

Enabling technologies for improved medical care



Oridion Systems Ltd.
Letter to Shareholders
August 2004



Dear Shareholder,

Oridion's second quarter of 2004 results have once more improved. I am pleased to report that revenues have grown for the tenth consecutive quarter compared to the same period in the previous year and that our Capnography Business Unit recorded a profit for the second quarter of 2004. 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 Q2, 2004

Revenues—

Company revenues for the second quarter of 2004 increased by 15% to USD 5.5 million compared to USD 4.8 million for the second quarter of 2003. Revenues for the six month period ending June 30, 2004 increased by 15% to USD 9.3 million compared to USD 8.1 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 for use with the constantly growing installed base of Microstream® enabled monitors. Consumable sales have for the first time exceeded 30% of total sales during both the second quarter and the first six months of 2004.

The Company's gross profit for the second quarter of 2004 reached USD 2.6 million compared to USD 2.1 million for the same period last year. Gross margin improved due to the increase in sales of the Company's high margin consumable products. As a result, the gross margin for the second quarter was 48.2% compared to 44.2% for the second quarter of 2003. Gross margin for the six-month period ending June 30, 2004 improved to 46.6% compared to 43.9% for the same period last year.

Operating Expenses—

Total operating expenses were reduced by more than 20% and amounted to USD 3.00 million for the second quarter of 2004 compared to USD 3.75 million for the second quarter of 2003. Details as to the reduction of these costs are the following:

Research and Development—

R&D expenses decreased to USD 0.7 million compared to USD 0.8 million for the second quarter of 2003 as the Company concluded 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 of new capnography devices.

Sales and Marketing—

Sales and marketing expenses decreased to USD 1.8 million compared to USD 2.2 million for the second quarter of 2003. This decrease is mainly a result of ceasing the Company's pilot breath testing sales program in the United States in June of last year. Current sales and marketing activities include the ongoing management of an intensive program of clinical studies of both Oridion's capnography and breath testing products. These studies, conducted by world renowned physicians in leading medical care centers worldwide, provide the basis for a wide variety of publications that are then presented at leading medical conferences and exhibitions worldwide. The vital role of these publications in demonstrating the unparalleled benefits of Microstream® technology has been clearly demonstrated in the increased usage rate of Oridion's products by the medical community.

Sales and marketing expenses also include the Company's activities in supporting its globally leading OEM partners, who include Microstream® technology in their patient monitoring and respiratory products. These are then sold into a wide range of medical settings worldwide.

General and Administration—

G&A expenses decreased to USD 0.4 million compared to USD 0.7 million for the second quarter of 2003 as the Company continued to restrict discretionary spending while implementing new steps aimed at increasing efficiency and reducing costs.

Operating Loss—

The operating loss decreased to USD 0.3 million compared to USD 1.6 million for the second quarter of 2003.

Net Loss—

For the second quarter of 2004 the Company almost reached a break-even result as net loss decreased to USD 0.4 million compared to a net loss of USD 1.8 million for the second quarter of 2003.

Achievements and Events in our Business Units during Q2, 2004

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

Capnography—

- **Capnography Business Unit recorded profit**

The Capnography Business Unit achieved an important milestone by attaining profitability in the second quarter of 2004, primarily as a result of increased consumable sales and margins combined with reduced operating expenses.

- **Eleven Clinical Studies Presented at World Congress of Anesthesiology**

Oridion presented eleven different clinical studies at the recent WCA conference, held every four years, and attended by leading anesthesiologists worldwide. These studies clearly demonstrated that end-tidal CO₂ (Capnography) monitoring is the earliest indicator of ventilatory adverse events / airway obstruction, and the most accurate measure of respiratory rate. Capnography monitoring is made especially accurate, accessible and reliable in all clinical environments with Oridion's Microstream® capnography products.

- **New Microstream® Enabled Products launched**

Two of Oridion's leading OEM partners released new Microstream® enabled patient safety monitoring systems. In addition, a third Oridion partner recently received FDA clearance for a new Microstream® enabled monitor which is expected to be launched soon.

Breath Testing—

- **Three clinical Studies Presented at Digestive Disease Week (DDW) Conference**

Oridion presented three new clinical studies performed in Belgium, Italy and Japan by world renowned physicians, with its BreathID® Multi Test Breath Testing Platform. The studies, which discussed the many advantages offered by the BreathID® platform over other testing methods, were presented at DDW, a leading conference attended by the most prominent gastroenterologists worldwide.

Annual General Meeting in July 2004

We would like to thank our shareholders for overwhelmingly approving all of the resolutions recommended by the Board of Directors at this year's Annual General Meeting, which was held on July 15, 2004.

As already reported in our previous Letter to Shareholders in May of this year, the founder and former CEO of Oridion, George Yariv announced his retirement from the CEO position as of April 1, 2004. He will continue to serve as an active member of the Company's Board of Directors and as Honorary Chairman. During the Annual General Meeting, shareholders overwhelmingly approved a compensation package for Mr. Yariv, which was recommended by compensation consultants from the international accounting firm KPMG. The consequence is a non-cash one-time expense of approximately USD 862,000 in the remainder of this fiscal year, resulting in a one-time cash payment of approximately USD 326,000 in fiscal year 2005.

Mr. Alan Adler, long serving Director and Chairman of the Board of Directors continues to fulfill the duties of Chairman and Acting CEO of Oridion.

Future Activities and Outlook

In the **Capnography Business Unit**, Oridion plans to continue working closely with its OEM partners and supplying them with the best CO2 monitoring products available for future versions of their patient monitoring systems. Oridion also plans to continue its extensive program of clinical studies and to launch new capnography products later this year.

In the **Breath Testing Business Unit**, Oridion plans to continue its clinical program with a number of new studies to further validate the clinical value of its breath tests for various medical conditions and to expand the number of pilot sites in preparation for full commercialization.

We remain grateful to our dedicated team of employees for their tireless efforts to continually improve the quality of our products, and the commercial success of our Company, and to our shareholders and partners for their ongoing support and belief in Oridion.

We will continue to strive toward our goal of improving the standard of medical care and patient safety worldwide while enhancing shareholder value. We look forward to sharing our future successes with you.

Alan Adler
Chairman of the Board of Directors and Acting CEO
Jerusalem, Israel
13 August 2004

Consolidated Income Statements

in USD 000's (except for share data)	Three months	Three months	Six months	Six months
	ended June 30	ended June 30	ended June 30	ended June 30
	2003	2004	2003	2004
Revenues from Sales	4,805	5,526	8,143	9,327
Gross Profit	2,123	2,662	3,571	4,343
Percent of Revenues	44%	48%	44%	47%
Operating Expenses	3,751	2,996	7,083	5,894
Operating Loss (EBIT)	(1,628)	(334)	(3,512)	(1,551)
Net Loss	(1,767)	(385)	(3,612)	(1,609)
EBITDA	(1,405)	(119)	(3,064)	(1,085)
Basic Loss Per Share (in actual numbers)	(0.17)	(0.03)	(0.34)	(0.15)

Consolidated Balance Sheet

	Dec 31, 2003	June 30, 2004
Assets		
Cash & cash equivalents	4,343	5,955
Trade receivables & inventories	7,664	7,328
Long term investments	1,294	1,395
Fixed assets	4,191	3,864
Total Assets	17,492	18,542
Liabilities & Shareholders Equity		
Curent Liabilities	4,931	4,817
Long Term Liabilities	2,130	4,634
Shareholder Equity	10,431	9,091
Total Liabilities & Shareholders Equity	17,492	18,542

Consolidated Cash Flow Statements

	Six months	Six months
	ended June 30	ended June 30
	2003	2004
Cash Flow		
Cash flow from operating activity	(1,645)	(205)
Cash flow from investing activity	(95)	(2,585)
Cash flow from finance activity	0	1,902
Increase net	(1,740)	(888) *

* This includes the return of short-term bank credit of USD 661, following a restructuring of the Company's credit facilities including the receipt of a long term loan of USD 2,500.