



February 23, 2004

To the Shareholders of Philom Bios Inc.

While we were pleased to welcome shareholders and other business associates and visitors from the business community to the Philom Bios Annual Meeting in Saskatoon on February 16, 2004, in recognition of those shareholders unable to attend, I am pleased to provide a brief summary of the business of the meeting and of my comments to the shareholders.

Additionally, I also enclose the Consolidated Financial Statements (unaudited) and Management Discussion and Analysis for the three months ended December 31, 2003 for your information and review.

### **Appointment of Board of Directors and Auditors**

The formal portion of our Annual meeting required the shareholders to vote on the re-appointment of Directors and our Auditors. I am pleased to advise that our nominated slate of Directors was re-elected and Deloitte & Touche reappointed as the Company's auditors.

The Company is fortunate to enjoy the broad range of experience and the superior standards of corporate governance that the Directors bring to the Company. I'm delighted that the collective and individual strengths of these Directors will continue at the Board table. The list of Directors, with brief biographical notes, is included in your Annual Report.

### **Building Executive Capacity**

Last Fall the Board implemented a succession plan to engage a President to add strength to our Executive capacity and provide a smooth and transparent transition pathway for my successor. As the result of a successful executive search the Board of Directors was pleased to introduce to the shareholders Mr. Calvin Sonntag, who joined us on February 16<sup>th</sup> as President of the Company.

With an educational background in plant science and business degrees, and over 14 years of business experience in increasingly senior positions with AgrEvo Canada, and with Monsanto Canada, Calvin's blend of technology, business skills, and broad experience in the agricultural sector is a strong addition to our existing Executive team of Sanford Gleddie - VP Research & Business Development, Trevor Thiessen - VP Commercial Operations, and David Cortens - CFO and Corporate Secretary.

I will continue in my role as CEO and Board Chairman and I look forward to working closely with all members of the Executive team. Shareholders can be assured that we have the executive and management talent in place to build long-term sustainable growth in our business.

## **Investing for Growth**

The Board is committed to building shareholder value, and has directed Management to set a course to achieve sustained business growth.

In 2002, the Board endorsed a growth investment strategy to aggressively drive business forward based on two interrelated thrusts: to develop new formulations and new products to increase our position in current markets, and to expand to new crops and to new markets. This investment, in the annual range of \$1.3 million cannot be capitalized, and therefore will temporarily constrain earnings until the returns from this investment are realized.

While there is always uncertainty in research and development, our calculations indicate we have a reasonable expectation of a return on investment in excess of 30%. The impact of the investment starts modestly this year with the introduction of TagTeam Peat for soybean, and increases yearly to full force in 2008, and continuing thereafter. This anticipated revenue growth refers only to sales in our current markets in Western Canada, North Dakota, and the contiguous areas of the adjacent states.

The other thrust of our growth plan is expansion into new markets. We have identified certain areas, particularly in the United States, as priority business expansion targets. Market expansion plans will form a key part of our 2005 — 2007 Business Plans with revenues from these new markets expected to further increase the returns from our growth investment.

This investment in the future is a business imperative. Our competitors see the value we have created in the marketplace with our inoculants since our first product introduction in 1989, and they are becoming more aggressive. We must run harder and faster to hold and build our position at home, and establish our products in new markets. Our growth investment is the route to larger market share in a larger market, and sustained financial performance.

## **The 2004 Crop Year**

Many farmers are relieved to put 2003 behind them. The effects of drought, BSE, grasshoppers, and an escalating dollar combined to yield the lowest net farm income in history. While moisture levels are certainly improved across most of the grain belt, good spring rains are needed for anything like good crops.

The net farm income picture is certainly dismal, but keep in mind that the numbers are aggregate, and not all farmers had a bad year. It's important to remember that our primary customer is the successful grower, the CEO of their farm business, who manages for maximum output and invests in the inputs to produce a crop he can be proud of and to generate optimum yields. These growers seek out retailers which deliver the highest level of agronomic advice, and are committed to superior value-add service. Our relationships with these growers and these leading retailers, built over the past six years, are our greatest marketing asset. We have built these relationships because our customers have experienced that we practice our Purpose in all our affairs — ***Serve the needs of individual customers by delivering high value inoculants.*** We are resolved to continue to fulfill our Purpose.

Farming is the most risk intensive profession in the world and this season has the usual array of uncertainties. Yet, we are encouraged by the response of our customers so far this year in terms of early product orders, and have a reasonable expectation of achieving a 20% revenue gain in 2004.

Your comments and questions on any aspect of the Company are welcome. We encourage you to visit our website at [www.philombios.com](http://www.philombios.com) for further information on the Company or feel free to call me anytime at (306) 668-8223.

Yours truly,

*“John Cross”*  
John Cross  
CEO and Chairman

*Enclosure*



## **CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE MONTHS ENDED DECEMBER 31, 2003**

**(Unaudited)**



**PHILOM BIOS INC.**  
**Management Discussion and Analysis**  
**For the three months ended December 31, 2003**

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PHILOM BIOS INC. reported a net loss for the three months ended December 31, 2003 of \$1.3 million or \$0.41 per share. This loss is within budgetary expectations as the Company fully expects to incur operating losses throughout the early part of the year due to its business cycle. During this time, the Company is engaged in the production of inventories to meet the demands of a spring selling season.

**Operations**

Total operating costs for the quarter amounted to \$1.32 million as compared to \$1.26 million in the comparable prior quarter. This small increase over the prior year reflects the effect of our growth investment commitment to expanded research and development and an increase in general and administrative expenses associated with certain personnel changes. In offset, marketing and sales expenses were down slightly, mainly due to the timing of certain promotional activities.

Since almost all sales are realized over the period of February to May, the Company does not record any significant revenues during the first quarter. However, the Company does encourage early commitment to its products through certain early order and payment incentive programs. In contrast to prior year, wherein the Company required short term borrowing to fund its operations, these early cash inflows, received subsequent to December, have not only eliminated the need for any interim financing prior to the main sales season, but have also provided significant optimism regarding anticipated overall results.

**Liquidity and Capital Resources**

For the first quarter, cash balances have declined by \$3.4 million as the Company has used up funds to finance ongoing operations and build up inventories. In addition, the Company has expended \$77 thousand on purchases of fixed assets and \$75 thousand in debt reduction payments. The significant draw down of cash reserves is fully consistent with past years since most cash inflows are collected in early order payments or after the primary sales season.

**Outlook Update**

The success of the early order programs in both the Canadian and US market, together with early positive feedback from various sales and distribution sources, gives the Company high expectations it will achieve its 2004 growth targets.

Due to the nature of the agricultural industry, there will always be uncertainty as to final outcomes until the completion of the entire seeding season. However, initial market assessments point to stability or growth in total acres for all main crops using our products. In addition, the Company anticipates gaining market share for all products, particularly in the U.S., arising from the success of our marketing and business development strategies which reflect our commitment to serve the needs of our individual customers by delivering high value inoculants.



**PHILOM BIOS INC.**  
**Management Discussion and Analysis**  
**For the three months ended December 31, 2003**

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Located in Saskatoon, Canada with over 55 employees in a wide range of research, manufacturing, marketing and management positions, Philom Bios is the leading inoculant producer in Western Canada. Philom Bios is the only Canadian-owned company with high-value inoculants serving the needs of Prairie farmers, and has a 20-year commitment to western farmers through a dynamic partnership with distributors and leading retailers.

February 23, 2004

*"John Cross"*

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John Cross, Chief Executive Officer

*"David A. Cortens"*

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David Cortens, Chief Financial Officer



**Philom Bios Inc.**  
**Consolidated Statement of Earnings and Deficit**  
**for the three months ended December 31, 2003 and 2002**  
**(in thousands of Canadian dollars except earnings per share)**  
**(unaudited)**

|  | Three months ended     |                        |
|--|------------------------|------------------------|
|  | December               |                        |
|  | <u>2003</u>            | <u>2002</u>            |
| <b>Sales</b>                               | \$ <b>6</b>            | \$ -                   |
| <b>Cost of Sales</b>                       | <u>(12)</u>            | <u>(3)</u>             |
| <b>Gross Margin (Loss)</b>                 | <u>(6)</u>             | <u>(3)</u>             |
| <b>Expenses</b>                            |                        |                        |
| Research and development, net              | 449                    | 382                    |
| Marketing and sales                        | 550                    | 591                    |
| General and administrative                 | 318                    | 308                    |
| Other expenses (income)                    | <u>10</u>              | <u>(11)</u>            |
|  | <u>1,327</u>           | <u>1,270</u>           |
| <b>Earnings (Loss) From Operations and</b> |                        |                        |
| <b>Before Income Taxes</b>                 | <b>(1,333)</b>         | <b>(1,273)</b>         |
| <b>Income Taxes (Note 2)</b>               |                        |                        |
| Current (expense) recovery                 | <u>-</u>               | <u>-</u>               |
| <b>Net Earnings (Loss)</b>                 | <b>(1,333)</b>         | <b>(1,272)</b>         |
| Retained earnings, beginning of period     | <u>548</u>             | <u>491</u>             |
| <b>Deficit, End of Period</b>              | <b>\$ <u>(785)</u></b> | <b>\$ <u>(781)</u></b> |
| <br>                                       |                        |                        |
| Basic (loss) earnings per share (Note 4)   | \$ (0.41)              | \$ (0.40)              |

(see accompanying notes)



**Philom Bios Inc.**  
**Consolidated Balance Sheet**  
**as at December 31, 2003**  
**(in thousands of Canadian dollars)**  
**(unaudited)**

|   | December 31<br>2003 | As At<br>December 31<br>2002 | September 30<br>2003<br>(audited) |
|---|---------------------|------------------------------|-----------------------------------|
| <b>Current Assets</b>                                     |                     |                              |                                   |
| Cash and short-term deposits                              | \$ 1,585            | \$ 1,961                     | \$ 4,977                          |
| Accounts receivable                                       | 90                  | 139                          | 145                               |
| Income tax receivable                                     | -                   | 200                          | 0                                 |
| Inventory (Note 3)  | 3,052               | 2,681                        | 1,591                             |
| Prepays and deposits                                      | 145                 | 122                          | 87                                |
|   | <u>4,872</u>        | <u>5,103</u>                 | <u>6,800</u>                      |
| <b>Property, Plant and Equipment</b>                      | 907                 | 1,014                        | 901                               |
| <b>Patents and Trademarks</b>                             | 109                 | 116                          | 110                               |
|   | <u>1,016</u>        | <u>1,131</u>                 | <u>1,011</u>                      |
|   | <u>\$ 5,888</u>     | <u>\$ 6,234</u>              | <u>\$ 7,811</u>                   |
| <b>Current Liabilities</b>                                |                     |                              |                                   |
| Accounts payable and accrued charges                      | \$ 977              | \$ 1,094                     | \$ 1,469                          |
| Deferred development assistance                           | 144                 | 256                          | 174                               |
| Current portion long term debt                            | 64                  | 90                           | 96                                |
|   | <u>1,185</u>        | <u>1,440</u>                 | <u>1,739</u>                      |
| <b>Long-Term Debt</b>                                     | 102                 | 219                          | 146                               |
|   | <u>1,287</u>        | <u>1,659</u>                 | <u>1,885</u>                      |
| <b>Shareholders' Equity</b>                               |                     |                              |                                   |
| Share capital   |                     |                              |                                   |
| Authorized: unlimited number of<br>common shares (Note 6) | 5,385               | 5,356                        | 5,381                             |
| Retained (deficit) earnings                               | (784)               | (781)                        | 544                               |
|   | <u>4,601</u>        | <u>4,575</u>                 | <u>5,925</u>                      |
|   | <u>\$ 5,888</u>     | <u>\$ 6,234</u>              | <u>\$ 7,810</u>                   |

(see accompanying notes)



**Philom Bios Inc.**  
**Consolidated Statement of Cash Flows**  
**for the three months ended December 31, 2003 and 2002**  
**(in thousands of Canadian dollars)**  
**(unaudited)**

|   | Three months ended<br>December 31 |                 |
|---|-----------------------------------|-----------------|
|   | 2003                              | 2002            |
| <b>Cash Flows From (Used in) the Following</b>          |                                   |                 |
| <b>Operating</b>  |                                   |                 |
| Net earnings (loss)                                     | \$ (1,333)                        | \$ (1,272)      |
| Add back non-cash expenses:                             |                                   |                 |
| Depreciation and amortization                           | 72                                | 79              |
|   | (1,261)                           | (1,193)         |
| Changes in non-cash working capital:                    |                                   |                 |
| Accounts receivable                                     | 55                                | 133             |
| Inventories   | (1,461)                           | (1,188)         |
| Prepays and deposits                                    | (58)                              | 6               |
| Accounts payable and accrued charges                    | (489)                             | (4)             |
| Deferred development assistance                         | (30)                              | (2)             |
|   | (3,244)                           | (2,248)         |
| <b>Investing</b>  |                                   |                 |
| Additions to property, plant and equipment              | (77)                              | (67)            |
|   | (77)                              | (67)            |
| <b>Financing</b>  |                                   |                 |
| Repayment of long term debt                             | (76)                              | (21)            |
| Proceeds from issuance of common shares                 | 4                                 | 4               |
|   | (72)                              | (17)            |
| <b>Net Increase (Decrease) in Cash</b>                  | (3,393)                           | (2,332)         |
| <b>Cash Position, Beginning of Period</b>               | 4,977                             | 4,293           |
| <b>Cash Position, End of Period</b>                     | \$ <b>1,584</b>                   | \$ <b>1,961</b> |
| <b>Supplemental Disclosure of Cash Flow Information</b> |                                   |                 |
| Interest paid   | \$ 5                              | \$ 7            |
| Income taxes paid                                       | \$ -                              | \$ -            |
| Income taxes received                                   | \$ -                              | \$ -            |

(see accompanying notes)



**Philom Bios Inc.**  
**Notes to Interim Consolidated Financial Statements**  
**for the three months ended December 31, 2003**  
**(unaudited)**

**1. DESCRIPTION OF BUSINESS**

Philom Bios Inc. is incorporated under the Business Corporations Act of Saskatchewan. The Company researches, develops, manufactures and sells microbial inoculants to serve the needs of farmers.

The interim consolidated financial statements should be read in conjunction with, and are based on, the same accounting policies as contained in the Company's September 30, 2003 Annual Report.

These statements are presented on a consolidated basis. The Company's wholly owned US subsidiary is accounted for using the temporal method. Under this method, monetary assets and liabilities are translated at the exchange rates in effect at the balance sheet dates. Non-monetary assets and liabilities are translated at historical rates. Revenues and expenses are translated at average rates for the period. Translation exchange gains or losses are reflected in net earnings. Intercompany balances and transactions have been eliminated.

**2. INCOME TAXES**

No tax provision was shown due to the uncertainty relating to the Company's ability to utilize current quarter or carry forward losses to reduce taxable income.

**3. INVENTORY**

| (000's)                          | December 31<br>2003 | December 31<br>2002 | September 30<br>2003<br>(audited) |
|----------------------------------|---------------------|---------------------|-----------------------------------|
| Raw materials & work in progress | \$ 2,644            | \$ 2,392            | \$ 1,529                          |
| Finished goods                   | 408                 | 289                 | 62                                |
|                                  | <u>\$ 3,052</u>     | <u>\$ 2,681</u>     | <u>\$ 1,591</u>                   |



**Philom Bios Inc.**  
**Notes to Interim Consolidated Financial Statements**  
**for the three months ended December 31, 2003**  
**(unaudited)**

**4. SHARE CAPITAL**

As at December 31, 2003, 3,231,221 (September 30, 2003 – 3,230,141) shares were issued and outstanding. Earnings per share are calculated using the weighted average number of shares outstanding during the period, which was 3,230,552.

The Company has employee, officer and director stock option plans. These plans are more fully described in the 2003 Annual Report.

During the quarter 1,080 options were exercised to purchase shares for cash proceeds of \$4,320. During the quarter 3,780 options expired.

**5. SEASONALITY**

The Company's sales are seasonal. The majority of sales are recorded in the period January to June, which covers the 2<sup>nd</sup> and 3<sup>rd</sup> quarters. Timing of customer purchases will vary each year and sales can be expected to shift from one quarter to another. Interim results are not indicative of the results expected for the fiscal year.

**6. RELATED PARTY TRANSACTION**

The Company leases manufacturing and warehouse facilities from a company owned by a shareholder. This transaction is in the normal course of operations and is measured at the exchange amount, which represents market value.

**7. COMPARATIVE FIGURES**

Certain of the comparative figures have been reclassified to conform with the current period's presentation.