



Annual Report
1999



Content
creates Value



The Phenomedia Group in Figures

DM thousand	1999	1998*	1997*
Sales	9,513	4,663	1,514

Breakdown of sales by business unit

• Creative Products	7,362	3,125	1,135
• Services	2,151	1,538	379
• Technology	0	0	0
Net profit or loss from ordinary activities	3,398	1,317	-2,045
Net profit for the period	661	2,507	-1,283
Total assets	57,677	2,479	6,607
Equity ratio	95.4 %	46.9 %	0.0 %

Investments in property, plant and equipment and intangible assets	3,328	781	653
Depreciation and amortization expense	1,889	781	510
Average number of employees for the year	36	19	16
Staff costs	1,687	677	1,217

Data relating to shares

Share capital: EUR 4.2 million	German Securities Code Number (WKN):	541 490
Authorized capital: EUR 2.1 million	Reuters abbreviation:	PNMG.DE
	Listing:	Frankfurt am Main (Neuer Markt)
	OTC market:	Stuttgart, Munich, Düsseldorf, Bremen
	Free float:	31 %

DM	1999	1998*	1997*
Earnings per share	0.80	-0.31	-0.31
Market capitalization (as of Dec. 31, 1999) in DM million	190.58	–	–

*) Phenomedia pro forma Group figures



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The Phnomedia Vision:

Phnomedia means interactive entertainment.

We link the human need for entertainment with tomorrow's digital information society.

We integrate interactive entertainment competences into Internet, TV and mobile communications platforms.

With our special combination of skills, we are making Phnomedia a leading brand name in interactive entertainment .

The future is phenomedial!



Dear shareholders,

Phenomenia AG's IPO was less than nine months ago, yet it feels as if this experience has already faded into the distant past. This is due, on the one hand, to the qualification process which the entire Phenomenia team is undergoing. On the other hand, it is a result of the enormous success of the Moorhuhn character – a success which far surpassed predictions. In the space of just a few months, the Moorhuhn became a key figure in Phenomenia AG's future development. Germany's number one cult grouse is not just bringing in millions of DM in licensing income – it has also made Phenomenia one of the best-known German games developers. As a result, the Company is seen as having a high degree of expertise, and it has also won tremendous sympathy with the public at large. When these characteristics are added to the Company's unique position as the first entertainment software company to list on the Neuer Markt – Phenomenia AG went public on November 22, 1999 – and to Phenomenia's many successful products, the overall picture is one of an exceptionally dynamic company.

It is worth taking a look at our 1999 figures, which have positioned Phenomenia as one of the most profitable companies on the Neuer Markt, with an EBIT margin of 35%. We surpassed our ambitious forecasts for 1999 even before the growth potential unleashed this fiscal year by the Moorhuhn and other characters, and without the effect of the inflow of funds from the IPO of November 22. In 1999, we increased sales by 104% from DM 4.7 million to DM 9.5 million and our operating result by a full 148% to DM 3.3 million. This result was achieved during preparations for the IPO, which placed heavy demands on all of Phenomenia's employees – both mentally and timewise. We are particularly proud of our success in mastering both of these tasks simultaneously.

We will further pursue our internationalization strategy, and our future role as a leading content developer for interactive entertainment on any platform with the same degree of motivation with which we organized our IPO – EUR 22.50 for the initial listing was a fair price. "Content creates value" is the guiding principle we work to at Phenomenia, and this is what generates the Company's income – with all of the advantages and margins associated with the Company's irreplaceable position at the beginning of the value chain. We gain the necessary competence via internal qualification, as well as through the purchase of, and investments in, attractive partners. In this context we would like to inform you that Managing Board member Stefan Heinemann moved to netrecord-z AG during the current fiscal year. We would like to thank him for his contribution to Phenomenia. netrecord-z AG is an Internet music label – in which Phenomenia has an interest – which Stefan Heinemann will take onto the Neuer Markt as Chairman of the Managing Board.

We will continue to pursue controlled development of the Company as planned. We are focusing our imaginative strength on developing our strategies and products with our eye on the future interactive entertainment market. If, at the end of the day, the market places a fair value on Phenomenia AG's achievements and opportunities, it will give us great satisfaction to share this success with you.

Your confidence in us will help us along this road.

Sincerely,

Markus Scheer
Chairman of the Managing Board



Report of the Supervisory Board



Univ.-Prof. Dr. Michael Nelles

In 1999/2000, the Supervisory Board performed the duties required of it by law and the Articles of Association and continually supervised the management of Phenomedia AG. The Supervisory Board examined all transactions of major importance to the Company and held regular meetings with the Managing Board to discuss the most important ones. The Managing Board's regular reporting related to information on the Company's sales and earnings development and employment trends, and on the main companies, divisions and business units. In addition, the Supervisory Board held numerous meetings to deal comprehensively with major questions relating to Phenomedia AG's strategic development and positioning. In the course of these meetings, the Supervisory Board satisfied itself that the Managing Board had taken appropriate measures to identify risks at an early stage, in order to fulfill its obligations under the Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG – German Law on Control and Transparency in Business).



Dipl.-Kfm. Dr. Jörg Penner

The Supervisory Board also ensured that all of the necessary precautions were taken to deal with the problems associated with the year 2000 date rollover.

The biggest event in the year under review was the Company's successful IPO. The Supervisory Board dealt in detail with this project and we gave our approval to the various capitalization measures. At the end of 1999, Phenomedia AG's shares were included in price fixing on the Neuer Markt of the Frankfurt Stock Exchange. In the context of Phenomedia AG's IPO, the Managing Board and Supervisory Board jointly developed and introduced an innovative employee equity compensation model which has made a lasting, positive and measurable contribution to the Company's pleasant working atmosphere.



Drs. Arnoud Jan Backer

Following the IPO, one of Phenomedia AG's focuses was on business expansion. The Managing Board and Supervisory Board discussed the acquisition of equity interests on numerous occasions. All of the relevant decisions were made during the regular Supervisory Board meetings.

One major success factor for Phenomedia AG was our presentation of the Moorhuhn advertising game. No other software product has ever succeeded in achieving a comparable level of awareness in German-speaking countries. Due to this success, demand from the enormous fan community necessitated the development of a second expanded program version. In addition, we managed to recruit the well-known German artist Wiegald Boning to interpret the Moorhuhn song, which went on to enjoy chart success. Overall, it was clear that the Moorhuhn product did not just meet with a positive response by its fan community, but also by the capital markets.

In the context of its implementation of the KonTraG the Managing Board began to develop a risk management system (early warning system) for Phenomedia AG during 1999. The accounting, financial controlling and quality management systems which were already in place have been integrated into this. The Managing Board presented a system concept to the Supervisory Board, which we approved. The Supervisory Board expects this system to be fully implemented in fiscal 2000.

Phenomenia AG's annual financial statements as of December 31, 1999 and the Management Report were prepared in accordance with the accounting principles of German commercial law and were audited by KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Düsseldorf and granted an unrestricted audit opinion.

The consolidated financial statements as of December 31, 1999 and the Group Management Report were prepared in accordance with the International Accounting Standards (IAS) and were audited by KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Düsseldorf and granted an unrestricted audit opinion. The Supervisory Board discussed the documentation for the annual financial statements and the consolidated financial statements in consultation with the auditors. The audit reports are available to the Supervisory Board, which examined them and concurs with the findings of the auditors, and with the Management Reports and the statements made in these reports with regard to the Company's further development. The Supervisory Board does not raise any objections and approves the annual financial statements. These statements are thereby adopted.

The Managing Board's proposal for the appropriation of profits envisages carrying forward the net accumulated profits of DM 295,116.16 to new account. The Supervisory Board examined and approved this proposal for the appropriation of profits.

The Supervisory Board's examination of the dependent company report did not lead to any objections. The Supervisory Board concurs with the results of the audit. Accordingly, and following the final results of its own examination, the Supervisory Board does not have any objections to the Managing Board's declaration at the end of the report concerning the Company's relationships with affiliated companies.

The Supervisory Board would like to thank the members of the Managing Board and all of our employees for their untiring commitment and for their performance during the year under review.

Bochum, June 2000

Prof. Michael Nelles
Chairman of the Supervisory Board



Company Profile

Phenomedica – much more than the Moorhuhn

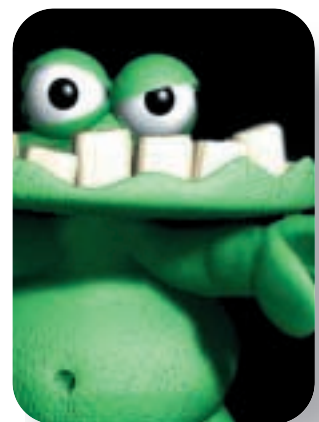
Since the beginning of 2000, Phenomedica has been identified with the Moorhuhn share by the business press: this in turn highlights our special ability to develop digital characters, transfer them to other platforms and generate high profits through our licensing business. At the same time, though, this focus has diverted attention somewhat from the variety of other highly successful Phenomedica products. Nevertheless, the Moorhuhn has made a unique contribution to making Phenomedica, our creative skill and Phenomedica shares well-known and highly popular. The Moorhuhn has also become the focus of high-publicity discussions on topics such as: playing PC games at work, proper use of Internet software (virus protection), animal welfare, and violence in games.

Nobody could have expected such a degree of public interest, regardless of the fact that a media campaign of such an impact could never have been funded. Phenomedica seized the day, and this has been a decisive factor in our success. Thanks to the immense popularity of the Moorhuhn, we have succeeded in emphasizing our skill in developing entertainment software and high-profile branded characters, and in establishing massive Internet communities through numerous TV/radio interviews as well as articles and placements in print and online media. Internet games also acquired a good reputation throughout Germany, even though the Moorhuhn itself is not an Internet game, but is merely efficiently distributed to target groups via the Internet.

The Moorhuhn has succeeded in introducing hundreds of thousands – perhaps even millions – of first-time players, including an unusually high number of women, to computer games (entertainment software) – and this is just as important for the future. We have developed a new market that is now eager for the launch of further Phenomedica products. Our product range also includes promotional games on behalf of brand name manufacturers and institutions, as well as online and offline computer games sold directly to customers for fun and entertainment.

To utilize all of these opportunities, it is important to us that we become more well-known and popular among users (the people who buy and play computer games) and companies (those who commission the development of entertainment software), than any entertainment software developer has ever been. We have also become a key consulting and alliance partner for the media in the area of games and entertainment.

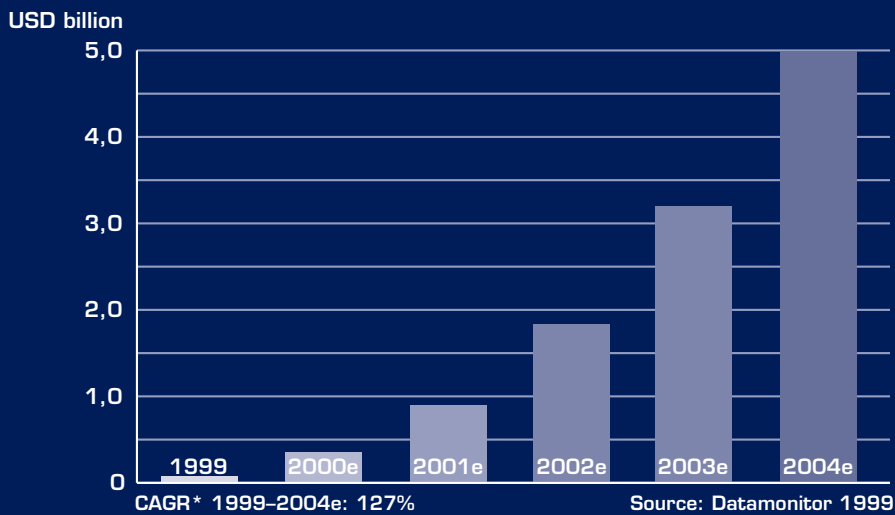
We will consistently exploit this public interest to the full, and further develop our online character Gnarf, which is currently being animated by a leading cartoon studio, Berliner Hahn Film AG. The Gnarf and the Moorhuhn – and, in the future, many other characters – as well as game and entertainment formats are clearly paving the way for Phenomedica in the area of interactive entertainment. Extending the marketability of our created characters to include merchandising activities will significantly contribute to Company profitability.



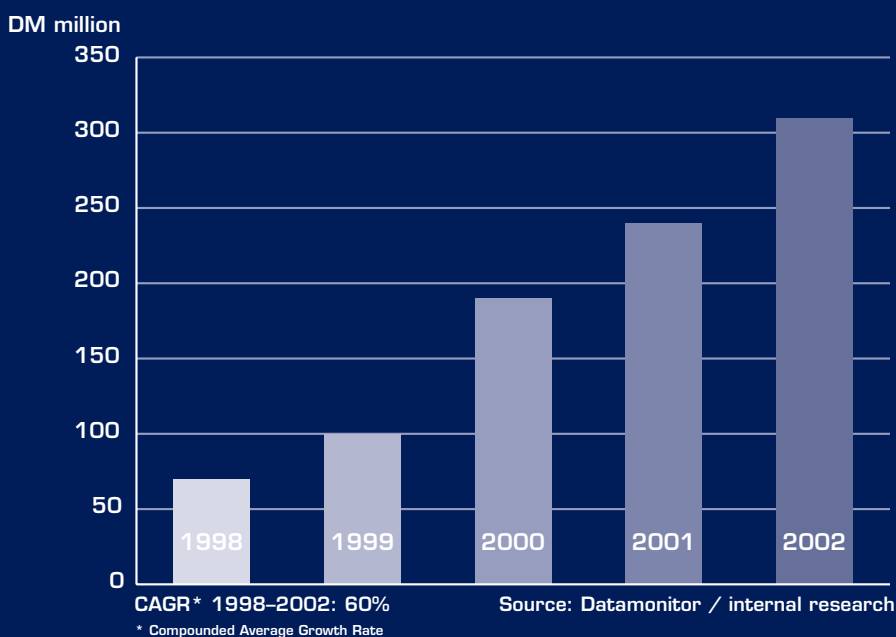
Phenomenia – active on the market for entertainment software

Phenomenia AG focuses on the highest growth segments within the entertainment market and has been successful on the dynamic entertainment software market since the beginning of the 1990s. We develop entertainment software (computer games) including the accompanying core technologies and provide additional services. With our range of services, we ideally accommodate the growing demand for up-to-date and sophisticated interactive entertainment services. Creative gaming concepts, which are increasingly becoming an integral part of recreational activities, can be attractively implemented, both offline and online, using state-of-the-art information technologies.

Online-Games – worldwide



3D-engine licensing market – worldwide



The value chain of a computer game generally comprises development, marketing (publishing) and distribution. Phenomenia is clearly positioned at the start of this value chain, i.e. we develop computer games. We are particularly experienced in 3D technologies, which enable the production of a three-dimensional representation of game processes on a computer screen. With its ability to give a completely natural representation of figures and scenarios, 3D technology is one of the standard technologies of the future, along with the Internet. We are also a prominent provider of services in our core business of entertainment software. One example of the services we offer is the localization of international computer games for national markets. Phenomenia is a market leader in this segment in Germany.

Phenomenia – we hold the key competences for interactive entertainment

With the merging of the Internet, TV and mobile telephone entertainment platforms, Phenomenia AG must integrate and further develop the relevant interactive entertainment competences. While billions are being invested worldwide in the technical and creative design of Internet information and entertainment platforms, the attractive entertainment formats required in order to lure visitors to these highly expensive pages (previously mainly used for services), are largely non-existent. Our creative skill means that this is no problem for us. Phenomenia has successfully positioned itself as a content developer and community builder for heavy-traffic Web sites which users access again and again.

The fine tuning of our company profile to focus on interactive entertainment – which we pushed forward in the course of the past few months – naturally influenced the structure of our core competences. We will more strongly refine the existing organization of individual activities, subsidiaries and partners in the three business units Creative Products, Technology and Services.

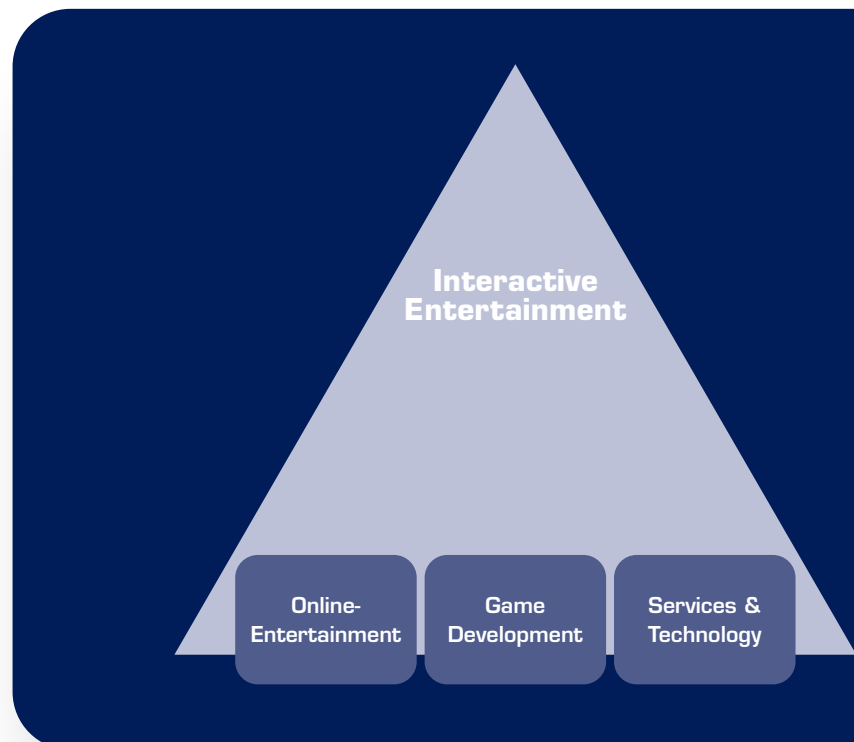
In the future, Phenomenia will operate in three segments in the interactive entertainment business sector:

Online Entertainment

Game Development

Services & Technology

This arrangement of competences is also reflected in our corporate strategy to acquire high-performing partners through acquisitions and alliances. We have made the first significant agreements here which will supplement our strong internal growth. Our strategy also includes acquiring additional capacity and competences, particularly in the areas of development and broadcasting, and likewise expanding our product and licensing portfolio.



Phenomenia corporate structure 2000



Corporate Strategy

Phenomenia's financial success is based on the development of creative games ideas and their attractive graphic and technical implementation, followed by the use of these games by third parties. From an economic perspective, we have positioned our company as the first link in the value chain, which is both crucial and exceptionally lucrative. The games, software technologies and characters which we produce are then passed on to the companies in the subsequent links in the value chain – such as publishers and merchandisers – who pay license fees. Using this business model, Phenomenia generates the high margins which are typical of companies in the entertainment sector. As an entertainment content developer, we are part of the dynamically growing interactive entertainment market, and we can be directly compared with producers of entertainment formats for film, radio and television. We do not compete with conventional software companies.



Furthermore, with the merging of the digital entertainment platforms Internet, television, and mobile phones and with our interactive offline and online expertise, Phenomenia AG is now also comprehensively developing the extraordinary opportunities offered by interactive entertainment. In order to hold our own internationally and to implement our existing visions, we will need to further develop our existing abilities and to enhance these with appropriate broadcasting expertise.

At Phenomenia, we have good opportunities to gain above-average benefits from the strong growth of interactive entertainment, to develop a strong market position and to internationalize our business. And there are good reasons for this:

- We are accompanying the rapid growth of our employee base with cautious development of our organizational structures. These allow creativity to flourish and also enable cost-effective project management and timely reporting.
- We are constantly increasing the number of products and licenses through growing in-house production and further acquisitions. On the one hand, Phenomenia AG only assumes the financially lucrative regular project management (in addition to concepts which are a fundamental factor in determining quality) and acquires major programming services at a low cost. On the other hand, we follow a platform strategy during development in which certain modules may be employed for various products, similar to a modular concept, without consumers becoming aware of the similarities in the core structure.
- From the word go, the creative work is structured in such a way that, for instance, digitally developed characters are immediately created so that they can be implemented on any entertainment platform. To attain optimal results in this respect, we formed Daywalker Studios GmbH together with Berliner Hahn Film AG.
- In selecting our alliance and acquisition partners, Phenomenia seeks to gain creativity and further expertise, in addition to products and licenses, which we integrate into our own business.

Overall, Phenomedia AG profits from the fact that our products make our company itself a part of media entertainment. Our products demand and gain publicity. They also convert interactive platforms – currently on the Internet and, in future, on interactive television – into marketplaces characterized by the formation of strong communities. In this very area, Phenomedia can not only boast of future prospects, but also of many successes achieved to date. The tightly structured Gnarf Internet game quickly gained a large, and lasting, fan community. The Gnarf is currently played on the Bertelsmann Game Channel and will soon be redesigned. As Germany's most successful free online-only game, it has already paved the way for the entire industry.

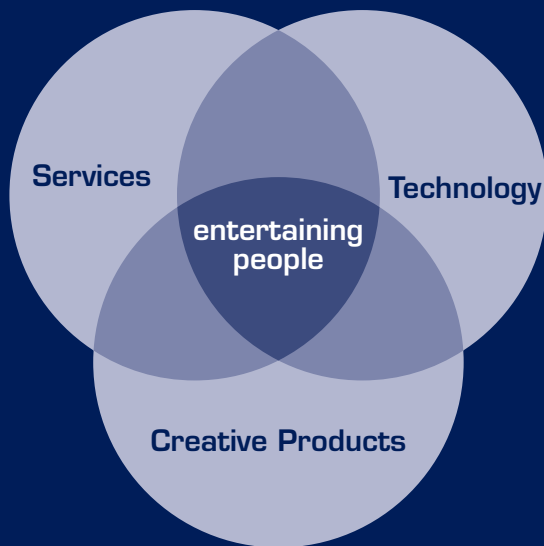
The continuation of the Moorhuhn's online success, through the national Moorhuhn online championships which were conducted in conjunction with the German Bild newspaper and RTL television in Germany, and the corresponding media partners in Austria and Switzerland, has proven that major opportunities are now open for professional marketing in the area of online games. For example, in the course of the first German Moorhuhn online championships, which took place during April and May, we reached 30 million hits at the Phenomedia domain www.moorhuhn.de with a solid community of almost a quarter of a million registered gamers.





Corporate Structure

In the course of the initial public offering in 1999, we focussed our competences in three business units: Creative Products, Technology and Services, and intensively used the resulting synergy potential. Our operating business was performed by the independent subsidiaries. By structuring the Group in this way, we ensured the necessary market proximity.



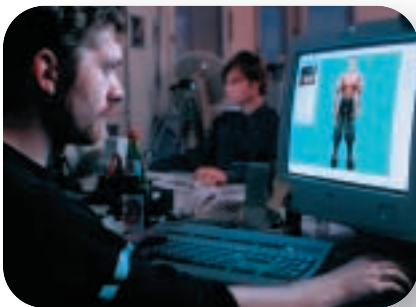
Phenomedica AG is represented on the market by two established brands: **Art Department** and **Greenwood Entertainment**. The products of both brands already made a significant contribution to the development of the computer games market in Germany in the early nineties. In 1999, the Phenomedica Group also comprised the wholly-owned subsidiaries Piranha Bytes Software GmbH (with its subsidiary codecult software research & development GmbH), Better Day Communications Werbeagentur GmbH, Effective 'Media Agentur für Medienberatung GmbH' and Ty-Phon Musicproductions & Publishing GmbH. The latter has since been sold to netrecord-z AG, which Phenomedica now also holds an interest in.

Phenomedica corporate structure 1999

Creative Products

Our Creative Products business unit focuses on developing full-price games for the international market, mid- and low-price games for national and European markets and online games.

With its Gothic project, Piranha Bytes Software GmbH aims to establish itself in the **full-price computer games** segment as one of the first German companies on the global market for mainstream computer games. This action roleplaying game has already caused a sensation among experts in the run-up to its simultaneous national and international release this summer, most recently at E3, the world's largest computer games trade fair, in Los Angeles in May 2000. As well as receiving license fees for the game through Egmont-Ehapa-Verlag, Piranha Bytes will share in the market success of the Gothic game through license fees dependent on the volume of sales. Agreements already made for Gothic comics, novels, action figures and add-ons emphasize the extent of the product's added value which stretches to merchandising activities. Piranha Bytes is already working intensively on a follow-up game with Zerberus as a working title.



At Phenomedica AG, we are currently successfully increasing the number of development teams and product developments in this segment. We have now successfully completed our first acquisitions of companies with highly promising products nearing completion. One example of a well-known cult character which we have been commissioned to convert into digital form is Werner Fan Racer, which will be completed in the fall.

Our Art Department and Greenwood Entertainment brands develop computer games in the **mid- and low-price** segments. Approximately 50 products have been developed and licensed in these segments since 1996, including products created together with SAT.1 (ran-Trainer, ran-Trainer 2, ran Soccer), for example. Over two million copies of „Der Planer“, a logistics game developed together with Mercedes-Benz Nutzfahrzeuge, have been sold and the next version of this successful game is currently in the design phase. Income from such games is generated by production to order or the exploitation of licenses.

We have set standards across Europe in the **online games** segment with our Gnarf and Moorhuhn online championships, which were held in Germany, Austria and Switzerland. This is true both for the games themselves and the resulting marketing opportunities. Phenomedia is developing similar concepts under the management of our subsidiary Better Day Communications, which is responsible for online activities. Games such as „Rettet die Kühe“ (save the cows) (www.milchland-bayern.de) developed for the Landesvereinigung der Bayerischen Milchwirtschaft (State association of the Bavarian dairy industry) and „Kick out“, the free game developed for UNICEF's anti-polio campaign (www.unicef.de) show that fun online games can also be used to convey a variety of messages.

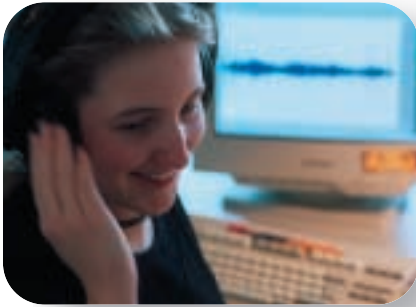
Technology

Both 3D graphics and development times are becoming critical success factors on the computer games market. There is an increasing trend towards releasing video games alongside the sale of other merchandise as part of marketing activities for cinema films. Examples include computer games such as Star Trek or Star Wars. As a result, games developers increasingly require licenses to ready-made 3D-engines as they do not have time to develop the engines themselves during game development. codecult software research & development GmbH is exploiting this bottleneck to develop such a 3D-engine for the international licensing markets and for in-house production.

We presented our codecreatures 3D-engine to selected prospective customers at the E3 computer games trade fair in the US in May 2000 as an innovative product designed to compete with the American market leaders. The decisive advantage of this 3D-engine is its ability to calculate curves in real time using NURBS tessellation algorithms. This technology allows characters to be depicted in a form that is much closer to reality, and landscapes and objects can be more realistically animated. It also offers greater choice in the development of different game genres. The use of a programming language similar to Java allows for improved documentation and usability as engine modifications do not have to be programmed into the source code. By using this technology, we are eliminating the need for services and support and setting new standards in terms of feasibility and user friendliness.



Services



Our Services business unit comprises the development of promotional games for customers, and the localization of computer games.

We tailor our **promotional games** for specific customers. This highly contact-intensive marketing instrument is used in industry, trade and by services providers, institutions and organizations to establish and strengthen market positions and build images. Well-known examples include the Bi-Fi trilogy (Unilever), Captain Zins (Dresdner Bank AG), Telekommando (Deutsche Telekom AG) and the DUNKLE SCHATTEN series for the Bundesinnenministerium (German interior ministry). Our Art Department subsidiary manages this highly-profitable promotional games business. The fact that we often develop several projects for the same customer is proof of the high level of customer satisfaction we enjoy. The Moorhuhnjagd (an ad game based on a grouse figure), which we developed for Johnnie Walker, has in the past few months become a total cult game in this segment. This game, the result of the greatest spontaneous creative impulse possible, has not only captured the attention of millions of PC users in offices and in the home, but has also resulted in innumerable fan pages springing up on the Internet where young people use their imagination and almost professional creative skill to play around with the Moorhuhn concept. The Moorhuhn has also burst the margins for the promotional games market: we have received over 80 concrete enquiries for such games. Together with Ede Kowalski, for example, we have developed a small game for a manufacturer of home electronic security systems. This game exploits the opportunities provided by distribution via the Internet and, as a result of media interest, allows the company to stage an ad campaign far beyond the normal budget of a small to medium-sized company.



The **localization of computer games** involves adapting international games to country-specific environments, as has been done for years in the film industry. This translation and adaptation service is performed within the Phenomedia Group by the subsidiary Effective Media „Agentur für Medienberatung“ GmbH. The company's full-service offering comprises the editing of video sequences, voice recordings using well-known synchronized voices and translation work in particular. Its core competence is in combining project management, programming and translation in order to produce a linguistically and culturally first-rate rendition of the game content that is in keeping with the situation concerned. Effective Media is a preferred partner for international publishers. Customers include leading global companies in the entertainment sector, such as Activision (USA), Infogrames (France) and GT Interactive (USA).



Alliances and Acquisitions

Before the IPO

After purchasing Piranha Bytes Software GmbH and codecult research & development GmbH and forming the subsidiary Ty-Phon Musicproductions & Publishing GmbH in the fiscal year 1999, the Phenomedia Group was positioned on the entertainment software market as a full service provider of products and services with a broad range of competences at the time of the IPO.

After the IPO

The alliances and acquisitions forged in recent months are considerably strengthening our market position. These are important steps towards becoming a leading content developer in the area of interactive entertainment. For example, with the help of Daywalker Studios GmbH, which we formed together with Berliner Hahn Film AG, Phenomedia AG's future digital characters will be created in such a way that they can be implemented on all media platforms. We further expanded our capacity in the games development segment with the acquisition of heart-line GmbH and FUNATICS Development GmbH. We acquired the German-Romanian company Informatics GmbH and formed the German-Indian company Shapre & Daywalker Studio India (Madras) through Daywalker Studios GmbH, also with the aim of expanding capacity. These acquisitions, which are usually financed through Phenomedia shares, are subject to long-term lockup periods. This enables the Company's key players to participate in Phenomedia's success on the one hand and on the other conserves capital resources which then can be used in preliminary investments in high-yield generating games development, for example.

We have formed a number of alliances in the area of project development with expert services providers, large media companies and institutions, all of which have significant future potential over and above the projects themselves. By licensing important Moorhuhn rights to the Munich-based RTV Family Entertainment AG, we have paved the way for an intensive economic evaluation of the brand-name potential of Germany's number 1 cult grouse and have caused quite a stir – not only in the specialist press. We will profit over and above day-to-day business in this partnership by developing strategies for the merchandising and TV segments and by developing and marketing state-of-the-art characters.

Examples of alliances formed in the media segment are those with RTL and the Axel Springer Verlag as well as with the online units of both companies in the course of the first German Moorhuhn online championships. We have also successfully concluded similar partnerships in Switzerland and Austria. Our work with UNICEF, whose "Kick out Polio" campaign we supported by developing an online skills game of that name (www.unicef.de), not only proves our readiness to commit ourselves to projects over and above our usual business operations, but also of the interest that well-known organizations have shown in working with Phenomedia.



We concluded a licensing agreement with the US-based Digital Addiction to establish a World Wide Gnarf League (WWGL) – our online strategy for our Gnarf character. This agreement was also a monumental first step for us onto the American online games market. With over five million active online gamers, the US is the most important and attractive submarket. We intend to discuss further possible collaborations with Digital Addiction extending beyond the contractually fixed operation of the Gnarf league in the US. Digital Addiction is currently enjoying success in the US with its online game „Sanctum“ and develops online games, among other things, for Electronic Arts, the global market leader.



Our acquisitions in detail

■ The joint formation of **Daywalker Studios GmbH** by Phenomedia AG and Hahn Film AG (Berlin) has enabled us to bring together expertise from the areas of cartoon and computer game production, which ideally supplement one another. The aim of both partners, each of which holds a 50 % interest in the company, is to develop and market concepts – particularly characters – for computer games, Internet services and offerings and for film and TV productions, and therefore for an extremely dynamic market. By moving into this new growth market at an early stage, we will be able to develop new earnings potential. Daywalker Studios GmbH is set to accommodate the enormous demand from the media and networks for newer content in electronic entertainment, which is expected to further increase rapidly. By forming Daywalker Studios GmbH, we will also be able to take advantage of the continuing integration of the entertainment software and media sectors.



■ Our equity interest in the Internet music label **netrecord-z AG** (Düsseldorf), which is about to go public, will serve to integrate the particular opportunities offered by the area of Internet music into our future strategy. Phenomedia initially acquired a 10 % interest in this company (www.netrecord-z.com) and has the option to acquire a further 14.9%. We sold our existing subsidiary Ty-Phon Musicproductions & Publishing GmbH to netrecord-z AG at the same time in order to bundle our music entertainment competences in this company. netrecord-z AG is an Internet music label that produces mainstream music which can be downloaded against payment. Deutsche Venture Capital Gesellschaft DVCG, a partner company of Deutsche Bank AG, is a further shareholder in netrecord-z AG. Following the acquisition of our equity interest, netrecord-z AG was joined by Stefan Heinemann, a former Managing Board member of Phenomedia AG responsible for development and communication. As Chairman of netrecord-z AG, Mr. Heinemann – a renowned expert in the music sector – will drive forward the company's initial public offering.





- Phenomedia secured a workforce of over 30 highly qualified experts in the highly competitive market for games software development following our 100% acquisition of the German-Romanian company **LunaTech Informatics GmbH**. These new Phenomedia games developers will both bring their own business into the Company and will provide welcome support in managing the explosion in demand for Phenomedia promotional games following our Moorhuhn success.
- We have succeeded in securing the services of one of the few top German development teams in the international full-price games segment with our 51% acquisition of **FUNATICS Development GmbH** (Mülheim a.d. Ruhr). This company converted the board game „Die Siedler von Catan“ into digital form for Ravensburger Interactive in 1999, for example. Our 100% acquisition of this company will take place in stages. Together with our subsidiary Piranha Bytes, the FUNATICS team will realize our business goal of providing national and international high-quality games on a regular basis in the full-price games segment. As well as the game „Cultures-Die Entdeckung Vinlands“, which will be released shortly and has already been very well received at the toy fair in Nuremberg, FUNATICS will bring more ready-made game concepts to the Company. In addition to integrating the FUNATICS development team into the Company, we plan to expand it to over 20 people by the end of 2000.
- Our acquisition of **heart-line GmbH** (Poing), which made a name for itself with the development of Kicker-Fußballmanager (a soccer game), will push forward Phenomedia's further expansion in the games and digital sport entertainment segments. heart-line GmbH has created a sensation in both the areas of football and specialized computer games with the two Fußballmanager games it has published up until now (Kurt – February 1999; Kicker – October 1999). The Kicker-Fußballmanager has received the following reviews from well-known specialist publications: „currently the most innovative product of its type“, „the new reference genre“, „cooler than the national league“, „the best in its class“, and „no alternative“. In view of the enormous response to this game, Kicker 2 will be in the shops just in time for Christmas 2000. At the same time, this game is being extended to other platforms, in particular to consoles, and is being developed as an online game. The developed platform can also easily be adapted for other games and related game types.
- The Phenomedia subsidiary Daywalker Studios GmbH has further expanded its base of first-class development teams with the formation of a joint German-Indian company. Our Indian partner Shapre (Madras) is a large IT company with branch offices in the US and the UK. The joint company **Shapre & Daywalker Studio India** (S.D.S.India) will, in future, create programs for 2D and 3D animations as well as flash animations for the online segment. Daywalker will send its game design specialists to India.

■ Following the acquisition of 100% of **Black Pencil AG** (Binningen/Switzerland) Phenomedia AG has acquired the undisputed market leader in Switzerland in the development of interactive TV entertainment through telephony computer games. As a result of this acquisition, we also have highly profitable game formats at our disposal which have been steadily receiving top ratings on Swiss television for years. As well as the acquisition of innovative expertise, the purchase of Black Pencil AG, which in the future will operate under the name **Phenomedia AG Switzerland**, signifies a key step forward in internationalizing Phenomedia business. The company will make a seven-digit profit contribution to Phenomedia earnings this year. Sales of DM 10 million are planned for the next three years in the interactive TV entertainment segment alone. The existing managing director of Black Pencil, Claude Cueni, will participate in the success of Phenomedia AG Switzerland as a member of the Board of Directors. The author Claude Cueni and Black Pencil have also been involved in numerous TV and film scripts, most recently in writing the scripts for the German RTL television series „Die Autobahnpolizei – Cobra 11“ (police series) and "Der Clown", for example. The company's TV thrillers have since been translated into eleven languages and televised in 24 countries.



Executive Bodies of the Company

Managing Board

Markus Scheer
Chief Executive

Dipl.-Oec. Dr. Achim Illner
Managing Board member responsible for finance

Supervisory Board

Univ.- Prof. Dr. Michael Nelles
Chair of Corporate Finance and Banking,
University of Wuppertal,
Chairman

Dipl.-Kfm. Jörg Penner,
Wirtschaftsprüfer and tax consultant

Drs. Arnoud Jan Backer,
Businessman

The IPO

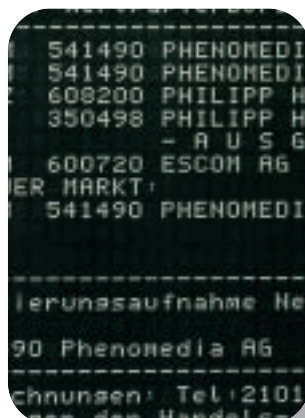
Providing the basis for further growth

On November 22, 1999 Phenomedia AG's shares were listed on the Neuer Markt of the Frankfurt Stock Exchange. The underwriting syndicate was composed of lead manager Gontard & MetallBank, WGZ-Bank (co-lead manager), Privatbank Delbrück and Net.IPO. The issuing proceeds amounting to approximately DM 44 million have provided the Phenomedia Group with the financial basis for sustained future growth.

Our corporate vision is to establish Phenomedia as a leading German company in the entertainment software market. The issuing proceeds and our access to the capital markets will be used to generate external company growth in particular. For this reason, the issuing proceeds will be used in part to expand our product portfolio and to develop our marketing and distribution structures, and also to further develop our 3D-engine technology, which should bring an appreciable boost to our organic growth.

The accrued funds will also be used to purchase strategic national and international software development companies and to develop our international activities. Phenomedia has also begun to accelerate its merchandising business – a business which is still largely undeveloped but is extremely attractive. An additional growth area is opening up here on the basis of successful games and game characters such as the Gnarf and the Moorhuhn.

The IPO itself has proven to be a unique learning process for us and our employees. Human resources, product quality and the customer and market situation – to name major factors – were systematically evaluated, weaknesses consistently reduced, and strengths developed. This optimization process is continuing and is being dynamically structured by the Managing Board. The run-up to the IPO itself turned into a media event. Comprehensive marketing activities and considerable interest on the part of the press brought the relevant publicity. As a result, the bookbuilding range was curtailed and when Phenomedia AG was listed on the stock exchange on November 22, 1999, it was well-known throughout Germany.



A flurry of media interest

Even in the run-up to the IPO, we succeeded in generating interest in Phenomenia AG's products and visions from the business and financial press and general newspapers as well as from the specialized computer games press. This interest was mainly focused in the print and online area. However, television stations also allocated valuable airtime to Phenomenia products such as the Gnarf and Gothic games in the run up to November 22, 1999.

As a result of the media interest generated by the Moorhuhn, television teams, radio reporters and representatives from other areas of the media became welcome and frequent guests at Phenomenia. Lately, the foreign press has also discovered Phenomenia as an interesting company and interview partner. In spite of the colossal demand, we succeeded throughout in meeting the public's information requirements and in constantly channeling this interest towards the important points that Phenomenia AG seeks to communicate.

The Phenomenia hotline and the Internet editorial team formed in the course of www.moorhuhn.de have helped provide positive answers to several thousand individual queries from interested people.



Investor Relations

Open discussion

At Phenomenia AG, we attach the utmost importance to maintaining an open and regular exchange of information with our shareholders, the financial markets and potential investors. This applies to statutory communication through the ad hoc publicity instrument as well as to roadshows, press conferences, press releases and one-on-one discussions. We strive to use our Phenomenia domain (www.phenomenia.com) to provide comprehensive and up-to-date information. Needless to say, we also include the response from the press and analysts. During the forthcoming relaunch of the Phenomenia Web pages, more emphasis than ever before will be placed on Phenomenia shares. At the same time, we will provide easier and more concentrated access to our product range.

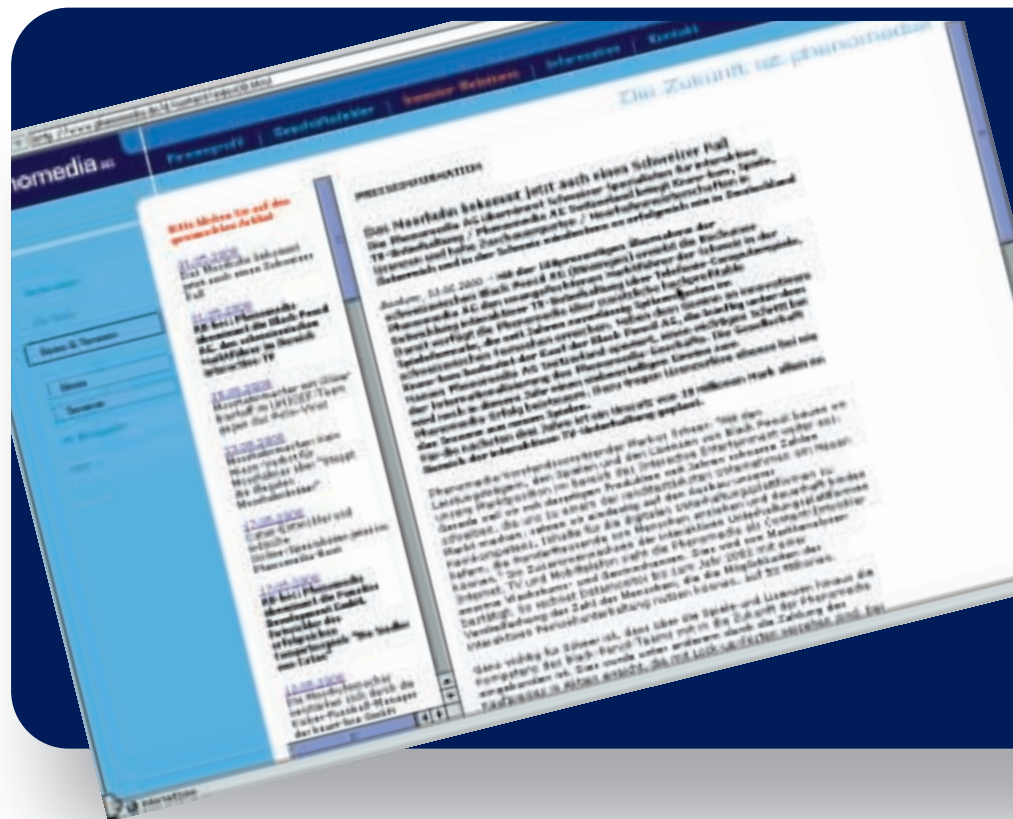
The exceptionally high degree of media interest in Phenomenia is also evident on the part of capital investors. During the IPO, over 1,500 interested investors used our hotline to find out information about the Company. In the spring, two roadshows were held in London, during which interest from German investment funds in Phenomenia shares – which had already been strongly expressed during the IPO – was also confirmed at an international level. We will continue to fully exploit this channel, in addition to any other means of conveying information, as a way of facilitating dialog about the Company, our visions and figures.

Phenomenia shares

Phenomenia shares on the Neuer Markt

Phenomenia shares were listed on the Neuer Markt (WKN – German Securities Code Number – 541 490) on November 22, 1999. A bookbuilding range for the shares of EUR 18.5 - 22.5 was fixed in the period from November 17 – 19, 1999. Due to high investor demand, the issuing price was fixed at the upper end of the range at EUR 22.5.

In the course of the IPO, Phenomenia AG's subscribed capital was increased from EUR 3.2 million to EUR 4.2 million. The share capital is composed of 4.2 million no-par value bearer shares with a theoretical interest in the share capital of EUR 1.00 each. Phenomenia shares have the ticker symbol PNM on the Neuer Markt and Gontard & MetallBank and WGZ Bank are designated sponsors.



Appropriation of profits

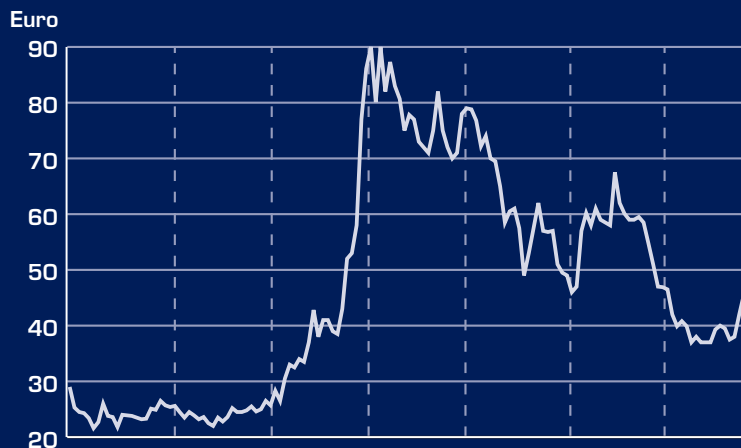
Earnings per share amounted to EUR 0.41 during the fiscal year under review. In view of the investment opportunities identified by Phenomedia AG's management, which carry exceptionally high value enhancement potential, the Supervisory Board and the Managing Board will propose to the General Meeting to fully retain our fiscal 1999 profits.

The first entertainment software shares on the Neuer Markt

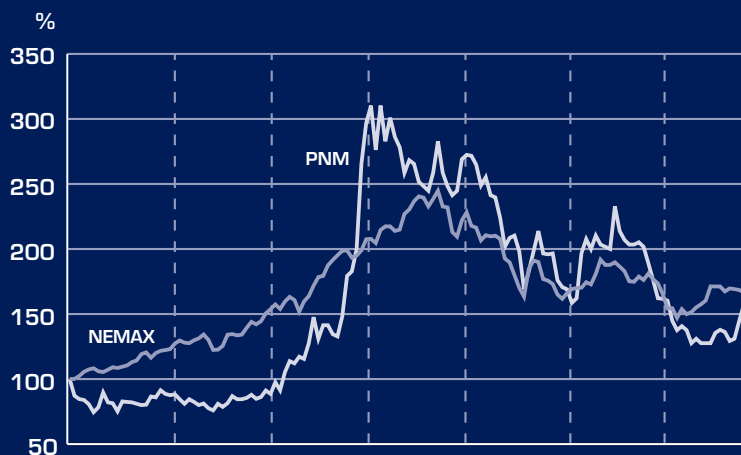
Phenomedia has issued the first entertainment software shares on the Neuer Markt and the share price has been developing extremely favorably since the IPO. In February 2000 it climbed to a high of EUR 96.00. This corresponds to growth of 326% compared with the issuing price. When the market in general gradually declined, Phenomedia shares also slipped below this peak. Our investors have been convinced by our strategy, products, management and employees, following three years of the Company's dynamic growth, and are trading accordingly. We will also continue to consistently follow our successful route in the future, with the goal of becoming one of the leading providers of entertainment formats

on the interactive entertainment market. We took key steps to achieve this in fiscal 1999.

Phenomedia share price development



Comparison between Phenomedia shares* and the NEMAX all-share index*



*) Index: Nov. 22, 1999 = 100%

Phenomedia shares – a promising investment

Phenomedia has what it takes for successful business development. This will be reflected in the share's future price development.

Reasons for investing in Phenomedia's shares:

- Very successful content products, such as the Moorhuhn and Gnarf
- A compelling Internet strategy
- An outstanding expertise portfolio for the future interactive entertainment market
- Phenomedia is already one of the Neuer Markt's most profitable companies (EBIT margin of 35% in fiscal 1999)
- The Company's strong growth from 1997 through 1999 will continue in the coming years

Annual financial statements
of Phenomedia AG (HGB)

Balance sheet of Phenomedica AG, Bochum,
as of December 31, 1999 (HGB)

Assets

	Dec. 31, 1999		Dec. 31, 1998	
	DM	DM	DM	DM
A Fixed assets				
I. Intangible assets				
1. Industrial and similar rights and assets and licenses in such rights and assets	584,229.30		411,667.04	
2. Payments on account	<u>0.00</u>	584,229.30	<u>546,600.66</u>	958,267.70
II. Tangible assets				
Operating and office equipment		236,770.00		28,091.00
III. Financial assets				
Shares in affiliates		<u>412,104.74</u>		<u>504,205.82</u>
		1,233,104.04		1,490,564.52
B. Current assets				
I. Inventories				
1. Merchandise	298,975.94		66,334.80	
2. Payments on account	<u>1,108,727.16</u>	1,407,703.10	<u>21,894.78</u>	88,229.58
II. Receivables and other assets				
1. Trade receivables	4,517,855.35		134,395.09	
2. Receivables from affiliates	2,397,366.34		82,059.21	
3. Other assets	<u>555,787.93</u>	7,471,009.62	<u>76,759.55</u>	293,213.85
III. Securities				
Other securities		3,191,260.61		0.00
IV. Cash in-hand, bank balances		<u>43,197,279.58</u>		<u>327,751.37</u>
		55,267,252.91		709,194.80
C. Prepaid expenses		22,008.65		2,500.00
		<u>56,522,365.60</u>		<u>2,202,259.32</u>

Equity and liabilities

	Dec. 31, 1999		Dec. 31, 1998	
	DM	DM	DM	DM
A. Equity				
I. Subscribed capital (€ 4,200,000)		8,214,486.00		50,000.00
II. Contributions made to implement the resolved capital increases		0.00		950,000.00
III. Capital reserves		46,156,121.14		0.00
IV. Retained profits (previous year: accumulated losses) brought forward		107,720.89		-4,274,782.17
V. Net income for the year		<u>187,395.27</u>		<u>4,382,503.06</u>
		54,665,723.30		1,107,720.89
B. Provisions				
1. Provisions for taxes	81,288.82		107,363.15	
2. Other provisions	<u>195,076.32</u>	<u>276,365.14</u>	<u>173,951.81</u>	<u>281,314.96</u>
C. Liabilities				
1. Liabilities to banks	0.00		93,622.44	
2. Payments received on account of orders	96,000.00		120,000.00	
3. Trade payables	405,455.41		196,103.93	
4. Liabilities to affiliates	513,638.20		92,426.85	
5. Other liabilities	565,183.55		311,070.25	
– thereof taxes: DM 306,120.12 (previous year: DM 80,571.98)				
– thereof social security: DM 20,048.57 (previous year: DM 2,311.29)				
		<u>1,580,277.16</u>		<u>813,223.47</u>
		56,522,365.60		2,202,259.32

Income statement of Phenomedica AG, Bochum,
for the period January 1 to December 31, 1999

	Dec. 31, 1999		Dec. 31, 1998	
	DM	DM	DM	DM
1. Sales		5,198,771.09		3,275,227.86
2. Other operating income		425,937.99		147,252.41
3. Cost of materials				
a) Cost of consumables and supplies and of purchased merchandise		-52,330.05		-214,529.74
b) Cost of purchased services		<u>-906,064.17</u>		<u>-495,400.18</u>
4. Personnel expenses				
a) Salaries		-535,428.83		-280,546.56
b) Social security costs		<u>-57,336.25</u>		<u>-30,540.38</u>
5. Amortization of intangible assets and depreciation of tangible assets		-1,026,682.44		-656,519.13
6. Other operating expenses		-1,456,561.91		-570,632.33
7. Income from investments		281,518.57		0.00
– thereof from affiliates: DM 281,518.57				
8. Income from profit transfer agreements		474,950.61		38,092.17
– thereof from affiliates: DM 474,950.61 (previous year: DM 38,092.17)				
9. Other interest and similar income		166,581.87		7,196.00
– thereof from affiliates: DM 2,768.47				
10. Interest and similar expenses		<u>-73,804.94</u>		<u>-20,475.72</u>
– thereof from affiliates: DM 4,873.42				
11. Result from ordinary activities		2,439,551.54		1,199,124.40
12. Extraordinary income		0.00		3,267,768.54
13. Extraordinary expense		<u>-2,080,566.66</u>		<u>0.00</u>
14. Extraordinary results		<u>-2,080,566.66</u>		<u>3,267,768.54</u>
15. Taxes on income		-176,699.07		-80,645.98
16. Other taxes reimbursed (previous year: other taxes)		<u>5,109.46</u>		<u>-3,743.90</u>
17. Net income for the year		187,395.27		4,382,503.06
18. Retained profits (previous year: accumulated losses) brought forward from the previous year		107,720.89		-4,274,782.17
19. Net retained profits		<u>295,116.16</u>		<u>107,720.89</u>

Notes to the financial statements of Phenomedia AG, Bochum, for fiscal year 1999

A. Preliminary remarks

The annual financial statements of Phenomedia AG, Bochum, were prepared in accordance with the provisions of the German Commercial Code (HGB) and the German Public Companies Act (AktG).

The Company is a large corporation as defined by section 267 (3) sentence 2 of the HGB.

B. Accounting and valuation policies

Intangible assets purchased from third parties are capitalized at cost and generally amortized over two years over the expected useful economic life using the straight-line method.

Purchased rights to computer games have a useful life of 15 months from the time of publication. 50% of the acquisition costs are written down in the first three months of use. Lower values are stated in special circumstances.

Tangible assets are carried at cost and reduced by regular straight-line depreciation. The operating and office equipment is written down over a useful life of three to eight years. Additions to movable tangible assets in the first six months of the year are written down at the full rate of depreciation for the year and additions in the second six months at the half-yearly rate. Low-value assets with an individual acquisition cost of up to DM 800.00 are written off in full in the year in which they are purchased.

Financial assets are generally carried at acquisition costs.

Inventories are carried at cost or at the lower fair value at the balance sheet date.

Receivables and other assets are generally carried at their principal amount. General risks are covered by a general bad debt provision.

Provisions are set up in the amount necessary determined by business prudence.

Liabilities are carried at their redemption amount.

C. Notes to the individual items of the balance sheet and income statement

1. Fixed assets

Changes in intangible and tangible assets and financial assets are presented in the accompanying statement of changes in fixed assets:

Statement of changes in fixed assets of Phenomedica AG, Bochum, in fiscal year 1999
(extended gross presentation)

	Jan. 1, 1999	Additions	Transfers	Disposals	Acquisition cost Dec. 31, 1999
	DM	DM	DM	DM	DM
I. Intangible assets					
1. Industrial and similar rights and assets and licenses in such rights and assets	2,853,018.05	1,131,679.60	23,500.00	2,754,255.55	1,253,942.10
2. Payments on account	586,727.90	0.00	-23,500.00	563,227.90	0.00
	<u>3,439,745.95</u>	<u>1,131,679.60</u>	<u>0.00</u>	<u>3,317,483.45</u>	<u>1,253,942.10</u>
II. Tangible assets					
Operating and office equipment	221,601.97	298,806.10	0.00	59,871.74	460,536.33
III. Financial assets					
Shares in affiliates	504,205.82	98,895.75	0.00	190,996.83	412,104.74
	<u>4,165,553.74</u>	<u>1,529,381.45</u>	<u>0.00</u>	<u>3,568,352.02</u>	<u>2,126,583.17</u>

Jan. 1, 1999	Additions	Depreciation and amortization		Dec. 31, 1999	Net book values
		Disposals	Dec. 31, 1999		
DM	DM	DM	DM	DM	DM
2,441,351.01	948,936.34	2,720,574.55	669,712.80	584,229.30	411,667.04
40,127.24	0.00	40,127.24	0.00	0.00	546,600.66
2,481,478.25	948,936.34	2,760,701.79	669,712.80	584,229.30	958,267.70
193,510.97	77,746.10	47,490.74	223,766.33	236,770.00	28,091.00
0.00	0.00	0.00	0.00	412,104.74	504,205.82
2,674,989.22	1,026,682.44	2,808,192.53	893,479.13	1,233,104.04	1,490,564.52

As of December 31, 1999, the Company's shareholdings comprised the following:

Company	Equity interest %	Equity DM	Result for the previous fiscal year DM
Effective Media `Agentur für Medienberatung` GmbH, Bochum	100	150,000.00	230,792.15 ¹⁾
Better Day Communications Werbeagentur GmbH, Bochum	100	50,000.00	134,579.24 ¹⁾
Ty-Phon Musicproductions & Publishing GmbH, Bochum	100	48,895.75	108,547.30 ¹⁾
Piranha Bytes Software GmbH, Bochum	100	222,268.10	312,569.47
codecult software research & development GmbH, Bochum	100	51,047.16	-24,795.06 ¹⁾

1) These are results prior to profit transfer / loss settlement

2. Receivables and other assets

The receivables and other assets disclosed at the balance sheet date are due within one year.

3. Equity

Phenomenia AG emerged from Art Department Werbeagentur GmbH through a change in legal form. The shareholders' meeting of the legal predecessor (Art Department Werbeagentur GmbH) of October 12, 1999 had resolved to convert its then ordinary share capital from DM to euros, in line with the official conversion rate (€ 1.00 = DM 1.95583). The ordinary share capital then amounted to € 511,291.88. It was also resolved to increase the ordinary share capital of € 511,291.88 by a total of € 1,708.12 by increasing the shares to € 513,000.00. The capital increase and its implementation were entered in the commercial register of Bochum Local Court on October 21, 1999.

By a shareholders' resolution of July 9, 1999 and October 12, 1999 to reorganize and transform the Company as Phenomenia AG, Art Department Werbeagentur GmbH's existing ordinary share capital became Phenomenia AG's share capital. This share capital was composed of 513,000 bearer shares. Finally, the Company's Extraordinary General Meeting of October 25, 1999 resolved, among other things, to increase the Company's share capital against cash contributions by € 3,687,000.00 from € 513,000.00 to € 4,200,000.00 by issuing 3,687,000 no-par value bearer shares.

While 2,376,000 of the new shares were distributed to the existing shareholders at an issuing price of € 1.00 per share, a total of 311,000 shares at an issuing price of € 7.75 were issued to persons and companies specified in the capital increase resolution, in addition to 1,000,000 shares at an issuing price of € 1.00 which were issued to a banking syndicate under the condition that they undertook to offer these for purchase to investors in the context of a public bid and to pay a placement surcharge to the Company, less any fees and commissions, as an additional premium.

The total premium generated in the context of the capital increase, amounting to DM 46,156,121.14, was allocated to the Company's capital reserves in accordance with Section 272 (2) clause 1 of the HGB.

All of the new shares carried dividend rights from January 1, 1999. The capital increase and its implementation were entered in the Commercial Register of Bochum Local Court on November 10, 1999.

Furthermore, the Extraordinary General Meeting of October 25, 1999 resolved to create authorized capital. According to this resolution, the Managing Board is authorized, with the approval of the Supervisory Board, to increase the Company's share capital until September 30, 2004 on one occasion or in partial amounts by a total of up to € 2,100,000.00 by issuing new shares against cash and/or non-cash contributions.

Finally, the Company's Extraordinary General Meeting of November 12, 1999 resolved a contingent share capital increase by an amount of up to € 420,000.00. This contingent capital increase is intended to serve the granting of subscription rights within the meaning of section 192 (2) clause 3 of the AktG (German Public Companies Act). Those eligible to subscribe are: members of Phenomedia AG's Managing Board, employees of Phenomedia AG and managers and employees of companies in which the Company has a direct or indirect majority interest. The details are regulated in an employee equity compensation program. A total of 420,000 stock options are available. These stock options were offered to the employees during a period of four weeks preceding the initial listing and may only be exercised within a maximum period of five years. There is a two-year lock-up period for the first-time exercise of the options. Within the first three years following the issue of the stock options a maximum of 50% of the share options may be exercised, and within the first four years following the issue a maximum of 75% of the share options may be exercised.

4. Provisions

Other provisions relate, in particular, to outstanding invoices received, year-end closing, legal and consulting costs.

5. Liabilities

The liabilities stated in the balance sheet are due within one year.

The liabilities do not contain any items which are secured by liens or similar rights.

6. Sales

About 85% of sales in fiscal 1999 are accounted for by revenue from the sale of computer games; much of the remaining part consists of revenue from the provision of services.

7. Other operating income

Other operating income contains (in addition to revenue from oncharging) revenue from asset disposals, among other things. Revenue amounting to DM 225,929.85 is attributable to previous years.

8. Extraordinary result

The Company's extraordinary expense in fiscal 1999 related to expenses which are directly related to the IPO at the end of the year.

The extraordinary income for the previous year primarily relates to income due to the waiver of claims by shareholders. In 1999, the shareholders waived the original condition subsequent of an adjustment clause.

D. Other disclosures

I. Employees

The Company had an average of eight employees in fiscal 1999.

II. Other financial obligations

Obligations from rental and leasing contracts are stated at the total amounts due up to the earliest termination date. As of December 31, 1999 they amount to DM 419 thousand. The purchase commitment for investments is within the customary range.

III. Executive bodies of the Company

In fiscal 1999 the Company's Managing Board comprised:

Markus Scheer, (Businessman), Chairman, Hattingen,
Stefan Heinemann, (Businessman), Essen,
Dr. Achim Illner, (Businessman), Essen.

The Managing Board members Markus Scheer and Stefan Heinemann were appointed by resolution (on July 9, 1999) of the Company's Supervisory Board, while Dr. Achim Illner was appointed by resolution of the Company's Supervisory Board on October 6, 1999.

Prior to the reorganization of Art Department Werbeagentur GmbH as Phenomedia AG resolved on July 9, 1999, Markus Scheer was the sole director of Art Department Werbeagentur GmbH.

Total remuneration for the Managing Board's activities in fiscal 1999 was DM 80 thousand.

In fiscal 1999, the Company's Supervisory Board comprised:

Univ.-Prof. Dr. Michael Nelles (University lecturer, Privatdozent), Chairman, Essen,
Drs. Arnoud Jan Backer, (Entrepreneur), Brasschaat/Belgium,
Jörg Penner (Wirtschaftsprüfer/tax consultant), Düsseldorf.

The Supervisory Board was appointed on the occasion of the reorganization of the former Art Department Werbeagentur GmbH as Phenomedia AG, which was resolved on July 9, 1999.

Total remuneration for the Supervisory Board's activities in fiscal 1999 was DM 39 thousand.

IV. Consolidated financial statements

Phenomedia AG prepares the consolidated financial statements, with the inclusion of its subsidiaries, for the largest group of companies. They are filed with the Bochum commercial register under the number 14 HRB 6556.

Bochum, March 9, 2000

The Managing Board

Management Report of Phenomedia AG, Bochum, for fiscal year 1999

1. Business Activities

a) Overview

Phenomedia AG, Bochum, produces creative products for the entertainment software market. Computer games have improved considerably over recent years with regard to both content and technical quality, and are becoming increasingly established as a key part of leisure culture. A computer game's value chain comprises, in general terms, development, marketing (publishing) and distribution. Phenomedia AG's place in this value chain is at the first stage, i.e. development.

b) Corporate development

Business trends 1999

Phenomedia AG recorded sales of DM 5,199 thousand in the year under review. Sales in fiscal 1998 amounted to DM 3,275 thousand. This corresponds to an increase of 59%, which is due to higher revenues from licenses and from the sale of the computer game Blow Your Planet.

Income from investments and profit transfer agreements amounted to DM 756 thousand in fiscal 1999. The previous year, income from investments only amounted to DM 38 thousand. This is a result of the purchase of Piranha Bytes Software GmbH and codecult software research & development GmbH and of the formation of Ty-Phon Musicproduction & Publishing GmbH.

The result from ordinary activities amounted to approximately DM 2,440 thousand in fiscal 1999. This represents a 104% increase on fiscal 1998, for which the figure was DM 1,199 thousand. This growth is due to a higher operating result and higher dividend income.

The IPO in Q4 1999 resulted in extraordinary costs of DM 2,081 thousand, which significantly impacted year-end results.

Phenomedia AG's business activities

Phenomedia AG has both an operating and management holding function within the Group. The purpose of the Company's operating activities is the production and licensing of low- and mid-price games and the development of promotional software.

Mid-price computer games (average retail price approx. DM 45.00) and low-price computer games (average retail price approx. DM 30.00) are characterized by compact, optically appealing games concepts that run on multiple platforms. Around ten products were developed and licensed in fiscal 1999. Art Department Werbeagentur GmbH was formed in 1993 on the basis of a business idea – which was innovative at the time – involving the development of promotional software to customer order. Promotional games represent a special communications platform thanks to their entertainment value and modern form of content delivery. This gives brand name manufacturers or public institutions, for instance, the possibility of generating qualified target-group contacts. Phenomedia AG's customers include numerous well-known major enterprises.

As a management holding company, Phenomedia AG establishes the Group's strategic direction. The Company also supports its subsidiaries in the areas of administration, finance, marketing and sales.

IPO

On November 22, 1999, Phenomedia AG's shares were introduced onto the Neuer Markt of the Frankfurt Stock Exchange. The underwriting syndicate was composed of Gontard & MetallBank, lead manager, co-lead WGZ-Bank and Privatbank Delbrück and Net.IPO. The issuing proceeds, which amounted to approximately DM 44 million, form the financial basis for Phenomedia AG's lasting internal and external future growth. In the run-up to the IPO, the capital of € 513,000 was increased to € 4,200,000. The placement of the shares on the Neuer Markt generated a share premium of DM 46 million, which was allocated to capital reserves.

2. Sector development

The entertainment software market more than tripled in Germany alone between 1995 and 1998 at an average yearly growth of about 50% to a volume of DM 2.9 billion (source: Verband der Unterhaltungssoftware Deutschland, 1998 – German entertainment software association). Offline and online products have differing growth rates, which means that a distinction must be made between the relevant market and competition situations when analyzing sales potential.

According to an independent Datamonitor study, global market growth of about 15% per year can be expected over the coming years in the offline games segment, which is relevant for Phenomedia AG. The total worldwide volume of the offline market, with the product platforms CD-ROM for the PC, consoles and Gameboys, amounted to approximately USD 10 billion in 1999.

Concentration processes have developed in the entertainment software industry sector, which has existed for some 15 years, and these processes will – in the opinion of Phenomedia AG – continue to become more pronounced. As such, the clear growth strategy which Phenomedia AG has followed, taking into account the capital market, provides the strategic answer which is necessary for an increasingly competitive environment.

When evaluating the strategic significance of the various links in the value chain within the entertainment software industry, it must be noted that the significance of the development stage can be regarded as being fundamentally high, due to the generally increasing demand for content. On the other hand, in Phenomedia AG's view structural changes in the entertainment software industry will give rise to a pressure to adapt for neighboring links in the value chain. This includes, on the one hand, more intense competition as a result of concentration processes, and, on the other, long-term changes are becoming apparent as a result of the trend towards online distribution. The Company is well positioned for these developments, since the Phenomedia Group's flexibility means that it is able to improve its competitive position in response to structural changes in the sector as a whole.

3. Key events after the end of the fiscal year

Moorhuhn success

The fiscal year 2000 got off to a successful start with the promotional game Moorhuhnjagd, which was developed by Phenomedia AG. Moorhuhnjagd is the most successful advertising game ever. Television stations, print media and numerous radio stations have given very intense coverage to the spread of the Moorhuhn. Within a single month the Phenomedia site www.moorhuhn.de recorded more than a million downloads.

Our success in communicating the link between Phenomedia AG and the Moorhuhn figure has resulted, on the one hand, in a highly positive image transfer for the Company. On the other, the increasing circulation of the Company's name has led to many new customers and a clear increase in demand. Phenomedia AG seeks to directly exploit the Moorhuhn's popularity by issuing licenses.

Moorhuhn licensed to the Bertelsmann Music Group

In the context of its goal to market and exploit the grouse's cult status and popularity, Phenomedia AG concluded an exclusive license agreement with Bertelsmann Music Group, which is one of Germany's leading music publishing houses. The subject of the contract is the production of singles, albums and compilations, for which the Moorhuhn will present German and international stars.

Participation in Morelogs Consulting GmbH

One of Phenomedia AG's strategic goals is the development of its market share in the fast-growing online games segment. In this context, Phenomedia AG has resolved – subject to the approval of the board – to acquire a 20% interest in Morelogs Consulting-GmbH, Essen, which is to be reorganized as a stock corporation. Morelogs Consulting GmbH's role within the Phenomedia Group will be the provision of extensive Internet and database technology for entertainment-oriented product concepts.

Formation of the joint venture company Daywalker Studios GmbH with Hahn Film AG

As a result of the success of the Moorhuhn game figure, great importance is being attached to the development and exploitation of characters which are established as brands. As a result, Phenomedia AG has a particular interest in developing its expertise in this area. For this reason the joint venture company Daywalker Studios GmbH was formed with Hahn Film AG. It is intended to establish the Gnarf and other characters for marketing at various levels in the context of this joint venture.

4. Likely development

The management buy-out of the former Art Department Werbeagentur GmbH from Funsoft Holding GmbH in 1997 constitutes the starting point of the Company's growth strategy. Since then, the primary focus of the Company's business activities has been the development of new products.

Phenomedia AG's corporate performance goal is to attain a strong market position as a provider of entertainment content in the interactive entertainment market. To this end, efforts are focused on the economic exploitation of the Moorhuhn's potential for success in the short to medium term. Phenomedia AG will pursue the further development of its characters in the online area, while it will seek to conclude cooperation agreements and contracts with licensees in the offline area (TV, merchandising and music). Furthermore, Phenomedia AG will develop its market position through acquisitions.

The consistent implementation of these corporate strategies will have a positive effect on both the sales and year-end results of Phenomedia AG and its subsidiaries.

5. Risks associated with the Company's future development

Dependence on qualified personnel

In successfully implementing its corporate goals, Phenomedia AG is very much dependent on the work of its management and key employees. The current situation on the labor market means that there is a latent risk of our personnel being head-hunted by the competition. This is a risk which Phenomedia AG counteracts by taking various measures. The most important measure to secure the long-term commitment of staff to Phenomedia AG is employee participation in the Company's success.

We are confident that we will succeed in retaining the qualified staff which we require for our planned growth, and that we will also succeed in recruiting new staff.

Lengthy development cycles for computer games

Despite shortening development cycles, the development of a full-price computer game, from translating a concept into a 'milestone plan' to the completion of the finished product, currently still takes about two years in Germany, in contrast to the US market leaders. Even the development of a low-price product can scarcely be completed within a year. This long development time carries a latent risk that other software developers could bring similar computer games onto the market sooner, and thereby place them better. Furthermore, fundamental technological developments can arise during the development phase which could lead to the Company's development time taking longer than the competition unless such technological developments are identified early and taken into account.

Volatility of sales

Phenomedia AG records fluctuations in sales from one quarter to another. These fluctuations result from the development cycles of computer games, which take several years, and from consumers' demand behavior, which is typical for the sector. In the entertainment software industry most sales are recorded in Q1 and Q4, with lower sales regularly being recorded during the six months over the summer period.

Brand risks

The characters which Phenomedia AG creates in the context of the computer games it develops have enormous profit potential as brands. The Moorhuhn is a particular case in point.

Nevertheless, Phenomedia AG is unable to give an accurate forecast as to the long-term sustained profit potential of its characters. This is because consumer preferences change, and because it is difficult to gauge the media, which are a decisive factor in influencing the public's interest in the characters. Nonetheless, Phenomedia AG – by licensing the Moorhuhn to the Bertelsmann Music Group and by forming the joint venture company Daywalker Studios GmbH – has already taken important steps to secure the sustained long-term value of its characters.

Bochum, March 2000

The Managing Board

Audit opinion

We have audited the annual financial statements, including the accounting and the management report, of Phenomedia AG, Bochum, for the fiscal year January 1 to December 31, 1999. The accounting, the annual financial statements and the management report in accordance with the provisions of the HGB (German Commercial Code) are the responsibility of the Company's management. Our responsibility is to express an opinion, based on our audit, on the annual financial statements, including the accounting and the management report.

We conducted our audit in accordance with section 317 of the HGB and in compliance with the principles of proper auditing adopted by the Institut der Wirtschaftsprüfer (IDW). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether inaccuracies and violations are identified that could have a material effect on the financial statement presentation in accordance with proper accounting principles and on the view of the financial position and results of operations presented by the management report. The process of defining the audit procedures takes account of knowledge about the business activities and the economic and legal environment of the Company, as well as expectations of possible errors. An audit includes examining, largely on a test basis, the effectiveness of the internal control system and evidence supporting the amounts and disclosures in the accounts, the annual financial statements and the management report. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the annual financial statements and the management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit did not result in any objections.

In our opinion, the annual financial statements give, in accordance with proper accounting principles, a true and fair view of the financial position of Phenomedia AG and of the results of its operations. Overall, the management report accurately reflects the position of the Company and accurately presents the risks associated with future developments.

Düsseldorf, March 10, 2000

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

Dr. Klar
Wirtschaftsprüfer

Hinnersmann
Wirtschaftsprüfer

Consolidated financial statements
of Phenomedia AG (IAS)

Consolidated financial statements of Phenomedia AG, Bochum,
as of December 31, 1999 (IAS)

Assets

	Notes	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
A. Noncurrent assets			
I. Intangible assets	(2)		
1. Licenses and software		1,685	712
2. Advance payments		0	547
3. Goodwill		77	90
		<u>1,762</u>	<u>1.349</u>
II. Property, plant and equipment	(3)		
Operating and office equipment		536	92
		<u>2,298</u>	<u>1.441</u>
B. Deferred tax assets	(4)	93	66
C. Current assets			
I. Inventories	(5)		
1. Goods purchase for resale		204	90
2. Advance payments		1,109	36
		<u>1,313</u>	<u>126</u>
II. Receivables and other assets	(6)		
1. Trade receivables		6,737	218
2. Other assets		591	259
		<u>7,328</u>	<u>477</u>
III. Marketable securities	(7)		
Other securities		3,191	0
IV. Cash and bank balances	(8)	43,431	344
		<u>55,263</u>	<u>947</u>
D. Prepaid expenses	(9)	23	25
		<u>57,677</u>	<u>2,479</u>

Equity and Liabilities

	Notes	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
A. Shareholders' equity	(10)		
I. Issued capital		8,215	50
II. Contributions paid to implement the resolved capital increase		0	950
III. Share premium		46,156	0
IV. Consolidated retained profits brought forward (previous year: consolidated accumulated losses brought forward)		22	-2,452
V. Consolidated net profit for the year		661	2,614
		55,054	1,162
B. Minority interest			
1. Interest in capital		0	50
2. Interest in net profit or loss		0	-140
		0	-90
C. Provisions	(11)		
1. Provisions for taxes		246	160
2. Other provisions		238	187
		484	347
D. Deferred tax liabilities	(12)	451	20
E. Current liabilities	(13)		
1. Liabilities to banks		0	132
2. Payments received on account of orders		96	120
3. Trade payables		870	380
4. Other liabilities		722	408
		1,688	1,040
		57,677	2,479

Consolidated income statement of Phenomedica AG, Bochum,
for the period January 1 to December 31, 1999 (IAS)

	Notes	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
1. Sales	(1)	9,513	4,663
2. Work performed by the enterprise and capitalized		492	21
3. Other operating income		353	170
4. Cost of materials	(2)		
a) Cost of consumables and supplies and goods purchased for resale		243	335
b) Cost of purchased services		1,451	897
		1,694	1,232
5. Staff costs	(3)		
a) Wages and salaries		1,467	568
b) Social security contributions		220	109
		1,687	677
6. Depreciation and amortization expense	(4)	1,889	781
7. Other operating expenses	(5)	1,777	829
8. Profit from operations		3,311	1,335
9. Other interest and similar income		164	10
10. Interest and similar expenses		77	28
11. Net profit or loss from ordinary activities		3,398	1,317
12. Waiver of claims by shareholders		0	3,132
13. IPO costs		2,081	0
14. Net profit or loss before taxes		1,317	4,449
15. Taxes on income	(6)		
a) Corporation and trade taxes		251	132
b) Deferred taxes		405	1,810
		656	1,942
16. Net profit for the year		661	2,507
thereof attributable to Group shareholders		661	2,614
thereof attributable to minority interests		0	-107
17. Earnings per share	(7)	0,56 DM	

Consolidated cash flow statement of Phenomedica AG, Bochum,
for the period January 1 to December 31, 1999 (IAS)

	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand	Changes DM thousand
Operating activities			
Net profit or loss before taxes	1,317	4,449	-3,132
Depreciation and amortization	1,889	781	+1,108
Gain/loss on the disposal of noncurrent assets	-166	4	-170
Waiver of claims by shareholders	0	-3,132	+3,132
Other cash income	0	-136	+136
Interest income	-164	-10	-154
Interest expense	77	28	+49
Profit from operations before changes in net current assets	2,953	1,984	+969
Decrease in provisions	137	262	-125
Increase in inventories	-1,187	-57	-1,130
Increase/decrease in trade receivables and other assets	-6,849	95	-6,944
Increase/decrease in trade payables and other liabilities	700	-2,212	+2,912
Income tax expense	-251	-132	-119
Net cash from operating activities	-4,497	-60	-4,437
Proceeds from disposal of noncurrent assets	748	0	+748
Cost of investments in noncurrent assets	-3,328	-781	-2,547
Securities investments	-3,191	0	-3,191
Interest expense	-77	-28	-49
Net cash used in investing activities	-5,848	-809	-5,039
Proceeds from capital increases and subsidies from shareholders	53,231	950	+52,281
Minority interest	90	-100	+190
Change in lease liabilities	79	-54	+133
Interest income	164	10	+154
Change in liabilities to banks	-132	132	-264
Net cash used in financing activities	53,432	938	+52,494
Net cash change in cash and cash equivalents	43,087	69	+43,018
Cash and cash equivalents at the start of the period	344	275	+69
Cash and cash equivalents at the end of the year	43,431	344	+43,087

Consolidated notes of Phenomedia AG, Bochum, for fiscal year 1999

I. Application of International Accounting Standards

General disclosures

The consolidated financial statements of Phenomedia AG, which was formed by way of a notarized resolution dated July 9, 1999, to reorganize and rename Art Department Werbeagentur GmbH as Phenomedia AG, were prepared in accordance with International Accounting Standards (IAS). The reorganization and change in name of the Company was entered in the commercial register on October 21, 1999.

The consolidated financial statements are based on consistent accounting policies. The principles of the Framework and the International Accounting Standards (IAS) promulgated by the International Accounting Standards Committee (IASC) are applied, and the Interpretations of the Standing Interpretations Committee (SIC) extant as of the balance sheet date are also observed¹⁾.

The application of IAS is explained in the disclosures on the individual items of the financial statements in these notes.

II. Group

a) Companies consolidated

Together with the parent company Phenomedia AG (formerly Art Department Werbeagentur GmbH), Bochum, the following subsidiaries are fully consolidated in the consolidated financial statements:

- Piranha Bytes Software GmbH, Bochum,
- Effective Media `Agentur für Medienberatung´ GmbH, Bochum,
- Better Day Communications Werbeagentur GmbH, Bochum,
- Ty-Phon Musicproductions & Publishing GmbH, Bochum,
- codecult software research & development GmbH, Bochum.

As Phenomedia AG either directly or indirectly holds all voting rights of the subsidiaries named above as of December 31, 1999, they were fully consolidated in the consolidated financial statements in the year of their formation or acquisition. Phenomedia AG was formed by way of cash contributions; the individual interests in other companies were acquired for a cash payment. There was no need to take differing balance sheet dates into account.

The composition of the consolidated companies changed in fiscal year 1999 as a result of the formation of Ty-Phon Musicproductions & Publishing GmbH by way of a notarized German private limited companies' formation agreement dated June 10, 1999 and Piranha Bytes Software GmbH's 100% acquisition of codecult software research & development GmbH by way of a notarized German private limited companies' share transfer agreement dated July 2, 1999. Piranha Bytes Software GmbH, which was also acquired in fiscal year 1999 with economic effect as of January 1, 1999, was consolidated for the first time as of January 1, 1999.

Ty-Phon Musicproductions & Publishing GmbH and codecult software research & development GmbH were consolidated at the date of acquisition or formation using the purchase method in compliance with IAS 22.

¹⁾ IAS 22 (revised 1998), IAS 36, IAS 37 and IAS 38, which are only to be applied for fiscal years beginning on or after July 1, 1999, are already anticipated by Phenomedia AG.

The following table gives an overview of the equity interests held by Phenomedia AG as of December 31, 1999:

Subsidiaries	Equity interest % DM thousand	Acqui- sition- cost DM thousand	Sales DM thousand	Result after taxes and before profit/loss transfer DM thousand	Average no. of employees for year
Effective Media `Agentur für Medienberatung` GmbH, Bochum	100	236	874	231	4
Better Day Communications Werbeagentur GmbH, Bochum	100	77	1,426	135	6
Piranha Bytes Software GmbH, Bochum	100	50	2,007	313	7
codecult software research & development GmbH, Bochum	100	60	214	-25	3
Ty-Phon Musicproductions & Publishing GmbH, Bochum	100	50	199	108	1

b) Consolidation methods

The consolidated financial statements are based on the annual financial statements of the companies included in the Group prepared in accordance with the International Accounting Standards (IAS) as of December 31, 1999.

Capital consolidation of the subsidiaries uses the purchase method in compliance with IAS 22 by elimination of acquisition costs against the share capital and reserves at the time of acquisition or formation, remaining differences are disclosed as goodwill.

Intragroup sales, expenses and earnings as well as all receivables and liabilities existing between the consolidated companies were eliminated.

III. Balance sheet

Changes in noncurrent assets are presented in the following statement of changes in :

1) Statement of changes in noncurrent assets in fiscal year 1999

(extended gross presentation)

	Jan. 1, 1999 DM thousand	Additions DM thousand	Additions from first time consolidation DM thousand	Acquisition or manufacturing cost		Dec. 31, 1999 DM thousand
				Transfer DM thousand	Disposal DM thousand	
I. Intangible assets						
1. Licenses and software	3,169	156	2,477	24	2,925	2,901
2. Advance payments	587	0	0	-24	563	0
3. Goodwill	113	0	11	0	0	124
	<u>3,869</u>	<u>156</u>	<u>2,488</u>	<u>0</u>	<u>3,488</u>	<u>3,025</u>
II. Property, plant and equipment						
Operating and office equipment	576	13	671	0	341	919
	<u>4,445</u>	<u>169</u>	<u>3,159</u>	<u>0</u>	<u>3,829</u>	<u>3,944</u>

Jan. 1, 1999 DM thousand	Additions DM thousand	Additions from firsttime consolidation DM thousand	Depreciation and amortization		Carrying amounts	
			Disposal DM thousand	Dec. 31, 1999 DM thousand	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
2,457	2	1,637	2,880	1,216	1,685	712
40	0	0	40	0	0	547
23	0	24	0	47	77	90
2,520	2	1,661	2,920	1,263	1,762	1,349
484	5	221	327	383	536	92
3,004	7	1,882	3,247	1,646	2,298	1,441

2) Intangible assets

Purchased intangible assets are capitalized at cost plus the incidental costs of acquisition and are generally amortized over two years in line with their expected useful economic life using the straight-line method.

Purchased rights to computer games have a useful life of 15 months from the time of publication. 50% of the acquisition costs are written down in the first three months of use and the remaining acquisition costs in the following 12 months. Lower values are carried under certain circumstances.

Significant additions relate to acquisitions of licenses for computer games.

Internally generated assets are capitalized at manufacturing cost and generally written down in line with their expected useful economic life.

The following development costs were capitalized as software and property rights in accordance with IAS 38 as of December 31, 1999:

	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
Capitalized development costs and property rights	1,483	21

Capitalized development costs in the individual fiscal years relate to staff costs, office space expenses, as well as rental costs which are directly attributable to the development of the Gothic computer game.

Goodwill from capital consolidation is generally capitalized in accordance with IAS 22 and written down over five years using the straight-line method. Exceptional write-downs of goodwill were not regarded as necessary in the periods under review.

3) Property, plant and equipment

Operating and office equipment

Property, plant and equipment is carried at acquisition or manufacturing cost less regular depreciation or, if necessary, special write-downs. Operating and office equipment is written down over a useful life of between three and eight years using the straight-line method. Additions to movable assets in the first six months of the fiscal year are written down at the full rate for the year and additions in the second six months at the half-yearly rate. Low-value assets with an individual cost price of up to DM 800.00 inclusive are written off in full in their year of acquisition.

Borrowing costs are not capitalized in accordance with IAS 23.

Noncurrent assets which are made available to the Group companies under the terms of a finance lease are carried in accordance with IAS 17 at the lower of the fair value of the assets and the net present value of the lease installments less regular depreciation and, if necessary, special write-downs. Future payment obligations are expensed.

The total value of the capitalized leased assets and the relevant obligations are presented for the individual periods as follows:

	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
Total value of capitalized leased assets	106	27
Liabilities	104	26

4) Deferred tax assets

	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
Intercompany profits	92	0
Loss carryforwards	0	60
Other	1	6
	<u>93</u>	<u>66</u>

Deferred tax assets in accordance with IAS 12 are based on temporary differences between carrying values in the IAS financial statements and the tax base. The distribution tax rate including trade income tax was used for the calculation of deferred taxes. The uniform Group tax rate calculated in this way is 43%.

Deferred tax assets and liabilities were not eliminated.

5) Inventories

	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
Goods purchased for resale	204	90
Advance payments	1,109	36
	<u>1,313</u>	<u>126</u>

Inventories are carried at acquisition or manufacturing cost.

In accordance with IAS 2, manufacturing costs comprise, as well as directly attributable prime costs, all indirect costs which are attributable to the production process. Borrowing costs are not capitalized in accordance with IAS 23.

6) Receivables and other assets

	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
Trade receivables	6,857	218
Global write-down	-120	0
	<u>6,737</u>	<u>218</u>
Other assets	591	259
	<u>7,328</u>	<u>477</u>

All receivables and other assets have less than one year to maturity.

Trade receivables are carried at their principal amount. A global write-down in the amount of DM 120 thousand was set up for the first time. Specific write-downs were not necessary.

There were no receivables denominated in foreign currencies at the balance sheet dates.

Other assets are carried at their principal amount.

Other assets as of December 31, 1999 relate mainly to receivables from the tax authorities, interest receivables from fixed-term deposit balances and from creditors with debit balances.

7) Other securities

Other marketable securities in the amount of DM 3,191 thousand comprise 161 shares in DWS-Geldmarkt Plus Anteile SL. Accrued interest in the amount of DM 20 thousand is disclosed under the other interest and similar income item.

8) Cash and bank balances

As well as cash and current bank balances, cash and cash equivalents comprise fixed-term deposit balances in particular. These fixed-term deposit balances, which served the partial investment of the cash and cash equivalents received in the course of the capital increases and the initial public offering in 1999, amounted to a total of DM 42,400 as of December 31, 1999. The rate of interest of the fixed-term deposit balances amounts to between 3.0% and 3.1%.

9) Prepaid expenses

Prepaid expenses relate mainly to leasing fees and vehicle insurance premiums.

10) Shareholders' equity

Phenomenia AG was formed by way of a reorganization of Art Department Werbeagentur GmbH. The Shareholders' Meeting of the legal predecessor, Art Department Werbeagentur GmbH, on October 12, 1999 resolved to convert its ordinary share capital from DM to Euros in accordance with the official conversion rate of € 1.00 = DM 1.95583. The ordinary share capital amounted afterwards to € 511,291.88. The Meeting also resolved to increase the ordinary share capital by a total of € 1,708.12 from € 511,291.88 to € 513,000.00 by increasing the shareholdings. The resolution and implementation of the capital increase were entered in the commercial register of Bochum Local Court on October 21, 1999.

Following the resolution of the Shareholders' Meetings on July 9 and October 12, 1999 on the reorganization of the Company as Phenomenia AG, the existing ordinary share capital of Art Department Werbeagentur GmbH became the share capital of Phenomenia AG. This share capital was represented by 513,000 no-par value bearer shares.

The Extraordinary General Meeting of the Company on October 25, 1999 then resolved, among other things, to increase the share capital of the Company against cash contributions by € 3,687,000.00 from € 513,000.00 to € 4,200,000.00 by issuing 3,687,000 new no-par value bearer shares.

While 2,376,000 new shares were issued at an issuing price of € 1.00 per share to existing shareholders, a total of 311,000 shares were issued at an issuing price of € 7.75 per share to persons and companies named in the resolution on the capital increase and 1,000,000 shares were issued at an issuing price of € 1.00 per share to an underwriting syndicate with the obligation to offer these shares for sale to investors in the course of a public offering and to pay a placement surcharge less any charges or commission fees to the Company as an additional premium.

The total premium generated in the course of the capital increase in the amount of DM 46,156,121.14 was appropriated to the Company's share premium in accordance with section 272 (2) clause 1 of the HGB (Handelsgesetzbuch – German Commercial Code).

All new shares carry dividend rights from January 1, 1999. The resolution and implementation of the capital increase were entered in the commercial register of Bochum Local Court on November 10, 1999.

The Extraordinary General Meeting on October 25, 1999 also resolved to create authorized capital. The Managing Board was authorized to increase the share capital of the Company with the approval of the Supervisory Board by a total of up to € 2,100,000.00 once or on several occasions up until September 30, 2004 by way of the issue of new shares against cash and/or non-cash contributions.

The Extraordinary General Meeting on November 12, 1999 resolved a contingent increase in the share capital of up to € 420,000.00. This contingent capital increase will serve to grant options in accordance with section 192 (2) clause 3 of the AktG. Shareholders entitled to subscribe include the members of the Managing Board of Phenomedia AG, the employees of Phenomedia AG, and the management and employees of those companies in which Phenomedia AG holds a direct or indirect majority equity interest. Details are set down in an employee equity compensation program. A total of 420,000 options to purchase shares are available to beneficiaries. These options were offered to employees during a four-week period before the first stock exchange listing and have a maximum term of five years. The waiting period for the first-time exercise of options is two years. Within the first three years following the issue of the stock options a maximum of 50 % of the share options may be exercised, and within the first four years following the issue a maximum of 75 % of the share options may be exercised.

Changes in the shareholders' equity item are presented in the following statement of changes in shareholders' equity.

	Issued capital DM thousand	Share premium DM thousand	Retained profits/ accumulated losses DM thousand	Net income of the year DM thousand	Total DM thousand
January 1, 1999	1,000	0	-2,452	2,614	1,162
Contributions made	7,215	0	0	0	7,215
Payments to share premium	0	46,156	0	0	46,156
Acquisition of minority interests	0	0	-140	0	-140
Net profit for the year	0	0	0	661	661
Elimination of net result for previous period	0	0	2,614	-2,614	0
December 31, 1999	8,215	46,156	22	661	55,054

11) Provisions

	Dec. 31, 1999 DM thousand	Dec. 31, 1998 DM thousand
Provisions		
Provisions for taxes	246	160
Other provisions	238	187
	484	347

Other provisions refer to all identifiable obligations to third parties in accordance with IAS 37 and have changed as follows:

	Balance				Balance
	at				at
	Jan. 1, 1999	Utilization	Reversal	Allocation	Dec. 31, 1999
	DM thousand	DM thousand	DM thousand	DM thousand	DM thousand
Year-end closing costs	78	66	0	133	145
Outstanding invoices received	25	22	1	48	50
Legal and consulting expenses	79	71	4	19	23
Remuneration of the Supervisory Board	0	0	0	20	20
	<u>182</u>	<u>159</u>	<u>5</u>	<u>220</u>	<u>238</u>

12) Deferred tax liabilities

The differences between the results of the IAS balance sheet and the tax bases of the consolidated companies arising from the capitalization of leased assets and development costs resulted in the following deferred tax liabilities:

	Dec. 31, 1999	Dec. 31, 1998
	DM thousand	DM thousand
Deferred tax liabilities	451	20

The uniform Group composite tax rate of 43% was applied to the calculation. Deferred tax assets and liabilities were not eliminated.

13) Current liabilities

	Dec. 31, 1999	Dec. 31, 1998
	DM thousand	DM thousand
Liabilities to banks	0	132
Payments received on account of orders	96	120
Trade payables	870	380
Other liabilities	722	408
– thereof taxes	366	101
– thereof social security	68	19
	<u>1,688</u>	<u>1,040</u>

Current liabilities are generally carried at their redemption values.

There were no liabilities secured by liens at the balance sheet dates.

There were no liabilities denominated in foreign currencies at the balance sheet dates.

The payments received and disclosed as of December 31, 1999 relate to payments from the future licensee of a computer game.

Short-term leasing liabilities in the amount of DM 42 thousand (previous year: DM 13 thousand) and long-term leasing liabilities in the amount of DM 63 thousand (previous year: DM 13 thousand) are disclosed under trade payables.

Leasing agreements for operating and office equipment have a maximum of five years to maturity.

Other liabilities relate mainly to loans and wage and church tax liabilities.

IV. Income statement

1) Sales

Sales are classified by business units and are presented in the attached segment report (VI. Segment reporting by product lines). The sales calculated result from ordinary activities and were generated exclusively in Germany, so there is no need for a presentation by geographic regions.

2) Cost of materials

The cost of goods purchased for resale disclosed in the income statement relate mainly to license fees and costs for diskettes, CD-ROMs as well as for goods used in the course of advertising measures implemented on behalf of customers.

The cost of purchased services relates mainly to advertising measures performed as well as to external services used in localizing computer games and external services used in programming computer games.

3) Staff costs

	1999 DM thousand	1998 DM thousand
Wages and salaries	1,467	568
Social security contributions	220	109
	<u>1,687</u>	<u>677</u>

The following table shows the changes in the average number of employees in each fiscal year:

	1999 No.	1998 No.
Salaried employees	31	16
Trainees	5	3
	<u>36</u>	<u>19</u>

4) Depreciation and amortization

	1999 DM thousand	1998 DM thousand
Amortization of intangible assets	1,663	662
Property, plant and equipment	226	119
	<u>1,889</u>	<u>781</u>

5) Other operating expenses

Other operating expenses relate to administrative expenses such as office space expenses, telephone costs and insurance contributions, as well as to advertising expenses and legal and consulting costs in particular.

6) Taxes

The tax expense disclosed in the income statement is composed of expenses to be paid in this period by the individual group companies as well as deferred tax assets and liabilities.

	1999 DM thousand	1998 DM thousand
Taxes		
Current taxes	251	132
Deferred taxes	405	1,810
	<u>656</u>	<u>1,942</u>

Deferred tax assets are recognized in accordance with the assumptions made in IAS 12 on both accounting differences between the companies included in the consolidated financial statements and on consolidation measures that are recognized in income. The uniform Group composite tax rate (distribution tax rate plus the regional trade tax rate) of 43% was applied to calculate deferred taxes.

The following income and expenses were eliminated in the periods under review:

	1999 DM thousand	1998 DM thousand
Deferred		
tax income	-93	-54
tax expense	498	1,864
	<u>405</u>	<u>1,810</u>
Net profit or loss before taxes	1,317	4,449

Reconciliation accounts:

	1999 DM thousand	1998 DM thousand
Expected tax income/expense	566	-1,913
+ Effects of loss carrybacks	66	0
+/- Other additions/deductions	24	-29
Effective tax expense	<u>656</u>	<u>-1,942</u>

The effective tax expense amounted to approximately 49.8% in 1999 (previous year: 43.7%).

7) Earnings per share

Net profit for the period 1999 in DM thousand	661
Average number of ordinary shares	1,189,792
EPS in DM	0.56
EPS in euros	0.28

For reasons of simplicity, the number of outstanding shares at October 25, 1999 was assumed to amount to 513,000. As of October 25, 1999, the number of outstanding shares amounts to 4,200,000.

The stock option program (Note 10) does not currently result in any change in earnings per share.

VI. Segment reporting by product lines

Profit from operations

Segment information is reported only by business unit. No classification by region is presented as Group sales up until now have been generated exclusively in Germany.

		Creative Products DM thousand	Services DM thousand	Techno- logy DM thousand	Sub- total DM thousand	Recon- ciliation DM thousand	Total DM thousand
External sales	1999	7,362	2,151	0	9,513	0	9,513
	1998	3,125	1,538	0	4,663	0	4,663
Internal sales	1999	42	150	214	406	0	406
	1998	147	41	0	188	0	188
Total sales	1999	7,404	2,301	214	9,919	0	9,919
	1998	3,272	1,579	0	4,851	0	4,851
Income from operations	1999	3,136	314	-144	3,306	0	3,306
	1998	1,081	254	0	1,335	0	1,335
Net profit/loss for the period	1999	903	307	-143	1,067	-406	661
	1998	1,014	167	0	1,181	1,433	2,614
Operating assets	1999	56,183	1,309	92	57,584	93	57,677
	1998	2,056	357	0	2,413	66	2,479
Current liabilities	1999	1,324	338	26	1,688	0	1,688
	1998	846	194	0	1,040	0	1,040
Investments	1999	3,155	90	81	3,326	0	3,328
	1998	626	155	0	781	0	781
Depreciation/amortization	1999	1,755	119	15	1,889	0	1,889
	1998	713	68	0	781	0	781

VII. Contingent liabilities and other financial obligations

Obligations from rental and leasing agreements are disclosed as the total of the amounts due at the earliest date of termination of the agreements. As of December 31, 1999 they amount to DM 313 thousand with a term of up to one year and DM 227 thousand with a term of up to five years. The purchase commitment for investments is within the customary range.

VIII. Related party disclosures

The exchange of goods and services with related parties is conducted at usual market conditions on an arm's-length basis. There are no significant relations with related parties within the meaning of IAS 24.

IX. Information on the executive bodies of the Company

The following persons were members of the Managing Board of the Company in fiscal year 1999:

Mr. Markus Scheer (Businessman), Chief Executive, Hattingen,
 Mr. Stefan Heinemann (Businessman), Essen,
 Dr. Achim Illner (Businessman), Essen.

Markus Scheer and Stefan Heinemann were appointed to the Managing Board following a resolution of the Supervisory Board of the Company on July 9, 1999. Dr. Achim Illner was appointed following a resolution of the Supervisory Board of the Company on October 6, 1999.

Markus Scheer was sole managing director of Art Department Werbeagentur GmbH before it was reorganized as Phenomedia AG following a resolution on July 9, 1999.

Total remuneration for the activities of the Managing Board in fiscal year 1999 amounted to DM 80 thousand.

The following persons were members of the Supervisory Board of the Company in fiscal year 1999:

Univ.-Prof. Dr. Michael Nelles (University teacher, Privatdozent), Chairman, Essen,
 Drs. Arnold Jan Becker (Entrepreneur), Brasselaat/Belgium,
 Jörg Penner (Wirtschaftsprüfer/tax consultant), Düsseldorf.

The Supervisory Board was appointed on the occasion of the resolution on July 9, 1999 to reorganize the former Art Department Werbeagentur GmbH as Phenomedia AG.

Total remuneration for the activities of the Supervisory Board in fiscal year 1999 amounted to DM 39 thousand.

Bochum, March 13, 2000

The Managing Board

Group Management Report of Phenomedia AG, Bochum, 1999

1. Business Activities

a) Overview

Phenomedia AG and its subsidiaries are active in the entertainment software market and focus primarily on entertainment software development. The Phenomedia Group offers an extensive portfolio of products and services, which are divided into the three main business units Creative Products, Services and Technology.

Business Units

Creative Products

The Creative Products business unit is divided into three main product areas:

- Full price games for the international market
- Mid- and low-priced games for the German and European market.
- Online games for the international market.

A full-price computer game (average recommended retail price approx. DM 80.00) is distinguished by its sophisticated optical and content quality, particularly in the area of three-dimensional representation. The target group comprising wealthy adult gamers is expected to provide considerable sales potential in the future, particularly in the area of computer games which boast a convincing concept and sophisticated technical implementation. Phenomedia AG's basic source of income in this market segment is derived from flatrate development budgets and from sales-dependent unit license fees. In the Phenomedia Group, the area of full price computer games is serviced by Piranha Bytes Software GmbH.

Mid-price computer games (average recommended retail price approx. DM 45.00) and low-price computer games (average recommended retail price less than DM 30.00) are characterized by their compact, visually attractive playing concepts that can be run on a wide variety of platforms. Mid- and low-price games are serviced by Phenomedia AG's Art Department and Greenwood Entertainment brands. Income models are of two types: production to order and the exploitation of licenses. About ten products were developed and licensed in fiscal 1999.

The area of online games is closely related to the worldwide growth in the use of the Internet. The Internet offers the possibility for new games formats to be developed: in addition to the conventional games structure "man versus machine", interactive formats have become established. Sales are generated in the online games areas through advertising revenue, games fees, merchandising and the sale of total concepts. Within the Phenomedia Group, the online games segment is serviced by Better Day Communications Werbeagentur GmbH. In this context, the Gnarf games format was a successful concept which was developed and placed in the area of fee-free online games. Various contracts have been concluded which highlight the attraction of the games format both for companies belonging to entertainment-oriented content providers and for the advertising industry.

The area of Creative Products is serviced by the activities of Ty-Phon Musicproductions & Publishing GmbH. The purpose of this company's business activities is music production.

Services

The services business unit has three product and services areas:

- Development of promotional software to customer order
- Localization of computer games
- Conventional advertising agency business

Art Department Werbeagentur GmbH was formed in 1993 on the basis of an innovative business idea involving the development of promotional software to customer order. Promotional games represent a special communications platform thanks to their entertainment value and modern form of content delivery. This gives brand name manufacturers or public institutions, for instance, the possibility of generating qualified target-group contacts. Phenomedia AG's customers include numerous well-known large enterprises.

The localization of computer games involves the linguistic adaptation of international titles to the relevant country-specific environment – something which has been practiced in the film industry for many years. In the Phenomedia Group, the localization of computer games is serviced by Effective Media `Agentur für Medienberatung´ GmbH. Effective Media is one of Germany's leading providers of professional games localization in this area.

In addition to translation work, the company's full-service offer comprises the editing of video sequences, voice recordings using the well-known voice-over actors of personalities such as Bruce Willis or Jack Nicholson and taking into account certain country-specific and cultural factors. Its core competence is in combining project management, programming and translation in order to produce a linguistically and culturally appropriate localization of the game content that is in keeping with the respective situation. This quality requirement is increasingly becoming a "must have" for consumers when deciding to purchase a product.

In the conventional advertising agency business, Better Day Communications Werbeagentur GmbH offers services in the area of online marketing and desktop publishing in particular.

Technology

codecult software research & development GmbH, which was formed in 1999, is developing multifunctional base technology for three-dimensional applications. The aim is to program a 3D engine: a complex application tool that is a necessary prerequisite for simulating virtual worlds for the development of sophisticated games in the full price segment.

Phenomedia AG believes that both 3D graphics and development times will become critical success factors on the computer games market. There is an increasing trend towards granting licenses for video games alongside the sale of conventional merchandise as part of future marketing activities for cinema films. Examples are the computer games based on the successful science fiction films Star Trek and Star Wars that are already available on the market. It is therefore probable that, in the future, full-price computer games will be developed parallel to the release of successful films. This underlines the necessity of shortening the development times for full-price computer games. It also means that it will become increasingly important for games developers to license 3D engines rather than developing them in-house, thus saving on time and costs.

codecult software research & development GmbH aims to offer this technology on specialized licensing markets as an international provider, and to utilize it within the Creative Products business unit in the area of offline games (Piranha Bytes Software GmbH) and online games (Better Day Communications Werbeagentur GmbH).

b) Business trends 1999

In fiscal 1999, the Phenomedia Group generated sales amounting to DM 9,513 thousand, thereby recording an increase of approximately 104 % on the sales for fiscal 1998 (DM 4,663 thousand). DM 7,362 thousand of sales for 1999 were generated by the Creative Products unit and DM 2,151 by the Services unit. No sales were generated by the Technology unit in the year under review, since projects here are still at the development stage. The key driver for the growth in sales in fiscal 1999 was the completion of projects which had commenced in previous years, in addition to the improved order book in the area of mid- and low-price games.

Staff costs increased from DM 667 thousand in fiscal 1998 to DM 1,687 thousand in fiscal 1999. This increase is due in particular to staff who previously worked on a freelance basis being drawn into fixed salaried employment. This is intended to commit qualified staff to the Company in the long term.

The cost of materials amounted to DM 1,694 thousand in fiscal 1999. This represents an increase of approximately 38 % compared to the previous year. The disproportionate growth in the cost of materials in relation to the increase in sales is also due to the freelancers being drawn into fixed salaried employment. This has resulted in the cost of purchased services being recorded at a far lower level.

The amortization and depreciation of noncurrent assets increased by about 142 % to DM 1,889 thousand in fiscal 1999. This increase is a result of more intensive investment activity in the first half of 1999. Conservative measurement principles were employed in the area of intangible assets in particular.

Other operating expenses amounting to DM 1,777 thousand in fiscal 1999 are about 114 % higher than the other operating expenses in fiscal 1998, which amounted to DM 829 thousand. This increase is due to the higher legal and consulting costs which accrued and to advertising and travel expenses.

The Phenomedia Group's net profit for the year amounted to DM 661 thousand in the year under review. This corresponds to a fall of approximately 74% compared to fiscal 1998, which ended with a net profit for the year of DM 2,507 thousand. This decrease can be primarily explained by two factors. Firstly, a waiver of claims by shareholders in fiscal 1999 increased profits, and secondly, fiscal 1999 was impacted by extraordinary costs of DM 2,081 thousand in the context of the Company's IPO. In contrast to the net profit for the year, the net profit or loss from ordinary activities, which amounted to DM 1,317 thousand in fiscal 1998, increased by about 158 % to DM 3,398 thousand in fiscal 1999.

2. Sector development

The Phenomedia Group develops products and services for the entertainment software market. As a result, the Phenomedia Group's future growth is dependent on the development of the market for entertainment software products as a whole. Changing consumer preferences mean that leisure time will become increasingly important – something which carries considerable growth opportunities, in general, for companies active in this market.

The entertainment software market is divided into two segments: offline games and online games. While the offline games segment, according to a Datamonitor study, carries probable worldwide market growth of approximately 15%, market growth of approximately 130% can be expected for the online games segment, which is by far the more attractive.

As such, the online games area is the market with the highest growth rates in the future. The Phenomedia Group's strategy thus attaches particular importance to the development of the Group's online expertise. In this context, it is important to highlight the particular strategic nature of the development, operation and marketing of the online game Gnarf by the Phenomedia Group; this is a game which has established itself on the German market. With Gnarf, Phenomedia has succeeded in developing a new and successful advertising platform, and in developing a technology which will serve as a basis for further projects over the years to come.

In the offline games segment, concentration processes have already begun to set in over recent years which, in our view, will become more pronounced. As such, the clear growth strategy which Phenomedia AG has followed, taking into account the capital market, provides the strategic answer which is necessary for an increasingly competitive environment. Behind the world market leader Electronic Arts (US), Infogrames (France), in particular, has improved its competitive position through an aggressive expansion strategy.

When evaluating the strategic significance of the various links in the value chain within the entertainment software industry, it must be noted that the significance of the development stage can be regarded as being fundamentally high, due to the generally increasing demand for content. On the other hand, in Phenomedia AG's view structural changes in the entertainment software industry will give rise to a pressure to adapt for neighboring links in the value chain. This includes, on the one hand, more intense competition as a result of concentration processes, and, on the other, long-term changes are becoming apparent as a result of the trend towards online distribution. The Company is well positioned for these developments, since the Phenomedia Group's flexibility means that it is able to improve its competitive position in response to structural changes in the sector as a whole.

3. Key events after the end of the fiscal year

Moorhuhn success

The fiscal year 2000 got off to a successful start with the promotional game Moorhuhnjagd (an Internet game based on a grouse figure), which was developed by Phenomedia AG. Moorhuhnjagd is the most successful promotional game ever. Television stations, print media and numerous radio stations have given very intense coverage to the spread of the Moorhuhn. Within a single month the Phenomedia site www.moorhuhn.de recorded more than a million downloads.

The success in communicating the link between Phenomedia AG and the Moorhuhn figure has resulted, on the one hand, in a highly positive image transfer for the Company. On the other, the spread of the Company's name has led to many new customers and a clear increase in demand. Phenomedia AG seeks to directly exploit the Moorhuhn's popularity by issuing licenses.

Moorhuhn licensed to the Bertelsmann Music Group

In the context of its goal to market and exploit the grouse's cult status and popularity, Phenomedia AG concluded an exclusive license agreement with Bertelsmann Music Group, which is one of Germany's leading music publishing houses. The subject of the contract is the production of singles, albums and compilations, for which the Moorhuhn will present German and international stars.

Investment in Morelogs Consulting GmbH

One of Phenomedia AG's strategic goals is the development of its market share in the fast-growing online games segment. In this context, Phenomedia AG has resolved – subject to the approval of the Board – to acquire a 20% interest in Morelogs Consulting GmbH, Essen, which is to be reorganized as a stock corporation. Morelogs Consulting GmbH's role within the Phenomedia Group will be the provision of extensive Internet and database technology for entertainment-oriented product concepts.

Formation of the joint venture company Daywalker Studios GmbH with Hahn Film AG

As a result of the success of the Moorhuhn game figure, great importance is being attached to the development and exploitation of characters which are established as brands. As a result, Phenomedia AG has a particular interest in developing its expertise in this area. For this reason the joint venture company Daywalker Studios GmbH was formed with Hahn Film AG. It is intended to establish the Gnarf and other characters for marketing at various levels in the context of this joint venture.

4. Likely development

The management buy-out of the former Art Department Werbeagentur GmbH from Funsoft Holding GmbH in 1997 constitutes the starting point of the company's growth strategy.

Since 1997 the primary focus of the Company's business activities has been in the development of new products. At the core of the Phenomedia Group's business strategy is the concentration on high-growth segments in the electronic entertainment market, with a particular eye on the Group's particular existing core competences.

Phenomedia AG's corporate performance goal is to attain a strong market position as a provider of entertainment content in the interactive entertainment market. To this end efforts are focused, on the one hand, on the economic exploitation of the Moorhuhn figure's potential for success in the short to medium term. Phenomedia AG will pursue the further development of its characters in the online area, while it will seek to conclude cooperation agreements and contracts with licensees in the offline area (TV, merchandising and music).

Phenomedia will also develop its market position through acquisitions focusing on the areas of software development and Internet technology. Nevertheless, expansion in the area of publishing is not being ruled out in principle in certain circumstances.

In the context of the exceptionally dynamic and satisfying business trend, the Company will issue revised sales and earnings forecasts by the end of Q2 taking into account the acquisitions concluded at that point. The baseline for sales planning in fiscal 2000 is the forecast contained in the research reports on the occasion of the IPO, which predict sales amounting to DM 16.3 million for the current year. For the coming years, the Company expects average yearly sales growth, in the area of internal growth, of at least 50%. The targeted sales growth will lead to earnings growth for Phenomedia AG, thereby bringing increases in value for the shareholders.

Phenomedia has a strategic focus on the high-growth market of interactive entertainment, which is characterized by the merging of the Internet and television. In this area, Phenomedia possesses the key expertise necessary for the design and implementation of interactive entertainment formats, which are required by important companies in the media sector, particularly film and television.

5. Risks associated with the Company's future development

Dependence on qualified personnel

In successfully implementing its corporate goals, Phenomedia AG is very much dependent on the work of its management and key employees. The current situation on the labor market means that there is a latent risk of our personnel being head-hunted by the competition. This is a risk which Phenomedia AG counteracts by taking various measures. The most important measure to secure the long-term commitment of staff to Phenomedia AG is employee participation in the Company's success.

Phenomedia AG is confident that it will succeed in retaining the qualified staff which it requires for its planned growth, and that it will also succeed in recruiting new staff.

Lengthy development cycles for computer games

Despite shortening development cycles, the development of a full-price computer game, from translating a concept into a 'milestone plan' to the completion of the finished product, currently still takes about two years in Germany, in contrast to the US market leaders. Even the development of a low-price product can scarcely be completed within a year. This long development time carries a latent risk that other software developers could bring similar computer games onto the market sooner, and thereby place them better. Furthermore, fundamental technological developments can arise during the development phase which could lead to the Company's development time taking longer than the competition unless such technological developments are identified early and taken into account.

Volatility of sales

Phenomedica AG records fluctuations in sales from one quarter to another. These fluctuations result from the development cycles of computer games, which take several years, and from consumers' demand behavior, which is typical for the sector. In the entertainment software industry most sales are recorded in Q1 and Q4, with lower sales regularly being recorded during the six months over the summer period.

Brand risks

The characters which Phenomedica AG creates in the context of the computer games it develops have enormous profit potential as brands. The Moorhuhn is a particular case in point.

Nevertheless, Phenomedica AG is unable to give an accurate forecast as to the long-term sustained profit potential of its characters. This is because consumer preferences change, and because it is difficult to gauge the media, which are a decisive factor in influencing the public's interest in the characters. Nonetheless, Phenomedica AG – by licensing the Moorhuhn to the Bertelsmann Music Group and by forming the joint venture company Daywalker Studios GmbH – has already taken important steps to secure the sustained long-term value of its characters.

Bochum, March 2000

The Managing Board

Audit opinion

We have audited the consolidated financial statements of Phenomedia AG (formerly Art Department Werbeagentur GmbH), Bochum, consisting of balance sheets, income statements, statements of cash flows and notes for the year January 1 to December 31, 1999. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion, based on our audit, as to whether the consolidated financial statements comply with International Accounting Standards (IAS).

We conducted our audits of the consolidated financial statements in accordance with German audit regulations and in compliance with the German principles of proper auditing adopted by the Institut der Wirtschaftsprüfer (IDW), as well as in compliance with International Standards on Auditing (ISA). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

The process of defining the audit procedures takes account of knowledge about the business activities and the economic and legal environment of the Group, as well as expectations of possible errors. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements as of December 31, 1999 give, in accordance with IAS, a true and fair view of the financial position of the Group and of the results of its operations and its cash flows from January 1 to December 31, 1999.

Our audit, which also included the Group management report prepared by the Company, did not result in any objections. In our opinion, the Group management report overall accurately reflects the position of the Group and accurately presents the risks associated with future developments. We also confirm that the consolidated financial statements and Group management report for the fiscal year January 1 to December 31, 1999 meet the requirements for exempting the Company from preparing consolidated financial statements and a Group management report in accordance with German law.

Our audit did not result in any objections.

In our opinion, the annual financial statements give, in accordance with proper accounting principles, a true and fair view of the financial position of Phenomedia AG, Bochum and of the results of its operations. Overall, the management report accurately reflects the position of the Group and accurately presents the risks associated with future developments.

Düsseldorf, March 14, 2000

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

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