

LYNX THERAPEUTICS INC

Form 10-Q

August 13, 2004

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**for the quarterly period ended June 30, 2004**

**OR**

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**for the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 0-22570**

**Lynx Therapeutics, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**94-3161073**  
(I.R.S. Employer  
Identification No.)

**25861 Industrial Blvd.**  
**Hayward, CA 94545**  
(Address of principal executive offices)

**(510) 670-9300**  
(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. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares of common stock outstanding as of August 3, 2004 was 7,527,538.

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**Lynx Therapeutics, Inc.**

**FORM 10-Q**  
**For the Quarter Ended June 30, 2004**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Lynx Therapeutics, Inc.****CONDENSED CONSOLIDATED BALANCE SHEETS***(In thousands)**(Unaudited)*

	<b>June 30, 2004</b>	<b>December 31, 2003</b>
	<b>(unaudited)</b>	<b>(*)</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 1,116	\$ 4,881
Restricted cash	364	728
Short term investments	905	
Accounts receivable	599	402
Inventory	937	904
Other current assets	296	722
	<hr/>	<hr/>
Total current assets	4,217	7,637
Property and equipment:		
Leasehold improvements	7,668	11,510
Laboratory and other equipment	20,375	21,667
	<hr/>	<hr/>
	28,043	33,177
Less accumulated depreciation and amortization	(18,841)	(22,190)
	<hr/>	<hr/>
Net property and equipment	9,202	10,987
Intangible assets, net	2,403	
Other non-current assets	256	172
	<hr/>	<hr/>
	\$ 16,078	\$ 18,796
	<hr/>	<hr/>
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 630	\$ 1,070
Accrued compensation	357	284
Accrued professional fees	213	181
Deferred revenue - current portion	759	759

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Note payable - current portion	460	1,128
Other accrued liabilities	119	163
	<u>          </u>	<u>          </u>
Total current liabilities	2,538	3,585
Deferred revenues	4,027	4,213
Other non-current liabilities	906	932
Stockholders' equity:		
Common stock	124,097	117,722
Accumulated other comprehensive income	16	17
Accumulated deficit	(115,506)	(107,673)
	<u>          </u>	<u>          </u>
Total stockholders' equity	8,607	10,066
	<u>          </u>	<u>          </u>
	\$ 16,078	\$ 18,796
	<u>          </u>	<u>          </u>

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\* The balance sheet amounts at December 31, 2003 have been derived from audited financial statements at that date but do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

*See accompanying notes.*

**Table of Contents****Lynx Therapeutics, Inc.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS***(In thousands, except per share amounts)  
(Unaudited)]*

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Net revenues:				
Technology access and service fees	\$ 1,486	\$ 4,187	\$ 2,626	\$ 7,187
License fees from related party	190	190	380	380
Collaborative research and other	67	208	78	282
	<u>1,743</u>	<u>4,585</u>	<u>3,084</u>	<u>7,849</u>
Total revenues				
Operating costs and expenses:				
Services fees and other	1,320	1,377	2,670	2,101
Research and development	2,601	3,196	5,064	6,761
General and administrative	1,500	1,893	3,087	3,678
Special charge for workforce reduction	16	—	118	292
	<u>5,437</u>	<u>6,466</u>	<u>10,939</u>	<u>12,832</u>
Total operating costs and expenses				
Loss from operations	(3,694)	(1,881)	(7,855)	(4,983)
Equity in net loss of related party	—	(891)	—	(1,716)
Interest income (expense), net	(3)	(84)	(21)	(128)
Other income (expense), net	86	—	44	—
	<u>(3,611)</u>	<u>(2,856)</u>	<u>(7,832)</u>	<u>(6,827)</u>
Net loss before provision for income taxes				
Provision for income taxes	1	1	1	2
	<u>(3,612)</u>	<u>(2,857)</u>	<u>(7,833)</u>	<u>(6,829)</u>
Net loss				
Basic income/(loss) per share	<u>(0.48)</u>	<u>(0.61)</u>	<u>(1.13)</u>	<u>(1.47)</u>
Shares used in computation of loss per share	<u>7,450</u>	<u>4,654</u>	<u>6,924</u>	<u>4,653</u>

*See accompanying notes.*

**Table of Contents****Lynx Therapeutics, Inc.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS***(In thousands)**(Unaudited)*

	<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$(7,833)	\$ (6,829)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,879	1,863
Stock based compensation expense	3	
Amortization of deferred compensation		9
Common stock issued in connection with acquisition of supplies	70	
Equity in net loss of related party		1,716
Loss/(gain) on disposal of fixed assets	(94)	
Changes in operating assets and liabilities:		
Accounts receivable	(197)	(340)
Inventory	(33)	18
Prepaid expenses and other current assets	426	283
Accounts payable	(440)	238
Other accrued liabilities	61	(192)
Deferred revenues	(185)	(4,070)
Other assets	(84)	
Non-current liabilities	(26)	(22)
	<hr/>	<hr/>
Net cash used in operating activities	(6,453)	(7,326)
<b>Cash flows from investing activities:</b>		
Purchase of short-term investments	(906)	
Purchases of property and equipment	(14)	(245)
Proceeds from sale of equipment	94	
	<hr/>	<hr/>
Net cash used in investing activities	(826)	(245)
<b>Cash flows from financing activities:</b>		
Issuance of common stock, net of repurchases	3,818	14
Repayment of equipment loan	(668)	(1,178)
	<hr/>	<hr/>
Net cash provided by (used in) financing activities	3,150	(1,164)
	<hr/>	<hr/>
Net increase (decrease) in cash and cash equivalents	(4,129)	(8,735)
Cash and cash equivalents at beginning of period	5,609	11,735



Cash and cash equivalents at end of period	\$ 1,480	\$ 3,000
<b>Supplemental schedule of non-cash investing activities</b>		
Cash paid during the period for income taxes	\$ 1	\$ 2
Interest paid	\$ 34	\$ 134
Common stock issued in connection with the acquisition of intellectual property and equipment.	\$ 2,554	\$

*See accompanying notes.*

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**Lynx Therapeutics, Inc.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2004**

**1. Nature of Business**

We believe that Lynx Therapeutics, Inc. ( Lynx or the Company ) is a leader in the development and application of novel genomics analysis solutions that provide comprehensive and quantitative digital gene expression information important to modern systems biology research in the pharmaceutical, biotechnology and agricultural industries. These solutions are based on Megaclone and Massively Parallel Signature Sequencing, or MPSS, Lynx's unique and proprietary cloning and sequencing technologies. Gene expression refers to the number of genes and the extent a cell or tissue expresses those genes, and represents a way to move beyond DNA sequence data to understand the function of genes, the proteins they encode and the role they play in health and disease. Systems biology is an approach in which researchers seek to gain a complete molecular understanding of biological systems in health and disease.

In April 2004, Lynx and UK-based Solexa Ltd. ( Solexa ), jointly acquired from Swiss-based Manteia SA ( Manteia ), the rights to proprietary technology assets for DNA colony generation. We intend to incorporate the acquired technology assets into our MPSS process, with the goal of streamlining sequencing service operations and developing commercial sequencing instrumentation for widespread laboratory use. The cluster technology is expected to improve our current bead-based sequencing process by delivering higher density, thus greater information content. We also intend to improve the MPSS technology by developing a battery of new sequencing assays beyond our current gene expression assays for various epigenomic and functional genomic applications.

**2. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements included herein have been prepared by Lynx without audit, pursuant to the rules and regulations promulgated by the Securities and Exchange Commission (the SEC ). Certain prior year amounts have been reclassified to conform to current year presentation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to SEC rules and regulations; nevertheless, Lynx believes that the disclosures are adequate to make the information presented not misleading. In the opinion of management, the financial statements contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position, results of operations and cash flows of the Company for the interim periods presented. The results of operations for the six months ended June 30, 2004 are not necessarily indicative of the results for the full year.

Our unaudited condensed consolidated financial statements have been presented on a basis that contemplates the realization of assets and satisfaction of liabilities in the normal course of business. We have experienced operating losses since our inception of \$115.5 million, including a net loss of \$3.6 million and \$7.8 million for the three and six months ended June 30, 2004, respectively. We expect to continue to incur net losses as we proceed with the commercialization and additional development of our technologies. Our cash and cash equivalents and short-term investments were \$2.4 million at June 30, 2004, which includes restricted cash of \$0.4 million. It was anticipated that these funds in combination with forecasted revenues and the ability to raise additional outside capital would be sufficient to meet our projected operating and capital requirements through at least December 31, 2004. Our revenues through June 2004 have been significantly less than had been forecasted at the beginning of this calendar year and we continue to pursue various options to raise additional funds, which will be required to allow us to continue our business activities through December 31, 2004. These options include securing additional equity financing and

obtaining new collaborators and customers. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. There can be no assurance that additional financing will be available on satisfactory terms, or at all. If we are unable to secure additional financing, or are unable to generate sufficient new sources of revenue through arrangements with customers, collaborators and licensees, we will be forced to take substantial restructuring actions, which may include significantly reducing our anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds

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by entering into financing or collaborative agreements on unattractive terms, or we will not be able to continue to operate.

The unaudited condensed consolidated financial statements include all accounts of Lynx and our wholly-owned subsidiary, Lynx Therapeutics GmbH ( Lynx GmbH ), formed under the laws of the Federal Republic of Germany. All significant intercompany balances and transactions have been eliminated.

These financial statements should be read in conjunction with Lynx's audited consolidated financial statements and notes thereto for the year ended December 31, 2003, included in Lynx's annual report on Form 10-K, as amended, filed with the SEC.

### **3. Summary of Significant Accounting Policies**

#### **Revenue Recognition**

Technology access fees have generally resulted from upfront payments from collaborators, customers and licensees who are provided access to our technologies for specified periods. We receive service fees from collaborators and customers for genomics discovery services performed by us on the biological samples they send to us. Collaborative research revenues are payments received under various agreements and include such items as milestone payments. Milestone payments are recognized as revenue pursuant to collaborative agreements upon the achievement of specified technology developments, representing the culmination of the earnings process. Other revenues include the proceeds from the sale of technology assets, the sale of proprietary instruments and reagents, and grant revenue.

Technology access and license fees are deferred and recognized as revenue on a straight-line basis over the noncancelable term of the agreement to which they relate. Payments for services and/or materials provided by Lynx are recognized as revenues when earned over the period in which the services are performed and/or materials are delivered, provided that no other consequential obligations, refunds or credits to be applied to future work exist. Revenues from the sale of technology assets are recognized upon the transfer of the assets to the purchaser. Revenues from the sales of instruments and reagents are recognized upon shipment to the customer.

#### **Inventory**

Inventory is stated at the lower of cost (which approximates first-in, first-out cost) or market. The balances at June 30, 2004 and December 31, 2003 were classified as raw materials and consisted primarily of reagents and other chemicals utilized while performing genomics discovery services. Inventory used in providing genomics discovery services and for reagent sales is charged to cost of services fees and other as consumed. Reagents and chemicals purchased for internal development purposes are charged to research and development expense upon receipt or as consumed.

#### **Net Loss Per Share**

Basic and diluted net loss per share have been computed using the weighted-average number of shares of common stock outstanding during the period. Basic and diluted net loss per share amounts are the same for each period as we have incurred a net loss for all periods presented. Had we been in a net income position, diluted earnings per share would have included the dilutive impact of outstanding options and warrants to purchase common stock. At June 30, 2004, options to purchase approximately 568,000 shares of common stock at a weighted-average exercise price of \$26.88 per share and warrants to purchase approximately 1,544,000 shares of common stock at exercise prices ranging from \$6.12 to \$39.76 per share, were excluded from the calculation of diluted loss per share for 2004 because the effect of inclusion would be antidilutive. The options and warrants will be included in the calculation at such time as

the effect is no longer antidilutive, as calculated using the treasury stock method. At June 30, 2003, options to purchase approximately 531,000 shares of common stock at a weighted-average exercise price of \$40.08 per share and warrants to purchase approximately 977,000 shares of common stock at exercise prices ranging from \$10.85 to \$39.76 per share were excluded from the calculation of diluted loss per share for 2003 because the effect of inclusion would be antidilutive.

**Table of Contents****Stock-Based Compensation**

We grant stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date prior to the date of grant. We account for stock option grants in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations. Under APB 25, when the exercise price of the Company's employee stock options equals or exceeds the market price of the underlying stock on the date of grant, no compensation expense is recognized.

All stock option awards to non-employees are accounted for at the fair value of the equity instrument issued, as calculated using the Black-Scholes model, in accordance with SFAS 123 and Emerging Issues Task Force Consensus No. 96-18, *Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. The option arrangements are subject to periodic remeasurement over their vesting terms.

Pro forma information regarding net loss and net loss per share required by Statement of Financial Accounting Standard No. 123, *Accounting for Stock-based Compensation* (SFAS 123), as amended by SFAS 148, is presented below and has been determined as if the Company had accounted for awards under its stock option and employee stock purchase plans using the fair value method:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Net loss, as reported	\$(3,612)	\$(2,857)	\$(7,833)	\$(6,829)
Add: Stock-based employee compensation as reported				9
Deduct: Stock-based employee compensation as if fair value method applied to all awards	(422)	(720)	(963)	(1,125)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net loss, pro forma as if fair value method applied to all awards	<u>\$(4,034)</u>	<u>\$(3,577)</u>	<u>\$(8,796)</u>	<u>\$(7,945)</u>
Basic and diluted net loss per share, as reported	<u>\$ (0.48)</u>	<u>\$ (0.61)</u>	<u>\$ (1.13)</u>	<u>\$ (1.47)</u>
Basic and diluted net loss per share, pro forma as if fair value method applied to all awards	<u>\$ (0.54)</u>	<u>\$ (0.77)</u>	<u>\$ (1.27)</u>	<u>\$ (1.71)</u>

**4. Comprehensive Loss**

The following are the components of comprehensive loss: (in thousands)

	<b>Three Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
Net income (loss)	\$(3,612)	\$(2,857)
Net unrealized loss on available-for-sale securities	(1)	
Currency translation	1	
	<u>          </u>	<u>          </u>
Comprehensive income (loss)	<b><u>\$(3,612)</u></b>	<b><u>\$(2,857)</u></b>

	<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
Net income (loss)	\$(7,833)	\$(6,829)
Net unrealized loss on available-for-sale securities	(1)	
Currency translation		
	<u>          </u>	<u>          </u>
Comprehensive income (loss)	<b><u>\$(7,834)</u></b>	<b><u>\$(6,829)</u></b>

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**5. Related-Party Transactions**

*Axaron Bioscience AG*

We hold an equity investment in Axaron Bioscience AG ( Axaron ). As of June 30, 2004, we held approximately a 42% ownership interest in Axaron and had the ability to exercise significant influence over Axaron s operating and accounting policies. We have accounted for the investment under the equity method in accordance with APB Opinion No. 18. Under the equity method, the Company records its pro-rata share of the income or losses of Axaron. Axaron is engaged in employing Lynx s technologies in its neuroscience, toxicology and microbiology research programs.

In 2001, we extended our technology licensing agreement with Axaron. The license extends Axaron s right to use our proprietary MPSS and Megasort technologies non-exclusively in Axaron s neuroscience, toxicology and microbiology programs until December 31, 2007. We received from Axaron a \$5.0 million technology license fee, which was recorded as deferred revenue and is being recognized on a straight-line basis over the noncancelable term of the agreement. The recorded revenue for the three-month and six-month period ended June 30, 2004 was \$190,000 and \$380,000, respectively. The recorded revenue for the three-month and six-month period ended June 30, 2003 was \$190,000 and \$380,000, respectively. In accordance with APB 18, we have discontinued applying the equity method as our investment in Axaron has been reduced to zero and no pro-rata share of Axaron losses has been reflected in the Condensed Consolidated Statement of Operations for the three months and six months ended June 30, 2004. Our pro-rata share of Axaron s losses for the three-month and six-month periods ended June 30, 2003 was approximately \$0.9 million and \$1.7 million, respectively.

We initially accounted for our investment in Axaron Bioscience AG, a company owned primarily by BASF AG and us, using the equity method. In accordance with APB 18, we have discontinued applying the equity method as of December 31, 2003, as our investment in Axaron has been reduced to zero.

We also subleased certain offices in Germany to Axaron. During 2003, the Company received an immaterial amount of sublease income from Axaron.

*Other Transactions with Related Parties*

For legal services, Lynx paid approximately \$129,000 during the quarter ended June 30, 2004 and approximately \$185,000 during the six months ended June 30, 2004 to Cooley Godward LLP, Lynx s counsel. A partner of Cooley Godward LLP is a director of Lynx. At June 30, 2004, Lynx had an outstanding liability to Cooley Godward LLP of approximately \$47,000. At December 31, 2003, Lynx had an outstanding liability to Cooley Godward LLP of approximately \$55,000.

For genomics discovery services performed during the quarter ended June 30, 2004, Lynx received revenues of \$30,000 from the Institute for Systems Biology. The President and Director of the Institute for Systems Biology is a director of Lynx. As of June 30, 2004, Lynx had a receivable of \$30,000 due from the Institute for Systems Biology.

In June 2001, Lynx entered into a consulting agreement with Dr. Sydney Brenner, a director of the Company. Pursuant to the agreement, Dr. Brenner may perform consulting services of at least eight to 16 hours per month in consideration of his standard consulting fee. During the three and six months ended June 30, 2004, Dr. Brenner received no consulting fees under this agreement.

**6. Restructuring Charges**



In March 2004, we implemented a reduction of approximately 15% of our workforce, or 14 people. The reduction included positions in all functions of the Company's business. The workforce reduction is intended to further focus our financial and human resources on expanding the commercial use of MPSS. We recorded a workforce reduction charge of \$118,000 in the six months ended June 30, 2004, which related primarily to severance compensation expense for our former employees, which amounts were paid in April and May 2004.

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**7. Common Stock**

On March 9, 2004, Lynx completed a \$4.0 million private placement of common stock and warrants to purchase common stock (the financing ) resulting in proceeds of \$3.8 million, net of commissions and expenses. The financing included the sale of 788,235 newly-issued shares of common stock at \$5.10 per share and the issuance of warrants to purchase 181,295 shares of common stock at an exercise price of \$6.25 per share.

**8. Acquisition of Intellectual Property**

In April 2004, Lynx and Solexa jointly acquired from Manteia the rights to proprietary technology assets for DNA colony generation. The acquired technology assets feature a process to enable parallel amplification of millions of DNA fragments, each from a single DNA molecule, to create DNA colonies or clusters. The clusters are dense collections of DNA molecules on a surface, which should enable fast and simplified preparation of the biological sample for analysis and allow reduced reagent consumption as a result of the highly parallel nature of the analysis. We intend to incorporate the cluster technology assets into our MPSS process, with the goal of streamlining our sequencing service operations and developing commercial sequencing instrumentation for widespread laboratory use. The cluster technology is expected to improve our current bead-based sequencing process by delivering higher density, thus greater information content. This improvement targets a significant reduction in the cost of DNA sequencing and is expected to create multiple market opportunities in basic and applied research. Lynx and Solexa have entered into a technology sharing agreement for the purpose of managing the ownership and development of the asset acquired from Manteia.

Lynx issued and delivered to Manteia 540,058 shares of common stock of Lynx for a value representing fifty (50) percent of the purchase price. The shares were valued at \$2.55 million and the purchase price was allocated to intellectual property in the amount of \$2.45 million and equipment and supplies valued at \$100,000. The acquired intellectual property is being amortized over 8 years.

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

*This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in this report and our 2003 audited financial statements and notes thereto included in our 2003 Annual Report on Form 10-K, as amended. Operating results for the quarter and six months ended June 30, 2004 are not necessarily indicative of results that may occur in future periods.*

*Except for the historical information contained herein, the following discussion contains forward-looking statements that involve risks and uncertainties. When used herein, the words believe, anticipate, expect, estimate and similar expressions are intended to identify such forward-looking statements. There can be no assurance that these statements will prove to be correct. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this section, as well as in our 2003 Annual Report on Form 10-K, as amended, as filed with the SEC. We undertake no obligation to update any of the forward-looking statements contained herein to reflect any future events or developments.*

**Overview**

We believe that Lynx Therapeutics, Inc. is a leader in the development and application of novel genomics analysis solutions that provide comprehensive and quantitative digital gene expression information important to modern systems biology research in the pharmaceutical, biotechnology and agricultural industries. These solutions are based on Megaclone and Massively Parallel Signature Sequencing, or MPSS, our unique and proprietary cloning and sequencing technologies. Gene expression refers to the number of genes and the extent a cell or tissue expresses those genes, and represents a way to move beyond DNA sequence data to understand the function of genes, the proteins they encode and the role they play in health and disease. Systems biology is an approach in which researchers seek to gain a complete molecular understanding of biological systems in health and disease.

We have incurred net losses each year since our inception in 1992. As of June 30, 2004, we had an accumulated deficit of approximately \$115.5 million. We expect net losses will continue for at least the next several years as we proceed with the commercialization and additional development of our technologies. The presence and size of these potential net losses will depend, in part, on the rate of growth, if any, in our revenues and on the level of our expenses.

Our cash and cash equivalents were \$5.6 million as of December 31, 2003, which included restricted cash of \$0.7 million. As of June 30, 2004, our cash and cash equivalents and short-term investments consisted of \$2.4 million including restricted cash of \$0.4 million. In March 2004, we raised an additional \$4.0 million through the sale of common stock. It was anticipated that these funds in combination with forecasted revenues and the ability to raise additional outside capital would be sufficient to meet our projected operating and capital requirements through at least December 31, 2004. Our revenues through June 2004 have been significantly less than had been forecast at the beginning of this calendar year and we continue to pursue various options to raise additional funds, which will be required to allow us to continue our business activities through December 31, 2004. These options include securing additional equity financing and obtaining new collaborators and customers. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. There can be no assurance that additional financing will be available on satisfactory terms, or at all. If we are unable to secure additional financing, or are unable to generate sufficient new sources of revenue through arrangements with customers, collaborators and licensees, we will be forced to take substantial restructuring actions, which may include significantly reducing our anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds by entering into financing or collaborative agreements on unattractive terms, or we will not be able to continue to operate.



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To date, we have received, and expect to continue to receive in the future, a significant portion of our revenues from a small number of collaborators, customers and licensees, as shown in the following table.

	<b>Six months Ended June 30,</b>		<b>Year Ended December 31,</b>
	<b>2004</b>	<b>2003</b>	<b>2003</b>
Takara Bio Inc.	2%	18%	39%
E.I. DuPont de Nemours and Company	55%	31%	28%
BASF AG	12%	24%	14%
Bayer CropScience		10%	4%
National Human Genome Research Institute	8%		

Revenues in each quarterly and annual period have in the past, and could in the future, fluctuate due to: the timing and amount of any technology access fees and the period over which the revenue is recognized; the level of service fees, which is tied to the number and timing of biological samples received from our collaborators and customers, as well as our performance of the related genomics discovery services on the samples; the timing of achievement of milestones and the amount of related payments to us; and the number, type and timing of new, and the termination of existing, agreements with collaborators, customers and licensees.

Our operating costs and expenses include services fees and other, research and development expenses and general and administrative expenses. Services fees and other includes primarily the costs of direct labor, materials and supplies, outside expenses, equipment and overhead incurred by us in performing our genomics discovery services for, and the costs of reagents and instruments sold to, our collaborators, customers and licensees. Research and development expenses include the costs of personnel, materials and supplies, outside expenses, equipment and overhead incurred by us in our technology and application development and process improvement efforts. Research and development expenses may increase due to spending for ongoing technology development and implementation, as well as new applications, primarily for MPSS. General and administrative expenses include the costs of personnel, materials and supplies, outside expenses, equipment and overhead incurred by us primarily in our administrative, business development, legal and investor relations activities. General and administrative expenses may increase in support of our research and development, commercial and business development efforts.

We initially accounted for our investment in Axaron Bioscience AG, a company owned primarily by BASF AG and us, using the equity method. In accordance with APB 18, we have discontinued applying the equity method as of December 31, 2003, as our investment in Axaron has been reduced to zero.

As of June 30, 2004, we employed 76 full-time employees, of which 63 were engaged in production and research and development activities. In March 2004, we implemented a reduction of approximately 15% of our total workforce, or 14 people. The reduction included positions in all functions of the Company's business. The workforce reduction is intended to further focus our financial and human resources on expanding the commercial use of MPSS.

On April 14, 2004, Lynx and Solexa closed a transaction to jointly acquire from Manteia the rights to proprietary technology assets for DNA colony generation. We issued and delivered to Manteia 540,058 shares of our common stock for a value representing fifty (50) percent of the purchase price. The acquired technology assets feature a process to enable parallel amplification of millions of DNA fragments, each from a single DNA molecule, to create DNA colonies or clusters. The clusters are dense collections of DNA molecules on a surface, which should enable fast and simplified preparation of the biological sample for analysis and allow reduced reagent consumption as a result of the

highly parallel nature of the analysis.

We have entered into a technology sharing agreement, dated as of March 22, 2004, for the purpose of managing the ownership and development of the assets acquired from Manteia.

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### **Results of Operations**

#### ***Revenues***

Revenues for the three-month period ended June 30, 2004 were approximately \$1.7 million, compared to revenues of \$4.6 million for the corresponding three-month period of 2003. Revenues for the three-month period in 2004 included technology access fees and services fees of \$1.5 million, license fees from Axaron, a related party, of \$190,000 and other revenues of \$67,000. Revenues for the three-month period in 2003 included technology access fees and service fees of \$4.2 million, license fees from Axaron, a related party, of \$190,000 and other revenues of \$208,000.

Revenues for the six months ended June 30, 2004 were approximately \$3.1 million, compared to revenues of \$7.8 million for the corresponding six-month period of 2003. Revenues for the six-month period in 2004 included technology access fees and service fees of \$2.6 million, license fees from Axaron, a related party, of \$380,000 and other revenues of \$78,000. Revenues for the six-month period in 2003 included technology access fees and service fees of \$7.2 million, license fees from Axaron of \$380,000 and other revenues of \$282,000.

The decrease in revenues in 2004 compared to 2003, was due to full recognition of previously deferred technology access fee revenue in 2003, for which there was no corresponding amount in 2004, and a decrease in fees charged per MPSS experiment.

Our revenues have historically fluctuated from quarter to quarter and year to year and may continue to fluctuate in future periods due primarily to our service fees, which are impacted principally by the timing and number of biological samples received from existing customers and collaborators, as well as our performance of related services on these samples. Additionally, the number, type and timing of new collaborations and agreements and the related demand for, and delivery of, our services or products will impact the level of future revenues.

#### ***Operating Costs and Expenses***

Total operating costs and expenses were approximately \$5.4 million for the three-month period ended June 30, 2004, compared to approximately \$6.5 million for the three-month period ended June 30, 2003. For the six-month periods ended June 30, 2004 and 2003, operating costs and expenses were approximately \$10.9 million and \$12.8 million, respectively.

For the three-month period in 2004, services fees and other was \$1.3 million, compared to \$1.4 million for the corresponding period in 2003. Services fees and other for the six-months ended June 30, 2004 and 2003 were \$2.6 million and \$2.1 million, respectively. Services fees and other reflect primarily the costs of providing our genomics discovery services. The increase in cost of services fees in 2004 reflects our organizational changes in that proportionally more overhead is allocated to the services group than in the past, and an increase in depreciation from the implementation of new production equipment.

Research and development expenses were approximately \$2.6 million for the three-month period ended June 30, 2004, compared to approximately \$3.2 million for the corresponding period in 2003. In April 2004 Lynx reorganized its staff to focus on the development of the cluster technology, its integration with Lynx's proprietary sequencing technology, and creation of a plan for commercial launch of the new technology. These increased efforts and related expenditures are included in Research and Development. For the six-month periods ended June 30, 2004 and 2003, research and development expenses were approximately \$5.1 million and \$6.8 million, respectively. The decrease in research and development expenses in 2004 reflects a decrease in materials consumed in research and development efforts and lower personnel expenses, primarily resulting from the workforce reduction that occurred in the first

quarter of 2004, partially offset by the increased efforts related to the new cluster technology. Research and development expenses may increase due to spending for ongoing technology development and implementation, as well as new applications, primarily for MPSS.

General and administrative expenses were \$1.5 million for the three-month period ended June 30, 2004, compared to \$1.9 million for the corresponding period in 2003. For the six-month periods ended June 30, 2004 and 2003, general and administrative expenses were approximately \$3.1 million and \$3.7 million, respectively. The



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decrease in general and administrative expenses in the 2004 periods over the same periods in 2003 primarily reflects results from the workforce reduction that occurred in the first quarter of 2004. General and administrative expenses may increase in support of our continuing commercial, business development and research and development activities.

In March 2004, we implemented a reduction of approximately 15% of our workforce, or 14 people. The reduction included positions in all functions of the Company's business. The workforce reduction is intended to further focus our financial and human resources on expanding the commercial use of MPSS. We recorded a workforce reduction charge of \$118,000 in the six months ended June 30, 2004, related primarily to severance compensation expense for our former employees, which amounts were paid in April and May 2004. We anticipate annualized cost savings of approximately \$1.3 million related to compensation, benefits and employer taxes that would have been paid to, and on behalf of, such former employees had they remained employed by Lynx.

### ***Equity in Net Loss of Related Party***

The equity share of loss of related party for the three-month and six-month periods ended June 30, 2004 was zero dollars, respectively, and for the three-month and six-month periods ended June 30, 2003 was approximately \$0.9 million and \$1.7 million, respectively, and reflects Lynx's pro-rata share of the net loss of Axaron, a joint venture investee. As of December 31, 2003, Lynx's investment in Axaron was reduced to zero and Lynx ceased recording its pro rata share of Axaron's net losses.

### ***Interest Expense, Net***

Net interest expense was approximately \$3,000 for the quarter ended June 30, 2004, compared to net interest expense of approximately \$84,000 for the corresponding period of 2003. The decrease in net interest expense from 2003 to 2004 reflects primarily interest expense in 2004 incurred on equipment-related debt outstanding during both the 2003 and 2004 periods. Net interest expense was approximately \$21,000 for the six months ended June 30, 2004, compared to net interest expense of approximately \$128,000 for the corresponding period of 2003. The lower debt balances in the three and six-month periods ended June 30, 2004 resulted in lower interest expense.

### ***Other Income (Expense), Net***

Other income was \$86,000 in the quarter ended June 30, 2004, compared to other income of zero in the 2003 period. Other income was \$44,000 for the six months ended June 30, 2004, compared to other income of zero in the 2003 period. The income was related to asset sales offset by Lynx GmbH closure expenses.

### ***Income Tax Provision***

The provisions for income tax for the quarter and six-months ended June 30, 2004 of \$1,000, consisted entirely of state withholding tax. The provisions for income tax for the quarter and six-months ended June 30, 2003 of approximately \$1,000 and \$2,000, respectively, consisted entirely of foreign withholding tax on payments received from our licensee, Takara.

### ***Liquidity and Capital Resources***

Cash and cash equivalents and short-term investments at June 30, 2004, consisted of \$2.4 million, including restricted cash of \$0.4 million. Net cash used in operating activities was \$6.5 million for the six months ended June 30, 2004, as compared to \$7.3 million for the same period in 2003. The change was due primarily to a higher net loss in 2004 and a decrease in accounts payable, offset by no related party loss in 2004, and a smaller decrease in deferred revenue as compared to 2003. The amount of net cash used in operating activities differed from the 2004 net

loss primarily due to depreciation and amortization expenses offset by a decrease in accounts payable. The amount of net cash used in operating activities differed from the 2003 net loss primarily due to depreciation and amortization expenses, and the impact of our pro-rata share of the net loss of Axaron, offset by a decrease in deferred revenues.

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Net cash used by investing activities of \$0.8 million for the six month period of 2004, was primarily due to the purchase of short-term investments. Net cash used by investing activities of \$0.2 million for the six month period of 2003 was due to expenditures for capital equipment.

Net cash provided by financing activities of \$3.2 million in the six months ended June 30, 2004 was due primarily to the issuance of common stock pursuant to a common stock purchase agreement between Lynx and certain investors. Net cash used by financing activities of \$1.2 million for the six months ended June 30, 2003 was due primarily to the repayment of principal on equipment-related debt.

In October 2002, we entered into a loan and security agreement with a financial institution, Comerica Bank-California, for an equipment line of credit of up to \$2.0 million with a drawdown period of one year. Under the initial advance, we drew down \$1.6 million in November 2002 related to the purchase of equipment made in previous periods. We granted Comerica Bank-California a security interest in all items we financed under this agreement. The initial advance under the loan to finance the purchase of equipment made in previous periods has a term of 24 months from the date of advance and bears interest at a rate of 7.25%. In May 2003, we renegotiated the terms of the agreement, which now require that we maintain a minimum cash balance of restricted cash and cash equivalents in an account at Comerica Bank-California of at least 110% of the principal balance under loans outstanding under this agreement until Comerica Bank-California receives payment in full of all outstanding obligations. As of June 30, 2004, the balance of restricted cash was approximately \$0.4 million. As of June 30, 2004, the principal balance of loans outstanding under this agreement was approximately \$265,000. We believe that we are in compliance with all terms of the loan agreement.

In late 1998, we entered into a financing agreement with a financial institution, Transamerica Business Credit Corporation, now known as GE Healthcare Financial Services, under which we drew down \$4.8 million during 1999 for the purchase of equipment and certain other capital expenditures. In September 2000, Lynx obtained additional financing of approximately \$1.0 million under an amendment to the original financing agreement. We granted the lender a security interest in all items financed by it under this agreement. Each draw-down under the loan has a term of 48 months from the date of the draw-down. As of June 30, 2004, the principal balance of loans outstanding under this agreement was \$159,000. The draw-down period under the agreement expired on June 30, 2000.

We plan to use available funds for ongoing commercial and research and development activities, working capital and other general corporate purposes and capital expenditures. We expect capital investments during the remainder of 2004 will be less than \$1.0 million and will be comprised primarily of expenditures for capital equipment required in the normal course of business. We intend to invest our excess cash in investment-grade, interest-bearing securities.

We have obtained funding for our operations primarily through sales of preferred and common stock, payments received under contractual arrangements with customers, collaborators and licensees, and interest income. Consequently, investors in our equity securities and our customers, collaborators and licensees are significant sources of liquidity for us. Therefore, our ability to maintain liquidity is dependent upon a number of uncertain factors, including but not limited to the following: our ability to advance and commercialize further our technologies; our ability to generate revenues through expanding existing collaborations, customer and licensee arrangements and obtaining significant new customers, collaborators and licensees; and the receptivity of capital markets toward our equity or debt securities. The cost, timing and amount of funds required for specific uses by us cannot be precisely determined at this time and will be based upon the progress and the scope of our commercial and research and development activities; payments received under customer, collaborative and license agreements; our ability to establish and maintain customer, collaborative and license agreements; costs of protecting intellectual property rights; legal and administrative costs; additional facilities capacity needs, and the availability of alternate methods of financing.

We have incurred net losses each year since our inception in 1992. As of June 30, 2004, we had an accumulated deficit of \$115.5 million. We expect net losses will continue for at least the next several years as we proceed with the commercialization and additional development of our technologies. The presence and size of these potential net losses will depend, in part, on the rate of growth, if any, in our revenues and on the level of our expenses.

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Cash and cash equivalents and short-term investments at June 30, 2004, consisted of \$2.4 million, including restricted cash of \$0.4 million. In March 2004, we completed a \$4.0 million private placement of common stock and warrants to purchase common stock resulting in proceeds of \$3.8 million, net of commissions and expenses. The financing included the sale of 788,235 newly issued shares of common stock at \$5.10 per share and the issuance of warrants to purchase 181,295 shares of common stock at an exercise price of \$6.25 per share. Also, in March 2004, we reduced our headcount by 15% to 76 employees. It was anticipated that these funds in combination with forecasted revenues and the ability to raise additional outside capital would be sufficient to meet our projected operating and capital requirements through at least December 31, 2004. Our revenues through June 2004 have been significantly less than had been forecasted at the beginning of this calendar year and we continue to pursue various options to raise additional funds, which will be required to allow us to continue our business activities through December 31, 2004. These options include securing additional equity financing and obtaining new collaborators and customers. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. There can be no assurance that additional financing will be available on satisfactory terms, or at all. If we are unable to secure additional financing, or are unable to generate sufficient new sources of revenue through arrangements with customers, collaborators and licensees, we will be forced to take substantial restructuring actions, which may include significantly reducing our anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds by entering into financing or collaborative agreements on unattractive terms, or we will not be able to continue to operate.

## **Additional Business Risks**

*Our business faces significant risks. These risks include those described below and may include additional risks of which we are not currently aware or which we currently do not believe are material. If any of the events or circumstances described in the following risks actually occurs, our business, financial condition or results of operations could be materially adversely affected. These risks should be read in conjunction with the other information set forth in this report.*

## **We have a history of net losses. We expect to continue to incur net losses, and we may not achieve or maintain profitability.**

We have incurred net losses each year since our inception in 1992, including net losses of approximately \$8.8 million for the year ended December 31, 2003, \$15.5 million in 2002 and \$16.7 million in 2001. As of June 30, 2004, we had an accumulated deficit of approximately \$115.5 million. Net losses may continue for at least the next several years as we proceed with the commercialization and additional development of our technologies. The presence and size of these potential net losses will depend, in part, on the rate of growth, if any, in our revenues and on the level of our expenses. Our research and development expenditures and general and administrative costs have exceeded our revenues to date. Research and development expenses may increase due to spending for ongoing technology development and implementation, as well as new applications. We will need to generate significant additional revenues to achieve profitability. Even if we do increase our revenues and achieve profitability, we may not be able to sustain profitability.

Our ability to generate revenues and achieve profitability depends on many factors, including:

our ability to continue existing customer relationships and enter into additional corporate collaborations and agreements;

our ability to expand the scope of our products and services into new areas of pharmaceutical, biotechnology and agricultural research;

our customers and collaborators abilities to develop diagnostic, therapeutic and other commercial products from the application of our technologies; and

the successful clinical testing, regulatory approval and commercialization of such products by our customers and collaborators.

The time required to reach profitability is highly uncertain. We may not achieve profitability on a sustained basis, if at all.

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**We will need additional funds in the future, which may not be available to us.**

We have invested significant capital in our scientific and business development activities. Our future capital requirements will be substantial as we conduct our operations, and will depend on many factors including:

the progress and scope of our research and development projects;

payments received under our customer, license and collaborative agreements;

our ability to establish and maintain customer, license and collaborative arrangements;

the progress of the development and commercialization efforts under our customer, license and collaborative agreements;

the costs associated with obtaining access to biological samples and related information; and

the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims and other intellectual property rights.

It was anticipated that with the funds raised in March 2004, in combination with forecasted revenues and the ability to raise additional outside capital would be sufficient to meet our projected operating and capital requirements through at least December 31, 2004. Our revenues through June 2004 have been significantly less than forecast at the beginning of this calendar year and we continue to pursue various options to raise additional funds, which will be required to allow us to continue our business activities. These options include securing additional equity financing and obtaining new collaborators and customers. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. There can be no assurance that additional financing will be available on satisfactory terms, or at all. If we are unable to secure additional financing, or are unable to generate sufficient new sources of revenue through arrangements with customers, collaborators and licensees, we will be forced to take substantial restructuring actions, which may include significantly reducing our anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds by entering into financing or collaborative agreements on unattractive terms, or we will not be able to continue to operate.

**Our technologies are new and unproven and may not allow our customers, collaborators or us to identify genes, proteins or targets for drug discovery.**

You must evaluate us in light of the uncertainties and complexities affecting an early stage genomics company. Our technologies are new and unproven. The application of these technologies is in too early a stage to determine whether it can be successfully implemented. These technologies assume that information about gene expression and gene sequences may enable scientists to better understand complex biological processes and, therefore, provide us with increased commercial opportunities for our products. Our technologies also depend on the successful integration of independent technologies, each of which has its own development risks. Relatively few therapeutic products based on gene discoveries have been successfully developed and commercialized. Our technologies may not enable our customers, collaborators or us to identify genes, proteins or targets for drug discovery. To date, neither our customers nor we have identified any targets for drug discovery based on our technologies.

Our cluster technology is new and we may not be able to successfully integrate clusters with our current MPSS sequencing process. The sequence data we generate with clusters may not be of the same quality as we currently generate using beads, or we may not be able to achieve the necessary yields to be cost competitive. We have no history of producing commercially available sequencing instruments and we may have difficulty integrating the cluster technology into a commercially available instrument. The timelines associated with the development of the

cluster technology contain elements of risk and uncertainty and may therefore be extended. Any prolonged delay with the development effort could allow competing technologies to capture significant market share ahead of us.



**Table of Contents****We are dependent on our customers and collaborators and will need to find additional customers and collaborators in the future to develop and commercialize diagnostic or therapeutic products.**

Our strategy for the development and commercialization of our technologies and potential products includes entering into collaborations, customer agreements or licensing arrangements with pharmaceutical, biotechnology and agricultural companies and research institutes. We do not have the resources to develop or commercialize diagnostic or therapeutic products on our own. If we cannot negotiate additional collaborative arrangements or contracts on acceptable terms, or at all, or if such collaborations or relationships are not successful, we may never become profitable.

We have derived substantially all of our revenues from corporate collaborations, customer agreements and licensing arrangements. Revenues from such agreements depend upon continuation of the related relationships, our performance of genomics discovery services, the achievement of milestones and royalties derived from future products developed from our research and technologies. To date, we have received, and expect to continue to receive in the future, a significant portion of our revenues from a small number of collaborators, customers and licensees, as shown on the following table:

	<b>Six months Ended June 30,</b>		<b>Year Ended December 31,</b>
	<b>2004</b>	<b>2003</b>	<b>2003</b>
Takara Bio Inc.	2%	18%	39%
E.I. DuPont de Nemours and Company	55%	31%	28%
BASF AG	12%	24%	14%
Bayer CropScience		10%	4%
National Human Genome Research Institute	8%		

If we fail to perform genomics discovery services or successfully achieve milestones or our collaborators fail to develop successful products, we will not earn the revenues contemplated under such agreements. If our collaborators, customers or licensees do not renew existing agreements, we lose one of these collaborators, customers or licensees, we do not attract new collaborators, customers or licensees or we are unable to enter into new collaborative, customer or license agreements on commercially acceptable terms, our revenues may decrease, and our activities may fail to lead to commercialized products.

Our dependence on collaborations, agreements or licenses with third parties subjects us to a number of risks. We have limited or no control over the resources that such third parties may choose to devote to our joint efforts. Our collaborators, customers or licensees may breach or terminate their agreements with us or fail to perform their obligations thereunder. Further, our collaborators, customers or licensees may elect not to develop products arising out of our agreements or may fail to devote sufficient resources to the development, manufacture, marketing or sale of such products. While we do not currently compete directly with any of our customers and collaborators, some of our customers and collaborators could become our competitors in the future if they internally develop DNA analysis technologies or if they acquire other genomics companies and move into the genomics industry. We will not earn the revenues contemplated under our customer and collaborative arrangements, if our customers and collaborators:

do not develop commercially successful products using our technologies;

develop competing products;

preclude us from entering into collaborations with their competitors;

fail to obtain necessary regulatory approvals; or

terminate their agreements with us.

**We depend on a single supplier to manufacture flow cells used in our MPSS technology.**

Flow cells are glass plates that are micromachined, or fabricated to very precise dimensions, to create a grooved chamber for immobilizing micro-beads in a planar microarray, which is a two-dimensional, dense ordered array of DNA samples. We use flow cells in our MPSS technology. We currently purchase the flow cells used in our MPSS technology from a single supplier, although the flow cells are potentially available from multiple suppliers. While

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we believe that alternative suppliers for flow cells exist, identifying and qualifying new suppliers could be an expensive and time-consuming process. Our reliance on outside vendors involves several risks, including:

the inability to obtain an adequate supply of required components due to manufacturing capacity constraints, a discontinuance of a product by a third-party manufacturer or other supply constraints;

reduced control over quality and pricing of components; and

delays and long lead times in receiving materials from vendors.

**We operate in an intensely competitive industry with rapidly evolving technologies, and our competitors may develop products and technologies that make ours obsolete.**

The biotechnology industry is highly fragmented and is characterized by rapid technological change. In particular, the area of genomics research is a rapidly evolving field. Competition among entities attempting to identify genes and proteins associated with specific diseases and to develop products based on such discoveries is intense. Many of our competitors have substantially greater research and product development capabilities and financial, scientific and marketing resources than we do.

We face, and will continue to face, competition from pharmaceutical, biotechnology and agricultural companies, as well as academic research institutions, clinical reference laboratories and government agencies. Some of our competitors, such as Affymetrix, Inc., Celera Genomics Group, Gene Logic, Inc., and Genome Therapeutics Corporation may be:

attempting to identify and patent randomly sequenced genes and gene fragments and proteins;

pursuing a gene identification, characterization and product development strategy based on positional cloning, which uses disease inheritance patterns to isolate the genes that are linked to the transmission of disease from one generation to the next; and

using a variety of different gene and protein expression analysis methodologies, including the use of chip-based systems, to attempt to identify disease-related genes and proteins.

In addition, numerous pharmaceutical, biotechnology and agricultural companies are developing genomics research programs, either alone or in partnership with our competitors. Our future success will depend on our ability to maintain a competitive position with respect to technological advances. Rapid technological development by others may make our technologies and future products obsolete.

Any products developed through our technologies will compete in highly competitive markets. Our competitors may be more effective at using their technologies to develop commercial products. Further, our competitors may obtain intellectual property rights that would limit the use of our technologies or the commercialization of diagnostic or therapeutic products using our technologies. As a result, our competitors' products or technologies may render our technologies and products, and those of our collaborators, obsolete or noncompetitive.

**The change in our primary business focus, from gene expression services alone, to services coupled with development and launch of instrument sales, may result in a change in MPSS service revenues as we concentrate more resources on the new instrument business, and could result in an impairment of the MPSS instruments.**

As we shift our strategic focus towards implementing new products and technologies to expand our overall business, we will try to enable many of our MPSS services customers to create their own analysis capabilities through

purchase of our new generation instruments and support products. If we are successful, this will cause our service revenues to decline substantially following the launch of our new products as our customers bring these capabilities into their own facilities. This reduced focus on the service business will mean that revenues from those services will be less than if we concentrated our efforts in this direction. It is possible that those revenues could fall below the levels needed to support the investment in our existing MPSS instruments, thus requiring we consider them impaired. Accordingly, we may be required to record an asset impairment charge in a future period related to these instruments, and such a charge could be significant.

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**If we fail to adequately protect our proprietary technologies, third parties may be able to use our technologies, which could prevent us from competing in the market.**

Our success depends in part on our ability to obtain patents and maintain adequate protection of the intellectual property related to our technologies and products. The patent positions of biotechnology companies, including our patent position, are generally uncertain and involve complex legal and factual questions. We will be able to protect our proprietary rights from unauthorized use by third parties only to the extent that our proprietary technologies are covered by valid and enforceable patents or are effectively maintained as trade secrets. The laws of some foreign countries do not protect proprietary rights to the same extent as the laws of the U.S., and many companies have encountered significant problems in protecting and defending their proprietary rights in foreign jurisdictions. We have applied and will continue to apply for patents covering our technologies, processes and products, as and when we deem appropriate. However, third parties may challenge these applications, or these applications may fail to result in issued patents. Our existing patents and any future patents we obtain may not be sufficiently broad to prevent others from practicing our technologies or from developing competing products. Furthermore, others may independently develop similar or alternative technologies or design around our patents. In addition, our patents may be challenged or invalidated or fail to provide us with any competitive advantage.

We also rely on trade secret protection for our confidential and proprietary information. However, trade secrets are difficult to protect. We protect our proprietary information and processes, in part, with confidentiality agreements with employees, collaborators and consultants. However, third parties may breach these agreements, we may not have adequate remedies for any such breach or our trade secrets may still otherwise become known by our competitors. In addition, our competitors may independently develop substantially equivalent proprietary information.

**Litigation or third-party claims of intellectual property infringement could require us to spend substantial time and money and adversely affect our ability to develop and commercialize our technologies and products.**

Our commercial success depends in part on our ability to avoid infringing patents and proprietary rights of third parties and not breaching any licenses that we have entered into with regard to our technologies. Other parties have filed, and in the future are likely to file, patent applications covering genes, gene fragments, proteins, the analysis of gene expression and protein expression and the manufacture and use of DNA chips or microarrays, which are tiny glass or silicon wafers on which tens of thousands of DNA molecules can be arrayed on the surface for subsequent analysis. We intend to continue to apply for patent protection for methods relating to gene expression and protein expression and for the individual disease genes and proteins and drug discovery targets we discover. If patents covering technologies required by our operations are issued to others, we may have to rely on licenses from third parties, which may not be available on commercially reasonable terms, or at all.

Third parties may accuse us of employing their proprietary technology without authorization. In addition, third parties may obtain patents that relate to our technologies and claim that use of such technologies infringes these patents. Regardless of their merit, such claims could require us to incur substantial costs, including the diversion of management and technical personnel, in defending ourselves against any such claims or enforcing our patents. In the event that a successful claim of infringement is brought against us, we may need to pay damages and obtain one or more licenses from third parties. We may not be able to obtain these licenses at a reasonable cost, or at all. Defense of any lawsuit or failure to obtain any of these licenses could adversely affect our ability to develop and commercialize our technologies and products and thus prevent us from achieving profitability.

**We have limited experience in sales and marketing and thus may be unable to further commercialize our technologies and products.**

Our ability to achieve profitability depends on attracting collaborators and customers for our technologies and products. There are a limited number of pharmaceutical, biotechnology and agricultural companies and research institutes that are potential collaborators and customers for our technologies and products. To market our technologies and products, we must develop a sales and marketing group with the appropriate technical expertise. We may not successfully build such a sales force. If our sales and marketing efforts fail to be successful, our technologies and products may fail to gain market acceptance.

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**Our sales cycle is lengthy, and we may spend considerable resources on unsuccessful sales efforts or may not be able to enter into agreements on the schedule we anticipate.**

Our ability to obtain collaborators and customers for our technologies and products depends in significant part upon the perception that our technologies and products can help accelerate their drug discovery and genomics efforts. Our sales cycle is typically lengthy because we need to educate our potential collaborators and customers and sell the benefits of our products to a variety of constituencies within such companies. In addition, we may be required to negotiate agreements containing terms unique to each collaborator or customer. We may expend substantial funds and management effort without any assurance that we will successfully sell our technologies and products. Actual and proposed consolidations of pharmaceutical companies have negatively affected, and may in the future negatively affect, the timing and progress of our sales efforts.

**The loss of key personnel or the inability to attract and retain additional personnel could impair the growth of our business.**

We are highly dependent on the principal members of our management and scientific staff. The loss of any of these persons' services might adversely impact the achievement of our objectives and the continuation of existing customer, collaborative and license agreements. In addition, recruiting and retaining qualified scientific personnel to perform future research and development work will be critical to our success. There is currently a shortage of skilled executives and employees with technical expertise, and this shortage is likely to continue. As a result, competition for skilled personnel is intense and turnover rates are high. Competition for experienced scientists from numerous companies, academic and other research institutions may limit our ability to attract and retain such personnel. We depend on our President and Chief Executive Officer, Kevin P. Corcoran, the loss of whose services could have a material adverse effect on our business. Although we have an employment agreement with Mr. Corcoran in place, currently we do not maintain key person insurance for him or any other key personnel.

**We use hazardous chemicals and radioactive and biological materials in our business. Any claims relating to improper handling, storage or disposal of these materials could be time consuming and costly.**

Our research and development processes involve the controlled use of hazardous materials, including chemicals and radioactive and biological materials. Our operations produce hazardous waste products. We cannot eliminate the risk of accidental contamination or discharge and any resultant injury from these materials. We may be sued for any injury or contamination that results from our use or the use by third parties of these materials, and our liability may exceed our insurance coverage and our total assets. Federal, state and local laws and regulations govern the use, manufacture, storage, handling and disposal of hazardous materials. Compliance with environmental laws and regulations may be expensive, and current or future environmental regulations may impair our research, development and production efforts.

**Ethical, legal and social issues may limit the public acceptance of, and demand for, our technologies and products.**

Our collaborators and customers may seek to develop diagnostic products based on genes or proteins. The prospect of broadly available gene-based diagnostic tests raises ethical, legal and social issues regarding the appropriate use of gene-based diagnostic testing and the resulting confidential information. It is possible that discrimination by third-party payors, based on the results of such testing, could lead to the increase of premiums by such payors to prohibitive levels, outright cancellation of insurance or unwillingness to provide coverage to individuals showing unfavorable gene or protein expression profiles. Similarly, employers could discriminate against employees with gene or protein expression profiles indicative of the potential for high disease-related costs and lost employment time. Finally, government authorities could, for social or other purposes, limit or prohibit the use of such tests under certain

circumstances. These ethical, legal and social concerns about genetic testing and target identification may delay or prevent market acceptance of our technologies and products.

Although our technology does not depend on genetic engineering, genetic engineering plays a prominent role in our approach to product development. The subject of genetically modified food has received negative publicity, which has aroused public debate. Adverse publicity has resulted in greater regulation internationally and trade restrictions on imports of genetically altered agricultural products. Claims that genetically engineered products are unsafe for consumption or pose a danger to the environment may influence public attitudes and prevent genetically



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engineered products from gaining public acceptance. The commercial success of our future products may depend, in part, on public acceptance of the use of genetically engineered products, including drugs and plant and animal products.

### **If we develop products with our collaborators, and if product liability lawsuits are successfully brought against us, we could face substantial liabilities that exceed our resources.**

We may be held liable, if any product we develop with our collaborators causes injury or is otherwise found unsuitable during product testing, manufacturing, marketing or sale. Although we have general liability and product liability insurance, this insurance may become prohibitively expensive or may not fully cover our potential liabilities. Inability to obtain sufficient insurance coverage at an acceptable cost or to otherwise protect us against potential product liability claims could prevent or inhibit our ability to commercialize products developed with our collaborators.

### **Healthcare reform and restrictions on reimbursements may limit our returns on diagnostic or therapeutic products that we may develop with our collaborators.**

If we successfully validate targets for drug discovery, products that we develop with our collaborators based on those targets may include diagnostic or therapeutic products. The ability of our collaborators to commercialize such products may depend, in part, on the extent to which reimbursement for the cost of these products will be available from government health administration authorities, private health insurers and other organizations. In the U.S., third-party payors are increasingly challenging the price of medical products and services. The trend towards managed healthcare in the U.S., legislative healthcare reforms and the growth of organizations such as health maintenance organizations that may control or significantly influence the purchase of healthcare products and services, may result in lower prices for any products our collaborators may develop. Significant uncertainty exists as to the reimbursement status of newly approved healthcare products. If adequate third-party coverage is not available in the future, our collaborators may fail to maintain price levels sufficient to realize an appropriate return on their investment in research and product development.

### **Our facilities are located near known earthquake fault zones, and the occurrence of an earthquake or other catastrophic disaster could cause damage to our facilities and equipment, which could require us to cease or curtail operations.**

Our facilities are located near known earthquake fault zones and are vulnerable to damage from earthquakes. We are also vulnerable to damage from other types of disasters, including fire, floods, power loss, communications failures and similar events. If any disaster were to occur, our ability to operate our business at our facilities would be seriously, or potentially completely, impaired. In addition, the unique nature of our research activities could cause significant delays in our programs and make it difficult for us to recover from a disaster. The insurance we maintain may not be adequate to cover our losses resulting from disasters or other business interruptions. Accordingly, an earthquake or other disaster could materially and adversely harm our ability to conduct business.

### **Our stock price may be extremely volatile.**

We believe that the market price of our common stock will remain highly volatile and may fluctuate significantly due to a number of factors. The market prices for securities of many publicly-held, early-stage biotechnology companies have in the past been, and can in the future be expected to be, especially volatile. For example, during the two-year period from July 1, 2002 to June 30, 2004, the closing sales price of our common stock as quoted on the Nasdaq National Market and Nasdaq SmallCap Market fluctuated from a low of \$1.61 to a high of \$8.61 per share. In addition, the securities markets have from time to time experienced significant price and volume fluctuations that may

be unrelated to the operating performance of particular companies. The following factors and events may have a significant and adverse impact on the market price of our common stock:

fluctuations in our operating results;

announcements of technological innovations or new commercial products by us or our competitors;

release of reports by securities analysts;

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developments or disputes concerning patent or proprietary rights;

developments in our relationships with current or future collaborators, customers or licensees; and

general market conditions.

Many of these factors are beyond our control. These factors may cause a decrease in the market price of our common stock, regardless of our operating performance.

**Our securities have been transferred from the Nasdaq National Market to the Nasdaq SmallCap Market, which has subjected us to various statutory requirements and may have adversely affected the liquidity of our common stock, and a failure by us to meet the listing maintenance standards of the Nasdaq SmallCap Market could result in delisting from the Nasdaq SmallCap Market.**

Effective May 22, 2003, a Nasdaq Qualifications Panel terminated our Nasdaq National Market Listing and transferred our securities to the Nasdaq SmallCap Market. In order to maintain the listing of our securities on the Nasdaq SmallCap Market, we must be able to demonstrate compliance with all applicable listing maintenance requirements. In the event we are unable to do so, our securities will be delisted from the Nasdaq Stock Market.

With our securities listed on the Nasdaq SmallCap Market, we face a variety of legal and other consequences that will likely negatively affect our business including, without limitation, the following:

we may have lost our exemption from the provisions of Section 2115 of the California Corporations Code, which imposes aspects of California corporate law on certain non-California corporations operating within California. As a result, (i) our stockholders may be entitled to cumulative voting and (ii) we may be subject to more stringent stockholder approval requirements and more stockholder-favorable dissenters' rights in connection with certain strategic transactions;

the state securities law exemptions available to us are more limited, and, as a result, future issuances of our securities may require time-consuming and costly registration statements and qualifications;

due to the application of different securities law exemptions and provisions, we have been required to amend our stock option plan, suspend our stock purchase plan and must comply with time-consuming and costly administrative procedures;

the coverage of Lynx by securities analysts may decrease or cease entirely; and

we may lose current or potential investors.

In addition, we are required to satisfy various listing maintenance standards for our common stock to be quoted on the Nasdaq SmallCap Market. If we fail to meet such standards, our common stock would likely be delisted from the Nasdaq SmallCap Market and trade on the over-the-counter bulletin board, commonly referred to as the "pink sheets." This alternative is generally considered to be a less efficient market and would seriously impair the liquidity of our common stock and limit our potential to raise future capital through the sale of our common stock, which could materially harm our business.

**Anti-takeover provisions in our charter documents and under Delaware law may make it more difficult to acquire us or to effect a change in our management, even though an acquisition or management change may be beneficial to our stockholders.**

Under our certificate of incorporation, our board of directors has the authority, without further action by the holders of our common stock, to issue 2,000,000 additional shares of preferred stock from time to time in series and with preferences and rights as it may designate. These preferences and rights may be superior to those of the holders of our common stock. For example, the holders of preferred stock may be given a preference in payment upon our liquidation or for the payment or accumulation of dividends before any distributions are made to the holders of common stock.

Any authorization or issuance of preferred stock, while providing desirable flexibility in connection with financings, possible acquisitions and other corporate purposes, could also have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock or making it more difficult to remove directors

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and effect a change in management. The preferred stock may have other rights, including economic rights senior to those of our common stock, and, as a result, an issuance of additional preferred stock could lower the market value of our common stock. Provisions of Delaware law may also discourage, delay or prevent someone from acquiring or merging with us.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

#### **Short-Term Investments**

The primary objective of our investment activities is to preserve principal while, at the same time, maximizing yields without significantly increasing risk. To achieve this objective, we invest in highly liquid and high-quality debt securities. Our investments in debt securities are subject to interest rate risk. To minimize the exposure due to adverse shifts in interest rates, we invest in short-term securities and maintain an average maturity of less than one year. As a result, we do not believe we are subject to significant interest rate risk.

#### **Foreign Currency Rate Fluctuations**

The functional currency for our German subsidiary is the Euro. Our German subsidiary's accounts are translated from the Euro to the U.S. dollar using the current exchange rate in effect at the balance sheet date, for balance sheet accounts, and using the average exchange rate during the period, for revenues and expense accounts. The effects of translation are recorded as a separate component of stockholders' equity. Our German subsidiary conducted its business primarily in Euros. Exchange gains and losses arising from these transactions are recorded using the actual exchange differences on the date of the transaction. We have not taken any action to reduce our exposure to changes in foreign currency exchange rates, such as options or futures contracts, with respect to transactions with our German subsidiary or transactions with our European collaborators and customers.

### **Item 4. Controls and Procedures**

Based on their evaluation as of June 30, 2004, our chief executive officer and acting chief financial officer, have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) were sufficiently effective to ensure that the information required to be disclosed by us in this quarterly report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and Form 10-Q. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2004 that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

Our management, including our chief executive officer and acting chief financial officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls 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; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

None

**Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities**

On April 14, 2004, Lynx and Solexa closed a transaction to jointly acquire from Manteia the rights to proprietary technology assets for DNA colony generation. Lynx issued and delivered to Manteia 540,058 shares of common stock of Lynx for a value representing fifty (50) percent of the purchase price. Lynx issued the shares of common stock in reliance upon an exemption from the registration requirements of the Securities Act by virtue of Section 4(2) thereof and Regulation D promulgated thereunder. Lynx filed a resale registration statement on Form S-3 (No. 333-114239) with the SEC relating to the issued common stock, which the SEC declared effective on May 3, 2004.

**Item 3. Defaults Upon Senior Securities**

None

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

None

**Item 5. Other Information**

None

**Item 6. Exhibits and Reports on Form 8-K.**

a) Exhibits The following documents are filed as Exhibits to this report:

Exhibit Number	Description
3.1	Amended and Restated Certificate of Incorporation of the Company, incorporated by reference to the indicated exhibit of the Company's Form 10-Q for the period ended September 30, 2000.
3.1.1	Certificate of Amendment to Amended and Restated Certificate of Incorporation of the Company, incorporated by reference to the indicated exhibit of the Company's Form 10-K for the year ended December 31, 2002.
3.2	

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Bylaws of the Company, as amended, incorporated by reference to the indicated exhibit of the Company's Form 10-Q for the period ended June 30, 2000.

- 4.1 Form of Common Stock Certificate, incorporated by reference to Exhibit 4.2 of the Company's Statement Form 10 (File No. 0-22570), as amended.
- 10.46 Asset Purchase Agreement, dated as of March 22, 2004, by and among the Company and the parties listed therein, incorporated by reference to the indicated exhibit of the Company's Form 10-Q filed on May 13, 2004.
- 10.47+ Colony Technology Sharing Agreement, dated as of March 22, 2004, by and between Solexa Ltd. and the Company, incorporated by reference to the indicated exhibit of the Company's Form 10-Q filed on May 13, 2004.



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<b>Exhibit Number</b>	<b>Description</b>
31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1*	Certification required by Rule 13a-14(a) or Rule 15d-14(a) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).

## b) Reports on Form 8-K.

A Current Report on Form 8-K was filed on May 13, 2004 describing and furnishing the press release announcing our financial results for the first quarter 2004. The press release was furnished under Item 12.

\* This certification accompanies the Quarterly Report on Form 10-Q to which it relates, pursuant to Section 906 of the Sarbanes Oxley Act of 2002, and is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Lynx Therapeutics, Inc. under the Securities Act or the Exchange Act (whether made before or after the date of the Quarterly Report on Form 10-Q), irrespective of any general incorporation language contained in such filing.

+ Confidential treatment requested as to specific portions of this agreement, which portions are omitted and filed separately with the Securities and Exchange Commission.

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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.

LYNX THERAPEUTICS, INC.

/s/ Kevin P. Corcoran

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By: Kevin P. Corcoran  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: August 13, 2004

/s/ Kathy A. San Roman

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By: Kathy A. San Roman  
Vice President, Human Resources &  
Administration and Acting Chief  
Financial Officer  
(Principal Financial and Accounting  
Officer)

Date: August 13, 2004

**Table of Contents****EXHIBIT INDEX**

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