LYNX THERAPEUTICS INC
Form 10-Q
May 15, 2003

Table of Contents

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, 2003.

OR

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

for the transition period from _____ to _____

Commission File Number 0-22570

Lynx Therapeutics, Inc.

(Exact name of registrant as specified in its charter)

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

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

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

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

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

The number of shares of common stock outstanding as of May 9, 2003 was 4,654,245.

TABLE OF CONTENTS

Table of Contents

Lynx Therapeutics, Inc.

FORM 10-Q
For the Quarter Ended March 31, 2003

INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Lynx Therapeutics, Inc.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	March 31, 2003	December 31, 2002
	(unaudited)	(*)
Assets		
Current assets:		
Cash and cash equivalents	$ 7,383	11,735
Accounts receivable	514	836
Inventory	1,276	1,030
Other current assets	576	714
Total current assets	9,749	14,315
Property and equipment:		
Leasehold improvements	12,236	12,238
Laboratory and other equipment	23,097	22,972
	35,333	35,210
Less accumulated depreciation and amortization	(20,643)	(19,640)
Net property and equipment	14,690	15,570
Investment in related party	1,106	1,930
Other non-current assets	172	172
	$ 25,717	$ 31,987
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 1,249	$ 962
Accrued compensation	547	516
Deferred revenues	3,926	2,926
Equipment loans current portion	2,083	2,250
Other accrued liabilities	415	604
Total current liabilities	8,220	7,258
Deferred revenues	7,769	10,634
Equipment loans, less current portion	686	1,093
Other non-current liabilities	935	946
Stockholders equity:		
Common stock	110,992	110,978
Deferred compensation		(9)
Accumulated deficit	(102,885)	(98,913)
Total stockholders equity	8,107	12,056
	$ 25,717	$ 31,987

*The balance sheet amounts at December 31, 2002 have been derived from audited financial statements at that date but do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See accompanying notes.

Table of Contents

Lynx Therapeutics, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended March 31,	
	2003	**2002**
Revenues:		
Technology access and services fees	$ 3,000	$ 2,154
License fee from related party	190	190
Collaborative research and other	74	2,678
Total revenues	3,264	5,022
Operating costs and expenses:		
Cost of services fees and other	724	299
Research and development	3,565	6,887
General and administrative	1,785	1,734
Restructuring charge for workforce reduction	292	
Total operating costs and expenses	6,366	8,920
Loss from operations	(3,102)	(3,898)
Equity share of loss of related party	(825)	(787)
Interest income (expense), net	(44)	(100)
Other income		987
Loss before provision for income taxes	(3,971)	(3,798)
Income tax provision (benefit)	1	(39)
Net loss	$(3,972)	$(3,759)
Basic and diluted net loss per share	$ (0.85)	$ (1.91)
Shares used in per share computation	4,652	1,970

See accompanying notes.

Table of Contents

Lynx Therapeutics, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2003	**2002**
Cash flows from operating activities:		
Net loss	$ (3,972)	$ (3,759)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization of fixed assets and leasehold improvements	1,002	1,183
Amortization of deferred compensation	9	97
Pro rata share of net loss of related party	825	787
Gain on sale of antisense program		(1,008)
Non-cash portion of gain from the sale of technology assets		(1,586)
Changes in operating assets and liabilities:		
Accounts receivable	322	216
Inventory	(246)	220
Other current assets	138	360
Accounts payable	287	803
Accrued liabilities	(158)	(51)
Deferred revenues	(1,865)	(1,086)
Other non-current liabilities	(11)	17
Net cash used in operating activities	(3,669)	(3,807)
Cash flows from investing activities:		
Proceeds from sale of equity securities		2,180
Leasehold improvements and equipment purchases, net of retirements	(123)	(833)
Notes receivable from officers and employees		51
Net cash provided by (used in) investing activities	(123)	1,398
Cash flows from financing activities:		
Repayment of equipment loan	(574)	(450)
Issuance of common stock, net	14	(3)
Net cash used in financing activities	(560)	(453)
Net increase (decrease) in cash and cash equivalents	(4,352)	(2,862)
Cash and cash equivalents at beginning of period	11,735	3,199
Cash and cash equivalents at end of period	$ 7,383	$ 337
Supplemental disclosure of cash flow information:		
Interest paid	$ 74	$ 115

See accompanying notes.

Table of Contents

Lynx Therapeutics, Inc.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2003

1. Nature of Business

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

2. Basis of Presentation

In January 2003, we received stockholder approval for, and effected, a reverse stock split of our common stock at a ratio of 1-for-7 (the reverse stock split). As a result of the reverse stock split, each outstanding share of common stock automatically converted into one-seventh of a share of common stock, with the par value of each share of common stock remaining at one cent ($.01) per share. Accordingly, common stock share and per share amounts for all periods presented have been adjusted to reflect the impact of the reverse stock split.

The accompanying unaudited condensed consolidated financial statements included herein have been prepared by Lynx without audit, pursuant to the rules and regulations promulgated by the Securities and Exchange Commission (the SEC). Certain prior year amounts have been reclassified to conform to current year presentation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to SEC rules and regulations; nevertheless, Lynx believes that the disclosures are adequate to make the information presented not misleading. In the opinion of management, the financial statements contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position, results of operations and cash flows of the Company for the interim periods presented. The results of operations for the three months ended March 31, 2003 are not necessarily indicative of the results for the full year.

Our unaudited condensed consolidated financial statements have been presented on a basis that contemplates the realization of assets and satisfaction of liabilities in the normal course of business. We have experienced operating losses since our inception of $102.9 million, including a net loss of $4.0 million for the quarter ended March 31, 2003. Net losses may continue as we proceed with the commercialization and additional development of our technologies. Our cash and cash equivalents were $7.4 million at March 31, 2003. We believe that our current cash and cash equivalents and funding anticipated to be received from customers, collaborators and licensees will enable us to maintain our operations through at least December 31, 2003. Changes to our current operating plan may require us to consume available capital resources significantly sooner than we expect. If our capital resources are insufficient to meet future capital requirements, we will have to raise additional funds. We may seek additional financing, as needed, through arrangements with customers, collaborators and licensees and equity or debt offerings. We do not know if we will be able to raise sufficient additional capital on acceptable terms, or at all. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. If we are unable to secure additional financing on reasonable terms, or are unable to generate sufficient new sources of revenue through arrangements with customers, collaborators and licensees, management may be forced to take substantial restructuring actions, which may include significantly reducing Lynx s anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds by entering into financing or collaborative agreements on unattractive terms, or we will not be able to fund operations.

Table of Contents

The unaudited condensed consolidated financial statements include all accounts of Lynx and our wholly-owned subsidiary, Lynx Therapeutics GmbH (Lynx GmbH), formed under the laws of the Federal Republic of Germany. All significant intercompany balances and transactions have been eliminated. Certain amounts in prior periods have been reclassified to conform to the current year presentation.

These financial statements should be read in conjunction with Lynx s audited consolidated financial statements and notes thereto for the year ended December 31, 2002, included in Lynx s annual report on Form 10-K, filed with the SEC.

3. Summary of Significant Accounting Policies

Revenue Recognition

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

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

Inventory

Inventory is stated at the lower of standard cost (which approximates first-in, first out cost) or market. The balances at March 31, 2003 and December 31, 2002 were classified as raw materials and consisted primarily of reagents and other chemicals utilized while performing genomics discovery services. Inventory is charged to cost of services fees and other as consumed.

Net Loss Per Share

Basic and diluted net loss per share have been computed using the weighted-average number of shares of common stock outstanding during the period. Basic and diluted net loss per share amounts are the same in each year as we have incurred a net loss for all periods presented. Had we been in a net income position, diluted earnings per share would have included the dilutive impact of outstanding options and warrants to purchase common stock. At March 31, 2003, options to purchase approximately 556,776 shares of common stock at a weighted-average exercise price of $42.81 per share and warrants to purchase 101,082 shares of common stock at an exercise price of $39.76 per share, 41,714 shares of common stock at an exercise price of $10.85 per share and 834,272 shares of common stock at an exercise price of $13.58 per share were excluded from the calculation of diluted loss per share for 2003 because the effect of inclusion would be antidilutive. The options and warrants will be included in the calculation at such time as the effect is no longer antidilutive, as calculated using the treasury stock method. At March 31, 2002, options to purchase approximately 377,815 shares of common stock at a weighted-average exercise price of $90.72 per share and warrants to purchase 62,399 shares of common stock at an exercise price of $64.41 per share were excluded from the calculation of diluted loss per share for 2002 because of the effect of inclusion would be antidilutive.

Table of Contents

Stock-Based Compensation

We grant stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date of grant. We account for stock option grants in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and related Interpretations. Under APB 25, when the exercise price of our employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

All stock option awards to non-employees are accounted for at the fair value of the consideration received or the fair value of the equity instrument issued, as calculated using the Black-Scholes model, in accordance with Accounting for Stock-based Compensation (SFAS 123) and Emerging Issues Task Force Consensus No. 96-18, Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services. The option arrangements are subject to periodic remeasurement over their vesting terms. Pro forma information regarding net loss and net loss per share required by SFAS 123, as amended by Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148), is presented below and has been determined as if we had accounted for awards under our stock option and employee stock purchase plans using the fair value method:

	Three Months Ended March 31,	
	2003	2002
	(in thousands, except per share amounts)	
Net loss, as reported	$(3,972)	$(3,759)
Stock-based employee compensation, net of taxes, as reported	9	97
Stock based employee compensation, net of taxes, as if fair value method applied to all awards	(399)	(1,396)
Net loss, pro forma as if fair value method applied to all awards	$(4,362)	$(5,058)
Basic and diluted net loss per share, as reported	$ (0.85)	$ (1.91)
Basic and diluted net loss per share, pro forma as if fair value method applied to all awards	$ (0.94)	$ (2.57)

Recent Accounting Pronouncements

In June 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146). SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS 146 is effective for exit and disposal activities initiated after December 31, 2002. We adopted this statement during the first quarter of fiscal 2003, and the adoption did not have a material effect on our operating results or financial position.

In November 2002, the FASB issued FASB Interpretation (FIN) No. 45, Guarantor s Disclosure Requirements for Guarantees, Including Indirect Guarantees of Others. FIN No. 45 clarifies the guarantor s requirements relating to the guarantor s accounting for, and disclosure of, the issuance of certain types of guarantees and requires the guarantor to recognize at the inception of a guarantee a liability for the fair value of the guarantee obligation. The provisions for the initial recognition and measurement of guarantees are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002. The accounting profession and regulatory agencies continue to discuss various provisions of this pronouncement with the objective of providing additional guidance on its application. These discussions and the issuance of any new interpretations, once finalized, could lead to an unanticipated impact on our future financial results. Therefore, although we currently do not believe these provisions

Table of Contents

will have a material effect on our operating results or financial position, we will continue to evaluate the impact of FIN 45.

In December 2002, the FASB issued Statement of Financial Accounting Standards Board No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123 (SFAS 148). SFAS 148 amends SFAS 123, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require expanded and more prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. While SFAS 148 does not amend SFAS 123 to require companies to account for employee stock options using the fair value method, the disclosure provisions of SFAS 148 are applicable to all companies with stock-based employee compensation, regardless of whether they account for that compensation using the fair value method of SFAS 123 or the intrinsic value method of APB 25. Since we account for our stock-based compensation under APB 25, and have no current plans to switch to SFAS 123, the impact of SFAS 148 will be limited to the interim reporting of the effects on net loss and loss per share if we accounted for stock-based compensation under SFAS 123. SFAS 148 is effective for fiscal years ending after December 15, 2002.

4. Comprehensive Loss

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

	Three Months Ended March 31,	
	2003	**2002**
Net loss	$(3,972)	$(3,759)
Net unrealized gain (loss) on available-for-sale securities		(118)
Reclassification adjustment for realized gains included in net income, net of tax		(1,008)
Comprehensive loss	$(3,972)	$(4,885)

The components of accumulated other comprehensive income (loss) relate entirely to unrealized gains (losses) on available-for-sale securities and were $0 at both March 31, 2003 and December 31, 2002.

5. Related-Party Transactions

Axaron Bioscience AG

We hold an equity investment in Axaron Bioscience AG. As of March 31, 2003, Lynx held approximately a 40% ownership interest in Axaron and had the ability to exercise significant influence over Axaron s operating and accounting policies. Lynx has accounted for the investment under the equity method in accordance with APB Opinion No. 18. Under the equity method, we record our pro-rata share of the income or losses of Axaron. Axaron is engaged in employing Lynx s technologies in its neuroscience, toxicology and microbiology research programs.

In 2001, we extended our technology licensing agreement with Axaron. The license extends Axaron s right to use our proprietary MPSS and Megasort technologies non-exclusively in Axaron s neuroscience, toxicology and microbiology programs until December 31, 2007. In 2001, we made a capital investment in Axaron of approximately $4.5 million. Also in 2001, we received from Axaron a $5.0 million technology license fee, which was recorded as deferred revenue and is being recognized on a straight-line basis over the period from June 1, 2001 to December 31, 2007. The recorded revenue for each three-month period ended March 31, 2003 and 2002 was approximately $190,000. Our pro-rata share of Axaron s losses was approximately $0.8 million for each of the quarters ended March 31, 2003 and March 31, 2002.

We also sublease certain offices in Germany to Axaron. During the three-month period ended March 31, 2003, we received an immaterial amount of sublease income from Axaron.

Table of Contents

Other Transactions with Related Parties

For legal services, Lynx paid approximately $103,000 during the quarter ended March 31, 2003 to Cooley Godward LLP, Lynx s counsel, of which a director of Lynx is a partner.

6. Restructuring Charges

In January 2003, we implemented a reduction of approximately 25% of our workforce, or 32 people. The groups affected primarily by this action included research and development personnel based at Lynx Therapeutics GmbH in Germany and those working in our proteomics group in California. The workforce reduction is intended to further focus our financial and human resources on expanding the commercial use of MPSS. We recorded a workforce reduction charge of $0.3 million in the quarter ended March 31, 2003 related primarily to severance compensation expense for our former employees, which amounts had been paid entirely as of April 30, 2003.

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

This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in this report and our 2002 audited financial statements and notes thereto included in our 2002 Annual Report on Form 10-K. Operating results for the three months ended March 31, 2003 are not necessarily indicative of results that may occur in future periods.

Except for the historical information contained herein, the following discussion contains forward-looking statements that involve risks and uncertainties. When used herein, the words believe, anticipate, expect, estimate and similar expressions are intended to identify such forward-looking statements. There can be no assurance that these statements will prove to be correct. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this section, as well as in our 2002 Annual Report on Form 10-K, as filed with the SEC. We undertake no obligation to update any of the forward-looking statements contained herein to reflect any future events or developments.

Overview

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

We have incurred net losses each year since our inception in 1992. As of March 31, 2003, we had an accumulated deficit of approximately $102.9 million. Net losses may continue for at least the next several years. The size of these losses will depend on the rate of growth, if any, in our revenues and on the level of our expenses.

To date, we have received, and expect to continue to receive in the future, a significant portion of our revenues from a small number of collaborators, customers and licensees. For the three months ended March 31, 2003, revenues from E.I. DuPont de Nemours and Company (DuPont), Bayer CropScience, Takara Bio Inc. (Takara) and BASF AG (BASF) accounted for 34%, 23%, 19% and 17%, respectively, of our total revenues. For the three months ended March 31, 2002, revenues from Geron Corporation, DuPont, BASF and Takara accounted for 51%, 10%, 10% and 10%, respectively, of our total revenues. For the year ended December 31, 2002, revenues from DuPont, Takara, Geron Corporation, Bayer CropScience and BASF accounted for 32%, 16%, 15%, 14% and 11%, respectively, of our total revenues. Revenues in each quarterly and annual period have in the past, and could in the future, fluctuate due to: the timing and amount of any technology access fees and the period over which the revenue is recognized; the level of service fees, which is tied to the number and timing of biological samples received from

Table of Contents

our collaborators and customers, as well as our performance of the related genomics discovery services on the samples; the timing of achievement of milestones and the amount of related payments to us; and the number, type and timing of new, and the termination of existing, agreements with collaborators, customers and licensees.

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

We account for our investment in Axaron Bioscience AG, a company owned primarily by BASF AG and us, using the equity method. For each of the three months ended March 31, 2003 and 2002, our pro-rata share of Axaron s losses was approximately $0.8 million.

As of March 31, 2003, we employed 96 full-time employees, of which 76 were engaged in production and research and development activities. In January 2003, we implemented a reduction of approximately 25% of our total workforce, or 32 people. The groups affected primarily by this action included research and development personnel based at Lynx GmbH in Germany and our proteomics group in California. The workforce reduction was intended to further focus our financial and human resources on expanding the commercial use of MPSS.

Results of Operations

Revenues

Revenues for the three-month period ended March 31, 2003 were approximately $3.3 million, compared to revenues of $5.0 million for the corresponding three-month period of 2002. Revenues for the three-month period in 2003 included technology access fees and service fees of $3.0 million, license fees from Axaron, a related party, of $190,000 and other revenues of $74,000. Revenues for the three-month period in 2002 included technology access fees and service fees of $2.2 million, license fees from Axaron, a related party, of $190,000 and other revenues of $2.7 million, including $2.6 million from the sale of certain of our technology assets. Our revenues have historically fluctuated from quarter to quarter and year to year and may continue to fluctuate in future periods due primarily to our service fees, which are impacted principally by the timing and number of biological samples received from existing customers and collaborators, as well as our performance of related services on these samples. Additionally, the number, type and timing of new collaborations and agreements and the related demand for, and delivery of, our services or products will impact the level of future revenues.

Operating Costs and Expenses

Total operating costs and expenses were approximately $6.4 million for the three-month period ended March 31, 2003, compared to approximately $8.9 million for the three-month period ended March 31, 2002. For the three-month period in 2003, cost of services fees was $0.7 million, compared to $0.3 million for the corresponding period in 2002, and reflects the costs of providing our genomics discovery services. Research and development expenses were approximately $3.6 million for the three-month period ended March 31, 2003, compared to approximately $6.9 million for the corresponding period in 2002. The decrease in research and development expenses in 2003 reflects a decrease in materials consumed in research and development efforts and lower personnel expenses, primarily resulting from the workforce reductions that occurred in the first quarter of 2003 and the second quarter of 2002. Research and development expenses may increase due to planned spending for ongoing technology development and implementation, as well as new applications, primarily for MPSS.

Table of Contents

General and administrative expenses were $1.8 million for the three-month period ended March 31, 2003, compared to $1.7 million for the corresponding period in 2002. General and administrative expenses may increase in support of Lynx s commercial, business development and research and development activities.

In January 2003, we implemented a reduction of approximately 25% of our workforce, or 32 people. The groups affected primarily by this action included research and development personnel based at Lynx Therapeutics GmbH in Germany and in our proteomics group in California. The workforce reduction is intended to further focus our financial and human resources on expanding the commercial use of MPSS. We recorded a workforce reduction charge of $0.3 million in the quarter ended March 31, 2003 related primarily to severance compensation expense for our former employees, which amounts had been paid entirely as of April 30, 2003. In terms of compensation, benefits and employer taxes that would have been paid to, and on behalf of, such former employees had they remained employed by Lynx, we anticipate annualized cost savings of approximately $2.0 million.

Equity Share of Loss of Related Party

The equity share of loss of related party of $0.8 million in each of the three months ended March 31, 2003 and March 31, 2002, reflects Lynx s pro-rata share of the net loss of Axaron, a joint venture investee.

Interest Income (Expense), Net

Net interest expense was $44,000 for the quarter ended March 31, 2003, compared to net interest expense of $100,000 for the corresponding period of 2002. The decrease in net interest expense from 2002 to 2003 reflects primarily decreased interest expense in 2003 incurred on equipment-related debt outstanding during both the 2003 and 2002 periods and an increase in interest income due to higher average cash, cash equivalents and investment balances in the first quarter of 2003.

Other Income

Other income was $0 in the quarter ended March 31, 2003, compared to other income of $1.0 million in the 2002 period. The 2002 other income was related primarily to the gain on the sale of our equity investment in Inex Pharmaceuticals Corporation.

Income Tax Provision (Benefit)

The provision for income tax of approximately $1,000 in 2003 consisted entirely of foreign withholding tax on a payment received from our licensee, Takara. The income tax benefit for 2002 relates to a refund of state income taxes.

Liquidity and Capital Resources

Cash and cash equivalents at March 31, 2003 totaled $7.4 million. Net cash used in operating activities was $3.7 million for the quarter ended March 31, 2003, as compared to $3.8 million for the same period in 2002. The change was due primarily to a higher net loss in 2002, as adjusted for the impact of non-cash gains in 2002 that are not in 2003, partially offset by a higher decrease in deferred revenues and accounts payable, an increase in inventory, a higher net loss and lower depreciation and amortization expenses during 2003 as compared to 2002. The amount of net cash used in operating activities differed from the 2003 net loss due primarily to depreciation and amortization expenses, the impact of our pro rata share of the net loss of Axaron and a decrease in accounts receivable, offset partially by a decrease in deferred revenues. The amount of net cash used in operating activities differed from the 2002 net loss due primarily to depreciation and amortization expenses, the impact of our pro rata share of the net loss of Axaron, an increase in accounts payable decreases in other current assets, inventory and accounts receivable, offset partially by the impact of non-cash gains and a decrease in deferred revenues.

Table of Contents

Net cash used in investing activities of $0.1 million for the first quarter of 2003 was due to expenditures for capital equipment. Net cash provided by investing activities of $1.4 million for the first quarter of 2002 was due primarily to proceeds from the sale of equity securities, offset partially by expenditures for capital equipment.

Net cash used in financing activities of $0.6 million in the first quarter of 2003 and $0.5 million in the first quarter of 2002 was due primarily to the repayment of principal under equipment-related debt outstanding during both the 2003 and 2002 periods.

In October 2002, we entered into a loan and security agreement with a financial institution, Comerica Bank-California, for an equipment line of credit of up to $2.0 million with a draw-down period of one year. Under the initial advance, we drew down $1.6 million in November 2002 related to the purchase of equipment made in previous periods. We granted Comerica Bank-California a security interest in all items we financed under this agreement. The initial advance under the loan to finance the purchase of equipment made in previous periods has a term of 24 months from the date of advance and bears interest at a rate of 7.25%. In May 2003, we renegotiated the terms of the agreement, which now require that we maintain a minimum cash balance of restricted cash and cash equivalents in an account at Comerica Bank-California of at least 110% of the principal balance under loans outstanding under this agreement until Comerica Bank-California receives payment in full of all outstanding obligations. Previously, we were required to maintain a minimum cash balance of unrestricted cash and cash equivalents in an account at Comerica Bank-California of at least $5.0 million until Comerica Bank-California receives payment in full of all outstanding obligations, and meet a liquidity requirement that we have a balance of unrestricted cash at each month s end that is greater than our net decrease in cash during the preceding four months. As of March 31, 2003, the principal balance under loans outstanding under this agreement was $1.3 million. We believe that we are in compliance with all terms of the agreement.

In late 1998, we entered into a financing agreement with a financial institution, Transamerica Business Credit Corporation, under which we drew down $4.8 million during 1999 for the purchase of equipment and certain other capital expenditures. We granted the lender a security interest in all items financed by it under this agreement. Each draw down under the loan has a term of 48 months from the date of the draw down. As of March 31, 2003, the principal balance under loans outstanding under this agreement was $1.5 million. The draw down period under the agreement expired on March 31, 2000.

We plan to use available funds for ongoing commercial and research and development activities, working capital and other general corporate purposes and capital expenditures. We expect capital investments during 2003 will be less than $1.0 million and will be comprised primarily of expenditures for capital equipment required in the normal course of business. We intend to invest our excess cash in investment-grade, interest-bearing securities.

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

We have experienced operating losses since our inception of $102.9 million, including a net loss of $4.0 million for the quarter ended March 31, 2003. Net losses may continue as we proceed with the commercialization and additional development of our technologies. Our cash and cash equivalents were $7.4 million at March 31, 2003. We believe that our current cash and cash equivalents and funding anticipated to be received from customers, collaborators and licensees will enable us to maintain our operations through at least December 31, 2003. Changes to our current operating plan may require us to consume available capital resources significantly sooner than we expect. If our capital resources are insufficient to meet future capital requirements, we will have to raise additional

Table of Contents

funds. We may seek additional financing, as needed, through arrangements with customers, collaborators and licensees and equity or debt offerings. We do not know if we will be able to raise sufficient additional capital on acceptable terms, or at all. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. If we are unable to secure additional financing on reasonable terms, or are unable to generate sufficient new sources of revenue through arrangements with customers, collaborators and licensees, management may be forced to take substantial restructuring actions, which may include significantly reducing Lynx s anticipated level of expenditures, the sale of some or all of our assets, or obtaining funds by entering into financing or collaborative agreements on unattractive terms, or we will not be able to fund operations.

Additional Business Risks

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

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

We have incurred net losses each year since our inception in 1992, including net losses of approximately $15.5 million in 2002, $16.7 million in 2001 and $13.3 million in 2000. As of March 31, 2003, we had an accumulated deficit of approximately $102.9 million. Net losses may continue for at least the next several years. The presence and size of these potential net losses will depend, in part, on the rate of growth, if any, in our revenues and on the level of our expenses. Our research and development expenditures and general and administrative costs have exceeded our revenues to date. Research and development expenses may increase due to spending for ongoing technology development and implementation, as well as new applications. We will need to generate significant additional revenues to achieve profitability. Even if we do increase our revenues and achieve profitability, we may not be able to sustain profitability.

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

- our ability to continue existing customer relationships and enter into additional corporate collaborations and agreements;
- our ability to expand the scope of our products and services into new areas of pharmaceutical, biotechnology and agricultural research;
- our customers and collaborators abilities to develop diagnostic, therapeutic and other commercial products from the application of our technologies; and
- the successful clinical testing, regulatory approval and commercialization of such products by our customers and collaborators.

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

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

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

- the progress and scope of our research and development projects;
- payments received under our customer, license and collaborative agreements;
- our ability to establish and maintain customer, license and collaborative arrangements;

Table of Contents

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

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

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

We believe that our current cash and cash equivalents and funding anticipated to be received from customers, collaborators and licensees will enable us to maintain our operations through at least December 31, 2003. Changes to our current operating plan may require us to consume available capital resources significantly sooner than we expect. If our capital resources are insufficient to meet future capital requirements, we will have to raise additional funds. We do not know if we will be able to raise sufficient additional capital on acceptable terms, or at all. If we raise additional capital by issuing equity or convertible debt securities, our existing stockholders may experience substantial dilution. If we fail to obtain adequate funds on reasonable terms, we may have to curtail operations significantly or obtain funds, if such funds are at all available, by entering into financing or collaborative agreements on unattractive terms, or we will not be able to fund our operations.

Our technologies are new and unproven and may not allow our customers, collaborators or us to identify genes, proteins or targets for drug discovery.

You must evaluate us in light of the uncertainties and complexities affecting an early stage genomics company. Our technologies are new and unproven. The application of these technologies is in too early a stage to determine whether it can be successfully implemented. These technologies assume that information about gene expression and gene sequences may enable scientists to better understand complex biological processes. Our technologies also depend on the successful integration of independent technologies, each of which has its own development risks. Relatively few therapeutic products based on gene discoveries have been successfully developed and commercialized. Our technologies may not enable our customers, collaborators or us to identify genes, proteins or targets for drug discovery. To date, neither our customers nor we have identified any targets for drug discovery based on our technologies.

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

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

We have derived substantially all of our revenues from corporate collaborations, customer agreements and licensing arrangements. Revenues from such agreements depend upon continuation of the related relationships, our performance of genomics discovery services, the achievement of milestones and royalties derived from future products developed from our research and technologies. To date, we have received a significant portion of our revenues from a small number of collaborators, customers and licensees. For the three months ended March 31, 2003, revenues from DuPont, Bayer CropScience, Takara, and BASF accounted for 34%, 23%, 19% and 17%, respectively, of our total revenues. For the three months ended March 31, 2002, revenues from Geron Corporation, DuPont, BASF and Takara accounted for 51%, 10%, 10% and 10%, respectively, of our total revenues. For the year ended December 31, 2002, revenues from DuPont, Takara, Geron Corporation, Bayer CropScience and BASF accounted for 32%, 16%, 15%, 14% and 11%, respectively, of our total revenues. For the year ended December 31, 2001, revenues from DuPont, BASF, Takara and the Institute of Molecular and Cell Biology accounted for 37%, 24%, 12% and 12%, respectively, of our total revenues. If we fail to perform genomics discovery services or successfully achieve milestones or our collaborators fail to develop successful products, we will not earn the revenues contemplated under such agreements. If our collaborators, customers or licensees do not renew existing agreements, we lose one of these collaborators, customers or licensees, we do not attract new collaborators,

Table of Contents

customers or licensees or we are unable to enter into new collaborative, customer or license agreements on commercially acceptable terms, our revenues may decrease, and our activities may fail to lead to commercialized products.

Our dependence on collaborations with third parties subjects us to a number of risks. We have limited or no control over the resources that our collaborators may choose to devote to our joint efforts. Our collaborators may breach or terminate their agreements with us or fail to perform their obligations thereunder. Further, our collaborators may elect not to develop products arising out of our collaborative arrangements or may fail to devote sufficient resources to the development, manufacture, marketing or sale of such products. While we do not currently compete directly with any of our customers and collaborators, some of our customers and collaborators could become our competitors in the future if they internally develop DNA analysis technologies or if they acquire other genomics companies and move into the genomics industry. We will not earn the revenues contemplated under our customer and collaborative arrangements, if our customers and collaborators:

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

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

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

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

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

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

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

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

Table of Contents

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

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

In addition, numerous pharmaceutical, biotechnology and agricultural companies are developing genomics research programs, either alone or in partnership with our competitors. Our future success will depend on our ability to maintain a competitive position with respect to technological advances. Rapid technological development by others may make our technologies and future products obsolete.

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

Our facilities are located near known earthquake fault zones and are vulnerable to damage from earthquakes. We are also vulnerable to damage from other types of disasters, including fire, floods, power loss, communications failures and similar events. If any disaster were to occur, our ability to operate our business at our facilities would be seriously, or potentially completely, impaired. In addition, the unique nature of our research activities could cause

Table of Contents

significant delays in our programs and make it difficult for us to recover from a disaster. The insurance we maintain may not be adequate to cover our losses resulting from disasters or other business interruptions. Accordingly, an earthquake or other disaster could materially and adversely harm our ability to conduct business.

Our stock price may be extremely volatile.

We believe that the market price of our common stock will remain highly volatile and may fluctuate significantly due to a number of factors. The market prices for securities of many publicly-held, early-stage biotechnology companies have in the past been, and can in the future be expected to be, especially volatile. For example, during the two-year period from April 2, 2001 to March 31, 2003, the closing sales price of our common stock as quoted on the Nasdaq National Market fluctuated from a low of $1.61 to a high of $59.69 per share. In addition, the securities markets have from time to time experienced significant price and volume fluctuations that may be unrelated to the operating performance of particular companies. The following factors and events may have a significant and adverse impact on the market price of our common stock:

fluctuations in our operating results;

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

release of reports by securities analysts;

developments or disputes concerning patent or proprietary rights;

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

general market conditions.

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

If we are unable to maintain our Nasdaq National Market listing, the liquidity of our common stock would be seriously impaired and we would become subject to various statutory requirements, which would likely harm our business.

On September 12, 2002, we received a letter from Nasdaq advising us that our common stock had not met Nasdaq s minimum $1.00 closing bid price requirement for 30 consecutive trading days and that, if we were unable to demonstrate compliance with this requirement during the 90-calendar day grace period ending December 9, 2002, our common stock may be subject to delisting from the Nasdaq National Market. We failed to regain compliance with the minimum bid price requirement during the 90-day grace period, and subsequently received a delisting letter from Nasdaq on December 13, 2002. On December 20, 2002, we requested an oral hearing before a Nasdaq Listing Qualifications Panel to appeal our potential delisting. At the oral hearing on January 23, 2003, we informed Nasdaq that we believed we had regained compliance with the Nasdaq National Market continued listing requirements following a 1-for-7 reverse split of our common stock effected on January 15, 2003.

On February 21, 2003, we received a letter from Nasdaq advising us that the Nasdaq Listing Qualifications Panel acknowledged that we had regained compliance with the requirements for continued listing on the Nasdaq National Market. The Nasdaq Listing Qualifications Panel determined to continue the listing of our securities on the Nasdaq National Market provided that we file our annual report on Form 10-K for the fiscal year ended December 31, 2002 with the Securities and Exchange Commission and Nasdaq evidencing shareholders equity of at least $10,000,000 and that we demonstrate compliance with all requirements for continued listing on the Nasdaq National Market at that time. At December 31, 2002, we had total stockholders equity of $12,056,000. On April 10, 2003, we received a letter from Nasdaq advising us that the Nasdaq Listing Qualifications Panel acknowledged that we had evidenced compliance with the requirements for continued listing on the Nasdaq National Market based on the filing on March 28, 2003 of our annual report on Form 10-K for the fiscal year ended December 31, 2002 with the Securities and Exchange Commission and Nasdaq that evidenced shareholders equity of at least $10,000,000. The Nasdaq Listing Qualifications Panel determined to continue the listing of our securities on the Nasdaq National Market provided that we file our quarterly report on Form 10-Q for the quarterly period ended March 31, 2003 with the Securities and Exchange Commission and Nasdaq evidencing shareholders equity of at least $10,000,000 and that we demonstrate compliance with all requirements for continued listing on the Nasdaq National Market at that

Table of Contents

time. At March 31, 2003, we had total stockholders equity of $8,107,000, which does not satisfy the Nasdaq Listing Qualifications Panel s requirement of $10,000,000 of shareholders equity for continuted listing. Thus, the Nasdaq Listing Qualifications Panel may terminate our Nasdaq National Market listing. In the event that the Nasdaq Listing Qualification Panel determines to terminate our Nasdaq National Market listing, our securities may be transferred to the Nasdaq SmallCap Market, provided we are able to demonstrate compliance with all applicable maintenance criteria and an ability to sustain long-term compliance. In the event we are unable to do so, our securities will be delisted from the Nasdaq Stock Market.

Transferring to the Nasdaq SmallCap Market would make us subject to certain adverse consequences as described below. In addition, we would still be required to satisfy various listing maintenance standards for our common stock to be quoted on the Nasdaq SmallCap Market, including the minimum bid price requirement. If we fail to meet such standards, our common stock would likely be delisted from the Nasdaq SmallCap Market and trade on the over-the-counter bulletin board, commonly referred to as the pink sheets. Such alternatives are generally considered less efficient markets and would seriously impair the liquidity of our common stock and limit our potential to raise future capital through the sale of our common stock, which could materially harm our business.

If we are delisted from the Nasdaq National Market, we will face a variety of legal and other consequences that would likely negatively affect our business including, without limitation, the following:

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

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

- due to the application of different securities law exemptions and provisions, we may be required to amend our stock option and stock purchase plans and comply with time-consuming and costly administrative procedures;

- the coverage of Lynx by securities analysts may decrease or cease entirely; and

- we may lose current or potential investors.

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

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

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

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Short-Term Investments

The primary objective of our investment activities is to preserve principal while, at the same time, maximizing yields without significantly increasing risk. To achieve this objective, we invest in highly liquid and high-quality debt securities. Our investments in debt securities are subject to interest rate risk. To minimize the exposure due to adverse shifts in interest rates, we invest in short-term securities and maintain an average maturity of less than 90 days. As a result, we do not believe we are subject to significant interest rate risk.

Foreign Currency Rate Fluctuations

The functional currency for our German subsidiary is the Euro. Our German subsidiary s accounts are translated from the Euro to the U.S. dollar using the current exchange rate in effect at the balance sheet date, for balance sheet accounts, and using the average exchange rate during the period, for revenues and expense accounts. The effects of translation are recorded as a separate component of stockholders equity, and to date, have not been material. Our German subsidiary conducts its business primarily in Euros. Exchange gains and losses arising from these transactions are recorded using the actual exchange differences on the date of the transaction. We have not taken any action to reduce our exposure to changes in foreign currency exchange rates, such as options or futures contracts, with respect to transactions with our German subsidiary or transactions with our European collaborators and customers.

Item 4. Controls and Procedures

Our chief executive officer and chief financial officer have concluded that Lynx s disclosure controls and procedures (as defined in Securities Exchange Act Rules 13a-14(c) and 15d-14(c)) are sufficiently effective to ensure that the information required to be disclosed by Lynx in the reports that we file under the Exchange Act is gathered, analyzed and disclosed with adequate timeliness, accuracy and completeness, based on an evaluation of such controls and procedures conducted within 90 days prior to the date hereof.

There have been no significant changes in Lynx s internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referred to above, nor were there any significant deficiencies or material weaknesses in Lynx s internal controls. Accordingly, no corrective actions were required or undertaken.

Lynx s management, including the chief financial officer and chief executive officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a 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 potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 2. Changes in Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K.

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

Exhibit Number	Description
10.36	Employment Agreement, dated as of March 20, 2003, by and between the Company and Edward C. Albini.
10.37	Employment Agreement, dated as of March 20, 2003, by and between the Company and Kathy A. San Roman.
99.1 *	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

b) Reports on Form 8-K No Current Reports on Form 8-K were filed during the quarter ended March 31, 2003.

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

Table of Contents

SIGNATURES

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

LYNX THERAPEUTICS, INC.

/s/ Kevin P. Corcoran

By: Kevin P. Corcoran
President and Chief Executive Officer

Date: May 15, 2003

/s/ Edward C. Albini

By: Edward C. Albini
Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: May 15, 2003

CERTIFICATIONS

I, Kevin P. Corcoran, Chief Executive Officer of Lynx Therapeutics, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Lynx Therapeutics, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

   c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):

Table of Contents

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 15, 2003

/s/ Kevin P. Corcoran

Kevin P. Corcoran
Chief Executive Officer

Table of Contents

I, Edward C. Albini, Chief Financial Officer of Lynx Therapeutics, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Lynx Therapeutics, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

   c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of registrant s board of directors (or persons performing the equivalent function):

   a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 15, 2003

/s/ Edward C. Albini

Edward C. Albini
Chief Financial Officer

Table of Contents

INDEX TO EXHIBITS

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