LYNX THERAPEUTICS INC
Form 10-Q
May 14, 2001

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

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2001.

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _____ TO _____.

COMMISSION FILE NUMBER 0-22570

LYNX THERAPEUTICS, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	94-3161073
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

25861 INDUSTRIAL BLVD.
HAYWARD, CA 94545
(Address of principal executive offices)

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

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

The number of shares of common stock outstanding as of May 2, 2001 was 11,665,494.

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LYNX THERAPEUTICS, INC.

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FOR THE QUARTER ENDED MARCH 31, 2001

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LYNX THERAPEUTICS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

	MARCH 31, 2001 (UNAUDITED)	DECEMBER 31, 2000*

ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,141	$ 7,875
Short-term investments	7,730	10,923
Accounts receivable	939	1,539
Other current assets	3,214	2,270
Total current assets	16,024	22,607
Property and equipment:		
Leasehold improvements	12,003	11,718
Laboratory and other equipment	14,744	13,364
	26,747	25,082
Less accumulated depreciation and amortization	(10,323)	(9,263)
Net property and equipment	16,424	15,819
Other non-current assets	791	789
	$ 33,239	$ 39,215
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,344	$ 1,640
Accrued compensation	996	614
Deferred revenues --- current portion	6,407	7,219
Notes payable --- current portion	1,354	1,319
Other accrued liabilities	811	928
Total current liabilities	10,912	11,720
Deferred revenues	16,406	17,467
Notes payable	2,743	3,077
Other non-current liabilities	766	729
Stockholders' equity:		
Common stock	76,265	75,851
Notes receivable from stockholders	(271)	(263)
Deferred compensation	(1,218)	(1,557)
Accumulated other comprehensive income (loss)	(14)	(1,157)
Accumulated deficit	(72,350)	(66,652)
Total stockholders' equity	2,412	6,222
	$ 33,239	$ 39,215

*The balance sheet amounts at December 31, 2000 have been derived from audited financial statements at that date but do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See accompanying notes.

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

	THREE MONTHS ENDED MARCH 31,	
	2001	2000
Revenues:		
Technology access and service fees and other	$ 3,395	$ 3,016
Total revenues	3,395	3,016
Operating costs and expenses:		
Cost of service fee revenues and other	656	445
Research and development	5,956	5,004
General and administrative	2,001	1,485
Total operating costs and expenses	8,613	6,934
Loss from operations	(5,218)	(3,918)
Interest income, net	6	314
Other income (loss), net	(486)	3,183
Loss before provision for income taxes	(5,698)	(421)
Provision for income taxes	--	60
Net loss	$ (5,698)	$ (481)
Basic and diluted net loss per share	$ (0.50)	$ (0.04)
Shares used in per share computation	11,470	11,209

See accompanying notes.

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LYNX THERAPEUTICS, INC.

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

	THREE MONTHS E MARCH 31,
	2001

CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$ (5,698)	$
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	1,117	
Amortization of deferred compensation	339	
(Gain) loss on sale of antisense business	545	
Changes in operating assets and liabilities		
Accounts receivable	600	
Other current assets	(944)	
Accounts payable	(296)	
Accrued liabilities	265	
Deferred revenues	(1,873)	
Other non-current liabilities	37	
Net cash used in operating activities	(5,908)	
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of short-term investments	(1,804)	
Maturities of short-term investments	5,593	
Leasehold improvements and equipment purchases, net of retirements	(1,722)	
Notes receivable from officers and employees	(8)	
Net cash provided by investing activities	2,059	
CASH FLOWS FROM FINANCING ACTIVITIES		
Repayment of equipment loan	(299)	
Issuance of common stock	414	
Net cash provided by financing activities	115	
Net increase (decrease) in cash and cash equivalents	(3,734)	
Cash and cash equivalents at beginning of period	7,875	
Cash and cash equivalents at end of period	$ 4,141	$
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Income taxes paid	$ --	$
Interest paid	$ 120	$

See accompanying notes.

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LYNX THERAPEUTICS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2001
(UNAUDITED)

1. NATURE OF BUSINESS

Lynx Therapeutics, Inc. ("Lynx" or the "Company") is a leader in the

development and application of novel technologies for the discovery of gene expression patterns and genomic variations important to the pharmaceutical, biotechnology and agricultural industries. These technologies are based on Megaclone(TM), Lynx's unique and proprietary cloning procedure. Megaclone(TM) transforms a sample containing millions of DNA molecules into one made up of millions of micro-beads, each of which carries approximately 100,000 copies of one of the DNA molecules in the sample. Based on Megaclone(TM), Lynx has developed a suite of applications that have the potential to enhance the pace, scale and quality of genomics and genetics research programs. Currently, Lynx's principal collaborators and customers are BASF AG, E.I. DuPont de Nemours and Company, Aventis CropScience GmbH, Oxagen Limited, Hybrigenics S.A., Genomics Collaborative Inc., Molecular Engines Laboratories S.A., the Institute of Molecular and Cell Biology, Phytera, Inc., Celera Genomics, AstraZeneca, UroGene S.A., GenoMar ASA and AniGenics, Inc. Additionally, Lynx has provided a license for the use of certain of its technologies to Takara Shuzo Co. Ltd.

2. BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements included herein have been prepared by the Company without audit, pursuant to the rules and regulations promulgated by the Securities and Exchange Commission (the "SEC"). Certain prior year amounts have been reclassified to conform to current year presentation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to SEC rules and regulations; nevertheless, the Company believes that the disclosures are adequate to make the information presented not misleading. In the opinion of management, the financial statements contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position, results of operations and cash flows of the Company for the interim periods presented. The results of operations for the three months ended March 31, 2001, are not necessarily indicative of the results for the full year.

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

These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the Company's year ended December 31, 2000, included in its annual report on Form 10-K filed with the SEC.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

REVENUE RECOGNITION

Revenues from technology access fees have generally resulted from upfront payments from collaborators, customers and licensees who are provided access to Lynx's technologies for specified periods. The Company receives service fees from collaborators and customers for genomics discovery services performed by Lynx on the biological samples they send to Lynx. Milestone payments are recognized pursuant to collaborative agreements upon the achievement of specified technology developments, representing the culmination of the earnings process, for financial accounting purposes. Other revenues include product sales and non-contract related revenues.

Technology access fees are deferred and recognized as revenues on a straight-line basis over the noncancelable term of the agreement to which they relate. Payments for services and/or materials provided by Lynx are recognized as revenues when earned over the period in which the services are performed and/or materials are delivered, provided no other obligations, refunds or

credits to be applied to future work exist. Milestone payments are recognized as revenues upon the achievement of the related milestone and the satisfaction of any related obligations. Revenues from the sales of products are recognized upon shipment to the customer.

NET LOSS PER SHARE

Basic earnings per share ("EPS") is computed by dividing income or loss applicable to common stockholders by the weighted-average number of common shares outstanding for the period, net of certain common shares outstanding which are subject to continued vesting and the Company's right of repurchase. Diluted EPS reflects the potential dilution of securities that could share in the earnings of the Company, to the extent such securities are dilutive. Basic and diluted net loss per share is equivalent for all periods presented herein due to the Company's net loss in all periods. At March 31, 2001, options to purchase approximately 2,521,000 shares of common stock at a weighted-average price of $13.65 per share have been excluded from the calculation of diluted loss per share for 2001 because the effect of inclusion would be antidilutive. The options will be included in the calculation at such time as the effect is no longer antidilutive, as calculated using the treasury stock method. At March 31, 2001, approximately 11,000 shares of common stock outstanding, but subject to the Company's right of repurchase that expires ratably over five years, have been excluded from the calculation of basic loss per share. The repurchasable shares will be included in the calculation of basic EPS at such time as the Company's right of repurchase lapses.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"), which is effective for the year ending December 31, 2001. This statement establishes accounting and reporting standards requiring that every derivative instrument, including certain derivative instruments embedded in other contracts, be recorded in the balance sheet as either an asset or liability measured at its fair value. The statement also requires that changes in the derivative's fair value be recognized in earnings unless specific hedge accounting criteria are met. Lynx Therapeutics believes the adoption of SFAS 133 on January 1, 2001 had no material effect on the financial statements, since the Company currently does not invest in derivative instruments and engage in hedging activities.

COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended March 31, 2001	2000
Net income (loss)	$ (5,698)	$ (481)
Net unrealized gain (loss) on available-for-sale securities	(22)	(1,713)
Comprehensive income (loss)	$ (5,720)	$ (2,194)

The components of accumulated other comprehensive income (loss) relate entirely

to unrealized losses on available-for-sale securities and are $14,000 at March 31, 2001 and $1.2 million at December 31, 2000.

4. CORPORATE COLLABORATIONS

Phytera

In January 2001, the Company entered into a collaboration with Phytera, Inc. to identify genes from plants involved in the biosynthesis of anti-oxidant polyphenols, naturally occurring compounds with nutraceutical and pharmaceutical activity. Phytera will select plant species from its culture libraries and apply its proprietary ExPAND(R) manipulation technology to regulate the expression of the metabolic pathways and genes responsible for the production of specific anti-oxidant polyphenolic compounds. Lynx will then use its proprietary Megasort(TM) technology to identify genes activated after target compounds are induced. Lynx and Phytera intend to validate gene targets and jointly commercialize the genes with other partners in the nutraceutical and pharmaceutical sectors.

Celera

In March 2001, the Company entered into two agreements with Celera Genomics. The first agreement involves the integration of sets of Lynx's high-resolution gene expression data, derived from normal human tissues analyzed using Lynx's MPSS technology, into Celera's database products for distribution to Celera's customers through the Celera Discovery System (CDS). Under a second agreement, Lynx will apply its MPSS technology to perform additional gene expression analyses on various tissues for Celera and to help supplement the Lynx database offering.

AstraZeneca

In March 2001, the Company entered into a collaboration with AstraZeneca to apply Lynx's Megatype(TM) technology for genome-wide scans to discover single nucleotide polymorphisms, or SNPs, associated with asthma. AstraZeneca will provide to Lynx DNA samples from asthma-affected and control individuals, which will then be analyzed using Megatype(TM) technology. The resulting SNP markers are expected to provide leads with which to discover asthma-related loci on the human genome. The data resulting from the collaborative research agreement are expected to provide insight into the genetic components of asthma.

UroGene

In March 2001, the Company entered into a collaboration with UroGene S.A. to discover differentially expressed genes associated with prostate cancer, benign prostatic hypertrophy, renal carcinoma and bladder cancer. Lynx will apply its Megasort(TM) technology to samples provided by UroGene to identify differentially expressed genes by comparing normal and diseased tissues in the various disorders. UroGene plans to incorporate the findings into its overall research in the area of prostate disorders and oncology.

5. SUBSEQUENT EVENTS

AstraZeneca

In April 2001, the Company entered into a collaboration with AstraZeneca to identify genes that are differentially expressed between different human tissues. AstraZeneca will provide DNA samples from certain human tissues, which

Lynx will analyze using its Megasort(TM) technology. The differences in the gene expression patterns are expected to provide important information on the physiological processes leading to diseases or conditions involving these tissue types.

GenoMar

In April 2001, the Company entered into a collaboration with GenoMar ASA to identify genes associated with saltwater tolerance in the tropical fin fish, Tilapia. GenoMar will provide Lynx with RNA samples from Tilapia raised in either freshwater or saltwater, which will then be compared using Lynx's Megasort(TM) technology. Genes associated with growth in saltwater are expected to provide economically important tools in improving the performance of farmed fish through selective breeding.

AniGenics

In May 2001, the Company entered into a collaboration with AniGenics, Inc. to identify genes associated with commercially valuable traits in certain food animal species. AniGenics will provide Lynx with samples from animals exhibiting desired traits. The samples will then be analyzed for differential gene expression using Lynx's Megasort(TM) technology. AniGenics will also provide animal samples to be analyzed using Lynx's MegatypeTM technology for SNP markers that could be used to identify genes controlling the desired traits. The research collaboration seeks to create gene expression profiles and to identify SNP markers that could impact marker-assisted breeding and result in potentially reduced husbandry costs or increased product differentiation in the supermarket.

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

This discussion and analysis should be read in conjunction with the Company's financial statements and accompanying notes included in this report and the Company's 2000 audited financial statements and notes thereto included in its 2000 Annual Report on Form 10-K. Operating results for the three months ended March 31, 2001 are not necessarily indicative of results that may occur in future periods.

Except for the historical information contained herein, the following discussion contains forward-looking statements that involve risks and uncertainties. When used herein, the words "believe," "anticipate," "expect," "estimate" and similar expressions are intended to identify such forward-looking statements. There can be no assurance that these statements will prove to be correct. Lynx's actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this section, as well as in Lynx's 2000 Annual Report on Form 10-K as filed with the SEC. Lynx undertakes no obligation to update any of the forward-looking statements contained herein to reflect any future events or developments.

RESULTS OF OPERATIONS

REVENUES

Revenues for the three-month periods ended March 31, 2001 and 2000 were $3.4 million and $3.0 million. Revenues for 2001 included technology access fees and service fees of $3.3 million and other revenues of $0.1 million. Revenues

for 2000 consisted entirely of technology access and service fees.

OPERATING COSTS AND EXPENSES

Total operating costs and expenses were $8.6 million for the three-month period ended March 31, 2001, and $6.9 million for the three-month period ended March 31, 2000. For the three-month period ended March 31, 2001, cost of services fees were $0.7 million, compared to $0.4 million in the corresponding period in 2000, and reflect the costs of providing our genomics discovery services. Research and development expenses were $6.0 million for the three-month period ended March 31, 2001, compared to $5.0 million in the corresponding period in 2000. The increase between years was primarily due to an increase in personnel and facilities-related expenses and an increase in materials consumed in research and development efforts, including on the continuing development of the Megatype(TM) and Protein ProFiler(TM) technologies and on Lynx's internal discovery projects. Lynx expects research and development expenses to increase due to planned spending for ongoing technology development and implementation, as well as new applications for our technology.

General and administrative expenses increased to $2.0 million for the three-month period ended March 31, 2001, compared to $1.5 million in the corresponding period in 2000. Contributing factors to the increase in expenses between years include increased personnel and facilities-related expenses. Lynx expects general and administrative expenses to increase in support of its research and development, commercial and business development efforts.

INTEREST INCOME, NET

Net interest income was $6,000 in the three-month period ended March 31, 2001, compared to $0.3 million in the 2000 period. The 2001 period reflects a decrease in interest income due to lower average cash, cash equivalents and investment balances, partially offset by lower interest expense incurred on equipment-related debt, as compared to the 2000 period.

OTHER INCOME (LOSS), NET

The other loss amount was $0.5 million in the three-month period ended March 31, 2001, compared to other income of $3.2 million in the 2000 period. The 2001 loss was related primarily to a writedown in the carrying value of our equity investment in Inex Pharmaceuticals Corporation, net of a gain recorded from the receipt of shares of common stock from Inex in the 2001 quarter as part of the proceeds related to the March 1998 sale of Lynx's former antisense program. The 2000 other income amount was primarily related to a $3.1 million gain recognized from the receipt of shares of common stock of Inex.

INCOME TAXES

There was not a provision for income taxes for the quarter ended March 31, 2001. The provision for income taxes for the quarter ended March 31, 2000 consisted entirely of alternative minimum tax.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was $5.9 million for the quarter ended March 31, 2001, as compared to net cash used in operating activities of $2.6 million for the same period in 2000. This change was primarily due to the decrease in deferred revenue, a higher loss from operations in the 2001 period and an increase in other current assets, offset partially by the decrease in

accounts receivable and higher depreciation and amortization expense for fixed assets and leasehold improvements. Net cash used in operating activities of $5.9 million for the 2001 quarter differed from the net loss primarily due to a decrease in deferred revenue and an increase in other current assets, offset partially by depreciation and amortization expense, the decrease in accounts receivable and the loss related to the equity investment in Inex common stock. Net cash provided by investing activities related primarily to net maturities of short-term investments, offset partially by capital expenditures. Net cash provided by financing activities related primarily to the issuance of common stock from the exercise of employee stock options, offset partially by repayment of principal under an equipment loan arrangement. Cash, cash equivalents, short-term investments and marketable securities were $11.9 million at March 31, 2001.

In late 1998, we entered into a financing agreement with a financial institution under which we drew down $4.8 million during 1999 for the purchase of equipment and certain other capital expenditures. Lynx granted the lender a security interest in all items financed by it under this agreement. Each draw down under the loan has a term of 48 months from the date of the draw down. As of March 31, 2001, the principal balance under loans outstanding under this agreement was approximately $4.1 million. The draw down period under the agreement expired on March 31, 2001.

Lynx plans to use available funds for ongoing commercial and research and development activities, working capital and other general corporate purposes and capital expenditures. We expect capital investments during 2001 will be comprised primarily of equipment purchases required in the normal course of business and expenditures for leasehold improvements. We intend to invest our excess cash in investment-grade, interest-bearing securities.

Lynx has obtained funding for its operations primarily through sales of preferred and common stock to venture capital investors, institutional investors and collaborators, payments under contractual arrangements with customers, collaborators and licensees and interest income. The cost, timing and amount of funds required for specific uses by us cannot be precisely determined at this time and will be based upon the progress and the scope of our collaborative and independent research and development projects; payments received under customer, collaborative and license agreements; our ability to establish and maintain customer, collaborative and license agreements; costs of protecting intellectual property rights; legal and administrative costs; additional facilities capacity needs and the availability of alternate methods of financing.

Lynx expects to incur substantial and increasing research and development expenses and intends to seek additional financing, as needed, through arrangements with customers, collaborators and licensees and equity or debt offerings. There can be no assurance that any additional financing required by Lynx will be available on favorable terms, or at all. The Company believes that its existing capital resources, and interest income thereon, will enable it to maintain its current and planned operations through at least the next 12 months.

ADDITIONAL BUSINESS RISKS

Lynx's business faces significant risks. These risks include those described below and may include additional risks of which Lynx is not currently aware or which Lynx currently does not believe are material. If any of the events or circumstances described in the following risks actually occurs, our business, financial condition or results of operations could be materially adversely affected. These risks should be read in conjunction with the other information set forth in this report.

OUR TECHNOLOGIES ARE NEW AND UNPROVEN AND MAY NOT ALLOW US OR OUR COLLABORATORS TO IDENTIFY GENES OR TARGETS FOR DRUG DISCOVERY.

Our technologies are new and unproven. The application of these technologies is in too early a stage to determine whether it can be successfully implemented. These technologies assume that information about gene expression and gene sequences may enable scientists to better understand complex biological processes. Relatively few therapeutic products based on gene discoveries have been successfully developed and commercialized. Our technologies may not enable us or our collaborators to identify genes or targets for drug discovery. To date, no targets for drug discovery have been identified based on our technologies.

WE ARE DEPENDENT ON OUR COLLABORATIONS AND WILL NEED TO FIND ADDITIONAL COLLABORATORS IN THE FUTURE TO DEVELOP AND COMMERCIALIZE DIAGNOSTIC OR THERAPEUTIC PRODUCTS.

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Our strategy for the development and commercialization of our technologies and potential products includes entering into collaborations, subscription arrangements or licensing arrangements with pharmaceutical, biotechnology and agricultural companies. We do not have the resources to develop or commercialize diagnostic or therapeutic products on our own. We cannot assure you that we will be able to negotiate additional collaborative arrangements or contracts on acceptable terms, or at all, or that such collaborations or relationships will be successful.

Substantially all of our revenues have been derived from corporate collaborations and agreements. Revenues from collaborations and related agreements depend upon continuation of the collaborations, the achievement of milestones and royalties derived from future products developed from our research and technologies. If we are unable to successfully achieve milestones or our collaborators fail to develop successful products, we will not earn the revenues contemplated under such collaborative agreements. If existing agreements are not renewed, or if we are unable to enter into new collaborative agreements on commercially acceptable terms, our revenues may decrease, and our activities may fail to lead to commercialized products.

Our dependence on collaborative arrangements with third parties subjects us to a number of risks. We have limited or no control over the resources that our collaborators may choose to devote to our joint efforts. Our collaborators may breach or terminate their agreements with us or fail to perform their obligations thereunder. Further, our collaborators may elect not to develop products arising out of our collaborative arrangements or may fail to devote sufficient resources to the development, manufacture, market or sale of such products. Some of our collaborators could also become our competitors in the future. Our business could be harmed if our collaborators:

- do not develop commercially successful products using our technologies;
- develop competing products;
- preclude us from entering into collaborations with their competitors;
- fail to obtain necessary regulatory approvals; or
- terminate their agreements with us.

WE ARE AN EARLY STAGE COMPANY, SO OUR PROFITABILITY IS UNCERTAIN AND THERE IS A HIGH RISK OF FAILURE.

You must evaluate us in light of the uncertainties and complexities affecting an early stage genomics company. Our products and services are still in the early stages of commercialization. Our technologies depend on the successful integration of independent technologies, each of which has its own development risks. We cannot assure you that our technologies will continue to be successfully developed, that our services will continue to be sought by customers or that any products developed from our technologies will prove to be commercially successful. Further, we cannot assure you that we will be successful in expanding the scope of our research into new areas of pharmaceutical, biotechnology or agricultural research. Significant research and development, financial resources and personnel will be required to capitalize on our technologies. Commercialization of our technologies, whether through the sales of services, royalties or other arrangements, may not generate sufficient or sustainable revenues to enable us to be profitable.

WE HAVE A HISTORY OF NET LOSSES. WE EXPECT TO CONTINUE TO INCUR NET LOSSES, AND WE MAY NOT ACHIEVE OR MAINTAIN PROFITABILITY.

We have incurred net losses each year since our inception in 1992, including net losses of approximately $4.3 million in 1998, $6.7 million in 1999 and $13.3 million in 2000. As of March 31, 2001, we had an accumulated deficit of approximately $72.3 million. We expect these losses to continue for at least the next several years. The size of these net losses will depend, in part, on the rate of growth, if any, in our revenues and on the level of our expenses. Our research and development expenditures and general and administrative costs have exceeded our revenues to date, and we expect research and development expenses to increase due to planned spending for ongoing technology development and implementation, as well as new applications. As a result, we will need to generate significant additional revenues to achieve profitability. Even if we do increase our revenues and achieve profitability, we may not be able to sustain profitability.

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

- our ability to enter into additional corporate collaborations and agreements;
- our ability to discover genes and targets for drug discovery;
- our collaborators' ability to develop diagnostic and therapeutic products from our drug discovery targets; and
- the successful clinical testing, regulatory approval and commercialization of such products.

The time required to reach profitability is highly uncertain, and we cannot assure you that we will be able to achieve profitability on a sustained basis, if at all.

WE MAY NEED TO RAISE ADDITIONAL FUNDS IN THE FUTURE, WHICH MAY NOT BE AVAILABLE TO US.

We have invested significant capital in our infrastructure and in our scientific and business development activities. We expect our capital and operating expenditures to increase over the next several years as we expand our operations. Our future capital requirements will depend on many factors, including:

- the progress and scope of our collaborative and independent research and development projects;
- payments received under collaborative agreements;
- our ability to establish and maintain collaborative arrangements;
- the progress of the development and commercialization efforts under our collaborations and corporate agreements;
- the costs associated with obtaining access to samples and related information; and
- the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims and other intellectual property rights.

Changes to our current operating plan may require us to consume available capital resources significantly sooner than we expect. We may be unable to raise sufficient additional capital when we need it, on favorable terms, or at all. If our capital resources are insufficient to meet future capital requirements, we will have to raise additional funds. The sale of equity or convertible debt securities in the future would be dilutive to our stockholders. If we are unable to obtain adequate funds on reasonable terms, we may be required to curtail operations significantly or to obtain funds by entering into financing or collaborative agreements on unattractive terms.

OUR REVENUES DEPEND ON A SMALL NUMBER OF COLLABORATORS AND CUSTOMERS.

To date, we have received a significant portion of our revenues from a small number of collaborators and customers. For the three-months ended March 31, 2001, revenues from four collaborators and customers accounted for 36%, 25%, 19% and 10% of our total revenues. For the three-months ended March 31, 2000, revenues from three collaborators and customers accounted for 46%, 31% and 23% of our total revenues. Our operating results may be harmed, if we lose one of these collaborators or customers and we are not able to attract new collaborators or customers.

WE DEPEND ON A SOLE SUPPLIER TO MANUFACTURE FLOW CELLS USED IN OUR MPSS TECHNOLOGY.

The flow cells used in our MPSS technology are obtained from a single supplier. Our reliance on outside vendors generally, and this sole supplier in particular, involves several risks, including:

- the inability to obtain an adequate supply of required components due to manufacturing capacity constraints, a discontinuance of a product by a third-party manufacturer or other supply constraints;
- reduced control over quality and pricing of components; and
- delays and long lead times in receiving materials from vendors.

THE GENOMICS INDUSTRY IS INTENSELY COMPETITIVE AND EVOLVING RAPIDLY, AND OUR COMPETITORS MAY DEVELOP PRODUCTS AND TECHNOLOGIES THAT MAKE OURS OBSOLETE.

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

We face, and will continue to face, competition from pharmaceutical, biotechnology and agricultural companies, as well as academic research institutions, clinical reference laboratories and government agencies. Some of our competitors:

- are attempting to identify and patent randomly sequenced genes and

gene fragments;

- o are pursuing a gene identification, characterization and product development strategy based on positional cloning; and
- o are using a variety of different gene expression analysis methodologies, including the use of chip-based systems, to attempt to identify disease-related genes.

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

competitive position with respect to technological advances. Rapid technological development by others may result in our technologies and future products becoming obsolete.

Any products that are developed through our technologies will compete in highly competitive markets. Our competitors may be more effective at using their technologies to develop commercial products. Further, we cannot assure you that our competitors will not obtain intellectual property rights that would limit the use of our technologies or the ability to commercialize diagnostic or therapeutic products using our technologies. As a result, our competitors may be able to more easily develop technologies and products that would render our technologies and products, and those of our collaborators, obsolete and noncompetitive.

IF WE ARE UNABLE TO ADEQUATELY PROTECT OUR PROPRIETARY TECHNOLOGIES, THIRD PARTIES MAY BE ABLE TO USE OUR TECHNOLOGY, WHICH COULD ADVERSELY AFFECT OUR ABILITY TO COMPETE IN THE MARKET.

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

We also rely on trade secret protection for our confidential and proprietary information. We have taken security measures to protect our proprietary information and trade secrets, but these measures may not provide adequate protection. While we seek to protect our proprietary information by entering into confidentiality agreements with employees, collaborators and consultants, we cannot assure you that our proprietary information will not be disclosed or that we can meaningfully protect our trade secrets. In addition, our competitors may independently develop substantially equivalent proprietary

information or may otherwise gain access to our trade secrets, which could adversely affect our ability to compete in the market.

LITIGATION OR THIRD-PARTY CLAIMS OF INTELLECTUAL PROPERTY INFRINGEMENT COULD REQUIRE US TO SPEND SUBSTANTIAL TIME AND MONEY AND ADVERSELY AFFECT OUR ABILITY TO DEVELOP AND COMMERCIALIZE OUR TECHNOLOGIES AND PRODUCTS.

Our commercial success depends in part on our ability to avoid infringing patents and proprietary rights of third parties and not breaching any licenses that we have entered into with regard to our technologies. Other parties have filed, and in the future are likely to file, patent applications covering genes, gene fragments, the analysis of gene expression and the manufacture and use of DNA chips. We intend to continue to apply for patent protection for methods relating to gene expression and for the individual disease genes and drug discovery targets we discover. If patents covering technologies required by our operations are issued to others, we may have to rely on licenses from third parties. We cannot assure you that such licenses will be available on commercially reasonable terms, or at all.

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

WE HAVE LIMITED EXPERIENCE IN SALES AND MARKETING AND THUS MAY BE UNABLE TO FURTHER COMMERCIALIZE OUR TECHNOLOGIES AND PRODUCTS.

Our ability to achieve profitability depends on attracting collaborators and customers for our technologies and products. There are a limited number of pharmaceutical, biotechnology and agricultural companies that are potential collaborators and customers for our technologies and products. To market our technologies and products, we must develop a

sales and marketing group with the appropriate technical expertise. We may not be able to build such a sales force. We cannot assure you that our sales and marketing efforts will be successful or that our technologies and products will gain market acceptance.

OUR SALES CYCLE IS LENGTHY, AND WE MAY SPEND CONSIDERABLE RESOURCES ON UNSUCCESSFUL SALES EFFORTS OR MAY NOT BE ABLE TO ENTER INTO AGREEMENTS ON THE SCHEDULE WE ANTICIPATE.

Our ability to obtain collaborators and customers for our technologies and products depends in significant part upon the perception that our technologies and products can help accelerate their drug discovery and genomics efforts. Our sales cycle is typically lengthy because we need to educate our potential collaborators and customers and sell the benefits of our products to a variety of constituencies within such companies. In addition, we may be required to negotiate agreements containing terms unique to each collaborator or customer. We may expend substantial funds and management effort with no assurance that we

will successfully sell our technologies and products. Actual and proposed consolidations of pharmaceutical companies have negatively affected, and may in the future negatively affect, the timing and progress of our sales efforts.

WE MAY HAVE DIFFICULTY MANAGING OUR GROWTH.

We expect to continue to experience significant growth in the number of our employees and the scope of our operations. This growth may place a significant strain on our management and operations. As our operations expand, we expect that we will need to manage additional relationships with various collaborators and customers, suppliers and other third parties. Our ability to manage our operations and growth effectively requires us to continue to improve our operational, financial and management controls, reporting systems and procedures. If we are unable to manage this growth effectively, our business may be harmed.

THE LOSS OF KEY PERSONNEL OR THE INABILITY TO ATTRACT AND RETAIN ADDITIONAL PERSONNEL COULD IMPAIR THE GROWTH OF OUR BUSINESS.

We are highly dependent on the principal members of our management and scientific staff. The loss of any of these persons' services might adversely impact the achievement of our objectives and the continuation of existing collaborations. In addition, recruiting and retaining qualified scientific personnel to perform future research and development work will be critical to our success. There is currently a shortage of skilled executives and employees with technical expertise, and this shortage is likely to continue. As a result, competition for skilled personnel is intense and turnover rates are high. Competition for experienced scientists from numerous companies, academic and other research institutions may limit our ability to attract and retain such personnel. We are dependent on our President and Chief Executive Officer, Norman J.W. Russell, Ph.D., the loss of whose services could have a material adverse effect on our business.

WE USE HAZARDOUS CHEMICALS AND RADIOACTIVE AND BIOLOGICAL MATERIALS IN OUR BUSINESS. ANY CLAIMS RELATING TO IMPROPER HANDLING, STORAGE OR DISPOSAL OF THESE MATERIALS COULD BE TIME CONSUMING AND COSTLY.

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

ETHICAL, LEGAL AND SOCIAL ISSUES MAY LIMIT THE PUBLIC ACCEPTANCE OF, AND DEMAND FOR, OUR TECHNOLOGIES AND PRODUCTS.

Our collaborators and customers may seek to develop diagnostic products based on genes we discover. The prospect of broadly available gene-based diagnostic tests raises ethical, legal and social issues regarding the appropriate use of gene-based diagnostic testing and the resulting confidential information. It is possible that discrimination by third-party payors, based on the results of such testing, could lead to the increase of premiums by such payors to prohibitive levels, outright cancellation of insurance or unwillingness to provide coverage to individuals showing unfavorable gene expression profiles. Similarly, employers could discriminate against employees with gene expression profiles indicative of the potential for high

disease-related costs and lost employment time. Finally, government authorities could, for social or other purposes, limit or prohibit the use of such tests under certain circumstances. We cannot assure you that ethical, legal and social concerns about genetic testing and target identification will not adversely affect market acceptance of our technologies and products.

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

IF WE DEVELOP PRODUCTS WITH OUR COLLABORATORS, AND IF PRODUCT LIABILITY LAWSUITS ARE SUCCESSFULLY BROUGHT AGAINST US, WE COULD FACE SUBSTANTIAL LIABILITIES THAT EXCEED OUR RESOURCES.

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

HEALTHCARE REFORM AND RESTRICTIONS ON REIMBURSEMENTS MAY LIMIT OUR RETURNS ON DIAGNOSTIC OR THERAPEUTIC PRODUCTS THAT WE MAY DEVELOP WITH OUR COLLABORATORS.

If we are successful in validating targets for drug discovery, products that we develop with our collaborators based on those targets may include diagnostic or therapeutic products. The ability of our collaborators to commercialize such products may depend, in part, on the extent to which reimbursement for the cost of these products will be available from government health administration authorities, private health insurers and other organizations. In the U.S., third-party payors are increasingly challenging the price of medical products and services. The trend towards managed healthcare in the U.S., legislative healthcare reforms and the growth of organizations such as health maintenance organizations that may control or significantly influence the purchase of healthcare products and services, may result in lower prices for any products our collaborators may develop. Significant uncertainty exists as to the reimbursement status of newly approved healthcare products, and we cannot assure you that adequate third-party coverage will be available to enable our collaborators to maintain price levels sufficient to realize an appropriate return on their investment in research and product development.

OUR FACILITIES ARE LOCATED NEAR KNOWN EARTHQUAKE FAULT ZONES, AND THE OCCURRENCE OF AN EARTHQUAKE OR OTHER CATASTROPHIC DISASTER COULD CAUSE DAMAGE TO OUR FACILITIES AND EQUIPMENT, WHICH COULD REQUIRE US TO CEASE OR CURTAIL OPERATION.

Our facilities are located near known earthquake fault zones and are vulnerable to damage from earthquakes. We are also vulnerable to damage from other types of disasters, including fire, floods, power loss, communications

failures and similar events. If any disaster were to occur, our ability to operate our business at our facilities would be seriously, or potentially completely, impaired. In addition, the unique nature of our research activities could cause significant delays in our programs and make it difficult for us to recover from a disaster. The insurance we maintain may not be adequate to cover our losses resulting from disasters or other business interruptions. Accordingly, an earthquake or other disaster could materially and adversely harm our ability to conduct business.

OUR STOCK PRICE MAY BE EXTREMELY VOLATILE.

The trading price of our common stock is subject to significant fluctuations. The market prices of the common stock of many publicly held, early stage biotechnology companies have in the past been, and can in the future be expected to be, especially volatile. In addition, the securities markets have from time to time experienced significant price and volume fluctuations that may be unrelated to the operating performance of particular companies. The following factors and events may have a significant and adverse impact on the market price of our common stock:

- fluctuations in our operating results;
- announcements of technological innovations or new commercial products by us or our competitors;
- release of reports by securities analysts;
- developments or disputes concerning patent or proprietary rights;
- developments in our relationships with current or future collaborators or customers; and
- general market conditions.

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

ANTI-TAKEOVER PROVISIONS IN OUR CHARTER DOCUMENTS AND UNDER DELAWARE LAW COULD PREVENT OR DELAY A CHANGE IN CONTROL OF OUR COMPANY, EITHER OF WHICH COULD ADVERSELY AFFECT OUR STOCK PRICE.

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

Although we have no present intention to authorize or issue any additional series of preferred stock, any authorization or issuance, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could also have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. The preferred stock may have other rights, including economic rights senior to those of our common stock, and, as a result, an issuance of additional preferred stock could adversely affect the market value of our common stock. Provisions of Delaware law may also discourage, delay or prevent someone from acquiring or merging with us.

RECENT PRONOUNCEMENTS COULD IMPACT OUR FINANCIAL POSITION AND RESULTS OF

OPERATIONS.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"), which is effective for the year ending December 31, 2001. This statement establishes accounting and reporting standards requiring that every derivative instrument, including certain derivative instruments embedded in other contracts, be recorded in the balance sheet as either an asset or liability measured at its fair value. The statement also requires that changes in the derivative's fair value be recognized in earnings unless specific hedge accounting criteria are met. We believe the adoption of SFAS 133 on January 1, 2001 had no material effect on the financial statements, since we currently do not invest in derivative instruments and engage in hedging activities.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The primary objective of the Company's investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, the Company invests in highly liquid and high-quality debt securities. The Company's investments in debt securities are subject to interest rate risk. To minimize the exposure due to adverse shifts in interest rates, the Company invests in short-term securities and maintains an average maturity of less than one year. As a result, Lynx believes it is not subject to significant interest rate risks.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

a) Exhibits - The following documents are filed as Exhibits to this report:

EXHIBIT NUMBER	DESCRIPTION
None.	

b) Reports on Form 8-K --- No reports on Form 8-K were filed during the three-month period ended March 31, 2001.

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.

LYNX THERAPEUTICS, INC.

/s/ Norman J.W. Russell

By: Norman J.W. Russell, Ph.D.
President and Chief Executive Officer
Date: May 14, 2001

/s/ Edward C. Albini

By: Edward C. Albini
Chief Financial Officer
(Principal Financial and Accounting Officer)
Date: May 14, 2001