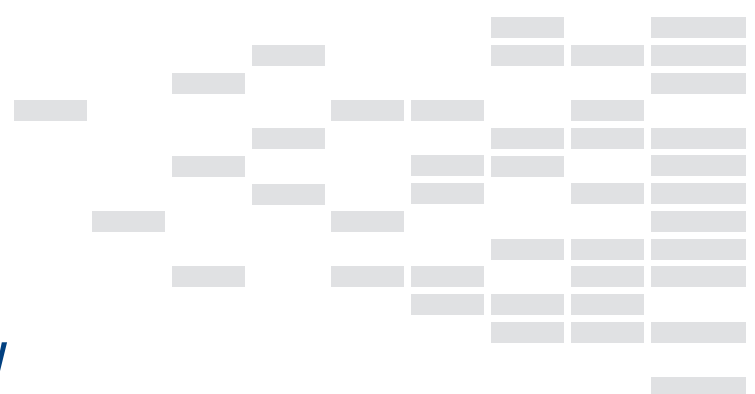




Engineering  
the Medicines  
of Tomorrow



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## Dear Shareholders,

MorphoSys has made solid progress in the first half of 2003.

The second quarter financial results continued to demonstrate the positive benefits associated with the Company's restructuring moves undertaken in November 2002. These benefits are in part borne out by the Company's reduction in operating loss, which reduced by 68% compared to the previous year's numbers of the same period. Moreover the cash position remains strong as evidenced by the level of cash and marketable securities which remained at virtually the same level as year-end 2002, and the net cash used in operations for the first 6 months of 2003 which was very close to cash breakeven.

Also during the second quarter, MorphoSys was able to welcome XOMA as a shareholder through the raising of new capital as part of the two companies' cooperation initiated in February 2002. With the acquisition of XOMA's licenses, MorphoSys has significantly strengthened its intellectual property portfolio surrounding its proprietary HuCAL<sup>®</sup> technology.

In May at the Annual Shareholders Meeting of MorphoSys in Munich, all proposals forwarded by management were approved. Moreover, the Company was pleased to have Prof. Dr. Jürgen Drews and Prof. Dr. Andreas Plückthun re-appointed to the Supervisory Board.

In the first half of 2003, MorphoSys entered an agreement with Boehringer Ingelheim, thereby gaining access to a therapeutic antibody program in the form of ICAM-1. ICAM-1 is the basis of the Company's proprietary development programs MOR101 and MOR102, which are currently at the stage of preclinical development. Further data relating to these products is expected later this year, and MorphoSys plans to outlicense these products prior to the start of clinical development, thereby creating significant value to the Company's shareholders.

We expect to achieve the goals set for ourselves this year and thank you for your continued interest and trust in MorphoSys.



Dave Lemus  
Chief Financial Officer  
MorphoSys AG

# Group Management Report Q2 2003

## Industry Overview

Only moderate global economic growth was evidenced in the second quarter. However, a significant recovery was noticeable on the stock markets worldwide. As an example, the German DAX stock exchange index increased by approximately 32%, making it one of the best performers among the world's stock exchanges indices.

The biotechnology industry also benefited from positive news. Several biotech drugs were approved in the second quarter, such as the antibody Xolair (Genentech, Novartis and Tanox). The sector's consolidation process also continued, as witnessed by the merger of Biogen and Idec, and the acquisition of Powderject by Chiron.

Consequently, the NASDAQ Biotechnology Index rose in the 2nd quarter by 31%, and the Deutsche Börse Prime Pharma & Healthcare Index gained 14%. In the same period, the MorphoSys share posted a price increase of 15%, an increase in line with German healthcare sector stocks.

## Financial Analysis

### Operating Revenues

Compared to the same period of the previous year, cumulative revenues for the first six months of 2003 decreased by 17% to EUR 7.2 million (2002: EUR 8.7 million), in line with expectations. Revenues arising from therapeutic antibody collaborations accounted for 85% of total revenues while target research collaborations generated 15% of the total. No milestones revenues were recorded in the second quarter of 2003. Geographically, 80% of MorphoSys' EUR 7.2 million commercial (non-grant) revenues were generated with biotechnology and pharmaceutical companies located in the United States, and 20% generated in Europe.

### Operating Expenses

For the first six months of 2003, total operating expenses, including stock-based compensation expense decreased by EUR 8.9 million to EUR 10.8 million (2002: EUR 19.7 million), resulting in an operating loss of EUR 3.6 million (2002: EUR 11.0 million), a decrease of the loss over the same period in the prior year of 67%. The reduction in expense resulted mainly from the Company's restructuring implemented in Q4 2002, as well as patent and licensing agreements and settlements entered into in 2002.

### Research and Development Expenses

Costs for Research and Development decreased by EUR 3.1 million to EUR 5.7 million (2002: EUR 8.8 million). The decrease in Research and Development expenses resulted predominantly from lower licensing costs relating to the XOMA agreement, as well as lower personnel costs and external research costs associated with the Company's restructuring.

**Sales, General and Administrative Expenses**

Sales, General and Administrative expenses amounted to EUR 4.1 million compared to EUR 8.7 million in the same period of the previous year. The decrease in General and Administrative expenses was mainly due to the decrease in patent litigation costs, which arose in part as a result of the settlement with Cambridge Antibody Technology (CAT) in December 2002.

**Stock-Based Compensation**

Stock-based compensation in the amount of EUR 1.1 million for the first six months of 2003 was recorded as a non-cash charge (2002: EUR 2.3 million), which results from application of SFAS No. 123 "Accounting for Stock Based Compensation" under U.S. GAAP accounting. The decrease in stock-based compensation is mainly due to a lesser number of convertible bonds granted in 2003 compared to the same period in 2002 and lower numbers of employees as a result of the Company's restructuring implemented in Q1 2003. Stock-based compensation for new grants was also lowered through the reduced stock price of MorphoSys shares underlying the bonds at the time of grant.

**Cost by Expenditure Type**

For the first six months of 2003, the Company's personnel costs in the amount of EUR 3.9 million (excluding stock-based compensation) accounted for approximately 36% of total operating costs, representing the largest single cost-type for the Company. Costs for external services, infrastructure and intangible assets were the next largest blocks of costs and represented 22%, 12% and 11%, respectively, of total operating costs for the first six months of 2003.

**Non-Operating Items**

Non-operating income decreased by EUR 2.6 million to EUR 1.3 million of expense (2002: EUR 1.3 million income). An increase in interest expense of EUR 0.8 million resulted from the election to raise shares associated with the XOMA agreement, and is a non-cash charge relating to the accounting of such conversion under US GAAP accounting. Additionally, approximately EUR 0.2 million of interest expense was recorded during the period and arose in connection with the net present value of liabilities payable associated with the CAT settlement. Finally, the Company, recorded an impairment related to unrealized losses on available-for-sale securities in the amount of EUR 0.75 million.

**Net Loss**

The Company posted a net loss of EUR 4.9 million for the first six months of 2003 compared to EUR 9.7 million in the same period of the previous year. The resulting loss per share for the first six months of 2003 amounted to EUR 1.22 (2002: EUR 2.50).

**Liquidity / Cash Flows**

During the first half of the year the Company's current assets decreased by EUR 6.9 million to EUR 22.6 million compared to EUR 29.5 million at December 31, 2002. On June 30, 2003, the Company had EUR 18.8 million in cash and cash equivalents, and marketable securities, compared to a EUR 19.1 million balance at December 31, 2002 - a decrease of EUR 0.3 million. Cash used in operating activities for the first six months of 2003 amounted to EUR 0.3 million compared to EUR 7.2 million in the first six months of 2002.

**Assets**

Total assets decreased by EUR 7.7 million to EUR 34.7 million at the end of June 2003, compared to EUR 42.4 million at December 31, 2002. The main reason for the decrease resulted from an accounts receivable decrease for the first six months of 2003 of EUR 6.0 million, resulting from payments received in the first quarter of 2003.

**Liabilities**

During the first six months of 2003, total current liabilities decreased by EUR 9.0 million mainly due to the decrease in licenses payable by EUR 4.9 million, a decrease in accounts payable of EUR 1.0 million, and a decrease in deferred revenues of EUR 2.4 million. The decrease in licenses payable resulted from the payment of certain obligations under the settlement agreement with CAT and payment of the XOMA license agreement with equity.

**Equity**

As part of the MorphoSys-XOMA licensing agreement signed in 2002, the MorphoSys Supervisory Board elected in October 2002 to issue 363,466 shares to XOMA as partial consideration for the XOMA licenses received. The capital increase was registered in May 2003 at the commercial register and the new shares were issued to XOMA.

In December 2002, MorphoSys signed a settlement with CAT to resolve long-standing patent litigation issues. As part of the agreement, MorphoSys will issue to CAT 588,160 MorphoSys shares as partial consideration for the CAT license. The license agreement and the contract for the capital increase against contribution in kind were signed in early July 2003. The CAT share issuance is expected to take place in the second half of 2003, and is subject to final registration in the commercial register.

The respective share issuances exclude stockholders' preemptive rights as allowed under the Company's articles of association.

At June 30, 2003, the total number of shares issued was 4,313,172, of which 4,253,410 were outstanding.

**Capital Expenditure**

During the first six months of 2003 and 2002, total investment in intangibles amounted to EUR 0.02 million and EUR 3.3 million, respectively. Amortization of capitalized intangibles for the first six months of 2003 amounted to EUR 0.6 million and remained unchanged compared to the same period of the previous year.

Investment in Property and Equipment amounted to EUR 0.2 million in the first six months of 2003 compared to EUR 0.6 million in the same period of the previous year. Depreciation for the first six months of 2003 of EUR 0.4 million remained unchanged compared to the same period in the previous year.

## Human Resources

### Number of Employees

On June 30, 2003, the MorphoSys Group employed 92 employees (compared to 110 employees on December 31, 2002). Of the 92 employees, 69 worked in research and development and 23 in sales, general and administrative positions. Of these employees, 34 held a Ph.D. degree at the end of the first six months 2003, down from 45 at the end of 2002. The Company employed an average of 93 people for the first six months of 2003 (2002: 115).

At the Annual Shareholder assembly on May 16, 2003, Prof. Dr. Jürgen Drews and Prof. Dr. Andreas Plückthun were re-appointed to the Supervisory Board of MorphoSys. Prof. Dr. Jürgen Drews, Managing Director of the Bear Stearns Health Innoventure Fund, has been a member of the MorphoSys Supervisory Board since 1997, and also holds the position of Vice Chairman. Prof. Dr. Andreas Plückthun, Professor for Biochemistry at the University of Zurich, Switzerland, is a co-founder of MorphoSys.

## Research & Development / Partnered Research

MorphoSys develops therapeutic antibodies for its commercial partners and its own account. At present, 20 partnered antibody programs are ongoing. MorphoSys' proprietary antibody pipeline presently consists of three antibody programs.

### Proprietary Product Development

MOR201, the antibody research program directed against the cancer target FGFR-3, was amended during the quarter. Specifically, the agreement between MorphoSys and ProChon is intended to continue with ProChon developing up to 4 antibodies with MorphoSys' HuCAL® GOLD library, but MorphoSys will return all rights concerning the FGFR-3 antibodies to ProChon which includes the MorphoSys internal research program MOR201. Currently, product development at MorphoSys will continue to focus on programs MOR101 and MOR102, in addition to another not-publicly announced research program.

### Partnered Product Development

#### *Bayer AG*

During the first quarter of 2003, Bayer purchased a license for the exclusive right to develop a HuCAL® antibody. The acquired license is for an antibody against an undisclosed, solid tumor cancer target molecule. The antibody was generated and characterized by Bayer Biotechnology (Berkeley, CA, U.S.A.) using the MorphoSys HuCAL® antibody library, and has demonstrated efficacy in several *in vitro* and *in vivo* assays. Bayer demonstrated significant anti tumor efficacy in several animal tumor models. In addition, Bayer intends to further characterize the antibody in additional pre-clinical studies and thereafter develop it in clinical trials in major solid tumor indications.

MorphoSys and Bayer signed a wide-ranging antibody collaboration in December 1999. In July 2001, the collaboration was extended for four additional years, focusing on the generation of human antibodies for therapeutic, diagnostic and genomics applications. Bayer retains further options to acquire exclusive licenses for therapeutic antibody programs.

*Boehringer Ingelheim*

MorphoSys and Boehringer Ingelheim entered into a therapeutic antibody collaboration and cross licensing agreement in February 2003. Under the terms of the agreements, MorphoSys received an exclusive, worldwide license to patents owned or controlled by Boehringer Ingelheim to develop, make and sell therapeutic and diagnostic antibodies targeting the ICAM-1 molecule. Boehringer Ingelheim will receive options for exclusive commercial licenses to therapeutic antibodies against two undisclosed targets, against which MorphoSys will generate fully human antibodies utilizing its HuCAL® GOLD antibody technology.

MorphoSys is currently developing fully human antibodies against ICAM-1, utilizing its proprietary HuCAL® GOLD technology, in two indications relating to inflammation. In the first program, MOR101, an antibody fragment, is being developed in the indication of deep dermal burn. With MOR102, the second antibody program, MorphoSys antibodies will be generated with the aim of developing a treatment for psoriasis. The fully human HuCAL® antibodies against ICAM-1 are expected to have excellent efficacy profiles in these inflammatory disorders while having none of the immunogenic side effects associated with the murine antibodies generated by Boehringer Ingelheim against the same target. MorphoSys expects to partner both compounds prior to their entry into clinical trials.

*Lonza Biologics*

In January 2003, MorphoSys signed an agreement with Lonza Biologics for production and supply of clinical grade antibody drugs derived from MorphoSys HuCAL® technology within the next five years. The agreement regulates access to Lonza's process development and manufacturing capacity for future antibody projects for both MorphoSys' own and partnered therapeutic antibody projects.

MorphoSys will offer its partners manufacturing capacities at Lonza, thereby increasing the potential value of its pre-clinical offerings to future partners.

## Risk Report

With regard to material risks to the future development of MorphoSys, no changes occurred compared to the financial year ending December 31, 2002. The detailed risk report can be found in the 2002 annual report.

## Outlook

MorphoSys' commercial focus is on the strengthening of its collaborations with partners, and the development of proprietary therapeutic antibodies. To this end, the Company continues to pursue efforts to extend its existing partnerships and enter into new collaborations. Additionally, MorphoSys will seek also to outlicense its proprietary preclinical development programs in order to generate additional value-added for the Company.

Presently MorphoSys expects to achieve its goals for 2003.

# Condensed Consolidated Balance Sheets (U.S. GAAP)

	06/30/2003 EURO unaudited	12/31/2002 EURO
<b>Assets</b>		
<b>Current Assets</b>		
Cash and Cash Equivalents	503,861	842,082
Marketable Securities	18,333,553	18,274,338
Accounts Receivable	2,756,221	8,732,790
Prepaid Expenses and Other Current Assets	1,000,253	1,684,729
<b>Total Current Assets</b>	<b>22,593,888</b>	<b>29,533,939</b>
Property and Equipment, Net	1,791,459	2,097,796
Patents, Net	6,494,432	6,898,990
Prepaid License Fees, Net	3,162,089	3,352,604
Other Assets	611,451	509,984
<b>Total Assets</b>	<b>34,653,319</b>	<b>42,393,313</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current Liabilities</b>		
Accounts Payable	1,308,097	2,273,539
Licenses Payable	715,996	5,569,291
Deferred Revenue	5,653,141	8,086,355
Accrued Employees Benefits	1,045,180	1,468,907
Other Accrued Expenses and Liabilities	1,749,400	2,029,608
<b>Total Current Liabilities</b>	<b>10,471,814</b>	<b>19,427,700</b>
<b>Non-Current Liabilities</b>		
Other Non-Current Liabilities	2,324,968	2,275,347
Convertible Bonds Due to Related Parties	136,900	74,800
<b>Total Non-Current Liabilities</b>	<b>2,461,868</b>	<b>2,350,147</b>
<b>Stockholders' Equity</b>		
Common Stock, EUR 3.00 Par Value; Ordinary Shares Authorized (8,626,344 and 7,345,582 for 2003 and 2002, respectively)		
Ordinary Shares Issued (4,313,172 and 3,949,706 for 2003 and 2002, respectively)		
Ordinary Shares Outstanding (4,253,410 and 3,889,944 for 2003 and 2002, respectively)	12,939,516	11,849,118
Treasury Stock (59,762 and 59,762 shares for 2003 and 2002, respectively), at cost	(21,934)	(21,934)
Additional Paid-in Capital	63,362,051	59,193,912
Accumulated Other Comprehensive Income/(Loss)	213,319	(517,591)
Accumulated Deficit	(54,773,315)	(49,888,039)
<b>Total Stockholders' Equity</b>	<b>21,719,637</b>	<b>20,615,466</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>34,653,319</b>	<b>42,393,313</b>

See accompanying notes

## Condensed Consolidated Statement of Operations (U.S. GAAP) - unaudited

	Three Months Ended June 30, 2003 EURO	Three Months Ended June 30, 2002 EURO	Six Months Ended June 30, 2003 EURO	Six Months Ended June 30, 2002 EURO
<b>Revenues</b>	<b>3,499,336</b>	<b>4,647,015</b>	<b>7,243,382</b>	<b>8,708,056</b>
<b>Operating Expenses</b>				
Research and Development	2,968,785	3,903,249	5,708,947	8,757,337
Sales, General and Administrative	1,823,560	6,075,101	4,071,981	8,700,732
Stock-Based Compensation	596,146	1,137,677	1,057,242	2,277,518
<b>Total Operating Expenses</b>	<b>5,388,491</b>	<b>11,116,027</b>	<b>10,838,170</b>	<b>19,735,587</b>
<b>Loss from Operations</b>	<b>(1,889,155)</b>	<b>(6,469,012)</b>	<b>(3,594,788)</b>	<b>(11,027,531)</b>
Interest Income	165,494	298,058	185,560	384,156
Interest Expense	(812,672)	(687)	(911,532)	(687)
Impairment of Marketable Securities	(753,768)	-	(753,768)	-
Other Income, Net	192,316	840,553	189,251	945,995
<b>Loss before Taxes</b>	<b>(3,097,785)</b>	<b>(5,331,088)</b>	<b>(4,885,277)</b>	<b>(9,698,067)</b>
Foreign Income Tax Expense	(1)	(5,230)	(1)	18,475
<b>Net Loss</b>	<b>(3,097,784)</b>	<b>(5,325,858)</b>	<b>(4,885,276)</b>	<b>(9,716,542)</b>
Basic and Diluted Net Loss per Share	(0.75)	(1.37)	(1.22)	(2.50)
Shares Used in Computing Basic and Diluted Net Loss per Share	4,113,615	3,889,449	4,002,398	3,889,449

See accompanying notes

# Condensed Consolidated Statement of Changes in Stockholders' Equity (U.S. GAAP) - unaudited

	Common Stock		Treasury Stock		Additional Paid-in Capital EURO	Accumulated		Total Stockholders' Equity EURO
	Shares	EURO	Shares	EURO		Other Com- prehensive Gain (Loss) EURO	Accumulated Deficit EURO	
<b>Balance at Jan. 1, 2002</b>	<b>3,591,331</b>	<b>10,773,275</b>	<b>59,762</b>	<b>(21,934)</b>	<b>32,452,966</b>	<b>37,047</b>	<b>(25,510,745)</b>	<b>17,730,609</b>
Exercise of Stock Options	495	1,485	—	—	7,177	—	—	8,662
Compensation Related to the Grant of Stock Options	—	—	—	—	3,940,412	—	—	3,940,412
Capital Increase for Euro Conversion	—	718	—	—	(718)	—	—	—
Capital Increase against Cash, Net of Issuance Cost of EUR 25,249	357,880	1,073,640	—	—	22,794,075	—	—	23,867,715
Other Comprehensive Loss: Change in Unrealized Losses on Available for Sales Securities	—	—	—	—	—	(557,178)	—	(557,178)
Foreign Currency Gain from Consolidation	—	—	—	—	—	2,540	—	2,540
Net Loss	—	—	—	—	—	—	(24,377,294)	(24,377,294)
Comprehensive Loss	—	—	—	—	—	—	—	(24,931,932)
<b>Balance at Dec. 31, 2002</b>	<b>3,949,706</b>	<b>11,849,118</b>	<b>59,762</b>	<b>(21,934)</b>	<b>59,193,912</b>	<b>(517,591)</b>	<b>(49,888,039)</b>	<b>20,615,466</b>
Compensation Related to the Grant of Stock Options (unaudited)	—	—	—	—	1,057,243	—	—	1,057,243
Capital Increase against Contribution in Kind (unaudited), Net of Issuance Cost of EUR 23,314	363,466	1,090,398	—	—	3,110,896	—	—	4,201,294
Other Comprehensive Loss: Change in Unrealized Gain on Available for Sales Securities (unaudited)	—	—	—	—	—	746,059	—	746,059
Foreign Currency Gain from Consolidation (unaudited)	—	—	—	—	—	(15,149)	—	(15,149)
Net Loss (unaudited)	—	—	—	—	—	—	(4,885,276)	(4,885,276)
Comprehensive Loss (unaudited)	—	—	—	—	—	—	—	(4,154,366)
<b>Balance at June 30, 2003 (unaudited)</b>	<b>4,313,172</b>	<b>12,939,516</b>	<b>59,762</b>	<b>(21,934)</b>	<b>63,362,051</b>	<b>213,319</b>	<b>(54,773,315)</b>	<b>21,719,637</b>

See accompanying notes

## Condensed Consolidated Statement of Cash Flows (U.S. GAAP) - unaudited

For the Period ended June 30,	2003 EURO	2002 EURO
<b>Operating Activities</b>		
Net Loss	(4,885,276)	(9,716,542)
<b>Adjustments to Reconcile Net Loss to Net Cash Used for Operating Activities:</b>		
Depreciation	440,591	444,067
Amortization of Intangible Assets	617,010	621,879
Net Gain on Sales of Marketable Securities	(196,831)	(93,927)
Impairment of Marketable Securities	753,768	–
Gain on Sale of Property and Equipment	235	(145)
Recognition of Deferred Revenue	(3,478,447)	(3,216,467)
Stock-Based Compensation	1,057,243	2,277,518
<b>Changes in Operating Assets and Liabilities:</b>		
Accounts Receivable	5,976,569	(1,777,935)
Prepaid Expenses and Other Assets	583,009	(405,988)
Accounts Payable	(965,442)	389,935
Licenses Payable	(628,687)	183,977
Deferred Revenue	1,045,233	3,341,704
Accrued Employee Benefits	(423,727)	(283,663)
Other Accrued Expenses and Liabilities	(280,208)	997,929
Other Non-Current Liabilities	49,621	–
<b>Net Cash Used in Operating Activities</b>	<b>(335,339)</b>	<b>(7,237,658)</b>
<b>Investing Activities:</b>		
Purchases of Marketable Securities	(8,592,506)	(36,448,503)
Proceeds from Sales of Marketable Securities	8,722,413	17,020,759
Purchases of Property and Equipment	(154,489)	(564,149)
Proceeds from Disposals of Property and Equipment	20,000	240
Additions to Intangibles	(21,937)	(176,939)
<b>Net Cash Used in Investing Activities</b>	<b>(26,519)</b>	<b>(20,168,592)</b>
<b>Financing Activities:</b>		
Proceeds from the Issuance of Common Stock, Net	–	23,867,715
Proceeds from the Issuance of Convertible Bonds to Related Parties	62,100	91,300
Cost of Share Issuance	(23,314)	–
<b>Net Cash Provided by Financing Activities</b>	<b>38,786</b>	<b>23,959,015</b>
Effect of Exchange Rate Differences on Cash	(15,149)	(9,112)
Decrease in Cash and Cash Equivalents	(338,221)	(3,456,347)
<b>Cash and Cash Equivalents at the Beginning of the Period</b>	<b>842,082</b>	<b>4,025,334</b>
<b>Cash and Cash Equivalents at the End of the Period</b>	<b>503,861</b>	<b>568,988</b>
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Cash Received During the Year for Foreign Income Taxes	–	38,889
Unrealized Gain on Marketable Securities	189,832	–
Capital Increase against Contribution in Kind	4,224,608	3,160,385

See accompanying notes

# Notes to the Condensed Consolidated Financial Statements - unaudited

## 1 Organization and Summary of Significant Accounting Policies

### **Business and Organization**

MorphoSys AG ("the Company") is a biotechnology company using combinatorial biology in drug discovery with the principal objective of developing and commercially exploiting new enabling technologies across a broad scientific spectrum. The Company was founded in July 1992 as a German limited liability company. In June 1998, MorphoSys AG was transformed into a German stock corporation. In March 1999, the Company went public on Germany's Neuer Markt, the stock exchange designated for high-growth enterprises. On January 15, 2003 MorphoSys AG was admitted to the Prime Standard segment of the Frankfurt Stock Exchange.

The interim information in this report is unaudited but, in management's opinion, includes all normal recurring adjustments necessary for a fair presentation of results for the periods presented. Interim results may not be indicative of results to be expected for the full year or future periods. The condensed consolidated balance sheet as of June 30, 2003 has been derived from the audited consolidated financial statements included in the Company's 2002 Annual Report. The unaudited consolidated condensed financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2002 included in its annual report.

Substantially all operations are located in Germany. The Company has two wholly owned subsidiaries:

- MorphoSys U.S.A., Inc., which was incorporated in the United States on February 16, 2000. The subsidiary's purpose is to assist the Company in the sale and licensing of MorphoSys AG products. MorphoSys U.S.A., Inc. substantially ceased its operations in November 2002.
- MorphoSys IP GmbH, which was incorporated in Munich, Germany, on November 6, 2002. The subsidiary's purpose is to purchase, maintain and administer certain intangible assets of the MorphoSys Group. The Company's operations are physically located at the premises of MorphoSys AG, and the operations of MorphoSys IP GmbH commenced on December 31, 2002.

The accompanying condensed consolidated financial statements reflect the application of certain significant accounting policies as described in this note and elsewhere in the accompanying condensed consolidated financial statements and notes.

### **Basis of Financial Statement Presentation**

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP). In accordance with German law, the Company is required to publish its financial statements in accordance with the German Commercial Code, which represents generally accepted accounting principles in Germany ("German GAAP"). German GAAP varies in certain significant respects from U.S. GAAP. Accordingly, the Company has recorded certain adjustments, principally relating to

revenue recognition and the recording of certain costs, in order to present the accompanying financial statements in accordance with U.S. GAAP.

**Use of Estimates**

The preparation of the condensed consolidated financial statements in conformity with accounting standards generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**Cash and Cash Equivalents**

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. The Company invests its cash in deposits with two major German financial institutions, mainly in money market funds.

**Consolidation**

The accompanying financial statements consolidate the financial position, results of operations, and cash flows of MorphoSys AG and its subsidiaries. All intercompany transactions and balances have been eliminated.

**Marketable Securities**

The Company accounts for its securities using Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Management determines the proper classifications of securities at the time of purchase and reevaluates such designations as of each balance sheet date. At June 30, 2003 and at December 31, 2002, such securities that are classified as available-for-sale are carried at market value with unrealized gains and losses reported in accumulated other comprehensive income, which is a separate component of stockholders' equity. Realized gains and losses on sales of investments, as determined on a specific identification basis, are included in the statements of operations when the investment is sold or matures. On a regular basis, the Company tests for impairment. If the fair value is less than the cost basis for more than six months, the amount is written down to its estimated fair value.

**Derivative Financial Instruments**

The Company accounts for its derivative instruments using SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" and its corresponding amendments under SFAS No. 138. SFAS No. 133 requires the Company to measure every derivative instrument at fair value and record them as either an asset or liability. Changes in fair value are recorded in earnings.

**Property and Equipment**

Property and equipment is stated at cost, less accumulated depreciation and amortization. Major replacements and improvements are capitalized while general repairs and maintenance are charged to expense as incurred. Assets are depreciated over three to ten years using the straight-line method. Leasehold improvements are amortized over the estimated useful lives of the assets or the related lease term, whichever is shorter.

**Revenue Recognition**

The Company's revenues include technology access fees; fees earned from research and development collaboration agreements mainly with companies based in the United States. Revenue related to non-refundable technology access fees, subscription fees and license fees are deferred and recognized on a straight-line basis over the relevant periods of the agree-

ment, generally the research term or the estimated useful life of the collaboration for those contracts without a stipulated term unless a more accurate means of recognizing revenue is available. Research and development collaboration service fees are recognized in the period that the services are provided. Milestone revenues are recognized upon achievement of certain criteria.

Investment grants from governmental agencies for the support of specific research and development projects are recorded as revenue to the extent the related expenses have been incurred: Under the terms of the investment grants, the governmental agencies generally have the right to audit the use of the payments received by the Company.

### **Segment Reporting**

The Company operates primarily in one business segment related to the development of antibody therapeutics within the Biotech-Industries. Accordingly the Company does not disclose significant additional segment information under the definition of segment reporting, defined by the standards of SFAS No. 131, "Disclosure About Segments of an Enterprise and Related Information."

### **Research and Development**

Research and development costs are expensed as incurred.

### **Stock-Based Compensation**

The Company applies the provisions of SFAS No. 123 "Accounting for Stock-Based Compensation," which requires the Company to record the estimated fair value of stock options and other awards at the grant date as compensation expense over the period in which the employees render the services associated with the award.

### **Foreign Currency Translation**

The financial statements of foreign subsidiaries have been translated into euros in accordance with SFAS No. 52, "Foreign Currency Translation." All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. The statement of operations amounts has been translated using the average exchange rate for the year. The gains and losses resulting from the changes in exchange rates from year-to-year have been reported in accumulated other comprehensive income.

### **Net Loss Per Share**

Basic and diluted loss per share is calculated in accordance with SFAS No. 128, "Earnings per Share". Basic loss per share is based upon the number of weighted-average shares of common stock outstanding for the respective years.

The Company's outstanding stock options and convertible bonds were excluded from the above calculations of dilutive net loss per share, as the effect of their inclusion would have been antidilutive.

### **Impairment of Long-Lived and Identifiable Intangible Assets**

The Company evaluates the carrying value of long-lived assets and identifiable intangible assets for potential impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability is determined by comparing projected undiscounted cash flows associated with such assets to the related carrying value. An impairment loss is recognized when the estimated undiscounted future cash flows are less than the carrying amount of the asset. An impairment loss would be measured as the amount by which the carrying value of the assets exceeds the fair value of the asset. No impairment charges have been recognized for the six month period ended June 30, 2003 and 2002.

**Patent Costs**

The Company capitalizes costs related to obtaining patents and protecting granted patents from infringement. Capitalized costs principally relate to the costs of legal counsel. Patent costs are amortized on a straight-line basis over the lesser of their estimated economic life or remaining patent term. Amortization commences at the time the patent is issued. The Company's patents covering its proprietary HuCAL<sup>®</sup> technology were granted in Australia in October 2000, in the United States in 2001 and in Europe in June 2002. Further patent applications are pending in Canada and Japan.

**Accounting for Acquired License Rights**

The Company acquired license rights by making upfront licensing payments, annual maintenance fees and sublicensing payments to third parties. The Company amortizes up-front licensing payments on a straight-line basis over the estimated useful life of the acquired license. Annual maintenance fees are amortized over the term of each annual agreement. Sublicensing payments are amortized on a straight-line basis over the life of the contract or the estimated useful life of the collaboration for those contracts without a stipulated term.

**Concentration of Credit Risk**

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash, cash equivalents, marketable securities and accounts receivable. The Company's cash and cash equivalents are principally denominated in euros and U.S. dollars. Marketable securities are placed in high-quality securities. Cash, cash equivalents and marketable securities are maintained principally with two high-quality financial institutions in Germany. The Company continually monitors its positions with, and the credit quality of, the financial institutions, which are counter parties to its financial instruments, and does not anticipate non-performance. The Company's revenues and accounts receivable are subject to credit risk as a result of customer concentrations. Three customers individually accounted for approximately 49% and 32% and 11% of the Company's June 30, 2003 accounts receivable balance. In addition, three customers individually accounted for 43%, 26% and 16% of the Company's total revenues in the six month period ended June 30, 2003.

**Accounts Receivable**

For accounts receivable, the allowance for doubtful accounts is based on the management's assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than the historical experience, management's estimates of the recoverability of amounts due the Company could be adversely affected. Based on management assessment, no allowance was necessary on June 30, 2003 and December 31, 2002. On June 30, 2003 and on December 31, 2002, accounts receivable included unbilled amounts of approximately EUR 2,632,395 and EUR 265,000 respectively.

**Fair Value of Financial Instruments**

The carrying value of financial instruments such as cash and cash equivalents, accounts receivable and accounts payable approximate their fair value based upon the short-term maturities of these instruments. The fair value of marketable securities is based upon quoted market prices (see note 4). Convertible Bonds are recorded at their accreted values, which approximate the cash outlay that is due upon the note settlements.

**Effects of New Accounting Standards and Regulations**

For the effects of new accounting standards we refer to our published accounts as of December 31, 2002.

## 2 Restructuring

In November 2002, MorphoSys announced restructuring measures. These measures included the discontinuation of clinical drug development and the refocusing of the Company's commercial strategy. It is expected that these measures will help buttress the Company's financial position by significantly reducing its cost base. As a consequence of the restructuring the Company took actions to reduce its headcount by 24% from 120 to 91 employees, thereof 26 in Germany and 3 in the U.S.A. As of June 30, 2003 the total liability associated with the remaining restructuring activities was US\$ 140,000, which was composed of obligations related to the early termination of leased office space.

## 3 Accounting Estimate Changes

In February 2002, the Company concluded a cross-licensing agreement for antibody-related technologies with XOMA Ltd. Under the agreement, the Company received a license to use HuCAL<sup>®</sup> antibody expression technology for developing antibody products (including Fab and scFV formats) using MorphoSys' phage display-based on HuCAL<sup>®</sup> antibody library. MorphoSys also received a license for the production of antibodies (including Fab and scFV formats) under XOMA patents. Under the agreement, Xoma obtained a license to use MorphoSys HuCAL<sup>®</sup> antibody library for its target discovery and research programs. The agreements also provide for the release of the Company for any past activities using the Company's technology to the extent they also use XOMA's antibody expression technology.

In accordance with the terms of the agreements, the Company recorded an expense of EUR 1.1 million in the six-month period ended June 30, 2002 related to the release and capitalized as an intangible asset EUR 4.6 million related to the license received. Subsequently, the Company completed an analysis to determine the fair values of the release and the license received and allocated the total consideration paid to each component based on their respective fair values. As a result of this analysis, the Company increased the amount expensed for the release and reduced the amount recorded for the license received by EUR 1.4 million in the fourth quarter of 2002. Accordingly, the Company has revised its financial statements for the six-month period ended June 30, 2002 to reflect this adjustment.

## 4 Marketable Securities

Marketable securities consist of the following as of June 30, 2003 and December 31, 2002 (in thousands EUR):

in 000's EUR	Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Market Value
<b>December 31, 2002</b>				
HVB Euro Bond	3,794	0	(526)	3,268
HVB Debentures	2,789	0	(269)	2,520
DB Money Market Funds	12,611	239	0	12,850
	<b>19,194</b>	<b>239</b>	<b>(795)</b>	<b>18,638</b>
Restricted Cash				364
				<b>18,274</b>
<b>June 30, 2003</b>				
HVB Euro Bond	3,268	0	(57)	3,211
HVB Debentures	2,562	0	0	2,562
DB Money Market Funds	12,678	247	0	12,925
	<b>18,508</b>	<b>247</b>	<b>(57)</b>	<b>18,698</b>
Restricted Cash				364
				<b>18,334</b>

The net unrealized holding gains of EUR 189,832 for the first six months 2003 was recorded as a separate component of stockholders' equity. The unrealized losses in 2002 were due to a decline in the market value of marketable securities placed with HypoVereinsbank, as a result of a down grading of the bank. The bank retains an investment grade rating as of June 30, 2003.

Proceeds from sales of securities available-for-sale were EUR 8,722,413 and EUR 17,020,758 for the six months 2003 and 2002, respectively. Net gains on the sales of securities available-for-sale for the first six months 2003 amounted to EUR 196,831 and for the same period in 2002, EUR 93,927.

The Company invested for an aggregate amount of EUR 3,800,000 in a silent partnership of HypoVereinsbank Luxembourg and EUR 2,800,00 in securities of the HypoVereinbank AG. Under SFAS No. 115 "Accounting for Certain Investments in Debt and Equity Securities", both investments are designated as available-for-sale and are reported at fair value on the Company's balance sheet. Unrealized holding gains and losses are generally excluded from earnings and reported as component of Accumulated Other Comprehensive Income. However, if a decline in the fair value of available-for-sale securities is judged to be other than temporary, the cost basis for the security is written down to fair value as new cost basis. The written down amount is included in earnings as an impairment charge.

Under the Company's accounting policy, marketable securities are presumed to be impaired, if their fair value is less than their cost basis for more than six months. If the Company deems these investments further impaired at the end of any other period, an additional impairment may occur. During 2002/2003 MorphoSys' HypoVereinsbank investments had traded below their original cost basis for more than six months and therefore the Company deemed that an impairment of these investments had occurred. Accordingly impairment charges of EUR 753,768 in the period ended June 30, 2003 were recognized.

## 5 Derivative Financial Instruments

In May 2003, MorphoSys entered into foreign currency forward contracts to hedge foreign exchange exposure related to U.S. dollar accounts receivable. At June 30, 2003 forward contracts in the notional amount of EUR 5,190,583 or US\$ 5,812,500 were outstanding and maturing between July 2003 and February 2004. The fair market value at June 30, 2003 was EUR 186,486 included as other current assets on the balance sheet. Foreign currency forward contracts outstanding at June 30, 2003 were as follows in thousands:

in 000's EUR	June 30, 2003	June 30, 2002
<b>Currency Hedging of Anticipated Sales</b>		
U.S. dollar	5,813	0
Fair Value of Asset in EUR	186	0

For the period ending at June 30, 2003, MorphoSys recognized gains of EUR 11,286 resulting from 2003 hedging contracts.

## 6 Restricted Assets

The Company has classified as restricted cash certain cash and cash equivalents and marketable securities that are not available for use in its operations. At June 30, 2003, the Company had commitments of EUR 364,000 for guarantees issued and EUR 136,900 for convertible bonds issued to employees.

## 7 Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) consists of unrealized gains or losses on marketable securities and translation adjustments from consolidation. For the period ended June 30, 2003 and December 31, 2002, the components of accumulated other comprehensive income (loss) were as follows (in thousands EUR):

in 000's EUR	Three Months Ended June 30, 2003	Three Months Ended June 30, 2002	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
Net Unrealized Gain (Loss) on Available-for Sale Securities	990	44	190	67
Foreign Currency Translation Adjustment	(22)	(5)	24	27
<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>968</b>	<b>39</b>	<b>213</b>	<b>94</b>

## 8 Intangible Assets

The following sets forth the intangible asset classes as of June 30, 2003 and December 31, 2002 (in thousands EUR):

in 000's EUR	06/30/2003	12/31/2002
<b>Amortized Intangibles</b>		
Patents	8,547	8,531
License Rights	3,810	3,810
Accumulated Amortization Patents	(2,144)	(1,717)
Accumulated Amortization Licenses	(648)	(457)
<b>Unamortized Intangible Assets</b>		
Patents	91	85
<b>Net Intangible Assets</b>	<b>9,656</b>	<b>10,252</b>

The changes in the carrying amount of un-amortized patents for the six months ended June 30, 2003 is as follows (in thousands EUR):

in 000's EUR	
<b>Unamortized Intangible Assets</b>	
<b>Balance on December 31, 2002</b>	<b>85</b>
Additions for the first six months 2003	6
Write-off of Capitalized Patent Costs	0
<b>Balance on June 30, 2003</b>	<b>91</b>

Amortization expense on intangible assets totaled EUR 617,010 for the first six months period ended June 30, 2003 (June 30, 2002: EUR 621,879).

## 9 Property and Equipment

Property and equipment consist of the following at June 30, 2003 and December 31, 2002 (in thousands EUR):

in 000's EUR	06/30/2003	12/31/2002
Office and laboratory equipment	3,205	3,145
Furniture and fixtures	1,263	1,260
Purchased software	1,114	1,044
<b>Total</b>	<b>5,582</b>	<b>5,449</b>
Less accumulated depreciation	(3,791)	(3,351)
<b>Net property and equipment</b>	<b>1,791</b>	<b>2,098</b>

## 10 Contingent Liabilities

In July 2001, a lawsuit was filed against the Company by Applied Molecular Evolution, Inc. (AME), San Diego, U.S.A. at the United States District Court of Massachusetts in Boston/ U.S.A., alleging that the Company infringes the Kauffman-Ballivet patent family. These patents cover the stochastic production of proteins and were granted in the late 1990's. A trial date has not yet been set, although in January 2003, MorphoSys confirmed that it had received a positive "Report and Recommendation" from the Magistrate Judge to the District Judge for the District Court in Boston, Massachusetts, U.S.A., in the legal action filed by Applied Molecular Evolution. The Magistrate Judge recommended that MorphoSys' motion for summary judgment of non-infringement is allowed and that AME's motion for partial summary judgment of infringement be denied. As a result no provisions for contingent liabilities have been made in the Company's financial statements.

In December 2002, the Company and Cambridge Antibody Technology (CAT) entered into a settlement agreement pursuant to which they agreed to settle all patent disputes between the two companies. Pursuant to the settlement agreement, the Company agreed to make annual payments of EUR 1 million over the next five years as well as issue 588,160 new shares of common stock and make certain ongoing royalty and milestone payments, and in return will receive a license under certain CAT patents with respect to the previous and future development of HuCAL® libraries. The Company has the option to buy out its cash obligations to CAT for a predefined fixed amount at any time during the duration of the agreement. The Company has recorded an accrual for the settlement with CAT in the year 2002. The Company has engaged with a company to complete a valuation, whose basis will provide the necessary information to finalize the accounting. As such, the accounting effects could change significantly from the current estimates recorded. The Company recorded a net present value discount of approximately EUR 1.2 million on the annual payments to record the liability at its estimated current fair value of EUR 3.8 million. The discount on the cash payments will be amortized to interest expense over the period of the payments. Certain aspects of the agreements with CAT are expected to be executed in the second half of 2003 at which time the accounting for the agreement with CAT will be finalized.

Management is not aware of any other matters that could give rise to any material liability to the Company that would have a material adverse effect on the Company's financial condition or results of operations.

## 11 Stockholders' Equity

### Common Stock

On June 30, 2003, the common stock of the Company was EUR 12,939,516. This is an increase of EUR 1,090,398 from December 31, 2002 as a result of the issuance of 363,466 shares to XOMA for capital increase against contribution in kind. On May 6, 2003, the capital increase was registered in the commercial register.

On December 23, 2002, as a result of the patent litigation settlement with Cambridge Antibody Technology (CAT), MorphoSys agreed to issue an equity stake for a contribution in kind, amounting to 588,160 shares for a license to use various technologies, granted by CAT. The license agreement and the contribution agreement with CAT were signed on July 7th 2003. On June 30, 2003, the capital increase was not yet registered in the commercial register.

**Authorized Capital**

On May 6, 2003, 363,466 shares of Authorized capital I were issued to XOMA for a capital increase against contribution in kind. On May 16, 2003, shareholder assembly authorized the Company to create a maximum of 1,725,269 new shares of Authorized Capital I.

On May 16, 2003, shareholder assembly authorized the Company to create a maximum of 431,317 new shares of Authorized Capital II.

**Conditional Capital**

No stock options or convertible bonds were exercised in the first six months of 2003.

On May 16, 2003, the shareholder assembly authorized the Company to create additional shares for Conditional Capital III, IV and V in the maximum amount of 1,275,000, 450,269 and 111,447 shares, respectively.

**Additional Paid-In Capital**

On June 30, 2003, Additional Paid-in Capital amounted to EUR 63,362,051 (December 31, 2002 EUR 59,193,912). The increased amount over the prior year is due to stock based compensation provisions in the amount of EUR 1,057,243 and EUR 3,110,896 as a result of the XOMA transaction.

**Treasury Stock**

Shares totaling EUR 21,934 (59,762 shares) remained unchanged compared to December 31, 2002.

## 12 Convertible Bonds and Stock Options

The Company was authorized by a shareholder assembly motion, subject to the Supervisory Board's and the Management Board's approval, until June 30, 2006 to issue up to 300,000 non-interest bearing convertible bonds with a par/nominal value of EUR 1.00 each (total nominal value EUR 300,000) to employees and members of the Board of Management of the Company and its affiliates. The pre-emptive rights of the shareholders were excluded.

On April 1, 2003, 70,700 convertible bonds were issued to Company employees and the management board.

With the approval of the Company's shareholder assembly motions in May 2003, the members of the Supervisory Board were allowed to subscribe to 10,500 convertible bonds until the middle of July 2003.

On July 1, 2003, various employees received a new grant of 15,000 stock options. Also on July 1, 2003, the Board of Management received 36,000 stock options and 14,000 convertible bonds.

## 13 Directors Dealings

The following table shows the shares, stock options and convertible bonds, and changes of ownership of the same, which were held by the Management and the Supervisory Board during the first half of 2003:

Shares	01/01/2003	Additions	Sales	06/30/2003
<b>Management Board</b>				
Dr. Simon Moroney (held through a controlled entity)	113,461	-	-	113,461
Dave Lemus	-	-	-	-
Dr. Thomas von Rüden	-	-	-	-
<b>Total</b>	<b>113,461</b>	<b>-</b>	<b>-</b>	<b>113,461</b>
<b>Management Board</b>				
Dr. Gerald Möller	-	-	-	-
Dr. Daniel Camus	-	-	-	-
Prof. Dr. Jürgen Drews	-	-	-	-
Prof. Dr. Andreas Plückthun	59,300	-	-	59,300
Dr. Jörg Reinhardt	-	-	-	-
Dr. Geoffrey N. Vernon	-	-	-	-
<b>Total</b>	<b>59,300</b>	<b>-</b>	<b>-</b>	<b>59,300</b>
<b>Stock Options</b>				
<b>Management Board</b>				
Dr. Simon Moroney	25,000	-	-	25,000
Dave Lemus	21,000	-	-	21,000
Dr. Thomas von Rüden	50,700	-	-	50,700
<b>Total</b>	<b>96,700</b>	<b>-</b>	<b>-</b>	<b>96,700</b>
<b>Supervisory Board</b>				
Dr. Gerald Möller	6,100	-	-	6,100
Dr. Daniel Camus	-	-	-	-
Prof. Dr. Jürgen Drews	5,930	-	-	5,930
Prof. Dr. Andreas Plückthun	3,500	-	-	3,500
Dr. Jörg Reinhardt	3,500	-	-	3,500
Dr. Geoffrey N. Vernon	3,500	-	-	3,500
<b>Total</b>	<b>22,530</b>	<b>-</b>	<b>-</b>	<b>22,530</b>
<b>Convertible Bonds</b>				
<b>Management Board</b>				
Dr. Simon Moroney	12,000	12,000	-	24,000
Dave Lemus	10,000	10,000	-	20,000
Dr. Thomas von Rüden	10,000	10,000	-	20,000
<b>Total</b>	<b>32,000</b>	<b>32,000</b>	<b>-</b>	<b>64,000</b>
<b>Supervisory Board</b>				
Dr. Gerald Möller	-	-	-	-
Dr. Daniel Camus	-	-	-	-
Prof. Dr. Jürgen Drews	-	-	-	-
Prof. Dr. Andreas Plückthun	-	-	-	-
Dr. Jörg Reinhardt	-	-	-	-
Dr. Geoffrey N. Vernon	-	-	-	-
<b>Total</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>

# Imprint

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