

LYNX THERAPEUTICS INC

Form 10-Q

November 15, 2004

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

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

for the quarterly period ended September 30, 2004

OR

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

for the transition period from _____ to _____

Commission File Number 0-22570

Lynx Therapeutics, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

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

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

(510) 670-9300
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant, (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

The number of shares of common stock outstanding as of November 5, 2004 was 7,527,538.

Lynx Therapeutics, Inc.

FORM 10-Q
For the Quarter Ended September 30, 2004
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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Lynx Therapeutics, Inc.****CONDENSED CONSOLIDATED BALANCE SHEETS***(In thousands)**(Unaudited)*

	September 30, 2004	December 31, 2003
	(unaudited)	(*)
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,625	\$ 4,881
Restricted cash	73	728
Accounts receivable	733	402
Inventory	965	904
Other current assets	326	722
	<hr/>	<hr/>
Total current assets	3,722	7,637
Property and equipment:		
Leasehold improvements	7,667	11,510
Laboratory and other equipment	20,376	21,667
	<hr/>	<hr/>
	28,043	33,177
Less accumulated depreciation and amortization	(19,650)	(22,190)
	<hr/>	<hr/>
Net property and equipment	8,393	10,987
Intangible assets, net	2,327	-
Other non-current assets	256	172
	<hr/>	<hr/>
	\$ 14,698	\$ 18,796
	<hr/>	<hr/>
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 884	\$ 1,070
Accrued compensation	359	284
Accrued professional fees	718	181
Deferred revenue - current portion	759	759
Note payable - current portion	197	1,128

Other accrued liabilities	94	163
	<u> </u>	<u> </u>
Total current liabilities	3,011	3,585
Deferred revenues	4,437	4,213
Other non-current liabilities	907	932
Note payable to Solexa	2,000	-
Stockholders' equity:		
Common stock	124,100	117,722
Accumulated other comprehensive income	17	17
Accumulated deficit	(119,774)	(107,673)
	<u> </u>	<u> </u>
Total stockholders' equity	4,343	10,066
	<u> </u>	<u> </u>
	\$ 14,698	\$ 18,796
	<u> </u>	<u> </u>

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

See accompanying notes.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net revenues:				
Technology access and service fees	\$ 1,322	\$7,046	\$ 3,948	\$14,233
License fees from related party	190	190	570	570
Collaborative research and other	39	1,036	117	1,318
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total revenues	<u>1,551</u>	<u>8,272</u>	<u>4,635</u>	<u>16,121</u>
Operating costs and expenses:				
Service fees and other	1,215	1,518	3,885	3,619
Research and development	2,333	2,988	7,397	9,749
General and administrative	2,300	1,325	5,387	5,003
Special charge for workforce reduction			118	292
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total operating costs and expenses	<u>5,848</u>	<u>5,831</u>	<u>16,787</u>	<u>18,663</u>
Income (loss) from operations	(4,297)	2,441	(12,152)	(2,542)
Equity in net income (loss) of related party		17		(1,699)
Interest income (expense), net	(17)	(5)	(38)	(133)
Other income (expense), net	46	(440)	90	(440)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Income (loss) before provision for income taxes	(4,268)	2,013	(12,100)	(4,814)
Provision for income taxes		200	1	202
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net income (loss)	<u>\$ (4,268)</u>	<u>\$ 1,813</u>	<u>\$ (12,101)</u>	<u>\$ (5,016)</u>
Basic net income (loss) per share	<u>\$ (0.57)</u>	<u>\$ 0.39</u>	<u>\$ (1.70)</u>	<u>\$ (1.07)</u>
Diluted net income (loss) per share	<u>\$ (0.57)</u>	<u>\$ 0.38</u>	<u>\$ (1.70)</u>	<u>\$ (1.07)</u>

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Shares used to compute basic net income (loss) per share	<u>7,528</u>	<u>4,703</u>	<u>7,125</u>	<u>4,670</u>
Shares used to compute diluted net income (loss) per share	<u>7,528</u>	<u>4,815</u>	<u>7,125</u>	<u>4,670</u>

See accompanying notes.

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

	Nine Months Ended September 30,	
	2004	2003
Cash flows from operating activities:		
Net loss	\$(12,101)	\$ (5,016)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,766	2,672
Stock based compensation expense	3	9
Common stock issued in connection with acquisition of supplies	70	
Equity in net loss of related party		1,699
Loss (gain) on disposal of fixed assets	(110)	381
Cost of instruments sold		711
Changes in operating assets and liabilities:		
Accounts receivable	(331)	486
Inventory	(61)	125
Other current assets	396	135
Accounts payable	(186)	105
Other accrued liabilities	543	(183)
Deferred revenues	224	(7,156)
Other assets	(84)	
Non-current liabilities	(25)	(19)
	<hr/>	<hr/>
Net cash used in operating activities	(8,896)	(6,051)
	<hr/>	<hr/>
Cash flows from investing activities:		
Purchase of short-term investments	(916)	
Maturity of short-term investments	916	
Purchases of property and equipment	(15)	(584)
Proceeds from sale of equipment	110	136
	<hr/>	<hr/>
Net cash provided by (used in) investing activities	95	(448)
	<hr/>	<hr/>
Cash flows from financing activities:		
Issuance of common stock, net of repurchases	3,821	2,894
Proceeds from Solexa loan	2,000	
Repayment of equipment loans	(931)	(1,772)

Net cash provided by financing activities	4,890	1,122
Net decrease in cash and cash equivalents	(3,911)	(5,377)
Cash and cash equivalents at beginning of period	5,609	11,735
Cash and cash equivalents at end of period	\$ 1,698	\$ 6,358
Supplemental cash flow information:		
Cash paid during the period for income taxes	\$ 1	\$ 202
Cash paid during the period for interest	\$ 41	\$ 177
Supplemental schedule of non-cash investing activities:		
Common stock issued in connection with the acquisition of intellectual property and equipment	\$ 2,554	\$

See accompanying notes.

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Lynx Therapeutics, Inc.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004

1. Nature of Business

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

On September 28, 2004, Lynx announced that it had entered into a definitive agreement with Solexa Limited, a United Kingdom company, or Solexa. Solexa is a privately held company that develops systems for the comprehensive and economical analysis of individual genomes. The transaction is subject to customary conditions of closing, including approval by the Lynx stockholders and acceptance of the offer by the Solexa shareholders. (See Note 8)

2. Basis of Presentation

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

Our unaudited condensed consolidated financial statements have been presented on a basis that contemplates the realization of assets and satisfaction of liabilities in the normal course of business. We have experienced losses since our inception, including a net loss for the nine months ended September 30, 2004. We expect to continue to incur net losses as we proceed with the commercialization and additional development of our technologies. The size of these losses will depend on the rate of growth, if any, in our revenues and on the level of our expenses. Our cash and cash equivalents have decreased from the \$5.6 million, including \$0.7 million of restricted cash, as of December 31, 2003. As of September 30, 2004, our cash and cash equivalents consisted of \$1.6 million in unrestricted cash and cash equivalents and restricted cash of \$0.1 million. We will require additional funding to continue our business activities through at least December 31, 2005. We are considering various options, which include securing additional equity financing, obtaining new collaborators and customers and other strategic actions. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. There can be no assurance that additional financing will be available on satisfactory terms, or at all. If we are unable to secure additional financing on reasonable terms, or are unable to generate sufficient new sources of revenue through

arrangements with customers, collaborators and licensees, we will be forced to take substantial restructuring actions, which may include significantly reducing our anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds by entering into financing or collaborative agreements on unattractive terms, or we will not be able to fund operations. The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern. The financial statements do not include any

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adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the matters discussed above.

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

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

3. Summary of Significant Accounting Policies**Revenue Recognition**

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

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

Inventory

Inventory is stated at the lower of cost (which approximates first-in, first-out cost) or market. The balances at September 30, 2004 and December 31, 2003 were classified as raw materials and work in process. The raw material inventories consist primarily of reagents and other chemicals utilized while performing genomics discovery services and work in process consists of accumulated cost of experiments not completed. Inventory used in providing genomics discovery services and for reagent sales is charged to cost of service fees and other as consumed. Reagents and chemicals purchased for internal development purposes are charged to research and development expense upon receipt or as consumed.

Inventory consisted of the following (in thousands):

	September 30, 2004	December 31, 2003
Raw materials	\$ 433	\$ 859
Work in process - MPSS	532	45

—	—
\$ 965	\$ 904
—	—

Net Loss Per Share

Basic net income (loss) per share has been computed using the weighted-average number of shares of common stock outstanding during the period. Basic and diluted net loss per share amounts are the same for each period in which we have incurred a net loss. At September 30, 2004, options to purchase approximately 550,000 shares of common stock at a weighted-average exercise price of \$25.82 per share and warrants to purchase approximately

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1,544,000 shares of common stock at exercise prices ranging from \$6.12 to \$39.76 per share, were excluded from the calculation of diluted loss per share for the 2004 periods because the effect of inclusion would be antidilutive. The options and warrants will be included in the calculation at such time as the effect is no longer antidilutive, as calculated using the treasury stock method.

At September 30, 2003, due to our net income for the three months ended September 30, 2003, options to purchase approximately 238,000 shares of common stock at a weighted-average exercise price of \$2.12 were included in the calculation of diluted net income per share which resulted in approximately 112,000 shares of common stock, calculated using the treasury stock method, being added to the weighted-average number of shares of common stock outstanding during the period to determine the number of shares used to compute diluted net earnings per share. Options to purchase approximately 291,300 shares of common stock at a weighted average exercise price of \$70.58 per share and warrants to purchase approximately 1,163,000 shares of common stock at exercise prices ranging from \$9.91 to \$39.76 per share were excluded from the calculation of diluted net income per share for the third quarter of 2003 because the effect of inclusion would be antidilutive. All outstanding options and warrants were excluded from the calculation of diluted net loss per share for the nine months ended September 30, 2003 because the effect of inclusion would be antidilutive. These remaining options and warrants will be included in the calculation at such time as the effect is no longer antidilutive, as calculated using the treasury stock method.

Stock-Based Compensation

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

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

Pro forma information regarding net loss and net loss per share required by SFAS 123, as amended by SFAS 148, is presented below and has been determined as if the Company had accounted for awards under its stock option and employee stock purchase plans using the fair value method:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income (loss), as reported	\$(4,268)	\$1,813	\$(12,101)	\$(5,016)
Add: Stock-based employee compensation as reported				9
Deduct: Stock-based employee compensation as if fair value method applied to all awards	(414)	(675)	(1,358)	(1,793)
	\$(4,682)	\$1,138	\$(13,459)	\$(6,800)

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Net income (loss), pro forma as if fair value method applied to all awards

	_____	_____	_____	_____
Basic net income (loss) per share, as reported	\$ (0.57)	\$ 0.39	\$ (1.70)	\$ (1.07)
	_____	_____	_____	_____
Basic net income (loss) per share, pro forma as if fair value method applied to all awards	\$ (0.62)	\$ 0.24	\$ (1.89)	\$ (1.46)
	_____	_____	_____	_____
Diluted net income (loss) per share, as reported	\$ (0.57)	\$ 0.38	\$ (1.70)	\$ (1.07)
	_____	_____	_____	_____
Diluted net income (loss) per share, pro forma as if fair value method applied to all awards	\$ (0.62)	\$ 0.24	\$ (1.89)	\$ (1.46)
	_____	_____	_____	_____

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

	Three Months Ended September 30,	
	2004	2003
Net income (loss)	\$ (4,268)	\$ 1,813
Currency translation	1	
Comprehensive income (loss)	\$ (4,267)	\$ 1,813

For the nine-month periods ended September 30, 2004 and 2003, the comprehensive loss equaled the net loss.

5. Related-Party Transactions*Axaron Bioscience AG*

We hold an equity investment in Axaron Bioscience AG, or Axaron, a company owned primarily by BASF AG and us. As of September 30, 2004, we held approximately a 42% ownership interest in Axaron and had the ability to exercise significant influence over Axaron's operating and accounting policies. We initially accounted for our investment in Axaron using the equity method in accordance with APB 18. Under the equity method, we recorded our pro-rata share of the income or losses of Axaron. We discontinued applying the equity method as of December 31, 2003, as our investment in Axaron has been reduced to zero.

In 2001, we extended our technology licensing agreement with Axaron. The license extends Axaron's right to use our proprietary MPSS and Megasort technologies non-exclusively in Axaron's neuroscience, toxicology and microbiology programs until December 31, 2007. We received from Axaron a \$5.0 million technology license fee, which was recorded as deferred revenue and is being recognized on a straight-line basis over the noncancelable term of the agreement. The recorded revenue for the three-month and nine-month period ended September 30, 2004 was \$190,000 and \$570,000, respectively. The recorded revenue for the three-month and nine-month period ended September 30, 2003 was \$190,000 and \$570,000, respectively. In accordance with APB 18, we have discontinued applying the equity method as our investment in Axaron has been reduced to zero and no pro-rata share of Axaron losses has been reflected in the Condensed Consolidated Statement of Operations for the three months and nine months ended September 30, 2004. Our pro-rata share of Axaron's losses for the three-month and nine-month periods ended September 30, 2003 was approximately \$0.9 million and \$1.7 million, respectively.

We also subleased certain offices in Germany to Axaron. During 2003, the Company received an immaterial amount of sublease income from Axaron. The sublease terminated on December 31, 2003.

Other Transactions with Related Parties

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For legal services, Lynx paid approximately \$106,000 during the quarter ended September 30, 2004 and approximately \$290,000 during the nine months ended September 30, 2004 to Cooley Godward LLP, Lynx's counsel. A partner of Cooley Godward LLP is a director of Lynx. At September 30, 2004, Lynx had an outstanding liability to Cooley Godward LLP of approximately \$238,000. At December 31, 2003, Lynx had an outstanding liability to Cooley Godward LLP of approximately \$55,000.

During the three month period ended September 30, 2004, Lynx did not perform genomics discovery services for the Institute for Systems Biology. During the nine month period ended September 2004 Lynx received \$60,000 for genomics discovery services performed. The President and Director of the Institute for Systems Biology is a director of Lynx.

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In June 2001, Lynx entered into a consulting agreement with Dr. Sydney Brenner, a director of the Company. Pursuant to the agreement, Dr. Brenner may perform consulting services of at least eight to 16 hours per month in consideration of his standard consulting fee. During the three and nine months ended September 30, 2004 and September 30, 2003, Dr. Brenner received no consulting fees under this agreement.

6. Restructuring Charges

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

7. Common Stock

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

8. Transactions with Solexa

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

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

In October 2004, pursuant to the terms of a loan agreement dated August 12, 2004, Lynx and Solexa entered into a deed to amend the technology sharing agreement. Under the terms of the deed, in the event that the first closing of the proposed combination with Solexa does not take place and the transaction is, therefore, not completed, Lynx has agreed to transfer its right, title and interest in the cluster technology to Solexa in consideration for the grant of a worldwide, perpetual and non-exclusive license of the cluster technology.

On August 12, 2004, Lynx and Solexa entered into a loan agreement pursuant to which Lynx issued Solexa four promissory notes each bearing an interest rate of 10% in the aggregate principal amount of \$2,500,000. Under the loan agreement and as a result of the issuance of the promissory notes, certain royalty rates contained in the technology

sharing agreement were reduced and Lynx was obligated to make certain instruments available to Solexa.

On September 28, 2004, Lynx announced that it had entered into a definitive agreement with Solexa, under which, for accounting purposes, Solexa will acquire Lynx. Solexa is a privately held company that develops

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systems for the comprehensive and economical analysis of individual genomes. Under the acquisition agreement, Lynx will issue up to 29.5 million shares or options to purchase shares of its common stock in exchange for all of the outstanding share capital and outstanding share options of Solexa. The transaction is subject to customary conditions of closing, including approval by the Lynx stockholders and acceptance of the offer by the Solexa shareholders.

In connection with the acquisition agreement, the directors and the executive officers and major shareholders of Solexa who are registered holders of approximately 90% of the outstanding shares of Solexa's share capital entered into support agreements with Lynx, pursuant to which they agreed to exchange their shares of Solexa capital stock for Lynx common stock in connection with the transaction. In addition, certain directors and executive officers of Lynx entered into support agreements with Solexa, pursuant to which they agreed to approve the transaction and the issuance of shares of Lynx common stock to the Solexa shareholders in connection with the combination.

In October 2004, Lynx signed an original equipment manufacturer development agreement with Solexa whereby Solexa will provide additional funding to Lynx to accelerate development of the next generation DNA sequencing instruments.

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

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

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

Overview

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

We have incurred net losses each year since our inception in 1992. As of September 30, 2004, we had an accumulated deficit of approximately \$119.8 million. We have experienced losses since our inception, including a net loss for the nine months ended September 30, 2004. We expect to continue to incur net losses as we proceed with the commercialization and additional development of our technologies. The size of these losses will depend on the rate of growth, if any, in our revenues and on the level of our expenses. Our cash and cash equivalents have decreased from the \$5.6 million, including \$0.7 million of restricted cash, as of December 31, 2003. As of September 30, 2004, our cash and cash equivalents consisted of \$1.6 million in unrestricted cash and investments and restricted cash of \$0.1 million. We will require additional funding to continue our business activities through at least December 31, 2005. We are considering various options, which include securing additional equity financing, obtaining new collaborators and customers and other strategic actions. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. There can be no assurance that additional financing will be available on satisfactory terms, or at all. If we are unable to secure additional financing on reasonable terms, or are unable to generate sufficient new sources of revenue through arrangements with customers, collaborators and licensees, we will be forced to take substantial restructuring actions, which may include significantly reducing our anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds by entering into financing or collaborative agreements on unattractive terms, or we will not be able to fund operations. The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the matters discussed above.

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

	Nine Months Ended		Year Ended December 31,
	September 30,		2003
	2004	2003	2003
Takara Bio Inc.	2%	43%	39%
E.I. DuPont de Nemours and Company	49%	24%	28%
BASF AG	12%	16%	14%
Bayer CropScience		5%	4%
National Human Genome Research Institute	15%		

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

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

We initially accounted for our investment in Axaron, using the equity method. In accordance with APB 18, we have discontinued applying the equity method as of December 31, 2003, as our investment in Axaron has been reduced to zero.

As of September 30, 2004, we employed 78 full-time employees, of which 65 were engaged in production and research and development activities. In March 2004, we implemented a reduction of approximately 15% of our total workforce, or 14 people. The reduction included positions in all functions of our business. The workforce reduction is intended to further focus our financial and human resources on expanding the commercial use of our technology.

On September 28, 2004, we announced that we had entered into a definitive agreement with Solexa, under which, for accounting purposes, Solexa will acquire Lynx. Solexa is a privately held company that develops systems for the comprehensive and economical analysis of individual genomes. Under the agreement, we will issue up to 29.5 million shares of common stock in exchange for all of the outstanding share capital and outstanding share options of Solexa.

The transaction is subject to customary conditions of closing, including approval by our stockholders and acceptance of the offer by the Solexa shareholders.

On August 12, 2004 we entered into a loan agreement with Solexa whereby Solexa agreed to loan us an aggregate principal amount of up to \$2.5 million. At September 30, 2004, we had received \$2.0 million under the loan agreement and in October 2004 received the remaining \$0.5 million.

On April 14, 2004, we closed a transaction with Solexa to jointly acquire from Manteia the rights to proprietary technology assets for DNA colony generation. We issued and delivered to Manteia 540,058 shares of our common stock for a value representing fifty percent of the purchase price. The acquired technology assets feature a process to enable parallel amplification of millions of DNA fragments, each from a single DNA molecule, to create DNA

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colonies or clusters. The clusters are dense collections of DNA molecules on a surface, which should enable fast and simplified preparation of the biological sample for analysis and allow reduced reagent consumption as a result of the highly parallel nature of the analysis.

We have entered into a technology sharing agreement with Solexa, dated as of March 22, 2004, for the purpose of managing the ownership and development of the assets acquired from Manteia. On October 25, 2004, Lynx and Solexa entered into a deed to amend the technology sharing agreement. Under the terms of the deed and pursuant to the terms of a loan agreement dated August 12, 2004, in the event that the first closing of the proposed combination with Solexa does not take place and the transaction is, therefore, not completed, Lynx shall transfer its right, title and interest in the cluster technology to Solexa in consideration for the grant of a worldwide, perpetual and non-exclusive license of the cluster technology.

Results of Operations

Revenues

Revenues for the three-month period ended September 30, 2004 were approximately \$1.6 million, compared to revenues of \$8.3 million for the corresponding three-month period of 2003. Revenues for the three-month period in 2004 included technology access and service fees of \$1.3 million, license fees from Axaron, a related party, of \$190,000 and other revenues of \$39,000. Revenues for the three-month period in 2003 included technology access and service fees of \$7.0 million, license fees from Axaron of \$190,000 and other revenues of \$1.0 million.

Revenues for the nine months ended September 30, 2004 were approximately \$4.6 million, compared to revenues of \$16.1 million for the corresponding nine-month period of 2003. Revenues for the nine-month period in 2004 included technology access and service fees of \$3.9 million, license fees from Axaron of \$570,000 and other revenues of \$117,000. Revenues for the nine-month period in 2003 included technology access and service fees of \$14.2 million, license fees from Axaron of \$570,000 and other revenues of \$1.3 million.

The decrease in technology access and service fees revenues in 2004 compared to 2003 was due to full recognition of previously deferred technology access fee revenue of \$7.0 million in 2003, for which there was no corresponding amount in 2004, and a decrease in fees charged per MPSS experiment. The decrease in other revenues for 2004 compared to 2003 was due to the sale of MPSS instruments to Takara in 2003 for which there was no corresponding amount in 2004. The instrument sales were related to an amendment of the existing collaboration agreement between Lynx and Takara.

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

Operating Costs and Expenses

Total operating costs and expenses were approximately \$5.8 million for the three-month period ended September 30, 2004, compared to approximately \$5.8 million for the three-month period ended September 30, 2003. For the nine-month periods ended September 30, 2004 and 2003, operating costs and expenses were approximately \$16.8 million and \$18.7 million, respectively.

Cost of service fees and other reflect primarily the costs of providing our genomics discovery services. For the three-month period in 2004, cost of service fees and other was \$1.2 million, compared to \$1.5 million for the corresponding period in 2003. The decrease in cost of service fees and other for the quarter ended September 30, 2004 was due to lower quarterly costs in two of the main production processes partially offset by organizational changes discussed below. Cost of service fees and other for the nine-months ended September 30, 2004 and 2003 were \$3.9 million and \$3.6 million, respectively. The increase in cost of service fees for the nine-month period in

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2004 reflects our organizational changes where proportionally more overhead was allocated to the services group than in the past, and an increase in depreciation from the implementation of new production equipment.

Research and development expenses were approximately \$2.3 million for the three-month period ended September 30, 2004, compared to approximately \$3.0 million for the corresponding period in 2003. For the nine-month periods ended September 30, 2004 and 2003, research and development expenses were approximately \$7.4 million and \$9.7 million, respectively. In April 2004, Lynx reorganized its staff to focus on the development of the cluster technology, its integration with Lynx's proprietary sequencing technology and creation of a plan for commercial launch of the new technology. The decrease in research and development expenses in 2004 reflects a decrease in materials consumed in research and development efforts and lower personnel expenses, primarily resulting from the workforce reduction that occurred in the first quarter of 2004, partially offset by the increased efforts related to the new cluster technology. Research and development expenses may increase due to spending for ongoing technology development and implementation, as well as new applications, primarily for our technology.

General and administrative expenses were \$2.3 million for the three-month period ended September 30, 2004, compared to \$1.3 million for the corresponding period in 2003. For the nine-month periods ended September 30, 2004 and 2003, general and administrative expenses were approximately \$5.4 million and \$5.0 million, respectively. The increase in general and administrative expenses in 2004 as compared to 2003 is primarily due to costs associated with the proposed merger between Lynx and Solexa. As of September 30, 2004, Lynx has incurred approximately \$777,000 in merger-related expenses. General and administrative expenses may increase in support of our continuing commercial, business development and research and development activities.

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

Equity in Net Loss of Related Party

The equity share of loss of related party for the three-month and nine-month periods ended September 30, 2004 was zero dollars, respectively. The equity share of net income for the three-month period ended September 30, 2003 was approximately \$17,000 and the equity share of net loss of related party for the nine-month period ended September 30, 2003 was approximately \$1.7 million, and reflects Lynx's pro-rata share of the net loss of Axaron, a joint venture investee. As of December 31, 2003, Lynx's investment in Axaron was reduced to zero and Lynx ceased recording its pro rata share of Axaron's net losses.

Interest Expense, Net

Net interest expense consists primarily of interest expense on outstanding equipment-related debt and interest accrued on the Solexa loan for the three months ended September 30, 2004. Net interest expense was approximately \$17,000 for the quarter ended September 30, 2004, compared to net interest expense of approximately \$5,000 for the corresponding period of 2003. The increase in net interest expense from 2003 to 2004 reflects interest accrued on the Solexa loan, offset by lower outstanding balances on equipment debt. Net interest expense was approximately \$38,000 for the nine months ended September 30, 2004, compared to net interest expense of approximately \$133,000 for the corresponding period of 2003. The lower equipment-related debt balances in the nine-month period ended September 30, 2004 resulted in lower interest expense.

Other Income (Expense), Net

Other income was \$46,000 in the quarter ended September 30, 2004, compared to other expense of \$440,000 in the 2003 period. Other income was \$90,000 for the nine months ended September 30, 2004, compared to other expense of \$440,000 in the 2003 period. The income was related to asset sales offset by Lynx GmbH closure

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expenses. The other expense amount for the 2003 periods related primarily to the loss recorded on the sale of certain fixed assets no longer used in the operations at Lynx GmbH.

Income Tax Provision

The provisions for income tax for the quarter and nine-months ended September 30, 2004 of zero dollars and \$1,000, respectively, consisted entirely of state withholding tax. The provisions for income tax for the quarter and nine-months ended September 30, 2003 of approximately \$200,000 and \$202,000, respectively, consisted primarily of foreign withholding tax on payments received from our licensee, Takara.

Liquidity and Capital Resources

Cash and cash equivalents have decreased from the \$5.6 million, including \$0.7 million of restricted cash, as of December 31, 2003. As of September 30, 2004, our cash and cash equivalents consisted of \$1.6 million in unrestricted cash and investments and restricted cash of \$0.1 million. Net cash used in operating activities was \$8.9 million for the nine months ended September 30, 2004, as compared to \$6.1 million for the same period in 2003. The change was due primarily to a higher net loss in 2004 and an increase in accounts receivable, offset by no related party loss in 2004, and a decrease in deferred revenue in 2003. The amount of net cash used in operating activities differed from the 2004 net loss primarily due to depreciation and amortization expenses offset by an increase in accounts receivable. The amount of net cash used in operating activities differed from the 2003 net loss primarily due to depreciation and amortization expenses, and the impact of our pro-rata share of the net loss of Axaron, offset by a decrease in deferred revenues.

Net cash provided by investing activities of \$95,000 for the nine-month period of 2004, was primarily due to proceeds from the sale of assets. Net cash used by investing activities of \$0.4 million for the nine-month period of 2003 was due to expenditures for capital equipment.

Net cash provided by financing activities of \$5.0 million in the nine months ended September 30, 2004 was due to the issuance of common stock pursuant to a securities purchase agreement between Lynx and certain investors and proceeds from the Solexa loans offset by the repayment of principal on equipment-related debt. Net cash provided by financing activities of \$1.1 million for the nine months ended September 30, 2003 was due primarily to the issuance of common stock pursuant to a common stock purchase agreement between Lynx and certain investors offset by the repayment of principal on equipment-related debt.

On August 12, 2004, Lynx and Solexa entered into a loan agreement pursuant to which Lynx issued Solexa four promissory notes each bearing an interest rate of 10% in the aggregate principal amount of \$2,500,000. Under the loan agreement and as a result of the issuance of the promissory notes, certain royalty rates contained in the technology sharing agreement were reduced and Lynx was obligated to make certain instruments available to Solexa.

On September 28, 2004, Lynx and Solexa entered into an agreement regarding the loan agreement pursuant to which they agreed that, should the acquisition agreement be terminated prior to consummation of the proposed combination of Lynx and Solexa, among other things, the royalty rates in the technology sharing agreement shall be reduced or eliminated depending on the cause of the termination of the acquisition agreement. The entire outstanding principal and accrued interest thereon will be payable on the earlier of (i) an event of default under the promissory notes, (ii) the first anniversary of the expiration of the exclusivity period provided for in the letter agreement between Lynx and Solexa, (iii) the first anniversary of the date on which the acquisition agreement shall have been terminated prior to the consummation of the transaction, or (iv) December 31, 2005.

In October 2002, we entered into a loan and security agreement with a financial institution, Comerica Bank-California, for an equipment line of credit of up to \$2.0 million with a drawdown period of one year. Under the initial advance, we drew down \$1.6 million in November 2002 related to the purchase of equipment made in previous periods. We granted Comerica Bank-California a security interest in all items we financed under this agreement. The initial advance under the loan to finance the purchase of equipment made in previous periods has a

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term of 24 months from the date of advance and bears interest at a rate of 7.25%. In May 2003, we renegotiated the terms of the agreement, which now require that we maintain a minimum cash balance of restricted cash and cash equivalents in an account at Comerica Bank-California of at least 110% of the principal balance under loans outstanding under this agreement until Comerica Bank-California receives payment in full of all outstanding obligations. As of September 30, 2004, the balance of restricted cash was approximately \$0.1 million and the principal balance of loans outstanding under this agreement was approximately \$66,200. In October 2004, the loan and security agreement was paid in full and all restrictions on our cash were removed.

In late 1998, we entered into a financing agreement with a financial institution, Transamerica Business Credit Corporation, now known as GE Healthcare Financial Services, under which we drew down \$4.8 million during 1999 for the purchase of equipment and certain other capital expenditures. In September 2000, Lynx obtained additional financing of approximately \$1.0 million under an amendment to the original financing agreement. We granted the lender a security interest in all items financed by it under this agreement. Each draw-down under the loan has a term of 48 months from the date of the draw-down. The draw-down period under the agreement expired on June 30, 2000. As of September 30, 2004, the principal balance of loans outstanding under this agreement was \$94,100. In October 2004, the loan and financing agreement was paid in full.

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

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

We have incurred net losses each year since our inception in 1992. As of September 30, 2004, we had an accumulated deficit of \$119.8 million. We expect net losses will continue for at least the next several years as we proceed with the commercialization and additional development of our technologies. The presence and size of these potential net losses will depend, in part, on the rate of growth, if any, in our revenues and on the level of our expenses.

We will require additional funding to continue our business activities through at least December 31, 2005. As a result, the report of Ernst & Young LLP regarding our consolidated financial statements for the year ended December 31, 2003, included in our annual report on Form 10-K, as amended, includes an explanatory paragraph concerning our ability to continue as a going concern. We are considering various options, which include securing additional equity financing, obtaining new collaborators and customers and other strategic actions. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. There can be no assurance that additional financing will be available on satisfactory terms, or at all. If we are unable to secure additional financing on reasonable terms, or are unable to generate sufficient new sources of revenue through arrangements with customers, collaborators and licensees, we will be forced to take substantial restructuring actions,

which may include significantly reducing our anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds by entering into financing or collaborative agreements on unattractive terms, or we will not be able to fund operations. The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern. The financial statements

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do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the matters discussed above.

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

Lynx will incur substantial costs related to the proposed merger transaction with Solexa whether or not the transaction is completed. These costs include fees for financial advisors, attorneys and accountants, filing fees, stamp duty and financial printing costs. Lynx currently expects to incur approximately \$2.8 million in costs, approximately \$1.2 million of which are not contingent on the completion of the transaction.

Additional Business Risks

Our business faces significant risks. These risks include those described below and may include additional risks of which we are not currently aware or which we currently do not believe are material. If any of the events or circumstances described in the following risks actually occurs, our business, financial condition or results of operations could be materially adversely affected. These risks should be read in conjunction with the other information set forth in or incorporated by reference into this report, including the risks discussed in the Registration Statement on Form S-4 (File No. 333-120101) under Risks Relating to the Transaction, which are incorporated herein by reference.

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

We have incurred net losses each year since our inception in 1992, including a net loss for the nine months ended September 30, 2004. As of December 31, 2003, we had an accumulated deficit of approximately \$107.7 million. Net losses may continue for at least the next several years as we proceed with the commercialization and additional development of our technologies. The presence and size of these potential net losses will depend, in part, on the rate of growth, if any, in our revenues and on the level of our expenses. Our research and development expenditures and general and administrative costs have exceeded our revenues to date. Research and development expenses may increase due to spending for ongoing technology development and implementation, as well as new applications. We will need to generate significant additional revenues to achieve profitability. Even if we do increase our revenues and achieve profitability, we may not be able to sustain profitability.

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

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

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

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

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

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

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

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

the progress and scope of our research and development projects;

payments received under our customer, license and collaborative agreements;

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

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

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

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

We have experienced losses since our inception, including a net loss for the nine months ended September 30, 2004. We expect to continue to incur net losses as we proceed with the commercialization and additional development of our technologies. The size of these losses will depend on the rate of growth, if any, in our revenues and on the level of our expenses. Our cash and cash equivalents have decreased from the \$5.6 million, including \$0.7 million of restricted cash, as of December 31, 2003. As of September 30, 2004, our cash and cash equivalents consisted of \$1.6 million in unrestricted cash and investments and restricted cash of \$0.1 million. We will require additional funding to continue our business activities through at least December 31, 2005. We are considering various options, which include securing additional equity financing obtaining new collaborators and customers and other strategic actions. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. If we require additional financing, there can be no assurance that it will be available on satisfactory terms, or at all. If we are unable to secure additional financing on reasonable terms, or are unable to generate sufficient new sources of revenue through arrangements with customers, collaborators and licensees, we will be forced to take substantial restructuring actions, which may include significantly reducing our anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds by entering into financing or collaborative agreements on unattractive terms, or we will not be able to fund operations. The accompanying condensed consolidated financial statements have been prepared assuming that we will continue as a going concern. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the matters discussed above.

Lynx may not realize the benefits it expects from the proposed combination with Solexa.

The integration of Lynx and Solexa will be complex, time consuming and expensive, and may disrupt Lynx's business. The combined group will need to overcome significant challenges in order to realize any benefits or synergies from the transaction. These challenges include the timely, efficient and successful execution of a number of post-transaction events, including:

obtaining sufficient additional financing in order to execute the combined group's business plan;

integrating the operations and technologies of the two companies;

retaining and assimilating personnel of each company;

retaining existing customers and attracting additional service customers of Lynx;

attracting new customers for future equipment sales by the combined group; and

creating and implementing financial controls, procedures, policies, standards and information systems.

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The execution of these post-transaction events will involve considerable risks and may not be successful. These risks include:

the inability to obtain sufficient additional financing;

the potential disruption of the combined group's ongoing business and distraction of its management;

the potential strain on the combined group's financial and managerial controls and reporting systems and procedures;

unanticipated expenses and potential delays related to integration of the operations, technology and other resources of the two companies;

the impairment of relationships with employees, suppliers and customers as a result of any integration of new management personnel;

greater than anticipated costs and expenses related to the integration; and

potential unknown liabilities and costs associated with the transaction and the combined operations.

Lynx may not succeed in addressing these risks or any other problems encountered in connection with the transaction. The inability to successfully integrate the operations, technology and personnel of Lynx, or any significant delay in achieving integration, could have a material adverse effect on the combined group after the transaction and, as a result, on the market price of Lynx common stock.

The issuance of shares of Lynx common stock to Solexa shareholders in the proposed transaction will substantially reduce the percentage interests of Lynx stockholders.

If the transaction is completed, Lynx will issue, or otherwise allocate for issuance under options to acquire Lynx common stock, a total of 29.5 million shares of Lynx common stock pursuant to the terms of the offer and the option offer. Following the completion of the transaction, current Solexa shareholders will, upon issuance, own approximately 80% of the outstanding Lynx common stock, and current Lynx stockholders will own approximately 20% of the outstanding Lynx common stock. The issuance of 29.5 million shares of Lynx common stock will cause a significant reduction in the relative percentage interests of current Lynx stockholders in the earnings, voting, liquidation value, and book and market value of Lynx.

The issuance of shares of Lynx common stock in the financing proposed in our registration statement on Form S-4 will substantially reduce the percentage interests of Lynx stockholders and will substantially reduce the interests of Solexa stockholders in the combined group following the completion of the transaction.

If the financing proposed in our registration statement on Form S-4 (File No. 333-120101) is completed, Lynx will issue up to 10,000,000 shares of Lynx common stock (including shares issuable upon conversion or exercise of convertible debt or warrants convertible into or exercisable for Lynx common stock) pursuant to the terms of the proposed financing. The issuance of up to 10,000,000 shares of Lynx common stock (including shares issuable upon conversion or exercise of convertible debt or warrants convertible into or exercisable for Lynx common stock), if any, will cause a significant reduction in the relative percentage interests of current Lynx stockholders in the earnings, voting, liquidation and book and market value of Lynx.

The technologies of Lynx and Solexa are new and unproven for market acceptance.

While some of Lynx's gene expression technology has been commercialized and is currently in use, subsequent to the consummation of the proposed combination with Solexa, the combined group anticipates developing additional technologies which assume that information about gene expression and genomic sequences may enable scientists to better understand complex biological processes. The combined group's technologies also depend on the successful integration of Lynx's and Solexa's technologies, each of which has its own development risks.

In addition, the cluster technology acquired from Manteia is new and the combined group may not be able to successfully integrate it with its existing technologies. The sequence data generated with clusters may not be of the

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same quality as Lynx currently generates using beads, or the combined group may not be able to achieve the necessary yields to be cost competitive. The combined group may have difficulty integrating the cluster technology into a commercially available instrument. The timelines associated with the development of the cluster technology contain elements of risk and uncertainty and may therefore be extended. Any prolonged delay with the development effort could allow competing technologies to capture significant market share ahead of the combined group.

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

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

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

	Nine Months Ended		Year Ended December 31,
	September 30,		31,
	2004	2003	2003
Takara Bio Inc.	2%	43%	39%
E.I. DuPont de Nemours and Company	49%	24%	28%
BASF AG	12%	16%	14%
Bayer CropScience		5%	4%
National Human Genome Research Institute	15%		

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

Our dependence on collaborations, agreements or licenses with third parties subjects us to a number of risks. We have limited or no control over the resources that such third parties may choose to devote to our joint efforts. Our collaborators, customers or licensees may breach or terminate their agreements with us or fail to perform their obligations thereunder. Further, our collaborators, customers or licensees may elect not to develop products arising out of our agreements or may fail to devote sufficient resources to the development, manufacture, marketing or sale of

such products. While we do not currently compete directly with any of our customers and collaborators, some of our customers and collaborators could become our competitors in the future if they internally develop DNA analysis technologies or if they acquire other genomics companies and move into the genomics industry. We will not earn the revenues contemplated under our customer and collaborative arrangements, if our customers and collaborators:

do not develop commercially successful products using our technologies;

develop competing products;

preclude us from entering into collaborations with their competitors;

fail to obtain necessary regulatory approvals; or

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terminate their agreements with us.

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

Flow cells are glass plates that are micromachined, or fabricated to very precise dimensions, to create a grooved chamber for immobilizing micro-beads in a planar microarray, which is a two-dimensional, dense ordered array of DNA samples. We use flow cells in our MPSS technology. We currently purchase the flow cells used in our MPSS technology from a single supplier, although the flow cells are potentially available from multiple suppliers. While we believe that alternative suppliers for flow cells exist, identifying and qualifying new suppliers could be an expensive and time-consuming process. Our reliance on outside vendors involves several risks, including:

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

reduced control over quality and pricing of components; and

delays and long lead times in receiving materials from vendors.

Lynx currently utilizes a single supplier to purchase PacI, an enzyme used with the Megaclone bead technology.

PacI is a restriction enzyme used to digest the PCR product that is loaded onto 5-micron beads prior to MPSS sequencing. While Lynx believes that alternative suppliers for PacI could be identified, the intellectual property rights to PacI belong to Lynx's current supplier New England BioLabs. If Lynx is successful in replacing its Megaclone bead loading process with DNA Clusters, the need for PacI will be removed. Lynx's reliance on outside vendors involves several risks, including:

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

reduced control over quality and pricing of components; and

delays and long lead times in receiving materials from vendors.

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

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

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

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

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

generation to the next; and

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

In addition, numerous pharmaceutical, biotechnology and agricultural companies are developing genomics research programs, either alone or in partnership with our competitors. Our future success will depend on our ability

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to maintain a competitive position with respect to technological advances. Rapid technological development by others may make our technologies and future products obsolete.

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

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

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

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

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

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

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

Our commercial success depends in part on our ability to avoid infringing patents and proprietary rights of third parties and not breaching any licenses that we have entered into with regard to our technologies. Other parties have filed, and in the future are likely to file, patent applications covering genes, gene fragments, proteins, the analysis of gene expression and protein expression and the manufacture and use of DNA chips or microarrays, which are tiny glass or silicon wafers on which tens of thousands of DNA molecules can be arrayed on the surface for subsequent

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analysis. We intend to continue to apply for patent protection for methods relating to gene expression and protein expression and for the individual disease genes and proteins and drug discovery targets we discover. If patents covering technologies required by our operations are issued to others, we may have to rely on licenses from third parties, which may not be available on commercially reasonable terms, or at all.

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

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

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

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

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

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

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

Lynx will incur substantial costs whether or not the transaction with Solexa is completed.

Lynx will incur substantial costs related to the proposed combination with Solexa whether or not the transaction is completed. These costs include fees for financial advisors, attorneys and accountants, filing fees, stamp duty and financial printing costs.

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Lynx currently expects to incur approximately \$2.8 million in costs, approximately \$1.2 million of which are not contingent on the completion of the transaction.

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

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

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

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

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

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

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

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

If we successfully validate targets for drug discovery, products that we develop with our collaborators based on those targets may include diagnostic or therapeutic products. The ability of our collaborators to commercialize such products may depend, in part, on the extent to which reimbursement for the cost of these products will be available from government health administration authorities, private health insurers and other organizations. In the U.S., third-

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party payors are increasingly challenging the price of medical products and services. The trend towards managed healthcare in the U.S., legislative healthcare reforms and the growth of organizations such as health maintenance organizations that may control or significantly influence the purchase of healthcare products and services, may result in lower prices for any products our collaborators may develop. Significant uncertainty exists as to the reimbursement status of newly approved healthcare products. If adequate third-party coverage is not available in the future, our collaborators may fail to maintain price levels sufficient to realize an appropriate return on their investment in research and product development.

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

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

Our stock price may be extremely volatile.

We believe that the market price of our common stock will remain highly volatile and may fluctuate significantly due to a number of factors. The market prices for securities of many publicly-held, early-stage biotechnology companies have in the past been, and can in the future be expected to be, especially volatile. For example, during the two-year period from October 1, 2002 to September 30, 2004, the closing sales price of our common stock as quoted on the Nasdaq National Market and Nasdaq SmallCap Market fluctuated from a low of \$1.48 to a high of \$7.94 per share. In addition, the securities markets have from time to time experienced significant price and volume fluctuations that may be unrelated to the operating performance of particular companies. The following factors and events may have a significant and adverse impact on the market price of our common stock:

fluctuations in our operating results;

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

release of reports by securities analysts;

developments or disputes concerning patent or proprietary rights;

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

general market conditions.

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

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

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

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

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

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

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

the coverage of Lynx by securities analysts has ceased entirely; and

we may lose current or potential investors.

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

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

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

Any authorization or issuance of preferred stock, while providing desirable flexibility in connection with financings, possible acquisitions and other corporate purposes, could also have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock or making it more difficult to remove directors and effect a change in management. The preferred stock may have other rights, including economic rights senior to those of our common stock, and, as a result, an issuance of additional preferred stock could lower the market value of our common stock. Provisions of Delaware law may also discourage, delay or prevent someone from acquiring or merging with us.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Short-Term Investments

The primary objective of our investment activities is to preserve principal while, at the same time, maximizing yields without significantly increasing risk. To achieve this objective, we invest in highly liquid and high-quality debt

securities. Our investments in debt securities are subject to interest rate risk. To minimize the exposure due to adverse shifts in interest rates, we invest in short-term securities and maintain an average maturity of less than one year. As a result, we do not believe we are subject to significant interest rate risk.

Foreign Currency Rate Fluctuations

The functional currency for our German subsidiary is the Euro. Our German subsidiary's accounts are translated from the Euro to the U.S. dollar using the current exchange rate in effect at the balance sheet date, for balance sheet accounts, and using the average exchange rate during the period, for revenues and expense accounts.

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The effects of translation are recorded as a separate component of stockholders' equity. Our German subsidiary conducted its business primarily in Euros. Exchange gains and losses arising from these transactions are recorded using the actual exchange differences on the date of the transaction. We have not taken any action to reduce our exposure to changes in foreign currency exchange rates, such as options or futures contracts, with respect to transactions with our German subsidiary or transactions with our European collaborators and customers.

Item 4. Controls and Procedures

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

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

Table of Contents**PART II. OTHER INFORMATION****Item 5. Other Information****Approval of Non-Audit Services**

Consistent with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002, Lynx is responsible for disclosing the nature of the non-audit services approved by our Audit Committee during a quarter to be performed by Ernst & Young LLP, our independent auditor. Non-audit services are services other than those provided by Ernst & Young LLP, or others, in connection with an audit or a review of our financial statements. During the nine months ended September 30, 2004 our Audit Committee approved the engagement of Ernst & Young LLP to perform professional services in connection with the proposed combination with Solexa.

Item 6. Exhibits

Exhibit Number	Description
2.2	Acquisition Agreement, dated as of September 28, 2004, by and between Solexa Limited and the Company, incorporated by reference to the indicated exhibit of the Company's Current Report on Form 8-K filed on September 30, 2004.
3.1	Amended and Restated Certificate of Incorporation of the Company, incorporated by reference to the indicated exhibit of the Company's Form 10-Q for the period ended September 30, 2000.
3.1.1	Certificate of Amendment to Amended and Restated Certificate of Incorporation of the Company, incorporated by reference to the indicated exhibit of the Company's Form 10-K for the year ended December 31, 2002.
3.2	Bylaws of the Company, as amended, incorporated by reference to the indicated exhibit of the Company's Form 10-Q for the period ended June 30, 2000.
4.1	Form of Common Stock Certificate, incorporated by reference to Exhibit 4.2 of the Company's Statement Form 10 (File No. 0-22570), as amended.
10.49	Loan Agreement, dated August 12, 2004, by and between the Company and Solexa Limited, incorporated by reference to the indicated exhibit of the Company's Registration Statement on Form S-4 filed on October 29, 2004.
10.50	Letter, dated September 28, 2004, from Solexa Limited to the Company, incorporated by reference to the indicated exhibit of the Company's Registration Statement on Form S-4 filed on October 29, 2004.
31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	

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Certification required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended

- 32.1* Certification required by Rule 13a-14(a) or Rule 15d-14(a) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).
- 99.1 Form of Support Agreement between Solexa Limited and certain stockholders of the Company, incorporated by reference to the indicated exhibit of the Company's Current Report on Form 8-K filed on September 30, 2004.
- 99.2 Form of Support Agreement between the Company and certain stockholders of Solexa Limited, incorporated by reference to the indicated exhibit of the Company's Current Report on Form 8-K filed on September 30, 2004.
- 99.3 Form of Support Agreement between the Company and the former Chief Executive Officer of Solexa Limited, incorporated by reference to the indicated exhibit of the Company's Current Report on Form 8-K filed on September 30, 2004.
- 99.4 Form of Irrevocable undertaking between the Company and certain holders of ordinary shares of Solexa Limited, from Solexa Limited to the Company, incorporated by reference to the indicated exhibit of the Company's Registration Statement on Form S-4 filed on October 29, 2004.
- 99.5 Form of Irrevocable undertaking between the Company and certain holders of ordinary shares of Solexa Limited, from Solexa Limited to the Company, incorporated by reference to the indicated exhibit of the

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**Exhibit
Number**

Description

Company's Registration Statement on Form S-4 filed on October 29, 2004.

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

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SIGNATURES

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

/s/ Kevin P. Corcoran

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

Date: November 15, 2004

/s/ Kathy A. San Roman

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

Date: November 15, 2004

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- 99.5 Form of Irrevocable undertaking between the Company and certain holders of ordinary shares of Solexa Limited, from Solexa Limited to the Company, incorporated by reference to the indicated exhibit of the Company's Registration Statement on Form S-4 filed on October 29, 2004.

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