LEXICON GENETICS INC/TX
Form 10-Q
May 09, 2006

==========

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2006

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: 000-30111

LEXICON GENETICS INCORPORATED
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	76-0474169
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NUMBER)

8800 TECHNOLOGY FOREST PLACE
THE WOODLANDS, TEXAS 77381
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES AND ZIP CODE)

(281) 863-3000
(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer ___ Accelerated filer X Non-accelerated filer ___

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 May 5, 2006, 64,624,015 shares of the registrant's common stock, par value $0.001 per share, were outstanding.

==========

LEXICON GENETICS INCORPORATED

TABLE OF CONTENTS

	PAGE
FACTORS AFFECTING FORWARD-LOOKING STATEMENTS	2
PART I - FINANCIAL INFORMATION	
Item 1. Financial Statements	
Consolidated Balance Sheets - March 31, 2006 (unaudited) and December 31, 2005	3
Consolidated Statements of Operations (unaudited) - Three Months Ended March 31, 2006 and 2005	4
Consolidated Statements of Cash Flows (unaudited) - Three Months Ended March 31, 2006 and 2005	5
Notes to Consolidated Financial Statements (unaudited)	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3. Quantitative and Qualitative Disclosures about Market Risk	20
Item 4. Controls and Procedures	20
PART II - OTHER INFORMATION	
Item 6. Exhibits	21
SIGNATURES	22

The Lexicon name and logo, LexVision(R) and OmniBank(R) are registered trademarks and Genome5000(TM) and e-Biology(TM) are trademarks of Lexicon Genetics Incorporated.

FACTORS AFFECTING FORWARD LOOKING STATEMENTS

This quarterly report on Form 10-Q contains forward-looking statements. These statements relate to future events or our future financial performance. We have attempted to identify forward-looking statements by terminology including "anticipate," "believe," "can," "continue," "could," "estimate," "expect," "intend," "may," "plan," "potential," "predict," "should" or "will" or the negative of these terms or other comparable terminology. These statements are only predictions and involve known and unknown risks, uncertainties and other factors, including the risks outlined under "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Risk Factors," that may cause our or our industry's actual results, levels of activity, performance

or achievements to be materially different from any future results, levels or activity, performance or achievements expressed or implied by these forward-looking statements.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We are not under any duty to update any of the forward-looking statements after the date of this quarterly report on Form 10-Q to conform these statements to actual results, unless required by law.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LEXICON GENETICS INCORPORATED

CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT PAR VALUE)

	AS OF MARCH 31, 2006	AS DEC 31,
	(UNAUDITED)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,858	$ 2
Short-term investments, including restricted investments of $430	65,126	7
Accounts receivable, net of allowance for doubtful accounts of $45	2,158	
Other receivables	--	
Prepaid expenses and other current assets	3,438	
Total current assets	92,580	10
Property and equipment, net of accumulated depreciation and amortization of $49,206 and $47,926, respectively	83,775	8
Goodwill	25,798	2
Intangible assets, net of amortization of $5,660 and $5,360, respectively	340	
Other assets	808	
Total assets	$ 203,301	$ 21
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,589	$
Accrued liabilities	6,857	
Current portion of deferred revenue	40,274	3
Current portion of long-term debt	4,767	
Total current liabilities	55,487	5
Deferred revenue, net of current portion	38,175	4
Long-term debt	31,982	3
Other long-term liabilities	725	
Total liabilities	126,369	13

Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $.01 par value; 5,000 shares authorized; no shares issued and outstanding	--	
Common stock, $.001 par value; 120,000 shares authorized; 64,607 and 64,554 shares issued and outstanding	65	
Additional paid-in capital	385,180	38
Deferred stock compensation	--	
Accumulated deficit	(308,261)	(29
Accumulated other comprehensive loss	(52)	
Total stockholders' equity	76,932	8
Total liabilities and stockholders' equity	$ 203,301	$ 21

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

LEXICON GENETICS INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

	THREE MONTHS ENDED MARCH 31,	
	2006	2005
Revenues:		
Collaborative research	$ 19,306	$ 8,883
Subscription and license fees	1,649	5,042
Total revenues	20,955	13,925
Operating expenses:		
Research and development, including stock-based compensation of $1,149 and ($11), respectively	26,672	22,760
General and administrative, including stock-based compensation of $692 and $0, respectively	5,303	4,432
Total operating expenses	31,975	27,192
Loss from operations	(11,020)	(13,267)
Interest income	1,003	491
Interest expense	(807)	(805)
Other income, net	(7)	315
Net loss	$(10,831)	$(13,266)
Net loss per common share, basic and diluted	$ (0.17)	$ (0.21)
Shares used in computing net loss per common share, basic and diluted	64,566	63,525

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

LEXICON GENETICS INCORPORATED

CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	THREE MONTHS MARCH 31	
	2006	--
Cash flows from operating activities:		
Net loss	$(10,831)	$(
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,682	
Amortization of intangible assets, other than goodwill	300	
Stock-based compensation	1,841	
Loss on disposal of property and equipment	--	
Changes in operating assets and liabilities:		
Decrease in accounts receivable	450	
Decrease in prepaid expenses and other current assets	306	
Decrease in other assets	156	
Decrease in accounts payable and other liabilities	(3,219)	
Decrease in deferred revenue	(3,133)	
Net cash used in operating activities	(11,448)	(
Cash flows from investing activities:		
Purchases of property and equipment	(1,192)	
Proceeds from disposal of property and equipment	--	
Purchases of investments	(27,590)	(
Maturities of investments	40,189	
Net cash provided by investing activities	11,407	
Cash flows from financing activities:		
Proceeds from issuance of common stock	120	
Repayment of debt borrowings	(191)	
Net cash used in financing activities	(71)	
Net decrease in cash and cash equivalents	(112)	
Cash and cash equivalents at beginning of period	21,970	
Cash and cash equivalents at end of period	$ 21,858	$
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 679	$
Supplemental disclosure of non-cash investing and financing activities:		
Unrealized loss on investments	$ --	$
Reversal of deferred stock compensation, in connection		

with stock options	$ --	$
Retirement of property and equipment	$ 1,402	$

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

LEXICON GENETICS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements of Lexicon Genetics Incorporated (Lexicon or the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three-month period ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006.

The accompanying consolidated financial statements include the accounts of Lexicon and its subsidiaries. Intercompany transactions and balances are eliminated in consolidation.

For further information, refer to the financial statements and footnotes thereto included in Lexicon's annual report on Form 10-K for the year ended December 31, 2005, as filed with the SEC.

2. NET LOSS PER SHARE

Net loss per share is computed using the weighted average number of shares of common stock outstanding during the applicable period. Shares associated with stock options and warrants are not included because they are antidilutive. There are no differences between basic and diluted net loss per share for all periods presented.

3. STOCK-BASED COMPENSATION

On January 1, 2006, Lexicon adopted Statement of Financial Accounting Standards Board No. 123 (Revised), "Share-Based Payment," SFAS No. 123(R). This statement requires companies to recognize compensation expense in the statement of operations for share-based payments, including stock options issued to employees, based on their fair values on the date of the grant, with the compensation expense recognized over the period in which an employee is required to provide service in exchange for the stock award. The Company adopted this statement using the modified prospective transition method, which applies the compensation expense recognition provisions to new awards and to any awards modified, repurchased or canceled after the January 1, 2006 adoption date. Additionally, for any unvested awards outstanding at the adoption date, the

Company will recognize compensation expense over the remaining vesting period. Stock-based compensation expense is recognized on a straight-line basis. The adoption of SFAS No. 123(R) resulted in stock-based compensation expense of $1.8 million, or $0.03 per share, for the three months ended March 31, 2006. There is no impact on cash flows from operating activities or financing activities. As of March 31, 2006, stock-based compensation cost for all outstanding unvested options was $16.6 million, which is expected to be recognized over a weighted-average period of 1.4 years.

Prior to the adoption of SFAS No. 123(R), Lexicon's stock-based compensation plans were accounted for under the recognition and measurement provisions of Accounting Principles Board Opinion

No. 25, "Accounting for Stock Issued to Employees, and Related Interpretations," APB No. 25. Under the intrinsic value method described in APB No. 25, no compensation expense was recorded because the exercise price of the employee stock options equaled the market price of the underlying stock on the date of grant.

Lexicon records expense for options issued to non-employee consultants at fair value and re-measures the fair value at each reporting date. Lexicon reversed stock-based compensation expense of $11,000 related to non-employee consultants during the three-month period ended March 31, 2005.

The following table illustrates the effect on net loss and net loss per share if the fair value recognition provisions of SFAS No. 123, "Accounting for Stock Based Compensation," had been applied to all outstanding and unvested awards in the period:

	THREE MONTHS ENDED MARCH 31, 2005
Net loss, as reported:	$(13,266)
Add: Stock-based compensation expense included in reported net loss	(11)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(3,130)
Pro forma net loss	$(16,407)
Net loss per common share, basic and diluted	
As reported	$ (0.21)
Pro forma	$ (0.26)

Valuation Assumptions

The fair value of stock options is estimated at the date of grant using the Black-Scholes method. The Black-Scholes option-pricing model requires the input of subjective assumptions. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not

necessarily provide a reliable single measure of the fair value of its employee stock options. For purposes of determining the fair value of stock options granted subsequent to the adoption of SFAS No. 123(R), the Company segregated its options into two homogeneous groups, based on exercise and post-vesting employment termination behaviors, resulting in a change in the assumptions used for expected option lives and forfeitures. Expected volatility is based on the historical volatility in the Company's stock price. The following weighted-average assumptions were used for options granted in the three-month periods ended March 31, 2006 and 2005, respectively:

	EXPECTED VOLATILITY	RISK-FREE INTEREST RATE	EXPECTED TERM	ESTIMA FORFEIT
March 31, 2006:				
Employees	69%	4.6%	7	18%
Officers and non-employee directors	69%	4.6%	9	3%
March 31, 2005:				
Employees, officers and non-employee directors	72%	4.2%	7	3%

Stock Option Plans

2000 Equity Incentive Plan: In September 1995, Lexicon adopted the 1995 Stock Option Plan, which was subsequently amended and restated in February 2000 as the 2000 Equity Incentive Plan (the "Equity Incentive Plan"). The Equity Incentive Plan provides for the grant of incentive stock options to employees and nonstatutory stock options to employees, directors and consultants of the Company. The Equity Incentive Plan also permits the grant of stock bonuses and restricted stock purchase awards. Incentive stock options have an exercise price of 100% or more of the fair market value of our common stock on the date of grant. Nonstatutory stock options may have an exercise price as low as 85% of fair market value on the date of grant. The purchase price of other stock awards may not be less than 85% of fair market value. However, the plan administrator may award bonuses in consideration of past services without a purchase payment. Shares may be subject to a repurchase option in the discretion of the plan administrator. Generally, stock options have a maximum term of 10 years, and options vest in increments over four years from the date of grant, although options may be granted with different vesting terms from time to time. Upon employee termination, unexercised options will expire at the end of three months. As of March 31, 2006, an aggregate of 20,500,000 shares of common stock had been reserved for issuance, options to purchase 15,689,998 shares were outstanding, and 3,570,701 shares had been issued upon the exercise of stock options issued under the Equity Incentive Plan.

2000 Non-Employee Directors' Stock Option Plan: In February 2000, Lexicon adopted the 2000 Non-Employee Directors' Stock Option Plan (the "Directors' Plan") to provide for the automatic grant of options to purchase shares of common stock to non-employee directors of the Company. Under the Directors' Plan, non-employee directors first elected after the closing of the Company's initial public offering receive an initial option to purchase 30,000 shares of common stock. In addition, on the day following each of the Company's annual meetings of stockholders, beginning with the annual meeting in 2001, each non-employee director who has been a director for at least six months was

automatically granted an option to purchase 6,000 shares of common stock. Beginning with the annual meeting in 2005, the annual grant was increased to an option to purchase 10,000 shares of common stock. Initial option grants become vested and exercisable over a period of five years and annual option grants become vested over a period of 12 months from the date of grant. Options granted under the Directors' Plan have an exercise price equal to the fair market value of the Company's common stock on the date of grant and term of ten years from the date of grant. As of March 31, 2006, an aggregate of 600,000 shares of common stock had been reserved for issuance, options to purchase 268,000 shares were outstanding, and no options had been exercised under the Directors' Plan.

Coelacanth Corporation 1999 Stock Option Plan: Lexicon assumed the Coelacanth Corporation 1999 Stock Option Plan (the "Coelacanth Plan") and the outstanding stock options under the plan in connection with our July 2001 acquisition of Coelacanth Corporation. The Company will not grant any further options under the Coelacanth Plan. As outstanding options under the plan expire or terminate, the number of shares authorized for issuance under the Coelacanth Plan will be correspondingly reduced. As of March 31, 2006, an aggregate of 122,649 shares of common stock had been reserved for issuance, options to purchase 73,676 shares of common stock were outstanding, and 27,045 shares of common stock had been issued upon the exercise of stock options issued under the Coelacanth Plan.

Stock Option Activity

The following is a summary of option activity under Lexicon's stock option plans for the first quarter of 2006:

	OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL TERM	AGGREGATE INTRINSIC VALUE
	(IN THOUSANDS)			(IN THOUSANDS)
Outstanding at December 31, 2005..	13,802	$6.36		
Granted.....	2,395	4.01		
Exercised.....	(53)	2.26		
Canceled.....	(112)	6.46		
Outstanding at March 31, 2006.....	16,032	6.02	6.1	$21,047
Exercisable at March 31, 2006.....	10,939	$6.48	4.8	$16,600

The weighted-average grant date fair value of options granted during the three-month periods ended March 31, 2006 and 2005 was $2.95 and $4.08, respectively. The total intrinsic value of options exercised during the three-month periods ended March 31, 2006 and 2005 were $146,000 and $271,000, respectively. As of March 31, 2006, 1,571,301 shares of common stock were available for grant under Lexicon's stock option plans.

Stock Options Outstanding

The following table summarizes information about stock options outstanding at March 31, 2006:

OPTIONS OUTSTANDING				OPTIONS EXERCISABLE	
RANGE OF EXERCISE PRICE	OUTSTANDING AS OF MARCH 31, 2006	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (IN YEARS)	WEIGHTED AVERAGE EXERCISE PRICE	EXERCISABLE AS OF MARCH 31, 2006	WEIGHTED AVERAGE EXERCISE PRICE
	(IN THOUSANDS)			(IN THOUSANDS)	
$ 1.67 - 2.50	4,727	3.0	$ 2.40	4,727	$ 2.40
3.16 - 4.72	3,882	8.8	4.00	1,045	3.96
4.76 - 7.12	2,557	8.4	5.81	956	5.84
7.15 - 10.55	3,004	6.6	8.55	2,349	8.82
10.87 - 16.00	1,369	4.9	12.62	1,369	12.62
16.63 - 22.06	363	4.0	19.71	363	19.71
25.25 - 31.63	28	4.6	26.23	28	26.23
38.00 - 38.50	102	4.4	38.49	102	38.49
	16,032	6.1	$ 6.02	10,939	$ 6.48

4. DEBT OBLIGATIONS

Genentech Loan: On December 31, 2002, Lexicon borrowed $4.0 million under a note agreement with Genentech, Inc. The proceeds of the loan are to be used to fund research efforts under the alliance agreement with Genentech. On November 30, 2005, the note agreement was amended to extend the maturity date of the loan by one year to December 31, 2006. No other terms of the note agreement were changed. The Company may repay the note, at any time up to the maturity date, at its option, in cash, in shares of common stock valued at the then-current market price, or in a combination of cash and shares, subject to certain limitations. The note accrues interest at an annual rate of 8%, compounded quarterly. The $4.0 million note has been classified as a current liability on the accompanying consolidated balance sheet as of December 31, 2005 and March 31, 2006.

Mortgage Loan: In April 2004, Lexicon purchased its facilities in The Woodlands, Texas that were previously subject to a synthetic lease. The Company repaid the $54.8 million funded under the synthetic lease with proceeds from a $34.0 million third-party mortgage financing and $20.8 million in cash. The mortgage loan has a ten-year term with a 20-year amortization and bears interest at a fixed rate of 8.23%. As a result of the refinancing, all restrictions on the cash and investments that had secured the obligations under the synthetic lease were eliminated.

5. COMMITMENTS AND CONTINGENCIES

In May 2002, Lexicon's subsidiary Lexicon Pharmaceuticals (New Jersey), Inc. leased a 76,000 square-foot laboratory and office space in Hopewell, New

Jersey under an agreement which expires in June 2013. The lease provides for an escalating yearly rent payment of $1.3 million in the first year, $2.1 million in years two and three, $2.2 million in years four to six, $2.3 million in years seven to nine and $2.4 million in years ten and eleven. Lexicon is the guarantor of the obligations of its subsidiary under the lease. The Company is required to maintain restricted investments to collateralize the Hopewell lease. As of March 31, 2006, the Company had $430,000 in restricted investments to collateralize a standby letter of credit for this lease.

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

OVERVIEW

We are a biopharmaceutical company focused on discovering and developing breakthrough treatments for human disease. We are using gene knockout technology to systematically discover the physiological functions of genes in living mammals, or in vivo. We generate our gene function discoveries using knockout mice - mice whose DNA has been altered to disrupt, or "knock out," the function of the altered gene. Our patented gene trapping and gene targeting technologies enable us to rapidly generate these knockout mice by altering the DNA of genes in a special variety of mouse cells, called embryonic stem cells, which can be cloned and used to generate mice with the altered gene. We employ an integrated platform of advanced medical technologies to systematically discover and validate which genes, when knocked out, result in a favorable medical profile with pharmaceutical utility. We then pursue those genes and the proteins they encode as potential targets for therapeutic intervention in our drug discovery programs.

We employ internal resources and drug discovery alliances to discover potential small molecule, antibody and protein drugs for in vivo-validated drug targets that we consider to have high pharmaceutical value. We use our own sophisticated libraries of drug-like chemical compounds and an industrialized medicinal chemistry platform to identify small molecule drug candidates for our in vivo-validated drug targets. We have established alliances with Bristol-Myers Squibb Company to discover and develop novel small molecule drugs in the neuroscience field; with Genentech, Inc. for the discovery of therapeutic proteins and antibody targets and the development of antibody and protein drugs based on those targets; with N.V. Organon for the discovery of another group of therapeutic proteins and antibody targets and the development and commercialization of antibody and protein drugs based on those targets; and with Takeda Pharmaceutical Company Limited to discover new drugs for the treatment of high blood pressure. In addition, we have established collaborations and license agreements with other leading pharmaceutical and biotechnology companies under which we receive fees and, in some cases, are eligible to receive milestone and royalty payments, for access to some of our technologies and discoveries for use in their own drug discovery efforts.

We derive substantially all of our revenues from drug discovery alliances, target validation collaborations for the development and, in some cases, analysis of the physiological effects of genes altered in knockout mice, government grants and contracts, and technology licenses. To date, we have generated a substantial portion of our revenues from a limited number of sources.

Our operating results and, in particular, our ability to generate additional revenues are dependent on many factors, including our success in

establishing collaborations, alliances and technology licenses, expirations of our collaborations and alliances, the success rate of our discovery efforts leading to opportunities for new collaborations, alliances and licenses, as well as milestone payments and royalties, the timing and willingness of collaborators to commercialize products which may result in royalties, and general and industry-specific economic conditions which may affect research and development expenditures. Our future revenues from collaborations, alliances and government grants and contracts are uncertain because our existing agreements have fixed terms or relate to specific projects of limited duration. Our future revenues from technology licenses are uncertain because they depend, in large part, on securing new agreements. Subject to limited exceptions, we do not intend to offer subscriptions to our databases or make our compound libraries available for purchase in the future. Our ability to secure future revenue-generating agreements will depend upon our ability to address the needs of our potential future collaborators, granting agencies and licensees, and to negotiate agreements that we believe are in our long-term best interests. We may determine that our interests are better served by retaining rights to

our discoveries and advancing our therapeutic programs to a later stage, which could limit our near-term revenues. Because of these and other factors, our operating results have fluctuated in the past and are likely to do so in the future, and we do not believe that period-to-period comparisons of our operating results are a good indication of our future performance.

Since our inception, we have incurred significant losses and, as of March 31, 2006, we had an accumulated deficit of $308.3 million. Our losses have resulted principally from costs incurred in research and development, general and administrative costs associated with our operations, and non-cash stock-based compensation expenses associated with stock options granted to employees and consultants prior to our April 2000 initial public offering. Research and development expenses consist primarily of salaries and related personnel costs, material costs, facility costs, depreciation on property and equipment, legal expenses resulting from intellectual property prosecution and other expenses related to our drug discovery programs, the development and analysis of knockout mice and our other target validation research efforts, and the development of compound libraries. General and administrative expenses consist primarily of salaries and related expenses for executive and administrative personnel, professional fees and other corporate expenses, including information technology, facilities costs and general legal activities. In connection with the expansion of our drug discovery programs and our target validation research efforts, we expect to incur increasing research and development and general and administrative costs. As a result, we will need to generate significantly higher revenues to achieve profitability.

CRITICAL ACCOUNTING POLICIES

Revenue Recognition

We recognize revenues when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed and determinable, and collectibility is reasonably assured. Payments received in advance under these arrangements are recorded as deferred revenue until earned.

Upfront fees under our drug discovery alliances are recognized as revenue on a straight-line basis over the estimated period of service, generally the contractual research term, to the extent they are non-refundable. Research funding under these alliances is recognized as services are performed to the

extent they are non-refundable, either on a straight-line basis over the estimated service period, generally the contractual research term, or as contract research costs are incurred. Milestone-based fees are recognized upon completion of specified milestones according to contract terms. Fees for access to our databases and other target validation resources are recognized ratably over the subscription or access period. Payments received under target validation collaborations and government grants and contracts are recognized as revenue as we perform our obligations related to such research to the extent such fees are non-refundable. Non-refundable technology license fees are recognized as revenue upon the grant of the license, when performance is complete and there is no continuing involvement.

Revenues recognized from multiple element contracts are allocated to each element of the arrangement based on the relative fair value of the elements. The determination of fair value of each element is based on objective evidence. When revenues for an element are specifically tied to a separate earnings process, revenue is recognized when the specific performance obligation associated with the element is completed. When revenues for an element are not specifically tied to a separate earnings process, they are recognized ratably over the term of the agreement.

A change in our revenue recognition policy or changes in the terms of contracts under which we recognize revenues could have an impact on the amount and timing of our recognition of revenues.

Research and Development Expenses

Research and development expenses consist of costs incurred for company-sponsored as well as collaborative research and development activities. These costs include direct and research-related overhead expenses and are expensed as incurred. Patent costs and technology license fees for technologies that are utilized in research and development and have no alternative future use are expensed when incurred.

We have advanced two of our drug discovery programs, LX-6171 and LX-1031, into preclinical development in preparation for regulatory filings for the commencement of clinical trials. For any potential drug, the drug development process takes many years to complete. The cost and length of time varies due to many factors, including the type, complexity and intended use of the product candidate. We estimate that drug development activities are typically completed over the following periods:

PHASE	ESTIMATED COMPLETION PERIOD
Preclinical development	1-2 years
Phase 1 clinical trials	1-2 years
Phase 2 clinical trials	1-2 years
Phase 3 clinical trials	2-4 years

We expect research and development costs to increase in the future as our drug discovery programs advance in preclinical development and clinical trials. Due to the variability in the length of time necessary for drug development, the

uncertainties related to the cost of these activities and ultimate ability to obtain governmental approval for commercialization, accurate and meaningful estimates of the ultimate costs to bring our potential product candidates to market are not available.

We record our research and development costs by type or category, rather than by project. Significant categories of costs include personnel, facilities and equipment costs, laboratory supplies and third-party and other services. In addition, a significant portion of our research and development expenses is not tracked by project as it benefits multiple projects. Consequently, fully-loaded research and development cost summaries by project are not available.

Stock-based Compensation Expense

On January 1, 2006, we adopted Statement of Financial Accounting Standards Board No. 123 (Revised), "Share-Based Payment," or SFAS No. 123(R). This statement requires companies to recognize compensation expense in the statement of operations for share-based payments, including stock options issued to employees, based on their fair values on the date of the grant, with the compensation expense recognized over the period in which an employee is required to provide service in exchange for the stock award. We adopted this statement using the modified prospective transition method, which applies the compensation expense recognition provisions to new awards and to any awards modified, repurchased or canceled after the January 1, 2006 adoption date. Additionally, for any unvested awards outstanding at the adoption date, we will recognize compensation expense over the remaining vesting period. Stock-based compensation expense is recognized on a straight-line basis. The adoption of SFAS No. 123(R) resulted in stock-based compensation expense of $1.8 million, or $0.03 per share, for the three months ended March 31, 2006. There is no impact on cash flows from operating activities or financing activities. As of March 31, 2006, stock-based compensation cost for all outstanding unvested options was $16.6 million, which is expected to be recognized over a weighted-average period of 1.4 years.

Prior to the adoption of SFAS No. 123(R), our stock-based compensation plans were accounted for under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees, and Related Interpretations," APB No. 25. Under the intrinsic value method described in APB No. 25, no compensation expense was recorded because the exercise price of the employee stock options equaled the market price of the underlying stock on the date of grant.

We record expense for options issued to non-employee consultants at fair-value and re-measure the fair value at each reporting date. We reversed stock-based compensation expense of $11,000 related to non-employee consultants during the three-month period ended March 31, 2005.

The fair value of stock options is estimated at the date of grant using the Black-Scholes option-pricing model. For purposes of determining the fair value of stock options granted subsequent to the adoption of SFAS No. 123(R), the Company segregated its options into two homogeneous groups, based on exercise and post-vesting employment termination behaviors, resulting in a change in the assumptions used for expected option lives and forfeitures. Expected volatility is based on the historical volatility in our stock price. The following weighted-average assumptions were used for options granted in the three-month periods ended March 31, 2006 and 2005, respectively:

	EXPECTED VOLATILITY	RISK-FREE INTEREST RATE	EXPECTED TERM	ESTIM FORFEI
March 31, 2006:				
Employees	69%	4.6%	7	18
Officers and non-employee directors	69%	4.6%	9	3
March 31, 2005:				
Employees, officers and non-employee directors	72%	4.2%	7	3

Goodwill Impairment

Goodwill is not amortized, but is tested at least annually for impairment at the reporting unit level. We have determined that the reporting unit is the single operating segment disclosed in our current financial statements. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The first step in the impairment process is to determine the fair value of the reporting unit and then compare it to the carrying value, including goodwill. We determined that the market capitalization approach is the most appropriate method of measuring fair value of the reporting unit. Under this approach, fair value is calculated as the average closing price of our common stock for the 30 days preceding the date that the annual impairment test is performed, multiplied by the number of outstanding shares on that date. A control premium, which is representative of premiums paid in the marketplace to acquire a controlling interest in a company, is then added to the market capitalization to determine the fair value of the reporting unit. If the fair value exceeds the carrying value, no further action is required and no impairment loss is recognized. Additional impairment assessments may be performed on an interim basis if we encounter events or changes in circumstances that would indicate that, more likely than not, the carrying value of goodwill has been impaired.

RESULTS OF OPERATIONS

Three Months Ended March 31, 2006 and 2005

REVENUES

Total revenues and dollar and percentage changes as compared to the corresponding period in the prior year are as follows (dollar amounts are presented in millions):

	THREE MONTHS ENDED MARCH 31,	
	2006	2005
Total revenues	$21.0	$13.9
Dollar increase	$ 7.1	
Percentage increase	50%	

- Collaborative research - Revenue from collaborative research increased 117% to $19.3 million, primarily due to the achievement of a performance milestone under our hypertension drug discovery alliance with Takeda as well as the recognition of revenues under our alliance with Organon and our award from the Texas Enterprise Fund.

- Subscription and license fees - Revenue from subscriptions and license fees decreased 67% to $1.6 million, primarily due to the fact that the prior-year period included a one-time technology license fee from Deltagen, Inc.

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses and dollar and percentage changes as compared to the corresponding period in the prior year are as follows (dollar amounts are presented in millions):

	THREE MONTHS ENDED MARCH 31,	
	2006	2005
Total research and development expense...	$26.7	$22.8
Dollar increase.....	$ 3.9	
Percentage increase.....	17%	

Research and development expenses consist primarily of salaries and other personnel-related expenses, facility and equipment costs, laboratory supplies, third-party and other services and stock-based compensation expenses.

- Personnel - Personnel costs increased 11% to $13.1 million, primarily due to increased personnel to support the expansion of our drug discovery programs and merit-based pay increases for employees. Salaries, bonuses, employee benefits, payroll taxes, recruiting and relocation costs are included in personnel costs.

- Facilities and equipment - Facilities and equipment costs increased 6% to $5.4 million, primarily due to an increase in utility costs.

- Laboratory supplies - Laboratory supplies expense increased 12% to $3.5 million, primarily due to research performed in connection with our award from the Texas Enterprise Fund.

- Third-party and other services - Third-party and other services increased 41% to $2.0 million, primarily due to an increase in third-party research costs.

- Stock-based compensation - Stock-based compensation expense increased by $1.2 million, primarily as a result of our adoption of SFAS No. 123(R), "Share-Based Payment," on January 1, 2006.

- Other - Other costs increased by 8% in 2006 to $1.5 million.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses and dollar and percentage changes as compared to the corresponding period in the prior year are as follows (dollar amounts are presented in millions):

	THREE MONTHS ENDED MARCH 31,	
	2006	2005
Total general and administrative expense...	$5.3	$4.4
Dollar increase.....	$0.9	
Percentage increase.....	20%	

General and administrative expenses consist primarily of personnel costs to support our research activities, facility and equipment costs, professional fees such as legal fees, and stock-based compensation expenses.

- Personnel - Personnel costs increased 12% to $3.0 million, primarily due to increased personnel and merit-based pay increases for employees. Salaries, bonuses, employee benefits, payroll taxes, recruiting and relocation costs are included in personnel costs.

- Facilities and equipment - Facilities and equipment costs were $0.8 million, consistent with the prior year.

- Professional fees - Professional fees decreased 19% to $0.3 million, primarily due to decreased litigation costs.

- Stock-based compensation - Stock-based compensation expense increased by $0.7 million as a result of our adoption of SFAS No. 123(R), "Share-Based Payment," on January 1, 2006.

- Other - Other costs decreased 13% to $0.5 million.

INTEREST INCOME, INTEREST EXPENSE AND OTHER INCOME, NET

Interest Income. Interest income increased 104% to $1.0 million in the three months ended March 31, 2006 from $0.5 million in the corresponding period in 2005, due to higher average cash balances and higher interest rates.

Interest Expense. Interest expense was $0.8 million in the three months ended March 31, 2006 and 2005.

Other Income, Net. Other income, net decreased 102% to expense of $7,000 in the three months ended March 31, 2006 from income of $0.3 million in the corresponding period in 2005. Other income in 2005 included a settlement with a vendor.

NET LOSS AND NET LOSS PER COMMON SHARE

Net Loss and Net Loss per Common Share. Net loss decreased to $10.8 million in the three months ended March 31, 2006 from $13.3 million in the corresponding period in 2005. Net loss per

common share decreased to $0.17 in the three months ended March 31, 2006 from $0.21 in the corresponding period in 2005.

Our quarterly operating results have fluctuated in the past and are likely to do so in the future, and we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations from inception primarily through sales of common and preferred stock, contract and milestone payments to us under our drug discovery alliance, target validation, database subscription and license agreements, government grants and contracts, and financing obtained under debt and lease arrangements. From our inception through March 31, 2006, we had received net proceeds of $295.5 million from issuances of common and preferred stock, including $203.2 million of net proceeds from the initial public offering of our common stock in April 2000 and $50.1 million from our July 2003 common stock offering. In addition, from our inception through March 31, 2006, we received $365.7 million in cash payments from drug discovery alliances, target validation collaborations, database subscription and technology license fees, sales of compound libraries and reagents, and government grants and contracts, of which $289.7 million had been recognized as revenues through March 31, 2006.

As of March 31, 2006, we had $87.0 million in cash, cash equivalents and short-term investments (including $0.4 million of restricted investments), as compared to $99.7 million (including $0.4 million of restricted investments) as of December 31, 2005. Cash of $11.4 million was used in operations in the three months ended March 31, 2006. This consisted primarily of the net loss for the period of $10.8 million offset by non-cash charges of $2.7 million related to depreciation expense, $1.8 million related to stock-based compensation expense and $0.3 million related to amortization of intangible assets other than goodwill; a $3.1 million decrease in deferred revenue; and changes in other operating assets and liabilities of $2.3 million. Investing activities provided cash of $11.4 million in the three months ended March 31, 2006, primarily due to net maturities of short-term investments of $12.6 million. This was offset by purchases of property and equipment of $1.2 million. We used cash of $0.1 million in financing activities. This consisted of principal repayments of $0.2 million on the mortgage loan, offset by cash proceeds of $0.1 million from stock option exercises.

In April 2004, we purchased our facilities in The Woodlands, Texas from the lessor under our previous synthetic lease agreement. In connection with such purchase, we repaid the $54.8 million funded under the synthetic lease with proceeds from a $34.0 million third-party mortgage financing and $20.8 million in cash. The mortgage loan has a ten-year term with a 20-year amortization and bears interest at a fixed rate of 8.23%. As a result of the refinancing, all restrictions on the cash and investments that had secured our obligations under the synthetic lease were eliminated.

In May 2002, our subsidiary Lexicon Pharmaceuticals (New Jersey), Inc. signed a ten-year lease for a 76,000 square-foot facility in Hopewell, New Jersey. The term of the lease extends until June 30, 2013. The lease provides for an escalating yearly base rent payment of $1.3 million in the first year, $2.1 million in years two and three, $2.2 million in years four to six, $2.3 million in years seven to nine and $2.4 million in years ten and eleven. We are the guarantor of the obligations of our subsidiary under the lease.

In December 2002, we borrowed $4.0 million under a note agreement with

Genentech. The proceeds of the loan are to be used to fund research efforts under our alliance with Genentech for the discovery of therapeutic proteins and antibody targets. On November 30, 2005, the note agreement was

amended to extend the maturity date of the loan by one year to December 31, 2006. No other terms of the note agreement were changed. We may repay the note, at any time up to the maturity date, at our option, in cash, in shares of our common stock valued at the then-current market value, or in a combination of cash and shares, subject to certain limitations. The note accrues interest at an annual rate of 8%, compounded quarterly.

Our future capital requirements will be substantial and will depend on many factors, including our ability to obtain alliance, collaboration and technology license agreements, the amount and timing of payments under such agreements, the level and timing of our research and development expenditures, market acceptance of our products, the resources we devote to developing and supporting our products and other factors. Our capital requirements will also be affected by any expenditures we make in connection with license agreements and acquisitions of and investments in complementary technologies and businesses. We expect to devote substantial capital resources to continue our research and development efforts, to expand our support and product development activities, and for other general corporate activities. We believe that our current unrestricted cash and investment balances and cash and revenues we expect to derive from drug discovery alliances, target validation collaborations, government grants and contracts, and technology licenses will be sufficient to fund our operations for approximately the next two years. During or after this period, if cash generated by operations is insufficient to satisfy our liquidity requirements, we will need to sell additional equity or debt securities or obtain additional credit arrangements. Additional financing may not be available on terms acceptable to us or at all. The sale of additional equity or convertible debt securities may result in additional dilution to our stockholders.

DISCLOSURE ABOUT MARKET RISK

We are exposed to limited market and credit risk on our cash equivalents, which have maturities of three months or less at the time of purchase. We maintain a short-term investment portfolio which consists of U.S. government agency debt obligations, investment grade commercial paper, corporate debt securities and certificates of deposit that mature within twelve months and auction rate securities that mature greater than twelve months from the time of purchase, which we believe are subject to limited market and credit risk. We currently do not hedge interest rate exposure or hold any derivative financial instruments in our investment portfolio.

We have operated primarily in the United States and substantially all sales to date have been made in U.S. dollars. Accordingly, we have not had any material exposure to foreign currency rate fluctuations.

RISK FACTORS

The following risks and uncertainties are important factors that could cause actual results or events to differ materially from those indicated by forward-looking statements. The factors described below are not the only ones we face and additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations.

Risks Related to Our Need for Additional Financing and Our Financial Results

- we will need additional capital in the future and, if it is not available on reasonable terms, we will be forced to significantly curtail or cease operations or obtain funds by entering into financing agreements on unattractive terms

- we have a history of net losses, and we expect to continue to incur net losses and may not achieve or maintain profitability

- our operating results have been and likely will continue to fluctuate, and we believe that period-to-period comparisons of our operating results are not a good indication of our future performance

Risks Related to Our Business

- we are an early-stage company, and we may not successfully develop or commercialize any therapeutics or drug targets that we have identified

- clinical testing of our future drug candidates in humans is an inherently risky and time-consuming process that may fail to demonstrate safety and efficacy, which could result in the delay, limitation or prevention of regulatory approval

- we are dependent upon our collaborations with major pharmaceutical companies, and if we are unable to achieve milestones under those collaborations or if our collaborators' efforts fail to yield pharmaceutical products on a timely basis, our business will suffer

- conflicts with our collaborators could jeopardize the success of our collaborative agreements and harm our product development efforts

- if we are unable to internally establish drug development and commercialization capabilities or arrange for the provision of such functions by third parties, our ability to develop and commercialize pharmaceutical products would be significantly impaired

- we lack the capability to manufacture materials for preclinical studies, clinical trials or commercial sales and will rely on third parties to manufacture our potential products, which may harm or delay our product development and commercialization efforts

- we face substantial competition in our drug discovery and product development efforts

- we may engage in future acquisitions, which may be expensive and time consuming and from which we may not realize anticipated benefits

- if we lose our key personnel or are unable to attract and retain additional personnel, we may be unable to successfully develop and commercialize our own products

- any contamination among our knockout mouse population could negatively affect the reliability of our scientific research or cause us to incur significant remedial costs

- because all of our target validation operations are located at a single facility, the occurrence of a disaster could significantly

disrupt our business

- we use hazardous chemicals and radioactive and biological materials in our business; any disputes relating to improper handling, storage or disposal of these materials could be time consuming and costly

Risks Related to Our Industry

- our ability to patent our inventions is uncertain because patent laws and their interpretation are highly uncertain and subject to change

- if we are unable to adequately protect our intellectual property, third parties may be able to use our technology, which could negatively impact our ability to compete in the market

- we may be involved in patent litigation and other disputes regarding intellectual property rights and may require licenses from third parties for our discovery and development and planned commercialization activities, and we may not prevail in any such litigation or other dispute or be able to obtain required licenses

- we use intellectual property that we license from third parties, and if we do not comply with these licenses, we could lose our rights under them

- we have not sought patent protection outside of the United States for some of our inventions, and some of our licensed patents only provide coverage in the United States, and as a result, our international competitors could be granted foreign patent protection with respect to our discoveries

- our industry is subject to extensive and uncertain government regulatory requirements, which could significantly hinder our ability, or the ability of our collaborators, to obtain, in a timely manner or at all, regulatory approval of potential therapeutic products, or to commercialize such products

- if our potential products receive regulatory approval, we or our collaborators will remain subject to extensive and rigorous ongoing regulation

- the uncertainty of pharmaceutical pricing and reimbursement may decrease the commercial potential of any products that we or our collaborators may develop and affect our ability to raise capital

- we may be sued for product liability

- public perception of ethical and social issues may limit or discourage the use of our technologies, which could reduce our revenues

For additional discussion of the risks and uncertainties that affect our business, see "Item 1. Business - Risk Factors" included in our annual report on Form 10-K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See "Disclosure about Market Risk" under "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" for quantitative and qualitative disclosures about market risk.

ITEM 4. CONTROLS AND PROCEDURES

Our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures (as defined in rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are sufficiently effective to ensure that the information required to be disclosed by us in the reports we file under the Securities Exchange Act is gathered, analyzed and disclosed with adequate timeliness, accuracy and completeness, based on an evaluation of such controls and procedures as of the end of the period covered by this report.

Subsequent to our evaluation, there were no significant changes in internal controls or other factors that could significantly affect internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART II OTHER INFORMATION

ITEM 6. EXHIBITS

EXHIBIT NO.	DESCRIPTION
31.1	-- Certification of CEO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	-- Certification of CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	-- Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

LEXICON GENETICS INCORPORATED

Date: May 9, 2006

By: /s/ Arthur T. Sands

Arthur T. Sands, M.D., Ph.D.
President and Chief Executive Officer

Date: May 9, 2006

By: /s/ Julia P. Gregory

Julia P. Gregory
Executive Vice President, Corporate Development and Chief Financial Officer

INDEX TO EXHIBITS

EXHIBIT NO.	DESCRIPTION
31.1	-- Certification of CEO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	-- Certification of CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	-- Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002