

Group Management Report

Industry Overview

Macroeconomic Development

European economic development improved in 2004 in comparison with the previous year. However, the growth rate was considerably slower in selected E.U. countries in the second half of the year. A significant increase in the price of oil and the weak dollar were important factors influencing the European economy during the year. Although oil price increases subsided following the record high of more than US\$ 50 in October 2004, the euro's continued advance against the dollar negatively impacted business sentiment in Europe. As a result, important economic indicators in Germany such as the Ifo Business Climate index evidenced large drops at year-end.

The U.S. economy recovered in the second half of the year following a weaker performance in the first half. The high current account deficit, which has now increased to over 6% of the gross domestic product, remains a structural problem for the U.S. economy, and weighs heavily on the minds of U.S. dollar investors. The U.S. Federal Reserve Bank has gradually raised the Federal Reserve lending rate to its present level of 2% in 5 increments, in order to counteract the continuing risk of inflation, and also, to thwart the possible creation of an asset bubble in the residential housing markets.

Global capital markets continued their recovery in 2004. However, the development of global stock markets, particularly in the second half of 2004, was characterized by high price volatility due to interest rate and oil price uncertainty. Looking at the year as a whole, stock market indexes developed positively, with the German DAX increasing by 7%, the NASDAQ Composite and U.S. Standard & Poor's 500 index by 9% each, and the Japanese Nikkei index by approximately 8%.

Development Within the Biotech Sector

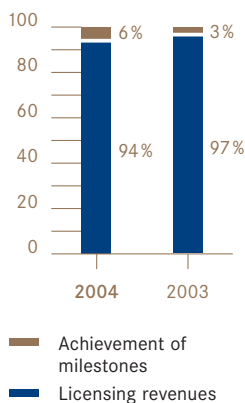
There was both good and bad news from the pharmaceutical and biotechnological sector during the year. The approval of Erbitux (Imclone/BMS/Merck) in the U.S.A., excellent phase 3 results for Tarceva (OSI/Genentech/Roche) and a positive assessment regarding the safety and effectiveness of Macugen (Eyetechnology/Pfizer) all helped to contribute to the positive news. However, the sector also experienced somewhat more disappointing news. Five years after it had been approved, Merck was forced to withdraw its analgetic blockbuster, Vioxx, from the market in September 2004 on account of safety concerns. Since the withdrawal, Merck has lost approximately 30% of its market capitalization. Additionally, in October 2004, it was announced that Chiron would have to temporarily close its influenza vaccine production plant in Great Britain due to safety issues. Adding further woe to the sector, AstraZeneca faced issues concerning its anticancer drug Iressa. The Company's shares dropped by over 7% after it announced that Iressa failed to prolong survival in a lung cancer study.

The year 2004 also brought gratifying news from the therapeutic antibodies sector. Two further therapeutic antibodies were approved for market—Avastin (Genentech) and Tysabri or Antegren (Biogen Idec/Elan). In addition, the sector posted a number of large and cash-rich antibody collaborations—a sign of the confidence and interest in antibodies as successful therapeutics. This confidence was exemplified in deals with fully human antibody providers including Medarex's deal with Pfizer, Cambridge Antibody Technology's deal with AstraZeneca, and MorphoSys's deal with Novartis and Pfizer.

In 2004, the German biotechnology sector reported a divergence of fortunes. While the performance of most publicly listed companies was relatively strong during the year, conditions for fundraising in private companies did not improve significantly compared to prior years. Underscoring this trend, several privately held German biotech companies declared bankruptcy during the year. Nevertheless, the relevant biotechnology indexes for publicly listed companies have rebounded from the low of August 2004 and since then have enjoyed a healthy upturn. Since the beginning of the year 2004, the German Prime Pharma & Healthcare index increased by 19.5%—in comparison, the U.S. NASDAQ Biotech index increased by 6.1%.

There were several biotechnology IPOs during 2004. In the U.S.A., there were 30 biotech IPOs, most of which were consummated in the first seven months of the year. A total of 11 IPOs were completed in Europe during the year, with one in Germany. The aftermarket trading of newly listed companies in Europe was disappointing, and impacted on other potential biotechnology initial public offerings. More specifically, at the end of 2004, of the 11 IPOs launched during the year, 4 of the companies quoted below their issue price. Nonetheless, overall European biotech fundraising in 2004 was at the second-highest level ever, with a few European companies raising money in follow-on offerings. Globally, biotech company fundraising surpassed the US\$ 20 billion mark for only the second time in the industry's history.

Revenues: Licenses vs. Milestones (in %)



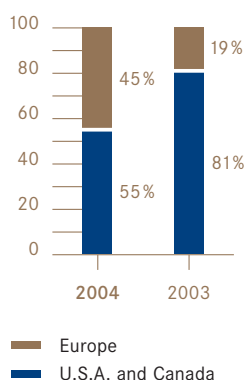
Financial Analysis

Operating Revenues

Compared to the same period of the previous year, revenues for the full year 2004 increased by 44% to € 22.0 million (2003: € 15.3 million).

The majority of revenues recorded in 2004 relate to partnered target research. In this regard, milestone revenues amounted to € 1.4 million or 6% for the full year 2004 compared to 3% in the prior year. The Company also recorded grant revenues, arising from the German Federal Ministry of Education and Research ("Bundesministerium für Bildung und Forschung"), amounting to € 0.1 million during the reporting period, and remained essentially unchanged to the same period in the previous year.

Revenues by Region (in %)



Of total revenues, approximately 88% related to therapeutic antibody collaborations, 8% to antibody research collaborations, and 4% to the “Antibodies by Design” initiative. For purposes of classification, the following partners were considered to be therapeutic antibody collaborations: Bayer, Centocor, GPC Biotech, ImmunoGen, Roche, Schering, Pfizer, Novartis and Boehringer Ingelheim U.S.A. Target research collaborations consisted of: Biogen, Bristol-Myers Squibb (formerly DuPont), ImmunoGen (expansion), Oridis Biomed and Novopiant. Approximately 71% of total Company revenues arose from MorphoSys’s three largest alliances with Centocor, Bayer and Novartis (2003: 81%: Centocor, Bayer and Schering).

Geographically, 55% of MorphoSys’s commercial (non-grant) revenues in the amount of € 12.0 million were generated with biotechnology and pharmaceutical companies located in the United States and Canada, 45% in Europe (2003: 81% and 19%, respectively).

Operating Expenses

For the full year 2004, total operating expenses, including stock-based compensation expenses, increased by 16% to € 21.3 million (2003: € 18.4 million), an increase of € 2.9 million. Higher expenses for intangibles and personnel expenses, partially offset by lower external services costs, served to increase operational expenses as compared to the prior year.

Research and Development Expenses

Costs for research and development rose by € 3.4 million to € 12.4 million (2003: € 9.0 million). Higher personnel and material costs resulting from cooperations recently signed were only partly offset by lower costs for external lab funding. An additional increase in expense comparing 2004 versus the prior year arose from a revaluation of the CAT license resulting in an accounting estimate change in 2003, which reduced research and development expense by € 2.3 million.

Sales, General and Administrative Expenses

Sales, general and administrative expenses amounted to € 7.5 million compared to € 7.2 million in the previous year and thus remained comparatively stable.

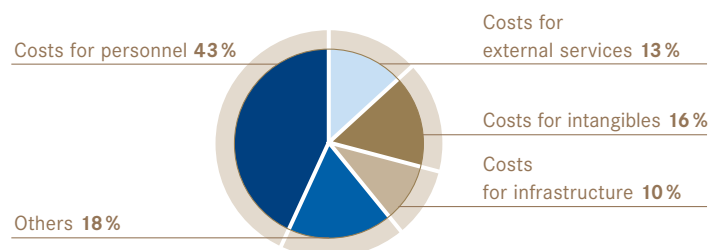
Stock-Based Compensation

Stock-based compensation in the amount of € 1.4 million for the year 2004 was recorded as a non-cash charge (2003: € 2.2 million), resulting from application of IFRS 2 “Share-Based Payments” under IFRS accounting. The decrease in stock-based compensation was mainly due to declining expenses from options and convertible bonds granted in prior periods. Stock-based compensation for new grants was mainly lower through forfeitures and reduced numbers of the same.

Cost by Expenditure Type

Personnel costs (excluding expenses arising from stock-based compensation) amounted to € 9.1 million (2003: € 7.5 million) or 43% of total costs, and were the largest cost block within operating expenses in 2004. The higher personnel cost level arose from higher operational activity and thereby higher revenues in 2004. Intangible costs, which include patent litigation costs and amortization of licenses and patents, amounted to € 3.3 million (2003: € 1.1 million), or 16% of total operating expenses in 2004 and were impacted by revaluation of the CAT license in 2003 and full-year amortization in 2004. External services, which include external lab funding and various outsourced administrative services, amounted to € 2.7 million (2003: € 3.8 million), or 13% of total costs and were primarily reduced by lower levels of external lab funding, legal expenses and other costs associated with the Company's two capital increases in 2003. Infrastructure costs, which mainly include rent, utilities and equipment depreciation costs, amounted to € 2.1 million (2003: € 1.7 million) or 10% of total operating costs, and were slightly higher due to increased equipment depreciation levels associated with higher investment in the same.

Costs by Expenditure Type



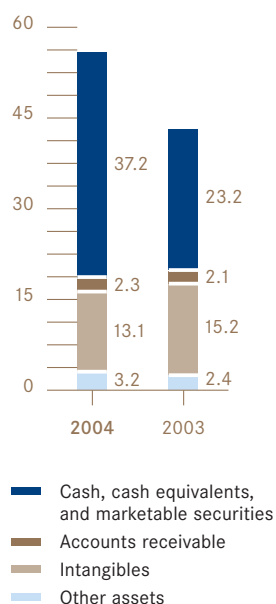
Non-Operating Items

Non-operating loss increased by € 0.3 million to € 0.4 million (2003: € 0.1 million), and was mainly due to higher losses arising from foreign currency transactions in connection with the weakening of the U.S. dollar against the euro, partially offset by the Company's foreign currency hedging activities.

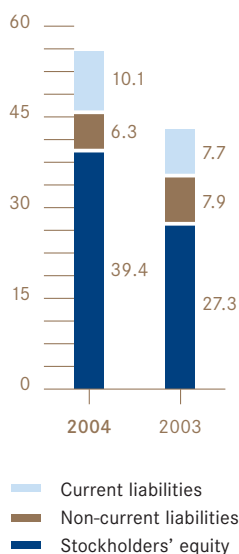
Net Income / Loss

For 2004, a net operating profit of € 0.6 million resulted (2003: operating loss of € 3.1 million). Additionally, a net income of € 0.3 million in 2004 resulted (2003: net loss of 3.1 million)—the Company's first full fiscal year of profitability. The resulting net income per share for the full year 2004 amounted to € 0.05 (2003: loss of € 0.72).

Total Assets (in million €)*



Liabilities (in million €)*



* Differences due to rounding up/down, see balance sheet page 63.

EBITDA (earnings before interest, taxes, depreciation, amortization and stock-based compensation) amounted to € 4.6 million (2003: € 1.8 million).

Liquidity / Cash Flows

On December 31, 2004, the Company had € 37.2 million in cash, cash equivalents and marketable securities compared to a € 23.2 million balance at December 31, 2003—an increase of more than 60% compared to the prior year. In 2004, cash provided by operating activities was, as in the previous year, positive, amounting to € 4.7 million (2003: 5.8 million).

During the year 2004, the Company's current assets increased by € 14.2 million to € 40.4 million compared to € 26.2 million at December 31, 2003, primarily as a result of the issuance of a convertible bond to Novartis of € 9.0 million in connection with the strategic antibody collaboration signed in May 2004. Positive cash inflows from operations also served to increase the year-end cash amount.

Assets

Largely as a result of the increased cash position, and to a lesser degree investment in equipment, total assets rose and amounted to € 55.8 million in the year 2004, compared to € 42.9 million at December 31, 2003.

Liabilities and Provisions

During the year 2004, total current liabilities increased by € 2.4 million. The increase was mainly due to higher accruals made for license payables as well as for employee-related benefits. In connection with milestone and exclusive license payments received in the fourth quarter of 2004, VAT payables also increased current liabilities. Furthermore, provisions amounting to € 0.6 million were made for pending trials.

The long-term portion of liabilities amounting to € 0.9 million decreased for the year ended December 31, 2004, (2003: € 1.7 million) by € 0.8 million due in large part to license payments made to CAT in 2004.

Equity

At year-end 2004, the total number of shares issued was 5,438,852, of which 5,408,790 were outstanding, compared to 4,901,332 and 4,841,570 respectively in the prior year.

The increase in outstanding shares arose from the conversion of a convertible bond issued to Novartis in May. These mandatory convertible debentures were converted into 490,133 common MorphoSys shares in June 2004. Additionally 47,387 shares were issued as a result of the exercise of options and convertible bonds granted to employees as part of the Company's equity incentive schemes.

Capital Expenditure

During 2004, total investment in intangibles amounted to € 0.2 million (2003: € 8.5 million). A large majority of the decrease related to the acquisition of the CAT license in 2003. Amortization of capitalized intangibles for the year 2004 was correspondingly higher at € 2.0 million compared to € 1.5 million in the previous year.

Investment in property and equipment amounted to € 1.5 million in the year 2004 compared to € 0.5 million in the previous year. Depreciation for 2004 of € 0.7 million compared to € 0.5 million in the same period last year. The increase in equipment was mainly due to investments made in connection with the antibody reagent business unit.

Subsidiaries / Segments / Organizational Structure

MorphoSys's global headquarters is located in Martinsried, Munich, Germany. The Company's R&D center and all administrative departments are presently located at its headquarters. The Company possesses four wholly owned subsidiaries:

MorphoSys U.S.A., Inc.

MorphoSys U.S.A., Inc. was formed in the year 2000 for the purpose of assisting MorphoSys AG in marketing and commercializing its technologies. The U.S. subsidiary, with its office in Charlotte, North Carolina, was responsible for all marketing and corporate development activities at MorphoSys. In line with the restructuring measures in 2002, the activities of MorphoSys U.S.A., Inc. were transferred to MorphoSys AG in Germany and the operations in Charlotte, NC, were substantially closed by year-end 2002.

MorphoSys IP GmbH

In November 2002, MorphoSys formed MorphoSys IP GmbH, whose purpose is to administer the internally generated intellectual property of MorphoSys AG. To this end, MorphoSys AG sold at fair market value the rights to certain internally generated intellectual property in 2002. MorphoSys IP GmbH is a wholly owned subsidiary of MorphoSys AG, and a profit pooling agreement exists between those two companies. In order to fulfill its operational needs, MorphoSys IP GmbH has contracted administrative services from MorphoSys AG and entered into a sublicensing agreement with MorphoSys AG in order to enable MorphoSys AG to commercialize said patents/technologies.

Biogenesis U.K. Ltd. and Biogenesis U.S.A., Inc.

On January 20, 2005, MorphoSys acquired two privately held companies, Biogenesis Ltd. (Poole, U.K.) and its sister company Biogenesis, Inc. (Brentwood, New Hampshire, U.S.A.). The final agreements specify the purchase of 100% ownership of Biogenesis Ltd. and Biogenesis, Inc. by MorphoSys for GBP 5.25 million, less net debt of approximately GBP 700,000, in cash. The two Biogenesis companies will become wholly owned subsidiaries of MorphoSys AG.

The acquisition of the Biogenesis Group is an expansion of the Company's efforts in the non-therapeutic applications for its HuCAL[®] technology. Additionally, it provides MorphoSys with immediate access to new market channels through Biogenesis's worldwide customer and global distributor network for the Company's existing portfolio of products and services.

Commercial Partnerships and Alliance Development

In 2004, the Company expanded existing partnerships and signed new collaborations. The following partnerships were either established or expanded in the 2004 fiscal year (in alphabetical order):

MorphoSys Research Antibodies Unit

In February 2004, MorphoSys unveiled a new business unit to market HuCAL[®] as a source for research products used in non-therapeutic applications. This business segment is presently known as the "research antibodies unit." The range of products and services offered by the business unit primarily targets industrial and academic institutions requiring custom-generated antibodies. More than 150 different customers in more than 15 different countries have been acquired to date, thus demonstrating the significant market potential for custom-generated research antibodies as well as an increasing awareness of the HuCAL[®] brand.

The HuCAL[®] technology has been traditionally employed at MorphoSys in therapeutic antibody collaborations with renowned pharmaceutical and biotechnology company partners. The research products unit was originally conceived in order to further expand the market for MorphoSys's core competence in the generation of fully human antibodies using its well-established HuCAL[®] technology.

In January 2005, MorphoSys acquired two companies, Biogenesis Ltd. (Poole, U.K.) and its sister company Biogenesis, Inc. (Brentwood, New Hampshire, U.S.A.). With more than 20 years of experience in antibody development and manufacturing, and a comprehensive antibody catalogue, the combined Biogenesis Group represents one of the larger European suppliers of antibodies to the life sciences research community. Combined with MorphoSys's existing efforts in this area, the acquisition has established MorphoSys as one of the top 5 European suppliers of research antibodies. While the therapeutic antibodies unit remains the key driver of the MorphoSys business, the expanded research antibodies unit becomes a more significant second pillar in the Company's overall commercial strategy.

Biogen Idec, Inc.

The research cooperation with Biogen Idec, which was signed in December 2000 and extended in January 2002, was successfully concluded at the end of September 2004.

Crucell N.V.

MorphoSys AG, Dutch biotechnology company Crucell N.V. and allied contract manufacturer DSM Biologics signed a non-exclusive license agreement in August 2004. Under the terms of the agreement, MorphoSys receives rights to Crucell's PER.C6[®] fully human cell line technology for use in its own and partnered antibody research programs conducted at MorphoSys. Furthermore, MorphoSys and its partners have an option to obtain a license for the clinical and commercial production of antibodies isolated from the MorphoSys HuCAL[®] library. The human cell line has been shown to be suited to the development and large-scale manufacturing of a wide range of biologics including antibodies. With the deal in place, MorphoSys is better positioned to broaden its technology base and further diversify its manufacturing offerings for existing and new partners.

GeneFrontier Corp.

In order to access the Japanese life science market, MorphoSys signed a strategic marketing cooperation with the Tokyo-based company, GeneFrontier Corporation, in September 2004. The objective of the cooperation is to drive new business opportunities by establishing the HuCAL[®] technology as the premium brand for both research and therapeutic antibody generation in Japan. As part of an ongoing pre-marketing agreement between the two companies, several research projects were conducted with Japanese partners and successfully completed, generating MorphoSys's first ever Japanese revenues. Under the Company's multi-year collaboration, both parties will continue to invest in customer development and marketing in Japan as part of a wider MorphoSys effort to expand geographically into new markets. Japan represents the second largest life science market in the world in terms of revenue size.

Novartis AG

MorphoSys and Novartis AG formed a significant strategic collaboration to discover and develop antibody-based biopharmaceuticals as therapeutic agents, in order to address unmet medical need across a variety of disease indications. In the collaboration which commenced in June 2004, MorphoSys brings validated and robust human antibody technologies (HuCAL GOLD®) to Novartis's new strategic research directions, building a collaboration that is expected to identify and develop novel therapeutic agents rapidly and efficiently.

MorphoSys scientists will work directly with Novartis scientists at various global sites of the Novartis Institutes for BioMedical Research (NIBR). As such, MorphoSys's HuCAL GOLD® technology is to play a central role in Novartis's antibody drug discovery and development efforts. During the three-year term of the agreement, which provides for an additional two-year extension beyond the original term, Novartis will fund internal research at MorphoSys that will generate and optimize HuCAL GOLD® antibodies. In addition, Novartis will have access to the current MorphoSys HuCAL GOLD® library at two of its research sites.

Under the terms of the collaboration, Novartis will be MorphoSys's first partner to receive a non-exclusive option on internalization of the entire MorphoSys technology platform, which would trigger an additional payment by Novartis to MorphoSys. As part of the agreement, MorphoSys will also receive over US\$ 30 million in committed R&D funding and technology license fees for the first three years. MorphoSys also stands to receive technology license payments, research and developmental milestones, as well as royalties on marketed antibody products.

Underscoring the strategic nature of the collaboration, Novartis made an approx. € 9 million investment in MorphoSys by purchasing non-interest bearing convertible bonds of the Company. The convertible bonds were converted into 490,133 common MorphoSys shares, issued from conditional capital, on June 15, 2004. At December 31, 2004, Novartis owned 9.0% of the issued common stock of MorphoSys.

Novoplant GmbH

MorphoSys AG and Novoplant GmbH signed a collaboration for the development of therapeutic antibodies in animal health applications in July 2004. Under the three-year agreement, Novoplant received a license from MorphoSys for the development and commercialization of therapeutic antibodies as feed components for use in veterinary medicine. In addition to annual licensing fees, Novoplant pays a technology access fee to MorphoSys for the utilization of the HuCAL GOLD® technology. Moreover, MorphoSys receives milestone fees and royalties for the subsequent development and marketing of any resulting products.

In the context of the cooperation, Novoplant will use MorphoSys's HuCAL GOLD® technology to generate antibodies against viruses, parasites and pathogenic micro-organisms such as *E. coli* or salmonella. The addition of such MorphoSys antibodies to animal feed stock intended for poultry, pigs or cattle may offer protection against infectious diseases in the respective animal's gastrointestinal tract. MorphoSys retains all rights in any human therapeutics or diagnostics emerging from the collaboration.

Oridis Biomed

The research cooperation with Oridis Biomed, which was signed in September 2001, ended at the end of September 2004 and was not extended.

Production

As a result of its partnership with Lonza Biologics, MorphoSys has gained a competent partner in the production of antibody material. Lonza has many years of experience in the field of process optimization and production of biological agents. The production of clinical antibody material is a time-consuming and expensive procedure, which is strictly controlled by the relevant authorities.

For its own pre-clinical investigations, MorphoSys produces antibodies in milligrams. The MorphoSys business segment "research antibodies unit" also produces antibodies for its customers in this quantity. The current MorphoSys capacity is fully capable of producing antibodies in these amounts, when these materials are used exclusively for research. MorphoSys currently has no plans to build its own production facilities for the manufacture of clinical antibody material due to the investment and expense involved with such production sites.

Human Resources

People at MorphoSys

With their commitment, expertise and experience, the employees of MorphoSys are the basis for the Company's success. It is of central significance to hire the most highly qualified and motivated employees and to be able to retain them for the long term.

Performance-Related Compensation and Stock Option Programs

MorphoSys's success is based on the high motivation of its employees. In this vein, all employees take part in a "management by objectives" program, which includes both personal and Company goals. The achievement of the goals is linked to the annual bonus program. Additionally, all employees have the chance to participate in a stock option or convertible bonds program as part of a long-term equity incentive scheme. The aim of this program is to give employees a long-term stake in the success of the Company.



Silvia Dermietzel
Senior Director
Human Resources

Defined Contribution Pension Fund

During 2004, MorphoSys introduced a company pension for all employees under the umbrella of the German pension law (“Altersvermögensgesetz”). The pension plan is a defined contribution pension fund, which is provided by an independent third-party provider for the individuals concerned. The plans are portable, and contributions are financed by voluntary salary reductions by the employees. Both employees and employers benefit, as the German federal tax authorities do not tax employee contributions, and thus taxes are deferred until pensions are actually withdrawn. The Company benefits through savings on social insurance payments which are lower due to the reduced salaries paid to employees. The pension plan is seen as an important element and building block in helping employees diversify and build their financial retirement assets.

Significant Changes**Supervisory Board of MorphoSys AG**

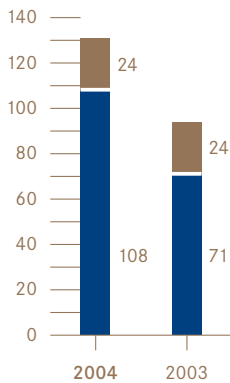
At the Annual Shareholders’ Assembly of May 11, 2004, Dr. Gerald Möller, Dr. Daniel Camus and Dr. Geoffrey N. Vernon were re-elected as members of the Supervisory Board. Dr. Gerald Möller, Managing Director of HBM BioCapital Management GmbH, is Chairman of the Supervisory Board and has been on the MorphoSys AG Supervisory Board since 1999. Dr. Daniel Camus, CFO and member of the Executive Committee of Electricité de France (EdF), France, has been on the Supervisory Board of MorphoSys since 2002. Dr. Geoffrey N. Vernon, Executive Chairman of Ziggus Holdings Limited, United Kingdom, has been on the Supervisory Board since 1999.

Dr. Metin Colpan was appointed as new Supervisory Board member. Dr. Colpan replaced Dr. Jörg Reinhardt, Director of Development and member of the Executive Committee at Novartis Pharma. Dr. Reinhardt joined the Supervisory Board of MorphoSys in July 2001 and refrained from seeking re-election due to other commitments. Dr. Colpan was co-founder, Chief Executive Officer and Managing Director of QIAGEN for approximately 20 years.

Management Board of MorphoSys AG

On September 3, 2004, MorphoSys announced the departure of Dr. Thomas von Rüden from the Company’s Management Board. Until a successor is appointed, the Company will continue to be managed by the other two Board members, Dr. Simon E. Moroney, Chief Executive Officer, and Dave Lemus, Chief Financial Officer. Dr. Moroney added Research and Development to his responsibilities, while Dave Lemus added Technical Operations to his responsibilities. The Company thanks Dr. von Rüden for his significant efforts over the last several years in helping establish the HuCAL GOLD® technology as the world’s premier fully human antibody technology.

Employees



■ S,G&A
■ R&D

Number and Qualification of Employees

On December 31, 2004, the MorphoSys Group employed 132 employees (December 31, 2003: 95). The MorphoSys Group employed an average of 117 employees for the full year 2004 (2003: 93); for Q4 2004, the average was 132 employees (Q4 2003: 95).

Of the 132 employees, 108 worked in research and development and 24 in administration and sales. At the end of 2004, 45 of MorphoSys's employees had a Ph.D. degree (December 31, 2003: 35).

On December 31, 2004, MorphoSys employed 2 trainees as "technical information processors in the area of information technology" (December 31, 2003: 2 trainees).

Environment and Health Protection

MorphoSys carries out its research in safety level "Bio I" and "Bio II" laboratories and under observance of all relevant legal guidelines. Internal standards are more stringent than those guidelines which are legally required. One designated full-time employee for work safety is part of the expert team of employees specifically responsible for work safety, biological safety and fire prevention. Employees are given regular training to inform them of the latest guidelines. To date, no official inspections have resulted in any requirement to change procedures. Due to regular maintenance by internal employees, all laboratory equipment adheres to the highest possible standard of safety.

A detailed waste management concept has been extensively documented and ensures that disposal of laboratory waste is always in line with valid limits and guidelines.

Regular medical checks are carried out for all MorphoSys employees. An initial medical check is carried out for all new employees in the research department. Such checks are repeated yearly. Furthermore, employees are routinely vaccinated against hepatitis A and B.



Dr. Günter Wellenhofer
Director
Technical Operations

Research and Development

MorphoSys uses its own HuCAL[®] technology for development of therapeutic antibodies and research reagents. This technology has been thoroughly tried and tested in numerous partnerships.

In the course of its therapeutic antibody collaborations, MorphoSys generates human antibodies for its partners which are then optimized according to their requirements. In the context of these partnerships, MorphoSys is responsible for the manufacture and optimization of the antibodies, whereas the partner is responsible for pre-clinical and clinical development.

More recently, MorphoSys has been developing its own proprietary therapeutic antibodies as candidates for out-licensing to potential partners, prior to their entry into clinical development.

Existing Collaborations

In the course of the 2004 fiscal year, MorphoSys made significant progress in various existing collaborations. For a description of all existing partnerships, please see pages 108 - 113.

Bayer AG

In the context of an agreement for the cross-licensing of certain technologies with Bayer HealthCare, MorphoSys received the human cell line HKB 11 for production of HuCAL[®] antibodies. The agreement was signed in January 2004. MorphoSys received the right to use the cell line for its own research and an option for the commercial production of antibodies using the HKB 11 cell line. In exchange, Bayer switched its in-house R&D programs to the MorphoSys HuCAL GOLD[®] antibody technology, triggering an installation fee from Bayer HealthCare to MorphoSys.

Boehringer Ingelheim

In August 2004, MorphoSys and its existing partner Boehringer Ingelheim announced the start of a new program for the development of a therapeutic antibody against an undisclosed target molecule involved in cardiovascular diseases. MorphoSys is generating this antibody using its proprietary HuCAL GOLD[®] technology. Boehringer Ingelheim will carry out the pre-clinical and clinical development, as well as subsequent marketing of all resulting products. MorphoSys will participate in the successful progress of the project, receiving milestone payments and royalties.

Centocor, Inc.

The collaboration agreement with Centocor was signed in December 2000, and was originally planned to end in December 2005. One year ahead of schedule, the companies extended the existing antibody cooperation which will now run until the end of 2007. Under the terms of the expanded agreement, Centocor increased its levels of research and development funding to MorphoSys, and paid an upfront payment. Furthermore, Centocor is committed to commence at least two new antibody development programs in 2005.

In August 2004, Centocor, Inc. exercised an option to retain a commercial license for HuCAL[®] antibodies directed against an undisclosed Centocor target molecule involved in inflammatory diseases. In exchange, MorphoSys received a license payment from Centocor. The cooperation between MorphoSys and Centocor, initiated in December 2000, is aimed at the development of human therapeutic antibodies in a range of indications. It includes an option for Centocor on the development of antibodies against up to 30 different target molecules using MorphoSys's proprietary technologies.

Prior to taking the commercial license, in April 2004, MorphoSys announced the achievement of a fourth milestone in its cooperation with Centocor Inc. In meeting the milestone, MorphoSys developed several highly optimized fully human IgG antibodies against a disease-associated target provided by Centocor. As part of the collaboration milestone, MorphoSys applied its proprietary HuCAL GOLD[®] antibody library in order to generate antibodies which passed nine different predefined criteria. Achievement of the milestone resulted in a payment from Centocor to MorphoSys. In the collaboration with Centocor, MorphoSys has achieved four performance-related milestones to date.

In March 2004, Centocor, Inc. elected a new target molecule involved in autoimmune diseases, marking the start of another therapeutic antibody program with MorphoSys. MorphoSys is generating antibodies against the target provided by Centocor using its proprietary HuCAL GOLD[®] technology. Centocor will carry out pre-clinical and clinical development and subsequent marketing of resulting products. In exchange, MorphoSys stands to receive licensing and milestone payments, in addition to royalties.

GPC Biotech AG

MorphoSys's first HuCAL[®]-generated antibody received clearance to go into the human clinical development trials in 2004. More specifically, the Company announced in December 2004 that its partner GPC Biotech AG received regulatory clearance from the Swiss Agency for Therapeutic Products to commence a phase 1 clinical trial with an anti-cancer antibody generated using MorphoSys's HuCAL[®] technology. The HuCAL[®]-derived antibody is expected to enter clinical trials in human patients at sites in three European countries.

The commencement of clinical trials will then trigger a clinical development milestone payment from GPC Biotech to MorphoSys, due on the first administration of the HuCAL[®] antibody in human patients.

Prior to receiving the regulatory clearance, GPC Biotech extended its exclusive license for HuCAL[®] antibodies directed against MHC class II target molecules in January 2004. The extension of the exclusive license was followed by a payment from GPC to MorphoSys.

Product Development at MorphoSys

MorphoSys's proprietary pipeline of therapeutic antibody programs comprises actually three candidates, MOR101, MOR102 and MOR202. MorphoSys plans to out-license all antibody programs before the start of clinical trials.

MOR202

In October 2004, MorphoSys presented promising initial *in vitro* and *in vivo* data for the internal cancer antibody program, MOR202, at the "Human Antibodies & Hybridomas" conference held in Dublin. The fully human antibodies generated from MorphoSys's HuCAL GOLD[®] library are directed against the target molecule CD38, which is heavily over-expressed on the surface of certain cancer cells. The MOR202 program is currently in pre-clinical development for the treatment of multiple myeloma and other blood cancer-related diseases. In line with its corporate strategy, MorphoSys plans to out-license the MOR202 antibody program prior to the start of clinical development.

The MOR202 antibodies were initially characterized in detail in various *in vitro* assays. By directing the MorphoSys antibodies against primary patient tumor material and specific hematologic cancer cell lines, the assays demonstrated that the antibodies were able to kill cancer cells efficiently. A MOR202 antibody also proved to be highly effective in an *in vivo* animal model. The HuCAL[®] IgG antibody was administered regularly to tumor-bearing mice over a period of between three and five weeks. In various experimental settings, different antibody constructs, dosages and treatment regimens were examined. In all cases, treatment with MOR202 antibody led to a significant slowdown of tumor growth, in some cases no tumor could be detected at the end of the observation period. MorphoSys has submitted several U.S. patent applications. These patents relate to specific anti-CD38 antibodies and their use.

Intellectual Property

A series of granted HuCAL®-related patents significantly strengthened the intellectual property position of MorphoSys in 2004. MorphoSys AG announced in March that the U.S. Patent & Trademark Office has granted the Company two new patents, which provide an extended protection of the MorphoSys HuCAL® technology and enlarge the potential area of application for MorphoSys's technologies.

The first new patent (U.S. 6,696,248) entitled "Protein/(Poly)Peptide Libraries" relates to MorphoSys's proprietary HuCAL® technology. The patent covers the genetic constitution of synthetic, fully modular human antibody libraries based on *in silico* consensus sequences. In addition, the U.S. Patent & Trademark Office granted a patent (U.S. 6,692,935 B1) entitled "Targeted Hetero-Association of Recombinant Proteins to Multi-Functional Complexes." The patent covers certain methods for the development of multifunctional protein complexes, such as the combination of antibody fragments with different specificities. In April, the U.S. Patent & Trademark Office granted a third patent (U.S. 6,706,484), which covers the method of obtaining an antigen-specific antibody or an antibody fragment from the HuCAL® library.

The fourth patent was one granted to MorphoSys by the U.S. Patent & Trademark Office in June, covering the Company's proprietary CysDisplay™ screening technology. CysDisplay™ is an important component of MorphoSys's proprietary HuCAL GOLD® technology, and the new patent provides additional protection for the same. The new patent (U.S. 6,753,136) titled "Novel methods for displaying (poly)peptides/proteins on bacteriophage particles via disulfide bonds" describes a selection technology based on phage display for selecting high-affinity antibodies.

MorphoSys's first HuCAL® patent, which is now complemented by the aforementioned patents, was issued by the U.S. Patent & Trademark Office in 2001. HuCAL® patents are currently granted in the United States, Australia and by the European Patent Office. Furthermore, MorphoSys has received several notifications of allowance for further patent applications in the U.S. Presently, MorphoSys has 13 granted patents and more than 50 applications pending worldwide.

Risk Report

MorphoSys AG operates on a global basis. Its business activities comprise different risks, which are relevant to many business functions. The business, financial condition and results of operation of MorphoSys may be materially adversely affected by each of these risks. The Company has established a risk management system that is used regularly to identify, measure and control such risks as an integrated part of normal business activities.

Product Development

MorphoSys is committed to generating therapeutic antibodies for its commercial partners and, more recently, its own account. Thus, the Company's product pipeline comprises both partnered and proprietary therapeutic antibody development programs. These programs are subject to a number of risks of failure inherent in the development of medical therapies. Product candidates require pre-clinical studies and clinical trials in humans as well as regulatory approval prior to commercialization. To date, none of the Company's licensees or partners has commercialized a product based on MorphoSys's HuCAL[®] technology, and HuCAL[®]-derived therapeutics are not expected to be commercially available for a number of years. In addition, none of the HuCAL[®]-derived product candidates has successfully completed all stages of clinical testing and regulatory approval procedures. Pre-clinical studies may not predict and do not ensure safety or efficacy in humans, and are not necessarily indicative of the results that may be achieved in pivotal clinical trials with humans.

Competition and Technological Change

MorphoSys's business environment is characterized by rapid change and intense competition. Its competitors include major pharmaceutical, chemical and biotech companies possessing greater financial, technical and marketing resources than those available to MorphoSys. In addition, certain biotech companies have formed collaborations with large established companies to support research, development and commercialization of products that may be competitive with those of MorphoSys. Moreover, certain research and academic institutions are also active in areas similar to MorphoSys. Some of MorphoSys's competitors currently focus their business efforts on gaining a share of the market and offer their technology at little or no cost to collaboration partners. The first pharmaceutical product to reach the market is often at a significant advantage to later entrants, particularly since subsequent potential entrants must prove an advantage of their product over products already in the market.

There is a risk that MorphoSys's competitors could succeed in developing technologies and products that are safer, less costly and more effective than its technologies or products. In addition, there is a risk that these technologies could produce products that reach the market earlier and could be more successful than those developed by MorphoSys.

Product Risks

The marketing and sale of antibody products and services for certain applications entail a potential risk of product liability, and there can be no assurance that product liability claims will not be brought against the Company. MorphoSys currently carries product liability insurance coverage. There can be no assurance, however, that the Company will be able to maintain such insurance at reasonable cost and on reasonable term, or that such insurance will be adequate to protect MorphoSys against any or all potential claims or losses.

Dependence on Health Care and Pharmaceutical Spending

MorphoSys is dependent on various sources of income, including, in particular, fees, milestone payments and royalties from licensees and partners, the financial condition of public treasuries and the financial markets, the government and governmental health authorities, research institutions, private health insurers and other organizations. Part of MorphoSys's revenue is derived from entering into collaborations with partners, including pharmaceutical companies. Many collaborative and/or out-licensing agreements provide for milestone payments and fees to be paid subject to the satisfaction of specific criteria. MorphoSys has no control over whether its partners or licensees will be able to meet such milestones, nor will MorphoSys be able to control whether products derived from its technology are being developed at all by its partners. Moreover, certain pharmaceutical companies may be more likely to seek to in-license products which have already reached a relatively advanced stage of development, such as phase 2 compounds, as opposed to less advanced product candidates still in pre-clinical stages. Consequently, the products in MorphoSys's pipeline may not reach a sufficiently advanced stage of development to be of interest to these pharmaceutical companies for some time. Therefore the Company can offer no assurance that there will be a guaranteed revenue stream from current or future collaborations.

IP Risks

MorphoSys is or has been involved in legal proceedings in Germany and certain foreign jurisdictions, including the United States, including claims brought by and against it for license or patent infringement, which arise in the ordinary course of business. Presently, the Company is in a patent dispute with Applied Molecular Evolution (AME), which was acquired by Eli Lilly. AME filed a complaint against MorphoSys AG and its wholly owned subsidiary MorphoSys U.S.A., Inc., alleging that MorphoSys AG and MorphoSys U.S.A., Inc. are willfully infringing the Kauffman patent family under which AME holds an exclusive license. While the Company cannot predict the ultimate outcome of the still pending proceedings, management does not currently believe them to have an adverse material effect on the business, financial condition and results of operations of MorphoSys. However, the field of recombinant antibody libraries and phage display, in which the Company is active, is relatively new, and the intellectual property position of the various parties involved is complex and litigious. Therefore, MorphoSys can offer no assurance that further patent suits will not be brought by companies possessing existing patents or patents which have not yet been granted or which the Company is currently not aware of. Any such proceedings, if brought and subsequently decided against MorphoSys, could have an adverse material effect on the business, financial condition and results of operations of MorphoSys.

Additional Funding Requirements

MorphoSys's future capital requirements will continue to be substantial and will be dependent on many factors, including its ability to find licensees and to enter into satisfactory collaboration agreements as well as the success of such collaborations in generating revenues (e.g., licensing fees, milestone payments and royalties). The costs of pre-clinical testing of MorphoSys's products and technologies as well as the costs associated with filing, defending and enforcing patent rights may exceed the returns from these products. MorphoSys may also need to raise additional funds in future years. The Company can offer no assurance that adequate funds will be available to MorphoSys when needed on satisfactory terms or at all.

If adequate funds are not available or are not available on acceptable terms, MorphoSys may have to further reduce its expenditures for research and development, production or marketing. Any such development could have a material adverse effect on MorphoSys's business, financial condition and results of operations. If additional funds are raised by issuing shares, stockholders are likely to experience a dilution of their interests.

Currency Risk

The Group accounts are administered in euros. While the expenses of MorphoSys are predominantly paid in euros, a significant part of the revenues depends on the current exchange rate of U.S. dollars and euros. The Company examines the necessity of hedging foreign exchange transactions to minimize currency risk during the year and addresses them by employing derivative financial instruments.

Dependence on Key Personnel

MorphoSys has not experienced any difficulties attracting or retaining key management or scientific staff, but the continued ability to recruit and retain qualified skilled personnel is critical to the Company's success. Due to the intense competition for experienced scientists from numerous pharmaceutical and biotechnology companies and academic and other research institutions, there can be no assurance that MorphoSys will be able to attract and retain such personnel on acceptable terms. Planned activities will also require additional personnel, including management, with expertise in different areas. The inability to recruit such personnel or develop such expertise could have an adverse material impact on the Company's operations.

Outlook for 2005

Outlook for the Biotech Sector

For 2005, it is expected that biotechnology companies will continue to benefit from the opportunities arising from the pharmaceutical sector's weak product pipelines. Innovative medications are hence still in high demand, meaning further possibilities should abound for rewarding collaborations between pharmaceutical and biotechnology companies. Additional positive impetus for the sector could result from new FDA approvals and positive clinical data. Other catalysts which could positively impact the sector include the U.S.-originated "Bioshield" bioterrorism program, appointment of a new FDA head, and positive news relating to clinical development projects across the industry as a whole.

Strategy

MorphoSys uses its antibody technology both for the development of medicines and the generation of reagents for research purposes and diagnostics agents. Both business activities are expected to continue a long-term growth trend. A stated goal of the Company is to establish the technology as an industry standard for the generation of human antibodies in the life science industry.

In this vein, MorphoSys expects to sign further therapeutic antibody collaborations in order to expand a wide pipeline of therapeutic antibodies with new partners.

As part of the reagent business, MorphoSys endeavors to increase its market share through a combination of further growth and exploration of further possibilities for inorganic growth.

For the year 2005, MorphoSys plans to out-license at least one of its proprietary drug development programs, which currently consist of MOR101, MOR102 and MOR202. No significant expansion of these programs is presently foreseen, nor is a move into clinical development for these projects envisioned. In addition, MorphoSys will strive for further improvements in the efficiency of antibody generation capacity.

Revenues

There continues to be significant interest in human antibodies. Based on this, MorphoSys expects its long-term sales growth to average at least 15%, in line with expectations for a life sciences-based growth company.

Sources of such revenues relating to the Therapeutic Antibodies business unit include long-term partnerships with pharmaceutical and biotechnology companies. MorphoSys receives annual license payments and research payments for provision of the technology and performance, or milestone payments for intermediate goals achieved in the partnerships. Particularly relevant in terms of financial size are clinical milestone payments. MorphoSys expects to receive its first clinical milestone payment in 2005, triggered by the first antibody to enter clinical phase 1 status. At least one additional antibody is expected to enter clinical testing during the year from one of the Company's other partners.

Revenues from the reagent business unit are expected to experience a further increase in 2005. The acquisition of the Biogenesis Group provides MorphoSys with immediate access to new market channels for its innovative HuCAL[®] antibody technology. MorphoSys will continue to support Biogenesis's pre-existing portfolio of research products and at the same time utilize all opportunities to further market the HuCAL[®] technology through Biogenesis's worldwide customer and global distributor network. Additionally, the opening up of new geographical markets, such as the marketing partnership with Japan-based GeneFrontier, are expected to help support revenue growth looking ahead.

Expenses

Expenses are expected to increase in 2005 compared to the prior year, due to an increased full-year total average headcount as compared to the previous year. Additionally, personnel cost is expected to be impacted by increased stock-based compensation expense resulting from the grant of stock options and convertible bonds granted at year-end 2004. Further increases in costs may arise from additional intangibles expense in conjunction with success-based license payments.

Capital Expenditure

Investment in property and equipment is expected to remain at approximately the same level as the previous year. Such investment is expected to focus on investment which increases the efficiency of antibody generation at MorphoSys using the HuCAL[®] antibody library.

Human Resources

The total number of employees as measured at year-end is expected to stay at roughly the same level in 2005. New employees required beyond presently foreseen business activities are contingent upon new collaborations or expansions of existing business activities to support the same. However, the average number of total employees is expected to be higher in 2005, due to significant numbers of hires in mid-year 2004.

Dividends

Although MorphoSys expects to achieve a net profit in 2005, the Company believes that the payment of dividends should be deferred until such time as its financial and liquidity position supports the same. As such, any profits generated by the business shall be reinvested into the operation of its business in order to create further growth opportunities for the future.