

# Enabling technologies for improved medical care



Oridion Systems Ltd.  
Letter to Shareholders  
November 2004



Dear Shareholder,

Following improved results during Oridion's first and second quarter of 2004, I am pleased to once again report improved results for Oridion's third quarter of 2004. This is now the 11<sup>th</sup> consecutive quarter, compared to the same periods in the previous year in which Oridion is able to report revenue growth. For the first time, Oridion is proud to report a quarterly operating profit for the business excluding a one-time non-recurring charge. I am pleased to present you with the following report on Oridion's financial results and other significant events and achievements for the quarter.

### **Financial results in Q3, 2004**

#### ***Revenues—***

Company revenues for the third quarter of 2004 increased by 26% to USD 6.3 million compared to USD 5.0 million for the third quarter of 2003. Revenues for the nine month period ending September 30, 2004 increased by 19% to USD 15.6 million compared to USD 13.1 million for the same period last year. Revenue growth continues to be driven primarily by the rapid increase in sales of Oridion's consumable products - a result of both an increased consumable product line offering, and increased usage rates of capnography in a growing number of medical care settings. Consumable sales constituted over 32% of total sales during both the third quarter and the first nine months of 2004.

The Company's gross profit for the third quarter of 2004 increased to USD 3.0 million compared to USD 2.1 million for the same period last year. The gross margin for the third quarter increased to 48.3% compared to 43.0% for the third quarter of 2003, due mainly to the increase in sales of Oridion's higher margin consumable products. The gross margin for the nine-month period ending September 30, 2004 improved to 47.2% compared to 43.5% for the same period last year.

#### ***Operating Expenses—***

Total operating expenses including a one-time non-recurring charge totaled USD 3.7 million for the third quarter of 2004 compared to USD 3.3 million for the third quarter of 2003. On a pro-forma basis, excluding the one-time non-recurring charge of USD 0.9 million, the operating expenses would have totaled USD 2.9 million, a decrease of 13.7% compared to the third quarter of 2003. This reduction is a result of lower expenses in R&D, Sales and Marketing, and general administration, as follows:

#### ***Research and Development—***

R&D expenses decreased to USD 0.7 million compared to USD 0.9 million for the third quarter of 2003 as the Company continued to conclude a number of development projects for next generation capnography products. Current R&D expenses include investments in enhancing the proprietary technology contained in the Company's consumable products, and the final design and testing stages of new capnography devices. Both of these types of projects are expected to help Oridion expand the use of capnography into clinical settings in which CO2 monitoring has in the past been very limited and in some instances, even non-existent.

***Sales and Marketing—***

Sales and marketing expenses decreased to USD 1.6 million compared to USD 1.9 million for the third quarter of 2003. This decrease is due mainly to the termination of Oridion's pilot US breath testing activities last year following the Company's decision to postpone its US launch. Current sales and marketing activities include Oridion's ongoing intensive program of clinical studies for both its capnography and breath testing products. These studies continue to be conducted in leading medical care centers worldwide by world renowned physicians, and provide the basis for a wide variety of publications that are then presented at leading medical conferences and exhibitions worldwide. As a result of these studies and its intensive clinical consultant support activities, Oridion is able to educate the medical care community worldwide about the vital role of CO<sub>2</sub> monitoring in improving patient safety, and about the many benefits offered by non-invasive breath testing – both enabled by Oridion's patented and innovative Microstream® technology. These efforts continue to result in the constantly increasing usage rate of Oridion's products by a wide range of segments of the medical community.

Sales and marketing expenses also include the Company's activities in supporting its world leading OEM partners that integrate Microstream® capnography into their patient monitoring and respiratory products. These products are then sold into a wide range of medical settings worldwide. They also help provide a rapidly growing installed base of Microstream® monitoring instruments into which Oridion's proprietary line of FilterLine® consumable products are then sold.

***General and Administration—***

G&A expenses decreased to USD 0.5 million compared to USD 0.6 million for the third quarter of 2003 as the Company continued to restrict discretionary spending while implementing new steps aimed at increasing efficiency and reducing costs.

***Operating Results—***

The operating loss decreased to USD 0.7 million compared to USD 1.2 million loss for the third quarter of 2003. On a pro-forma basis, without the one-time non-recurring charge, the Company would have made an operating profit of USD 0.15 million. This would have been the first time that the Company made a quarterly operating profit.

***Net Results—***

The net loss decreased to USD 0.8 million for the third quarter of 2004 compared to USD 1.1 million for the third quarter of 2003. On a pro-forma basis without the one-time non-recurring charge, the Company would have made a net profit of USD 0.09 million.

**Achievements and Events in our Business Units during Q3, 2004**

The following milestones were achieved during the third quarter of 2004:

***Capnography—***

- **New OEM Agreement Signed**  
Oridion signed an OEM agreement this quarter with Larsen & Toubro Ltd. - a new OEM partner that will be integrating Microstream® capnography into its patient safety monitoring system. Larsen & Toubro Ltd. is one of India's largest engineering and industrial conglomerates with a growing medical device division.

- **Distribution Network Enhanced with specialty distributors**  
Oridion strengthened the distribution network for its capnography products this quarter, by signing a number of agreements with specialty distributors in the US. These distributors were carefully selected owing to their expertise and experience in marketing medical devices especially consumable products, into specialized medical care settings and are expected to play an important role in Oridion's direct sales activities.
- **Microstream® Capnography Paper Presented at 7th Congress of the European Resuscitation Council**  
Oridion presented an important paper at the 7<sup>th</sup> Congress of the European Resuscitation Council. The paper, which discusses the vital role Microstream® capnography plays in detecting possible complications in surgical, emergency and other medical care settings, was presented before leading physicians worldwide in attendance.
- **London Ambulance Service to adopt Microstream® Capnography**  
Oridion marked another important achievement this quarter when the London Ambulance Service (LAS) announced that it will be adopting Microstream® Capnography throughout its entire system as its primary CO<sub>2</sub> monitoring technology. This decision was reached following a review by LAS of all available CO<sub>2</sub> monitoring products and the conclusion that none offered the quality and benefits provided by Microstream®.

*Breath Testing—*

- **Vital Study Involving Oridion Breath Testing Technology Presented at Leading European Conferences**  
Positive results of a proof-of-principle study in the development of a breath test for gastric accommodation assessment, performed by renowned physician Professor J. Tack of Leuven, Belgium, was presented at the European Motility Meeting held in the UK, and at the European Gastroenterology Week (UEGW) 2004 held in Prague. The Company also displayed and demonstrated the BreathID® System at these conferences to many opinion leaders in attendance, and held meetings with many of the participants for discussions on the ongoing development of Oridion's breath testing business.
- **Preliminary Positive Results of Pilot Study Presented at European Motility Meeting**  
Preliminary positive results from a pilot study that deals with fundamentals of gastric emptying and accommodation breath testing were presented at the European Motility Meeting. The study is being performed by renowned physicians Dr. O. Goetze and Professor M. Fried of Zurich, Switzerland.

## **Recent Events and Outlook**

In the **Capnography Business Unit**, Oridion plans to further enhance its position as the leading provider of CO<sub>2</sub> monitoring solutions. This will be done by continuing to strengthen the Company's relationship with its world leading OEM partners, by continuing its extensive program of clinical studies and clinical education, by increasing its sales coverage and by launching new capnography products for both existing and new clinical settings.

Oridion's role as a leading supplier of capnography products is made possible, in part, by the innovative and proprietary technologies developed by Oridion and integrated into its products. Accordingly, Oridion recently filed a lawsuit against GE Medical Systems IT GmbH for infringement of European Patent no. 0 707 827 - a patent owned by Oridion - which covers one element of Oridion's CO<sub>2</sub> sampling technologies. Oridion is confident of a favorable outcome of the matter.

In the **Breath Testing Business Unit**, Oridion plans to strengthen the medical community's awareness and appreciation of the many benefits offered by Oridion's breath testing products. To achieve this, the Company plans to both continue its clinical program with new studies and to expand the number of pilot sites in preparation for full commercialization. The Company also plans to continue increasing its joint activities with leading physicians worldwide and together with them shape the future direction of this cutting edge field of patient care. Similar to its leadership position in capnography, Oridion also strives to become the market leader in non invasive breath testing diagnostics. To enable the Company to reach the level of commercialization necessary to achieve such leadership, Oridion recently signed an agreement with a local investment bank to assist Oridion in developing the most beneficial strategic/financial partnerships for actively commercializing its breath testing business.

We again thank our dedicated team of employees, those women and men behind the Oridion brand, who diligently never cease to push past existing technological boundaries in an effort to produce medical technologies and products of unparalleled capabilities and quality. We also continue to thank our shareholders and partners for their ongoing support and belief in Oridion. We strive to reward that support with increased shareholder value as Oridion improves its financial results and, after many years of intensive growth-oriented investments, begins to achieve profitability. We look forward to sharing our future successes with you.

Alan Adler  
Chairman of the Board of Directors and Acting CEO  
Jerusalem, Israel  
22 November 2004

## **CONSOLIDATED BALANCE SHEETS**

*U.S. dollars in thousands (except share and per share data)*

	<b>December 31, 2003</b>	<b>September 30, 2004</b>
		<b>Unaudited</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	4,343	3,894
Short-term deposits	-	2,500
Trade receivables	3,195	4,091
Other accounts receivable and prepaid expenses	459	775
Inventories	4,010	3,325
<u>Total current assets</u>	12,007	14,585
SEVERANCE PAY FUND	1,294	1,399
PROPERTY AND EQUIPMENT, NET	4,191	3,717
LONG-TERM PREPAID EXPENSES	-	55
<b><u>Total Assets</u></b>	17,492	19,756
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Short-term bank credit	768	438
Trade payables	1,562	2,450
Other accounts payable and accrued expenses	2,601	2,904
<u>Total current liabilities</u>	4,931	5,792
<b>LONG-TERM LIABILITIES:</b>		
Long-term loans, net of current maturities	-	2,500
Accrued severance pay	2,130	2,366
<u>Total long-term liabilities</u>	2,130	4,866
<b>SHAREHOLDERS' EQUITY:</b>		
Share capital:		
Ordinary shares of NIS 0.01 par value -		
Authorized: 20,000,000 shares at December 31, 2003 and		
September 30, 2004; Issued and outstanding: 10,501,421		
shares at December 31, 2003 and 10,823,340 shares at		
September 30, 2004	25	25
Additional paid-in capital	73,721	74,774
Accumulated deficit	(63,315)	(65,701)
<u>Total shareholders' equity</u>	10,431	9,098
<b><u>Total Liabilities and Shareholders' Equity</u></b>	17,492	19,756

## CONSOLIDATED STATEMENTS OF OPERATIONS

*U.S. dollars in thousands (except share and per share data)*

	Year ended December 31, 2003	Three months ended September 30,		Nine months ended September 30,	
		2003	2004	2003	2004
		Unaudited			
<b>Revenues</b>	18,117	4,973	6,271	13,116	15,598
Cost of sales	9,792	2,834	3,245	7,406	8,229
<b>Gross profit</b>	8,325	2,139	3,026	5,710	7,369
Operating expenses:					
Research and development, net	3,328	856	747	2,517	2,089
Selling and marketing, net	8,102	1,892	1,624	6,040	5,235
General and administrative	2,592	590	510	1,864	1,457
Retirement	-	-	863	-	863
<b>Total operating expenses</b>	14,022	3,338	3,744	10,421	9,644
<b>Operating loss</b>	(5,697)	(1,199)	(718)	(4,711)	(2,275)
Financial income (expenses), net	(168)	76	(72)	(78)	(117)
Other expenses	350	-	-	-	-
Loss before taxes on income	(6,215)	(1,123)	(790)	(4,789)	(2,392)
Taxes on income	(54)	(4)	(13)	(58)	(6)
<b>Net loss</b>	(6,161)	(1,119)	(777)	(4,731)	(2,386)
Basic and diluted net loss per share (in U.S. dollars)	(0.59)	(0.11)	(0.07)	(0.45)	(0.22)
Weighted average number of shares used for computing basic and diluted net loss per share	10,501,421	10,501,421	10,738,673	10,501,421	10,590,947

## CONSOLIDATED STATEMENTS OF CASH FLOWS

*U.S. dollars in thousands*

	Year ended December 31, 2003	Nine months ended September 30, 2003      2004	
		Unaudited	
<u>Cash flows from operating activities:</u>			
Net loss	(6,161)	(4,731)	(2,386)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation	921	653	625
Amortization of deferred stock compensation	42	37	750
Amortization of deferred stock compensation related to warrants issued to credit providers and others	-	-	36
Accrued severance pay, net	97	74	131
Decrease (increase) in trade receivables	131	1,246	(896)
Decrease (increase) in other accounts receivable and prepaid expenses	221	22	(167)
Decrease (increase) in inventories	(912)	(1,868)	670
Increase (decrease) in trade payables	(201)	949	888
Increase in other accounts payable and accrued expenses	129	162	303
Loss (gain) on sale of property and equipment	(1)	(1)	7
<b>Net cash used in operating activities</b>	<b>(5,734)</b>	<b>(3,457)</b>	<b>(39)</b>
<u>Cash flows from investing activities:</u>			
Purchase of property and equipment	(244)	(153)	(147)
Proceeds from sale of property and equipment	49	19	4
Investment in short-term bank deposits	-	-	(2,500)
<b>Net cash used in investing activities</b>	<b>(195)</b>	<b>(134)</b>	<b>(2,643)</b>
<u>Cash flows from financing activities:</u>			
Short-term bank credit, net	768	492	(330)
Proceeds from long-term loan	-	-	2,500
Proceeds from exercise of options, net	-	-	63
<b>Net cash provided by financing activities</b>	<b>768</b>	<b>492</b>	<b>2,233</b>
Decrease in cash and cash equivalents	(5,161)	(3,099)	(449)
Cash and cash equivalents at the beginning of the period	9,504	9,504	4,343
<b>Cash and cash equivalents at the end of the period</b>	<b>4,343</b>	<b>6,405</b>	<b>3,894</b>