NEKTAR THERAPEUTICS
Form 10-Q
May 10, 2007
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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, 2007

or,

¨ TRANSITION REPORTS PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the transition period from _____ to _____

Commission File Number: 0-24006

NEKTAR THERAPEUTICS

(Exact name of registrant as specified in its charter)

Delaware	**94-3134940**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

150 Industrial Road

San Carlos, California 94070

(Address of principal executive offices)

650-631-3100

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 ¨

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 file in Rule 12b-2 of the Exchange Act. (check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act). Yes ¨ No x

The number of outstanding shares of the registrant s Common Stock, $0.0001 par value, was 91,681,687 on April 30, 2007.

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Forward-Looking Statements

This report includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the 1933 Act) and Section 21E of the Securities Exchange Act of 1934, as amended (the 1934 Act). All statements other than statements of historical fact are forward-looking statements for purposes of this quarterly report, including any projections of earnings, revenues or other financial items, any statements of the plans and objectives of management for future operations, any statements concerning proposed new products or services, any statements regarding future economic conditions or performance and any statement of assumptions underlying any of the foregoing. In some cases, forward-looking statements can be identified by the use of terminology such as may, will, expects, plans, anticipates, estimates, p or continue, or the negative thereof or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements contained herein are reasonable, there can be no assurance that such expectations or any of the forward-looking statements will prove to be correct and actual results could differ materially from those projected or assumed in the forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to inherent risks and uncertainties, including but not limited to the risk factors set forth in Part II Item 1A below and for the reasons described elsewhere in this annual report. All forward-looking statements and reasons why results may differ included in this report are made as of the date hereof and we do not intend to update any forward-looking statements except as required by law or applicable regulations.

Trademarks

All Nektar brand and product names contained in this document are trademarks or registered trademarks of Nektar Therapeutics in the United States (U.S.) and other countries. The following, which appear in this document, are registered or other trademarks owned by the following companies: Exubera and Somavert (Pfizer Inc); PEGASYS (Hoffmann-La Roche Ltd.); Neulasta (Amgen Inc.); PEG-INTRON (Schering-Plough Corporation); Macugen ((OSI)-Eyetech); MIRCERA® (Hoffman-La Roche Ltd.); Ostabolin-C (Zelos Therapeutics, Inc.);

Hematide (Affymax, Inc.) and Cimzia (UCB Group).

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PART I: FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements unaudited:

NEKTAR THERAPEUTICS

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share information)

	March 31, 2007 Unaudited	December 31, 2006 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 83,140	$ 63,760
Short-term investments	315,187	394,880
Accounts receivable, net of allowance of $1,062 and $357 at March 31, 2007 and December 31, 2006, respectively.	64,747	47,148
Inventory	16,770	14,656
Other current assets	11,733	14,595
Total current assets	$ 491,577	$ 535,039
Long-term investments		8,337
Property and equipment, net	132,345	133,812
Goodwill	78,431	78,431
Other intangible assets, net	3,390	3,626
Other assets	7,997	8,932
Total assets	$ 713,740	$ 768,177
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,658	$ 7,205
Accrued compensation	11,596	12,994
Accrued expenses	15,338	17,942
Interest payable	1,130	3,814
Capital lease obligations, current portion	760	711
Deferred revenue, current portion	8,635	16,409
Convertible subordinated notes, current portion	66,627	102,653
Other current liabilities	3,732	3,586
Total current liabilities	$ 111,476	$ 165,314
Convertible subordinated notes	315,000	315,000
Capital lease obligations	19,548	19,759
Deferred revenue	40,272	23,697
Other long-term liabilities	16,821	17,347
Total liabilities	$ 503,117	$ 541,117
Commitments and contingencies		
Stockholders equity:		

Preferred stock		
Common stock, $0.0001 par value; 300,000 authorized; 91,651 shares and 91,280 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively	9	9
Capital in excess of par value	1,292,977	1,283,982
Accumulated other comprehensive income	303	62
Accumulated deficit	(1,082,666)	(1,056,993)
Total stockholders equity	210,623	227,060
Total liabilities and stockholders equity	$ 713,740	$ 768,177

(1) Derived from audited consolidated financial statements at this date.

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share information)

(unaudited)

	Three months ended March 31,	
	2007	**2006**
Revenue:		
Product sales and royalties	$ 73,019	$ 12,896
Contract research	11,997	16,063
Total revenue	85,016	28,959
Operating costs and expenses:		
Cost of goods sold	56,522	8,995
Research and development	37,492	31,401
General and administrative	16,735	20,373
Amortization of other intangible assets	236	1,364
Total operating costs and expenses	110,985	62,133
Loss from operations	(25,969)	(33,174)
Interest income	5,473	4,882
Interest expense	(4,933)	(5,142)
Other income (expense), net	6	(37)
Loss before provision for income taxes	(25,423)	(33,471)
Provision for income taxes	(250)	
Net loss	$ (25,673)	$ (33,471)
Basic and diluted net loss per share	$ (0.28)	$ (0.38)
Shares used in computing basic and diluted net loss per share	91,454	88,926

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Three months ended March 31,	
	2007	2006
Cash flows used in operating activities:		
Net loss	$ (25,673)	$ (33,471)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	7,571	8,608
Loss on disposal of assets	304	
Amortization of gain related to sale of building	(219)	(218)
Stock-based compensation	6,861	7,749
Changes in assets and liabilities:		
Decrease (increase) in trade accounts receivable	(17,599)	(9,660)
Decrease (increase) in inventories	(2,114)	(14,552)
Decrease (increase) in prepaids and other assets	3,227	(696)
Increase (decrease) in accounts payable	(3,547)	(4,429)
Increase (decrease) in accrued compensation	(1,635)	(2,528)
Increase (decrease) in accrued expenses	(2,604)	10,793
Increase (decrease) in interest payable	(2,684)	(888)
Increase (decrease) in deferred revenue	8,801	1,433
Increase (decrease) in other liabilities	314	(859)
Net cash used in operating activities	$ (28,997)	$ (38,718)
Cash flows from investing activities:		
Purchases of investments	(79,411)	(33,725)
Maturities of investments	167,696	72,334
Purchases of property and equipment	(5,556)	(4,588)
Net cash provided by investing activities	$ 82,729	$ 34,021
Cash flows from financing activities:		
Repayments of convertible subordinated notes	(36,026)	
Payments of loan and capital lease obligations	(400)	(297)
Issuance of common stock related to employee stock purchase plan	572	769
Issuance of common stock related to employee stock option exercises	1,562	4,975
Net cash (used in) provided by financing activities	$ (34,292)	$ 5,447
Effect of exchange rates on cash and cash equivalents	(60)	5
Net increase in cash and cash equivalents	$ 19,380	$ 755
Cash and cash equivalents at beginning of period	63,760	261,273
Cash and cash equivalents at end of period	$ 83,140	$ 262,028

The accompanying notes are an integral part of these condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2007

(unaudited)

Note 1 Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation

We are a biopharmaceutical company headquartered in San Carlos, California and incorporated in Delaware. Our mission is to develop breakthrough products that make a difference in patients lives. We create differentiated, innovative products by applying our platform technologies to established or novel medicines. Our two leading technology platforms are Pulmonary Technology and PEGylation Technology. Nine products using these technology platforms have received regulatory approval in the U.S. or the European Union (EU). In June 2006, we terminated the research and development activity related to the Nektar Super Critical Fluids Technology, which was conducted at our former Bradford, UK facility.

We prepared the condensed consolidated financial statements following the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by generally accepted accounting principles in United States of America (U.S. GAAP) can be condensed or omitted. In the opinion of management, the financial statements include all normal and recurring adjustments that are considered necessary for the fair presentation of our financial position and operating results.

Revenues, expenses, assets, and liabilities can vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be the same as those for the full year. The information included in this quarterly report on Form 10-Q should be read in conjunction with the consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2006.

Principles of Consolidation

Our condensed consolidated financial statements include the financial position and results of operations and cash flows of our wholly-owned subsidiaries: Nektar Therapeutics AL, Corporation (Nektar AL); Nektar Therapeutics UK, Ltd. (Bradford), Nektar Therapeutics (India) Private Limited, and Aerogen Inc. All intercompany accounts and transactions have been eliminated in consolidation.

Our condensed consolidated financial statements are denominated in U.S. dollars. Accordingly, changes in exchange rates between the applicable foreign currency and the U.S. dollar will affect the translation of each foreign subsidiary s financial results into U.S. dollars for purposes of reporting our consolidated financial results. Translation gains and losses are included in accumulated other comprehensive income in the stockholders equity section of the consolidated balance sheet. To date, such cumulative translation adjustments have not been material to our consolidated financial position.

Segment Information

We operate in one business segment which focuses on applying our technology platforms to improve the performance of established and novel medicines. We believe we operate in one segment because our business offerings have similar economic and other characteristics, including the nature of products and production processes, types of customers, distribution methods and regulatory environment. We are comprehensively managed as one business segment by our Executive Committee, who reports to the Chief Executive Officer, and is our chief operating decision maker. Within our one business segment we have two components, Pulmonary Technology and PEGylation Technology.

Reclassifications

Certain items previously reported in specific financial statement captions have been reclassified to conform to the current period presentation. Such reclassifications have not impacted previously reported revenues, operating loss or net loss.

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Revenue Recognition

Beginning January 1, 2007, we recognized Exubera revenue upon shipment of product. Prior to January 1, 2007, we deferred Exubera revenue until the expiration of Pfizer s 60-day contractual right of return related to non-conformity with product quality specifications; even though prior to shipment, we and our contract manufacturers test, inspect and validate that all products meet contractual quality specifications. In 2006, we deferred Exubera revenue over the contractual right of return period because we did not have sufficient historical returns data to reasonably estimate product returns. As of January 1, 2007, we believe we have the ability to estimate returns as we have over 12 months of product shipment history and have not had any returns from Pfizer. As a result, we recognized revenue of $26.0 million and costs of goods sold $20.8 million related to the February and March 2007 Exubera shipments which would have previously been deferred for 60 days. Our gross margin increased $5.2 million and net loss per share decreased $0.06 as a result of our ability to recognize revenue upon shipment.

Income Taxes

In June 2006, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109* effective for years beginning after December 15, 2006. FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained upon tax authority examination, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement.

We adopted FIN 48 on January 1, 2007. Upon adoption, we did not recognize an increase or a decrease in the liability for net unrecognized tax benefits, which would be accounted for through retained earnings. Further, we did not have any significant unrecognized tax benefits on the date of adoption. We historically accrued for uncertain tax positions in deferred tax assets as we have been in a net operating loss position since inception and any adjustments to our tax positions would result in an adjustment of our net operating loss or tax credit carry forwards rather than resulting in a cash outlay. If the Company is eventually able to recognize these uncertain positions, our effective tax rate would be reduced. We currently have a full valuation allowance against our net deferred tax asset which would impact the timing of the effective tax rate benefit should any of these uncertain tax positions be favorably settled in the future.

Our policy is to include interest and penalties related to unrecognized tax benefits, if any, within the provision for taxes in the consolidated condensed statements of operations under the provisions of FIN 48. As of the date of adoption of FIN 48, the Company has not accrued any amounts for the payment of interest and penalties relating to unrecognized tax benefits.

The Company or its subsidiaries files income tax returns in the U.S. as well as California, Alabama and various other foreign jurisdictions. The Company is currently not the subject of any income tax examinations. In general, the earliest open year subject to examination is 2002, although depending upon jurisdiction, tax years may remain open subject to limitations.

Note 2 Cash and Cash Equivalents, Short-Term Investments, and Investments in Marketable Securities

Cash, cash equivalents and investments in marketable securities are as follows (in thousands):

	Estimated Fair Value at	
	March 31, 2007	December 31, 2006
Cash and cash equivalents	$ 83,140	$ 63,760
Short-term investments (less than one year to maturity)	315,187	394,880
Long-term investments (one to two years to maturity)		8,337
Total Cash and Available-for-Sale Securities	$ 398,327	$ 466,977

Our portfolio of cash and available for sale debt securities include (in thousands):

	Estimated Fair Value at March 31, 2007	Estimated Fair Value at December 31, 2006
U.S. corporate commercial paper	$ 207,169	$ 234,512
Obligations of U.S. corporations	109,650	151,288
Obligations of U.S. government agencies	31,921	27,372
Repurchase agreements	23,038	33,948
Cash and other debt securities	26,549	19,857
Total Cash and Available-for-Sale Securities	$ 398,327	$ 466,977

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At March 31, 2007, the average portfolio duration was approximately three months and the contractual maturity of any single investment did not exceed twelve months. At December 31, 2006, the average portfolio duration was approximately four months and the contractual maturity of any single investment did not exceed twenty-four months.

Gross unrealized gains on the portfolio were nil as of both March 31, 2007 and December 31, 2006. Gross unrealized losses on the portfolio were $0.3 million and $ 0.5 million as of March 31, 2007 and December 31, 2006, respectively. We have a history of holding our investments to maturity. Additionally, we have the ability and intent to hold our debt securities to maturity when they will be redeemed at full par value. Accordingly, management considers these unrealized losses to be temporary and has not recorded a provision for impairment.

At March 31, 2007 and December 31, 2006, we had letter of credit arrangements with certain financial institutions and vendors including our landlord totaling $2.6 million, which are secured by investments of similar amounts.

Note 3 Accounts Receivable and Deferred Revenue

On March 30, 2007, Nektar and Pfizer executed an initial joint development, clinical supply and clinical testing agreement for the next generation insulin program. The next generation Exubera inhaler program includes an insulin inhalation powder formulation that will be tested for use in a next generation Exubera inhaler device.

This agreement provides for a payment from Pfizer to Nektar of $17.6 million for reimbursement of the development costs incurred by Nektar from 2004 through January 31, 2007. Additionally, the agreement provides for the shipment of small quantities of insulin inhalation powder formulation. In connection with the above agreement, we recorded $17.6 million in accounts receivable and non-current deferred revenue as of March 31, 2007. The payment was subsequently received on April 27, 2007. The deferred revenue will be accounted for as an upfront fee and will be amortized into revenue over the expected length of the next generation Exubera inhaler program beginning in the second quarter of 2007.

Note 4 Inventory

Inventory consists of the following (in thousands):

	March 31, 2007	December 31, 2006
Raw material	$ 8,426	$ 8, 609
Work-in-process	7,998	4,736
Finished goods	346	1,311
Total	$ 16,770	$ 14,656

Raw materials primarily include materials used in the production of our PEGylation products. Exubera Inhalers are manufactured and supplied by two of our contract manufacturers, then drop shipped to our customer. No inventory of Exubera Inhalers is held at Nektar. Reserves are determined using specific identification plus an estimated reserve against finished goods for potential defective or excess inventory based on historical experience or projected usage. Inventories are reflected net of reserves of $5.1 million and $4.7 million as of March 31, 2007 and December 31, 2006, respectively.

Note 5 Convertible Subordinated Notes

The outstanding balance of our convertible subordinated notes is as follows (in thousands):

	Semi-Annual Interest Payment Dates	March 31, 2007	December 31, 2006

5% Notes due February 2007	August 8, February 8	$	$ 36,026
3.5% Notes due October 2007	April 17, October 17	66,627	66,627
3.25% Notes due September 2012	March 28, September 28	315,000	315,000
Total outstanding convertible subordinated notes		$ 381,627	$ 417,653
Less: current portion		(66,627)	(102,653)
Convertible subordinated notes		$ 315,000	$ 315,000

Our convertible subordinated notes are unsecured and subordinated in right of payment to any future senior debt. The carrying value approximates fair value for both periods presented. Costs related to the issuance of these convertible notes are recorded in Other assets in our Consolidated Balance Sheets and are amortized to interest expense on a straight-line basis over the contractual life of the notes. The unamortized deferred financing costs were $6.7 million and $7.3 million as of March 31, 2007 and December 31, 2006, respectively.

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Our 5% convertible subordinated notes were repaid on February 7, 2007. There are no remaining deferred financing costs related to the 5% convertible subordinated notes.

Note 6 Commitments and Contingencies

Legal Matters

On August 1, 2006, Novo Nordisk filed a lawsuit against Pfizer in federal court claiming that Pfizer willfully infringes on Novo s patents covering inhaled insulin with Exubera. The case is currently proceeding with discovery and other pre-trial activities. Although we are not currently a named party in this litigation, we have incurred litigation costs as a result of such litigation and may incur substantial future costs and potential indemnity claims from Pfizer associated with the litigation. These and other disputes may have a material impact on our business, results of operation and financial condition.

From time to time, we may be involved in lawsuits, claims, investigations and proceedings, consisting of intellectual property, commercial, employment and other matters, which arise in the ordinary course of business. In accordance with the SFAS No. 5, *Accounting for Contingencies*, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impact of negotiations, settlements, ruling, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. If any unfavorable ruling were to occur in any specific period, there exists the possibility of a material adverse impact on the results of operations of that period or on our cash flows and liquidity.

Collaboration Agreements for Pulmonary Products

As part of our collaboration agreements with our partners for the development, manufacture and supply of products based on our Pulmonary Technology, we generally agree to defend, indemnify and hold harmless our partners from and against third party liabilities arising out of the agreement, including product liability and infringement of intellectual property. The term of these indemnification obligations is generally perpetual any time after execution of the agreement. There is no limitation on the potential amount of future payments we could be required to make under these indemnification obligations.

To date we have not incurred costs to defend lawsuits or settle claims related to these indemnification obligations. If any of our indemnification obligations is triggered, we may incur substantial liabilities. Because the obligated amount under these agreements is not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. No liabilities have been recorded for these obligations on our Consolidated Balance Sheets as of March 31, 2007 or December 31, 2006.

License, Manufacturing and Supply Agreements for Products Based on our PEGylation Technology

As part of our license, manufacturing and supply agreements with our partners for the development or manufacture and supply of PEG reagents based on our PEGylation Technology, we generally agree to defend, indemnify and hold harmless our partners from and against third party liabilities arising out of the agreement, including product liability and infringement of intellectual property. The term of these indemnification obligations is generally perpetual any time after execution of the agreement. There is no limitation on the potential amount of future payments we could be required to make under these indemnification obligations. We have never incurred costs to defend lawsuits or settle claims related to these indemnification obligations. If any of our indemnification obligations is triggered, we may incur substantial liabilities. Because the obligated amount of this agreement is not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations in our Consolidated Balance Sheets as of March 31, 2007 or December 31, 2006.

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Note 7 Stock-Based Compensation

During the three months ended March 31, 2007 and 2006, we recognized $6.3 million and $6.9 million of stock-based compensation expense and capitalized $0.1 million and $0.3 million, respectively. Total stock-based compensation costs were recorded in the following income statement and balance sheet lines items of our Condensed Consolidated Financial Statements:

	Three months ended March 31,	
	2007	2006
Cost of goods sold	$ 582	$ 127
Research and development expense	3,004	2,442
General and administrative expense	2,669	4,334
Total stock-based compensation expense	$ 6,255	$ 6,903
Inventory	117	300
Total stock-based compensation costs	$ 6,372	$ 7,203

Black-Scholes Assumptions

The following tables list the Black-Scholes assumptions used to calculate the fair value of employee stock option grants and ESPP purchases during the period. For the weighted average expected life, w applied the guidance in Staff Accounting Bulletin No. 107 that permits the initial application of a simplified method based on the average of the vesting term and the term of the option. We based our estimate of expected volatility for options granted on the daily historical trading data of our common stock over the period equivalent to the expected term of the respective stock-based grant. For the period ended March 31, 2007, the annual forfeiture rate for executives and staff was estimated to be 4.7% and 7.4%, respectively, based on our qualitative and quantitative analysis of our historical forfeitures.

	Three months ended March 31,			
	2007		2006	
	Employee Stock Options	ESPP	Employee Stock Options	ESPP
Average risk-free interest rate	4.6%	5.13%	4.6%	4.7%
Dividend yield	0.0%	0.0%	0.0%	0.0%
Volatility factor	59.9%	37.1%	69.8%	41.3%
Weighted average expected life	5.2 years	0.5 years	5.3 years	0.5 years

Summary of Stock Option Activity

The table below presents a summary of stock option activity under the 2000 Equity Incentive Plan, the Non-Employee Directors Stock Option Plan and the 2000 Non-Officer Equity Incentive Plan (the Option Plans) (in thousands, except for per share information):

	Options Outstanding			
	Number of Shares	Exercise Price Per Share	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (1)
Balance at December 31, 2006	10,703	$ 0.01-61.63	18.97	4.78	$ 15,348
Options granted	1,899	11.38 15.24	12.52		
Options exercised	(180)	0.03 14.25	9.17		$ 761
Options expired and canceled	(267)	5.05 52.13	20.34		

Balance at March 31, 2007	12,155	0.01-61.63	18.08	5.03	$ 10,683
Exercisable at December 31, 2006	8,185		19.88	4.09	$ 12,229
Exercisable at March 31, 2007	8,193		19.83	4.03	$ 7,288

(1) Aggregate Intrinsic Value represents the difference between the exercise price of the option and the closing market price of our common stock on the exercise or period end date, as applicable.

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The weighted average grant-date fair value of options granted during the three-months ended March 31, 2007 and 2006 was $7.04 per share and $12.36 per share, respectively.

Summary of RSU Award Activity

During the three months ended March 31, 2007, we granted service based RSU awards totaling 283,461 shares of our common stock to certain employees and directors. These RSU awards will cliff-vest annually over a three year period. The grant date fair value of RSU awards is always equal to the intrinsic value of the award on the date of grant since the awards were issued for no consideration. The fair value of these RSU awards on the date of grant was approximately $3.2 million.

During 2006, we issued performance based RSU awards totaling 1,088,300 shares of our common stock to certain employees and directors. These awards will vest based upon achieving three pre-determined performance milestones all of which were initially expected to occur over a period of 40 months. We expense the grant date fair value of the awards ratably over the expected performance period of each milestone. During the three months ended March 31, 2007, we determined that our vesting assumptions for two of the performance based milestones, each representing 40% of the total 2006 RSU awards, no longer reflected our current expectations. As a result, we revised the estimated amortization period for the second performance milestones from an original 26 months to 96 months and have prospectively adjusted the amortization expense to reflect a remaining vesting period of 84 months. The unamortized expense related to this performance milestone was approximately $4.8 million at January 1, 2007. As a result of this change in estimate, we expensed approximately $0.7 million less in the three-month ended March 31, 2007 than the prior quarter. For the third performance milestone, we had previously determined in the three months ended September 30, 2006 that vesting was not probable under a Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* definition and reversed all previously recognized expense. However, due to certain changes in our product pipeline development efforts in Q1 2007, we determined that the performance milestone was probable of achievement by the end of the first quarter in 2010. As a result we recorded a $2.0 million cumulative catch-up adjustment of additional stock compensation expense in the three months ended March 31, 2007.

Aggregate Unrecognized Stock-based Compensation Expense

During the three months ended March 31, 2007, we granted 1.9 million stock options, which resulted in an increase in unrecognized compensation expense of $11.0 million. As of March 31, 2007, there was approximately $49.4 million of aggregate unrecognized compensation expense related to unvested stock-based compensation arrangements under the Option Plans. This total unrecognized expense is expected to be recognized as follows:

Fiscal Year	**(in thousands)**
2007 (remaining 9 months)	$ 15,327
2008	15,065
2009	10,469
2010	6,177
2011 and thereafter	2,407
	$ 49,445

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Note 8 Net Loss Per Share

Basic net loss per share is calculated based on the weighted-average number of common shares outstanding during the periods presented. For all years presented in the Condensed Consolidated Statements of Operations, the net loss available to common shareholders is equal to the reported net loss. Basic and diluted net loss per share are the same due to our historical net losses and the requirement to exclude potentially dilutive securities which would have an anti-dilutive effect on net loss per share. These potentially dilutive securities have been excluded from the diluted net loss per share calculation and are as follows (in thousands):

	March 31,	
	2007	2006
Convertible debentures and notes	15,958	16,896
Stock options and restricted stock units	9,707	6,439
Warrants		20
Total	25,665	23,355

Note 9 Comprehensive Loss

Comprehensive loss is comprised of net loss and accumulated other comprehensive income and includes the following components (in thousands):

	Three months ended March 31,	
	2007	2006
Net loss, as reported	$ (25,673)	$ (33,471)
Change in net unrealized gains (losses) on available-for-sale securities	255	33
Translation adjustment	(14)	(60)
Total comprehensive loss	$ (25,432)	$ (33,498)

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

	March 31, 2007	December 31, 2006
Unrealized loss on available-for-sale securities	$ (244)	$ (499)
Translation adjustment	547	561
Total accumulated other comprehensive income	$ 303	$ 62

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

The following discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this section as well as factors described in Part II, Item 1-A Risk Factors.

Overview

We are a biopharmaceutical company with a mission to develop breakthrough products that make a difference in patients lives. We create differentiated, innovative products by applying our platform technologies to established or novel medicines. Our two leading technology platforms are Pulmonary Technology and PEGylation Technology. Nine products using these technology platforms have received regulatory approval in the U.S. or the EU.

We create or enable potential products in two ways. First, we develop products in collaboration with pharmaceutical and biotechnology companies that seek to improve and differentiate their products. Second, we apply our technologies to already approved drugs to create and develop our own differentiated, proprietary programs. Our proprietary programs are designed to target serious diseases in novel ways. We believe our proprietary products and development programs have the potential to raise the standards of current patient care by improving one or more performance parameters including efficacy, safety and ease-of-use.

Our technology platforms enable improved performance of a variety of new and existing molecules. Our Pulmonary Technology makes drugs inhaleable to deliver them to and through the lungs for both systemic and local lung applications. Our PEGylation Technology is a chemical process designed to enhance the performance of most drug classes with the potential to improve solubility and stability, increase drug half-life, reduce immune responses to an active drug, and improve the efficacy or safety of a molecule in certain instances.

We currently depend on sales to Pfizer for a significant portion of our revenues primarily from the manufacture and sale of Exubera Inhalation Powder and Inhalers. Revenue from Pfizer represented 76% of our total revenue for the three-month period ending March 31, 2007. As a result, Exubera manufacturing is currently the critical determinant of our product sales revenue. Pfizer has taken a phased approach to the Exubera commercial launch. In the second half of 2006, the early phase of the Exubera launch focused on manufacturing scale-up activities and educating diabetes specialists. In 2007, Pfizer initiated the next phase of the launch expanding the education, marketing and sales efforts more broadly to primary care physicians. Because the Exubera commercial roll-out is still in its early phases, we cannot predict the level of Exubera sales or expected royalty revenues for this or subsequent years. Exubera sales to date have not been significant, and because Pfizer is responsible for all Exubera sales and marketing, we have very little visibility to estimate future Exubera sales. There are substantial risks and uncertainties with respect to the commercial success of Exubera, including physician and patient education and experiences, alternative insulin and diabetes therapies, the timing and success of the commercialization in various markets, third party payor reimbursement, country specific pricing approvals, manufacturing and supply execution, and other risks and uncertainties identified in this report.

Currently, we are the exclusive manufacturer of the Exubera Inhalation Powder and Inhalers. Under our agreement, Pfizer is permitted to manufacture up to one-half of the Exubera Inhalation Powder and also has responsibility for the automated filling of all insulin blister packs for the Exubera Inhaler and packaging of the Exubera product. Pfizer has an Exubera Inhalation Powder manufacturing facility and will likely manufacture a portion of the Exubera Inhalation Powder in the future. Our manufacturing revenues received from Pfizer for Exubera Inhalation Powder and Inhalers are calculated on a cost-plus basis. Exubera royalty revenue levels depend on the level of Exubera sales and Pfizer s cost of goods sold for Exubera.

We have been manufacturing Exubera Inhalation Powder and Inhalers at commercial scale since early 2006. Because the commercial launch of Exubera by Pfizer has been much slower than originally anticipated, Pfizer has built substantial Exubera inventory. As a result, we are working with Pfizer to reduce Exubera manufacturing volumes in the second half of 2007 and 2008 to address the current supply and demand imbalance while maintaining future Exubera manufacturing capacity. A reduction in Exubera manufacturing would reduce our Exubera product sales revenue in the second half of 2007 with such lower Exubera product sales likely continuing throughout 2008.

We continue to make significant investments in our proprietary development programs which comprise a substantial portion of our research and development spending. Our strategy is to develop a portfolio of proprietary programs that is intended to address critical unmet medical needs by exploiting our know-how and technology in combination with established medicines. We intend to develop some of these programs in partnership with pharmaceutical and biotechnology companies in various stages of their development in an effort to help fund the investment of our proprietary development programs. Our decision as to when to seek partners for our proprietary development programs, if at all, will be made on an individual program basis and such decisions will have an important impact on our future revenues, research and development spending, and financial position. In this regard, we are currently seeking collaboration partners for two of our proprietary development programs and the success and timing of these partnering efforts will affect our research and development expense levels and revenues in 2007 and beyond.

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We will continue to seek collaborative arrangements with pharmaceutical and biotechnology companies, where appropriate. We believe our partnering strategy enables us to develop a large and diversified pipeline of products and development programs using our technologies. To date the revenues we have received from the sales of our partner products have been insufficient to meet our operating and other expenses. We do not anticipate receiving sufficient amounts of revenue from other partner product sales or royalties in the near future to meet our operating expenses.

To fund the expense related to our research and development activities, we have raised significant amounts of capital through the sale of our equity and convertible debt securities. As of March 31, 2007, we had approximately $411.3 million in indebtedness. Our ability to meet the repayment obligations of this debt is dependent upon our and our partners ability to develop, obtain regulatory approvals, and successfully commercialize products. Even if we are successful in this regard, we may require additional capital to repay our debt obligations.

We are carefully evaluating our ongoing spending levels and exploring various alternatives to significantly reduce our expenditure levels. We are currently in the review and evaluation phase and have not yet approved or committed to a plan to reduce expenditures. If such a plan is implemented in the future, we could incur significant restructuring charges as early as the second quarter of 2007.

Research and Development Activities

Our product pipeline includes both partnered and proprietary development programs. We have ongoing collaborations or licensing arrangements with more than thirty biotechnology and pharmaceutical companies to provide our technologies. Our technologies are currently being used in nine approved products, in two partner programs that have been filed for with the FDA and twelve development programs in human clinical trials.

The length of time that a development program is in a given phase varies substantially according to factors relating to the development program, such as the type and intended use of the potential product, the clinical trial design, and the ability to enroll suitable patients. Generally, for partnered programs, advancement from one phase to the next and the related costs to do so is dependent upon factors that are primarily controlled by our partners.

Our portfolio of development programs is based on our Pulmonary Technology and PEGylation Technology platforms. Within each major category, we have both partnered and proprietary development programs. The estimated completion dates and costs for our programs are not reasonably certain. See Risk Factors for discussion of the risks associated with our partnered and proprietary research and development programs.

In connection with our research and development for partner products and development programs, we earned $12.0 million and $16.1 million in contract research revenue for the three months ending March 31, 2007 and 2006, respectively.

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The costs incurred in connection with these programs, including allocations of facilities, cGMP quality programs and other shared costs, is as follows (in millions):

Molecule	Status as of March 31, 2007 (1)	Three months ended March 31, 2007	2006
Pulmonary			
Partnered Products and Development Programs			
Exubera® (insulin human [rDNA origin]) Inhalation Powder	Approved in U.S., EU, Brazil, and Mexico	$ 4.7	$ 5.3
Next generation Exubera inhaler program	Pre-Clinical	8.5	2.4
Tobramycin inhalation powder (TIP)	Phase 3	3.9	2.9
Other partner programs	Various	3.8	3.9
Proprietary Development Programs			
Amphotericin B inhalation powder	Phase 1 (pre-pivotal)	3.9	4.3
Inhaled Antibiotics (Aerosolized amikacin)	Phase 2	2.4	3.3
Other proprietary products	Various	1.9	0.3
Technology platform	Various	2.6	3.5
Total Pulmonary		$ 31.7	$ 25.9
PEGylation			
Partnered Products and Development Programs	Various	$ 1.7	$ 1.3
Proprietary Development Programs			
PEG product (Oncology-related)	Pre-clinical	1.0	0.6
PEG product (Pain-related)	Pre-clinical	0.5	0.6
Other	Various	2.6	1.3
Total PEGylation		$ 5.8	$ 3.8
Other	Various		1.7
Total Research and Development Expense		$ 37.5	$ 31.4

(1) Status definitions are:

Approved regulatory approval to market and sell product obtained in the U.S., EU and other countries.

Phase 3 or Pivotal Product in large-scale clinical trials conducted to obtain regulatory approval to market and sell a drug. Typically, these trials are initiated following encouraging Phase II trial results.

Phase 2 Product in clinical trials to establish dosing and efficacy in patients.

Phase 1 Product in clinical trials typically in healthy subjects to test safety.

Pre-clinical Group of studies that test a drug on animals and other nonhuman test systems. This testing is conducted to gain more data about the pharmaceutical s efficacy and safety before tests on humans can begin.

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Results of Operations

Three-Months Ended March 31, 2007 and 2006

Revenue (in thousands except percentages)

	Three months ended March 31, 2007	Three months ended March 31, 2006	Increase / (Decrease) 2007 vs 2006	Percentage Increase / (Decrease) 2007 vs 2006
Product sales and royalties	$ 73,019	$ 12,896	$ 60,123	> 100 %
Contract research	11,997	16,063	(4,066)	(25)%
Total revenue	$ 85,016	$ 28,959	$ 56,057	> 100 %

The increase in total revenue for the three months ended March 31, 2007 as compared to the three months ended March 31, 2006 was primarily due to an increase in Exubera product sales to Pfizer, partially offset by a decrease in contract research revenue from Pfizer. Pfizer represented 76% and 44% of our revenue for the three months ended March 31, 2007 and 2006, respectively. No other single customer represented 10% or more of our total revenues for either of the three months ended March 31, 2007 or 2006.

Product sales and royalties

The increase in product sales and royalties for the three months ended March 31, 2007 as compared to the three months ended March 31, 2006 was primarily due to a significant increase in Exubera product sales volume. Also, prior to January 1, 2007, we had deferred recognition of Exubera product revenue and related costs of goods sold until the expiration of the 60 day contractual right of return related to non-conformity with product quality specifications because we did not have sufficient historical return data necessary to reasonably estimate product returns. After 12 months of product shipments, we had not experienced any Exubera product returns; therefore as of January 1, 2007, we began recognizing Exubera revenue and related cost of goods sold upon shipment. As a result, we recognized revenue of $26.0 million related to the February and March 2007 shipments which would have previously been deferred for 60 days. Accordingly, the amount of product sales for the three months ended March 31, 2007 will likely not be representative of quarterly revenue for future periods. Further, Exubera product sales during the three months ended March 31, 2007 were negatively impacted by a fire, which required the closure of our San Carlos manufacturing facility for a brief period of time. We estimate that lost product revenue was approximately $2.2 million. We intend to seek recovery of our lost revenue as a result of the fire under our business interruption insurance policy. Also contributing to the increase in product sales and royalties during the three months ended March 31, 2007 as compared to the three months ended March 31, 2006 was approximately $3.6 million from our PEGylation products, partially offset by a decrease in royalty revenue of approximately $1.7 million.

Contract research

Contract research revenue includes reimbursed research and development expenses as well as the amortization of deferred up-front signing fees and milestone payments received from our collaboration partners. Contract research revenue is expected to fluctuate from year to year, and future contract research revenue cannot be predicted accurately. The level of contract research revenues depends in part upon the continuation of existing collaborations, signing of new collaborations, and achievement of milestones under current and future agreements.

The decrease in contract research revenue during the three months ended March 31, 2007 as compared to the same period in 2006 was primarily due to a $6.6 million decrease in Pfizer contract research revenue after the FDA and EMEA regulatory approval of Exubera in January 2006, and the transition from contract research revenue and commercialization readiness revenue from Pfizer for the Exubera development program to sales of commercial volumes of Exubera Inhalation Powder and Inhalers to Pfizer. The decrease in contract research revenue from Pfizer was partially offset by a $2.7 million increase in contract research revenues from Novartis Pharma AG under our collaboration agreement to develop a dry powder inhaled formation of tobramycin using our Pulmonary Technology.

The estimated completion dates and costs of our programs are not reasonably certain. See Risk Factors for discussion of the risks associated with our partnered research and development programs.

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Cost of Goods Sold and Gross Margin (in thousands except percentages)

	Three months ended March 31, 2007	Three months ended March 31, 2006	Increase / (Decrease) 2007 vs 2006	Percentage Increase / (Decrease) 2007 vs 2006
Cost of goods sold	$ 56,522	$ 8,995	$ 47,527	> 100 %
Product gross margin	$ 16,497	$ 3,901	12,596	> 100 %
Product gross margin %	23%	30%		

The increase in cost of goods sold for the three months ended March 31, 2007 as compared to the three months ended March 31, 2006 was primarily due to a significant increase in Exubera product sales. Also, prior to January 1, 2007, we had deferred recognition of Exubera product revenue and the related cost of goods sold until the expiration of the 60 day contractual right of return related to non-conformity with product quality specifications because we did not have sufficient historical return data necessary to reasonably estimate product returns. After 12 months of product shipments, we had not experienced any Exubera product returns; therefore as of January 1, 2007, we began recognizing Exubera revenue and the related cost of goods sold upon shipment. As a result, we recognized $20.8 million of costs of goods sold related to the February and March 2007 shipments which would have previously been deferred for 60 days. Recognition of Exubera revenue and the related costs upon shipment resulted in a net increase to gross margin of $5.2 million during the three months ended March 31, 2007. However, the decrease in gross margin percentage during the three months ended March 31, 2007 as compared to 2006 is primarily related to a higher margin product mix in the first quarter of 2006. Further, the gross margin percentage during the three months ended March 31, 2007 was negatively impacted by the February 2007 fire in our San Carlos manufacturing facility by approximately $1.7 million. Accordingly, our costs of goods sold for the three months ended March 31, 2007 will likely not be representative of quarterly costs of goods sold for future periods.

Research and Development Expenses (in thousands except percentages)

	Three months ended March 31, 2007	Three months ended March 31, 2006	Increase / (Decrease) 2007 vs 2006	Percentage Increase / (Decrease) 2007 vs 2006
Research and development	$ 37,492	$ 31,401	$ 6,091	19%

The increase in our research and development expense during the three months ended March 31, 2007 as compared to the same period in 2006 is primarily related to increased spending in our Pulmonary programs of $5.8 million and PEGylation programs of $2.0 million. The increased spending in our Pulmonary and PEGylation programs was partially offset by decreased spending of $1.7 million in other research and development programs.

The increased spending in the above program categories is primarily attributable to increased headcount and annual salary increases. Salaries and benefits, including healthcare premiums, increased $2.5 million for the three months ended March 31, 2007 as compared to the same period in 2006. Additionally, in the three month period ended March 31, 2006, we received $2.7 million related to the sale of previously expensed excess clinical supplies to our contract manufacturers. We recognized this reimbursement as a one-time reduction to research and development expense.

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General and Administrative Expenses (in thousands except percentages)

	Three months ended March 31, 2007	Three months ended March 31, 2006	Increase / (Decrease) 2007 vs 2006	Percentage Increase / (Decrease) 2007 vs 2006
General and administrative	$ 16,735	$ 20,373	$ (3,638)	(18)%

General and administrative expenses are associated with administrative staffing, business development and marketing.

The decrease in general and administrative expenses for the three months ended March 31, 2007 as compared to the same period in 2006 was primarily due to decreased stock based compensation expense of $1.7 million and decreased outside services of $1.2 million. Stock-based compensation expense decreased during the three months ended March 31, 2007 due to higher stock-based compensation related to executive severance during the three months ended March 31, 2006. Outside services decreased during the three months ended March 31, 2007 due to lower professional accounting and audit fees.

Liquidity and Capital Resources

We had cash, cash equivalents and investments in marketable securities of $398.3 million and indebtedness of $411.3 million, including $381.6 million of convertible subordinated notes, $20.3 million in capital lease obligations and $9.4 million in other long-term liabilities as of March 31, 2007.

We have financed our operations primarily through revenue from product sales and research and development contracts, public and private placements of debt and equity securities and financing of equipment acquisitions and certain tenant leasehold improvements. We do not utilize off-balance sheet financing arrangements as a source of liquidity or financing.

Cashflow Activities

During the three-month period ended March 31, 2007, net cash used in operating activities was $29.0 million. To date, revenue has not been sufficient to cover our expenses and we are not generating positive cash flow through our operations. In the first quarter of 2007, we purchased $5.6 million of property and equipment and repaid $36.4 million of our convertible subordinated notes and other debt obligations. These uses of cash were partially offset by $2.1 million in cash collected from employees for the purchase of common stock.

During the three-month period ended March 31, 2006, net cash used in operating activities was $38.7 million. We purchased $4.6 million of property and equipment. These uses of cash were offset by $5.7 million in proceeds from the issuance of common stock to employees.

We expect to use a substantial portion of our cash to fund our on-going operations over the next few years and to repay our $411.3 million of indebtedness outstanding as of March 31, 2007, including $66.6 million of convertible subordinated notes due in October 2007.

Contractual Obligations

During the quarter ended March 31, 2007, other than the repayment of our 5% convertible subordinated notes balance of $36.0 million, there has not been a material change to the summary of contractual obligations in our Annual Report on Form 10-K for the year ended December 31, 2006.

Critical Accounting Policies and Management s Estimates

The preparation of financial statements in conformity with U.S. Generally Accepted Accounting Principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the result of which form our basis for

making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources, and evaluate our estimates on an ongoing basis. Actual results may differ from those estimates under different assumptions or conditions. Accounting policies and estimates are described in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 1, Organization and Summary of Significant Accounting Policies, to our consolidated audited financial statements in our December 31, 2006 Form 10-K.

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During the three months ended March 31, 2007, we revised our method of estimating Exubera product returns and adopted FASB interpretation No. 48, Accounting for Uncertainty in Income Taxes .

Revenue Recognition

Beginning January 1, 2007, we recognized Exubera revenue upon shipment of drugs and devices. Prior to January 1, 2007, we deferred Exubera revenue until the expiration of Pfizer s 60-day contractual right of return for non-conformity with product quality specifications, even though prior to shipment, we and our contract manufacturers test, inspect and validate that all products meet contractual quality specifications. In 2006, we deferred Exubera revenue for 60 days because we did not have enough historical data to reasonably estimate product returns. As of January 1, 2007, we believe we have the ability to estimate returns as we have over 12 months of product shipment history and have not had any returns from Pfizer. As a result, we recognized revenue of $26.0 million and costs of goods sold $20.8 million related to the February and March 2007 Exubera shipments which would have previously been deferred for 60 days. Our gross margin increased $5.2 million and net loss per share decreased $0.06 as a result of our ability to recognize revenue upon shipment.

Income Taxes

On January 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). Adoption of FIN 48 had no impact on our consolidated financial position, results of operations, cash flows or our effective tax rate, however, revisions to the estimated net realizable value of the deferred tax asset in the future could cause our provision for income taxes to vary significantly from period to period.

At March 31, 2007, we had significant federal and state net operating loss and research credit carry forwards which were offset by a full valuation allowance, due to our inability to estimate long-term future taxable income with a high level of certainty. Upon adoption of FIN 48, we did not recognize an increase or a decrease in the liability for net unrecognized tax benefits, which would be accounted for through retained earnings. Further, we did not have any significant unrecognized tax benefits on the date of adoption. We historically accrued for uncertain tax positions in deferred tax assets as we have been in a net operating loss position since inception and any adjustments to our tax positions would result in an adjustment of our net operating loss or tax credit carry forwards rather than resulting in a cash outlay. If the Company is eventually able to recognize these uncertain positions, our effective tax rate would be reduced. We currently have a full valuation allowance against our net deferred tax asset which would impact the timing of the effective tax rate benefit should any of these uncertain tax positions be favorably settled in the future.

On a periodic basis, we will continue to evaluate the realizability of our deferred tax assets and liabilities and adjust such amounts in light of changing facts and circumstances, including but not limited to the level of past and future taxable income, the utilization of the carry forwards, tax legislation, rulings by relevant tax authorities, tax planning strategies and if applicable, the progress of ongoing tax audits. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the period in which those temporary differences become deductible or the net operating loss and research credit carry forwards can be utilized.

Stock-Based Compensation

We use the Black-Scholes option valuation model adjusted for the estimated historical forfeiture rate for the respective grant to determine the estimated fair value of our stock-based compensation arrangements on the date of grant (grant date fair value) and expense this value ratably over the estimated life of the option or performance period of the RSU award. The Black-Scholes option pricing model requires the input of highly subjective assumptions. Because our employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models may not provide a reliable single measure of the fair value of our employee stock options or common stock purchased under the ESPP. In addition, management continually assesses these assumptions and methodologies used to calculate the estimated fair value of stock-based compensation. Circumstances may change and additional data may become available over time, which could result in changes to these assumptions and methodologies, and which could materially impact our fair value determination.

During 2006, we issued performance-based RSU awards totaling 1,088,300 shares of our common stock to certain employees and directors. The RSU awards are settled by delivery of shares of our common stock on or shortly after the date the awards vest. These awards will vest based upon achieving three pre-determined performance milestones all of which were initially expected to occur over a period of 40 months. We expense the grant date fair value of the awards ratably over the expected performance period. The total grant date fair value of these RSU s was $19.8 million, including $4.0 million for milestone #1, $7.9 million for milestone #2, and $7.9 million for milestone #3. In the first quarter of 2007, we revised our estimates regarding the probable expected achievement dates for the second and third milestones. This resulted in a cumulative catch-up of $2.0 million in stock compensation expense.

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Our total remaining unamortized stock compensation expense relating to the 2006 RSU s is approximately $11.4 million. Based on our current assumptions, we will expense approximately $3.2 million in the remainder of 2007, $2.7 million per year in 2008 through 2010 and approximately $0.7 million from 2011 through 2014. Possible future changes in events and/or management estimates regarding the probable expected achievement date of these milestones will result in changes in the timing and amount of expense recognition related to these RSU s.

Issuer Purchases of Equity Securities

There were no purchases of any class of our equity securities by us or any affiliate pursuant to any publicly announced repurchase plan in the three-month period ended March 31, 2007.

Approval of Non-Audit Services

During the three-month period ended March 31, 2007, the Audit Committee of the Board of Directors approved nil in non-audit related services to be provided by Ernst & Young LLP, our independent registered public accounting firm.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our market risks at March 31, 2007 have not changed significantly from those discussed in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2006 on file with the Securities and Exchange Commission.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Nektar Therapeutics maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company s Securities Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required financial disclosure.

As of the end of the period covered by this report, Nektar carried out an evaluation, under the supervision and with the participation of Nektar s management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon, and as of the date of, this evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective

Changes in Internal Control Over Financial Reporting

Nektar continuously seeks to improve the efficiency and effectiveness of our internal controls. This results in refinements to processes throughout the Company. However, there was no change in our internal control over financial reporting that occurred during the three-months ended March 31, 2007 that has materially affected, or is reasonably likely to materially affect, Nektar s internal control over financial reporting.

Limitations on the Effectiveness of Controls

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

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PART II: OTHER INFORMATION

Item 1. Legal Proceedings

Reference is hereby made to our disclosures in Legal Matters under Note 5 of the Notes to Condensed Consolidated Financial Statements and the information under the heading Legal Matters is incorporated by reference herein.

Item 1A. Risk Factors

We are providing the following cautionary discussion of risk factors, uncertainties and possibly inaccurate assumptions that we believe are relevant to our business. These are factors that, individually or in the aggregate, we think could cause our actual results to differ materially from expected and historical results and our forward-looking statements. We note these factors for investors as permitted by Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider this section to be a complete discussion of all potential risks or uncertainties that may substantially impact our business. We have marked with an asterisk (*) those risks described below that reflect substantive changes from the risks described under Item 1A. Risk Factors included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 1, 2007.

***Our revenue and results of operations depend on sales to Pfizer.**

We currently depend on Pfizer as the source of a significant portion of our revenues. Revenue from Pfizer represented 76% and 44% of our total revenue for the three-month periods ending March 31, 2007 and 2006, respectively. We expect a significant portion of our future revenue from Pfizer will come from the commercial manufacture and sale of Exubera Inhalation Powder to Pfizer, the sale of Exubera Inhalers and component parts to Pfizer, and royalties from Exubera product sales by Pfizer. Under our collaboration agreement with Pfizer, the Exubera royalties depend on the level of Exubera sales and Pfizer s cost of goods sold for the product. The commercial launch of Exubera is in the early stages and has been slower than originally anticipated. Pfizer has sole responsibility for the sales and marketing of Exubera, and as a result, it is difficult to predict future Exubera sales and the royalties we will receive from those sales.

We have been manufacturing Exubera Inhalation Powder and Inhalers at commercial scale since early 2006. Because the commercial launch of Exubera by Pfizer has been much slower than originally anticipated, Pfizer has built substantial Exubera inventory. As a result, we are working with Pfizer to reduce Exubera manufacturing volumes in the second half of 2007 and 2008 to address the current supply and demand imbalance while maintaining future Exubera manufacturing capacity. A reduction in Exubera manufacturing would reduce our Exubera product sales revenue in the second half of 2007 with such lower Exubera product sales likely continuing throughout 2008. There can be no assurance that we will be able to reduce manufacturing volumes for Exubera such that it will not result in a significant reduction in Exubera product sales in one or more future periods.

***The Exubera commercial launch is in the early stages and there can be no assurance regarding the commercial success of Exubera.**

Pfizer has taken a phased approach to the Exubera commercial launch. In the second half of 2006, the first phase of the Exubera launch focused on manufacturing scale-up activities and the education of diabetes specialists. In 2007, Pfizer initiated the next phase of the launch expanding the education, marketing and sales efforts more broadly to primary care physicians. More than a year after Exubera received regulatory approval, sales to date have not been significant. We do not participate in any way in the sales and marketing of Exubera and therefore have no direct control over the commercial success of Exubera. There can be no assurance regarding the commercial success of Exubera which will depend on such factors as Pfizer s investment in the marketing and sales of Exubera, physician and patient education and experiences, alternative insulin and diabetes therapies, third party payor reimbursement, country specific pricing approvals, market potential for inhaled insulin, successful product manufacturing and the impact of competition from other diabetes therapies. If sales of Exubera are not successful or delayed, it would have a material impact on our revenue, results of operations, and financial condition.

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***If we are not able to manufacture and supply sufficient quantities of Exubera Inhalation Powder to meet market demand it would negatively impact our revenue and results of operations.**

We have performed insulin powder processing on the scale needed for commercial production of Exubera Inhalation Powder for approximately 15 months. Although we have been successful at meeting our Exubera Inhalation Powder manufacturing objectives to date, we could encounter manufacturing and quality control problems as we continue to manufacture Exubera Inhalation Powder. Although the sales of Exubera have been slower than originally anticipated to date, if market demand requires, we may not be able to expand commercial production of Exubera Inhalation Powder in a timely manner or at a commercially reasonable cost. Increasing manufacturing capacity requires significant capital investments and substantial periods of time to implement and obtain regulatory qualifications. As a result of the long-lead time required to add manufacturing capacity, increases in demand for Exubera could result in our inability to meet market demand.

We are required to maintain compliance with current Good Manufacturing Practices, or cGMP, and are subject to inspections by the FDA or comparable agencies in other jurisdictions to confirm such compliance. We anticipate periodic regulatory inspections of our powder drug manufacturing facilities for compliance with applicable regulatory requirements. The results of these inspections could result in costly manufacturing changes, facility or capital equipment upgrades, or suspension of manufacturing until the FDA is satisfied that the manufacturing and quality control procedures are in substantial compliance with cGMP. Manufacturing delays for Exubera Inhalation Powder pending resolution of regulatory deficiencies or suspensions would have a significant adverse impact on our revenue and results of operations.

We depend on two contract manufacturers to manufacture the Exubera Inhalers and the failure to manufacture sufficient quantities of the Exubera Inhalers to meet market demand would negatively impact our revenues and results of operations.

We depend on two contract manufacturers and their supply chains to manufacture and supply the Exubera Inhalers. Because the manufacturing process for the Exubera Inhaler is complex and subject to extensive government regulations, alternative qualified contract manufacturers or increased capacity may not be available on a timely basis, at a commercially reasonable cost or at all. Although the sales of Exubera have been slower than originally anticipated to date, if market demand requires, Increasing manufacturing capacity at our contract manufacturers involves significant risks and uncertainties including significant lead time requirements, large capital investments, the recruitment and training of additional qualified personnel, and other operational complexities. Although our contract manufacturers have been successful at meeting the commercial manufacturing objectives for Exubera Inhalers to date, there can be no assurance that in future periods our contract manufacturers may not experience manufacturing or quality control problems or that they will be able to continue to scale-up manufacturing to meet commercial demand for the Exubera Inhaler devices.

We also depend on the suppliers of our contract manufacturers to provide a large number of component parts for the Exubera Inhaler in sufficient quantities and on a timely basis to meet market demand. A failure by one or more of these suppliers to provide sufficient parts or components in accordance with our specifications on a timely basis to meet market demand would limit our Exubera Inhaler production capacity and would have a negative impact on our revenue and results of operations.

In addition, we anticipate periodic regulatory inspections of our contract manufacturers facilities. Although our contract manufacturers have obligations to comply with regulatory requirements, the results of these regulatory inspections could result in costly manufacturing changes, facility or capital equipment upgrades or expansion, or suspension of manufacturing until the FDA is satisfied that the manufacturing and quality control procedures are in substantial compliance with cGMP. Manufacturing delays pending resolution of regulatory deficiencies or suspensions would have a severe negative impact on our revenue, results of operations, and financial position.

If Pfizer is unable to manufacture and deliver bulk insulin for powder processing, fill the insulin powder into blister packs for the Exubera Inhaler, or package sufficient quantities of the Exubera product to meet market demand, it would significantly and negatively impact our revenues and results of operations.

Pfizer is responsible for providing the bulk insulin for powder processing, automated filling of all the powder insulin blister packs, and all packaging required for the final Exubera product. Pfizer may encounter manufacturing, filling or packaging problems that cannot be remedied in a timely manner to meet commercial demand for the Exubera product. In addition, Pfizer also has the right to manufacture up to one-half of the Exubera Inhalation Powder. In the second half of 2006, Pfizer experienced manufacturing scale-up challenges due to the complex Exubera manufacturing process designed by Pfizer which requires highly automated, specially engineered equipment. Any failure, delay or inability to address these challenges and scale-up Pfizer s portion of the manufacturing, filling and packaging processes could impede Exubera sales and would significantly and negatively impact our revenues, results of operations and financial condition.

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We also anticipate periodic regulatory inspections of Pfizer manufacturing, filling and packaging facilities for regulatory compliance. Findings from these regulatory inspections could result in costly manufacturing changes, facility or capital equipment upgrades or suspension of Pfizer s manufacturing activities until the FDA is satisfied that the manufacturing and quality control procedures are in substantial compliance with cGMP. Manufacturing delays pending resolution of deficiencies or suspension would have a negative impact on our revenue, results of operations, regulatory approvals, and public confidence in the Exubera product.

The discovery of any new or more severe side effects or negative efficacy findings for Exubera could significantly harm our business.

While the safety of Exubera for patients has been extensively studied in clinical trials with generally mild to moderate side-effects to date, Pfizer is conducting controlled long-term safety and efficacy studies of Exubera. Exubera is known to have certain side effects such as a small decrease in lung function generally within the first months of treatment, lowered blood sugar levels (hypoglycemia) and a mild cough within seconds to minutes after taking Exubera. There can be no assurance that additional or more severe side effects or negative efficacy findings may not be discovered based on Pfizer s long-term safety and efficacy studies or required reporting of adverse events regarding Exubera, any of which could severely harm our business and result in one or more of the following regulatory events:

- a voluntary or involuntary recall or market withdrawal of Exubera;
- labeling changes such as restriction on intended uses, additional contraindications, warnings, precautions, or adverse reactions that would limit Exubera market potential;
- a boxed warning in the label;
- imposition of post-marketing surveillance studies or risk management programs;
- distribution restrictions; and
- adverse publicity.

In addition, one or more of the above factors would also have the potential to negatively impact regulatory registrations for Exubera in other countries.

If we are not successful in developing the next generation Exubera pulmonary inhaler device it could negatively impact our revenue and results of operations.

We currently are working on the development of a next generation Exubera Inhaler device which we believe will be important to maintaining a long term competitive advantage for Exubera. The objective of these development efforts is to improve the device portability, convenience, reliability and ease of use. There are significant risks associated with this program including developing the formulation for the next generation device, design engineering challenges, design for manufacturability and cost effectiveness and regulatory considerations. The next-generation Exubera Inhaler will require regulatory approval which could be a very costly and time consuming process with substantial risk. Competitors with products under development could successfully develop, obtain regulatory approval, and commercialize a more convenient, easy to use, smaller pulmonary insulin inhaler device for insulin which could negatively impact market share for Exubera. If we are not successful in developing a next generation Exubera Inhaler on a timely basis or at all, it could result in loss of market share for Exubera which would negatively impact our revenues and results of operations.

If product liability lawsuits are brought against us, we may incur substantial liabilities.

The manufacture, testing, marketing and sale of medical products involves an inherent risk of product liability. If product liability costs exceed our product liability insurance coverage, we may incur substantial liabilities that could have a severe negative impact on our financial position.

Whether or not we were ultimately successful in product liability litigation, such litigation would consume substantial amounts of our financial and managerial resources, and might result in adverse publicity, all of which would impair our business. Additionally, we may not be able to maintain our clinical trial insurance or product liability insurance at an acceptable cost, if at all, and this insurance may not provide adequate coverage against potential claims or losses.

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If we fail to establish future successful collaborative relationships, then our results of operation and financial condition may be adversely impacted.

We intend to seek future collaborative relationships with pharmaceutical and biotechnology partners to fund some of our research and development expenses and develop and commercialize product candidates. We are currently seeking partners for two of our proprietary product candidates and the success, timing and terms and conditions of these partnering efforts will affect our revenues and financial results in 2007 and beyond. If we are ultimately not able to negotiate acceptable collaborative arrangements with respect to our existing and future product candidates, or if any arrangements we do negotiate do not include sufficiently favorable commercial terms, we may not receive an adequate return on these investments and our results of operations and financial condition would suffer.

If the collaborative partners we depend on to obtain regulatory approvals for and commercialize our partner products are not successful, or if such collaborations fail, then the product development or commercialization of our partner products may be delayed or unsuccessful.

When we sign a collaborative development agreement or license agreement to develop a product candidate with a pharmaceutical or biotechnology company, the pharmaceutical or biotechnology company is generally expected to:

- synthesize active pharmaceutical ingredients to be used in the product candidate;
- design and conduct large scale clinical studies;
- prepare and file documents necessary to obtain government approvals to sell a given product candidate; or
- market and sell our products when and if they are approved.

Reliance on collaborative relationships poses a number of risks, including:

- the potential inability to control whether and the extent to which our collaborative partners will devote sufficient resources to the development programs or commercial efforts;
- disputes which may arise in the future with respect to the ownership of rights to technology or intellectual property developed with collaborative partners;
- disagreements with collaborative partners which could lead to delays in or termination of the research, development or commercialization of product candidates, or result in litigation or arbitration;
- the potential for contracts with our collaborative partners to fail to provide significant protection or to be effectively enforced if one of these partners fails to perform. Collaborative partners have considerable discretion in electing whether to pursue the development of any additional product candidates and may pursue alternative technologies or products either on their own or in collaboration with our competitors;
- the potential for collaborative partners with marketing rights to choose to devote fewer resources to the marketing of our products than they do to products of their own development;

the timing and level of resources that our collaborative partners dedicate to the development program will affect the timing and amount of revenue we receive;

risks related to the ability of our collaborative partners to pay us; and

the potential for collaborative partners to terminate their agreements with us unilaterally for any or no reason.

Given these risks, there is a great deal of uncertainty regarding the success of our current and future collaborative partner arrangements.

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We have entered into collaborations in the past that have been subsequently terminated. If other collaborations are suspended or terminated, our ability to commercialize certain other proposed product candidates could also be negatively impacted. If our collaborations fail, our product development or commercialization of product candidates could be delayed or cancelled and it would negatively impact our revenues and results of operations.

If our preclinical testing or clinical trials or those of our collaborative partners are delayed or unsuccessful, our business could be significantly harmed.

All of our partner product candidates and proprietary product candidates are in research and development, including preclinical testing and clinical trials. Preclinical testing and clinical trials are long, expensive and uncertain processes. It may take us, or our collaborative partners, several years to complete clinical trials, and failure can occur at any stage and at any time. Typically, there is a high rate of attrition for product candidates in preclinical and clinical trials. Success in preclinical testing and early clinical trials does not necessarily predict success in later clinical trials. A number of companies in the pharmaceutical and biotechnology industries have suffered significant setbacks in later stage clinical trials due to such factors as inconclusive results and adverse medical events, even after achieving positive results earlier trials that were satisfactory to us, our collaborative partners and the reviewing regulatory agencies. If our partner product candidates or proprietary product candidates fail in clinical trial stage, it could have a significant and adverse impact on our business prospects.

We depend on third parties in the conduct of our proprietary product candidate clinical trials and any failure of those parties to fulfill their obligations could adversely affect our development and commercialization plans.

We depend on independent clinical investigators, contract research organizations and other third party service providers and our collaborators in the conduct of clinical trials for our proprietary product candidates. We rely heavily on these parties for successful execution of our clinical trials but do not control many aspects of their activities. For example, the investigators are not our employees. However, we are responsible for ensuring that each of our clinical trials is conducted in accordance with the general investigational plan and protocols for the trial. Third parties may not complete activities on schedule or may not conduct our clinical trials in accordance with regulatory requirements or our stated protocols. The failure of these third parties to carry out their obligations could delay or prevent the development, approval and commercialization of our product candidates.

If we or our partners do not obtain regulatory approval for our product candidates on a timely basis or at all, or if the terms of any approval impose significant restrictions or limitations on use, then our revenues and results of operations may be affected negatively.

There is a risk that we, or our partners, will not obtain regulatory approval (which in some countries includes pricing approval) for product candidates on a timely basis, or at all, or that the terms of any approval will impose significant restrictions or limitations on use. Product candidates must undergo rigorous animal and human testing and an extensive FDA mandated or equivalent foreign authorities review process for safety and efficacy. This process generally takes a number of years and requires the expenditure of substantial resources. The time required for completing such testing and obtaining such approvals is uncertain. The FDA and other U.S. and foreign regulatory agencies also have substantial discretion to terminate clinical trials, require additional testing, delay or withhold registration and marketing approval and mandate product withdrawals including recalls. Even though our partners have obtained regulatory approval for some of our products, these products and our manufacturing processes are subject to continued review by the FDA and other regulatory authorities. Even if we or our partners receive regulatory approval of a product, the approval may limit the indicated uses for which the product may be marketed. In addition, any marketed products and manufacturing facilities used in the manufacture of such products will be subject to continual review and periodic inspections. Later discovery from such review and inspection of previously unknown problems may result in restrictions on marketed products or on us, including withdrawal of such products from the market, recall, or suspension of our manufacturing operations. The failure to obtain timely regulatory approval of product candidates, any product marketing limitations or a product withdrawal would negatively impact our revenues and results of operations.

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Our collaboration agreements with our partners contain complex commercial terms that could result in disputes or litigation that could materially and adversely affect our revenues, results of operations, or financial condition.

We currently derive, and expect to derive in the foreseeable future, all of our revenue from collaboration agreements with biotechnology and pharmaceutical companies. These collaboration agreements contain complex commercial terms including:

- research and development performance and reimbursement obligations for our personnel and other resources allocated to partner product development programs;
- clinical and commercial manufacturing agreements, some of which are priced on an actual cost basis for products supplied to partners by us with complicated cost calculation and allocation formulas and methodologies;
- intellectual property ownership allocation between us and our partners for improvements and new inventions developed during the course of the collaborative partnership;
- royalties on end product sales based on a number of complex variables including net sales calculations, cost of goods, geography, patent life, and other financial metrics; and
- indemnity obligations for third-party intellectual property, infringement, product liability and certain other claims.

From time to time, we have informal dispute resolution discussions with our partners regarding the appropriate interpretation of the complex commercial terms contained in our collaboration agreements. There can be no assurance that one or more disputes may arise in the future regarding our collaborative contracts which will not ultimately result in costly litigation and unfavorable interpretation of contract terms that could have a material adverse impact on our revenue, results of operations, or financial condition.

Because our proprietary product candidates are in the early stages of development, there is a high risk of failure, and we may never succeed in developing marketable products or generating revenue from our proprietary product candidates.

We are now applying our Pulmonary Technology and PEGylation Technology to our proprietary product development programs. None of our proprietary product candidates have received regulatory approval and our development efforts may never result in a commercialized product. Development of our proprietary products will require extensive additional time, effort and cost in preclinical testing and clinical trials. Our proprietary product candidates also require lengthy regulatory reviews before they can be marketed by us or our partners. Drug development is an uncertain process that involves trial and error, and we may fail at numerous stages along the way. In addition, it can also be very difficult to estimate the commercial potential of early stage product candidates due to such factors as safety and efficacy when compared to other available treatments, changing standards of care, patient and physician preferences and the availability competitive alternatives that may emerge either during the long development process or after commercial introduction.

Our investment in the development and commercialization of our proprietary product candidates prior to seeking partnering arrangements may be unsuccessful and adversely impact our results of operations and financial condition.

Our strategy is to fund our proprietary product development programs, including some or all of the clinical trials, prior to partnering with pharmaceutical and biotechnology companies. While we believe this strategy may result in improved economics for our proprietary product candidates, it will require significant investment by us without reimbursement. As a result, we bear an increased economic risk in the event one or more of our proprietary product candidates is not successful. Even if the product development is ultimately successful, our increased investment could adversely impact our results of operations and financial condition prior to commercialization.

We may incur substantial litigation costs and liabilities, which may adversely affect our business, results of operations and financial position.

Third parties from time to time have asserted or may assert that we or our commercial partners are infringing their proprietary rights based upon their patents that they believe cover our technology. In addition, future patents may issue to third parties that may give rise to similar assertions of infringement. We agree, in certain circumstances, to indemnify and hold harmless our collaborative partners from intellectual property infringement, product liability and certain other claims.

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We could incur substantial costs in defending ourselves and our commercial partners against any such claims. Furthermore, parties making such claims may be able to obtain injunctive or other equitable relief, which could effectively block our ability or the ability of our partners to develop or commercialize some or all of our products or product candidates in the United States and abroad, and could result in the award of substantial damages. We cannot predict with certainty the eventual outcome of any pending litigation or future litigation. Costs associated with such litigation, substantial damage claims, indemnification claims, or royalties paid for licenses from third parties could have a material adverse effect on our business, results of operations and financial condition.

On June 30, 2006, we entered into a litigation settlement related to an intellectual property dispute with the University of Alabama Huntsville pursuant to which we paid $11 million and agreed to pay an additional $10 million in equal $1 million installments over ten years beginning on July 1, 2007.

On August 1, 2006, Novo Nordisk filed a lawsuit against Pfizer in federal court claiming that Pfizer willfully infringes on Novo s patents covering inhaled insulin with Exubera. The case is currently proceeding with discovery and other pre-trial activities. Although we are not currently a named party in this litigation, we have incurred litigation costs as a result of such litigation and may incur substantial future costs and potential indemnity claims from Pfizer associated with the litigation. These and other disputes may have a material impact on our business, results of operation and financial condition.

If any of our pending patent applications do not issue or following issuance are deemed invalid, we may lose valuable intellectual property protection. We rely on trade secret protection for important proprietary technologies.

We have filed patent applications (and we plan to file additional patent applications) covering, among other things, aspects of our Pulmonary Technology (in general and as it relates to specific molecules) including, without limitation, our powder processing technology, our powder formulation technology, and our inhalation device technology; our PEGylation Technology; and certain other early stage technologies. We own over 1,000 U.S. and foreign patents and a number of patent applications that cover various aspects of our technologies. The patent positions of pharmaceutical, medical device and biotechnology companies, including ours, are uncertain and involve complex legal and factual issues. There can be no assurance that patents we apply for will issue, or that patents that have issued will be valid and enforceable. Even if such patents are enforceable, we anticipate that any attempt to enforce our patents could be time consuming and costly. Additionally, the coverage claimed in a patent application can be significantly reduced before the patent is issued. As a consequence, we do not know whether any of our patent applications will result in patents with broad coverage or whether the claims that eventually issue or that have issued will be circumvented. Since publication of discoveries in scientific or patent literature often lag behind the date such discoveries, we cannot be certain that we were the first inventor of inventions covered by our patents or patent applications. Moreover, we may have to participate in interference proceedings declared by the U.S. Patent and Trademark Office, which could result in substantial cost to us, even if the eventual outcome is favorable. An adverse outcome could subject us to significant liabilities to third parties, require disputed rights to be licensed from or to third parties or require us to cease using the technology in dispute.

U.S. and foreign patents and patent applications exist which comprise intellectual property rights and potential rights owned by third parties that relate to pharmaceutical compositions and reagents, medical devices, and equipment and methods for preparation, packaging, and delivery of pharmaceutical compositions. We cannot predict with any certainty which, if any, these rights will be considered relevant to our technology by authorities in the various jurisdictions where such rights exist, nor can we predict with certainty which, if any, of these rights will or may be asserted against us by third parties. There can be no assurance that we can obtain on reasonable terms, if at all, a license to any technology that we determine we need or that we could develop or otherwise obtain alternate technology. The failure to obtain such licenses or obtain such alternative technology would have a material adverse effect on us.

We also rely upon trade secret protection for our confidential and proprietary information. No assurance can be given that others will not independently develop substantially equivalent confidential and proprietary information or otherwise gain access to our trade secrets or disclose such technology, or that we can meaningfully protect our trade secrets.

We may be required to obtain intellectual property licenses from third parties and there is a risk we may not be able to obtain such licenses on a commercially reasonable basis, if at all.

Numerous pending and issued U.S. and foreign patent rights and other proprietary rights owned by third parties relate to pharmaceutical compositions, medical devices, and equipment and methods for preparation, packaging, and delivery of pharmaceutical compositions. We cannot predict with any certainty which, if any, patent references will be considered relevant to our or our collaborative partners technology by authorities in the various jurisdictions where such rights exist, nor can we predict with certainty which, if any, of these rights will or may be asserted against us by third parties. There can be no

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assurance that we can obtain a license to any technology that we determine we need on reasonable terms, if at all, or that we could develop or otherwise obtain alternate technology. The failure to obtain licenses on commercially reasonable terms, or at all, if needed, would have a material adverse effect on us.

There is significant competition for our technology platforms and partnered and proprietary product and product candidates which could make our products, product candidates or technologies obsolete or uncompetitive and it would negatively impact our revenues and results of operations.

There are competitors to our platform technologies and partnered and proprietary products and product candidates. Some of our competitors with regard to our Pulmonary Technology include Alexza Pharmaceuticals, Alkermes, Inc., Aradigm Corporation, 3M, MannKind Corporation, Microdose Technologies Inc., Skyepharma and Vectura. Some of our competitors with regard to our PEGylation Technology include Dow Chemical Company, Enzon Pharmaceuticals, Inc., SunBio Corporation, Mountain View Pharmaceuticals, Inc., Neose, NOF Corporation and Valentis, Inc., and there may be several chemical, biotechnology, and pharmaceutical companies also developing PEGylation technologies. Some of these companies license or provide the technology to other companies, while others are developing the technology for internal use.

There are several direct competitors with development programs underway for inhaled insulin products. If these products are approved, they could be competitive to Exubera. These companies include Novo Nordisk, Alkermes, Inc. in collaboration with Eli Lilly Company, MannKind Corporation, and Kos Pharmaceuticals, all of which are working on various versions of inhaled insulin products in either a liquid or dry powder form. Some products are in late stage clinical testing including Alkermes s inhalable insulin product (AIR Insulin System) in Phase 3 clinical development and Mannkind s Technosphere® Insulin System also in Phase 3 clinical development. There are other smaller companies that we believe are developing oral or buccal products for insulin delivery, such as Biocon, Emisphere Technologies, Inc., Coremed Corporation, and Generex Biotechnology Corporation. Exubera also competes with approved injectable insulins, including both fast-acting and longer-acting basal insulins. Lastly, Exubera competes with other treatment modalities for diabetes including oral agents and other injectable products approved for patients with Type 2 diabetes, such as Amilyn Pharmaceutical s Byetta.

Many of our competitors have greater research and development capabilities, experience, manufacturing, marketing, financial and managerial resources than we do and represent significant competition for us. Acquisitions of or collaborations with competing drug delivery companies by large pharmaceutical or biotechnology companies could enhance our competitors financial, marketing and other resources. Accordingly, our competitors may succeed in developing competing technologies, obtaining regulatory approval for products, or gaining market acceptance before us. Developments by others could make our products or technologies uncompetitive or obsolete. There can be no assurance that we or our partners will successfully develop, obtain regulatory approvals, and commercialize next generation products or new products that will successfully compete with those of certain of our competitors.

If government and private insurance programs do not provide reimbursement for our partnered products or proprietary products, those products will not be widely accepted and it would have a negative impact on our revenue and results of operations.

In both domestic and foreign markets, sales of our partners products and any of our proprietary products that may be approved will depend in part upon pricing approvals by government authorities and the availability of reimbursement from third-party payors, such as government health administration authorities, managed care providers, private health insurers and other organizations. In addition, such third-party payors are increasingly challenging the price and cost effectiveness of medical products and services. Significant uncertainty exists as to the pricing approvals for, and the reimbursement status of, newly approved health care products. For example, Type 1 and Type 2 diabetes patients have current insulin therapies available to them, primarily injectable and oral insulin therapies. Therefore, an important factor in the commercial success of Exubera will be the timing and availability of reimbursement from third-party payors. Moreover, legislation and regulations affecting the pricing of pharmaceuticals may change before regulatory agencies approve our proposed products for marketing. Adoption of such legislation and regulations could further limit pricing approvals for, and reimbursement of, medical products. A government or third-party payor decision not to approve pricing for, or provide adequate coverage and reimbursements of, our products would limit market acceptance of such products.

If we are not able to manufacture products in accordance with cGMP in commercially feasible quantities or at commercially feasible costs, then our proprietary product candidates or those of our partners will not be successfully commercialized.

If we are not able to scale-up manufacturing to meet the drug quantities required to support large clinical trials or commercial manufacturing in a timely manner or at a commercially reasonable cost, we risk not meeting our collaborative

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partners supply requirements, our contractual obligations or supply requirements for our proprietary product candidates. Building and validating commercial-scale manufacturing facilities and processes, recruiting and training of qualified personnel and obtaining the necessary regulatory approvals is complex, expensive and time-consuming. In addition, we also sometimes face very limited supply for certain critical raw materials from single or a limited number of suppliers that could constrain our manufacturing output. Failure to manufacture products in commercially feasible quantities or at commercially feasible costs, would negatively impact our revenues and results of operations and cause us not to meet our customers supply requirements, contractual obligations or requirements for our proprietary product candidates.

If earthquakes and other catastrophic events strike, our business may be negatively affected.

Our corporate headquarters, including a substantial portion of our research and development and manufacturing operations, are located in the San Francisco Peninsula, a region known for seismic activity. A significant natural disaster such as an earthquake would have a material adverse impact on our business, results of operations, and financial condition. There are no backup facilities for our manufacturing operations located in the San Francisco Peninsula and in the event of any earthquake or other natural disaster or terrorist event, we would not be able to manufacture and supply bulk powder drugs, such as the Exubera Inhalation Powder, without significant disruption. Certain of our collaborative partners located elsewhere may also be subject to catastrophic events such as hurricanes and tornadoes, any of which could have a material adverse effect on our business, results of operations, and financial condition.

If we do not generate sufficient cash flow through increased revenues or raising additional capital, then we may not be able to meet our substantial debt obligations.

As of March 31, 2007, we had cash, cash equivalents, short-term investments, and investments in marketable securities valued at approximately $398.3 million and approximately $411.3 million of indebtedness including approximately $381.6 million in convertible subordinated notes, $20.3 million in capital lease obligations and $9.4 million of other long-term liabilities. We expect to use a substantial portion of our cash to fund our on-going operations over the next few years and to repay the $66.6 million of convertible subordinated notes due in October 2007. The remaining $315.0 million of convertible subordinated notes will mature in 2012.

Our substantial indebtedness has and will continue to impact us by:

- making it more difficult to obtain additional financing;
- constraining our ability to react quickly in an unfavorable economic climate; and
- constraining our ability to invest in our proprietary product development programs.

Currently we are not generating positive cash flow. If Exubera is not successful it will adversely impact our ability to meet our debt obligations. In addition, if the market price of our common stock is below the related conversion price, the holders of the related outstanding convertible subordinated notes will not likely convert such securities to equity in accordance with their existing terms. If we are unable to satisfy our debt service requirements, substantial liquidity problems could result.

In the future, we may not generate sufficient cash from operations to repay our remaining convertible subordinated notes or satisfy any other of these obligations when they become due and may have to raise additional funds from the sale of equity or debt securities or otherwise restructure our obligations in order to do so. There can be no assurance that any such financing or restructuring will be available to us on commercially acceptable terms, if at all.

If we cannot raise additional capital our financial condition may suffer.

Our capital needs may change as a result of numerous factors including without limitation significant investments in our proprietary product candidates, and may result in additional funding requirements. In addition, we may choose to raise additional capital due to market conditions or strategic considerations. To the extent that additional capital is raised through the sale of equity or convertible debt securities, the issuance of such securities could result in dilution to our stockholders.

We have no material credit facility or other material committed sources of capital. To the extent operating and capital resources are insufficient to meet our future capital needs, we will have to raise additional funds to continue the development and commercialization of our technologies and proprietary products. Such funds may not be available on favorable terms, or at all. In particular, our substantial leverage may limit our ability to obtain additional financing. In addition, as an early stage

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biotechnology company, we do not qualify to issue investment grade debt and therefore any financing we do undertake will likely involve the issuance of equity, convertible debt instruments or high-yield debt. These sources of capital may not be available to us in the event we require additional financing. If adequate funds are not available on reasonable terms, we may be required to curtail operations significantly or obtain funds by entering into financing, supply or collaboration agreements on unattractive terms. Our inability to raise capital could negatively impact our business.

Anti-takeover provisions in our charter documents and under Delaware law may make it more difficult to acquire us, even though such acquisitions may be beneficial to our stockholders.

Provisions of our certificate of incorporation and bylaws, as well as provisions of Delaware law, could make it more difficult for a third party to acquire us, even though such acquisitions may be beneficial to our stockholders. These anti-takeover provisions include:

- establishment of a classified board of directors such that not all members of the board may be elected at one time;
- lack of a provision for cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;
- the ability of our board to authorize the issuance of blank check preferred stock to increase the number of outstanding shares and thwart a takeover attempt;
- prohibition on stockholder action by written consent, thereby requiring all stockholder actions to be taken at a meeting of stockholders;
- establishment of advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings; and
- limitations on who may call a special meeting of stockholders.

Further, we have in place a preferred share purchase rights plan, commonly known as a poison pill. The provisions described above, our poison pill and provisions of Delaware law relating to business combinations with interested stockholders may discourage, delay or prevent a third party from acquiring us. These provisions may also discourage, delay or prevent a third party from acquiring a large portion of our securities, or initiating a tender offer or proxy contest, even if our stockholders might receive a premium for their shares in the acquisition over the then current market prices. We also have a change of control severance benefits plan which provides for certain cash severance, stock award acceleration and other benefits in the event our employees are terminated (or, in some cases, resign for specified reasons) following an acquisition. This severance plan could discourage a third party from acquiring us.

We expect our stock price to remain volatile.

Our stock price is volatile. During the twelve-month period ending March 31, 2007, based on closing bid prices on the NASDAQ Stock Market, our stock price ranged from $11.20 to $22.75. We expect our stock price to remain volatile. A variety of factors may have a significant effect on the market price of our common stock, including:

- announcement of Exubera prescription and sales results;

clinical trial results or product development delays or delays in product approval or launch;

announcements by collaboration partners as to their plans or expectations related to products using our technologies;

announcements or terminations of collaborative relationships by us or our competitors;

fluctuations in our results of operations;

developments in patent or other proprietary rights;

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announcements of technological innovations or new therapeutic products that may compete with our approved products or products under development;

governmental regulation;

litigation brought against us or third parties to whom we have indemnification obligations;

public concern as to the safety of drug formulations developed by us or others; and

general market conditions.

Item 2. Unregistered Sales of Equity 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

On January 16, 2007, the Organization and Compensation Committee of the Board of Directors established the corporate objectives or the first half 2007 performance period (January 1, 2007 through June 30, 2007) under our Discretionary Performance-Based Incentive Compensation Policy. A summary of the 7 corporate objectives with the associated weight of each objective is as follows:

1. Improve leadership and management of the Company make the Company a great place to work (10%)

2. Meet Exubera manufacturing commitments (20%)

3. Development objective related to a next-generation pulmonary device development program (15%)

4. Execute business transformation system and process changes (10%)

5. Development objective related to advancing our proprietary product portfolio (15%)

6. Development objective related to meeting partner development program commitments (10%)

7. Operating loss/income objective (20%)

We file electronically with the Securities and Exchange Commission (SEC) our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to those reports, pursuant to Section 13(a) or 15(d) of the 1934 Act. The public may read or

copy any materials we file with the SEC at the SEC s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information statements, and other information regarding issuers that file electronically with the SEC. The address of that site is http://www.sec.gov.

You may obtain a free copy of our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K and amendments to those reports on the day of filing with the SEC on our website at http://www.nektar.com, by contacting the Investor Relations Department at our corporate offices by calling (650) 631-3100 or by sending an e-mail message to investors@nektar.com.

Disclosure regarding the operations of our board of director nominating committees and the means by which security holders may communicate with directors can be found in the definitive proxy statement for our 2007 Annual Meeting of Stockholders filed with the SEC on April 25, 2007 (the Proxy Statement) under the heading Nominating and Corporate Governance Committee.

As permitted by SEC Rule 10b5-1, certain of our executive officers, directors and other employees have set up a predefined, structured stock trading program with his/her broker to sell our stock. The stock trading program allows a broker acting on behalf of the executive officer, director or other employee to trade our stock during blackout periods or while such

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executive officer, director or other employee may be aware of material, nonpublic information, if the trade is performed according to a pre-existing contract, instruction or plan that was established with the broker during a non-blackout period and when such executive officer, director or employee was not aware of any material, nonpublic information. Our executive officers, directors and other employees may also trade our stock outside of the stock trading programs set up under Rule 10b5-1 subject to our blackout periods and insider trading rules.

Item 6. Exhibits

Except as so indicated in Exhibit 32.1, the following exhibits are filed as part of, or incorporated by reference into, this Quarterly Report on Form 10-Q.

Exhibit Number		Description of Documents
2.1	(1)	Agreement and Plan of Merger, dated June 4, 1998, by and between Inhale Therapeutic Systems, a California corporation, and Inhale Therapeutic Systems (Delaware), Inc., a Delaware corporation.
2.2	(5)	Recommended Offer, dated December 21, 2000, by Cazenove & Co. on behalf of Nektar Therapeutics for Bradford Particle Design plc.
2.3	(8)	Agreement and Plan of Merger and Reorganization, dated May 22, 2001, by and among Nektar Therapeutics, Square Acquisition Corp., Shearwater Corporation, Certain Shareholders of Shearwater Corporation and J. Milton Harris as Shareholders Agent.
2.4	(8)	Amendment to Agreement and Plan of Merger and Reorganization, dated June 21, 2001, by and among Nektar Therapeutics, Square Acquisition Corp., Shearwater Corporation, J. Milton Harris, as Shareholders Agent and a Designated Shareholder, and Puffinus, L.P.
3.1	(1)	Certificate of Incorporation of Inhale Therapeutic Systems (Delaware), Inc.
3.2	(1)	Bylaws of Nektar Therapeutics.
3.3	(3)	Certificate of Amendment of the Amended Certificate of Incorporation of Nektar Therapeutics.
3.4	(7)	Certificate of Designation of Series A Junior Participating Preferred Stock of Nektar Therapeutics.
3.5	(9)	Certificate of Designation of Series B Convertible Preferred Stock of Nektar Therapeutics.
3.6	(10)	Certificate of Ownership and Merger of Nektar Therapeutics.
4.1		Reference is made to Exhibits 3.1, 3.2, 3.3, 3.4, 3.5 and 3.6.
4.2	(2)	Indenture, dated February 8, 2000, by and between Nektar Therapeutics, as Issuer, and Chase Manhattan Bank and Trust Company, National Association, as Trustee.
4.3	(10)	Specimen Common Stock certificate.
4.4	(4)	Specimen warrants to purchase shares of Common Stock.
4.5	(6)	Indenture, dated October 17, 2000, by and between Nektar Therapeutics, as Issuer, and Chase Manhattan Bank and Trust Company, National Association, as Trustee.
4.6	(7)	Rights Agreement, dated as of June 1, 2001, by and between Nektar Therapeutics and Mellon Investor Services LLC., as Rights Agent.
4.7	(7)	Form of Right Certificate.

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4.8	(11)	Resale Registration Rights Agreement, dated June 30, 2003, by and among Nektar Therapeutics, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Deutsche Bank Securities Inc., Lehman Brothers Inc., Friedman, Billings, Ramsey & Co. Inc. and SG Cowen Securities Corporation
4.9	(12)	Resale Registration Rights Agreement, dated October 9, 2003, by and among Nektar Therapeutics and the entities named therein.
4.10	(13)	Common Stock Purchase Agreement dated as of August 15, 2005, by and between Nektar Therapeutics and Mainfield Enterprises, Inc.
4.11	(13)	Indenture, dated September 28, 2005, by and between Nektar Therapeutics, as Issuer, and J.P. Morgan Trust Company, and National Association, as Trustee.
4.12	(13)	Registration Right Agreement, dated as of September 28, 2005, among Nektar Therapeutics and entities named therein.
10.1	(14)	Letter Agreement, dated January 5, 2007, by Nektar Therapeutics and Mr. Howard W. Robin.
10.2	(15)	Discretionary Performance-Based Incentive Compensation Policy.
10.3	(15)	Amended and Restated Change in Control Severance Benefit Plan.
10.4	(16)	Amended and Restated Compensation Plan for Non-Employee Directors.
31.1	(17)	Certification of Nektar Therapeutics principal executive officer required by Rule 13a-14(a) or Rule 15d-14(a).
31.2	(17)	Certification of Nektar Therapeutics principal financial officer required by Rule 13a-14(a) or Rule 15d-14(a).
32.1	(17)	Section 1350 Certifications.

(1) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Quarterly Report on Form 10-Q for the quarter ended June 30, 1998.
(2) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Annual Report on Form 10-K for the year ended December 31, 1999.
(3) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Quarterly Report on Form 10-Q for the quarter ended June 30, 2000.
(4) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Quarterly Report on Form 10-Q for the quarter ended September 30, 2000.
(5) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Current Report on Form 8-K, filed on January 11, 2001.
(6) Incorporated by reference to Nektar Therapeutics Registration Statement on Form S-3 (No. 333-53678), filed on January 12, 2001.
(7) Incorporated by reference to Nektar Therapeutics Current Report on Form 8-K, filed on June 4, 2001.
(8) Incorporated by reference to Nektar Therapeutics Current Report on Form 8-K, filed on July 10, 2001.
(9) Incorporated by reference to Nektar Therapeutics Current Report on Form 8-K, filed on January 8, 2002.
(10) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Current Report on Form 8-K, filed on January 23, 2003.
(11) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Current Report on Form 8-K, filed on July 2, 2003.
(12) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Current Report on Form 8-K, filed on November 3, 2003.
(13) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Current Report on Form 8-K, filed on September 28, 2005.
(14) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Current Report on Form 8-K, filed on January 9, 2007.

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(15) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Annual Report on Form 10-K for the year ended December 31, 2006.
(16) Incorporated by reference to the indicated exhibit in Nektar Therapeutics Current Report on Form 8-K, filed on February 26, 2007.
(17) Filed herewith.

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SIGNATURES

Pursuant to the requirement 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.

By: /s/ Howard W. Robin
Howard W. Robin
Chief Executive Officer, President and Director

Date: May 10, 2007

By: /s/ Louis Drapeau
Louis Drapeau
Senior Vice President, Finance, and Chief Financial Officer

Date: May 10, 2007

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