

Quarterly Report

Second Quarter – Fiscal 2005

Q2

PRESIDENT'S MESSAGE TO SHAREHOLDERS

FELLOW SHAREHOLDERS:

This is truly a very exciting time for Labopharm. We are moving ever closer to a number of very significant milestones for the Company. Most importantly, we stand on the verge of the launch of our once-daily tramadol product in Europe and the generation of our very first revenue from product sales.

ONCE-DAILY TRAMADOL WELL POSITIONED TO CAPTURE SIZABLE PROPORTION OF GROWING EUROPEAN MARKET

We are confident about the prospects for our product when it is launched. Tramadol is a popular analgesic globally, with worldwide sales of almost four billion standard units in 2004. It is widely accepted by both physicians and patients due to its track record of safety and efficacy, as well as its advantages over other analgesics such as NSAIDs and stronger opioids.

Europe is a significant component of the global tramadol market, accounting for half of all standard unit sales in 2004 and representing revenue in excess of US\$613 million. The compounded annual rate of growth for standard unit sales is 14% both globally and within the European market. I will remind you that much of this growth is being driven by sustained release formulations of the drug – primarily the twice-daily formulations – especially in the larger markets within Europe. We believe that our once-daily formulation is well positioned to capture a sizable proportion of the market, based on a number of competitive advantages:

- Our once-daily tramadol product has a favourable pharmacokinetic profile that not only provides efficacy for a full 24-hour period but that also exhibits an early onset of action;
- We have a superior side effect profile to existing tramadol products;
- We have flexibility in our dosing with three dosages, allowing physicians to titrate patients up to the optimal level;
- We will have a strong label throughout all of those countries participating in the MRP process; and
- Finally, we have excellent partners with a defined pricing and marketing strategy designed to leverage the strengths of our product and maximize the opportunity before us.

CONTINUED PROGRESS TOWARD EUROPEAN LAUNCH OF ONCE-DAILY TRAMADOL

With this in mind, during the second quarter, we continued to work closely with our partners to prepare for the European launch of our product. In May, we hosted our first medical marketing meeting, which brought together our European partners to discuss launch-related matters such as product positioning. We have a second meeting planned for October. We are finalizing the supply chain, have received our first commercial order and are currently validating the manufacturing process at an additional third-party manufacturer.

We are also approaching the conclusion of the Mutual Recognition Procedure (MRP), which leverages our approval in France to facilitate rapid approval across the European Union (EU) countries. We expect full MRP approval in September, with individual country approvals and launch beginning in the fourth quarter. Because MRP provides for a single label across all of the EU, we know that our broad French label – which designates our product as a once-daily formulation for use in moderate to severe pain, including both acute and chronic conditions – will be the label in all countries approved through the MRP process.

We are also continuing to work toward broadening our sales coverage of the European market beyond the 20 countries for which we currently have licensing and distribution partners. We are in active discussions to secure agreements for the remaining key markets in Europe so that when we do launch our product, we are launching into as much of the market as possible.

US COMMERCIALIZATION PROGRAM FOR ONCE-DAILY TRAMADOL PROGRESSING

Turning to our US commercialization program for once-daily tramadol, the ongoing US Phase III clinical trial is proceeding well. We are concurrently compiling our NDA, which we expect to submit to the US Food and Drug Administration prior to year end.

DEBT FINANCING STRENGTHENS CAPITAL RESOURCES

We strengthened our capital resources during the second quarter with the completion of a US\$10 million debt financing with US-based Hercules Technology Growth Capital. The size of the transaction was very specific in that we believe this is the amount of financing required to take us through the achievement of several significant milestones in the second half of this year, including the start of sales in Europe of our once-daily tramadol product. Importantly, as a debt financing, there is little dilution to existing shareholders.

A DEFINING PERIOD FOR LABOPHARM

In conclusion, the next few months will be a defining period for Labopharm. We are confident that we will receive MRP approval for once-daily tramadol in Europe in the near term, with national approvals beginning soon after that and the launch of our product before year end.

In the US, our Phase III clinical trial is progressing well and we are compiling our NDA for submission toward the end of the year. In addition, we are very comfortable with our progress toward conclusion of a licensing and distribution agreement.

Finally, we have always viewed once-daily tramadol as a global product and we continue to prepare regulatory submissions for a number of key jurisdictions worldwide. We have already filed in Mexico and look forward to approval in that country. At the same time, we are actively pursuing marketing partnerships for these same jurisdictions and are making good progress in this regard.

Yours truly,

(signed)

James R. Howard-Tripp
President and Chief Executive Officer
July 28, 2005

MANAGEMENT'S DISCUSSION & ANALYSIS

for the three-month period ended June 30, 2005 and for the six-month period ended June 30, 2005

The following information should be read in conjunction with our unaudited interim consolidated financial statements as at June 30, 2005, and related notes thereto as well as the audited consolidated financial statements and Management's Discussion and Analysis for the year ended December 31, 2004. Our unaudited consolidated interim financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP") for interim financial statements. The Management's Discussion and Analysis provides a review of the performance of the Company for the quarter ended June 30, 2005, as compared to the quarter ended June 30, 2004, and for the six-month period then ended. This review was performed by management with information available on July 26, 2005. Additional information relating to the Company, including its Annual Information Form, can be found on SEDAR at www.sedar.com.

To the extent any statements made in this document contain information that is not historical, these statements are essentially forward-looking and are subject to risks and uncertainties. Actual results, levels of activity, performance, or achievements could differ materially from those projected herein and depend on a number of factors, including the successful and timely completion of clinical studies, the uncertainties related to the regulatory approval process, and the commercialization of products thereafter.

Where we say "we", "us", "our", or the "Company" we mean Labopharm Inc. and its subsidiaries unless otherwise indicated. All amounts are presented in Canadian dollars unless otherwise indicated.

OVERVIEW

We are an international, specialty pharmaceutical company developing novel drug products using our proprietary drug delivery technologies. By applying our reformulation expertise and delivery technologies to existing drug compounds with proven efficacy and safety, we believe that we can accelerate drug development and lower development risk compared to traditional pharmaceutical and biotechnology companies. We currently have a number of products at various stages of development, including our lead product, once-daily tramadol, which has been approved for marketing and sale in France, for which we have initiated the Mutual Recognition Procedure (MRP) for an additional 25 countries in the European Union and for which we are currently conducting a third Phase III trial in the US. We also have three other products that are in early clinical development (a once-daily formulation of betahistine, a once-daily formulation of trazodone, and DDS-2001). Our existing products are based on our proprietary technology, Contramid[®], which we use to develop new branded products that improve on existing drugs by providing the benefits of controlled-release drug delivery. We believe Contramid[®] can be applied to a wide variety of drugs in solid oral dosage form to

improve their administration and performance. We are also developing novel polymeric nano-delivery systems for delivery of water-insoluble and poorly bio-available drugs.

Our primary focus is on the global commercialization of our once-daily tramadol product. Following our first regulatory approval in France, we have initiated the Mutual Recognition Procedure in the European Union seeking approval in an additional 25 countries and we are preparing to launch in certain European countries in the fourth quarter of this year. As part of our global commercialization strategy, we have initiated the regulatory approval process in Mexico and we plan to submit additional marketing applications in other jurisdictions around the world in the coming year. We are currently conducting a third Phase III trial in the US under a Special Protocol Assessment with the Food and Drug Administration (FDA) and it is our intention to file a New Drug Application with the FDA by the end of the year. Securing a partnership with a leading pharmaceutical company to share sales and marketing responsibilities for our product in the US remains a top priority.

Our Goal

Our goal is to become a fully integrated, international, specialty pharmaceutical company developing and commercializing our own pharmaceutical products. Full integration should maximize the value inherent in our technology and product candidates by allowing greater control over the development and commercialization process and generating higher returns on investment.

Liquidity

We have incurred substantial operating losses since our inception due in large part to expenditures for our research and development activities. As at June 30, 2005, we had an accumulated deficit of \$126 million. We expect our operating losses to decrease over the next several years as we will begin the commercialization of our lead product, once-daily tramadol, while continuing to advance our other product candidates and expand our development pipeline. On June 28, 2005, we entered into a term loan agreement which generated gross proceeds of \$12,317,000. However, our committed cash obligations and expected level of expenses for the upcoming twelve months exceed the committed sources of funds and our cash and cash equivalents on hand. Our ability to continue as a going concern is dependent upon us raising additional funds or signing new partnership agreements that would provide us with significant up-front and/or milestone payments.

Revenue

To date, we have not generated any revenue from product sales. We, however, expect to commercially launch our once-daily tramadol in Europe during the fourth quarter of 2005 thereby generating our first product sales from the commercialization of one of our products. Revenue to date has been generated primarily

by our research collaboration agreements and our distribution and licensing agreements. To date, we have entered into a number of research collaboration agreements for a variety of product candidates. These agreements generally include up-front fees upon initiation of the services, payments upon completion of feasibility and formulation stage of development and/or other milestones, and could include royalties upon successful commercialization of the products.

In addition, we also have entered into four distribution and license agreements and one letter of intent in Europe for once-daily tramadol. The arrangements are, with HEXAL AG for Germany, with Gruppo Angelini for Italy, with Esteve S.A. for Spain and Portugal, with CSC Pharma for 14 Eastern European countries and Russia, and with Sanofi-aventis for France. The terms of these arrangements may include up-front payments upon signature and additional payments upon market and/or price approval in the respective European countries. Under these arrangements we are primarily responsible for supplying finished packaged goods. We are also actively pursuing discussions with potential marketing partners for once-daily tramadol for those European countries not yet covered as well as for the US and Latin American markets.

Research and Development Expenses

Our research and development expenses consist primarily of fees paid to outside parties that we use to conduct clinical studies and manufacturing process validation, salaries and related personnel expenses, laboratory supplies and costs for facilities and equipment. In the second quarter of 2005, research and development expenses increased considerably in comparison to the quarter ended June 30, 2004, mostly due to the currently ongoing phase III clinical trial in the US and due to the ongoing validation of the commercial manufacturing process of tramadol at a second third-party manufacturer.

CHANGE IN ACCOUNTING POLICY Consolidation of Variable Interest Entities

In June 2003, the Canadian Institute of Chartered Accountants ("CICA") issued Accounting Guideline AcG-15, *Consolidation of Variable Interest Entities* which requires consolidation of variable interest entities ("VIE") for fiscal years beginning on or after November 1, 2004. A VIE is any legal structure used to conduct activities or hold assets which are not controlled by voting interests but rather by contractual or other interests that change with that entity's underlying net asset value. AcG-15 requires the consolidation of a VIE by its primary beneficiary, i.e., the party that receives the majority of the expected residual returns and/or absorbs the majority of the entity's expected losses. Our assessment to date indicates that the adoption of AcG-15 does not result in any change to the consolidated financial statements.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our critical accounting policies and estimates remain substantially the same as reported in our Management's Discussion

& Analysis as included in our annual report for the year ended December 31, 2004.

RESULTS OF OPERATIONS Fluctuations in Operating Results

Our results of operations have fluctuated significantly from period to period in the past and are likely to do so in the future. We anticipate that our quarterly and annual results of operations will be impacted for the foreseeable future by several factors, including the timing and amount of payments received pursuant to our current and future collaborations, and the progress and timing of expenditures related to our research, development and commercialization efforts. Due to these fluctuations, we believe that the period-to-period comparisons of our operating results are not a good indication of our future performance.

Revenue

For the second quarter ended June 30, 2005, revenue amounted to \$11,000 compared to \$93,000 for the quarter ended June 30, 2004. Total revenue for the six-month period ended June 30, 2005 was \$751,000 compared with \$186,000 for the corresponding period last year.

There was no revenue generated from research and development contracts for the quarter ended June 30, 2005 while for the quarter ended June 30, 2004, \$81,000 was derived from our agreement with Gruppo Angelini, under which we are formulating a once-daily version of the anti-depressant trazodone. For the six-month period ended June 30, 2004, the above mentioned research and development agreement generated \$162,000 in revenue.

We recognized \$11,000 of licensing revenue during the quarter, and \$12,000 in the corresponding quarter last year, representing a portion of the up-front payments received from Gruppo Angelini and Esteve S.A. under our license and distribution agreement for once-daily tramadol. Over the next several quarters, additional milestone payments provided for in the current licensing and distribution arrangements for once-daily tramadol are anticipated to be recognized as revenue as we receive market and/or price approval or launch the product in the various European countries. For the six-month period ended June 30, 2005, licensing revenues amounted to \$751,000 representing a portion of the up-front payments received from Gruppo Angelini and Esteve S.A. and a portion of the additional milestone payment received from HEXAL AG, compared with \$24,000 for the corresponding period last year.

Research and Development Expenses

Research and development expenses (net of tax credits) for the quarter ended June 30, 2005 were \$5,307,000 compared with \$2,118,000 for the quarter ended June 30, 2004, an increase of \$3,189,000. The increase in the current quarter is primarily attributable to the timing and the cost of our clinical trial program for our once-daily tramadol product. The quarter ended

June 30, 2004 included very few clinical trial costs, as the two initial Phase III studies for once-daily tramadol were being concluded, while the second quarter of 2005 included the costs for the current Phase III study in the US. The current quarter also included costs associated with the ongoing validation of the commercial manufacturing process of tramadol at a second manufacturer. Our intention is to qualify and register a second manufacturer to avoid capacity and dependency issues that come with using a single manufacturer. Also during the quarter, pharmacokinetics studies were conducted on our once-daily formulation of betahistine and on our once-daily formulation of trazodone.

For the six-month period ended June 30, 2005, research and development expenses totalled \$8,930,000 compared to \$7,092,000 for the comparative period, an increase of \$1,838,000. The increase can primarily be explained by the validation of the commercial manufacturing process of tramadol at a second manufacturer, by the timing and costs related to clinical trials and the higher compensation costs as we prepare for commercial launch in Europe. During the period, we also received a favourable ruling on our notice of objection for previous taxation years, allowing us to increase our research and development tax credits by \$386,000.

Research and development costs in relation to our once-daily tramadol program amounted to approximately \$4,337,000 for the quarter ended June 30, 2005, and \$7,123,000 for the six-month period then ended.

QUARTERLY INFORMATION

The following selected financial information is derived from our unaudited quarterly financial statements for each of the last eight quarters, all of which cover periods of three months.

\$000s except per share data	Three months ended							
	June 30, 2005	March 31, 2005	Dec. 31, 2004	Sept. 30, 2004	June 30, 2004	March 31, 2004	Dec. 31, 2003	Sept. 30, 2003
Revenue ¹	11	740	970	238	93	93	14	8
Net loss	(8,789)	(5,929)	(6,631)	(5,895)	(7,084)	(7,569)	(9,388)	(7,889)
Basic and diluted net loss per share	(0.21)	(0.14)	(0.16)	(0.14)	(0.18)	(0.21)	(0.27)	(0.22)

¹ The comparative figures for revenue were reclassified to conform with the presentation in the current period.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents, investments and accrued interest on investments totalled \$24,579,000 as at June 30, 2005. On June 28, 2005 we entered into a term loan agreement which generated gross proceeds of \$12,317,000. As part of the transaction we issued 543,104 warrants to purchase common shares. Despite the proceeds from this financing, our committed cash obligations and expected level of expenses for the upcoming twelve months exceed the committed sources of funds and our cash and cash equivalents on hand. Our ability to continue as a going concern is dependent upon receiving funds through product licensing agreements or collaborative research contracts, raising additional financing through borrowings or equity financing, or achieving

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the quarter ended June 30, 2005 were \$2,873,000 compared to \$2,879,000 for the quarter ended June 30, 2004. Selling, general and administrative expenses for the six-month period ended June 30, 2005 were \$5,348,000 compared with \$5,020,000 for the six-month period ended June 30, 2004, an increase of \$328,000 or 7%, consistent with our efforts to prepare for global commercialization of our once-daily tramadol.

Expenses Related to An Incomplete Financing Initiative

During the second quarter of 2004, we incurred \$1,597,000 of non-recurring financing costs that were expensed during the quarter, and were in relation to a contemplated cross-border financing, which was eventually halted due to unfavourable market conditions. The expenses are composed primarily of legal and accounting fees.

Net Loss

Net loss for the quarter ended June 30, 2005 was \$8,789,000, or \$0.21 per share, compared with \$7,084,000, or \$0.18 per share, for the quarter ended June 30, 2004. The increase in net loss is the result of higher expenses related to the clinical trial program for our once-daily tramadol product, and the validation of the commercial manufacturing process of tramadol at a second manufacturer, partially offset by lower expenses due to non recurring financing costs expensed in 2004. For the six-month period ended June 30, 2005, net loss was \$14,718,000, or \$0.34 per share, compared with \$14,653,000, or \$0.39 per share for the comparative period.

future profitable operations. The outcome of these matters is dependent on a number of items outside of our control. As a result, there is significant uncertainty as to whether we will have the ability to continue as a going concern. However, we expect to raise additional funds using one or a combination of alternatives including the receipt of up-front and milestone payments in relation to existing and additional product distribution and licensing agreements, the obtaining of credit facilities or through equity financing. However, there can be no assurance that we will be able to raise such capital on favourable terms, or that commercial agreements will be concluded or that we will receive payments under existing agreements.

Funds used in operating activities during the quarter ended June 30, 2005 amounted to \$8,846,000 compared to \$6,542,000 for the corresponding period last year, and were used primarily to develop our in-house product portfolio, principally our once-daily tramadol product, and for general operating purposes. The increase of \$2,304,000 in funds used in operating activities is mainly due to increased clinical trial activity and the validation of the commercial manufacturing process of tramadol at a second manufacturer. For the six-month period ended June 30, 2005 funds used in operating activities were \$12,700,000 compared to \$15,196,000 for the comparative period last year. The decrease in funds used in operating activities is mostly attributable to the licensing payments received during the first quarter of 2005.

Funds provided from investing activities for the quarter ended June 30, 2005 amounted to \$5,601,000 compared to \$22,877,000 of funds applied to investing activities for the quarter ended June 30, 2004. In the second quarter of 2004, acquisitions of investments were \$31,480,000 compared to \$2,407,000 for the quarter ended June 30, 2005, reflecting the marketable securities acquired with the net proceeds generated from the equity financing completed on May 26, 2004. Capital expenditures in the current quarter were \$249,000, similar to the corresponding period last year, and were principally related to our information technology infrastructure. Funds provided from investing activities for the six-month period ended June 30, 2005 amounted to \$13,919,000 compared to \$13,402,000 of funds applied to investing activities for the six-month period ended June 30, 2004, variance explained by the investments made following the May 2004 equity financing.

Funds provided from financing activities amounted to \$12,360,000 for the quarter ended June 30, 2005 as compared to \$27,873,000 for the corresponding quarter of the preceding fiscal year. On June 28, 2005, we entered into a term loan agreement which generated gross proceeds of \$12,317,000, of which \$11,586,000 was attributed to the term loan and \$731,000 to the 543,104 warrants issued as part of the agreement. Related financing costs paid during the quarter totaled \$154,000. In the second quarter of 2004, net proceeds of \$27,835,000 were generated from the equity financing completed on May 26, 2004. Proceeds of \$241,000 were obtained from the exercise of stock options in the quarter ended June 30, 2005 compared to \$81,000 for the corresponding quarter of the previous year.

As at June 30, 2005, working capital was \$16,957,000. Accounts receivable totaled \$784,000 as at June 30, 2005 and included primarily the amount receivable for sales tax, as well as accrued interest on investments. Research and development tax credits receivable totaled \$1,340,000 and included the estimated tax credits for 2004 and for the first six months of 2005. In preparation for commercial launch of our product, we have accumulated \$412,000 of inventories consisting of the active pharmaceutical ingredient tramadol. We have also issued purchase orders to our approved manufacturer to produce bulk tablets. Inventory levels should consequently increase over the next several quarters.

Accounts payable and accrued liabilities decreased from \$5,930,000 at December 31, 2004 to \$4,702,000 at June 30, 2005 due primarily to the timing of the payments of expenses related to the US Phase III study associated with our once-daily tramadol product. Deferred revenue totaled \$4,720,000 as at June 30, 2005 and included (i) the portion of the payments from HEXAL AG, Gruppo Angelini and Esteve S.A. received at the signing of the distribution and license agreements for our once-daily tramadol product, which will be recognized over the terms of the respective agreements, and (ii) other payments, or portion of, from Sanofi-aventis and HEXAL AG received upon notification of regulatory approval for our once-daily tramadol product in France, which will be recognized upon reaching future milestones. Obligations under capital leases decreased in 2005 by \$90,000 to \$5,967,000 as at June 30, 2005, as a result of payments made since December 31, 2004.

Cash and cash equivalents, investments and accrued interest on investments totaled \$24,579,000 as at June 30, 2005 compared to \$25,101,000 as at December 31, 2004, a \$522,000 decrease, primarily as a result of the loss incurred during the period, net of the milestone payments received in the period and the proceeds from the financing completed in June 2005. Our investment policy regulates our investment activities relating to cash resources. We invest in liquid, high-grade investment securities with varying terms to maturity, selected with regard to the expected timing of expenditures for continuing operations. As at June 30, 2005, our short term investments included four governmental agencies and one Chartered Bank in amounts ranging from \$433,000 to \$2,500,000.

Off-Balance Sheet Arrangements

To date, we have not had any relationships with unconsolidated entities or financial partnerships, such as entities referred to as structured finance or special purpose entities, which are established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

OUTSTANDING SHARE DATA

The number of common shares outstanding as of July 26, 2005 is 42,979,330 and has increased by 68,000 since June 30, 2005 due to the exercise of stock options. The number of options outstanding as of July 26, 2005 is 3,339,075 and has decreased by 83,000 since June 30, 2005, due to the exercise of 68,000 options, and the expiry of 15,000 options.

Pursuant to the term loan agreement executed on June 28, 2005, we have 543,104 warrants outstanding at an exercise price of \$2.71, and expiring on June 29, 2010, all of which can be exercised immediately.

QUANTITATIVE AND QUALITATIVE DISCLOSURES OF MARKET RISK

Foreign Currency Risk

We operate internationally, and a substantial portion of our expense activities and capital expenditures are in Canadian dollars,

whereas our revenue (current and potential) from research contracts and licensing and distribution agreements is, and will be, primarily in US dollars or Euros. In addition, in June 2005 we contracted a \$10 million term loan denominated in US currency. A significant adverse change in foreign currency exchange rates between the Canadian dollar relative to the US dollar and Euro, could have a material effect on our consolidated results of operations, financial position or cash flows. We have not hedged exposures denominated in foreign currencies.

Interest Rate Risk

We invest our excess cash in investment-grade, interest-bearing securities. The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we invest in highly liquid and high quality debt instruments or commercial paper of major corporations, government agencies and financial institutions with maturities generally of less than two years. A significant change in interest rates could have a material effect on the fair value of our investments if these investments were not held to maturity.

OTHER RISKS AND UNCERTAINTIES

If any of the following risks occur, our business, results of operations or financial condition could be materially adversely affected.

- We have not generated significant revenue to date, and expect to continue to experience losses for at least the next two years. It is also difficult to estimate timing and future costs of our research and development programs.
- If we fail to obtain additional regulatory approvals for our product candidates under development, and in particular our lead product candidate once-daily tramadol, we will not be able to generate revenues from the commercialization of our product candidates.
- We may not achieve our projected development goals in the time frames we announce and expect.
- Rapid technological change could make our products obsolete.
- We face uncertainties related to regulatory approval which could result in delays in product development.
- Even if we obtain marketing approval, our products will be subject to ongoing regulatory review.
- Our products, if approved, may fail to achieve market acceptance.
- Development of drugs can be costly and require years of research and development activities.
- If we cannot raise additional capital on acceptable terms, we may be unable to complete planned clinical trials, obtain regulatory approvals or commercialize our product candidates.
- If we are unable to protect our intellectual property rights, our competitors may develop and market products with similar features that may reduce demand for our products and the effective commercialization of our products may be inhibited.
- We are aware of US and foreign patents owned by third parties including potential competitors that arguably cover aspects of our once-daily tramadol product. Claims by these and other companies that we infringe their proprietary technology may result in liability for damages or stop our development and commercialization efforts.
- We may become involved in lawsuits to protect or enforce our patents that would be expensive and time consuming.
- If third-party manufacturers of our products fail to devote sufficient time and resources to our concerns, or if their performance is substandard, our clinical trials and product introductions may be delayed and our costs may rise.
- We currently have a single source of supply for Contramid®.
- We may not be able to manufacture our products in commercial quantities, which would prevent us from marketing our products.
- We have no experience in selling, marketing or distributing our products and no internal capability to do so yet.
- We have and will continue to establish collaborative relationships, and those relationships may expose us to a number of risks.
- If we are unable to retain key personnel and hire additional qualified scientific, sales and marketing, and other personnel, we may not be able to successfully achieve our goals.
- We have international operations that expose us to additional business risks.
- We may not be able to successfully acquire and integrate complementary technologies or businesses needed for the development of our business and any acquisitions we make could disrupt our business and harm our financial condition.
- We may incur losses associated with foreign currency fluctuations.
- Competition in the pharmaceutical industry is intense, and if we fail to compete effectively our financial results will suffer.
- Generic pharmaceutical manufacturers will increase competition for certain products.
- Market acceptance of our products will be limited if users of our products are unable to obtain adequate reimbursement from third-party payors.
- We are subject to the risk of product liability claims, for which we may not have or be able to obtain adequate insurance coverage.
- Our products involve the use of hazardous materials, and as a result we are exposed to potential liability claims and to costs associated with complying with laws regulating hazardous waste.
- Our share price may be volatile, and an investment in our common shares could suffer a decline in value.
- Future sales of common shares by us or our existing shareholders may cause our stock price to fall.
- We have never paid dividends on our common shares, and we do not anticipate paying any cash dividends in the foreseeable future.

CERTIFICATION OF INTERIM FILINGS

I, James R. Howard-Tripp, President and Chief Executive Officer of Labopharm Inc., certify that:

1. I have reviewed the interim filings (as this term is defined in *Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings*) of Labopharm Inc. (the issuer) for the interim period ending June 30, 2005;
2. Based on my knowledge, the interim filings do not contain any untrue statements of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings; and
3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings.

(signed)

President and Chief Executive Officer
July 26, 2005

I, Warren Whitehead, Chief Financial Officer of Labopharm Inc., certify that:

1. I have reviewed the interim filings (as this term is defined in *Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings*) of Labopharm Inc. (the issuer) for the interim period ending June 30, 2005;
2. Based on my knowledge, the interim filings do not contain any untrue statements of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings; and
3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings.

(signed)

Chief Financial Officer
July 26, 2005

CONSOLIDATED STATEMENTS OF LOSS

[Unaudited] [note 1]

For periods of :	Three months ended		Six months ended	
	June 30, 2005	June 30, 2004	June 30, 2005	June 30, 2004
[Thousands of dollars, except share and per share amounts]	\$	\$	\$	\$
REVENUE				
Research and development contracts	—	81	—	162
Licensing	11	12	751	24
	11	93	751	186
EXPENSES				
Research and development expenses, net [note 4]	5,307	2,118	8,930	7,092
Selling, general and administrative expenses	2,873	2,879	5,348	5,020
Depreciation and amortization	414	438	819	836
Interest expense	210	212	420	424
Interest income	(102)	(94)	(237)	(200)
Foreign exchange loss	97	9	188	39
	8,799	5,562	15,468	13,211
LOSS BEFORE THE UNDERNOTED ITEMS	(8,788)	(5,469)	(14,717)	(13,025)
Expenses related to an incomplete financing initiative	—	1,597	—	1,597
LOSS BEFORE INCOME TAXES	(8,788)	(7,066)	(14,717)	(14,622)
Income taxes:				
Current	1	18	1	31
NET LOSS FOR THE PERIOD	(8,789)	(7,084)	(14,718)	(14,653)
NET LOSS PER SHARE - BASIC AND DILUTED	(0.21)	(0.18)	(0.34)	(0.39)
Weighted average number of common shares outstanding	42,800,835	38,767,796	42,710,427	37,403,553

See accompanying notes.

CONSOLIDATED STATEMENTS OF CASH FLOWS

[Unaudited] [note 1]

For periods of :	Three months ended		Six months ended	
	June 30, 2005 \$	June 30, 2004 \$	June 30, 2005 \$	June 30, 2004 \$
[Thousands of dollars]				
OPERATING ACTIVITIES				
Net loss for the period	(8,789)	(7,084)	(14,718)	(14,653)
Items not affecting cash :				
Depreciation of property, plant and equipment	380	373	750	738
Amortization of intangible assets	34	65	69	98
Unrealized foreign exchange loss	73	—	181	—
Stock-based compensation	521	684	647	1,095
	(7,781)	(5,962)	(13,071)	(12,722)
Net change in non-cash operating items	(1,065)	(580)	371	(2,474)
	(8,846)	(6,542)	(12,700)	(15,196)
INVESTING ACTIVITIES				
Acquisition of investments	(2,407)	(31,480)	(3,798)	(31,931)
Disposals of investments	—	971	958	3,121
Maturities of investments	8,257	7,909	17,203	16,057
Acquisition of property, plant and equipment	(210)	(276)	(358)	(598)
Acquisition of intangible assets	(39)	(1)	(86)	(51)
	5,601	(22,877)	13,919	(13,402)
FINANCING ACTIVITIES				
Repayment of capital lease obligations	(44)	(43)	(90)	(84)
Proceeds from issuance of capital stock	241	30,081	860	30,773
Issuance costs of capital stock	—	(2,165)	—	(2,165)
Proceeds from issuance of long term debt	11,586	—	11,586	—
Proceeds from issuance of warrants	731	—	731	—
Deferred financing costs	(154)	—	(154)	—
	12,360	27,873	12,933	28,524
Foreign exchange loss on cash held in foreign currencies	(136)	—	(250)	—
INCREASE IN CASH AND CASH EQUIVALENTS DURING THE PERIOD	8,979	(1,546)	13,902	(74)
Cash and cash equivalents, beginning of period	7,732	2,192	2,809	720
CASH AND CASH EQUIVALENTS, END OF PERIOD	16,711	646	16,711	646
Cash flows include the following items:				
Interest paid	204	209	410	421
Income taxes paid	1	3	1	6

See accompanying notes.

CONSOLIDATED BALANCE SHEETS

[Unaudited] [note 1]

[Thousands of dollars]	As at June 30, 2005 \$	As at Dec. 31, 2004 [note 2] \$
ASSETS [note 6]		
Current		
Cash and cash equivalents	16,711	2,809
Short-term investments	6,451	20,814
Accounts receivable	784	967
Research and development tax credits receivable	1,340	800
Inventories [note 5]	412	—
Prepays and other assets	499	247
Total current assets	26,197	25,637
Long-term investments	1,274	1,282
Property, plant and equipment	10,569	10,961
Intangible assets	2,053	2,036
Deferred financing costs	526	—
	40,619	39,916
LIABILITIES		
Current		
Accounts payable and accrued liabilities	4,702	5,930
Current portion of deferred revenue	3,142	266
Current portion of obligations under capital leases	84	134
Current portion of long term debt [note 6]	1,312	—
	9,240	6,330
Deferred revenue	1,578	1,510
Obligations under capital leases	5,883	5,923
Long term debt [note 6]	10,245	—
	26,946	13,763
SHAREHOLDERS' EQUITY		
Capital stock [note 7]	133,518	132,658
Warrants [note 7]	731	—
Contributed surplus [notes 3 and 7]	5,392	4,745
Deficit	(125,968)	(111,250)
Total shareholders' equity	13,673	26,153
	40,619	39,916

See accompanying notes.

CONSOLIDATED STATEMENTS OF DEFICIT

[Unaudited] [note 1]

For periods of six months ended: [Thousands of dollars]	June 30, 2005 \$	June 30, 2004 \$
BALANCE, beginning of period	(111,250)	(81,095)
Adjustment for change in accounting policy [note 3]	—	(2,976)
Net loss	(14,718)	(14,653)
BALANCE, end of period	(125,968)	(98,724)

See accompanying notes.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at June 30, 2005 [thousands of dollars, except share and per share amounts]

NOTE 1. DESCRIPTION OF BUSINESS AND GOING CONCERN UNCERTAINTY

The Company, incorporated under the *Companies Act (Québec)* is specialized in the development of drugs using advanced controlled-release technologies and the development of pharmaceutical products incorporating its proprietary technologies. The Company carries on business in Canada, Barbados, United States and Ireland and substantially all of the Company's tangible assets are located in Canada. All licensing revenues have been derived from business carried on in Ireland, by the Company's subsidiary Labopharm Europe Limited, and all other revenues have been derived from business carried on in Canada. The intangible assets are jointly owned by the Company and its foreign subsidiaries.

The Company's strategy is to develop products internally in order to form strategic alliances or licensing agreements with national or international pharmaceutical companies that have the necessary resources and distribution networks to market and sell the pharmaceutical products incorporating the Company's proprietary technologies. To date, the Company has financed its cash requirements primarily through share issuances, investment tax credits, collaborative research contracts, licensing and distribution agreements and interest income. The future profitability of the Company is dependent upon such factors as the success of the clinical trials, the approval by regulatory authorities of products developed by the Company, the ability of the Company to successfully market, sell and distribute its products and the ability of the Company to obtain the necessary financing to complete its projects through licensing and research agreements.

The Company has incurred significant operating losses and cash outflows from operations. As at June 30, 2005, the Company's committed cash obligations and expected level of expenses for the upcoming twelve months exceed the committed sources of funds and the Company's cash and cash equivalents on hand. The ability of the Company to continue as a going concern is dependent upon raising additional financing through borrowings or equity financing, receiving funds through collaborative research contracts or product licensing agreements and achieving future profitable operations. The outcome of these matters is dependent on a number of items outside of the Company's control. As a result, there is significant uncertainty as to whether the Company will have the ability to continue as a going concern.

The consolidated financial statements have been prepared on a going concern basis, which assumes the Company will continue in operation for the foreseeable future and will be able

to realize its assets and discharge its liabilities and commitments in the ordinary course of business. These financial statements do not include any adjustments to the amounts and classification for assets and liabilities that may be necessary should the Company not be successful in its efforts to obtain additional financing or not receive significant funds resulting from signing collaborative research contracts or by out licensing its products.

NOTE 2. BASIS OF PRESENTATION AND ACCOUNTING POLICIES

The unaudited interim consolidated financial statements of the Company have been prepared in accordance with generally accepted accounting principles ("GAAP") in Canada for interim financial statements. Accordingly, they do not include all of the information and notes required by GAAP for annual financial statements and should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2004 and the accompanying notes, included in the Company's annual report. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the interim consolidated financial statements have been included.

The accounting policies used in preparation of these interim consolidated financial statements are the same as those used in the preparation of the Company's most recent annual consolidated financial statements, and are set forth in notes 2 and 3 of the audited consolidated financial statements for the year ended December 31, 2004 included in the Company's annual report except for the notes shown below.

Inventories

Inventories are valued at the lower of cost, which is determined on an average cost basis, and net realizable value for finished goods and work-in-progress and replacement cost for raw materials.

Deferred Financing costs

Financing costs associated with the issuance of debt are deferred and amortized straight-line over the term of the related debt.

NOTE 3. CHANGE IN ACCOUNTING POLICY

In 2003, the Canadian Institute of Chartered Accountants ("CICA") amended its pronouncement relating to stock-based compensation requiring companies to measure and expense all equity instruments awarded to employees and directors starting in fiscal years beginning on or after January 1, 2004 in accordance with the fair value method. The fair value of stock options to employees and directors is determined at the date

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at June 30, 2005 [thousands of dollars, except share and per share amounts]

of grant using the Black-Scholes option pricing model, and expensed over the vesting period of the options. The transitional provisions provide for a prospective treatment to this change in accounting policy for those companies who adopt this new pronouncement in fiscal years beginning before January 1, 2004 and a retroactive treatment for those companies adopting on or after January 1, 2004.

Effective January 1, 2004, the Company adopted the retroactive treatment without restatement, for options granted since March 1, 2002. Consequently, the opening deficit and contributed surplus balances as at January 1, 2004 increased by \$2,976. The compensation expense for the quarter ended June 30, 2005 was \$521 of which \$141 were included in research and development expenses and of which \$380 were included in selling, general and administrative expenses. The compensation expense for the six-month period ended June 30, 2005 was \$647. The compensation expense charged against income was \$684 for the quarter ended June 30, 2004, of which \$164 were included in research and development expenses and of which \$520 were included in selling, general and administrative expenses. The compensation expense for the six-month period ended June 30, 2004 was \$1,095. The counterpart has been recorded as contributed surplus. Prior to January 1, 2004, no compensation expense was recognized when stock options were granted to employees and directors, however the Company provided pro forma information as if the fair value method had been applied.

NOTE 4. RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses are presented net of tax credits of \$206 and \$217 for the three-month periods ended June 30, 2005 and 2004 respectively and net of tax credits of \$746 and \$417 for the six-month periods ended June 30, 2005 and 2004 respectively.

NOTE 5. INVENTORIES

In preparation for the commercial launch of its once-daily tramadol product, the Company has accumulated inventories comprised of raw materials. The Company has issued purchase orders in the amount of \$329 for the manufacture of intermediate finished products (bulk tablets) also in preparation of commercial launch of the product which is expected towards the end of 2005.

NOTE 6. LONG-TERM DEBT

	\$
Term loan, maturing on July 1, 2008 with interest payable monthly and repayable in 30 monthly payments of \$477 including interest, commencing on February 1, 2006.	11,557
Current portion of long term debt	(1,312)
	<u>10,245</u>

On June 28, 2005, the Company entered into a US\$10,000 term loan agreement bearing interest at 11.95%, resulting in gross proceeds of \$12,317. As part of the agreement, the Company issued 543,104 warrants to purchase common shares [note 7]. Proceeds were allocated to the long-term debt for \$11,586 and the warrants for \$731. As a result of the warrants and the loan termination fee of \$430 [US\$350] due on repayment, the effective interest rate of the term loan is 17%.

The estimated financing costs related to the term loan agreement amount to \$526 and were recorded as deferred financing costs.

The term loan is collateralized by all of the Company's assets except for its intellectual property.

Minimum annual principal repayments of long-term debt during the next four twelve-month periods ending June 30, are as follows:

	\$
2006	1,312
2007	4,278
2008	5,078
2009	889

NOTE 7. CAPITAL STOCK

Authorized

Unlimited number of preferred shares, non-participating, non-voting, without par value

Unlimited number of common shares, voting, without par value

Issued

42,911,330 common shares [December 31, 2004 – 42,510,630]

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS [UNAUDITED]

As at June 30, 2005 [thousands of dollars, except share and per share amounts]

Capital Stock Transactions

During the six-month period ended June 30, 2005, 400,700 [2004 – 191,200] options were exercised for a total cash consideration of \$860 [2004 – \$414]. For options exercised which were granted after March 1, 2002, capital stock was increased by nil [2004 – \$4] and contributed surplus reduced by the same amount to consider compensation expense recorded.

Warrants

On June 29, 2005, as part of the term loan agreement described in note 6, the Company issued 543,104 warrants having an exercise price of \$2.71 and expiring on June 29, 2010. The Company valued the warrants using the Black-Scholes option pricing model with the following weighted average assumptions:

Expected volatility	0.63
Expected life	5.0 years
Risk-free interest rate	3.16%
Dividend yield	Nil

Proceeds from the term loan agreement were allocated on a pro-rata basis to the long-term debt and the warrants. The fair value attributed to the warrants was \$731.

During the six-month period ended June 30, 2004, 180,000 warrants were exercised for a total of 180,000 shares for a total cash consideration of \$360. As at June 30, 2005, 543,104 warrants were outstanding [2004 – nil].

Stock Option Plan

On April 20, 2005, the Company's stock option plan was amended in order to express the maximum number of securities issuable thereunder as a percentage of the Company's issued and outstanding shares rather than a fixed number. The maximum number of common shares that are issuable under the plan shall not exceed 9.9% of the Company's total issued and outstanding shares at any time.

The changes to the number of stock options granted by the Company and their weighted average exercise prices, for the six-month period ended June 30, 2005, are as follows:

	#	\$
Balance, beginning of period	3,363,475	5.01
Granted	459,700	3.16
Exercised	(400,700)	2.15
Forfeited	(400)	7.92
Balance, end of period	3,422,075	5.10
Options eligible to be exercised	2,986,375	5.11

The fair value of options granted in the six-month periods ended June 30, 2005 and 2004 was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	For the six-month period ended	
	June 30, 2005	June 30, 2004
Expected volatility	0.63	0.72
Expected life	4.0 years	4.0 years
Risk-free interest rate	3.36%	3.63%
Dividend yield	Nil	Nil

The weighted average fair value of stock options granted during the six-month period ended June 30, 2005 using the above assumptions amounted to \$3.16 [2004 – \$2.76].

A compensation expense of \$647 and \$1,095 has been recognized during the six-month periods ended June 30, 2005 and 2004 respectively, for stock options granted to employees and directors since March 1, 2002 [note 3].

NOTE 8. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform with the presentation in the current period.

GENERAL INFORMATION

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Chairman of the Board (Non-Executive)

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Vice-President, Clinical Development

Lisane Dostie, LLB
General Counsel and Corporate Secretary

Allan Mandelzys, PhD., MBA
Vice-President, Business Development

Damon Smith, BSc., PhD.
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