

ILLUMINA INC  
Form 10-Q  
October 31, 2007

**Table of Contents**

**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 Quarterly Period Ended September 30, 2007**

☐ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 000-30361**

**Illumina, Inc.**

(Exact name of registrant as specified in its charter)

Delaware

33-0804655

(State or other Jurisdiction of  
Incorporation or Organization)

(I.R.S. Employer  
Identification No.)

9885 Towne Centre Drive, San Diego, CA

92121

(Address of Principal Executive Offices)

(Zip Code)

(858) 202-4500

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

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

As of October 16, 2007, there were 54,700,385 shares of the Registrant's Common Stock outstanding.

**ILLUMINA, INC.  
INDEX**

	<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	3
<u>Item 1. Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets September 30, 2007 (unaudited) and December 31, 2006</u>	3
<u>Condensed Consolidated Statements of Operations Three and Nine Months Ended September 30, 2007 and October 1, 2006 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows Nine Months Ended September 30, 2007 and October 1, 2006 (unaudited)</u>	5
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	30
<u>Item 4. Controls and Procedures</u>	31
<b><u>PART II. OTHER INFORMATION</u></b>	32
<u>Item 1. Legal Proceedings</u>	32
<u>Item 1A. Risk Factors</u>	33
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	39
<u>Item 3. Defaults upon Senior Securities</u>	39
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	39
<u>Item 5. Other Information</u>	39
<u>Item 6. Exhibits</u>	40
<b><u>SIGNATURES</u></b>	41
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	
<u>EXHIBIT 32.2</u>	

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.**

**Illumina, Inc.**  
**Condensed Consolidated Balance Sheets**  
**(In thousands)**

	<b>September 30, 2007 (unaudited)</b>	<b>December 31, 2006 (1)</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 64,107	\$ 38,386
Short-term investments	288,745	92,418
Accounts receivable, net	79,886	39,984
Inventory, net	45,245	20,169
Prepaid expenses and other current assets	8,948	2,769
Total current assets	486,931	193,726
Property and equipment, net	39,330	25,634
Investment in Solexa		67,784
Goodwill	249,227	2,125
Acquired intangible assets, net	22,633	
Other assets, net	12,088	11,315
Total assets	\$ 810,209	\$ 300,584
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 78,996	\$ 33,713
Current portion of long-term debt	25	63
Total current liabilities	79,021	33,776
Long-term debt, less current portion	400,000	
Other long-term liabilities	9,930	19,466
Commitments and contingencies		
Stockholders' equity	321,258	247,342
Total liabilities and stockholders' equity	\$ 810,209	\$ 300,584

(1) The Condensed Consolidated Balance Sheet at December 31, 2006 has been derived from the audited financial statements as of that date.



**Table of Contents**

**Illumina, Inc.**  
**Condensed Consolidated Statements of Operations**  
**(Unaudited)**  
**(In thousands, except per share amounts)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September</b>		<b>September</b>	
	<b>30,</b>	<b>October 1,</b>	<b>30,</b>	<b>October 1,</b>
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Revenue:				
Product revenue	\$ 90,021	\$ 46,918	\$ 225,583	\$ 106,582
Service and other revenue	7,364	6,441	28,211	16,503
Research revenue	125	113	400	1,066
Total revenue	97,510	53,472	254,194	124,151
Costs and expenses:				
Cost of product revenue (including non-cash stock compensation expense of \$1,059, \$360, \$2,901 and \$858, respectively, and excluding amortization of acquired intangible assets)	34,582	14,523	83,436	34,111
Cost of service and other revenue (including non-cash stock compensation expense of \$60, \$57, \$197 and \$159, respectively)	2,496	1,833	8,903	5,114
Research and development (including non-cash stock compensation expense of \$2,607, \$955, \$7,035 and \$2,790, respectively)	19,753	7,744	53,893	24,547
Selling, general and administrative (including non-cash stock compensation expense of \$4,942, \$2,383, \$13,998 and \$6,405, respectively)	24,307	14,118	71,237	39,143
Amortization of acquired intangible assets	662		1,767	
Acquired in-process research and development			303,400	
Total costs and expenses	81,800	38,218	522,636	102,915
Income (loss) from operations	15,710	15,254	(268,442)	21,236
Interest and other income, net	3,978	1,996	9,043	3,420
Income (loss) before income taxes	19,688	17,250	(259,399)	24,656
Provision for income taxes	5,185	1,088	14,912	1,830
Net income (loss)	\$ 14,503	\$ 16,162	\$ (274,311)	\$ 22,826
Net income (loss) per basic share	\$ 0.27	\$ 0.35	\$ (5.09)	\$ 0.52
Net income (loss) per diluted share	\$ 0.24	\$ 0.32	\$ (5.09)	\$ 0.48

Shares used in calculating basic net income				
(loss) per share	54,318	46,293	53,847	43,766
Shares used in calculating diluted net income				
(loss) per share	59,395	50,579	53,847	48,004

*See accompanying notes to the condensed consolidated financial statements.*

4

**Table of Contents**

**Illumina, Inc.**  
**Condensed Consolidated Statements of Cash Flows**  
**(Unaudited)**  
**(In thousands)**

	<b>Nine Months Ended</b>	
	<b>September 30, 2007</b>	<b>October 1, 2006</b>
Operating activities:		
Net income (loss)	\$ (274,311)	\$ 22,826
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Acquired in-process research and development	303,400	
Amortization of increase in inventory valuation	942	
Amortization of intangible assets	1,803	20
Amortization of debt issuance costs	839	
Depreciation expense	8,177	4,198
Loss on disposal of property and equipment	16	31
Stock-based compensation expense	24,130	10,212
Amortization of gain on sale of land and building	(145)	(281)
Changes in operating assets and liabilities:		
Accounts receivable	(33,920)	(11,049)
Inventory	(17,151)	(8,978)
Prepaid expenses and other current assets	(890)	(1,566)
Other assets	1,674	(2,287)
Accounts payable and accrued liabilities	18,414	9,937
Accrued income taxes	12,130	1,328
Other long-term liabilities	(667)	5,828
Net cash provided by operating activities	44,441	30,219
Investing activities:		
Cash obtained in acquisition, net of cash paid for transaction costs	72,083	
Investment in secured convertible debentures		(3,036)
Purchases of available-for-sale securities	(449,088)	(188,238)
Sales and maturities of available-for-sale securities	256,239	62,400
Proceeds from sale of fixed assets	40	
Cash paid for intangible assets	(85)	(15)
Purchases of property and equipment	(15,257)	(13,477)
Net cash used in investing activities	(136,068)	(142,366)
Financing activities:		
Payments on long-term debt	(86)	(78)
Proceeds from issuance of convertible debt, net of issuance costs	390,270	
Purchase of convertible note hedges	(139,040)	
Sale of warrants	92,642	
Common stock repurchases	(251,622)	

Edgar Filing: ILLUMINA INC - Form 10-Q

Proceeds from issuance of common stock	25,684	105,586
Net cash provided by financing activities	117,848	105,508
Effect of foreign currency translation on cash and cash equivalents	(500)	(17)
Net increase (decrease) in cash and cash equivalents	25,721	(6,656)
Cash and cash equivalents at beginning of period	38,386	50,822
Cash and cash equivalents at end of period	\$ 64,107	\$ 44,166

*See accompanying notes to the condensed consolidated financial statements.*

5

**Table of Contents**

**Illumina, Inc.**  
**Notes to Condensed Consolidated Financial Statements**  
**(Unaudited)**

**1. Summary of Significant Accounting Principles**

***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation. In management's opinion, the accompanying financial statements reflect all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the results for the interim periods presented.

Interim financial results are not necessarily indicative of results anticipated for the full year. These unaudited financial statements should be read in conjunction with the Company's 2006 audited financial statements and footnotes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission (SEC) on February 28, 2007.

The preparation of financial statements requires that management make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

***Fiscal Year***

The Company's fiscal year consists of 52 or 53 weeks ending the Sunday closest to December 31, with quarters of 13 or 14 weeks ending the Sunday closest to March 31, June 30, and September 30. The three and nine months ended September 30, 2007 and October 1, 2006 were both 13 and 39 weeks, respectively.

***Revenue Recognition***

The Company's revenue is generated primarily from the sale of products and services. Product revenue consists of sales of arrays, reagents, flow cells, instrumentation, and oligonucleotides (oligos), which are short sequences of DNA. Service and other revenue consists of revenue received for performing genotyping and sequencing services, extended warranty sales and revenue earned from milestone payments.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable and collectibility is reasonably assured. In instances where final acceptance of the product or system is required, revenue is deferred until all the acceptance criteria have been met. All revenue is recorded net of any applicable allowances for returns or discounts.

Revenue for product sales is recognized generally upon shipment and transfer of title to the customer, provided no significant obligations remain and collection of the receivables is reasonably assured. Revenue from the sale of instrumentation is recognized when earned, which is generally upon shipment. Revenue for genotyping and sequencing services is recognized when earned, which is generally at the time the genotyping and sequencing analysis data is delivered to the customer or as specific milestones are achieved.

In order to assess whether the price is fixed and determinable, the Company ensures there are no refund rights. If payment terms are based on future performance, the Company defers revenue recognition until the price becomes fixed and determinable. The Company assesses collectibility based on a number of factors, including past transaction history with the customer and the creditworthiness of the customer. If the Company determines that collection of a payment is not reasonably assured, revenue recognition is deferred until the time collection becomes reasonably assured, which is generally upon receipt of payment.

Sales of instrumentation generally include a standard one-year warranty. The Company also sells separately priced maintenance (extended warranty) contracts, which are generally for one or two years, upon the expiration of the initial warranty. Revenue for

**Table of Contents**

extended warranty sales is recognized ratably over the term of the extended warranty period. Reserves are provided for estimated product warranty expenses at the time the associated revenue is recognized. If the Company were to experience an increase in warranty claims or if costs of servicing its warranted products were greater than its estimates, gross margins could be adversely affected.

While the majority of its sales agreements contain standard terms and conditions, the Company does enter into agreements that contain multiple elements or non-standard terms and conditions. Emerging Issues Task Force (EITF) No. 00-21, *Revenue Arrangements with Multiple Deliverables*, provides guidance on accounting for arrangements that involve the delivery or performance of multiple products, services, or rights to use assets within contractually binding arrangements. Significant contract interpretation is sometimes required to determine the appropriate accounting, including whether the deliverables specified in a multiple element arrangement should be treated as separate units of accounting for revenue recognition purposes, and if so, how the price should be allocated among the deliverable elements, when to recognize revenue for each element, and the period over which revenue should be recognized. The Company recognizes revenue for delivered elements only when it determines that the fair values of undelivered elements are known and there are no uncertainties regarding customer acceptance.

A third source of revenue, research revenue, consists of amounts performed under government grants, which is recognized in the period during which the related costs are incurred.

***Cash and Cash Equivalents***

Cash and cash equivalents are comprised of short-term, highly liquid investments primarily consisting of commercial paper and money market-type funds.

***Investments***

The Company applies Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to its investments. Under SFAS No. 115, the Company classifies its investments as available-for-sale and records such assets at estimated fair value in the balance sheet, with unrealized gains and losses, if any, reported in stockholders' equity. As of September 30, 2007, the Company's excess cash balances were primarily invested in marketable debt securities, including commercial paper, auction rate certificates and corporate bonds and notes, with strong credit ratings or short maturity mutual funds providing similar financial returns. The Company limits the amount of investment exposure as to institutions, maturity and investment type.

***Stock-Based Compensation***

On January 2, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment*, which addresses the accounting for stock-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The Company uses the Black-Scholes-Merton option-pricing model to determine the fair-value of stock-based awards under SFAS No. 123R. As of September 30, 2007, approximately \$111.1 million of total unrecognized compensation cost related to stock options, restricted stock and ESPP shares issued to date is expected to be recognized over a weighted-average period of approximately two and a half years.

The Company has elected to use the Black-Scholes-Merton option-pricing model, which incorporates various assumptions including volatility, expected life, and interest rates. Historically, the Company used an expected stock-price volatility assumption that was primarily based on historical realized volatility of the underlying stock during a period of time. Volatility for the three months ended September 30, 2007, was determined by equally weighing the historical and implied volatility of its common stock. The historical volatility of the Company's common stock over the most recent period is generally commensurate with the estimated expected life of the Company's stock options, adjusted for the impact of unusual fluctuations not reasonably expected to recur and other relevant factors. The implied volatility is calculated from the implied market volatility of exchange-traded call options on the Company's common stock. The expected life of an award is based on historical experience and on the terms and conditions of the stock awards granted to employees.

**Table of Contents**

The assumptions used for the specified reporting periods and the resulting estimates of weighted-average fair value per share of options granted and for stock purchases under the ESPP during those periods are as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Interest rate stock options	4.47 - 4.90%	4.83 - 5.05%	4.61 - 4.90%	4.36 - 5.05%
Interest rate stock purchases	4.71 - 4.83%	4.08 - 4.85%	4.71 - 4.86%	4.85 - 4.85%
Volatility stock options	55 - 58%	75%	55 - 70%	76%
Volatility stock purchases	69 - 75%	76 - 90%	69 - 76%	76 - 90%
Expected life stock options	6 years	6 years	6 years	6 years
Expected life stock purchases	6 - 12 months	6-12 months	6-12 months	6-12 months
Expected dividend yield	0%	0%	0%	0%
Weighted average fair value per share of options granted	\$ 25.92	\$ 24.40	\$ 25.09	\$ 18.35
Weighted average fair value per share of employee stock purchases	\$ 14.66	\$ 5.27	\$ 13.35	\$ 4.76

**Net Income (Loss) per Share**

Basic and diluted net income (loss) per share is presented in conformity with SFAS No. 128, *Earnings per Share*, for all periods presented. In accordance with SFAS No. 128, basic net income (loss) per share is computed using the weighted-average number of shares of common stock outstanding during the period, less shares subject to repurchase. Diluted net income (loss) per share is typically computed using the weighted average number of common and dilutive common equivalent shares from stock options and warrants using the treasury stock method. The following table presents the calculation of weighted-average shares used to calculate basic and diluted net income (loss) per share (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2007	October 1, 2006	September 30, 2007	October 1, 2006
Weighted-average shares outstanding	54,336	46,331	53,864	43,804
Less: Weighted-average shares of common stock subject to repurchase	(18)	(38)	(17)	(38)
Weighted-average shares used in calculating basic net income (loss) per share	54,318	46,293	53,847	43,766
Plus: Effect of dilutive potential common shares	5,077	4,286		4,238
Weighted-average shares used in calculating diluted net income (loss) per share	59,395	50,579	53,847	48,004

The total number of shares excluded from the calculation of diluted net loss per share, prior to application of the treasury stock method, was 11,179,388 for the nine months ended September 30, 2007. The total number of warrants excluded from the calculation of diluted net loss per share was 1,759,217 for the nine months ended September 30, 2007. These warrants were assumed as part of the Company's merger with Solexa, Inc. on January 26, 2007. In addition, the warrants sold to the initial purchasers and/or their affiliates of the Convertible Senior Notes to acquire a maximum of 18,322,320 shares of the Company's common stock were excluded from the calculation of diluted net income (loss) per share for the three and nine months ended September 30, 2007 since the average fair market value of the Company's stock during both periods was below the strike price of \$62.87 per share.

**Comprehensive Income (Loss)**

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on the Company's available-for-sale securities, changes in the fair value of derivatives designated as effective cash flow hedges, and foreign currency translation adjustments.

The components of other comprehensive income (loss) are as follows (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September</b>	<b>October 1,</b>	<b>September</b>	<b>October 1,</b>
	<b>30,</b>	<b>2006</b>	<b>30, 2007</b>	<b>2006</b>
	<b>2007</b>			
Net income (loss)	\$ 14,503	\$ 16,162	\$ (274,311)	\$ 22,826
Foreign currency translation adjustments	312	30	514	190
Unrealized gain (loss) on investments	428	(49)	(10,299)	32
Unrealized loss on cash flow hedges				(10)
Total other comprehensive income (loss)	\$ 15,243	\$ 16,143	\$ (284,096)	\$ 23,038

**Table of Contents*****Recently Adopted Accounting Pronouncements***

Effective January 1, 2007, the Company adopted FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in tax positions. FIN No. 48 requires that the Company recognize the impact of a tax position in its financial statements only if that position is more likely than not to be sustained on audit, based on the technical merits of the position. The adoption of FIN No. 48 did not result in an adjustment to the Company's opening retained earnings since there was no cumulative effect from the change in accounting principle due to the Company maintaining a full valuation allowance against its U.S. deferred tax assets. At the date of adoption, the Company reduced its deferred tax assets and related valuation allowance by approximately \$5.1 million for uncertain tax positions. As of September 30, 2007, the Company further reduced its deferred tax assets and related valuation allowance by approximately \$8.1 million for uncertain tax positions. Interest and penalties related to uncertain tax positions will be reflected in income tax expense. All of the Company's tax years remain subject to future examination by the major tax jurisdictions in which it is subject to tax.

***Reclassifications***

Certain previously reported amounts have been reclassified to conform to the current period's presentation.

**2. Acquisition of Solexa, Inc.**

On January 26, 2007, the Company completed its acquisition of Solexa, Inc. (Solexa), a Delaware corporation, in a stock-for-stock merger transaction. The Company issued approximately 13.1 million shares of its common stock as consideration for this merger. The results of Solexa's operations have been included in the Company's consolidated financial statements since the acquisition date of January 26, 2007.

Upon the closing of the merger on January 26, 2007, there were approximately 3.7 million shares of the Company's restricted stock and shares issuable upon the exercise of outstanding options and warrants assumed as part of the acquisition. Total estimated merger consideration also includes approximately \$75.3 million, which represents the fair market value of the vested options, warrants and restricted stock assumed. The Company also expects to recognize approximately \$14.7 million of non-cash stock-based compensation expense related to unvested stock options and restricted stock at the acquisition date. This expense will be recognized beginning from the acquisition date over a weighted-average period of approximately two years. These awards were valued using the following assumptions as of January 25, 2007 (the measurement date, as discussed below):

Interest rate	4.56	5.05%
Volatility		54.26%
	0.35	3.98
Expected life		years
Expected dividend yield		0%

The purchase price of the acquisition is as follows (in thousands):

Fair market value of securities issued	\$ 527,067
Fair market value of change of control bonuses and related taxes	8,182
Transaction costs not included in Solexa net tangible assets acquired	8,129
Fair market value of vested stock options, warrants and restricted stock assumed	75,334
Total purchase price	\$ 618,712

The fair value of the Company's shares used in determining the purchase price was based on the average of the closing price of the Company's common stock for a range of four trading days, including two days prior to and two days subsequent to January 25, 2007, the measurement date. The measurement date was determined per the guidance in EITF No. 99-12, *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination*. Based on these closing prices, the Company estimated the fair value of its common stock to be \$40.14 per share, which equates to a total fair value of common stock issued of \$527.1 million.

***Purchase Price Allocation***

The Solexa purchase price was allocated to tangible and intangible assets acquired and liabilities assumed based on their estimated fair values at the acquisition date (January 26, 2007). The excess of the purchase price over the fair value of net assets acquired was allocated to goodwill.

**Table of Contents**

The Company believes the fair values assigned to the assets acquired and liabilities assumed were based on reasonable assumptions. The following table summarizes the estimated fair values of net assets acquired (in thousands):

Current assets	\$ 51,444
Property, plant and equipment, net	6,515
Other assets	786
Current liabilities	(13,479)
Other long-term liabilities	(1,455)
Net tangible assets acquired	43,811
Identifiable intangible assets (core technology and customer relationships)	24,400
In-process research and development	303,400
Goodwill	247,101
Total net assets acquired	\$ 618,712

The Company's fair value estimates for the purchase price allocation may change during the allowable allocation period, which is up to one year from the acquisition date, if additional information becomes available.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized, but will be subject to a periodic assessment for impairment by applying a fair-value-based test. None of this goodwill is expected to be deductible for tax purposes. The Company performs its annual test for impairment of goodwill in May of each year. The Company is required to perform a periodic assessment between annual tests in certain circumstances. The Company has determined there was no impairment of its goodwill through the third quarter of 2007.

***In-Process Research and Development***

The Company allocated \$303.4 million of the purchase price to in-process research and development projects. In-process research and development (IPR&D) represents the valuation of acquired, to-be-completed research projects. At the acquisition date, Solexa's ongoing research and development initiatives were primarily involved with the development of its genetic analysis platform for sequencing and expression profiling. These in-process research and development projects are composed of Solexa's reversible terminating nucleotide biochemistry platform, referred to as sequencing-by-synthesis (SBS) biochemistry, as well as Solexa's reagent, analyzer and sequencing services related technologies, which were valued at \$237.2 million, \$44.2 million, \$19.1 million and \$2.9 million, respectively, at the acquisition date. Although these projects were approximately 95% complete at the acquisition date, they had not reached technological feasibility and had no alternative future use. Accordingly, the amounts allocated to those projects were written off in the first quarter of 2007, the period the acquisition was consummated.

The values of the research projects were determined by estimating the costs to develop the acquired technology into commercially viable products, estimating the resulting net cash flows from the projects, and discounting the net cash flows to their present value. These cash flows were estimated by forecasting total revenue expected from these products and then deducting appropriate operating expenses, cash flow adjustments and contributory asset returns to establish a forecast of net cash flows arising from the in-process technology. These cash flows were substantially reduced to take into account the time value of money and the risks associated with the inherent difficulties and uncertainties given the projected stage of development of these projects at closing. Due to the nature of the forecast and the risks associated with the projected growth and profitability of the developmental projects, discount rates of 19.5% were considered appropriate for valuation of the IPR&D. The Company believes that these discount rates were commensurate with the projects' stage of development and the uncertainties in the economic estimates described above.

If these projects are not successfully developed, the sales and profitability of the combined company may be adversely affected in future periods. The Company believes that the foregoing assumptions used in the IPR&D analysis were reasonable at the time of the acquisition. No assurance can be given, however, that the underlying

assumptions used to estimate expected project sales, development costs or profitability, or the events associated with such projects, will transpire as estimated.

***Identifiable Intangible Assets***

Acquired identifiable assets include various patents that are separate and distinct from the intellectual property surrounding the SBS biochemistry platform (core technology) as well as customer relationships. These patents are held in both the U.S. and Europe. The Company valued the patents and developed technology utilizing a discounted cash flow model which uses forecasts of future royalty savings and expenses related to the intangible assets. The Company utilized a discount rate of 19.5% when preparing this model. The value of the customer relationships is the benefit derived, based upon estimated cash flows, from having a customer in place versus having to incur the time, cost and foregone cash flow required to develop or replace the customer. The amounts assigned to the core technology and customer relationships are \$23.5 million and \$0.9 million, respectively. The useful lives of the core technology and customer relationships were deemed to be ten and three years, respectively.

10

---

**Table of Contents*****Goodwill***

Goodwill represents the excess of the Solexa purchase price over the sum of the amounts assigned to assets acquired less liabilities assumed. The Company believes that the acquisition of Solexa will produce the following significant benefits:

*Increased Market Presence and Opportunities.* The combination of the Company and Solexa should increase the combined Company's market presence and opportunities for growth in revenue, earnings and stockholder return. The Company believes that the Solexa technology is highly complementary to the Company's own portfolio of products and services and will enhance the Company's capabilities to service its existing customers, as well as accelerate the development of additional technologies, products and services. The Company believes that integrating Solexa's capabilities with the Company's technologies will better position the Company to address the emerging biomarker research and development and in-vitro and molecular diagnostic markets. The Company began to recognize revenue from products shipped as a result of this acquisition during the first quarter of 2007.

*Operating Efficiencies.* The combination of the Company and Solexa provides the opportunity for potential economies of scale and cost savings.

The Company believes that these primary factors support the amount of goodwill recognized as a result of the purchase price paid for Solexa, in relation to other acquired tangible and intangible assets, including in-process research and development.

The following unaudited pro forma information shows the results of the Company's operations for the specified reporting periods as though the acquisition had occurred as of the beginning of that period (in thousands, except per share data):

	<b>Three Months Ended October 1, 2006</b>	<b>Nine Months Ended September 30, 2007</b>	<b>October 1, 2006</b>
Revenue	\$ 54,041	\$254,249	\$ 126,585
Net income (loss)	\$ 4,321	\$ 21,436	\$ (12,217)
Basic and diluted net income (loss) per share	\$ 0.07	\$ 0.40	\$ (0.21)

The pro forma results have been prepared for comparative purposes only and are not necessarily indicative of the actual results of operations had the acquisition taken place as of the beginning of the periods presented, or the results that may occur in the future. The pro forma results exclude the \$303.4 million non-cash acquired IPR&D charge recorded upon the closing of the acquisition during the first quarter of 2007.

***Investment in Solexa***

On November 12, 2006, the Company entered into a definitive securities purchase agreement with Solexa in which the Company invested approximately \$50 million in Solexa in exchange for 5,154,639 newly issued shares of Solexa common stock in conjunction with the merger of the two companies. This investment was valued at \$67.8 million as of December 31, 2006, which represented a market value of \$13.15 per share of Solexa common stock. This investment was eliminated as part of the Company's purchase accounting upon the closing of the merger on January 26, 2007.

**3. Segment Information**

The Company has determined that, in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, it operates in one segment as it only reports operating results on an aggregate basis to its chief operating decision maker of the Company.

**Table of Contents****4. Inventories**

Inventories are stated at the lower of standard cost (which approximates actual cost) or market. Inventory includes raw materials and finished goods that may be used in the research and development process and such items are expensed as consumed. Provisions for slow moving, excess and obsolete inventories are provided based on product life cycle and development plans, product expiration and quality issues, historical experience and inventory levels. The components of net inventories are as follows (in thousands):

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Raw materials	\$ 20,087	\$ 8,365
Work in process	18,471	8,907
Finished goods	6,687	2,897
	<b>\$ 45,245</b>	<b>\$ 20,169</b>

**5. Goodwill and Intangible Assets**

The Company accounts for goodwill and intangibles under SFAS No. 142, *Goodwill and Other Intangible Assets*. As such, goodwill and other indefinite-lived intangible assets are not amortized, but are subject to annual impairment reviews, or more frequent reviews if events or circumstances indicate there may be an impairment. The Company performs its test of goodwill annually in May.

The carrying amount of goodwill was \$249.2 million as of September 30, 2007, compared to \$2.1 million at December 31, 2006. The increase in goodwill was due to the acquisition of Solexa in January 2007. The \$2.1 million balance at December 31, 2006 was related to the acquisition of CyVera in April 2005. This balance is included in goodwill as of September 30, 2007 and there has been no impairment of goodwill as of that date.

Intangible assets other than goodwill are required to be separated into two categories: finite-lived and indefinite-lived. Intangible assets with finite useful lives are amortized over their estimated useful life, while intangible assets with indefinite useful lives are not amortized. The Company currently has no intangible assets with indefinite lives.

Following is a summary of the Company's amortizable intangible assets as of the respective balance sheet dates (in thousands):

	<b>September 30, 2007</b>		<b>December 31, 2006</b>	
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>
Acquired intangible assets:				
Core technology	\$ 23,500	\$ (1,567)	\$	\$
Customer relationships	900	(200)		
Total acquired intangible assets	24,400	(1,767)		
Other intangible assets:				
License agreements	1,029	(873)	944	(836)
Total intangible assets	\$ 25,429	\$ (2,640)	\$ 944	\$ (836)

The increase in the gross carrying amount of the Company's amortizable intangible assets as of September 30, 2007 was due to the acquisition of Solexa in January 2007. The core technology is being amortized over a ten-year life and customer relationships are being amortized over a three-year life. The amortization of the core technology and customer relationships is excluded from product cost of revenue and is separately classified as amortization of

acquired intangible assets on the condensed consolidated statements of operations.

## **6. Warranties**

The Company generally provides a one-year warranty on instrument systems. At the time revenue is recognized, the Company establishes an accrual for estimated warranty expenses associated with system sales. This expense is recorded as a component of cost of product revenue. Estimated warranty expenses associated with extended maintenance contracts are recorded as a component of cost of service and other revenue and are recognized ratably over the term of the maintenance contract.

Changes in the Company's warranty liability during the specified reporting period are as follows (in thousands):

Balance at December 31, 2006	\$ 996
Additions charged to cost of revenue	3,557
Repairs and replacements	(1,637)
Balance at September 30, 2007	\$ 2,916

12

**Table of Contents****7. Accounts Payable and Accrued Liabilities**

Accounts payable and accrued liabilities consist of the following (in thousands):

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Accounts payable	\$ 22,497	\$ 9,853
Compensation	12,094	8,239
Taxes	16,969	1,804
Legal and other professional fees	2,851	3,831
Short-term deferred revenue	13,001	3,382
Customer deposits	4,730	3,703
Reserve for product warranties	2,916	996
Short-term deferred rent	1,271	
Short-term deferred gain on sale of building	171	375
Other	2,496	1,530
	<b>\$ 78,996</b>	<b>\$ 33,713</b>

**8. Stockholders Equity**

As of September 30, 2007, the Company had 54,672,673 shares of common stock outstanding, of which 4,848,395 shares were sold to employees and consultants subject to restricted stock agreements. The restricted common shares vest in accordance with the provisions of the agreements, generally over five years. As of September 30, 2007, 17,419 shares of common stock were subject to repurchase. In addition, the Company also issued 12,000 shares for a restricted stock award to an employee under the Company's 2005 Stock and Incentive Plan based on service performance. These shares vest monthly over a three-year period.

*2005 Stock and Incentive Plan*

In June 2005, the stockholders of the Company approved the 2005 Stock and Incentive Plan (the 2005 Stock Plan). Upon adoption of the 2005 Stock Plan, issuance of options under the Company's existing 2000 Stock Plan ceased. The 2005 Stock Plan initially provided that an aggregate of up to 11,542,358 shares of the Company's common stock be reserved and available to be issued. In addition, the 2005 Stock Plan provides for an automatic annual increase in the shares reserved for issuance by the lesser of 5% of the number of outstanding shares of the Company's common stock on the last day of the immediately preceding fiscal year, 1,200,000 shares or such lesser amount as determined by the Company's board of directors. As of September 30, 2007, options to purchase 1,974,920 shares remained available for future grant under the 2005 Stock Plan.

The Company's stock option activity under all stock option plans during the specified reporting period is as follows:

	<b>Options</b>	<b>Weighted-Average Exercise Price</b>
Outstanding at December 31, 2006	8,359,120	\$ 13.94
Granted	3,481,708	\$ 39.26
Options assumed through business combination	1,424,332	\$ 21.37
Exercised	(1,470,420)	\$ 11.21
Cancelled	(614,152)	\$ 21.68
Outstanding at September 30, 2007	11,180,588	\$ 22.70

**Table of Contents**

Following is a further breakdown of the options outstanding as of September 30, 2007:

<b>Range of</b>	<b>Options</b>	<b>Weighted Average Remaining Life</b>	<b>Weighted Average Exercise Price</b>	<b>Options</b>	<b>Weighted Average Exercise Price of Options</b>
<b>Exercise Prices</b>	<b>Outstanding</b>	<b>in Years</b>	<b>Price</b>	<b>Exercisable</b>	<b>Exercisable</b>
\$0.03-5.99	1,504,679	5.27	\$ 4.33	987,870	\$ 3.79
\$6.00-8.60	1,691,935	6.75	\$ 8.05	814,043	\$ 7.87
\$8.70-17.35	1,635,091	7.02	\$ 12.43	789,082	\$ 12.08
\$17.73-25.20	1,491,519	8.00	\$ 21.21	622,880	\$ 20.64
\$25.43-33.99	1,404,746	9.04	\$ 29.61	256,540	\$ 27.82
\$34.07-39.22	1,528,609	9.03	\$ 37.60	202,763	\$ 37.63
\$39.42-40.59	1,406,342	9.34	\$ 40.09	167,892	\$ 40.08
\$40.63-3,123.55 <sup>1</sup>	517,667	9.73	\$ 50.72	3,567	\$742.54
 \$0.03-3,123.55	 11,180,588	 7.82	 \$ 22.70	 3,844,637	 \$ 14.74

<sup>1</sup> Adjusted for reverse split of securities underlying options assumed with Solexa acquisition.

The aggregate intrinsic value of options outstanding and options exercisable as of September 30, 2007 was \$328.8 million and \$145.3 million, respectively. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the fiscal period, which was \$51.88 as of September 28, 2007, and the exercise price multiplied by the number of options outstanding. Total intrinsic value of options exercised was \$42.2 million for the nine months ended September 30, 2007.

#### *2000 Employee Stock Purchase Plan*

In February 2000, the board of directors and stockholders adopted the 2000 Employee Stock Purchase Plan (the Purchase Plan). A total of 6,233,713 shares of the Company's common stock have been reserved for issuance under the Purchase Plan. The Purchase Plan permits eligible employees to purchase common stock at a discount, but only through payroll deductions, during defined offering periods.

The price at which stock is purchased under the Purchase Plan is equal to 85% of the fair market value of the common stock on the first or last day of the offering period, whichever is lower. The initial offering period commenced in July 2000. In addition, beginning with fiscal 2001, the Purchase Plan provides for annual increases of shares available for issuance by the lesser of 3% of the number of outstanding shares of the Company's common stock on the last day of the immediately preceding fiscal year, 1,500,000 shares or such lesser amount as determined by the Company's board of directors. 133,481 shares were issued under the Purchase Plan during the nine months ended September 30, 2007. As of September 30, 2007, there were 4,035,180 shares available for issuance under the Purchase Plan.

#### *Warrants*

In conjunction with its acquisition of Solexa, Inc. on January 26, 2007, the Company assumed 2,244,843 warrants issued by Solexa prior to the acquisition. During the nine months ended September 30, 2007, there were 359,544

warrants exercised, resulting in cash proceeds to the Company of approximately \$5.5 million.

A summary of the warrants outstanding as of September 30, 2007 is as follows:

<b>Number of Shares</b>	<b>Exercise Price</b>	<b>Expiration Date</b>
31,989	\$57.62	9/24/2008
136,423	\$14.54	4/25/2010
549,222	\$14.54	7/12/2010
404,623	\$21.81	11/23/2010
636,960	\$21.81	1/19/2011
1,759,217		

**Table of Contents**

*Treasury Stock*

In conjunction with its issuance of \$400 million principal amount of 0.625% Convertible Senior Notes due 2014 on February 16, 2007, the Company repurchased 5.8 million shares of its outstanding common stock for approximately \$201.6 million in privately negotiated transactions concurrently with the offering.

On February 20, 2007, the Company executed a Rule 10b5-1 trading plan to repurchase up to \$75.0 million of its outstanding common stock over a period of six months. The Company repurchased approximately 1.6 million shares of its common stock under this plan for approximately \$50.0 million. As of September 30, 2007, this plan had expired. In any period, cash used in financing activities related to common stock repurchases may differ from the comparable change in stockholders' equity, reflecting timing differences between the recognition of share repurchase transactions and their settlement for cash.

**9. Convertible Senior Notes**

On February 16, 2007, the Company issued \$400.0 million principal amount of 0.625% Convertible Senior Notes due 2014 (the Notes), which included the exercise of the initial purchasers' option to purchase up to an additional \$50.0 million aggregate principal amount of Notes. The net proceeds from the offering, after deducting the initial purchasers' discount and offering expenses, were approximately \$390.3 million. The Company will pay 0.625% interest per annum on the principal amount of the Notes, payable semi-annually in arrears in cash on February 15 and August 15 of each year. The Company made an interest payment of approximately \$1.2 million on August 15, 2007. The Notes mature on February 15, 2014.

The Notes will be convertible into cash and, if applicable, shares of the Company's common stock, \$0.01 par value per share, based on an initial conversion rate, subject to adjustment, of 22.9029 shares per \$1,000 principal amount of Notes (which represents an initial conversion price of approximately \$43.66 per share), only in the following circumstances and to the following extent: (1) during the five business-day period after any five consecutive trading period (the measurement period) in which the trading price per note for each day of such measurement period was less than 97% of the product of the last reported sale price of the Company's common stock and the conversion rate on each such day; (2) during any calendar quarter after the calendar quarter ending March 31, 2007, if the last reported sale price of the Company's common stock for 20 or more trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter exceeds 130% of the applicable conversion price in effect on the last trading day of the immediately preceding calendar quarter; (3) upon the occurrence of specified events; and (4) the notes will be convertible at any time on or after November 15, 2013 through the third scheduled trading day immediately preceding the maturity date.

In connection with the offering of the notes, the Company entered into convertible note hedge transactions (the hedge) with the initial purchasers and/or their affiliates (the counterparties) entitling the Company to purchase a maximum of 11,451,480 shares of the Company's common stock at an initial strike price of \$43.66 per share, subject to adjustment. In addition, the Company sold to these counterparties warrants to acquire a maximum of 18,322,320 shares of the Company's common stock (the warrants) at an initial strike price of \$62.87 per share, subject to adjustment. The cost of the hedge that was not covered by the proceeds from the sale of the warrants was approximately \$46.6 million. The hedge is expected to reduce the potential equity dilution upon conversion of the notes if the daily volume-weighted average price per share of the Company's common stock exceeds the strike price of the hedge. The warrants could have a dilutive effect on the Company's earnings per share to the extent that the price of the Company's common stock during a given measurement period exceeds the strike price of the warrants.

**Table of Contents****10. Commitments and Long-Term Debt*****Deferred Gain / Building Loan***

In August 2004, the Company completed a sale-leaseback transaction of its land and buildings located in San Diego. The sale of this property resulted in a \$3.7 million gain. Effective upon the closing of the sale, the Company leased the property back from the buyer for an initial term of ten years, which was extended in February 2007 to 19 years (see below). In accordance with SFAS No. 13, *Accounting for Leases*, the Company has deferred the gain and is amortizing it over the 19-year lease term.

***Operating Leases***

In August 2004, the Company entered into an initial ten-year lease for its San Diego facility after the land and building were sold (as discussed above). Under the terms of the lease, the Company paid a \$1.9 million security deposit and monthly rent was \$318,643 for the first year with an annual increase of 3% in each subsequent year through 2014. The current monthly rent under this lease is \$348,189. On February 14, 2007, the Company extended this lease. The terms of the new lease provide for monthly rent increases each year to a maximum of \$504,710 per month during the last year of the lease, which is now 2023. Under the terms of the new lease, approximately \$1.0 million of the original \$1.9 million security deposit was refunded to the Company during the nine months ended September 30, 2007. The Company has the option to extend the term of the lease for three additional five-year periods. In accordance with SFAS No. 13, the Company records rent expense on a straight-line basis and the resulting deferred rent is recorded as a liability in the accompanying consolidated balance sheet.

On February 14, 2007, the Company also entered into an operating lease agreement with BioMed Realty Trust, Inc. (BioMed) to expand into a new office building BioMed will build in San Diego, California. The new building will be used for research and development, manufacturing and administrative purposes. The lease expires 15 years from the date the first phase is occupied (October 1, 2008), subject to the Company's right to extend the term for up to three additional five-year periods. The Company will begin paying rent once the first phase is occupied, at an initial rate of \$114,425 per month, which will increase as the remaining two phases are occupied, based on an initial monthly base rent of \$2.80 per rentable square foot. The monthly rent will increase by 5% every 24 months.

As of September 30, 2007, the Company also leased an office and laboratory facility in Connecticut, additional office, distribution and storage facilities in San Diego, and four foreign facilities located in Japan, Singapore, China and the Netherlands under non-cancelable operating leases that expire at various times through June 2011. These leases contain renewal options ranging from one to five years.

As part of the acquisition of Solexa on January 26, 2007, the Company assumed a non-cancelable operating lease for facilities in Hayward, California. One of the buildings is utilized for administrative operations, research and development, as well as sequencing services and instrument production. The remaining space is undeveloped and vacant with no current plans to occupy. The Hayward lease runs through December 2008. The Company has an option to extend the lease for an additional five-year period, subject to certain conditions. The Company also leases a facility in Little Chesterford, United Kingdom, which is occupied by Solexa Limited, the Company's wholly-owned subsidiary, which expires in July 2008.

**11. Legal Proceedings**

The Company has incurred substantial costs in defending itself against patent infringement claims, and expects to devote substantial financial and managerial resources to protect its intellectual property and to defend against the claims described below as well as any future claims asserted against it.

**Table of Contents*****Affymetrix Litigation***

On July 26, 2004, Affymetrix, Inc. (Affymetrix) filed a complaint in the U.S. District Court for the District of Delaware alleging that the use, manufacture and sale of the Company's BeadArray products and services, including the Company's Array Matrix and BeadChip products, infringe six Affymetrix patents. Affymetrix seeks an injunction against the sale of any products that may ultimately be determined to infringe these patents, unspecified monetary damages, interest and attorneys' fees. On February 15, 2006, the Company filed its first amended answer and counterclaims, adding allegations of inequitable conduct with respect to all six asserted Affymetrix patents, violation of Section 2 of the Sherman Act, and unclean hands. The scope of the trial was subsequently narrowed to five patents at the request of Affymetrix. In a February 2007 pre-trial order, the court established a multi-phase trial structure. The court explained that it decided to address the Company's defenses of invalidity and enforceability of the patents-in-suit, as well as the Company's claims for unfair competition and antitrust violations, in subsequent trials.

The first phase, which began on March 5, 2007, addressed the issues of infringement and damages. On March 13, 2007, the jury returned a verdict finding infringement of the five patents asserted by Affymetrix. That finding was made without consideration of the validity and enforceability of these five Affymetrix patents. The jury awarded retroactive damages, for sales prior to the end of 2005 of products launched by that time, at a royalty rate of 15% in an amount of approximately \$16.7 million. This first-phase verdict remains subject to the Company's post-trial motions and appeals. A judgment on this verdict has not been entered in the case and the Company does not believe such judgment, along with any final damages award, will be entered until after the subsequent phases of the trial are completed.

To the extent the Company succeeds in proving some or all of Affymetrix' patents invalid or unenforceable, the damages amount may be reduced, including to zero, and the court may require a new trial on the damages amount. If the Company is not successful in the subsequent phases, damages may be assessed, in addition to the \$16.7 million amount, on post-2005 sales of the Company's products that were found to infringe the Affymetrix patents. Affymetrix has also asserted that certain of the Company's products launched post-2005 infringe these patents, but these other products were not at issue in the prior jury trial, and the court has yet to indicate how the issues of infringement and potential damages will be judged for these other products. In addition, Affymetrix is contending that the Company's infringement was willful, and if a jury finds the Company's infringement to be willful, the judge will have the discretion to increase any damage award by up to three times. Affymetrix has also contended that it should be awarded its attorney's fees and pre-judgment interest on any damages award.

The second phase of the trial, which has been scheduled to begin on February 11, 2008, will only address the issues of the validity of the Affymetrix patents being asserted and will be tried before a different jury. The Company's defense of inequitable conduct, and its counterclaims for tortious interference and unfair competition by Affymetrix, will be addressed in a third phase of the trial that is expected to be scheduled for late spring 2008. For Affymetrix to prevail in the case and receive a judgment in its favor, the patent claims found to have been infringed must also be found to be valid and enforceable in the remaining phases of the trial, and then such findings must be upheld on appeal. The Company believes it has prior art that pre-dates and invalidates the Affymetrix patents. The Company is also claiming that the inventors or their agents engaged in inequitable conduct before the United States Patent and Trademark Office in connection with the prosecution of one or more of the patents-in-suit, and it believes that this conduct should render the affected patents unenforceable.

In the second and third phases of the trial, the Affymetrix patents will be presumed to be valid and the Company will have the burden of proving, by clear and convincing evidence, that the patents are invalid and/or unenforceable. To the extent the Company is unable to prove invalidity or unenforceability, the court will likely enter a judgment against the Company and assess damages. Affymetrix is also seeking an injunction to prevent the Company from making, selling or offering to sell products that infringe patents that are found valid and enforceable.

## **Table of Contents**

On October 24, 2007, Affymetrix filed complaints in the U.S. District Court for the District of Delaware, in Regional Court in Düsseldorf (Germany), and in the High Court of Justice, Chancery Division Patents Court in London (United Kingdom) alleging that the use, manufacture and sale of certain of the Company's BeadArray products and services, including the Company's Array Matrix and BeadChip products, infringe three U.S. patents and three European patents of Affymetrix. In its U.S. complaint, Affymetrix also alleged that the Company's sequencing technology, including the Company's Genome Analyzer, infringes two Affymetrix U.S. patents. Affymetrix seeks an injunction against the sale of any products that may ultimately be determined to infringe these patents, unspecified monetary damages, interest and attorneys' fees. The Company believes that it does not infringe any valid claims of the patents asserted by Affymetrix in its recent complaints.

Although the Company believes that it has strong defenses to Affymetrix' patent claims, the results of litigation are difficult to predict and no assurance can be given that the Company will succeed in proving the patents were not infringed, or are invalid or unenforceable. Judges overseeing these types of cases have discretion over how and when issues will be tried, and over the granting and scope of any injunction. Any damages award or injunction would be subject to appeal and the Company will carefully consider that option at the appropriate time. In such a case, if the Company chooses to appeal, the Company would likely be required to post a bond or provide other security for some or the entire amount of the final damages award during the appeal, and such amount may be material.

The Company has analyzed the potential for a loss from the March 2007 jury verdict of infringement in accordance with SFAS No. 5, *Accounting for Contingencies*. Due to the Company's beliefs about its position in that case, and because the Company is unable to reasonably estimate the amount of loss the Company would incur if it does not prevail, the Company has not recorded a reserve for contingent loss. Should the Company ultimately lose either of these lawsuits, such result could have a material adverse effect on its consolidated results of operations for the period in which the loss is recorded.

### ***Former Employee Claim***

On June 15, 2005, a former employee, filed suit against the Company in the U.S. District Court for the District of Delaware seeking an order requiring the Company and the U.S. Patent and Trademark Office to correct the inventorship of certain of the Company's patents and patent applications by adding the former employee as an inventor, alleging that the Company committed inequitable conduct and fraud in not naming him as an inventor, and seeking a judgment declaring certain of the Company's patents and patent applications unenforceable, unspecified monetary damages and attorney's fees. In July 2006, the court granted the Company's motion to dismiss the counts of the complaint dealing with correction of inventorship in pending applications and inequitable conduct, and the Company filed an answer to the two remaining counts of the amended complaint (correction of inventorship in issued patents, and fraud). Trial is expected in 2008. The Company believes it has meritorious defenses against these claims.

**Table of Contents****12. Collaborative Agreements***deCODE genetics*

In May 2006, the Company and deCODE genetics, ehf. (deCODE) executed a Joint Development and Licensing Agreement (the Development Agreement). Pursuant to the Development Agreement, the parties agreed to collaborate exclusively to develop, validate and commercialize specific diagnostic tests for variants in genes involved in three disease-related pathways: the gene-encoding leukotriene A4 hydrolase, linked to heart attack; the gene-encoding transcription factor 7-like 2 (TCF7L2), linked to type 2 diabetes; and the gene-encoding BARD1, linked to breast cancer. The Company and deCODE are developing diagnostic tests based on these variants for use on the Company's BeadXpress system.

Under the agreement, the Company will be responsible for the manufacturing, marketing and selling of the diagnostic products. The companies will share the development costs of these products and split the profits from sales of the diagnostics tests. The Development Agreement may be terminated as to a particular product under development if one party decides to discontinue funding the development of that product, and may be terminated in whole by either party if the other party commits an uncured material breach, files for bankruptcy or becomes insolvent. Under a separate supply agreement, the Company installed instrumentation at deCODE that will enable deCODE to perform whole genome association studies on up to 100,000 samples using the Company's Sentrix HumanHap300 BeadChips and associated reagents. The Company has deferred approximately \$2.0 million of revenue for instruments installed during the third quarter of 2006 under guidance provided by SFAS No. 48, *Revenue Recognition When Right of Return Exists*. This amount is classified as a long-term customer deposit as of September 30, 2007. The Company has also deferred approximately \$1.3 million of costs related to product shipments to deCODE, which are classified as a long-term asset as of September 30, 2007.

**13. Investment in Genizon BioSciences Inc.**

In January 2006, Genizon BioSciences Inc. (Genizon), a Canadian company focused on gene discovery, purchased from the Company approximately \$1.9 million in equipment and committed to purchase an additional \$4.3 million in consumables. Genizon is using Illumina's products to perform whole-genome and targeted association studies involving thousands of members of the Quebec Founder Population. The goal of the studies is to provide understanding of the genetic origins and mechanisms of common diseases which may then lead to possible drug targets.

In March 2006, the Company entered into a Subscription Agreement for Secured Convertible Debentures with Genizon. Pursuant to the agreement, the Company purchased a secured convertible debenture (the debenture) of Genizon and certain warrants for CDN\$3.5 million (approximately U.S. \$3.0 million).

The debenture is convertible, automatically upon the occurrence of a liquidity event, as defined in the debenture, into Class H Preferred Shares of Genizon. Upon the occurrence of certain events, Illumina may be entitled to receive additional shares of Genizon's Class H Preferred Shares. The debenture matures two years from issuance and bears interest, payable semiannually, at a rate of 5% per annum for the first year and 12.5% per annum for the second year. Unless the debenture is converted before maturity, 112.5% of the principal amount of the debenture is due upon maturity. Illumina also received warrants to purchase 226,721 shares of Genizon Class H Preferred Shares at an exercise price of \$1.54 per share.

As of September 30, 2007, the debenture was recorded at face value, which is the fair value, and is classified in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, as an available-for-sale security.

The Company concluded that the purchase of the debenture and the concurrent purchase by Genizon of Illumina's products are linked transactions under guidance contained in EITF No. 00-21. Since the transactions are considered

linked, the Company deferred approximately \$3.0 million of revenue (the face value of the Debentures) in the first quarter of 2006, related to the Genizon product shipments. The deferred revenue is classified as a short-term liability as of September 30, 2007. This amount is expected to remain in deferred revenue until Genizon settles the Debenture in cash or when a liquidity event occurs that generates cash or a security that is readily convertible into cash. The Company has deferred approximately \$1.1 million of costs related to product shipments to Genizon, in the first quarter of 2006, which is classified as an other current asset as of September 30, 2007. All Genizon shipments that generate

revenue over the face value of the debenture will be evaluated under the Company's revenue recognition policy, which is outlined in Note 1.

**Table of Contents**

**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 Quarterly Report on Form 10-Q and the financial statements and notes thereto for the year ended December 31, 2006 included in our Annual Report on Form 10-K. Operating results are not necessarily indicative of results that may occur in future periods.

The discussion and analysis in this Quarterly Report on Form 10-Q contain forward-looking statements that involve risk and uncertainties, such as statements of our plans, objectives, expectations and intentions. Words such as anticipate, believe, continue, estimate, expect, intend, may, plan, potential, predict, project, or similar phrases, or the negatives of these words, may identify forward-looking statements, but the absence of these words does not necessarily mean that a statement is not forward-looking. Examples of forward-looking statements include, among others, statements regarding the costs and outcome of our litigation with Affymetrix, the integration of Solexa's technology with our existing technology, the commercial launch of new products, including products based on Solexa's and our VeraCode technologies, and the duration which our existing cash and other resources is expected to fund our operating activities.

Forward-looking statements are subject to known and unknown risks and uncertainties and are based on potentially inaccurate assumptions that could cause actual results to differ materially from those expected or implied by the forward-looking statements. Factors that could cause or contribute to these differences include, but are not limited to, those discussed in the subsection entitled Item 1A. Risk Factors. below as well as those discussed elsewhere. Accordingly, you should not unduly rely on these forward-looking statements, which speak only as of the date of this Quarterly Report. We undertake no obligation to publicly revise these forward-looking statements to reflect circumstances or events after the date of this Quarterly Report or to reflect the occurrence of unanticipated events. You should, however, review the factors and risks we describe in the reports we file from time to time with the Securities and Exchange Commission (SEC).

**Overview**

We are a leading developer, manufacturer and marketer of next-generation life science tools and integrated systems for the large scale analysis of genetic variation and biological function. Using our proprietary technologies, we provide a comprehensive line of products and services that currently serve the sequencing, genotyping and gene expression markets, and we expect to enter the market for molecular diagnostics. Our customers include leading genomic research centers, pharmaceutical companies, academic institutions, clinical research organizations and biotechnology companies. Our tools provide researchers around the world with the performance, throughput, cost effectiveness and flexibility necessary to perform the billions of genetic tests needed to extract valuable medical information from advances in genomics and proteomics. We believe this information will enable researchers to correlate genetic variation and biological function, which will enhance drug discovery and clinical research, allow diseases to be detected earlier and permit better choices of drugs for individual patients.

**Table of Contents****Our Technologies***BeadArray Technology*

We have developed a proprietary array technology that enables the large-scale analysis of genetic variation and biological function. Our BeadArray technology combines microscopic beads and a substrate in a simple proprietary manufacturing process to produce arrays that can perform many assays simultaneously. Our BeadArray technology provides a unique combination of high throughput, cost effectiveness, and flexibility. We believe that these features have enabled our BeadArray technology to become a leading platform for the emerging high-growth market of SNP genotyping and expect they will enable us to become a key player in the gene expression market.

*Sequencing Technology*

Our DNA sequencing technology, acquired as part of the Solexa, Inc. (Solexa) merger that was completed on January 26, 2007, is based on the use of our proprietary sequencing-by-synthesis (SBS) biochemistry. We believe that our technology, which can potentially generate over a billion bases of DNA sequence from a single experiment with a single sample preparation, will dramatically reduce the cost, and improve the practicality, of human resequencing compared to conventional technologies.

*VeraCode Technology*

The VeraCode technology, acquired as part of the acquisition of CyVera Corporation in April 2005, enables cost-effective, high-throughput analysis of DNA, RNA and proteins at mid- to low- multiplex range. Multiplexing refers to the number of individual pieces of information that are simultaneously extracted from one sample. In addition to Life Science research applications, we believe the molecular diagnostics market will require systems that are extremely high throughput and cost effective in this mid- to low-multiplex range. We began shipping the BeadXpress System, which uses the VeraCode technology, for Life Science research applications during the first quarter of 2007, along with several assays for the system.

**Product Developments**

During the nine months ended September 30, 2007, we announced the following key new product developments:

*BeadXpress System.* The BeadXpress System is a high-throughput, dual-color laser detection system that enables scanning of a broad range of multiplexed assays developed using the VeraCode digital microbead technology. Shipments of the BeadXpress System began during the first quarter of 2007.

*Illumina Genome Analyzer.* This product can generate more than one billion bases of data in a single run using a massively parallel sequencing approach. The system leverages Solexa sequencing technology and novel reversible terminator chemistry, optimized to achieve unprecedented levels of cost effectiveness and throughput. Shipments of the Illumina Genome Analyzer began during the first quarter of 2007.

*Human 1M DNA Analysis BeadChip.* This product combines an unprecedented level of content for both whole-genome and copy number variation (CNV) analysis, along with additional unique, high-value genomic regions of interest all on a single microarray chip. Shipments of the Human 1M DNA Analysis BeadChip began during the second quarter of 2007.

*HumanCNV370-Duo BeadChip.* The HumanCNV370-Duo enables researchers to analyze two samples simultaneously and access novel content for detecting disease-relevant CNV regions. Shipments of the HumanCNV370-Duo BeadChip began during the second quarter of 2007.

*HumanHap550-Duo BeadChip.* The HumanHap550-Duo provides the same content as the HumanHap550 BeadChip in a dual-format, resulting in significantly greater throughput and lower costs per sample. The HumanHap550-Duo contains more than 550,000 SNPs, selected based on a novel tag SNP approach. Shipments of the HumanHap550-Duo BeadChip began during the third quarter of 2007.

## **Table of Contents**

### **Critical Accounting Policies and Estimates**

#### *General*

Our discussion and analysis of our financial condition and results of operations is based upon our condensed unaudited consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of financial statements requires that management make estimates, assumptions and judgments with respect to the application of accounting policies that affect the reported amounts of assets, liabilities, revenue and expenses, and the disclosures of contingent assets and liabilities. Actual results could differ from those estimates. Our significant accounting policies are described in Note 1 to our unaudited condensed consolidated financial statements. Certain accounting policies are deemed critical if 1) they require an accounting estimate to be made based on assumptions that were highly uncertain at the time the estimate was made, and 2) changes in the estimate that are reasonably likely to occur, or different estimates that we reasonably could have used would have a material effect on our unaudited condensed consolidated financial statements.

Management has discussed the development and selection of these critical accounting policies with the Audit Committee of our Board of Directors, and the Audit Committee has reviewed the disclosure. In addition, there are other items within our financial statements that require estimation, but are not deemed critical as defined above. We believe the following critical accounting policies reflect our more significant estimates and assumptions used in the preparation of the unaudited condensed consolidated financial statements.

#### *Revenue Recognition*

Our revenue is generated primarily from the sale of products and services. Product revenue consists of sales of arrays, reagents, flow cells, instrumentation and oligonucleotides (oligos), which are short pieces of DNA. Service and other revenue consists of revenue received for performing genotyping and sequencing services, extended warranty sales and revenue earned from milestone payments.

We recognize revenue in accordance with the guidelines established by SEC Staff Accounting Bulletin (SAB) No. 104. Under SAB No. 104, revenue cannot be recorded until all of the following criteria have been met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the seller's price to the buyer is fixed or determinable; and collectibility is reasonably assured. All revenue is recorded net of any applicable allowances for returns or discounts.

Revenue for product sales is recognized generally upon shipment and transfer of title to the customer, provided no significant obligations remain and collection of the receivables is reasonably assured. Revenue from the sale of instrumentation is recognized when earned, which is generally upon shipment. Revenue for genotyping and sequencing services is recognized when earned, which is generally at the time the genotyping and sequencing analysis data is delivered to the customer or as specific milestones are achieved.

In order to assess whether the price is fixed and determinable, we ensure there are no refund rights. If payment terms are based on future performance or a right of return exists, we defer revenue recognition until the price becomes fixed and determinable. We assess collectibility based on a number of factors, including past transaction history with the customer and the creditworthiness of the customer. If we determine that collection of a payment is not reasonably assured, revenue recognition is deferred until the time collection becomes reasonably assured, which is generally upon receipt of payment. Changes in judgments and estimates regarding application of SAB No. 104 might result in a change in the timing or amount of revenue recognized.

Sales of instrumentation generally include a standard one-year warranty. We also sell separately priced maintenance (extended warranty) contracts, which are generally for one or two years, upon the expiration of the initial warranty. Revenue for extended warranty sales is recognized ratably over the term of the extended warranty period. Reserves are provided for estimated product warranty expenses at the time the associated revenue is recognized. If we were to experience an increase in warranty claims or if costs of servicing our warrantied products were greater than our estimates, gross margins could be adversely affected.

While the majority of our sales agreements contain standard terms and conditions, we do enter into agreements that contain multiple elements or non-standard terms and conditions. Emerging Issues Task Force (EITF) No. 00-21, *Revenue Arrangements with Multiple Deliverables*, provides guidance on accounting for arrangements that involve the delivery or performance of multiple products, services, or rights to use assets within contractually binding arrangements. Significant contract interpretation is sometimes required to determine the appropriate accounting,

including whether the deliverables specified in a multiple element arrangement should be treated as separate units of accounting for revenue recognition purposes, and if so, how the price should be allocated among the deliverable elements, when to recognize revenue for each element, and the period over which revenue should be recognized. We recognize revenue for delivered elements only when we determine that the fair values of undelivered elements are known and there are no uncertainties regarding customer acceptance.

## **Table of Contents**

Research revenue consists of amounts earned under research agreements with government grants, which is recognized in the period during which the related costs are incurred.

### *Allowance for Doubtful Accounts*

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We evaluate the collectibility of our accounts receivable based on a combination of factors. We regularly analyze customer accounts, review the length of time receivables are outstanding and review historical loss rates. If the financial condition of our customers were to deteriorate, additional allowances could be required.

### *Inventory Valuation*

We record adjustments to inventory for potentially excess, obsolete or impaired goods in order to state inventory at net realizable value. We must make assumptions about future demand, market conditions and the release of new products that will supercede old ones. We regularly review inventory for excess and obsolete products and components, taking into account product life cycle and development plans, product expiration and quality issues, historical experience and our current inventory levels. If actual market conditions are less favorable than anticipated, additional inventory adjustments could be required.

### *Contingencies*

We are subject to legal proceedings primarily related to intellectual property matters. Based on the information available at the balance sheet dates and through consultation with our legal counsel, we assess the likelihood of any adverse judgments or outcomes of these matters, as well as the potential ranges of probable losses. If losses are probable and reasonably estimable, we will record a liability in accordance with Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*. Currently, we have no such liabilities recorded. This may change in the future depending upon new developments in each matter.

### *Goodwill and Intangible Asset Valuation*

The purchase method of accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including in-process research and development (IPR&D). Goodwill and intangible assets deemed to have indefinite lives are not amortized, but are subject to at least annual impairment tests. The amounts and useful lives assigned to other acquired intangible assets impact future amortization, and the amount assigned to IPR&D is expensed immediately. Determining the fair values and useful lives of intangible assets especially requires the exercise of judgment. While there are a number of different acceptable generally accepted valuation methods to estimate the value of intangible assets acquired, we primarily use the discounted cash flow method. This method requires significant management judgment to forecast the future operating results used in the analysis. In addition, other significant estimates are required such as residual growth rates and discount factors. The estimates we use to value and amortize intangible assets are consistent with the plans and estimates that we use to manage our business and are based on available historical information and industry estimates and averages. These judgments can significantly affect our net operating results.

SFAS No. 142, *Goodwill and Other Intangible Assets*, requires that goodwill and certain intangible assets be assessed for impairment using fair value measurement techniques. If the carrying amount of a reporting unit exceeds its fair value, then a goodwill impairment test is performed to measure the amount of the impairment loss, if any. The goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. The implied fair value of goodwill is determined in the same manner as in a business combination. Determining the fair value of the implied goodwill is judgmental in nature and often involves the use of significant estimates and assumptions. These estimates and assumptions could have a significant impact on whether or not an impairment charge is recognized and also the magnitude of any such charge. Estimates of fair value are primarily determined using discounted cash flows and market comparisons. These approaches use significant estimates and assumptions, including projection and timing of future cash flows, discount rates reflecting the risk inherent in future cash flows, perpetual growth rates, determination of appropriate market comparables, and determination of whether a premium or discount should be applied to comparables. It is reasonably possible that the plans and estimates used to value these assets may be incorrect. If our actual results, or the plans and estimates used in future impairment analyses, are lower than the original estimates used to assess the recoverability of these assets, we could incur

additional impairment charges. As of September 30, 2007, we had \$249.2 million of goodwill. This goodwill is reported as a separate line item in the balance sheet. We perform our test of goodwill annually in May. We have determined there has been no impairment of goodwill through September 30, 2007.

**Table of Contents***Stock-Based Compensation*

We account for stock-based compensation in accordance with SFAS No. 123R, *Share-Based Payment*. Under the provisions of SFAS No. 123R, stock-based compensation cost is estimated at the grant date based on the award's fair-value as calculated by the Black-Scholes-Merton (BSM) option-pricing model and is recognized as expense over the requisite service period. The BSM model requires various highly judgmental assumptions including volatility, forfeiture rates, and expected option life. If any of these assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

*Income Taxes*

In accordance with SFAS No. 109, *Accounting for Income Taxes*, the provision for income taxes is computed using the asset and liability method, under which deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities, and for the expected future tax benefit to be derived from tax loss and credit carryforwards. Deferred tax assets and liabilities are determined using the enacted tax rates in effect for the years in which those tax assets are expected to be realized. A valuation allowance is established when it is more likely than not the future realization of all or some of the deferred tax assets will not be achieved. The evaluation of the need for a valuation allowance is performed on a jurisdiction by jurisdiction basis, and includes a review of all available positive and negative evidence. As of September 30, 2007, we have maintained a full valuation allowance against our U.S. deferred tax assets and certain foreign deferred tax assets, since we have not met the more likely than not threshold required under SFAS No. 109.

Due to the adoption of SFAS No. 123R, we recognize excess tax benefits associated with share-based compensation to stockholders' equity only when realized. When assessing whether excess tax benefits relating to share-based compensation have been realized, we follow the with-and-without approach excluding any indirect effects of the excess tax deductions. Under this approach, excess tax benefits related to share-based compensation are not deemed to be realized until after the utilization of all other tax benefits available to us.

Effective January 1, 2007, we adopted FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*—an interpretation of FASB Statement No. 109, which clarifies the accounting for uncertainty in tax positions. FIN No. 48 requires that we recognize the impact of a tax position in our financial statements only if that position is more likely than not of being sustained upon examination by taxing authorities, based on the technical merits of the position. The adoption of FIN No. 48 did not result in an adjustment to our opening retained earnings since there was no cumulative effect from the change in accounting principle due to our maintaining a full valuation allowance against our U.S. deferred tax assets. At the date of adoption, we reduced our deferred tax assets and related valuation allowance by approximately \$5.1 million for uncertain tax positions. As of September 30, 2007, we have reduced our deferred tax assets and related valuation allowance by approximately \$8.1 million for uncertain tax positions. Interest and penalties, if any, related to uncertain tax positions will be reflected in income tax expense. Tax years 1998 to 2006 remain subject to future examination by the major tax jurisdictions in which we are subject to tax.

**Results of Operations**

To enhance comparability, the following table sets forth our unaudited condensed consolidated statements of operations for the specified reporting periods stated as a percentage of total revenue.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September</b>	<b>October</b>	<b>September</b>	<b>October</b>
	<b>30,</b>	<b>1,</b>	<b>30,</b>	<b>1,</b>
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Revenue:				
Product revenue	92%	88%	89%	86%
Service and other revenue	8	12	11	13
Research revenue				1
Total revenue	100	100	100	100

Costs and expenses:				
Cost of product revenue	35	27	33	27
Cost of service and other revenue	3	3	4	4
Research and development	20	14	21	20
Selling, general and administrative	25	27	28	32
Amortization of acquired intangible assets	1		1	
Acquired in-process research and development			119	
Total costs and expenses	84	71	206	83
Income (loss) from operations	16	29	(106)	17
Interest and other income, net	4	3	4	3
Income (loss) before income taxes	20	32	(102)	20
Provision for income taxes	5	2	6	1
Net income (loss)	15%	30%	(108)%	19%

**Table of Contents*****Three and Nine Months Ended September 30, 2007 and October 1, 2006***

Our fiscal year consists of 52 or 53 weeks ending the Sunday closest to December 31, with quarters of 13 or 14 weeks ending the Sunday closest to March 31, June 30, and September 30. The three and nine months ended September 30, 2007 and October 1, 2006 were both 13 and 39 weeks, respectively.

***Revenue***

	<b>Three Months Ended</b>		<b>Percentage Change</b>	<b>Nine Months Ended</b>		<b>Percentage Change</b>
	<b>September</b>	<b>October</b>		<b>September</b>	<b>October</b>	
	<b>30, 2007</b>	<b>1, 2006</b>		<b>30, 2007</b>	<b>1, 2006</b>	
	<b>(in thousands)</b>			<b>(in thousands)</b>		
Product revenue	\$ 90,021	\$ 46,918	92%	\$ 225,583	\$ 106,582	112%
Service and other revenue	7,364	6,441	14%	28,211	16,503	71%
Research revenue	125	113	11%	400	1,066	(62)%
Total revenue	\$ 97,510	\$ 53,472	82%	\$ 254,194	\$ 124,151	105%

Total revenue was \$97.5 million and \$254.2 million, respectively, for the three and nine months ended September 30, 2007, compared to \$53.5 million and \$124.2 million, respectively, for the three and nine months ended October 1, 2006. This represents an increase of \$44.0 million, or 82%, and \$130.0 million, or 105%, respectively, compared to the three and nine months ended October 1, 2006.

Product revenue increased to \$90.0 million and \$225.6 million, respectively, for the three and nine months ended September 30, 2007 compared to \$46.9 million and \$106.6 million, respectively, for the three and nine months ended October 1, 2006. The increase for the three months ended September 30, 2007 was primarily driven by higher instrument sales, mainly associated with sales of the Illumina Genome Analyzer, which was introduced during the first quarter of 2007, as well as higher consumable sales. The increase for the nine months ended September 30, 2007 was primarily driven by increased sales of consumables and, to a lesser extent, higher instrument sales. Growth in consumable revenue was primarily attributable to strong demand for our Infinium products, which we began selling during the second quarter of 2006. In addition, growth in product revenue can be attributed to the growth in our installed base of instruments. We expect to see continued growth in product revenue, which can be mainly attributed to the launch of several new products, sales of existing products and the growth of our installed base of instruments.

Service and other revenue increased to \$7.4 million and \$28.2 million, respectively, for the three and nine months ended September 30, 2007, as compared to \$6.4 million and \$16.5 million, respectively, for the three and nine months ended October 1, 2006. The increase in service and other revenue is primarily due to the completion of several significant Infinium and iSelect custom SNP genotyping service contracts and sequencing services contracts. We expect sales from SNP genotyping and sequencing services contracts to fluctuate on a yearly and quarterly basis, depending on the mix and number of contracts that are completed. The timing of completion of SNP genotyping and sequencing services contracts are highly dependent on the customers' schedules for delivering the SNPs and samples to us.

Government grants and other research funding remained relatively consistent for the three months ended September 30, 2007 as compared to the three months ended October 1, 2006, but decreased to \$0.4 million for the nine months ended September 30, 2007 from \$1.1 million for the nine months ended October 1, 2006. We do not expect research revenue to be a material component of our total revenue going forward.

**Table of Contents***Cost of Product and Service and Other Revenue*

	<b>Three Months Ended</b>			<b>Nine Months Ended</b>		
	<b>September</b>	<b>October</b>		<b>September</b>	<b>October</b>	
	<b>30,</b>	<b>1,</b>	<b>Percentage</b>	<b>30,</b>	<b>1,</b>	<b>Percentage</b>
	<b>2007</b>	<b>2006</b>	<b>Change</b>	<b>2007</b>	<b>2006</b>	<b>Change</b>
	<b>(in thousands)</b>			<b>(in thousands)</b>		
Cost of product revenue	\$ 34,582	\$ 14,523	138%	\$ 83,436	\$ 34,111	145%
Cost of service and other revenue	2,496	1,833	36%	8,903	5,114	74%
Total cost of product and service and other revenue	\$ 37,078	\$ 16,356	127%	\$ 92,339	\$ 39,225	135%

Cost of product and service and other revenue represents manufacturing costs incurred in the production process, including component materials, assembly labor and overhead, installation, warranty, packaging and delivery costs, as well as costs associated with performing genotyping services on behalf of our customers. Costs related to research revenue are included in research and development expense. Cost of product revenue increased to \$34.6 million and \$83.4 million, respectively, for the three and nine months ended September 30, 2007, compared to \$14.5 million and \$34.1 million, respectively, for the three and nine months ended October 1, 2006, primarily driven by higher consumable and instrument sales. Cost of product revenue for the three and nine months ended September 30, 2007 included non-cash stock-based compensation expense totaling \$1.1 million and \$2.9 million, respectively, compared to \$0.4 million and \$0.9 million, respectively, for the three and nine months ended October 1, 2006. Gross margin on product revenue decreased to 62% and 63%, respectively, for the three and nine months ended September 30, 2007 compared to 69% and 68%, respectively, for the three and nine months ended October 1, 2006. The decrease in the gross margin percentage for both periods is primarily due to unfavorable product mix. In addition, the gross margin percentage for both periods was adversely impacted by the increase in non-cash stock-based compensation expense. In the nine months ended September 30, 2007, the amortization of inventory revaluation costs related to our acquisition of Solexa in January 2007 adversely impacted the gross margin by \$0.8 million. The impact of non-cash stock-based compensation charges decreased our gross margin by 41 basis points and 48 basis points, respectively, for the three and nine months ended September 30, 2007, compared to the three and nine months ended October 1, 2006. The inventory revaluation costs decreased our gross margin by 34 basis points for the nine months ended September 30, 2007, compared to the nine months ended October 1, 2006.

Cost of service and other revenue increased to \$2.5 million and \$8.9 million, respectively, for the three and nine months ended September 30, 2007, compared to \$1.8 million and \$5.1 million, respectively, for the three and nine months ended October 1, 2006, primarily due to higher service revenue. Gross margin on service and other revenue was 66% and 68%, respectively, for the three and nine months ended September 30, 2007, compared to 72% and 69%, respectively, for the three and nine months ended October 1, 2006. The decrease in the gross margin percentage is primarily driven by unfavorable product mix.

We expect product mix to continue to affect our future gross margins. We expect price competition to continue in our market, and our margins may fluctuate from year to year and quarter to quarter as a result.

*Research and Development Expenses*

	<b>Three Months Ended</b>			<b>Nine Months Ended</b>		
	<b>September</b>	<b>October</b>		<b>September</b>	<b>October 1,</b>	
	<b>30,</b>	<b>1,</b>	<b>Percentage</b>	<b>30,</b>	<b>2006</b>	<b>Percentage</b>
	<b>2007</b>	<b>2006</b>	<b>Change</b>	<b>2007</b>		<b>Change</b>
	<b>(in thousands)</b>			<b>(in thousands)</b>		
	\$ 19,753	\$ 7,744	155%	\$ 53,893	\$ 24,547	120%

Research and  
development

Our research and development expenses consist primarily of salaries and other personnel-related expenses, laboratory supplies and other expenses related to the design, development, testing and enhancement of our products. We expense our research and development expenses as they are incurred.

Research and development expenses increased to \$19.8 million and \$53.9 million, respectively, for the three and nine months ended September 30, 2007, compared to \$7.7 million and \$24.5 million, respectively, for the three and nine months ended October 1, 2006. Research and development expenses as a percentage of total revenue were 20% and 21%, respectively, for the three and nine months ended September 30, 2007, compared to 14% and 20%, respectively, for the three and nine months ended October 1, 2006.

Approximately \$7.3 million and \$19.4 million, respectively, of the increase for the three and nine months ended September 30, 2007 was due to higher research and development expenses associated with our acquisition of Solexa in January 2007. Costs to support our BeadArray technology research activities increased approximately \$3.4 million and \$6.6 million, respectively, for the three and nine months ended September 30, 2007, compared to the three and nine months ended October 1, 2006, primarily due to an

**Table of Contents**

overall increase in personnel-related expenses and increased lab and material expenses. Several new Infinium chip products, including the Human 1M DNA Analysis BeadChip, HumanCNV370-Duo BeadChip and HumanHap550-Duo BeadChip, have been introduced to the market in 2007. In addition, non-cash stock-based compensation expense increased approximately \$1.7 million and \$4.2 million, respectively, compared to the three and nine months ended October 1, 2006. These increases were partially offset by decreases of \$0.3 million and \$0.8 million, respectively, in research and development expenses related to the VeraCode technology, compared to the three and nine months ended October 1, 2006. We began shipping our BeadXpress System, which is based on our VeraCode technology, during the first quarter of 2007. As a result of completing the development of this product, the related research and development expenses have decreased.

We believe a substantial investment in research and development is essential to remaining competitive and expanding into additional markets. Accordingly, we expect our research and development expenses to increase in absolute dollars as we expand our product base and integrate the operations of Solexa into our business.

*Selling, General and Administrative Expenses*

	<b>Three Months Ended</b>			<b>Nine Months Ended</b>		
	<b>September 30, 2007</b>	<b>October 1, 2006</b>	<b>Percentage Change</b>	<b>September 30, 2007</b>	<b>October 1, 2006</b>	<b>Percentage Change</b>
	<b>(in thousands)</b>			<b>(in thousands)</b>		

Selling, general and administrative

\$24,307	\$14,118	72%	\$71,237	\$39,143	82%
----------	----------	-----	----------	----------	-----

Our selling, general and administrative expenses consist primarily of personnel costs for sales and marketing, finance, human resources, business development, legal and general management, as well as professional fees, such as expenses for legal and accounting services. Selling, general and administrative expenses increased to \$24.3 million and \$71.2 million, respectively, for the three and nine months ended September 30, 2007, compared to \$14.1 million and \$39.1 million, respectively, for the three and nine months ended October 1, 2006. Selling, general and administrative expenses as a percentage of total revenue were 25% and 28%, respectively, for the three and nine months ended September 30, 2007, compared to 27% and 32%, respectively, for the three and nine months ended October 1, 2006. Selling, general and administrative expenses for the three and nine months ended September 30, 2007 included stock-based compensation expenses totaling \$4.9 million and \$14.0 million, respectively, compared to \$2.4 million and \$6.4 million, respectively, for the three and nine months ended October 1, 2006.

Sales and marketing expenses increased \$5.7 million for the three months ended September 30, 2007, compared to the three months ended October 1, 2006. The increase is primarily due to increases of \$4.0 million attributable to personnel-related expenses to support the growth of our business, \$1.3 million attributable to other non-personnel-related expenses consisting mainly of sales and marketing activities for our existing and new products, and \$0.4 million of non-cash stock-based compensation expense. General and administrative expenses increased \$4.5 million during the three months ended September 30, 2007, compared to the three months ended October 1, 2006, due to increases of \$2.3 million in personnel-related expenses associated with the growth of our business, \$2.1 million of non-cash stock-based compensation expense, and \$0.9 million in other outside services, primarily due to increases in consulting fees, partially offset by a \$0.8 million decrease in legal fees from reduced activity related to our litigation with Affymetrix during the three months ended September 30, 2007.

Sales and marketing expenses increased \$14.8 million for the nine months ended September 30, 2007, compared to the nine months ended October 1, 2006. The increase is primarily due to increases of \$11.4 million attributable to personnel-related expenses to support the growth of our business, \$2.1 million attributable to other non-personnel-related expenses consisting mainly of sales and marketing activities for our existing and new products, and \$1.3 million of non-cash stock-based compensation expense. General and administrative expense increased \$17.3 million during the nine months ended September 30, 2007, compared to the nine months ended October 1, 2006, due to increases of \$6.3 million of non-cash stock-based compensation expense, \$5.8 million in personnel-related expenses associated with the growth of our business, \$2.0 million in outside legal fees primarily related to the

Affymetrix litigation and \$3.2 million in other outside service expenses, primarily due to increases in consulting fees.

We expect our selling, general and administrative expenses to increase in absolute dollars as we expand our staff, add sales and marketing infrastructure, incur increased litigation costs and incur additional costs to support the growth in our business.

**Table of Contents***Interest and Other Income, Net*

	<b>Three Months Ended</b>			<b>Nine Months Ended</b>		
	<b>September</b>	<b>October 1,</b>	<b>Percentage</b>	<b>September</b>	<b>October 1,</b>	<b>Percentage</b>
	<b>30,</b>	<b>2006</b>	<b>Change</b>	<b>30,</b>	<b>2006</b>	<b>Change</b>
	<b>2007</b>			<b>2007</b>		
	<b>(in thousands)</b>			<b>(in thousands)</b>		

Interest and other

income, net	\$3,978	\$1,996	99%	\$9,043	\$3,420	164%
-------------	---------	---------	-----	---------	---------	------

Interest income on our cash and cash equivalents and investments was \$4.3 million and \$11.6 million, respectively, for the three and nine months ended September 30, 2007, compared to \$2.2 million and \$3.6 million, respectively, for the three and nine months ended October 1, 2006. The increase in interest income over the prior periods was primarily driven by higher cash balances from the proceeds from our February 2007 convertible debt and May 2006 stock offerings, as well as improved operating cash flow. In addition, we experienced higher effective interest rates on our cash equivalents and short-term investments. These increases in interest income were partially offset by approximately \$1.0 million and \$2.6 million, respectively, of interest expense for the three and nine months ended September 30, 2007, primarily related to our convertible debt offering in February 2007. In addition, we experienced approximately \$0.7 million in net foreign currency transaction gains in the three months ended September 30, 2007. In the nine months ended September 30, 2007, there were immaterial amounts recognized in earnings related to net foreign currency transaction gains and losses.

*Provision for Income Taxes*

	<b>Three Months Ended</b>			<b>Nine Months Ended</b>		
	<b>September</b>	<b>October 1,</b>	<b>Percentage</b>	<b>September</b>	<b>October 1,</b>	<b>Percentage</b>
	<b>30,</b>	<b>2006</b>	<b>Change</b>	<b>30,</b>	<b>2006</b>	<b>Change</b>
	<b>2007</b>			<b>2007</b>		
	<b>(in thousands)</b>			<b>(in thousands)</b>		

Provision for income

taxes	\$5,185	\$1,088	377%	\$14,912	\$1,830	715%
-------	---------	---------	------	----------	---------	------

The provision for income taxes was approximately \$5.2 million and \$14.9 million for the three and nine months ended September 30, 2007, respectively, compared to \$1.1 million and \$1.8 million for the three and nine months ended October 1, 2006, respectively. The provision consists of federal, state, and foreign income tax expenses.

As of January 1, 2007, we had net operating loss carryforwards for federal and state tax purposes of approximately \$76.7 million and \$39.7 million, respectively, which begin to expire in 2022 and 2013, respectively, unless previously utilized. In addition, we also had U.S. federal and state research and development tax credit carryforwards of approximately \$6.5 million and \$6.4 million, respectively, which begin to expire in 2018 and 2019, respectively, unless previously utilized. As result of the Solexa acquisition on January 26, 2007, we obtained additional net operating loss carryforwards for federal and state tax purposes of approximately \$24.9 million and \$64.3 million, respectively, which begin to expire in 2025 and 2015, respectively, unless previously utilized. To the extent these assets are recognized, the adjustment will be applied first to reduce to zero any goodwill related to the acquisition, and then as a reduction to the income tax provision.

Pursuant to Section 382 and 383 of the Internal Revenue Code, utilization of our net operating losses and credits may be subject to annual limitations in the event of any significant future changes in our ownership structure. These annual limitations may result in the expiration of net operating losses and credits prior to utilization. Previous limitations due to Section 382 and 383 have been reflected in the deferred tax assets as of September 30, 2007.

Based upon the available evidence as of September 30, 2007, we are not able to conclude it is more likely than not the remaining deferred tax assets in the U.S. or certain foreign jurisdictions will be realized. Therefore, we have recorded a valuation allowance of approximately \$93.6 million and \$19.8 million against our U.S. deferred tax assets, and certain foreign deferred tax assets, respectively.

**Liquidity and Capital Resources***Cashflow (in thousands)*

	<b>Nine Months Ended</b>	
	<b>September 30, 2007</b>	<b>October 1, 2006</b>
Net cash provided by operating activities	\$ 44,441	\$ 30,219
Net cash used in investing activities	(136,068)	(142,366)
Net cash provided by financing activities	117,848	105,508
Effect of foreign currency translation on cash and cash equivalents	(500)	(17)
Net increase (decrease) in cash and cash equivalents	\$ 25,721	\$ (6,656)

28

## **Table of Contents**

Historically, our sources of cash have included:

issuance of equity and debt securities, including cash generated from the exercise of stock options and participation in our ESPP;

cash generated from operations, primarily from the collection of accounts receivable resulting from product sales; and

interest income.

Our historical cash outflows have primarily been associated with:

cash used for operating activities such as the purchase and growth of inventory, expansion of our sales and marketing and research and development infrastructure and other working capital needs;

cash used for our stock repurchases;

expenditures related to increasing our manufacturing capacity and improving our manufacturing efficiency; and

interest payments on our debt obligations.

Other factors that impact our cash inflow and outflow include the following:

significant increases in our product and services revenue, leading to gross margins greater than 64% in each of the last three fiscal years. As our product sales have increased significantly since 2001, our gross profit and operating income have increased significantly as well, providing us with an increased source of cash to finance the expansion of our operations; and

fluctuations in our working capital.

As of September 30, 2007, we had cash, cash equivalents and short-term investments of \$352.9 million, compared to \$130.8 million as of December 31, 2006. The primary inflows of cash during the nine months ended September 30, 2007 were approximately \$390.3 million from the net proceeds of our convertible debt offering in February 2007, \$256.2 million from the sale and maturity of our investments in available-for-sale securities, and \$92.6 million generated from the sale of warrants in February 2007. In addition, on January 26, 2007, we completed the merger with Solexa, which resulted in net cash acquired of \$72.1 million. The primary cash outflows during the nine months ended September 30, 2007 were attributable to the purchase of available-for-sale securities for approximately \$449.1 million, the repurchase of an aggregate of 7.4 million shares of our common stock for approximately \$251.6 million, as well as approximately \$139.0 million for the purchase of convertible note hedges. These convertible note transactions and our stock repurchase program are discussed in detail below.

On February 16, 2007, we issued \$400 million principal amount of 0.625% Convertible Senior Notes due 2014 (the Notes). The net proceeds from the offering, after deducting the initial purchasers' discount and offering expenses, were approximately \$390.3 million. We used approximately \$201.6 million of the net proceeds to purchase approximately 5.8 million shares of our common stock in privately negotiated transactions concurrently with the offering. We used \$46.6 million of the net proceeds of this offering to pay the cost of convertible note hedge and warrant transactions, which are designed to reduce the potential dilution upon conversion of the notes. We intend to use the balance of the net proceeds for other general corporate purposes, which may include acquisitions and additional repurchases of our common stock. The notes mature on February 15, 2014 and bear interest semi-annually at a rate of 0.625% per year, payable on February 15 and August 15 of each year, beginning on August 15, 2007. In addition, we may in certain circumstances be obligated to pay additional interest. If a designated event, as defined in the indenture for the notes, occurs, holders of the notes may require us to repurchase all or a portion of their notes for cash at a repurchase price equal to the principal amount of the notes to be repurchased, plus accrued and unpaid interest. In addition, upon conversion of the notes, we must pay the principal portion in cash. The notes will become convertible only in certain circumstances based on conditions relating to the trading price of the notes and our common stock or upon the

occurrence of specified corporate events. However, the notes will be convertible at any time from, and including, November 15, 2013 through the third scheduled trading day immediately preceding February 15, 2014.

On February 20, 2007, we executed a Rule 10b5-1 trading plan to repurchase up to \$75.0 million of our outstanding common stock over a period of six months. As of September 30, 2007, we had repurchased approximately 1.6 million shares of our common stock under this plan for approximately \$50.0 million in cash.

29

---

## **Table of Contents**

Our primary short-term needs for capital, which are subject to change, include expenditures related to:  
the continued advancement of research and development efforts;

support of our commercialization efforts related to our current and future products, including expansion of our direct sales force and field support resources both in the United States and abroad;

improvements in our manufacturing capacity and efficiency;

our facilities expansion needs, including costs of leasing additional facilities;

the acquisition of equipment and other fixed assets for use in our current and future manufacturing and research and development facilities; and

ongoing costs associated with our litigation with Affymetrix, including any potential damages and/or royalties that may be awarded to Affymetrix.

Approximately \$15.3 million of our net cash generated from operations for the nine months ended September 30, 2007 was used on capital expenditures, primarily for manufacturing and research and development equipment, furniture, fixtures and computer equipment and we anticipate using a significant portion of our net cash generated from operations on capital expenditures in the fourth quarter of 2007. We expect that our product revenue and the resulting operating income, as well as the status of each of our new product development programs, will significantly impact our cash management decisions.

We anticipate that our current cash and cash equivalents and income from operations will be sufficient to fund our operating needs for at least the next twelve months. Operating needs include the planned costs to operate our business, including amounts required to fund working capital and capital expenditures. At the present time, we have no material commitments for capital expenditures. However, our future capital requirements and the adequacy of our available funds will depend on many factors, including:

the successful resolution of our litigation with Affymetrix;

our ability to successfully commercialize our sequencing and VeraCode technologies and to expand our SNP genotyping services product lines;

scientific progress in our research and development programs and the magnitude of those programs;

competing technological and market developments; and

the need to enter into collaborations with other companies or acquire other companies or technologies to enhance or complement our product and service offerings.

As a result of the factors listed above, we may require additional funding in the future. Our failure to raise capital on acceptable terms, when needed, could have a material adverse effect on our business.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

#### ***Interest Rate Sensitivity***

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The fair market value of fixed rate securities may be adversely impacted by fluctuations in interest rates while income earned on floating rate securities may decline as a result of decreases in interest rates. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes. We attempt to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in investment grade securities. We have historically maintained a relatively short average maturity for our investment portfolio, and we believe a hypothetical 100 basis point adverse move in interest rates along the entire interest rate yield curve would not materially affect the fair value of our interest-sensitive

financial instruments.

30

---

**Table of Contents*****Foreign Currency Exchange Risk***

Although most of our revenue is realized in U.S. dollars, some portions of our revenue are realized in foreign currencies. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. The functional currencies of our subsidiaries are their respective local currencies. Accordingly, the accounts of these operations are translated from the local currency to the U.S. dollar using the current exchange rate in effect at the balance sheet date for the balance sheet accounts, and using an approximated weighted average exchange rate during the period for revenue and expense accounts. The effects of translation are recorded in accumulated other comprehensive income as a separate component of stockholders' equity.

Periodically, we hedge significant foreign currency firm sales commitments and accounts receivable with forward contracts. We only use derivative financial instruments to reduce foreign currency exchange rate risks; we do not hold any derivative financial instruments for trading or speculative purposes. We primarily use forward exchange contracts to hedge foreign currency exposures and they generally have terms of one year or less. These contracts have been designated as cash flow hedges and accordingly, to the extent effective, any unrealized gains or losses on these foreign currency forward contracts are reported in other comprehensive income. Realized gains and losses for the effective portion are recognized with the underlying hedge transaction. As of September 30, 2007, we had no foreign currency forward contracts outstanding. For the nine months ended September 30, 2007 and October 1, 2006, there were no amounts recognized in earnings due to hedge ineffectiveness and we settled foreign exchange contracts of \$0 and \$0.1 million, respectively.

**Item 4. Controls and Procedures.**

We design our internal controls to provide reasonable assurance that (1) our transactions are properly authorized; (2) our assets are safeguarded against unauthorized or improper use; and (3) our transactions are properly recorded and reported in conformity with U.S. generally accepted accounting principles. We also maintain internal controls and procedures to ensure that we comply with applicable laws and our established financial policies.

We have carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of 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, or the Securities Exchange Act), as of September 30, 2007. Based upon that evaluation, our principal executive officer and principal financial officer concluded that, as of September 30, 2007, our disclosure controls and procedures are effective to ensure that (a) the information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (b) such information is accumulated and communicated to our management, including our principal executive officer and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management have concluded that the disclosure controls and procedures are effective at the reasonable assurance level. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected.

An evaluation was also performed under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of any change in our internal control over financial reporting that occurred during the third quarter of 2007 and that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. That evaluation did not identify any such change. We completed the system upgrade of our new Enterprise Resource Planning system during the third quarter ended September 30, 2007, which included the integration of Solexa, Inc. onto this system. This system upgrade did not result in any change to our internal control over financial reporting. We are currently in the process of assessing and integrating Solexa, Inc.'s internal controls over financial reporting into our financial reporting systems and expect to complete our integration activities by the end of 2007.

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

We have incurred substantial costs in defending ourselves against patent infringement claims and expect to devote substantial financial and managerial resources to protect our intellectual property and to defend against the claims described below as well as any future claims asserted against us.

***Affymetrix Litigation***

On July 26, 2004, Affymetrix, Inc. (Affymetrix) filed a complaint in the U.S. District Court for the District of Delaware alleging that the use, manufacture and sale of our BeadArray products and services, including our Array Matrix and BeadChip products, infringe six Affymetrix patents. Affymetrix seeks an injunction against the sale of any products that may ultimately be determined to infringe these patents, unspecified monetary damages, interest and attorneys' fees. On February 15, 2006, we filed our first amended answer and counterclaims, adding allegations of inequitable conduct with respect to all six asserted Affymetrix patents, violation of Section 2 of the Sherman Act, and unclean hands. The scope of the trial was subsequently narrowed to five patents at the request of Affymetrix. In a February 2007 pre-trial order, the court established a multi-phase trial structure. The court explained that it decided to address our defenses of invalidity and enforceability of the patents-in-suit, as well as our claims for unfair competition and antitrust violations, in subsequent trials.

The first phase, which began on March 5, 2007, addressed the issues of infringement and damages. On March 13, 2007, the jury returned a verdict finding infringement of the five patents asserted by Affymetrix. That finding was made without consideration of the validity and enforceability of these five Affymetrix patents. The jury awarded retroactive damages, for sales prior to the end of 2005 of products launched by that time, at a royalty rate of 15% in an amount of approximately \$16.7 million. This first-phase verdict remains subject to our post-trial motions and appeals. A judgment on this verdict has not been entered in the case and we do not believe such judgment, along with any final damages award, will be entered until after the subsequent phases of the trial are completed.

To the extent we succeed in proving some or all of Affymetrix' patents invalid or unenforceable, the damages amount may be reduced, including to zero, and the court may require a new trial on the damages amount. If we are not successful in the subsequent phases, damages may be assessed, in addition to the \$16.7 million amount, on post-2005 sales of our products that were found to infringe the Affymetrix patents. Affymetrix has also asserted that certain of our products launched post-2005 infringe these patents, but these other products were not at issue in the prior jury trial, and the court has yet to indicate how the issues of infringement and potential damages will be judged for these other products. In addition, Affymetrix is contending that our infringement was willful, and if a jury finds our infringement to be willful, the judge will have the discretion to increase any damage award by up to three times. Affymetrix has also contended that it should be awarded its attorney's fees and pre-judgment interest on any damages award.

The second phase of the trial, which has been scheduled to begin on February 11, 2008, will only address the issues of the validity of the Affymetrix patents being asserted and will be tried before a different jury. Our defense of inequitable conduct, and our counterclaims for tortious interference and unfair competition by Affymetrix, will be addressed in a third phase of the trial that is expected to be scheduled for late spring 2008. For Affymetrix to prevail in the case and receive a judgment in its favor, the patent claims found to have been infringed must also be found to be valid and enforceable in the remaining phases of the trial, and then such findings must be upheld on appeal. We believe we have prior art that pre-dates and invalidates the Affymetrix patents. We are also claiming that the inventors or their agents engaged in inequitable conduct before the United States Patent and Trademark Office in connection with the prosecution of one or more of the patents in-suit, and we believe that this conduct should render the affected patents unenforceable.

In the second and third phases of the trial, the Affymetrix patents will be presumed to be valid and we will have the burden of proving, by clear and convincing evidence, that the patents are invalid and/or unenforceable. To the extent we are unable to prove invalidity or unenforceability, the court will likely enter a judgment against us and assess damages. Affymetrix is also seeking an injunction to prevent us from making, selling or offering to sell products that infringe patents that are found valid and enforceable.

On October 24, 2007, Affymetrix filed complaints in the U.S. District Court for the District of Delaware, in Regional Court in Düsseldorf (Germany), and in the High Court of Justice, Chancery Division Patents Court in London (United Kingdom) alleging that the use, manufacture and sale of certain of the Company's BeadArray products and services, including our Array Matrix and BeadChip products, infringe three U.S. patents and three European patents of Affymetrix. In its U.S. complaint, Affymetrix also alleged that our sequencing technology, including the Genome Analyzer, infringes two Affymetrix U.S. patents. Affymetrix seeks an injunction against the sale of any products that may ultimately be determined to infringe these patents, unspecified monetary damages, interest and attorneys' fees. We believe we do not infringe any valid claims of the patents asserted by Affymetrix in its recent complaints.

Although we believe we have strong defenses to Affymetrix' patent claims, the results of litigation are difficult to predict and no assurance can be given that we will succeed in proving the patents were not infringed, or are invalid or unenforceable. Judges overseeing these types of cases have discretion over how and when issues will be tried, and over the granting and scope of any injunction. Any damages award or injunction would be subject to appeal and we will carefully consider that option at the appropriate time. In such a case, if we choose to appeal, we would likely be required to post a bond or provide other security for some or the entire amount of the final damages award during the appeal, and such amount may be material.

**Table of Contents**

We have analyzed the potential for a loss from the March 2007 jury verdict of infringement in accordance with SFAS No. 5, *Accounting for Contingencies*. Due to our beliefs about our position in that case, and because we are unable to reasonably estimate the amount of loss we would incur if we do not prevail, we have not recorded a reserve for contingent loss. Should we ultimately lose either of these lawsuits, such result could have a material adverse effect on our consolidated results of operations for the period in which the loss is recorded.

***Former Employee Claim***

On June 15, 2005, a former employee, filed suit against us in the U.S. District Court for the District of Delaware seeking an order requiring us and the U.S. Patent and Trademark Office to correct the inventorship of certain of our patents and patent applications by adding the former employee as an inventor, alleging that we committed inequitable conduct and fraud in not naming him as an inventor, and seeking a judgment declaring certain of our patents and patent applications unenforceable, unspecified monetary damages and attorney's fees. In July 2006, the court granted our motion to dismiss the counts of the complaint dealing with correction of inventorship in pending applications and inequitable conduct, and we filed an answer to the two remaining counts of the amended complaint. Trial is expected in 2008. We believe we have meritorious defenses against these claims.

**ITEM 1A. Risk Factors.**

Our business is subject to various risks, including those described below. In addition to the other information included in this Form 10-Q, the following issues could adversely affect our operating results or our stock price.

***Litigation or other proceedings or third party claims of intellectual property infringement could require us to spend significant time and money and could prevent us from selling our products or services or impact our stock price.***

Our commercial success depends, in part, on our non-infringement of the patents or proprietary rights of third parties and on our ability to protect our own intellectual property. As we have previously disclosed, in July 2004 Affymetrix, Inc. filed a complaint against us in federal court in Wilmington, Delaware, alleging infringement of six of its patents. In a preliminary proceeding, the scope of the trial was narrowed to five patents at the request of Affymetrix. A March 5, 2007 infringement trial led to a jury finding of infringement of these five patents. That finding was made without consideration of the validity and enforceability of these patents. The jury also ordered us to pay damages based on a royalty of 15% for certain products that we launched and sold before the end of 2005. The total amount of damages awarded by the jury was \$16.7 million. Although we believe the subsequent trials will confirm the invalidity and unenforceability positions we have taken with respect to these Affymetrix patents, we cannot assure you that the patents will be found invalid or unenforceable. In addition, patents enjoy a presumption of validity that can be rebutted only by clear and convincing evidence. Any adverse ruling or perception of an adverse ruling throughout these proceedings will likely have a material adverse impact on our stock price, which may be disproportionate to the actual import of the ruling itself.

Third parties, including Affymetrix, have asserted or may assert that we are employing their proprietary technology without authorization. As we enter new markets, we expect that competitors will likely assert that our products infringe their intellectual property rights as part of a business strategy to impede our successful entry into those markets. In addition, third parties may have obtained and may in the future obtain patents allowing them to claim that the use of our technologies infringes these patents. We could incur substantial costs and divert the attention of our management and technical personnel in defending ourselves against any of these claims. Furthermore, parties making claims against us may be able to obtain injunctive or other relief, which effectively could block our ability to develop further, commercialize and sell products, and could result in the award of substantial damages against us. In the event of a successful claim of infringement against us, we may be required to pay damages and obtain one or more licenses from third parties, or be prohibited from selling certain products. We may also not be able to obtain these licenses at a reasonable cost, if at all. We could therefore incur substantial costs related to royalty payments for licenses obtained from third parties, which could negatively affect our gross margins. In addition, we could encounter delays in product introductions while we attempt to develop alternative methods or products. Defense of any lawsuit or failure to obtain any of these licenses on favorable terms could prevent us from commercializing products, and the prohibition of sale of any of our products could materially affect our ability to grow and maintain profitability.

**Table of Contents**

***We expect intense competition in our target markets, which could render our products obsolete, result in significant price reductions or substantially limit the volume of products that we sell. This would limit our ability to compete and maintain profitability. If we cannot continuously develop and commercialize new products, our revenue may not grow as intended.***

We compete with life sciences companies that design, manufacture and market instruments for analysis of genetic variation and biological function and other applications using technologies such as two-dimensional electrophoresis, capillary electrophoresis, mass spectrometry, flow cytometry, microfluidics, nanotechnology, next-generation DNA sequencing and mechanically deposited, inkjet and photolithographic arrays. We anticipate that we will face increased competition in the future as existing companies develop new or improved products and as new companies enter the market with new technologies. The markets for our products are characterized by rapidly changing technology, evolving industry standards, changes in customer needs, emerging competition, new product introductions and strong price competition. For example, prices per data point for genotyping have fallen significantly over the last two years and we anticipate that prices will continue to fall. One or more of our competitors may render our technology obsolete or uneconomical. Some of our competitors have greater financial and personnel resources, broader product lines, a more established customer base and more experience in research and development than we do. Furthermore, life sciences and pharmaceutical companies, which are our potential customers and strategic partners, could develop competing products. For example, Applied Biosystems Group, a business segment of Applera Corporation, recently launched the SOLiD System, its next generation sequencing technology. If we are unable to develop enhancements to our technology and rapidly deploy new product offerings, our business, financial condition and results of operations will suffer.

***We may encounter difficulties in integrating acquisitions that could adversely affect our business.***

We acquired Solexa, Inc. (Solexa) in January 2007 and CyVera Corporation in April 2005 and we may in the future acquire technology, products or businesses related to our current or future business. We have limited experience in acquisition activities and may have to devote substantial time and resources in order to complete acquisitions. Further, these potential acquisitions entail risks, uncertainties and potential disruptions to our business. For example, we may not be able to successfully integrate a company's operations, technologies, products and services, information systems and personnel into our business. An acquisition may further strain our existing financial and managerial resources, and divert management's attention away from our other business concerns. In connection with these acquisitions, we assumed certain liabilities and hired certain employees, which is expected to continue to result in an increase in our research and development expenses and capital expenditures. There may also be unanticipated costs and liabilities associated with an acquisition that could adversely affect our operating results. To finance any acquisitions, we may choose to issue shares of our common stock as consideration, which would result in dilution to our stockholders. Additionally, an acquisition may have a substantial negative impact on near-term expected financial results.

The success of the Solexa merger will depend, in part, on our ability to realize the anticipated synergies, growth opportunities and cost savings from integrating Solexa's businesses with our businesses. Our success in realizing these benefits and the timing of this realization depend upon the successful integration of the operations of Solexa. The integration of two independent companies is a complex, costly and time-consuming process. The difficulties of combining the operations of the companies include, among other factors:

- lost sales and customers as a result of certain customers of either of the two companies deciding not to do business with the combined company;

- complexities associated with managing the combined businesses;

- integrating personnel from diverse corporate cultures while maintaining focus on providing consistent, high quality products and customer service;

- coordinating geographically separated organizations, systems and facilities;

potential unknown liabilities and unforeseen increased expenses or delays associated with the merger; and

performance shortfalls at one or both of the companies as a result of the diversion of management's attention to the merger.

If we are unable to successfully combine the businesses in a manner that permits the combined company to achieve the cost savings and operating synergies anticipated to result from the merger, such anticipated benefits of the merger may not be realized fully or at all or may take longer to realize than expected. In addition, we and Solexa have operated and will continue to operate independently. It is possible that the integration process could result in the loss of key employees, diversion of each company's management's attention, the disruption or interruption of, or the loss of momentum in, each company's ongoing businesses or inconsistencies in standards, controls, procedures and policies, any of which could adversely affect our ability to maintain relationships with customers and employees or our ability to achieve the anticipated benefits of the merger, or could reduce our earnings or otherwise adversely affect the business and financial results of the combined company.

## **Table of Contents**

### ***The combined company may fail to realize the anticipated benefits of the merger as a result of our failure to achieve anticipated revenue growth following the merger.***

For various reasons, including significant competition, low market acceptance or market growth, and lack of technology advantage, revenue recognized from the Solexa acquisition may not grow as anticipated and if so, we may not realize the expected value from this transaction.

### ***Our manufacturing capacity may limit our ability to sell our products.***

We continue to ramp up our capacity to meet the anticipated demand for our products. Although we have significantly increased our manufacturing capacity and we believe that we have sufficient plans in place to ensure we have adequate capacity to meet our business plan in 2007 and 2008, there are uncertainties inherent in expanding our manufacturing capabilities and we may not be able to increase our capacity in a timely manner. For example, manufacturing and product quality issues may arise as we increase production rates at our manufacturing facility and launch new products. As a result, we may experience difficulties in meeting customer, collaborator and internal demand, in which case we could lose customers or be required to delay new product introductions, and demand for our products could decline. Additionally, in the past, we have experienced variations in manufacturing conditions that have temporarily reduced production yields. Due to the intricate nature of manufacturing products that contain DNA, we may encounter similar or previously unknown manufacturing difficulties in the future that could significantly reduce production yields, impact our ability to launch or sell these products, or to produce them economically, prevent us from achieving expected performance levels or cause us to set prices that hinder wide adoption by customers.

### ***Our sales, marketing and technical support organization may limit our ability to sell our products.***

We currently have fewer resources available for sales and marketing and technical support services compared to some of our primary competitors. In order to effectively commercialize our sequencing, genotyping and gene expression systems and other products to follow, we will need to expand our sales, marketing and technical support staff both domestically and internationally. We may not be successful in establishing or maintaining either a direct sales force or distribution arrangements to market our products and services. In addition, we compete primarily with much larger companies that have larger sales and distribution staffs and a significant installed base of products in place, and the efforts from a limited sales and marketing force may not be sufficient to build the market acceptance of our products required to support continued growth of our business.

### ***If we are unable to find third-party manufacturers to manufacture components of our products, we may not be able to launch or support our products in a timely manner, or at all.***

The nature of our products requires customized components that currently are available from a limited number of sources. For example, we currently use multiple components in our products that are single-sourced. If we are unable to secure a sufficient supply of those or other product components, we will be unable to meet demand for our products. We may need to enter into contractual relationships with manufacturers for commercial-scale production of some of our products, or develop these capabilities internally, and we cannot assure you that we will be able to do this on a timely basis, for sufficient quantities or on commercially reasonable terms. Accordingly, we may not be able to establish or maintain reliable, high-volume manufacturing at commercially reasonable costs.

### ***The merger will cause dilution of our earnings per share.***

The merger and the transactions contemplated by the merger agreement are expected to have a dilutive effect on our earnings per share at least through 2007 due to losses of Solexa, the additional shares of our common stock that were issued in the merger, the transaction and integration-related costs and other factors such as the potential failure to realize any benefit from synergies anticipated in the merger. These factors could adversely affect the market price of our common stock.

### ***Solexa had a material weakness in its internal controls over financial reporting as of December 31, 2005. If additional material weaknesses are identified in the future, current and potential stockholders could lose confidence in our consolidated financial reporting, which could harm our business and the trading of our common stock.***

As of December 31, 2005, Solexa did not maintain effective control over the application of GAAP related to the financial reporting process. This control deficiency resulted in numerous adjustments being required to bring Solexa's financial statements into



**Table of Contents**

compliance with GAAP. Additionally, this deficiency could have resulted in material misstatement of the annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, Solexa's management determined that this control deficiency constituted a material weakness. Because of this material weakness, Solexa's management concluded that, as of December 31, 2005, it did not maintain effective internal control over financial reporting based on those criteria. Should we, or our independent registered public accounting firm, determine in future fiscal periods that there are material weaknesses in our consolidated internal controls over financial reporting (including Solexa), the reliability of our financial reports may be impacted, and our results of operations or financial condition may be harmed and the price of our common stock may decline.

***Any inability to adequately protect our proprietary technologies could harm our competitive position.***

Our success will depend in part on our ability to obtain patents and maintain adequate protection of our intellectual property in the United States and other countries. If we do not protect our intellectual property adequately, competitors may be able to use our technologies and thereby erode our competitive advantage. The laws of some foreign countries do not protect proprietary rights to the same extent as the laws of the United States, and many companies have encountered significant challenges in protecting their proprietary rights abroad. These challenges can be caused by the absence of rules and methods for the establishment and enforcement of intellectual property rights abroad.

The patent positions of companies developing tools for the life sciences and pharmaceutical industries, including our patent position, generally are 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. We intend to apply for patents covering our technologies and products, as we deem appropriate. However, our patent applications may be challenged and may not result in issued patents or may be invalidated or narrowed in scope after they are issued. Questions as to inventorship may also arise. For example, in June 2005, a former employee filed a complaint against us, claiming he is entitled to be named as joint inventor of certain of our U.S. patents and pending U.S. and foreign patent applications, and seeking a judgment that the related patents and applications are unenforceable. Any finding that our patents and applications are unenforceable could harm our ability to prevent others from practicing the related technology, and a finding that others have inventorship rights to our patents and applications could require us to obtain certain rights to practice related technologies, which may not be available on favorable terms, if at all.

In addition, 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. There also is risk that others may independently develop similar or alternative technologies or design around our patented technologies. Also, our patents may fail to provide us with any competitive advantage. We may need to initiate additional lawsuits to protect or enforce our patents, or litigate against third party claims, which would be expensive and, if we lose, may cause us to lose some of our intellectual property rights and reduce our ability to compete in the marketplace. Furthermore, these lawsuits may divert the attention of our management and technical personnel.

We also rely upon trade secret protection for our confidential and proprietary information. We have taken security measures to protect our confidential information. These measures, however, may not provide adequate protection for our trade secrets or other confidential information. Among other things, we seek to protect our trade secrets and confidential information by entering into confidentiality agreements with employees, collaborators and consultants. Nevertheless, employees, collaborators or consultants may still disclose our confidential information, and we may not otherwise be able to effectively protect our trade secrets. Accordingly, others may gain access to our confidential information, or may independently develop substantially equivalent information or techniques.

***If we are unable to develop and maintain operation of our manufacturing capability, we may not be able to launch or support our products in a timely manner, or at all.***

We currently possess limited facilities capable of manufacturing our principal products and services for both sale to our customers and internal use. If a natural disaster were to significantly damage one of our facilities or if other events were to cause our operations to fail, these events could prevent us from developing and manufacturing our products and services. Also, many of our manufacturing processes are automated and are controlled by our custom-designed Laboratory Information Management System (LIMS). Additionally, as part of the decoding step in our array manufacturing process, we record several images of each array to identify what bead is in each location on the array

and to validate each bead in the array. This requires significant network and storage infrastructure. If either our LIMS system or our networks or storage infrastructure were to fail for an extended period of time, it would adversely impact our ability to manufacture our products on a timely basis and may prevent us from achieving our expected shipments in any given period.

**Table of Contents*****We may encounter difficulties in managing our growth. These difficulties could impair our profitability.***

We have experienced and expect to continue to experience rapid and substantial growth in order to achieve our operating plans, which will place a strain on our human and capital resources. If we are unable to manage this growth effectively, our profitability could suffer. Our ability to manage our operations and growth effectively requires us to continue to expend funds to enhance our operational, financial and management controls, reporting systems and procedures and to attract and retain sufficient numbers of talented employees. If we are unable to scale up and implement improvements to our manufacturing process and control systems in an efficient or timely manner, or if we encounter deficiencies in existing systems and controls, then we will not be able to make available the products required to successfully commercialize our technology. Failure to attract and retain sufficient numbers of talented employees will further strain our human resources and could impede our growth.

***We have a significant amount of indebtedness. We may not be able to make payments on our indebtedness, and we may incur additional indebtedness in the future, which could adversely affect our operation and profitability.***

In February 2007, we issued \$400 million of 0.625% Convertible Senior Notes due February 2014. The notes bear interest semi-annually, mature on February 15, 2014 and obligate us to repurchase the notes at the option of the holders if a designated event (as defined in the indenture for the notes), such as certain merger transactions involving us, occurs. In addition, upon conversion of the notes, we must pay in cash the principal portion of the notes being converted. Our ability to make payments on the notes will depend on our future operating performance and our ability to generate cash and may also depend on our ability to obtain additional debt or equity financing. We may need to use our cash to pay principal and interest on our debt, which will reduce the funds available to fund our research and development programs, strategic initiatives and working capital requirements. Our ability to generate sufficient operating cash flow to service the notes and fund our operating requirements will depend on our continued ability to commercialize new products and expand our manufacturing capabilities. Our debt service obligations increase our vulnerabilities to competitive pressures, because our competitors may be less leveraged than us. If we are unable to generate sufficient operating cash flow to service our indebtedness and fund our operating requirements, we may be forced to reduce our development programs or seek additional debt or equity financing, which may not be available to us on satisfactory terms, or at all, or may dilute the interests of our existing stockholders. Our level of indebtedness may make us more vulnerable to economic or industry downturns. If we incur new indebtedness, the risks relating to our business and our ability to service our indebtedness will intensify.

***We expect that our results of operations will fluctuate. This fluctuation could cause our stock price to decline.***

Our revenue is subject to fluctuations due to the timing of sales of high-value products and services projects, the impact of seasonal spending patterns, the timing and size of research projects our customers perform, changes in overall spending levels in the life sciences industry, and other unpredictable factors that may affect customer ordering patterns. Given the difficulty in predicting the timing and magnitude of sales for our products and services, we may experience quarter-to-quarter fluctuations in revenue resulting in the potential for a sequential decline in quarterly revenue. A large portion of our expenses are relatively fixed, including expenses for facilities, equipment and personnel. In addition, we expect operating expenses to continue to increase significantly in absolute dollars. Accordingly, if revenue does not grow as anticipated, we may not be able to maintain annual profitability. Any significant delays in the commercial launch of our products, unfavorable sales trends in our existing product lines, or impacts from the other factors mentioned above, could adversely affect our future revenue growth or cause a sequential decline in quarterly revenue. Due to the possibility of fluctuations in our revenue and expenses, we believe that quarterly comparisons of our operating results are not a good indication of our future performance. If our operating results fluctuate or do not meet the expectations of stock market analysts and investors, our stock price could decline.

***We have only recently achieved annual operating profitability.***

Prior to 2006, we had incurred net losses each year since our inception. As of September 30, 2007, our accumulated deficit was \$378.9 million. Our ability to sustain annual profitability will depend, in part, on the rate of growth, if any, of our revenue and on the level of our expenses. Non-cash stock-based compensation expense and expenses related to our acquisition of Solexa in January 2007 are also likely to adversely affect our future profitability. We expect to continue incurring significant expenses related to research and development, sales and marketing efforts

to commercialize our products and the continued development of our manufacturing capabilities. In addition, we expect that our research and development and selling and marketing expenses will increase at a higher rate in the future as a result of the development and launch of new products. Even if we maintain profitability, we may not be able to increase profitability on a quarterly basis.

## **Table of Contents**

### ***Changes in our effective income tax rate could impact our profitability.***

We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgments based on interpretations of existing tax laws or regulations are required in determining the provision for income taxes. Our effective income tax rate could be adversely affected by various factors including, but not limited to, changes in the mix of earnings in tax jurisdictions with different statutory tax rates, changes in the valuation of deferred tax assets and liabilities, changes in existing tax laws or tax rates, changes in the level of non-deductible expenses including share-based compensation, changes in our future levels of research and development spending, mergers and acquisitions, and the result of examinations by various tax authorities.

### ***If we lose our key personnel or are unable to attract and retain additional personnel, we may be unable to achieve our goals.***

We are highly dependent on our management and scientific personnel, including Jay Flatley, our president and chief executive officer. The loss of their services could adversely impact our ability to achieve our business objectives. We will need to hire additional qualified personnel with expertise in molecular biology, chemistry, biological information processing, sales, marketing and technical support. We compete for qualified management and scientific personnel with other life science companies, universities and research institutions, particularly those focusing on genomics. Competition for these individuals, particularly in the San Diego and San Francisco area, is intense, and the turnover rate can be high. Failure to attract and retain management and scientific personnel would prevent us from pursuing collaborations or developing our products or technologies.

Our planned activities will require additional expertise in specific industries and areas applicable to the products developed through our technologies, including the life sciences and healthcare industries. Thus, we will need to add new personnel, including management, and develop the expertise of existing management. The failure to do so could impair the growth of our business.

### ***A significant portion of our sales are to international customers.***

Approximately 33% and 53% of our revenue for the three months ended September 30, 2007 and October 1, 2006, respectively, was derived from shipments to customers outside the United States. Approximately 34% and 48% of our revenue for the nine months ended September 30, 2007 and October 1, 2006, respectively, was derived from shipments to customers outside the United States. We intend to continue to expand our international presence and export sales to international customers and we expect the total amount of non-U.S. sales to continue to grow. Export sales entail a variety of risks, including:

- currency exchange fluctuations;

- unexpected changes in legislative or regulatory requirements of foreign countries into which we import our products;

- difficulties in obtaining export licenses or in overcoming other trade barriers and restrictions resulting in delivery delays; and

- significant taxes or other burdens of complying with a variety of foreign laws.

In addition, sales to international customers typically result in longer payment cycles and greater difficulty in accounts receivable collection. We are also subject to general geopolitical risks, such as political, social and economic instability and changes in diplomatic and trade relations. One or more of these factors could have a material adverse effect on our business, financial condition and operating results.

### ***Our success depends upon the continued emergence and growth of markets for analysis of genetic variation and biological function.***

We design our products primarily for applications in the life sciences and pharmaceutical industries. The usefulness of our technology depends in part upon the availability of genetic data and its usefulness in identifying or treating disease. We are focusing on markets for analysis of genetic variation and biological function, namely sequencing, SNP genotyping and gene expression profiling. These markets are new and emerging, and they may not develop as quickly as we anticipate, or reach their full potential. Other methods of analysis of genetic variation and

biological function may emerge and displace the methods we are developing. Also, researchers may not seek or be able to convert raw genetic data into medically valuable information through the analysis of genetic variation and biological function. In addition, factors affecting research and development spending generally, such as changes in the regulatory environment affecting life sciences and pharmaceutical companies, and changes in government programs that provide funding to companies and research institutions, could harm our business. If useful genetic data is not available or if our target markets do not develop in a timely manner, demand for our products may grow at a slower rate than we expect, and we may not be able to sustain annual profitability.

**Table of Contents****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

The following table discloses the repurchases of our common stock during the first nine months of 2007:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid Per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs</b>
January 29, 2007 - February 25, 2007 (1)	5,771,000	\$ 34.93	5,771,000	
February 26, 2007 - April 1, 2007	1,638,545	\$ 30.54	1,638,545	
Total	7,409,545		7,409,545	\$

(1) Reflects approximately \$201.6 million of shares repurchased with proceeds from our \$400 million Convertible Senior Notes offering on February 16, 2007.

**Item 3. Defaults Upon Senior Securities.**

None.

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

None.

**Item 5. Other Information.**

None.

**Table of Contents**

**Item 6. Exhibits.**

<b>Exhibit Number</b>	<b>Description of Document</b>
10.43 <sup>(1)</sup>	Amended and Restated 2005 stock and Incentive Plan.
31.1	Certification of Jay T. Flatley pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Christian O. Henry pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Jay T. Flatley pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Christian O. Henry pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
(1)	Incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K, filed with SEC on July 30, 2007.

40

**Table of Contents**

**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.

Illumina, Inc.  
(Registrant)

Date: October 31, 2007

/s/ CHRISTIAN O. HENRY  
Christian O. Henry  
Senior Vice President and Chief Financial  
Officer