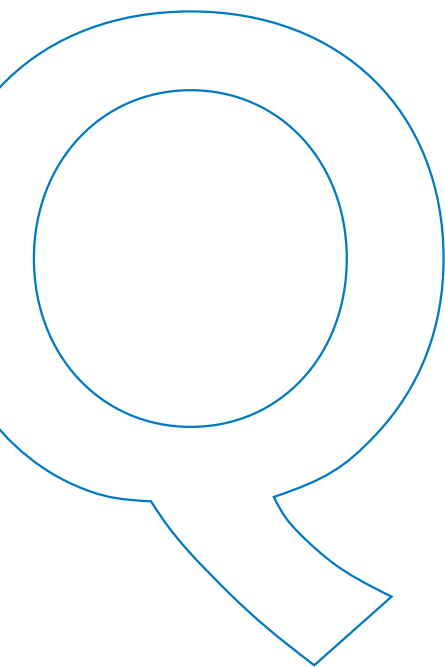




M I C R O L O G I X

(October 31, 2002)



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**Micrologix
Second 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, multiple product opportunities in development, and several early-stage technologies in various stages of research and evaluation.

FROM THE MICROLOGIX TEAM

Our principal focus for the past 12 months has been: **PEOPLE**, **PIPELINE** and **PARTNERSHIPS**. The result of this focus has been some very solid achievements, most notably:

- Completion of our senior management team augmentation and restructuring.
- Acquisition of two preclinical anti-infective programs (lipopeptide and polyene programs).
- Acquisition of a portfolio of three anti-viral technologies with five product opportunities.
- Completion of a collaboration and license agreement with Fujisawa Healthcare for the development and commercialization of MBI 226.

To give you a visualisation of how we have expanded our product opportunity pipeline in the past 9 months alone, below is an image of our pipeline:

MICROLOGIX BIOTECH PRODUCT OPPORTUNITY PIPELINE

PRODUCT CANDIDATE AND INDICATION	STAGE OF DEVELOPMENT					
	Research	Pre-clinical	Clinical			Market
			Phase I	Phase II	Phase III	
MBI 226 (CVC)	Partnered with Fujisawa Healthcare, Inc.					
MBI 594AN (Acne)	Phase IIb					
MBI 1121 (HPV)	Phase I					
Lipopeptide	Lead ID					
HCV Assay	Validation		NOT APPLICABLE			
Nucleoside—HBV						
Nucleoside—HCV						
Polyene						
RNAse—HIV						

While we remain committed to the three areas mentioned above, we are now adding three new areas of focus for the next twelve months. These are: **CAPITAL**, **CLINICALS** and **CRITICAL MASS**. These mantras are important to us because they keep the whole team focused on our most important objectives and goals. Here is what we mean by each:

CAPITAL

“Capital” refers to our market capitalization and our capital resources. Building a successful, sustainable company means having the resources necessary to execute our strategy, along with the fundamental market value to increasingly attract investors and ultimately increase shareholder value. Over the next year, we intend to implement several initiatives directed at enhancing and supporting this aspect of our business.

The recent investment by San Francisco-based Biotechnology Value Fund, (December 3, 2002) serves two purposes in this area of “capital”. First, it increases our cash resources, maintaining the runway we feel we need to succeed long-term. Second, it gives us a solid U.S. investor, increasing our visibility in the U.S. capital markets with the ultimate goal of enhancing liquidity.

As part of this focus on “capital”, we are also investigating various non-dilutive means to increase and/or leverage our cash resources. These include partnerships, early-stage collaborations and project-specific government grants. As stated in May of 2002, our strategy is to consistently maintain and augment our already strong financial position.

CLINICALS

“Clinicals” relates to our objective of advancing product candidates that are already in clinical trials toward regulatory submission, while simultaneously moving research and preclinical product candidates into the clinic. Clinical trial results will be value drivers this upcoming year. In addition, we will continue to explore ways to expand the pipeline to provide us with new clinical opportunities. This is important for a sustainable business model. Part of our strategy remains focused on eventually having regular entries into clinical development, leading to multiple commercial opportunities.

CRITICAL MASS

“Critical Mass” refers to the fact that in today's environment, size matters. Our commitment is to reduce risk to our shareholders by ensuring we keep pace with our growing company. This includes internal growth, as well as external expansion opportunities. To prepare for this growth, we have streamlined our internal operations, augmented the team to deal with the increased activities, and focused our efforts toward the highest value-adding projects.

Now, to update you on our various development programs:

MBI 226—Prevention of CVC-related Bloodstream Infections

Enrollment in the Phase III trial currently exceeds 1300 patients and is forecast to be completed in the first quarter of calendar 2003 at approximately 1400 patients. Based on this, results from the trial are expected during the third quarter of calendar 2003.

In the meantime, we and our development and commercialization partner, Fujisawa Healthcare, are working on all other tasks related to completing the study and ultimately filing a NDA with the U.S. Food and Drug Administration for market approval. Assuming successful completion of this study, and pre-NDA meetings with the FDA, we plan to move quickly to compile the information necessary to submit an NDA during the first half of 2004.

MBI 594AN—Treatment of Acne

We will begin a Phase IIb acne clinical trial in the first calendar quarter of 2003. The protocol for this study is powered for statistical significance, includes a planned enrollment of approximately 240 patients, and is randomized for patients to receive either a 2.5% active solution, a 1.25% active solution, or the vehicle (placebo) alone, for 12 weeks. The study will be conducted at approximately 10 sites in the U.S. We expect to complete the study in the fourth quarter of calendar 2003.

MBI 1121—Treatment of diseases related to HPV (Human Papillomavirus)

This recent acquisition represents our next clinical-stage product candidate, having completed a Phase I human study, targeting genital warts caused by Human Papillomavirus (HPV). The Center for Disease Control estimates that there are 750,000 to 1 million new cases of HPV-induced genital warts annually in the United States alone. Since this program was just acquired in September, we are now preparing our development plan. Our expectation is that we will complete our development plan in early 2003 and be able to communicate more specific information at that time.

Lipopeptide Program

The lipopeptide program is in the lead optimization stage of preclinical development. Within days of our acquisition of this technology in May of this year, our team established an aggressive development plan focused on delivering a clinical candidate. We are currently testing several potential leads, both *in vitro* and *in vivo*. We intend to identify a lead candidate in H2 2003, move into advanced non-clinical studies (i.e., those qualifying for an IND submission) in H1 2004 and, if successful, into clinical trials in H2 2004.

Hepatitis C Virus Assay

Hepatitis C Virus (HCV) is a huge global issue, with many companies developing programs targeting the disease. Currently, there is no broad-based HCV assay to adequately address the optimal development of these compounds, thereby creating a real opportunity for us to out-license this assay technology to companies developing such compounds. This could help accelerate their development efforts and reduce the development risk associated with these programs. We are currently creating the validation program for this technology and plan to initiate activities soon aimed at advancing the technology to licensing status. If successful, we could expect licensing revenue potential in 2004.

Other Programs

As part of our portfolio planning and prioritization process, we are moving ahead with certain prospects at varying rates. For example, the development plan for our new Hepatitis B Virus (HBV) technology is being created. We expect to complete non-clinical studies to evaluate efficacy and move ahead from there. We should know more about this, and our other recent antiviral acquisitions, during the first half of 2003 as we complete our portfolio management process.

In summary, this is what you can expect from Micrologix over the next 12 to 18 months. We plan to:

- Initiate and complete the Phase IIb clinical trial on MBI 594AN and secure a commercial partner.
- Complete the Phase III trial of MBI 226 in the first quarter of calendar 2003 with results expected during the third quarter.
- Establish and advance the development plan for MBI 1121.
- Complete the validation process for our new HCV Assay and, if successful, seek to out-license this technology to multiple parties.
- Select a lead candidate in the lipopeptide program by H2 2003 and move this lead into non-clinical studies.
- Establish one or more early-stage research collaborations that help accelerate the development of various programs, while allowing us to leverage our cash resources.

We have established ourselves to be able to manage our expanded pipeline very well. We are focused, efficient, and well organized. With our attention on *Capital*, *Clinicals*, and *Critical Mass*, these results are very possible.

It is important to remember that our commitment is on growing the company over the long term. Obviously, no company can meet every short-term objective set, or succeed at every milestone expected. For us, however, as demonstrated over the past year, we intend to continue our practice of *doing what we say we will do* by executing on our plan and producing the results that add long-term value.

We thank you for your support.

On behalf of the entire Micrologix Team,



JAMES M. DEMESA, MD
December 17, 2002
President and CEO, Director

Second Quarter ended October 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 October 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 enrollment 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 with Fujisawa for the co-development and commercialization of MBI 226 and received an additional US\$1 million payment as an upfront license fee. Additional terms under the agreement include:

- 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 enrollment (targeting 1,400 patients) 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 necessary 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 JDMC; and discussions with the FDA preceding the NDA submission. During the quarter the validation of peptide manufacturing was completed and many activities in support of a NDA submission were advanced including drug product manufacturing. The JDMC is targeting to submit the NDA in the first half of calendar 2004.

MBI 594AN—Treatment of Acne

A Phase IIb clinical trial for MBI 594AN is planned to commence in the first quarter of calendar 2003. This study will be conducted in approximately 10 centers in the US, enrolling 240 patients, with 2 active groups (2.5% and 1.25%) and vehicle alone (placebo). The treatment period will be 12 weeks and the study will be powered for statistical significance at the 80% level. The study is planned to be completed in the fourth quarter of calendar 2003.

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.

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

Second Quarter ended October 31, 2002

Micrologix is targeting to identify a lead candidate in the lipopeptide program (acquired May 2002) by the end of 2003 and to begin clinical trials in the second half of calendar 2004.

In September 2002, Micrologix acquired, pursuant to a Call for Tenders in the bankruptcy of Origenix Technologies Inc., a broad portfolio of antiviral technologies and product candidates. The portfolio includes both clinical and preclinical product opportunities focused on the treatment of serious viral infectious diseases, consisting of:

- An anti-sense oligonucleotide topical drug candidate (MBI 1121) previously called ORI 1001, in clinical development for the treatment of diseases associated with Human Papillomavirus (HPV) such as external genital warts. A Phase I clinical study to evaluate safety in 30 human volunteers was completed in late 2001.
- A Hepatitis C Virus (HCV) assay technology under development as a novel, cell-based viral replication assay. This assay has the potential for out-licensing to companies seeking to develop anti-HCV drugs.
- A portfolio of therapeutic programs based on a proprietary, novel nucleic acid mimic technology:
 - Hepatitis B Virus (HBV) program in the lead optimization stage of development.
 - Hepatitis C Virus (HCV) program in early lead optimization.
 - Human Immunodeficiency Virus (HIV) program comprised of a library of potential compounds.

We are currently in the process of establishing our development plans for these programs including the review of each program, the assessment of potential external collaborations, and the engagement of external advisors to assist us with the review and the preparation of development plans. Some restructuring and augmentation of our research and development personnel has occurred and is planned to support the anti-viral development programs.

In conjunction with the acquisition of the MBI 1121 program, we entered into a collaboration and license agreement with Hybridon, Inc. In consideration of the agreement with Hybridon, we agreed to pay certain collaboration, upfront and milestone payments upon the achievement of agreed clinical objectives as well as royalties on HPV product sales and sublicensing revenues. The collaboration, upfront and milestone payments, if achieved, would total US\$5.75 million payable to Hybridon in cash and/or equity.

RESULTS OF OPERATIONS

The net loss for the three months ended October 31, 2002 ("Q2/03"), is \$2.5 million (\$0.07 per share) compared to a net loss of \$4.6 million (\$0.12 per share) for the same period last year ("Q2/02"). The year to date six month net loss ("YTD Fiscal 2003") is \$4.0 million (\$0.10 per share) compared to \$9.2 million (\$0.24 per share) for the same period last year ("YTD Fiscal 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 \$65.2 million to October 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.

Second Quarter ended October 31, 2002

Revenues

In July 2002, 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. This 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 YTD Fiscal 2003, the Company earned \$3.9 million (\$nil YTD Fiscal 2002) in research and development collaboration revenue pursuant to the collaboration with Fujisawa. See Note 2 of the financial statements for the Company's Revenue Recognition policy which was adopted during the quarter ended July 31, 2002.

Interest income generated from investments of cash resources for Q2/03 was \$0.3 million (\$0.6 million in Q2/02) bringing YTD Fiscal 2003 interest income to \$0.6 million (\$1.3 million for YTD Fiscal 2002). 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 for Q2/03 were \$3.7 million (\$4.0 million in Q2/02) bringing YTD Fiscal 2003 research and development expenses to \$6.2 million (\$8.2 million for YTD Fiscal 2002). The decrease in research and development expenses from YTD Fiscal 2002 results principally from lower enrollment in the MBI 226 Phase III clinical trial during YTD Fiscal 2003 and the termination of the Harbor-UCLA research collaboration. Clinical development program costs were \$2.6 million of research and development expenses in Q2/03 (\$3.0 million in Q2/02) bringing YTD Fiscal 2003 clinical development program costs to \$4.4 million (\$6.3 million for YTD Fiscal 2002).

The level of research and development expenses for the remainder of Fiscal 2003 will be impacted principally by completion of enrollment in the MBI 226 Phase III trial, the start of the Phase IIb MBI 594AN trial in the first quarter of calendar 2003 and the establishment and advancement of development plans for the new antiviral programs.

General and Corporate Expenses

General and corporate expenses for Q2/03 were \$1.2 million (\$1.0 million in Q2/02) bringing YTD Fiscal 2003 general and corporate expenses to \$2.1 million (\$1.9 million for YTD Fiscal 2002).

CAPITAL AND INTANGIBLE ASSET EXPENDITURES

Expenditures in Q2/03 for capital and intangible assets were \$1.6 million (\$0.2 million in Q2/02) bringing YTD Fiscal 2003 capital and intangible asset expenditures to \$2.9 million (\$0.5 million for YTD Fiscal 2002). The major components of capital and intangible asset expenditures were for the acquisition of the Origenix antiviral programs in September, the Hybridon license for the MBI 1121 HPV program in September and the acquisition of the lipopeptide and polyene programs in May. These expenditures total \$2.6 million. See "Building Our Product Pipeline", Notes 3, 4 [a] [ii], 4 [a] [iii], and 6[d] to the financial statements and "Liquidity and Capital Resources" below for additional information in respect of these acquisitions.

LIQUIDITY AND CAPITAL RESOURCES

At October 31, 2002, we had \$28.2 million (April 30, 2002: \$39.9 million) in cash, cash equivalents and short-term investments. At October 31, 2002, \$25.8 million of these funds were invested in high-grade liquid short-term investments with interest rates ranging from 2.3% to 5.3% and maturities ranging from November 2002 to June 2004. The \$11.7 million decrease in cash, cash equivalents and short-term investments since April 30, 2002 consists primarily of the \$4.0 million net loss for YTD Fiscal 2003, \$1.9 million in asset acquisitions (cash component),

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

Second Quarter ended October 31, 2002

\$4.4 million decrease in accounts payable and accrued liabilities, \$2.5 million increase in amounts receivable (research and collaboration development revenue is billed quarterly to Fujisawa—see “Revenues”), and \$0.6 million paid on redemption of 400,000 Series A preferred shares, less \$1.4 million of deferred revenue related to the upfront MBI 226 license fee (see “Revenues”).

During Q1/03 the Company issued 750,000 Series A preferred shares and 1,000,000 Series B preferred shares in conjunction with the acquisition of the lipopeptide and polyene programs (see also “Capital and Intangible Asset 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. In Q2/03 the Company redeemed 400,000 Series A preferred shares for US\$400,000. The remaining 350,000 Series A and all of the 1,000,000 Series B are 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 million cash if certain drug development milestones are achieved; and
- ii. royalties on product sales.

During Q2/03 the Company acquired a portfolio of antiviral technologies and product candidates and entered into a collaboration and license agreement in respect of the MBI 1121 HPV program with the following future obligations:

- i. non-milestone payment of US\$250,000 is payable in the current fiscal year;
- ii. milestone payments of up to US\$5.25 million upon the achievement of specified drug development milestones; and
- iii. royalties on future product sales resulting from the MBI 1121 HPV program.

On December 17, 2002 the Company issued 5,500,000 Series C convertible, redeemable preferred shares in respect of the US\$5.5 million in MBI 1121 HPV program obligations described above. The Series C 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.

On December 3, 2002 the Company issued 7,850,000 common shares for gross proceeds of approximately \$5.5 million. Additionally, the Company issued warrants to purchase 987,500 common shares at \$1.50 per common share and 982,914 common shares at \$3.00 per common share. These warrants, subject to certain earlier expiry provisions, expire December 3, 2005 and December 3, 2007, respectively. There are currently 47,372,159 common shares outstanding.

Micrologix believes that its current funds on hand (including the recent investment by Biotechnology Value Fund), together with research and development collaboration revenue and expected interest income, should be sufficient to finance its operating and capital needs for at least the next 24 months before considering the effect of potential milestone payments in the amount of US\$15 million that could be received 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	October 31, 2002	April 30, 2002
(Unaudited—in thousands of Canadian dollars)	\$	\$
ASSETS		
Current		
Cash and cash equivalents	2,383	4,607
Short-term investments	25,775	35,281
Amounts receivable	2,540	84
Prepaid expenses and deposits	661	508
Total current assets	31,359	40,480
Capital assets	1,402	1,556
Intangible assets (note 3)	3,472	720
	36,233	42,756
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	3,116	7,507
License fee payable (note 3(b))	397	—
Deferred revenue	448	—
Total current liabilities	3,961	7,507
Deferred revenue, non-current portion	933	—
Shareholders' equity		
Common shares (note 4(a)(i))	96,401	96,358
Preferred shares (note 4(a)(ii) and (iii))	—	—
Shares to be issued	111	111
Contributed surplus	19	—
Deficit	(65,192)	(61,220)
Total shareholders' equity	31,339	35,249
	36,233	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		Six months ended	
	October 31		October 31	
	2002	2001	2002	2001
(Unaudited—in thousands of Canadian dollars except per share amounts)	\$	\$	\$	\$
REVENUE				
Licensing	114	—	142	—
Research and development collaboration	2,181	—	3,920	—
Interest	268	597	598	1,263
	2,563	597	4,660	1,263
EXPENSES				
Research and development	3,698	3,965	6,182	8,166
General and corporate	1,182	1,042	2,093	1,917
Amortization	197	167	357	330
Write-down of intangible assets	—	—	—	40
	5,077	5,174	8,632	10,453
Loss for the period	(2,514)	(4,577)	(3,972)	(9,190)
Deficit, beginning of period	(62,678)	(45,922)	(61,220)	(41,309)
Deficit, end of period	(65,192)	(50,499)	(65,192)	(50,499)
Basic and diluted loss per common share	(0.07)	(0.12)	(0.10)	(0.24)
Weighted average number of common shares outstanding (in thousands)	38,335	38,287	38,311	38,237

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three months ended		Six months ended	
	October 31		October 31	
	2002	2001	2002	2001
(Unaudited—in thousands of Canadian dollars)	\$	\$	\$	\$
OPERATING ACTIVITIES				
Loss for the period	(2,514)	(4,577)	(3,972)	(9,190)
Items not affecting cash:				
Amortization	197	167	357	330
Stock based compensation	19	—	19	—
Write-down of intangible assets	—	—	—	40
(Gain) Loss on disposal of capital assets	(9)	27	(6)	47
Changes in non-cash working capital items relating to operating activities:				
Accrued interest on short-term investments	23	(98)	168	(220)
Amounts receivable	(2,225)	25	(2,455)	84
Prepaid expenses and deposits	(113)	(196)	(153)	(221)
Accounts payable and accrued liabilities	(2,575)	(32)	(4,419)	1,406
Deferred Revenue	(114)	—	1,381	—
Cash flows used in operating activities	(7,311)	(4,684)	(9,080)	(7,724)
FINANCING ACTIVITIES				
Issuance of common shares, net of issue costs	43	—	43	49
Issuance of special warrants, net of issue costs	—	—	—	(19)
Redemption of preferred shares	(619)	—	(619)	—
Cash flows provided by (used in) financing activities	(576)	—	(576)	30
INVESTING ACTIVITIES				
Funds from short-term investments	9,110	8,827	17,802	18,208
Purchase of short-term investments	(4,663)	(8,267)	(8,463)	(19,187)
Purchase of capital assets	(48)	(120)	(133)	(241)
Intangible asset expenditures	(1,117)	(49)	(1,787)	(124)
Proceeds on disposal of capital assets	13	—	13	—
Cash flows provided by (used in) investing activities	3,295	391	7,432	(1,344)
Decrease in cash and cash equivalents	(4,592)	(4,293)	(2,224)	(9,038)
Cash and cash equivalents, beginning of period	6,975	5,208	4,607	9,953
Cash and cash equivalents, end of period	2,383	915	2,383	915
Supplemental cash flow information				
Increase in intangible assets for license fee payable (notes 3(b)(i) and 6(d))	397	—	397	—
Increase in intangible assets for preferred shares issued (note 3(a)(ii))	—	—	619	—
Increase in intangible assets for common shares issued or to be issued	—	—	—	85

See accompanying notes

NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

Six months ended October 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 for stock options granted to employees and directors 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

	Accumulated Cost \$	Amortization \$	Net Book Value \$
October 31, 2002			
Patents	1,032	298	734
Technology licenses	3,283	567	2,716
Trademarks	26	4	22
	4,341	869	3,472
April 30, 2002			
Patents	813	253	560
Technology licenses	609	473	136
Trademarks	26	2	24
	1,448	728	720

Six months ended October 31, 2002 (Unaudited—Canadian dollars)

- [a] 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:
- an up-front cash payment of \$618,560 (US\$400,000);
 - the issuance of 750,000 Series A preferred shares with a value of \$618,561 (US\$400,001) (Note 4 [a] [ii]); and
 - 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 (note 4(a) (ii) and (iii)). The Company is also obligated in the future to pay:

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

- [b] On September 12, 2002, the Company acquired a portfolio of antiviral technologies and product candidates pursuant to a Call for Tenders in the bankruptcy of Origenix Technologies Inc. and entered into a collaboration and license agreement with Hybridon, Inc. in respect of one of the acquired technologies (the "HPV drug candidate") for consideration as follows:

- payment of \$1,213,835 of which \$396,575 (US\$250,000) remains payable (see note 6(d));
- milestone payments of up to US\$5,250,000 upon the achievement of specified drug development milestones (see note 6(d)); and
- royalties on future product sales of the HPV drug candidate.

The amount of \$1,213,835 has been recorded as technology licenses and is being amortized on a straight line basis over ten years.

4. SHARE CAPITAL

[a] Issued and outstanding

[i] *Common shares*

	Number of Shares (thousands)	Amount \$ (thousands)
Balance, April 30, 2002	39,474	96,358
Issued pursuant to private placement	48	43
Balance, October 31, 2002	39,522	96,401

[ii] *Preferred shares, Series A*

	Number of Shares (thousands)	Amount \$ (thousands)
Balance, April 30, 2002	—	—
Issued pursuant to asset acquisition (note 3(a))	750	619
Redeemed by cash payment	(400)	(619)
Balance, October 31, 2002	350	—

During the quarter ended October 31, 2002, the Company paid US\$400,000 on redemption of 400,000 Series A preferred shares. The remaining 350,000 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, from time to time upon the achievement of specified drug development milestones.

NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS, CONTINUED

Six months ended October 31, 2002 (Unaudited—Canadian dollars)

4. SHARE CAPITAL, CONTINUED

[ii] Preferred shares, Series A, Continued

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.

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 the remaining 350,000 Series A preferred shares are uncertain, these Series A preferred shares have been recorded at an aggregate value of US\$1.

[iii] Preferred shares, Series B

	Number of Shares (thousands)	Amount \$ (thousands)
Balance, April 30, 2002	—	—
Issued pursuant to license and collaboration agreement (note 3(a))	1,000	—
Balance, October 31, 2002	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 \$
Balance, April 30, 2002	2,658	2.20
Options granted	662	0.87
Options forfeited/expired	(78)	(3.24)
Balance, October 31, 2002	3,242	1.91

The stock options expire at various dates between December 3, 2002 and August 31, 2011.

Six months ended October 31, 2002 (Unaudited—Canadian dollars)

[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 six month period ended October 31, 2002 using the fair value accounting method.

	Amount \$ (thousands, except per share amounts)
Net loss for the period as reported	(3,972)
Compensation expense under CICA 3870	(138)
Proforma net loss	(4,110)
Proforma basic loss per share	(0.11)

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

The estimated fair value of stock options issued during the six months ended October 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 \$0.68 per option:

Annualized volatility	98.7%
Risk-free interest rate	3.4%
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 granted options to employees to acquire 90,000 common shares with exercise prices ranging from \$0.62 to \$0.72 and expiry dates through Dec 1, 2010.
- [b] Options to acquire 1,250 common shares with an exercise price of \$0.89 expired unexercised.
- [c] On December 3, 2002, the Company issued 7,850,000 common shares for gross proceeds of \$5,495,000. Additionally, the Company issued warrants to purchase 987,500 common shares at \$1.50 per common share and 982,914 common shares at \$3.00 per common share. These warrants, subject to certain earlier expiry provisions, expire December 3, 2005 and December 3, 2007, respectively.
- [d] On December 17, 2002, the Company issued 5,500,000 Series C convertible, redeemable preferred shares in respect of the remaining US\$5,500,000 in obligations described in Notes 3(b) (i) and (ii). The Series C 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 250,000 of the Series C preferred shares four months after the date of the agreement with the remaining 5,250,000 Series C preferred shares to be redeemed or converted from time to time upon the achievement of specified drug development milestones.



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Forward-looking Statements

This Quarterly Report, including the discussion "From The Micrologix Team" 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.