a company and environment that allows us to attract and retain top talent. In fiscal 2006 we made great strides in this area. SurModics offers a variety of technologies and products to our customers. However, it is our capability as an organization in applying those technologies to a variety of different specific customer applications that distinguishes the SurModics team.

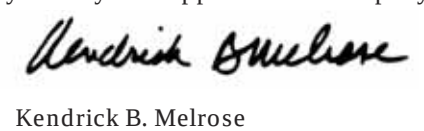
## Confidence in the Future

We are successfully executing on our strategy and revenue growth plan, and we are well positioned to continue to deliver positive results. We realize that SurModics is valued for what we do, not just what we say. Together with our dedicated employees, we will work to continue to achieve results that investors have come to expect from us, and more. SurModics was built on customer focus, and that is still true today. By delivering value for our customers, we deliver value for our shareholders. We are fully committed to delivering value for both.

On behalf of everyone at SurModics, we thank you for your support of the company.



Bruce J Barclay
President and CEO



Kendrick B. Melrose
Chairman of the Board

**SurModics Corporate Officers:** Back row (left to right): Aron Anderson, Doug Astry, Mike Shoup, Loren Miller, Steve Keough, Paul Lopez, Jan Webster, Phil Ankeny, Charlie Olson, Brian Robey. Seated: Lise Duran, Bruce Barclay, Peter Ginsberg.

* Non-cash charges include: **2006** - stock-based compensation of $5.5 million; Novocell impairment loss of $4.7 million. Including these non-cash charges, operating margin was 51.7% and diluted EPS was $1.09. **2005** - stock-based compensation of $588,000; in-process research and development charge of $30.3 million; Bloomington facility impairment charge of $2.5 million. Including these non-cash charges, operating margin was 4.8% and diluted EPS was ($0.45). **2004** - stock-based compensation of $212,000; Bloomington facility impairment charge of $16.5 million. Including these non-cash charges, operating margin was 21.1% and diluted EPS was $0.41.

**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.

SurModics
Bringing Innovation Together™

9924 West 74th Street, Eden Prairie, MN 55344
www.surmodics.com 