



Dechra

Pharmaceuticals PLC

Interim Report 2006



Developing Pharmaceuticals
Improving Animal Health



Our Business

An emerging pharmaceutical business, focused on the veterinary market

Our Strategy

Our focus is the development of our own veterinary pharmaceutical portfolio and increasing our pharmaceutical penetration into international markets

Welcome to Dechra

Interim Results 2006	31 December		
	2005	2004	
Revenue	£116.1m	£104.3m	+11%
Operating profit	£5.8m	£5.5m	+5%
Operating profit (pre-product and USA development cost)	£6.6m	£5.9m	+13%
Profit before taxation	£5.2m	£4.8m	+9%
Profit before taxation (pre-product and USA development cost)	£6.0m	£5.1m	+18%
Earnings per share	6.99p	6.49p	+8%
Interim dividend	1.91p	1.70p	+12%
Net borrowings	£10.2m	£13.2m	

All figures now reported under International Financial Reporting Standards as adopted by the European Union



Developing Pharmaceuticals
Improving Animal Health



Pharmaceuticals

- Pharmaceutical revenue accelerated through lead products in UK and EU
- US launch of Thyroxyl — establishing Dechra Veterinary Products in USA ahead of Vetoryl® launch



Services

- Strong revenue growth and market share strengthened
- NVS has improved its competitive position and gained new accounts

Half Year Review

“In addition to the strong organic growth achieved, the Group has continued to lay the foundations of future growth by significantly increased product development expenditure and further investment in the establishment of our USA operation”

INTRODUCTION

The Group continues to make solid progress across all businesses, with revenue growth of 11%. This reflects both strong market conditions and further penetration of our products and services within the veterinary market.

In addition to the strong organic growth achieved, the Group has continued to lay the foundations of future growth by, as previously indicated, significantly increased product development expenditure compared to the same period last year, and further investment in the establishment of our USA operation. Therefore, whilst operating profit showed a 5% improvement over the comparable period and pre-tax profit a 9% improvement, these figures rise to 13% and 18% respectively if stated before increased product and USA development cost, both of which will be key drivers of value over the long term.

Our strategic focus continues to be the ongoing development of the Group's own veterinary pharmaceutical portfolio for the world's companion animal markets. It is pleasing to report that two milestones have been achieved in the period. Firstly, through the mutual recognition procedure, we have gained approval in the EU for one of our lead products, Vetoryl® capsules. Marketing will commence via our European partners in the key territories prior to the end of this financial year. Secondly, the Group continues to make progress on the licensing of both Vetoryl capsules and Felimazole® tablets in the USA. Feedback received from the Food and Drug Administration (“FDA”) on the safety and efficacy sections of our applications has provided clarity on the specific requirements to license these key products in the world's largest companion animal market. We remain confident of the potential for substantial sales. Further details are provided later in this report.

FINANCIALS

These interim results are our first to be presented using International Financial Reporting Standards (“IFRS”). The comparative figures for the year ended 30 June 2005 and the six months ended 31 December 2004 have been restated accordingly.

In the six months ended 31 December 2005, Group revenues were up 11% to £116.1 million (2004: £104.3 million), whilst operating profit increased by 5% to £5.8 million (2004: £5.5 million), and profit before taxation rose 9% to £5.2 million (2004: £4.8 million).

Basic earnings per share amounted to 6.99 pence, against 6.49 pence in 2004, up 8%.

As normal, inventory levels were at a seasonally high level at the end of the period being reported on and this caused net borrowings to increase compared to 30 June 2005. However, the net borrowings at 31 December 2005 of £10.2 million showed a 22% reduction when compared to the £13.2 million at the same point last year. We expect by the year-end to have reduced borrowings further, reflecting the Group's strong cash generation.

Interest cover remains strong at 9.2 times operating profit (2004: 7.1 times).

DIVIDEND

In view of the Board's confidence in the future direction of the Group, the Directors are declaring an Interim dividend of 1.91 pence (2004: 1.70 pence), an increase of 12%.

The Interim dividend will be paid on 7 April 2006 to shareholders on the Register as at 10 March 2006. This dividend is covered 3.6 times by earnings (2004: 3.8 times).

REVIEW

Pharmaceutical Division

This division comprises Dechra Veterinary Products (“DVP”), Arnolds Veterinary Products (“Arnolds”) and Dales Pharmaceuticals (“Dales”).

Sales and Marketing

The rebranding of our UK pharmaceuticals is progressing to plan with our major strategic products now being marketed under the global ‘Dechra Veterinary Products’ brand.

DVP continues to increase pharmaceutical sales, driven by accelerated growth of one of our lead products, Felimazole, within the UK and EU. This was achieved by launches into new EU territories by our marketing partners and the UK introduction of a new 2.5 mg dosage form.

DVP USA, established in April 2005, has successfully launched our own branded Thyroxyl oral solution and Thyroxyl tablets for the treatment of canine hypothyroidism in this important region. DVP, led by our experienced US team, recently presented and exhibited at the North American Veterinary Conference where our introduction to the market and our long-term plans were well received by veterinarians. Terms have been agreed with all the major national and regional distributors, a key step in establishing our presence in North America.

We continue to develop the Arnolds brand, which is now focused on instruments, consumables and critical care products. We have made progress as market leaders in critical care with market share gains and product introductions. The Vetivex® range of licensed products used for fluid therapy, which we acquired last year, has seen improvement in market share and pleasing revenue growth. Although our Instruments and Consumables business has suffered from competitive pressures, grey imports and price deflation, it produced a satisfactory performance with volume sales being maintained.



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Improving Animal Health

“Solid progress across all businesses reflecting both strong market conditions and further penetration of our products and services within the veterinary market”



Half Year Review

“Training and development remain key to the future of the business and we continue to invest in our people”

Pharmaceutical Manufacturing

Dales, our manufacturing facility, enjoyed a positive first-half performance through further productivity improvements and investment. Service levels to customers are now at record highs, and we expect this trend to be maintained.

A complete revision of our Quality Management Systems is at an advanced stage. Also during the first half, we began the commissioning of a new IT system. These changes will enhance quality procedures and improve efficiency as we work towards achieving FDA compliance.

Services Division

This division comprises National Veterinary Services (“NVS”), Vetcom Systems (“Vetcom”), NationWide Laboratories (“NWL”) and Cambridge Specialist Laboratory Services (“CSLS”).

Distribution

Despite the continuing competitive market conditions, our wholesaling business NVS has focused on improving its competitive position and gaining new accounts. This has produced strong sales growth and further strengthened NVS's market share.

We have commenced a substantial investment in NVS's central facility, which will increase capacity and further improve operational efficiency. The warehouse has been extended by a new 16,000 square foot mezzanine floor with major extensions and operational improvements also being made to the automatic picking circuit.

Vetcom Systems

This month has seen the launch of 'Vpod', a hand-held, stand-alone, electronic on-line ordering device. Utilising barcode technology, this fast and easy-to-use ordering system will allow veterinary practices to maintain optimum stock levels and place orders at any time of the day.

Laboratory Services

Our laboratory businesses, NWL and CSLS, have produced strong results with sales and operating profit significantly ahead of 2004.

Organic growth has been achieved from gaining new accounts, by maximising the return from existing customers and by providing new services.

Our allergy testing brand, 'Allervet', launched last year, continues to exceed our sales expectations.

PRODUCT DEVELOPMENT

As outlined in the introduction, Vetoryl capsules, which are used for the treatment of Cushing's disease in dogs, have received approval for marketing in all 19 European territories which were applied for. This is a major achievement for our Regulatory team and is now the second product we have successfully licensed throughout the key territories of Europe.

Guidance has been received on Vetoryl capsules from the US regulators, the FDA, providing clear requirements on the further clinical trial work necessary to satisfy US regulations. Protocols for these trials have been submitted and are awaiting approval. Trial sites have been identified on the East coast of America and implementation will commence shortly. These trials are expected to be completed by the end of 2007. A 10mg strength Vetoryl® capsule, which will improve maintenance dosage options, is also under development for introduction to all markets.

Felimazole, our own-developed tablet for feline hyperthyroidism, is also currently undergoing clinical trials within the USA. The protocol for the efficacy study has been approved by the FDA and the trials have commenced.

Felimazole tablets and Vetoryl capsules also represent a sizeable opportunity in other territories. Dossiers have already been submitted to the Australian and Canadian authorities and negotiations are underway to identify partners in other territories where there are significant companion animal markets.

Following the recent launch of Urilin®, our first UK licensed branded generic product, used for the treatment of canine urinary incontinence, we have been granted a UK marketing authorisation for a further licensed branded generic which will be launched in Q4 of this financial year.

PEOPLE

Training and development remain key to the future of the business and we continue to invest in our people.

During the period, we have welcomed a number of new staff, including senior appointments: Martin Riley as Managing Director and Caitrina Harrison as Sales & Marketing Director at NVS.

During the second half, we will be looking to add to our Regulatory team, through the recruitment of a US national to monitor our US based field trials.

PROSPECTS AND CURRENT TRADING

Our Group wholesaling business NVS, will continue to build on its solid market share and take advantage of opportunities within a sector that has recently witnessed a significant consolidation.

Market penetration of our veterinary pharmaceutical portfolio into new and existing markets is increasing and we expect to deliver further growth and report positively on the clinical trials in North America in the future.

Overall, trading continues to be in line with management expectations and we look forward to the future with confidence.



Developing Pharmaceuticals
Improving Animal Health

Michael Redmond
Non-Executive Chairman

Ian Page
Chief Executive

“Market penetration of our veterinary pharmaceutical portfolio into new and existing markets is increasing and we expect to deliver further growth and report positively on the clinical trials in North America in the future”



Consolidated Income Statement

For the six months ended 31 December 2005

		Six months ended		Year ended
	Note	31.12.05	31.12.04	30.06.05
		£'000	£'000	£'000
Revenue	3	116,088	104,263	210,267
Cost of sales		(100,015)	(90,023)	(180,550)
Gross profit		16,073	14,240	29,717
Operating expenses		(10,264)	(8,705)	(18,462)
Operating profit before product and USA development cost		6,646	5,873	12,493
Product development costs		(680)	(310)	(1,053)
USA development cost		(157)	(28)	(185)
Operating profit	3	5,809	5,535	11,255
Finance income	4	378	161	355
Finance expense	5	(1,012)	(937)	(1,909)
Profit before taxation		5,175	4,759	9,701
Income tax expense	6	(1,595)	(1,451)	(2,674)
Profit for the period attributable to equity holders of the parent		3,580	3,308	7,027
Earnings per share (pence)				
Basic	8	6.99p	6.49p	13.77p
Diluted	8	6.86p	6.38p	13.54p
Dividend per share (declared/proposed)	7	1.91p	1.70p	5.20p

Consolidated Balance Sheet

At 31 December 2005

	As at 31.12.05 £'000	As at 31.12.04 £'000	As at 30.06.05 £'000
ASSETS			
Non-current assets			
Intangible assets			
— goodwill	4,385	4,385	4,385
— software	226	203	255
— development costs	536	360	510
— other intangibles	1,880	789	1,889
Property, plant and equipment	5,431	5,073	4,946
Deferred taxes	540	155	406
Total non-current assets	12,998	10,965	12,391
Current Assets			
Inventories	27,616	24,394	20,390
Trade and other receivables	32,656	31,466	33,708
Cash and cash equivalents	7,893	6,224	13,924
Total current assets	68,165	62,084	68,022
Total assets	81,163	73,049	80,413
LIABILITIES			
Current liabilities			
Borrowings	(2,315)	(1,506)	(1,502)
Trade and other payables	(40,367)	(37,869)	(41,971)
Current tax liabilities	(2,535)	(1,793)	(2,057)
Total current liabilities	(45,217)	(41,168)	(45,530)
Non-current liabilities			
Borrowings	(15,819)	(17,903)	(17,281)
Total non-current liabilities	(15,819)	(17,903)	(17,281)
Total liabilities	(61,036)	(59,071)	(62,811)
Net assets	20,127	13,978	17,602
EQUITY			
Issued share capital	515	510	511
Share premium account	27,417	26,828	26,953
Hedging reserve	(71)	—	—
Merger reserve	1,720	1,720	1,720
Retained earnings	(9,454)	(15,080)	(11,582)
Total equity attributable to equity holders of the parent	20,127	13,978	17,602

Consolidated Statement of Changes in Shareholders' Equity

For the six months ended 31 December 2005

	Issued Share Capital £'000	Share Premium Account £'000	Hedging Reserve £'000	Merger Reserve £'000	Retained Earnings £'000	Total £'000
Six months ended 31 December 2004						
At 1 July 2004	510	26,784	—	1,720	(17,012)	12,002
Profit for the period being total recognised income and expense for the period	—	—	—	—	3,308	3,308
Dividends paid	—	—	—	—	(1,606)	(1,606)
Share-based payments including deferred tax taken directly to equity	—	—	—	—	230	230
Shares issued	—	44	—	—	—	44
At 31 December 2004	510	26,828	—	1,720	(15,080)	13,978
Year ended 30 June 2005						
At 1 July 2004	510	26,784	—	1,720	(17,012)	12,002
Profit for the period being total recognised income and expense for the period	—	—	—	—	7,027	7,027
Dividends paid	—	—	—	—	(2,473)	(2,473)
Share-based payments including deferred tax taken directly to equity	—	—	—	—	876	876
Shares issued	1	169	—	—	—	170
At 30 June 2005	511	26,953	—	1,720	(11,582)	17,602
Six months ended 31 December 2005						
At 1 July 2005 as previously stated	511	26,953	—	1,720	(11,582)	17,602
Impact of adoption of IAS32 and IAS39 on 1 July 2005	—	—	(71)	—	—	(71)
At 1 July 2005 — re-stated	511	26,953	(71)	1,720	(11,582)	17,531
Profit for the period being total recognised income and expense for the period	—	—	—	—	3,580	3,580
Dividends paid	—	—	—	—	(1,794)	(1,794)
Share-based payments including deferred tax taken directly to equity	—	—	—	—	342	342
Shares issued	4	464	—	—	—	468
At 31 December 2005	515	27,417	(71)	1,720	(9,454)	20,127

Consolidated Statement of Cash Flows

For the six months ended 31 December 2005

	Note	Six months ended 31.12.05 £'000	31.12.04 £'000	Year ended 30.06.05 £'000
CASH FLOWS FROM OPERATING ACTIVITIES				
Profit for the period		3,580	3,308	7,027
<i>Adjustments for:</i>				
Depreciation		431	489	935
Amortisation		68	18	41
Gain on sale of property, plant and equipment		(10)	(32)	(42)
Finance income		(378)	(161)	(355)
Finance expense		1,012	937	1,909
Equity-settled share-based payment expenses		199	(34)	488
Income tax expense		1,595	1,451	2,674
Operating profit before changes in working capital		6,497	5,976	12,677
Increase in inventories		(7,226)	(7,415)	(3,411)
Decrease/(increase) in trade and other receivables		970	1,427	(787)
(Decrease)/increase in trade and other payables		(1,711)	884	5,070
Cash generated from operations		(1,470)	872	13,549
Interest paid		(967)	(1,101)	(2,022)
Income taxes paid		(1,078)	(909)	(1,996)
Net cash from operating activities		(3,515)	(1,138)	9,531
CASH FLOWS FROM INVESTING ACTIVITIES				
Proceeds from sale of property, plant and equipment		10	130	140
Interest received		334	161	355
Purchase of property, plant and equipment		(821)	(283)	(644)
Capitalised development expenditure		(56)	(148)	(321)
Purchase of other intangible fixed assets		—	—	(1,100)
Net cash from investing activities		(533)	(140)	(1,570)
CASH FLOWS FROM FINANCING ACTIVITIES				
Proceeds from the issue of share capital		500	40	138
New borrowings		66	13,160	13,160
Repayment of borrowings		(755)	(768)	(1,538)
Dividends paid		(1,794)	(1,606)	(2,473)
Net cash from financing activities		(1,983)	10,826	9,287
Net (decrease)/increase in cash and cash equivalents		(6,031)	9,548	17,248
Cash and cash equivalents at start of period		13,924	(3,324)	(3,324)
Cash and cash equivalents at end of period		7,893	6,224	13,924
RECONCILIATION OF NET CASH TO MOVEMENT IN NET BORROWINGS				
Net (decrease)/increase in cash and cash equivalents		(6,031)	9,548	17,248
Repayment of borrowings		755	768	1,538
New borrowings		(66)	(13,160)	(13,160)
New finance leases		—	(346)	(438)
Other non-cash changes		(40)	115	63
Movement in net borrowings in the period		(5,382)	(3,075)	5,251
Net borrowings at start of period		(4,859)	(10,110)	(10,110)
Net borrowings at end of period	9	(10,241)	(13,185)	(4,859)

Notes to the Financial Statements

For the six months ended 31 December 2005

1. Transition to International Financial Reporting Standards

The attached interim financial statements are the first Group interim financial statements following the adoption of International Financial Reporting Standards as adopted by the European Union ("adopted IFRS"). These interim financial statements have been prepared in accordance with the accounting policies set out below and are consistent with the policies the Group expects to follow at the year-end, taking into account the requirements and options in IFRS1 'First-time adoption of International Financial Reporting Standards'.

The transition date for the Group's application of adopted IFRS is 1 July 2004 and the comparative figures for 31 December 2004 and 30 June 2005 have been restated accordingly. Reconciliations of the income statement, balance sheet and net equity from previously reported UK GAAP to IFRS are shown in note 10. The consolidated interim statements are prepared on the basis of adopted IFRS published by the International Accounting Standards Board ("IASB") that are currently in issue. The adopted IFRS that will be effective (or available for early adoption) in the annual financial statements to 30 June 2006 are still subject to change and additional interpretations. Therefore, the accounting policies set out below may be updated by the time the Group prepares its first full set of financial statements under IFRS for the year ending 30 June 2006.

The information relating to the six months ended 31 December 2005 and 31 December 2004 is unaudited and does not constitute statutory accounts. The comparative figures for the year ended 30 June 2005 are not the Company's statutory accounts for that financial year. The statutory accounts for the year ended 30 June 2005, prepared under UK GAAP, have been reported on by the Company's auditors and delivered to the Registrar of Companies. The report of the auditors was unqualified and did not contain statements under section 237(2) or (3) of the Companies Act 1985.

The interim financial statements are unaudited but have been reviewed by the auditors and their report to Dechra Pharmaceuticals PLC is set out at the end of this document.

2. Accounting Policies

The Group's significant accounting policies are listed below:

(a) First Time Adoption

The Group has applied IFRS1 'First time adoption of International Financial Reporting Standards' in its initial application of IFRS. The Group is required to select appropriate accounting policies under IFRS and, subject to a few exemptions detailed below, apply them retrospectively to its financial statements such that all comparative information is presented on the same basis. Accordingly, this necessitates the restatement of the balance sheet at 1 July 2004, the date of transition (this being the date of the beginning of the earliest financial year for which full comparative information is required) as well as at 30 June 2005.

IFRS1 permits certain exemptions to the full retrospective restatement. The exemptions that have been adopted by the Group are as follows:

Business combinations — business combinations made prior to 1 July 2004 have not been restated in accordance with IFRS3 'Business Combinations'.

Share-based payments — IFRS2 'Share-based payments' has only been applied to awards of share options granted after 7 November 2002 which had not vested by 1 January 2005.

Financial instruments — IAS32 'Financial Instruments: Disclosure and Presentation' and IAS39 'Financial Instruments: Recognition and Measurement' have been adopted prospectively from 1 July 2005 with no restatement of comparative information which continues to be presented in accordance with UK GAAP.

(b) Basis of Preparation

The financial statements are presented in Sterling, rounded to the nearest thousand. They are prepared on the historical cost basis except for derivative financial instruments that are stated at fair value.

The restated financial information for the transition to IFRS at 1 July 2004, the interim period ended 31 December 2004, the year ended 30 June 2005 and the adoption of IAS32 and IAS39 at 1 July 2005 has been prepared in accordance with adopted IFRS and in accordance with the accounting policies as set out below.

Notes to the Financial Statements

For the six months ended 31 December 2005

2. Accounting Policies continued

The preparation of financial statements in conformity with adopted IFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

(c) Basis of Consolidation

(i) Subsidiaries

Subsidiaries are entities controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

(ii) Transactions Eliminated on Consolidation

Intragroup balances and any unrealised gains and losses or income and expenses arising from intragroup transactions, are eliminated in preparing the consolidated financial statements.

(d) Foreign Currency

Foreign Currency Transactions

Transactions in foreign currencies are translated at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to Sterling at the foreign exchange rate ruling at that date. Foreign exchange differences arising on translation are recognised in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated to Sterling at the foreign exchange rates ruling at the dates the fair value was determined.

(e) Derivative Financial Instruments (applicable from 1 July 2005)

The Group uses derivative financial instruments to manage its exposure to foreign exchange and interest rate risks. In accordance with its treasury policy, the Group does not hold or issue derivative financial instruments for speculative purposes. However, derivatives that do not qualify for hedge accounting are accounted for as trading instruments.

On adoption of IAS32 and IAS39, the comparative financial statements have not been restated. As permitted under IFRS1 'First time adoption of International Financial Reporting Standards' the comparative statements continue to hedge account under UK GAAP. On 1 July 2005, the fair values of derivatives used for hedging were included in a hedging reserve. The corresponding adjustments were to increase trade and other payables by £102,000 and the deferred tax asset by £31,000. As the Group has not adopted hedge accounting under IAS39 from 1 July 2005 the hedging reserve is frozen and will only be released to the income statement when the related forecast transactions occur.

Derivative financial instruments are recognised initially at fair value. Subsequent to initial recognition, derivative financial instruments are stated at fair value. The gain or loss on remeasurement to fair value is recognised immediately in the income statement.

The fair value of interest rate swaps, floors and ceilings is the estimated amount that the Group would receive or pay to terminate the instrument at the balance sheet date. The fair value of forward exchange contracts and options is their quoted market price at the balance sheet date, being the present value of the quoted forward price.

(f) Property, Plant and Equipment

(i) Owned Assets

Items of property, plant and equipment are stated at cost less accumulated depreciation (see below) and impairment losses (see accounting policy k).

Notes to the Financial Statements

For the six months ended 31 December 2005

2. Accounting Policies continued

(ii) Leased Assets

Leases under the terms of which the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Assets acquired by finance leases are stated at an amount equal to the lower of their fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and impairment losses.

(iii) Subsequent Costs

The Group recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if it is probable that the future economic benefits embodied with the item will flow to the Group and the cost of the item can be measured reliably. All other costs are recognised in the income statement as an expense as incurred.

(iv) Depreciation

Depreciation is charged to the income statement on a straight-line basis over the estimated useful lives of each part of an item of property, plant and equipment. Land is not depreciated. The estimated useful lives are as follows:

- leasehold improvements period of lease
- fixtures, fittings and equipment 10%–33¹/₃%
- motor vehicles 25%

The residual value, if not insignificant, is reassessed annually.

(g) Intangible Assets

(i) Goodwill

All business combinations are accounted for by applying the purchase method. Goodwill represents amounts arising on acquisition of subsidiaries, associates and joint ventures. In respect of business acquisitions that have occurred since 1 July 2004, goodwill represents the difference between the cost of the acquisition and the fair value of the net identifiable assets acquired.

In respect of acquisitions prior to this date, goodwill is included on the basis of its deemed cost, which represents the amount recorded under previous GAAP. The classification and accounting treatment of business combinations that occurred prior to 1 July 2004 has not been reconsidered in preparing the Group's opening IFRS balance sheet at 1 July 2004.

Goodwill is stated at cost less any accumulated impairment losses. Goodwill is not amortised but is allocated to cash generating units and is tested annually for impairment.

(ii) Research and Development Costs

Expenditure on research activities, undertaken with the prospect of gaining new scientific or technical knowledge and understanding, is recognised in the income statement as an expense is incurred.

The Group is also engaged in development activity with a view to bringing new pharmaceutical products to market. Costs of development are capitalised in the balance sheet unless those costs cannot be measured reliably or it is not probable that future economic benefits will flow to the Group, in which case the relevant costs are expensed to the income statement as incurred. Due to the strict regulatory process involved, there is inherent uncertainty as to the technical feasibility of development projects often until regulatory approval is achieved, with the possibility of failure even at a late stage. The Group considers that this uncertainty means that the criteria for capitalisation are not met unless it is probable that regulatory approval will be achieved and the project is commercially viable.

Where development costs are capitalised, the expenditure includes the cost of materials, direct labour and an appropriate proportion of overheads.

Capitalised development expenditure is stated at cost less accumulated amortisation and impairment losses.

Notes to the Financial Statements

For the six months ended 31 December 2005

2. Accounting Policies continued

(iii) Other Intangible Assets

Other intangible assets that are acquired by the Group are stated at cost less accumulated amortisation and impairment losses. Expenditure on internally generated goodwill and other intangibles is recognised in the income statement as an expense as incurred.

(iv) Subsequent Expenditure

Subsequent expenditure on capitalised intangible assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

(v) Amortisation

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of intangible assets unless such lives are indefinite. Goodwill and intangible assets with an indefinite useful life are systematically tested for impairment at each balance sheet date. Other intangible assets are amortised from the date that they are available for use. The estimated useful lives are as follows:

- software 5 years
- capitalised development costs 5–10 years
- patent rights Period of patent
- marketing authorisations Indefinite life
- product rights Period of product rights

(h) Trade and Other Receivables

Trade and other receivables are stated at their amortised cost.

(i) Inventories

Inventories are stated at the lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses.

The cost of inventories is based on the first-in, first-out principle and includes expenditure incurred in acquiring the inventories and bringing them to their existing location and condition. In the case of manufactured inventories and work in progress, cost includes an appropriate share of overheads based on normal operating capacity.

(j) Cash and Cash Equivalents

Cash and cash equivalents comprises cash balances and call deposits. Bank overdrafts that are repayable on demand and form an integral part of the Group's cash management are included as a component of cash and cash equivalents for the purpose of the statement of cash flows.

(k) Impairment

The carrying amounts of the Group's assets, other than inventories and deferred tax assets, are reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated.

The recoverable amount of assets is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

For goodwill, assets that have an indefinite useful life and intangible assets that are not yet available for use, the recoverable amount is estimated at each balance sheet date and, in the case of goodwill, at the date of transition to IFRS.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement.

Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to cash-generating units (group of units) and then, to reduce the carrying amount of the other assets in the unit (group of units) on a pro rata basis.

Notes to the Financial Statements

For the six months ended 31 December 2005

2. Accounting Policies continued

An impairment loss in respect of goodwill is not reversed.

In respect of other assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount.

An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

(l) Dividends

Dividends are recognised in the period in which they are approved by the Company's shareholders or, in the case of an interim dividend, when the dividend is paid.

(m) Interest-Bearing Borrowings

Interest-bearing borrowings are recognised at fair value less attributable transaction costs. Subsequent to initial recognition, interest-bearing borrowings are stated at amortised cost with any difference between cost and redemption value being recognised in the income statement over the period of borrowings on an effective interest basis.

(n) Employee Benefits

(i) Pensions

The Group operates a defined contribution pension plan for certain employees. Obligations for contributions are recognised as an expense in the income statement as incurred.

(ii) Share-Based Payment Transactions

The Group operates a number of equity-settled share-based payment programmes that allow employees to acquire shares of the Company. The Group also operates a Long Term Incentive Plan for Directors and Senior Executives.

The fair value of shares or options granted is recognised as an employee expense on a straight-line basis in the income statement with a corresponding movement in equity. The fair value is measured at grant date and spread over the period during which the employees become unconditionally entitled to the shares or options (the vesting period). The fair value of the shares or options granted is measured using a valuation model, taking into account the terms and conditions upon which the shares or options were granted. For schemes with no market-related performance conditions, the amount recognised as an expense in the income statement is adjusted to take into account an estimate of the number of shares or options that are expected to vest together with an adjustment to reflect the number of shares or options that actually do vest. In the case of schemes that already contain market-related performance criteria, no such adjustments are necessary.

The fair value of grants under the Long Term Incentive Plan has been determined using the Monte Carlo simulation model.

The fair values of options granted under all other share option schemes have been determined using the Black-Scholes option pricing model.

(o) Trade and Other Payables

Trade and other payables are stated at their amortised cost.

(p) Revenue

(i) Goods Sold

Revenue from the sale of goods is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer. Appropriate provision is made, based on past experience, for the possible return of goods and discounts given to customers.

(ii) Milestone Payments

Milestone payments received from the granting of distribution and marketing rights for products are recognised in the income statement over the period in which the Company fulfils all of its obligations relating to such payments.

Notes to the Financial Statements

For the six months ended 31 December 2005

2. Accounting Policies continued

(q) Expenses

(i) Operating Lease Payments

Payments made under operating leases are recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives received are recognised in the income statement evenly over the period of the lease, as an integral part of the total lease expense.

(ii) Finance Lease Payments

Minimum lease payments are apportioned between the finance charge and the reduction of the outstanding liability.

(iii) Net Financing Costs

Net financing costs comprise interest payable on borrowings, interest receivable on funds invested, foreign exchange gains and losses, and gains and losses on hedging instruments that are recognised in the income statement (see accounting policy e).

Interest income is recognised in the income statement as it accrues. The interest expense component of finance lease payments is recognised in the income statement using the effective interest rate method.

(r) Income Tax

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided using the balance sheet liability method and represents the tax payable or recoverable on most temporary differences which arise between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes (the tax base). Temporary differences are not provided on: goodwill that is not deductible for tax purposes; the initial recognition of assets or liabilities that affect neither accounting nor taxable profit and do not arise from a business combination; and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates expected to apply in the period in which the liability is settled or the asset is realised and is based upon tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is not probable that the related tax benefit will be realised against future taxable profits. The carrying amounts of deferred tax assets are reviewed at each balance sheet date.

(s) Segment Reporting

A segment is a distinguishable component of the Group that is engaged either in providing products or services (business segment), or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments.

(t) Operating Profit and Operating Cash Flow

Operating profit and operating cash flow is stated before investment income and finance costs.

Notes to the Financial Statements

For the six months ended 31 December 2005

3. Segmental Analysis

The Group's primary reporting segment is business divisions which correspond with the way the operating businesses are organised and managed within the Group and its secondary segment is geographical origin.

The following table analyses revenue and operating profit accordingly:

	Six months ended		Year ended
	31.12.05	31.12.04	30.06.05
	£'000	£'000	£'000
BUSINESS SEGMENT			
Revenue			
Pharmaceuticals	11,179	9,949	21,381
Services	108,101	97,230	194,611
Inter division	(3,192)	(2,916)	(5,725)
	116,088	104,263	210,267
Operating Profit			
Pharmaceuticals	2,047	2,081	4,292
Services	4,275	3,910	7,973
Central costs	(513)	(456)	(1,010)
	5,809	5,535	11,255
GEOGRAPHICAL ORIGIN			
Revenue			
United Kingdom	115,945	104,263	210,267
USA	143	—	—
	116,088	104,263	210,267
Operating Profit			
United Kingdom	6,479	6,019	12,450
USA	(157)	(28)	(185)
Central costs	(513)	(456)	(1,010)
	5,809	5,535	11,255

4. Finance Income

	Six months ended		Year ended
	31.12.05	31.12.04	30.06.05
	£'000	£'000	£'000
Bank interest receivable	318	161	355
Other interest receivable	36	—	—
Fair value gains on derivative financial instruments	24	—	—
	378	161	355

Notes to the Financial Statements

For the six months ended 31 December 2005

5. Finance Expense

	Six months ended		Year ended
	31.12.05	31.12.04	30.06.05
	£'000	£'000	£'000
Bank loans and overdrafts	928	873	1,774
Amortisation of arrangement fees	53	51	103
Finance charges payable on finance leases and hire purchase contracts	19	13	32
Fair value losses on derivative financial instruments	12	—	—
	1,012	937	1,909

6. Taxation

The tax charge for the six months ended 31 December 2005 has been based on the estimated effective rate for the year ending 30 June 2006 of 30.8% (six months ended 31 December 2004: 30.5%). All taxation is in the United Kingdom.

7. Dividends

The Directors have declared an interim dividend of 1.91p per share (2004: 1.70p) costing £983,000 (2004: £867,000). It is payable on 7 April 2006, to shareholders whose names are on the Registrar of Members at close of business on 10 March 2006. The ordinary shares will become ex-dividend on 8 March 2006.

As the dividend was declared after the end of the period being reported and in accordance with IAS10 'Events After the Balance Sheet Date', the interim dividend has not been accrued for in these financial statements. It will be shown as a deduction from equity in the financial statements for the year ending 30 June 2006.

8. Earnings per Share

Earnings per ordinary share have been calculated by dividing the profit attributable to equity holders of the parent on ordinary activities after taxation for each financial period by the weighted average number of ordinary shares in issue during the period.

	Six months ended		Year ended
	31.12.05	31.12.04	30.06.05
	Pence	Pence	Pence
Basic earnings per share	6.99	6.49	13.77
Diluted earnings per share	6.86	6.38	13.54
The calculation of basic and diluted earnings per share is based upon:			
	£'000	£'000	£'000
Earnings for basic and diluted earnings per share calculations	3,580	3,308	7,027
	No.	No.	No.
Weighted average number of ordinary shares for basic earnings per share	51,229,294	50,997,064	51,022,645
Impact of share options	938,907	832,674	879,018
Weighted average number of ordinary shares for diluted earnings per share	52,168,201	51,829,738	51,901,663

Notes to the Financial Statements

For the six months ended 31 December 2005

9. Analysis of Net Borrowings

	As at 31.12.05 £'000	As at 31.12.04 £'000	As at 30.06.05 £'000
Bank loans and overdraft	(17,750)	(19,058)	(18,410)
Finance leases and hire purchase contracts	(384)	(351)	(373)
Cash and cash equivalents	7,893	6,224	13,924
	(10,241)	(13,185)	(4,859)

10. Explanation of Transition to IFRS

The accounting policies set out in note 2 have been applied in preparing the consolidated interim financial statements for the six months ended 31 December 2005, the comparative information for the six months ended 31 December 2004 and the year ended 30 June 2005, and the preparation of the opening IFRS balance sheet at 1 July 2004 (the Group's date of transition).

In preparing its opening balance sheet, comparative information for the six months ended 31 December 2004 and the year ended 30 June 2005, the Group has adjusted amounts reported previously in financial statements prepared in accordance with UK GAAP.

A full explanation of the principal changes in accounting policies and how the transition from UK GAAP to IFRS has affected the Group's income statement, balance sheet and net equity was published on 19 October 2005 and is summarised below. A copy of the full document can be obtained from the Company's Corporate website www.dechra.com by clicking on the press releases section.

(a) IFRS Reconciliation of Income Statement Comparatives

	Notes	Six months ended 31 December 2004			Year ended 30 June 2005		
		Published UK GAAP £'000	IFRS adjust- ments £'000	Restated under IFRS £'000	Published UK GAAP £'000	IFRS adjust- ments £'000	Restated under IFRS £'000
Revenue	a	103,263	1,000	104,263	208,197	2,070	210,267
Cost of sales	a	(89,023)	(1,000)	(90,023)	(178,480)	(2,070)	(180,550)
Gross profit		14,240	—	14,240	29,717	—	29,717
Operating expenses	b, c, d, e	(9,097)	392	(8,705)	(19,305)	843	(18,462)
Operating profit		5,143	392	5,535	10,412	843	11,255
Finance income		161	—	161	355	—	355
Finance expense		(937)	—	(937)	(1,909)	—	(1,909)
Profit before taxation		4,367	392	4,759	8,858	843	9,701
Income tax expense		(1,418)	(33)	(1,451)	(2,590)	(84)	(2,674)
Profit attributable to equity holders of the parent		2,949	359	3,308	6,268	759	7,027
Earnings per share (pence)							
Basic		5.78p	0.71p	6.49p	12.28p	1.49p	13.77p
Diluted		5.69p	0.69p	6.38p	12.08p	1.46p	13.54p

Notes to the Financial Statements

For the six months ended 31 December 2005

(b) IFRS Reconciliation of Balance Sheet Comparatives

	Notes	31 December 2004			30 June 2005		
		Published	IFRS	Restated	Published	IFRS	Restated
		UK GAAP £'000	adjust- ments £'000	under IFRS £'000	UK GAAP £'000	adjust- ments £'000	under IFRS £'000
Non-current assets							
Intangible assets							
— goodwill	a	4,103	282	4,385	3,821	564	4,385
— software	b	—	203	203	—	255	255
— other intangibles	c	789	360	1,149	1,889	510	2,399
Property, plant and equipment	b	5,276	(203)	5,073	5,201	(255)	4,946
Deferred taxes	d	—	155	155	—	406	406
Total non-current assets		10,168	797	10,965	10,911	1,480	12,391
Current assets							
Inventories		24,394	—	24,394	20,390	—	20,390
Trade and other receivables		31,466	—	31,466	33,708	—	33,708
Deferred taxes	d	—	—	—	4	(4)	—
Cash and cash equivalents		6,224	—	6,224	13,924	—	13,924
Total current assets		62,084	—	62,084	68,026	(4)	68,022
Total assets		72,252	797	73,049	78,937	1,476	80,413
Current liabilities							
Borrowings		(1,506)	—	(1,506)	(1,502)	—	(1,502)
Trade and other payables	e	(37,726)	(143)	(37,869)	(41,826)	(145)	(41,971)
Current tax liabilities		(1,793)	—	(1,793)	(2,057)	—	(2,057)
Proposed dividend	f	(867)	867	—	(1,789)	1,789	—
Total current liabilities		(41,892)	724	(41,168)	(47,174)	1,644	(45,530)
Non-current liabilities							
Borrowings		(17,903)	—	(17,903)	(17,281)	—	(17,281)
Provisions		—	—	—	—	—	—
Deferred taxes	d	(174)	174	—	—	—	—
Total non-current liabilities		(18,077)	174	(17,903)	(17,281)	—	(17,281)
Total liabilities		(59,969)	898	(59,071)	(64,455)	1,644	(62,811)
Net assets		12,283	1,695	13,978	14,482	3,120	17,602
Equity							
Called up share capital		510	—	510	511	—	511
Share premium account		26,828	—	26,828	26,953	—	26,953
Merger reserve		1,720	—	1,720	1,720	—	1,720
Retained earnings	g	(16,775)	1,695	(15,080)	(14,702)	3,120	(11,582)
Equity holders' funds attributable to the parent		12,283	1,695	13,978	14,482	3,120	17,602

Notes to the Financial Statements

For the six months ended 31 December 2005

(c) Reconciliation of Equity

	1 July 2004 £'000	31 December 2004 £'000	30 June 2005 £'000
Equity under UK GAAP	10,157	12,283	14,482
Write-back of proposed dividend	1,606	867	1,789
Deferred tax	98	329	402
Lease incentive	(89)	(143)	(145)
Capitalisation of development costs	230	360	510
Write-back of goodwill amortisation	—	282	564
Equity under IFRS	12,002	13,978	17,602

Explanatory notes to the UK GAAP to IFRS Reconciliations

Income Statement

- Under IAS18 'Revenue' certain items, such as the sale of trading data to suppliers, have been reclassified to revenue from cost of sales. There is no impact on profit, earnings per share or net assets.
- Under UK GAAP, goodwill was amortised over its estimated useful life. Under IFRS3 'Business Combinations', goodwill is not amortised but is subject to annual impairment review. This has resulted in a credit to the income statement of £282,000 for the six months ended 31 December 2004 and £564,000 for the year ended 30 June 2005.
- Under UK GAAP, the accounting policy of the Group was, in general, to write off all development expenditure to the income statement as incurred. Under IAS38 'Intangible Assets' development expenditure meeting the required criteria must be capitalised. This has resulted in a credit to the income statement of £130,000 for the six months ended 31 December 2004 and £280,000 for the year ended 30 June 2005.
- Under IFRS2 'Share-based Payments', the cost of employee share options recognised in the income statement is based upon the excess of the fair value of the option over the exercise price at the date of grant. Under UK GAAP, the cost recognised was generally the intrinsic value being the difference in exercise price and market price at the date of grant of the option.

The change in method of calculation has resulted in a net credit to the income statement of £34,000 in respect of the six months ended 31 December 2004 and £55,000 in respect of the year ended 30 June 2005.

- Under UK GAAP, the benefit of lease incentives received (in the form of rent-free periods) was spread over the period until the rent reverts to market rates. Under IAS17 'Leases', the benefit must be spread over the entire lease period. This change has resulted in an additional charge to the income statement of £54,000 for the six months ended 31 December 2004 and £56,000 for the year ended 30 June 2005.
- The income tax expense has been adjusted to reflect the tax effect of the above adjustments.

Balance Sheet

- The increase in goodwill reflects the write-back of amortisation previously charged under UK GAAP.
- Under IAS38 'Intangible Assets', software costs are classed as intangible assets. They have therefore been reclassified from property, plant and equipment. There is no impact on the income statement or net assets.
- The increase in other intangible assets represents capitalised development costs under IAS38 'Intangible Assets'.
- The calculation of deferred tax under IAS12 'Income Taxes' can be different from UK GAAP, under which deferred tax is calculated based upon income statement timing differences. The principal reason for the increase in the deferred tax asset is that deferred tax in respect of share-based payments is calculated by reference to a figure which differs from the charge for such payments in the income statement. Deferred tax in respect of share-based payments charged directly to the income statement is also taken to the income statement but any excess tax relief over this amount is taken directly to equity.

Notes to the Financial Statements

For the six months ended 31 December 2005

- e. The increase in trade and other payables represents the balance of lease incentives received that are being spread over the remaining lease periods.
- f. Under IAS10 'Events After the Balance Sheet Date', dividends are recognised when they are paid or approved by the shareholders. This generally results in a later recognition in the financial statements than under UK GAAP.
- g. The increase in retained earnings at 31 December 2004 is made up as follows:
 - net adjustments to the income statement of £359,000
 - reduction to credit to equity in respect of share-based payments of (£34,000)
 - capitalised development costs at 1 July 2004 of £230,000
 - increase in lease incentives carried forward at 1 July 2004 of (£89,000)
 - de-recognition of the interim dividend of £867,000
 - credit to deferred tax recognised directly in equity of £362,000

The increase in retained earnings at 30 June 2005 is made up as follows:

- net adjustments to the income statement of £759,000
- reduction to credit to equity in respect of share-based payments of (£55,000)
- capitalised development costs at 1 July 2004 of £230,000
- increase in lease incentives carried forward at 1 July 2004 of (£89,000)
- de-recognition of the final dividend of £1,789,000
- credit to deferred tax recognised directly in equity of £486,000

Independent Review Report to Dechra Pharmaceuticals PLC

INTRODUCTION

We have been engaged by the Company to review the financial information set out on pages 6 to 21 and we have read the other information contained in the interim report and considered whether it contains any apparent misstatements or material inconsistencies with the financial information.

This report is made solely to the Company in accordance with the terms of our engagement to assist the Company in meeting the requirements of the Listing Rules of the Financial Services Authority. Our review has been undertaken so that we might state to the Company those matters we are required to state to it in this report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company for our review work, for this report, or for the conclusions we have reached.

DIRECTORS' RESPONSIBILITIES

The interim report, including the financial information contained therein, is the responsibility of, and has been approved by, the Directors. The Directors are responsible for preparing the interim report in accordance with the Listing Rules which require that the accounting policies and presentation applied to the interim figures should be consistent with those applied in preparing the preceding annual financial statements except where any changes and the reason for them are disclosed.

As disclosed in note 1 to the financial information, the next annual financial statements of the Group will be prepared in accordance with IFRSs as adopted by the European Union. The accounting policies that have been adopted in preparing the financial information are consistent with those that the Directors currently intend to use in the next annual financial statements. There is, however, a possibility that the Directors may determine some changes to these policies are necessary, when preparing the full annual financial statements for the first time in accordance with those IFRSs adopted by the European Union.

REVIEW WORK PERFORMED

We conducted our review in accordance with guidance contained in Bulletin 1999/4: Review of Interim Financial Information issued by the Auditing Practices Board for use in the United Kingdom. A review consists principally of making enquiries of Group management and applying analytical procedures to the financial information and underlying financial data and, based thereon, assessing whether the accounting policies and presentation have been consistently applied unless otherwise disclosed. A review is substantially less in scope than an audit performed in accordance with Auditing Standards and therefore provides a lower level of assurance than an audit. Accordingly, we do not express an audit opinion on the financial information.

REVIEW CONCLUSION

On the basis of our review, we are not aware of any material modifications that should be made to the financial information as presented for the six months ended 31 December 2005.

KPMG Audit Plc

Chartered Accountants
Birmingham
28 February 2006

Dechra Pharmaceuticals PLC

Dechra House
Jamage Industrial Estate
Talke Pits Stoke-on-Trent ST7 1XW
Staffordshire England

t: +44 (0)1782 771100

f: +44 (0)1782 773366

e: corporate.enquiries@dechra.com

www.dechra.com