EXELIXIS INC
Form 10-Q
November 04, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended October 1, 2010

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: 000-30235

Exelixis, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**04-3257395**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

170 Harbor Way

P.O. Box 511

South San Francisco, California 94083

(Address of Principal Executive Offices) (Zip Code)

(650) 837-7000

(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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of October 29, 2010, there were 108,984,958 shares of the registrant s common stock outstanding.

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EXELIXIS, INC.

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED OCTOBER 1, 2010

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EXELIXIS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	September 30, 2010 (unaudited)	December 31, 2009 [1]
ASSETS		
Current assets:		
Cash and cash equivalents	$ 95,342	$ 86,796
Marketable securities	71,929	116,290
Other receivables	7,306	11,864
Prepaid expenses and other current assets	17,635	15,050
Total current assets	192,212	230,000
Restricted cash and investments	6,399	6,444
Long-term investments	87,295	11,463
Property and equipment, net	18,776	29,392
Goodwill	63,684	63,684
Other assets	4,540	2,427
Total assets	$ 372,906	$ 343,410
LIABILITIES, NONCONTROLLING INTEREST AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$ 2,906	$ 7,403
Accrued clinical trial liabilities	30,060	24,000
Other accrued liabilities	19,625	16,399
Accrued compensation and benefits	12,069	16,677
Current portion of notes payable and bank obligations	9,005	11,204
Current portion of convertible loans	28,050	28,050
Deferred revenue	102,254	103,385
Total current liabilities	203,969	207,118
Long term portion of notes payable and bank obligations	87,295	11,463
Long term portion of convertible loans	110,561	28,900
Other long-term liabilities	23,415	17,325
Deferred revenue	165,259	242,329
Total liabilities	590,499	507,135
Commitments		
Stockholders deficit:		

Exelixis, Inc. stockholders deficit:		
Common stock	109	108
Additional paid-in-capital	946,469	925,736
Accumulated other comprehensive income	18	155
Accumulated deficit	(1,164,189)	(1,089,724)
Total Exelixis, Inc. stockholders deficit	(217,593)	(163,725)
Noncontrolling interest		
Total stockholders deficit	(217,593)	(163,725)
Total liabilities, noncontrolling interest, and stockholders deficit	$ 372,906	$ 343,410

(1) The condensed consolidated balance sheet at December 31, 2009 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

The accompanying notes are an integral part of these condensed consolidated financial statements

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EXELIXIS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenues:				
Contract	$ 11,865	$ 24,608	$ 43,915	$ 37,615
License	24,542	30,368	73,648	70,066
Collaboration reimbursements	18,067		26,706	
Total revenues	54,474	54,976	144,269	107,681
Operating expenses:				
Research and development	49,388	60,186	168,375	170,567
General and administrative	8,952	8,643	27,358	25,910
Collaboration cost sharing		2,965		2,807
Restructuring charge	339		25,823	
Total operating expenses	58,679	71,794	221,556	199,284
Loss from operations	(4,205)	(16,818)	(77,287)	(91,603)
Other income (expense):				
Interest income and other, net	(376)	355	331	1,276
Interest expense	(4,094)	(2,122)	(5,378)	(6,356)
Gain on sale of business			7,797	1,800
Loss on deconsolidation of Symphony Evolution, Inc.				(9,826)
Total other income (expense), net	(4,470)	(1,767)	2,750	(13,106)
Consolidated loss before taxes	(8,675)	(18,585)	(74,537)	(104,709)
Income tax benefit (provision)	72	(6,860)	72	(6,014)
Consolidated net loss	(8,603)	(25,445)	(74,465)	(110,723)
Loss attributable to noncontrolling interest.				4,337
Net loss attributable to Exelixis, Inc.	$ (8,603)	$ (25,445)	$ (74,465)	$ (106,386)
Net loss per share, basic and diluted, attributable to Exelixis, Inc.	$ (0.08)	$ (0.24)	$ (0.69)	$ (1.00)
Shares used in computing basic and diluted loss per share amounts	108,667	107,336	108,373	106,853

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EXELIXIS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended September 30,	
	2010	2009
Cash flows from operating activities:		
Consolidated net loss	$ (74,465)	$ (110,723)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	8,276	9,558
Stock-based compensation expense	16,744	17,512
Impairment of assets	2,481	
Gain on sale of business	(7,797)	
Loss on deconsolidation of Symphony Evolution, Inc.		9,826
Accretion of Deerfield implied interest	1,661	
Other	2,415	621
Changes in assets and liabilities:		
Other receivables	4,558	(8,035)
Prepaid expenses and other current assets	(2,957)	(2,909)
Other assets	(1,720)	1,111
Accounts payable and other accrued expenses	(1,210)	1,305
Accrued restructuring liability	9,169	
Other long-term liabilities	(1,256)	1,287
Deferred revenue	(78,201)	116,606
Net cash used in operating activities	(122,302)	36,159
Cash flows from investing activities:		
Purchases of investments held by Symphony Evolution, Inc.		(49)
Proceeds on sale of investments held by Symphony Evolution, Inc.		4,497
Purchases of property and equipment	(1,481)	(1,592)
Proceeds from sale of property and equipment	179	
Proceeds on sale of business	8,600	1,800
Increase (decrease) in restricted cash and investments	45	(729)
Proceeds from maturities of marketable securities	95,100	5,998
Proceeds from sale of marketable securities	12,780	7,793
Purchases of marketable securities	(141,186)	(121,889)
Net cash used in investing activities	(25,963)	(104,171)
Cash flows from financing activities:		
Proceeds from exercise of stock options and warrants	1,054	4
Proceeds from employee stock purchase plan	2,122	2,150
Proceeds from note payable and bank obligations	162,508	
Principal payments on notes payable and bank obligations	(8,873)	(11,245)
Repayments, net from deconsolidation of Symphony Evolution, Inc.		(25)
Net cash provided by (used in) financing activities	156,811	(9,116)

Net increase (decrease) in cash and cash equivalents	8,546	(77,128)
Cash and cash equivalents, at beginning of period	86,796	247,698
Cash and cash equivalents, at end of period	$ 95,342	$ 170,570

The accompanying notes are an integral part of these condensed consolidated financial statements.

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2010

(unaudited)

NOTE 1. Organization and Summary of Significant Accounting Policies

Organization

Exelixis, Inc. (Exelixis, we, our or us) is committed to developing innovative therapies for cancer. Through our drug discovery and developmen activities, we are building a portfolio of novel compounds that we believe have the potential to be high-quality, differentiated pharmaceutical products. Our most advanced pharmaceutical programs focus on drug discovery and development of small molecule drugs for cancer. XL184, an inhibitor of MET, VEGFR2 and RET, is our most advanced drug candidate and is currently being evaluated in a broad development program.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and pursuant to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (GAAP) for complete financial statements. In our opinion, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the results of operations and cash flows for the period presented have been included.

Exelixis has adopted a 52- or 53-week fiscal year that ends on the Friday closest to December 31st of each year. Fiscal year 2009, a 52-week year, ended on January 1, 2010, and fiscal year 2010, a 52-week year, will end on December 31, 2010. For convenience, references in these Condensed Consolidated Financial Statements and Notes as of and for the fiscal year ended January 1, 2010 are indicated on a calendar year basis as ended December 31, 2009 and as of and for the fiscal quarters ended October 2, 2009 and October 1, 2010 are indicated as ended September 30, 2009 and 2010, respectively.

Operating results for the three and nine months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2010 or for any future period. These financial statements and notes should be read in conjunction with the consolidated financial statements and notes thereto for the fiscal year ended December 31, 2009 included in our Annual Report on Form 10-K filed with the SEC on March 10, 2010.

Basis of Consolidation

The consolidated financial statements include the accounts of Exelixis and our wholly owned subsidiaries as well as one former variable interest entity, Symphony Evolution, Inc. (SEI), for which we were the primary beneficiary. As of June 9, 2009, our purchase option for SEI expired and as a result, we are no longer considered to be the primary beneficiary (refer to Note 6 of the financial statements included in our Annual Report on Form 10-K filed with the SEC on March 10, 2010). All significant intercompany balances and transactions have been eliminated.

Cash and Investments

We consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. We invest in high-grade, short-term commercial paper and money market funds, which are subject to minimal credit and market risk.

All marketable securities are classified as available-for-sale and are carried at fair value. We view our available-for-sale portfolio as available for use in current operations. Accordingly, we have classified certain investments as short-term marketable securities, even though the stated maturity date may be one year or more beyond the current balance sheet date. Available-for-sale securities are stated at fair value based upon quoted market prices of the securities. We have classified certain investments as cash and cash equivalents or marketable securities that collateralize loan balances. However, they are not restricted to withdrawal. Unrealized gains and losses on available-for-sale investments are

reported as a separate component of stockholders equity. Realized gains and losses, net, on available-for-sale securities are included in interest income. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest income.

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(unaudited)

The following summarizes available-for-sale securities included in cash and cash equivalents, restricted cash, and marketable securities as of September 30, 2010 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Money market funds	$ 150,606	$	$	$ 150,606
Commercial paper	28,995	1		28,996
Corporate bonds	32,435	28	(12)	32,451
U.S. government agency securities	2,002	1		2,003
Government sponsored enterprises	35,547	2	(2)	35,547
Municipal bonds	12,040			12,040
Total	$ 261,625	$ 32	$ (14)	$ 261,643

As of September 30, 2010, all of our investments in debt securities had remaining maturities of less than one year.

The following summarizes available-for-sale securities included in cash and cash equivalents, restricted cash, and marketable securities as of December 31, 2009 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Money market funds	$ 74,465			$ 74,465
Commercial paper	24,277			24,277
Corporate bonds	55,808	152	(17)	55,943
U.S. government agency securities	11,077	8		11,085
Government sponsored enterprises	37,990	17	(1)	38,006
Municipal bonds	17,769		(3)	17,766
Total	$ 221,386	177	(21)	$ 221,542

Foreign Currency Forward Contract

We have entered into foreign currency forward contracts to reduce our net exposure to Eurodollar currency fluctuations. We entered into a contract in February 2010 which had a notional amount of approximately $7.0 million that expired in June 2010. In June 2010, we settled this contract for a net gain and cash receipt of $0.7 million and entered into another foreign contract for a notional amount of $6.1 million that expired in October 2010. The fair value of the foreign currency contracts is estimated based on pricing models using readily observable inputs from actively quoted markets. As of September 30, 2010, the fair value of the current foreign currency forward contract was a loss of

approximately $0.8 million, and was classified in other accrued liabilities on our consolidated balance sheet. The net unrealized gain/loss on our foreign currency forward contracts, neither of which was designated as a hedge, was recorded in our consolidated statement of operations as Interest income and other (net).

Fair Value Measurements

The fair value of our financial instruments reflects the amounts that would be received upon sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The fair value hierarchy has the following three levels:

Level 1 quoted prices in active markets for identical assets and liabilities.

Level 2 observable inputs other than quoted prices in active markets for identical assets and liabilities.

Level 3 unobservable inputs.

Our financial instruments are valued using quoted prices in active markets or based upon other observable inputs. The following tables set forth the fair value of our financial assets for the periods ended September 30, 2010 and December 31, 2009, respectively (in thousands):

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(unaudited)

As of September 30, 2010:

	Level 1	Level 2	Level 3	Total
Money market funds	$ 150,606	$	$	$ 150,606
Commercial paper		28,996		28,996
Corporate bonds		32,451		32,451
U.S. government agency securities		2,003		2,003
Government sponsored enterprises		35,547		35,547
Municipal bonds		12,040		12,040
Foreign currency forward contract [(1)]		(757)		(757)
Total	$ 150,606	$ 110,280	$	$ 260,886

(1) As of September 30, 2010, the fair value of our Level 2 current assets included approximately $0.8 million in unrealized losses related to a foreign exchange forward contract established during the quarter ended September 30, 2010.

As of December 31, 2009:

	Level 1	Level 2	Level 3	Total
Money market funds	$ 74,465	$	$	$ 74,465
Commercial paper		24,277		24,277
Corporate bonds		55,943		55,943
U.S. government agency securities		11,085		11,085
Government sponsored enterprises		38,006		38,006
Municipal bonds		17,766		17,766
Total	$ 74,465	$ 147,077	$	$ 221,542

We have estimated the fair value of our long-term debt instruments, where possible, using the net present value of the payments discounted at an interest rate that is consistent with our current borrowing rate for similar long-term debt. However, due to the unique structure of our 2010 financing agreement with Deerfield Private Design Fund, L.P. and Deerfield Private Design International, L.P. (collectively, the Deerfield Entities) and the current non-liquid market in structured notes, there is no practicable method to determine the fair value of this instrument. See Note 6 for details on the structure and terms of our 2010 financing with the Deerfield Entities. The estimated fair value of our outstanding debt, excluding our 2010 financing with the Deerfield Entities, was as follows (in thousands):

	September 30, 2010	December 31, 2009
GlaxoSmithKline loan	$ 53,893	$ 50,191
Equipment lines of credit	16,183	22,530
Silicon Valley Bank Loan	77,384	
Total	$ 147,460	$ 72,721

At September 30, 2010 and December 31, 2009, the book value of our debt outstanding, including our 2010 financing with the Deerfield Entities, was $233.0 million and $79.6 million, respectively. Our payment commitments associated with these debt instruments are generally fixed during the corresponding terms and are comprised of interest payments, principal payments or a combination thereof. The fair value of our debt will fluctuate with movements of interest rates, increasing in periods of declining rates of interest, and declining in periods of increasing rates of interest.

Net Loss Per Share

Basic and diluted net loss per share are computed by dividing the net loss attributable to Exelixis, Inc. for the period by the weighted average number of shares of common stock outstanding during the period. The calculation of diluted net loss per share excludes potential common stock because its effect is antidilutive. Potential common stock consists of incremental common shares issuable upon the exercise of stock options and warrants and shares issuable under restricted stock units (RSUs) and upon conversion of our convertible loans.

As of September 30, 2010, our potential common stock includes 23,036,592 shares related to convertible notes payable, 20,185,410 shares issuable upon the exercise of outstanding stock options, 2,196,756 shares issuable under RSUs and 2,250,000 shares issuable upon the exercise of outstanding warrants, all of which have been excluded from the computation of diluted net loss per share because their impact is antidilutive.

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(unaudited)

Collaboration Arrangements

Collaborative agreement reimbursement revenue or collaboration cost sharing expenses are recorded as earned or owed based on the performance requirements by both parties under the respective contracts. Under our 2008 cancer collaboration with Bristol-Myers Squibb Company (Bristol-Myers Squibb), both parties have been actively involved with compound development and certain research and development expenses were partially reimbursable to us on a net basis by compound. On an annual basis, amounts owed by Bristol-Myers Squibb to us, net of amounts reimbursable to Bristol-Myers Squibb by us on those projects, are recorded as collaboration reimbursement revenue. Conversely, research and development expenses may include the net settlement of amounts we owe Bristol-Myers Squibb for research and development expenses that Bristol-Myers Squibb incurred on joint development projects, less amounts reimbursable to us by Bristol-Myers Squibb on these projects. In 2009, when net research and development funding payments were payable to Bristol-Myers Squibb, these payments were presented as collaboration cost-sharing expense. However, during the fiscal year ending December 31, 2010 and in future fiscal years, we expect to be in a net receivable position, and will therefore present reimbursement payments as collaboration reimbursement revenue. Revenue and expenses from collaborations that are not co-development agreements are recorded as contract revenue or research and development expenses in the period incurred.

Recent Accounting Pronouncements

In March 2010, Accounting Standards Codification Topic 605, *Revenue Recognition* (ASC 605) was amended to define a milestone and clarify that the milestone method of revenue recognition is a valid application of the proportional performance model when applied to research or development arrangements. Accordingly, a company can make an accounting policy election to recognize a payment that is contingent upon the achievement of a substantive milestone in its entirety in the period in which the milestone is achieved. We adopted ASC 605 in the third quarter of 2010 on a prospective basis. However, we are not changing our method by which we recognize milestones and therefore do not expect our adoption of ASC 605 to have a material effect on our financial statements going forward.

Accounting Standards Update No. 2009-13, Revenue Recognition Topic 605: *Multiple Deliverable Revenue Arrangements A Consensus of the FASB Emerging Issues Task Force* (ASU 2009-13) provides application guidance on whether multiple deliverables exist, how the deliverables should be separated and how the consideration should be allocated to one or more units of accounting. This update establishes a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor-specific objective evidence, if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific or third-party evidence is available. We expect to adopt this guidance prospectively beginning on January 1, 2011. We believe that the adoption of ASU 2009-13 could have a material impact on our financial statements going forward.

NOTE 2. Comprehensive Loss

Comprehensive loss represents consolidated net loss plus the results of certain stockholders equity changes, which are comprised of unrealized gains and losses on available-for-sale securities, not reflected in the consolidated statements of operations. Comprehensive loss was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009

Consolidated net loss	$ (8,603)	$ (25,445)	$ (74,465)	$ (110,723)
Increase in unrealized gains (losses) on available-for-sale securities		76	(138)	96
Comprehensive loss	(8,603)	(25,369)	(74,603)	(110,627)
Comprehensive loss attributable to the noncontrolling interest				4,337
Comprehensive loss attributable to Exelixis, Inc.	$ (8,603)	$ (25,369)	$ (74,603)	$ (106,290)

NOTE 3. Stock-Based Compensation

We recorded and allocated employee stock-based compensation expenses as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Research and development expense	$ 2,477	$ 3,979	$ 9,148	$ 11,789
General and administrative expense	2,956	1,951	6,546	5,689
Restructuring-related stock compensation expense			961	
Total employee stock-based compensation expense	$ 5,433	$ 5,930	$ 16,655	$ 17,478

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(unaudited)

During July 2010, our former Chief Executive Officer, George A. Scangos, Ph.D., resigned as an employee of Exelixis and in connection with such resignation agreed to cancel unvested stock options exercisable for 981,302 and unvested RSUs with respect to 101,050 share of our common stock. Due to Dr. Scangos continued services as a director of Exelixis he would have been entitled to retain his stock options and RSUs. Therefore, we treated the cancellation as a modification of his stock option and RSU agreements and recorded a non-cash compensation charge of approximately $1.5 million to our consolidated statement of operations during the third quarter of 2010. To calculate the charge, we assumed Dr. Scangos would continue to serve as a director until our 2011 annual stockholder meeting.

We use the Black-Scholes option pricing model to value our stock options. The expected life computation is based on historical exercise patterns and post-vesting termination behavior. We considered implied volatility as well as our historical volatility in developing our estimate of expected volatility. The fair value of employee share-based payments awards was estimated using the following assumptions and weighted average fair values:

	Stock Options Three Months Ended September 30,		ESPP Three Months Ended September 30,	
	2010 (1)	2009 (2)	2010	2009
Weighted average fair value of awards	$ N/A	$ 3.54	$ 2.08	$ 1.37
Risk-free interest rate	N/A	2.5%	0.25%	0.30%
Dividend yield	N/A	0%	0%	0%
Volatility	N/A	67%	75%	61%
Expected life	N/A	5.6 years	0.5 years	0.44 years

(1)There were no options granted during the three months ended September 30, 2010.

	Stock Options Nine Months Ended September 30,		ESPP Nine Months Ended September 30,	
	2010	2009(2)	2010	2009
Weighted average fair value of awards	$ 3.60	$ 2.93	$ 1.99	$ 1.67
Risk-free interest rate	2.25%	2.3%	0.20%	0.18%
Dividend yield	0%	0%	0%	0%
Volatility	70%	67%	66.%	65%
Expected life	5.2 years	5.6 years	0.5 years	0.17 years

(2) These exclude the assumptions used to estimate the fair value of the options granted under the stock option exchange program as discussed below.

On July 7, 2009, we commenced a stock option exchange program approved by our stockholders on May 14, 2009. The exchange program was open to all eligible employees who, at the start of the exchange program, were employed by us or one of our subsidiaries and remained employed through August 5, 2009, the date that the replacement stock options were granted. As a result of the exchange, 9.9 million options

were cancelled, of which 7.3 million and 2.6 million were vested and unvested, respectively. Of the 7.2 million replacement options that were granted, 5.1 million were issued in exchange for vested options and will vest over a one year term, while 2.1 million options were issued in exchange for unvested options and will vest over three years, with a one year cliff. In association with these grants, we expect to recognize incremental compensation cost of approximately $0.8 million ratably over the vesting period, of which we have recognized approximately $0.1 million as of September 30, 2009.

The fair value of replacement options issued under the option exchange were estimated using the following assumptions and weighted average fair values:

Weighted average fair value of awards	2.82
Risk-free interest rate	2.1%
Dividend yield	0%
Volatility	67%
Expected life	3.7 years

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2010

(unaudited)

A summary of all stock option activity for the nine months ended September 30, 2010 is presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Options outstanding at December 31, 2009	24,393,598	$ 7.46		
Granted	243,500	6.28		
Exercised	(206,851)	5.10		
Cancelled	(4,244,837)	7.33		
Options outstanding at September 30, 2010	20,185,410	$ 7.49	5.8 years	$ 11,517
Exercisable at September 30, 2010	14,507,195	$ 7.89	5.0 years	$ 5,288

As of September 30, 2010, $15.5 million of total unrecognized compensation expense related to employee stock options was expected to be recognized over a weighted-average period of 2.44 years.

A summary of all RSU activity for the nine months ended September 30, 2010 is presented below:

	Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
RSUs outstanding at December 31, 2009	2,679,224	$ 7.46		
Awarded	145,575	6.20		
Forfeited	(628,043)	7.45		
Awards outstanding at September 30, 2010	2,196,756	$ 7.39	1.6 years	$ 8,721,121

As of September 30, 2010, $11.1 million of total unrecognized compensation expense related to employee RSUs was expected to be recognized over a weighted-average period of 3.39 years.

NOTE 4. Collaborations

Bristol-Myers Squibb

2008 Cancer Collaboration. In December 2008, we entered into a worldwide collaboration with Bristol-Myers Squibb for XL184 and XL281. Upon effectiveness of the collaboration agreement, Bristol-Myers Squibb made an upfront cash payment of $195.0 million and additional license payments of $45.0 million, which were received in 2009. On June 18, 2010, we regained full rights to develop and commercialize XL184 following receipt of notice from Bristol-Myers Squibb of its decision to terminate the 2008 collaboration, solely as to XL184, on a worldwide basis.

Bristol-Myers Squibb received an exclusive worldwide license to develop and commercialize XL281. We will carry out certain clinical trials of XL281 which may include a backup program on XL281. Bristol-Myers Squibb is responsible for funding all future development on XL281, including our activities. We are eligible for development and regulatory milestones of up to $315.0 million on XL281, sales performance milestones of up to $150.0 million and double-digit royalties on worldwide sales of XL281.

The upfront payment of $195.0 million and the license payments of $45.0 million are being recognized ratably from the effective date of the agreement over the estimated development term and recorded as license revenue. Any milestone payments that we may receive under the collaboration agreement will be recognized ratably over the remaining development term but recorded as contract revenue. We record as operating expense 100% of the cost incurred for work performed by us under the collaboration agreement. Prior to the termination of the collaboration as to XL184, there were periods during which Bristol-Myers Squibb partially reimbursed us for certain research and development expenses, and other periods during which we owed Bristol-Myers Squibb for research and development expenses that Bristol-Myers Squibb incurred on joint development projects, less amounts reimbursable to us by Bristol-Myers Squibb on these projects. For the year ended December 31, 2009, we incurred a net payable to Bristol-Myers Squibb and presented these payments as collaboration cost sharing expense. However, during the fiscal year ending December 31, 2010 and in future fiscal years, we expect to be in a net receivable position, and will therefore present these reimbursement payments as collaboration reimbursement revenue.

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As a result of the termination of the 2008 collaboration with respect to XL184, we regained full rights to develop and commercialize XL184 and on June 28, 2010, in connection with the termination, we received a $17.0 million transition payment from Bristol-Myers Squibb which was recognized in full as collaboration reimbursement revenue in the third quarter of 2010. This transition payment was made in satisfaction of Bristol-Myers Squibb s obligations under the collaboration agreement to continue to fund its share of development costs for XL184 for a period of three months following the notice of termination. As a result of the termination, Bristol-Myers Squibb s license relating to XL184 was terminated, the rights to XL184 reverted to us, and we will receive, subject to certain terms and conditions, licenses from Bristol-Myers Squibb to research, develop and commercialize XL184. The collaboration remains in full force and effect with respect to XL281 and the upfront license fees continue to be recognized over the estimated performance obligation which was revised in the second quarter of 2010 and is expected to be completed during 2013.

Amounts attributable to both programs under the collaboration agreement consisted of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009 (2)	2010	2009 (2)
Exelixis research and development expenses (1)	$ 845	$ 15,218	$ 41,320	$ 34,987
Net amount due from (owed to) collaboration partner	18,067	(2,965)	26,706	(2,807)

(1) Total research and development expenses attributable to us include direct third party expenditures plus estimated internal personnel costs.
(2) The net amount owed to the collaborative partner is classified as an increase in operating expenses for the three and nine months ended September 30, 2009.

On October 8, 2010, we entered into new agreements with Bristol-Myers Squibb relating to two of our programs and amended certain of our existing collaborations agreements. See Note 7 for details regarding these transactions.

sanofi-aventis

On May 27, 2009, we entered into a global license agreement with sanofi-aventis for XL147 and XL765, and a broad collaboration for the discovery of inhibitors of phosphoinositide-3 kinase (PI3K) for the treatment of cancer. The license agreement and collaboration agreement became effective on July 7, 2009. The effectiveness of the license and collaboration on July 20, 2009 triggered upfront payments of $140.0 million ($120.0 million for the license and $20.0 million for the collaboration), which we received during the third quarter of fiscal 2009.

Under the license agreement, sanofi-aventis received a worldwide exclusive license to XL147 and XL765, which are currently in phase 1, phase 1b/2 and phase 2 clinical trials, and has sole responsibility for all subsequent clinical, regulatory, commercial and manufacturing activities. It is expected that we will continue to participate in the conduct of ongoing and potential future clinical trials and manufacturing activities. Sanofi-aventis is responsible for funding all future development activities with respect to XL147 and XL765, including our activities. Under the collaboration agreement, the parties are combining efforts in establishing several preclinical PI3K programs and jointly share responsibility for research and preclinical activities related to isoform-selective inhibitors of PI3K-a and -ß. Sanofi-aventis will provide us with guaranteed annual research and development funding during the research term and is responsible for funding all development activities for each product following approval of the investigational new drug application filed with the applicable regulatory authorities for such product. Sanofi-aventis will have sole responsibility for all subsequent clinical, regulatory, commercial and manufacturing activities of any products arising from the

collaboration; however, we may be requested to conduct certain clinical trials at sanofi-aventis expense. The research term under the collaboration is three years, although sanofi-aventis has the right to extend the term for an additional one-year period upon prior written notice.

In addition to the aggregate upfront cash payments for the license and collaboration agreements, we are entitled to receive guaranteed research funding of $21.0 million over three years to cover certain of our costs under the collaboration agreement. For both the license and the collaboration combined, we will be eligible to receive development, regulatory and commercial milestones of over $1.0 billion in the aggregate, as well as royalties on sales of any products commercialized under the license or collaboration. The aggregate upfront payments of $140.0 million will be recognized over the estimated research and development term of four years, and recorded as license revenue, from the effective date of the agreements. For the nine months ended September 30, 2010, we recognized $26.3 million in license revenue related to such upfront payments. Any milestone payments that we may receive under the agreements will be amortized over the remaining research and development term and recorded as contract revenue. We will record as operating expenses all costs incurred for work performed by us under the agreements. Reimbursements we receive from sanofi-aventis under the agreements will be recorded as contract revenue as earned, commencing as of the effective date, including reimbursements for costs incurred under the license from the date of signing. In addition, the guaranteed research funding that we expect to receive over the three year research term under the collaboration will be recorded as contract revenue commencing as of the effective date of the

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collaboration. For the nine months ended September 30, 2010, we recognized $32.3 million in contract revenue related to cost reimbursement and guaranteed research funding.

Sanofi-aventis may, upon certain prior notice to us, terminate the license as to products containing XL147 or XL765. In the event of such termination election, sanofi-aventis license relating to such product would terminate and revert to us, and we would receive, subject to certain terms, conditions and potential payment obligations, licenses from sanofi-aventis to research, develop and commercialize such products.

The collaboration will automatically terminate under certain circumstances upon the expiration of the research term, in which case all licenses granted by the parties to each other would terminate and revert to the respective party, subject to sanofi-aventis right to receive, under certain circumstances, the first opportunity to obtain a license from us to any isoform-selective PI3K inhibitor. In addition, sanofi-aventis may, upon certain prior written notice to us, terminate the collaboration in whole or as to certain products following expiration of the research term, in which case we would receive, subject to certain terms, conditions and potential payment obligations by us, licenses from sanofi-aventis to research, develop and commercialize such products.

Boehringer Ingelheim

On May 7, 2009, we entered into a collaboration agreement with Boehringer Ingelheim International GmbH (Boehringer Ingelheim) to discover, develop and commercialize products that consist of agonists of the sphingosine-1-phosphate type 1 receptor (S1P1R), a central mediator of multiple pathways implicated in a variety of autoimmune diseases.

Under the terms of the agreement, Boehringer Ingelheim paid us an upfront cash payment of $15.0 million for the development and commercialization rights to our S1P1R agonist program. We share responsibility for discovery activities under the collaboration. The agreement provides that the parties will each conduct research under a mutually agreed upon research plan until such time that we submit a compound that has met agreed-upon criteria, or such later time as agreed upon by the parties. The parties are responsible for their respective costs and expenses incurred in connection with performing research under the collaboration. Under the collaboration, Boehringer Ingelheim also has the right, at its own expense, to conduct additional research on S1P1R agonists outside of the scope of the research plan agreed to by the parties. The agreement further provides that Boehringer Ingelheim will receive an exclusive worldwide license to further develop, commercialize and manufacture compounds developed under the collaboration and will have sole responsibility for, and shall bear all costs and expenses associated with, all subsequent preclinical, clinical, regulatory, commercial and manufacturing activities. In return, we will potentially receive up to $339.0 million in further development, regulatory and commercial milestones and are eligible to receive royalties on worldwide sales of products commercialized under the collaboration. The upfront payment is being recognized ratably over the estimated research term and recorded as license revenue from the effective date of the agreement. During the first half of 2010, the expected research term was extended from eleven months to twenty three months through March 2011, resulting in an extension of the term for revenue recognition purposes and a corresponding decrease in license revenue recognized each quarter. From commencement of the collaboration through September 30, 2010, we have recognized a total of $13.6 million in license revenue under this agreement.

Boehringer Ingelheim may, upon certain prior notice to us, terminate the agreement as to any product developed under the collaboration. In the event of such termination election, Boehringer Ingelheim s license relating to such product would terminate and revert to us, and we would receive, subject to certain terms and conditions, licenses from Boehringer Ingelheim to research, develop and commercialize such product.

NOTE 5: 2010 Restructuring Charge

On March 8, 2010, we implemented a restructuring plan that resulted in a reduction of our workforce by approximately 40%, or 270 employees. A small number of the terminated employees were subsequently recalled and the termination of a small group of employees has been delayed, all of whom continue to provide services to us. The remaining impacted employees were terminated immediately upon implementation of the plan or by March 31, 2010. The decision to restructure our operations was based on our corporate strategy to focus our efforts on our lead

clinical compounds, XL184, XL147 and XL765, by dedicating the majority of our resources to aggressively drive these drug candidates through development towards commercialization.

In connection with the 2010 restructuring plan, we recorded a charge of approximately $16.1 million in the first quarter of 2010 primarily related to one-time termination benefits, which includes the modification of certain stock option awards previously granted to the terminated employees. The modification accelerates the vesting of any stock options that would have vested over the period beginning from cessation of employment through August 5, 2010. Employees who were terminated in March also received an additional two months to exercise their options, for which a small charge was taken. The remainder of the charge was for the impairment of various assets and for non-cash charges relating to the closure of our facility in San Diego, California. The total impairment charge of $2.5 million was due to the disposal and write-down to estimated fair-market value of fixed assets that were deemed redundant or will have a reduced useful life as a result of us vacating our San Diego facility and our exit of one of our South

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San Francisco facilities. The fair-value of the fixed assets impaired assumed that we would exit the South San Francisco building by June 30, 2010, which subsequently occurred.

On July 9, 2010, we entered into a sublease with Onyx Pharmaceuticals, Inc. (Onyx) with respect to approximately 68,738 square feet of the property located at 249 East Grand Avenue, South San Francisco, California. The term of the sublease commenced on September 1, 2010, and will expire on November 30, 2015, the end of our lease term. Under the sublease, Onyx agreed to pay us monthly base rent for the subleased premises in addition to certain operating expenses. In connection with the execution and delivery of the sublease, we also entered into an amendment to our lease with the landlord, pursuant to which, among other things, our right to extend the term of the lease was terminated. We recorded further restructuring expenses of approximately $9.4 million during the second quarter of 2010 and $0.3 million during the third quarter of 2010 associated primarily with lease-exit costs associated with the sublease and exit of our South San Francisco building, partially offset by a reduction in one-time termination benefits following the recall of certain employees that were originally terminated under the restructuring plan and the continued delay in the termination of the small group of employees referred to above.

We expect that the restructuring plan will result in total cash expenditures of approximately $24.8 million, of which approximately $14.3 million is expected to be paid in 2010. The balance will be paid over an additional five years and primarily relates to net payments due under the lease for our South San Francisco building that we exited during the second quarter of 2010, partially offset by payments due to us under the sublease agreement that we signed in July 2010.

The outstanding restructuring liability is included in Accrued Compensation and Benefits , Other Accrued Expenses , and Other Long-Term Liabilities on our Condensed Consolidated Balance Sheet as of September 30, 2010 and the components are summarized in the following table (in thousands):

	Employee Severance And Other Benefits	Facility Charges	Asset Impairment	Legal and Other Fees	Total
Restructuring charge as of December 31, 2009	$	$	$	$	$
Restructuring charge recorded in the nine months ended September 30 2010	11,702	11,609	2,482	30	25,823
Cash payments	(10,456)	(3,238)		(10)	(13,704)
Adjustments or non-cash credits including stock compensation expense	(1,082)	613	(2,482)		(2,951)
Ending accrual balance as of September 30, 2010	$ 164	$ 8,984	$	$ 20	$ 9,168

NOTE 6: Debt

Silicon Valley Bank Loan and Security Agreement

In May 2002, we entered into a loan and security agreement with Silicon Valley bank for an equipment line of credit of up to $16.0 million with a draw down period of one year. Each draw on the line of credit has a payment term of 48 months and bears interest at the bank s published prime rate. We extended the draw down period on the line-of-credit for an additional year in June 2003 and increased the principal amount of the line of credit from $16.0 million to $19.0 million in September 2003. This equipment line of credit was fully drawn as of December 31, 2004 and was fully paid off as of December 31, 2007.

In December 2004, we entered into a loan modification agreement to the loan and security agreement originally entered into in May 2002. The terms associated with the original $16.0 million line of credit under the May 2002 agreement were not modified. The loan modification agreement provided for an additional equipment line of credit in the amount of up to $20.0 million with a draw down period of one year. Pursuant to the terms of the modified agreement, we were required to make interest only payments through February 2006 at an annual rate of 0.70% on all outstanding advances. This equipment line of credit was fully drawn as of March 31, 2006 and was fully paid off as of March 31, 2010.

In December 2006, we entered into a second loan modification agreement to the loan and security agreement originally entered into in May 2002. The terms associated with the original line of credit under the May 2002 agreement and December 2004 loan modification agreement were not modified. The December 2006 loan modification agreement provided for an additional equipment line of credit in the amount of up to $25.0 million with a draw down period of approximately one year. Each advance must be repaid in 48 equal, monthly installments of principal, plus accrued interest, at an annual rate of 0.85% fixed and is subject to a prepayment penalty of 1.0%. The loan facility is secured by a non-interest bearing certificate of deposit account with the bank, in an amount equal to at least 100% of the outstanding obligations under the line of credit. This equipment line of credit was fully drawn as of December 31, 2008. The collateral balance of $4.8 million is recorded in the accompanying consolidated balance sheet as cash and cash equivalents and marketable securities as the deposit account is not restricted as to withdrawal. The outstanding obligation under the line of credit as of September 30, 2010 and 2009 was $4.3 million and $10.5 million, respectively.

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In December 2007, we entered into a third loan modification agreement to the loan and security agreement originally entered into in May 2002. The terms associated with the original line of credit under the May 2002 agreement and the subsequent loan modifications were not modified. The December 2007 loan modification agreement provides for an additional equipment line of credit in the amount of up to $30.0 million with a draw down period of approximately 2 years. Each advance must be repaid in 48 equal, monthly installments of principal, plus accrued interest, at an annual rate of 0.75% fixed. In December 2009, we amended the agreement and extended the draw down period on the line-of-credit for an additional 18 months through June 2011 and increased the principal amount of the line of credit from $30.0 million to $33.6 million. Pursuant to the terms of the amendment, we are required to make minimum draws of $2.5 million every 6 months through June 2011, for total additional draws of $7.5 million. The loan facility requires security in the form of a non-interest bearing certificate of deposit account with the bank, in an amount equal to at least 100% of the outstanding obligations under the line of credit. In June 2008, we drew down $13.6 million under this agreement, in December 2009, we drew down $5.0 million, and in June 2010, in accordance with the terms of the modified agreement, we drew down an additional $2.5 million. The collateral balance of $12.5 million is recorded in the accompanying consolidated balance sheet as cash and cash equivalents and marketable securities as the deposit account is not restricted as to withdrawal. The outstanding obligation under the line of credit as of September 30, 2010 and 2009 was $12.0 million and $9.1 million, respectively.

On June 2, 2010, we amended our loan and security agreement with Silicon Valley Bank to provide for a new seven-year term loan in the amount of $80.0 million. The principal amount outstanding under the term loan accrues interest at 1.00% per annum, which interest is due and payable monthly. We are required to repay the term loan in one balloon principal payment, representing 100% of the principal balance and accrued and unpaid interest, on May 31, 2017. We have the option to prepay all, but not less than all, of the amounts advanced under the term loan, provided that we pay all unpaid accrued interest thereon that is due through the date of such prepayment and the interest on the entire principal balance of the term loan that would otherwise have been paid after such prepayment date until the maturity date of the term loan. We are required to maintain at all times on deposit in a non-interest bearing demand deposit account(s) with Silicon Valley Bank or one of its affiliates a compensating balance, which constitutes support for the obligations under the term loan, with a principal balance in value equal to at least 100% of the outstanding principal balance of the term loan. Any amounts outstanding under the term loan during the continuance of an event of default under the loan and security agreement will, at the election of Silicon Valley Bank, bear interest at a per annum rate equal to 6.00%. If one or more events of default under the loan and security agreement occurs and continues beyond any applicable cure period, Silicon Valley Bank may declare all or part of the obligations under the loan and security agreement to be immediately due and payable and stop advancing money or extending credit to us under the loan and security agreement.

Deerfield Financing

On June 2, 2010, we entered into a note purchase agreement with the Deerfield Entities, pursuant to which, on July 1, 2010, we sold to the Deerfield Entities an aggregate of $124.0 million initial principal amount of our secured convertible notes due June 2015 for an aggregate purchase price of $80.0 million, less closing fees and expenses of approximately $2.0 million. The outstanding principal amount of the notes bears interest in the annual amount of $6.0 million, payable quarterly in arrears. We will be required to make mandatory prepayments on the notes on an annual basis in 2013, 2014 and 2015 equal to 15% of certain revenues from our collaborative arrangements received during the prior fiscal year, subject to a maximum annual prepayment amount of $27.5 million and, for payments due in January 2013 and 2014, a minimum prepayment amount of $10.0 million. We may also prepay all or a portion (not less than $5.0 million) of the principal amount of the notes at an optional prepayment price based on a discounted principal amount (during the first three years of the term, subject to a prepayment premium) determined as of the date of prepayment, plus accrued and unpaid interest, plus in the case of a prepayment of the full principal amount of the notes (other than prepayments upon the occurrence of specified transactions relating to a change of control or a substantial sale of assets), all accrued interest that would have accrued between the date of such prepayment and the next anniversary of the note purchase agreement. At any time after July 1, 2011, subject to certain limitations (including a cap on the number of shares issuable under the note purchase agreement), we have the right to convert all or a portion of the principal amount of the notes into, or satisfy all or any portion of the optional prepayment amounts or mandatory prepayment amounts (other than the first $10.0 million of mandatory prepayments required in 2013 and 2014) with shares

of our common stock. Additionally, in lieu of making any payment of accrued and unpaid interest in respect of the notes in cash, at any time after July 1, 2011, subject to certain limitations, we may elect to satisfy any such payment with shares of our common stock. The number of shares of our common stock issuable upon conversion or in settlement of principal and interest obligations will be based upon the discounted trading price of our common stock over a specified trading period. Upon certain changes of control of our company, a sale or transfer of assets in one transaction or a series of related transactions for a purchase price of more than $400 million or a sale or transfer of more than 50% of our assets, the Deerfield Entities may require us to prepay the notes at the optional prepayment price, plus accrued and unpaid interest and any other accrued and reimbursable expenses (the Put Price). Upon an event of default, the Deerfield Entities may declare all or a portion of the Put Price to be immediately due and payable.

We also entered into a security agreement in favor of the Deerfield Entities which provides that our obligations under the notes will be secured by substantially all of our assets except intellectual property. The note purchase agreement and the security agreement

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include customary representations and warranties and covenants made by us, including restrictions on the incurrence of additional indebtedness.

NOTE 7: Subsequent Event

On October 8, 2010, we entered into new agreements with Bristol-Myers Squibb relating to two of our programs. Under the first agreement, we will grant to Bristol-Myers Squibb a license to our small-molecule TGR5 agonist program, including rights to the program s lead compound, XL475, as well as potential backups. Under the second agreement, we will collaborate to discover, optimize, and characterize ROR antagonists. We simultaneously amended three of our existing collaboration agreements with Bristol-Myers Squibb for the treatment of cancer, cardiovascular and metabolic disorders, each as more fully described below.

TGR5 License Agreement

We entered into a global license agreement with Bristol-Myers Squibb for XL475 (and any potential backups), a preclinical compound that modulates the metabolic target known as TGR5 (the TGR5 License Agreement). Pursuant to the terms of the TGR5 License Agreement, Bristol-Myers Squibb will have a worldwide exclusive license to XL475 and will have sole control and responsibility for all subsequent research, development, commercial and manufacturing activities. The TGR5 License Agreement is subject to and will become effective upon clearance under the Hart-Scott-Rodino Antitrust Improvement Act of 1976, as amended (HSR). Upon effectiveness of the TGR5 License Agreement, Bristol-Myers Squibb is required to pay us an upfront cash payment of $35.0 million. Additionally, for each product developed by Bristol-Myers Squibb under the license, we will be eligible to receive development and regulatory milestones of up to $250.0 million in the aggregate and commercial milestones of up to $150.0 million in the aggregate, as well as royalties on commercial sales of any such products.

ROR Collaboration Agreement

We entered into a worldwide collaboration with Bristol-Myers Squibb pursuant to which each party granted to the other certain intellectual property licenses to enable the parties to discover, optimize and characterize ROR antagonists that may subsequently be developed and commercialized by Bristol-Myers Squibb (the ROR Collaboration Agreement). The ROR Collaboration Agreement became effective on October 8, 2010. In consideration for entry into the ROR Collaboration Agreement, we will receive an upfront cash payment of $5.0 million. We will also be eligible to receive additional development and regulatory milestones of up to $255.0 million in the aggregate and commercial milestones of up to $150.0 million in the aggregate, as well as royalties on commercial sales of any such products.

Amendments

We entered into amendments to our cancer collaboration agreement with Bristol-Myers Squibb dated December 11, 2008, as amended and our collaboration agreement with Bristol-Myers Squibb dated December 5, 2005, as amended, pursuant to which the parties made certain minor amendments to the rights and obligations of the parties under each agreement.

We also entered into an amendment to our cancer collaboration agreement with Bristol-Myers Squibb dated December 15, 2006, which became effective on January 11, 2007, as amended, pursuant to which we exercised our right to opt-out of further co-development of XL139 in consideration for a payment of $20.0 million. The amendment is subject to and will become effective upon clearance under HSR. Upon the effectiveness of the amendment, we will have no further responsibility for conducting new activities or funding new development or commercialization activities with respect to XL139 and will therefore no longer be eligible to share profits on sales of any commercialized products under the collaboration. We will continue to be eligible to receive regulatory and commercial milestones as well as double-digit royalties on any future sales of any products commercialized under the collaboration. As a result of the amendment, the research term will end, and we will have no further obligation to deliver to Bristol-Myers Squibb a third Investigational New Drug candidate under the collaboration agreement.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis contains forward-looking statements. These statements are based on our current expectations, assumptions, estimates and projections about our business and our industry, and involve known and unknown risks, uncertainties and other factors that may cause our or our industry s results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied in, or contemplated by, the forward-looking statements. Words such as believe, anticipate, expect, intend, plan, will, determine, may, eligible, could, would, estimate, goal, predict, potential, continue or the negative of such terms or other similar expressions identify forward-looking statements. Our actual results and the timing of events may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a difference include those discussed in Part II, Item 1A of this Form 10-Q, as well as those discussed elsewhere in this report.

This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in this report and the financial statements and accompanying notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, filed with the Securities and Exchange Commission, or SEC, on March 10, 2010. Operating results are not necessarily indicative of results that may occur in future periods. We undertake no obligation to update any forward-looking statement to reflect events after the date of this report.

Overview

We are committed to discovering, developing and commercializing innovative therapies for the treatment of cancer. Through our integrated drug discovery and development activities, we are building a portfolio of novel compounds that we believe have the potential to be high-quality, differentiated pharmaceutical products that can make a meaningful difference in the lives of patients. The majority of our programs focus on discovery and development of small molecule drugs for cancer.

XL184, our most advanced drug candidate, inhibits MET, VEGFR2 and RET, proteins that are key drivers of tumor growth and/or vascularization. XL184 is the most advanced inhibitor of MET in clinical development and is being evaluated in a broad development program encompassing multiple solid tumor indications. A global phase 3 registration trial of XL184 as a potential treatment for medullary thyroid cancer is currently enrolling. Assuming positive results from this registration trial, we currently expect to submit a new drug application, or NDA, for XL184 as a treatment for medullary thyroid cancer in the United States in the second half of 2011. An immediate priority for us is to generate additional data in the five leading cohorts of hepatocellular carcinoma, melanoma, non-small cell lung cancer, ovarian cancer and prostate cancer in our ongoing randomized discontinuation trial to support the prioritization of our clinical and commercial options for XL184. Additional phase 2 clinical trials of XL184 in glioblastoma and non-small cell lung cancer are also ongoing. We are also preparing to initiate a phase 3 registration trial of XL184 as a potential treatment for recurrent glioblastoma by the end of 2010.

We are also actively pursuing the development of XL147 and XL765, leading inhibitors of phosphoinositide-3 kinase, or PI3K, that we out-licensed to sanofi-aventis in 2009. XL147 is a selective inhibitor of PI3K while XL765 is a dual inhibitor of PI3K and mTOR. Sanofi-aventis is responsible for funding all development activities with respect to XL147 and XL765, including our activities. We currently are conducting the majority of the clinical trials for these compounds. XL147 and XL765 are currently being evaluated in a series of phase 1b/2 clinical trials for a variety of solid tumor indications and a broad phase 2 clinical trial program that commenced in early 2010.

We also have several earlier novel drug candidates in clinical development for the treatment of cancer, and preclinical programs for cancer, metabolic disease and inflammation. Based on the strength of our expertise in biology, drug discovery and development, we have established collaborations with leading pharmaceutical and biotechnology companies, including Bristol-Myers Squibb, sanofi-aventis, Genentech (a wholly owned member of the Roche Group), Boehringer Ingelheim GmbH, GlaxoSmithKline and Daiichi-Sankyo that allow us to retain economic participation in compounds and support additional development of our pipeline. Our collaborations have historically fallen into one of two categories: collaborations in which we co-develop compounds with a partner, share development costs and profits from commercialization and may have the right to co-promote products in the United States, and collaborations in which we out-license compounds to a partner for further development and commercialization, have no further unreimbursed cost obligations and are entitled to receive milestones and royalties or a share of profits from commercialization. Under either form of collaboration, we may also be entitled to license fees, research funding and milestone payments from research results and subsequent product development activities. Reimbursement revenues and expenses under co-development collaborations are recorded as collaboration reimbursement revenue and collaboration cost-sharing expenses, respectively, while reimbursement revenues and expenses under other collaborations are recorded as contract revenue and research and development expenses in the period incurred.

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Our Strategy

Our business strategy is to leverage our biological expertise and integrated research and development capabilities to generate a pipeline of development compounds with significant therapeutic and commercial potential for the treatment of cancer and potentially other serious diseases.

Our strategy consists of three principal elements:

Focus on lead clinical compound We are focusing our development efforts on XL184. This drug candidate is the most advanced in our pipeline, and we believe that it has the greatest near-term therapeutic and commercial potential. As a result, we are dedicating our resources to aggressively advance this drug candidate through development toward commercialization.

Partner compounds We continue to pursue new collaborations with leading pharmaceutical and biotechnology companies for the development and ultimate commercialization of some of our preclinical and clinical compounds, particularly those drug candidates for which we believe that the capabilities and resources of a partner can accelerate development and help to fully realize their therapeutic and commercial potential. Collaborations provide us with a means of shifting all or a portion of the development costs related to partnered drug candidates and provide financial resources that we can apply to fund our share of the development of our lead clinical compounds and other areas of our pipeline. Our goal is to increase the portion of our development expenses that are reimbursed by partners while maintaining financial upside from potential downstream milestones and royalties if these drug candidates are marketed in the future.

Control costs We are committed to managing our costs, and we continually analyze our expenses to align expenses with our cash resources. We are selective with respect to funding our clinical development programs and have established definitive go/no-go criteria to ensure that we commit our resources only to those programs that we believe have the greatest therapeutic and commercial potential.

We are conducting a comprehensive corporate strategic review, with a focus on the evaluation of various options for advancing XL184 in light of emerging clinical data. The evaluation includes a review of XL184 clinical data and priorities, ongoing and planned clinical trials, potential partnering scenarios, regulatory strategies, the competitive landscape, our resources and financial considerations. Our goal remains to appropriately deploy our resources in a manner that is designed to maximize the therapeutic and commercial potential of XL184.

Our Pipeline

Overview

We have an extensive pipeline of compounds in various stages of development that will potentially treat cancer and various metabolic, cardiovascular and inflammatory disorders. All of our development compounds were generated through our internal drug discovery efforts, although we are developing certain of these compounds in collaboration with partners and have out-licensed others. We are focusing our development efforts on our lead clinical compound, XL184. This drug candidate is the most advanced in our pipeline, and we believe it has the greatest near-term therapeutic and commercial potential. As a result, we are dedicating our resources to aggressively advance this drug candidate through development towards commercialization.

XL184

XL184 inhibits MET, VEGFR2 and RET, proteins that are key drivers of tumor growth and/or vascularization. XL184 is the most advanced inhibitor of MET in clinical development and is being evaluated in a broad development program encompassing multiple solid tumor indications. A global phase 3 registration trial of XL184 as a potential treatment for medullary thyroid cancer is currently enrolling. Assuming positive results from this registration trial, we currently expect to submit a new drug application, or NDA, for XL184 as a treatment for medullary thyroid cancer in the United States in the second half of 2011. An immediate priority for us is to generate additional data in the five leading cohorts of hepatocellular carcinoma, melanoma, non-small cell lung cancer, ovarian cancer and prostate cancer in our ongoing randomized discontinuation trial to support the prioritization of our clinical and commercial options for XL184. Additional phase 2 clinical trials

of XL184 in glioblastoma and non-small cell lung cancer are also ongoing. We are also preparing to initiate a phase 3 registration trial of XL184 as a potential treatment for recurrent glioblastoma by the end of 2010.

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Other Compounds

The following table sets forth those compounds that we have out-licensed to third parties:

Compound	Partner	Principal Targets	Indication	Stage of Development
XL880	GlaxoSmithKline	MET, VEGFR2	Cancer	Phase 2
XL147	sanofi-aventis	PI3K	Cancer	Phase 2
XL765	sanofi-aventis	PI3K, mTOR	Cancer	Phase 1b/2
XL139*	Bristol-Myers Squibb	Hedgehog	Cancer	Phase 1b
XL518	Genentech	MEK	Cancer	Phase 1b
XL281	Bristol-Myers Squibb	RAF	Cancer	Phase 1
XL652	Bristol-Myers Squibb	LXR	Metabolic and cardiovascular diseases	Phase 1
XL041	Bristol-Myers Squibb	LXR	Metabolic and cardiovascular diseases	Phase 1
XL475*	Bristol-Myers Squibb	TGR5 (agonist)	Metabolic disease	Preclinical
XL550	Daiichi-Sankyo	MR	Metabolic and cardiovascular diseases	Preclinical
S1P1R	Boehringer Ingelheim	S1P1R (agonist)	Inflammation	Preclinical
Isoform Selective PI3Ka and PI3Kb	sanofi-aventis	PI3Ka and PI3Kb	Cancer	Preclinical
ROR Antagonists	Bristol-Myers Squibb	ROR antagonist	Inflammation	Preclinical

* Upon clearance under the Hart-Scott-Rodino Antitrust Improvement Act of 1976, as amended, or HSR.

The following table sets forth those compounds for which we are pursuing collaborations or other external opportunities:

Compound	Principal Targets	Indication	Stage of Development
XL228	IGF1R , ABL, SRC	Cancer	Phase 1
XL388	TORC1 & 2	Cancer	IND
XL499	PI3K-d	Cancer and inflammation	Preclinical
XL541	S1P1R (antagonist)	Cancer	Preclinical
XL888	HSP90	Cancer	Phase 1

Recent Developments

Transactions with Bristol-Myers Squibb Company

On October 8, 2010, we entered into new agreements with Bristol-Myers Squibb relating to two of our programs. Under the first agreement, we will grant to Bristol-Myers Squibb a license to our small-molecule TGR5 agonist program, including rights to the program s lead compound, XL475, as well as potential backups. Under the second agreement, we will collaborate to discover, optimize, and characterize ROR antagonists. We simultaneously amended three of our existing collaboration agreements with Bristol-Myers Squibb for the treatment of cancer, cardiovascular and metabolic disorders, each as more fully described below.

TGR5 License Agreement

We entered into a global license agreement with Bristol-Myers Squibb for XL475 (and any potential backups), a preclinical compound that modulates the metabolic target known as TGR5, or, the TGR5 License Agreement. Pursuant to the terms of the TGR5 License Agreement, Bristol-Myers Squibb will have a worldwide exclusive license to XL475 and will have sole control and responsibility for all subsequent research, development, commercial and manufacturing activities. The TGR5 License Agreement is subject to and will become effective upon

clearance under HSR. Upon effectiveness of the TGR5 License Agreement, Bristol-Myers Squibb is required to pay us an upfront cash payment of $35.0 million. Additionally, for each product developed by Bristol-Myers Squibb under the license, we will be eligible to receive development and regulatory milestones of up to $250.0 million in the aggregate and commercial milestones of up to $150.0 million in the aggregate, as well as royalties on commercial sales of any such products.

Bristol-Myers Squibb may at any time, upon specified prior notice to us, terminate the license on a product-by-product and country-by-country basis. In addition, either party may terminate the agreement for the other party s uncured material breach. In the event of termination by Bristol-Myers Squibb at will or by us for Bristol-Myers Squibb s uncured material breach, the license granted to Bristol-Myers Squibb would terminate, the right to such product would revert to us, and we would receive a royalty-free license, if

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terminated at will, or a royalty-bearing license, if terminated for an uncured material breach, from Bristol-Myers Squibb to develop and commercialize such product in the related country. In the event of termination by Bristol-Myers Squibb for our uncured material breach, Bristol-Myers Squibb would retain the right to such product and we would receive reduced royalties from Bristol-Myers Squibb on commercial sales of such product.

ROR Collaboration Agreement

We entered into a worldwide collaboration with Bristol-Myers Squibb pursuant to which each party granted to the other certain intellectual property licenses to enable the parties to discover, optimize and characterize ROR antagonists that may subsequently be developed and commercialized by Bristol-Myers Squibb, or, the ROR Collaboration Agreement. In consideration for entry into the ROR Collaboration Agreement, we will receive an upfront cash payment of $5.0 million. We will also be eligible to receive additional development and regulatory milestones of up to $255.0 million in the aggregate and commercial milestones of up to $150.0 million in the aggregate, as well as royalties on commercial sales of any such products.

Under the terms of the ROR Collaboration Agreement, we will be primarily responsible for activities related to the discovery, optimization and characterization of the ROR antagonists during the collaborative research period. The collaborative research period began on October 8, 2010 and will end on the earliest to occur of (i) October 8, 2013 if a compound has not satisfied certain specified criteria by such time, (ii) such time that a compound satisfies certain specified criteria, or (iii) October 8, 2015. Following the collaborative research period, Bristol-Myers Squibb will have sole responsibility for any further research, development, manufacture and commercialization of products developed under the collaboration and will bear all costs and expenses associated with those activities.

Bristol-Myers Squibb may, at any time, terminate the ROR Collaboration Agreement upon certain prior notice to us. In addition, either party may terminate the agreement for the other party s uncured material breach. In the event of termination by Bristol-Myers Squibb at will or by us for Bristol-Myers Squibb s uncured material breach, the license granted to Bristol-Myers Squibb would terminate, the right to such product would revert to us, and we would receive a royalty-bearing license for late-stage reverted compounds and a royalty-free license for early-stage reverted compounds from Bristol-Myers Squibb to develop and commercialize such product in the related country. In the event of termination by Bristol-Myers Squibb for our uncured material breach, Bristol-Myers Squibb would retain the right to such product, subject to continued payment of milestones and royalties.

The ROR Collaboration Agreement became effective on October 8, 2010.

Amendment to 2008 Cancer Collaboration

We entered into Amendment No. 3 to our cancer collaboration agreement with Bristol-Myers Squibb dated December 11, 2008, as amended, or, the 2008 Cancer Collaboration Agreement, pursuant to which the parties made certain minor amendments to the rights and obligations of the parties with respect to XL281.

Amendment No. 3 to the 2008 Cancer Collaboration Agreement became effective on October 8, 2010.

Amendment to 2007 Cancer Collaboration

We entered into Amendment No. 3 to our cancer collaboration agreement with Bristol-Myers Squibb dated December 15, 2006, which became effective on January 11, 2007, as amended, or, the 2007 Cancer Collaboration Agreement, pursuant to which we exercised our right to opt-out of further co-development of XL139 in consideration for a payment of $20.0 million. The amendment is subject to and will become effective upon clearance under HSR. Upon the effectiveness of the amendment, we will have no further responsibility for conducting new activities or funding new development or commercialization activities with respect to XL139 and will therefore no longer be eligible to share profits on sales of any commercialized products under the collaboration. We will continue to be eligible to receive regulatory and commercial milestones as well as double-digit royalties on any future sales of any products commercialized under the collaboration. As a result of the amendment, the research term will end, and we will have no further obligation to deliver to Bristol-Myers Squibb a third Investigational New Drug, or IND, candidate under the collaboration agreement.

Amendment to LXR Collaboration

We entered into Amendment No. 1 to our collaboration agreement with Bristol-Myers Squibb dated December 5, 2005, as amended, or, the LXR Collaboration Agreement, pursuant to which we made certain minor amendments to the rights and obligations of the parties under the collaboration agreement.

Amendment No. 1 to the LXR Collaboration Agreement became effective on October 8, 2010.

Accounting Treatment

The TGR5 License Agreement, ROR Collaboration Agreement and Amendment No. 3 to the 2007 Cancer Collaboration Agreement will be accounted for as one unit of accounting with the revenue from all agreements being recognized over the longest

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commitment period. The ROR Collaboration Agreement has the longest commitment period of the three agreements with a research term of approximately 42 months. Therefore, we expect to recognize the upfront payments received under the TGR5 License Agreement and the ROR Collaboration Agreement ratably over approximately 42 months and to record them as license revenue.

The payment to be received under the Amendment No. 3 to the 2007 Cancer Collaboration Agreement will be added to the deferred revenue balance remaining as of the effective date of the amendment and we expect to recognize the combined total ratably over approximately 42 months and to record it as contract revenue.

For illustrative purposes, if the agreements become effective during the fourth quarter of 2010, we estimate the total incremental revenue related to the new and amended agreements in 2010 and 2011 will be approximately $0.9 million and $8.5 million, respectively. Any milestone payments that we may receive under any of the agreements will be recognized in accordance with our existing policy as contract revenue ratably over the remaining commitment period under the agreements.

Any costs incurred in connection with the ROR Collaboration Agreement or TGR5 License Agreement will be recorded as operating expense.

Loan Payment to GlaxoSmithKline

In October 2002, we entered into a loan and security agreement in connection with our collaboration with GlaxoSmithKline to discover and develop novel therapeutics in the areas of vascular biology, inflammatory disease and oncology. We borrowed an aggregate of $85.0 million pursuant to the loan agreement. On October 27, 2010, we paid approximately $37.0 million in cash to GlaxoSmithKline as the second of three installments of principal and accrued interest due under the loan agreement. After giving effect to all repayments made, as of October 27, 2010, the aggregate principal and interest outstanding under the loan was $35.7 million.

Certain Factors Important to Understanding Our Financial Condition and Results of Operations

Successful development of drugs is inherently difficult and uncertain. Our business requires significant investments in research and development over many years, often for products that fail during the research and development process. Our long-term prospects depend upon our ability and the ability of our partners to successfully commercialize new therapeutics in highly competitive areas such as cancer treatment. Our financial performance is driven by many factors, including those described below.

Limited Sources of Revenues

We currently have no pharmaceutical products that have received marketing approval, and we have generated no revenues to date from the sale of such products. We do not expect to generate revenues from the sale of pharmaceutical products in the near term and expect that all of our near term revenues, such as research and development funding, license fees and milestone payments and royalty revenues, will be generated from collaboration agreements with our current and potential future partners. Milestones under these agreements may be tied to factors that are outside of our control, such as significant clinical or regulatory events with respect to compounds that have been licensed to our partners.

Clinical Trials

We currently have multiple compounds in clinical development and expect to expand the development programs for our compounds, particularly XL184. Our compounds may fail to show adequate safety or efficacy in clinical testing. Furthermore, predicting the timing of the initiation or completion of clinical trials is difficult, and our trials may be delayed due to many factors, including factors outside of our control. The future development path of each of our compounds depends upon the results of each stage of clinical development. In general, we will incur increased operating expenses for compounds that advance in clinical development, whereas expenses will end for compounds that do not warrant further clinical development.

We are responsible for all development costs for compounds in our pipeline that are not partnered. We typically share development costs with partners in our co-development collaborations, when we enter into such arrangements, and have no unreimbursed cost obligations with respect to compounds that we have out-licensed.

Liquidity

As of September 30, 2010, we had $261.0 million in cash and cash equivalents and short-term and long-term marketable securities, which included restricted cash and investments of $6.4 million. We anticipate that our current cash and cash equivalents, short-term and long-term

marketable securities, funding from our October 2010 transactions with Bristol-Myers Squibb and funding that we expect to receive from collaborators, which includes anticipated cash from additional business development activity, will enable us to maintain our operations for a period of at least 12 months following the filing date of this report. However, our future capital requirements will be substantial and depend on many factors, including the following:

- the progress and scope of the development activity with respect to XL184, our most advanced compound;

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- the progress and scope of other research and development activities conducted by us;
- whether we repay amounts outstanding under our loan and security agreement with GlaxoSmithKline in cash or shares of our common stock;
- whether we elect to issue shares of our common stock in respect of any conversion of our principal, prepayments or payments of interest in connection with the secured convertible notes we issued to the Deerfield Entities under the note purchase agreement;
- the level of payments received under existing collaboration agreements, licensing agreements and other arrangements;
- the degree to which we conduct funded development activity on behalf of partners to whom we have out-licensed compounds; and
- whether we enter into new collaboration agreements, licensing agreements or other arrangements (including in particular with respect to XL184) that provide additional capital.

Our minimum liquidity needs are also determined by financial covenants in our loan and security agreement, as amended, with GlaxoSmithKline, our loan and security agreement with Silicon Valley Bank and our note purchase agreement with the Deerfield Entities, as well as other factors, which are described under Liquidity and Capital Resources Cash Requirements . In particular, our loan and security agreement with Silicon Valley Bank requires that we maintain $80.0 million at all times on deposit in a non-interest bearing demand deposit account(s) as support for our obligations under the loan and security agreement.

Our ability to raise additional funds may be severely impaired if any of our product candidates fails to show adequate safety or efficacy in clinical testing.

sanofi-aventis

In May 2009, we entered into a global license agreement with sanofi-aventis for XL147 and XL765 and a broad collaboration for the discovery of inhibitors of PI3K for the treatment of cancer. The license agreement and collaboration agreement became effective on July 7, 2009. In connection with the effectiveness of the license and collaboration on July 20, 2009, we received upfront payments of $140.0 million ($120.0 million for the license and $20.0 million for the collaboration), less applicable withholding taxes of $7.0 million, for a net receipt of $133.0 million. We expect to receive a refund payment from the French government in the first half of 2011 with respect to the withholding taxes previously withheld.

Under the license agreement, sanofi-aventis received a worldwide exclusive license to XL147 and XL765, which are currently in phase 1, phase 1b/2 and phase 2 clinical trials, and has sole responsibility for all subsequent clinical, regulatory, commercial and manufacturing activities. It is expected that we will continue to participate in the conduct of ongoing and potential future clinical trials and manufacturing activities. Sanofi-aventis is responsible for funding all future development activities with respect to XL147 and XL765, including our activities. Under the collaboration agreement, the parties are combining efforts in establishing several pre-clinical PI3K programs and jointly share responsibility for research and preclinical activities related to isoform-selective inhibitors of PI3K- and -ß. Sanofi-aventis will provide us with guaranteed annual research and development funding during the research term and is responsible for funding all development activities for each product following approval of the IND application filed with the applicable regulatory authorities for such product. Sanofi-aventis will have sole responsibility for all subsequent clinical, regulatory, commercial and manufacturing activities of any products arising from the collaboration; however, we may be requested to conduct certain clinical trials at sanofi-aventis expense. The research term under the collaboration is three years, although sanofi-aventis has the right to extend the term for an additional one-year period upon prior written notice.

In addition to the aggregate upfront cash payments for the license and collaboration agreements, we are entitled to receive guaranteed research funding of $21.0 million over three years to cover certain of our costs under the collaboration agreement. For both the license and the collaboration combined, we will be eligible to receive development, regulatory and commercial milestones of over $1.0 billion in the aggregate, as well as royalties on sales of any products commercialized under the license or collaboration.

Sanofi-aventis may, upon certain prior notice to us, terminate the license as to products containing XL147 or XL765. In the event of such termination election, sanofi-aventis license relating to such product would terminate and revert to us, and we would receive, subject to certain terms, conditions and potential payment obligations, licenses from sanofi-aventis to research, develop and commercialize such products.

The collaboration will automatically terminate under certain circumstances upon the expiration of the research term, in which case all licenses granted by the parties to each other would terminate and revert to the respective party, subject to sanofi-aventis right to receive, under certain circumstances, the first opportunity to obtain a license from us to any isoform-selective PI3K inhibitor. In addition, sanofi-aventis may, upon certain prior written notice to us, terminate the collaboration in whole or as to certain products

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following expiration of the research term, in which case we would receive, subject to certain terms, conditions and potential payment obligations by us, licenses from sanofi-aventis to research, develop and commercialize such products.

2008 Cancer Collaboration with Bristol-Myers Squibb

In December 2008, we entered into a worldwide collaboration with Bristol-Myers Squibb for XL184 and XL281. Upon effectiveness of the collaboration agreement in December 2008, Bristol-Myers Squibb made an upfront cash payment of $195.0 million for the development and commercialization rights to both programs. The agreement required Bristol-Myers Squibb to make additional license payments to us of $45.0 million, which were received during 2009.

Under the terms of the collaboration agreement, Bristol-Myers Squibb has an exclusive worldwide license to develop and commercialize XL281. We will carry out certain clinical trials of XL281 which may include a backup program on XL281. Bristol-Myers Squibb is responsible for funding all future development of XL281, including our activities. We are eligible for development and regulatory milestones of up to $315.0 million on XL281, sales performance milestones of up to $150.0 million and double-digit royalties on worldwide sales of XL281.

On June 18, 2010, we regained full rights to develop and commercialize XL184 under our collaboration agreement with Bristol-Myers Squibb following receipt of notice from Bristol-Myers Squibb of its decision to terminate the 2008 collaboration, solely as to XL184, on a worldwide basis. Bristol-Myers Squibb informed us that the termination was based upon its review of XL184 in the context of Bristol-Myers Squibb s overall research and development priorities and pipeline products. On June 28, 2010, in connection with the termination, we received a $17.0 million transition payment from Bristol-Myers Squibb in satisfaction of its obligations under the collaboration agreement to continue to fund its share of development costs for XL184 for a period of three months following the notice of termination. As a result of the termination, Bristol-Myers Squibb s license relating to XL184 has terminated and its rights to XL184 have reverted to us, and we received, subject to certain terms and conditions, licenses from Bristol-Myers Squibb to research, develop and commercialize XL184.

The upfront payment of $195.0 million we received upon effectiveness of the collaboration agreement and the license payments of $20.0 million and $25.0 million that we received in the first quarter and second quarter of 2009, respectively, will be recognized ratably over the estimated development term, and recorded as license revenue, from the effective date of the agreement in December 2008. During the second quarter of 2010, we revised the development term from five years to four years and 8.5 months, which is our current estimate of the term of our performance obligation under the collaboration. Any milestone payments that we may receive under the agreement will be recognized ratably over the same revised period but will be recorded as contract revenue. We will record as operating expense 100% of the cost incurred for work performed by us on XL281. The transition payment we received in connection with the termination of the collaboration agreement as to XL184 was recognized as collaboration reimbursement revenue in the third quarter of 2010.

Prior to the termination of the collaboration by Bristol-Myers Squibb as to XL184, there were periods during which Bristol-Myers Squibb partially reimbursed us for certain research and development expenses, and other periods during which we owed Bristol-Myers Squibb for research and development expenses that Bristol-Myers Squibb incurred on joint development projects, less amounts reimbursable to us by Bristol-Myers Squibb on these projects. To the extent that net research and development funding payments were received from Bristol-Myers Squibb, these payments were presented as collaboration reimbursement revenue. In periods when net research and development funding payments were payable to Bristol-Myers Squibb, these payments were presented as collaboration cost sharing expense. Notwithstanding termination by Bristol-Myers Squibb, revenues from the collaboration will continue to be determined and reflected on an annual basis. As we fulfilled our responsibility for funding the initial $100.0 million of combined costs in the second quarter of 2010 and received reimbursements from Bristol-Myers Squibb prior to the termination of the collaboration as to XL184, we expect to be in a net receivable position for the fiscal year ending December 31, 2010 and in future fiscal years, and will therefore present reimbursement payments as collaboration reimbursement revenue.

GlaxoSmithKline Loan Repayment Obligations

In October 2002, we entered into a collaboration with GlaxoSmithKline to discover and develop novel therapeutics in the areas of vascular biology, inflammatory disease and oncology. As part of the collaboration, we entered into a loan and security agreement with GlaxoSmithKline, pursuant to which we borrowed $85.0 million for use in our efforts under the collaboration. The loan bears interest at a rate of 4.0% per annum and is secured by certain intellectual property, technology and equipment created or utilized pursuant to the collaboration. On October 27, 2010, we paid approximately $37.0 million in cash to GlaxoSmithKline as the second of three installments of principal and accrued interest due under the loan agreement. After giving effect to all repayments made, as of October 27, 2010, the aggregate principal and interest outstanding under the loan was $35.7 million. The third installment of principal and accrued interest under the loan is due October 27, 2011. Repayment of all or any of the amounts advanced to us under the loan agreement may, at our election, be made in the form of our common stock at fair market value, subject to certain conditions, or cash. Following the conclusion on October 27, 2008 of the development term under our collaboration with GlaxoSmithKline, we are no longer eligible to receive selection milestone payments from GlaxoSmithKline to credit against outstanding loan

amounts, and in the

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event the market price for our common stock is depressed, we may not be able to repay the loan in full using shares of our common stock due to restrictions in the agreement on the number of shares we may issue. In addition, the issuance of shares of our common stock to repay the loan may result in significant dilution to our stockholders. As a result, we may need to obtain additional funding to satisfy our repayment obligations. There can be no assurance that we will have sufficient funds to repay amounts outstanding under the loan when due or that we will satisfy the conditions to our ability to repay the loan in shares of our common stock.

Critical Accounting Estimates

Our consolidated financial statements and related notes are prepared in accordance with U.S. generally accepted accounting principles, or GAAP, which require us to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and related disclosure of contingent assets and liabilities. We have based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our senior management has discussed the development, selection and disclosure of these estimates with the Audit Committee of our Board of Directors. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is considered to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the financial statements. We believe the following critical accounting policies reflect the more significant estimates and assumptions used in the preparation of our consolidated financial statements.

Revenue Recognition

Our revenues are derived from three primary sources: license fees, milestone payments and collaborative agreement reimbursements.

Revenues from license fees and milestone payments primarily consist of up-front license fees and milestone payments received under various collaboration agreements. We initially recognize upfront fees received from third party collaborators as unearned revenue and then recognize these amounts on a ratable basis over the expected term of the research collaboration. Therefore, any changes in the expected term of the research collaboration will impact revenue recognition for the given period. For example, in the second quarter of 2010, the estimated research term under the Boehringer Ingelheim agreement was extended through March 2011, resulting in an extension in the period over which we will recognize license revenue and decreasing our license revenue recognized in the period to $0.7 million. Often, the total research term is not contractually defined and an estimate of the term of our total obligation must be made. For example, under the 2008 cancer collaboration with Bristol-Myers Squibb, we estimate our term to be through August 2013, which is the estimated term of our performance obligations for XL281. We estimate that this is the period over which we are obligated to perform services and therefore the appropriate term with which to ratably recognize any license fees. This estimate was reduced from five years following notice from Bristol-Myers Squibb of its decision to terminate the 2008 collaboration as to XL184. License fees are classified as license revenue in our consolidated statement of operations.

Although milestone payments are generally non-refundable once the milestone is achieved, we recognize milestone revenues on a straight-line basis over the expected research term of the arrangement. This typically results in a portion of a milestone being recognized on the date the milestone is achieved, with the balance being recognized over the remaining research term of the agreement. There is diversity in practice on the recognition of milestone revenue. Other companies have adopted an alternative milestone revenue recognition policy, whereby the full milestone fee is recognized upon completion of the milestone. If we had adopted such a policy, our revenues recorded to date would have increased and our deferred revenues would have decreased by a material amount compared to total revenue recognized. In certain situations, we may receive milestone payments after the end of our period of continued involvement. In such circumstances, we would recognize 100% of the milestone revenue when the milestone is achieved. Milestones are classified as contract revenue in our consolidated statement of operations.

Collaborative agreement reimbursement revenue consists of research and development support received from collaborators. Collaborative agreement reimbursement revenue is recorded as earned based on the performance requirements by both parties under the respective contracts. Under the 2008 cancer collaboration with Bristol-Myers Squibb and prior to its termination by Bristol-Myers Squibb as to XL184, certain research and development expenses were partially reimbursable to us. On an annual basis, the amounts that Bristol-Myers Squibb owed us, net of amounts reimbursable to Bristol-Myers Squibb by us on those projects, were recorded as revenue. Conversely, research and development expenses included the net settlement of amounts we owed Bristol-Myers Squibb for research and development expenses that Bristol-Myers Squibb incurred on joint development projects, less amounts reimbursable to us by Bristol-Myers Squibb on such projects. In annual periods when net research and development funding payments were payable to Bristol-Myers Squibb, these payments were presented as collaboration cost-sharing expense. Reimbursements under co-development agreements were classified as collaboration reimbursement revenue, while reimbursements under other arrangements were classified

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as contract revenue in our consolidated statement of operations. Notwithstanding termination by Bristol-Myers Squibb, revenues from the 2008 cancer collaboration will continue to be determined and reflected on an annual basis.

Some of our research and licensing arrangements have multiple deliverables in order to meet our customer s needs. For example, the arrangements may include a combination of intellectual property rights and research and development services. Multiple element revenue agreements are evaluated to determine whether the delivered item has value to the customer on a stand-alone basis and whether objective and reliable evidence of the fair value of the undelivered item exists. Deliverables in an arrangement that do not meet the separation criteria are treated as one unit of accounting for purposes of revenue recognition. Generally, the revenue recognition guidance applicable to the final deliverable is followed for the combined unit of accounting. For certain arrangements, the period of time over which certain deliverables will be provided is not contractually defined. Accordingly, management is required to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. In 2008, under our collaboration with GlaxoSmithKline, we accelerated $18.5 million in previously deferred revenue as a result of the development term concluding on the earliest scheduled end date of October 27, 2008, instead of the previously estimated end date of October 27, 2010.

Clinical Trial Accruals

Substantial portions of our preclinical studies and all of our clinical trials have been performed by third-party contract research organizations, or CROs, and other vendors. We accrue expenses for preclinical studies performed by our vendors based on certain estimates over the term of the service period and adjust our estimates as required. We accrue costs for clinical trial activities performed by CROs based upon the estimated amount of work completed on each study. For clinical trial expenses, the significant factors used in estimating accruals include the number of patients enrolled, the number of active clinical sites, and the duration for which the patients will be enrolled in the study. We monitor patient enrollment levels and related activities to the extent possible through internal reviews, correspondence with CROs and review of contractual terms. We base our estimates on the best information available at the time. However, additional information may become available to us which will allow us to make a more accurate estimate in future periods. In this event, we may be required to record adjustments to research and development expenses in future periods when the actual level of activity becomes more certain. Such increases or decreases in cost are generally considered to be changes in estimates and will be reflected in research and development expenses in the period first known. During the quarter ended September 30, 2010, we recorded a reduction of $1.9 million, or $0.02 per share, to our accrued clinical trial liabilities and research and development expense related to patient procedures in our phase 2 and 3 clinical trials for XL184.

Stock Option Valuation

Our estimate of compensation expense requires us to determine the appropriate fair value model and a number of complex and subjective assumptions including our stock price volatility, employee exercise patterns, future forfeitures and related tax effects. The most significant assumptions are our estimates of the expected volatility and the expected term of the award. We have limited historical information available to support the underlying estimates of certain assumptions required to value stock options. The value of a stock option is derived from its potential for appreciation. The more volatile the stock, the more valuable the option becomes because of the greater possibility of significant changes in stock price. Because there is a market for options on our common stock, we have considered implied volatilities as well as our historical realized volatilities when developing an estimate of expected volatility. The expected option term also has a significant effect on the value of the option. The longer the term, the more time the option holder has to allow the stock price to increase without a cash investment and thus, the more valuable the option. Further, lengthier option terms provide more opportunity to exploit market highs. However, empirical data shows that employees, for a variety of reasons, typically do not wait until the end of the contractual term of a nontransferable option to exercise. Accordingly, companies are required to estimate the expected term of the option for input to an option-pricing model. As required under the accounting rules, we review our valuation assumptions at each grant date and, as a result, from time to time we will likely change the valuation assumptions we use to value stock based awards granted in future periods. The assumptions used in calculating the fair value of share-based payment awards represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and recognize expense only for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. As of September 30, 2010, $15.5 million of total unrecognized compensation expense related to stock options was expected to be recognized over a weighted-average period of 2.44 years in addition to $11.1 million of total unrecognized compensation expense relating to restricted stock units, or RSUs, which was expected to be recognized over 3.39 years. See Note 3 to our Consolidated Financial Statements for a further discussion on stock-based compensation.

Fiscal Year Convention

We have adopted a 52- or 53-week fiscal year that ends on the Friday closest to December 31st of each year. Fiscal year 2009, a 52-week year, ended on January 1, 2010, and fiscal year 2010, a 52-week year, will end on December 31, 2010. For convenience,

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references in this report as of and for the fiscal year ended January 1, 2010 are indicated on a calendar year basis, ended December 31, 2009, and as of and for the fiscal quarters ended October 2, 2009 and October 1, 2010 are indicated as ended September 30, 2009 and 2010, respectively.

Results of Operations

Revenues

Total revenues by category, as compared to the prior year period, were as follows (dollar amounts are presented in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Contract revenue:				
Research and development funding	$ 10.5	$ 18.2	$ 32.6	$ 21.8
Milestones	1.4	6.4	11.4	15.8
License revenue, amortization of upfront payments, including amortization of premiums for equity purchases	24.5	30.4	73.6	70.1
Collaboration reimbursements	18.1		26.7	
Total revenues	$ 54.5	$ 55.0	$ 144.3	$ 107.7
Dollar (decrease)/increase	$ (0.5)		$ 36.6	
Percentage (decrease)/increase	(0.9%)		34.0%	

Total revenues by customer, as compared to the prior year period, were as follows (dollar amounts are presented in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Sanofi-aventis	$ 19.2	$ 24.9	$ 58.6	$ 24.9
Bristol-Myers Squibb	34.6	22.4	75.9	63.5
Genentech		3.5	7.0	11.9
GlaxoSmithKline				0.5
Boehringer Ingelheim	0.7	4.2	2.8	6.7
SEI				0.2
Total revenues	$ 54.5	$ 55.0	$ 144.3	$ 107.7
Dollar (decrease)/increase	$ (0.5)		$ 36.6	
Percentage (decrease)/increase	(0.9%)		34.0%	

The small decrease in revenues for the three months ended September 30, 2010, as compared to the comparable period for the prior year, was primarily due to a one-time recognition of revenue in connection with drug supplies at the initiation of our May 2009 collaboration agreement with sanofi-aventis for XL147 and XL765 and the conclusion of the research funding portion of the Bristol Myers-Squibb LXR agreement and Genentech MEK program, offset by increased reimbursement revenue relating to our 2008 cancer collaboration agreement with Bristol Myers-Squibb for XL184 and XL281. In addition, we had a reduction in license revenue under our agreement with Boehringer Ingelheim as a result of extending the expected research term in early 2010 from eleven months to twenty three months through March 2011.

The increase in revenues for the nine months ended September 30, 2010, as compared to the comparable period for the prior year, was primarily due to our collaboration agreements with sanofi-aventis for XL147, XL765 and the discovery of inhibitors of P13K. In addition to the increase resulting from the agreements with sanofi-aventis, we also recognized an increase of $26.7 million due to increased reimbursement revenue relating to our 2008 cancer collaboration agreement with Bristol Myers-Squibb for XL184 and XL281. These increases in revenue were partially offset by a reduction in milestone revenues related to our 2007 cancer collaboration with Bristol-Myers Squibb and the completion of revenue recognition under our LXR collaboration with Bristol-Myers Squibb.

Collaboration reimbursement revenue consisted of research and development expenses and reimbursements related to our 2008 cancer collaboration agreement with Bristol Myers-Squibb for XL184 and XL281. To the extent that net annual research and development funding payments are expected to be received from Bristol-Myers Squibb, these payments will be presented as

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collaboration reimbursement revenue. In 2009, when net research and development funding payments were expected to be payable to Bristol-Myers Squibb, these payments were presented as collaboration cost sharing expense. However, for the year ending December 31, 2010, we expect to receive net collaboration reimbursements and have recorded collaboration reimbursement revenue of $18.1 million and $26.7 million for the three and nine months ended September 30, 2010, respectively. Collaboration reimbursement revenue for the three and nine months ended September 30, 2010 included the $17.0 million transition payment received from Bristol-Myers Squibb upon termination of the 2008 collaboration with respect to XL184 during the second quarter of 2010.

Research and Development Expenses

Total research and development expenses, as compared to the prior year period, were as follows (dollar amounts are presented in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Research and development expenses	$ 49.4	$ 60.2	$ 168.4	$ 170.6
Dollar decrease	$ (10.8)		$ (2.2)	
Percentage decrease	(17.9%)		(1.3%)	

Research and development expenses consist primarily of personnel expenses, clinical trials, consulting, laboratory supplies and facilities costs.

The decrease for the three months ended September 30, 2010, as compared to the comparable period in 2009, resulted primarily from the following:

Personnel Personnel expense, which includes salaries, bonuses, related fringe benefits, recruiting and relocation costs, decreased by $6.1 million, or 34%, primarily due to a reduction in headcount resulting from our restructuring implemented in March 2010.

General Corporate Costs There was a decrease of $2.7 million, or 24%, in the allocation of general corporate costs (such as facilities costs, property taxes and insurance) to research and development, primarily as a result of a decrease in personnel and the exit of certain facilities in San Diego and South San Francisco, as a result of our March restructuring plan, and the resulting decrease in costs to be allocated.

Laboratory Supplies Laboratory supplies decreased by $2.4 million, or 60%, primarily due to the decrease in headcount and other cost cutting measures.

Stock-Based Compensation Stock-based compensation expense decreased by $1.5 million or 37% as a result of our reduction in headcount from our restructuring implemented in March 2010.

These decreases were partially offset by an increase in clinical trial expenses. Clinical trial expenses, which include services performed by third-party contract research organizations and other vendors, increased by $1.9 million, or 10%, primarily due to increased phase 2 and phase 3 clinical trial activity for XL184 and increased phase 2 clinical trial activity for XL147. These increases were partially offset by reduced activities and trial wind-down costs associated with various other compounds.

The decrease for the nine months ended September 30, 2010, as compared to the comparable period in 2009, resulted primarily from the following:

Personnel Personnel expense, which includes salaries, bonuses, related fringe benefits, recruiting and relocation costs, decreased by $12.2 million, or 22%, primarily due to a reduction in headcount resulting from our restructuring implemented in March 2010.

General Corporate Costs There was a decrease of $4.8 million, or 15%, in the allocation of general corporate costs (such as facilities costs, property taxes and insurance) to research and development, primarily as a result of a decrease in personnel and the exit of certain facilities in San Diego and South San Francisco, as a result of our March restructuring plan, and the resulting decrease in costs to be allocated.

Laboratory Supplies Laboratory supplies decreased by $4.5 million, or 38%, primarily due to the decrease in headcount and other cost cutting measures.

Stock-Based Compensation Stock-based compensation expense decreased by $2.6 million or 22% as a result of our reduction in headcount from our restructuring implemented in March 2010.

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These decreases were partially offset by an increase in clinical trial expenses and a decline in cost reimbursements. Clinical trial expenses, which include services performed by third-party contract research organizations and other vendors, increased by $20.6 million, or 46%, primarily due to increased phase 2 and phase 3 clinical trial activity for XL184 and increased phase 2 clinical trial activity for XL147. These increases were partially offset by reduced activities associated with SEI-related compounds, for which the arrangement ended in 2009, as well as a decline in activities associated with various other compounds. In addition, under our 2007 contract research agreement with Agrigenetics, Inc., we received an increase in research and development funding of $5.4 million that was recognized as a reduction to research and development expense in 2009. The Agrigenetics agreement ended in 2009. The 2010 research and development funding, which stems from our agreement with a third party relating to the sale of our cell factory business, ended in the second quarter of 2010.

We do not track total research and development expenses separately for each of our research and development programs. We group our research and development expenses into three categories: drug discovery, development and other. Our drug discovery group utilizes a variety of high-throughput technologies to enable the rapid discovery, optimization and extensive characterization of lead compounds such that we are able to select development candidates with the best potential for further evaluation and advancement into clinical development. Drug discovery expenses relate primarily to personnel expense, lab supplies and general corporate costs. Our development group leads the development and implementation of our clinical and regulatory strategies and prioritizes disease indications in which our compounds may be studied in clinical trials. Development expenses relate primarily to clinical trial, personnel and general corporate costs. The other category primarily includes stock compensation expense.

In addition to reviewing the three categories of research and development expenses described above, we principally consider qualitative factors in making decisions regarding our research and development programs. Such factors include enrollment in clinical trials for our drug candidates, the results of and data from clinical trials, the potential indications for our drug candidates and the clinical and commercial potential for our drug candidates and competitive dynamics. We also make our research and development decisions in the context of our overall business strategy, which includes the pursuit of commercial collaborations with major pharmaceutical and biotechnology companies for the development of our drug candidates.

The expenditures summarized in the following table reflect total research and development expenses by category, including allocations for general and administrative expense (dollar amounts are presented in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,		Inception to date (1)
	2010	2009	2010	2009	
Drug discovery	$ 11.7	$			