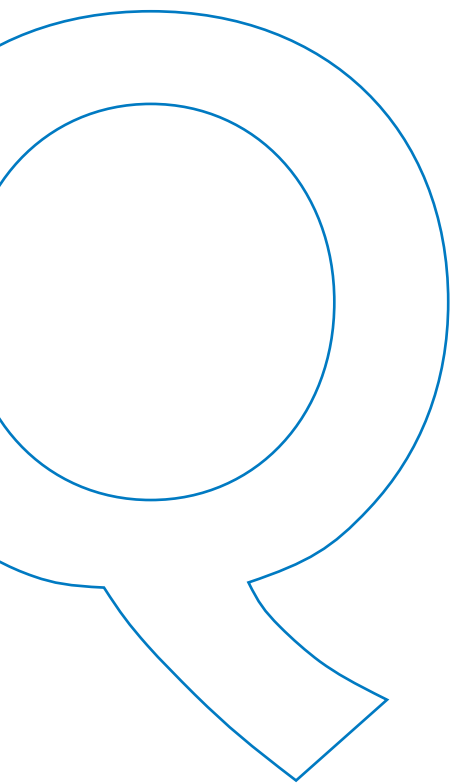




**M I C R O L O G I X**

( July 31, 2002 )



**1**

**Micrologix  
First Quarter  
Report**

## MICROLOGIX BIOTECH INC.

is engaged in the research, development, and commercialization of drugs that advance therapy, improve health, and enrich lives. The Company's focus is toward anti-infective drug development with three product candidates in human clinical studies and earlier-stage candidates in various stages of research, development and evaluation.

# Advancing Therapy.

# Improving Health.

# Enriching Life!

## THE MICROLOGIX COMMITMENT

The Micrologix team is committed to building an outstanding, profitable, highly valuable business based on people, relationships, and integrity, with a clear focus and a passionate drive toward *the best that can be done* to deliver new therapeutic products that advance therapy, improve health and enrich lives.

## FROM THE MICROLOGIX TEAM

If we were to choose two words that would best describe this past quarter, those words would be **EXECUTION** and **RESULTS**. After several months developing the strategic plan that would guide us as we build our Company, we have now started to see some results toward the execution of that plan.

We have become a market driven anti-infective company, well positioned with multiple product opportunities. Simultaneously, we have decreased our burn rate by focusing on the most value added projects, establishing win-win partnerships and reorganizing internally for maximal efficiency and cash management. It has been a quarter marked by significant progress in our three main areas of focus: **PEOPLE**, **PIPELINE** and **PARTNERSHIPS**. Some highlights:

### PEOPLE

- Completed our senior management team augmentation and restructuring. This added significant expertise and experience to our team from both the biotechnology and pharmaceutical industries.

### PIPELINE

- Acquired two preclinical anti-infective programs (lipopeptide and polyene programs) and commenced development work for the lipopeptide program in collaboration with BioSource Pharm, Inc.
- Commenced planning for the next clinical study for MBI 594AN, our topical cationic peptide for the treatment of acne, which we expect to start in the first half of 2003.
- Acquired a portfolio of anti-viral technologies and product candidates including: a human clinical, topical product candidate focused on the treatment of diseases associated with Human Papillomavirus (HPV) such as genital warts (a Phase I study was completed in late 2001); a Hepatitis C Virus (HCV) assay technology currently under development as a novel, cell-based viral replication assay; a portfolio of therapeutic programs at various stages of research & development based on a proprietary, novel nucleic acid mimic technology targeted at Hepatitis B Virus (HBV), Hepatitis C Virus (HCV) and Human Immunodeficiency Virus (HIV). Signed a license and collaboration agreement with Hybridon, Inc. for the development of the above mentioned HPV clinical product candidate.

### PARTNERSHIPS

- Completed a collaboration and license agreement with Fujisawa Healthcare for the development and commercialization of MBI 226, our topical cationic peptide for the prevention of central venous catheter-related bloodstream infections.

So, as you can see by the above results, we have consistently done what we said we would do over the past year, and as a result, Micrologix is now a very different and much stronger company. We now have a team capable of executing on our plan and delivering results. We possess a much broader pipeline comprised of product opportunities in the three main categories of infectious diseases: viral, bacterial and fungal. And, we have completed a solid, win-win partnership for our most advanced product candidate. Now, to update you on our various development programs:

### MBI 226—Prevention of CVC-related Bloodstream Infections

In July 2002, we signed a Collaboration and License Agreement for the co-development and commercialization of MBI 226 with Fujisawa Healthcare, Inc. Under the terms of the agreement, we can receive an additional US\$20 million in milestone payments, and a royalty of 20% on sales of the product. Fujisawa will also fund 100% of the remaining development costs and will assume responsibility for the manufacturing of MBI 226.

A Micrologix-Fujisawa Joint Development Management Committee (“JDMC”) was established with representation from both organizations to oversee and guide the future development of MBI 226. Enrollment in the Phase III trial currently exceeds 1,200 patients. Based on the decision of the JDMC, the enrollment target in the trial has been increased and, therefore, is now planned to be completed in the first quarter of calendar 2003 with results from the trial expected during the third quarter of calendar 2003.

#### **MBI 594AN—Treatment of Acne**

We completed a proof of concept Phase II study of MBI 594AN in the fall of 2001 and obtained favorable results from the study. Based on this, we determined that a Phase IIb trial would be the next study. We are currently planning this study, which we expect to start in the first half of calendar 2003. The study would be dose-ranging, powered for statistical significance, and conforming to the standard acne clinical trial treatment period of 12 weeks. In addition, we have made significant progress in managing the manufacturing scenarios for the product to ensure appropriate cost of goods and margins.

#### **Lipopeptide Program**

This program is aimed at developing a systemic antibiotic with a novel mechanism of action, bactericidal activity, broad gram positive coverage, a good therapeutic index and convenient dosing. There are only a limited number of products on the market for problematic gram positive infections and even fewer in clinical trials. It's estimated by analysts that the market opportunity for a drug with this profile would be about US\$500 million. Several potential leads have been identified to date in the lipopeptide program with initial *in vivo* efficacy and preliminary toxicity studies completed. We entered into a research and development collaboration with BioSource Pharm, Inc. in May 2002 for the development of the lipopeptide program. Our current development schedule indicates that following successful lead optimization and non-clinical studies, we could file an IND to conduct human studies in H2 2004.

#### **Antiviral Portfolio**

As mentioned above, we completed the acquisition and in-licensing of a portfolio of antiviral product candidates just prior to this writing. This portfolio has product candidates in various stages of development targeted at significant market opportunities: infectious diseases associated with Human Papillomavirus (HPV) such as genital warts (a Phase I study was completed in late 2001), Hepatitis B Virus (HBV), Hepatitis C Virus (HCV), and Human Immunodeficiency Virus (HIV). We also acquired an HCV assay technology currently under development as a novel, cell-based viral replication assay. There are currently no true, cell-based replication assays for HCV, so this assay should have broad appeal and out-licensing potential to companies involved in developing anti-HCV drugs.

As we have only very recently completed this transaction, and the collaboration and license agreement with Hybridon on the HPV program, we expect to provide more information regarding the future development process once we have completed a portfolio analysis and development plan, which should occur by calendar year end.

#### **Annual General Meeting Recap**

The team would like to thank William J. (Bud) Foran for his contributions to Micrologix as a director and an executive of the Company. Bud retired from the Board effective the date of this year's AGM. The six remaining directors were re-elected at this year's meeting.

#### **PLAN, EXECUTE AND GET RESULTS!**

The philosophy of the entire team here at Micrologix has been to methodically execute on our strategy by adhering to our plan and producing the kind of results that enable us to meet our long-term objectives. This is what we believe will create value. And as we've said many times before, this is a process and no one event will define the value of Micrologix.

We've added tremendous fundamental value in our main areas of focus: people, pipeline and partnerships. We remain consistent in our commitment to build a valuable, sustainable company with results that speak for themselves over time. We are executing on the strategy that we announced earlier in the year, we're delivering results and we're doing everything we said we would do. And, while we've been augmenting our team, strengthening the infrastructure and building our pipeline, we have reduced our burn rate significantly and improved our cash position in the process. From my perspective, that's an incredible accomplishment in the last eleven months and we are all very proud of it. Our intent is to continue to produce consistent, solid results that ultimately add value.

We thank you for your support.

On behalf of the entire Micrologix Team,



**JAMES M. DEMESA, MD**  
President and CEO

September 18, 2002

## **MANAGEMENT'S DISCUSSION & ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

First Quarter ended July 31, 2002

The following should be read in conjunction with the audited consolidated financial statements and management's discussion & analysis of financial condition and results of operations for the year ended April 30, 2002; and the interim unaudited consolidated financial statements for the period ended July 31, 2002, including the related notes therein.

#### **OVERVIEW**

##### **MBI 226—Prevention of Central Venous Catheter-Related Bloodstream Infections**

In May 2002, the Company entered into an option agreement for the exclusive negotiation of a definitive license agreement with Fujisawa Healthcare Inc. (“Fujisawa”) for MBI 226. Micrologix received a US\$1 million option payment to be used during the exclusive negotiation period to fund the continuation of enrolment in the Phase III study and to recruit additional clinical sites. In July 2002, pursuant to these negotiations Micrologix completed a Collaboration and License Agreement for the co-development and commercialization of MBI 226 with Fujisawa and received an additional US\$1 million payment as an upfront license fee. Additional terms under the agreement include:

## MANAGEMENT'S DISCUSSION & ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, CONTINUED

First Quarter ended July 31, 2002

- Micrologix can receive up to US\$20 million in milestone payments, as well as a royalty of 20% on sales of the product.
- Fujisawa will fund 100% of remaining development costs and will assume responsibility for the manufacturing of MBI 226.
- Fujisawa will have exclusive rights to market and sell the product in the US, Canada, and Mexico.
- A joint development management committee ("JDMC") has been established with representation from both organizations to oversee and guide the future development of MBI 226.

Based on the decisions of the JDMC, the Company anticipates that patient enrolment in the Phase III study will be completed in the first calendar quarter of 2003 with results available in the third calendar quarter of 2003.

Normally two pivotal Phase III studies are required as part of a New Drug Application ("NDA") to obtain marketing approval in the United States for a new drug. Based on having received fast-track designation from the United States Food and Drug Administration for MBI 226, Micrologix and Fujisawa are pursuing a strategy to file a NDA based on one pivotal Phase III study. The filing of the NDA is dependent upon a number of factors, including, but not limited to, positive results from the current Phase III study; successful completion of the validation and scale up of manufacturing operations; decisions of the Micrologix-Fujisawa joint development management committee; and discussions with the FDA preceding the NDA submission.

### MBI 594AN—Treatment of Acne

The Company is planning to commence the next clinical study for MBI 594AN in the first half of 2003. The study is anticipated to be an expanded Phase II study that would include lower dose levels, a longer treatment period (12 weeks vs. 6 weeks) and a larger number of patients than the Phase II study completed in 2001. In combination with protocol design considerations for this study, management of the product formulation and manufacturing scenarios is necessary to ensure appropriate cost of goods and margins.

### Building the Product Pipeline

As part of the Company's strategy, technologies and compounds are being evaluated that could expand the Company's technology base and product pipeline and broaden the number of indications being pursued.

In May 2002 Micrologix acquired two preclinical anti-infective programs, a lipopeptide and a polyene. Both technologies comprise multiple compounds in the lead identification stage of development, and are intended to target serious systemic bacterial and systemic fungal infections, respectively. As part of the acquisition, Micrologix entered into a license and research agreement with BioSource Pharm, Inc., a New York-based research organization specializing in the discovery and development of novel antibiotics. The Company has begun the implementation of a development plan for the lipopeptide program, along with BioSource Pharm, to pursue the identification of a lead candidate for ultimate human clinical testing.

Part of the drug development process is the termination of programs that have a low probability of success and/or add little long-term value. During the quarter Micrologix terminated the research collaboration established in June 2000 with Harbor-UCLA Research and Education Institute. The Company recorded a \$1.0 million write-down of intangible assets (technology license and capitalized patent costs) during the fourth quarter of Fiscal 2002 in respect of this collaboration and no further write-down was required during the current quarter to reflect the termination of this collaboration.

First Quarter ended July 31, 2002

## RESULTS OF OPERATIONS

The net loss for the three months ended July 31, 2002 ("Q1/03"), is \$1.5 million (\$0.04 per share) compared to a net loss of \$4.6 million (\$0.12 per share) for the same period in fiscal 2002 ("Q1/02") and a net loss of \$5.8 million (inclusive of \$1.0 million write-down of intangible assets) for three months ended April 30, 2002. The decrease in net loss results principally from revenues associated with the Collaboration and License agreement entered into with Fujisawa for MBI 226 (see "Revenues") and a reduction in the MBI 226 Phase III clinical development costs (see "Research & Development Expenses").

Effective May 1, 2002 Micrologix adopted the recommendations of the new CICA handbook section 3870, Stock Based Compensation and other Stock-Based Payments (see Notes 2 and 4 [b] [ii] to the financial statements).

Micrologix has been unprofitable since its formation in January 1993 and has incurred a cumulative deficit of \$62.7 million to July 31, 2002. Losses are expected to continue for the next several years as we pursue the research, development and commercialization of our drug candidates and technologies.

### Revenues

During the quarter the Company entered into a Collaboration and License agreement with Fujisawa for MBI 226 (see "MBI 226—Prevention of Central Venous Catheter-Related Bloodstream Infections") and received a non-refundable upfront fee of US\$1 million and a US\$1 million option payment. The upfront license fee is being amortized into income over the estimated development period (approximately three and one-half years) for MBI 226 in the United States, Canada and Mexico with the unamortized portion being recorded as deferred revenue on the balance sheet. During the quarter the Company earned \$1.7 million in research and development collaboration revenue pursuant to the collaboration with Fujisawa and the US\$1 million option payment received in May 2002 from Fujisawa was applied on account of this amount. See Note 2 for the Company's Revenue Recognition policy which was adopted during the current quarter.

Interest income generated from investments of cash resources for Q1/03 was \$0.3 million (\$0.7 million in Q1/02). The decrease is the result of lower average cash balances available for investment (see "Liquidity and Capital Resources") and declining interest rates.

### Research and Development Expenses

Research and development expenses decreased in Q1/03 to \$2.5 million (\$4.2 million in Q1/02). The decrease in research and development expenses results principally from lower enrollment in the MBI 226 Phase III clinical trial during the current quarter as the study was nearing completion prior to entering into the option with Fujisawa; and the termination of the Harbor-UCLA research collaboration. Clinical development program costs were \$1.8 million in Q1/03 (\$3.4 million in Q1/02) of research and development expenses.

The level of research and development expenses for the remainder of Fiscal 2003 will be impacted principally by enrolment in the MBI 226 Phase III trial and activities related to starting the next clinical study of MBI 594AN in the first half of 2003.

### General and Corporate Expenses

General and corporate expenses for Q1/03 were \$0.9 million (\$0.9 million in Q1/02).

**MANAGEMENT'S DISCUSSION & ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS,  
CONTINUED**

First Quarter ended July 31, 2002

**CAPITAL EXPENDITURES**

Expenditures in Q1/03 for capital and intangible assets were \$1.4 million (\$0.3 million in Q1/02). The major component of capital expenditures was \$1.2 million (\$0.6 million cash and \$0.6 million in preferred shares) for the acquisition of two preclinical anti-infective programs in May 2002 (see "Building The Product Pipeline", Notes 3, 4 [a] [ii] and 4 [a] [iii] to the financial statements and "Liquidity and Capital Resources" below for additional information in respect of this acquisition and the preferred shares).

**LIQUIDITY AND CAPITAL RESOURCES**

At July 31, 2002, we had \$37.2 million (April 30, 2002: \$39.9 million) in cash, cash equivalents and short-term investments. At July 31, 2002 \$30.2 million of these funds were invested in high-grade liquid short-term investments with interest rates ranging from 2.2% to 6.0% and maturities ranging from August 2002 to June 2004. The \$2.7 million decrease in cash, cash equivalents and short-term investments since April 30, 2002 consists primarily of the \$1.5 million net loss for Q1/03, \$0.8 million in asset acquisitions and a \$1.9 million decrease accounts payable and accrued liabilities less \$1.5 million of deferred revenue related to the upfront MBI 226 license fee (see "Revenues").

During the quarter the Company issued 750,000 Series A preferred shares and 1,000,000 Series B preferred shares in conjunction with the acquisition of two preclinical programs (see also "Capital Expenditures", Notes 3, 4 [a] [ii] and 4 [a] [iii] to the financial statements for additional information). The Series A and Series B preferred shares are at the Company's option either convertible into common shares of the Company or redeemable for cash at US\$1 per preferred share. The Company is obligated to convert or redeem 400,000 Series A preferred shares on September 20, 2002 with the remaining 350,000 Series A and all of the 1,000,000 Series B to be redeemed or converted from time to time upon the achievement of specified drug development milestones. The Company is also obligated in the future to pay:

[i] up to US\$3,000,000 cash if certain drug development milestones are achieved; and

[ii] royalties on product sales.

Micrologix believes that its current funds on hand, together with licensing payments, reimbursement of development costs and expected interest income, should be sufficient to finance its operating and capital needs for at least the next 24 months before receipt of potential milestone payments in the amount of US\$15 million during this period. Micrologix's funding needs will vary, however, depending upon a number of factors including the breadth and progress of research and development programs, the costs associated with clinical studies and the regulatory process, collaborative and licensing arrangements with third parties, opportunities to in-license or acquire additional products for development, the possibility of unanticipated costs and expenses, technological and market developments and the costs of obtaining and enforcing patent claims. In the future, Micrologix will need to raise additional funds in support of its operations.

**CONSOLIDATED BALANCE SHEETS**

As at	July 31, 2002	April 30, 2002
(Unaudited—in thousands of Canadian dollars)	\$	\$
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents	6,975	4,607
Short-term investments	30,244	35,281
Amounts receivable	314	84
Prepaid expenses and deposits	548	508
<b>Total current assets</b>	<b>38,081</b>	<b>40,480</b>
Capital assets	1,481	1,556
Intangible assets (note 3)	1,940	720
	41,502	42,756
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	5,597	7,507
Deferred revenue	448	—
<b>Total current liabilities</b>	<b>6,045</b>	<b>7,507</b>
Deferred revenue, non-current portion	1,047	—
<b>Shareholders' equity</b>		
Common shares (note 4(a))	96,358	96,358
Preferred shares (note 4(a))	619	—
Shares to be issued	111	111
Deficit	(62,678)	(61,220)
<b>Total shareholders' equity</b>	<b>34,410</b>	<b>35,249</b>
	41,502	42,756

See accompanying notes

On behalf of the Board:



**COLIN R. MALLET**  
Director



**JAMES M. DEMESA**  
Director

**CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT**

	Three months ended July 31	
	2002 \$	2001 \$
(Unaudited—in thousands of Canadian dollars except per share amounts)		
<b>REVENUE</b>		
Licensing	28	—
Research and development collaboration	1,739	—
Interest	330	666
	2,097	666
<b>EXPENSES</b>		
Research and development	2,484	4,201
General and corporate	911	875
Amortization	160	163
Write-down of intangible assets	—	40
	3,555	5,279
<b>Loss for the period</b>	(1,458)	(4,613)
Deficit, beginning of period	(61,220)	(41,309)
<b>Deficit, end of period</b>	(62,678)	(45,922)
<b>Basic and diluted loss per common share</b>	(0.04)	(0.12)
<b>Weighted average number of common shares outstanding (in thousands)</b>	38,287	38,187

See accompanying notes

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Three months ended July 31	
	2002 \$	2001 \$
(Unaudited—in thousands of Canadian dollars)		
<b>OPERATING ACTIVITIES</b>		
Loss for the period	(1,458)	(4,613)
Items not affecting cash:		
Amortization	160	163
Write-down of intangible assets	—	40
Loss on disposal of capital assets	3	20
Changes in non-cash working capital items relating to operating activities:		
Accrued interest on short-term investments	145	(122)
Amounts receivable	(230)	59
Prepaid expenses and deposits	(40)	(25)
Accounts payable and accrued liabilities	(1,844)	1,438
Deferred Revenue	1,495	—
<b>Cash flows used in operating activities</b>	(1,769)	(3,040)
<b>FINANCING ACTIVITIES</b>		
Issuance of common shares, net of issue costs	—	49
Issuance of special warrants, net of issue costs	—	(19)
<b>Cash flows provided by financing activities</b>	—	30
<b>INVESTING ACTIVITIES</b>		
Funds from short-term investments	8,692	9,381
Purchase of short-term investments	(3,800)	(10,920)
Purchase of capital assets	(85)	(121)
Intangible asset expenditures	(670)	(75)
<b>Cash flows provided by (used in) investing activities</b>	4,137	(1,735)
<b>Increase (decrease) in cash and cash equivalents</b>	2,368	(4,745)
Cash and cash equivalents, beginning of period	4,607	9,953
<b>Cash and cash equivalents, end of period</b>	6,975	5,208
<b>Supplemental cash flow information</b>		
Increase in intangible assets for preferred shares issued	619	—
Increase in intangible assets for common shares issued or to be issued	—	85

See accompanying notes

## NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

Three months ended July 31, 2002 (Unaudited—Canadian dollars)

### 1. BASIS OF PRESENTATION

The accompanying unaudited interim consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles for interim financial statements. The accounting policies used in the preparation of these interim financial statements are consistent with the Company's most recent annual audited financial statements for the year ended April 30, 2002 except as disclosed in note 2. These interim financial statements and notes do not include all disclosures required for annual financial statements and should be read in conjunction with the annual audited consolidated financial statements of the Company.

In the opinion of management, all adjustments (including reclassification and normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows have been made. Interim results are not necessarily indicative of results for a full year.

### 2. CHANGES IN SIGNIFICANT ACCOUNTING POLICIES

The following new accounting principles have been adopted for the preparation of these consolidated interim financial statements:

#### Stock-based compensation plan

The Company has adopted the recommendations of the new CICA Handbook section 3870, *Stock-Based Compensation and Other Stock-Based Payments*, effective May 1, 2002. This section establishes standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made in exchange for goods and services. The standard requires that all stock-based awards made to non-employees be measured and recognized using a fair value based method. The standard encourages the use of a fair value based method for all awards granted to employees, but only requires the use of a fair value based method for direct awards of stock, stock appreciation rights, and awards that call for settlement in cash or other assets. The Company has adopted the disclosure only provisions of section 3870 and consequently has disclosed the pro forma effects to net loss and net loss per share as if the fair value method had been used.

#### Revenue Recognition

Licensing revenue consists of non-refundable initial fees derived from collaborative licensing arrangements. Initial fees received which require the Company's ongoing involvement through development collaboration are deferred and amortized into income on a straight-line basis over the term of the relevant license or related underlying product development period.

Research and development collaboration revenues consist of non-refundable research and development funding under collaborative agreements with the Company's strategic partners. Research and development funding generally compensates the Company for non-clinical and clinical expenses related to the collaborative development programs for certain product candidates of the Company, and is recognized as revenue when the research and development activities are performed under the terms of the agreements.

### 3. INTANGIBLE ASSETS

	Cost \$	Accumulated Amortization \$	Net Book Value \$
<b>July 31, 2002</b>			
Patents	849	273	576
Technology licenses	1,846	505	1,341
Trademarks	26	3	23
	2,721	781	1,940
<b>April 30, 2002</b>			
Patents	813	253	560
Technology licenses	609	473	136
Trademarks	26	2	24
	1,448	728	720

Three months ended July 31, 2002 (Unaudited—Canadian dollars)

On May 20, 2002, the Company acquired certain intangible assets related to two pre-clinical programs (lipopeptide and polyene) from IntraBiotics Pharmaceuticals Inc. and entered into a license and research agreement with Biosource Pharm Inc. for consideration as follows:

- i. an up-front cash payment of \$618,560 (US\$400,000);
- ii. the issuance of 750,000 Series A preferred shares with a value of \$618,561 (US\$400,001) (Note 4 [a] [ii]); and
- iii. the issuance of 1,000,000 Series B preferred shares with a value of \$2 (US\$1) (Note 4 [a] [iii]).

The amount of \$1,237,123 (US\$800,002) has been recorded as technology licenses and is being amortized on a straight line basis over ten years. The Series A and Series B preferred shares are at the Company's option either convertible into common shares of the Company or redeemable for cash at US\$1 per preferred share. The Company is obligated to redeem or convert 400,000 Series A preferred shares on September 20, 2002 with the remaining 350,000 Series A and all of the 1,000,000 Series B to be redeemed or converted from time to time upon the achievement of specified drug development milestones. The Company is also obligated in the future to pay:

- i. up to US\$3,000,000 cash if certain drug development milestones are achieved; and
- ii. royalties on product sales.

### 4. SHARE CAPITAL

#### [a] Issued and outstanding

##### [i] Common shares

	Number of Shares (thousands)	Amount \$ (thousands)
<b>Balance, April 30, 2002 and July 31, 2002</b>	39,474	96,358

##### [ii] Preferred shares, Series A

	Number of Shares (thousands)	Amount \$ (thousands)
<b>Balance, April 30, 2002</b>	—	—
Issued pursuant to asset acquisition (note 3)	750	619
<b>Balance, July 31, 2002</b>	750	619

The Series A preferred shares are, at the Company's option, either convertible into common shares of the Company or redeemable for cash at US\$1 per Series A preferred share as follows:

- i. as at September 20, 2002, 400,000 Series A preferred shares having an aggregate value of US\$400,000; and
- ii. from time to time upon the achievement of specified drug development milestones such number of the remaining 350,000 Series A preferred shares as set for the particular milestones achieved.

If the Company elects to convert any of the Series A preferred shares into common shares the conversion will be based upon the average closing price of the Company's common shares on the Toronto Stock Exchange for the 5 trading days prior to the applicable conversion date (the "Conversion Price"). If the average closing price of the Company's common shares for the 20 trading days subsequent to a conversion date is less than the Conversion Price the Company is obligated to pay the difference in cash for the applicable number of common shares.

## NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS, CONTINUED

Three months ended July 31, 2002 (Unaudited—Canadian dollars)

### 4. SHARE CAPITAL, CONTINUED

#### [ii] Preferred shares, Series A, Continued

Effective May 19, 2010, the Company can redeem the then outstanding Series A preferred shares for an aggregate value of US\$1. As the achievement of the specified milestones for the redemption or conversion of 350,000 Series A preferred shares are uncertain, the Series A preferred shares have been recorded at an aggregate value of US\$400,001.

#### [iii] Preferred shares, Series B

	Number of Shares (thousands)	Amount \$ (thousands)
<b>Balance, April 30, 2002</b>	—	—
Issued pursuant to license and collaboration agreement (note 3)	1,000	—
<b>Balance, July 31, 2002</b>	1,000	—

The Series B preferred shares are, at the Company's option, either convertible into common shares of the Company or redeemable for cash at US\$1 per Series B preferred share from time to time upon the achievement of specified drug development milestones.

If the Company elects to convert any of the Series B preferred shares into common shares the conversion will be based upon the average closing price of the Company's common shares on the Toronto Stock Exchange for the 5 trading days prior to the applicable conversion date (the "Conversion Price"). If the average closing price of the Company's common shares for the 20 trading days subsequent to a conversion date is less than the Conversion Price the Company is obligated to pay the difference in cash for the applicable number of common shares.

Effective May 19, 2010, the Company can redeem the then outstanding Series B preferred shares for an aggregate value of US\$1. As the achievement of the specified milestones for the redemption or conversion of 1,000,000 Series B preferred shares are uncertain, the Series B preferred shares have been recorded at an aggregate value of US\$1.

#### [b] Stock options

[i] Stock option transactions and the number of stock options outstanding with respect to both the 1996 and 2000 Stock Option Plans are summarized as follows:

	Number of Common Shares (thousands)	Weighted Average Exercise Price \$
<b>Balance, April 30, 2002</b>	2,658	2.20
Options granted	137	0.79
Options forfeited/expired	(4)	(2.08)
<b>Balance, July 31, 2002</b>	2,791	2.14

The stock options expire at various dates between October 25, 2002 and November 25, 2010.

[ii] As permitted by CICA Handbook Section 3870 *Stock-Based Compensation and Other Stock-Based Payments*, the Company has adopted the disclosure only provisions of Section 3870 for disclosing compensation cost based on the fair value accounting method for options granted to employees and directors. No compensation expense is recognized when stock options are granted to employees and directors, as the exercise price of each option approximates the market price on the date immediately preceding the grant. The following pro forma financial information presents the net loss and net loss per common share had the Company recognized stock based compensation for options awarded to employees and directors during the three month period ended July 31, 2002 using the fair value accounting method.

Three months ended July 31, 2002 (Unaudited—Canadian dollars)

	Amount \$ (thousands, except per share amounts)
Net loss for the period as reported	(1,458)
Compensation expense under CICA 3870	(22)
Proforma net loss	(1,480)
Proforma basic loss per share	(0.04)

Under the transitional provisions of Section 3870, comparative figures are not required.

The estimated fair value of stock options issued during the three months ended July 31, 2002 was determined using the Black-Scholes option pricing model using the following weighted average assumptions, resulting in a weighted average fair value of \$0.56 per option:

Annualized volatility	82.3%
Risk-free interest rate	3.8%
Expected life of options in years	5.0
Dividend yield	0.0%

### 5. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to the presentation adopted in the current period.

### 6. SUBSEQUENT EVENTS

- [a] The Company's shareholders approved an increase in the number of common shares that can be issued under the Company's 2000 Stock Option Plan from 2,000,000 to 4,000,000.
- [b] The Company issued 48,100 common shares at the market price of \$0.90 per common share for proceeds of \$43,290 pursuant to a private placement with four senior executives.
- [c] The Company granted options to employees to acquire 310,000 common shares, with exercise prices ranging from \$0.92 to \$0.95 and expiry dates through August 11, 2010.
- [d] On September 12, 2002, the Company acquired a portfolio of antiviral technologies and product candidates formerly owned by Origenix Technologies Inc. for \$500,000. Concurrent with this acquisition, the Company entered into a Collaboration and License Agreement with Hybridon Inc. to develop an antisense drug candidate for the treatment of Human Papillomavirus (HPV). Under the agreement, Hybridon has licensed to Micrologix the exclusive worldwide rights to a family of patents covering a number of antisense oligonucleotides targeted to the HPV genome. In addition, Hybridon licensed to Micrologix, on a non-exclusive basis, rights to a portfolio of antisense chemistries owned or licensed by Hybridon. In consideration for the Collaboration and License Agreement, the Company will pay Hybridon certain collaboration, up-front and milestone payments upon the achievement of agreed clinical objectives as well as royalties on product sales and sublicensing revenues. The collaboration, up-front and milestone payments, if achieved, would total US\$5,750,000 in cash and/or equity. The Company will also assume responsibility for the development costs of the drug candidate.



# MICROLOGIX

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### **Forward-looking Statements**

This Quarterly Report, including the discussion "To Our Shareholders" and "Management's Discussion & Analysis of Financial Condition and Results of Operations" contains forward-looking statements within the meaning of the United States Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact may be deemed to be forward-looking statements. Forward-looking statements frequently, but not always use the words "expects", "anticipates", "suggests", "plans", "believes" or "intends", or similar words and/or include statements concerning the Company's strategies, goals and plans, or state that certain actions, events or results "will" be taken, occur or be achieved. These forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the results, performance or achievement of the company, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such statements. Such factors include, among others: uncertainties related to early stage of development, technology and product development; dependence on future corporate collaborations; dependence on proprietary technology and uncertainty of patent protection; management of growth; future capital needs and uncertainty of additional funding; intense competition; manufacturing and market uncertainties; government regulation; product liability exposure and insurability. These and other factors are described in detail in the Company's Annual Information Form and Annual Report on Form 20-F, forthcoming Quarterly Reports and other filings with the Canadian securities regulatory authorities and the U.S. Securities & Exchange Commission. Forward-looking statements are based on our current expectations and Micrologix is not obligated to update such information to reflect later events or developments.