INCYTE CORP
Form 10-Q
July 29, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2008

or

o TRANSITION REPORTS PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 0-27488

INCYTE CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-3136539**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

Experimental Station, Route 141 & Henry Clay Road,

Building E336, Wilmington, DE 19880

(Address of principal executive offices)

(302) 498-6700

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

x Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer x
Non-accelerated filer (Do not check if a smaller reporting company) o	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes x No

The number of outstanding shares of the registrant s Common Stock, $0.001 par value, was 84,989,650 as of July 25, 2008.

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INCYTE CORPORATION

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

INCYTE CORPORATION

Condensed Consolidated Balance Sheets

(in thousands, except share and per share amounts)

	June 30, 2008 (unaudited)	December 31, 2007*
ASSETS		
Current assets:		
Cash and cash equivalents	$ 134,712	$ 108,854
Marketable securities available-for-sale	51,309	147,576
Accounts receivable, net	787	1,551
Prepaid expenses and other current assets	7,247	6,431
Total current assets	194,055	264,412
Marketable securities available-for-sale	2,011	897
Property and equipment, net	3,110	3,943
Intangible and other assets, net	5,559	6,443
Total assets	$ 204,735	$ 275,695
LIABILITIES AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$ 13,481	$ 7,806
Accrued compensation	5,954	10,693
Interest payable	5,273	5,273
Accrued and other current liabilities	12,177	7,226
Deferred revenue	52	649
Accrued restructuring	4,714	4,948
Total current liabilities	41,651	36,595
Convertible senior notes	126,498	122,180
Convertible subordinated notes	264,781	264,376
Other liabilities	9,000	12,061
Total liabilities	441,930	435,212
Stockholders deficit:		
Preferred stock		
Common stock, $0.001 par value; 200,000,000 shares authorized; 84,989,650 and 84,533,069 shares issued and outstanding as of June 30, 2008 and December 31, 2007, respectively	85	85
Additional paid-in capital	850,692	841,320

Accumulated other comprehensive loss		(1,857)		(528)
Accumulated deficit		(1,086,115)		(1,000,394)
Total stockholders deficit		(237,195)		(159,517)
Total liabilities and stockholders deficit	$	204,735	$	275,695

* The condensed consolidated balance sheet at December 31, 2007 has been derived from the audited financial statements at that date.

See accompanying notes.

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INCYTE CORPORATION

Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Revenues:				
Contract revenues	$ 57	$ 8,933	$ 644	$ 15,007
License and royalty revenues	557	1,643	1,276	2,991
Total revenues	614	10,576	1,920	17,998
Costs and expenses:				
Research and development	38,132	23,301	71,087	47,207
Selling, general and administrative	4,103	3,535	8,456	7,227
Other expenses	(918)	(73)	(795)	34
Total costs and expenses	41,317	26,763	78,748	54,468
Loss from operations	(40,703)	(16,187)	(76,828)	(36,470)
Interest and other income, net	1,353	3,713	3,493	7,780
Interest expense	(6,213)	(5,965)	(12,386)	(11,896)
Net loss	(45,563)	(18,439)	(85,721)	(40,586)
Basic and diluted net loss per share:	$ (0.54)	$ (0.22)	$ (1.01)	$ (0.48)
Shares used in computing basic and diluted net loss per share	84,871	84,136	84,736	84,060

See accompanying notes.

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INCYTE CORPORATION

Condensed Consolidated Statements of Comprehensive Loss

(in thousands)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Net loss	$ (45,563)	$ (18,439)	$ (85,721)	$ (40,586)
Other comprehensive gain (loss):				
Unrealized gain (loss) on marketable securities	(91)	(163)	(1,329)	109
Comprehensive loss	$ (45,654)	$ (18,602)	$ (87,050)	$ (40,477)

See accompanying notes.

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INCYTE CORPORATION

Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	Six Months Ended June 30,	
	2008	**2007**
Cash flows from operating activities:		
Net loss	$ (85,721)	$ (40,586)
Adjustments to reconcile net loss to net cash used in operating activities:		
Non-cash restructuring charges	(795)	34
Depreciation and amortization	6,560	6,460
Stock-based compensation	7,290	4,811
Changes in operating assets and liabilities:		
Accounts receivable	764	806
Prepaid expenses and other assets	(788)	1,695
Accounts payable	5,675	(957)
Accrued and other current liabilities	(2,288)	(1,784)
Deferred revenue	(597)	(11,601)
Net cash used in operating activities	(69,900)	(41,122)
Cash flows from investing activities:		
Capital expenditures	(190)	(345)
Purchases of marketable securities	52	(35,322)
Sales and maturities of marketable securities	93,814	90,924
Net cash provided by investing activities	93,676	55,257
Cash flows from financing activities:		
Proceeds from issuance of common stock under stock plans	2,082	939
Net cash provided by financing activities	2,082	939
Net increase in cash and cash equivalents	25,858	15,074
Cash and cash equivalents at beginning of period	108,854	18,861
Cash and cash equivalents at end of period	$ 134,712	$ 33,935

See accompanying notes.

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INCYTE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2008

(Unaudited)

1. Organization and business

Incyte Corporation (Incyte, we, us, or our) is a drug discovery and development company focused on developing proprietary small molecule drugs to treat serious unmet medical needs. We have a pipeline with programs in oncology, inflammation, diabetes, and human immunodeficiency virus (HIV).

2. Summary of significant accounting policies

Basis of presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The condensed consolidated balance sheet as of June 30, 2008 and the condensed consolidated statements of operations and comprehensive loss for the three and six months ended June 30, 2008 and 2007, and statements of cash flows for the six months ended June 30, 2008 and 2007 are unaudited, but include all adjustments, consisting only of normal recurring adjustments, which we consider necessary for a fair presentation of the financial position, operating results and cash flows for the periods presented. The condensed consolidated balance sheet at December 31, 2007 has been derived from audited financial statements.

Although we believe that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote information normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

Results for any interim period are not necessarily indicative of results for any future interim period or for the entire year. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007.

Recent Accounting Pronouncements

We adopted Financial Accounting Standards Board Statement No. 157, *Fair Value Measurements* (SFAS 157) effective January 1, 2008. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (the exit price) in an orderly transaction between market participants at the measurement date. The standard outlines a valuation framework and creates a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and the related disclosures. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets (market approach). As of June 30, 2008, the fair value of our financial assets are based on level one observable inputs. We have determined that our fair value measurements are in accordance with the requirements of SFAS 157, therefore, the implementation of SFAS 157 did not have any impact on our consolidated financial condition or results of operations.

In May 2008, the Financial Accounting Standards Board issued Staff Position No. Accounting Principles Board 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (FSP No. APB 14-1). FSP No. APB 14-1 requires that the liability and equity components of convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) be separately accounted for in a manner that reflects an issuer s nonconvertible debt borrowing rate. FSP No. APB 14-1 is effective for us as of January 1, 2009. We do not expect the adoption of APB 14-1 to have a material impact on our consolidated financial statements.

3. Marketable securities

Marketable securities consist of investments in corporate debt securities, mortgage backed securities, U.S. Treasury notes, and other U.S. government agency securities that are classified as available-for-sale. We classify marketable securities available to fund current operations as current assets on the condensed consolidated balance sheet. Marketable securities are classified as long-term assets on the consolidated balance sheets if (i) they have been in an unrealized loss position for longer than six months and (ii) we have the ability to hold them until the carrying value is recovered and such holding period may be longer than one year.

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4. Revenues

For the three and six months ended June 30, 2008, one customer contributed 54% and 34% of revenues, respectively. For the three and six months ended June 30, 2007, one customer contributed 84% and 83% of revenues, respectively.

Three customers comprised 70% of the accounts receivable balance at June 30, 2008. Three customers comprised 68% of the accounts receivable balance at December 31, 2007.

5. Collaborative research and license agreement

Effective in January 2006, we entered a collaborative research and license agreement with Pfizer Inc. (Pfizer) for the pursuit of our CCR2 antagonist program. Pfizer gained worldwide development and commercialization rights to our portfolio of CCR2 antagonist compounds. Pfizer s rights extend to the full scope of potential indications, with the exception of multiple sclerosis and autoimmune nephritides, where we retained worldwide rights, along with certain compounds. We do not have obligations to Pfizer on pre-clinical development candidates we select for pursuit in these indications. The agreement will terminate upon the expiration of the last to expire of patent rights licensed under the agreement. Prior to such expiration, either party can terminate the agreement for the uncured material breach of the agreement by the other party or for the insolvency of the other party. In addition, Pfizer may terminate the agreement at any time upon 90 days notice. We received an upfront nonrefundable, non-creditable payment of $40 million in January 2006 and are eligible to receive additional future development and milestone payments.

We determined that there were two deliverables under the agreement: (i) the worldwide license and (ii) our obligations in connection with a research plan (the Research Plan), which were limited to completion of chemistry and biology research services on Pfizer s behalf by our full time equivalents (FTEs). We concluded that these deliverables should be accounted for as a single unit of accounting and the $40 million upfront payment should be recognized as revenue over the two year term that we complete our obligations in connection with the Research Plan, our estimated performance period under the agreement. We have no further substantive obligations to Pfizer after the completion of our obligations in connection with the Research Plan. All milestone payments will be recognized as revenue upon the achievement of the associated milestone. Consistent with the terms of the agreement and our original expectations at the inception of the agreement, the Research Plan concluded after two years in January 2008 and, as such, there are no remaining substantive obligations to Pfizer under the agreement.

Contract revenues related to the upfront consideration received, research services provided to Pfizer, and the difference between the cash received and the present value of convertible subordinated notes issued to Pfizer (the Pfizer Notes), of approximately $0.6 million were recognized for the six months ended June 30, 2008 and $5.9 million and $12.0 million for the three and six months ended June 30, 2007, respectively. Also included in contract revenues for the three and six months ended June 30, 2007 was a $3.0 million milestone payment from Pfizer.

6. Stock compensation

Under the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS 123R), we recorded $3.9 million and $7.3 million of stock compensation expense on our unaudited condensed consolidated statement of operations for the three and six months ended June 30, 2008. We recorded $2.6 million and $4.8 million of stock compensation expense on our unaudited condensed consolidated statement of operations for the three and six months ended June 30, 2007, respectively. We utilized the Black-Scholes valuation model for estimating the fair value of the stock compensation granted, with the following weighted-average assumptions:

	Employee Stock Options				Employee Stock Purchase Plan			
	For the Three Months Ended June 30,		For the Six Months Ended June 30,		For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007	2008	2007	2008	2007
Average risk-free interest rates	2.30%	4.78%	2.04%	4.87%	2.63%	4.87%	2.34%	4.67%
Average expected life (in years)	2.60	2.50	2.92	2.91	0.50	0.50	0.50	0.50
Volatility	64%	66%	65%	65%	50%	39%	67%	45%
Weighted-average fair value (in dollars)	4.25	3.14	5.14	3.23	2.15	0.93	1.49	1.06

The risk-free interest rate is derived from the U.S. Federal Reserve rate in effect at the time of grant. The expected life calculation is based on the observed and expected time to the exercise of options by our employees based on historical exercise patterns for similar type options. Expected volatility is based on the historical volatility of our common stock over the period commensurate with the expected life of the options. A dividend yield of zero is assumed based on the fact that we have never paid cash dividends and have no present intention to pay cash dividends. Options granted have a seven-year term and vest over a three-year period with a one-year cliff (i.e., vesting occurs as to one-third (1/3) at the end of the first year and in equal monthly installments on a monthly basis for the remaining two years).

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Based on our historical experience, we have assumed an annualized forfeiture rate of 5% for our options. Under the true-up provisions of SFAS 123R, we will record additional expense if the actual forfeiture rate is lower than we estimated, and will record a recovery of prior expense if the actual forfeiture is higher than we estimated.

The amortization of stock compensation under SFAS 123R for the period after its adoption was calculated in accordance with FASB Interpretation (FIN) No. 28. Total compensation cost of options granted but not yet vested, as of June 30, 2008, was $14.5 million, which is expected to be recognized over the weighted average period of 3.05 years.

The following table summarizes activity under all stock option plans:

	Shares Available for Grant	Number Outstanding	Weighted Average Exercise Price per Share
Balance at December 31, 2007	4,227,469	12,434,505	$ 7.81
Additional authorized	4,000,000		
Options granted	(3,261,000)	3,261,000	11.76
Options exercised		(182,458)	5.72
Options cancelled	19,917	(19,917)	9.06
Balance at June 30, 2008	4,986,386	15,493,130	$ 8.67
Exercisable, June 30, 2008		9,303,497	$ 8.24

7. Net loss per share

For all periods presented, both basic and diluted net loss per common share are computed by dividing the net loss by the number of weighted average common shares outstanding during the period. Stock options and potential common shares issuable upon conversion of our 3½% convertible senior notes due 2011 (the 3½% Senior Notes), 3½% convertible subordinated notes due 2011 (the 3½% Subordinated Notes), and the Pfizer Notes were excluded from the computation of diluted net loss per share, as their share effect was anti-dilutive for all periods presented. The potential common shares that were excluded from the diluted net loss per share computation at June 30, 2008 and 2007, respectively, are as follows:

	2008	2007
Outstanding stock options	15,493,130	12,640,651
Common shares issuable upon conversion of 3½% Senior Notes	13,531,224	13,531,224
Common shares issuable upon conversion of 3½% Subordinated Notes	22,284,625	22,284,625
Common shares issuable upon conversion of Pfizer Note due 2013	1,461,496	1,461,496
Common shares issuable upon conversion of Pfizer Note due 2014	1,025,641	
Total potential common shares excluded from diluted net loss per share computation	53,796,116	49,917,996

8. Segment reporting

Our operations are treated as one operating segment, drug discovery and development, in accordance with FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131).

9. Other expenses

Below is a summary of the activity related to other expenses recorded for the periods in which activity related to our restructuring programs has taken place through the six months ended June 30, 2008. The estimates below have been made based upon management s best estimate of the amounts and timing of certain events included in the restructuring plan that will occur in the future. It is possible that the actual outcome of certain events may differ from the estimates. Changes will be made to the restructuring accrual at the point that the differences become determinable. The accrual balances for the restructuring plans are included in accrued restructuring and other liabilities (long-term) in the consolidated balance sheets.

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2004 Restructuring

	Original Charge Recorded in 2004	Accrual Balance at December 31, 2007	2008 Charges to Operations	2008 Charges Utilized	Accrual Balance at June 30, 2008
			(in thousands)		
Lease commitment and related costs	$ 15,497	$ 9,179	$ (778)	$ 1,469	$ 6,932
Other costs			76	76	
Restructuring expenses	$ 15,497	$ 9,179	$ (702)	$ 1,545	$ 6,932

2002 Restructuring

	Original Charge Recorded in 2002	Accrual Balance at December 31, 2007	2008 Charges to Operations	2008 Charges Utilized	Accrual Balance at June 30, 2008
			(in thousands)		
Lease commitment and related costs	$ 16,155	$ 7,534	$ (89)	$ 787	$ 6,658

Maxia Acquisition Costs

	Original Charge	Accrual Balance at December 31, 2007	2008 Charges to Operations	2008 Charges Utilized	Accrual Balance at June 30, 2008
			(in thousands)		
Lease commitment and related costs	$ 2,373	$ 274	$ (4)	$ 145	$ 125

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our financial condition and results of operations as of and for the three and six months ended June 30, 2008 should be read in conjunction with the financial statements and notes to those statements included elsewhere in this Quarterly Report on Form 10-Q and our audited financial statements as of and for the year ended December 31, 2007 included in our Annual Report on Form 10-K previously filed with the SEC.

This report contains forward-looking statements that involve risks and uncertainties. These statements relate to future periods, future events or our future operating or financial plans or performance. These statements can often be identified by the use of forward-looking terminology such as expects, believes, intends, anticipates, estimates, plans, may, or will, or the negative of these terms, and other similar expressions. These forward-looking statements include statements as to:

- *the discovery, development, formulation, manufacturing and commercialization of our compounds and our product candidates;*
- *focus on our drug discovery and development efforts;*
- *conducting clinical trials internally, with collaborators, or with clinical research organizations;*
- *our collaboration and strategic alliance strategy; anticipated benefits and disadvantages of entering into collaboration agreements;*
- *our licensing, investment and commercialization strategies;*
- *the regulatory approval process, including determinations to seek U.S. Food and Drug Administration(FDA) and other international health authorities approval for, and plans to commercialize, our products in the United States and abroad;*
- *the safety, effectiveness and potential benefits and indications of our product candidates and other compounds under development; potential uses for our product candidates and our other compounds;*
- *the timing and size of our clinical trials; the compounds expected to enter clinical trials; timing of clinical trial results;*

- *our ability to manage expansion of our drug discovery and development operations;*

- *future required expertise relating to clinical trials, manufacturing, sales and marketing;*

- *obtaining and terminating licenses to products, compounds or technology, or other intellectual property rights;*

- *the receipt from or payments pursuant to collaboration or license agreements resulting from milestones or royalties; the decrease in revenues from our information product-related activities;*

- *plans to develop and commercialize products on our own;*

- *plans to use third party manufacturers;*

- *expected expenses and expenditure levels; expected uses of cash; expected revenues and sources of revenues;*

- *expected losses; fluctuation of losses;*

- *our profitability; the adequacy of our capital resources to continue operations;*

- *the need to raise additional capital;*

- *the costs associated with resolving matters in litigation;*

- *our expectations regarding competition;*

- *our investments, including anticipated expenditures, losses and expenses;*

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- *our gene and genomics-related patent prosecution and maintenance efforts; and*

- *our indebtedness, and debt service obligations.*

These forward-looking statements reflect our current views with respect to future events, are based on assumptions and are subject to risks and uncertainties. These risks and uncertainties could cause actual results to differ materially from those projected and include, but are not limited to:

- *our ability to discover, develop, formulate, manufacture and commercialize a drug candidate or product;*

- *the risk of unanticipated delays in research and development efforts;*

- *the risk that previous preclinical testing or clinical trial results are not necessarily indicative of future clinical trial results;*

- *risks relating to the conduct of our clinical trials;*

- *changing regulatory requirements;*

- *the risk of adverse safety findings;*

- *the risk that results of our clinical trials do not support submission of a marketing approval application for our product candidates;*

- *the risk of significant delays or costs in obtaining regulatory approvals;*

- *risks relating to our reliance on third party manufacturers, collaborators, and clinical research organizations;*

- *risks relating to the development of new products and their use by us and our current and potential collaborators;*

- *risks relating to our inability to control the development of out-licensed drug compounds or drug candidates;*

- *our ability to in-license a potential drug compound or drug candidate;*

- *the cost of accessing, licensing or acquiring potential drug compounds or drug candidates developed by other companies;*

- *the costs of terminating any licensing or access arrangement for third party drug compounds or drug candidates;*

- *costs associated with prosecuting, maintaining, defending and enforcing patent claims and other intellectual property rights;*

- *our ability to maintain or obtain adequate product liability and other insurance coverage;*

- *the risk that our product candidates may not obtain regulatory approval;*

- *the impact of technological advances and competition;*

- *the ability to compete against third parties with greater resources than ours;*

- *competition to develop and commercialize similar drug products;*

- *our ability to obtain patent protection and freedom to operate for our discoveries and to continue to be effective in expanding our patent coverage;*

- *the impact of changing laws on our patent portfolio;*

- *developments in and expenses relating to litigation;*

- *the impact of past or future acquisitions on our business;*

- *the results of businesses in which we have made investments;*

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- *our ability to obtain additional capital when needed;*

- *fluctuations in net cash used by investing activities;*

- *our history of operating losses; and*

- *the risks set forth under Risk Factors.*

Given these risks and uncertainties, you should not place undue reliance on these forward-looking statements. Except as required by federal securities laws, we undertake no obligation to update any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

In this report all references to Incyte, we, us or our mean Incyte Corporation and our subsidiaries, except where it is made clear that the term means only the parent company.

Incyte is our registered trademark. We also refer to trademarks of other corporations and organizations in this Quarterly Report on Form 10-Q.

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Overview

Incyte is a drug discovery and development company focused on developing proprietary small molecule drugs to treat serious unmet medical needs. We have a pipeline with programs in oncology, inflammation, diabetes and human immunodeficiency virus (HIV).

Our wholly-owned pipeline includes the following compounds:

Drug Target	Drug Compound	Indication	Development Status
JAK			
	INCB18424 (Oral)	Myelofibrosis	Phase II
		Polycythemia vera/Essential thrombocythemia	Phase II
		Rheumatoid Arthritis	Phase IIa
		Refractory Prostate Cancer	Phase IIa
		Multiple Myeloma	Phase IIa
	INCB18424 (Topical)	Psoriasis	Phase IIa
	INCB28050	Rheumatoid Arthritis	Phase I
HSD1			
	INCB13739	Type 2 Diabetes	Phase IIb
	INCB20817	Type 2 Diabetes	Phase I
HM74a			
	INCB19602	Type 2 Diabetes	Phase IIa
Sheddase			
	INCB7839	Solid Tumors	Phase IIa
		Breast Cancer	Phase II
CCR2			
	INCB8696	Multiple Sclerosis	Phase I
CCR5			
	INCB9471	HIV	Phase II
	INCB15050	HIV	Phase I
Other			
Lead clinical candidate		Oncology	Pre-clinical
Lead clinical candidate		Oncology	Pre-clinical

In March 2008, we announced that we would not advance our lead CCR5 antagonist into Phase IIb trials and that we are seeking to out-license this program. This decision reflects our objective to focus our resources on programs that we believe have the greatest near-term value. We have also decided to delay initiation of the oral 28-day Phase IIa trial in psoriasis with our orally administered JAK inhibitor until next year.

We anticipate incurring additional losses for several years as we expand our drug discovery and development programs. We also expect that losses will fluctuate from quarter to quarter and that such fluctuations may be substantial. Conducting clinical trials for our drug candidates in development is a lengthy, time-consuming and expensive process. We do not expect to generate product sales from our drug discovery and development efforts for several years, if at all. If we are unable to successfully develop and market pharmaceutical products over the next several years, our business, financial condition and results of operations would be adversely impacted.

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Critical Accounting Policies and Significant Estimates

The preparation of financial statements requires us to make estimates, assumptions and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, we evaluate our estimates. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances, the results of which form our basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from those estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our consolidated financial statements:

- Revenue recognition;
- Research and development costs;
- Valuation of long-lived assets;
- Restructuring charges; and
- Stock compensation.

Revenue Recognition. Revenues are recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed and determinable and collectibility is reasonably assured. We have entered into various types of agreements for access to our information databases and use of our intellectual property. Revenues are deferred for fees received before earned or until no further obligations exist. We exercise judgment in determining that collectibility is reasonably assured or that services have been delivered in accordance with the arrangement. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectibility based primarily on the customer s payment history and on the creditworthiness of the customer.

Revenues from ongoing database agreements are recognized evenly over the access period. Revenues from licenses to our intellectual property are recognized when earned under the terms of the related agreements. Royalty revenues are recognized upon the sale of products or services to third parties by the licensee or other agreed upon terms. We estimate royalty revenues based on previous period royalties received and information provided by the third party licensee. We exercise judgment in determining whether the information provided by licensees is sufficiently reliable for us to base our royalty revenue recognition thereon.

Under agreements involving multiple products, services and/or rights to use assets, the multiple elements are divided into separate units of accounting when certain criteria are met, including whether the delivered items have stand alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered items. When separate units of accounting exist, consideration is allocated among the separate elements based on their respective fair values. The determination of fair value of each element is based on objective evidence from historical sales of the individual elements by us to other customers. If such evidence of fair value for each undelivered element of

the arrangement does not exist, all revenue from the arrangement is deferred until such time that evidence of fair value for each undelivered element does exist or until all elements of the arrangement are delivered. When elements are specifically tied to a separate earnings process, revenue is recognized when the specific performance obligation tied to the element is completed. When revenues for an element are not specifically tied to a separate earnings process, they are recognized ratably over the term of the agreement.

In connection with our collaborative research and license agreement with Pfizer Inc. (Pfizer), we received an upfront non-refundable payment of $40.0 million in January 2006. The $40.0 million upfront fee was recorded as deferred revenue and was recognized on a straight-line basis over two years, our estimated performance period under the agreement. In February 2006 and October 2007, Pfizer purchased, for a total of $20.0 million, a convertible subordinated note due 2013 and a convertible subordinated note due 2014 (collectively, the Pfizer Notes). As the Pfizer Notes are non-interest bearing, they have been discounted to their net present value. The difference between the cash received and the present value of the Pfizer Notes, plus the related beneficial conversion feature, totals $3.2 million for each note, which represented additional consideration from Pfizer under the agreement. We have accounted for this additional consideration as deferred revenue and have recognized it over our estimated performance period under the agreement. We recognized contract revenues for research services provided by our full time equivalents to Pfizer in the periods in which the services were performed. We received a $3.0 million milestone payment from Pfizer in the second quarter of 2007. All milestone payments will be recognized as revenue upon the achievement of the associated milestone.

Research and Development Costs. In accordance with Statement of Financial Accounting Standards No. 2 (SFAS 2), *Accounting for Research and Development Costs*, it is our policy to expense research and development costs as incurred. We often contract with clinical research organizations (CROs) to facilitate, coordinate and perform agreed upon research and development of a new drug. To ensure that research and development costs are expensed as incurred, we record monthly accruals for clinical trials and preclinical testing costs based on the work performed under the contract.

These CRO contracts typically call for the payment of fees for services at the initiation of the contract and/or upon the achievement of

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certain clinical trial milestones. In the event that we prepay CRO fees, we record the prepayment as a prepaid asset and amortize the asset into research and development expense over the period of time the contracted research and development services are performed in accordance with EITF 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities.* Most professional fees, including project and clinical management, data management, monitoring, and medical writing fees are incurred throughout the contract period. These professional fees are expensed based on their percentage of completion at a particular date.

Our CRO contracts generally include pass through fees. Pass through fees include, but are not limited to, regulatory expenses, investigator fees, travel costs, and other miscellaneous costs, including shipping and printing fees. We expense the costs of pass through fees under our CRO contracts as they are incurred, based on the best information available to us at the time. The estimates of the pass through fees incurred are based on the amount of work completed for the clinical trial and are monitored through correspondence with the CROs, internal reviews and a review of contractual terms. The factors utilized to derive the estimates include the number of patients enrolled, duration of the clinical trial, estimated patient attrition, screening rate and length of the dosing regimen. CRO fees incurred to set up the clinical trial are expensed during the setup period.

Valuation of Long-Lived Assets. We assess the impairment of long-lived assets, which includes property and equipment as well as intangible and other assets, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important that could indicate the need for an impairment review include the following:

- Significant changes in the strategy of our overall business;
- Significant underperformance relative to expected historical or projected future operating results;
- Significant changes in the manner of use of the acquired assets;
- Significant negative industry or economic trends;
- Significant decline in our stock price for a sustained period; and
- Our market capitalization relative to net book value.

When we determine that the carrying value of long-lived assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, in accordance with Financial Accounting Standards Board (FASB) Statement No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets* (SFAS 144), we perform an undiscounted cash flow analysis to determine if impairment exists. If impairment exists, we measure the impairment based on the difference between the asset s carrying amount and its fair value.

Restructuring Charges. Costs associated with restructuring activities initiated after December 31, 2002, are accounted for in accordance with FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146). Costs associated with restructuring activities initiated prior to December 31, 2002 have been recorded in accordance with Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)* (EITF 94-3) and Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges* (SAB 100). Restructuring costs resulting from the acquisition of Maxia Pharmaceuticals, Inc. (Maxia) have been recorded in accordance with EITF Issue No. 95-3*, Recognition of Liabilities in Connection with a Purchase Business Combination* (EITF 95-3). The restructuring charges are comprised primarily of costs to

exit facilities, reduce our workforce, write-off fixed assets, and pay for outside services incurred in the restructuring. The workforce reduction charge is determined based on the estimated severance and fringe benefit charge for identified employees. In calculating the cost to exit the facilities, we estimate for each location the amount to be paid in lease termination payments, the future lease and operating costs to be paid until the lease is terminated, the amount, if any, of sublease receipts and real estate broker fees. This requires us to estimate the timing and costs of each lease to be terminated, the amount of operating costs, and the timing and rate at which we might be able to sublease the site. To form our estimates for these costs, we perform an assessment of the affected facilities and consider the current market conditions for each site. We also estimate our credit adjusted risk free interest rate in order to discount our projected lease payments in accordance with SFAS 146. Estimates are also used in our calculation of the estimated realizable value on equipment that is being held for sale. These estimates are formed based on recent history of sales of similar equipment and market conditions. Our assumptions on either the lease termination payments, operating costs until terminated, the offsetting sublease receipts and estimated realizable value of fixed assets held for sale may turn out to be incorrect and our actual cost may be materially different from our estimates. Our estimates of future liabilities may change, requiring us to record additional restructuring charges or reduce the amount of liabilities recorded.

At the end of each reporting period, we evaluate the remaining accrued balances to ensure their adequacy, that no excess accruals are retained and the utilization of the provisions are for their intended purposes in accordance with developed exit plans. We periodically evaluate current available information and adjust our restructuring reserve as necessary. We also make adjustments related to accrued professional fees to adjust estimated amounts to actual.

Stock Compensation. Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS 123R), *Share-Based Payment*, which revised Statement of Financial Accounting Standards 123 (SFAS 123), *Accounting for Stock-Based Compensation*. SFAS 123R requires all share-based payment transactions with employees, including grants of

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employee stock options, to be recognized as compensation expense over the requisite service period based on their relative fair values. SFAS 123R requires significant judgment and the use of estimates, particularly surrounding Black-Scholes assumptions such as stock price volatility and expected option lives, as well as expected option forfeiture rates, to value equity-based compensation. SFAS 123R requires the recognition of the fair value of stock compensation in the statement of operations. Prior to the adoption of SFAS 123R, stock-based compensation expense related to employee stock options was not recognized in the statement of operations. Prior to January 1, 2006, we had adopted the disclosure-only provisions under SFAS 123. Under the provisions of SFAS 123R, we recorded $3.9 million and $7.3 million of stock compensation expense for the three and six months ended June 30, 2008, respectively, and $2.6 million and $4.8 million for the three and six months ended June 30, 2007, respectively.

Results of Operations

We recorded net losses of $45.6 million and $85.7 million and basic and diluted net losses per share of $0.54 and $1.01 per share for the three and six months ended June 30, 2008, respectively, as compared to net losses of $18.4 million and $40.6 million and basic and diluted net losses per share of $0.22 and $0.48 per share in the corresponding periods in 2007.

Revenues.

	For the three months ended, June 30,		For the six months ended, June 30,	
	2008	2007	2008	2007
	(in millions)		(in millions)	
Contract revenues	$0.1	$8.9	$0.6	$15.0
License and royalty revenues	0.5	1.7	1.3	3.0
Total revenues	$0.6	$10.6	$1.9	$18.0

Our contract revenues for the three and six months ended June 30, 2008 decreased to $0.1 million and $0.6 million, respectively, from $8.9 million and $15.0 million, respectively, for the three and six months ended June 30, 2007 as we have fully recognized at June 30, 2008 contract revenues associated with the Pfizer $40.0 million upfront fee, the debt discount and beneficial conversion feature related to the Pfizer Notes and the reimbursement of certain expenses by Pfizer for research and development expenses pursuant to the collaborative research and license agreement.

Our license and royalty revenues for the three and six months ended June 30, 2008 decreased to $0.5 million and $1.3 million, respectively, from $1.7 million and $3.0 million, respectively, for the three and six months ended June 30, 2007. License and royalty revenues were derived from the licensing of our gene- and genomic-related intellectual property. We expect that revenues generated from information products, including licensing of gene- and genomic-related intellectual property, will decline as we focus on our drug discovery and development programs.

Operating Expenses.

Research and development expenses.

	For the three months ended, June 30,		For the six months ended, June 30,	
	2008	2007	2008	2007
	(in millions)		(in millions)	
Salary and benefits related	$ 8.8	$ 7.6	$ 17.9	$ 15.5
Stock compensation	2.9	1.8	5.3	3.3
Collaboration and outside services	22.5	9.5	39.9	19.5
Occupancy and all other costs	3.9	4.4	8.0	8.9
Total research and development expenses	$ 38.1	$ 23.3	$ 71.1	$ 47.2

We currently track research and development costs by natural expense line and not costs by project. For salary and benefit related costs, the increase from the three and six months ended June 30, 2007 to the three and six months ended June 30, 2008 was primarily the result of increased headcount to sustain our development pipeline. Stock compensation increased for the three and six months ended June 30, 2008 as compared to the three and six months ended June 30, 2007 due primarily to an increase in our average stock price. Stock compensation expense may fluctuate from period to period based on the number of options granted, stock price volatility and expected option lives, as well as expected option forfeiture rates which are used to value equity-based compensation. For collaboration and outside services, the increase from the three and six months ended June 30, 2007 to the three and six months ended June 30, 2008 is due primarily from the growth and advancement of our clinical pipeline. The decrease in occupancy and all other costs for the three and six months ended June 30, 2008 as compared to the three and six months ended June 30, 2007 is due primarily to decreases in depreciation expense.

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Research and development expenses may fluctuate from period to period depending upon the stage of certain projects and the level of pre-clinical and clinical trial-related activities. Many factors can affect the cost and timing of our clinical trials, including requests by regulatory agencies for more information, inconclusive results requiring additional clinical trials, slow patient enrollment, adverse side effects among patients, insufficient supplies for our clinical trials and real or perceived lack of effectiveness or safety of our investigational drugs in our clinical trials. In addition, the development of all of our products will be subject to extensive governmental regulation. These factors make it difficult for us to predict the timing and costs of the further development and approval of our products.

Selling, general and administrative expenses.

	For the three months ended, June 30,		For the six months ended, June 30,	
	2008	2007	2008	2007
	(in millions)		(in millions)	
Salary and benefits related	$ 1.5	$ 1.4	$ 3.1	$ 2.9
Stock compensation	1.0	0.8	2.0	1.5
Other contract service and outside costs	1.6	1.3	3.4	2.8
Total selling, general and administrative expenses	$ 4.1	$ 3.5	$ 8.5	$ 7.2

Salary and benefits related expenses were consistent for the three and six months ended June 30, 2008 as compared to the corresponding periods in 2007. Stock compensation increased for the three and six months ended June 30, 2008 as compared to the three and six months ended June 30, 2007 due primarily to an increase in our average stock price. Stock compensation expense may fluctuate from period to period based on the number of options granted, stock price volatility and expected option lives, as well as expected option forfeiture rates which are used to value equity-based compensation. Other contract service and outside costs increased for the three and six months ended June 30, 2008 as compared to the three and six months ended June 30, 2007 due primarily to increased professional services fees.

Other expenses. Total other expenses for the three and six months ended June 30, 2008 were $(0.9) million and $(0.8) million, respectively, compared to $(0.1) million and $0.0 million, respectively, for the corresponding periods in 2007, and represent charges recorded in connection with previously announced restructuring programs. The increase is due primarily to a $1.0 million gain recorded for the three and six months ended June 30, 2008 that was related to an increase in estimated sublease income from a facility closed in connection with a previous restructuring of our operations.

Interest and Other Income, net. Interest and other income, net, for the three and six months ended June 30, 2008 was $1.4 million and $3.5 million, respectively, compared to $3.7 million and $7.8 million for the corresponding periods in 2007. The decrease is due primarily to a lower average cash balance and lower interest rates for the three and six months ended June 30, 2008 as compared to the corresponding periods in 2007.

Interest Expense. Interest expense for the three and six months ended June 30, 2008 was $6.2 million and $12.4 million, respectively, compared to $6.0 million and $11.9 million, respectively, for the corresponding periods in 2007.

Liquidity and Capital Resources

Due to our significant research and development expenditures, we have not been profitable and have generated operating losses since we were incorporated in 1991 through 1996 and in 1999 through June 30, 2008. As such, we have funded our research and development operations through sales of equity securities, the issuance of convertible notes, cash received from customers, and collaborative arrangements. At June 30, 2008, we had available cash, cash equivalents, and short-term and long-term marketable securities of $188.0 million. Our cash and marketable securities balances are held in a variety of interest-bearing instruments including obligations of U.S. government agencies, high-grade corporate bonds, asset backed and mortgage backed securities and government agency and treasury money market accounts. Available cash is invested in accordance with our investment policy s primary objectives of liquidity, safety of principal and diversity of investments.

Net cash used in operating activities was $69.9 million for the six months ended June 30, 2008 and net cash used in operating activities was $41.1 million for the six months ended June 30, 2007. The $28.8 million increase was due primarily to the increase in our net loss during 2008.

Our investing activities, other than purchases, sales and maturities of marketable securities, have consisted predominantly of capital expenditures. Net cash provided by investing activities was $93.7 million for the six months ended June 30, 2008, which represented primarily sales and maturities of marketable securities of $93.8 million. In the future, net cash used by investing activities may fluctuate significantly from period to period due to the timing of capital expenditures, maturities/sales and purchases of marketable securities, and acquisitions, including possible earn-out payments to former stockholders of Maxia.

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Net cash provided by financing activities was $2.1 million and $1.0 million for the six months ended June 30, 2008 and 2007, respectively. For the six months ended June 30, 2008, we received $2.1 million of proceeds from issuance of common stock under our stock plans and employee stock purchase plan. For the six months ended June 30, 2007, we received $1.0 million from issuance of common stock under our stock plans and employee stock purchase plan.

The following summarizes our significant contractual obligations as of June 30, 2008 and the effect those obligations are expected to have on our liquidity and cash flow in future periods:

	Total	Less Than 1 Year	Years 1 - 3 (in millions)	Years 4 - 5	Over 5 Years
Contractual Obligations:					
Principal on convertible subordinated debt	$ 270.0	$	$ 250.0	$ 20.0	$
Principal on convertible senior debt	151.8		151.8		
Interest on convertible subordinated debt	26.3	8.8	17.5		
Interest on convertible senior debt	15.9	5.3	10.6		
Non-cancelable operating lease obligations:					
Related to current operations	9.6	4.8	4.8		
Related to vacated space	21.3	8.1	13.2		
Total contractual obligations	$ 494.9	$ 27.0	$ 447.9	$ 20.0	$

The amounts and timing of payments related to vacated facilities may vary based on negotiated timing of lease terminations. We have entered into sublease agreements for our vacated space with scheduled payments to us of $2.8 million (less than 1 year) and $4.2 million (years 1-3); these scheduled payments are not reflected in the above table.

The table above excludes certain commitments that are contingent upon future events. The most significant of these contractual commitments that we consider to be contingent obligations are summarized below.

Commitments related to Maxia are considered contingent commitments as future events must occur to cause these commitments to be enforceable. In February 2003, we completed our acquisition of Maxia. Under the merger agreement, former Maxia stockholders have the right to receive certain earn out amounts of up to a potential aggregate amount of $14.0 million upon the occurrence of certain research and development milestones set forth in the merger agreement. Twenty percent of each earn out payment, if earned, will be paid in cash and the remaining eighty percent will be paid in shares of our common stock such that an aggregate of $2.8 million in cash and $11.2 million in our common stock (based upon the then fair value) could potentially be paid pursuant to the earn out milestones. The milestones are set to occur as Maxia products enter various stages of human clinical trials and may be earned at any time prior to the tenth anniversary of the consummation of the merger. In any event, no more than 13,531,138 shares of our common stock may be issued to former Maxia stockholders in the aggregate pursuant to the merger agreement. None of these milestones has been achieved as of June 30, 2008.

We have entered into licenses in the past and may in the future continue to seek to license additional rights relating to compounds or technologies in connection with our drug discovery and development programs. Under these licenses, we may be required to pay up-front fees, milestone payments, and royalties on sales of future products.

We believe that our cash, cash equivalents and marketable securities will be adequate to satisfy our capital needs for at least the next twelve months. Our cash requirements depend on numerous factors, including our expenditures in connection with alliances, license agreements and acquisitions of and investments in complementary products, technologies and businesses; expenditures in connection with potential repayments of our 3½% convertible senior notes due 2011, 3½% convertible subordinated notes due 2011, and the Pfizer Notes; expenditures in connection with our drug discovery and development programs; expenditures in connection with litigation or other legal proceedings; competing technological and market developments; the cost of filing, prosecuting, defending and enforcing patent claims and other intellectual property rights; our receipt of any milestone or other payments under any collaborative agreements we may enter into, including the agreement with Pfizer; and costs associated with the integration of new operations assumed through any mergers and acquisitions. Changes in our research and development plans or other changes affecting our operating expenses may result in changes in the timing and amount of expenditures of our capital resources. We expect that future revenues generated from information products, including licensing of intellectual property, will continue to decline as we focus on drug discovery and development programs, and in 2008, will not represent a significant source of cash inflow for us.

Off Balance Sheet Arrangements

We have no off-balance sheet arrangements other than those that are discussed above.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our investments in marketable securities, which are composed primarily of investment-grade corporate bonds, U.S. government

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agency debt securities, mortgage and asset-backed securities and money market funds, are subject to default, changes in credit rating and changes in market value. These investments are also subject to interest rate risk and will decrease in value if market rate interest rates increase. As of June 30, 2008, cash, cash equivalents and short-term and long-term marketable securities were $188.0 million. Due to the nature of these investments, if market interest rates were to increase immediately and uniformly by 10% from levels as of June 30, 2008 the decline in fair value would not be material.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

***Changes in internal control over financial reporting*.** There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II: OTHER INFORMATION

Item 1A. Risk Factors

RISKS RELATING TO OUR BUSINESS

We are at the early stage of our drug discovery and development efforts and we may be unsuccessful in our efforts.

We are in the early stage of building our drug discovery and development operations. Our ability to discover, develop and commercialize pharmaceutical products will depend on our ability to:

- hire and retain key scientific employees;
- identify high quality therapeutic targets;
- identify potential drug candidates;
- develop products internally or license drug candidates from others;
- identify and enroll suitable human subjects, either in the United States or abroad, for our clinical trials;
- complete laboratory testing and clinical trials on humans;
- obtain and maintain necessary intellectual property rights to our products;
- obtain and maintain necessary regulatory approvals for our products, both in the United States and abroad;
- enter into arrangements with third parties to provide services or to manufacture our products on our behalf;
- deploy sales and marketing resources effectively or enter into arrangements with third parties to provide these functions;
- lease facilities at reasonable rates to support our growth; and

- enter into arrangements with third parties to license and commercialize our products.

We have limited experience with the activities listed above and may not be successful in discovering, developing, or commercializing drug products.

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Our efforts to discover and develop potential drug candidates may not lead to the discovery, development, commercialization or marketing of drug products.

Our drug candidates in clinical trials are in early stage Phase I and Phase II trials. Our other drug candidates are still undergoing preclinical testing. We have also licensed to Pfizer our portfolio of CCR2 antagonist compounds. We have no control over the further clinical development of any compounds we licensed to Pfizer. Discovery and development of potential drug candidates are expensive and time-consuming, and we do not know if our efforts will lead to discovery of any drug candidates that can be successfully developed and marketed. If our efforts do not lead to the discovery of a suitable drug candidate, we may be unable to grow our clinical pipeline or we may be unable to enter into agreements with collaborators who are willing to develop our drug candidates. Of the compounds that we identify as potential drug products or that we in-license from other companies, only a few, if any, are likely to lead to successful drug development programs. For example, in 2006, we discontinued the development of DFC, which was at the time our most advanced drug candidate and was in Phase IIb clinical trials. Prior to discontinuation of the DFC program, we expended a significant amount of effort and money on that program.

The success of our drug discovery and development efforts may depend on our ability to find suitable collaborators to fully exploit our capabilities. If we are unable to establish collaborations or if these future collaborations are unsuccessful, our research and development efforts may be unsuccessful, which could adversely affect our results of operations and financial condition.

An important element of our business strategy will be to enter into collaborative or license arrangements with other parties, such as our collaboration with Pfizer, under which we license our drug candidates to those parties for development and commercialization. We expect that while we plan to conduct initial clinical trials on our drug candidates, we may need to seek collaborators for our drug candidates such as our chemokine receptor antagonists because of the expense, effort and expertise required to continue additional clinical trials and further develop those drug candidates. We may also seek collaborators for our drug candidates that target large primary care indications such as diabetes because of the expense involved in further clinical development of these indications and in establishing a sales and marketing organization to address these indications. Because collaboration arrangements are complex to negotiate, we may not be successful in our attempts to establish these arrangements. Also, we may not have drug compounds that are desirable to other parties, or we may be unwilling to license a drug compound because the party interested in it is a competitor. The terms of any such arrangements that we establish may not be favorable to us. Alternatively, potential collaborators may decide against entering into an agreement with us because of our financial, regulatory or intellectual property position or for scientific, commercial or other reasons. If we are not able to establish collaborative agreements, we may not be able to develop and commercialize a drug product, which would adversely affect our business and our revenues.

In order for any of these collaboration or license arrangements to be successful, we must first identify potential collaborators or licensees whose capabilities complement and integrate well with ours. We may rely on these arrangements for not only financial resources, but also for expertise or economies of scale that we expect to need in the future relating to clinical trials, manufacturing, sales and marketing, and for licenses to technology rights. However, it is likely that we will not be able to control the amount and timing of resources that our collaborators or licensees devote to our programs or potential products. If our collaborators or licensees prove difficult to work with, are less skilled than we originally expected or do not devote adequate resources to the program, the relationship will not be successful. If a business combination involving a collaborator or licensees and a third party were to occur, the effect could be to diminish, terminate or cause delays in development of a potential product.

We face significant competition for our drug discovery and development efforts, and if we do not compete effectively, our commercial opportunities will be reduced or eliminated.

The biotechnology and pharmaceutical industries are intensely competitive and subject to rapid and significant technological change. Our drug discovery and development efforts may target diseases and conditions that are already subject to existing therapies or that are being developed by our competitors, many of which have substantially greater resources, larger research and development staffs and facilities, more experience in completing preclinical testing and clinical trials, and formulation, marketing and manufacturing capabilities. As a result of these resources, our competitors may develop drug products that render our products obsolete or noncompetitive by developing more effective drugs or by developing their products more efficiently. Our ability to develop competitive products would be limited if our competitors succeeded in obtaining regulatory approvals for drug candidates more rapidly than we were able to or in obtaining patent protection or other intellectual property rights that limited our drug development efforts. Any drugs resulting from our research and development efforts, or from our joint efforts with collaborators or licensees, might not be able to compete successfully with our competitors existing and future products, or obtain regulatory approval in the United States or elsewhere.

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We depend on our collaboration with Pfizer for the development and commercialization of CCR2 antagonist compounds.

Under our collaborative research and license agreement with Pfizer, Pfizer gained worldwide development and commercialization rights to our portfolio of CCR2 antagonist compounds. Pfizer s rights extend to the full scope of potential indications, with the exception of multiple sclerosis and autoimmune nephritides.

Although Pfizer is required to use commercially reasonable efforts to develop and commercialize CCR2 antagonists for the indications for which they are responsible, we cannot control the amount and timing of resources Pfizer may devote to the development of CCR2 antagonists. Any failure of Pfizer to perform its obligations under our agreement could negatively impact the development of CCR2 antagonists, lead to our loss of potential revenues from product sales and milestones and delay our achievement, if any, of profitability.

Pfizer has certain rights to terminate the license agreement, including the right to terminate upon 90 days notice for any reason. Pfizer also has the right to terminate its rights and obligations with respect to certain indications and licensed compounds. If Pfizer terminates the license agreement or its rights with respect to certain indications, we may not be able to find a new collaborator to replace Pfizer, and our business could be adversely affected.

If conflicts arise between our collaborators, including Pfizer, licensees, or advisors and us, our collaborators, licensees, or advisors may act in their self-interest, which may adversely affect our business.

If conflicts arise between us and our collaborators or licensees, including Pfizer, or our scientific advisors, the other party may act in its self-interest and not in the interest of our stockholders. Conflicts may arise with our collaborators or licensees if they pursue alternative technologies or develop alternative products either on their own or in collaboration with others as a means for developing treatments for the diseases that we have targeted. Competing products, either developed by these future collaborators or licensees or to which these future collaborators or licensees have rights, may result in their withdrawal of support for our product candidates.

Additionally, conflicts may arise if there is a dispute about the achievement and payment of a milestone amount or the ownership of intellectual property that is developed during the course of the relationship. Similarly, the parties to a collaboration or license agreement may disagree as to which party owns newly developed products. Should an agreement be terminated as a result of a dispute and before we have realized the benefits of the collaboration or license, our reputation could be harmed and we may not obtain revenues that we anticipated receiving.

We have limited expertise with and capacity to conduct preclinical testing and clinical trials, and our resulting dependence on other parties could result in delays in and additional costs for our drug development efforts.

We have only limited experience with clinical trials, formulation, manufacturing and commercialization of drug products. We also have limited internal resources and capacity to perform preclinical testing and clinical trials. As a result, we intend to continue to hire Clinical Research Organizations, or CROs, to perform preclinical testing and clinical trials for drug candidates. If the CROs that we hire to perform our preclinical testing and clinical trials or our collaborators or licensees do not meet deadlines, do not follow proper procedures, or a conflict arises between us

and our CROs, our preclinical testing and clinical trials may take longer than expected, may be delayed or may be terminated. If we were forced to find a replacement entity to perform any of our preclinical testing or clinical trials, we may not be able to find a suitable entity on favorable terms, or at all. Even if we were able to find another company to perform a preclinical test or clinical trial, the delay in the test or trial may result in significant additional expenditures. Events such as these may result in delays in our obtaining regulatory approval for our drug candidates or our ability to commercialize our products and could result in increased expenditures that would adversely affect our operating results.

In addition, for some of our drug candidates, we plan to contract with collaborators or licensees to advance those candidates through later-stage, more expensive clinical trials, rather than invest our own resources to perform these clinical trials. Depending on the terms of our agreements with these collaborators or licensees, we may not have any control over the conduct of these clinical trials, and in any event we would be subject to the risks associated with depending on collaborators or licensees to develop these drug candidates.

If we are unable to obtain regulatory approval to develop and market products in the United States and foreign jurisdictions, we will not be permitted to manufacture or commercialize products resulting from our research.

In order to manufacture and commercialize drug products in the United States, our drug candidates will have to obtain regulatory approval from the Food and Drug Administration, or the FDA. Satisfaction of regulatory requirements typically takes many years. To obtain regulatory approval, we must first show that our drug products are safe and effective for target indications through preclinical testing (animal testing) and clinical trials (human testing). Preclinical testing and clinical development are long, expensive and uncertain processes, and we do not know whether the FDA will allow us to undertake clinical trials of any potential drug products in addition to our compounds currently in clinical trials.

Completion of clinical trials may take several years and failure may occur at any stage of testing. The length of time required varies

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substantially according to the type, complexity, novelty and intended use of the product candidate. Interim results of a preclinical test or clinical trial do not necessarily predict final results, and acceptable results in early clinical trials may not be repeated in later clinical trials. For example, a drug candidate that is successful at the preclinical level may cause harmful or dangerous side effects when tested at the clinical level. Our rate of commencement and completion of clinical trials may be delayed by many factors, including:

- the high degree of risk associated with drug development;
- our inability to formulate or manufacture sufficient quantities of materials for use in clinical trials;
- variability in the number and types of patients available for each study;
- difficulty in maintaining contact with patients after treatment, resulting in incomplete data;
- unforeseen safety issues or side effects;
- poor or unanticipated effectiveness of drug candidates during the clinical trials; or
- government or regulatory delays.

Regulatory authorities may delay or prevent the initiation of clinical trials for our drug candidates. For example, we may be unable to successfully complete discussions with the FDA regarding trial design, including agreement on appropriate dosing and specific endpoints, for the registration trials for our JAK inhibitor for myelofibrosis.

Data obtained from clinical trials are susceptible to varying interpretation, which may delay, limit or prevent regulatory approval. A number of companies in the pharmaceutical industry, including biotechnology companies, have suffered significant setbacks in advanced clinical trials, even after achieving promising results in earlier clinical trials. In addition, regulatory authorities may refuse or delay approval as a result of other factors, such as changes in regulatory policy during the period of product development and regulatory agency review. For example, the FDA has in the past required and could in the future require that we conduct additional trials of any of our product candidates, which would result in delays.

Due, in part, to the early stage of our drug candidate research and development process, we cannot predict whether regulatory approval will be obtained for any product we develop. Our drug candidates in clinical trials are in early stage Phase I and Phase II trials. Our other drug candidates are still undergoing preclinical testing. We have also licensed to Pfizer our portfolio of CCR2 antagonist compounds. We have no control over the further clinical development of any compounds we licensed to Pfizer. Compounds developed by us, alone or with other parties, may not prove to be safe and effective in clinical trials and may not meet all of the applicable regulatory requirements needed to receive marketing approval. If regulatory approval of a product is granted, this approval will be limited to those disease states and conditions for which the product is demonstrated through clinical trials to be safe and effective. Failure to obtain regulatory approval would delay or prevent us from commercializing products.

Outside the United States, our ability to market a product is contingent upon receiving a marketing authorization from the appropriate regulatory authorities. This foreign regulatory approval process typically includes all of the risks associated with the FDA approval process described above and may also include additional risks.

We may not obtain a special protocol assessment for our JAK inhibitor for myelofibrosis. A special protocol assessment does not guarantee any particular outcome from regulatory review, including any regulatory approval.

We currently intend to seek a special protocol assessment, or SPA, for the registration trials for our JAK inhibitor for myelofibrosis. The SPA process allows for FDA evaluation of a clinical trial protocol intended to form the primary basis of an efficacy claim in support of a new drug application, or NDA, and provides a product sponsor with an agreement confirming that the design and size of the trial will be appropriate to form the primary basis of an efficacy claim for an NDA if the trial is performed according to the SPA. However, an SPA must be approved by the FDA before the trial can be initiated, and there is no guarantee that an SPA would be granted on a timely basis. Accordingly, if we submit a request for an SPA, the initiation of this trial may be delayed. If we believe that the submission of a request for an SPA will significantly delay the initiation of this trial, we may determine not to submit a request for an SPA. Without the FDA s concurrence on an SPA, we cannot be certain that the design, conduct and data analysis approach for this clinical trial will be sufficient to allow us to submit or receive approval of a JAK inhibitor for the treatment of myelofibrosis.

An SPA is not a guarantee of approval, and we cannot be certain that the design of, or data collected from, the trial will be adequate to demonstrate safety and efficacy, or otherwise be sufficient to support regulatory approval. There can be no assurance that the terms of an SPA will ultimately be binding on the FDA, and the FDA is not obligated to approve an NDA, if any, even if the clinical outcome is positive. The FDA retains significant latitude and discretion in interpreting the terms of an SPA and the data and results from a clinical trial, and can require trial design changes if issues arise essential to determining safety or efficacy. In addition, data may subsequently become available that causes the FDA to reconsider the previously agreed upon scope of review and the FDA may have subsequent safety or efficacy concerns that override an SPA, and we can give no assurance that as clinical trials proceed or as part of an NDA review process, if any, the FDA will determine that a previously approved SPA is still valid.

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Additionally, an SPA may be changed only with written agreement of the FDA, and any further changes we may propose to the protocol will remain subject to the FDA s approval. The FDA may not agree to any such an amendment and, even if they agree, they may request other amendments to the trial design that could require additional cost and time, as well as increase the degree of difficulty in reaching clinical endpoints. As a result, even with an SPA, we cannot be certain that the trial results will be found to be adequate to support an efficacy claim and product approval.

Our reliance on other parties to manufacture our drug candidates could result in a short supply of the drugs, delays in clinical trials or drug development, increased costs and withdrawal or denial of the regulatory authority s approval.

We do not currently operate manufacturing facilities for clinical or commercial production of our drug candidates. We expect to continue to rely on third parties for the manufacture of our drug candidates and any drug products that we may develop. The FDA requires that drug products be manufactured according to its current Good Manufacturing Practices, or cGMP, regulations and a limited number of manufacturers comply with these requirements. If the other parties that we choose to manufacture our drug products are not compliant with cGMP, the FDA may not approve our application to manufacture our drug products. We may not be able to arrange for our drug candidates or any drug products that we may develop to be manufactured by one of these parties on reasonable terms, if at all. Failure to comply with cGMP in the manufacture of our products could result in the FDA withdrawing or denying regulatory approval of our drug product or other enforcement actions.

We may not be able to obtain sufficient quantities of our drug candidates or any drug products we may develop if our designated manufacturers do not have the capacity or capability to manufacture our products according to our schedule and specifications. Also, raw materials that may be required to manufacture any products we develop may only be available from a limited number of suppliers. If we have promised delivery of a new product and are unable to meet the delivery requirement due to manufacturing difficulties, our development programs would be delayed, and we may have to expend additional sums in order to ensure that manufacturing capacity is available when we need it even if we do not use all of the manufacturing capacity. This expense would adversely affect our operating results.

Manufacturers of pharmaceutical products often encounter difficulties in production, especially in scaling up initial production. These problems include difficulties with production costs and yields, quality control and assurance and shortages of qualified personnel, as well as compliance with strictly enforced federal, state and foreign regulations. We may not be able to adequately manage and oversee the manufacturers we choose, they may not perform as agreed or they may terminate their agreements with us. Foreign manufacturing approval processes typically include all of the risks associated with the FDA approval process for manufacturing and may also include additional risks.

We may incur additional expense in order to market our drug products.

We do not have experience marketing drug products. If the FDA grants regulatory approval to one or more of our drug candidates, we would have to employ additional personnel or engage another party to market our drug products, which would be an additional expense to us.

We might not be able to commercialize our drug candidates successfully, and we may spend significant time and money attempting to do so.

We have a limited number of drug candidates in early stage Phase I and Phase II clinical trials. We have also licensed to Pfizer our portfolio of CCR2 antagonist compounds. We, or our collaborators or licensees, may decide to discontinue development of any or all of our drug candidates at any time for commercial, scientific or other reasons. We discontinued development of DFC in April 2006 for safety reasons. We recently announced that we would not advance our lead CCR5 antagonist into Phase IIb trials and that we are seeking to out-license this program. If a product is developed, but is not marketed, we may have spent significant amounts of time and money on it, which would adversely affect our operating results and financial condition. Even if a drug candidate that we develop receives regulatory approval, we may decide not to commercialize it if we determine that commercialization of that product would require more money and time than we are willing to invest. For example, drugs that receive approval are subject to post-regulatory surveillance and may have to be withdrawn from the market if previously unknown side effects occur. At this point, the regulatory agencies may require additional clinical trials or testing. Once a drug is marketed, if it causes side effects, the drug product may be recalled or may be subject to reformulation, additional studies, changes in labeling, warnings to the public and negative publicity. As a result, we may not continue to commercialize a product even though it has obtained regulatory approval. Further, we may decide not to continue to commercialize a product if the market does not accept the product because it is too expensive and third parties such as insurance companies or Medicare have not approved it for substantial reimbursement. In addition, we may decide not to continue to commercialize a product if another product comes on the market that is as effective but has fewer side effects. There is also a risk that competitors may develop similar or superior products or have proprietary rights that preclude us from ultimately marketing our products.

If we fail to enter into additional licensing agreements or if these arrangements are unsuccessful, our business and operations might be adversely affected.

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In addition to establishing collaborative or license arrangements under which other parties license our drug candidates for development and commercialization, we intend to continue to explore opportunities to develop our clinical pipeline by in-licensing drug compounds that fit within our expertise and research and development capabilities. We may be unable to enter into any additional in-licensing agreements because suitable product candidates that are within our expertise may not be available to us on terms that are acceptable to us or because competitors with greater resources seek to in-license the same product candidates. Product candidates that we would like to develop may not be available to us because they are controlled by competitors who are unwilling to license the rights to the drug compound or candidate to us. In addition, we may enter into license agreements that are unsuccessful and our business and operations might be adversely affected by the termination of a drug candidate and termination and winding down of the related license agreement. For example, in April 2006, we announced the discontinuation of development of DFC and we gave notice of termination of our collaborative license agreement with Pharmasset, Inc., which licensed DFC to us. DFC was at the time our most advanced drug candidate. We may also need to license drug delivery or other technology in order to continue to develop our drug candidate pipeline. If we are unable to enter into additional agreements to license drug candidates, drug delivery technology or other technology or if these arrangements are unsuccessful, our research and development efforts could be adversely affected.

Our ability to generate revenues will be diminished if we are unable to obtain acceptable prices or an adequate level of reimbursement from payors of healthcare costs.

The continuing efforts of government and insurance companies, health maintenance organizations, or HMOs, and other payors of healthcare costs to contain or reduce costs of health care may affect our future revenues and profitability, and the future revenues and profitability of our potential customers, suppliers and collaborative or license partners and the availability of capital. For example, in certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. In the United States, given recent federal and state government initiatives directed at lowering the total cost of health care, the U.S. Congress and state legislatures will likely continue to focus on health care reform, the cost of prescription pharmaceuticals and on the reform of the Medicare and Medicaid systems. While we cannot predict whether any such legislative or regulatory proposals will be adopted, the announcement or adoption of these proposals could reduce the price that we or any of our collaborators or licensees receive for any products in the future.

Our ability to commercialize our products successfully will depend in part on the extent to which appropriate reimbursement levels for the cost of our products and related treatment are obtained by governmental authorities, private health insurers and other organizations, such as HMOs. Third-party payors are increasingly challenging the prices charged for medical products and services. Also, the trend toward managed health care in the United States and the concurrent growth of organizations such as HMOs, which could control or significantly influence the purchase of health care services and products, as well as legislative proposals to reform health care or reduce government insurance programs, may all result in lower prices for or rejection of our products. The cost containment measures that health care payors and providers are instituting and the effect of any health care reform could materially and adversely affect our ability to generate revenues.

As our drug discovery and development operations are conducted at our headquarters in Wilmington, Delaware, the loss of access to this facility would negatively impact our business.

Our facility in Wilmington, Delaware is our headquarters and is also where we conduct all of our drug discovery operations and research and development activities. Our lease contains provisions that provide for its early termination upon the occurrence of certain events of default or upon a change of control. Further, our headquarters facility is located in a large research and development complex that may be temporarily or permanently shutdown if certain environmental or other hazardous conditions were to occur within the complex. In addition, actions of activists opposed to aspects of pharmaceutical research may disrupt our experiments or our ability to access or use our facilities. The loss of access to or use of our Wilmington, Delaware, facility, either on a temporary or permanent basis, or early termination of our lease would result in an interruption of our business and, consequently, would adversely affect the advancement of our drug discovery and development programs and our overall business.

We depend on key employees in a competitive market for skilled personnel, and the loss of the services of any of our key employees or our inability to attract and retain additional personnel would affect our ability to expand our drug discovery and development programs and achieve our objectives.

We are highly dependent on the principal members of our management, operations and scientific staff. We experience intense competition for qualified personnel. Our future success also depends in part on the continued service of our executive management team, key scientific and management personnel and our ability to recruit, train and retain essential scientific personnel for our drug discovery and development programs, including those who will be responsible for overseeing our preclinical testing and clinical trials as well as for the establishment of collaborations with other companies. If we lose the services of any of these people or if we are unable to recruit sufficient qualified personnel, our research and product development goals, including the identification and establishment of key collaborations, operations and marketing efforts could be delayed or curtailed. We do not maintain key person insurance on any of our employees.

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If we fail to manage our growth effectively, our ability to develop and commercialize products could suffer.

We expect that if our clinical drug candidates continue to progress in development, we continue to build our development organization and our drug discovery efforts continue to generate drug candidates, we will require significant additional investment in personnel, management and resources. Our ability to commercialize our drug candidates and to achieve our research and development objectives depends on our ability to respond effectively to these demands and expand our internal organization, systems and controls to accommodate additional anticipated growth. If we are unable to manage our growth effectively, our business could be harmed and our ability to execute our business strategy could suffer.

We may encounter difficulties in integrating companies we acquire, which may harm our operations and financial results.

As part of our business strategy, we have in the past and may in the future acquire assets, technologies, compounds and businesses. Our past acquisitions, such as the acquisition of Maxia have involved, and our future acquisitions may involve, risks such as the following:

- we may be exposed to unknown liabilities of acquired companies;

- our acquisition and integration costs may be higher than we anticipated and may cause our quarterly and annual operating results to fluctuate;

- we may experience difficulty and expense in assimilating the operations and personnel of the acquired businesses, disrupting our business and diverting our management s time and attention;

- we may be unable to integrate or complete the development and application of acquired technology, compounds or drug candidates;

- we may experience difficulties in establishing and maintaining uniform standards, controls, procedures and policies;

- our relationships with key customers, suppliers or collaborative or license partners of acquired businesses may be impaired, due to changes in management and ownership of the acquired businesses;

- we may be unable to retain key employees of the acquired businesses;

- we may incur amortization or impairment expenses if an acquisition results in significant goodwill or other intangible assets; or

- our stockholders may be diluted if we pay for the acquisition with equity securities.

If product liability lawsuits are brought against us, we could face substantial liabilities and may be required to limit commercialization of our products and our results of operations could be harmed.

The clinical trials and marketing of medical products that are intended for human use entails an inherent risk of product liability. If any product that we or any of our collaborators or licensees develops causes or is alleged to cause injury or is found to be unsuitable during clinical trials, manufacturing or sale, we may be held liable. If we cannot successfully defend ourselves against product liability claims, we may incur substantial liabilities, including substantial damages to be paid to the plaintiffs and legal costs, or we may be required to limit commercialization of our products. Our product liability insurance policy that provides coverage for liabilities arising from our clinical trials may not fully cover our potential liabilities. In addition, we may determine that we should increase our coverage upon the undertaking of new clinical trials, and this insurance may be prohibitively expensive to us or our collaborators or licensees and may not fully cover our potential liabilities. Our inability to obtain sufficient product liability insurance at an acceptable cost to protect against potential product liability claims could prevent or inhibit the commercialization of pharmaceutical products we develop, alone or with our collaborators. Additionally, any product liability lawsuit could cause injury to our reputation, recall of products, participants to withdraw from clinical trials, and potential collaborators or licensees to seek other partners, any of which could impact our results of operations.

Because our activities involve the use of hazardous materials, we may be subject to claims relating to improper handling, storage or disposal of these materials that could be time consuming and costly.

We are subject to various environmental, health and safety laws and regulations governing, among other things, the use, handling, storage and disposal of regulated substances and the health and safety of our employees. Our research and development processes involve the controlled use of hazardous and radioactive materials and biological waste resulting in the production of hazardous waste products. We cannot completely eliminate the risk of accidental contamination or discharge and any resultant injury from these materials. If any injury or contamination results from our use or the use by our collaborators or licensees of these materials, we may be sued and our liability may exceed our insurance coverage and our total assets. Further, we may be required to indemnify our collaborators or licensees against all damages and other liabilities arising out of our development activities or products produced in connection with these collaborations or licenses. Compliance with the applicable environmental and workplace laws and regulations is

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expensive. Future changes to environmental, health, workplace and safety laws could cause us to incur additional expense or may restrict our operations or impair our research, development and production efforts.

RISKS RELATING TO OUR FINANCIAL RESULTS

We expect to incur losses in the future and we may not achieve or maintain profitability in the future.

We had net losses from inception in 1991 through 1996 and in 1999 through 2008. Because of those losses, we had an accumulated deficit of $1.1 billion as of June 30, 2008. We will continue to spend significant amounts on our efforts to discover and develop drugs. As a result, we expect to continue to incur losses in 2008 and in future periods as well.

We anticipate that our drug discovery and development efforts and related expenditures will increase as we focus on the studies, including preclinical tests and clinical trials prior to seeking regulatory approval, that are required before we can sell a drug product. The development of drug products will require us to spend significant funds on research, development, testing, obtaining regulatory approvals, manufacturing and marketing. To date, we do not have any drug products that have generated revenues and we cannot assure you that we will generate revenues from the drug candidates that we license or develop for several years, if ever. We cannot be certain whether or when we will achieve profitability because of the significant uncertainties relating to our ability to generate commercially successful drug products. Even if we were successful in obtaining regulatory approvals for manufacturing and commercializing a drug candidate, we expect that we will continue to incur losses if our drug products do not generate significant revenues. If we achieve profitability, we may not be able to sustain or increase profitability.

We will need additional capital in the future. The capital markets may not permit us to raise additional capital at the time that we require it, which could result in limitations on our research and development or commercialization efforts or the loss of certain of our rights in our technologies or drug candidates.

Our future funding requirements will depend on many factors and we anticipate that we will need to raise additional capital to fund our business plan and research and development efforts going-forward. Additional factors that may affect our future funding requirements include:

- any changes in the breadth of our research and development programs;
- the results of research and development, preclinical testing and clinical trials conducted by us or our future collaborative partners or licensees, if any;
- the acquisition or licensing of businesses, technologies or compounds, if any;

- our ability to maintain and establish new corporate relationships and research collaborations;

- competing technological and market developments;

- the amount of revenues generated from our business activities, if any;

- the time and costs involved in filing, prosecuting, defending and enforcing patent and intellectual property claims;

- the receipt of contingent licensing or milestone fees or royalties on product sales from our current or future collaborative and license arrangements, if established; and

- the timing of regulatory approvals, if any.

If we require additional capital at a time when investment in companies such as ours, or in the marketplace generally, is limited due to the then prevailing market or other conditions, we may have to scale back our operations, eliminate one or more of our research or development programs, or attempt to obtain funds by entering into an agreement with a collaborative partner that would result in terms that are not favorable to us or relinquishing our rights in certain of our proprietary technologies or drug candidates. If we are unable to raise funds at the time that we desire or at any time thereafter on acceptable terms, we may not be able to continue to develop our potential drug products. The sale of equity or additional convertible debt securities in the future would be dilutive to our stockholders, and debt financing arrangements may require us to pledge certain assets or enter into covenants that could restrict our operations or our ability to incur further indebtedness.

Our current revenues are derived from collaborations and from licensing our intellectual property. If we are unable to achieve milestones, develop products or renew or enter into new collaborations, our revenues may decrease, and future milestone and royalty payments from our gene and genomics-related intellectual property may not contribute significantly to revenues for several years, and may never result in revenues.

We derived substantially all of our revenues for the six months ended June 30, 2008 from our collaborative research and license agreement with Pfizer and from licensing our intellectual property to others. We may be unable to enter into additional collaborative agreements. Revenues from research and development collaborations depend upon continuation of the collaborations, the achievement

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of milestones and royalties we earn from any future products developed from our research. If we are unable to successfully achieve milestones or our collaborators fail to develop successful products, we will not earn the revenues contemplated under our collaborative agreements. Part of our prior strategy was to license to our database customers and to other pharmaceutical and biotechnology companies our know-how and patent rights associated with the information we have generated in the creation of our proprietary databases, for use in the discovery and development of potential pharmaceutical, diagnostic or other products. Any potential product that is the subject of such a license will require several years of further development, clinical trials and regulatory approval before commercialization, all of which is beyond our control, and possibly beyond the control of our licensee. These licensees may not develop the potential product if they do not devote the necessary resources or decide that they do not want to expend the resources to do the clinical trials necessary to obtain the necessary regulatory approvals. Therefore, milestone or royalty payments from these licenses may not contribute to our revenues for several years, if at all. We have decided to discontinue some of our gene and genomics-related patent prosecution and maintenance, and may in the future decide to discontinue additional gene and genomics-related patent prosecution and maintenance, which could limit our ability to receive license-based revenues from our gene and genomics-related patent portfolio.

We have a large amount of debt and our debt service obligations may prevent us from taking actions that we would otherwise consider to be in our best interests.

As of June 30, 2008, the aggregate principal amount of total consolidated debt was $421.8 million and our stockholders deficit was $237.2 million. The documents pursuant to which our outstanding convertible senior and subordinated notes were issued do not limit the issuance of additional indebtedness. Our substantial leverage could have significant negative consequences for our future operations, including:

- increasing our vulnerability to general adverse economic and industry conditions;

- limiting our ability to obtain additional financing for working capital, capital and research and development expenditures, and general corporate purposes;

- requiring the dedication of a substantial portion of our expected cash flow or our existing cash to service our indebtedness, thereby reducing the amount of our cash available for other purposes, including working capital, capital expenditures and research and development expenditures;

- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we compete; or

- placing us at a possible competitive disadvantage compared to less leveraged competitors and competitors that have better access to capital resources;

In the past five years, we have had negative cash flow from operations. We likely will not generate sufficient cash flow from our operations in the future to enable us to meet our anticipated fixed charges, including our debt service requirements with respect to our outstanding convertible senior notes and convertible subordinated notes. As of June 30, 2008, $151.8 million aggregate principal amount of our 3½% convertible senior notes due 2011 was outstanding. Our annual interest payments, beginning in 2007, for the 3½% convertible senior notes through 2010, assuming none of these notes are converted, redeemed, repurchased or exchanged, are $5.3 million, and an additional $2.6 million in interest is payable in 2011. As of June 30, 2008, $250.0 million aggregate principal amount of our 3½% convertible subordinated notes due 2011 was outstanding. Our annual interest payments for the 3½% convertible subordinated notes through 2010, assuming none of these notes are converted, redeemed, repurchased or exchanged, are $8.8 million, and an additional $4.4 million in interest is payable in 2011. As of June 30, 2008, $20.0 million aggregate principal amount of the non-interest bearing convertible subordinated notes held by Pfizer was outstanding, of which $10.0 million is due in 2013 and $10.0 million is due in 2014. If we are unable to generate cash from our operations or raise additional cash through financings sufficient to meet these obligations, we will need to use existing cash or liquidate marketable securities in order to fund these obligations, which may delay or curtail our research, development and commercialization programs.

RISKS RELATING TO INTELLECTUAL PROPERTY AND LEGAL MATTERS

If we are subject to arbitration, litigation and infringement claims, they could be costly and disrupt our drug discovery and development efforts.

The technology that we use to make and develop our drug products, the technology that we incorporate in our products, and the products we are developing may be subject to claims that they infringe the patents or proprietary rights of others. The success of our drug discovery and development efforts will also depend on our ability to develop new compounds, drugs and technologies without infringing or misappropriating the proprietary rights of others. We are aware of patents and patent applications filed in certain countries claiming intellectual property relating to some of our drug discovery targets and product candidates. While the validity of issued patents, patentability of pending patent applications and applicability of any of them to our programs are uncertain, if any of these patents are asserted against us or if we choose to license any of these patents, our ability to commercialize our products could be harmed or the potential return to us from any product that may be successfully commercialized could be diminished.

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From time to time we have received, and we may in the future receive, notices from third parties offering licenses to technology or alleging patent, trademark, or copyright infringement, claims regarding trade secrets or other contract claims. Receipt of these notices could result in significant costs as a result of the diversion of the attention of management from our drug discovery and development efforts. Parties sending these notices may have brought and in the future may bring litigation against us or seek arbitration relating to contract claims.

We may be involved in future lawsuits or other legal proceedings alleging patent infringement or other intellectual property rights or contract violations. In addition, litigation or other legal proceedings may be necessary to:

- assert claims of infringement;
- enforce our patents or trademarks;
- protect our trade secrets or know-how; or
- determine the enforceability, scope and validity of the proprietary rights of others.

We may be unsuccessful in defending or pursuing these lawsuits, claims or other legal proceedings. Regardless of the outcome, litigation or other legal proceedings can be very costly and can divert management s efforts. For example, we settled patent litigation with Invitrogen Corporation in 2006. We incurred significant expenses related to this litigation and, as part of the settlement, paid Invitrogen $3.4 million. An adverse determination may subject us to significant liabilities or require us or our collaborators or licensees to seek licenses to other parties patents or proprietary rights. We or our collaborators or licensees may also be restricted or prevented from manufacturing or selling a drug or other product that we or they develop. Further, we or our future collaborators or licensees may not be able to obtain any necessary licenses on acceptable terms, if at all. If we are unable to develop non-infringing technology or license technology on a timely basis or on reasonable terms, our business could be harmed.

We may be unable to adequately protect or enforce our proprietary information, which may result in its unauthorized use, a loss of revenue under a collaboration agreement or loss of sales to generic versions of our products or otherwise reduce our ability to compete in developing and commercializing products.

Our business and competitive position depends in significant part upon our ability to protect our proprietary technology, including any drug products that we create. Despite our efforts to protect this information, unauthorized parties may attempt to obtain and use information that we regard as proprietary. For example, one of our collaborators may disclose proprietary information pertaining to our drug discovery efforts. In addition, while we have filed numerous patent applications with respect to our product candidates in the United States and in foreign countries, our patent applications may fail to result in issued patents. In addition, because patent applications can take several years to issue as patents, there may be pending patent applications of others that may later issue as patents that cover some aspect of our drug candidates. Our existing patents and any future patents we may obtain may not be broad enough to protect our products or all of the potential uses of our products, or

otherwise prevent others from developing competing products or technologies. In addition, our patents may be challenged and invalidated or may fail to provide us with any competitive advantages if, for example, others were first to invent or first to file a patent application for the technologies and products covered by our patents.

Additionally, when we do not control the prosecution, maintenance and enforcement of certain important intellectual property, such as a drug compound in-licensed to us or subject to a collaboration with a third party, the protection of the intellectual property rights may not be in our hands. If we do not control the intellectual property rights in-licensed to us with respect to a compound and the entity that controls the intellectual property rights does not adequately protect those rights, our rights may be impaired, which may impact our ability to develop, market and commercialize the in-licensed compound.

Our means of protecting our proprietary rights may not be adequate, and our competitors may:

- independently develop substantially equivalent proprietary information, products and techniques;
- otherwise gain access to our proprietary information; or
- design around patents issued to us or our other intellectual property.

We pursue a policy of having our employees, consultants and advisors execute proprietary information and invention agreements when they begin working for us. However, these agreements may not provide meaningful protection for our trade secrets or other proprietary information in the event of unauthorized use or disclosure. If we fail to maintain trade secret and patent protection, our potential, future revenues may be decreased.

If the effective term of our patents is decreased due to changes in the United States patent laws or if we need to refile some of our patent applications, the value of our patent portfolio and the revenues we derive from it may be decreased.

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The value of our patents depends in part on their duration. A shorter period of patent protection could lessen the value of our rights under any patents that we obtain and may decrease the revenues we derive from our patents. The United States patent laws were amended in 1995 to change the term of patent protection from 17 years from patent issuance to 20 years from the earliest effective filing date of the application. Because the time from filing to issuance of biotechnology applications may be more than three years depending on the subject matter, a 20-year patent term from the filing date may result in substantially shorter patent protection. Also, we may need to refile some of our applications filed before 1995 that claim large numbers of genes or other additional subject matter and, in these situations, the patent term will be measured from the date of the earliest priority application. This would shorten our period of patent exclusivity and may decrease the revenues that we might derive from the patents.

International patent protection is particularly uncertain and costly, and if we are involved in opposition proceedings in foreign countries, we may have to expend substantial sums and management resources.

Biotechnology and pharmaceutical patent law outside the United States is even more uncertain and costly than in the United States and is currently undergoing review and revision in many countries. Further, the laws of some foreign countries may not protect our intellectual property rights to the same extent as United States laws. For example, certain countries do not grant patent claims that are directed to the treatment of humans. We may participate in opposition proceedings to determine the validity of our foreign patents or our competitors foreign patents, which could result in substantial costs and diversion of our efforts.

Item 4. Submission of Matters to a Vote of Security Holders

On May 22, 2008, we held our Annual Meeting of Stockholders.

The following actions were taken at the annual meeting:

1. The following Directors were elected:

	For	Withheld
Richard U. De Schutter	60,803,437	5,326,579
Barry M. Ariko	62,797,553	3,332,463
Julian C. Baker	61,702,837	4,427,179
Paul A. Brooke	62,714,326	3,415,690
Matthew W. Emmens	65,596,726	533,290
Paul A. Friedman	65,720,792	409,224

John F. Niblack	65,714,043	415,973
Roy A. Whitfield	44,688,739	21,441,277

2. The amendment to our 1991 Stock Plan was approved.

For	Against	Abstain	Broker Non-Votes
44,923,314	10,416,484	37,675	33,029,439

3. The amendment to our 1997 Employee Stock Purchase Plan was approved.

For	Against	Abstain	Broker Non-Votes
51,611,997	3,717,129	42,347	33,029,439

4. The ratification of the appointment of Ernst & Young LLP as our independent registered public accounting firm for the 2008 fiscal

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year was approved.

For	Against	Abstain
65,613,875	451,105	65,036

Item 6. Exhibits

Exhibit Number	Description of Document
10.1#	1991 Stock Plan of Incyte Corporation, as amended
10.2#	1997 Employee Stock Plan of Incyte Corporation, as amended
31.1	Rule 13a 14(a) Certification of Chief Executive Officer
31.2	Rule 13a 14(a) Certification of Chief Financial Officer
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32.2*	Statement of the Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C Section 1350)

# Indicates management contract or compensatory plan or arrangement.

* In accordance with Item 601(b)(32)(ii) of Regulation S-K and SEC Release Nos. 33-8238 and 34-47986, Final Rule: Management s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, the certifications furnished in Exhibits 32.1 and 32.2 hereto are deemed to accompany this Form 10-Q and will not be deemed filed for purpose of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

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SIGNATURES

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

INCYTE CORPORATION

Dated:	July 29, 2008	By:	/s/ PAUL A. FRIEDMAN PAUL A. FRIEDMAN Chief Executive Officer (Principal Executive Officer)
Dated:	July 29, 2008	By:	/s/ DAVID C. HASTINGS DAVID C. HASTINGS Chief Financial Officer (Principal Financial Officer)

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INCYTE CORPORATION

EXHIBIT INDEX

Exhibit Number	Description of Document
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