SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-KSB

Annual Report Pursuant to Section 13 or 15(d) of
The Securities Exchange Act of 1934

For the fiscal year ended September 30, 1999
Commission file number 0-23837

SURMODICS, INC.
(Name of Small Business Issuer in its Charter)

Minnesota	41-1356149
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification Number)

9924 West 74th Street
Eden Prairie, Minnesota 55344
(Address of Principal Executive Offices; Zip Code)

Issuer's telephone number Including Area Code: (612) 829-2700

Securities registered Under Section 12(b) of the Act: None

Securities registered Under Section 12(g) of the Act: Common Stock

Check whether the Issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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.
X Yes ____ No

Check if no disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [X]

The issuer's revenues for the fiscal year ended September 30, 1999 were $13,493,540.

The aggregate market value of the Issuer's Common Stock held by non-affiliates (persons other than officers, directors or holders of more than 5% of the outstanding stock) as of December 15, 1999, was approximately $137.7 million (based on the closing sale price of the Issuer's Common Stock on such date).

Shares of Common Stock outstanding on December 15, 1999: 7,736,674

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Annual Report to Shareholders for the fiscal year ended September 30, 1999 are incorporated into Part II of this Form 10-KSB. Portions of the Registrant's Proxy Statement for its 1999 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-KSB.

Transitional Small Business Disclosure Format (check one): Yes No X

PART I

ITEM 1. DESCRIPTION OF BUSINESS

General

SurModics, Inc. ("SurModics" or the "Company") is a leading provider of surface modification solutions to the medical device industry. The Company's primary focus is the commercialization of its patented PhotoLink process through third-party licensing arrangements. PhotoLink is a versatile, easily applied, light-activated coating technology that modifies medical device surfaces by creating covalent bonds between those surfaces and a variety of chemical agents. Through the PhotoLink process, these chemical agents can impart many performance-enhancing characteristics, such as lubricity, hemocompatibility, infection resistance and drug delivery, onto the surface of a medical device without materially changing the dimensions or physical properties of the device. The Company believes that medical device manufacturers who utilize the Company's technology are able to significantly improve the performance of their products and, in many cases, differentiate their products in a highly competitive marketplace.

The Company focuses on providing high value-added surface modification solutions to a variety of medical device markets and product categories. Examples of products in the market or under development that incorporate the PhotoLink technology include interventional cardiology catheters, vascular stents, interventional neurology catheters, guide wires and shunts, cardiac rhythm management devices, and urological and gynecological devices. The surface properties created by the PhotoLink technology have greatly reduced treatment times in catheter-based vascular procedures and have shown the potential to enhance the long-term performance of implantable devices by improving infection resistance and promoting host cell attachment, growth and subsequent tissue integration. During fiscal 1999, the Company introduced its first coated product: 3D-Link Activated Slides. This product is a coated glass slide used by the genomics market to orient DNA strands for analysis. The Company believes

further opportunities exist to commercialize its PhotoLink technology both in the genomics market and other market applications.

The Company has commercialized its PhotoLink technology through licensing arrangements with medical device manufacturers who apply the PhotoLink coatings to their own products. The Company believes this approach allows it to focus its resources on further development of its technology and expansion of its licensing activities, while leveraging the established manufacturing, sales and marketing capabilities of its licensees. Revenues from these arrangements include initial license fees, development revenue, minimum royalties, and earned royalties based on a percentage of licensees' product sales. In addition to licensing its PhotoLink technology, the Company also licenses certain diagnostic technology to Abbott Laboratories for use with rapid point-of-care diagnostic tests, such as pregnancy and strep tests. The Company also manufactures and sells the chemical reagents used in the PhotoLink process, and offers a line of stabilization products used to extend the shelf life of immunoassay diagnostic tests.

The Company was organized as a Minnesota corporation in June 1979 and changed its name from BSI Corporation to SurModics, Inc. in June 1997.

Markets and Need for Surface Modification

Recent trends in healthcare toward improved patient outcomes and reduced total costs have resulted in intense competition for the development of medical devices that demonstrate superior product performance, reduced procedure times, improved outcomes and overall cost effectiveness. Medical device manufacturers have attempted to address these competitive pressures by developing innovative medical devices manufactured from a wide variety of synthetic materials, including many new, expensive and exotic materials. In an effort to further differentiate their products through improved product performance, a growing number of medical device manufacturers are turning to the emerging field of surface modification technology. Surface modification technology enables device manufacturers to provide medical devices with desired surface characteristics including improved lubricity, hemocompatability and infection resistance, as well as the ability to deliver drugs and promote cell growth and tissue integration.

Although it is an emerging field, surface modification technology has been used to improve medical devices in many different industry segments. The table below identifies several of these market segments and the surface properties the Company believes are desired by each segment.

Market Segment Served	Desired Surface Property and Examples of Applications
Interventional cardiology and vascular access	Lubricity: catheters, guide wires Hemocompatability: vascular stents, catheters, guide wires Therapeutic drug delivery and release: vascular stents,catheters Infection resistance: catheters, implantable ports
Cardiac rhythm management	Lubricity: pacemaker and defibrillator leads, electrophysiology devices Hemocompatability: electrophysiology devices
Cardiothoracic surgery	Infection resistance: heart valves Hemocompatability: minimally invasive bypass devices, vascular grafts, ventricular assist devices Cell growth and tissue integration: heart valves, vascular grafts
Interventional neurology and neurosurgery	Lubricity: catheters, guide wires Infection resistance: catheters, shunts

Urology and gynecology	Lubricity: urinary catheters, incontinence devices, ureteral stents, fertility devices Infection resistance: urinary catheters, incontinence devices, ureteral stents, fertility devices, penile implants
Orthopedics	Cell growth and tissue integration: bone regeneration

In addition to the above-identified market segments, the Company believes that one of the next areas of growth for surface modification technology will be the genomics market. SurModics recently launched its 3D-Link Activated Slides which provide lower background levels and more consistent results for reproducible microarrays used in DNA analysis to screen for new drugs, to sequence unknown portions of the human genome, or to search for signs of viruses. The Company believes the slides will benefit from surface modification technology to provide biomolecule immobilization and wettability properties.

The PhotoLink Solution

PhotoLink is a versatile, easily applied, light-activated coating technology that modifies medical device surfaces by creating covalent bonds between those surfaces and a variety of chemical agents. The PhotoLink solution to surface modification involves the utilization of proprietary, light sensitive (photochemical) reagents. These reagents can consist of advanced polymers or active biomolecules having desired surface characteristics and an attached light-reactive chemical compound (photogroup). When the reagent is exposed to a direct light source, typically ultraviolet, a photochemical reaction creates a covalent bond between the photogroup and the surface of the medical device, thereby imparting the desired property to the surface. A covalent bond is a very strong chemical bond which results from the sharing of electrons between carbon molecules of the substrate and the applied coating.

SurModics' proprietary PhotoLink reagents work on most polymer-based (e.g., plastic) substrates, biological substrates (latex rubber, cellulose, tissue and natural fibers), and metal and glass substrates. Metal and glass substrates generally require pretreating with polymers to make a carbon-molecule available for bonding prior to the application of the PhotoLink reagents. The reagents are easily applied to a clean material surface by dipping, spraying, roll coating, ink jetting or brushing. SurModics continues to develop proprietary photochemical reagents providing new product features while expanding the number and type of substrates on which the reagents can be applied.

The Company believes that its proprietary PhotoLink process provides its licensees with a number of benefits.

- Flexibility. PhotoLink coatings can be applied to many different kinds of surfaces and can immobilize a variety of chemical, pharmaceutical and biological agents, which allows licensees to be innovative in the design of their products without significantly changing the dimensions or physical properties of the devise.

- Variety of Surface Properties. The PhotoLink process can be tailored to provide SurModics' licensees with the ability to improve the performance of their devices by choosing the specific coating properties desired for particular applications. The PhotoLink technology also provides the medical device manufacturer with the ability to combine multiple surface-enhancing characteristics on the same device.

- Ease of Use. The PhotoLink coating process is a relatively simple process that does not require expensive special equipment or the use of hazardous materials and does not subject the coated products to harsh chemical, pressure or temperature conditions. Further, PhotoLink coatings are compatible with all the generally accepted sterilization processes, so the surface attributes are not lost when the medical device is sterilized prior to usage.

Surface Properties

SurModics' PhotoLink process has been used by manufacturers of pacemaker leads, drug infusion catheters, laser and balloon angioplasty catheters, urinary drainage catheters, vascular closure devices, wound drains, guide wires, stent delivery catheters, angiography catheters, ureteral stents and hydrocephalic shunts, among other devices. The PhotoLink process can be used to provide medical device manufacturers with the following surface properties to improve product performance:

- Lubricity. Low friction or lubricious coatings reduce the force and time required for insertion, navigation and removal of devices in vascular, neurological and urogenital applications. Lubricity also reduces tissue irritation and damage caused by products such as catheters, guide wires and endoscopy devices. Based on Company and licensee testing, when compared to uncoated surfaces, the PhotoLink process has reduced the friction on surfaces by as much as 85% to 95%, depending on the substrate being coated.

- Hemocompatibility. Hemocompatible coatings help reduce adverse reactions that may be created when a device is inserted into the body and comes in contact with blood. Heparin has been used for decades as an injectable drug to reduce blood clotting in patients. SurModics can immobilize heparin on the surface of blood-contacting medical devices thereby inhibiting blood clotting on the device surface, minimizing patient risk and enhancing the performance of the device. PhotoLink heparin coatings have been shown in Company and licensee testing to reduce blood clotting by greater than 90% compared to uncoated surfaces.

- Infection Resistance. Antimicrobial coatings are advantageous for most implantable medical devices where risk of infection is a concern. PhotoLink technology can apply passive coatings which significantly reduce bacterial adhesion to the device or active coatings incorporating antimicrobial agents which kill bacteria around the device. Testing by the Company has demonstrated that a PhotoLink coating can reduce the adherence of microorganisms to biomaterial surfaces by 97% to over 99% depending on the base material of the device. In addition, when compared to uncoated products, the PhotoLink process has been shown to increase the uptake of antimicrobial agents applied to the device just prior to implantation and prolong the release of these agents.

- Drug Delivery. PhotoLink technology can be used to create reservoirs to entrap drugs on the surface of medical devices. These drugs can then be released from the surface on a controlled basis by tailoring the polymers, by adjusting the extent of crosslinking, or by using a barrier coating to control diffusion. For example, SurModics has developed a PhotoLink coating that would allow a coronary stent manufacturer to incorporate a drug onto the surface of a stent which would be released over time to reduce the incidence of restenosis (the re-narrowing of the artery).

- Wettability. PhotoLink hydrophilic coatings have been shown in tests by the Company and its licensees to accelerate liquid flow rates on normally hydrophobic (water repelling) materials by 75%. Rapid point-of-care diagnostic tests, such as home monitoring or physician monitoring of glucose levels in diabetics, are currently done by pricking a patient's finger and carefully placing a drop of blood onto a polymer strip which is then inserted into a blood glucose reader. The Company believes that the time it takes for the blood to flow up the strip to provide the patient with a readout can be dramatically reduced and the consistency can be greatly improved with PhotoLink technology.

- Cell Growth, Tissue Integration and Other Tissue Engineering. Studies have shown that attachment of extracellular matrix proteins and peptides onto surfaces of implantable medical devices improves host cell attachment, growth and subsequent tissue integration. PhotoLink technology has been used to coat biomedical devices with photoreactive collagens and other proteins upon which cells normally grow within the body. Company studies have shown that biomedical devices (such as vascular grafts and ocular implants) coated with such proteins, have improved attachment, growth of cells and acceptance by surrounding tissues. In addition, the Company is also using its PhotoLink technology to produce three-dimensional scaffolds to promote bone regeneration.

- Biomolecule Immobilization. During a DNA gene analysis, typically hundreds of different probes need to be placed in a pattern on a surface, called a DNA microarray. These microarrays are used by the pharmaceutical industry to screen for new drugs, by genome mappers to sequence unknown portions of the human genome, or by diagnostic companies to search a patient sample for disease causing bacteria or viruses. However, DNA does not readily adhere to most surfaces that are important for DNA assays. The Company has demonstrated a versatile method for the immobilization of DNA on various surfaces and introduced a coated slide during fiscal 1999.

Current Licensing Arrangements

The Company has commercialized its PhotoLink technology through licensing arrangements with medical device manufacturers who apply the PhotoLink coatings to their own products in their own facility. The Company believes this approach allows it to focus its resources on further developing its technology and expanding its licensing activities, while leveraging the established manufacturing, sales and marketing capabilities of its licensees for the marketing of the specific medical device utilizing the PhotoLink technology. The Company's licensing agreements are designed to allow manufacturers to incorporate the PhotoLink process into their own manufacturing processes so they can control production and quality without the need to send product outside their facility.

The licensing process begins with the medical device manufacturer specifying the surface characteristics it desires. Because each surface is unique, the Company routinely conducts a feasibility study at no charge to the customer to qualify each new potential product application. Once the feasibility has been proven, the customer typically funds further development by SurModics to optimize the coating formulation to meet the customer's technical needs. A license agreement is then executed granting the licensee the rights to use the technology. SurModics' technical personnel are then available to provide services in the transfer of the PhotoLink technology into the licensee's manufacturing process. Such services can include further coating optimization, process control and trouble shooting which are billable to the licensee. The Company also manufactures and sells the chemical reagents used by all licensees in the PhotoLink process, thus creating another source of revenue.

The term of a license agreement is generally for a period of 15 years or the life of SurModics' patents, whichever is longer, although an agreement may be terminated for any reason upon prior written notice, typically required at least 90 days before termination. The worldwide license can be either exclusive or nonexclusive for a particular medical device, but over 80% of the Company's licensed applications are nonexclusive. SurModics requires the payment of a non-refundable license fee which has historically ranged from $25,000 to $750,000 and quarterly "earned" royalties of 2% to 6% on the sales of products incorporating SurModics' technology. The amount of license fees and the royalty rate are based on whether the arrangement is exclusive or nonexclusive, the perceived value of the PhotoLink application to the device and the size of the potential market. Certain nonrefundable license and research and development fees are recoverable by the licensees as offsets against a percentage of future earned royalties. Most of SurModics' agreements also incorporate a minimum royalty to be paid by the licensee while the medical devices are developed, tested and commercialized. In most cases, payment of these minimum royalties will not commence until several months after the execution of an agreement for a particular application. On a quarterly basis a client will pay the greater of earned or minimum royalties to SurModics

Other Products

Stabilization Products

Although the primary focus of the Company is the development and marketing of its PhotoLink technology, the Company also markets stabilization

products for use by manufacturers of immunoassay diagnostic tests. SurModics' StabilCoat and StabilZyme Stabilizers are designed to maintain the activity of biological components of the immunoassays, resulting in a longer shelf life. These products offer SurModics' customers the benefit of product differentiation and improvement while providing the ultimate end users the benefit of a faster test with fewer steps and fewer errors. In fiscal 1999, SurModics generated $2.3 million of revenue from its stabilization products.

Diagnostic Formats

The Company also licenses a format for in vitro diagnostic tests developed during the early years of the Company. This format has found broad application in the expanding area of rapid point-of-care diagnostic testing, such as pregnancy and strep tests, and generated $2.8 million of royalty revenue for the Company in fiscal 1999 pursuant to a license agreement with Abbott Laboratories. Although this revenue is expected to grow in the future with the increased sales of licensed products, limited additional SurModics-funded research and development is being undertaken in this area.

Industrial Applications

While it is not the Company's primary focus, the Company occasionally pursues industrial applications for its PhotoLink technology. The Company only pursues those applications that are perceived to be high value applications in a market that is not considered to be price sensitive. To date, revenue associated with industrial applications has been immaterial and is not expected to be significant in the foreseeable future.

Research and Development

SurModics' research and development department supports the sales and marketing staff in performing feasibility studies, providing technical assistance to potential licensees, optimizing the coating methodologies for specific licensee applications, assisting in training licensees and integrating the Company's technology and know-how into licensee manufacturing processes. In addition, the research and development department works to enhance and expand the PhotoLink technology through the development of new reagents and new applications.

As medical devices become more sophisticated and complex, the Company believes the need for optimized surface properties will grow. The Company intends to continue its development efforts to expand its PhotoLink technology to provide additional optimized surface properties to meet these needs. The Company's technical strategy is to target selected coating characteristics for further development, in order to facilitate and shorten the license cycle. The Company has begun to perform research into applications for future products both on its own and in conjunction with some of its licensees. Some of the research and development projects currently being worked on include coatings for site-specific drug release, bone and cartilage repair, enhanced tissue growth, long-term blood compatibility and DNA immobilization methods. In addition to expanding the number of medical applications that may use PhotoLink technology, the Company is working on improving the coating process for metals, developing a process for coating the interior diameter of medical devices, expanding the portfolio of PhotoLink reagents, and developing additional proprietary products in which PhotoLink reagents serve as the end product. An example of this is the 3D-Link Activated Slide.

The technical staff of the Company consists of 61 employees, including eleven with Ph.D. degrees, seven with Masters degrees and 40 with Bachelor degrees, with expertise in chemistry, biomedical engineering, biology, microbiology, cell biology and biochemistry. The technical staff is organized into five areas of specialization: hydrophilicity, microbiology, hemocompatibility, biochemistry and tissue engineering. In addition, a chemistry group supports the synthesis of new reagents needed by the other five groups.

In fiscal 1998 and 1999, the Company's research and development expenses were $4.5 million and $5.2 million, respectively. The Company's research and development efforts are often funded by commercial licensees and government agencies. Such research and development revenues were approximately $2.0 million in both years.

Since its founding, the Company has actively participated in the federal government's Small Business Innovative Research ("SBIR") program to fund development efforts. Since 1979, 141 research contracts resulting in revenues of over $25.0 million have been awarded to SurModics, primarily under the SBIR program. Grant proposals are generally directed toward the commercial strategies of the Company. The Company retains commercial rights to discoveries and technologies resulting from the research and development efforts funded by these grants. Where possible, licensees' products or substrates are used when performing research under the grant; thus the results are often directly applicable to SurModics' licensees. Grant funding has also allowed SurModics to maintain a larger and more technologically diverse employee base than would otherwise be possible.

Patents and Proprietary Rights

The Company has taken steps intended to protect certain PhotoLink related inventions through a series of patents covering a variety of coating methods, reagents and formulations, as well as particular medical device applications, based on or employing the Company's proprietary photoreactive chemistry. The patents related to the PhotoLink technology include 16 issued U.S. patents, twelve pending U.S. patent applications, 30 issued foreign patents, and 40 pending foreign patent applications. The Company generally files international patent applications in parallel with its U.S. applications. The Company generally files national or regional applications in Australia, Canada, Europe, Japan, and Mexico. In addition to the patents related to the PhotoLink technology, SurModics has seven issued U.S. patents, one pending U.S. patent application, 19 issued foreign patents and four pending foreign patent applications related to its diagnostic technology. There can be no assurance that any of the pending patent applications will be allowed.

The Company also relies heavily upon trade secrets and unpatented proprietary technology. The Company seeks to maintain the confidentiality of such information by requiring employees, consultants and other parties to sign confidentiality agreements and by limiting access by parties outside the Company

to such information. The Company also does not divulge the detailed chemical structure of its reagent chemical to anyone, including clients. There can be no assurance, however, that these measures will prevent the unauthorized disclosure or use of this information or that others will not be able to independently develop such information. Additionally, there can be no assurance that any agreements regarding confidentiality and non-disclosure will not be breached, or, in the event of any breach, that adequate remedies would be available to the Company.

Marketing and Sales

The Company markets its PhotoLink technology throughout the world using a direct sales force consisting of three licensing managers who focus on specific markets such as cardiology, neurology, urology and orthopedic products. This specialization fosters an in-depth knowledge of the issues faced by SurModics' licensees within these markets such as technology changes, biomaterial changes and the regulatory environment.

Because the sales cycle can take several months from feasibility demonstration to the execution of a license agreement, the Company focuses its sales efforts on potential licensees with established market positions rather than those with only development stage products which may never come to market. Generally, the PhotoLink technology is licensed on a nonexclusive basis to medical device manufacturers for use on specific products. This strategy enables the Company to license the PhotoLink technology to multiple licensees in the same market. SurModics also targets selling new applications to existing licensees. The Company believes the sales cycle is much faster in these situations because the licensee is already familiar with the technology and the general terms of the license have already been negotiated.

As part of its marketing strategy, the Company publishes technical literature on each surface capability of the PhotoLink technology (i.e., lubricity, hemocompatibility, etc.). In addition, the Company participates at major trade shows and technical meetings, advertises in trade journals and through its website, and conducts direct mailings to appropriate target markets.

The Company also offers ongoing customer service and technical support throughout a licensee's relationship with SurModics. This service and support begins with a coating feasibility study at no charge to the licensee and also includes additional services such as assistance in the transfer of the technology to the licensee, further coating optimization, process control and trouble shooting, and assistance with FDA submissions for coated product approval. Certain of these services are billable to the client.

Competition

Competition in the medical device industry has resulted in an increase in competition in the surface modification market. The Company's PhotoLink technology competes with technologies developed by Carmeda (a division of Norsk Hydro, Inc.), Specialty Coatings Systems, Spire Corporation and STS Biopolymers Inc., among others. In addition, many medical device manufacturers have developed or are engaged in efforts to develop surface modification technologies for use on their own products. Most competitors marketing surface modification to the outside marketplace are divisions of organizations with businesses in addition to surface modification. Overall, the Company believes the worldwide market is very fragmented with no competitor marketing to third parties having

more than a 10% market share. Some of the Company's existing and potential competitors (especially medical device manufacturers pursuing coating solutions through their own research and development efforts) have substantially greater financial, technical and marketing resources than the Company.

SurModics attempts to differentiate itself from its competition by providing what it believes is a high value-added solution to surface modification. The Company believes that the primary factors customers consider in choosing a particular surface modification technology are performance, ease of manufacturing, ability to produce multiple properties from a single process, compliance with manufacturing regulations, customer service and pricing. The Company believes that its PhotoLink process competes favorably with respect to these factors, enabling it to charge a premium price. The Company believes that the cost and time required to obtain the necessary regulatory approvals significantly reduces the likelihood of a manufacturer changing the coating process it uses once a device has been approved for sale.

Because a significant portion of the Company's revenue is dependent on the receipt of royalties based on sales of medical devices incorporating PhotoLink coatings, the Company is also affected by competition within the markets for such devices. The Company believes that the intense competition within the medical device markets creates opportunities for the Company's coating technology as medical device manufacturers seek to differentiate their products through new enhancements or to remain competitive with enhancements offered by other manufacturers. Because the Company seeks to license its technology on a non-exclusive basis, the Company may further benefit from competition within the medical device markets by offering its PhotoLink technology to multiple competing manufacturers of a device. However, competition in the medical device markets could also have an adverse effect on the Company. While the Company seeks to license its products to established manufacturers, in certain cases the Company's licensees may compete directly with larger, dominant manufacturers with extensive product lines and greater sales, marketing and distribution capabilities. The Company also is unable to control other factors that may impact commercialization of PhotoLink-coated devices, such as the marketing and sales efforts of its licensees or competitive pricing pressures within the particular device market. There can be no assurance that products coated with the PhotoLink technology will be successfully commercialized by the Company's licensees or that such licensees will otherwise be able to effectively compete.

The primary competition for SurModics' stabilization products is its customers' internally developed formulations. The consolidation of the diagnostic industry increases the availability of internally developed stabilizers to the market. There are several direct competitors that have recently emerged, of which Pierce Medical Products, Inc. and Medix, Inc. are the two largest. The Company believes that quick market penetration is the best strategy for addressing these threats. As in the coating market, the Company also believes that once its stabilization products are accepted in an FDA-approved diagnostic test, the likelihood of change is reduced because of the cost and time required to qualify a new component. SurModics' marketing strategy for its stabilization products is to develop a strong market presence by offering superior product performance and technical service.

Manufacturing

In accordance with its licensing strategy, the Company does not perform the actual coating of its licensees' medical devices, nor does it manufacture any of these devices. The Company has, however, adopted a strategy of developing and manufacturing the reagents itself, allowing it to maintain the quality of the reagents and their proprietary nature, while providing an additional source of revenue. PhotoLink reagents are specialty photoreactive chemicals that are prepared using a proprietary formula in small batch processes (as contrasted with commodity chemicals prepared by large continuous methods). Generally, all PhotoLink reagents share a similar production process: a water soluble polymer is synthesized in a glass reactor; reactive photochemical groups are attached to the polymer; the solution is purified and freeze-dried, thus removing the water and creating a solid; and the PhotoLink reagents are packaged in standard quantities in light- and moisture-proof packaging. The reagents are sold dry, requiring the licensee, in most cases, to simply add water or a water and isopropyl alcohol mix before application. The Company has developed proprietary testing and quality assurance standards for manufacturing the reagents and does not disclose the reagent formulas or manufacturing methods. Although licensees may purchase the requisite chemical reagents from any source, all have elected to purchase them from the Company.

The Company also manufactures its stabilization products. These products are a group of sterile-filtered liquids that generally share a three-step production process. A standard recipe of chemicals is mixed in high purity water, these liquids are sterile-filtered into specific container sizes under aseptic conditions, and the resultant finished goods are bottled and labeled.

The Company maintains multiple sources of supply for the key raw materials used to manufacture reagents and stabilization products. The Company does, however, purchase some raw materials from single sources, but it believes that additional sources of supply are readily available.

Although not required to follow Good Manufacturing Practice quality procedures, SurModics does follow such procedures in part to respond to requests of licensees to establish compliance with their criteria. The Company has not yet sought ISO 9001 certification but may do so in the future.

Government Regulation

Although PhotoLink technology itself is not directly regulated by the FDA, the medical devices incorporating this technology are subject to FDA regulation. The burden of demonstrating safety and efficacy of such medical devices, the ultimate criteria applied by the FDA, rests with the Company's licensees (the medical device manufacturers). Medical products incorporating the PhotoLink technology may generally be marketed only after 510(k) or PMA applications have been submitted and approved by the FDA, which process can take anywhere from six months for a 510(k) application, to two or three years for a PMA application. These applications are prepared by the manufacturer and contain results of extensive laboratory toxicity, mutagenicity and clinical evaluations on animals and humans conducted by the manufacturer.

The Company maintains confidential Device Master Files at the FDA regarding the nature, chemical structure and biocompatibility of the PhotoLink reagents. Although the Company's licensees do not have access to these files, the licensees may, with the permission of the Company, reference these files in any medical device submission to the FDA. This process allows the FDA to understand in confidence the details of the PhotoLink technology without the Company having to share this highly confidential information with its licensees.

Recent U.S. legislation allows device manufacturers, prior to obtaining FDA approval to market a medical device in the U.S., to manufacture the device in the U.S. and export it for sale in international markets, which generally allows SurModics to realize earned royalties sooner. However, sales of medical devices outside the U.S. are subject to international requirements that vary from country to country. The time required to obtain approval for sale internationally may be longer or shorter than that required by the FDA.

Employees

As of December 1, 1999, SurModics had 102 full-time and 4 part-time employees of whom 74 were engaged in development or manufacturing positions, with the remainder in marketing, quality or administrative positions. Of SurModics' employees, 11 hold Ph.D. degrees and 15 hold Masters degrees. The Company is not a party to any collective bargaining agreements and believes that its employee relations are good.

Management believes that the future success of the Company will depend in part on its ability to attract and retain qualified technical, management and marketing personnel. Such experienced personnel are in high demand, and the Company must compete for their services with other firms which may be able to offer more favorable benefits.

ITEM 2. DESCRIPTION OF PROPERTY

In May 1999, SurModics purchased the land and building it currently occupies in Eden Prairie, Minnesota for approximately $3.2 million. The purchase of the building was internally funded and remains unencumbered. The building has approximately 64,000 square feet of space. The Company occupies approximately 48,000 square feet and rents the remaining 16,000 square feet to two tenants. In August 1999, the Company began approximately $1.0 million of construction to convert 12,000 square feet of space previously leased by two tenants to additional laboratory space and office space. When construction is completed in December 1999, there will be approximately 17,000 square feet of office space, 23,000 square feet of laboratory space and 8,000 square feet of manufacturing space. Approximately 6,000 square feet of the manufacturing space is a HEPA-filtered, highly controlled environment, but not certified as a "clean room" under FDA standards. The Company believes that projected capacity of the manufacturing area is adequate to service the needs of its licensees for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

The Company is not a party to nor is any of its property subject to any material pending legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter of fiscal 1999.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

(a) Use of Proceeds for the period ending September 30, 1999.

(1)	Effective Date:	March 3, 1998
	SEC File Number:	333-43217
(2)	Offering Date:	March 3, 1998
(4)(i)	The offering has terminated; all securities registered were sold.	
(4)(ii)	Managing Underwriter:	John G. Kinnard and Company, Incorporated
(4)(iii)	Title of Securities:	Common Stock
(4)(iv)	Amount Registered:	2,300,000
	Aggregate Offering Price:	$17,250,000
	Amount Sold:	2,300,000
	Aggregate Offering Price Sold:	$17,250,000
(4)(v)	Underwriting Discounts and Commissions	$ 1,293,750
	Other Expenses	$ 435,148
	Total Expenses	$ 1,728,898
All the above items represented direct or indirect payments to others.		
(4)(vi)	Net Offering Proceeds	$15,521,102
(4)(vii)	Use of Net Offering Proceeds:	
	Research and development	$ 1,066,000
	Sales and marketing	$ 825,000
	Building and equipment upgrades	$ 5,046,000
	Patent protection	$ 111,000
	Working capital and general corporate purposes	$ 666,000
	Administration	$ 62,000
	Money market funds	$ 7,745,102
	All the above items represented direct or indirect payments to others.	

(b) The information required by Item 5 relating to the Company's Common Stock and other shareholder matters is incorporated herein by reference to the section entitled "Stock Listing and Price History" which appears in the Company's 1999 Annual Report to Shareholders.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

The Section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the 1999 Annual Report to Shareholders is incorporated herein by reference.

ITEM 7. FINANCIAL STATEMENTS

The balance sheets as of September 30, 1999 and 1998 and the statements of operations, stockholders' equity and cash flows for each of the three years in the period ended September 30, 1999 together with the Report of Independent Public Accountants contained on pages 14 through 24 of the Company's Annual Report to Shareholders for the year ended September 30, 1999 are incorporated herein by reference.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT

The names, ages and positions of the Company's executive officers are as follows:

Name	Age	Position
Dale R. Olseth	69	Chairman and Chief Executive Officer
James C. Powell	50	President and Chief Operating Officer
Stephen C. Hathaway	44	Vice President and Chief Financial Officer
Patrick E. Guire, Ph.D. ...	63	Senior Vice President of Research and Chief Scientific Officer
Walter H. Diers, Jr.....	48	Vice President of Corporate Development
Marie J. Versen	38	Vice President of Quality Management and Regulatory Compliance

Dale R. Olseth joined the Company in 1986 as its President, Chief Executive Officer and a director of the Company and has served as Chairman since 1988. Mr. Olseth also serves on the Board of Directors of The Toro Company and Graco Inc. He served as Chairman or President and Chief Executive Officer of Medtronic, Inc. from 1976 to 1986. From 1971 to 1976, Mr. Olseth served as President and Chief Executive Officer of Tonka Corporation. Mr. Olseth received a B.B.A. degree from the University of Minnesota in 1952 and an M.B.A. degree from Dartmouth College in 1956.

James C. Powell joined the Company in 1987. He became Vice President of Technical Operations in 1992 and was elected President and Chief Operating Officer in 1998. He was employed at Precision-Cosmet Company, Inc., a manufacturer of contact and intraocular lenses, from 1978 until he joined SurModics. Mr. Powell received a B.S. degree in wood sciences from Texas A&M University in 1972 and an M.S. degree in polymer science in 1975 from the University of Washington.

Stephen C. Hathaway joined the Company as its Vice President and Chief Financial Officer in September 1996. Prior to joining SurModics, he served as Director of Finance for Ceridian Employer Services, Ceridian Corporation from 1995 to 1996. Prior to that, Mr. Hathaway was Vice President - Finance & Operations for Wilson Learning Corporation from 1988 to 1995. He also spent ten years with Arthur Andersen LLP. Mr. Hathaway received a B.S. degree in accounting in 1977 from Miami University and became a Certified Public Accountant in 1980.

Patrick E. Guire, Ph.D. is a co-founder of the Company and has served as Senior Vice President of Research and Chief Scientific Officer and a director since 1980. Dr. Guire is responsible for the research affairs of the Company. Prior to founding SurModics, Dr. Guire was employed by Kallestad Laboratories, Inc. as a senior scientist from 1978 to 1979 and was a researcher at the Midwest Research Institute, Inc. in Kansas City, Missouri from 1972 to 1978. He received a B.S. degree in Chemistry from the University of Arkansas, Fayetteville in 1958 and a Ph.D. in biochemistry from the University of Illinois in 1963.

Walter H. Diers, Jr. joined the Company in 1988 and currently serves as Vice President of Corporate Development. He served as a consultant to several small, high technology companies from 1984 until he joined SurModics. Prior to that, he was the Controller of the Laserdyne division of Data Card Corporation. Mr. Diers received a B.S. degree in economics and a B.S. degree in business in 1977 and an M.B.A. degree in finance in 1979 from the University of Minnesota.

Marie J. Versen joined the Company in 1987, and in 1996 became its Vice President of Quality Management and Regulatory Compliance. She was previously employed at Precision-Cosmet Company, Inc. from 1983 to 1986. Ms. Versen received a B.S. degree in chemical engineering from the University of Minnesota in 1983.

The executive officers of the Company are elected by and serve at the discretion of the Board of Directors.

The information required by Item 9 relating to directors and compliance with Section 16(a) is incorporated herein by reference to the sections entitled "Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance" which appear in the Company's definitive proxy statement for its 1999 Annual Meeting of Shareholders.

ITEM 10. EXECUTIVE COMPENSATION

The information required by Item 10 is incorporated herein by reference to the section entitled "Executive Compensation" which appears in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by Item 11 is incorporated herein by reference to the section entitled "Shareholdings of Principal Shareholders and Management" which appears in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by Item 12 is incorporated herein by reference to the section entitled "Certain Transactions" in the Company's definitive Proxy Statement for its 1999 Annual Meeting of Shareholders.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits. See "Exhibit Index" on the page following signatures.

(b) Reports on Form 8-K. No reports on Form 8-K were filed during the fourth quarter ended September 30, 1999.

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Registrant has caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

SURMODICS, INC.
("Registrant")

Dated: December 22, 1999

By: /s/ Dale R. Olseth
Dale R. Olseth
Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed by the following persons on behalf of the Registrant, in the capacities, and on the dates, indicated.

(Power of Attorney)

Each person whose signature appears below constitutes and appoints DALE R. OLSETH and STEPHEN C. HATHAWAY as his true and lawful attorneys-in-fact and agents, each acting alone, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any or all amendments to this Annual Report on Form 10-KSB and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, each acting alone, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all said attorneys-in-fact and agents, each acting alone, or his substitute or substitutes, may lawfully do or cause to be done by virtue thereof.

Signature	Title	Date
/s/ Dale R. Olseth Dale R. Olseth	Chairman, Chief Executive Officer and Director (Chief Executive Officer)	December 22, 1999
/s/ Stephen C. Hathaway Stephen C. Hathaway	Vice President and Chief Financial Officer (Chief Financial and Accounting Officer)	December 22, 1999
- ------------------------ Donald S. Fredrickson, M.D.	Director	December __, 1999

- ------------------------ James J. Grierson	Director	December __, 1999
/s/ Patrick E. Guire Patrick E. Guire	Director	December 22, 1999
/s/ Kenneth H. Keller Kenneth H. Keller	Director	December 22, 1999
/s/ David A. Koch David A. Koch	Director	December 22, 1999
/s/ Kendrick B. Melrose Kendrick B. Melrose	Director	December 22, 1999

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

EXHIBIT INDEX TO FORM 10-KSB

For the Fiscal Year Ended September 30, 1999

SURMODICS, INC.

Exhibit	
3.1	Restated Articles of Incorporation, as amended--incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-QSB for the quarter ended March 31, 1998, SEC. File No. 0-23837
3.2	Bylaws, as amended to date--incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-QSB for the quarter ended December 31, 1998, SEC. File No. 0-23837.
10.1*	Company's Incentive 1987 Stock Option Plan, including specimen of Incentive Stock Option Agreement--incorporated by reference to Exhibit 10.2 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.2*	Company's Incentive 1997 Stock Option Plan, including specimen of Incentive Stock Option Agreement--incorporated by reference to Exhibit 10.3 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.3*	Form of Restricted Stock Agreement--incorporated by reference to Exhibit 10.4 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.4*	Form of Non-qualified Stock Option Agreement--incorporated by reference to Exhibit 10.5 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.5	Form of License Agreement--incorporated by reference to Exhibit 10.6 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.6	License Agreement with Abbott Laboratories dated November 20, 1990, as amended--incorporated by reference to Exhibit 10.7 to the Company's Registration Statement on form SB-2, Reg. No. 333-43217
10.7	Purchase and Sale Agreement dated March 31, 1999 between the Company and Prairie View Jack Ltd.--incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-QSB for the quarter ended March 31, 1999, SEC. File No. 0-23837.

10.8*	SurModics, Inc. Executive Income Continuation Plan--incorporated by reference to Exhibit 10 to the Company's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1999, SEC. File No. 0-23837.
13	Portions of Annual Report to Shareholders for the fiscal year ended September 30, 1999 incorporated by reference in this Form 10-KSB
23	Consent of Arthur Andersen LLP
24	Power of Attorney (included on signature page of this Form 10-KSB).
27	Financial Data Schedule

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*Management contract or compensatory plan or arrangement

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS

General

SurModics is a leading provider of surface modification solutions to medical device manufacturers. The Company's revenues are derived from four primary sources: fees from licensing its patented technology to customers; royalties received from licensees; the sale of photo-reactive chemical compounds to licensees and stabilization products to the diagnostics industry; and research and development fees generated on projects for commercial customers and government grants. In March 1998, the Company completed an initial public offering ("IPO") of 2.3 million shares of Common Stock which generated proceeds of approximately $15.5 million, net of related offering expenses.

SurModics' royalty-based economic model once again drove strong financial performance in fiscal 1999. Total revenues increased 38% to $13.5 million in fiscal 1999 from $9.8 million in fiscal 1998. The overall revenue growth was led by an 84% increase in PhotoLink-related revenue to a record $7.6 million in fiscal 1999. The Company is continuing to see significant increases in the usage of the PhotoLink technology as shown by the growth in royalty revenue and reagent sales. PhotoLink royalties increased 77% to $3.9 million and reagent sales, those chemicals used by licensees in the PhotoLink coating process, increased 136% to $1.9 million. These revenue gains resulted in net income of $4.4 million, or $.54 per diluted share, compared to $1.6 million, or $.24 per diluted share, in fiscal 1998.

Results of Operations

Years Ended September 30, 1999 and 1998

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

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

The revenue growth in fiscal 1999 was mainly due to the 84% increase in PhotoLink revenue between years. PhotoLink royalty revenue increased 77% due to the introduction of six additional coated products as well as increases in the sales of previously introduced coated products by licensees. Two of these new products are already generating meaningful royalties to the Company. SurModics' clients now have 43 PhotoLink-coated products on the market. Reagent sales increased 136% due to increased production of PhotoLink-coated devices by these

clients. A single customer purchased 57% of the reagents sold during fiscal 1999 up from 12% in fiscal 1998. It is expected that the reagent purchases by this customer will decrease in the last half of fiscal 2000. During fiscal 1999, SurModics signed 14 new license agreements, compared to three new agreements in fiscal 1998, resulting in a 191% increase in license fees. Three new license agreements were signed in fiscal 1998. The Company now has license agreements with 44 companies covering over 100 product applications. Increased customer-funded development projects resulted in a 26% increase in commercial development revenue. Approximately 75% of the commercial development revenue resulted from work on projects for two customers. One of these customers accounted for 50% of the commercial development revenue in fiscal 1998.

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

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

Research and development expense. Research and development expense was

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

Sales and marketing expense. Sales and marketing expense was $1.8 million for fiscal 1999, an increase of $400,000, or 25%, over fiscal 1998. This increase was primarily due to compensation and benefit expenses associated with additional sales and marketing personnel hired during the year, increased incentive compensation associated with the sales growth and increased promotional spending. These cost increases were offset by a reduction in market research costs. An external market study performed last year was not repeated this year.

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

Other income, net. The Company's net other income was $1.2 million for fiscal 1999, an increase of $400,000 or 59%, over fiscal 1998. The increase in interest income was due to earnings generated on the investments resulting from the $15.5 million of IPO proceeds received in March 1998. The level of investments also increased due to the $4.4 million of cash provided by operating activities in fiscal 1999.

Benefit from income taxes. The Company's net income was benefited by a positive income tax adjustment. During fiscal 1999, management concluded that the Company would generate sufficient taxable income in the future to utilize all of the previously unrecognized tax net operating loss ("NOL") carryforwards

prior to their expiration. Therefore, during fiscal 1999, the Company reversed a $2.5 million valuation allowance related to these NOL carryforwards.

Years Ended September 30, 1998 and 1997

Revenues. The Company's revenues were $9.8 million in fiscal 1998, an increase of 29% over fiscal 1997. The revenue components were as follows:

(Dollars in thousands)	Fiscal 1998	Fiscal 1997	Increase (Decrease)	% Increase (Decrease)
PhotoLink revenue:				
Royalties	$2,205	$1,448	$757	52%
License fees	222	540	(318)	(59%)
Reagent sales	794	494	300	61%
Commercial development	891	742	149	20%
Total PhotoLink revenue	4,112	3,224	888	28%
Diagnostic royalties	2,578	1,465	1,113	76%
Stabilization products	2,004	1,665	339	20%
Government research	1,085	1,228	(143)	(12%)
Total revenues	$9,779	$7,582	$2,197	29%

The fiscal 1998 revenue growth was primarily due to an increase in royalty revenue received from licensed clients. The 52% growth in PhotoLink royalties was due to increases in the minimum royalty payments from certain clients, the introduction of 10 additional coated products by the Company's licensees, and increased earned royalties from greater market penetration of previously released coated products sold by licensees. The sales of reagent chemicals increased 61%, as a result of growing production of PhotoLink-coated devices by SurModics' customers. Commercial development revenue increased 20% between years due to more customer-funded development projects related to PhotoLink coatings. Half of this revenue was generated on projects for a single customer. License revenue decreased due to the completion of fewer new license agreements during the year. Three new license agreements were signed in fiscal 1998, compared to ten in fiscal 1997.

The 76% increase in diagnostic royalties was due primarily to the impact of two events in fiscal 1998: a product acquisition by a licensee and the issuance of a new patent to SurModics, both of which resulted in more of the licensee's sales being subject to royalties. The 20% increase in stabilization product sales was the result of greater market penetration due to the Company's sales and marketing efforts.

Product costs. The Company's product costs were $1.2 million for fiscal 1998, a decrease of $200,000, or 17%, from fiscal 1997. Overall product margins increased to 57% in fiscal 1998 from 34% in fiscal 1997. The margin improvement was due to various manufacturing efficiencies achieved during the year as a result of increased production volumes. The most significant factors were: the transfer of stabilization production to a new manufacturing space which increased efficiency; a change to a less costly raw material formulation for the production of some stabilization products; and the increased market demand for some of the Company's products that allowed the Company to establish separate teams for stabilization and reagent production.

Research and development expense. Research and development expense was $4.5 million for fiscal 1998, an increase of $900,000, or 26%, over fiscal 1997. Most of this increase was due to compensation, benefit, and general business expenses associated with the additional technical personnel hired by the Company during the year. In addition, the Company incurred additional depreciation expense associated with the build-out of additional laboratory space. These cost increases were offset by a reduction in the amount of research performed at external laboratories on government grants.

Sales and marketing expense. Sales and marketing expense was $1.4 million for fiscal 1998, an increase of $300,000, or 29%, over fiscal 1997. This increase was primarily due to compensation, benefit, and travel expenses associated with additional sales and marketing personnel hired during the year and the cost of an external market study performed on potential genomics product applications.

General and administrative expense. General and administrative expense was $1.7 million for fiscal 1998, an increase of $300,000, or 20%, over fiscal 1997. The increase was primarily due to the cost of a new directors' and officers' liability insurance policy that was entered into at the time of the IPO; new expenses associated with being a public company (such as investor relations costs, Nasdaq fees and other external reporting expenses); and additional expenses associated with certain consulting projects.

Other income, net. The Company's net other income was $700,000 for fiscal 1998, an increase of $500,000, or 247%, over fiscal 1997. The increase in interest income was due to the earnings generated on the additional investments resulting from the $15.5 million of proceeds received from the IPO in March.

Net Operating Loss Carryforwards

As of September 30, 1999, the Company had a NOL carryforward of approximately $5.6 million, which expires in varying amounts through 2014. The Company also has $400,000 of capital loss carryforwards at September 30, 1999, which expire in 2001. A valuation allowance of $149,000 has been established due to the uncertainty of realization of the capital loss carryforwards.

Year 2000 Compliance

The Company has evaluated and tested its information technology infrastructure for Year 2000 compliance. The Company has an internal technical infrastructure comprised of client server networks and desktop microcomputers. The applications which run on these computers are primarily purchased software without any significant customized programming. Over the last few years, the Company has routinely upgraded most of its computer hardware, software and telecommunications systems. As a result of its evaluation, the Company does not anticipate any problems related to Year 2000 compliance with its information technology infrastructure.

The Company has also evaluated and tested its non-information technology systems with regard to Year 2000 compliance, including contacting significant raw material suppliers. This is especially important related to embedded technology such as microcontrollers contained in various lab equipment, and raw material suppliers who support the Company's manufacturing process. Based upon information currently available, the Company does not anticipate any material disruption in its operations as a result of any failure by either non-information technology equipment or one of its suppliers to be in compliance. Compliance should not be an issue with the Company's products, since they are not date-sensitive.

Costs associated with Year 2000 compliance are expensed as incurred. To date, those costs have not been material. Based upon currently available information, the Company does not expect that the costs of addressing any further Year 2000 issues will have a material impact on the Company's financial condition or results of operations.

Although the Company believes it has addressed all Year 2000 issues, there are risks if the Company's evaluation has not been complete. The most severe risk is business interruption. Specific examples of situations that could cause business interruption include, among others, (i) computer hardware or application software processing errors or failures; (ii) failure of lab or manufacturing equipment; (iii) outside suppliers who may not be Year 2000 compliant. Depending on the extent and duration of the business interruption resulting from non-compliant Year 2000 systems, such interruption could have a material adverse effect on the Company's financial condition and results of operations.

Liquidity and Capital Resources

As of September 30, 1999, the Company had working capital of approximately $5.8 million and cash, cash equivalents and investments totaling approximately $21.8 million. The Company generated positive cash flows from operating activities of approximately $4.4 million in fiscal 1999, $2.1 million in fiscal 1998 and $0.5 million in fiscal 1997. The increase in cash flow in fiscal 1999 was primarily due to the increased net income generated during the year.

The significant increase in investing activities over the last two years was primarily due to the activity in the Company's available-for-sale investment portfolio as managed by an independent investment manager. SurModics' investment policy requires investments with high credit quality issuers and limits the amount of credit exposure to any one issuer. The Company's investments principally consist of U.S. government and government agency obligations and investment grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are three years or less. A 10% increase in interest rates would result in an approximate $150,000 decrease in the fair value of the Company's available-for-sale securities as of September 30, 1999, but no material impact on the results of operations or cash flows. SurModics' does not use derivative instruments in its investment portfolio.

The increase in purchases of property and equipment in fiscal 1999 was primarily due to the Company's purchase of the land and building it currently occupies (which includes additional space for expansion) for approximately $3.2 million. The most significant financing activity over the last three years was the completion of the initial public offering of 2.3 million shares of Common Stock in March 1998, which generated net proceeds to the Company of approximately $15.5 million net of related offering expenses. The exercise of stock options generated an additional $1.3 million of cash during fiscal 1999.

As of September 30, 1999, the Company had no debt, nor did it have any credit agreements. The Company believes that its existing capital resources will be adequate to fund the Company's operations into the foreseeable future.

Forward-Looking Statements

Certain statements contained in this Annual Report and other written and oral statements made from time to time by the Company do not relate strictly to historical or current facts. As such, they are considered "forward-looking statements" which provide current expectations or forecasts of future events. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Reform Act of 1995. Such statements can be identified by the use of terminology such as "anticipate," "believe," "estimate," "expect," "intend," "may," "could," "possible," "plan," "project," "will," "forecast" and similar words or expressions. The Company's forward-looking statements generally relate to its growth strategy, financial results, product development programs, sales efforts, and Year 2000 compliance. One must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions. Consequently, no forward-looking statement can be guaranteed and actual results may vary materially. The Company undertakes no obligation to update any forward-looking statement.

Although it is not possible to create a comprehensive list of all factors that may cause actual results to differ from the Company's forward-looking statements, such factors include, among others, (i) the trend of consolidation in the medical device industry, resulting in more significant, complex and long-term contracts than in the past and potentially greater pricing pressures; (ii) the Company's ability to attract new licensees and to enter into agreements for additional product applications with existing licensees, and the willingness of potential customers to sign license agreements under the terms offered by the Company; (iii) the success of existing licensees in selling products incorporating SurModics' technology and the timing of new product introductions by licensees; (iv) the difficulties and uncertainties associated with the lengthy and costly new product development and foreign and domestic regulatory approval processes, such as delays, difficulties or failures in achieving acceptable clinical results or obtaining foreign or FDA marketing clearances, which may result in lost market opportunities or postpone or preclude product commercialization by licensees; (v) efficacy or safety concerns with respect to products marketed by SurModics and its licensees, whether scientifically justified or not, that may lead to product recalls, withdrawals or declining sales; (vi) the development of new products or technologies by competitors, technological obsolescence and other changes in competitive factors; (vii) the Company's ability to successfully respond to Year 2000 issues, which depends, in part, on the availability of personnel, the Company's ability to identify and resolve issues, both foreseen and unforeseen, and the readiness of third parties to resolve their issues; and (viii) economic factors over which the Company has no control, including changes in inflation and consumer confidence. Investors are advised to consult any further disclosures by the Company on this subject in its filings with the Securities and Exchange Commission.

SurModics, Inc.
Financial Statements as of
September 30, 1999 and 1998
Together With Report of
Independent Public Accountants

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To SurModics, Inc.:

We have audited the accompanying balance sheets of SurModics, Inc. (a Minnesota corporation) as of September 30, 1999 and 1998, and the related statements of operations, stockholders' equity and cash flows for each of the three years in the period ended September 30, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SurModics, Inc. as of September 30, 1999 and 1998, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 1999, in conformity with generally accepted accounting principles.

/s/ ARTHUR ANDERSEN LLP

Minneapolis, Minnesota,
October 27, 1999

SurModics, Inc.
Balance Sheets
As of September 30

	1999	1998
ASSETS		
Current Assets		
Cash and cash equivalents	$1,975,188	$1,343,561
Short-term investments	3,947,273	3,526,493
Accounts receivable, net of allowance of $40,000 and $35,000	1,433,328	1,056,710
Inventories, net	458,888	379,946
Prepaids and other	259,403	255,456
Total current assets	8,074,080	6,562,166
Property and Equipment, net	5,275,165	1,239,548
Long-Term Investments	15,916,538	16,248,914
Deferred Tax Asset	2,465,000	--
Other Assets, net	227,504	254,361
	$31,958,287	$24,304,989
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$710,363	$304,706
Accrued liabilities-		
Compensation	783,271	615,264
Other	477,351	334,904
Deferred revenues	268,283	227,725
Total current liabilities	2,239,268	1,482,599
Deferred Revenues, less current portion	--	124,231
Total liabilities	2,239,268	1,606,830
Commitments and Contingencies (Note 6)		
Stockholders' Equity		
Series A preferred stock- $.05 par value, 150,000 shares authorized no shares issued and outstanding	--	--
Common stock- $.05 par value, 15,000,000 shares authorized 7,701,921 and 7,214,085 shares issued and outstanding	385,096	360,704
Additional paid-in capital	32,008,996	28,934,732
Unearned compensation	(267,157)	(170,335)
Stock purchase notes receivable	(58,273)	(182,273)
Accumulated other comprehensive income (loss)	(186,502)	278,244
Accumulated deficit	(2,163,141)	(6,522,913)
Total stockholders' equity	29,719,019	22,698,159
	$31,958,287	$24,304,989

The accompanying notes are an integral part of these balance sheets.

SurModics, Inc.
Statements of Operations
For the Years Ended September 30

	1999	1998	1997
Revenues			
Royalties	$6,670,153	$4,782,626	$2,913,119
License fees	645,000	222,500	540,000
Product sales	4,135,970	2,797,647	2,158,572
Research and development	2,042,417	1,975,888	1,970,174
Total revenues	13,493,540	9,778,661	7,581,865
Operating Costs and Expenses			
Product	1,510,582	1,193,178	1,431,675
Research and development	5,247,647	4,521,689	3,597,061
Sales and marketing	1,768,578	1,419,028	1,098,316
General and administrative	2,547,716	1,696,741	1,417,524
Total operating costs and expenses	11,074,523	8,830,636	7,544,576
Income from Operations	2,419,017	948,025	37,289
Other Income			
Investment income and other, net	1,068,861	698,193	209,204
Gain on sale of investments	88,599	27,634	--
Other income, net	1,157,460	725,827	209,204
Net Income Before Income Taxes	3,576,477	1,673,852	246,493
Provision for (benefit from) Income Taxes	(783,295)	37,220	10,820
Net Income	$4,359,772	$1,636,632	$ 235,673
Net Income per Share			
Basic	$.59	$.26	$.05
Diluted	$.54	$.24	$.04
Weighted Average Shares Outstanding			
Basic	7,354,013	6,224,362	4,853,558
Dilutive effect of outstanding stock options	688,064	574,271	531,780
Diluted	8,042,077	6,798,633	5,385,338

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

SurModics, Inc.
Statements of Stockholders' Equity
For the Years Ended September 30, 1999, 1998 and 1997

	Convertible Preferred Stock		Voting Common Stock		
	Shares	Amount	Shares	Amount	Additional Paid-In Capital
Balance, September 30, 1996	376,828	$18,841	3,311,480	$165,576	$13,093,961
Components of comprehensive income:					
Net income	-	-	-	-	-
Change in unrealized gain on available-for-sale securities	-	-	-	-	-
Total comprehensive income					
Common stock options exercised	-	-	45,388	2,268	179,904
Restricted stock granted	-	-	44,000	2,200	217,800
Amortization of unearned compensation	-	-	-	-	-
Balance, September 30, 1997	376,828	18,841	3,400,868	170,044	13,491,665
Components of comprehensive income:					
Net income	-	-	-	-	-
Change in unrealized gain on available-for-sale securities	-	-	-	-	-
Total comprehensive income					
Common stock options exercised	-	-	25,905	1,296	111,988
Conversion of preferred stock to common stock	(376,828)	(18,841)	1,507,312	75,364	(56,523)
Issuance of common stock	-	-	2,300,000	115,000	15,406,102
Restricted stock activity	-	-	(20,000)	(1,000)	(18,500)
Net loan activity	-	-	-	-	-
Amortization of unearned compensation	-	-	-	-	-
Balance, September 30, 1998	-	-	7,214,085	360,704	28,934,732
Components of comprehensive income:					
Net income	-	-	-	-	-
Change in unrealized gain on available-for-sale securities	-	-	-	-	-
Total comprehensive income					
Common stock options exercised, net	-	-	482,777	24,139	1,309,787
Tax benefit from exercise of stock options	-	-	-	-	1,650,000
Restricted stock activity	-	-	8,500	425	170,305
Net loan activity	-	-	(3,441)	(172)	(55,828)
Amortization of unearned compensation	-	-	-	-	-
Balance, September 30, 1999	-	$ -	7,701,921	$385,096	$32,008,996

SurModics, Inc.
Statements of Stockholders' Equity
For the Years Ended September 30, 1999, 1998 and 1997
(continued)

	Unearned Compensation	Stock Purchase Notes Receivable	Accumulated Other Comprehensive Income(Loss)	Accumulated Deficit	Total Stockholders' Equity
Balance, September 30, 1996	$(142,720)	$ -	$ -	$(8,395,218)	$4,740,440
Components of comprehensive income:					
Net income	-	-	-	235,673	235,673
Change in unrealized gain on available-for-sale securities	-	-	-	-	-
Total comprehensive income					235,673
Common stock options exercised	-	(160,000)			22,172
Restricted stock granted	(220,000)	-	-	-	-
Amortization of unearned compensation	103,720	-	-	-	103,720
Balance, September 30, 1997	(259,000)	(160,000)	-	(8,159,545)	5,102,005
Components of comprehensive income:					
Net income	-	-	-	1,636,632	1,636,632
Change in unrealized gain on available-for-sale securities	-	-	278,244	-	278,244
Total comprehensive income					1,914,877
Common stock options exercised	-	-	-	-	113,284
Conversion of preferred stock to common stock	-	-	-	-	-
Issuance of common stock	-	-	-	-	15,521,102
Restricted stock activity	19,500	-	-	-	-
Net loan activity	-	(22,273)	-	-	(22,273)
Amortization of unearned compensation	69,165	-	-	-	69,165
Balance, September 30, 1998	(170,335)	(182,273)	278,244	(6,522,913)	22,698,159
Components of comprehensive income:					
Net income	-	-	-	4,359,772	4,359,772
Change in unrealized gain on available-for-sale securities	-	-	(464,746)	-	(464,746)
Total comprehensive income					3,895,026
Common stock options exercised, net	-	-	-	-	1,333,926
Tax benefit from exercise of stock options	-	-	-	-	1,650,000
Restricted stock activity	(170,730)	-	-	-	-
Net loan activity	-	124,000	-	-	68,000
Amortization of unearned compensation	73,908	-	-	-	73,908
Balance, September 30, 1999	$(267,157)	$(58,273)	$(186,502)	$(2,163,141)	$29,719,019

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

SurModics, Inc.
Statements of Cash Flows
For the Years Ended September 30

	1999	1998	1997
Operating Activities			
Net income	$ 4,359,772	$ 1,636,632	$ 235,673
Adjustments to reconcile net income to net cash provided by operating activities-			
Depreciation and amortization	708,937	617,536	460,039
Gain on sale of investments	(88,599)	(27,634)	-
Amortization of unearned compensation, net	73,908	69,165	103,720
Change in deferred rent	(30,481)	(17,742)	(11,104)
Change in deferred tax	(815,000)	-	-
Change in assets and liabilities:			
Accounts receivable	(376,618)	(134,244)	(294,647)
Inventories	(78,942)	(115,938)	(3,240)
Accounts payable and accrued liabilities	716,111	481,739	446,729
Deferred revenue	(53,192)	(205,418)	(393,416)
Prepaids and other	(3,947)	(181,332)	(12,701)
Net cash provided by operating activities	4,411,949	2,122,764	531,053
Investing Activities			
Purchases of property and equipment, net	(4,720,703)	(775,402)	(298,388)
Purchases of available-for-sale investments	(24,436,386)	(33,595,043)	(3,923,184)
Sales/maturities of available-for-sale investments	23,971,835	17,455,608	2,425,000
Repayment (issuance) of stock purchase notes receivable	68,000	(22,273)	-
Other	3,006	31,897	(277,935)
Net cash used in investing activities	(5,114,248)	(16,905,213)	(2,074,507)
Financing Activities			
Issuance of common stock, net of offering costs	1,333,926	15,634,386	22,172
Net cash provided by financing activities	1,333,926	15,634,386	22,172
Net increase (decrease) in cash and cash equivalents	631,627	851,937	(1,521,282)
Cash and Cash Equivalents			
Beginning of year	1,343,561	491,624	2,012,906
End of year	$ 1,975,188	$ 1,343,561	$ 491,624
Supplemental Cash Flow Information			
Interest paid	$ -	$ -	$ 1,700
Non-cash investing and financing activity--			
Issuance of stock purchase notes receivable from exercised stock options	$ -	$ -	$ 160,000
Tax benefit from exercise of stock options	$ 1,650,000	$ -	$ -

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

SurModics, Inc.
Notes to Financial Statements

1. Description

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

In March 1998, the Company completed an initial public offering of 2.3 million shares of Common Stock, generating net proceeds to the Company of approximately $15.5 million net of offering expenses.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents

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

Investments

Investments consist principally of U.S. government and government agency obligations and corporate debt securities and are classified as available-for-sale as of September 30, 1999 and 1998. Available-for-sale investments are reported at fair value with unrealized gains and losses excluded from operations and reported as a separate component of stockholders' equity, except for other-than-temporary impairments, which are reported as a charge to current operations and result in a new cost basis for the investment.

The amortized cost, unrealized holding gains and losses, and fair value of investments as of September 30, 1999 and 1998 were as follows:

	September 30, 1999			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government obligations	$10,422,826	$225	$(133,645)	$10,289,406
Corporate bonds	3,457,977	-	(4,521)	3,453,455
Mortgage-backed securities	2,682,899	2,742	(28,455)	2,657,186
Asset-backed securities	2,309,677	447	(7,854)	2,302,271
Municipal bonds	1,176,934	726	(16,167)	1,161,493
Total	$20,050,313	$4,140	$(190,642)	$19,863,811

	September 30, 1998			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. government obligations	$12,178,480	$243,326	$ -	$12,421,806
Corporate bonds	5,638,397	5,755	(724)	5,643,428
Mortgage-backed securities	1,286,413	28,784	(3,071)	1,312,126
Municipal bonds	200,000	4,174	-	204,174
Other debt securities	193,873	-	-	193,873
Total	$19,497,163	$282,039	$(3,795)	$19,775,407

The amortized cost and fair value of investments by contractual maturity at September 30, 1999, were as follows:

	Amortized Cost	Fair Value
Debt securities due within:		
One year	$3,947,273	$3,947,273
One to five years	14,534,234	14,356,330
Five years or more	1,568,806	1,560,208
Total	$20,050,313	$19,863,811

Inventories

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

	1999	1998
Raw materials	$179,205	$107,522
Finished products	279,683	272,424
Total	$458,888	$379,946

Property and Equipment

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

	1999	1998
Laboratory fixtures and equipment	$3,009,379	$2,313,236
Office furniture and equipment	1,383,197	1,002,210
Building and improvements	4,532,713	1,323,387
Construction-in-progress	408,362	--
Less-Accumulated depreciation and amortization	(4,058,486)	(3,399,285)
Property and equipment, net	$5,275,165	$1,239,548

Other Assets

Other assets consist principally of patents, which are amortized over 7 to 12 years. Accumulated amortization was $64,000 and $40,000 as of September 30, 1999 and 1998, respectively.

Revenue Recognition

Royalties are recognized as third-party licensees report sales of the licensed product or as minimum royalties become due. Initial nonrefundable license fees

are recognized as revenue upon execution of the license agreement. Certain nonrefundable license and research and development fees are recoverable by the licensees as offsets against a percentage of future earned royalties.

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

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

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Ultimate results could differ from those estimates.

Reclassification

Certain 1998 and 1997 amounts in the accompanying financial statements have been reclassified to conform to the 1999 presentation. These reclassifications had no effect on previously reported net income or stockholders' equity.

New Accounting Pronouncements

SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability measured at its fair value. Based on its current operations, the Company anticipates that the adoption of SFAS No. 133 in fiscal 2002 will have not have a significant impact on its financial statements.

3. Stockholders' Equity

Authorized Shares

The authorized capital stock of the Company consists of 20,000,000 shares of capital stock, $.05 per share par value, of which 15,000,000 shares are Common Stock, 150,000 are Series A Preferred Stock and 4,850,000 shares are undesignated. The Series A Preferred Stock was designated by board action in conjunction with a Shareholder Rights Plan and has certain preferential voting, liquidation and dividend rights as follows:

a. Each share of Series A Preferred Stock is entitled to 100 votes on all matters submitted to a vote of the stockholders of the Company.

b. In the event of liquidation of the Company, the holders of these shares are entitled to receive the greater of $100 per share or 100 times the per share amount to be distributed to holders of shares of Common Stock.

c. Preferred stockholders are entitled to receive a quarterly dividend of the greater of $1.00 per share or 100 times the per share amount of any dividend declared on the Common Stock.

Shareholder Rights Plan

In April 1999, the Company adopted a Shareholder Rights Plan (the "Rights Plan"). Under the Rights Plan, the Board of Directors declared a dividend to stockholders of record on April 5, 1999 of one preferred stock purchase right

(the "Rights") for each outstanding share of Common Stock. Each right entitles the holder to purchase one one-hundredth of a share of Series A Preferred Stock from the Company. The Rights issued under the plan will only become exercisable by stockholders, other than a potential acquirer, following an acquisition by the acquirer (without prior approval of the Company's board of directors) of 15% or more of the Company's Common Stock, or the announcement of a tender offer for 15% or more of the Common Stock. The Rights will expire in April 2009.

Restricted Stock Awards

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

Transactions in restricted stock were as follows:

Outstanding at September 30, 1996	82,400
Granted	44,000
Outstanding at September 30, 1997	126,400
Granted	4,000
Canceled	(24,000)
Exercised	(42,400)
Outstanding at September 30, 1998	64,000
Granted	12,500
Canceled	(4,000)
Outstanding at September 30, 1999	72,500

Stock Purchase Notes Receivable

The Company established a loan program during fiscal 1997 to assist employees in purchasing shares of the Company's stock. The loans are collateralized by the employees' purchased shares and require annual interest payments at a rate equal to prime at the date of issuance (8.5%) with principal and any unpaid interest due at the earlier of five years after the date of issuance or three months after termination of employment. The loans may be repaid in either cash or mature shares held by the employee. No further loans are being granted under this program.

4. Stock-Based Compensation Plan

Under the Company's 1997 Incentive Stock Option Plan (the Plan), 600,000 shares of Common Stock were reserved for issuance to employees and officers. The Plan requires that the option price per share must be at least 100% of the fair market value of the Common Stock on the date of the grant of the option or 110% with respect to optionees who own more than 10% of the total combined voting power of all classes of stock. Options expire in five to seven years or upon termination of employment and are exercisable at a rate of 20% per year from the date of grant or 20% per year commencing one year after the date of grant. In addition, options representing a total of 195,350 shares remain outstanding from the Company's 1987 Incentive Stock Option Plan which was replaced by the 1997 Plan.

Under the Company's Nonqualified Stock Option Plan, 972,240 shares of Common Stock were reserved for issuance to outside directors, employees and officers.

The options are granted at fair market value. Options expire in five to ten years and are exercisable at a rate of 20% per year from the date of grant or 20% per year commencing two years after the date of grant.

As of September 30, 1999, there were 420,380 additional shares available for grant under the stock plans. Information regarding stock options under all plans is summarized as follows:

	1999		1998		1997	
Options	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	1,269,640	$4.86	1,204,800	$4.60	1,163,600	$4.52
Granted	183,700	15.73	137,300	6.98	157,400	5.00
Exercised	(541,030)	4.16	(26,220)	4.47	(45,388)	4.01
Canceled	(38,020)	5.82	(46,240)	4.78	(70,812)	4.51
Outstanding, end of year	874,290	$7.53	1,269,640	$4.86	1,204,800	$4.60
Exercisable, end of year	439,410	$5.18	757,860	$4.49	589,320	$4.42
Weighted average fair value of options granted	$11.47		$4.91		$3.30	

The options outstanding at September 30, 1999 have exercise prices ranging between $5.00 and $16.75, with a weighted average exercise price of $7.53 and a weighted average remaining contractual life of 5.33 years.

The fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1999, 1998 and 1997, respectively: risk-free interest rates of 6.01%, 5.00% and 6.24%; expected lives of 7.3, 6.4 and 5.6 years; and expected volatility of 71%, 73% and 73%.

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

	1999	1998	1997
Net income:			
As reported	$4,359,772	$1,636,632	$235,673
Pro forma	$4,119,529	$1,506,492	$155,541
Net income per share:			
As reported	$.54	$.24	$.04
Pro forma	$.51	$.22	$.03

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

5. Income Taxes

The Company utilizes the liability method to account for income taxes. Deferred taxes are based on the estimated future tax effects of differences between the financial statement and tax bases of assets and liabilities given the provisions of the enacted tax laws. Reserves are established on the basis of expected ability to utilize the deferred assets. During fiscal 1999, management concluded that the Company would generate sufficient taxable income in the future to utilize all of the previously unrecognized tax net operating loss ("NOL") carryforwards attributable to ordinary income prior to their expiration.

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

	1999	1998	1997
Current provision:			
Federal	$ -	$33,477	$ 356
State and foreign	16,705	3,743	10,464
Total current provision	16,705	37,220	10,820
Deferred benefit:			
Federal	(735,000)	-	-
State	(65,000)	-	-
Total deferred benefit	(800,000)	-	-
Total provision (benefit)	$ (783,295)	$37,220	$10,820

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

	1999	1998	1997
Amount at statutory federal income tax rate:	$1,323,000	$ 621,000	$ 93,000
Change due to:			
Reversal of tax valuation allowance	(2,466,000)	-	-
Utilization of net operating losses	-	(619,000)	(91,000)
Rate difference for deferred tax assets	180,000	-	-
Other	179,705	35,220	8,820
Income tax provision (benefit)	$ (783,295)	$ 37,220	$ 10,820

The components of deferred income taxes consisted of the following as of September 30:

	1999	1998
Net operating loss carryforwards	$2,048,000	$1,875,000
Capital loss carryforwards	149,000	197,000
Depreciation	265,000	247,000
Other	152,000	296,000
Total deferred tax assets	2,614,000	2,615,000
Less- valuation allowance	(149,000)	(2,615,000)
Net deferred tax assets	$2,465,000	$ -

These deferred tax assets result from differences in the recognition of transactions for income tax and financial reporting purposes. The Company's NOL carryforwards of approximately $5.6 million at September 30, 1999 expire in varying amounts through 2014. The Company also has $400,000 of capital loss carryforwards at September 30, 1999, which expire in 2001, on which a 100% valuation allowance has been established.

6. Commitments and Contingencies

Government Contracts

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

Construction Commitments

The Company has entered into agreements with certain contractors for the construction of additional laboratory and office space totaling approximately $1.0 million, of which $408,000 was recorded in construction-in-progress as of September 30, 1999. This construction is expected to be completed in the first quarter of fiscal 2000.

7. Defined Contribution Plan

The Company has a 401(k) retirement and savings plan for the benefit of qualified employees. Under the plan, qualified employees may elect to defer up to 20% of their compensation, subject to a maximum limit determined by the Internal Revenue Service. Beginning October 1, 1998, the Company matched 50 percent of each dollar of the first six percent of the tax deferral elected by each employee. In prior years, the Company made discretionary contributions to the plan subject to the approval of the Board of Directors. Company contributions totaling $122,000, $117,000 and $86,000 have been charged to operations for the years ended September 30, 1999, 1998 and 1997, respectively.

8. Operating Segments (Dollars in thousands)

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

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

	Licensing	Manufacturing	Research & development	Corporate	Consolidated
Year Ended September 30, 1999					
Revenues:					
PhotoLink	$4,557	$1,876	$1,122	$ -	$7,555
Diagnostic	2,758	-	-	-	2,758
Stabilization	-	2,261	-	-	2,261
Government	-	-	920	-	920
Total Revenues	7,315	4,137	2,042	-	13,494
Expenses	-	1,511	5,248	4,316	11,075
Operating income (loss)	7,315	2,626	(3,206)	(4,316)	2,419
Other income				1,158	1,158
Income tax benefit				783	783
Net income					$4,360
Year Ended September 30, 1998					
Revenues:					
PhotoLink	$2,427	$794	$891	$ -	$4,112
Diagnostic	2,578	-	-	-	2,578
Stabilization	-	2,004	-	-	2,004
Government	-	-	1,085	-	1,085
Total Revenues	5,005	2,798	1,976	-	9,779
Expenses	-	1,193	4,522	3,116	8,831
Operating income (loss)	5,005	1,605	(2,546)	(3,116)	948
Other income				726	726
Income tax expense				(37)	(37)
Net income					$1,637

Year Ended September 30, 1997

Revenues:					
PhotoLink	$1,988	$494	$742	$-	$3,224
Diagnostic	1,465	-	-	-	1,465
Stabilization	-	1,665	-	-	1,665
Government	-	-	1,228	-	1,228
Total Revenues	3,453	2,159	1,970	-	7,582
Expenses	-	1,432	3,597	2,516	7,545
Operating income (loss)	3,453	727	(1,627)	(2,516)	37
Other income				209	209
Income tax expense				(10)	(10)
Net income					$236

Major Customers

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

	1999	1998	1997
U.S. government agencies	7%	11%	16%
Company A	20%	26%	21%
Company B	12%	2%	--

Revenues from U.S. Government agencies are derived from the Research and development segment. Revenues from Company A are derived from the Licensing and royalties segment. Revenues from Company B are derived from all three revenue segments.

Geographic Revenue

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

	1999	1998	1997
Domestic	87%	90%	93%
Foreign	13%	10%	7%

9. Quarterly Financial Data (Unaudited, in thousands except per share data)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Fiscal 1999				
Revenues	$2,639	$3,308	$3,685	$3,862
Income from operations	265	591	755	808
Net income	925	1,105	1,214	1,117
Net income per share:				
Basic	.13	.15	.16	.15
Diluted	.12	.14	.15	.14
Fiscal 1998				
Revenues	$1,909	$2,579	$2,672	$2,619
Income from operations	101	288	330	229
Net income	151	376	566	544
Net income per share:				
Basic	.03	.07	.08	.08
Diluted	.03	.06	.07	.07

STOCK LISTING AND PRICE HISTORY

Surmodics' stock is traded on the Nasdaq National Market under the symbol "SRDX." On March 4, 1998, the Company completed its initial public offering of Common Stock at a price of $7.50 per share. The following table sets forth the range of high and low closing sale prices for the Company's Common Stock, as reported by Nasdaq:

FISCAL QUARTER ENDED	HIGH	LOW
September 30, 1999	$ 18 3/4	$ 14 1/8
June 30, 1999	$ 16 3/4	$ 12 3/4
March 31, 1999	$ 14 1/2	$ 9 7/8
December 31, 1998	$ 15 1/2	$ 6 1/2
September 30, 1998	$ 14 1/8	$ 7 3/16
June 30, 1998	$ 11 3/4	$ 8 1/4
March 31, 1998	$ 9	$ 7 3/4
December 31, 1997	N/A	N/A

According to the records of the Company's transfer agent, as of November 29, 1999, the Company had 227 holders of record of the Company's Common Stock (excluding beneficial owners of shares registered in nominee or street name).

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

EXHIBIT 23

CONSENT OF INDEPENDENT PUBLIC ACCOUNTANTS

As independent public accountants, we hereby consent to the incorporation of our report incorporated by reference in this Form 10-KSB, into the Company's previously filed Registration Statements-File Nos. 333-64171, 333-64173 and 333-79741.

/s/ ARTHUR ANDERSEN LLP

Minneapolis, Minnesota,
December 21, 1999

5
1,000
U.S. Dollars

YEAR
SEP-30-1999
OCT-01-1998
SEP-30-1999
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0
4,360
.59
.59