

PhotoLink

Genomics

Tissue
Engineering

The Right Chemistry

Drug
Delivery

 **SurModics**

Annual Report 2000

Financial Highlights

(Dollars in thousands, except per share data)		Fiscal years ended September 30,			
		1999	1998	1997	1996
Total revenues	\$18,279	\$13,494	\$9,779	\$7,583	\$6,183
PhotoLink revenues	\$12,071	\$ 7,555	\$4,112	\$3,224	\$2,319
PhotoLink royalty revenues	\$ 6,763	\$ 3,912	\$2,205	\$1,448	\$1,052
Operating income (loss)	\$ 5,333	\$ 2,419	\$ 948	\$ 37	\$ (415)
Net income (loss)	\$ 4,240	\$ 2,286 **	\$1,637	\$ 236	\$ (194)
Diluted net income (loss) per share*	\$.25	\$.14 **	\$.12	\$.02	\$ (.02)

*All per share amounts have been retroactively restated to reflect the 2-for-1 stock split effected on December 6, 2000.

** Pro forma, excluding the reversal of a \$2.5 million income tax valuation allowance.

Corporate Profile

SurModics, Inc. is the leading provider of surface modification solutions to the medical device industry. The Company's primary focus is its patented PhotoLink® coating technology. PhotoLink is a versatile, easily applied, light-activated process that modifies medical device surfaces. Many performance-enhancing characteristics are achievable with PhotoLink, including lubricity, hemocompatibility and infection resistance. These coatings make medical devices easier for physicians to use and more compatible with the human body.

SurModics' strategy is to license its technology to medical device manufacturers who apply the coatings in their own facilities. The Company generates PhotoLink revenue from four sources: license fees, high-margin royalties, sales of reagent chemicals, and research and development fees.

By partnering with the world's leading medical device and biotechnology companies, SurModics is also leveraging its core technology into other high-growth, high-value opportunities, including genomics, tissue engineering and drug incorporation coatings.

“The Right Chemistry” describes SurModics’ scientific excellence, dynamic staff, spirit of innovation, and the valuable relationships the Company has forged in the medical device, diagnostic and genomics industries.

To Our Shareholders

In our business, having “the right chemistry” is everything.

In fiscal 2000, SurModics saw rising demand for its coatings among medical device manufacturers as market awareness of the value of the Company’s patented PhotoLink® process increased. We also leveraged our core surface modification technology in some exciting new arenas with coatings in development that incorporate drugs and anti-infective agents onto the surface of medical devices. The biggest single event of the past year was a landmark licensing and development agreement signed with Motorola’s BioChip Systems division, expanding our presence in the emerging field of genomics research and development.

However, the most important effort underway at SurModics is our progress toward fulfilling the promise of our technology through the management and execution of business fundamentals. We are becoming a more well-rounded company, expanding our capabilities beyond technical innovation to include marketing acumen, manufacturing excellence and even stronger financial stewardship.

To SurModics, the phrase “the right chemistry” means much more than technical excellence in surface modification. It describes our scientific excellence, dynamic staff, spirit of innovation,

and the valuable relationships we’ve forged in the medical device, diagnostics and genomics industries. This “chemistry” is the foundation for the outstanding growth we’ve achieved.

2000 Financial Review

SurModics once again produced record financial results for the fiscal year ended September 30, 2000. Revenues increased 35 percent to \$18.3 million. We showed continued strong growth in all aspects of the PhotoLink business. Total PhotoLink revenues increased 60 percent to \$12.1 million. Royalties accounted for \$6.8 million of this total, a 73 percent increase over last year, indicating the success our clients are enjoying in the marketplace with coated medical devices. We also received a \$1.0 million license fee from Motorola as the initial payment under our new partnership. Our unique business model allowed us to leverage this revenue into 120 percent growth in operating income. Finally, fully taxed net income was \$4.2 million, or \$.25 per diluted share, up from the pro forma amount of \$2.3 million, or \$.14 per diluted share, in fiscal 1999.

On December 6, 2000, we completed a two-for-one stock split, increasing the number of common shares outstanding from 8.3 million to 16.6 million shares.



James C. Powell & Dale R. Olseth

A Platform for Success

At the heart of SurModics' success is PhotoLink, our light-activated surface modification technology. We optimize the PhotoLink coatings and process to meet the unique requirements of each client's medical device. We earn revenue in the form of license fees, development revenue, sales of chemical reagents and, most importantly, royalties from our clients' sales of coated products. In fiscal 2000, we saw large increases in both royalties and reagent sales, by 73 percent and 28 percent, respectively. We also had a successful year closing new license agreements, executing ten licenses, thereby reaching the top end of our goal of eight to ten new agreements for the year.

While PhotoLink continues to serve as the foundation of our business, its flexibility has enabled us to capitalize on new opportunities within both the medical device market and in the exciting new field of genomics.

A Platform for DNA Analysis

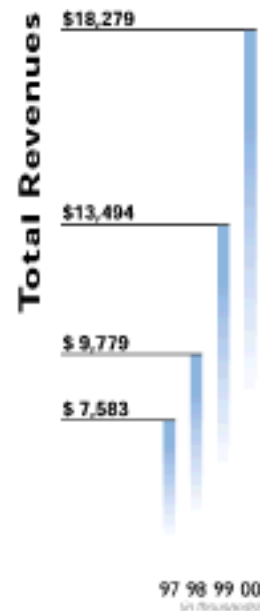
In June 2000, SurModics signed a landmark agreement with Motorola's BioChip Systems division. We have exclusively licensed to Motorola the technology platform for the 3D-Link™ Activated Slide that we successfully introduced to the genomics research market in fiscal 1999. SurModics'

chemistry has the potential to become an integral part of Motorola's new products for research and clinical diagnostics. As Motorola is successful in its visionary strategy, these products will enable health care professionals to better understand the impact of genetics on diseases and ultimately improve the quality of diagnosis and treatment.

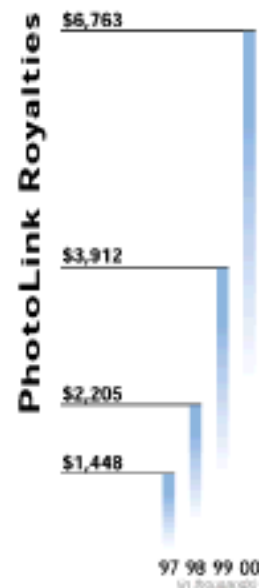
Under this agreement, SurModics received both an up-front license fee and an equity investment. Similar to our other licenses, additional revenue will be received in the future in the form of royalties, development revenue, license fees and product sales. Most importantly, the partnership represents an invaluable opportunity for our company to play a meaningful role in the scientific and medical community's rapidly expanding understanding of the human genome.

A Platform for Drug Incorporation

With a flexible core technology and an exceptional scientific staff, SurModics has the ability to move quickly into new surface modification applications. Among our most promising near-term developments is the capability to incorporate drugs onto the surface of medical devices for release into the human body. We are working with Johnson &



Total revenues increased 35 percent in fiscal 2000, the third straight year of revenue growth greater than our 25 percent target.



The high-margin PhotoLink royalty revenues have increased at a compound annual rate of 47 percent over the last four years.

Johnson's Cordis division on a project to release drugs from the surface of coronary stents to prevent restenosis. These coated stents are presently being evaluated in human clinical trials in Europe. We are also working on an application that would incorporate anti-infective agents onto the surface of orthopedic implants. Given the technical results to date and the significant size of these markets, we have a very positive outlook on the prospects for these applications.

Delivering on Promises, Focusing on Fundamentals

Last year, in our annual report we discussed the promise of taking our core PhotoLink technology "beyond slippery surfaces" for medical devices. We have delivered on that promise, demonstrating PhotoLink's flexibility, value and diverse applications. However, we have many challenges ahead of us. We must continue to apply "the right chemistry" if we are to maintain our exceptional performance.

Moving into fiscal 2001, we will focus intensively on business fundamentals. A major area of activity will be developing our sales and marketing organi-

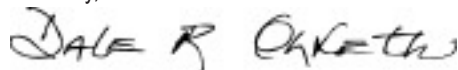
zation to ensure that we select the best projects for investment from a myriad of opportunities. To that end, we have made several recent additions to our staff – individuals with deep experience in the medical device industry.

Additionally, we are in the process of increasing our manufacturing capacity and optimizing our chemical synthesis operations to meet the growing needs of Motorola, Medtronic, Johnson & Johnson and other medical device customers. Our opportunities in the genomics and drug incorporation markets have the potential to be even more significant than the results we've achieved to date with lubricious coatings for medical devices. We look forward to updating our shareholders on progress toward fulfilling these promises, as well.

Finally, we will continue our traditions of technological innovation and solid financial management. We remain committed to achieving our goals of annual revenue growth of at least 25 percent and annual net income growth exceeding that level.

In closing, we thank our shareholders and employees for their continued support and look forward to sharing a successful 2001 with you.

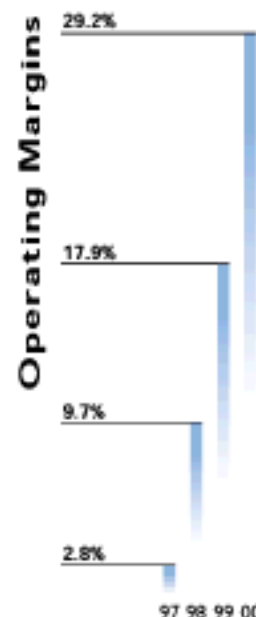
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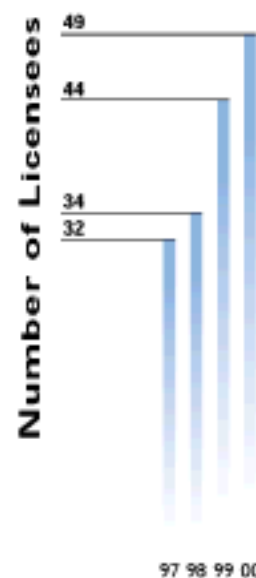
Dale R. Olseth
Chairman and Chief Executive Officer



James C. Powell
President and Chief Operating Officer



SurModics has leveraged its high-margin business model into rapidly growing earnings.



The Company added 10 new license agreements in fiscal 2000. Five of these were with new licensees.

With breadth in coating expertise unparalleled in the surface modification industry, SurModics continues to leverage its PhotoLink[®] technology to new footholds in the medical device market.

During the year, SurModics signed ten new license agreements and achieved a marketing milestone by introducing our first coating application developed outside of a specific client relationship. Our advanced lubricious coating for guidewires will enable physicians to more easily navigate arteries during catheterization procedures.

Also in fiscal 2000, Medtronic AVE gained market share with its new coronary stent systems. The Medtronic AVE GFX[®]2 coronary stent delivery systems contain a SurModics lubricious coating, which is marketed under the private-label brand Dura-Trac[™]. These systems have received market approval in Europe, Canada, Japan

and the United States during the last two years and represent a growing source of royalties to SurModics.

SurModics has readied itself for future growth by outlining key objectives for the medical device market:

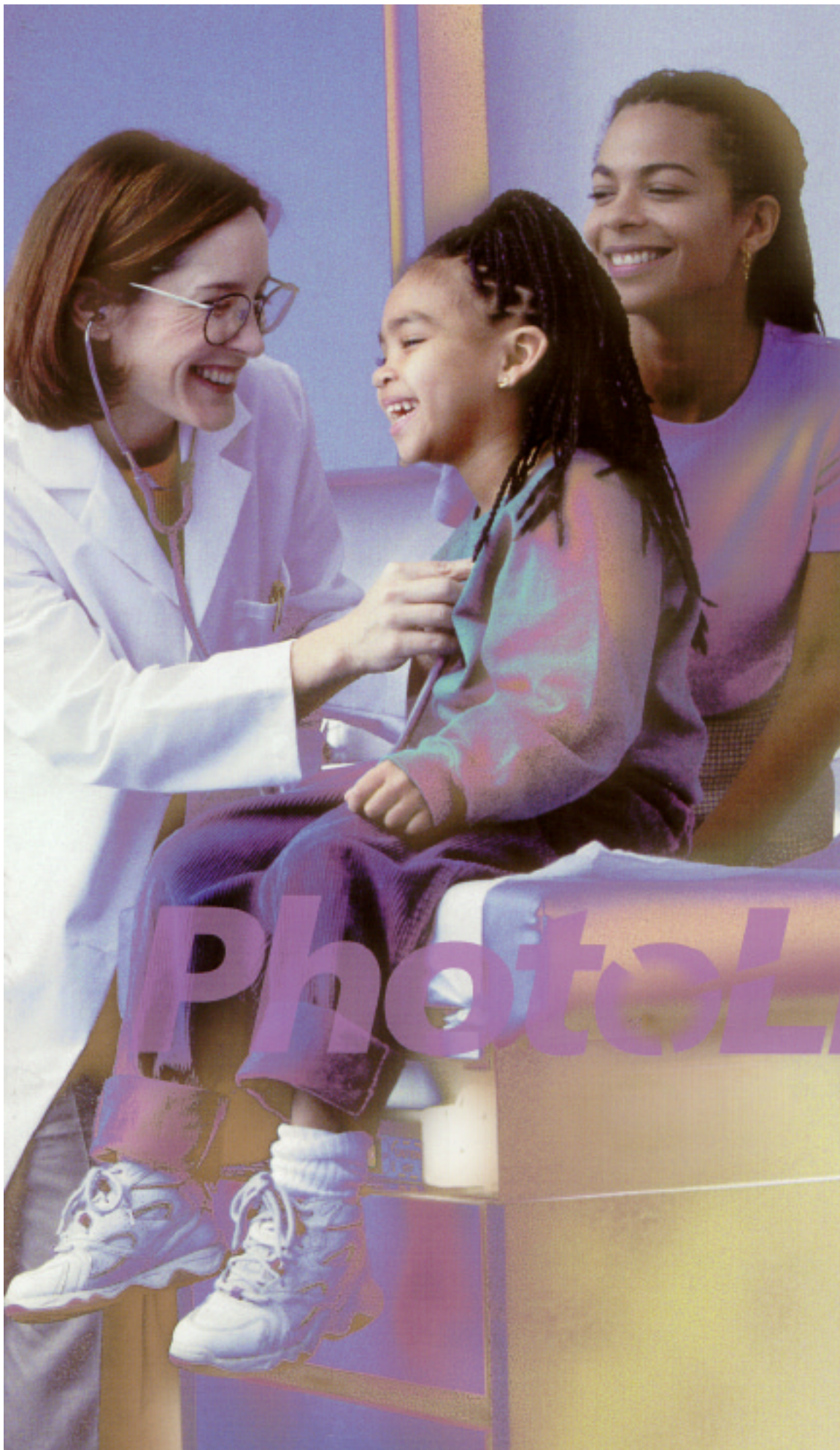
- Target high-growth/high-value medical device products which would benefit most from PhotoLink's strengths and versatility;
- Integrate PhotoLink into the product life cycles of new and existing clients, thereby fostering long-term business partnerships; and
- Become the sole-source provider of surface modification solutions for the world's leading medical device manufacturers.

Although SurModics remains best known for its lubricious coatings—which make devices such as catheters more slippery—the Company is gaining additional visibility in the areas of hemocompatible, infection resistant and drug incorporation coatings. These applications tap market opportunities comparable in size to the lubricious coatings market that the Company has already successfully penetrated.

Hemocompatible
*coatings that make
a device compatible
with human blood,
so that blood clots
do not develop.*

Infection Resistant
*coatings that reduce
or eliminate the
growth of micro-
organisms to pre-
vent device-centered
infections.*

PhotoLink



Biochip

a miniature glass or plastic device containing short DNA strands which interact with DNA from blood or other samples to create a platform for analysis and diagnosis of diseases and genetic mutations.

PhotoLink

Earlier this year, the Human Genome Project caught the world's attention by unveiling a draft of the master blueprint for the genetic code of a human being. Scientists will now apply this knowledge to new technologies that will:

- Enable health care providers to more accurately diagnose diseases and plan more effective treatments;
- Aid in the development of new drugs;
- Screen populations for individuals who may have adverse reactions to specific drugs or treatment approaches; and
- Improve preventive care.

During fiscal 1999, SurModics entered the genomics market and quickly gained acceptance with the 3D-Link™ Activated Slide. With PhotoLink technology at its core, the coated glass slide enables scientists to produce microarrays, also called "biochips," that provide stronger signals with lower background levels for DNA screening.

In fiscal 2000, after less than one year on the market, the slide's unique characteristics caught the attention of Motorola's BioChip Systems division for its potential to be used as a technology platform for products Motorola is developing for the detection and mapping of genetic materials. In June, Motorola signed an exclusive agreement with SurModics for the technology, which includes an ongoing research and development relationship and the potential for significant revenue generation in the future.

Most exciting, however, is the Joint Development Committee formed by both companies to improve the existing surface chemistry technology, and identify and develop new products and technologies for the genomics market.

The collaborative efforts of Motorola and its partners will help create the next generation of medical technology. SurModics is pleased to be a part of this exciting new aspect of biotechnology.

Continuing its tradition of innovation, SurModics is exploring new avenues for its PhotoLink technology and looking for growth opportunities to expand its base of business.

For example, the Company is working with Johnson & Johnson's Cordis division on an application that incorporates drugs onto the surface of a stent. This application, which is currently in initial human clinical trials in Europe, is designed to combat restenosis (the reclosure of an artery due to vessel damage following angioplasty or a stenting procedure). According to the American College of Cardiology, more than one-half million Americans and one million patients worldwide undergo nonsurgical coronary artery procedures each year, with more than half receiving stents. Approximately one-third of the patients who receive stents develop restenosis within 12 months of the procedure.

Once restenosis develops, there are few options available to remedy the situation other than surgery. Clearly, this is a promising new application for PhotoLink technology that addresses a major unmet medical need.

On other fronts, SurModics is delving into orthopedic product coatings and tissue engineering applications to broaden its product platform and take advantage of PhotoLink's industry-leading versatility. These products address critical issues relating to treatment of abdominal aortic aneurysms, post-surgical adhesions, and bone and cartilage repair. Some of these technologies could be available for market introduction during the next five years.

As SurModics looks to the future, it is focused on building a strong development pipeline, new technologies, and the next-generation PhotoLink coatings and applications. By leveraging its core technology and exploring new markets with formidable partners, SurModics is in a unique position to capitalize on its successes.

Stent

small cylindrical scaffolds that hold open narrowed coronary arteries; a successful complement to angioplasty.

Drug Incorporation

a coating for medical devices that provides for the controlled release of a therapeutic agent from the surface into the surrounding tissue.



Management's Discussion and Analysis of Financial Conditions and Results of Operations

General

SurModics is a leading provider of surface modification solutions to medical device manufacturers. The Company's revenues are derived from four primary sources: fees from licensing its patented technology to customers; royalties received from licensees; the sale of photo-reactive chemical compounds to licensees and stabilization products to the diagnostics industry; and research and development fees generated on projects for commercial customers and government grants. In March 1998, the Company completed an initial public offering ("IPO") of 4.6 million shares of Common Stock that generated proceeds of \$15.5 million, net of related offering expenses.

Fiscal 2000 was a record year for SurModics. Total revenues increased 35% to \$18.3 million from \$13.5 million in fiscal 1999. The primary revenue growth driver was PhotoLink, as demand for its coating technology continued to increase. PhotoLink-related revenue increased 60% to a record \$12.1 million in fiscal 2000 from \$7.6 million in 1999 as all categories showed double-digit growth. PhotoLink royalties increased 73% to \$6.8 million and reagent sales, those chemicals used by licensees in the coating process, increased 28% to \$2.4 million. These revenue gains resulted in a 120% increase in operating income to \$5.3 million from \$2.4 million in fiscal 1999. Net income was \$4.2 million, or \$.25 per diluted share, compared to \$4.4 million, or \$.27 per diluted share, in fiscal 1999. However, the fiscal 1999 results included the reversal of a \$2.5 million income tax valuation allowance related to net operating loss carryforwards.

Results of Operations

Years Ended September 30, 2000 and 1999

Revenues. The Company's revenues were \$18.3 million in fiscal 2000, an increase of 35% over fiscal 1999. The revenue components were as follows:

(Dollars in thousands)	Fiscal 2000	Fiscal 1999	Increase (Decrease)	% Increase (Decrease)
PhotoLink revenue:				
Royalties	\$ 6,763	\$ 3,912	\$2,851	73%
License fees	1,470	645	825	128%
Reagent sales	2,393	1,876	517	28%
Commercial development	1,445	1,122	323	29%
Total PhotoLink revenue	12,071	7,555	4,516	60%
Diagnostic royalties	2,917	2,758	159	6%
Stabilization & other products	2,687	2,261	426	19%
Government research	604	920	(316)	(34%)
Total revenues	\$18,279	\$13,494	\$4,785	35%

The revenue growth in fiscal 2000 was largely due to the 60% increase in total PhotoLink revenue between years. PhotoLink royalties increased 73% due primarily to sales growth of previously introduced coated products by licensees. SurModics' clients now have 47 coated products on the market. Reagent sales increased 28% due to increased production of coated devices by PhotoLink clients. A single customer purchased 55% of the reagents sold during fiscal 2000, down from 57% in fiscal 1999. More importantly, reagent sales to all other customers increased 32% between years. During fiscal 2000, SurModics signed 10 new license agreements, compared to 14 new agreements executed in fiscal 1999. Revenue from license fees increased 128% from fiscal 1999 due to the receipt of a \$1.0 million license fee from Motorola BioChip Systems during the fourth quarter of fiscal 2000. The Company now has license agreements with 49 companies covering over 100 product applications. Customer-funded development projects to optimize the PhotoLink coatings for each customer's specific application resulted in a 29% increase in commercial development revenue. Approximately 63% of the commercial development revenue resulted from work on a project for a single customer. This same customer accounted for 34% of the commercial development revenue in fiscal 1999.

Non-PhotoLink revenue sources also grew in fiscal 2000; however, this growth was offset by a reduction in government revenue. The diagnostic royalties increased 6% between years. Most of this growth occurred in the first half of the year, as FDA manufacturing issues at the sole licensee impacted royalties in the second half. These royalties are expected to remain at a reduced level over the next two or three quarters. Sales of stabilization & other products

grew 19%. A 9% decrease in stabilization chemical sales was more than offset by large growth in 3D-Link Activated Slides. Stabilization sales suffered from the loss of a large customer. Finally, revenue from government grants decreased 34% between years, as the Company has de-emphasized its reliance on grants and has internally funded more of its research and development projects.

Product costs. The Company's product costs were \$1.9 million for fiscal 2000, an increase of \$400,000, or 26%, over fiscal 1999. Overall product margins averaged 63% during both years. Efficiencies gained through increased sales volumes were offset by additional scrap and labor costs.

Research and development expense. Research and development expense was \$6.8 million for fiscal 2000, an increase of \$1.5 million, or 30%, over fiscal 1999. Most of this increase was due to compensation and benefit expenses associated with the additional technical personnel hired by the Company during the year. In addition, the Company incurred increased costs due to the build-out of additional lab space within the current facility early in the year and the associated costs to furnish the new space with equipment and supplies.

Sales and marketing expense. Sales and marketing expense was \$1.6 million for fiscal 2000, a decrease of \$200,000, or 11%, over fiscal 1999. This decrease was due primarily to compensation and benefit expenses associated with unfilled sales and marketing positions throughout the year. Some of these positions were filled during the fourth quarter, so it is expected that sales and marketing expense will be higher in fiscal 2001.

General and administrative expense. General and administrative expense was \$2.7 million for fiscal 2000, an increase of \$100,000, or 5%, over fiscal 1999. The increase was primarily due to inflation, resulting in higher compensation and benefit costs, and increased legal and professional fees.

Other income, net. The Company's net other income was \$1.4 million for fiscal 2000, an increase of \$300,000, or 22%, over fiscal 1999. This income primarily represents interest earned on the Company's investments. The level of investments increased due to the \$7.4 million of cash provided by operating activities, \$13.2 million from the issuance of Common Stock and higher yields due to an increase in interest rates.

Income tax expense. The Company's income tax provision was \$2.5 million for fiscal year 2000 versus a \$783,000 income tax benefit recorded in fiscal 1999. The Company's effective tax rate was 37% in fiscal 2000. The income tax benefit in fiscal 1999 resulted from

the reversal of an income tax valuation allowance of approximately \$2.5 million, reducing the Company's tax provision at statutory rates to a net credit of \$783,000.

Years Ended September 30, 1999 and 1998

Revenues. The Company's revenues were \$13.5 million in fiscal 1999, an increase of 38% over fiscal 1998. The revenue components were as follows:

<i>(Dollars in thousands)</i>	<i>Fiscal 1999</i>	<i>Fiscal 1998</i>	<i>Increase (Decrease)</i>	<i>% Increase (Decrease)</i>
PhotoLink revenue:				
Royalties	\$ 3,912	\$2,205	\$1,707	77%
License fees	645	222	423	191%
Reagent sales	1,876	794	1,082	136%
Commercial development	1,122	891	231	26%
Total PhotoLink revenue	7,555	4,112	3,443	84%
Diagnostic royalties	2,758	2,578	180	7%
Stabilization & other products	2,261	2,004	257	13%
Government research	920	1,085	(165)	(15%)
Total revenues	\$13,494	\$9,779	\$3,715	38%

The revenue growth in fiscal 1999 was mainly due to the 84% increase in PhotoLink revenue between years. PhotoLink royalties increased 77% due to the introduction of six additional coated products as well as increases in the sales of previously introduced coated products by licensees. Reagent sales increased 136% due to increased production of PhotoLink-coated devices by these clients. A single customer purchased 57% of the reagents sold during fiscal 1999, up from 12% in fiscal 1998. During fiscal 1999, SurModics signed 14 new license agreements, compared to three new agreements in fiscal 1998, resulting in a 191% increase in license fees. Increased customer-funded development projects resulted in a 26% increase in commercial development revenue. Approximately 75% of the commercial development revenue resulted from work on projects for two customers. One of these customers accounted for 50% of the commercial development revenue in fiscal 1998.

The growth of the non-PhotoLink revenues was more moderate in fiscal 1999. The diagnostic royalties grew 7% between years due to increased product sales by the licensee. Sales of stabilization chemicals grew 13% between years as a result of increased market penetration. Finally, revenue from government grants decreased 15% between years, as the Company began to internally fund more of its research and development projects rather than relying on grants.

Product costs. The Company's product costs were \$1.5 million for fiscal 1999, an increase of \$300,000, or 27%, over fiscal 1998. Overall product margins increased to 63% in fiscal 1999 from 57% in fiscal 1998. The margin improvement was primarily due to cost efficiencies realized in the production of reagent chemicals as a result of increased production volumes. The margins on stabilization product sales remained relatively flat between years.

Research and development expense. Research and development expense was \$5.2 million for fiscal 1999, an increase of \$700,000, or 16%, over fiscal 1998. Most of this increase was due to compensation and benefit expenses associated with the additional technical personnel hired by the Company during the year. In addition, the Company incurred expense on project management training for its technical personnel and increased legal expense related to the filing of new patents. These cost increases were offset by a reduction in the amount of research performed at external laboratories on government grants.

Sales and marketing expense. Sales and marketing expense was \$1.8 million for fiscal 1999, an increase of \$400,000, or 25%, over fiscal 1998. This increase was primarily due to compensation and benefit expenses associated with additional sales and marketing personnel hired during the year, increased incentive compensation associated with the sales growth and increased promotional spending. These cost increases were offset by a reduction in market research costs.

General and administrative expense. General and administrative expense was \$2.5 million for fiscal 1999, an increase of \$800,000, or 50%, over fiscal 1998. The increase was primarily due to compensation and benefit costs associated with additional personnel hired during the year, increased expenses associated with being a public company for the full year (such as investor relations costs, Nasdaq fees and other external reporting expenses) and expenses associated with the shareholder rights plan adopted in fiscal 1999. In addition, a portion of the overall increase was from expenses associated with the Company president, who was appointed in the fourth quarter of 1998.

Other income, net. The Company's net other income was \$1.2 million for fiscal 1999, an increase of \$400,000, or 59%, over fiscal 1998. The increase in interest income was due to earnings generated

on the investments resulting from the \$15.5 million of IPO proceeds received in March 1998. The level of investments also increased due to the \$4.4 million of cash provided by operating activities in fiscal 1999.

Benefit from income taxes. The Company's net income was benefited by a positive income tax adjustment. During fiscal 1999, management concluded that the Company would generate sufficient taxable income in the future to utilize all of the previously unrecognized tax net operating loss ("NOL") carryforwards prior to their expiration. Therefore, during fiscal 1999, the Company reversed a \$2.5 million valuation allowance related to these NOL carryforwards.

Net Operating Loss Carryforwards

As of September 30, 2000, the Company had NOL carryforwards of approximately \$450,000 that expire in varying amounts through 2014. It is expected that these NOL carryforwards will be fully utilized in fiscal 2001. The Company also has \$400,000 of capital loss carryforwards at September 30, 2000, which expire in 2001. A valuation allowance has been established due to the uncertainty of realization of the capital loss carryforwards.

Liquidity and Capital Resources

As of September 30, 2000, the Company had working capital of \$18.7 million and cash, cash equivalents and investments totaling \$39.7 million. The Company generated positive cash flows from operating activities of \$7.4 million in fiscal 2000, \$4.4 million in fiscal 1999 and \$2.1 million in fiscal 1998. The increase in cash flows in fiscal 2000 was primarily due to the increased net income generated during the year and the usage of NOL carryforwards, which resulted in a limited amount of cash required for the payment of income taxes.

The significant increase in investing activities over the last year was primarily due to the activity in the Company's available-for-sale investment portfolio as managed by an independent investment manager. Additional funds were available for investment due to the Company's positive cash flows and from the issuance of Common Stock. SurModics' investment policy requires investments with high credit quality issuers and limits the amount of credit exposure to any one issuer. The Company's investments principally consist of U.S. government and government agency obligations and investment grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are five years or less. A 10% increase in interest rates would result in an approximate \$380,000 decrease in the fair value of the Company's available-for-sale securities as of September 30, 2000, but no material impact on the results of

operations or cash flows.

The Company purchased \$3.0 million of property and equipment in fiscal 2000, and \$4.7 million in fiscal 1999, including \$3.2 million for the land and building it currently occupies.

The most significant financing activity over the last three years was the completion of the initial public offering of 4.6 million shares of Common Stock in March 1998, which generated net proceeds to the Company of \$15.5 million, net of related offering expenses. In August 2000, the Company sold almost 800,000 shares of its Common Stock to Motorola, Inc. in a private placement that generated \$13.0 million. Proceeds from stock option exercises generated an additional \$200,000 and \$1.3 million during fiscal 2000 and 1999, respectively.

As of September 30, 2000, the Company had no debt, nor did it have any credit agreements. The Company believes that its existing capital resources will be adequate to fund the Company's operations into the foreseeable future.

New Accounting Pronouncements

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." SAB 101 requires that license and other up-front fees be recognized over the term of the agreement unless the fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process. The Company will adopt SAB 101 when required, which is currently expected to be in the fourth quarter of fiscal 2001. The Company is currently evaluating SAB 101 to determine whether its implementation will have any material impact on the Company's financial position or results of operations with respect to the license fees earned by SurModics. Any adjustment would result in a charge to earnings for the cumulative effect of the change. This amount would then be deferred and be recognized as revenue in future periods.

Forward-Looking Statements

Certain statements contained in this Annual Report and other written and oral statements made from time to time by the Company do not relate strictly to historical or current facts. As such, they are considered "forward-looking statements" that provide current expectations or forecasts of future events. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Reform Act of 1995. Such statements can be identified by the use of terminology such as "anticipate," "believe," "estimate," "expect," "intend," "may," "could," "possible," "plan," "project," "will," "forecast"

and similar words or expressions. The Company's forward-looking statements generally relate to its growth strategy, financial results, product development programs, sales efforts and the impact of the Motorola and Cordis agreements. One must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions. Consequently, no forward-looking statement can be guaranteed and actual results may vary materially. The Company undertakes no obligation to update any forward-looking statement.

Although it is not possible to create a comprehensive list of all factors that may cause actual results to differ from the Company's forward-looking statements, such factors include, among others, (i) the trend of consolidation in the medical device industry, resulting in more significant, complex and long-term contracts than in the past and potentially greater pricing pressures; (ii) the Company's ability to attract new licensees and to enter into agreements for additional product applications with existing licensees, and the willingness of potential customers to sign license agreements under the terms offered by the Company; (iii) the success of existing licensees in selling products incorporating SurModics' technology and the timing of new product introductions by licensees; (iv) the difficulties and uncertainties associated with the lengthy and costly new product development and foreign and domestic regulatory approval processes, such as delays, difficulties or failures in achieving acceptable clinical results or obtaining foreign or FDA marketing clearances, which may result in lost market opportunities or postpone or preclude product commercialization by licensees; (v) efficacy or safety concerns with respect to products marketed by SurModics and its licensees, whether scientifically justified or not, that may lead to product recalls, withdrawals or declining sales; (vi) the development of new products or technologies by competitors, technological obsolescence and other changes in competitive factors; (vii) economic factors over which the Company has no control, including changes in inflation and consumer confidence. Investors are advised to consult any further disclosures by the Company on this subject in its filings with the Securities and Exchange Commission.

Balance Sheets

As of September 30

2000

1999

(in thousands, except share data)

Assets**Current Assets**

Cash and cash equivalents	\$ 1,510	\$ 1,975
Short-term investments	15,847	3,947
Accounts receivable, net of allowance for doubtful accounts of \$40	1,406	1,433
Inventories, net	500	459
Deferred tax asset	912	—
Prepays and other	911	260

Total current assets	21,086	8,074
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Property and Equipment, net	7,166	5,275
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Long-Term Investments	22,293	15,917
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Other Assets, net	204	2,692
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	\$50,749	\$31,958
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Liabilities and Stockholders' Equity**Current Liabilities**

Accounts payable	\$ 379	\$ 710
Accrued liabilities—		
Compensation	1,110	783
Other	474	478
Deferred revenues	433	268

Total current liabilities	2,396	2,239
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Deferred Revenues, less current portion	50	—
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Total liabilities	2,446	2,239
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Commitments and Contingencies (Note 6)**Stockholders' Equity**

Series A preferred stock- \$.05 par value, 450,000 shares authorized, no shares issued and outstanding	—	—
Common stock- \$.05 par value, 45,000,000 shares authorized, 16,556,002 and 15,403,842 shares issued and outstanding	828	770
Additional paid-in capital	45,740	31,624
Unearned compensation	(289)	(267)
Stock purchase notes receivable	(7)	(58)
Accumulated other comprehensive loss	(46)	(187)
Retained earnings (accumulated deficit)	2,077	(2,163)

Total stockholders' equity	48,303	29,719
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	\$50,749	\$31,958
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The accompanying notes are an integral part of these balance sheets.

Statements of Operations

For the Years Ended September 30

(in thousands, except net income per share)

	2000	1999	1998
Revenues			
Royalties	\$ 9,680	\$ 6,670	\$ 4,783
License fees	1,470	645	222
Product sales	5,080	4,137	2,798
Research and development	2,049	2,042	1,976
Total revenues	18,279	13,494	9,779
Operating Costs and Expenses			
Product	1,903	1,511	1,193
Research and development	6,797	5,248	4,522
Sales and marketing	1,573	1,769	1,419
General and administrative	2,673	2,547	1,697
Total operating costs and expenses	12,946	11,075	8,831
Income from Operations	5,333	2,419	948
Other Income			
Investment income and other, net	1,418	1,069	698
Gain (loss) on sale of investments	(2)	89	28
Other income, net	1,416	1,158	726
Income Before Income Taxes	6,749	3,577	1,674
Income Tax	2,509	(783)	37
Net Income	\$ 4,240	\$ 4,360	\$ 1,637
Net Income per Share			
Basic	\$.27	\$.30	\$.13
Diluted	\$.25	\$.27	\$.12
Weighted Average Shares Outstanding			
Basic	15,699	14,708	12,449
Dilutive effect of outstanding stock options	1,119	1,376	1,148
Diluted	16,818	16,084	13,597

The accompanying notes are an integral part of these financial statements.

Statements of Stockholders' Equity

For the Years Ended September 30, 2000, 1999, and 1998 (in thousands)	Convertible Preferred Stock		Common Stock	
	Shares	Amount	Shares	Amount
Balance, September 30, 1997	377	\$ 19	6,802	\$340
Components of comprehensive income:				
Net income	—	—	—	—
Change in unrealized gain on available-for-sale securities	—	—	—	—
Total comprehensive income				
Common stock options exercised	—	—	52	2
Conversion of preferred stock to common stock	(377)	(19)	3,014	151
Issuance of common stock	—	—	4,600	230
Restricted stock activity	—	—	(40)	(2)
Net loan activity	—	—	—	—
Amortization of unearned compensation	—	—	—	—
Balance, September 30, 1998	—	—	14,428	721
Components of comprehensive income:				
Net income	—	—	—	—
Change in unrealized gain on available-for-sale securities	—	—	—	—
Total comprehensive income				
Common stock options exercised, net	—	—	966	48
Tax benefit from exercise of stock options	—	—	—	—
Restricted stock activity	—	—	17	1
Net loan activity	—	—	(7)	—
Amortization of unearned compensation	—	—	—	—
Balance, September 30, 1999	—	—	15,404	770
Components of comprehensive income:				
Net income	—	—	—	—
Change in unrealized gain on available-for-sale securities	—	—	—	—
Total comprehensive income				
Issuance of common stock	—	—	794	40
Common stock options exercised, net	—	—	360	18
Tax benefit from exercise of stock options	—	—	—	—
Restricted stock activity	—	—	(2)	—
Net loan activity	—	—	—	—
Amortization of unearned compensation	—	—	—	—
Balance, September 30, 2000	—	\$ —	16,556	\$828

The accompanying notes are an integral part of these financial statements.

<i>Additional Paid-In-Capital</i>	<i>Unearned Compensation</i>	<i>Stock Purchase Notes Receivable</i>	<i>Accumulated Other Comprehensive Income (Loss)</i>	<i>Retained Earnings (Accumulated Deficit)</i>	<i>Total Stockholders' Equity</i>
\$13,322	\$(259)	\$(160)	\$ —	\$(8,160)	\$ 5,102
—	—	—	—	1,637	1,637
—	—	—	278	—	278
					1,915
111	—	—	—	—	113
(132)	—	—	—	—	—
15,291	—	—	—	—	15,521
(18)	20	—	—	—	—
—	—	(22)	—	—	(22)
—	69	—	—	—	69
28,574	(170)	(182)	278	(6,523)	22,698
—	—	—	—	4,360	4,360
—	—	—	(465)	—	(465)
					3,895
1,286	—	—	—	—	1,334
1,650	—	—	—	—	1,650
170	(171)	—	—	—	—
(56)	—	124	—	—	68
—	74	—	—	—	74
31,624	(267)	(58)	(187)	(2,163)	29,719
—	—	—	—	4,240	4,240
—	—	—	141	—	141
					4,381
12,960	—	—	—	—	13,000
220	—	—	—	—	238
818	—	—	—	—	818
118	(118)	—	—	—	—
—	—	51	—	—	51
—	96	—	—	—	96
\$45,740	\$(289)	\$ (7)	\$ (46)	\$ 2,077	\$48,303

Statements of Cash Flows

For the Years Ended September 30

(in thousands)

	2000	1999	1998
Operating Activities			
Net income	\$ 4,240	\$ 4,360	\$ 1,637
Adjustments to reconcile net income to net cash provided by operating activities-			
Depreciation and amortization	1,126	709	617
Loss (gain) on sale of investments	2	(89)	(28)
Amortization of unearned compensation, net	96	74	69
Change in deferred rent	—	(30)	(18)
Tax benefit from exercise of stock options	818	1,650	—
Deferred tax provision	1,553	(2,465)	—
Change in operating assets and liabilities:			
Accounts receivable	27	(377)	(134)
Inventories	(41)	(79)	(116)
Accounts payable and accrued liabilities	(8)	716	482
Deferred revenue	215	(53)	(205)
Prepays and other	(651)	(4)	(181)
Net cash provided by operating activities	7,377	4,412	2,123
Investing Activities			
Purchases of property and equipment, net	(2,994)	(4,721)	(775)
Purchases of available- for -sale investments	(52,862)	(24,436)	(33,595)
Sales/maturities of available- for -sale investments	34,725	23,972	17,455
Repayment (issuance) of stock purchase notes receivable	51	68	(22)
Other	—	3	32
Net cash used in investing activities	(21,080)	(5,114)	(16,905)
Financing Activities			
Issuance of common stock, net	13,238	1,334	15,634
Net cash provided by financing activities	13,238	1,334	15,634
Net increase (decrease) in cash and cash equivalents	(465)	632	852
Cash and Cash Equivalents			
Beginning of year	1,975	1,343	491
End of year	\$ 1,510	\$ 1,975	\$ 1,343

The accompanying notes are an integral part of these financial statements.

Notes to Financial Statements

1 Description

SurModics, Inc. (the Company) develops, manufactures and markets innovative surface modification solutions to the medical device industry. The Company's revenues are derived from the following: fees from licensing its patented technology to customers; royalties received from licensees; the sale of photoreactive chemical compounds to licensees, stabilization products to the diagnostic industry, and coated glass slides to the genomics market; and research and development fees generated on projects for commercial customers and government grants. The Company markets its products through a direct sales force primarily in the United States and some international markets.

2 Summary of Significant Accounting Policies

Cash and Cash Equivalents

Cash and cash equivalents consist principally of money market instruments with original maturities of three months or less and are stated at cost which approximates fair value.

Investments

Investments consist principally of U.S. government and government agency obligations and corporate debt securities and are classified as available-for-sale as of September 30, 2000 and 1999. Available-for-sale investments are reported at fair value with unrealized gains and losses excluded from operations and reported as a separate component of stockholders' equity, except for other-than-temporary impairments, which are reported as a charge to current operations and result in a new cost basis for the investment.

The amortized cost, unrealized holding gains and losses, and fair value of investments as of September 30, 2000 and 1999 were as follows (in thousands):

September 30, 2000	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government obligations	\$14,039	\$ 52	\$ (74)	\$14,017
Corporate bonds	9,095	2	(14)	9,083
Mortgage-backed securities	9,003	35	(33)	9,005
Asset-backed securities	3,598	10	(7)	3,601
Municipal bonds	2,451	3	(20)	2,434
Total	\$38,186	\$102	\$(148)	\$38,140

September 30, 1999	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government obligations	\$10,423	\$ —	\$(134)	\$10,289
Corporate bonds	3,458	—	(5)	3,453
Mortgage-backed securities	2,683	3	(28)	2,658
Asset-backed securities	2,310	—	(8)	2,302
Municipal bonds	1,177	1	(16)	1,162
Total	\$20,051	\$ 4	\$(191)	\$19,864

The amortized cost and fair value of investments by contractual maturity at September 30, 2000, were as follows:

	Amortized Cost	Fair Value
Debt securities due within:		
One year	\$15,896	\$15,847
One to five years	17,815	17,799
Five years or more	4,475	4,494
Total	\$38,186	\$38,140

Inventories

Inventories are stated at the lower of cost or market using the specific identification method and include direct labor, materials and overhead. Inventories consisted of the following components as of September 30 (in thousands):

	2000	1999
Raw materials	\$197	\$179
Finished products	303	280
Total	\$500	\$459

Property and Equipment

Property and equipment are stated at cost and are depreciated using the straight-line method over three to twenty years, the estimated useful lives of the assets. Upon completion, construction-in-progress will begin depreciation over the estimated useful lives of the assets (in thousands).

	2000	1999
Laboratory fixtures and equipment	\$ 4,651	\$ 3,009
Office furniture and equipment	1,790	1,383
Building and improvements	5,811	4,533
Construction-in-progress	52	408
Less-Accumulated depreciation	(5,138)	(4,058)
Property and equipment, net	\$ 7,166	\$ 5,275

Notes to Financial Statements

Other Assets

Other assets consist principally of patents, which are amortized over seven to twelve years. Accumulated amortization was \$87,000 and \$64,000 as of September 30, 2000 and 1999, respectively.

Revenue Recognition

Royalties are recognized as third-party licensees report sales of the licensed product or as minimum royalties become due. Initial nonrefundable license fees are recognized as revenue upon execution of the license agreement. Certain nonrefundable license and research and development fees are recoverable by the licensees as offsets against a percentage of future earned royalties.

Revenues on product sales are recognized as products are shipped, and revenues for research and development are recorded as performance progresses under the applicable contract.

Cash received prior to performance is recorded as deferred revenues in the accompanying balance sheets.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used for such items as depreciable lives and uncollectible accounts. Ultimate results could differ from those estimates.

New Accounting Pronouncements

SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. The Company will adopt SFAS No. 133 on October 1, 2000 with no expected impact on its financial statements.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." SAB 101 requires that license and other up-front fees be recognized over the term of the agreement unless the fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process. The Company will adopt SAB 101 when required, which is currently expected to be in the fourth quarter of fiscal 2001. The Company is currently evaluating SAB 101 to determine whether its implementation will have any material impact on the Company's financial position or results of operations with respect to the license fees earned by SurModics. Any adjustment would result in a charge to earnings for the cumulative effect of the change. This amount would

then be deferred and be recognized as revenue in future periods.

3 Stockholders' Equity

The Company effected a 2-for-1 split of its Common Stock on December 6, 2000, in the form of a 100% stock dividend. All share, per share and weighted average share information has been restated to reflect the split.

On January 24, 2000, shareholders approved an amendment to the Articles of Incorporation to eliminate all references in the Articles to a class of Convertible Preferred Stock, shares of which were automatically converted as part of the Company's initial public offering in 1998. The amendment also increased the number of capital shares to 50,000,000 shares of capital stock, \$.05 per share par value, of which 45,000,000 shares are Common Stock, 450,000 are Series A Preferred Stock and 4,550,000 shares are undesignated. The Series A Preferred Stock was designated by board action in conjunction with a Shareholder Rights Plan and has certain preferential voting, liquidation and dividend rights as follows:

- Each share of Series A Preferred Stock is entitled to 200 votes on all matters submitted to a vote of the stockholders of the Company.
- In the event of liquidation of the Company, the holders of these shares are entitled to receive the greater of \$100 per share or 200 times the per share amount to be distributed to holders of shares of Common Stock.
- Preferred stockholders are entitled to receive a quarterly dividend of the greater of \$1.00 per share or 200 times the per share amount of any dividend declared on the Common Stock.

1999 Employee Stock Purchase Plan

During fiscal 2000, the Company adopted the 1999 Employee Stock Purchase Plan (the "Stock Purchase Plan") under which the Company is authorized to issue up to 200,000 shares of Common Stock. All full-time and part-time employees (including officers) can choose to have up to 10% of their annual compensation withheld to purchase the Company's Common Stock. The purchase price of the stock is 85% of the average closing price over the five trading days immediately preceding March 1, 2000 or the average closing price over the five days immediately preceding February 28, 2001, whichever is less. The Company has not issued any shares under the Stock Purchase Plan during fiscal 2000. As of September 30, 2000, there was approximately \$164,000 of employee contributions included in accrued liabilities in the accompanying financial statements. The Stock Purchase Plan does not allow an employee to purchase stock through the Stock Purchase Plan if immediately after the grant of an option, he or she would own stock representing 5% or more of the total combined voting power or value of all classes of the stock of the Company. The Stock Purchase Plan will terminate on February 28, 2010, unless the Board

Notes to Financial Statements

of Directors extends the term.

Restricted Stock Awards

The Company has entered into restricted stock agreements with certain key employees, covering the issuance of Common Stock (the "Restricted Stock"). The Restricted Stock will be released to the key employees if they are employed by the Company at the end of a five-year waiting period. Unearned compensation has been recognized for the estimated fair value of the applicable common shares, reflected as a reduction of stockholders' equity, and is being charged to operations over the five-year term.

Transactions in restricted stock were as follows:

Outstanding at September 30, 1997	252,800
Granted	8,000
Canceled	(48,000)
Exercised	(84,800)
Outstanding at September 30, 1998	128,000
Granted	25,000
Canceled	(8,000)
Outstanding at September 30, 1999	145,000
Granted	11,000
Canceled	(12,500)
Exercised	(48,000)
Outstanding at September 30, 2000	95,500

Stock Purchase Notes Receivable

The Company established a loan program during fiscal 1997 to assist employees in purchasing shares of the Company's stock. The loans are collateralized by the employees' purchased shares and require annual interest payments at a rate equal to prime at the date of issuance (8.5%) with principal and any unpaid interest due at the earlier of five years after the date of issuance or three months after termination of employment. The loans may be repaid in either cash

or mature shares held by the employee. No further loans have been granted under this program since fiscal 1997.

4 Stock-Based Compensation Plan

Under the Company's 1997 Incentive Stock Option Plan (the Plan), 1.2 million shares of Common Stock were reserved for issuance to employees and officers. The Plan requires that the option price per share must be at least 100% of the fair market value of the Common Stock on the date of the grant of the option or 110% with respect to optionees who own more than 10% of the total combined voting power of all classes of stock. Options expire in five to seven years or upon termination of employment and are exercisable at a rate of 20% per year from the date of grant or 20% per year commencing one year after the date of grant. In addition, options representing a total of 170,220 shares remain outstanding from the Company's 1987 Incentive Stock Option Plan which was replaced by the 1997 Plan.

Under the Company's Nonqualified Stock Option Plan, 1,944,480 shares of Common Stock were reserved for issuance to outside directors, employees and officers. The options are granted at fair market value. Options expire in five to ten years and are exercisable at a rate of 20% per year from the date of grant or 20% per year commencing two years after the date of grant.

As of September 30, 2000, there were 603,560 additional shares available for grant under the stock plans. Information regarding stock options under all plans is summarized as follows:

Options	2000		1999		1998	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	1,748,580	\$ 3.76	2,539,280	\$ 2.43	2,409,600	\$ 2.30
Granted	270,300	23.74	367,400	7.87	274,600	3.49
Exercised	(417,720)	2.56	(1,082,060)	2.08	(52,440)	2.24
Canceled	(33,100)	4.83	(76,040)	2.91	(92,480)	2.39
Outstanding, end of year	1,568,060	\$ 7.48	1,748,580	\$ 3.76	2,539,280	\$ 2.43
Exercisable, end of year	727,280	\$ 3.19	878,820	\$ 2.59	1,515,720	\$ 2.24
Weighted average fair value of options granted	\$16.92		\$ 5.73		\$ 2.45	

Notes to Financial Statements

The options outstanding at September 30, 2000 have exercise prices ranging between \$2.50 and \$25.09, with a weighted average exercise price of \$7.48 and a weighted average remaining contractual life of 4.12 years.

The fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 2000, 1999 and 1998, respectively: risk-free interest rates of 5.95%, 6.01% and 5.00%; expected lives of 7.2, 7.3 and 6.4; and expected volatility of 72%, 71% and 73%.

The Company accounts for the options under APB Opinion No. 25, under which no compensation cost has been recognized. Had compensation cost for the options been determined consistent with SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income would have been the following pro forma amounts for the years ended September 30 (in thousands, except per share data):

	2000	1999	1998
Net income:			
As reported	\$4,240	\$4,360	\$1,637
Pro forma	\$3,565	\$4,120	\$1,506
Net income per share-diluted:			
As reported	\$.25	\$.27	\$.12
Pro forma	\$.21	\$.26	\$.11

Because the SFAS No. 123 method of accounting has not been applied to options granted prior to October 1, 1995, the resulting pro forma information may not be representative of that to be expected in future periods.

5 Income Taxes

The Company utilizes the liability method to account for income taxes. Deferred taxes are based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Reserves are established on the basis of expected ability to utilize the deferred assets.

The deferred income tax provision (benefit) reflects the net change during the year in deferred tax assets and liabilities. Income taxes in the accompanying statements of operations for the years ended September 30 were as follows (in thousands):

	2000	1999	1998
Current provision:			
Federal	\$ 904	\$ —	\$ 33
State and foreign	77	17	4
Total current provision	981	17	37
Deferred provision (benefit):			
Federal	1,528	(735)	—
State	—	(65)	—
Total deferred provision (benefit)	1,528	(800)	—
Total provision (benefit)	\$2,509	\$(783)	\$ 37

The reconciliation of the difference between amounts calculated at the statutory federal tax rate and the Company's effective tax rate was as follows (in thousands):

	2000	1999	1998
Amount at statutory federal income tax rate:	\$2,500	\$ 1,323	\$ 621
Change due to:			
Reversal of tax valuation allowance	—	(2,466)	—
Utilization of net operating losses	—	—	(619)
Rate difference for deferred tax assets	—	180	—
Other	9	180	35
Income tax provision (benefit)	\$2,509	\$(783)	\$ 37

The components of deferred income taxes consisted of the following as of September 30 (in thousands):

	2000	1999
Net operating loss carryforwards	\$ 167	\$2,048
Capital loss carryforwards	149	149
Depreciation	319	265
Deferred revenue	129	—
Accruals and reserves	297	152
Total deferred tax assets	1,061	2,614
Less- valuation allowance	(149)	(149)
Net deferred tax assets	\$ 912	\$2,465

Notes to Financial Statements

These deferred tax assets result from differences in the recognition of transactions for income tax and financial reporting purposes. The Company has NOL carryforwards of approximately \$450,000 at September 30, 2000. The Company also has \$400,000 of capital loss carryforwards at September 30, 2000, which expire in 2001, on which a 100% valuation allowance has been established.

6 Commitments and Contingencies

Government Contracts

Under provisions contained in the government research contracts, representatives of the government agencies have the right to access and review the Company's underlying records of contract costs. The government retains the right to reject expenses considered unallowable under the terms of the contract. The Defense Contract Audit Agency has reviewed the contracts through 1989. In the opinion of management, future amounts due, if any, with respect to open contract years will not have a material impact on the financial position or results of operations of the Company.

7 Defined Contribution Plan

The Company has a 401(k) retirement and savings plan for the benefit of qualified employees. Under the plan, qualified employees may elect to defer up to 20% of their compensation, subject to a maximum limit determined by the Internal Revenue Service. Beginning October 1, 1998, the Company matched 50% of each dollar of the first 6% of the tax deferral elected by each employee. In prior years, the Company made discretionary contributions to the plan subject to the approval of the Board of Directors. Company contributions totaling \$138,000, \$122,000, and \$117,000 have been charged to operations for the years ended September 30, 2000, 1999 and 1998, respectively.

8 Operating Segments

(Dollars in thousands)

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

The Company manages its business on the basis of three business segments: licensing, manufacturing, and research and development. The licensing segment includes all license fees and royalty revenues generated from the transfer of the Company's technology. No expenses are allocated to the licensing segment. The manufacturing segment includes revenue from the sale of PhotoLink reagents, stabilization products and DNA slides. The expenses include all production costs, including analytical costs to verify quality of the finished products and certain technical support. The research and development segment includes the revenue generated from development projects for commercial customers and research revenues received from government grants. The expenses include all costs of the Company's technical personnel. Corporate includes all administrative, sales and marketing costs of the Company. These costs, along with interest income and income taxes, are not allocated to the other business segments. The Company's assets are not reviewed by business segment. The accounting policies for segment reporting are the same as for the Company as a whole (see Note 2).

Notes to Financial Statements

<i>Year Ended September 30, 2000</i>	<i>Licensing</i>	<i>Manufacturing</i>	<i>Research & Development</i>	<i>Corporate</i>	<i>Consolidated</i>
Revenues:					
PhotoLink	\$ 8,233	\$2,393	\$ 1,445	\$ —	\$12,071
Diagnostic	2,917	—	—	—	2,917
Stabilization & other	—	2,687	—	—	2,687
Government	—	—	604	—	604
Total revenues	11,150	5,080	2,049	—	18,279
Expenses	—	1,903	6,797	4,246	12,946
Operating income (loss)	11,150	3,177	(4,748)	(4,246)	5,333
Other income				1,416	1,416
Income tax provision				(2,509)	(2,509)
Net income					\$ 4,240

Year Ended September 30, 1999

Revenues:					
PhotoLink	\$ 4,557	\$1,876	\$ 1,122	\$ —	\$ 7,555
Diagnostic	2,758	—	—	—	2,758
Stabilization & other	—	2,261	—	—	2,261
Government	—	—	920	—	920
Total revenues	7,315	4,137	2,042	—	13,494
Expenses	—	1,511	5,248	4,316	11,075
Operating income (loss)	7,315	2,626	(3,206)	(4,316)	2,419
Other income				1,158	1,158
Income tax benefit				783	783
Net income					\$ 4,360

Year Ended September 30, 1998

Revenues:					
PhotoLink	\$ 2,427	\$ 794	\$ 891	\$ —	\$ 4,112
Diagnostic	2,578	—	—	—	2,578
Stabilization & other	—	2,004	—	—	2,004
Government	—	—	1,085	—	1,085
Total revenues	5,005	2,798	1,976	—	9,779
Expenses	—	1,193	4,522	3,116	8,831
Operating income (loss)	5,005	1,605	(2,546)	(3,116)	948
Other income				726	726
Income tax provision				(37)	(37)
Net income					\$ 1,637

Notes to Financial Statements

Major Customers

Revenues from customers that exceed 10% of total revenues were as follows for the years ended September 30:

	2000	1999	1998
U.S. government agencies	3%	7%	11%
Company A	20%	20%	26%
Company B	24%	12%	2%

Revenues from U.S. government agencies are derived from the research and development segment. Revenues from Company A are derived from the licensing segment. Revenues from Company B are derived from all three revenue segments.

Geographic Revenue

Geographic revenues were as follows for the years ended September 30:

	2000	1999	1998
Domestic	89%	87%	90%
Foreign	11%	13%	10%

9 Quarterly Financial Data

(Unaudited, in thousands except per share data)

	<i>First Quarter</i>	<i>Second Quarter</i>	<i>Third Quarter</i>	<i>Fourth Quarter</i>
<i>Fiscal 2000</i>				
Revenues	\$4,149	\$4,441	\$4,165	\$5,524
Income from operations	1,206	1,151	1,039	1,937
Net income	944	904	861	1,531
Net income per share:				
Basic	.06	.06	.06	.10
Diluted	.06	.05	.05	.09
<i>Fiscal 1999</i>				
Revenues	\$2,639	\$3,308	\$3,685	\$3,862
Income from operations	265	591	755	808
Net income	925	1,105	1,214	1,117
Net income per share:				
Basic	.06	.08	.08	.07
Diluted	.06	.07	.08	.07

Report of Independent Public Accountants

To SurModics, Inc.:

We have audited the accompanying balance sheets of SurModics, Inc. (a Minnesota corporation) as of September 30, 2000 and 1999, and the related statements of operations, stockholders' equity and cash flows for each of the three years in the period ended September 30, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SurModics, Inc. as of September 30, 2000 and 1999, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2000 in conformity with accounting principles generally accepted in the United States.

ARTHUR ANDERSEN LLP

Minneapolis, Minnesota,

December 6, 2000

Report of Management

December 6, 2000

The management of SurModics, Inc. is responsible for the integrity of the financial statements and other financial information contained in this annual report. The financial statements and related information were prepared in accordance with generally accepted accounting principles and include some amounts that are based on management's best estimates and judgments.

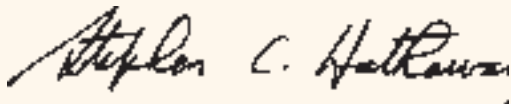
To meet its responsibility, management depends on its accounting systems and related internal accounting controls. These systems are designed to provide reasonable assurance, at an appropriate cost, that financial records are reliable for use in preparing financial statements and that assets are safeguarded. Qualified personnel throughout the organization maintain and monitor these internal accounting controls on an ongoing basis.

The Company's financial statements have been audited by Arthur Andersen LLP, independent public accountants, whose report thereon was based on audits conducted in accordance with generally accepted auditing standards. As part of their audits, the independent public accountants consider the Company's system of internal accounting controls for the purpose of determining the nature, scope and timing of audit tests to be performed.

The Audit Committee of the Board of Directors, composed entirely of directors who are not employees of the Company, meets at least twice per year with the Company's independent public accountants, as well as management, to review accounting, auditing, internal control, financial reporting and other matters.

A handwritten signature in black ink that reads "DALE R. OLSETH". The letters are cursive and somewhat stylized, with the first name being the most prominent.

Dale R. Olseth
Chairman and Chief Executive Officer

A handwritten signature in black ink that reads "Stephen C. Hathaway". The signature is written in a cursive style, with the first name being the most prominent.

Stephen C. Hathaway
Vice President and Chief Financial Officer

SurModics, Inc.
Corporate Information

Board of Directors

Dale R. Olseth

Chairman and Chief Executive Officer
SurModics, Inc.

Donald S. Fredrickson, M.D. (1)

President and Chief Executive Officer
D.S. Fredrickson Associates, Inc.

James J. Grierson (2)

Retired Vice President of
Business Development
Honeywell, Inc.

Patrick E. Guire, Ph.D.

Senior Vice President and
Chief Scientific Officer
SurModics, Inc.

Kenneth H. Keller, Ph.D. (1)(2)

Professor of Science and Technology Policy
Hubert H. Humphrey Institute
of Public Affairs
University of Minnesota

David A. Koch (1)(2)

Chairman of the Board
Graco Inc.

Kendrick B. Melrose (1)(2)

Chairman of the Board and
Chief Executive Officer
The Toro Company

John A. Meslow (1)

Retired Corporate Senior Vice President
Medtronic, Inc.

(1) Member of the Compensation Committee

(2) Member of the Audit Committee

Officers

Dale R. Olseth

Chairman and Chief Executive Officer

James C. Powell

President and Chief Operating Officer

Richard C. Carlson

Vice President of Marketing and Sales

Walter H. Diers, Jr.

Vice President of Corporate Development

Lise W. Duran, Ph.D.

Vice President of Product Development

Patrick E. Guire, Ph.D.

Senior Vice President and
Chief Scientific Officer

Stephen C. Hathaway

Vice President and
Chief Financial Officer

Marie J. Versen

Vice President of Quality Management
and Regulatory Compliance

Headquarters

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Eden Prairie, Minnesota
55344-3523
(952) 829-2700
(952) 829-2743 fax
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Transfer Agent

Firststar Bank
1555 North RiverCenter Drive
Suite 301
Milwaukee, Wisconsin 53212
(800) 637-7549

Legal Counsel

Fredrikson & Byron, P.A.
Minneapolis, Minnesota

**Independent Public
Accountants**

Arthur Andersen LLP
Minneapolis, Minnesota

**Investor Relations
Counsel**

Padilla Speer Beardsley Inc.
Minneapolis, Minnesota

Annual Meeting

The annual meeting of SurModics, Inc. shareholders will take place on Monday, January 22, 2001, beginning at 4:00 p.m. at the Hotel Sofitel in Bloomington, Minnesota.

SurModics, Inc.

Corporate Information

Information Requests

Shareholders, securities analysts and investors seeking additional information about the Company should contact Stephen C. Hathaway, Vice President and Chief Financial Officer, at (952) 829-2700.

Requests for copies of news releases describing significant company events, quarterly financial results and Form 10-K and Form 10-Q Reports as filed with the Securities and Exchange Commission may be obtained from Investor Relations at the Company's principal address.

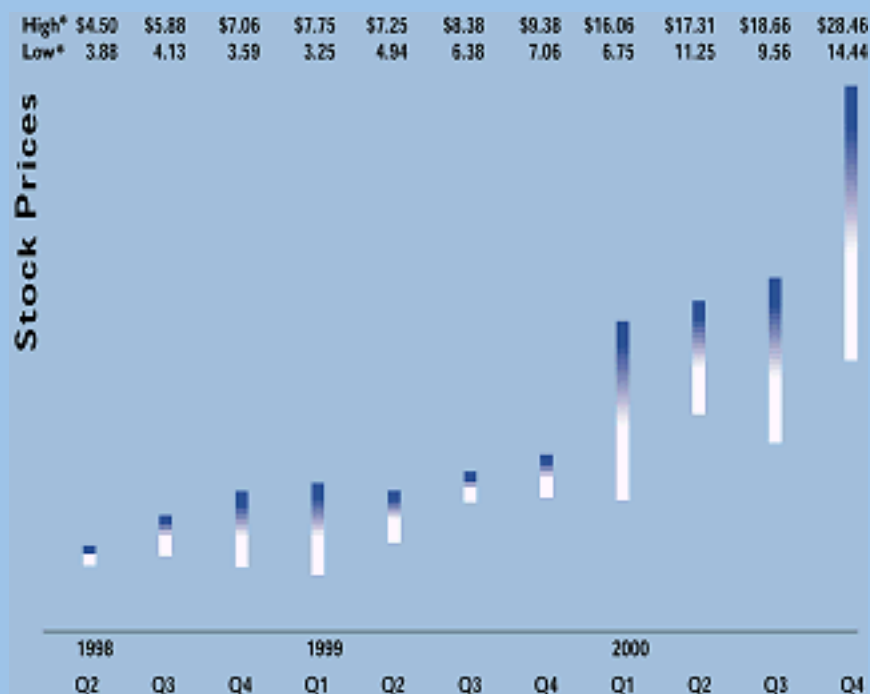
You may also learn more about SurModics at our Web site:
www.surmodics.com.

Stock Listing and Price History

SurModics' stock is traded on the Nasdaq National Market under the symbol "SRDX." The table below sets forth the range of high and low closing sale prices for the Company's Common Stock, as reported by Nasdaq, since the date of the Company's Initial Public Offering in March 1998.

According to the records of the Company's transfer agent, as of November 27, 2000, the Company had 201 holders of record of the Company's Common Stock and approximately 2,900 beneficial owners of shares registered in nominee or street name.

The Company has never paid any cash dividends on its Common Stock and does not anticipate doing so in the foreseeable future.



* Share prices have been retroactively restated to reflect the 2-for-1 stock split effected on December 6, 2000.



SurModics, Inc.

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