METABASIS THERAPEUTICS INC
Form 10-Q
August 15, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2005.

OR

o **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 000-50785

METABASIS THERAPEUTICS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**33-0753322**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
9390 Towne Centre Drive, Building 300, San Diego, CA	**92121**
(Address of principal executive offices)	(Zip code)

(858) 587-2770
(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. ý Yes o No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). o Yes ý No

The number of outstanding shares of the registrant s common stock, par value $0.001 per share, as of August 10, 2005 was 18,226,998.

METABASIS THERAPEUTICS, INC.

FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2005

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Metabasis Therapeutics, Inc.
Balance Sheets
(In thousands, except par value data)

	June 30, 2005 (Unaudited)	December 31, 2004
Assets		
Current assets:		
Cash and cash equivalents	$ 11,398	$ 10,921
Securities available-for-sale	21,989	32,934
Accounts receivable	5,982	525
Other current assets	846	1,126
Total current assets	40,215	45,506
Property and equipment, net	2,227	2,354
Other assets	153	
Total assets	$ 42,595	$ 47,860
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 715	$ 864
Accrued liabilities	2,872	2,835
Deferred rent	17	67
Deferred revenue, current portion	2,569	
Current portion of capital lease obligations, net of discount	854	834
Total current liabilities	7,027	4,600
Deferred revenue	3,296	
Other long-term liabilities	5	4
Capital lease obligations, net of current portion and discount	1,266	1,392
Stockholders equity:		
Preferred stock, $0.001 par value; 5,000 shares authorized at June 30, 2005 (unaudited) and December 31, 2004, no shares issued or outstanding		
Common stock, $0.001 par value; 100,000 shares authorized at June 30, 2005 (unaudited) and December 31, 2004; 18,225 and 18,169 shares issued and outstanding at June 30, 2005 (unaudited) and December 31, 2004, respectively	18	18
Additional paid-in capital	98,615	98,602
Deferred compensation	(4,241)	(5,337)
Accumulated deficit	(63,334)	(51,365)
Accumulated other comprehensive loss	(57)	(54)
Total stockholders equity	31,001	41,864
Total liabilities and stockholders equity	$ 42,595	$ 47,860

See accompanying notes.

Metabasis Therapeutics, Inc.

Statements of Operations

(In thousands, except per share data)

(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Revenues:				
Sponsored research	$ 396	$ 344	$ 740	$ 688
Milestones		1,000		4,500
License fees	37	125	37	250
Other revenue	184	302	237	503
Total revenues	617	1,771	1,014	5,941
Operating expenses:				
Research and development	4,937	4,103	10,034	7,756
General and administrative	1,186	898	2,497	1,593
Amortization of employee stock-based compensation	426	413	855	756
Total operating expenses	6,549	5,414	13,386	10,105
Loss from operations	(5,932)	(3,643)	(12,372)	(4,164)
Other income (expense):				
Interest income	250	66	509	130
Interest expense	(52)	(56)	(106)	(111)
Total interest and other income (expense)	198	10	403	19
Net loss	$ (5,734)	$ (3,633)	$ (11,969)	$ (4,145)
Basic and diluted net loss per share	$ (0.32)	$ (1.17)	$ (0.67)	$ (1.85)
Shares used to compute basic and diluted net loss per share	17,893	3,106	17,868	2,242
The composition of employee stock-based compensation is as follows:				
Research and development	$ 295	$ 288	$ 592	$ 528
General and administrative	131	125	263	228
	$ 426	$ 413	$ 855	$ 756

See accompanying notes.

Metabasis Therapeutics, Inc.

Statements of Cash Flows

(In thousands)

(Unaudited)

	Six months ended June 30,	
	2005	**2004**
Operating activities		
Net loss	$ (11,969)	$ (4,145)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of deferred employee stock-based compensation	855	756
Amortization of deferred compensation on tendered shares	89	89
Deferred rent	(50)	(28)
Depreciation and amortization	422	324
Amortization of discount on equipment loan	5	7
Stock options issued for services	58	
Change in operating assets and liabilities:		
Accounts receivable	(5,457)	(1,123)
Other current assets	280	(103)
Other assets	(153)	50
Deferred revenue	5,865	(216)
Accounts payable	(149)	(84)
Accrued liabilities and other long-term liabilities	38	(26)
Net cash flows used in operating activities	(10,166)	(4,499)
Investing activities		
Purchases of securities available-for-sale	(9,461)	(7,585)
Sales/maturities of securities available-for-sale	20,403	10,592
Purchases of property and equipment	(295)	(841)
Net cash flows provided by investing activities	10,647	2,166
Financing activities		
Issuance of common stock	125	31,478
Payments under capital lease obligations	(426)	(365)
Proceeds from capital lease obligations	315	410
Repurchase unvested common stock	(18)	
Net cash flows (used in) provided by financing activities	(4)	31,523
Increase in cash and cash equivalents	477	29,190
Cash and cash equivalents at beginning of year	10,921	11,017
Cash and cash equivalents at end of period	$ 11,398	$ 40,207
Supplemental schedule of noncash investing and financing activities:		
Conversion of convertible preferred stock to common stock upon initial public offering	$	$ 64

See accompanying notes.

Metabasis Therapeutics, Inc.

Notes to Financial Statements

(Unaudited)

1. Basis of Presentation

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles and with the rules and regulations of the Securities and Exchange Commission (SEC) related to a quarterly report on Form 10-Q. Accordingly, they do not include all of the information and disclosures required by U.S. generally accepted accounting principles for complete financial statements. The balance sheet at December 31, 2004 has been derived from the audited financial statements at that date but does not include all information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The interim financial statements reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial condition and results of operations for the periods presented. Except as otherwise disclosed, all such adjustments are of a normal recurring nature.

Operating results for the three and six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, see the financial statements and notes thereto for the year ended December 31, 2004 included in our Annual Report on Form 10-K filed with the SEC.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as well as disclosures of contingent assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The terms Company and we and our are used in this report to refer to Metabasis Therapeutics, Inc.

2. Stock-Based Compensation

The Company has elected to follow Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its employee and director stock options. Under APB No. 25, if the exercise price of the Company s employee and director stock options equals or exceeds the estimated fair value of the underlying stock on the date of grant, no compensation expense is recognized. In conjunction with the Company s initial public offering completed in June 2004, the Company reviewed its historical exercise prices through June 15, 2004 and, as a result, revised the estimate of fair value for the stock underlying all stock options granted subsequent to June 30, 2002. The weighted average exercise price for the options to purchase 930,000 shares of common stock granted to the Company s employees and directors during July 2002 through June 15, 2004 was $1.46. With respect to employee and director options granted, the Company has deferred stock compensation balances of $3.9 million and $4.9 million at June 30, 2005 and December 31, 2004, respectively, for the difference between the original exercise price per share determined by the Board of Directors and the revised estimate of fair value per share at the respective grant dates. Deferred stock compensation is recognized and amortized on a straight-line basis over the vesting period of the related options, generally four years. Compensation expense related to stock options granted to the Company s employees and directors was $426,000 and $413,000 for the three months ended June 30, 2005 and 2004, respectively and $855,000 and $756,000 for the six months ended

June 30, 2005 and 2004, respectively.

Options or stock awards issued to non-employees other than directors have been valued in accordance with Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, and Emerging Issues Task Force (EITF) Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services*, and expensed over the period the services are provided. Deferred charges for options granted to such non-employees are periodically remeasured as the options vest.

As required under SFAS No. 123, the pro forma effects of stock-based compensation on net loss were estimated at the date of grant using the minimum-value method for all grants made through June 15, 2004, the effective date of the Company s registration statement for its initial public offering, and the Black-Scholes method thereafter. The Company became a public company on June 16, 2004, and accordingly began using the Black-Scholes valuation model in accordance with SFAS No. 123. The minimum-value method and the Black-Scholes valuation model were developed for use in estimating the fair value of publicly traded options that have no vesting restrictions and are fully transferable. Because the Company s employee and director stock options have characteristics significantly different from those of publicly traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in

management s opinion, these existing models do not necessarily provide a reliable single measure of the fair value of the Company s employee and director stock options.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the vesting period of such stock options. The Company s pro forma information is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
	(in thousands, except per share amounts)			
Net loss applicable to common stockholders as reported	$ (5,734)	$ (3,633)	$ (11,969)	$ (4,145)
Add: Stock-based employee compensation expense included in reported net loss	426	413	855	756
Deduct: Stock-based employee compensation expense determined under fair value method	(523)	(383)	(1,029)	(757)
Pro forma net loss applicable to common stockholders	$ (5,831)	$ (3,603)	$ (12,143)	$ (4,146)
Basic and diluted net loss per share as reported	$ (0.32)	$ (1.17)	$ (0.67)	$ (1.85)
Pro forma basic and diluted net loss per share	$ (0.33)	$ (1.16)	$ (0.68)	$ (1.85)

3. Comprehensive Loss

SFAS No. 130, *Reporting Comprehensive Income*, requires that all components of comprehensive loss, including net loss, be reported in the financial statements in the period in which they are recognized. Comprehensive loss is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. The Company s comprehensive loss is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
	(in thousands)			
Net loss	$ (5,734)	$ (3,633)	$ (11,969)	$ (4,145)
Unrealized gain (loss) on available for-sale investments	34	(13)	(3)	(8)
Comprehensive loss	$ (5,700)	$ (3,646)	$ (11,972)	$ (4,153)

4. Net Loss Per Share

The Company calculated net loss per share in accordance with SFAS No. 128, *Earnings Per Share*. Basic earnings per share (EPS) is calculated by dividing the net loss by the weighted average number of common shares outstanding for the period, without consideration for common stock equivalents. Diluted EPS is computed by dividing the net loss by the weighted average number of common share equivalents outstanding for the period determined using the treasury-stock method. For purposes of this calculation, common stock subject to repurchase by the Company, options, and warrants are considered to be common stock equivalents and are only included in the calculation of diluted EPS when their effect is dilutive.

The actual net loss per share amounts for the three and six months ended June 30, 2005 and 2004 were computed based on the shares of common stock outstanding during the respective periods, including the 5.0 million shares of common stock issued in the Company s initial public offering on June 21, 2004, an additional 75,000 shares of common stock issued pursuant to the exercise by the underwriters of an over-allotment option on July 20, 2004 and the 11.0 million shares of the Company s common stock issued upon conversion of the Company s preferred stock in conjunction with the initial public offering. As a result of the issuance of these common shares, there is a lack of comparability in the basic and diluted net loss

per share amounts for the periods presented below. In order to provide a more relevant measure of operating results, the following unaudited pro forma net loss per share calculation has been included. The shares used to compute unaudited pro forma basic and diluted net loss per share represent the weighted average common shares outstanding for the period, reduced by the weighted average unvested common shares subject to repurchase, and including the assumed conversion of all outstanding shares of preferred stock into shares of common stock using the as-if converted method as of the beginning of each period presented.

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
	(in thousands, except per share amounts)			
Actual:				
Numerator:				
Net loss	$ (5,734)	$ (3,633)	$ (11,969)	$ (4,145)
Denominator:				
Weighted average common shares	18,188	3,550	18,184	2,675
Weighted average unvested common shares subject to repurchase	(295)	(444)	(316)	(433)
Denominator for basic and diluted net loss per share	17,893	3,106	17,868	2,242
Basic and diluted net loss per share	$ (0.32)	$ (1.17)	$ (0.67)	$ (1.85)
Pro forma:				
Numerator:				
Pro forma net loss	$ (5,734)	$ (3,633)	$ (11,969)	$ (4,145)
Denominator:				
Shares used above	17,893	3,106	17,868	2,242
Pro forma adjustments to reflect assumed weighted average effect of conversion of preferred stock		9,952		10,498
Pro forma shares used to compute basic net loss per share	17,893	13,058	17,868	12,740
Pro forma basic and diluted net loss per share	$ (0.32)	$ (0.28)	$ (0.67)	$ (0.33)

5. Collaboration Agreement Merck & Co., Inc.

In June 2005, the Company entered into a collaboration agreement with Merck & Co., Inc. (Merck) to research, develop and commercialize novel small molecule therapeutics with the potential to treat several metabolic diseases including type 2 diabetes, hyperlipidemia and obesity by activating an enzyme in the liver called AMP-activated Protein Kinase. The expected research term is three years, subject to renewal for one additional year by mutual agreement of the Company and Merck. As part of this collaboration, Merck paid an initial non-refundable license fee of $5.0 million in July 2005 and will provide research support funding of a minimum of $2.1 million each year during the three-year research term. The Company s level of research activities, and the minimum research support funding, may be increased during the term upon mutual agreement of both parties. Merck is also obligated to pay milestone payments if specified preclinical and clinical development and regulatory events occur and to pay royalties on sales of any product resulting from this collaboration. The Company would also have the option to co-promote any such product in the United States. If all pre-clinical and clinical milestones are achieved on multiple indications, then including the $5.0 million initial, non-refundable license fee and the minimum $6.3 million in research support funding, the Company may be entitled to payments which total up to $74.3 million, plus royalties. Merck is solely responsible for conducting and funding all development work for compounds resulting from this

collaboration.

6. New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R, *Share Based Payment*. This statement is a revision to SFAS No. 123 and supersedes APB No. 25 and amends FASB Statement No. 95, *Statement of Cash Flows*. This statement requires a public entity to expense the cost of employee and director services received in exchange for an award of equity instruments. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements of these equity arrangements. On April 14, 2005 the SEC announced that the effective date of SFAS No. 123R will be suspended until January 1, 2006, for calendar year companies.

SFAS No. 123R permits public companies to choose between the following two adoption methods:

1. A modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date, or

2. A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

As permitted by SFAS No. 123, the Company currently accounts for share-based payments to employees and directors using APB No. 25 s intrinsic value method and, as such, the Company generally recognizes no compensation cost for employee or director stock options. The impact of the adoption of SFAS No. 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, valuation of employee and director stock options under SFAS No. 123R is similar to SFAS No. 123, with minor exceptions. The impact on the Company s results of operations and EPS had the Company adopted SFAS No. 123 for the three and six month periods ended June 30, 2005 and 2004, is described in Note 2 above. Accordingly, the adoption of SFAS No. 123R s fair value method will have a significant impact on the Company s results of operations, although it will have no impact on the Company s overall financial position. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. Due to timing of the release of SFAS No. 123R, the Company has not yet completed the analysis of the ultimate impact that this new pronouncement will have on its results of operations, nor the method of adoption it will choose for this new standard.

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

You should read the following discussion and analysis together with our unaudited financial statements and the notes to those statements included elsewhere in this quarterly report on Form 10-Q, as well as our audited financial statements and notes to those statements as of and for the year ended December 31, 2004 included in our annual report on Form 10-K filed with the Securities and Exchange Commission on March 31, 2005. This discussion contains forward-looking statements that involve risks and uncertainties. As a result of many factors, such as those set forth under Risk Factors and elsewhere in this quarterly report on Form 10-Q and in our other filings with the Securities and Exchange Commission, our actual results may differ materially from those anticipated in these forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements. The forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update such statements to reflect events that occur or circumstances that exist after the date on which they are made.

Overview

We are a biopharmaceutical company **focused** on the discovery, development and commercialization of **novel drugs to address some of the world s most widespread and costly chronic diseases** involving pathways in the liver These diseases include diabetes, hyperlipidemia, a disease involving elevated levels of lipids such as cholesterol, and obesity, among others. We have established a broad and growing product pipeline targeting large markets with significant unmet medical needs.

We currently have three product candidates in clinical development, CS-917, pradefovir and MB07133, which are being developed for the treatment of type 2 diabetes, hepatitis B and primary liver cancer, respectively. Until recently, full clinical development of CS-917 had been on hold due to a safety concern that arose during a Phase I drug combination study conducted by Sankyo, Co., Ltd., our development partner for CS-917. However, after completing an analysis of the issue Sankyo decided to resume full development of CS-917. We expect Sankyo to commence a three-month, dose-ranging Phase IIb clinical trial of CS-917 during the fourth quarter of 2005 pending discussions of the development plans and protocols with the U.S. Food and Drug Administration, or FDA. In addition to our product candidates in clinical development, we have research programs focused on metabolic diseases linked to pathways in the liver such as type 2 diabetes, hyperlipidemia and obesity, as well as liver diseases such as hepatitis C and liver fibrosis. We believe our advanced research programs, which are research programs in which we have identified lead drug compounds and shown them to have efficacy in animal models, have the potential to yield additional clinical development candidates within the next two years. One of these advanced research programs yielded a compound, MB07803, that we recommended for clinical development in the first quarter of 2004. MB07803 is a clinical development candidate for the treatment of type 2 diabetes that works by the same mechanism as CS-917. A second advanced research program yielded a compound, MB07811, that we recommended for clinical development in the second quarter of 2005. MB07811 is a clinical development candidate for the treatment of hyperlipidemia and possibly obesity. We plan to file Investigation New Drug Applications (INDs) and expect to commence clinical trials of both MB07803 and MB07811 in 2006.

We have incurred annual net losses since inception. As of June 30, 2005, our accumulated deficit was approximately $63.3 million. We expect to incur substantial and increasing losses for the next several years as we:

- continue to develop current and future clinical development candidates,
- commercialize our product candidates, if any, that receive regulatory approval,
- continue and expand our research and development programs, and

acquire or in-license products, technologies or businesses that are complementary to our own.

We have a limited history of operations and, to date, we have not generated any product revenues. In addition to our initial public offering in June 2004, we have financed our operations and internal growth through private placements of preferred stock as well as direct payments of sponsored research funding, license fees, milestone payments and equity investments from our collaborative partners. We have received additional funding through equipment financing arrangements and Small Business Innovation Research, or SBIR, grants.

Our agreements with collaborators may include joint marketing or promotion arrangements of our products or products licensed from our collaborators. For example, we have retained co-promotion rights for CS-917 in North America.

Alternatively, we may grant exclusive marketing rights to our collaborators in exchange for up-front fees, milestones and royalties on future sales, if any. For example, we have licensed worldwide commercialization rights for pradefovir to Valeant Pharmaceuticals International. In June 2005, we entered into a collaboration agreement with Merck to research, develop and commercialize novel small molecule therapeutics with potential to treat several metabolic diseases including type 2 diabetes, hyperlipidemia and obesity by activating an enzyme in the liver called AMP-activated Protein Kinase (AMPK). These compounds, if successfully developed, are designed to target type 2 diabetes by a different mechanism than CS-917 and hyperlipidemia by a different mechanism than MB07811. We have retained the option for certain co-promotion rights in the U.S. for any product that results from this collaboration.

We have retained worldwide commercialization rights to MB07133, MB07803, MB07811 and all of the compounds generated from our current research programs, with the exception of the hepatitis C and metabolic disease compounds covered by collaborations with Merck.

We intend to eventually market one or more of the product candidates for which we retain commercialization rights through our own sales force or with a co-promotion partner in the U.S. and through strategic collaborations abroad.

We will rely on our partners or third-party manufacturers to produce sufficient quantities of these products for pre-clinical and clinical studies and large-scale commercialization upon their approval.

Our business is subject to significant risks, including the risks inherent in our ongoing clinical trials and the regulatory review and approval process, the results of our research and development efforts, reliance on third parties for the development and commercialization of our product candidates, competition from other products and uncertainties associated with obtaining and enforcing patent rights.

Research and Development

Our research and development expenses consist primarily of compensation and other expenses for research and development personnel, costs associated with pre-clinical development and clinical trials of our product candidates, facility costs, supplies and materials, costs for consultants and related contract research and depreciation. We charge all research and development expenses to operations as they are incurred.

Our clinical development efforts are primarily focused on the ongoing clinical trial of MB07133 and supporting the activities of our development partners for CS-917 and pradefovir. In September 2003, we initiated a Phase I clinical trial of MB07133 in the U.S. and Asia. We are responsible for all costs incurred in the clinical trials of MB07133. Sankyo and Valeant are responsible for the costs of clinical development of CS-917 and pradefovir, respectively. We are also expending significant resources on advancing MB07811 and MB07803 towards clinical development as well as on additional, earlier stage research and development programs.

We are responsible for all costs incurred in our research programs with the exception of the hepatitis C and metabolic disease programs partnered with Merck. Under the terms of our collaboration agreements with Merck, we had received approximately $2.4 million in research funding through June 30, 2005.

At this time, due to the risks inherent in the clinical trial process and given the early stage of development of our product candidates and lead compounds from our research programs, we are unable to estimate with any certainty the costs we will incur in the continued development of our product candidates for commercialization. Due to these same factors, we are unable to determine the anticipated completion dates for our current research and development projects. However, we expect our research and development costs to be substantial and to increase as we continue the development of our current product candidates, as well as continue and expand our research programs.

Generally, Phase I clinical trials can be expected to last from 6 to 18 months, Phase II clinical trials can be expected to last from 12 to 24 months and Phase III clinical trials can be expected to last from 18 to 36 months. However, clinical development timelines vary widely, as do the likelihood of success and total costs of clinical trials. Although we are currently focused primarily on advancing MB07133 through clinical development, and on advancing MB07803 and MB07811 towards clinical development, we anticipate that we will make determinations as to which research and development projects to pursue, and how much funding to direct to each project on an ongoing basis in response to the scientific and clinical success of each product candidate, as well as an ongoing assessment of each product candidate s market potential.

The lengthy process of seeking regulatory approvals for our product candidates, and the compliance with applicable regulations, require the expenditure of substantial resources. Any failure by us to obtain, or any delay in obtaining, regulatory

approvals could cause our research and development expenditures to increase and, in turn, have a material unfavorable effect on our results of operations. We cannot be certain when or if any net cash inflow due to sales of any of our current product candidates will commence.

General and Administrative

General and administrative expenses consist primarily of salaries and other related costs for personnel in executive, finance, accounting, business development, investor relations and human resource functions. Other costs include facility costs not otherwise included in research and development expenses and professional fees for legal and accounting services as well as other expenses associated with operating as a publicly traded company.

We anticipate continued increases in general and administrative expenses as our research and development activities continue to expand. These increases will likely include the hiring of additional support personnel.

Other Income (Expense), Net

Other income (expense), net includes interest earned on our cash, cash equivalents and securities available-for-sale, net of interest expense.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based on our unaudited financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles, or GAAP, for interim information, and with the rules and regulations of the Securities and Exchange Commission related to a quarterly report on Form 10-Q. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. We review our estimates on an on-going basis. We base 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. Actual results may differ from these estimates under different assumptions or conditions. We believe the following accounting policies to be critical to the judgments and estimates used in the preparation of our financial statements.

Revenue Recognition. Our revenue recognition policies are in accordance with Securities and Exchange Commission Staff Accounting Bulletin, or SAB, 104, *Revenue Recognition* and Emerging Issues Task Force, or EITF, Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. Our agreements generally contain multiple elements, including downstream milestones and royalties. All fees are nonrefundable. Revenue from milestones is recognized when earned, provided that:

the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, and

collaborator funding, if any, of our performance obligations after the milestone achievement will continue at a level comparable to before the milestone achievement.

If both of these criteria are not met, the milestone payment is recognized over the remaining minimum period of our performance obligations under the agreement. Upfront, nonrefundable fees under our collaborations are recognized over the period the related services are provided. Nonrefundable upfront fees not associated with our future performance are recognized when received. Amounts received for research funding are recognized as revenues as the services are performed. Amounts received for research funding for a specific number of full-time researchers are recognized as revenue as the services are provided, as long as the amounts received are not refundable regardless of the results of the research project.

Clinical Trial Expenses. Our clinical trials are often conducted under contracts with multiple research institutions and clinical research organizations that conduct and manage clinical trials on our behalf. The financial terms of these agreements are subject to negotiation and vary from contract to contract and may result in uneven payment flows. Generally, these agreements set forth the scope of work to be performed at a fixed fee or unit price. Payments under the contracts depend on factors such as the successful enrollment of patients or the completion of clinical trial milestones. Expenses related to clinical trials generally are accrued based on contracted amounts applied to the actual level of patient enrollment and activity according to the protocol. Other incidental costs related to patient enrollment are accrued when known. If contracted amounts

are modified based upon changes in the clinical trial protocol or scope of work to be performed, we modify our accruals accordingly on a prospective basis.

Recently Issued Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board, or FASB issued SFAS No. 123R, *Share Based Payment*. This statement is a revision to SFAS No. 123 and supersedes Accounting Principles Board, or APB Opinion No. 25 and amends FASB Statement No. 95, *Statement of Cash Flows*. This statement requires a public entity to expense the cost of employee and director services received in exchange for an award of equity instruments. This statement also provides guidance on valuing and expensing these awards, as well as disclosure requirements of these equity arrangements. On April 14, 2005 the Securities and Exchange Commission announced that the effective date of SFAS No. 123R will be suspended until January 1, 2006, for calendar year companies.

SFAS No. 123R permits public companies to choose between the following two adoption methods:

1. A modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date, or

2. A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

As permitted by SFAS No. 123, we currently account for share-based payments to employees and directors using APB Opinion No. 25 s intrinsic value method and, as such, we generally recognize no compensation cost for employee or director stock options. The impact of the adoption of SFAS No. 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, valuation of employee and director stock options under SFAS No. 123R is similar to SFAS No. 123, with minor exceptions. For information about what our reported results of operations and earnings per share would have been had we adopted SFAS No. 123 for the three and six months ended June 30, 2005 and 2004, please see the discussion in Note 2 to our unaudited financial statements included elsewhere in this quarterly report on Form 10-Q. Accordingly, the adoption of SFAS No. 123R s fair value method will have a significant impact on our results of operations, although it will have no impact on our overall financial position. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. Due to timing of the release of SFAS No. 123R, we have not yet completed the analysis of the ultimate impact that this new pronouncement will have on our results of operations, nor the method of adoption we will choose for this new standard.

Results of Operations

Comparison of the Three Months Ended June 30, 2005 and 2004

Revenues. Revenues were $617,000 for the three months ended June 30, 2005, compared with $1.8 million for the three months ended June 30, 2004. The $1.2 million decrease was due primarily to a milestone payment of $1.0 million earned in 2004 under our collaboration agreement with Valeant with no similar milestones achieved under this agreement in 2005.

Research and Development Expenses. Research and development expenses were $4.9 million for the three months ended June 30, 2005, compared with $4.1 million for the three months ended June 30, 2004. The $834,000 increase was mainly due to a $360,000 increase in pre-clinical study fees attributable to our development of MB07811 and MB07803 and a $312,000 increase was due to increased staffing levels in our development and research departments.

General and Administrative Expenses. General and administrative expenses were $1.2 million for the three months ended June 30, 2005, compared with $898,000 for the three months ended June 30, 2004. The $288,000 increase was primarily due to an increase of $168,000 in professional services and other expenses associated with becoming a publicly-traded company and a $114,000 increase was due to increased staffing levels in our investor relations, business development and human resources departments.

Amortization of Employee Stock-based Compensation. In connection with the grant of stock options to employees and directors, we recorded amortization of deferred stock-based compensation of approximately $426,000 and $413,000 for the three months ended June 30, 2005 and 2004, respectively. We anticipate recording amortization of deferred stock-based compensation expense of approximately $847,000, $1.7 million, $1.2 million and $125,000 for the six months ended December 31, 2005 and the years ended December 31, 2006, 2007 and 2008, respectively.

Other Income (Expense), Net. Net interest income was $198,000 for the three months ended June 30, 2005, compared to net interest income of $10,000 for the three months ended June 30, 2004. The $188,000 increase was a result of higher investment yields in 2005 as well as higher levels of invested cash from the proceeds of our initial public offering in June 2004.

Comparison of the Six Months Ended June 30, 2005 and 2004

Revenues. Revenues were $1.0 million for the six months ended June 30, 2005, compared with $5.9 million for the six months ended June 30, 2004. The $4.9 million decrease was due primarily to milestone payments totaling $4.5 million earned in 2004 under our collaboration agreements with Sankyo and Valeant with no similar milestones achieved under these agreements in 2005.

Research and Development Expenses. Research and development expenses were $10.0 million for the six months ended June 30, 2005, compared with $7.8 million for the six months ended June 30, 2004. The $2.2 million increase was mainly due to a $991,000 increase in pre-clinical study fees attributable to our development of MB07811 and MB07803 and a $837,000 increase was due to increased staffing levels in our development and research departments.

General and Administrative Expenses. General and administrative expenses were $2.5 million for the six months ended June 30, 2005, compared with $1.6 million for the six months ended June 30, 2004. The $904,000 increase was primarily due to an increase of $462,000 in professional services and other expenses associated with becoming a publicly-traded company and a $303,000 increase was due to increased staffing levels in our investor relations, business development and human resources departments.

Amortization of Employee Stock-based Compensation. In connection with the grant of stock options to employees and directors, we recorded amortization of deferred stock-based compensation of approximately $855,000 and $756,000 for the six months ended June 30, 2005 and 2004, respectively.

Other Income (Expense), Net. Net interest income was $403,000 for the six months ended June 30, 2005, compared to net interest income of $19,000 for the six months ended June 30, 2004. The $384,000 increase was a result of higher

investment yields in 2005 as well as higher levels of invested cash from the proceeds of our initial public offering in June 2004.

Liquidity and Capital Resources

On June 21, 2004, we completed an initial closing of our initial public offering in which we sold 5.0 million shares of common stock for proceeds of $30.6 million, net of underwriting discounts and commissions and offering expenses. In addition, on July 20, 2004, we completed an additional closing of our initial public offering in which we sold an additional 75,000 shares of common stock pursuant to the exercise by the underwriters of an over-allotment option which resulted in proceeds of $0.5 million, net of underwriting discounts and commissions. Prior to our initial public offering, we financed our operations and internal growth primarily through private placements of preferred stock as well as direct payments of sponsored research funding, license fees, milestone payments and equity investments from our collaborative partners. Additional funding has come through equipment financing arrangements and via our receipt of SBIR grant funds.

In June 2005, we entered into a collaboration agreement with Merck to research, develop and commercialize novel small molecule therapeutics with the potential to treat several metabolic diseases including type 2 diabetes, hyperlipidemia and obesity by activating an enzyme in the liver called AMP-activated Protein Kinase. As part of this collaboration, Merck paid an initial non-refundable license fee of $5.0 million in July 2005 and will provide research support funding of a minimum of $2.1 million each year during the three-year research term. Our level of research activities, and the minimum research support funding, may be increased during the term upon mutual agreement of both parties. Merck is also obligated to pay milestone payments if specified preclinical and clinical development and regulatory events occur and to pay royalties on sales of any product resulting from this collaboration. We would also have the option to co-promote any such product in the United States. If all pre-clinical and clinical milestones are achieved on multiple indications, then including the $5.0 million

initial, non-refundable fee and the minimum $2.1 million in research support for the three-year research term, we may be entitled to payments which total up to $74.3 million, plus royalties.

As of June 30, 2005, we had financed through leases and loans the purchase of equipment and leasehold improvements totaling approximately $4.5 million, of which $2.1 million was outstanding at that date. The loans are collateralized with the purchased equipment, bear interest at rates ranging from approximately 8.6% to 11.6%, and are due in monthly installments through May 2009. Additionally, we have received cumulative SBIR grant funding of approximately $1.2 million through June 30, 2005.

As of June 30, 2005, we had $33.4 million in cash and cash equivalents and securities available-for-sale as compared to $43.9 million as of December 31, 2004, a decrease of $10.5 million. The decrease was primarily due to the use of cash to fund ongoing operations and payments on debt. Net cash provided by investing activities of $10.6 million for the six months ended June 30, 2005 resulted from net sales/maturities of investments of $10.9 million offset by $295,000 of equipment purchases. Net cash used in financing activities was $4,000 primarily resulting from principal payments on capital leases.

Our future capital uses and requirements depend on numerous forward-looking factors. These factors may include but are not limited to the following:

the rate of progress and cost of our clinical trials and other research and development activities,

the scope, prioritization and number of clinical development and research programs we pursue,

the costs of expanding our operations, including costs related to our relocation to our new facility in 2005,

the terms and timing of any collaborative, licensing and other arrangements that we may establish,

the costs of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights,

the costs and timing of regulatory approvals,

the costs of establishing or contracting for manufacturing, sales and marketing capabilities,

the effect of competing technological and market developments, and

the extent to which we acquire or in-license new products, technologies or businesses.

We believe that our existing cash, cash equivalents and securities available-for-sale will be sufficient to meet our projected operating requirements through at least the next twelve months.

Until we can generate significant cash from our operations, we expect to continue to fund our operations with existing cash resources that were primarily generated from the proceeds of offerings of our equity securities, cash payments under our strategic collaborations, debt financing arrangements and government grants. In addition, we may finance future cash needs through the sale of other equity securities, entering into additional strategic collaboration agreements, government grants and debt financing. However, we may not be successful in obtaining additional collaboration agreements, or in receiving milestone or royalty payments under current or future agreements. In addition, we cannot be sure that our existing cash, cash equivalents and securities available-for-sale will be adequate or that additional financing will be available when needed or that, if available, financing will be obtained on terms favorable to us or our stockholders. Having insufficient funds may require us to delay, scale back or eliminate some or all of our research or development programs or to relinquish greater or all rights to product candidates at an earlier stage of development or on less favorable terms than we would otherwise choose. Failure to obtain adequate financing also may adversely affect our ability to operate as a going concern. If we raise additional funds by issuing equity securities, substantial dilution to existing stockholders would likely result. If we raise additional funds by incurring debt financing, the terms of the debt may involve significant cash payment obligations as well as covenants and specific financial ratios that may restrict our ability to operate our business.

As of June 30, 2005, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not

engage in trading activities involving non-exchange traded contracts. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in these relationships.

FORWARD-LOOKING STATEMENTS

This quarterly report on Form 10-Q contains forward-looking statements that are based on our management s beliefs and assumptions and on information currently available to our management. Forward-looking statements include information concerning our possible or assumed future results of operations, business strategies, financing plans, competitive position, industry environment, potential growth opportunities, the effects of future regulation and the effects of competition. Forward-looking statements include all statements that are not historical facts and can be identified by terms such as anticipates, believes, could, estimates, expects, intends, may, plans, potential, predicts, projects, or similar expressions.

Forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. We discuss these risks in greater detail in the Risk Factors section below and in our other filings with the Securities and Exchange Commission, including our annual report on Form 10-K for the year ended December 31, 2004. Given these uncertainties, you should not place undue reliance on these forward-looking statements.

Also, forward-looking statements represent our management s beliefs and assumptions only as of the date of this quarterly report on Form 10-Q. Our actual future results may be materially different from what we expect. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

RISK FACTORS

You should consider carefully the following information about the risks described below, together with the other information contained in this quarterly report on Form 10-Q and in our other filings with the Securities and Exchange Commission, before you decide to buy or maintain an investment in our common stock. We believe the risks described below are the risks that are material to us as of the date of this quarterly report. If any of the following risks actually occur, our business, financial condition, results of operations and future growth prospects would likely be materially and adversely affected. In these circumstances, the market price of our common stock could decline, and you may lose all or part of the money you paid to buy our common stock.

Risks Related to our Business

We are dependent on the success of one or more of our current product candidates and clinical development candidates, and we cannot be certain that any of them will receive regulatory approval or be commercialized.

We have expended significant time, money and effort in the development of our three current product candidates, CS-917, pradefovir and MB07133, and our two current clinical development candidates, MB07803 and MB07811. To date, clinical trials with CS-917 have demonstrated it was capable of significantly lowering blood glucose levels in type 2 diabetics. Likewise, clinical trials conducted to date in patients treated with pradefovir have provided strong evidence of efficacy as measured by clinically and statistically significant reductions in serum HBV DNA. Recent interim results from a Phase IIb study indicated that pradefovir produced greater viral load reductions than the marketed drug Hepsera®. However, our product candidates will require additional development, clinical trials and regulatory clearances before they can be commercialized. Positive results from pre-clinical studies and early clinical trials do not necessarily mean later clinical trials will succeed. Before we can market any of our product candidates or clinical development candidates, we will need to demonstrate that they are safe and effective in humans, and we will also need to obtain necessary marketing approval from the FDA, or similar foreign regulatory agencies. Our product development efforts may not lead to commercial drugs, either because our product candidates or clinical development candidates fail to be safe and effective in clinical trials or because we have inadequate financial or other resources to pursue our product candidates through the clinical trial process. If any of our product candidates fail to demonstrate safety or efficacy at any time or during any phase of development, we would experience potentially significant delays in, or be required to abandon, development of the product candidate.

We do not anticipate that any of our current product candidates or clinical development candidates will be eligible to receive regulatory approval and begin commercialization for a number of years, if at all. Even if we were ultimately to receive regulatory approval for these product candidates or clinical development candidates, we may be unable to commercialize them successfully for a variety of reasons. These include, for example, the availability of alternative treatments, cost effectiveness, the cost of manufacturing the product on a commercial scale and the effect of competition with other drugs. The success of our product candidates or clinical development candidates may also be limited by the prevalence and severity of any adverse side effects. If we fail to commercialize one or more of our current product candidates or clinical development candidates, we may be unable to generate sufficient revenues to attain or maintain profitability, and our reputation in our industry and the investment community may be damaged.

If clinical trials of our product candidates do not produce successful results, we will be unable to commercialize these products.

To receive regulatory approval for the commercialization of CS-917, pradefovir, MB07133 or any other product candidates that we may develop, adequate and well-controlled clinical trials must be conducted to demonstrate safety and efficacy in humans to the satisfaction of the FDA in the U.S. and other regulatory agencies elsewhere in the world. In order to support marketing approval, these agencies typically require

successful results in one or more Phase III clinical trials, which our current product candidates have not yet reached and may never reach. Clinical testing is expensive, can take many years and has an uncertain outcome. Failure can occur at any stage of the testing. We may experience numerous unforeseen events during, or as a result of, the clinical trial process that could delay or prevent commercialization of our current or future product candidates, including the following:

our clinical trials may produce negative or inconclusive results,

patient recruitment and enrollment in our clinical trials may be slower than we anticipate,

costs of our clinical trials may be greater than we anticipate,

our product candidates may cause undesirable side effects that delay or preclude regulatory approval or limit their commercial use or market acceptance if approved,

collaborators who are responsible for clinical trials of our product candidates may not devote sufficient resources to these clinical trials or conduct them in a timely manner, or

we may face delays in obtaining regulatory approvals to commence a clinical trial.

Success in pre-clinical testing and early clinical trials does not mean that later clinical trials will be successful because product candidates in later-stage clinical trials may fail to demonstrate sufficient safety and efficacy despite having progressed through initial clinical testing. Our clinical experience with our product candidates is limited, and to date we have conducted tests in less than the number of patients that will likely need to be studied to gain regulatory approval of these product candidates. The data collected from clinical trials with larger patient populations may not demonstrate sufficient safety and efficacy to support regulatory approval of these product candidates.

The targeted endpoints for clinical trials of CS-917 and pradefovir have been, and will continue to be, primarily established by Sankyo and Valeant, respectively. We are solely responsible for establishing the targeted endpoints for clinical trials of MB07133. These targeted endpoints may be inadequate to demonstrate the safety and efficacy levels required for regulatory approvals. Even if we believe data collected from clinical trials of our product candidates are promising, such data may not be sufficient to support marketing approval by the FDA or other regulatory agencies abroad. Further, pre-clinical and clinical data can be interpreted in different ways, and the FDA or other foreign regulatory agencies may interpret such data in different ways than us or our collaborators. Our failure to adequately demonstrate the safety and efficacy of our product candidates would prevent our receipt of regulatory approval, and ultimately the commercialization of these product candidates.

Our product candidates may cause undesirable side effects that could delay or prevent their regulatory approval or commercialization or have other significant adverse implications on our business.

Prior to receiving regulatory approval, undesirable side effects caused by our product candidates could interrupt, delay or halt clinical trials and could result in the denial of regulatory approval by the FDA or other regulatory authorities for any or all targeted indications, and in turn prevent us from commercializing our product candidates and generating revenues from their sale.

For example, the inhibition of gluconeogenesis can cause elevated levels of lactic acid, or lactate, which, if high and sustained, under certain conditions can lead to lactic acidosis, a serious and potentially fatal condition. Certain pre-clinical animal studies have shown that CS-917 raises lactate levels two- to three-fold in some but not all animal models. Elevated lactate levels have also been observed in certain human clinical trials of CS-917. For example, in a 28-day Phase II clinical trial of CS-917, isolated instances of lactate elevation significantly above the normal range were seen in some patients in both CS-917 and placebo treated groups over the course of the 28 days. No patient exhibited sustained lactate levels significantly above the normal range over a period of consecutive days during the study. However, one patient who received 200

milligrams of CS-917 twice a day was withdrawn from the study by the investigator on day 15 due to concerns over consistently elevated lactate levels measured the previous day.

In March 2005, we were notified by Sankyo that two serious adverse events involving lactic acidosis had occurred in two patients in a clinical trial evaluating the interaction of CS-917 with the marketed diabetes drug metformin. The serious adverse events were resolved after medical intervention. The two patients were administered CS-917 in combination with metformin. Three clinical trials that were ongoing at the time were stopped while one clinical trial which did not combine CS-917 with metformin continued and was completed. It was subsequently determined that the two patients that experienced the lactic acidosis had blood levels of metformin that were elevated compared to other patients in the study that received metformin before administration of CS-917. After CS-917 administration, when the two patients were being administered metformin and CS-917 the metformin blood levels increased significantly, into a range that is associated with lactic acidosis. CS-917 blood levels also rose higher than expected. In July 2005, after completing a comprehensive review of the program and the events and data surrounding the two serious adverse events, we and Sankyo concluded that the lactic acidosis observed in the two patients was likely due to the significantly increased blood levels of metformin described above. Subsequently, Sankyo decided that full development of CS-917 could safely resume pending discussions of the proposed plans and protocols with the FDA. We expect Sankyo to commence a Phase IIb study of CS-917, which will allow

measurement of the regulatory endpoint HbA1c, in the fourth quarter of 2005. In addition, we expect Sankyo to conduct additional studies combining CS-917 with other diabetes drugs to assess both the safety and eventually the potential for enhanced efficacy with the combination. However, further combination of CS-917 and metformin is not likely unless additional data suggests lactic acidosis can be avoided through patient exclusion or through the administration of CS-917 at lower doses or through other means. In addition, based on the results of this comprehensive review we expect to resume development of our second-generation treatment for diabetes, MB07803 and we expect to commence clinical trials of this product candidate early in 2006.

It is also possible that CS-917 and MB7803 may cause other side effects. In certain pre-clinical studies, as expected based on the mechanism of these compounds, fasted animals treated with CS-917 showed pronounced hypoglycemia, a condition involving abnormally low blood glucose levels that can lead to coma or death. Hypoglycemia has been observed in one patient participating in a clinical trial that involved multi-day administration of the highest dose tested to date in patients (400 milligrams twice a day). This dose is above what is expected to be used in Phase III clinical trials if warranted. However, we cannot yet rule out the possibility that CS-917 may increase a patient s susceptibility to hypoglycemia, including the potential for severe hypoglycemia, by inhibiting gluconeogenesis, especially in elderly patients who are already prone to develop this condition. Some rodent models of diabetes studied in pre-clinical trials of CS-917 demonstrated, at glucose lowering doses, increased levels of fat molecules known as triglycerides, which are associated with an increased risk of cardiovascular disease. Elevated triglyceride levels have not been observed in human clinical trials to date. Other side effects observed during early clinical trials of CS-917 included nausea and vomiting.

We apply our HepDirect technology to make liver-specific prodrugs of certain compounds. A prodrug is a drug to which a chemical modification has been made that renders it inactive until enzymes in the body convert it to its active form. When converted by the body to their active forms, HepDirect prodrugs produce a byproduct that is within a class of compounds that have the potential of causing toxicity, genetic mutations and cancer. We are unaware of any byproduct-related toxicities demonstrated to date in clinical trials of either pradefovir or MB07133. However, we cannot be certain that this byproduct will not cause adverse effects in current or future clinical trials of these product candidates or other HepDirect prodrugs we may develop. In addition, because our current product candidates are in early stages of development and have been tested in relatively small populations, additional side effects may be observed as their development progresses.

In addition, undesirable side effects seen in the clinical trials of our product candidates, such as those recently observed with CS-917 may have other significant adverse implications on our business, for example:

we may be unable to obtain additional financing on acceptable terms, if at all,

our stock price could decline,

our collaborators may ultimately terminate development of our partnered products, may further decide not to develop backup product candidates and may even terminate our agreements,

were these agreements to terminate we may determine not to further develop the affected product candidates due to resource constraints and may not be able to establish additional collaborations for their further development on acceptable terms, if at all,

even if we were to later continue the clinical trials of these product candidates and receive regulatory approval, earlier findings may significantly limit their marketability and thus significantly lower our potential future revenues from their sale,

we may be subject to product liability or stockholder litigation, and

we may be unable to attract and retain key employees.

In addition, if any of our product candidates receive marketing approval and we or others later identify undesirable side effects caused by the product:

regulatory authorities may withdraw their approval of the product,

we may be required to change the way the product is administered, conduct additional clinical trials, change the

labeling of the product, or change the product s manufacturing facilities, and

our reputation may suffer.

Any of these events could prevent us from achieving or maintaining market acceptance of the affected product or could substantially increase the costs and expenses of commercializing the product, which in turn could delay or prevent us from generating significant revenues from the sale of the product.

We are dependent on our collaborations with Sankyo and Valeant for development of CS-917 and pradefovir, respectively, and events involving these collaborations, our collaborations with Merck, or any future collaborations could prevent us from developing and commercializing our product candidates and achieving or sustaining profitability.

We have entered into collaborations with Sankyo and Valeant for the development and commercialization of CS-917 and pradefovir, respectively. Sankyo and Valeant have agreed to finance the clinical trials for CS-917 and pradefovir, respectively, and, if they are approved, manufacture and market them. Accordingly, we are dependent on Sankyo and Valeant to gain FDA and other foreign regulatory agency approval of, and to commercialize, CS-917 and pradefovir. We have also entered into two collaborations with Merck. The first collaboration with Merck seeks to develop and commercialize new products for the treatment of hepatitis C infection and the second seeks to develop and commercialize new products to treat several metabolic diseases including type 2 diabetes, hyperlipidemia and obesity. Although our collaborations with Merck have not yet yielded any product candidates, should they be successful, we will be dependent on Merck for further development and commercialization of any resulting product candidates. In addition, since we do not currently possess the resources necessary to independently develop and commercialize all of the potential products that may be based upon our technologies, including MB07133, we may need to enter into additional collaborative agreements to assist in the development and commercialization of some of these potential products. However, our discussions with potential collaborators may not lead to the establishment of new collaborations on acceptable terms, if at all.

We have limited control over the amount and timing of resources that Sankyo, Valeant, Merck or any future collaborators devote to our programs or potential products. These collaborators may breach or terminate their agreements with us or otherwise fail to conduct their collaborative activities successfully and in a timely manner. Further, our collaborators may not develop products that arise out of our collaborative arrangements or devote sufficient resources to the development, manufacture, marketing or sale of these products. In the event that one of our collaborations is terminated, and we believe that the continued development or commercialization of a product candidate or drug compound covered by the collaboration is warranted, we would seek to obtain rights to develop and commercialize the product candidate or drug compound, if we did not already have those rights. We would then determine whether to continue the development or commercialization of the product candidate or drug compound independently or together with a new collaborator. However, in the event that we do not have sufficient resources to independently develop or commercialize the product candidate or drug compound, and we cannot establish a new collaboration on acceptable terms, we would be forced to discontinue its development or commercialization.

Our agreement with Sankyo contains certain rights and restrictions regarding our access to and use of confidential data and information generated by Sankyo. We are developing MB07803, a second-generation gluconeogenesis inhibitor to which Sankyo has no rights and that may be a direct competitor to CS-917. Because of this competitive situation and with our consent, the transfer of confidential information and data related to CS-917 from Sankyo has already been reduced and we expect that further reductions in information flow will occur. This situation may limit our ability to (i) provide information regarding clinical results unless they are publicly released by Sankyo, (ii) influence decisions made at Sankyo regarding CS-917, and (iii) accurately track Sankyo s diligence on the development program

We and our present and future collaborators may fail to develop or effectively commercialize products or drug compounds covered by our present and future collaborations if:

we do not achieve our objectives under our collaboration agreements we are unable to obtain patent protection for the product candidates or proprietary technologies we discover in our collaborations,

we are unable to manage multiple simultaneous product discovery and development collaborations,

our potential collaborators are less willing to expend their resources on our programs due to their focus on other programs or as a result of general market conditions,

our collaborators become competitors of ours or enter into agreements with our competitors,

we or our collaborators encounter regulatory hurdles that prevent commercialization of our product candidates,

we develop products and processes or enter into additional collaborations that conflict with the business objectives of our other collaborators,

consolidation in our target markets limits the number of potential collaborators, or

we are unable to negotiate additional collaboration agreements under terms satisfactory to us.

If we are unable to develop or commercialize our products as a result of the occurrence of any of these events, we may not be able to generate sufficient revenues to achieve or maintain profitability.

Because our collaborations with Merck may involve Merck s proprietary compounds, if Merck terminates development of product candidates we may not have the right to pursue development of these product candidates on our own.

The objective of our hepatitis C collaboration with Merck is to discover product candidates for the treatment of this disease by applying our technology to certain Merck compounds. Accordingly, if Merck terminates this collaboration before a defined stage of development of a product candidate, which it may do without cause at any time after the end of the collaboration s research term upon 90 days advance written notice to us, we will not have any right to develop or commercialize that product candidate. In addition, if this collaboration with Merck terminates and Merck successfully develops products based on these proprietary compounds without applying our technology, we will not be entitled to milestone payments or royalties with respect to those products.

Our agreement with Merck to develop and commercialize new products to treat several metabolic diseases including type 2 diabetes, hyperlipidemia and obesity may include the development of compounds owned or controlled by Merck. Accordingly, if Merck terminates this collaboration it may be prove difficult for Metabasis to continue development of such compounds.

Conflicts may arise between us and any of our collaborators that could delay or prevent the development or commercialization of our product candidates.

Conflicts may arise between our collaborators and us, such as conflicts concerning the interpretation of clinical data, the achievement of milestones or the ownership of intellectual property developed during the collaboration. If any conflicts arise with Sankyo, Valeant, Merck or any future collaborators, they may act in their self-interest, which may be adverse to our best interests. Any such disagreement between us and a collaborator could result in one or more of the following, each of which could delay or prevent the development or commercialization of our product candidates, and in turn prevent us from generating sufficient revenues to achieve or maintain profitability:

unwillingness on the part of a collaborator to pay us research funding, milestone payments or royalties we believe are due to us under our collaboration agreement,

uncertainty regarding ownership of intellectual property rights arising from our collaborative activities, which could prevent us from entering into additional collaborations, or disagreements with our collaborators regarding the protection of intellectual property rights,

unwillingness on the part of a collaborator to keep us informed regarding the progress of its development and commercialization activities or to permit public disclosure of the results of those activities, or

slowing or cessation of a collaborator s development or commercialization efforts with respect to our product candidates.

Our agreement with Sankyo contains certain rights and restrictions regarding our access to and use of confidential data and information generated by Sankyo. MB07803 is our second-generation gluconeogenesis inhibitor to which Sankyo has no rights and that may be a direct competitor to CS-917. Because of this competitive situation and with our consent, the transfer

of confidential information and data related to CS-917 from Sankyo has already been reduced and we expect that further reductions in information flow will occur. This situation may limit our ability to (i) provide information regarding clinical results unless they are publicly released by Sankyo, (ii) influence decisions made at Sankyo regarding CS-917, and (iii) accurately track Sankyo s diligence on the development program. It could also lead to disagreements between Sankyo and us.

Our efforts to discover product candidates beyond our current product candidates may not succeed, and any product candidates we recommend for clinical development may not actually begin clinical trials.

We intend to use our proprietary technologies and our knowledge and expertise to develop and commercialize **novel drugs to address some of the world s most widespread and costly chronic diseases** involving pathways in the liver. Our goal is to expand our clinical development pipeline by continuing to recommend new drug compounds for clinical development. However, the process of researching and discovering drug compounds is expensive, time-consuming and unpredictable. Data from our current research programs may not support the clinical development of our lead compounds or other compounds from these programs, and we may not identify any additional drug compound suitable for recommendation for clinical development. Moreover, any drug compounds we recommend for clinical development may not be effective or safe for their designated use, which would prevent their advancement into clinical trials and impede our ability to maintain or expand our clinical development pipeline. Our ability to identify new drug compounds and advance them into clinical development also depends upon our ability to fund our research and development operations, and we cannot be certain that additional funding will be available on acceptable terms, or at all.

Delays in the commencement or completion of clinical testing could result in increased costs to us and delay our ability to generate significant revenues.

Delays in the commencement or completion of clinical testing could significantly impact our product development costs. We do not know whether planned clinical trials will begin on time or be completed on schedule, if at all. The commencement of clinical trials can be delayed for a variety of reasons, including delays in:

obtaining regulatory approval to commence a clinical trial,

reaching agreement on acceptable terms with prospective contract research organizations and trial sites,

manufacturing sufficient quantities of a product candidate,

obtaining institutional review board approval to conduct a clinical trial at a prospective site, and

recruiting and enrolling patients to participate in a clinical trial.

In addition, once a clinical trial has begun, it may be suspended or terminated by us, our collaborators, the FDA or other regulatory authorities due to a number of factors, including:

failure to conduct the clinical trial in accordance with regulatory requirements or clinical protocols,

inspection of the clinical trial operations or trial site by the FDA or other regulatory authorities resulting in the imposition of a clinical hold,

unforeseen safety issues such as the serious adverse events recently observed in a clinical trial of CS-917, or

lack of adequate funding to continue the clinical trial.

If we experience significant delays in the commencement or completion of clinical testing, our product development costs may increase, we may lose any competitive advantage associated with early market entry and our ability to generate significant revenues may be delayed. For example, recent events related to CS-917 have delayed our clinical timeline for CS-917 as well as our second-generation gluconeogenesis inhibitor, MB07803. In addition, many of the factors that cause, or lead to, a delay in the commencement or completion of clinical trials may also ultimately lead to the denial of regulatory approval of a product candidate.

We rely on third parties to conduct our clinical trials. If these third parties do not successfully meet their obligations under our agreements, we may not be able to obtain regulatory approval for or commercialize our product candidates.

Sankyo and Valeant are responsible for conducting clinical trials of CS-917 and pradefovir, respectively. Although our collaborations with Merck to discover product candidates for the treatment of hepatitis C and metabolic diseases including type 2 diabetes, hyperlipidemia and obesity have not yet yielded product candidates, should they be successful, we will be dependent on Merck to conduct clinical trials of any resulting product candidates. We intend to rely on other third parties, such as contract research organizations, medical institutions, clinical investigators and contract laboratories, to conduct our clinical trials of MB07133 and other product candidates that we may develop for which a collaborator is not responsible for clinical development. If Sankyo, Valeant, Merck or these other third parties do not successfully meet their obligations under our agreements, or if the quality or accuracy of the clinical data they obtain is compromised due to the failure to adhere to clinical protocols or for other reasons, clinical trials may be extended, delayed or terminated, and these product candidates may not receive regulatory approval or be successfully commercialized.

Because our product candidates, research programs and collaborative efforts depend on our proprietary technologies, adverse events affecting our proprietary technologies may delay or prevent the commercialization of our product candidates.

We used our NuMimetic technology to identify CS-917 and MB07803, and our HepDirect technology to discover pradefovir and MB07133. We intend to use these and future proprietary technologies to expand our product pipeline in the future. We also may leverage our HepDirect and other liver-targeting technology through strategic alliances and collaborations with other companies, such as our hepatitis C collaboration with Merck in which we are applying our technology to certain Merck compounds. Our proprietary technologies are subject to many of the same risks as our product candidates, including risks related to:

- obtaining and maintaining patent and trade secret protection for these technologies,
- avoiding infringement of the proprietary rights of third parties,
- the development of competing technologies by others, and
- in HepDirect s case, the safety and effectiveness of this technology in humans.

Because certain of our product candidates and research programs are dependent on our proprietary technologies, adverse events affecting our proprietary technologies may in turn delay or prevent the development or commercialization of our product candidates, which could impede our ability to generate revenues and achieve or maintain profitability.

Our product candidates are subject to extensive regulation, which can be costly and time consuming, cause unanticipated delays or prevent the receipt of the required approvals to commercialize our product candidates.

The clinical development, manufacturing, labeling, storage, record-keeping, advertising, promotion, export, marketing and distribution of our product candidates are subject to extensive regulation by the FDA and other regulatory agencies in the U.S. and by comparable governmental authorities in foreign markets. In the U.S., neither we, nor our collaborators, are permitted to market our product candidates until we or our collaborators receive approval of an NDA from the FDA or receive similar approvals abroad. The process of obtaining these approvals is expensive, often takes many years, and can vary substantially based upon the type, complexity and novelty of the product candidates involved. Approval policies or regulations may change. In addition, as a company, we have not previously filed NDAs with the FDA or filed similar applications with other foreign regulatory agencies. This lack of experience may impede our ability to obtain FDA or other foreign regulatory agency approval in a timely manner, if at all, for our product candidates for which development and commercialization is our responsibility.

Despite the time and expense invested, regulatory approval is never guaranteed. The FDA or other foreign regulatory agencies can delay, limit or deny approval of a product candidate for many reasons, including:

a product candidate may not be safe and effective,

FDA or other foreign regulatory agency officials may not find the data from pre-clinical testing and clinical trials sufficient,

the FDA or other foreign regulatory agency may not approve of our third-party manufacturers processes or facilities, or

the FDA or other foreign regulatory agency may change its approval policies or adopt new regulations.

Any delay in obtaining, or inability to obtain, these approvals would prevent us from commercializing our product candidates.

Even if any of our product candidates receive regulatory approval, our product candidates may still face future development and regulatory difficulties.

If any of our product candidates receive regulatory approval, the FDA or other foreign regulatory agencies may still impose significant restrictions on the indicated uses or marketing of the product candidates or impose ongoing requirements for potentially costly post-approval studies. In addition, regulatory agencies subject a product, its manufacturer and the manufacturer s facilities to continual review and periodic inspections. If a regulatory agency discovers previously unknown problems with a product, including adverse events of unanticipated severity or frequency, or problems with the facility where the product is manufactured, a regulatory agency may impose restrictions on that product, our collaborators or us, including requiring withdrawal of the product from the market. Our product candidates will also be subject to ongoing FDA and other foreign regulatory agency requirements for the labeling, packaging, storage, advertising, promotion, record-keeping and submission of safety and other post-market information on the drug. If our product candidates fail to comply with applicable regulatory requirements, a regulatory agency may:

issue warning letters,

impose civil or criminal penalties,

suspend regulatory approval,

suspend any ongoing clinical trials,

refuse to approve pending applications or supplements to approved applications filed by us or our collaborators,

impose restrictions on operations, including costly new manufacturing requirements, or

seize or detain products or require a product recall.

In order to market any products outside of the U.S., we and our collaborators must establish and comply with numerous and varying regulatory requirements of other countries regarding safety and efficacy. Approval procedures vary among countries and can involve additional product testing and additional administrative review periods. The time required to obtain approval in other countries might differ from that required to obtain FDA approval. The regulatory approval process in other countries may include all of the risks regarding FDA approval in the U.S. Regulatory approval in one country does not ensure regulatory approval in another, but a failure or delay in obtaining regulatory approval in one country may negatively impact the regulatory process in others. Failure to obtain regulatory approval in other countries or any delay or setback in obtaining such approval could have the same adverse impact regarding FDA approval in the U.S., including the risk that our product candidates may not be approved for all indications requested, which could limit the uses of our product candidates and adversely impact potential royalties and product sales, and that such approval may be subject to limitations on the indicated uses for which the product may be marketed or require costly, post-marketing follow-up studies.

If we and our collaborators fail to comply with applicable foreign regulatory requirements, we and our collaborators may be subject to fines, suspension or withdrawal of regulatory approvals, product recalls, seizure of products, operating restrictions and criminal prosecution.

Our inability to complete required renovations and improvements to our new facility in a timely fashion could increase our costs, interrupt continuing operations and delay or prevent the commercialization of our products.

We perform all of our research, development, management, administrative and other activities in a single facility, which

we currently occupy under a sublease from Sicor Inc., a wholly owned subsidiary of Teva Pharmaceutical Industries Limited. The term of the sublease expires in September 2005, and may expire earlier if the master lease for the facility is terminated. We do not have a contractual option to renew the sublease and we have no control over the early termination of the master lease. In December 2004, we entered into a new lease for laboratory and office space in San Diego. This new facility will require extensive renovations and improvements to be ready for our occupancy by our scheduled move in date in September 2005. These renovations are being financed and constructed by our new landlord. Any delay in the completion of these renovations beyond the scheduled move in date could increase our costs, interrupt continuing operations and delay or prevent the commercialization of our products and adversely affect our ability to generate revenues, which could prevent us from achieving or maintaining profitability. For example, should any potential delay extend for several months or longer, we could be subject to eviction and/or litigation related to our inability to vacate our current facility at the end of our sublease term.

If our competitors have products that are approved faster, marketed more effectively or demonstrated to be more effective than ours, our commercial opportunity will be reduced or eliminated.

The biotechnology and biopharmaceutical industries are characterized by rapidly advancing technologies, intense competition and a strong emphasis on proprietary products. We face competition from many different sources, including commercial pharmaceutical and biotechnology enterprises, academic institutions, government agencies and private and public research institutions. Due to the high demand for treatments for liver and metabolic diseases, research is intense and new treatments are being sought out and developed by our competitors.

We are aware of many competitive products currently marketed or under development that are used to treat some of the diseases we have targeted. If CS-917 and/or MB07803 are ultimately determined safe and effective and approved for marketing, these products will face significant competition from various formulations of metformin and products containing metformin. Metformin is a drug that, like CS-917 and MB07803, inhibits liver glucose production, albeit through an unknown mechanism. Because it does not cause weight gain, metformin is often prescribed as a first line therapy to obese diabetics, who are reported to comprise more than 90% of newly diagnosed type 2 diabetics. Bristol-Myers-Squibb also markets Glucovance®, a single pill that contains both metformin and the insulin secretion enhancer glyburide. Biovail Corp. and DepoMed Inc. recently launched Glumetza , a once-daily, extended-release formulation of metformin hydrochloride. In addition, a less expensive generic form of metformin recently became available. Accordingly, unless CS-917 and/or MB07803 demonstrate significant benefits over metformin or demonstrate that they can be used in the patient population who do not tolerate and/or adequately respond to metformin treatment, the price required to effectively compete with the generic form of metformin may be so low that it becomes uneconomical for us or Sankyo to market CS-917 and/or for us to market MB07803. Other competitors to CS-917 and MB07803 may include, but are not limited to, the insulin sensitizers Actos® (pioglitazone), co-marketed by Takeda Chemical Industries, Ltd. and Eli Lilly and Company, Avandia® (rosiglitazone), marketed by GlaxoSmithKline PLC, Byetta (exenatide) injection, marketed by Amylin Pharmaceuticals and Eli Lilly , and other products that may be developed from time to time. GlaxoSmithKline has combined metformin and Avandia in a single pill called Avandamet®.

Competitors to pradefovir may include, but are not limited to: Intron® A (interferon alfa-2b), marketed by Schering-Plough Corporation, Epivir-HBV® and Zeffix™ (lamivudine), marketed by GlaxoSmithKline, Hepsera (adefovir dipivoxil), marketed in the U.S. by Gilead Sciences, Inc., and Baraclude (entecavir), marketed by Bristol-Myers Squibb Company. Pradefovir and Hepsera are prodrugs of the same active drug, and therefore will directly compete. In order to effectively compete with Hepsera, pradefovir may have to be significantly more beneficial or less expensive than Hepsera.

There are no currently approved drugs for primary liver cancer. However, there are potential competitors and treatments which may include, but are not limited to: Bayer Pharmaceuticals Corp. and Onyx Pharmaceuticals Inc., which have begun a Phase III clinical trial of sorafenib in patients with advanced liver cancer; Amgen Inc., which may be developing a product candidate called T67 currently in Phase II/III trials for the treatment of primary liver cancer; and other products that may be developed from time to time. We will also compete with non-surgical therapies that use either radioactive microscopic beads (such as TheraSpheres®) or chemotherapy (known as Transcatheter Arterial Chemoembolization (TACE)) injected through a catheter directly into the liver.

If MB07811 is ultimately determined safe and effective and approved for marketing, it would compete with products marketed by several large pharmaceutical companies that currently comprise a very large share of the hyperlipidemia market. The major drugs currently marketed for the treatment of hyperlipidemia are statins (cholesterol-reducers), including Lipitor® ($10.9 billion in sales in 2004; marketed by Pfizer Inc.) and Zocor® ($5.2 billion in sales in 2004; marketed by Merck), which were also two of the best selling prescription medicines in 2004.

In addition, many other competitors are developing products for the treatment of the diseases we are targeting and if successful, these products could compete with our products. If we receive approval to market and sell any of our product candidates, we may compete with these companies and their products as well as others in varying stages of development.

Many of our competitors have significantly greater financial resources and expertise in research and development, manufacturing, pre-clinical testing, clinical trials, regulatory approvals and marketing approved products than we do. Smaller or early-stage companies may also prove to be significant competitors, particularly through collaborative arrangements with large and established companies. Our competitors may succeed in developing technologies and therapies that are more effective, better tolerated or less costly than any which we are developing, or that would render our product candidates obsolete and noncompetitive. Our competitors may succeed in obtaining approvals from the FDA and foreign regulatory authorities for their products sooner than we do for ours. We will also face competition from these third parties in recruiting and retaining qualified scientific and management personnel, establishing clinical trial sites and patient registration for clinical trials, and in acquiring and in-licensing technologies and products complementary to our programs or advantageous to our business.

We do not have internal manufacturing capabilities, and if we fail to develop and maintain supply relationships with collaborators or other third-party manufacturers, we may be unable to develop or commercialize our products.

Our ability to develop and commercialize our products depends in part on our ability to manufacture, or arrange for collaborators or other third parties to manufacture, our products at a competitive cost, in accordance with regulatory requirements and in sufficient quantities for clinical testing and eventual commercialization. Sankyo and Valeant are responsible for all clinical and commercial manufacturing of CS-917 and pradefovir, respectively. We have relied on a number of suppliers to manufacture sufficient quantities of MB07133 for use in our current clinical trial. Although none of our current product candidates has been manufactured on a commercial scale our historical suppliers have manufactured other companies products on a commercial scale. However, we have not yet determined if our suppliers are capable of manufacturing our products on a commercial scale. Similarly, we rely on outside manufacturing for MB07803 and MB07811. We, our collaborators and third-party manufacturers may encounter difficulties with the small- and large-scale formulation and manufacturing processes required to manufacture our product candidates, resulting in delays in our clinical trials and regulatory submissions, in the commercialization of our product candidates or, if any of our product candidates is approved, in the recall or withdrawal of the product from the market. Further, development of large-scale manufacturing processes may require additional validation studies, which the FDA and other foreign regulatory agencies must review and approve. Our inability to enter into or maintain agreements with collaborators or capable third-party manufacturers on acceptable terms could delay or prevent the commercialization of our products, which would adversely affect our ability to generate revenues and could prevent us from achieving or maintaining profitability.

We currently expect that in any future clinical trials of MB07133, MB07803 and MB07811, we will rely on our current suppliers to manufacture these compounds. However, we do not have long-term supply agreements with these third parties, and we may not be able to enter into new supply agreements with them in a timely manner or on acceptable terms, if at all. These third parties may also be subject to capacity constraints that would cause them to limit the amount of these compounds that we can purchase. While we believe alternative sources to manufacture these compounds are readily available, in the event we have to seek such alternative sources we will incur costs associated with identifying and qualifying one or more alternate suppliers. We cannot estimate these costs with certainty but do not expect them to be material. In addition, any resulting interruption or delay we experience in the supply of MB07133, MB07803 or MB07811 may impede the clinical development of these compounds.

In addition, we, our collaborators or other third-party manufacturers of our products must comply with current good manufacturing practice, or CGMP, requirements enforced by the FDA and other foreign regulatory agencies through their facilities inspection programs. These requirements include quality control, quality assurance and the maintenance of records and documentation. In addition, product manufacturing facilities in California are subject to licensing requirements of the California Department of Health Services and may be inspected by the California Department of Health Services at any time. We, our collaborators or other third-party manufacturers of our products may be unable to comply with these CGMP requirements and with other FDA, state and foreign regulatory requirements. We have little control over third-party

manufacturers compliance with these regulations and standards. A failure to comply with these requirements may result in fines and civil penalties, suspension of production, suspension or delay in product approval, product seizure or recall, or withdrawal of product approval.

If we are unable to establish sales and marketing capabilities or enter into agreements with third parties to sell and market our product candidates, we may be unable to generate significant revenues.

We do not have a sales and marketing organization, and we have no experience as a company in the sales, marketing and distribution of pharmaceutical products. Sankyo and Valeant are responsible for worldwide marketing and commercialization for CS-917 and pradefovir, respectively, although we have an option to co-promote CS-917 in North America with Sankyo. Although our hepatitis C and metabolic disease collaborations with Merck have not yet yielded product candidates, should they be successful, Merck will be responsible for worldwide marketing and commercialization of any resulting product candidates (subject to, in the case of our metabolic disease collaboration, our option to co-promote the product in the U.S. with certain financial assistance from Merck). In order to co-promote any of these products, or to commercialize MB07133 or any future product candidates, we must develop our sales, marketing and distribution capabilities, or make arrangements with a third party to perform these services. Even though we may receive financial assistance from Merck if we exercise our co-promotion option under the metabolic disease collaboration developing a sales force is expensive, and time consuming and could delay any product launch. We may be unable to establish and manage an effective sales force in a timely or cost-effective manner, if at all, and any sales force we do establish may not be capable of generating sufficient demand for our product candidates. To the extent that we enter into arrangements with collaborators or other third parties to perform sales and marketing services, our product revenues are likely to be lower than if we directly marketed and sold our product candidates. If we are unable to establish adequate sales and marketing capabilities, independently or with others, we may not be able to generate significant revenues and may not become profitable.

The commercial success of our product candidates depends upon their market acceptance among physicians, patients, healthcare payors and the medical community.

Even if our product candidates obtain regulatory approval, our products, if any, may not gain market acceptance among physicians, patients, healthcare payors and the medical community. The degree of market acceptance of any of our approved product candidates will depend on a number of factors, including:

our ability to provide acceptable evidence of safety and efficacy,

relative convenience and ease of administration,

the prevalence and severity of any adverse side effects, such as the serious adverse events recently observed in a clinical trial of CS-917,

availability of alternative treatments,

pricing and cost effectiveness,

effectiveness of our or our partners sales and marketing strategy, and

our ability to obtain sufficient third-party coverage or reimbursement.

If approved, CS-917 may have to be administered several times daily. Additionally, it may result in variable drug levels in different patient populations, which could complicate its use and limit its marketability. Since CS-917 is eliminated from the body through the kidney, it may be of limited use in diabetics with kidney dysfunction. In addition, CS-917 and HepDirect prodrugs such as pradefovir and MB07133 may also exhibit interactions with other marketed drugs that could limit their combination with those drugs. Serious adverse events recently observed in a clinical trial of CS-917 in combination with metformin have raised questions about the safety of the potential use of CS-917 and metformin in combination. Therefore, even if CS-917 receives regulatory approval, its combination with metformin may be restricted which may reduce its market potential. In addition, various risk management strategies may be required to minimize inadvertent use with metformin including prominent warning labels known as black-box warnings, physician education programs and/or other steps designed to more tightly control the sale and use of CS-917. Such strategies and programs will likely adversely impact the sales of CS-917 and may incur additional selling expenses thereby reducing profits. In addition, primarily because the number of treatable patients in the U.S. with primary liver cancer is relatively small, we expect to market MB07133, if approved, at a relatively high price in the U.S. in order to generate sufficient revenues to recoup our costs and provide a return on our investment. This could prevent us from achieving market acceptance of MB07133 in the U.S. The number of treatable patients outside of the U.S. is much larger than the number of treatable patients in the U.S. However, because third party reimbursement in many of these countries is uncertain, we may be unable to recoup our costs or generate sufficient returns on our investment in these countries. If any of our product candidates is approved but does not achieve an adequate level of acceptance by physicians, healthcare payors and patients, we may not generate sufficient revenue from this product candidate and we may not become or remain profitable.

We are subject to uncertainty relating to health care reform measures and reimbursement policies which, if not favorable to our product candidates, could hinder or prevent our product candidates commercial success.

The continuing efforts of the government, insurance companies, managed care organizations and other payors of health care costs to contain or reduce costs of health care may adversely affect:

our ability to set a price we believe is fair for our products,

our ability to generate revenues and achieve or maintain profitability,

the future revenues and profitability of our potential customers, suppliers and collaborators, and

the availability of capital.

In certain foreign markets, the pricing of prescription drugs is subject to government control. In the U.S., given recent federal and state government initiatives directed at lowering the total cost of health care, Congress and state legislatures will likely continue to focus on health care reform, the cost of prescription drugs and the reform of the Medicare and Medicaid systems. For example, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 was recently enacted. This legislation provides a new Medicare prescription drug benefit beginning in 2006 and mandates other reforms. While we cannot predict the full outcome of the implementation of this legislation, it is possible that the new Medicare prescription drug benefit, which will be managed by private health insurers and other managed care organizations, will result in decreased reimbursement for prescription drugs, which may further exacerbate industry-wide pressure to reduce prescription drug prices. This could harm our ability to market our products and generate revenues. It is also possible that other similar proposals will be adopted.

Our ability to commercialize our product candidates successfully will depend in part on the extent to which governmental authorities, private health insurers and other organizations establish appropriate coverage and reimbursement levels for the cost of our products and related treatments. Third-party payors are increasingly challenging the prices charged for medical products and services. Also, the trend toward managed health care in the U.S., which could significantly influence the purchase of health care services and products, as well as legislative proposals to reform health care or reduce government insurance programs, may result in lower prices for our product candidates or exclusion of our product candidates from coverage and reimbursement programs. The cost containment measures that health care payors and providers are instituting and the effect of any health care reform could significantly reduce our revenues from the sale of any approved product.

We will need to increase the size of our organization, and we may experience difficulties in managing growth.

Since we became an independent company in 1999, we have increased the number of our full-time employees from 50 to 93 as of June 30, 2005. We may need to continue to expand our managerial, operational, financial and other resources in order to manage and fund our operations and

clinical trials, continue our research and development and collaborative activities, and commercialize our product candidates. It is possible that our management and scientific personnel, systems and facilities currently in place may not be adequate to support this future growth. Our need to effectively manage our operations, growth and various projects requires that we continue to improve our operational, financial and management controls, reporting systems and procedures and to attract and retain sufficient numbers of talented employees. We may be unable to successfully implement these tasks on a larger scale and, accordingly, may not achieve our research, development and commercialization goals.

If we fail to attract and keep key management and scientific personnel, we may be unable to successfully develop or commercialize our product candidates.

Our success depends on our continued ability to attract, retain and motivate highly qualified management and scientific personnel. The loss of the services of any principal member of our management or scientific staff, particularly Paul K. Laikind, Ph.D., our Chairman of the Board, Chief Executive Officer and President, and Mark D. Erion, Ph.D., our Executive Vice President of Research and Development, could delay or prevent the commercialization of our product candidates. We employ these individuals on an at-will basis and their employment can be terminated by us or them at any time, for any reason and with or without notice, subject to the terms of their stock restriction agreements and severance agreements.

Competition for qualified personnel in the biotechnology field is intense. We will need to hire additional personnel as we continue to expand our manufacturing, research and development activities. We may not be able to attract and retain quality personnel on acceptable terms given the competition for such personnel among biotechnology, pharmaceutical and other companies.

We have established a scientific advisory board, the members of which assist us in formulating our research, development and clinical strategies. These scientific advisors are not our employees and may have commitments to, or consulting or advisory contracts with, other entities that may limit their availability to us. In addition, our scientific advisors may have arrangements with other companies to assist those companies in developing products or technologies that may compete with ours.

We have limited experience in identifying, completing and integrating acquisition targets, and if we do not successfully integrate any future acquisitions, we may incur unexpected costs and disruptions to our business.

An important part of our business strategy is to continue to develop a broad pipeline of product candidates. In addition to our internal drug development efforts, we may seek to expand our product pipeline, at the appropriate time and as resources allow, by acquiring products or businesses or in-licensing technologies that we believe are a strategic fit with our business and complement our existing product candidates and research programs. We are not currently a party to any agreements or commitments and we have no understandings with respect to any such acquisitions. Future acquisitions, however, may entail numerous operational and financial risks including:

exposure to unknown liabilities,

disruption of our business and diversion of our management s time and attention to developing acquired products or technologies,

incurrence of substantial debt or dilutive issuances of securities to pay for acquisitions,

higher than expected acquisition and integration costs,

increased amortization expenses,

difficulty and cost in combining the operations and personnel of any acquired businesses with our operations and personnel,

impairment of relationships with key suppliers or customers of any acquired businesses due to changes in management and ownership, and

inability to retain key employees of any acquired businesses.

We have limited experience in identifying acquisition targets, successfully completing potential acquisitions and integrating any acquired products, businesses or technologies into our current infrastructure. Moreover, we may devote resources to potential acquisitions that are never completed or fail to realize the anticipated benefits of any acquisition.

Risks Related to our Finances and Capital Requirements

We have a history of net losses, which we expect to continue for the foreseeable future, and we are unable to predict the extent of future losses or when we will become profitable, if at all.

We have incurred net losses from our inception. As of June 30, 2005, we had an accumulated deficit of approximately $63.3 million. We expect to increase our operating expenses over the next several years as we continue and expand our research and development activities, including conducting clinical trials for our product candidates and further developing our product pipeline, acquiring or in-licensing products, technologies or businesses, and funding other working capital and general corporate purposes. As a result, we expect to continue to incur significant and increasing operating losses for the foreseeable future. Because of the numerous risks and uncertainties associated with our product development efforts, we are unable to predict the extent of any future losses or when we will become profitable, if at all.

We currently lack a significant continuing revenue source and may not become or remain profitable.

Our ability to become and remain profitable depends upon our ability to generate continuing revenues. To date, our product candidates and strategic collaborations have not generated any significant revenues, other than one-time or time-limited payments associated with our collaborations such as milestone payments and option fees. Our ability to generate significant continuing revenues depends on a number of factors, including:

successful completion of ongoing clinical trials for our product candidates,

achievement of regulatory approval for our product candidates,

successful completion of our current and future strategic collaborations, and

successful sales, manufacturing, distribution and marketing of our products.

We do not anticipate that we will generate significant continuing revenues for several years. If we are unable to generate significant continuing revenues, we will not become or remain profitable, and we may be unable to continue our operations.

We will need substantial additional funding and may be unable to raise capital when needed, which would force us to delay, reduce or eliminate our research and development programs or commercialization efforts and affect our ability to continue as a going concern.

We believe that our existing cash, cash equivalents and short-term investments will be sufficient to meet our projected operating requirements through at least the next twelve months. Because we do not anticipate that we will generate significant continuing revenues for several years, if at all, we will need to raise substantial additional capital to finance our operations in the future. Our additional funding requirements will depend on, and could increase significantly, as a result of many factors, including:

the rate of progress and cost of our clinical trials and other research and development activities,

the scope, prioritization and number of clinical development and research programs we pursue,

the costs of expanding our operations, including costs related to our relocation to our new facility in 2005,

the terms and timing of any collaborative, licensing and other arrangements that we may establish,

the costs of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights,

the costs and timing of regulatory approvals,

the costs of establishing or contracting for sales and marketing capabilities,

the effect of competing technological and market developments, and

the extent to which we acquire or in-license new products, technologies or businesses.

Until we can generate significant continuing revenues, if ever, we expect to satisfy our future cash needs through public or private equity offerings, debt financings or corporate collaboration and licensing arrangements, as well as through interest income earned on cash balances. We cannot be certain that additional funding will be available on acceptable terms, or at all. If adequate funds are not available, we may be required to delay, reduce the scope of or eliminate one or more of our research and development programs or our commercialization efforts and we may be unable to continue as a going concern.

Raising additional funds by issuing securities or through collaboration and licensing arrangements may cause dilution to existing stockholders, restrict our operations or require us to relinquish proprietary rights.

We may raise additional funds through public or private equity offerings, debt financings or corporate collaboration and licensing arrangements. To the extent that we raise additional capital by issuing equity securities, our existing stockholders

ownership will be diluted. Any debt financing we enter into may involve covenants that restrict our operations. These restrictive covenants may include limitations on additional borrowing, specific restrictions on the use of our assets as well as prohibitions on our ability to create liens, pay dividends, redeem our stock or make investments. In addition, if we raise additional funds through collaboration and licensing arrangements, it may be necessary to relinquish potentially valuable rights to our potential products or proprietary technologies, or grant licenses on terms that are not favorable to us.

Our quarterly operating results and stock price may fluctuate significantly.

We expect our operating results to be subject to quarterly fluctuations. The revenues we generate, if any, and our operating results will be affected by numerous factors, including:

the development status of our product candidates, including results of our clinical trials,

our recommendation of additional drug compounds for clinical development,

our addition or termination of research programs or funding support,

variations in the level of expenses related to our product candidates or research programs, and

our execution of collaborative, licensing or other arrangements, and the timing of payments we may make or receive under these arrangements.

For example, our announcement of serious adverse events recently observed in a clinical trial of CS-917 had a significant negative impact on our stock price. Quarterly fluctuations in our operating results may, in turn, cause the price of our stock to fluctuate substantially. We believe that quarterly comparisons of our financial results are not necessarily meaningful and should not be relied upon as an indication of our future performance.

Risks Related to our Intellectual Property

Our success depends upon our ability to protect our intellectual property, including the proprietary technologies and compounds used in our business.

Our commercial success depends on obtaining and maintaining patent protection and/or trade secret protection of our product candidates, proprietary technologies and their uses, as well as successfully defending any patents that issue against third-party challenges. We may only be able to protect our product candidates, proprietary technologies and their uses from unauthorized use by third parties to the extent that valid and enforceable patents or trade secrets cover them.

The filing, prosecution and defense of patents at pharmaceutical and biotechnology companies can be highly uncertain and involve complex legal and factual questions for which important legal principles remain unresolved. No consistent policy regarding the breadth of claims allowed in biotechnology patents has emerged to date in the U.S. The biotechnology patent situation outside the U.S. is even more uncertain. We may be particularly affected by this because we expect that pradefovir and MB07133, if approved, will be marketed in foreign countries with high incidences of hepatitis B and primary liver cancer, respectively. Decisions or actions regarding patent filing and/or changes in either the patent laws or in interpretations of patent laws in the U.S. and other countries may diminish the value of our intellectual property.

Decisions or actions regarding patent filing are complex and we may not be successful in protecting our products from competition. Patent positions for products are highly uncertain and involve complex legal and factual questions which may ultimately be decided to the detriment of our products competitive positions in the U.S. and these other countries. We may not be able to develop patentable products or processes in the U.S. and these other countries, and may not be able to obtain patents from pending applications. Even if patent claims are allowed in the U.S. and these other countries, the claims may not issue, or in the event of issuance, may not be sufficient to protect the technology owned by or licensed to us. Any patents or patent rights that we obtain in the U.S. and other countries may be circumvented, challenged or invalidated by our competitors. In addition, we are dependent on outside patent firms for advice and action regarding our efforts to secure patents. Should these firms fail to take appropriate action to secure or enforce our patents in a timely manner, or should they provide us with incorrect or inappropriate advice it could be detrimental to our patent positions.

Accordingly, we cannot predict the breadth of claims that may be allowed or enforced in our patents or in third-party patents in the U.S. and other countries.

The degree of future protection for our proprietary rights is uncertain because legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep our competitive advantage. For example:

we might not have been the first to make the inventions covered by each of our pending patent applications and issued patents,

we might not have been the first to file patent applications for these inventions,

others may independently develop similar or alternative technologies or duplicate any of our technologies,

it is possible that none of our pending patent applications will result in issued patents,

our issued patents may not provide a basis for commercially viable products, may not provide us with any competitive advantages, or may be challenged by third parties,

our issued patents may not be valid or enforceable,

we may not develop additional proprietary technologies that are patentable, or

the patents of others may have an adverse effect on our business.

Proprietary trade secrets and unpatented know-how are also very important to our business. Although we have taken steps to protect our trade secrets and unpatented know-how, including entering into proprietary information and inventions agreements with our employees and consultants and entering into confidentiality agreements with other third parties to whom we disclose our proprietary information, third parties may still obtain this information without our knowledge and consent. Enforcing a claim that a third party illegally obtained and is using our trade secrets or unpatented know-how is expensive and time consuming, and the outcome is unpredictable. In addition, courts outside the U.S. may be less willing to protect this information. Moreover, our competitors may independently develop equivalent knowledge, methods and know-how.

If we are sued for infringing intellectual property rights of third parties, it will be costly and time consuming, and an unfavorable outcome in that litigation would have a material adverse effect on our business.

Our commercial success also depends upon our ability and the ability of our collaborators to develop, manufacture, market and sell our product candidates and use our proprietary technologies without infringing the proprietary rights of third parties. Numerous U.S. and foreign issued patents and pending patent applications, which are owned by third parties, exist in the fields in which we and our collaborators are developing products. Because patent applications can take many years to issue, there may be currently pending applications, unknown to us, which may later result in issued patents that our product candidates or proprietary technologies may infringe. We have not conducted a complete search of existing patents to identify existing patents that our product candidates or proprietary technologies may inadvertently infringe.

We may be exposed to future litigation by the companies holding these patents or other third parties based on claims that our product candidates and/or proprietary technologies infringe their intellectual property rights. If one of these patents was found to cover our product candidates, proprietary technologies or their uses, we or our collaborators could be required to pay damages and could be unable to commercialize our product candidates or use our proprietary technologies unless we or they obtained a license to the patent. In addition, while we are not currently subject to pending litigation nor are we aware of any threatened litigation, third parties may contact us or our collaborators in the ordinary course of business to bring certain patents to our attention. We and our collaborators evaluate all such communications on a case-by-case basis to assess whether such patents cover our product candidates or proprietary technologies and if so, whether to seek a license from such third parties. A license may not be available to us or our collaborators on acceptable terms, if at all.

There is a substantial amount of litigation involving patent and other intellectual property rights in the biotechnology and biopharmaceutical industries generally. If a third party claims that we or our collaborators infringe on its technology, we may face a number of issues, including:

infringement and other intellectual property claims which, with or without merit, may be expensive and time-consuming to litigate and may divert our management s attention from our core business,

substantial damages for infringement, including treble damages and attorneys fees, as well as damages for products developed using allegedly infringing drug discovery tools or methods, which we may have to pay if a court decides that the product or proprietary technology at issue infringes on or violates the third party s rights,

a court prohibiting us from selling or licensing the product or using the proprietary technology unless the third party licenses its technology to us, which it is not required to do,

if a license is available from the third party, we may have to pay substantial royalties, fees and/or grant cross licenses to our technology, and

redesigning our products or processes so they do not infringe, which may not be possible or may require substantial funds and time.

We have conducted searches of U.S. and foreign patents, but cannot guarantee that the searches were comprehensive and therefore whether any of our product candidates or the methods of using, making or identifying our product candidates infringe the patents searched, or that other patents do not exist that cover our product candidates or these methods. There may also be pending patent applications that are unknown to us and may prevent us from marketing our product candidates. Other product candidates that we may develop, either internally or in collaboration with others, could be subject to similar delays and uncertainties.

Existing patents and patent applications covering adefovir or prodrugs of adefovir in the U.S. and foreign countries may prevent the commercialization of pradefovir in the future.

Our product candidate pradefovir is a prodrug of adefovir. A third party, Gilead, has rights to another product called Hepsera that is a non-liver specific prodrug of adefovir. Adefovir is covered by U.S. and foreign patents that are scheduled to expire in April 2006. On their face, these patents are assigned to Gilead. We currently anticipate that, if approved, pradefovir will not be commercialized until after April 2006, and therefore should not infringe upon these patents. However, in some cases, the terms of U.S. and foreign patents covering drug products approved for commercialization may be extended if the holder of the patents requests an extension within a specified period following the date of regulatory approval and the request for extension is approved by the appropriate agencies. We are not aware that the term of the U.S. patents covering adefovir was extended following regulatory approval of Hepsera in the U.S., and the period in which extensions may have been requested has ended. The extension of any patent covering adefovir may prevent the commercialization of pradefovir in the relevant country until the expiration of the extended patent term, unless we or Valeant obtained a license to this patent. We are not aware of any request for an extension of patents covering adefovir in Europe.

We are aware of third party patents and patent applications in European and other foreign countries with claims to prodrugs of adefovir. These patents are scheduled to expire in September 2011. Although we do not believe that any valid claim covers pradefovir, we cannot guarantee this. If it is determined that patent claims are valid and cover pradefovir, we may not be able to commercialize pradefovir in foreign countries, including those in Europe. Further, we are aware that a patent term extension of one of these prodrug patents has been requested in one or more European countries based on the regulatory approval of Hepsera. If the extension request is granted, the patents would expire in September 2016. If granted, this extension may have an adverse impact on the commercialization of pradefovir in any such country if it is determined that the

patent claims are valid and cover pradefovir. Additional third party patents covering Hepsera or adefovir may exist, and may expire later than April 2006 in the U.S. and later than 2011 in foreign countries.

Risks Related to Other Legal Matters

We may incur significant costs complying with environmental laws and regulations.

We use hazardous materials, including chemicals, biological agents and radioactive isotopes and compounds that could be dangerous to human health and safety or the environment. As appropriate, we store these materials and wastes resulting from their use at our facility pending their ultimate use or disposal. We currently contract with a third party to dispose of these materials and wastes. We are subject to a variety of federal, state and local laws and regulations governing the use, generation, manufacture, storage, handling and disposal of these materials and wastes. We may also incur significant costs complying with environmental laws and regulations adopted in the future.

The radioactive isotopes and compounds we use can cause radiation contamination to our facility. State and federal laws

require that before permanently leaving a facility in which radioactive materials have been used, the user of the radioactive materials must make certain that the facility passes a series of tests known as decommissioning. The decommissioning process is highly regulated and may be expensive. In connection with the upcoming expiration of our current sublease and our planned move to a new facility, we have incurred, and will continue to incur, costs in the decommissioning of our current facility. We cannot predict the ultimate amount of these costs, and they may be substantial. The decommissioning process may also prevent us from moving to an alternate facility in a timely manner, which could increase our costs and delay or prevent the commercialization of our products.

We may incur substantial liabilities from any product liability claims if our insurance coverage for those claims is inadequate.

We face an inherent risk of product liability exposure related to the testing of our product candidates in human clinical trials, and will face an even greater risk if we sell our product candidates commercially. For example, two cases of lactic acidosis were recently observed in a clinical trial combining CS-917 with metformin. As a result, unless further data changes the situation, the combination of CS-917 and metformin is contraindicated and the inadvertent combination of the drugs could put patients at risk for lactic acidosis. Therefore, even if CS-917 receives regulatory approval the FDA may require us to enact various risk management programs to avoid its inadvertent use with metformin. However, none of these programs can be assured of eliminating the possibility of the inadvertent use of CS-917 with metformin and the consequent risk of lactic acidosis. Therefore, these programs may not effectively protect us from a liability claim.

An individual may bring a liability claim against us if one of our product candidates causes, or merely appears to have caused, an injury. If we cannot successfully defend ourselves against the product liability claim, we will incur substantial liabilities. Regardless of merit or eventual outcome, liability claims may result in:

decreased demand for our product candidates,

injury to our reputation,

withdrawal of clinical trial participants,

costs of related litigation,

substantial monetary awards to patients or other claimants,

loss of revenues, and

the inability to commercialize our product candidates.

We have product liability insurance that covers our clinical trials, up to an annual aggregate limit of $10 million. We intend to expand our insurance coverage to include the sale of commercial products if marketing approval is obtained for any of our product candidates. However, insurance coverage is increasingly expensive. We may not be able to maintain insurance coverage at a reasonable cost and we may not be able to obtain insurance coverage that will be adequate to satisfy any liability that may arise.

If we use biological and hazardous materials in a manner that causes injury, we may be liable for damages.

Our research and development and manufacturing activities involve the use of biological and hazardous materials. Although we believe our safety procedures for handling and disposing of these materials comply with federal, state and local laws and regulations, we cannot entirely eliminate the risk of accidental injury or contamination from the use, storage, handling or disposal of these materials. If one of our employees was accidentally injured from the use, storage, handling or disposal of these materials, the medical costs related to his or her treatment would be covered by our workers compensation insurance policy. However, we do not carry specific biological or hazardous waste insurance coverage and our property and casualty and general liability insurance policies specifically exclude coverage for damages and fines arising from biological or hazardous waste exposure or contamination. Accordingly, in the event of contamination or injury, we could be held liable for damages or penalized with fines in an amount exceeding our resources.

Risks Related to the Securities Markets and Investment in our Common Stock

Market volatility may affect our stock price and the value of your investment.

The market price for our common stock has been and is likely to continue to be volatile, in part because our shares have only recently been traded publicly. In addition, the market price of our common stock may fluctuate significantly in response to a number of factors, most of which we cannot control, including:

changes in the regulatory status of our product candidates, including the status and results of our clinical trials,

events affecting Sankyo, Valeant, Merck or any future collaborators,

announcements of new products or technologies, commercial relationships or other events by us or our competitors,

regulatory developments in the U.S. and foreign countries,

fluctuations in stock market prices and trading volumes of similar companies,

variations in our quarterly operating results,

changes in securities analysts estimates of our financial performance,

changes in accounting principles,

sales of large blocks of our common stock, including sales by our executive officers, directors and significant

stockholders,

additions or departures of key personnel, and

discussion of us or our stock price by the financial and scientific press and in online investor communities.

For example, our announcement of serious adverse events recently observed in a clinical trial of CS-917 had a significant negative impact on our stock price.

Anti-takeover provisions in our charter documents and under Delaware law could make an acquisition of us, which may be beneficial to our stockholders, more difficult and may prevent attempts by our stockholders to replace or remove our current management.

Provisions in our amended and restated certificate of incorporation and bylaws may delay or prevent an acquisition of us or a change in our management. These provisions include a classified board of directors, a prohibition on actions by written consent of our stockholders, and the ability of our board of directors to issue preferred stock without stockholder approval. In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which prohibits stockholders owning in excess of 15% of our outstanding voting stock from merging or combining with us. Although we believe these provisions collectively provide for an opportunity to receive higher bids by requiring potential acquirors to negotiate with our board of directors, they would apply even if the offer may be considered beneficial by some stockholders. In addition, these provisions may frustrate or prevent any attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors, which is responsible for appointing the members of our management.

We may incur increased costs as a result of changes in laws and regulations relating to corporate governance matters.

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules adopted or proposed by the Securities and Exchange Commission and by the Nasdaq Stock Market, will result in increased costs to us as we continue to evaluate the implications of these laws and regulations and respond to their requirements. These laws and regulations could make it more difficult or more costly for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, our board committees or as executive officers. We are presently evaluating and monitoring developments with respect to these laws and regulations

and cannot predict or estimate the amount or timing of additional costs we may incur to respond to their requirements.

If our executive officers, directors and largest stockholders choose to act together, they may be able to control our operations and act in a manner that advances their best interests and not necessarily those of other stockholders.

Our executive officers, directors and holders of 5% or more of our outstanding common stock, beneficially owned approximately 73% of our common stock as of June 30, 2005. As a result, these stockholders, acting together, are able to control all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions. The interests of this group of stockholders may not always coincide with our interests or the interests of other stockholders, and they may act in a manner that advances their best interests and not necessarily those of other stockholders.

Future sales of our common stock may cause our stock price to decline.

A large portion of our shares are held by a small number of persons and investment funds. In addition, these persons and funds hold warrants to purchase 1,347,176 shares of common stock that, if exercised, will result in these additional shares becoming available for sale. Moreover, several of our stockholders and warrant holders have rights, subject to some conditions, to require us to file registration statements covering the unregistered shares they currently hold or may acquire upon exercise of warrants, or to include these shares in registration statements that we may file for ourselves or other stockholders. Sales by these stockholders or warrant holders of a substantial number of shares could significantly reduce the market price of our common stock.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our primary exposure to market risk is interest income sensitivity, which is affected by changes in the general level of U.S. interest rates, particularly because the majority of our investments are in short-term marketable securities. Due to the nature of our short-term investments, we believe that we are not subject to any material market risk exposure. We do not have any foreign currency or other derivative financial instruments.

Our long-term capital lease obligations bear interest at fixed rates and therefore we do not have significant market risk exposure with respect to these obligations.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in our internal control over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Our initial public offering of our common stock, par value $0.001, was effected through a Registration Statement on Form S-1 (File No. 333-112437) that was declared effective by the Securities and Exchange Commission on June 15, 2004. The Registration Statement covered the offer and sale of up to 5,750,000 shares of our common stock for an aggregate offering price of $40.3 million. Our initial public offering commenced on June 15, 2004. On June 21, 2004, 5,000,000 shares of our common stock were sold for an aggregate offering price of $35.0 million. On July 20, 2004, 75,000 shares of our common stock were sold for an aggregate offering price of $525,000 upon the partial exercise of the underwriters over-allotment option. Our initial public offering terminated following the sale of all of the securities registered on the registration statement and the expiration of the underwriters over-allotment option. Our initial public offering resulted in aggregate proceeds to us of approximately $31.1 million, net of underwriting discounts and commissions of approximately $2.5 million and offering expenses of approximately $1.9 million, through a syndicate of underwriters managed by SG Cowen & Co., LLC, Deutsche Bank Securities Inc., Thomas Weisel Partners LLC, and Legg Mason Wood Walker, Incorporated.

No offering expenses were paid directly or indirectly to any of our directors or officers (or their associates) or person owning ten percent or more of any class of our equity securities or to any other affiliates. All offering expenses were paid directly to others.

As of June 30, 2005, we had used approximately $28.8 million of the initial public offering proceeds for investments in medium-term, interest-bearing obligations, investment-grade instruments, or guaranteed obligations of the U.S. government. We had used the remainder for the development of MB07133, MB07811, MB07803 and the lead compounds in our advanced research programs and to a lesser extent, to continue and expand our other research and development activities and for general corporate purposes.

The foregoing payments were direct payments made to third parties who were not our directors or officers (or their associates), persons owning ten percent or more of any class of our equity securities or any other affiliate, except that the proceeds used for working capital included regular compensation for officers and directors. The use of proceeds does not represent a material change from the use of proceeds described in the prospectus we filed pursuant to Rule 424(b)(4) of the Securities Act of 1933, as amended, with the Securities and Exchange Commission on June 16, 2004.

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

We held our 2005 Annual Meeting of Stockholders on May 18, 2005. As of the close of business on April 11, 2005, the record date for the Annual Meeting, there were 18,183,283 shares of our common stock entitled to vote, of which there were 10,532,964 shares present at the Annual Meeting in person or by proxy. At the Annual Meeting, our stockholders approved the following matters:

Proposal 1. Election of two directors to serve as Class I directors until our 2008 Annual Meeting of Stockholders. The vote for the nominees for Class I director was as follows:

Daniel D. Burgess, M.B.A. 10,526,172 shares were voted in favor of the nominee; 6,791 shares withheld their vote.

Luke B. Evnin, Ph.D. 10,525,372 shares were voted in favor of the nominee; 7,591 shares withheld their vote.

Our Class II directors, Mark D. Erion, Ph.D., Arnold L. Oronsky, Ph.D. and William R. Rohn, continue in office until our 2006 Annual Meeting of Stockholders. Our Class III directors, Heinz W. Gschwend, Ph.D.,David F. Hale and Paul K. Laikind, Ph.D., continue in office until our 2007 Annual Meeting of Stockholders.

Proposal 2. Ratification of the selection by the Audit Committee of our Board of Directors of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2005. 10,525,767 shares voted in favor of the proposal; and 7,197 shares voted against the proposal.

Item 6. Exhibits

Exhibit Number	Description
3.1(1)	Amended and Restated Certificate of Incorporation of the Company.
3.2(1)	Amended and Restated Bylaws of the Company.
4.1(1)	Form of Common Stock Certificate.
10.28*	License and Collaboration Agreement dated June 22, 2005 between the Company and Merck & Co., Inc.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Confidential treatment has been requested with respect to certain portions of this exhibit. Omitted portions have been filed separately with the Securities and Exchange Commission.

(1) Incorporated by reference to the exhibit of the same number to the Company s Registration Statement on Form S-1 (No. 333-112437), originally filed on February 3, 2004.

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.

Date: August 15, 2005

By: /s/ John W. Beck
John W. Beck, C.P.A., *Senior Vice President of Finance, Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)*