

Group Management Report

Corporate Development 2005

Therapeutic Antibodies Segment

The Therapeutic Antibodies segment comprises MorphoSys's activities in the area of therapeutic antibodies, which includes its therapeutic antibody collaborations with pharmaceutical and biotech companies, as well as own antibody development programs. In 2005, the Therapeutic Antibodies segment was able to build upon the positive development of the prior years. Existing partnerships were extended or strengthened during the year, including those with Bayer, Boehringer Ingelheim, Bristol-Myers Squibb and ImmunoGen. At the same time, MorphoSys signed three new partnerships with pharmaceutical companies: Shionogi, Eli Lilly and Merck & Co. The Company ended the year with 29 active partner programs, and the first antibody from this group entered clinical trials. In total, the Therapeutic Antibodies segment generated sales of € 29.1 million in 2005, an increase of 37% compared to the previous year.

Research Antibodies Segment (AbD)

The Research Antibodies segment comprises all activities of MorphoSys's Antibodies by Design unit, as well as all activities of its subsidiaries Biogenesis Ltd. and Biogenesis, Inc. From 2006 onwards, the segment will be named AbD—Antibodies Direct. The AbD segment will comprise all activities of Antibodies by Design, Biogenesis, and the Serotec Group, which was acquired in January 2006. During the year 2005, MorphoSys also remained on a growth curve in the Research Antibodies segment. Following the acquisition of the Biogenesis Group in January, MorphoSys greatly expanded its customer base. Since then, the first HuCAL antibodies have been marketed via the Biogenesis catalog. The Research Antibodies segment sales contributed € 4.3 million, representing about 13% of total Company revenues.

Macroeconomic Development

Economic Development

The global economy grew by approximately 4% in 2005, nearly one percentage point less than in 2004. The slowdown was widespread, reaching virtually every economic region. It was precipitated by higher oil prices, resource-sector capacity constraints, tightening monetary policy in the United States and, in some countries, the maturation of the investment cycle following a year of very fast growth. Of these aforementioned effects, oil prices exerted a particularly strong pull on the economy. At year-end 2005, the price for Brent crude oil had risen to US\$ 58.16 per barrel, up 45% over the prior year.

In Europe, for instance, the growth slowdown was less pronounced. The relatively low oil intensity of European economies and relaxed macroeconomic policy stance helped explain why the slowdown in Europe was not more prominent. After a downturn in spring, the German economy posted stronger growth in the second half of 2005, totaling in an overall growth of approximately 1%.

In Asia, growth remained robust. In Japan, GDP was estimated to have increased by 2.3%. Growth in China remained very strong despite a substantial slowing in both private consumption and investment demand.

With regard to interest rates, year-end European interest rates were slightly higher at 3.5%, compared to the prior year. In 2005, the U.S. Federal Reserve increased interest rates resulting largely from asset price inflation concerns. Related to these developments, the euro ended the year at the rate of US\$ 1.18, weaker than at the end of the year before.

Development in the Global Capital Markets

Overall, growth in the German capital market was positive in 2005. The DAX closed with an increase of 27%. Although the American stock markets displayed a negative trend in the first six months, they witnessed a recovery in the second half of the year, and the S&P 500 Index registered an increase of 3% year on year. The Japanese Nikkei Index increased by 40%, its best performance in years.

Within the technology sector, the U.S.-based NASDAQ Composite Index ended the year with an increase of 1%, while in comparison to its German counterpart, the Frankfurt Stock Exchange (FSE) TecDAX, it outperformed with an increase of 15% for the year.

Within the pharmaceutical and biotechnology sub-segments, the FSE Prime Biotechnology Performance Index increased by 21% and the Prime Pharma & Healthcare Index rose by 26%. The NASDAQ Biotechnology Index managed to recover from its low in May 2005, achieving an annual growth of 4%.

Development Within the Pharmaceutical and Biotechnology Sector

For the pharmaceutical and biotechnology sector, 2005 was a year of mixed messages. Data from industry analysts at IMS Health confirm that growth in the American pharmaceutical market was 6 to 7% in 2005 (2004: 8.3%). Ongoing discussions on drug safety, caused by the product recall of Vioxx® by the U.S.-based Merck Group in 2004, hindered market growth. In the coming years, the U.S. Food and Drug Administration (FDA) is expected to adopt a more cautious approach toward the approval of new drugs. In light of this, few new drugs were approved

in 2005, while the number of so-called black box warning labels on drug packaging grew. In addition, a slew of fast-selling drugs, such as the cholesterol-reducing Zocor® from Merck, are losing their patent protection in 2006. This could have a negative effect on future sales growth, as cheaper imitation drugs (so-called generic drugs) can enter the market.

The financing window for biotechnology companies remained open in 2005 and enabled 18 biotechnology IPOs to be registered in the U.S. and 21 in Europe, including three in Germany. Many firms successfully refinanced in 2005. Worldwide, biotechnology companies raised approximately US\$ 20 billion in capital through IPOs and subsequent financings. As in previous years, numerous pharmaceutical and biotechnology mergers took place. The strong interest paid by pharmaceutical groups to this trend is evidenced by a range of significant deals. In June 2005, the pharmaceutical group Pfizer acquired the biopharmaceutical company Vicuron for US\$ 1.9 billion. In September, Novartis agreed to a long-term partnership with Alnylam Pharmaceuticals and acquired a 20% stake in the company. In the same month, Biogen Idec licensed a portfolio of antibodies, which are currently in phase 2 clinical development, from Protein Design Labs.

In the antibodies sector, the unexpected product recall of the approved antibody Tysabri® at the beginning of the year shook the industry. The monoclonal, humanized antibody developed by Biogen Idec and Elan had received approval in November 2004 for the treatment of multiple sclerosis. After cases of a rare and fatal neurological disease occurred in connection with the use of the drug, Biogen Idec and Elan decided to issue an immediate product recall. As a result, the stock prices of both companies fell dramatically, losing 40% and 70% respectively. The resulting fallout also negatively affected antibody sector share prices.

Despite these setbacks, as the year progressed, a number of highly positive reports emerged from the sector. More specifically, Genentech, Inc., presented convincing phase 3 results for the therapeutic antibodies Herceptin® and Avastin®. In addition to various clinical results, other company reports uplifted sentiment in the antibody sector. As an example, Serono acquired the exclusive worldwide rights from Genmab to the fully human cancer antibody Humax-CD4, which is currently in phase 2 of clinical development.



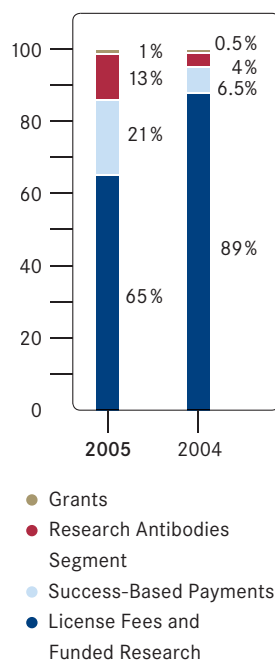
Christopher Stift
Director, Head of
Controlling and Accounting

Also fueling bullish speculation in the antibody sector were a few antibody company acquisitions. Of these, three relating to therapeutic antibody companies are particularly worthy of mention: in July 2005, the Roche Group acquired the Swiss company GlycArt Biotechnology GmbH. Shortly afterwards, in August 2005, Pfizer announced the acquisition of the firm Bioren. Finally, in December 2005, Amgen announced a takeover bid for Abgenix for almost US\$ 2.2 billion. Acquisitions and consolidation in the research antibodies sector also occurred in 2005. More specifically, Invitrogen acquired three providers of immunological reagents and antibodies in 2005 – Zymed Laboratories, BioSource and Caltag Laboratories.

On the whole, these developments helped to contribute to a positive price performance for the antibody sector. A peer group of listed antibody companies (source: BioCentury) displayed an average sector price increase of 30% in 2005. MorphoSys shares gained 8% in value during the year.

Financial Analysis

Revenue Split (in %)



Revenues

Compared to the same period in the previous year, revenues for the full year 2005 increased by 52% to € 33.5 million (2004: € 22.0 million). Reasons for the increase included revenues arising from new deals and the inclusion of success-based payments from existing collaborations (comprising 21% of the reporting year's total revenues), which included clinical and research milestones achieved in 2005. The Group also recorded grant revenues, amounting to € 0.4 million (2004: € 0.1 million) during the reporting period. Approximately 64% of total Group revenues arose from MorphoSys's three largest alliances with Novartis, Centocor and Schering (2004: 71% from Centocor, Bayer and Novartis). Geographically, 56% of MorphoSys's commercial revenues were generated with biotechnology and pharmaceutical companies located in Europe and Asia compared to 42% in North America (see also Notes to the Consolidated Financial Statements – section 2). This compares to 45% and 55% respectively, in the year 2004.

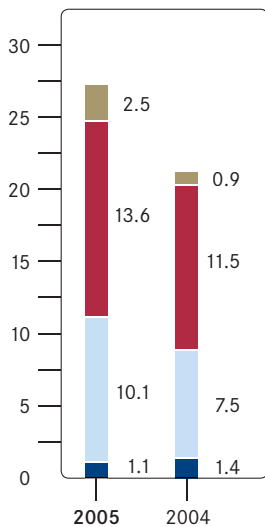
Therapeutic Antibodies Segment

Included in the Therapeutic Antibodies segment are all collaborations which have a strong therapeutic and licensing aspect to them. In 2005, this segment's revenues were generated with the following antibody collaborations: Bayer, Boehringer Ingelheim, Bristol-Myers Squibb, Centocor (Johnson & Johnson), Eli Lilly, F. Hoffmann-La Roche, GPC Biotech, ImmunoGen, Merck & Co., Novartis, Novopiant, Pfizer, Schering, Shionogi and XOMA. The Therapeutic Antibodies segment also includes all activities in the area of proprietary product development. Revenues arising from the Therapeutic Antibodies segment accounted for 87% of total revenues (€ 29.1 million) in 2005. This total comprises € 22.2 million funded research and paid license fees, as well as € 6.9 million success-based payments (which include clinical milestones).

Research Antibodies Segment

The Research Antibodies segment, comprising MorphoSys's Antibodies by Design unit and the Biogenesis Group companies in the U.S.A. and the U.K., generated 13% (€ 4.3 million) of total revenues. The Biogenesis Group, acquired in January 2005, contributed € 2.8 million in revenues, or 65% of the total segment revenues. The Antibodies by Design unit, based in Munich, contributed the remaining 35%, or € 1.5 million, of the total MorphoSys Research Antibodies segment revenues.

Operating Expenses (in million €)



- Costs of Goods Sold
- Research and Development Expenses
- Sales, General and Administrative Expenses
- Stock-Based Compensation

Operating Expenses

For the year 2005, operating expenses including stock-based compensation expenses increased by 28% to € 27.3 million (2004: € 21.3 million), while operating profit increased by € 5.6 million to € 6.2 million (2004: € 0.6 million). The total increase in operating expenses of € 6.0 million was mainly due to higher personnel-related costs in conjunction with new collaborations and increased intangible expenses. The incorporation of the Biogenesis Group companies into Group accounts had the effect of increasing operating expenses by € 3.9 million.

Cost of Goods Sold (COGS)

COGS only arise in the Research Antibodies segment. This item is composed of the cost of goods sold for Antibodies by Design and Biogenesis, as well as amortization relating to the fair value adjustment of Biogenesis's stock identified at the time of the acquisition. For the year 2005, total COGS rose to € 2.5 million compared to € 0.9 million in the year 2004, which resulted largely from the € 1.5 million inclusion of Biogenesis COGS into consolidated Group accounts.

Research and Development Expenses

Costs for research and development increased by € 2.1 million to € 13.6 million (2004: € 11.5 million). This increase mainly resulted from higher success-based license fees and intangible costs. Costs for intangibles rose due to the Lilly patent settlement and increased payments to third-party licensors in conjunction with higher revenue levels. Impairment of assets acquired in 2005 in context with the Biogenesis transaction contributed additional costs of € 0.5 million.

Sales, General and Administrative Expenses

Sales, general and administrative expenses amounted to € 10.1 million compared to € 7.5 million in the previous year. This effect mainly resulted from increased costs for external services and higher personnel costs associated with Biogenesis. Biogenesis's total contribution to sales, general and administrative expenses amounted to € 1.6 million for the year 2005.

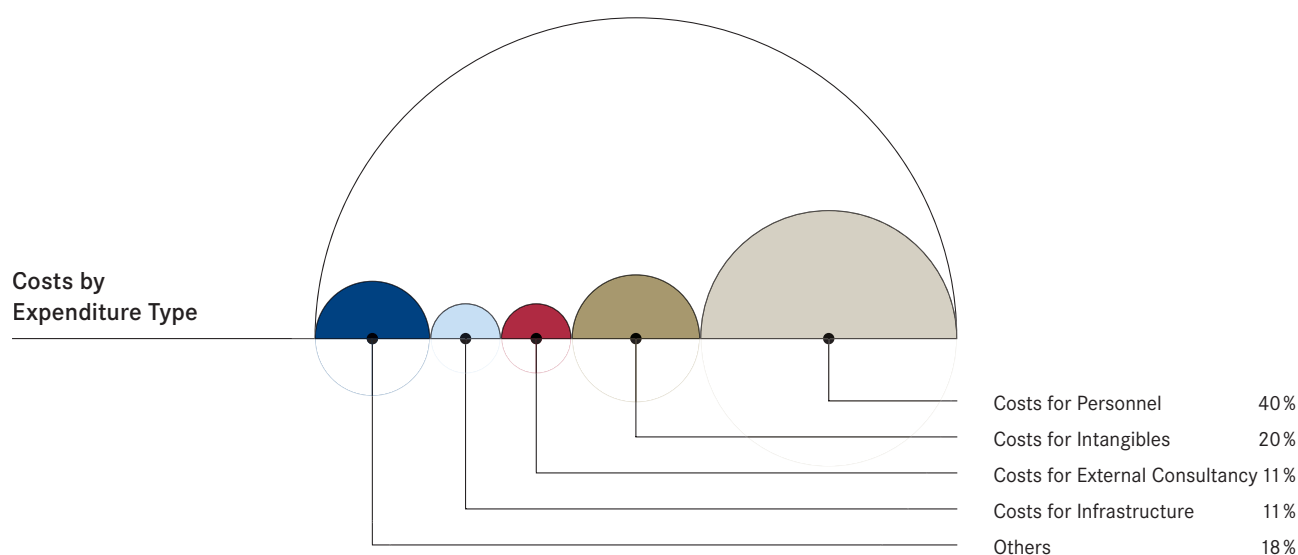
Stock-Based Compensation

Stock-based compensation in the amount of € 1.1 million for the year 2005 was recorded as a non-cash charge (2004: € 1.4 million), resulting from the application of IFRS 2 “Share-Based Payment” under IFRS accounting. The decrease in stock-based compensation was mainly due to declining expenses from options granted in prior periods.

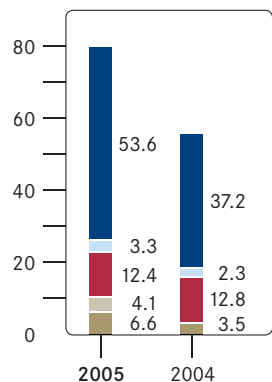
Cost by Expenditure Type

For the year 2005, personnel costs (excluding expenses arising from stock-based compensation) amounted to € 10.8 million (2004: € 9.1 million) or 40% of total operating expenses, thus representing the largest cost block within operating expenses in the year 2005. The higher personnel costs arose from the increased head count in association with the Group’s expanded operational activity.

Intangible costs, which include patent litigation costs and amortization of licenses and patents, amounted to € 5.4 million (2004: € 3.3 million) or 20% of total operating expenses in the year 2005. External consultancy costs amounted to € 2.9 million (2004: € 2.7 million) or 11% of total operating expenses and mainly consisted of marketing expenses, legal costs, costs for tax, auditing and accounting, and general consulting. Costs for infrastructure accounted for € 2.9 million, compared to € 2.1 million in the prior year.

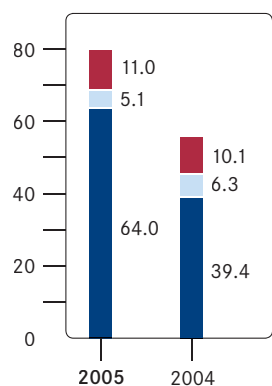


Total Assets
(in million €)*



- Cash Equivalents and Available-for-Sale Financial Assets
- Accounts Receivable
- Intangibles
- Goodwill
- Other Assets

Liabilities
(in million €)*



- Current Liabilities
- Non-Current Liabilities
- Stockholders' Equity

* Differences due to rounding up/down, see balance sheet pages 70/71

Non-Operating Items

Non-operating expenses amounted to € 1.5 million compared to non-operating expenses of € 0.4 million in the year 2004. In the last quarter of 2005, foreign exchange losses were reclassified into non-operating expenses in an amount of € 0.8 million. These foreign exchange losses relate to certain commercial contracts and are shared with the respective partners. Formerly, such shared losses were netted into revenues. Losses on foreign exchange (€ 1.2 million in total), tax expenses (€ 0.4 million) and interest expenses (€ 0.3 million) were mainly offset by gains from available-for-sale securities (€ 0.6 million) and interest income (€ 0.1 million).

Net Profit/Loss

Continuing the positive trend established in 2004, the Company presented a net profit of € 4.7 million, compared to the prior year's net profit of € 0.3 million. The resulting profit per share for the entire MorphoSys Group for the year 2005 amounted to € 0.84 (2004: € 0.05).

Liquidity/Cash Flows

At the end of 2005, the Group held € 53.6 million in cash, cash equivalents and marketable securities compared to a € 37.2 million balance in the year 2004. The increased cash item mainly derived from higher cash inflows as a result of the expanded operational activity and from a capital increase successfully executed in March 2005. The cash inflow from operations contributed € 4.4 million to the same.

Assets

Total assets increased by € 24.3 million to € 80.1 million in the year 2005, compared to € 55.8 million in the year 2004, mainly as a result of the increased cash item and the acquisition of the Biogenesis Group's assets, including property and equipment in the amount of € 3.3 million, intangibles in the amount of € 2.4 million, and acquired goodwill in the amount of € 4.1 million. The purchase price allocation resulting from the application of IFRS 3 "Business Combinations" exercised is reflected in the Group accounts (see also Notes to the Consolidated Financial Statements—section 9).

Accounts Receivable

Accounts receivable increased by € 1.0 million to € 3.3 million in comparison to year-end 2004 (€ 2.3 million). Accounts receivable attributable to the Therapeutic Antibodies segment (€ 2.7 million) accounted for 82% of total accounts receivable. The Research Antibodies segment represented € 0.6 million or 18% of total accounts receivable, whereas the Biogenesis Group and the Antibodies by Design unit contributed € 0.2 million and € 0.4 million respectively to this item.

Liabilities

In the year 2005, current liabilities increased by € 0.9 million to € 11.0 million (2004: € 10.1 million). This was mainly due to increased provisions including income tax provisions for the fiscal year 2005, as well as increased license payable in connection with success-based third-party payments for higher revenue.

Equity

At year-end 2005, the total number of shares issued was 6,025,863, of which 5,996,701 were outstanding, compared to 5,438,852 and 5,408,790 respectively in 2004. The increase arose from the issuance of 490,133 shares in connection with a capital increase in March 2005. An additional increase of 96,878 shares resulted from the exercise and conversion of options and bonds issued to related parties during the year 2005.

Capital Expenditure

MorphoSys's investment in property, plant and equipment amounted to € 0.6 million for the year 2005, compared to € 1.5 million for the prior year. Investment in intangibles amounted to € 0.1 million and € 0.2 million respectively in the years 2005 and 2004. Depreciation of property, plant and equipment for the year 2005 accounted for € 0.9 million compared to € 0.7 million in the year 2004. Amortization of intangibles amounted to € 2.7 million in 2005 (2004: € 2.0 million). The increase in amortization and depreciation was mainly due to the acquisition of the Biogenesis Group.

Organization/Subsidiaries/Acquisitions

Acquisition of the Biogenesis Group

In January 2005, MorphoSys announced the acquisition of two privately held 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 catalog, the combined Biogenesis Group represents one of the larger European suppliers of antibodies to the life sciences research community. The final agreements, signed on January 20, 2005, specify the purchase of 100% ownership of Biogenesis Ltd. and Biogenesis, Inc., by MorphoSys. The two Biogenesis companies became wholly owned subsidiaries of MorphoSys AG. At the beginning of 2006, both subsidiaries were renamed to MorphoSys UK Ltd. and MorphoSys US, Inc.

The acquisition of Biogenesis was an important strategic step for MorphoSys, one of the leading sources of next-generation antibody therapeutics, in establishing its innovative HuCAL technology in new antibody market segments. It followed the establishment of the Antibodies by Design unit in late 2003 to serve the research and diagnostics markets with custom monoclonal antibodies. The Biogenesis Group has a strong catalog and industrial antibody production business, providing clients in the research and diagnostics field with many different antibody services.

Biogenesis and Antibodies by Design have merged all marketing and commercial activities. Most importantly, the combined companies have now been organized along three markets: first, in the **custom monoclonal antibodies segment**, custom monoclonal antibodies are generated in Munich by Antibodies by Design using the HuCAL technology for global clients of both companies. Second, Biogenesis provides a **comprehensive catalog** of antibody products, which serves as a potential portal for the other segments of the business. An initial series of HuCAL-derived antibodies was added to the Biogenesis catalog during 2005. The third segment comprises a **contract manufacturing business** where antibodies are produced in a scale from 10 milligrams to 10 grams or more on behalf of customers.

Acquisition of the Serotec Group

In January 2006, the Research Antibodies segment was further strengthened through the acquisition of the Serotec Group. The acquisition of Serotec, a renowned and internationally active supplier of research antibodies, more than triples MorphoSys's existing Research Antibodies segment revenues and establishes the Company as the leading supplier of research antibodies and antibody research technologies in Europe. Serotec provides MorphoSys with a strong distribution network including subsidiaries and sales offices in the U.S., U.K., Germany, France and Scandinavia. Serotec (Serotec Ltd., Serotec, Inc., Serotec GmbH and Oxford Biotech Ltd.) has become a wholly owned subsidiary of MorphoSys AG and is being integrated within MorphoSys's existing Research Antibodies segment represented to date by the Biogenesis and Antibodies by Design brands.

The purchase price of approximately £ 20 million (approx. € 29.3 million) has been paid via approximately £ 14 million (approx. € 20.5 million) cash and through the issuance of 208,560 new MorphoSys shares from a capital increase against contribution in kind.

Business Development

Therapeutic Antibodies Segment

In 2005, the Company expanded existing partnerships and signed new collaborations. The following partnerships were either established or expanded in the 2005 fiscal year (in alphabetical order). For a detailed description of the partnerships, please refer to the Notes to the Consolidated Financial Statements—section 24.

Bayer Pharmaceuticals Corporation

In December 2005, MorphoSys extended its collaboration with Bayer Pharmaceuticals Corporation ("Bayer"). The collaboration was extended by five years, with a termination option after the first collaboration year.

Boehringer Ingelheim GmbH

Boehringer Ingelheim GmbH (“Boehringer Ingelheim”) and MorphoSys expanded their existing cooperation involving both research and therapeutic applications in March 2005. Under the new contract, Boehringer Ingelheim has acquired an option to receive several exclusive licenses on new therapeutic antibody programs.

Bristol-Myers Squibb Company

In January 2005, MorphoSys signed a further expansion of its existing license agreement with Bristol-Myers Squibb Company (“Bristol-Myers Squibb”). Under the amended agreement, MorphoSys granted Bristol-Myers Squibb access to its HuCAL GOLD library for use in Bristol-Myers Squibb’s pharmaceutical discovery programs for target characterization and validation and for therapeutic and diagnostic antibody product development.

Eli Lilly & Company

In September 2005, MorphoSys announced a cross-license agreement with Eli Lilly & Company (“Lilly”) on the use of certain recombinant protein technologies. Under the agreement, MorphoSys received a license under the Kauffman patent estate to generate and screen certain recombinant peptide and protein libraries and to commercialize any resulting products. The agreement also provides Lilly access to the MorphoSys HuCAL GOLD technology for Lilly’s internal research and development programs. The agreement was part of a settlement to resolve patent litigation initiated by Applied Molecular Evolution (AME), a wholly owned subsidiary of Lilly, involving several U.S. patents of the Kauffman patent family.

ImmunoGen, Inc.

MorphoSys announced in June 2005 that the U.S. biotechnology company, ImmunoGen, Inc., (“ImmunoGen”) has extended its license to use the MorphoSys HuCAL GOLD library in ImmunoGen’s internal target research programs for another year.

Merck & Co., Inc.

In December 2005, MorphoSys signed a five-year license agreement with the U.S. pharmaceutical company Merck & Co., Inc. (“Merck”), for the use of MorphoSys’s HuCAL GOLD and AutoCAL™ technologies in the research and development of human therapeutic antibodies.

Shionogi & Co. Ltd.

MorphoSys and Shionogi & Co. Ltd. (“Shionogi”) announced in September 2005 that they have signed a three-year license agreement on the use of MorphoSys’s HuCAL technology. Under the terms of the agreement, MorphoSys grants Shionogi access to its HuCAL GOLD antibody library for use in Shionogi’s pharmaceutical drug discovery programs.

Research Antibodies Segment

Armbruster Biotechnology GmbH

In March 2005, Antibodies by Design and Armbruster Biotechnology GmbH (“Armbruster”) received a grant of approx. € 1 million from the German Federal Ministry of Education and Research (BMBF). The goal of this project is the research of new therapies against bone cancer metastasis, a life-threatening disease associated with various advanced cancers.

ProQinase/NMI

In June 2005, Antibodies by Design announced the start of a joint project with ProQinase, a division of KTB Tumorforschungs GmbH at the Tumor Biology Center, Freiburg, and the NMI Natural and Medical Sciences Institute at the University of Tübingen, which could transform the analysis of all human protein kinases – the human “kinome.” The project combines the established protein kinase platform of ProQinase with the know-how of Antibodies by Design in the field of custom-made antibody generation and the experience of NMI with siRNA and biochip technologies. In the coming three years, the project will be supported by approximately € 2.0 million within the scope of the BioChancePLUS Program of the German Federal Ministry of Education and Research (BMBF).

Research and Development/Alliance Management



Dr. Harald Watzka
Director, Head of Alliance
Management

MorphoSys uses its own HuCAL technology for the development of therapeutic antibodies and research reagents. Its technology has been thoroughly tried and tested in numerous partnerships. The following represents the progress made in various existing collaborations throughout the year:

Therapeutic Antibodies Segment

In the course of the 2005 fiscal year, MorphoSys made significant progress in various existing collaborations. For a description of all existing partnerships, please see section 24 of the Notes to the Consolidated Financial Statements.

Centocor, Inc.

In September 2005, Centocor, Inc. (“Centocor”), a Johnson & Johnson company, elected a new target molecule involved in immune-mediated and inflammatory diseases, against which MorphoSys will generate antibodies using its proprietary HuCAL GOLD technology. Centocor will carry out pre-clinical and clinical development and the subsequent marketing of resulting products.

GPC Biotech AG

In February 2005, MorphoSys announced that GPC Biotech AG has commenced a phase 1 clinical trial with a fully human cancer antibody generated using MorphoSys's HuCAL technology.

Novartis AG

In August 2005, MorphoSys successfully concluded an initial therapeutic antibody program with Novartis AG ("Novartis"). MorphoSys generated numerous fully human antibodies against a cancer disease-related target molecule from Novartis, fulfilling previously defined success criteria, and thus achieved the first performance-related milestone in the cooperation. The project work commenced in September 2004 and was completed within eleven months.

Schering AG

MorphoSys started three more therapeutic antibody programs within the scope of its collaboration with Schering AG ("Schering") in October 2005. Schering has selected three new target molecules, against which MorphoSys will generate antibodies using its proprietary HuCAL GOLD technology. Additionally, MorphoSys has granted Schering eight exclusive licenses for *in vivo* diagnostic applications.

MorphoSys's Proprietary Product Development

MorphoSys did not achieve its 2005 goal of presenting a commercial partner for at least one of its proprietary antibody candidates. Currently, the Company's proprietary pipeline of therapeutic antibody programs comprises four candidates, MOR101, MOR102, MOR103 and MOR202. To increase the future commercial success, MorphoSys is currently performing a strategic review of its own product pipeline. The results of this review will be presented at the Company's year-end press conference in February 2006.

MOR102

In April 2005, MorphoSys provided an update on its MOR102 antibody program for chronic inflammatory diseases. As part of this program, MorphoSys commissioned a pre-clinical study to compare the effectiveness of MOR102 with that of the approved biologics Amevive® and Raptiva® in an animal model of psoriasis. Although therapeutic effects were observed for all tested compounds in several psoriatic skin samples, the in-depth analysis showed that it is not possible to discriminate on a statistically valid basis between compound-mediated effects and spontaneous healing observed in the negative control group. Hence, this study did not enable conclusions to be drawn regarding the efficacy of MOR102 versus Amevive® or Raptiva®.

Research Antibodies Segment

Since the start of the Research Antibodies segment, various achievements within the identification and production process of research antibodies have been obtained. The overall goal is to create better research antibodies faster and more efficiently.

High Throughput in Generating Antibodies

The Antibodies by Design unit concluded an extensive software project designed to allow increased antibody generation throughput via automated management of parallel projects. This new relational database system improves the efficiency of internal data administration relating to customers, processes, storage and shipment of materials. It includes establishment of a bar code system supporting the PSA (Panning & Screening Automation) software and is part of an ongoing comprehensive automation program by Antibodies by Design to increase the efficiency and speed of high-throughput antibody generation.

Introduction of Several HuCAL GOLD Recombinant Antibodies at Biogenesis

In September 2005, the Antibodies by Design unit introduced a series of fully human, recombinant research antibodies from the HuCAL GOLD antibody library into the sales catalog of the Biogenesis Group. These recombinant research antibodies were identified and developed as part of ongoing research cooperations and proactive projects at Biogenesis for targets with significant demand from potential new clients.

National Institute of Diabetes and Digestive and Kidney Diseases (NIDDK)

In November 2005, Antibodies by Design announced the publication of a scientific research paper by a customer using antibodies generated from the MorphoSys HuCAL GOLD antibody library. Using its rapid, high-throughput antibody generation system, Antibodies by Design selected a set of eight monoclonal and fully human mini-antibodies targeted specifically against the HIV-1 protein gp41 antigens provided by Dr. G. Marius Clore. Scientists working in the team of Drs. Clore and Bewley at the National Institute of Diabetes and Digestive and Kidney Diseases (NIDDK)—part of the U.S. National Institutes of Health (NIH)—subsequently analyzed these antibodies in detail and published the results in the current edition of the *Journal of Molecular Biology*. The analysis demonstrates that the HuCAL-based antibody fragments provide a set of useful probes for studying HIV-1 envelope-mediated cell fusion and may act as fusion inhibitors preventing HIV-1 virus particles from entering their target cells.

Intellectual Property

Patent Litigation with AME/Eli Lilly Settled

In September 2005, MorphoSys signed a cross-licensing agreement with the pharmaceutical group Eli Lilly & Company concerning the use of certain recombinant protein technologies. The agreement allows MorphoSys rights to the Kauffman patents. At the same time, the agreement grants Lilly a license to use MorphoSys's HuCAL GOLD technology in its own internal research and development programs over a certain period of time. This agreement stems from the patent dispute with Applied Molecular Evolution (AME), a wholly owned subsidiary of the Lilly Group, initiated by AME against MorphoSys in 2001.

Information Technology

MorphoSys is experiencing rapid growth in head counts and operations, which demands management and IT infrastructures. MorphoSys will continuously improve and enhance its information and communication systems to ensure that all offices around the world are well coordinated and all employees can effectively communicate with the Company's growing customer base.

During 2005, MorphoSys implemented a new customer relationship management (CRM) system to improve the communication between customers and employees of MorphoSys. Additionally, the Biogenesis companies, which were acquired in January 2005, were integrated into the Company's network to ensure that all employees have access to all necessary information. Internally, the Company implemented management software for human resources to facilitate the management of the increased number of employees.

Financing

In March 2005, MorphoSys placed 490,133 shares in a private placement at a price of € 35.50 per share. The Company raised gross proceeds of approx. € 17.4 million. The issue proceeds will be used to capitalize on existing and future expansion opportunities to accelerate internal and external sales growth, primarily in MorphoSys's activities in the field of research antibodies. With the capital increase, the number of issued shares rose from 5,438,852 to 5,928,985 shares, corresponding to an increase of subscribed share capital in common stock from € 16,316,556 to € 17,786,955.

Production

To improve its production capabilities, MorphoSys has conducted a feasibility study with Wacker Biotech GmbH (“Wacker”). Wacker demonstrated that its proprietary *E. coli* secretion system can offer a far simpler and more cost-effective way of obtaining high yields of antibody fragments, which can be used for research, diagnostic and therapeutic applications. Under the joint agreement, MorphoSys obtains the right to use Wacker’s secretion system for antibody fragment production in research quantities for therapeutic projects both on its own behalf and with its commercial partners.

Procurement

MorphoSys’s procurement is focused on chemicals and laboratory supplies for R&D. The Company procures all needed material from international suppliers, and tends to place its purchase orders with the most favorably priced suppliers, taking into consideration all relevant quality aspects. One major goal is to secure sufficient supply at all times, at the lowest cost. In this vein, key global suppliers are being identified, in conjunction with recent acquisitions, in order to achieve maximum negotiating power with the Company’s global vendors.

Human Resources



Silvia Dermietzel
Senior Director, Head of
Human Resources

People at MorphoSys

MorphoSys is committed to building up a sustainable competitive advantage through the quality, the capability, the commitment and ultimately the performance of its employees. The Company’s success is predicated on its ability to recruit and retain highly qualified and motivated people in all areas of the Company. During 2005, the fluctuation rate of employees was very low at 3.5%.

Performance-Related Compensation and Stock Option Programs

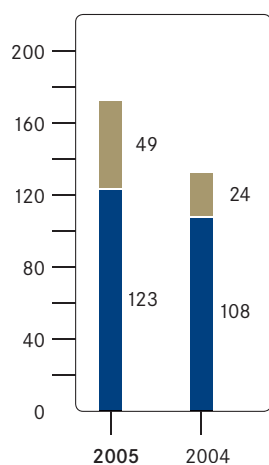
MorphoSys’s success is based on the high motivation of its employees. In this vein, all employees take part in a “management by objectives” program. During 2005, MorphoSys implemented a new bonus scheme for all employees. The yearly bonus payments for each employee are dependent on the achievement of personal goals, as well as department and Company goals. For employees with management functions, the Company goals account for a higher percentage of the individual bonus payment. The new bonus payment is set up to support the future growth of the MorphoSys Group.

Additionally to the performance-related compensation, 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.

Appointment of a New Member of the Management Board

On November 1, 2005, Dr. Marlies Sproll was appointed as Chief Scientific Officer and a member of the Management Board of MorphoSys AG. Dr. Sproll leads MorphoSys's research and development departments, as well as alliance management. Dr. Sproll joined MorphoSys in October 2000 as R&D department head. In September 2004, Dr. Sproll was promoted to Senior Vice President R&D, heading the complete research and development department of MorphoSys AG.

Employees of MorphoSys Group



- Sales, General and Administration
- Research and Development

Number and Qualification of Employees

On December 31, 2005, the MorphoSys Group employed 172 people (December 31, 2004: 132). On average, the MorphoSys Group employed 170 people for the year 2005 (2004: 117).

Of the 172 employees, 123 worked in research and development and 49 in sales, general and administration. At the end of 2005, 46 of the employees of the MorphoSys Group had a Ph.D. (December 31, 2004: 45).

Of total employees, 27 worked for the Biogenesis Group, of whom 10 were engaged in research and development and 17 in sales, general and administration.

On December 31, 2005, MorphoSys employed one trainee as a technical information processor in the area of information technology (December 31, 2004: 2).

Number of Employees	
MorphoSys AG, Martinsried / Munich	145
MorphoSys, Inc., Charlotte, North Carolina, U.S.A.	-
MorphoSys IP GmbH, Martinsried / Munich	-
Biogenesis Ltd., Poole, U.K.	23
Biogenesis, Inc., Brentwood, New Hampshire, U.S.A.	4
Total	172

Environment and Health Protection



Dr. Günter Wellnhofer
Director, Head of
Technical Operations

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 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. During 2005, no industrial accident was subject to mandatory reporting.

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.

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 operating results of MorphoSys may be materially adversely affected by each of these risks. In line with the German “Corporate Sector Supervision and Transparency Act” (“Gesetz zur Kontrolle und Transparenz im Unternehmensbereich” – KonTraG), MorphoSys has established a comprehensive and effective system to identify, assess, communicate and manage risks across its functions and operations. Risk management has the goal of identifying risks as early as possible, limiting business losses by means of suitable measures, and avoiding risks that pose a threat to the Company’s existence. Regular risk analyses at a corporate level are carried out in the following areas: Legal, Taxes and Insurance, Human Resources, Finance, Strategic Planning and Controlling, Business Development, Research and Development, and Production.

General Business-Related Risks

MorphoSys is subject to the typical industry and market risks inherent to the development of fully human antibodies for use in research, diagnostics and therapy. It is known that the development of drugs takes 10 to 15 years, with high attrition rates. MorphoSys is minimizing these risks by partnering its products with pharmaceutical and biotechnology companies, which are responsible for clinical development and marketing. In general, there is a risk that none of the antibody products in MorphoSys's current antibody pipeline will be successfully developed.

Within its second operating segment, the MorphoSys Group generates antibodies for research applications and diagnostics applications. There is a risk that those products will not fulfill the requirements of the customers, or that other products will be more favorably priced.

Acquisition Risks

During 2005, MorphoSys acquired the Biogenesis Group, through which the Company has gained access to new distribution and sales channels. In the future, MorphoSys may acquire additional companies or technologies to increase market share and to complement existing business. Acquisition can expose the Company to risks associated with the assimilation of new technologies, operations, sites and personnel, the inability to generate sales to offset acquisition costs, the issuance of dilutive equity securities, the inability to maintain relationships with employees and customers and additional expenses associated with future amortization or impairment of acquired intangible assets or potential business. The failure to address the aforementioned risks may prevent the Company from achieving the anticipated benefits from the acquisition in a reasonable time frame.

Product Development Risks

MorphoSys is committed to generating therapeutic antibodies for its commercial partners and, more recently, on 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 the 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 are currently focusing 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 entails 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 a 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 outlicensing 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 inlicense 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. These involve claims brought by and against it for license or patent infringement, which arise in the ordinary course of business. After the settlement of the litigation with Applied Molecular Evolution/Eli Lilly in September 2005, no significant patent litigation is pending. 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 operating results 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 the pre-clinical testing of MorphoSys's products and technologies and 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 an adverse material 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 Risks

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 this risk by employing derivative financial instruments.

Dependence on Key Personnel

MorphoSys has not experienced any difficulties in 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.

Opportunities

MorphoSys is one of the world's leading biotechnology companies focusing on fully human antibodies. With its proprietary technologies, MorphoSys is developing not only the next generation of therapeutic antibodies, but also antibodies for research and diagnostics purposes. Antibodies represent the single fastest-growing class of therapeutic agents in the pharmaceutical industry. The Company is well positioned in this market and expects to continue its growth.

Therapeutic Antibodies

MorphoSys is a global player in the field of therapeutic antibodies. Only a few companies offer technologies to develop fully human antibodies, and MorphoSys offers one of the most advanced technologies in this field. MorphoSys owns several issued and pending patents on its core antibody technologies, which provide the Company with protection from competition. Due to high market entry barriers for new companies, as well as an increasing demand for antibody therapeutics, MorphoSys expects an increasing deal flow over the coming years. As can be seen from its partnership roster over the last six to seven years, MorphoSys has a broad set of alliances with

pharmaceutical and biotechnology companies that have the know-how and resources to develop new therapeutics. Furthermore, the Company has been extremely successful in extending existing alliances. There may well be opportunities in the future not only to add new partnerships, but to extend and expand the scope of existing alliances.

By participating in drug development with multiple partners, MorphoSys has effectively lowered its risk profile. With currently between 25 and 30 active therapeutic antibody development programs ongoing with its partners, the chance that MorphoSys will participate financially in one or more marketed drugs is much higher than if fewer partnerships and fewer programs were ongoing. As time goes on, and development projects advance, it is expected that both the number and magnitude of success-based payments will increase.

With regard to MorphoSys's proprietary antibody pipeline, the Company plans to increase its investments in own development programs, and intends to develop the antibody MOR103 for the treatment of rheumatoid arthritis at least as far as IND. By taking this program forward without a partner, the Company stands to benefit from more lucrative financial terms at such time as an alliance for its further development is entered into.

Research Antibodies

Through its acquisition of the Serotec Group, MorphoSys became Europe's leading provider of antibodies and antibody technology for research and diagnostic applications. With this, and the earlier acquisition of Biogenesis, the Company is establishing a strong base from which to commercialize HuCAL-derived antibodies in the research and diagnostics markets. These markets have traditionally been totally dominated by antibodies derived from animals. With its first-mover advantage, MorphoSys intends to lead the transition to new *in vitro* technologies for antibody generation. In contrast to animal-based methods, *in vitro* technologies, such as the HuCAL library, offer greater speed, throughput and flexibility in antibody generation.

The Company has demonstrated its ability to complete acquisitions in this segment of the industry and to use these transactions to accelerate its growth. MorphoSys intends to continue using a merger and acquisition strategy as a means of increasing its market share and achieving its growth objectives. From its current position as a leader in the European market, the Company expects to become one of the leading global players in this field.

Outlook and Forecast

Global Economic Outlook

In its September 2005 World Economic Outlook, the IMF (International Monetary Fund) continued to assume that the world economy—despite the renewed surge in oil prices in the third quarter of 2005—will grow by 4.25% in 2006. The growth rate would thus remain well above the long-term average of 3.5%. The IMF forecast is based on the expectation that the growth-dampening effects of higher oil prices will be offset by a continued accommodative monetary policy, favorable financial market conditions, especially low long-term interest rates, and a sustained improvement in corporate balance sheet structures.

Development of the Biotechnology Sector

For 2006, a continued positive development of the biotechnology sector is anticipated. According to Burrill & Company, in comparison to 2005, an increasing IPO market is expected, with more than 30 IPOs in the U.S. and an even larger number internationally. It is intended that companies of the biotechnology industry will raise over US\$ 35 billion in 2006, with approximately US\$ 25 billion from the public equity markets capital and US\$ 10 billion in partnering. The trend towards consolidation through M&A activities is expected to continue with more deals than in 2005, especially among the larger companies.

Strategy

MorphoSys runs its business in two operating segments. One segment, the Therapeutic Antibodies unit, develops drug candidates for commercial partners and MorphoSys's own proprietary product pipeline. MorphoSys's second operating segment, the Research Antibodies segment, delivers antibodies to the research antibody market under the brands "Antibodies by Design," "Biogenesis," and from 2006, "Serotec." From 2006 onwards, the segment will be named AbD—Antibodies Direct.

In the future, MorphoSys expects further growth in both segments of its business. The Company anticipates signing further therapeutic and research antibody collaborations. Additionally, it plans to invest in the development of its own proprietary antibody therapeutics. For the Research Antibodies segment (AbD), it is the stated goal of the Company to establish the HuCAL technology as an industry standard for the generation of antibodies within the life science industry. MorphoSys further endeavors to increase its worldwide market share through a combination of organic and inorganic growth. For both segments, it intends to further expand to new geographical markets, e.g. the Asia-Pacific region.

Revenues

In line with growth expectations for a life sciences "growth" company, MorphoSys expects its long-term organic sales growth to average at least 15% per annum. Over the last 5 years, annual revenue growth has averaged 36%.

MorphoSys receives periodic license payments (both short and long term), funded research payments, performance-based success payments, and clinical milestone payments within the realm of its therapeutic antibody collaborations. In 2006, it is anticipated that milestones and success-based payments will contribute an increasing percentage of total revenues as compared to previous years. Such performance-based payments lend themselves to potentially higher upside, but also more volatility and unpredictability throughout the year.

Revenues from the Research Antibodies segment (AbD) are expected to further increase. Through the acquisition of Serotec in January 2006, revenues will at least triple in 2006. The acquisition of Biogenesis and Serotec provides MorphoSys with immediate access to new distribution channels and customers for its innovative HuCAL antibody technology. Revenues from the AbD segment comprise sales of readymade antibodies from the Biogenesis and Serotec antibody catalogs, revenues for services of the Antibodies by Design unit for custom monoclonal antibodies, and revenues for contract manufacturing services.

Expenses

Expenses are expected to increase in 2006 compared to the prior year, mainly due to an increased full-year total average head count of the MorphoSys Group as compared to the previous year. Additionally, personnel costs are expected to be impacted by higher stock-based compensation expenses resulting from stock options and convertible bonds granted at the beginning of 2006. Further increases in costs are expected to arise from further investment into development of the underlying HuCAL technology and higher levels of investment into product development.

Research and Development

Research and development is to remain the key focus in coming years. MorphoSys intends to maintain its technological leadership in the area of human antibodies and plans to invest money in further technology development. The Company continues to pursue further proprietary product development, and more specifically, focus these efforts on getting MOR103 for the treatment of rheumatoid arthritis at least as far as IND.

Financing

MorphoSys achieved profitability for the first time in 2004, and has been cash positive since 2003. The present business model is predicated on running operations independent of the capital market, i. e. at least cash neutral. Free cash flow and operating profits are intended to be reinvested into research and development, as well as in future growth opportunities in order to secure the long-term growth of the Company. On this basis, financings required for continuation of normal operations are currently not foreseen in 2006. However, a financing in conjunction with future acquisition would not be excluded per se on this basis.

Capital Expenditures

Investment in property, plant and equipment is expected to increase in comparison to the previous year. Such investment is expected to focus on increasing the efficiency of antibody generation at MorphoSys and maintaining the technological leadership using the HuCAL antibody library. For the newly acquired Serotec Group, investments for integration and exploitation of synergies are planned.

Human Resources

The average number of total employees of the MorphoSys Group is expected to be higher in 2006 due to the acquisition of Serotec, which adds approximately 80 employees to the corporate head count. New employees required beyond these levels are presently contingent upon new collaborations or expansions of existing business activities to support the same.

Supply Chain Management

In conjunction with the newly acquired affiliates in the U.K. and the U.S. (i. e. the Biogenesis Group and the Serotec Group), MorphoSys is presently identifying common vendors across its various subsidiaries, in order to secure global agreements with these parties. It is expected that additional critical mass could thereby be gained in these agreements, which would help the Company to secure the most beneficial terms for Group companies.

Future Legal Corporate Structure and Organization

The acquired Biogenesis Ltd. and Biogenesis, Inc., are now subsidiaries of MorphoSys AG and were renamed MorphoSys UK Ltd. and MorphoSys US, Inc., by the beginning of 2006. The recently acquired Serotec Group, which includes Serotec Ltd., Serotec, Inc., Serotec GmbH and Oxford Biotechnology Ltd., also became an affiliate of MorphoSys AG. A review is presently ongoing relating to corporate structure, with the ultimate purpose of making the present MorphoSys Group companies work as efficiently and smoothly as possible.

Dividends

Although MorphoSys achieved 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.