NANOGEN INC
Form 10-Q
November 14, 2002

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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 September 30, 2002

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 000-23541

NANOGEN, INC.

(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**33-0489621** (I.R.S. Employer Identification No.)
10398 Pacific Center Court, San Diego, CA (Address of principal executive offices)	**92121** (Zip code)

(858) 410-4600
(Registrant's telephone number, including area code)

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

YES ý NO o

As of November 12, 2002, 21,941,398 shares of the Registrant's Common Stock were outstanding.

NANOGEN, INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NANOGEN, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	September 30, 2002 (unaudited)	December 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,340	$ 10,455
Short-term investments	33,041	57,069
Receivables, net	1,396	4,380
Inventories, net	4,607	4,688

	September 30, 2002	December 31, 2001
Other current assets	3,108	2,473
Total current assets	55,492	79,065
Property and equipment, net	5,220	5,386
Acquired technology rights, net	4,747	4,183
Other assets, net	908	1,158
Restricted cash	64	299
	$ 66,431	$ 90,091
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 707	$ 1,051
Accrued liabilities	5,435	4,916
Deferred revenue	863	522
Current portion of capital lease obligations	842	1,060
Total current liabilities	7,847	7,549
Capital lease obligations, less current portion	1,322	1,755
Other long-term liabilities	3,037	1,675
Total long-term liabilities	4,359	3,430
Minority interest in consolidated subsidiary	2,339	4,183
Stockholders' equity:		
Convertible preferred stock, $.001 par value, 5,000,000 shares authorized; no shares issued and outstanding at September 30, 2002 and December 31, 2001		
Common stock, $.001 par value, 50,000,000 shares authorized; 21,941,398 and 21,616,172 shares issued and outstanding at September 30, 2002 and December 31, 2001, respectively	22	22
Additional paid-in capital	199,534	198,387
Accumulated other comprehensive income	1,051	1,253
Deferred compensation	(164)	(336)
Notes receivable from officers	(1,027)	(984)
Accumulated deficit	(147,530)	(123,413)
Total stockholders' equity	51,886	74,929
	$ 66,431	$ 90,091

See accompanying notes.

NANOGEN, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)
(in thousands, except per share data)

	Three months ended September 30,		Nine months ended September 30,	
	2002	2001	2002	2001
Revenues:				
Product	$ 957	$ 1,023	$ 2,873	$ 1,554
Sponsored research	354	1,828	980	6,229
Contract and grant	240	368	1,182	1,091
Total revenues	1,551	3,219	5,035	8,874
Operating expenses:				
Cost of product sales	687	727	2,080	1,127
Research and development	5,780	4,824	15,672	14,023
Selling, general and administrative	5,428	6,054	15,346	15,982
Litigation and settlement of patent matter, net	(963)	263	(165)	6,836
Total operating expenses	10,932	11,868	32,933	37,968
Loss from operations	(9,381)	(8,649)	(27,898)	(29,094)
Interest income, net	488	1,019	1,834	3,437
Minority interest in loss of consolidated subsidiary	651	485	1,634	485
Other income	18	125	153	123
Net loss	$ (8,224)	$ (7,020)	$ (24,277)	$ (25,049)
Net loss per share basic and diluted	$ (0.38)	$ (0.33)	$ (1.12)	$ (1.20)
Number of shares used in computing net loss per share basic and diluted	21,923	21,206	21,732	20,898

See accompanying notes.

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NANOGEN, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

	Nine months ended September 30,	
	2002	2001
Operating activities:		
Net loss	$ (24,277)	$ (25,049)
Adjustments to reconcile net loss to net cash used in operating activities:		
Issuance of common stock pursuant to settlement of patent matter		2,500
Depreciation and amortization	3,067	2,516

	Nine months ended September 30,	
Asset impairment and other non-cash charges	452	
Amortization (accretion) related to short-term investments	44	(51)
Stock-based compensation expense	64	353
Interest capitalized on notes receivables from officers	(43)	(48)
Minority interest in loss of consolidated subsidiary	(1,634)	(485)
Gain on sale of short-term investments	(182)	(116)
Changes in operating assets and liabilities:		
Receivables	2,984	(2,259)
Inventories	(926)	(1,923)
Other assets	(744)	(988)
Accounts payable	(344)	(280)
Accrued liabilities	528	(415)
Deferred revenue	340	321
Net cash used in operating activities	(20,671)	(25,924)
Investing activities:		
Purchase of short-term investments	(12,303)	(23,851)
Proceeds from sale and maturities of short-term investments	35,686	4,102
Purchase of equipment	(131)	(55)
Purchase of technology rights	(835)	
Net cash provided by (used in) investing activities	22,417	(19,804)
Financing activities:		
Principal payments on capital lease obligations	(1,108)	(1,946)
Proceeds from development partner	1,373	1,125
Proceeds from minority interest shareholder		4,794
Issuance of common stock, net of repurchases	313	382
Note receivable payments from officers		38
Proceeds from restricted cash balances	235	50
Net cash provided by financing activities	813	4,443
Effect of exchange rate changes	326	204
Net increase (decrease) in cash and cash equivalents	2,885	(41,081)
Cash and cash equivalents at beginning of period	10,455	55,330
Cash and cash equivalents at end of period	$ 13,340	$ 14,249
Supplemental disclosure of cash flow information:		
Interest paid	$ 140	$ 258
Supplemental schedule of noncash investing and financing activities:		
Equipment acquired under capital leases	$ 435	$ 1,283
Unrealized gain (loss) on short-term investments	$ (783)	$ 1,141

	Nine months ended September 30,	
Warrant issued for research and development collaboration	$	$ 1,200
Accrued fee for purchase of technology rights	$ 225	$
Common stock issued for settlement of patent matter	$	$ 2,500
Common stock issued in connection with purchase of license rights	$ 872	$
Common stock issued in connection with employee benefit plan, net of forfeitures	$ 112	$ 134
Cancellation of notes receivable related to unvested restricted stock, net of payments on notes receivable	$	$ 139
Options issued to non-employees	$ 4	$ 105
Inventory acquired as fixed assets	$ 1,007	$ 483

See accompanying notes.

NANOGEN, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)
September 30, 2002

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. The consolidated balance sheet as of September 30, 2002, consolidated statements of operations for the three and nine months ended September 30, 2002 and 2001, and the consolidated statements of cash flows for the nine months ended September 30, 2002 and 2001 are unaudited, but include all adjustments (consisting of normal recurring adjustments) which the Company considers necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. The results of operations for the three and nine months ended September 30, 2002 shown herein are not necessarily indicative of the results that may be expected for the year ending December 31, 2002.

For more complete financial information, these financial statements, and notes thereto, should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2001 included in the Nanogen, Inc. Annual Report on Form 10-K for the year ended December 31, 2001, filed with the Securities and Exchange Commission.

Net Loss per Share

The Company computes net loss per share in accordance with SFAS No. 128, "Earnings per Share." Under the provisions of SFAS No. 128, basic net income (loss) per share is computed by dividing the net income (loss) available to common stockholders for the period by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed by dividing the net income (loss) for the period by the weighted average number of common shares outstanding during the period and dilutive common shares outstanding computed using the treasury stock method. The weighted average common shares outstanding during the period does not include those shares issued pursuant to the exercise of stock options prior to vesting and shares issued under the Company's 401K benefit plan prior to vesting. Due to the losses incurred by the Company during the three and nine months ended September 30, 2002 and 2001, common stock equivalents resulting from the assumed exercise of outstanding stock options and warrants have been excluded from the computation of diluted net loss per share as their effect would be anti-dilutive.

Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board ("FASB") issued FASB Statements Nos. 141 and 142 (FAS 141 and FAS 142), "Business Combinations" and "Goodwill and Other Intangible Assets." FAS 141 replaces APB 16 and eliminates pooling-of-interests accounting prospectively. It also provides guidance on purchase accounting related to the recognition of intangible assets and accounting for negative goodwill. FAS 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Under FAS 142, goodwill will be tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. FAS 141 and FAS 142 are effective for all business combinations completed after June 30, 2001. Upon adoption of FAS 142, amortization of goodwill recorded for business combinations consummated prior to July 1, 2001 will cease, and intangible assets acquired prior to July 1, 2001 that do not meet the criteria for recognition under FAS 141 will be reclassified to goodwill. Companies are required to adopt FAS 141 and 142 beginning

in fiscal 2002. The adoption of these standards did not result in a material impact on the Company's results of operations and financial position.

In August 2001, the FASB issued FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." FAS 144 replaces FAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." The FASB issued FAS 144 to establish a single accounting model, based on the framework established in FAS 121, as FAS 121 did not address the accounting for a segment of a business accounted for as a discontinued operation under APB 30, "Reporting The Results of Operations Reporting The Effects of Disposal of a Segment of a Business, and Extraordinary Unusual and Infrequently Occurring Events and Transactions." FAS 144 also resolves significant implementation issues related to FAS 121. The Company was required to adopt FAS 144 for 2002. The adoption of this standard did not have a material impact on the Company's results of operations and financial position.

In June 2002, the FASB issued Statement No. 146, or SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal." SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The principal difference between Statement 146 and Issue 94-3 relates to Statement 146's requirements for recognition of a liability for a cost associated with an exit or disposal activity. Statement 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost as generally defined in Issue 94-3 was recognized at the date of an entity's commitment to an exit plan. The provisions of this Statement 146 are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. We do not expect the adoption of SFAS No. 146 will have a material impact on the consolidated financial statements.

Reclassification

Certain prior period amounts have been reclassified to conform to current period presentation.

2. Inventories

Inventories consist of the following (in thousands):

	September 30, 2002	December 31, 2001
	(unaudited)	
Raw materials	$ 1,178	$ 796
Work in process	805	1,436
Finished goods	4,656	3,956
	6,639	6,188
Reserve for excess and obsolete	(2,032)	(1,500)

	September 30, 2002	December 31, 2001
	$ 4,607	$ 4,688

Finished goods includes $2.7 million and $2.0 million of NanoChip® Molecular Biology Workstations ("NanoChip® Workstations") at September 30, 2002 and December 31, 2001, respectively, that are installed at customer sites where title has not transferred to the customer. The majority of these instruments are placed at customer sites under Development Site Agreements. Under these arrangements, a NanoChip® Workstation is placed at a customer site for a period normally between nine and twelve months for the purpose of developing content and optimizing assays which may result in the creation or enhancement of intellectual property that the Company may license in the future. The customer has the option to purchase the NanoChip® Workstation during the period of the

arrangement or at its expiration. The Company provides warranty for these NanoChip® Workstations as well as insures them during the development site period. Development site customers are normally required to purchase any cartridges to be used on the instrument from us during the development site period. As of September 30, 2002, we had a total of thirty-two NanoChip® Workstations under agreements whereby we retain title to the Workstation. The Company classifies this inventory as consignment inventory and includes this within finished goods. The Company accrues refurbishment costs for each unit included in consignment inventory for the purpose of resale in the event the unit is returned under this arrangement. This reserved totaled $426,000 and $303,000 at September 30, 2002 and December 31, 2001, respectively. In addition, the Company has recorded a reserve related to the older production units which may be deemed obsolete or sold to the customer at a discount due to the depreciation of the unit during the development site period. This reserve totaled $1.4 million and $982,000 at September 30, 2002 and December 31, 2001, respectively.

The Company's manufacturing agreement with Hitachi, Ltd. ("Hitachi") requires that the Company provide annual purchase commitments to Hitachi for NanoChip® Workstations. As of September 30, 2002, the Company had commitments to purchase approximately $2.7 million in NanoChip® Workstations through March 31, 2003. At September 30, 2002, the inventory under our purchase commitment with Hitachi is within our expected usage levels based upon current and estimated future demands.

3. Licensed Technology

The Company has acquired various licenses to technologies which are incorporated into certain of the Company's current products or products under development. The Company capitalizes the cost (which includes cash and equity consideration) in conjunction with the acquisition of these licenses and amortizes the cost over the expected life of the product. In June 2002, the Company issued 254,151 shares of the Company's common stock valued at $750,000, based on the closing price of the Company's stock at the effective date, to a licensor in exchange for license rights. In April 2002, the Company issued a warrant exercisable through April 12, 2007 to purchase 50,000 shares of the Company's common stock at a per share price of $4.10, the fair market value on the effective date of the agreement. The value of the warrant was determined to be $122,000 using the Black-Scholes valuation model. Assumptions used in determining the value of the warrant were as follows: dividend yield of 0%, expected volatility of 65%, risk-free interest rate of 5.5%, expected life of 5 years, stock price of $4.10 per share, and an exercise price of $4.10 per share. The warrant has a term of five years, and was issued in return for license rights.

In July 2002, the Company and Graviton, Inc. entered into an agreement to terminate and release Nanogen and Graviton of their obligations under the Collaboration and License Agreement dated December 15, 1999 (see footnote 9 for further discussion of this transaction) which originally resulted in acquired technology rights of $1 million by the Company in fiscal 1999. In September 2002, the Company and Graviton, Inc. entered into a subsequent agreement to terminate and release Nanogen and Graviton of their obligations under the Collaboration and License Agreement dated December 15, 1999 and the termination and release agreement entered into in July 2002. As a result of the termination of this collaboration arrangement, the Company recorded a loss of approximately $452,000 included in research and development expenses (the remaining value of the acquired technology rights obtained in 1999) for the three month period ended September 30, 2002.

4. Comprehensive Loss

SFAS No. 130, Reporting Comprehensive Income, requires the Company to report, in addition to net income (loss), comprehensive income (loss) and its components. A summary is as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2002	2001	2002	2001
Comprehensive loss:				
Net unrealized gain/(loss)	$ (156)	$ 549	$ (783)	$ 1,141
Foreign currency translation adjustment	(45)	21	581	21
Net loss	(8,224)	(7,020)	(24,277)	(25,049)
Comprehensive loss	$ (8,425)	$ (6,450)	$ (24,479)	$ (23,887)

5. Collaborative Alliances

Hitachi, Ltd.

Manufacturing Agreement

In January 2000, the Company executed an agreement with Hitachi, Ltd., effective as of December 15, 1999, for the full-scale commercial manufacturing and distribution of the NanoChip® Molecular Biology Workstation in specified research markets. Hitachi, Ltd.'s Instrument Group provides technology and technical support to aid in the manufacturing of the NanoChip® Molecular Biology Workstation's components.

Hitachi, Ltd. has the right to be the sole distributor of NanoChip® Molecular Biology Workstations in Japan. Hitachi, Ltd. also has the non-exclusive right to distribute NanoChip® Cartridges in Japan. Under this arrangement, the Company receives a royalty for NanoChip® Molecular Biology Workstations sold by Hitachi, Ltd. in Japan. The Company retains the right to distribute, directly or through others, NanoChip® Molecular Biology Workstations outside of Japan. In addition, the Company manufactures NanoChip® Cartridges at its San Diego, California facility for distribution worldwide. The Company also retains the right to form other manufacturing and distribution agreements.

Pursuant to our manufacturing agreement with Hitachi, the Company is required to provide annual purchase commitments to Hitachi for NanoChip® Workstations. As of September 30, 2002, the Company had a commitment to purchase approximately $2.7 million in NanoChip® Workstations from Hitachi through March 31, 2003.

Research Collaboration Agreement

In July 2000, the Company executed a ten-year agreement with Hitachi, Ltd., Nissei Sangyo Co. Ltd. and Hitachi Instruments Service Co. Ltd. of Japan (collectively, "Hitachi") to develop, manufacture and distribute additional potential products based on the parties' proprietary technologies, potentially including, among other things, reduced-size instruments for genetic testing, integrated amplification and point-of-care detection. The agreement provides that the parties will jointly determine which projects to prioritize over the term of the agreement. The agreement may be terminated before its expiration by either party, subject to certain restrictions. Pursuant to the terms of the agreement, Hitachi and the Company each may contribute, toward the research and development efforts of the Company, up to $28.5 million in cash over the ten-year period. At a minimum the Company is required to contribute on an annual basis funding for its own general technology development in an amount equal to or greater than payments made by Hitachi. In addition, the

Company is liable to repay to Hitachi fifty percent of all funding provided by Hitachi over an indefinite period of time. Repayment amounts are determined as a percentage of the Company's gross NanoChip® Cartridge sales until the liability is paid in full. Furthermore, Hitachi made an equity investment in the Company by purchasing 74,590 shares of the Company's common stock worth approximately $2.0 million pursuant to a private sale by the Company based on a per share price of $26.813 (the fair market value as of the signing date of the Hitachi agreement). Hitachi has the right to be the exclusive distributor of collaboration products in Japan and, based upon the attainment of minimum sales targets to be mutually agreed upon, in other Asian countries. The Company retains the exclusive right to distribute collaboration products outside of these countries.

Sponsored research revenue recognized under this agreement totaled $354,000 and $980,000 for the three and nine months ended September 30, 2002, respectively, and $292,000 and $792,000 for the three and nine months ended September 30, 2001, respectively. In accordance with SFAS No. 68, the Company records sponsored research revenue under this arrangement as expenses are incurred not exceeding scheduled payments under the agreement. The Company records a long-term liability for fifty percent of the funds received from Hitachi upon the receipt of such funds. The amount owed to Hitachi for proceeds received under this agreement was $3.0 million and $1.6 million at September 30, 2002 and December 31, 2001, respectively. The current portion of the long-term liability remains immaterial as payment amounts due under this obligation are determined as a percentage of the Company's gross NanoChip® Cartridge sales which have not been significant to date. As such, we have classified the entire balance of this liability as long-term.

Service Agreement

In October 2000, the Company entered into an agreement with Hitachi for the service by Hitachi of the NanoChip® Molecular Biology Workstations in the United States after their sale or placement by the Company with the Company's customers. The Company pays an agreed-upon amount (as specified in the agreement) to Hitachi for annual service for each Workstation covered under the agreement. Nanogen amortizes the cost of the warranty agreement over the service period. As the Company provides the first year of warranty at no charge to the customer, the Company defers the portion of the Workstation sale revenue that relates to the warranty agreement. This deferred revenue is then amortized into revenue ratably over the annual service period. In subsequent years, the customer can pay an annual service fee to the Company and the Company will in turn pay Hitachi the annual service amount as specified in the agreement. The amount charged to the customer by the Company is based upon the cost of the service (i.e. the payment to Hitachi) plus an industry accepted profit margin for comparable service on similar types of products. Both the service revenue and the service expense are amortized ratably over the service period, generally one year.

In December 2001, this agreement was amended to include, among other things, a commitment by the Company to provide Hitachi with a minimum of $200,000 in payments for warranty service in fiscal 2002 and the expense is being recorded during fiscal 2002.

Aventis Research and Technologies

In September 1999, the Company entered into two technology development programs with Aventis Research and Technologies, an affiliate of Hoechst AG ("Aventis"), which focused on the development of gene expression tools utilizing electronic bioarrays and the development of high throughput screening tools for kinase analyses. In total, the two programs provided $11.9 million in funding to the Company through December 31, 2001. Under these programs, the Company demonstrated quantitative, multiplexed and reliable gene expression monitoring on a Nanogen electronic microarray system. Additionally, the Company delivered an electronic hybridization-based gene expression prototype detection system as well as a prototype system for analyzing protein kinases. This prototype system was sold during the fourth quarter of 2001 to an affiliate of Aventis. All project milestones established

under these arrangements were completed as of December 31, 2001 at which time the agreements expired. The Company does not expect to receive additional funding for these projects.

Revenue was primarily recognized under these agreements as expenses were incurred, and totaled $1.5 million and $5.4 million for the three and nine months ended September 30, 2001, respectively. No revenue was recognized during 2002 as these projects were completed as of December 31, 2001.

In June 2001, the Company entered into agreements with Aventis to create a new company, Nanogen Recognomics GmbH ("Nanogen Recognomics"). Nanogen Recognomics was established to develop new products and applications for the NanoChip® System. Nanogen Recognomics is sixty percent owned by the Company and forty percent owned by Aventis and is based in Frankfurt, Germany. Aventis provided the first $5 million of funding for the operations of Nanogen Recognomics and also contributed intellectual property in the form of eighteen patents. The Company is also required to spend an aggregate of $5.5 million, at the rate of $1.1 million per year beginning April 1, 2001, for its own general technology development which benefits the commercialization and development of potential Nanogen Recognomics products. This funding is recorded as research and development expense in the Company's statement of operations as incurred. The amounts contributed by Aventis are spent by the joint venture and reported in the operating results of the joint venture. Aventis has no further commitments to provide funding beyond the first five years of operation. In addition, Nanogen Recognomics will own several patent applications filed jointly by the Company and Aventis. The Company has licensed certain aspects of its NanoChip® technology to Nanogen Recognomics and will seek to commercialize new products and applications developed by Nanogen Recognomics. Aventis retains the right to utilize the former Aventis patent portfolio in fields outside of Nanogen Recognomics. In conjunction with the agreement to form Nanogen Recognomics, the Company issued a warrant to Aventis to purchase 315,863 shares of common stock exercisable through July 17, 2006 at an agreed upon price of $9.828 per share. The value of this warrant, as determined by the Black-Scholes valuation model, was $1.2 million, is included in other assets in the accompanying consolidated financial statements and is being amortized over a two and a half year period, the estimated period for which the $5 million in funding will provide for operating expenses. Assumptions used in determining the value of the warrant were as follows: dividend yield of 0%, expected volatility of 70%, risk-free interest rate of 6.5%, expected life of 5 years, stock price of $6.79 per share, and an exercise price of $9.828 per share. In the event Nanogen Recognomics should run out of funds, we will take over wind-down costs and Nanogen Recognomics will be restructured to hold the original patents contributed by Aventis and any jointly owned patents. The restructured company will collect royalties, if any, and pay the equity owners accordingly. Our exclusive commercialization license will continue for 10 years after restructuring.

The results of operations for Nanogen Recognomics are fully consolidated in our financial statements. There is no off-balance sheet component to this joint venture. The total operating loss of Nanogen Recognomics is reflected as a reduction of the "minority interest" in the accompanying balance sheet and totaled $651,000 and $1.6 million for the three and nine months ended September 30, 2002, respectively, and 485,000 for the three and nine months ended September 30, 2001, respectively.

6. Litigation

In July 2001, the Company entered into a settlement agreement with Motorola, Genometrix, and MIT concluding the declaratory judgment action by the Company against Motorola, Genometrix and MIT and Motorola's counterclaim against the Company. In connection with the settlement, the Company has secured a license from Motorola to certain claims of the disputed patent. In exchange, the Company made a one-time payment of $2.5 million in cash and issued 416,666 shares of the Company's common stock (valued at approximately $2.5 million based upon a per share price of $6.00, the fair market value on the date of settlement) to the parties involved. The settlement does not

include any cross-licensing provisions of the Company's technology to Motorola, Genometrix or MIT. The lawsuit and the counterclaim have now been dismissed. For the three and nine months ended September 30, 2001 costs associated with the litigation of the Motorola patent matter totaled approximately $123,000 and $6.4 million, respectively. There were no costs incurred in 2002 related to this litigation matter.

In September 2002, the Company entered into a settlement agreement with CombiMatrix Corp. ("CombiMatrix") and Dr. Donald Montgomery concluding pending litigation in the U.S. District Court for the Southern District of California. Pursuant to the settlement agreement, Nanogen agreed to drop its claims against CombiMatrix and Dr. Montgomery that include certain causes of action relating to U.S. patent Nos. 6,093,302 and 6,280,595 (the "patented technology") that were assigned by Dr. Montgomery, an ex-Nanogen employee, to CombiMatrix in 1995 and assertions relating to other matters. In exchange, CombiMatrix agreed to pay $1.0 million as a reimbursement of legal costs; issue 4,016,346 shares of CombiMatrix common stock, which represents seventeen and one-half percent (17.5%) of its outstanding common stock; and make royalty payments of twelve and one-half percent (12.5%) on sales of products by either CombiMatrix or its affiliates that incorporate the patented technology. Also, as part of the settlement agreement, CombiMatrix and Dr. Montgomery agreed to drop their counterclaims against Nanogen and CombiMatrix retained sole ownership of the patented technology. Additionally, because CombiMatrix is a wholly owned subsidiary of Acacia Research Corporations and a market value for the CombiMatrix stock could not be determined, the Company has deferred recognizing the value of its 4,016,346 shares of CombiMatrix common stock until the value of the stock can be more readily determined. Acacia Research Corporation has announced a Special Meeting of Stockholders to be held on December 11, 2002 at which shareholders will vote on a measure to recapitalize Acacia's stock into two new classes "New CombiMatrix" stock, that would reflect the performance of its subsidiary CombiMatrix Corporation, and new "Acacia Technologies" stock. If the plan is approved, Nanogen, as a holder of old CombiMatrix stock, would receive shares of the New CombiMatrix tracking stock, and CombiMatrix has agreed to attempt to register such shares on the Nasdaq National Market or another market. It is Nanogen's intention to value the shares received under this settlement agreement based upon the value they are traded at when the new shares are traded separately on the Nasdaq National Market or another market.

Costs for litigation and settlement of patent matters are shown net of the settlement payment due Nanogen. Costs associated with the litigation and settlement of the CombiMatrix and Dr. Montgomery litigation patent matter totaled approximately $337,000 and $1.1 million for the three and nine months ended September 30, 2002, respectively, excluding the settlement receivable of $1.0 million from CombiMatrix and a credit of $300,000 from outside counsel. As of September 30, 2002, a receivable totaling $1.3 million has been recorded in the Company's financial statements.

7. Stock Transaction

In July 2002, the Compensation Committee of the Board of Directors ("the Compensation Committee") approved the issuance of employee retention options for 969,500 shares of the Company's common stock. The options were issued to the Company's employees and the employees of the Company's subsidiary, Nanogen Europe B.V. pursuant to the Company's 1997 Stock Incentive Plan, as amended. Each incentive stock option grant will be 50% vested on January 1, 2003 and 50% will vest ratably over the period January 1, 2003 through July 26, 2004.

8. Subsequent Events

In October 2002, the Company reduced its workforce by approximately 10%. A one-time severance charge of approximately $300,000 will be recognized in the fourth quarter of fiscal 2002 related to this event.

In November 1997, Mr. Birndorf purchased 437,496 shares of Common Stock at $.90 per share. In connection with this purchase, the Company loaned approximately $394,000 to Mr. Birndorf at an interest rate of 6.01% per annum pursuant to a five-year full recourse promissory note. This note was secured by the shares purchased by Mr. Birndorf. In November 2002, Mr. Birndorf repaid this promissory note plus accrued interest by tendering to the Company 339,857 shares of common stock valued based on the closing price, as reported on the Nasdaq National Market, on the day the shares were tendered.

In November 2002, the Company announced that its Board of Directors had approved a stock repurchase program under which the Company may purchase up to an aggregate of ten percent (10%) of its outstanding common stock from time-to-time. Any purchases under the stock repurchase program may be made by the Company through its broker in the open market or in privately negotiated transactions and may be initiated and discontinued at any time.

9. Related Party Transactions

In November 1998, the Company entered into a Standstill Agreement and Right of First Negotiation (the "Agreement") with Graviton, Inc. ("Graviton"), granting the Company an exclusive period of time to negotiate a license to certain technologies licensed to and/or developed by Graviton. In exchange for the Agreement, the Company advanced to Graviton through a secured loan the sum of $500,000. In May 1999, the Company advanced to Graviton through a secured loan an additional $500,000, the proceeds of which were to be used by Graviton in part to secure additional intellectual property rights which the Company could license. In December 1999, the Company entered into a Collaboration and License Agreement with Graviton. Pursuant to this agreement, the total loans of $1.0 million, plus accrued interest, were exchanged for a warrant for 23,076 shares of Graviton Series B Preferred Stock with a per share exercise price of $1.00 and two technology licenses to certain intellectual property licenses provided to Graviton by third parties. The Company recognized the value of such licenses as "acquired technology rights" in the accompanying consolidated balance sheets that totaled approximately $603,000 as of December 31, 2001.

In July 2002, the Company entered into an agreement with Graviton, Inc. to terminate and release ("the July 2002 Release") Nanogen and Graviton of their obligations under the Collaboration and License Agreement dated December 15, 1999. The Company received compensation from Graviton for termination of this arrangement in the form of 50,000 shares of Graviton Series D-Prime Preferred Stock and a waiver of the exercise price of $1.00 per share for a warrant to purchase 23,076 shares of Graviton Series B Preferred Stock, which was exercised in July 2002.

In September 2002, Graviton commenced a recapitalization and a new round of financing. In exchange for Nanogen's consent for the recapitalization and new round of financing, Graviton also issued to Nanogen a ten year warrant to purchase 440,000 shares of Series 1 Preferred Stock at a price of $2 per share, the price at which the September 2002 financing was completed. As Graviton is privately-held and currently does not maintain a market for its stock, the fair value of these securities could not be determined. As a result of the termination of the collaboration agreement, the Company recorded a loss of approximately $452,000 (the remaining carrying value of the acquired technology rights obtained in 1999) fo