BIACORE INTERNATIONAL AB
Form 20-F
June 19, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

[ ] Registration statement pursuant to section 12(b) or (g) of the Securities Exchange Act of 1934

or

[X] Annual report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934
For the financial year ended December 31, 2002

or

[ ] Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission file number 000-28966

Biacore International AB (publ)
(Exact name of Registrant as specified in its charter)

Kingdom of Sweden
(Jurisdiction of incorporation or organization)

Biacore International SA, Puits-Godet 12, CH-2000 Neuchatel, Switzerland
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:
None

Securities registered or to be registered pursuant to Section 12(g) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Ordinary Shares of SEK 10 each	The Nasdaq Stock Market

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:
None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.
Ordinary Shares of SEK 10 each.....9,750,000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No

Indicate by check mark which financial statement item the registrant has elected to follow.
Item 17 x Item 18

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INTRODUCTION

In this Annual Report references to "Biacore", the "Group" or "the Company," except as the context may otherwise require, refer to Biacore International AB (publ) including its consolidated subsidiaries. References to "Pfizer" are to Pfizer Inc., its predecessors and its consolidated subsidiaries, including Pharmacia Corporation and Pharmacia AB. However, regarding related party transactions, references to Pfizer before January 1, 2003 relate only to the Pharmacia Group, which was merged with Pfizer on April 16, 2003.

Biacore publishes its financial statements expressed in Swedish kronor (SEK). In this Annual Report, references to "SEK" or "krona" are to the lawful currency of Sweden and references to "USD" or "U.S. dollar" are to the lawful currency of the United States. Solely for the convenience of the reader, this Annual Report contains translations of certain SEK amounts into USD amounts at specified rates. Unless otherwise stated, the translations of SEK into USD have been made at the noon buying rate in New York City for cable transfers in SEK, as certified for customs purposes by the Federal Reserve Bank of New York (the "Noon Buying Rate") in effect on December 31, 2002, which was
USD 1 = SEK 8.6950. See Item 3A "Selected Financial Data - Exchange Rates" for historical information regarding the Noon Buying Rate. Although the Swedish krona is a convertible currency and Sweden currently has no or limited foreign exchange restrictions, no representation is made that SEK have been, could have been or could be converted into USD at the rates indicated or at any other rate.

All financial information in this annual report has been prepared in accordance with accounting principles generally accepted in Sweden ("Swedish GAAP"), unless otherwise stated. These accounting principles differ in certain significant respects from accounting principles generally accepted in the United States ("U.S. GAAP"). See Note 23 for a reconciliation of the principal differences between Swedish GAAP and U.S. GAAP affecting Biacore's net income and shareholders' equity.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This annual report contains certain forward-looking statements within the meaning of section 21E of the U.S. Securities Exchange Act of 1934, as amended, and section 27A of the U.S. Securities Act of 1933, as amended, with respect to certain of Biacore's plans and its current goals and expectations relating to its future financial condition and performance.

Biacore may also make forward-looking statements in other written materials, including other documents filed with or furnished to the U.S. Securities and Exchange Commission (SEC). In addition, Biacore's senior management may make forward-looking statements orally to analysts, investors, representatives of the media and others. In particular, among other statements, certain statements in this annual report with regard to customer demand, market growth, competition, technology combinations, sales and other statements relating to Biacore's future business development are forward looking in nature. These forward-looking statements can be identified by the fact that they do not relate only to historical or current facts. Forward-looking statements often use words such as "anticipate," "target," "expect," "estimate," "intend," "plan," "goal," "believe," or other words of similar meaning.

By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. Biacore's actual future results may differ materially from those set out in Biacore's forward-looking statements. There are many factors that could cause actual results and developments to differ materially from those expressed or implied by these forward-looking statements. Any forward-looking statements made by or on behalf of Biacore speak only as of the date they are made. Biacore does not undertake to update forward-looking statements to reflect any changes in its expectations with regard thereto or any changes in events, conditions or circumstances on which any such statement is based. The reader should, however, consult any further disclosures Biacore may make in documents it files with the SEC, makes public or otherwise provides.

For a discussion of some of the factors that could cause actual results and developments to differ, see Item 3D "Risk Factors."

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable

ITEM 3. KEY INFORMATION

A. SELECTED FINANCIAL DATA

The following table sets forth selected financial data for Biacore for each of the years in the five-year period ended December 31, 2002. The financial statements of Biacore for each of the years in the three-year period ended December 31, 2002 and as of December 31, 2000, 2001 and 2002 have been included elsewhere herein. The selected financial data set forth in the following table, other than "other data", are qualified by reference to these financial statements of Biacore and the notes thereto, which have been audited by PricewaterhouseCoopers AB, independent public accountants, or its predecessors. The financial statements have been prepared in accordance with Swedish GAAP, which differ in certain significant respects from U.S. GAAP. A discussion of the principal differences between Swedish GAAP and U.S. GAAP as they relate to Biacore are summarized in Note 23 of Notes to Financial Statements. The following information should be read in conjunction with Item 5 "Operating and Financial Review and Prospects" and the financial statements and the related notes thereto included elsewhere herein.

Amounts are in thousands, except per share and other data, unless otherwise stated	As of and for the years ended December 31					
	2002 USD (1)	2002 SEK	2001 SEK	2000 SEK	1999 SEK	1998 SEK
Income statement data						
Swedish GAAP						
Sales	70,633	614,154	543,717	438,820	340,414	288,753
Cost of goods sold	-11,608	-100,930	-99,800	-78,096	-66,213	-52,680
Marketing	-22,981	-199,817	-188,696	-147,383	-113,994	-91,589

Administration	-7,852	-68,271	-86,739	-60,827	-34,782	-41,960
Research and development	-12,003	-104,370	-104,667	-72,760	-52,889	-48,719
Operating foreign currency gains and losses	-1,914	-16,644	4,539	3,167	2,206	3,525
Other operating income	2,413	20,982	742	9	32	1,289
Other operating expenses	-1	-10	-	-	-253	-109
Amortization of goodwill	-519	-4,515	-4,964	-4,956	-6,882	-5,716
Operating income	16,168	140,579	64,132	77,974	67,639	52,794
Gain on sale of long-term investments	-	-	4,605	-	-	-
Write-downs of long-term investments	-3,296	-28,655	-	-	-	-
Interest income	1,168	10,158	9,981	8,411	7,329	8,819
Interest expense	-210	-1,833	-1,055	-1,054	-732	-821
Financial foreign currency gains and losses	-2	-16	199	1,326	991	-3,470
Other financial income and expenses	-	-	-5	-	34	-
Financial items, net	-2,340	-20,346	13,725	8,683	7,622	4,528
Income after financial items	13,828	120,233	77,857	86,657	75,261	57,322
Income taxes	-4,611	-40,096	-27,588	-27,536	-24,016	-17,624
Minority interest	71	623	-	-	-	-
Net income	9,288	80,760	50,269	59,121	51,245	39,698
Diluted earnings per share	0.94	8.20	5.04	6.02	5.26	4.07
U.S. GAAP						
Net income	8,585	74,644	51,262	75,024	49,090	23,787
Diluted earnings per share	0.88	7.66	5.23	7.67	5.03	2.44
Sales by region						
Americas	31,113	270,524	249,347	191,872	141,199	125,990
Europe	19,999	173,894	151,004	139,152	116,203	92,099
Asia-Pacific	19,521	169,736	143,366	107,796	83,012	70,664
Total sales	70,633	614,154	543,717	438,820	340,414	288,753
Financial structure						
Swedish GAAP						
Operating capital	37,655	327,410	336,476	188,294	207,247	142,568
Long-term investments	911	7,920	40,470	68,025	17,214	9,750
Net interest-bearing assets	36,106	313,938	193,058	243,582	212,748	221,406
Net payable and deferred income tax liability	-1,581	-13,745	-769	-5,770	-8,069	-7,247
Minority interest	-98	-853	-	-	-	-
Shareholders' equity	72,993	634,670	569,235	494,131	429,140	366,477
Total assets	95,622	831,431	730,934	643,769	569,985	520,874
Number of shares, thousands	9,750	9,750	9,750	9,750	9,750	9,750
Average number of shares, diluted, thousands	9,851	9,851	9,981	9,817	9,750	9,750
U.S. GAAP						
Shareholders' equity	70,972	617,099	556,227	478,980	398,654	339,315
Other data						
Operating margin, %	22.9	22.9	11.8	17.8	19.9	18.3

Return on operating capital, %	42.4	42.4	24.4	39.4	38.7	35.5
Return on equity, %	13.4	13.4	9.5	12.8	12.9	11.6
Interest coverage, times	66.0	66.0	74.4	83,2	103.8	14.4
Equity ratio, %	76.4	76.4	77.9	76.8	75.3	70.4
Capital expenditures	3,653	31,764	39,979	14,236	22,922	11,245
Dividend per share	0.35	3.00	-	-	-	-
Average number of employees (2)	319	319	269	212	183	161

(1) Solely for the convenience of the reader, SEK amounts have been translated into USD at the Noon Buying Rate on December 31, 2002 of USD 1 = SEK 8.6950. Such translated amounts are unaudited.

(2) Average number of employees is calculated by dividing the total number of hours worked at Biacore during the year by the number of working hours constituting a full-time working year.

FINANCIAL DEFINITIONS

Basic earnings per share	Net income divided by the average number of shares (including shares represented by ADSs) issued and outstanding during each year.
Capital expenditures	Investments in tangible fixed assets, such as buildings, land, land improvements, machinery and equipment.
Diluted earnings per share	Net income divided by the average number of shares (including shares represented by ADSs) during each year. The average number of shares has been calculated using the treasury stock method to account for options outstanding. In accordance with Swedish GAAP, proceeds from issuance of stock at exercise of options have been discounted to present value. In accordance with U.S. GAAP, such discounting has not been performed in calculating diluted earnings per share according to U.S. GAAP.
Equity ratio	Shareholders' equity and minority interest, divided by total assets.
Interest coverage	Income before expenses for interest-bearing liabilities, divided by expenses for interest-bearing liabilities.
Net interest-bearing assets	The net balance of interest-bearing assets and liabilities, including pension liabilities.
Net payable and deferred income tax liability	The total of income taxes payable and provisions for deferred taxes, less the total of income tax receivables and deferred tax assets.
Operating capital	The net balance of assets and liabilities except for; long-term investments, net interest-bearing assets, and net payable and deferred income tax liability.
Operating margin	Operating income divided by sales.
Return on equity	Net income divided by average shareholders' equity.
Return on operating capital	Operating income divided by average operating capital.

EXCHANGE RATES

During the last five years, the exchange rates for the U.S. dollar against the Swedish krona based on the Noon Buying Rate have been as follows.

SEK per USD	Average rate (1)
1998	7.9658
1999	8.3007
2000	9.2200
2001	10.4328
2002	9.6571

(1) The average of the Noon Buying Rates on the last business day of each full month.

Since December 2002, the monthly high and low Noon Buying Rates have been as follows.

SEK per USD	High	Low
2002, December	9.0750	8.6950
2003, January	8.7920	8.4750
2003, February	8.5650	8.4100
2003, March	8.7030	8.3650
2003, April	8.6425	8.1700
2003, May	8.1470	7.7479

On December 31, 2002 and June 2, 2003, the Noon Buying Rate was SEK 8.6950 and SEK 7.7730 per USD, respectively.

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

Prior to making any investment or other significant decision relating to Biacore, one should carefully consider the risks and uncertainties described below in addition to other information presented in this annual report. Additional risks and uncertainties that do not currently exist, that we are unaware of or that we currently believe are immaterial may also become important factors that adversely affect Biacore and yourself.

Technological Change

The business environment in which Biacore operates, including Surface Plasmon Resonance (SPR) based systems that measure interactions between biomolecules and other biotechnologies, is characterized by extensive technological change, which is expected to continue at a rapid pace. Existing and potential competitors are investing substantial amounts of resources in research and development. There can be no assurance that developments by others will not limit Biacore's ability to expand its business or render Biacore's technologies, products and services obsolete or uneconomical.

Research and development projects are subject to high risk. They generally

relate to issues which have not been thoroughly investigated before. Unexpected problems often appear, and research and development projects are sometimes discontinued for lack of success.

Rapid technological change and other technological issues make future planned product introductions uncertain. Lack of successful new product introductions may have a material adverse effect on Biacore's financial condition and results of operations.

In order to acquire patents and otherwise maximize the advantage of new knowledge, Biacore may, during a certain period and to the extent allowed by law and regulation of financial markets, abstain from making public new research and development findings.

The extent to which Biacore can advance its technology and competitive position depends to a significant extent on its ability to enter and successfully complete partnerships and other collaborations. The outcome of such arrangements depends on various factors, many of which are not controlled by Biacore.

Patents and Proprietary Technologies

Biacore's future development depends to a large extent on its ability to develop proprietary products and technologies, and to establish and protect its existing and future patents and other rights. The patent positions of technology-based companies, including Biacore, involve complex legal and factual questions and may be uncertain, and the laws governing the scope of patent coverage and the periods of enforceability of patent protection are continuing to evolve. In addition, patent applications in certain jurisdictions are maintained in secrecy until patents are issued, and publication of discoveries tend to lag behind actual discoveries. Therefore, no assurance can be given that patents will be issued from any patent application owned by or licensed to Biacore or, if patents are issued, that the rights granted will be sufficiently broad to protect Biacore's technology. In addition, no assurance can be given that any issued patent owned by or licensed to Biacore will not be challenged, invalidated or circumvented, or that the rights granted thereunder will provide competitive advantages to Biacore.

Biacore also relies on trade secrets and proprietary know-how, which it generally seeks to protect through confidentiality agreements with its employees and consultants. There can be no assurance that these agreements will not be breached, that Biacore would have adequate remedies for any breach or that Biacore's trade secrets will not otherwise become known or be independently developed by competitors.

Litigation or other proceedings for intellectual property rights infringement may require Biacore to spend time and money on such proceedings, may delay development and commercialization of new or existing technologies and products and, if the outcome of the proceedings are unfavorable to Biacore, may force Biacore to pay damages.

Collaborations

Biacore currently engages in, and from time to time may engage in, collaborations with academic researchers, institutions, pharmaceutical and biotechnology companies, and others. There can be no assurance that under the terms of such collaborations, third parties will not acquire rights in certain inventions developed during such collaborations.

Competition and Potential Limitations on Growth

Biacore faces competition both directly from other manufacturers of

instruments that use SPR or similar technologies and indirectly from other technologies that have certain applications in common with Biacore's products and services. Biacore expects to face increased competition in the future, leading to a reduction of Biacore's rate of growth, market share and operating margin. There can be no assurance that Biacore will be able to develop or enhance its products to compete successfully with new or emerging technologies.

Customer Demand

The life science research market has grown over many years. While Biacore currently expects this market to continue to grow, market growth is difficult to predict. The development of biotechnology has not progressed as rapidly as many had predicted and the pace of development may be slowing down. Factors such as the already high level of mergers in the pharmaceutical industry, with research laboratories being combined and rationalized, are believed to limit market growth and may reduce demand. During the first quarter of 2003, Biacore's sales fell by 25% compared with the first quarter of 2002. See also the next two subsections "Funding of Customers" and "High Fixed Costs, Dependence on Individual Orders, Seasonality and Limited Forecasts," and Note 22 of Notes to Financial Statements.

Funding of Customers

Currently, approximately 55% of Biacore's products are sold to academic or government research laboratories, private research foundations and other institutions, the funding of which may depend on grants from government agencies. Research funding by governments is subject to political risk, including competition from other technologies as they become available. In addition, government budgets for research funding in all countries may be subject to general political trends and changes in economic growth and government finances, calling for reduced governmental expenditures. Reduction in governmental funding for research or deferral of the availability of such funding may materially affect the ability of Biacore's prospective customers to acquire Biacore's products, which may have a material adverse effect on Biacore's financial condition and results of operations.

High Fixed Costs, Dependence on Individual Orders, Seasonality and Limited Forecasts

Substantial gross margins and a high proportion of relatively fixed research and development, marketing and administration expenses make Biacore's net income highly dependent on variations in sales. Any slow-down in sales could have a material negative impact on net income.

Each analytical system that Biacore markets has a high unit value and the number of analytical systems sold is comparatively small. This makes analysis of changes in trends more difficult and increases uncertainty relating to future sales during individual periods.

Historically, Biacore has had approximately 30 to 40% of annual sales in the fourth quarter of each year. Combined with high fixed costs and significant dependence on individual orders, the strong seasonality of sales has caused operating income to vary substantially between different quarters and made forecasts of annual sales and income highly uncertain.

Sales within each quarter have often been higher in the third than in the first and second months.

As a result of these factors, Biacore has often not published any forecast of income, has only provided limited indications of future sales and in the future may not provide any forecast at all.

Fluctuations in sales and income could affect the market price of the Shares or ADSs in a manner unrelated to the longer-term operating performance of Biacore.

Potential Adverse Effect of Exchange Rate Fluctuations

Approximately 97%, 99% and 97% of Biacore's sales in 2000, 2001 and 2002, respectively, were derived from customers located outside Sweden and were generally denominated in currencies other than the Swedish krona, including the U.S. dollar, the Japanese yen, the euro and the British pound. Production and research and development are mainly carried out in Sweden. Therefore, Biacore has larger expenses than revenues denominated in Swedish kronor. As a result, appreciation of the Swedish krona would tend to reduce Biacore's operating income margins.

Taxation

The interpretation of tax laws involves judgement. It is therefore common for tax experts not to provide firm opinions. Management may then rely on indications from tax experts, and management's own understanding of complex and subjective tax issues. Conditions under which taxes have been calculated may turn out not to have been fulfilled and actual taxes for past periods may be different from those estimated and accrued for.

Acquisitions and Joint Ventures

Biacore's plan for growing its business includes not only organic growth but also the possibility of acquisitions and joint ventures. The process of integrating an acquired or co-managed business, project, technology, service or product may result in unforeseen difficulties, expenses and dilution of existing investors' ownership. Furthermore, acquisitions generally lead to reduction of liquid funds, increased debt, increased goodwill or other intangible assets, increased amortization of intangible assets and, therefore, substantially increased financial risk.

Dependence on a Single Manufacturing Facility

The vast majority of manufacturing activities performed by Biacore currently take place in a single facility located in a single building in Uppsala, Sweden. A single serious incident, such as a fire, could result in significant interruption of production and result in loss of sales, which could adversely affect Biacore's financial condition and results of operations.

Dependence on Certain Sources of Supply

Biacore purchases components and other materials from a limited number of suppliers on a just-in-time basis. Certain components are only available from a single supplier. From time to time, suppliers may cease operating, extend lead times, limit supply to Biacore or increase prices due to capacity constraints, fires or other factors, which may adversely affect Biacore's financial condition and results of operations.

Key Personnel

Biacore relies upon a number of key executives and employees, including the President of Biacore. The loss of services of any of Biacore's key executives or employees could have a material adverse effect on its financial condition and results of operations.

Ability to Attract and Retain Skilled Staff

The high technology and continuously rapid changes necessary to be able to

satisfy the requirements of Biacore's existing and potential new customers put high demands on Biacore being able to attract and retain highly competent staff, both in scientific, product development, marketing, management and other functions. Biacore attempts to attract and retain key staff by offering challenging career opportunities, a professional company culture and competitive financial compensation. However, applicable markets for employees with relevant skills are very tight. The general unemployment rate in the Stockholm/Uppsala area, where most of Biacore's research and development, production and certain other functions are located, is approximately 3.3%. The corresponding unemployment rate for skilled scientists, relevant engineers and other key personnel is believed to be even lower. In a high technology industry such as Biacore's, any failure to attract and retain highly skilled staff could have a material adverse effect on its financial condition and results of operations.

Control by Principal Shareholder

Pfizer owns approximately 41% of Biacore. As a result, it is in a position to exercise significant influence over matters put to a vote of shareholders, including the election of Biacore's directors. Pfizer's interests may differ from those of other investors.

Limited Trading of American Depositary Shares

Although Biacore has had American Depositary Shares listed on Nasdaq National Market since 1996, the frequency and amount of trading of ADSs has been limited. Biacore's ordinary shares are listed on the Stockholm Stock Exchange. Trading of Biacore's ordinary shares in that market is relatively active. ADSs in Biacore may, under certain circumstances and against a certain charge, be converted to ordinary shares listed on the Stockholm Stock Exchange. Correspondingly, ordinary shares listed on the Stockholm Stock Exchange may, under certain circumstances and against a certain charge, be converted to ADSs listed on Nasdaq National Market.

Net Assets per Share

Shareholders' equity per share and net tangible book value per share are substantially below current stock market prices.

Stock Options

At December 31, 2002, Biacore International AB had 760,000 long-term stock options outstanding, of which 696,575 were also outstanding in the consolidated accounts. These stock options are exercisable at prices between SEK 244 and SEK 363. The options are exercisable, and any new shares issued therefore payable, between May 2006 and May 2011. Although exercise of these stock options may increase shareholders' equity per share and/or net tangible assets per share, the possibility of such exercise may have a dilutive effect on earnings per share. See also Notes 20, 22 and 23 of Notes to Financial Statements.

Accounting standards, policies and issues

Accounting standards and policies are subject to interpretation and continuous change. Currently reported financial statements may be restated in the future as an effect of e.g. changes in accounting standards. Accounting policies and issues that Biacore currently believes involve significant uncertainty include research and development, impairment of intangible assets, incentive stock options and deferred tax assets. See also Item 5A "Operating Results - Important Accounting Policies and New Accounting Standards."

The preparation of financial statements 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 dates of

the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Item 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY

LEGAL ENTITY

The legal and commercial name of the Company is Biacore International AB (publ). It is domiciled in Sweden, was incorporated as a limited liability corporation ("aktiebolag") in 1996 under the Swedish Companies' Act ("Aktiebolagslagen"), acts as a holding company and has no operating revenue of its own apart from sales of services to other group companies. The registered office address is Rapsgatan 7, 754 50 Uppsala, Sweden, the website is www.biacore.com and the telephone number is +46 18 675700.

IMPORTANT EVENTS IN THE DEVELOPMENT OF THE COMPANY'S BUSINESS

Biacore began developing its SPR-based technology in 1984, when expertize and know-how from several independent research activities were collected within Biacore International AB's predecessor, Pharmacia Biosensor AB. In 1990, the first commercial product was sold. In 1996, Pfizer (Pharmacia) incorporated Biacore International AB and made it the new holding company of the Biacore Group. Later in 1996, Pfizer (Pharmacia) divested 59% of the Company and Biacore was listed on the O-list of the Stockholm Stock Exchange and Nasdaq National Market in the United States.

During 2002, Biacore moved its headquarters from Uppsala, Sweden to Neuchatel in Switzerland. The domicile and principle place of operations remains Uppsala, Sweden.

One of Biacore's most important current projects relates to the development of SPR array technology, which Biacore currently expects to lead to the launch of a commercial product based on this technology in approximately 2004. Biacore believes that such a product would be of particular use within the drug discovery sector.

PRINCIPAL CAPITAL EXPENDITURES AND DIVESTITURES

During 2000, 2001 and 2002, annual capital expenditures on machinery and equipment were SEK 14 million, SEK 31 million and SEK 15 million, respectively. During the same period, SEK 0 million, SEK 9 million and SEK 17 million were invested in buildings, mainly offices in Uppsala.

Investments in intangible assets amounted to SEK 0 million, SEK 58 million and SEK 7 million in 2000, 2001 and 2002, respectively. Of the amount in 2001, USD 5 million (SEK 53.6 million) related to the acquisition of a license from Axiom Biotechnologies Inc. ("Axiom") (see Notes 2 and 5 of Notes to Financial Statements). Of the amount in 2002, SEK 5.0 million related to capitalized product development (see notes 1 and 5 of Notes to Financial Statements).

In 2000, SEK 51 million was invested in the acquisition of long-term investments in closely related technology ventures. In 2001, Biacore received SEK 32 million from the sale of long-term investments, which related to the sale of 1,000,000 shares in Axiom to Axiom for USD 3 million. The two transactions with Axiom in 2001 referred to in this and the prior paragraph were negotiated simultaneously and the payments of USD 5 million to Axiom and USD 3 million from Axiom were netted. In 2002, the remaining shares in Axiom were exchanged for shares in Sequenom, Inc. (see also Note 7 of Notes to Financial Statements).

Biacore currently has no significant capital expenditure or divestment in progress except as set forth in Item 4D "Property, Plant and Equipment." See also Item 5B "Liquidity and Capital Resources."

B. BUSINESS OVERVIEW

GENERAL

Biacore's business mainly relates to the commercialization of surface plasmon resonance (SPR) technology, which is used for the real-time detection and monitoring of biomolecular binding interactions. Identifying and characterizing the sometimes small changes in the way biomolecules interact can increase understanding of the causes of disease as well as the differences in the effectiveness of different drug therapies.

Biacore has a well-balanced customer base, which includes well-known life science research institutes, pharmaceutical and biotechnology companies and food manufacturers.

THE CORE LIFE SCIENCE RESEARCH BUSINESS

Recently, Biacore's focus has been to maximize the potential of its SPR technology to improve the overall economics of the drug discovery and development process. This process relies on important discoveries being made by researchers in academic life science laboratories as well as in the pharmaceutical and biotechnology industry.

The important role of these major academic and government funded laboratories is the key reason that Biacore focuses its marketing and product development activities on this important customer group. Biacore believes that its SPR technology can make an important contribution to developing a more comprehensive understanding of the molecular causes of disease. This is an important step in the search for novel medicines that generate better clinical outcomes with lower side effects. Biacore believes that the ability to generate medicines with these improved characteristics is important if the pharmaceutical industry is to resume its previous growth.

A NICHE TECHNOLOGY SUPPLIER TO THE LIFE SCIENCE MARKET

Biacore is still a niche player in the global life science research market. In 2002, the overall market for instruments supplied to life science customers was estimated to be worth USD 20.5 billion (Instrument Business Outlook, December 2002). In recent years, this market has been growing at approximately 10% per annum, although the estimated growth slowed somewhat in 2002.

The biggest consumers of life science instrumentation are pharmaceutical and biotechnology companies, and government and academic institutions involved in life science and pharmaceutical research and development.

In 2002, this R&D focused customer group accounted for an estimated 44% of the overall market with a total value of USD 9 billion. This is the key market segment for Biacore, with more than an estimated 80% of Biacore's SPR technology systems being sold to this important customer group. The other key areas where Biacore's technology is beginning to develop more of a profile is in analytical services and quality control (QC).

Other techniques that form a significant element of the overall life science instrumentation market are chromatography including high pressure liquid chromatography (HPLC) and gas chromatography (GC), bioinstrumentation including DNA synthesizers and sequencers as well as electrophoresis equipment and mass spectrometry.

The historically attractive rate of growth of the life science instrumentation market, relative to the growth in overall economic activity, has been driven by an increasing desire by both governments and private sector companies to invest in basic life science research. This investment allows them to benefit from the significant advances that have been made in molecular biology to elucidate the human genome and gain insight into the mechanisms of disease at a molecular level. This research is expected, in time, to lead to the development of better medicines and improved human health.

Due to the overall size of the life science research market, Biacore believes that there is considerable scope for growth. Another factor that supports Biacore's growth prospects is the limited competition that it faces. Although there are a number of other companies involved in supplying SPR based systems to the life science market, to-date these have largely been lower priced systems that are often unable to produce the reproducible and high-quality data needed by researchers. Such data is often available by using Biacore's systems.

The major short-term risks that Biacore faces in terms of the life science research market revolve around funding. These include:

- Changes in the amounts and availability of funds as a result of changes in economic growth and government finances.
- Competition from other 'hot' technologies for funds.

Biacore's global reach means that its geographic diversity helps shelter it from changes to the market dynamics in individual regions.

UNDERSTANDING THE MOLECULAR BASIS OF DISEASE

Building better insights into the molecular basis of disease and normal processes within biological systems drives much of the research currently undertaken in well known life science research laboratories. These include the National Institutes of Health (NIH), the Ludwig Institute (LICR), the National Cancer Institute (NCI) and the Imperial Cancer Research Fund (ICRF) as well as the major pharmaceutical and biotechnology companies.

These research institutions are key customers for Biacore's SPR technology, which offers the ability to generate unique real-time functional data on biomolecular interactions in biological systems often involving samples that might be too crude, too small or too low in affinity for other technologies to handle.

This high quality data allows scientists to develop a better understanding of biological systems. Based on such improved understanding and that of disease processes, scientists are able to make better decisions about which new drugs to develop.

The growing recognition of the value of the data generated by Biacore's SPR based systems is reflected in the fact that there have been more than 2,900 citations of Biacore's technology in research papers. These papers have focused on a wide range of applications, including key areas of life science research such as cancer, neuroscience, immunology, infectious diseases and proteomics.

SPR TECHNOLOGY - AN IMPORTANT PROTEOMICS TECHNOLOGY

The sequencing of the human genome in 2001 resulted in a wealth of new genetic information becoming available to researchers. Biacore believes that the unraveling of the information on the proteins that are derived from these gene sequences, the study of which is called proteomics, is important to developing the new medicines of the future.

There are two key areas of the high growth proteomics research market,

protein mapping and functional proteomics.

PROTEIN MAPPING

Unlike the genome, the proteome (protein complement of the genome) is constantly changing in response to a cell's environment. By comparing the proteome under varying conditions, researchers have the means to identify key proteins involved in a disease process, which may have potential as new targets for therapeutic intervention.

Protein mapping demands technologies capable of analyzing the protein content of whole cells or tissues. In recent years, two core tools have been used in this area, two-dimensional (2-D) gel electrophoresis and mass spectrometry (MS).

Two-dimensional gel electrophoresis is used for separating proteins according to their charge and size, and can separate up to 10,000 distinct proteins and peptide spots in one gel. Using MS, it is possible to characterize proteins according to their mass and peptide sequence.

However, protein mapping, which is focused on the detection, separation and characterization of proteins, is not an end in itself. Simply knowing that a particular protein of known mass and amino acid sequence is more abundant in e.g. a cancer cell compared with a healthy cell, does not necessarily contribute to understanding what has caused the cancer and how it could be cured.

It is important to understand the protein's function in the cell, whether it is involved in the disease process, and whether its activity can be altered by targeted drug design. Generating this information is called functional proteomics.

FUNCTIONAL PROTEOMICS

The functional proteomics market represents an important opportunity for Biacore, given that the function of a significant proportion of the proteins found in humans is unknown. The study of the function of a protein currently fucuses on establishing the interactions of that protein with other molecules, something to which Biacore's SPR technology is well suited. A key advantage of Biacore's SPR technology is that nearly all of the data is generated using proteins in their native state, and it is important when conducting studies with proteins to conserve their complex, native three-dimensional structure, as this structure dictates the proteins' in vivo function.

Proteins do not work in isolation but form complexes with other molecules within the cell and on the cell membrane. The cell's communication systems are based around these interactions and even small changes in protein structure and/or abundance can have significant consequences on disease initiation and progression.

SPR technology identifies binding partners to a novel protein and researchers can begin to unravel the pathways in which the protein is involved via a process called ligand fishing. Ligand fishing is a key application of Biacore's SPR technology and is an essential element of functional proteomics, as it links a receptor of potential disease or therapeutic interest to a chemical structure (ligand) that might form the basis of a new pharmaceutical product.

Biacore's SPR technology has a number of advantages when it is used for ligand fishing. These include:

- The ability to screen complex mixtures as a source of ligands with only minimal sample preparation.

- The ability to repeat consistently these experiments due to Biacore's microfluidics systems.
- The high sensitivity of Biacore's systems, which makes them particularly suitable for finding chemical structures (molecules) that only bind with low affinity to the proteins of interest.

Given the potential size of this market and the ability of Biacore's SPR technology to help unravel this functional information, proteomics has been a key marketing focus for the Company's life science research business unit.

IDENTIFICATION COMBINED WITH FUNCTION - THE COLLABORATION WITH BRUKER DALTONICS

In October 2001, Biacore signed a collaboration agreement with Bruker Daltonics Inc. (BDAL), designed to combine the two companies' core technologies, SPR and mass spectrometry, respectively.

Together, the companies aim to commercialize the combined technique of SPR-MS in order to create a comprehensive technical solution for functional proteomics studies. This new combined approach will help researchers to:

- Generate functional information on proteins, receptors and ligands of interest.
- Isolate and purify these molecules.
- Identify and characterize these proteins or other molecules of interest.

A growing number of customers have begun to explore this technology combination across an array of applications in areas as diverse as cancer research, plant biology and product quality assurance. With the continuing collaboration, the increased understanding of the methodology has led to a number of new applications.

In response to the need for more automated and larger capacity recovery, as well as the ability to directly deposit targets to a MALDI (Matrix-Assisted Laser Desorption Ionization), Biacore has in March 2003 launched a new module for Biacore(r)3000 which will further enhance and integrate the SPR-MS approach.

Biacore believes that the SPR-MS technology combination will provide researchers with a new approach to functional proteomics studies and will give both companies a significant competitive position in the proteomics market.

In August 2002, Biacore and the U.S. company Intrinsic Bioprobes Inc. started a complementary strategic collaboration aimed at combining SPR and MALDI TOF (Matrix-Assisted Laser Desorption Ionization - Time of Flight) mass spectrometry. Through this collaboration, researchers are expected to be able to quickly screen protein-protein interactions and study protein information combined with information on the structure of interacting substances.

OUR PHARMACEUTICAL AND BIOTECHNOLOGY BUSINESS

In addition to providing insights into the molecular causes of disease, Biacore's SPR technology is used in the discovery and development of new medicines.

A key attribute of SPR technology is that it provides pharmaceutical and biotechnology companies with the ability to discover and develop new drugs more economically. This economic benefit derives from the technology's ability to generate high-quality data, that allows more informed decisions to be taken earlier about which targets to focus on or which drug candidates to develop.

Biacore has been working over the last three years to further develop its business with this important customer group. This has involved the introduction

of a range of systems, which are designed to overcome bottlenecks faced by the pharmaceutical industry in the development of new pharmaceutical products.

THE OVERALL PHARMACEUTICAL RESEARCH MARKET

In 2001, the global pharmaceutical and biotechnology industries investment in research and development was estimated to be in excess of USD 70 billion, with half of this expenditure taking place in the U.S. Within this figure, Biacore's systems are targeted at a market estimated to be worth USD 8.5 billion in 2001 (High Tech Business Decisions 2002). This expenditure covers both biological testing and pharmacology screening.

SPR SOLUTIONS TO THE PHARMACEUTICAL INDUSTRY

A key element of Biacore's strategy to extend its pharma/biotech business has been to develop new systems that tackle some of the problems that slow the flow of new medicines to the market. A number of these problems have arisen from the adoption of technologies such as combinatorial chemistry and high throughput screening, and include:

- Target identification and validation. This is an important step prior to starting the High Throughput Screening (HTS) of chemical libraries. In order to screen these libraries for the most appropriate new molecules for further development, it is vital that the target being screened is actually of value as a potential point of therapeutic intervention.
- Assay development and validation for HTS. In order for HTS to actually find molecules of value, the assays used in these high throughput screens must reflect accurately the target that any future drugs will be developed against.
- Lead optimization and secondary screening. Once a 'hit' has been achieved during HTS, the molecule has to be optimized in terms of its activity, in order to generate the best medicine possible. In addition, other characteristics of the molecule have to be investigated to assess their impact on the effectiveness of the drug when given to humans.

In addition to developing market-focused instrument systems, Biacore has recruited a team of personnel who are highly experienced in marketing high-end drug discovery and development technologies to the pharmaceutical and biotechnology industry.

Biacore(r)3000 provides high-quality binding data that can be used to determine the most appropriate targets within a biological system, against which new drugs can be developed. In addition, once the most suitable target has been identified, this same system can also be used to develop and optimize the assays needed to run the HTS process.

ENHANCED SECONDARY SCREENING OFFERING

In late 2001, Biacore introduced its first system specifically designed for the pharmaceutical and biotechnology industry. The new Biacore(r)S51 addresses important bottlenecks in the drug discovery process downstream of HTS. Biacore believes that Biacore(r)S51 provides more relevant biological information on compound activity, in a single assay, than any other technology available today.

One of the rate limiting steps in developing drugs faster is the conversion of 'hits', which have been generated from HTS, into lead compounds for pre-clinical evaluation. Biacore(r)S51 can rapidly and efficiently address the key steps in the 'hit'-to-lead selection process, by combining the advantage of Biacore's SPR technology with advanced instrumentation and software, which result in higher throughput, enhanced data quality and reduced sample usage.

Specifically, Biacore(r)S51 provides data-rich analysis in four important

stages of the drug discovery and development process. These are:

- Rapid confirmation of HTS 'hits'.
- Comprehensive kinetic characterization of potential lead compounds.
- Detailed kinetics based QSAR (quantitative structure activity relationship) to drive lead optimization.
- Rapid in vitro early ADME (absorption, distribution, metabolism and excretion) analysis to maximize lead selection criteria and define likely in vivo behavior.

An important aspect of pharmaceutical development is to pick up problems early so that resources can be redirected to molecules with a better chance of reaching the market, and by using Biacore's SPR technology in the areas mentioned above the technology can contribute to this.

Sales of Biacore(r)S51 have been made to well-known pharmaceutical and biotechnology companies around the globe. Given the progress that has been made with Biacore(r)S51 since its launch, Biacore believes that this type of system can be an important contributor to its sales. In addition, new customer-generated data highlighting the benefits of using Biacore(r)S51 is expected to become increasingly available during the course of 2003, and new applications for the Biacore(r)S51, particularly in the area of structure activity relationships, based on the work of university research scientists, have occurred.

PROCEL(tm) - A NOVEL COMPLEMENTARY CELL-BASED ASSAY FOR SECONDARY SCREENING

In late 2002, Biacore introduced its new cell-based assay system, Procel(tm). This product has resulted from Biacore acquiring a license to proprietary fluorescent cell-based assay technology developed by the U.S. company Axiom Biotechnologies Inc.

Procel(tm), which had its full commercial launch in March 2003 at the Screentech Conference in San Diego, is designed to complement Biacore(r)S51 and provide a competitive offering in the field of lead optimization. By using Procel(tm), researchers will have access to an easy-to-use cell-based fluorescent analytical system which has been designed to characterize compounds that interact with both G protein coupled receptors (GPCRs) and ion channels. These are two of the main classes of drug targets under evaluation today.

Procel(tm) is able to carry out a number of important cell-based applications which are important in the lead optimization process, including hit verification, automated hit profiling and Schild analysis, as well as a number of other pharmacological parameters.

Biacore believes that the combination of Procel(tm) and Biacore(r)S51 will provide researchers with access to detailed information on the biological activity of potential drug candidates in a competitive timeframe and to a depth and quality superior to existing analytical instrumentation. It also expects the complementary nature of these two products to lead to synergies in Biacore's sales and marketing efforts.

THE PHARMACEUTICAL/BIOTECHNOLOGY INDUSTRY NEED FOR NOVEL QC SOLUTIONS

Biacore introduced its second system specifically for the pharmaceutical and biotechnology industry in late 2001. The new system, called Biacore(r)C, is designed for rapid concentration analysis of bio-therapeutics in drug development, manufacturing quality control (QC) and in-process control applications. Biacore(r)C is the first SPR-based system for QC applications designed for compliance with pharmaceutical regulatory requirements. The pharmaceutical industry is coming under increasing regulatory scrutiny at a time when it is striving to bring new pharmaceutical products to the market faster.

The regulatory authorities are becoming more and more focused on ensuring that companies are in strict compliance with Good Laboratory Practice (GLP) / Good Manufacturing Practice (GMP), leading to the fact that the validation of analytical systems and procedures is becoming a major rate-limiting step.

Biacore(r)C was specifically developed within a Good Automation Manufacturing Practice (GAMP) model, with regulatory requirements in mind, and Biacore expects that it will reduce the time for biomolecular analysis while meeting high demands for accuracy, sensitivity and reproducibility.

The overall package offered by Biacore(r)C is designed to make it easier for users to provide the regulatory authorities with the data needed to comply with the strict guidelines that cover the development, and more importantly the manufacturing, of biopharmaceutical products.

In conjunction with the launch of the Biacore(r)C, Biacore also introduced a new system validation service, which is intended to further support our customers' efforts to comply with generally accepted GLP/GMP standards.

In April 2003, and in order to ensure that Biacore's instrumentation will meet the future needs of the regulatory authorities, Biacore launched a GLP/GMP package for Biacore(r)3000 which will assist these customers in generating the documentation and procedures that they need in their dealings with regulators. In addition, Biacore has taken the decision to develop all relevant current and planned systems to meet compliance guidelines so that it will be in a position to capitalize on the expected growth of the validated instrument market as regulatory bodies push compliance back down the discovery chain.

BUILDING A QUALITY CONTROL BUSINESS WITH THE FOOD INDUSTRY

Over the last several years, Biacore has been working to build up recognition of its SPR technology's ability to provide novel solutions for food analysis/QC (quality control).

In the last eighteen months, these modestly funded activities have started to yield some significant results, particularly in terms of generating accreditation/validation of the use of Biacore's SPR technology in a range of food analysis applications.

In September 2002, Biacore achieved an important milestone in the development of its food business. This milestone was the full validation and certification as a Performance Tested Method of its folic acid analysis by the AOAC (Association of Analytical Communities) Research Institute, the foremost independent body determining food-testing standards worldwide.

The AOAC certification, which is recognized by food manufacturers globally, means that Biacore is now in much stronger position to market its unique rapid routine test for the determination of the vitamin food supplement folic acid.

In September 2002, Biacore also extended its product offering to the food industry with the introduction of a highly sensitive test for the beta-agonist ractopamine. This is an important test for the food industry due to ractopamine's different regulatory status in the U.S. and Europe. In the U.S., ractopamine is licensed as a growth promoter for livestock while in Europe, its use along with other beta-agonists is banned entirely. The test that Biacore has developed for ractopamine is run on Biacore(r)Q and can be used for routine testing.

These developments, allied to an expansion of its product offering, have allowed Biacore to extend its customer base in the food industry to include some of the world's major food manufacturers. The growing interest in applying Biacore SPR technology in the food industry was reflected in the decision to

hold a special session on food applications at the Biacore Symposium that was held in Chicago in May 2002, at which companies such as Nestle and Fronterra from New Zealand made presentations.

SPR ARRAY TECHNOLOGY - HIGHER INFORMATION CONTENT FROM BIACORE'S NEXT GENERATION SYSTEMS

In the late 1990s, Biacore's scientists made a number of technological breakthroughs in SPR detection and micro-fluidics that have paved the way for the development of a new SPR array system. Biacore expects this system to be able to deliver a substantial improvement in the speed with which information on protein interactions can be generated. It expects to introduce this system in 2004. Delivering the high sensitivity and data quality that Biacore's customers currently receive, this new platform will enable Biacore's SPR technology to be used in a wide range of applications in both basic life science research and drug discovery and development.

The development of Biacore's SPR array technology is progressing in accordance with Biacore's plans with Biacore having made significant investments in order to drive the commercialization of this technology. In 2001, this investment amounted to approximately SEK 30 million and a further approximately SEK 35 million was invested in 2002. Biacore believes that this level of investment has allowed recruitment of key personnel needed to develop and test the individual modules that will make up the new SPR array systems.

BIACORE'S SPR ARRAY PARTNERS

To commercialize its SPR array technology, Biacore has on-going communications and discussions with major pharmaceutical companies and other people dealing with SPR and has entered into two collaborations to develop specific applications and gain access to reagent expertize. These collaborations and relationships enable Biacore to develop important elements in the specification of the system to meet the demands of the end-users.

The first collaboration started in June 2000 with Millennium Pharmaceuticals Inc. to examine potential applications of SPR array technology. By collaborating with Millennium, Biacore expects to be able to develop new systems that are tailored to the needs of major customers in the pharmaceutical/biotechnology industry.

Input from Millennium's scientists on applications and industry needs has enabled R&D efforts to focus on the key array technology formats that will meet the requirements of Biacore's major target customer groups for higher throughput SPR instrumentation. The agreed format will build on the advantages of Biacore's proprietary SPR and micro-fluidics technology, emphasizing sensitivity, data quality and high information content, combined with an increase in throughput that Biacore believes will meet important industrial needs.

The SPR array system is designed for applications in the interaction proteomics and post-HTS small molecule characterization areas, where its sensitivity, increased throughput and high information content will complement Biacore's existing systems. Over time, Biacore expects the SPR array system to have applications across the spectrum of drug discovery and development activities and be a valuable tool in many proteomics applications.

In order to address higher throughput proteomics applications, it is important to have access to the right reagents. To achieve this, Biacore signed a further complementary collaboration with the U.S. company BD Biosciences Pharmingen in July 2002. This collaboration provides access to targeted panels of antibodies and reagents for array applications. BD Biosciences Pharmingen manufactures monoclonal antibodies, protein expression systems and recombinant proteins using advanced bioprocessing techniques. It is part of BD Biosciences,

one of the world's largest businesses supporting the life sciences.

In addition, Biacore's SPR array technology has potential uses in the clinical trials field where it is likely to be used to characterize the immune response that is generated by drugs and their metabolites. To support such future potential applications, the array system is being developed under a GAMP model, to ensure that the system will meet global regulatory requirements when launched.

COMPETITION

Biacore's market share in 2002 was approximately 90%, measured by its share of references to SPR-based systems in scientific literature.

Currently, Biacore faces direct competition from approximately five other manufacturers of instruments employing affinity-based biosensor technology.

In the food and beverage analysis market, Biacore faces competition from a variety of other technologies. Immunoassays and culture methods have traditionally dominated the food and beverage analysis market. Biacore also competes in this market against the same classical techniques with which Biacore currently competes in the life science research area, such as high-performance liquid chromatography and mass spectrophotometry, which have increasingly been adopted in the food analysis market.

Competition may also come from developing new technologies for measuring biomolecular interactions. Biacore's business environment is characterized by extensive research and technological change, and new developments are expected to continue at a rapid pace. Biacore's future success will depend in large part on its ability to maintain a strong position in technological development. Major general device or instrument manufacturers may choose to enter the affinity-based biosensor market. Moreover, Biacore believes that certain entities have developed, are developing or are investigating the development of technologies in areas that have direct application to affinity-based biosensor systems.

GEOGRAPHICAL MARKETS AND MARKETING ORGANIZATION

The sales and marketing organization of Biacore focuses on providing highly qualified support to enable customers to achieve their research and development objectives.

Biacore has a direct presence with its own sales organizations in the largest markets, North America, Europe and Japan, as well as sales branches in Australia and New Zealand and distributors in many other countries. Sales is reported divided into three sales regions; Americas, Europe and Asia-Pacific.

The following table presents sales broken down by region during the last three financial years.

SEK thousands	For the years ended December 31 2002	2001	2000
Americas	270,524	249,347	191,872
Europe	173,894	151,004	139,152
Asia-Pacific	169,736	143,366	107,796
Total sales	614,154	543,717	438,820

In the Americas region, sales are handled by the Group's wholly-owned subsidiary Biacore Inc. in New Jersey. Staff are based in a number of locations across the United States. There are also distributors in major Latin American countries. Approximately half of Biacore's sales in the Americas is to

industrial customers, primarily in North America's pharmaceutical and biotechnology industries.

In the European region, sales in Germany, France, the United Kingdom, Ireland, the Benelux countries, Switzerland, Austria and the Nordic countries are made directly through branch offices. Biacore also has distributors in other European countries, including Italy and Spain, and in the Middle East. The majority of Biacore's customers in the European region have been in academia. However, Europe has a strong presence within the pharmaceutical industry, which is accounting for close to half of sales in Europe.

In the Asia-Pacific region, sales are made via the wholly-owned subsidiary Biacore KK in Japan and through branch offices in Australia and New Zealand. Other parts of the region are covered by a network of distributors. Sales in Japan are generally made to specialized distributors who service specific segments of the Japanese market. Such distributors act as intermediaries between the importer/specialist and the users of the analytical systems. The main end users in Asia-Pacific are universities and government research institutes, with the pharmaceutical and biotechnology industry being another important customer group.

Outside the main markets, Amersham Biosciences market and distribute Biacore's products in a number of countries. During 2000 and 2001, Amersham Biosciences was 45% owned by Biacore's largest shareholder Pfizer (Pharmacia) (see also Note 2 of Notes to Financial Statements).

Under Biacore's distributor agreements, Biacore generally supplies the distributor with centrally produced promotional material and assists in the training of the distributor's sales and technical staff. The sales and marketing of Biacore's products is otherwise conducted rather independently by the distributor.

Biacore has three business units that develop the markets and co-ordinate Biacore's efforts towards three key market segments:

- Pharmaceutical & Biotechnology.
- Basic Life Science Research.
- Food.

There are other central functions that continuously develop the www.biacore.com website, which includes extensive customer service features, publish the BIAJournal, develop technical literature, etc. Some of these central marketing functions are highly integrated with the Technology Supply division, which mainly includes the Research and Development organization.

New product launches, increased sales and an increase in direct representation in Biacore's major markets, including the build-up of the sales and marketing operation in Japan, has required a substantial build-up in the resources dedicated to sales and other marketing activities. Total marketing expenses increased from SEK 147.4 million in 2000 to SEK 199.8 million in 2002. This increase reflects an increase in the number of employees engaged in marketing activities from 95 at the end of 1999 to 143 at the end of 2002.

SEASONALITY

Historically, Biacore has had approximately 30 to 40% of annual sales in the fourth quarter of each year. Combined with high fixed costs and significant dependence on individual orders, the strong seasonality of sales has caused operating income to vary substantially between different quarters.

PRODUCTS

The first Biacore(r) instrument using SPR was launched in 1990. Since then, the technology has advanced considerably. These advances have broadened the application of SPR technology.

There are now several Biacore(r) systems on the market, with the latest products approximately 100 times more sensitive than the first and with substantially increased throughput capacity. The systems generally consist of an SPR instrument and a PC. Most of the instruments consist of a microfluidic system, an optical detection unit and a sample handling unit. The PC controls the system functions, except for manual operations such as inserting the sensor chip into the instrument and pre-loading the samples. The measurements are analyzed using Biacore's own evaluation software. Other examples of features of the instruments include:

- On-line reference subtraction.
- Optimized wash routines which ensure that an efficient screening process can be developed.
- Efficient recovery of material that has bound to the sensor surface during an analysis which enables samples to be recovered and used for analysis by mass spectrometry for sample identification purposes (the most common technique used for the identification and characterization of a specific target molecule).
- GxP functions for efficient compliance with regulatory requirements.

Biacore(r)S51 was launched in the third quarter of 2001. It is a high-performace and high-throughput system designed to reduce bottlenecks in drug discovery down-stream of high throughput screening (HTS).

Biacore(r)C was also launched in the second half of 2001. It has been designed for concentration analysis with automatic report generation. Biacore(r)C is the first system developed for use in a regulatory environment.

Biacore(r)3000 is Biacore's best-selling instrument and its top of the line general purpose system. Biacore(r)3000 is a high sensitivity, fully automated system for individual sample characterization and multi-sample analysis, and is mainly used upstream of HTS.

The Procel(tm) system is based on new proprietary fluorescent cell-based assay technology, is used for secondary screening and quantitative pharmacology profiling of compounds using live cells, and had its full commercial launch in March 2003.

Less expensive general purpose systems include Biacore(r)2000, Biacore(r)1000, Biacore(r)X and Biacore(r)J. Biacore(r)Q is optimized for food analysis. Other products include a number of different sensor chips, that have been designed for characterization of specific types of interactions, and other consumables such as reagents.

The prices of Biacore(r) instruments range from approximately SEK 400 thousand to approximately SEK 5 million.

In general, Biacore warrants its new systems against defects in design, materials and workmanship for one year. To date, the expense associated with warranty claims has been immaterial.

Biacore also offers comprehensive after sales service contracts, which include both routine maintenance and emergency servicing. Contracts are designed to offer a flexible choice of service support, to suit both the system and the customer's requirements.

To increase the size of the market and maximize utilization of its expertize, Biacore has offered and performed Research Consulting Services (RCS)

since late 2001.

BIACORE'S SPR TECHNOLOGY

Biacore's SPR technology is able to add value, across a wide range of industries and applications, through its ability to provide answers in real time to important questions concerning the progress of biomolecular interactions. Biacore's SPR technology can be used to measure:

Specificity - How specific is the binding between two molecules?
Kinetics - How fast does the binding take place?
Affinity - How strong is the binding?
Concentration - How much of a given molecule is present and active?

THE BASIS OF BIACORE'S SPR TECHNOLOGY

SPR is a phenomenon based on the transfer of light energy (photons) to a group of electrons (a plasmon) on a metal surface. In Biacore's SPR technology, the target molecule is bound to the surface of a gold-coated sensor chip. Once a target molecule has been bound, solution from the test material is passed over the sensor chip. The chip surface interacts with light at a characteristic angle that depends on the molecular composition on the gold surface. Any binding to the target molecule can be detected in real-time.

When molecules in the test solution bind to a target molecule at the sensor chip surface, the angle of reflected light increases. When they detach, the angle falls. These changes form the basis of the Biacore sensorgram, a continuous, real-time monitoring of the attachment and detachment of interacting molecules.

ADVANTAGES OF BIACORE'S SPR TECHNOLOGY

A fundamental advantage of Biacore's SPR technology is that unique biomolecular binding data can be generated without the need for researchers to label the molecules of interest. This reduces the time and workload needed to carry out assays. It also helps eliminate the risks of misleading results caused by the molecular changes that can result from sample labeling.

Another important benefit of Biacore's SPR technology is its ability to monitor bio-molecular interactions continuously, thereby providing real-time kinetic information. This is a major benefit for investigating molecular binding events, which can often be quite transient, but yet significant. It is not possible to generate detailed real-time data using traditional 'end-point' analytical methods, which require large numbers of measurements at different time intervals to picture bio-molecular binding processes.

Using Biacore's SPR technology, samples can often be analyzed without the need for purification. This again improves the data quality and reduces time to results. Because Biacore's technology does not make measurements through the use of light absorption, samples that are light sensitive, turbid or colored can also be analyzed.

These benefits have led to Biacore's SPR technology being used in a broad range of areas.

PROCEL(tm) - COMPLEMENTING SPR WITH CELL-BASED COMPOUND PROFILING

In addition to progressing its SPR technology, in 2002 Biacore also launched a new fluorescence-based instrument, Procel(tm), which is dedicated to secondary screening and quantitative pharmacology profiling of compounds, using live cells. The system complements Biacore's SPR technology in delivering the high-content information needed to rapidly identify successful drug candidates.

Procel(tm) is the first automated system dedicated to high-content profiling of compounds targeting G-protein coupled receptors and ion channels. Its complementary position alongside Biacore(r)S51 allows important decisions to be made earlier in the drug discovery process.

HIGH INFORMATION CONTENT SPR

Biacore continues to advance its SPR array technology. Developed partly in collaboration with Millennium Pharmaceuticals Inc., this is designed to focus on delivering the sensitivity, data quality and high information content, along with increased throughput, demanded by customers. The SPR array platform will build on Biacore's position in SPR and further develop its patented flow-based micro-fluidics capabilities that are central to providing the sensitivity and assay flexibility required for high-quality kinetic data and hence high information content. The system will have the throughput and capabilities required to simultaneously study targeted protein panels, providing a level of information on protein interactions that has not previously been available. In addition, the sensitivity and assay flexibility will enable small molecule characterization against panels of related targets, saving time and resources in drug discovery.

R&D INFRASTRUCTURE AND EXPENDITURES

Between 1993 and 1999, Biacore's R&D costs were rather constant and in the range of SEK 41 million to SEK 53 million per year. In 2000 and 2001, R&D expenses increased to SEK 73 million and SEK 105 million, respectively, largely as a result of the programs to develop new high-performance systems and SPR array technology. In 2002, R&D expenditures were almost unchanged at SEK 104 million. The extent of R&D efforts increased in 2002, but there was less engineering work undertaken or purchased relating to final design of new products. Furthermore, in 2002, SEK 5 million of R&D was capitalized in accordance with new Swedish accounting principles relating to product development expenses (see Notes 1 and 5 of Notes to Financial Statements). In general, variations from year to year have to a significant extent been due to the volume of services purchased from external consultants for generic engineering tasks.

The SPR array technology program cost approximately SEK 15 million in 2000, SEK 30 million in 2001 and SEK 35 million in 2002.

R&D expenses as a percentage of sales decreased from 55% in 1993 to 16% in 1999, then increased to 17% and 19% in 2000 and 2001, respectively, and fell to 17% in 2002. Biacore's long-term target is to maintain R&D expenses at a level corresponding to approximately 15% of sales.

INTELLECTUAL PROPERTY

Biacore actively seeks to protect its intellectual property by patenting innovative developments, and has approximately 50 patents pending or granted pertaining to most parts of its affinity biosensor technology, including:

- The optical sensor system.
- The sensor surface that enables selective molecular interactions.
- The surface plasmon resonance (SPR) based measurement unit.
- The optical component that is used to couple light from the measurement unit to the sensor surface.
- The microfluidic system.
- SPR array technology.

Biacore has also been granted patents and filed applications for patents pertaining to various analytical procedures, and has an exclusive license to use certain patents and technical information regarding fiber-optic SPR detection.

In 2001, Biacore acquired an exclusive license to Axiom Biotechnologies' proprietary fluorescent cell-based assay technology, with the exception of flow cytometry-based applications.

"Biacore" is a registered trademark owned by Biacore, and Biacore is in possession of the web address www.biacore.com, the Biacore homepage.

For a description of a legal proceeding brought by Biacore against Thermo BioAnalysis Corp. for patent infringement, please see Item 5A "Operating Results - Year Ended December 31, 2002 Compared with 2001 - Other Operating Income."

See also Item 3D "Risk Factors - Patents and Proprietary Technologies" and "Item 3D "Risk Factors - Collaborations."

MANUFACTURING AND SOURCES OF COMPONENTS, MATERIALS AND SUPPLIES

Biacore generally manufactures technically advanced and patented components, including sensor chips, the optical measurement unit and key components in the instruments' liquid handling systems. Final assembly of the instruments and quality control are also conducted by Biacore. Through a network of subcontractors for other components, materials and supplies, Biacore's fixed production costs have been limited.

The current Biacore production facilities are sufficient for current production volumes. However, to be able to cope with increases in production volumes and new products, Biacore is extending its storage and logistics facilities and may make further extensions in the medium term, see Item 4D "Property, Plant and Equipment."

See also Item 3D "Risk Factors - Dependence on a Single Manufacturing Facility" and "Dependence on Certain Sources of Supply."

QUALITY SYSTEMS

In February 2003, Biacore's main research and development and production unit, Biacore AB, received certification according to the international quality standard ISO 9001:2000 of its development and manufacturing of analytical systems and consumables for use in the field of biotechnology. Quality assurance and regulatory factors are becoming increasingly important to Biacore's customers, and Biacore strongly emphasizes these issues.

C. ORGANIZATIONAL STRUCTURE

Biacore International AB is the parent company of the Biacore Group. Biacore believes that it is not a subsidiary of any other entity, that it has been considered to be an associated company to and therefore equity-accounted by Pharmacia, and that it may be considered to be an associated company to Pfizer and therefore equity-accounted by Pfizer. The following legal entities are included in Biacore:

Company	Incorporated in	Ownership, %
Biacore International AB	Sweden	Parent
Biacore AB	Sweden	100
Biacore Administration AB	Sweden	100
Biacore International SA	Switzerland	100
Biacore KK	Japan	100
Biacore Holding Inc.	United States	100
Biacore Inc.	United States	100
XenoSense Ltd	United Kingdom	84 (1)

(1) Biacore has no formal ownership in XenoSense Ltd but would receive approximately 84% ownership upon conversion of convertible loans made by Biacore to XenoSense.

Business is carried out under the legal name of each respective legal entity.

D. PROPERTY, PLANT AND EQUIPMENT

Biacore owns one property. It is located in Uppsala, Sweden and has an area of 35,347 square meters of freehold land. At December 31, 2002, the property included one main building for industrial and office use, two office buildings and two mobile office units. All five are attached and have a total usable area ("bruksarea") of approximately 9,500 square meters. The vast majority of Biacore's production and research and development activities are carried out on this property. It also houses the Swedish marketing and administrative functions.

During 2002, the group headquarters was moved to the Swiss subsidiary Biacore International SA, which rents a combined office and light industrial area of approximately 1,500 square meters on a five-year lease in Neuchatel, Switzerland. The facility also includes a small office and light industrial building owned by Biacore but located on land included in that lease agreement.

Biacore believes that the space owned and leased by it at December 31, 2002, while adequate for its activities during 2002, was too small for Biacore's anticipated near- or medium-term activities. However, during the second quarter of 2003, Biacore is completing an extention of its storage and logistics facility in Uppsala by approximately 1,200 square meters. There is also a slight shortage of office and other space for the marketing, administration and research and development functions, and in the medium-term the production facilities may need to be expanded. E.g., Biacore may make further extensions of its building complex in Uppsala in the near or medium term.

The amount of future expenditure for ongoing and other decided property projects is not expected to be material to Biacore and is expected to be financed from existing liquid funds.

Biacore leases a small number of other properties of limited size for use in its operations, and believes that the terms of its leases generally reflect market rates in their respective areas.

See also Item 4A "History and Development of the Company - Principle Capital Expenditures and Divestitures."

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. OPERATING RESULTS

GENERAL

The following discussion should be read together with and is qualified in its entirety by reference to Item 3A "Selected Financial Data" and the financial statements of Biacore included in Item 17 herein. The financial data analyzed in this discussion has been prepared in accordance with Swedish GAAP, which differs in certain significant respects from U.S. GAAP. See Note 23 of Notes to Financial Statements for a description of significant differences between Swedish GAAP and U.S. GAAP applicable to Biacore.

OVERVIEW

There is potential for further significant advances in the life sciences and, as a result, for high demand for new and improved research tools. Products developed, manufactured and sold by Biacore have often been useful and sometimes essential in such life science research and development work. The rapid advances in genomics have increased the potential for research and development within proteomics and other areas. One of the most promising areas for increased demand for Biacore's technology is drug discovery applications mainly within the pharmaceutical and biotechnology industries. Biacore believes that its present and future SPR-based analytical systems can play an important role in this development.

Biacore has developed the technology of SPR-based analytical systems, and the market for these systems has grown in response to Biacore's efforts in fostering awareness of the technology's capabilities and potential. Management expects that, in the medium and long term, the overall market for SPR-based systems will continue to expand through Biacore's efforts as well as through the activities of competitors that have already or may enter the market.

Over time, increased competition is expected to reduce Biacore's share of the market, which since a number of years has been approximately 90%, measured by its share of references to SPR-based systems in scientific literature. Increased competition is expected to increase pressure on product margins over time.

However, one of the key elements of Biacore's strategy is to invest in research and development in order to maintain the technological position of its products, which to date has allowed Biacore to maintain satisfying gross margins.

Biacore has substantially increased its endeavours to develop technology for the application of SPR technology in the drug discovery sector.

SPR array technology remains one of the primary research and development projects. The technology is based on further development of the principles of detection, immobilization and sample and reagent handling, and will make it possible to use a large number of measurement spots simultaneously. In July 2002, Biacore and BD Biosciences Pharmingen, one of the world's largest manufacturers of reagents, announced a research collaboration for the development of methods for quality control of antibodies and reagents, and development of applications of the SPR array technology. Extensively characterized antibodies and reagents are considered to be important to the development of the protein array market. This collaboration is complementary to Biacore's collaboration with Millennium Pharmaceuticals Inc. Biacore retains the right to commercialize technology-related developments arising from these collaborations. The SPR array project is currently on target. If the project can be completed as planned, the first instrument is expected to be launched in the year 2004.

In November 2002, Biacore introduced Procel(tm), an analytical system that is based on proprietary fluorescent cell-based assay technology acquired in 2001 for USD 5 million (SEK 53.6 million). Procel(tm) is designed specifically for cell-based secondary screening and pharmacology profiling of potential new drug leads, and will complement Biacore's existing molecular-based systems. Sales activities started in 2003.

In October 2001, Biacore and Bruker Daltonics entered into an agreement that aims to commercialize the combination of Biacore's SPR technology and Bruker Daltonics' mass spectrometry technology. The co-operation has produced results in the form of model analytical systems that combine SPR and mass spectrometry technology in a comprehensive platform for functional proteomics studies.

Biacore's results of operations are also dependent on Biacore's ability to further penetrate the market within basic life science research, where major life science research laboratories make up the main customer group. In this market, which accounted for approximately 55% of its sales in 2002, Biacore has mainly sold to well-known life science laboratories, with proteomics, cancer research and neuroscience being important areas of application.

Other applications that present significant opportunities for Biacore include quality control, process control and environmental analysis; with target customer groups in the food and beverage, pharmaceutical, biotechnology and chemical industries and government laboratories. Biacore's sales will also be affected by Biacore's ability to make further technological advances, expand its product range, introduce new applications and expand the customer base.

In light of the further potential that Biacore believes its technology to possess, Biacore has continued to increase the resources devoted to marketing activities. Total marketing expenses increased from SEK 147.4 million in 2000 to SEK 199.8 million in 2002. This increase reflects an increase in the number of employees engaged in marketing activities from 95 at the end of 1999 to 143 at the end of 2002, including the build-up of the Biacore marketing operation in Japan.

Biacore's revenues are generated primarily from sales of analytical systems. Revenues are also generated by sales of consumables, after sales services, spare parts, rental of analytical systems and research consulting services.

Biacore's sales have typically shown a pattern of being unevenly distributed over the year, with the strongest sales during the fourth quarter of each year, principally due to its customers' typical budgeting and capital expenditure patterns. This pattern, together with the high proportion of fixed costs in Biacore, has caused operating income to be even more disproportionately distributed over the year. This pattern will probably continue, but the future extent of these variations is uncertain.

During the year 2002, the legal and commercial structure of Biacore changed. The head office was moved to the subsidiary Biacore International SA, located in Neuchatel, Switzerland. Biacore International SA also acts as the commercial center of Biacore, and includes the Pharmaceutical and biotechnology business unit and certain production and logistics activities. Neuchatel is located in a regional development zone and the taxation of Biacore International SA is subject to certain conditions tied to the development of its operation in Neuchatel. Biacore believes that the new structure of the Group will have a favorable impact on its average tax rate. Uppsala remains the domicile of the Company and the Group's center for research and development and production.

Other factors which affect sales and income include the timing of new product introductions by Biacore and other manufacturers of competing analytical systems, regulatory actions, government funding of research, the growth rate of the pharmaceutical and biotechnology industry and general economic trends.

Biacore's business is also characterized by a number of other factors which make future sales and income difficult to predict. See Item 3D "Risk Factors."

Biacore's sales fell by 25% in the first quarter of 2003 to SEK 106.5 million compared with SEK 141.3 million in the first quarter of 2002. Diluted earnings per share fell by 65% from SEK 2.17 in the first quarter of 2002 to SEK 0.77 in the first quarter of 2003.

YEAR ENDED DECEMBER 31, 2002 COMPARED WITH 2001

The following table sets forth certain consolidated income statement data for Biacore expressed as a percentage of sales for the periods indicated:

%	For the years ended December 31		
	2002	2001	2000
Sales	100.0	100.0	100.0
Cost of goods sold	-16.4	-18.4	-17.8
Marketing	-32.5	-34.7	-33.6
Administration	-11.1	-16.0	-13.9
Research and development	-17.0	-19.3	-16.6
Operating foreign currency gains and losses	-2.7	0.9	0.8
Other income	3.4	0.2	-
Other expenses	-0.1	-	-
Amortization of goodwill	-0.7	-0.9	-1.1
Operating income	22.9	11.8	17.8

The table below sets forth Biacore's sales by geographic area for the periods indicated:

SEK thousands	For the years ended December 31					
	2002		2001		2000	
Americas	270,524	44.0%	249,347	45.9%	191,872	43.7%
Europe	173,894	28.3%	151,004	27.8%	139,152	31.7%
Asia-Pacific	169,736	27.7%	143,366	26.3%	107,796	24.6%
Total sales	614,154	100.0%	543,717	100.0%	438,820	100.0%

Sales

Sales increased by 13.0% from SEK 543.7 million in 2001 to SEK 614.2 million in 2002. Excluding currency effects, sales increased by 14.0% (measured by applying currency exchange rates for 2001 to the 2002 revenues in local currencies).

As in 1999, 2000 and 2001, Biacore(r)3000, launched in 1998, was Biacore's best-selling analytical system.

In the Americas, sales increased by 8.5% from SEK 249.3 million in 2001 to SEK 270.5 million in 2002. Again, the Americas was Biacore's best-selling region, even though sales in the second half-year and to the pharmaceuticals industry was lower than expected.

Sales in Europe increased by 15.2% from SEK 151.0 million in 2001 to SEK 173.9 million in 2002. Market conditions in Europe remained stable and increased efforts were focused on introducing Biacore's analytical systems in drug discovery applications. During the fourth quarter of 2002, Biacore completed an extensive restructuring of the sales and support organization in Europe.

In Asia-Pacific, sales increased by 18.4% from SEK 143.4 million in 2001 to SEK 169.8 million in 2002, making Asia-Pacific the fastest-growing region within Biacore. The increase was equally strong in both Japan, the largest market within the Asia-Pacific region, and other countries.

The increase in total sales was an effect of higher volumes and a change in product mix. The increase also reflected a 17% increase, from SEK 111.3 million in 2001 to SEK 129.9 million in 2002, in sales of consumables, after sales services and spare parts, each of which depends primarily on the installed base of Biacore instruments.

Cost of Goods Sold

Cost of goods sold remained relatively stable at SEK 100.9 million in 2002 compared with SEK 99.8 million in 2001. As a percentage of sales, these costs decreased from 18.4% in 2001 to 16.4% in 2002 after having increased in the prior year.

Marketing

Marketing expenses increased by 6% from SEK 188.7 million in 2001 to SEK 199.8 million in 2002, corresponding to 34.7% of sales in 2001 and 32.5% in 2002. Thus, marketing expenses increased at a lower rate than sales.

Administration

Administrative expenses decreased by 21% from SEK 86.7 million in 2001 (16.0% of sales) to SEK 68.3 million in 2002 (11.1% of sales), after having increased by 43% in 2001. During 2001, administrative expenses included a charge of SEK 13 million relating to pension to the former Chief Executive Officer.

Research and Development

After having increased by 38% in 2000 and 44% in 2001, research and development expenses decreased marginally from SEK 104.7 million in 2001 to SEK 104.4 million in 2002. In 2001, research and development expenses included significant expenses relating to the development of the Biacore(r)S51 and Biacore(r)C systems. As from 2002, product development expenses that fulfil certain criteria are capitalized and amortized over their estimated economic lives (See Notes 1 and 5 to the financial statements). Capitalization of product development has reduced research and development expenses by SEK 5.0 million in 2002. As a proportion of sales, research and development expenses decreased from 19.3% to 17.0%.

Operating Foreign Currency Gains and Losses

Net operating foreign currency gains and losses, which mainly relate to accounts receivable, decreased from SEK 4.5 million in 2001 to SEK -16.6 million in 2002. The amount mainly relates to the appreciation of the Swedish krona against the U.S. dollar and Japanese yen in 2002.

Other Operating Income

In 2002, the United States Court of Appeals for the Federal Circuit confirmed an earlier judgement relating to infringement by Thermo BioAnalysis Corp. on Biacore's U.S. patent No. 5,436,161. The SEK 19.6 million in damages awarded is included in Other income during 2002, which increased from SEK 0.7 million in 2001 to SEK 21.0 million in 2002.

Amortization of Goodwill

All goodwill relates to the acquisition by Biacore's Japanese subsidiary of Amersham Biosciences' Japanese sales operation for Biacore products. See also Note 5 of Notes to Financial Statements. For a description of the treatment of the contract with Amersham Biosciences according to United States generally accepted accounting principles, see Note 23 of Notes to Financial Statements.

Operating Income

For the reasons discussed above, Biacore's operating income increased by 119% from SEK 64.1 million in 2001 to SEK 140.6 million in 2002, representing an increase in operating margin from 11.8% in 2001 to 22.9% in 2002.

Financial Items, net

Financial items, net, decreased from income of SEK 13.8 million in 2001 to a loss of SEK 20.4 million in 2002. Interest income increased slightly from SEK 10.0 million in 2001 to SEK 10.2 million in 2002. Interest expenses increased from SEK 1.1 million in 2001 to SEK 1.8 million in 2002 due to a higher calculated interest on the pension liability administered by the Swedish Pension Registration Institute PRI. Net financial foreign currency gains and losses decreased from SEK 0.2 million in 2001 to SEK 0.0 million in 2002. Biacore's financial foreign currency gains and losses derive from temporary lending to, and temporary borrowing of surplus liquidity from, non-Swedish subsidiaries. As a result of a deteriorating business climate and financing situation for early-stage biotechnology companies, Biacore has made write-downs against its portfolio related to this sector. This has caused a charge to the financial net of SEK -28.7 million.

Income Taxes

Income taxes increased from SEK 27.6 million in 2001 to SEK 40.1 million in 2002. Biacore's effective tax rate decreased from 35% in 2001 to 33% in 2002. This still relatively high level of taxation resulted from losses on equity instruments only being deductible against gains on similar financial instruments according to legislation and regulations in effect on December 31, 2002. At December 31, 2002, Biacore had no realized or unrealized gain on any such instrument against which it could offset any loss. This effect was partly offset by a change in the geographical mix of income in subsidiaries, one factor being the establishment of the group headquarters and commercial center in Neuchatel, which is located in a regional development zone in Switzerland.

Net Income

Net income increased by 60.7% from SEK 50.3 million in 2001 to SEK 80.8 million in 2002, corresponding to an increase in basic earnings per share from SEK 5.16 in 2001 to SEK 8.28 in 2002 and an increase in diluted earnings per share from SEK 5.04 in 2001 to SEK 8.20 in 2002.

YEAR ENDED DECEMBER 31, 2001 COMPARED WITH 2000

Sales

Sales increased by 23.9% from SEK 438.8 million in 2000 to SEK 543.7 million in 2001. Excluding currency effects, sales increased by 15.6% (measured by applying currency exchange rates for 2000 to the 2001 revenues in local currencies). The favorable currency effect mainly resulted from appreciation of the average value of the United States dollar and to a lesser extent the British pound and the euro.

In the Americas, sales increased by 30.0% from SEK 191.9 million in 2000 to SEK 249.3 million in 2001. The importance of this region to Biacore again increased as it accounted for 46% of sales in 2001. Both the Pharmaceutical and Biotechnology and Life Science business units performed well.

Sales in Europe increased by 8.5% from SEK 139.1 million in 2000 to SEK 151.0 million in 2001.

In Asia-Pacific, sales increased 33.0% from SEK 107.8 million in 2000 to SEK 143.4 million in 2001. Sales to the Japanese pharmaceuticals industry increased significantly and outside Japan sales almost doubled.

The increase in total sales was an effect of higher volumes and currency effects. The increase also reflected a 24% increase, to SEK 111.3 million, in sales of consumables, after sales services and spare parts.

Cost of Goods Sold

Cost of goods sold increased from SEK 78.1 million in 2000 to SEK 99.8 million in 2001. As a percentage of sales, these costs increased from 17.8% in 2000 to 18.4% in 2001. The gross margin was thereby approximately unchanged at 82%.

Marketing

Marketing expenses increased from SEK 147.4 million in 2000 to SEK 188.7 million in 2001, corresponding to 33.6% of sales in 2000 and 34.7% in 2001. An increase in the number of sales and other marketing personnel in mainly the United States led to a 28% increase in marketing expenses, which is somewhat higher than the increase in sales.

Administration

Administrative expenses increased from SEK 60.8 million in 2000 (13.9% of sales) to SEK 86.7 million in 2001 (16.0% of sales), an increase of 43%. Approximately half of the increase was due to an expense of SEK 13 million for pension to the former Chief Executive Officer.

Research and Development

Research and development expenses increased by 44% from SEK 72.8 million in 2000 to SEK 104.7 million in 2001, mainly due to the SPR array and high performance system projects. As a proportion of sales, research and development expenses increased from 16.6% in 2000 to 19.3% in 2001.

Operating Foreign Currency Gains and Losses

Net operating foreign currency gains, which mainly relate to accounts receivable, increased from SEK 3.2 million in 2000 to SEK 4.5 million in 2001.

Amortization of Goodwill

All goodwill relates to the acquisition by Biacore's Japanese subsidiary of Amersham Biosciences' Japanese sales operation for Biacore products.

Operating Income

For the reasons discussed above, Biacore's operating income decreased from SEK 78.0 million in 2000 to SEK 64.1 million in 2001, representing a decrease in operating margin from 17.8% in 2000 to 11.8% for 2001.

Financial Items, net

Financial items, net, increased from income of SEK 8.7 million in 2000 to income of SEK 13.8 million in 2001. Net interest income increased from SEK 7.4 million in 2000 to SEK 8.9 million in 2001 due to a higher average net interest-bearing asset and better interest rates received. Net financial foreign currency gains and losses decreased from SEK 1.3 million in 2000 to SEK 0.2 million in 2001. Furthermore, in 2001, 1,000,000 shares in Axiom were sold at a gain of SEK 4.6 million.

Income Taxes

Income taxes were unchanged at SEK 27.6 million in 2001. Biacore's effective tax rate increased from 32% in 2000 to 35% in 2001. The increase was due to a sharp reduction of the loss in the Japanese subsidiary, where the applicable tax rate is approximately 42% and for which a part of the tax loss

carry forward has been accounted for as a deferred tax asset, and higher non-deductible pension expenses as a result of the shortening of the accrual period for pension to the former Chief Executive Officer Lars-Goran Andren.

Net Income

Net income decreased by 15.0% from SEK 59.1 million in 2000 to SEK 50.3 million in 2001. Basic earnings per share fell from SEK 6.06 in 2000 to SEK 5.16 in 2001, and diluted earnings per share fell from from SEK 6.02 in 2000 to SEK 5.04 in 2001.

INFLATION

During the three year period ended December 31, 2002, inflation in Sweden amounted to approximately 2% per year. At the level indicated, inflation had limited impact on the Company's operations or financial condition.

FOREIGN CURRENCY FLUCTUATIONS

For a description of the effects of foreign currency fluctuations and hedging activities, see this Item 5A "Operating Results" above, Item 11 "Quantitative and Qualitative Disclosures About Market Risk" and Note 19 of Notes to Financial Statements.

GOVERNMENTAL POLICIES AND FACTORS

Biacore is affected by a large number of government policies and factors. Apart from large government funding of customers' purchases of products and services from Biacore (see Item 3D "Risk Factors - Funding of Customers"), Biacore believes that it is not subject to any other government policy or factor of which a description is required in this context.

BUSINESS CYCLES AND GENERAL ECONOMY

Biacore believes that it may be less affected by business cycles and the general economy than many other companies, that are often more dependent on limited geographical markets. However, capital goods, which make up the vast majority of Biacore's sales, are highly sensitive to the growth, financial position and competing other short or long-term priorities of their customers and customers' funding organizations.

OFF-BALANCE SHEET ARRANGEMENTS

At December 31, 2002, Biacore had contractual obligations involving SEK 37.9 million in operating lease payments and contingent liabilities of SEK 0.5 million (see Note 16 of Notes to Financial Statements).

See also Item 11 "Quantitative and Qualitative Disclosures about Market Risk" and Note 23 of Notes to Financial Statements - Hedge on Social Security Costs of Stock Options.

These off-balance sheet arrangements could have been financed by Biacore's liquid funds and are of limited importance to Biacore.

IMPORTANT ACCOUNTING POLICIES AND NEW ACCOUNTING STANDARDS

The preparation of financial statements 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 dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. See Note 1 of Notes to Financial Statements for a presentation of the most

important of the Company's accounting policies.

Those accounting policies and issues that Biacore believes involve the largest uncertainties in, and therefore also risks to, the presentation of the position and performance of the Company relate to research and development, impairment of intangible assets, incentive stock options and deferred tax assets.

The allocation of research and development expenses between product development expenses to be capitalized and amortized, and product development expenses to be charged to income, involves highly judgmental issues such as estimated future sales and the certainty of such estimates. The same applies to already capitalized product development.

If there is indication of an impairment of an intangible asset or a property, plant or equipment, then the recoverable cost of the asset is calculated. If the recoverable cost is less than the carrying amount of the asset, a write-down to the recoverable amount is recorded. Biacore has goodwill relating to its Japanese sales operation and capitalized acquisition cost related to fluorescent cell-based assay technology. The estimated fair values of these assets have been regularly calculated by applying the discounted cash flow method to the forecasted future performance of these businesses. The last such calculations have indicated that the assets are not impaired. However, the analyses rely on forecasts of future sales and expenses which involve considerable uncertainty. At this early stage, Biacore has had no significant revenue from any product based on fluorescent cell-based assay technology.

In Biacore's opinion, Swedish companies are currently not required to charge incentive stock options to income. Accordingly, Biacore has not charged incentive stock options to income. However, in the future, Biacore may charge incentive stock options to income as remuneration.

The Japanese entity Biacore KK has made significant losses. At December 31, 2002, the accumulated tax loss carryforward was approximately SEK 40.0 million and it expires over the five-year period between 2003 and 2007. Based on a forecast of the future performance of Biacore KK, Biacore has calculated a deferred tax asset as required by generally accepted accounting principles and made a valuation allowance for the portion that is not expected to be utilized (see Note 4 of Notes to Financial Statements). The calculation of the valuation allowance relies on forecasts of future sales and expenses which involve considerable uncertainty.

Several new accounting standards based on International Financial Reporting Standards from the International Accounting Standards Board have recently been adopted by the Swedish Financial Accounting Standards Council. Those new standards are not expected to have any material effect on Biacore's reported financial position or results of operations during 2003. The Swedish Financial Accounting Standards Council's statement No. 29 Employee Benefits is effective for financial years beginning January 1, 2004 or later. Biacore does not expect the impact of the adoption of this accounting standard to be material to its income statement or balance sheet, but will further assess its impact at a later date. See also Note 1 of Notes to Financial Statements.

See Note 23 of Notes to Financial Statements regarding generally accepted accounting principles in the United States, including recently announced changes to United States accounting and disclosure requirements.

B. LIQUIDITY AND CAPITAL RESOURCES

Biacore's balance of liquid funds was SEK 220.8 million at December 31, 2001 and SEK 351.6 million at December 31, 2002. Of liquid funds, SEK 90.9 million at December 31, 2001 and SEK 182.8 million at December 31, 2002

consisted of cash and cash equivalents as defined under U.S. GAAP. See Note 23 of Notes to Financial Statements for a further discussion of cash and cash equivalents according to U.S. GAAP.

For a description of Biacore's liquid funds and related treasury policies, see Notes 12, 18 and 19 of Notes to Financial Statements.

At December 31, 2002, Biacore had only SEK 4.3 million in financial debt, and no other interest-bearing debt or borrowing commitments from external sources. There is currently no significant seasonality in borrowing requirements. The current financial debt is related to regional development support received in Switzerland.

Net cash provided by operating activities has been between SEK 18 million and SEK 164 million over the past three years, with variations mainly being due to the timing of sales and payments of sales and expenses around year-ends, and changes in income before write-downs.

Transactions and balances with Pfizer (Pharmacia) are specified in Note 2 of Notes to Financial Statements.

Net cash used in investing activities were SEK 64.3 million in 2000, SEK 65.3 million in 2001 and SEK 37.1 million in 2002. Investments in intangible assets amounted to SEK 0 million, SEK 57.5 million and SEK 7.0 million in 2000, 2001 and 2002, respectively. Of the amount in 2001, USD 5 million (SEK 53.6 million) related to the acquisition of a license from Axiom Biotechnologies Inc. ("Axiom") and the amount in 2002 mainly related to capitalized research and development (see Notes 1 and 5 of Notes to Financial Statements).

There was no investment in property in 2000. In 2001, SEK 8.6 million was invested in further offices in Uppsala. In 2002, SEK 16.7 million was invested in buildings, mainly a storage and logistics unit in Uppsala. Purchases of machinery and equipment were SEK 14.2 million in 2000, SEK 31.4 million in 2001 and SEK 15.1 million in 2002. The increase in purchases of machinery and equipment in 2001 was due to Biacore's expansion and capital expenditure on buildings. In 2000, investments also included SEK 0.8 million in payments for the acquisition of the Japanese sales operation. In 2000, Biacore invested SEK 50.8 million in a number of technology ventures related to Biacore's business. These investments included SEK 36.7 million in shares in Axiom, a further SEK 10.2 million in shares in Bioreason Inc. and SEK 3.9 million in a convertible loan to XenoSense Ltd. In 2001, there was no purchase of long-term investments. USD 3 million was received in 2001 for the sale of 1,000,000 shares in Axiom to Axiom. The two transactions with Axiom in 2001 referred to in this subsection were negotiated simultaneously and the payments of USD 5 million to Axiom and USD 3 million from Axiom were netted. The acquisition and consolidation of XenoSense is described in Note 21 of Notes to Financial Statements, and led to SEK 1.6 million in higher liquid funds in the Biacore Group balance sheet in 2002. Due to the classification of marketable securities with more than 3 months until maturity at the day of acquisition as investing activities under U.S. GAAP, net cash used in investing activities was SEK 70.9 million lower in 2000, SEK 1.6 million higher in 2001 and SEK 33.9 million higher in 2002 under U.S. GAAP as compared with Swedish GAAP. See also Note 23 of Notes to Financial Statements.

Net cash provided by (used in) financing activities was SEK -7.9 million in 2000, SEK 0.0 million in 2001 and SEK 4.2 million in 2002. The items relate to a temporary interest-bearing loan in a subsidiary and regional development support.

Biacore has a tax loss carry-forward in Japan amounting to approximately SEK 40.0 million (see Note 4 of Notes to Financial Statements).

There have not been, are not currently and are not within the foreseeable future expected to be any or only limited restrictions on the ability of subsidiaries to transfer funds to the parent company in the form of cash dividends, loans or advances.

Biacore's use of financial instruments for hedging purposes is described in Item 11 "Quantitative and Qualitative Disclosures About Market Risk."

At December 31, 2002, there was no material commitment for capital expenditure.

The working capital of Biacore is sufficient for its present requirements. However, Biacore may make further significant investments, e.g. in connection with potential acquisitions in new market areas, the development and acquisition of complementary technology and intellectual property, expansion of facilities in Uppsala or elsewhere, and the development of its sales infrastructure both organically and through the acquisition of direct control over distribution in certain geographic markets. To the extent that its existing financial resources are deemed to be insufficient to meet Biacore's capital needs, Biacore intends to seek additional debt and/or equity financing to capitalize on these opportunities.

C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES, ETC

Although Biacore has a number of research and development collaborations with other entities, virtually all research and development expenses relate to company-sponsored activities. Total research and development expenses for each of the years in the three-year period ending December 31, 2002 are stated in the Income Statement in the Financial Statements. In addition, SEK 5.0 million of research and development was recorded as capitalized product development in the balance sheet in 2002. For a description of Biacore's research and development activities, see Item 4B "Business Overview", Item 5A "Operating Results" and Notes 1 and 5 of Notes to Financial Statements. See also Item 3D "Risk Factors."

D. TREND INFORMATION

See Item 5A "Operating Results", Item 5B "Liquidity and Capital Resources" and Note 22 of Notes to Financial Statements.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

A. DIRECTORS AND SENIOR MANAGEMENT

DIRECTORS

Biacore currently has the following directors:

Lars-Goran Andren. Born 1943, Non-Executive Chairman of the Board since January 2002. Executive Chairman and Chief Executive Officer between 2000 and 2001. Director, President and CEO between 1992 and 2000. Formerly Group Vice President, Corporate Development, at Kabi Pharmacia AB. Director of Medivir AB. M.Sc. Chem. Eng., Chalmers University of Technology, Gothenburg, Sweden.

Donald R. Parfet. Born 1952. Deputy Chairman of the Board since 2000. Chairman of the Board between 1996 and 2000. Executive President Apjohn Group LLC. Director of Bronson Health Care Group, Kalamazoo College, MPI Research Inc., SenseGene Therapeutics Inc. and W.E. Upjohn Institute. Former Senior Vice President, Associated Businesses of Pharmacia. MBA, University of Michigan, United States.

Gordon Edge. Born 1937. Director since 1993, Chairman and founder of the

Generics Group AG, a U.K. listed technology consulting, business development and investment firm. Trustee, Treasurer and Council Member of the Royal Society of Arts and Sciences. Chairman of Cambridge University-MIT Advisory Board. Associate Professor at the University of Bath, United Kingdom. Advisory Board member of EPFL, Lausanne, and the Entrepreneurship Center, University of Pennsylvania. Director of Applied NanoSystems BV, ETeCH AG and Quantum Beam Ltd. D.Tech., MIEE., C.Eng., CBE, Member of IVA.

Tom Erixon. Born 1960. Director since 1999. Group Vice President of Corporate Business Development and IT at Sandvik AB. Director of Seco Tools AB. Between 1988 and 2001 active within the Boston Consulting Group and Managing Partner in Denmark between 1998 and 2001. Master of Laws, Lund University, Sweden and MBA from IESE, Barcelona, Spain.

Ulf Jonsson. Born 1953. Chief Executive Officer since January 2002. Director and President since 2000. Executive Vice President and Chief Scientific Officer between 1998 and 2000. Former Head of Project Management and Marketing Director at Pharmacia Biotech. Ph.D. in Applied Physics and M.Sc. in Physics and Electronics at Linkoping University, Sweden.

Magnus Lundberg. Born 1956. Director since 2002. Executive President of Pharmacia Diagnostics. Chairman of the Board of Allergon AB. Director of Aerocrine AB, Onyx Inc., Sweden Biotechnology Industry Organization and Uppsvenska Handelskammaren. Former Vice President of Chiron Corp. Active within the Pharmacia group between 1981 and 1996. M.Sc. in biochemistry and biology, Abo Akademi, Finland.

Mats Pettersson. Born 1945. Director since 2000. Chief Executive Officer of Biovitrum from 2001. Director of Lundbeck A/S and Sweden Biotechnology Industry Organization. Former Senior Vice President, Mergers & Acquisitions of Pharmacia Corporation. Active within the Pharmacia Group between 1976 and 2001. MBA, Gothenburg School of Economics, Sweden.

Marc Van Regenmortel. Born 1934. Director since 1995. Chairman of the International Committee on Taxonomy of Viruses. Director of Entomed Ltd., Kalmar Biotechnology and Pepscan Ltd. Emeritus director at the Biotechnology School of the University of Strasbourg, France. Former Secretary General of the International Union of Microbiological Societies. Ph.D., University of Cape Town, South Africa.

Anna Hansson. Born 1964. Director (employee representative) since 2000. B.Sc. in Organic Chemistry, Uppsala University, Sweden. Employed since 1987.

Markku Hamalainen. Born 1958. Director (employee representative) since 2000. Ph.D. in Chemometrics, Agricultural University of Sweden. Employed since 1993.

Eva-Lotta Hedstrom. Born 1960. Deputy Director (employee representative) from May 2002.

Hans Sjobom. Born 1968. Deputy Director (employee representative) since 2000.

George Van der Veer. Born 1948. Deputy Director (employee representative) to May 2002.

SENIOR MANAGEMENT

The Executive Management Group of Biacore currently consists of:

Ulf Jonsson, Born 1953. Chief Executive Officer since 2002 and President since 2000. See also Item 6A "Directors and Senior Management - Directors."

Lars-Olov Forslund, born 1952. Executive Vice President and Chief Financial Officer since 1997. Former CFO at the Nordic steel group Fundia AB. MBA, Uppsala University, Sweden.

Anders Svenberg. Born 1956. Executive Vice President and Head of Human Resources since 2000. Former Vice President of Human Resources at Pharmacia & Upjohn, Sweden. Master of Laws, Stockholm University, Sweden.

B. COMPENSATION

Non-executive board members do not receive stock options or other compensation, except for the board fee and normal remuneration to employee representatives. Senior management participate in stock option plans subject to limitations decided by shareholders' meetings and applied by the board of directors of Biacore.

Non-executive board members, except for employee representatives, do not participate in any bonus plan. Senior management do participate in bonus plans. Bonuses are calculated as a proportion of base salaries and depend on group business performance and achievement of individual objectives.

See also Note 20 of Notes to Financial Statements, where information on compensation reflects compensation accrued.

C. BOARD PRACTICES

Directors are elected for a period until the next Annual General Meeting of shareholders. Any Extra General Meeting of shareholders may, effective immediately, end the term of or elect new directors. Apart from notice periods and severance payments disclosed in Note 20 of Notes to Financial Statements, there are no terms of office for senior management. The period during which Directors and senior managers have served is disclosed in Item 6A "Directors and Senior Management."

Employee representatives have normal termination and pension benefits. Among other directors, only two, the former Executive Chairman of the Board, and the current President and Chief Executive Officer, have service contracts with Biacore providing for benefits upon termination of employment, see Note 20 of Notes to Financial Statements.

As permitted by Swedish and Unites States laws and regulations and the Company's agreement with the Nasdaq Stock Market, the Company has no audit committee as defined by United States laws and regulations. Similar duties are handled by the company's shareholders' meetings and Board of Directors. Biacore has had no compensation committee before 2003 (see Note 20 of Notes to Financial Statements). Corresponding functions were handled by the Shareholders' Meetings and the Board of Directors of Biacore. The current members of the compensation committee are Lars-Goran Andren, Gordon Edge and Tom Erixon.

D. EMPLOYEES

At year-end 2002, Biacore had 325 permanent employees, an increase of 37 people from 2001.

The following table shows the number of employees at year-end broken down by main category of activity:

Function	2002	2001	2000
Production	41	37	27
Marketing	143	128	110

Management	32	30	22
Research and development	109	93	69
Number of employees at year end	325	288	228

The number of employees has continued to grow, notably in the research and development and marketing areas. The increase in the number of employees in research and development is partly related to the SPR array project. Biacore's marketing function has been expanded in all regions, notably in the United States.

The sophistication of Biacore's products and the advanced research and development activities conducted place high demands on Biacore to recruit and retain highly educated and competent employees. Of the 325 Biacore employees at year-end 2002, 40 held a Ph.D. degree. A further 145 held a bachelor's or higher degree, and 68 had other forms of tertiary education. These highly skilled people are from a large number of disciplines, bringing to Biacore the broad base of knowledge that is needed to develop, produce and market Biacore(r) systems and other products and services. Biacore's research and development team encompasses people highly skilled in biology, chemistry, physics, mechanics, electronics and software programming.

Biacore believes that its labor relations are good.

See also Item 3D "Risk Factors - Key Personnel," Item 3D "Risk Factors - Ability to Attract and Retain Skilled Staff," Item 4B "Business Overview" and Note 20 of Notes to Financial Statements.

E. SHARE OWNERSHIP

The ownership of shares in Biacore at December 31, 2002 among the Directors of the Board and other members of senior management is presented in the table below.

Name	Function	Shares (1)	Options
Lars-Goran Andren	Chairman of the Board	2,281	47,000
Donald R. Parfet	Deputy Chairman of the Board	24,500	-
Gordon Edge	Director	-	-
Tom Erixon	Director	-	-
Ulf Jonsson	Director, Chief Executive Officer and President	1,100	33,000
Magnus Lundberg	Director from May 2002	-	-
Mats Pettersson	Director	100	-
Marc Van Regenmortel	Director	400	-
Anna Hansson	Director (employee representative)	-	1,500
Markku Hamalainen	Director (employee representative)	281	3,000
Eva-Lotta Hedstrom	Deputy Director from May 2002 (employee representative)	-	500
Hans Sjobom	Deputy Director (employee representative)	46	2,750
George Van der Veer	Deputy Director to May 2002 (employee representative)	N/a	N/a
Lars-Olov Forslund	Executive Vice President and Chief Financial Officer	="font-family:Arial;font-size:9pt;">-	

Interest and other income, net
77

93

189

179

1,881

(14,725
)

10,801

(29,577
)

INCOME FROM CONTINUING OPERATIONS
25,224

12,157

57,082

21,320

DISCONTINUED OPERATIONS

Loss from discontinued operations
—

(19
)

(17
)

(27
)

Gain on sales of real estate properties
—

7

5

7

LOSS FROM DISCONTINUED OPERATIONS
—

(12
)

(12
)

(20
)
NET INCOME
$
25,224

$
12,145

$
57,070

$
21,300

BASIC EARNINGS PER COMMON SHARE:

Income from continuing operations
$
0.22

$
0.12

$
0.50

$
0.21

Discontinued operations
0.00

0.00

0.00

0.00

Net income
$
0.22

$
0.12

$
0.50

$
0.21

DILUTED EARNINGS PER COMMON SHARE:

Income from continuing operations
$

0.22

$
0.12

$
0.49

$
0.21

Discontinued operations
0.00

0.00

0.00

0.00

Net income
$
0.22

$
0.12

$
0.49

$
0.21

WEIGHTED AVERAGE COMMON SHARES OUTSTANDING—BASIC
114,721

103,988

114,698

102,710

WEIGHTED AVERAGE COMMON SHARES OUTSTANDING—DILUTED
115,674

104,770

115,597

103,471

DIVIDENDS DECLARED, PER COMMON SHARE, DURING THE PERIOD
$
0.30

$
0.30

$
0.60

$
0.60

The accompanying notes, together with the Notes to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, are an integral part of these financial statements.

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Healthcare Realty Trust Incorporated
Condensed Consolidated Statements of Comprehensive Income
For the Three and Six Months Ended June 30, 2017 and 2016
(Dollars in thousands)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
NET INCOME	$25,224	$12,145	$57,070	$21,300
Other comprehensive income:				
Forward starting interest rate swaps:				
Reclassification adjustment for losses included in net income (Interest expense)	42	42	85	84
Total other comprehensive income	42	42	85	84
COMPREHENSIVE INCOME	$25,266	$12,187	$57,155	$21,384

The accompanying notes, together with the Notes to the Consolidated Financial Statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016, are an integral part of these financial statements.

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Healthcare Realty Trust Incorporated
Condensed Consolidated Statement of Equity
(Dollars in thousands, except per share data)
(Unaudited)

	Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Cumulative Net Income Attributable to Common Stockholders	Cumulative Dividends	Total Stockholders' Equity
Balance at December 31, 2016	$ 1,164	$2,917,914	$ (1,401)	$ 995,256	$(2,259,519)	$1,653,414
Issuance of common stock	—	1,041	—	—	—	1,041
Common stock redemptions	—	(502)	—	—	—	(502)
Stock-based compensation	1	5,066	—	—	—	5,067
Net income	—	—	—	57,070	—	57,070
Reclassification of loss on forward starting interest rate swaps	—	—	85	—	—	85
Dividends to common stockholders ($0.60 per share)	—	—	—	—	(69,898)	(69,898)
Balance at June 30, 2017	$ 1,165	$2,923,519	$ (1,316)	$ 1,052,326	$(2,329,417)	$1,646,277

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Healthcare Realty Trust Incorporated
Condensed Consolidated Statements of Cash Flows
For the Six Months Ended June 30, 2017 and 2016
(Dollars in thousands)
(Unaudited)

	Six Months Ended June 30,	
	2017	2016
OPERATING ACTIVITIES		
Net income	$57,070	$21,300
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	71,504	63,280
Stock-based compensation	5,067	3,798
Amortization of straight-line rent receivable	(3,534)	(4,223)
Amortization of straight-line rent liability	316	368
Gain on sales of real estate assets	(39,532)	(8)
Impairment of real estate assets	328	—
Provision for bad debts, net	171	39
Changes in operating assets and liabilities:		
Other assets	536	3,139
Accounts payable and accrued liabilities	(10,236)	(7,927)
Other liabilities	2,281	(20,287)
Net cash provided by operating activities	83,971	59,479
INVESTING ACTIVITIES		
Acquisitions of real estate	(53,536)	(63,172)
Development of real estate	(10,098)	(18,982)
Additional long-lived assets	(36,329)	(29,286)
Proceeds from sales of real estate	117,010	—
Proceeds from mortgages and notes receivable repayments	10	9
Net cash provided by (used in) investing activities	17,057	(111,431)
FINANCING ACTIVITIES		
Net repayments on unsecured credit facility	(72,000)	(16,000)
Borrowings of notes and bonds payable	—	11,500
Repayments on notes and bonds payable	(2,249)	(19,963)
Dividends paid	(69,898)	(62,239)
Net proceeds from issuance of common stock	1,005	145,125
Common stock redemptions	(1,125)	(1,282)
Debt issuance and assumption costs	(84)	(265)
Net cash (used in) provided by financing activities	(144,351)	56,876
(Decrease) increase in cash, cash equivalents and restricted cash	(43,323)	4,924
Cash, cash equivalents and restricted cash at beginning of period	54,507	4,102
Cash, cash equivalents and restricted cash at end of period	$11,184	$9,026
Supplemental Cash Flow Information:		
Interest paid	$27,570	$28,692
Invoices accrued for construction, tenant improvements and other capitalized costs	$6,355	$12,745
Mortgage notes payable assumed upon acquisition (adjusted to fair value)	$12,460	$13,951
Capitalized interest	$484	$452

The accompanying notes, together with the Notes to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, are an integral part of these financial statements.

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Healthcare Realty Trust Incorporated

Notes to the Condensed Consolidated Financial Statements
June 30, 2017
(Unaudited)

Note 1. Summary of Significant Accounting Policies
Business Overview
Healthcare Realty Trust Incorporated (the "Company") is a self-managed, self-administered real estate investment trust ("REIT") that integrates owning, leasing, managing, financing, developing and redeveloping income-producing real estate properties associated primarily with the delivery of outpatient healthcare services throughout the United States. As of June 30, 2017, the Company had gross investments of approximately $3.6 billion in 197 real estate properties located in 26 states totaling approximately 14.5 million square feet. The Company provided leasing and property management services to approximately 10.9 million square feet nationwide.

Basis of Presentation
The Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. They do not include all of the information and footnotes required by GAAP for complete financial statements. However, except as disclosed herein, management believes there has been no material change in the information disclosed in the Notes to the Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2016. All material intercompany transactions and balances have been eliminated in consolidation.

This interim financial information should be read in conjunction with the financial statements included in this report and in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016. Management believes that all adjustments of a normal, recurring nature considered necessary for a fair presentation have been included. In addition, the interim financial information does not necessarily represent or indicate what the operating results will be for the year ending December 31, 2017 for many reasons including, but not limited to, acquisitions, dispositions, capital financing transactions, changes in interest rates and the effects of other trends, risks and uncertainties.

Use of Estimates in the Condensed Consolidated Financial Statements
Preparation of the Condensed Consolidated Financial Statements in accordance with GAAP requires management to make estimates and assumptions that affect amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Actual results may differ from those estimates.
Cash, Cash Equivalents and Restricted Cash
Cash and cash equivalents includes short-term investments with original maturities of three months or less when purchased. Restricted cash includes cash held in escrow in connection with proceeds from the sales of certain real estate properties. These sales proceeds will be disbursed as the Company acquires real estate investments under Section 1031 of the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”). The carrying amount approximates fair value due to the short term maturity of these investments. The following table provides a reconciliation of cash, cash equivalents and restricted cash reported within the Company's Consolidated Balance Sheets to the combined amounts shown on the Company's Consolidated Statements of Cash Flows:

(Dollars in thousands)	6/30/2017	12/31/2016
Cash and cash equivalents	$ 2,033	$ 5,409
Restricted cash	9,151	49,098
Total cash, cash equivalents and restricted cash	$ 11,184	$ 54,507

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Reclassifications

Condensed Consolidated Statements of Income

Certain reclassifications have been made on the Company's Condensed Consolidated Statements of Income. The Company reclassified acquisition and pursuit costs from the general and administrative line item to a separate line item. The acquisition and pursuit costs line item includes direct third party and travel costs related to the Company's pursuit of acquisitions and developments. In addition, the Company combined the line items labeled depreciation and amortization into one line item. These reclassifications are as follows:

	June 30, 2016			
	Three Months Ended		Six Months Ended	
(in thousands)	As Previously Reported	As Reclassified	As Previously Reported	As Reclassified
General and administrative	$8,129	$ 7,756	$18,375	$ 15,828
Acquisition and pursuit costs	—	373	—	2,547
Total	$8,129	$ 8,129	$18,375	$ 18,375
Depreciation	$28,528	$ —	$56,221	$ —
Amortization	2,762	—	5,463	—
Depreciation and amortization	—	31,290	—	61,684
Total	$31,290	$ 31,290	$61,684	$ 61,684

New Accounting Pronouncements

Accounting Standards Update No. 2014-09 and No. 2015-14

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, "Revenue from Contracts with Customers," a comprehensive new revenue recognition standard that supersedes most existing revenue recognition guidance, including sales of real estate. This standard's core principle is that a company will recognize revenue when it transfers goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods and services. However, leasing contracts, representing the major source of the Company's revenues, are not within the scope of the new standard and will continue to be accounted for under other standards.

In August 2015, the FASB issued ASU No. 2015-14, "Revenue from Contracts with Customers (Topic 606); Deferral of the Effective Date." This standard is effective for the Company for annual and interim periods beginning after December 15, 2017 with early adoption permitted only as of annual reporting periods beginning after December 15, 2016, including interim periods within that year.

The Company plans on adopting this standard by using the full retrospective adoption method beginning on January 1, 2018. The Company's revenue-producing contracts are primarily leases that are not within the scope of this standard. As a result, the Company does not expect the adoption of this standard to have a material impact on the timing and measurement of the Company's leasing revenues. The Company is continuing to evaluate the impact on other revenue sources. However, the Company does expect additional disclosures that are required from the adoption of this standard.

Accounting Standards Update No. 2016-02

In February 2016, the FASB issued ASU No. 2016-02, "Leases." For lessees, the new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The Company expects that all of the leases where

the Company is the lessee will be recorded on the Company's balance sheet. For lessors, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as financing. If the lessor doesn't convey risks and rewards or control, then the lease would be classified as an operating lease.

The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years with early adoption permitted. A modified retrospective transition approach is required for lessors for sales-type, direct financing, and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is in the initial stages of evaluating the impact from the adoption of this new standard on the Consolidated Financial Statements and related notes.

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Accounting Standards Update No. 2016-13
In June 2016, the FASB issued ASU 2016-13, "Measurement of Credit Losses on Financial Instruments." This update is intended to improve financial reporting by requiring timelier recognition of credit losses on loans and other financial instruments that are not accounted for at fair value through net income, including loans held for investment, held-to-maturity debt securities, trade and other receivables, net investment in leases and other such commitments. This update requires that financial statement assets measured at an amortized cost and certain other financial instruments be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. This standard is effective for annual and interim periods beginning after December 15, 2019 with early adoption permitted. The Company is in the initial stages of evaluating the impact from the adoption of this new standard on the Consolidated Financial Statements and related notes.

Accounting Standards Update No. 2016-15
In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments." This update clarifies whether the following items should be classified as operating, investing or financing in the statement of cash flows: (i) debt prepayments and extinguishment costs, (ii) settlement of zero-coupon debt, (iii) settlement of contingent consideration, (iv) insurance proceeds, (v) settlement of corporate-owned life insurance and bank-owned life insurance policies, (vi) distributions from equity method investees, (vii) beneficial interest in securitization transactions and (viii) receipts and payments with aspects of more than one class of cash flows.

This standard is effective for the Company for annual and interim periods beginning on January 1, 2018 with early adoption permitted on a retrospective transition method to each period presented. The Company adopted this standard effective January 1, 2017. There was not a material impact on the Company's Consolidated Financial Statements and related notes resulting from the adoption of this standard.

Accounting Standards Update No. 2017-01
In January 2017, the FASB issued ASU No. 2017-01, "Business Combinations: Clarifying the Definition of a Business." This update modifies the requirements to meet the definition of a business under Topic 805, "Business Combinations." The amendments provide a screen to determine when an integrated set of assets and activities is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business. The Company believes that this amendment will result in most of its real estate acquisitions being accounted for as asset acquisitions rather than business combinations. This standard is effective for the Company for annual and interim periods beginning after December 15, 2017 with early adoption permitted. The Company adopted this standard effective January 1, 2017. The impact to the Consolidated Financial Statements and related notes as a result of the adoption of this standard is primarily related to the difference in the accounting of acquisition costs. When accounting for these costs as a part of an asset acquisition, the Company will be permitted to capitalize the costs. The adoption of this standard did not have a material impact on the Consolidated Financial Statements and related notes.

Accounting Standards Update No. 2017-04
In January 2017, the FASB issued ASU 2017-04, "Simplifying the Test for Goodwill Impairment." This update eliminates Step 2 of the goodwill impairment test. As such, an entity will perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize a goodwill impairment charge for the amount by which the reporting unit's carrying amount exceeds its fair value. This standard is effective for the Company for annual and interim periods beginning after December 15, 2019. The Company does not expect a material impact on the Consolidated Financial Statements and related notes from the adoption of this standard.

Accounting Standards Update No. 2017-05
In February 2017, the FASB issued ASU 2017-05, "Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets." This update defines an in-substance nonfinancial asset, unifies guidance related to partial sales of nonfinancial assets, eliminates rules specifically addressing the sales of real estate, removes exception to the financial asset derecognition model and clarifies the accounting for contributions of nonfinancial assets to joint ventures. This standard is effective for the Company for annual and interim periods beginning after December 15, 2017 with early adoption permitted. The Company does not expect a material impact on the Consolidated Financial Statements and related notes from the adoption of this standard.

Accounting Standards Update No. 2017-09
In May 2017, the FASB issued ASU 2017-09, "Compensation - Stock Compensation - Scope of Modification Accounting." This update provides guidance about which changes to the terms and conditions of share-based awards require an entity to apply modification accounting in Topic 718. This standard is effective for the Company for the annual and interim periods

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beginning after December 15, 2017 with early adoption permitted. The Company does not expect a material impact on the Consolidated Financial Statements and related notes from the adoption of this standard.

Note 2. Real Estate Investments

2017 Acquisitions

The following table details the Company's acquisitions for the six months ended June 30, 2017 (dollars in millions):

Location	Type [1]	Date Acquired	Purchase Price	Mortgage Note Payable Assumed [2]	Cash Consideration [3]	Real Estate	Other [4]	Square Footage
St. Paul, Minnesota	MOB	3/6/17	$ 13.5	$ —	$ 13.5	$13.3	$0.2	34,608
San Francisco, California	MOB	6/12/17	26.8	—	26.8	26.8	—	75,649
Washington, D.C.	MOB	6/13/17	24.0	(12.1)	12.5	24.8	(0.2)	62,379
Total acquisitions			$ 64.3	$ (12.1)	$ 52.8	$64.9	$—	172,636

(1) MOB = medical office building

(2) The mortgage note payable assumed in the acquisition does not reflect the fair value adjustments totaling $0.4 million recorded by the Company upon acquisition (included in Other).

(3) Cash consideration excludes prorations of revenue and expense due to/from seller at the time of the acquisition.

(4) Includes assets acquired, liabilities assumed, and intangibles recognized at acquisition.

2017 Dispositions

The following table details the Company's dispositions for the six months ended June 30, 2017 (dollars in millions):

Location	Type [1]	Date Disposed	Sales Price	Closing Adjustments	Net Proceeds	Net Real Estate Investment	Other (including receivables)[3]	Gain	Square Footage
Evansville, Indiana	OTH	3/6/17	$6.4	$ —	$ 6.4	$ 1.1	$ —	$5.3	29,500
Columbus, Georgia [2]	MOB	3/7/17	0.6	—	0.6	0.6	—	—	12,000
Las Vegas, Nevada [2]	MOB	3/30/17	5.5	(0.7)	4.8	2.2	0.3	2.3	18,147
Texas (3 properties)	IRF	3/31/17	69.5	(1.6)	67.9	46.9	5.2	15.8	169,722
Chicago, Illinois [2]	MOB	6/16/17	0.5	(0.1)	0.4	0.4	—	—	5,100
San Antonio, Texas [2]	IRF	6/29/17	14.5	(0.2)	14.3	5.1	0.9	8.3	39,786
Roseburg, Oregon	MOB	6/29/17	23.2	(0.6)	22.6	14.5	0.3	7.8	62,246
Total dispositions			$120.2	$ (3.2)	$ 117.0	$ 70.8	$ 6.7	$39.5	336,501

(1) OTH = other; MOB = medical office building; IRF = inpatient rehabilitation facility

(2) Previously classified as held for sale.

(3) Includes straight-line rent receivables, leasing commissions and lease inducements.

Subsequent Acquisition

On July 31, 2017, the Company acquired a 42,780 square foot medical office building in Los Angeles, California for a purchase price of $16.3 million.

Potential Disposition

The Company is under contract to sell an off-campus, 79,980 square foot medical office building located in St. Louis, Missouri. The Company's net investment in the property is approximately $7.4 million at June 30, 2017. The sales

price of the building will be approximately $2.6 million. In July 2017, the sale became probable based on the expiration of the due diligence period and therefore, the Company reclassified the property to held for sale and recognized a $5.2 million impairment using level one input.

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Assets Held for Sale

At June 30, 2017 and December 31, 2016, the Company had one and two properties, respectively, classified as held for sale. During the six months ended June 30, 2017, the Company reclassified three properties to held for sale and four properties were sold. A summary of each of the properties reclassified as held for sale is below:

- a 78,731 square foot inpatient rehabilitation facility located in Pittsburgh, Pennsylvania reclassified to held for sale in connection with management's decision to sell the property;
- a 39,786 square foot inpatient rehabilitation facility located in San Antonio, Texas reclassified to held for sale in connection with management's decision to sell the property. The Company sold this property in the second quarter of 2017 and recognized an $8.3 million gain on the disposition; and
- a 5,100 square foot medical office building located in Chicago, Illinois reclassified to held for sale in connection with management's decision to sell the property. In the first quarter of 2017, the Company recorded an impairment charge of $0.3 million using level one inputs. The Company sold this property in the second quarter of 2017 and recognized an immaterial impairment loss on the disposition.

The table below reflects the assets and liabilities of the properties classified as held for sale and discontinued operations as of June 30, 2017 and December 31, 2016:

(Dollars in thousands)	June 30, 2017	December 31, 2016
Balance Sheet data:		
Land	$1,125	$ 1,362
Buildings, improvements and lease intangibles	18,231	4,410
	19,356	5,772
Accumulated depreciation	(10,657)	(2,977)
Real estate assets held for sale, net	8,699	2,795
Other assets, net (including receivables)	68	297
Assets held for sale and discontinued operations, net	$8,767	$ 3,092
Accounts payable and accrued liabilities	$186	$ 22
Other liabilities	213	592
Liabilities of properties held for sale and discontinued operations	$399	$ 614

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Discontinued Operations

The following table represents the results of operations of the properties included in discontinued operations on the Company's Condensed Consolidated Statements of Income for the three and six months ended June 30, 2017 and 2016.

(Dollars in thousands)	Three Months Ended June 30, 2017	2016	Six Months Ended June 30, 2017	2016
Statements of Income data:				
Revenues				
Rental income	$—	$—	$—	$—
	—	—	—	—
Expenses				
Property operating	—	19	17	27
	—	19	17	27
Other Income (Expense)				
Interest and other income, net	—	—	—	—
	—	—	—	—
Discontinued Operations				
Loss from discontinued operations	—	(19)	(17)	(27)
Gain on sales of real estate assets	—	7	5	7
Loss from Discontinued Operations	$—	$(12)	$(12)	$(20)

Note 3. Notes and Bonds Payable

The table below details the Company’s notes and bonds payable.

(Dollars in thousands)	Maturity Dates	Balance as of June 30, 2017	December 31, 2016	Effective Interest Rate as of June 30, 2017	
Unsecured Credit Facility	7/20	$35,000	$107,000	2.22	%
Unsecured Term Loan Facility, net of issuance costs	2/19	149,609	149,491	2.42	%
Senior Notes due 2021, net of discount and issuance costs	1/21	397,483	397,147	5.97	%
Senior Notes due 2023, net of discount and issuance costs	4/23	247,499	247,296	3.95	%
Senior Notes due 2025, net of discount and issuance costs	5/25	247,930	247,819	4.08	%
Mortgage notes payable, net of discounts and issuance costs and including premiums	1/18-5/40	125,625	115,617	5.06	%
		$1,203,146	$1,264,370		

Changes in Debt Structure

On May 1, 2017, the Company repaid in full a mortgage note payable bearing interest at a rate of 6.50% per annum with outstanding principal of $0.2 million. The mortgage note encumbered a 60,476 square foot medical office building located in Minnesota.

On June 13, 2017, in connection with the acquisition of a 62,379 square foot medical office property in Washington D.C., the Company assumed a $12.1 million mortgage note payable (excluding a fair value premium adjustment of $0.4 million). The mortgage note payable has a contractual interest rate of 4.69% per annum (effective rate of 4.27% per annum).

Note 4. Derivative Financial Instruments

Risk Management Objective of Using Derivatives

In addition to operational risks which arise in the normal course of business, the Company is exposed to economic risks such as interest rate, liquidity and credit risk. In certain situations, the Company may enter into derivative financial instruments such as interest rate swap and interest rate cap agreements to manage interest rate risk exposure arising from variable rate debt transactions that result in the receipt or payment of future known and uncertain cash amounts, the value of which are

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determined by interest rates. The Company's objective in using interest rate derivatives is to manage its exposure to interest rate movements on its variable rate debt.

Cash Flow Hedges of Interest Rate Risk
Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without changing the underlying notional amount.

As of June 30, 2017, the Company did not have any outstanding interest rate derivatives that were designated as cash flow hedges of interest rate risk.
The effective portion of changes in the fair value of derivatives designated as, and that qualify as, cash flow hedges is recorded in accumulated other comprehensive income or loss ("OCI") and is reclassified into earnings as interest expense in the period that the hedged forecasted transaction affects earnings. The effective portion of the Company's interest rate swaps that was recorded in the accompanying Condensed Consolidated Statements of Income for the three and six months ended June 30, 2017 and 2016 respectively, was as follows:

(Dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Amount of loss reclassified from accumulated OCI into Interest Expense (effective portion)	$(42)	$(42)	$(85)	$(84)

The Company estimates that an additional $0.2 million will be reclassified from accumulated other comprehensive loss as an increase to interest expense over the next 12 months.

Note 5. Commitments and Contingencies
Legal Proceedings
The Company is, from time to time, involved in litigation arising in the ordinary course of business. The Company is not aware of any pending or threatened litigation that, if resolved against the Company, would have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

Redevelopment Activity
The Company is in the process of finalizing the redevelopment of a medical office building in Nashville, Tennessee, which includes a 70,000 square foot expansion. During the six months ended June 30, 2017, the Company funded approximately $10.3 million on the redevelopment of this property, including approximately $3.1 million related to overages on tenant improvement projects that have yet to be finalized and collected from the tenant. The Company expects to spend an additional $2.2 million throughout the remainder of 2017.

Development Activity
The Company is developing a 99,957 square foot medical office building in Denver, Colorado. The total development budget is $26.5 million, of which $21.6 million has been spent as of June 30, 2017. The Company received the certificate of substantial completion on the core and shell in the second quarter of 2017. Tenants are expected to begin taking occupancy in the third quarter of 2017.

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Note 6. Stockholders' Equity

Common Stock
The following table provides a reconciliation of the beginning and ending shares of common stock outstanding for the six months ended June 30, 2017 and the year ended December 31, 2016:

	June 30, 2017	December 31, 2016
Balance, beginning of period	116,416,900	101,517,009
Issuance of common stock	41,020	14,063,100
Nonvested share-based awards, net of withheld shares	87,034	836,791
Balance, end of period	116,544,954	116,416,900

Common Stock Authorization
On May 2, 2017, the Company's shareholders approved an amendment to the Company's Articles of Incorporation to increase the number of authorized shares of common stock from 150,000,000 to 300,000,000.

At-The-Market Equity Offering Program
No shares were sold under this program during the six months ended June 30, 2017. The Company has 5,868,697 authorized shares remaining available to be sold under the current sales agreements as of July 31, 2017.

Common Stock Dividends
During the six months ended June 30, 2017, the Company declared and paid common stock dividends totaling $0.60 per share. On August 1, 2017, the Company declared a quarterly common stock dividend in the amount of $0.30 per share payable on August 31, 2017 to stockholders of record on August 11, 2017.

Accumulated Other Comprehensive Loss
The following table represents the changes in balances of each component and the amounts reclassified out of accumulated other comprehensive loss related to the Company during the six months ended June 30, 2017 and 2016:

	Forward-starting Interest Rate Swaps	
(Dollars in thousands)	2017	2016
Beginning balance	$(1,401)	$(1,569)
Amounts reclassified from accumulated other comprehensive loss	85	84
Net accumulated other comprehensive income	85	84
Ending balance	$(1,316)	$(1,485)

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Earnings Per Common Share

The following table sets forth the computation of basic and diluted earnings per common share for the three and six months ended June 30, 2017 and 2016.

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands, except per share data)	2017	2016	2017	2016
Weighted average Common Shares outstanding				
Weighted average Common Shares outstanding	116,528,181	105,306,479	116,499,667	103,970,376
Nonvested shares	(1,807,082)	(1,318,730)	(1,801,448)	(1,260,457)
Weighted average Common Shares outstanding—Basic	114,721,099	103,987,749	114,698,219	102,709,919
Weighted average Common Shares outstanding—Basic	114,721,099	103,987,749	114,698,219	102,709,919
Dilutive effect of restricted stock	861,037	691,064	796,283	646,341
Dilutive effect of employee stock purchase plan	92,228	90,732	102,327	114,274
Weighted average Common Shares outstanding—Diluted	115,674,364	104,769,545	115,596,829	103,470,534
Net Income				
Income from continuing operations	$25,224	$ 12,157	$57,082	$ 21,320
Discontinued operations	—	(12)	(12)	(20)
Net income	$25,224	$ 12,145	$57,070	$ 21,300
Basic Earnings Per Common Share				
Income from continuing operations	$0.22	$ 0.12	$0.50	$ 0.21
Discontinued operations	0.00	0.00	0.00	0.00
Net income	$0.22	$ 0.12	$0.50	$ 0.21
Diluted Earnings Per Common Share				
Income from continuing operations	$0.22	$ 0.12	$0.49	$ 0.21
Discontinued operations	0.00	0.00	0.00	0.00
Net income	$0.22	$ 0.12	$0.49	$ 0.21

Incentive Plans

A summary of the activity under the stock-based incentive plans for the three and six months ended June 30, 2017 and 2016 is included in the table below.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Stock-based awards, beginning of period	1,814,039	1,326,746	1,786,497	1,092,262
Granted	23,231	21,374	103,615	321,580
Vested	(39,584)	(36,951)	(92,426)	(102,673)
Stock-based awards, end of period	1,797,686	1,311,169	1,797,686	1,311,169

During the six months ended June 30, 2017 and 2016, the Company withheld 16,581 and 14,442 shares of common stock, respectively, from participants to pay estimated withholding taxes related to shares that vested. No such shares were withheld during the three months ended June 30, 2017.

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In addition to the stock-based incentive plans, the Company maintains the 2000 Employee Stock Purchase Plan (the "Purchase Plan"). A summary of the activity under the Purchase Plan for the three and six months ended June 30, 2017 and 2016 is included in the table below.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Outstanding and exercisable, beginning of period	365,618	361,955	316,321	340,958
Granted	—	—	206,824	198,450
Exercised	(7,595)	(10,839)	(19,030)	(37,528)
Forfeited	(13,451)	(6,208)	(27,233)	(13,890)
Expired	—	—	(132,310)	(143,082)
Outstanding and exercisable, end of period	344,572	344,908	344,572	344,908

Note 7. Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practical to estimate that value.

Cash and cash equivalents - The carrying amount approximates fair value due to the short term maturity of these investments.

Borrowings under the unsecured credit facility due 2020 and unsecured term loan facility due 2019 - The carrying amount approximates fair value because the borrowings are based on variable market interest rates.

Senior Notes and Mortgage Notes payable - The fair value of notes and bonds payable is estimated using cash flow analyses, based on the Company’s current interest rates for similar types of borrowing arrangements.

The table below details the fair values and carrying values for notes and bonds payable at June 30, 2017 and December 31, 2016.

	June 30, 2017		December 31, 2016	
(Dollars in millions)	Carrying Value	Fair Value	Carrying Value	Fair Value
Notes and bonds payable [1]	$1,203.1	$1,208.3	$1,264.4	$1,265.1

(1) Level 3 - Fair value derived from valuation techniques in which one or more significant inputs or significant value drivers is unobservable.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Disclosure Regarding Forward-Looking Statements

This report and other materials the Company has filed or may file with the Securities and Exchange Commission, as well as information included in oral statements or other written statements made, or to be made, by management of the Company, contain, or will contain, disclosures that are “forward-looking statements.” Forward-looking statements include all statements that do not relate solely to historical or current facts and can be identified by the use of words such as “may,” “will,” “expect,” “believe,” “anticipate,” “target,” “intend,” “plan,” “estimate,” “project,” “continue,” “should,” and other comparable terms. These forward-looking statements are based on the current plans and expectations of management and are subject to a number of risks and uncertainties, including the risks described in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016, that could significantly affect the Company’s current plans and expectations and future financial condition and results.

The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Stockholders and investors are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in the Company’s filings and reports, including, without limitation, estimates and projections regarding the performance of development projects the Company is pursuing.

For a detailed discussion of the Company’s risk factors, please refer to the Company’s filings with the Securities and Exchange Commission, including its Annual Report on Form 10-K for the year ended December 31, 2016.

The purpose of this Management's Discussion and Analysis of FInancial Condition and Results of Operations ("MD&A") is to provide an understanding of the Company's consolidated financial condition, results of operations and cash flows by focusing on the changes in certain key measures from year to year. MD&A is provided as a supplement to, and should be read in conjunction with, the Company's Condensed Consolidated Financial Statements and accompanying notes. MD&A is organized in the following sections:

- Liquidity and Capital Resources
- Trends and Matters Impacting Operating Results
- Results of Operations

Liquidity and Capital Resources

Sources and Uses of Cash

The Company’s primary sources of cash include rent receipts from its real estate portfolio based on contractual arrangements with its tenants and sponsors, borrowings under the Company's Unsecured Credit Facility, proceeds from the sales of real estate properties and proceeds from public or private debt or equity offerings.

The Company expects to continue to meet its liquidity needs, including funding additional investments, paying dividends, and funding debt service through cash on hand and restricted cash, cash flows from operations, and the cash flow sources described above. The Company had unencumbered real estate assets with a gross book value of approximately $3.3 billion at June 30, 2017, of which a portion could serve as collateral for secured mortgage financing. The Company believes that its liquidity and sources of capital are adequate to satisfy its cash requirements. The Company cannot, however, be certain that these sources of funds will be available at a time and upon terms acceptable to the Company in sufficient amounts to meet its liquidity needs.

Investing Activities

Cash flows provided by investing activities for the six months ended June 30, 2017 were approximately $17.1 million. Below is a summary of the significant investing activities.

- The Company acquired three medical office buildings totaling 172,636 square feet during the six months ended June 30, 2017 for a total purchase price of $64.3 million, including cash consideration of $52.8 million and the assumption of a mortgage note payable totaling $12.1 million (excluding a fair value premium adjustment of $0.4 million). These properties are located on Fairview Health Services' St. John’s Hospital campus, Sutter Health's Santa Rosa Regional Hospital campus, and Trinity Health's Holy Cross Hospital campus.
- The Company disposed of nine properties during the six months ended June 30, 2017 for a total sales price of $120.2 million, including $84.0 million for four inpatient rehabilitation facilities.
- The Company funded approximately $21.1 million at its development and redevelopment properties.
- Other items funded during the six months ended June 30, 2017 include the following:

first generation tenant improvements and planned capital expenditures relating to properties acquired during the most recent two-year period totaling $2.6 million;

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second generation tenant improvements totaling $9.0 million; and
capital expenditures totaling $8.2 million.

Subsequent Acquisition
On July 31, 2017, the Company acquired a 42,780 square foot medical office building in Los Angeles, California for a purchase price of $16.3 million. The property is located on HCA's West Hills Hospital and Medical Center campus.

Potential Disposition
The Company is under contract to sell an off-campus, 79,980 square foot medical office building located in St. Louis, Missouri. The Company's net investment in the property is approximately $7.4 million at June 30, 2017. The sales price of the building will be approximately $2.6 million. In July 2017, the Company reclassified the property to held for sale and recognized a $5.2 million impairment using level one input. The property was included in the reposition category at 41% occupancy and recognized trailing-twelve month net operating income of $39,000 as of June 30, 2017.

Financing Activities
Cash flows used in financing activities for the six months ended June 30, 2017 were approximately $144.4 million. Inflows from equity related to the Company's dividend reinvestment program and employee stock purchase plan totaled $1.0 million, net of issuance costs incurred. Aggregate cash outflows totaled approximately $145.4 million primarily associated with dividends paid to common stockholders and debt repayments. See Notes 3 and 6 to the Condensed Consolidated Financial Statements for more information about capital markets and financing activities.

Changes in Debt Structure
On May 1, 2017, the Company repaid in full a mortgage note payable bearing interest at a rate of 6.50% per annum with outstanding principal of $0.2 million. The mortgage note encumbered a 60,476 square foot medical office building located in Minnesota.

On June 13, 2017, in connection with the acquisition of a 62,379 square foot medical office property in Washington, D.C., the Company assumed a $12.1 million mortgage note payable (excluding a fair value premium adjustment of $0.4 million). The mortgage note payable has a contractual interest rate of 4.69% per annum (effective rate of 4.27% per annum).

Operating Activities
Cash flows provided by operating activities increased from $59.5 million for the six months ended June 30, 2016 to $84.0 million for the six months ended June 30, 2017. Items impacting cash flows from operations include, but are not limited to, cash generated from property operations, interest payments and the timing related to the payment of invoices and other expenses and receipts of tenant rent.
The Company may, from time to time, sell additional properties and redeploy cash from property sales and mortgage repayments into new investments. To the extent revenues related to the properties being sold and the mortgages being repaid exceed income from these new investments, the Company's results of operations and cash flows could be adversely affected.

Off-Balance Sheet Arrangements
The Company has no off-balance sheet arrangements that are reasonably likely to have a current or future material effect on the Company’s financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

New Accounting Pronouncements

See Note 1 to the Company's Condensed Consolidated Financial Statements accompanying this report for information on new accounting standards.

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Trends and Matters Impacting Operating Results

Management monitors factors and trends important to the Company and the REIT industry to gauge the potential impact on the operations of the Company. In addition to the matters discussed in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, below are some of the factors and trends that management believes may impact future operations of the Company.

Expiring Leases

The Company expects that approximately 15% to 20% of the leases in its multi-tenanted portfolio will expire each year in the ordinary course of business. There are 343 leases totaling 1.2 million square feet in the Company's multi-tenant portfolio that will expire during the remainder of 2017. Approximately 93% of the leases expiring in 2017 are located in buildings on or adjacent to hospital campuses, are distributed throughout the portfolio, and are not concentrated with any one tenant, health system or market area. The Company typically expects to retain 75% to 90% of multi-tenant property tenants upon expiration, and the retention ratio for the first six months of the year has been within this range.

Five single-tenant net leases expire on December 31, 2017. The Company expects each of these leases to be renewed or the properties to be sold to the lessee under its applicable purchase option. The purchase option price is greater than the Company's net investment in the properties. See "Purchase Options" below.

Property Operating Agreement Expirations

Two of the Company's owned real estate properties as of December 31, 2016 were subject to property operating agreements between the Company and a sponsoring health system. These agreements contractually obligate the sponsoring health system to provide to the Company a minimum return on the Company's investment in the property in exchange for the right to be involved in the operating decisions of the property, including tenancy. If the minimum return is not achieved through normal operations of the property, the Company calculates and accrues to property lease guaranty revenue any shortfalls due from the sponsoring health systems under the terms of the property operating agreement. One agreement expired in January 2017, resulting in a decrease of $0.2 million per quarter in property lease guaranty revenue. The remaining agreement will expire in February 2019. The Company recognized $0.2 million of property lease guaranty revenue in the second quarter of 2017.

Operating Expenses

The Company has historically experienced increases in property taxes throughout its portfolio as a result of increasing assessments and tax rates levied across the country. The Company continues its efforts to appeal property tax increases and manage the impact of the increases. In addition, the Company has historically incurred variability in portfolio utilities expense based on seasonality, with the first and third quarters usually reflecting greater amounts. The effects of these operating expense increases are mitigated in leases that have provisions for operating expense reimbursement. As of June 30, 2017, leases for 85% of the Company's multi-tenant leased square footage allow for some recovery of operating expenses, with 55% allowing recovery of all expenses.

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Purchase Options

Additional information about the Company's unexercised purchase options and the amount and basis for determination of the purchase price is detailed in the table below (dollars in thousands):

Year Exercisable	Number of Properties	Gross Real Estate Investment as of June 30, 2017		
		Fair Market Value Method (1)	Non Fair Market Value Method (2)	Total
Current	4	$94,831	$—	$94,831
Remainder of 2017 (3)	7	—	49,003	49,003
2018	—	—	—	—
2019	2	41,521	—	41,521
2020	—	—	—	—
2021	1	—	14,984	14,984
2022	—	—	—	—
2023	—	—	—	—
2024	—	—	—	—
2025	5	18,883	221,929	240,812
2026	—	—	—	—
2027 and thereafter	4	114,536	—	114,536
Total	23	$269,771	$285,916	$555,687

(1) The purchase option price includes a fair market value component that is determined by an appraisal process.

(2) Includes properties with stated purchase prices or prices based on fixed capitalization rates. These properties have purchase prices that are on average 13% greater than the Company's current gross investment.

(3) These seven properties, comprised of five single-tenant net leased buildings and two multi-tenant buildings, are covered by one purchase option with a stated purchase price of approximately $45.2 million, subject to certain contractual adjustments. The Company's aggregate net book value for these properties was $24.3 million at June 30, 2017. The Company recognized net operating income of approximately $3.1 million for the six months ended June 30, 2017 from these properties.

Non-GAAP Financial Measures and Key Performance Indicators

Management believes that net income, as defined by GAAP, is the most appropriate earnings measurement. However, management considers certain non-GAAP financial measures and key performance indicators to be useful supplemental measures of the Company's operating performance. A non-GAAP financial measure is generally defined as one that purports to measure historical or future financial performance, financial position or cash flows, but excludes or includes amounts that would not be so adjusted in the most comparable GAAP measure. Set forth below are descriptions of the non-GAAP financial measures and key performance indicators management considers relevant to the Company's business and useful to investors, as well as reconciliations of these measures to the most directly comparable GAAP financial measures.

The non-GAAP financial measures and key performance indicators presented herein are not necessarily identical to those presented by other real estate companies due to the fact that not all real estate companies use the same definitions. These measures should not be considered as alternatives to net income (determined in accordance with GAAP), as indicators of the Company's financial performance, or as alternatives to cash flow from operating activities (determined in accordance with GAAP) as measures of the Company's liquidity, nor are these measures necessarily indicative of sufficient cash flow to fund all of the Company's needs. Management believes that in order to facilitate a

clear understanding of the Company's consolidated historical operating results, these measures should be examined in conjunction with net income as presented in the Condensed Consolidated Financial Statements and other financial data included elsewhere in this report.

Funds from Operations ("FFO"), Normalized FFO and Funds Available for Distribution ("FAD")
FFO and FFO per share are operating performance measures adopted by the National Association of Real Estate Investment Trusts (“NAREIT”). NAREIT defines FFO as the most commonly accepted and reported measure of a REIT’s operating performance equal to “net income (computed in accordance with GAAP), excluding gains (or losses) from sales of property, plus depreciation and amortization related to real estate properties, leasing commission amortization and after adjustments for unconsolidated partnerships and joint ventures.” The Company follows the NAREIT definition in calculating and presenting FFO and FFO per share.

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Management believes FFO and FFO per share to be supplemental measures of a REIT's performance because they provide an understanding of the operating performance of the Company's properties without giving effect to certain significant non-cash items, primarily depreciation and amortization expense. Historical cost accounting for real estate assets in accordance with GAAP assumes that the value of real estate assets diminishes predictably over time. However, real estate values instead have historically risen or fallen with market conditions. The Company believes that by excluding the effect of depreciation, amortization and gains or losses from sales of real estate, all of which are based on historical costs and which may be of limited relevance in evaluating current performance, FFO and FFO per share can facilitate comparisons of operating performance between periods. The Company reports FFO and FFO per share because these measures are observed by management to also be the predominant measures used by the REIT industry and by industry analysts to evaluate REITs and because FFO per share is consistently reported, discussed, and compared by research analysts in their notes and publications about REITs. For these reasons, management has deemed it appropriate to disclose and discuss FFO and FFO per share. However, FFO does not represent cash generated from operating activities determined in accordance with GAAP and is not necessarily indicative of cash available to fund cash needs. FFO should not be considered as an alternative to net income attributable to common stockholders as an indicator of the Company's operating performance or as an alternative to cash flow from operating activities as a measure of liquidity.

In addition to FFO and FFO per share, the Company presents Normalized FFO, Normalized FFO per share, and funds available for distribution ("FAD"). Normalized FFO is presented by adding to FFO acquisition-related costs, acceleration of deferred financing costs, debt extinguishment costs and other Company-defined normalizing items to evaluate operating performance. FAD is presented by adding to Normalized FFO non-real estate depreciation and amortization, deferred financing fees amortization, share-based compensation expense and provision for bad debts, net; and subtracting maintenance capital expenditures, including second generation tenant improvements and leasing commissions paid and straight-line rent income, net of expense. The Company's definition of these terms may not be comparable to that of other real estate companies as they may have different methodologies for computing these amounts. Normalized FFO and FAD should not be considered as an alternative to net income as an indicator of the Company's financial performance or to cash flow from operating activities as an indicator of the Company's liquidity. Normalized FFO and FAD should be reviewed in connection with GAAP financial measures.

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The table below reconciles net income attributable to common stockholders to FFO, Normalized FFO and FAD for the three and six months ended June 30, 2017 and 2016:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Amounts in thousands, except per share data)	2017	2016	2017	2016
Net Income	$25,224	$12,145	$57,070	$21,300
Gain on sales of properties	(16,124)	(8)	(39,532)	(8)
Impairments of real estate assets	5	—	328	—
Real estate depreciation and amortization	35,421	31,716	70,975	62,517
Total adjustments	19,302	31,708	31,771	62,509
Funds from Operations Attributable to Common Stockholders	$44,526	$43,853	$88,841	$83,809
Acquisition and pursuit costs [1]	785	232	1,371	1,850
Pension termination	—	4	—	4
Revaluation of awards upon retirement	—	—	—	89
Normalized Funds from Operations Attributable to Common Stockholders	$45,311	$44,089	$90,212	$85,752
Non-real estate depreciation and amortization	1,539	1,360	2,894	2,750
Provision for bad debt, net	105	78	171	39
Straight-line rent, net	(1,623)	(1,907)	(3,218)	(3,855)
Stock-based compensation	2,453	1,850	5,067	3,709
Total non-cash items	2,474	1,381	4,914	2,643
2nd generation TI	(3,680)	(5,559)	(8,957)	(9,761)
Leasing commissions paid	(984)	(1,587)	(2,568)	(2,666)
Capital additions	(5,667)	(5,653)	(8,187)	(7,751)
Funds Available for Distribution	$37,454	$32,671	$75,414	$68,217
Funds from Operations per Common Share—Diluted	$0.38	$0.42	$0.77	$0.81
Normalized Funds from Operations per Common Share—Diluted	$0.39	$0.42	$0.78	$0.83
Weighted Average Common Shares Outstanding—Diluted	115,674	104,770	115,597	103,471

(1) Acquisition and pursuit costs include third party and travel costs related to the pursuit of acquisitions and developments. Beginning in 2017, FFO and FAD are normalized for all acquisition and pursuit costs. Prior to 2017, FFO and FAD were normalized for acquisition and pursuit costs associated with only those acquisitions that closed in the period. These changes were prompted by the Company's adoption of ASU 2017-01 which was effective January 1, 2017.

Net Operating Income

Net operating income ("NOI") and same store NOI are non-GAAP historical financial measures of performance. Management considers same store NOI a supplemental performance measure because it allows investors, analysts and Company management to measure unlevered property-level operating results. The Company defines NOI as operating revenues (property operating revenue, single-tenant net lease revenue, and property lease guaranty revenue) less property operating expenses related specifically to the property portfolio. NOI excludes straight-line rent, general and administrative expenses, interest expense, depreciation and amortization, gains and losses from property sales, property management fees, amortization of non-cash items, lease termination fees and other revenues and expenses not specifically related to the property portfolio. Same store NOI is historical and not necessarily indicative of future results.

The following table reflects the Company's same store NOI for the three months ended June 30, 2017 and 2016.

	Same Store NOI for the

(Dollars in thousands)	Number of Properties	Gross Investment at June 30, 2017	Three Months Ended June 30, 2017	2016
Multi-tenant Properties	137	$2,492,031	$45,902	$44,085
Single-tenant Net Lease Properties	24	524,444	12,251	12,459
Total	161	$3,016,475	$58,153	$56,544

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Properties included in the same store analysis are stabilized properties that have been included in operations and were consistently reported as leased and stabilized properties for the duration of the year-over-year comparison period presented. Accordingly, properties that were recently acquired or disposed of, properties classified as held for sale, and properties in stabilization or conversion from stabilization are excluded from the same store analysis. In addition, the Company excludes properties that meet any of the following Company-defined criteria to be included in the reposition property group:

- Properties having less than 60% occupancy that is expected to last at least two quarters;
- Properties that experience a loss of occupancy over 30% in a single quarter;
- Properties with negative net operating income that is expected to last at least two quarters; or
- Condemnation.

Any recently acquired property will be included in the same store pool once the Company has owned the property for eight full quarters. Development properties will be included in the same store pool eight full quarters after substantial completion. Any property included in the reposition property group will be included in the same store analysis once occupancy has increased to 60% or greater with positive net operating income and has remained at that level for eight full quarters.

The following tables reconcile net income to same store NOI and the same store property count to the total owned real estate portfolio:

Reconciliation of Same Store NOI:

	Three Months Ended June 30,	
(Dollars in thousands)	2017	2016
Net income	$25,224	$12,145
Loss (income) from discontinued operations	—	12
Income from continuing operations	25,224	12,157
Other income (expense)	(1,881)	14,725
General and administrative expense	8,005	7,756
Depreciation and amortization expense	34,823	31,290
Other expenses [1]	2,204	1,696
Straight-line rent revenue	(1,783)	(2,091)
Other revenue [2]	(1,211)	(1,465)
NOI	65,381	64,068
NOI not included in same store	(7,228)	(7,524)
Same store NOI	$58,153	$56,544

(1) Includes acquisition and pursuit costs, bad debt, above and below market ground lease intangible amortization, leasing commission amortization and ground lease straight-line rent.

(2) Includes interest and other income, mortgage interest income, above and below market lease intangible amortization, lease inducement amortization, lease terminations and TI amortization.

Reconciliation of Same Store Property Count:

	Property Count as of

	June 30, 2017
Same Store Properties	161
Acquisitions	19
Development Conversion	2
Reposition	15
Total Owned Real Estate Properties	197

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Results of Operations

Three Months Ended June 30, 2017 Compared to Three Months Ended June 30, 2016

The Company's results of operations for the three months ended June 30, 2017 compared to the same period in 2016 were significantly impacted by acquisitions, dispositions, gains, impairments recorded and capital markets transactions.

Revenues

Total revenues increased $2.6 million, or 2.5%, to approximately $105.2 million for the three months ended June 30, 2017 compared to $102.6 million in the prior year period and is comprised of the following:

	Three Months Ended June 30,		Change	
(Dollars in thousands)	2017	2016	$	%
Property operating	$90,360	$83,283	$7,077	8.5 %
Single-tenant net lease	12,726	16,098	(3,372)	(20.9)%
Straight-line rent	1,783	2,091	(308)	(14.7)%
Rental income	104,869	101,472	3,397	3.3 %
Other operating	376	1,170	(794)	(67.9)%
Total Revenues	$105,245	$102,642	$2,603	2.5 %

Property operating income increased $7.1 million, or 8.5%, from the prior year period primarily as a result of the following activity:

- Acquisitions and developments in 2016 and 2017 contributed $4.3 million.
- Leasing activity including contractual rent increases contributed $3.9 million.
- Dispositions in 2016 and 2017 resulted in a decrease of $1.1 million.

Single-tenant net lease revenue decreased $3.4 million, or 20.9%, from the prior year period primarily as a result of the following activity:

- Dispositions in 2016 and 2017 resulted in a decrease of $2.8 million.
- Reduction in lease revenue of $0.5 million upon tenant vacate and classification to held for sale.
- Reduction in lease revenue of $0.4 million upon tenant renewal.
- Contractual rent increases contributed $0.1 million.
- Acquisitions in 2017 contributed $0.2 million.

Straight-line rent decreased $0.3 million, or 14.7%, from the prior year period primarily as a result of the following activity:

- Net leasing activity including contractual rent increases and the effects of rent abatements that expired resulted in a decrease of $0.4 million.
- Dispositions in 2016 and 2017 resulted in a decrease of $0.1 million.
- Acquisitions in 2016 and 2017 resulted in an increase of $0.2 million.

Other operating revenue decreased $0.8 million, or 67.9%, from the prior year period primarily as a result of the expiration of four property operating agreements in 2016 and 2017.

Expenses

Property operating expenses increased $1.9 million, or 5.3%, for the three months ended June 30, 2017 compared to the prior year period primarily as a result of the following activity:

- Acquisitions and developments in 2016 and 2017 resulted in an increase of $1.5 million.
- Increases in portfolio operating expenses as follows:

property tax of approximately $0.1 million;

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compensation-related expenses of approximately $0.1 million;
janitorial expense of approximately $0.1 million; and
utilities expense of approximately $0.4 million.

- Dispositions in 2016 and 2017 resulted in a decrease of $0.3 million.

General and administrative expenses increased approximately $0.2 million, or 3.2%, for the three months ended June 30, 2017 compared to the prior year period primarily as a result of the following activity:

- Increase in performance-based compensation expense of $0.4 million.
- Increase in payroll compensation of $0.1 million.
- Decreases in professional fees and other administrative costs of $0.2 million.

Depreciation and amortization expense increased $3.5 million, or 11.3%, for the three months ended June 30, 2017 compared to the prior year period primarily as a result of the following activity:

- Acquisitions and developments in 2016 and 2017 resulted in an increase of $2.4 million.
- Various building and tenant improvement expenditures resulted in an increase of $3.3 million.
- Dispositions in 2016 and 2017 resulted in a decrease of $1.5 million.
- Assets that became fully depreciated resulted in a decrease of $0.7 million.

Other income (expense)

In the second quarter of 2017, the Company recorded gains of approximately $16.1 million on the sale of two properties and an immaterial impairment on the sale of one property. There were no such transactions in the second quarter of 2016.

Interest expense decreased $0.5 million for the three months ended June 30, 2017 compared to the prior year period. The components of interest expense are as follows:

	Three Months Ended June 30,		Change	
(Dollars in thousands)	2017	2016	$	%
Contractual interest	$13,854	$14,355	$(501)	(3.5)%
Net discount/premium accretion	53	(31)	84	(271.0)%
Deferred financing costs amortization	612	722	(110)	(15.2)%
Interest rate swap amortization	42	42	—	— %
Interest cost capitalization	(246)	(273)	27	(9.9)%
Total interest expense	$14,315	$14,815	$(500)	(3.4)%

Contractual interest expense decreased $0.5 million primarily due to the following activity:

- Unsecured Credit Facility repayments resulted in a decrease in interest expense of approximately $0.3 million.
- Mortgage notes payable repayments resulted in a decrease in interest expense of approximately $0.2 million.

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Results of Operations

Six Months Ended June 30, 2017 Compared to Six Months Ended June 30, 2016

The Company's results of operations for the six months ended June 30, 2017 compared to the same period in 2016 were significantly impacted by acquisitions, dispositions, gains, impairments recorded and capital markets transactions.

Revenues

Total revenues increased $7.2 million, or 3.5%, to approximately $209.8 million for the six months ended June 30, 2017 compared to $202.7 million in the prior year period and is comprised of the following:

	Six Months Ended June 30,		Change	
(Dollars in thousands)	2017	2016	$	%
Property operating	$178,427	$163,785	$14,642	8.9 %
Single-tenant net lease	26,996	32,204	(5,208)	(16.2)%
Straight-line rent	3,534	4,223	(689)	(16.3)%
Rental income	208,957	200,212	8,745	4.4 %
Other operating	857	2,451	(1,594)	(65.0)%
Total revenues	$209,814	$202,663	$7,151	3.5 %

Property operating income increased $14.6 million, or 8.9%, from the prior year period primarily as a result of the following activity:

- Acquisitions and developments in 2016 and 2017 contributed $9.5 million.
- Leasing activity including contractual rent increases contributed $7.2 million.
- Dispositions in 2016 and 2017 resulted in a decrease of $2.0 million.

Single-tenant net lease revenue decreased $5.2 million, or 16.2%, from the prior year period primarily as a result of the following activity:

- Dispositions in 2016 and 2017 resulted in a decrease of $4.4 million.
- Reduction in lease revenue of $1.4 million upon tenant vacate and classification to held for sale.
- Acquisitions in 2017 contributed to $0.3 million.
- Contractual rent increases contributed $0.3 million.

Straight-line rent decreased $0.7 million, or 16.3%, from the prior year period primarily as a result of the following activity:

- Net leasing activity including contractual rent increases and the effects of prior year rent abatements that expired resulted in a decrease of $1.2 million.
- Acquisitions and developments in 2016 and 2017 resulted in an increase of $0.5 million.

Other operating revenue decreased $1.6 million, or 65.0%, from the prior year period primarily as a result of the expiration of four property operating agreements in 2016 and 2017.

Expenses

Property operating expenses increased $4.4 million, or 6.1%, for the six months ended June 30, 2017 compared to the prior year period primarily as a result of the following activity:

- Acquisitions and developments in 2016 and 2017 resulted in an increase of $3.4 million.

- Increases in portfolio operating expenses as follows:
property tax of approximately $0.6 million;
compensation-related expenses of approximately $0.3 million;
janitorial and other expense of $0.3 million; and

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utilities expense of approximately $0.5 million.
- Dispositions in 2016 and 2017 resulted in a decrease of $0.7 million.

General and administrative expenses increased approximately $0.9 million, or 5.5%, for the six months ended June 30, 2017 compared to the prior year period primarily as a result of the following activity:
- Increase in performance-based compensation expense of $0.8 million.
- Increase in payroll compensation of $0.2 million.
- Decrease in professional fees and other administrative costs of $0.1 million.

Depreciation and amortization expense increased $7.6 million, or 12.3%, for the six months ended June 30, 2017 compared to the prior year period primarily as a result of the following activity:
- Acquisitions and developments in 2016 and 2017 resulted in an increase of $5.3 million.
- Various building and tenant improvement expenditures resulted in an increase of $5.7 million.
- Dispositions in 2016 and 2017 resulted in a decrease of $2.1 million.
- Assets that became fully depreciated resulted in a decrease of $1.3 million.

Other income (expense)
In the second quarter of 2017, the Company recorded gains of approximately $39.5 million on the sale of seven properties and an impairment charge of approximately $0.3 million of one property. There were no such transactions in the 2016 period.
Interest expense decreased $1.2 million for the six months ended June 30, 2017 compared to the prior year period. The components of interest expense are as follows:

	Six Months Ended June 30,		Change	
(Dollars in thousands)	2017	2016	$	%
Contractual interest	$27,658	$28,718	$(1,060)	(3.7)%
Net discount/premium accretion	105	(60)	165	(275.0)%
Deferred financing costs amortization	1,224	1,462	(238)	(16.3)%
Interest rate swap amortization	84	85	(1)	(1.2)%
Interest cost capitalization	(484)	(452)	(32)	7.1 %
Total interest expense	$28,587	$29,753	$(1,166)	(3.9)%

Contractual interest expense decreased $1.1 million primarily due to the following activity:
- Unsecured Credit Facility repayments resulted in a decrease in interest expense of approximately $0.5 million.
- Mortgage notes payable repayments resulted in a decrease in interest expense of approximately $0.5 million.
- Unsecured Term Loan repayments resulted in a decrease in interest expense of approximately $0.1 million.

Item 3. Quantitative and Qualitative Disclosures about Market Risk
The Company is exposed to market risk in the form of changing interest rates on its debt and mortgage notes. Management uses regular monitoring of market conditions and analysis techniques to manage this risk. During the six months ended June 30, 2017, there were no material changes in the quantitative and qualitative disclosures about market risks presented in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016.

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Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")), as of the end of the period covered by this report. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports it files or submits under the Exchange Act.

Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II—OTHER INFORMATION

Item 1. Legal Proceedings

The Company is, from time to time, involved in litigation arising in the ordinary course of business. The Company is not aware of any pending or threatened litigation that, if resolved against the Company, would have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

Item 1A. Risk Factors

In addition to the other information set forth in this report, an investor should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, which could materially affect the Company's business, financial condition or future results. The risks, as described in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, are not the only risks facing the Company. Additional risks and uncertainties not currently known to management or that management currently deems immaterial also may materially, adversely affect the Company's business, financial condition, operating results or cash flows.

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Item 6. Exhibits

Exhibit	Description
Exhibit 3.1	Second Articles of Amendment and Restatement of the Company, as amended[1]
Exhibit 3.2	Amended and Restated Bylaws of the Company, as amended[1]
Exhibit 4.1	Specimen Stock Certificate[2]
Exhibit 4.2	Indenture, dated as of May 15, 2001, by and between the Company and Branch Banking and Trust Company, as trustee (as successor to the trustee named therein)[3]
Exhibit 4.3	Fourth Supplemental Indenture, dated December 13, 2010, by and between the Company and Branch Banking and Trust Company, as Trustee (as successor to the trustee named therein)[4]
Exhibit 4.4	Form of 5.750% Senior Notes due 2021 (set forth in Exhibit B to the Fourth Supplemental Indenture filed as Exhibit 4.5 thereto)[4]
Exhibit 4.5	Fifth Supplemental Indenture, dated March 26, 2013, by and between the Company and Branch Banking and Trust Company, as Trustee (as successor to the trustee named therein)[5]
Exhibit 4.6	Form of 3.75% Senior Notes due 2023 (set forth in Exhibit B to the Fifth Supplemental Indenture filed as Exhibit 4.7 thereto)[5]
Exhibit 4.7	Sixth Supplemental Indenture, dated April 24, 2015, by and between the Company and Branch Banking and Trust Company, as Trustee (as successor to the trustee named therein)[6]
Exhibit 4.8	Form of 3.875% Senior Notes due 2025 (set forth in Exhibit B to the Sixth Supplemental Indenture filed as Exhibit 4.9 thereto)[6]
Exhibit 11	Statement re: Computation of per share earnings (filed herewith in Note 6 to the Condensed Consolidated Financial Statements)
Exhibit 31.1	Certification of the Chief Executive Officer of Healthcare Realty Trust Incorporated pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
Exhibit 31.2	Certification of the Chief Financial Officer of Healthcare Realty Trust Incorporated pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
Exhibit 32	Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith)
Exhibit 101.INS	XBRL Instance Document (furnished electronically herewith)
Exhibit 101.SCH	XBRL Taxonomy Extension Schema Document (furnished electronically herewith)

Exhibit 101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (furnished electronically herewith)
Exhibit 101.LAB	XBRL Taxonomy Extension Labels Linkbase Document (furnished electronically herewith)
Exhibit 101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (furnished electronically herewith)
Exhibit 101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (furnished electronically herewith)

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(1) Filed as an exhibit to the Company's Form 8-K filed May 5, 2017 and hereby incorporated by reference.
(2) Filed as an exhibit to the Company’s Registration Statement on Form S-11 (Registration No. 33-60506) previously filed pursuant to the Securities Act of 1933 and hereby incorporated by reference.
(3) Filed as an exhibit to the Company's Form 8-K filed May 17, 2001 and hereby incorporated as reference.
(4) Filed as an exhibit to the Company’s Form 8-K filed December 13, 2010 and hereby incorporated by reference.
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(6) Filed as an exhibit to the Company's Form 8-K filed April 24, 2015 and hereby incorporated by reference.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HEALTHCARE REALTY TRUST INCORPORATED

By: /s/ J. CHRISTOPHER DOUGLAS
J. Christopher Douglas
Executive Vice President and Chief Financial Officer

Date: August 2, 2017

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