ARENA PHARMACEUTICALS INC
Form 10-Q
May 07, 2010
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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, 2010

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: 000-31161

ARENA PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**23-2908305**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
6166 Nancy Ridge Drive, San Diego, CA	**92121**
(Address of principal executive offices)	**(Zip Code)**

858.453.7200

(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. x Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

The number of shares of common stock outstanding as of the close of business on May 5, 2010:

Class	**Number of Shares Outstanding**
Common Stock, $0.0001 par value	101,226,889

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ARENA PHARMACEUTICALS, INC.

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In this report, Arena Pharmaceuticals, Arena, we, us and our refer to Arena Pharmaceuticals, Inc., and our wholly owned subsidiaries, unless context otherwise provides.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

Arena Pharmaceuticals, Inc.

Condensed Consolidated Balance Sheets

(In thousands)

	March 31, 2010 (Unaudited)	December 31, 2009 *
Assets		
Current assets:		
Cash and cash equivalents	$ 86,746	$ 94,733
Short-term investments, available-for-sale	20,869	20,716
Accounts receivable	1,960	1,415
Prepaid expenses and other current assets	4,489	4,409
Total current assets	114,064	121,273
Land, property and equipment, net	94,451	95,445
Acquired technology and other intangibles, net	12,273	13,123
Other non-current assets	6,481	6,437
Total assets	$ 227,269	$ 236,278
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 5,400	$ 9,677
Accrued compensation	3,378	3,928
Accrued clinical and preclinical study fees	1,831	2,279
Deferred revenues	4,049	4,086
Current portion of lease financing obligations	783	717
Current portion of note payable to Siegfried	3,147	
Total current liabilities	18,588	20,687
Deferred rent	530	564
Derivative liabilities	5,223	6,642
Note payable to Siegfried, less current portion	5,809	9,143
Note payable to Deerfield**	51,828	47,906
Lease financing obligations, less current portion	76,556	76,769
Commitments		
Stockholders equity:		
Common stock	10	10
Additional paid-in capital	987,549	961,269
Treasury stock, at cost	(23,070)	(23,070)
Accumulated other comprehensive income	103	945
Accumulated deficit	(895,857)	(864,587)

Total stockholders equity	68,735	74,567
Total liabilities and stockholders equity	$ 227,269	$ 236,278

* The balance sheet data at December 31, 2009 has been derived from audited financial statements at that date. It does not include, however, all of the information and notes required by US generally accepted accounting principles for complete financial statements.

** The outstanding principal balance of the note payable to Deerfield at March 31, 2010 and December 31, 2009 was $90.0 million. See Note 5.

See accompanying notes to unaudited condensed consolidated financial statements.

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Arena Pharmaceuticals, Inc.

Condensed Consolidated Statements of Operations

(In thousands, except per share data)

(Unaudited)

	Three months ended March 31,	
	2010	**2009**
Revenues:		
Manufacturing services	$ 1,975	$ 1,418
Collaborative agreements	538	1,240
Total revenues	2,513	2,658
Operating Expenses:		
Cost of manufacturing services	1,865	1,354
Research and development	18,314	42,620
General and administrative	7,014	7,642
Amortization of acquired technology and other intangibles	537	566
Total operating expenses	27,730	52,182
Loss from operations	(25,217)	(49,524)
Interest and Other Income (Expense):		
Interest income	139	170
Interest expense	(7,650)	(1,717)
Gain from valuation of derivative liabilities	1,419	365
Other	39	92
Total interest and other expense, net	(6,053)	(1,090)
Net loss	$ (31,270)	$ (50,614)
Net loss per share, basic and diluted	$ (0.33)	$ (0.68)
Shares used in calculating net loss per share, basic and diluted	94,955	74,189

See accompanying notes to unaudited condensed consolidated financial statements.

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Arena Pharmaceuticals, Inc.

Condensed Consolidated Cash Flow Statements

(In thousands)

(Unaudited)

	Three months ended March 31,	
	2010	**2009**
Operating Activities		
Net loss	$ (31,270)	$ (50,614)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,645	2,829
Amortization of acquired technology and other intangibles	537	566
Share-based compensation	1,811	2,021
Gain from valuation of derivative liabilities	(1,419)	(365)
Amortization of short-term investment premium		43
Amortization of prepaid financing costs	115	30
Accretion of note payable to Deerfield	3,922	
Accretion of note payable to Siegfried	66	59
Gain on disposal of equipment	(1)	(4)
Changes in assets and liabilities:		
Accounts receivable	(557)	(40)
Prepaid expenses and other assets	(135)	703
Accounts payable and accrued liabilities	(5,640)	(6,872)
Deferred revenue	(37)	
Deferred rent	(34)	(28)
Net cash used in operating activities	(29,997)	(51,672)
Investing Activities		
Purchases of short-term investments, available-for-sale	(145)	
Proceeds from sales/maturities of short-term investments, available-for-sale		28,941
Purchases of land, property and equipment	(1,855)	(2,275)
Proceeds from sale of equipment	2	6
Deposits, restricted cash and other non-current assets	(152)	83
Net cash provided by (used in) investing activities	(2,150)	26,755
Financing Activities		
Principal payments on lease financing obligations	(147)	(202)
Proceeds from lease financing		15,000
Proceeds from issuance of common stock	24,469	266
Net cash provided by financing activities	24,322	15,064
Effect of exchange rate changes on cash	(162)	(1,018)
Net decrease in cash and cash equivalents	(7,987)	(10,871)
Cash and cash equivalents at beginning of period	94,733	73,329
Cash and cash equivalents at end of period	$ 86,746	$ 62,458

See accompanying notes to unaudited condensed consolidated financial statements.

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Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Arena Pharmaceuticals, Inc., which includes our wholly owned subsidiaries, should be read in conjunction with the audited consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2009, as filed with the Securities and Exchange Commission, or SEC, from which we derived our balance sheet as of December 31, 2009. The accompanying financial statements have been prepared in accordance with US generally accepted accounting principles, or GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, since they are interim statements, the accompanying financial statements do not include all of the information and notes required by GAAP for complete financial statements. The accompanying financial statements reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of our management, necessary to a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year.

The preparation of financial statements in accordance with GAAP requires our management to make estimates and assumptions that affect amounts reported in the financial statements and notes thereto. The amounts reported could differ under different estimates and assumptions.

2. Short-term Investments, Available-for-Sale

We define short-term investments as income-yielding securities that can be readily converted to cash, and classify such investments as available-for-sale. We carry these securities at fair value, and report unrealized gains and losses as a separate component of accumulated other comprehensive income or loss. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in interest income. Realized gains and losses and declines in securities judged to be other than temporary are included in other income or expense. The cost of securities sold is based on the specific identification method. Interest and dividends on available-for-sale securities are included in interest income.

The following table summarizes the investment categories comprising our available-for-sale securities at March 31, 2010 and December 31, 2009, in thousands:

	Maturity in Years	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
March 31, 2010					
US government and agency obligations	Less than 1	$ 20,578	$ 394	$ (103)	$ 20,869
Total available-for-sale securities		$ 20,578	$ 394	$ (103)	$ 20,869
December 31, 2009					
US government and agency obligations	Less than 1	$ 20,433	$ 404	$ (121)	$ 20,716
Total available-for-sale securities		$ 20,433	$ 404	$ (121)	$ 20,716

3. Fair Value Disclosures

We measure our financial assets and liabilities at fair value, which is defined as the exit price, or the amount that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

We use the following three-level valuation hierarchy that maximizes the use of observable inputs and minimizes the use of unobservable inputs to value our financial assets and liabilities:

Level 1 - Observable inputs such as unadjusted quoted prices in active markets for identical instruments.

Level 2 - Quoted prices for similar instruments in active markets or inputs that are observable for the asset or liability, either directly or indirectly.

Level 3 - Unobservable inputs based on our assumptions.

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The following table presents our valuation hierarchy for our financial assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2010, in thousands:

	Fair Value Measurements at March 31, 2010			
	Balance at March 31, 2010	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market funds and cash equivalents (1)	$ 66,870	$ 66,870	$	$
US government and agency obligations (2)	20,869	20,869		
Liabilities:				
Warrants and other derivative instruments	$ 5,223	$	$	$ 5,223

(1) Included in cash and cash equivalents on our condensed consolidated balance sheet.
(2) Included in short-term investments, available-for-sale on our condensed consolidated balance sheet.

The following table presents the activity for our derivative liabilities during the three months ended March 31, 2010, in thousands:

	Significant Unobservable Inputs (Level 3)
Balance at December 31, 2009	$ 6,642
Gain from valuation of derivative liabilities	(1,419)
Balance at March 31, 2010	$ 5,223

4. Acquired Technology and Other Intangibles

In February 2001, we acquired Bunsen Rush Laboratories, Inc., or Bunsen Rush, for $15.0 million in cash and assumed $0.4 million in liabilities. We allocated $15.4 million to the patented Melanophore technology, our primary screening technology, acquired in such transaction. We are amortizing the Melanophore technology over its estimated useful life of 10 years, which was determined based on an analysis, as of the acquisition date, of the conditions in, and the economic outlook for, the pharmaceutical and biotechnology industries and the patent life of the technology.

In January 2008, we acquired certain assets from Siegfried Ltd, or Siegfried, including manufacturing facility production licenses and an assembled workforce originally valued at $12.1 million and $1.6 million, respectively. We are amortizing the manufacturing facility production licenses, which are necessary for us to produce and package tablets and other dosage forms in such facility, over their estimated useful life of 20 years as of the acquisition date. We amortized the acquired workforce over its estimated benefit of two years, which was determined based on an analysis as of the acquisition date.

Acquired technology and other intangibles, net, consisted of the following at March 31, 2010, in thousands:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount

Acquired technology from Bunsen Rush	$ 15,378	$ (13,961)	$ 1,417
Acquired manufacturing facility production licenses from Siegfried	12,232	(1,376)	10,856
Acquired workforce from Siegfried	1,584	(1,584)	
Total identifiable intangible assets, net	$ 29,194	$ (16,921)	$ 12,273

5. Note Payable to Deerfield

In June 2009, we entered into a Facility Agreement with Deerfield Private Design Fund, L.P., Deerfield Private Design International, L.P., Deerfield Partners, L.P., Deerfield International Limited, Deerfield Special Situations Fund, L.P., and Deerfield Special

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Situations Fund International Limited, or collectively Deerfield, pursuant to which Deerfield agreed to provide us with a $100.0 million secured loan and we agreed to issue Deerfield warrants to purchase an aggregate of 28,000,000 shares of our common stock at an exercise price of $5.42 per share upon the closing of such loan. In July 2009, we received net proceeds of $95.6 million from this loan and issued the warrants to Deerfield. On or before June 17, 2011, Deerfield may make a one-time election, which we refer to as the Deerfield Additional Loan Election, to loan us up to an additional $20.0 million under the Facility Agreement, with the additional loan maturing on the same date as the original loan, June 17, 2013. For each additional $1.0 million that Deerfield loans us under the Facility Agreement, we will issue Deerfield warrants for 280,000 shares of common stock at an exercise price of $5.42 per share. All of the warrants issued or issuable in connection with the Facility Agreement are exercisable until June 17, 2013. Under certain circumstances, Deerfield also has the right to require us to accelerate principal payments under the loan. At any time we may prepay any or all of the outstanding principal at par, and we may be required to make the scheduled repayments earlier in connection with certain equity issuances. At March 31, 2010, the outstanding principal balance on the Deerfield loan was $90.0 million.

In accordance with relevant guidance, we separately valued four components under the Facility Agreement at the July 6, 2009 issuance date, as follows:

(1) The $100.0 million loan was valued at $47.9 million on a relative fair value basis, and is recorded as a long-term liability on our condensed consolidated balance sheet.

(2) The warrants to purchase an aggregate of 28,000,000 shares of our common stock, net of issuance costs, were valued at $39.1 million on a relative fair value basis. The relative fair value of the warrants is recorded as additional paid-in capital on our condensed consolidated balance sheet, and the resulting debt discount is being accreted to interest expense over the term of the loan or until paid using the effective interest rate method. These warrants were valued at the date of issuance using an option pricing model and the following assumptions: expected life of 3.95 years, risk-free interest rate of 2.0%, expected volatility of 66% and no dividend yield. Because these warrants are eligible for equity classification, no adjustments to the recorded value will be made on an ongoing basis.

(3) The Deerfield Additional Loan Election, including the 5,600,000 contingently issuable warrants to purchase up to 5,600,000 shares of our common stock, was valued at $9.5 million. The Deerfield Additional Loan Election is classified as a long-term liability on our condensed consolidated balance sheet and, accordingly, will be revalued on each subsequent balance sheet date until it is exercised or expires, with any changes in the fair value between reporting periods recorded in the interest and other income (expense) section of our condensed consolidated statements of operations (see Note 6). This allocation of proceeds under the Facility Agreement resulted in additional debt discount that is being accreted to interest expense over the term of the loan or until paid using the effective interest rate method.

(4) Deerfield s ability to accelerate principal payments under the loan was valued at $0.5 million. The acceleration right is classified as a long-term liability on our condensed consolidated balance sheet and, accordingly, will be revalued on each subsequent balance sheet date until it is exercised or expires, with any changes in the fair value between reporting periods recorded in the interest and other income (expense) section of our condensed consolidated statements of operations (see Note 6). This allocation of proceeds under the Facility Agreement resulted in additional debt discount that is being accreted to interest expense over the term of the loan or until paid using the effective interest rate method.

The difference between the $51.8 million recorded value of the loan and the $90.0 million outstanding principal balance of the loan as of March 31, 2010 represents the remaining debt discount, which will be accreted over the term of the loan or until paid.

The loan matures on June 17, 2013, and the outstanding principal accrues interest at a rate of 7.75% per annum on the stated principal balance, payable quarterly in arrears. Total interest expense of $5.7 million, including accretion of the debt discount attributable to the warrants and the other derivative financial instruments and amortization of capitalized issuance costs, was recognized in connection with this loan in the three months ended March 31, 2010. At March 31, 2010, we expected interest expense of $17.2 million to be paid in cash over the term of the loan. The current effective annual interest rate on the loan is 33.6%.

As a result of the closing of our public offering of common stock in July 2009, we were required to repay Deerfield $10.0 million that was originally scheduled to be repaid in July 2010. In connection with this $10.0 million repayment, we retired a proportional share of the debt discount and issuance costs directly related to the repaid debt and recorded a loss on extinguishment of debt of $2.5 million in 2009. The

remainder of required scheduled principal repayments is as follows: $20.0 million in July 2011, $30.0 million in July 2012, and $40.0 million at maturity.

6. Derivative Liabilities

In June 2006 and August 2008, we issued seven-year warrants, which we refer to as the Series B warrants, to purchase 829,856 and 1,106,344 shares of our common stock, respectively, at an exercise price of $15.49 and $7.71 per share, respectively. The Series B warrants are related to our Series B Convertible Preferred Stock, which we redeemed in 2008 and is no longer outstanding. The warrants contain an anti-dilution provision and, as a result of subsequent equity issuances at prices below the adjustment price of $6.72 defined in the warrants, as of March 31, 2010 the number of shares issuable upon exercise of the outstanding June 2006 and

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August 2008 Series B warrants was increased to 960,723 and 1,280,768 respectively, and the exercise price was reduced to $13.38 and $6.66 per share, respectively.

In January 2009, we adopted amendments to the authoritative guidance related to contracts in an entity s own equity. These amendments provide a new two-step model to be applied in determining whether a financial instrument or an embedded feature in a financial instrument is indexed to an entity s own stock that would qualify such financial instruments or embedded features for a scope exception. This scope exception specifies that a contract that would otherwise meet the definition of a derivative but is both (i) indexed to the entity s own stock and (ii) classified in the stockholders equity section of the balance sheet would not be considered a derivative financial instrument. Our adoption of these amendments resulted in the determination that our Series B warrants are ineligible for equity classification as a result of provisions in the Series B warrants that may result in an adjustment to the warrant exercise price. As such, upon adoption of the new amendments, we recorded a $9.7 million adjustment to equity, a $2.1 million long-term liability for the fair value of the Series B warrants and a $7.6 million adjustment to the opening accumulated deficit balance as a cumulative effect of a change in accounting principle. We have revalued these warrants on each subsequent balance sheet date, and will continue to do so until they are exercised or expire, with any changes in the fair value between reporting periods recorded as other income or expense. The June 2006 Series B warrants were valued at March 31, 2010 using an option pricing model and the following assumptions: expected life of 3.25 years, risk-free interest rate of 1.7%, expected volatility of 73% and no dividend yield. The August 2008 Series B warrants were valued at March 31, 2010 using an option pricing model and the following assumptions: expected life of 5.38 years, risk-free interest rate of 2.7%, expected volatility of 66% and no dividend yield.

We separately valued the Deerfield Additional Loan Election, including the 5,600,000 contingently issuable warrants to purchase up to 5,600,000 shares of our common stock, as of the July 6, 2009 issuance date of the Deerfield loan (see Note 5). The value of the Deerfield Additional Loan Election is classified as a long-term liability on our condensed consolidated balance sheet and, accordingly, will be revalued on each subsequent balance sheet date until it is exercised or expires, with any changes in the fair value between reporting periods recorded as other income or expense. In July 2009, the Deerfield Additional Loan Election was valued using an option pricing model and the following assumptions: expected life of 2 to 3 years, risk-free interest rate of 2.0%, expected volatility of 66% and no dividend yield. At March 31, 2010, the Deerfield Additional Loan Election was revalued using an option pricing model and the following assumptions: expected life of 3.22 years, risk-free interest rate of 1.7%, expected volatility of 73% and no dividend yield.

We also separately valued Deerfield s right to require us to accelerate principal payments of the loan under certain circumstances at $0.5 million as of the July 6, 2009 issuance date of the Deerfield loan (see Note 5). The value of this acceleration right is classified as a long-term liability on our condensed consolidated balance sheet and, accordingly, will be revalued on each subsequent balance sheet date until it is exercised or expires, with any changes in the fair value between reporting periods recorded as other income or expense. At both July 6, 2009 and March 31, 2010, this acceleration right was valued using a discounted cash flow model.

Our derivative liabilities consisted of the following as of March 31, 2010 and December 31, 2009, in thousands:

	March 31, 2010	December 31, 2009
Series B warrants	$ 2,174	$ 2,386
Deerfield Additional Loan Election	2,662	3,831
Deerfield acceleration right	387	425
Total derivative liabilities	$ 5,223	$ 6,642

The change in the fair value of our derivative liabilities is recorded in the interest and other income (expense) section of our condensed consolidated statements of operations. The following table presents the gain we recorded in the three months ended March 31, 2010 and 2009, in thousands:

	Three months ended March 31,	
	2010	2009
Series B warrants	$ 212	$ 365

Deerfield Additional Loan Election	1,169	
Deerfield acceleration right	38	
Total gain due to revaluation of derivative liabilities	$ 1,419	$ 365

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7. Share-based Activity

Share-based Compensation

We use the Black-Scholes option pricing model to estimate the grant-date fair value of share-based awards in determining our share-based compensation expense. In June 2009, our stockholders approved our 2009 Long-Term Incentive Plan and, concurrently, our 2006 Long-Term Incentive Plan, as amended, was terminated. The table below sets forth the weighted-average assumptions and estimated fair value of stock options we granted under these plans during the three months ended March 31, 2010 and 2009:

	Three months ended March 31,	
	2010	**2009**
Risk-free interest rate	2.4%	2.0%
Dividend yield	0%	0%
Expected volatility	69% - 71%	86%
Expected life (years)	5.76	5.72
Weighted-average estimated fair value per share of stock options granted	$ 2.06	$ 2.88

In June 2009, our stockholders also approved our 2009 Employee Stock Purchase Plan and, concurrently, our 2001 Employee Stock Purchase Plan, as amended, was terminated. The table below sets forth the weighted-average assumptions and estimated fair value of the options to purchase stock granted under these plans for multiple offering periods during the three months ended March 31, 2010 and 2009:

	Three months ended March 31,	
	2010	**2009**
Risk-free interest rate	0.1% - 2.8%	0.1% - 5.1%
Dividend yield	0%	0%
Expected volatility	57% - 82%	53% - 72%
Expected life (years)	0.25 - 2.0	0.25 - 2.0
Weighted-average estimated fair value per share of options granted under our employee stock purchase plans	$ 1.45 - $2.64	$ 1.85 - $4.70

Expected volatility is based on a combination of 75% historical volatility of our common stock and 25% market-based implied volatilities from traded options on our common stock, with historical volatility being more heavily weighted due to the low volume of traded options on our common stock. The expected life of options is determined based on historical experience of similar awards, giving consideration to the contractual terms of the share-based awards, vesting schedules and post-vesting terminations. The risk-free interest rates are based on the US Treasury yield curve, with a remaining term approximately equal to the expected term used in the option pricing model.

Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Based on historical experience, forfeitures of unvested options were estimated to be 7.0% and 6.4% for the three months ended March 31, 2010 and 2009, respectively. If actual forfeitures vary from estimates, we will recognize the difference in compensation expense in the period the actual forfeitures occur or when stock options vest.

We recognized share-based compensation expense as follows, in thousands, except per share data:

	Three months ended March 31,	
	2010	**2009**
Research and development	$ 861	$ 892
General and administrative	950	1,129

Total share-based compensation expense and impact on net loss allocable to common stockholders	$ 1,811	$ 2,021
Impact on net loss per share allocable to common stockholders, basic and diluted	$ 0.02	$ 0.03

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Share-based Award Activity

The following table summarizes our stock option activity during the three months ended March 31, 2010:

	Options	Weighted-Average Exercise Price
Outstanding at January 1, 2010	7,226,824	$ 8.94
Granted	1,489,087	3.25
Exercised	(33,250)	0.60
Forfeited/cancelled/expired	(50,401)	8.04
Outstanding at March 31, 2010	8,632,260	$ 7.99

The following table summarizes activity with respect to our performance-based restricted stock unit awards during the three months ended March 31, 2010:

	Performance Units	Weighted-Average Grant-Date Fair Value
Outstanding at January 1, 2010	1,714,350	$ 12.44
Granted		
Vested		
Forfeited/cancelled	(11,100)	6.99
Outstanding at March 31, 2010	1,703,250	$ 12.47

8. Concentration of Credit Risk and Major Customers

Financial instruments, which potentially subject us to concentrations of credit risk, consist primarily of cash, cash equivalents and short-term investments. We limit our exposure to credit loss by placing our cash and investments in US government, agency and government-sponsored enterprise obligations and in corporate debt instruments that are rated investment grade, in accordance with our board-approved investment policy.

We manufacture drug products for Siegfried under a manufacturing services agreement, and all of our manufacturing services revenues are attributable to Siegfried.

Percentages of our total revenues derived from our manufacturing services agreement and from our most significant collaborator are as follows:

	Three months ended March 31,	
Source of Revenue	**2010**	**2009**
Manufacturing services agreement with Siegfried	78.6%	53.3%
Collaboration with Ortho-McNeil-Janssen Pharmaceuticals, Inc.	21.2%	46.3%

9. Net Loss Per Share

We compute basic and diluted net loss per share using the weighted-average number of shares of common stock outstanding during the period, less any shares subject to repurchase or forfeiture.

Because no shares of our common stock were subject to repurchase or forfeiture, no such shares were excluded from the calculation of basic and diluted net loss per share for the three months ended March 31, 2010. For the three months ended March 31, 2009, there were 25,000 shares of common stock excluded from our calculation of basic and diluted net loss per share because they were subject to repurchase or forfeiture. Because we are in a net loss position, we have excluded the following outstanding unvested performance-based restricted stock unit awards, which are subject to forfeiture, warrants and stock options from our calculation of diluted net loss per share for the three months ended March 31, 2010 and 2009 because these securities are antidilutive:

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	Three months ended March 31,	
	2010	2009
Warrants	30,241,491	1,936,200
Stock options	8,632,260	7,686,675
Performance-based restricted stock unit awards	1,703,250	1,930,150
Total	40,577,001	11,553,025

Had they been dilutive, these securities would have been included in our computation of diluted net loss per share.

10. Comprehensive Income (Loss)

We report all components of comprehensive income (loss), including foreign currency translation gain and loss and unrealized gains and losses on investment securities, in the financial statements in the period in which they are recognized. Comprehensive income (loss) is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Below is a reconciliation, in thousands, of our net loss to comprehensive loss for all periods presented.

	Three months ended March 31,	
	2010	2009
Net loss	$ (31,270)	$ (50,614)
Foreign currency translation loss	(851)	(2,176)
Unrealized gain on available-for-sale securities and other investments, net of taxes	9	18
Comprehensive loss	$ (32,112)	$ (52,772)

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 notes thereto included in this quarterly report on Form 10-Q, or Quarterly Report, and the audited consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2009, or 2009 Annual Report, as filed with the Securities and Exchange Commission, or SEC. Operating results are not necessarily indicative of results that may occur in future periods.

This Quarterly Report includes forward-looking statements, which involve a number of risks and uncertainties. These forward-looking statements can generally be identified as such because the context of the statement will include words such as may, will, intend, plan, believe, anticipate, expect, estimate, predict, potential, continue, likely, or opportunity, the negative of these words or other similar words. S statements that describe our future plans, strategies, intentions, expectations, objectives, goals or prospects and other statements that are not historical facts are also forward-looking statements. For such statements, we claim the protection of the Private Securities Litigation Reform Act of 1995. Readers of this Quarterly Report are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the time this Quarterly Report was filed with the SEC. These forward-looking statements are based largely on our expectations and projections about future events and future trends affecting our business, and are subject to risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. These risks and uncertainties include, without limitation, the risk factors identified in our SEC reports, including this Quarterly Report. In addition, past financial or operating performance is not necessarily a reliable indicator of future performance, and you should not use our historical performance to anticipate results or future period trends. We can give no assurances that any of the events anticipated by the forward-looking statements will occur or, if any of them do, what impact they will have on our results of operations and financial condition. Except as required by law, we undertake no obligation to update publicly or revise our forward-looking statements.

OVERVIEW AND RECENT DEVELOPMENTS

We are a clinical-stage biopharmaceutical company focused on discovering, developing and commercializing oral drugs that target G protein-coupled receptors, or GPCRs, an important class of validated drug targets, in four major therapeutic areas: cardiovascular, central nervous system, inflammatory and metabolic diseases. Our most advanced drug candidate is lorcaserin hydrochloride, or lorcaserin, for weight management, including weight loss and maintenance of weight loss, and it has completed a pivotal Phase 3 clinical trial program. In December 2009, we submitted a New Drug Application, or NDA, for lorcaserin to the US Food and Drug

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Administration, or FDA, for regulatory approval, and the FDA has assigned an October 22, 2010 Prescription Drug User Fee Act, or PDUFA, date for their review of our application.

Our recent developments include:

- The FDA accepted our NDA for lorcaserin and assigned a PDUFA date of October 22, 2010 for review of the application. The NDA is based on a data package from lorcaserin s development program that includes 18 clinical trials totaling 8,576 patients. The pivotal Phase 3 clinical trials, BLOOM and BLOSSOM, evaluated nearly 7,200 patients treated for up to two years. In both trials, lorcaserin produced highly statistically significant weight loss with excellent safety and tolerability.

- Initiated a Phase 1 clinical trial of APD916, a novel oral drug candidate we discovered that targets the histamine H3 receptor for the treatment of narcolepsy and cataplexy. This randomized, double-blind and placebo-controlled Phase 1 trial will evaluate the safety, tolerability and pharmacokinetics of single-ascending doses of APD916.

- Received aggregate net proceeds of $24.2 million from the sale of approximately 8.3 million shares of common stock under an equity financing commitment with Azimuth Opportunity Ltd, which terminated in connection with this financing.

RESULTS OF OPERATIONS

We are providing the following summary of our revenues, research and development expenses and general and administrative expenses to supplement the more detailed discussion below. The dollar values in the following tables are in millions.

Revenues

	Three months ended March 31,	
Source of revenue	**2010**	**2009**
Manufacturing services agreement	$ 2.0	$ 1.4
Collaborative agreements	0.5	1.3
Total revenues	$ 2.5	$ 2.7

Research and development expenses

	Three months ended March 31,	
Type of expense	**2010**	**2009**
Salary and other personnel costs (excluding non-cash share-based compensation)	$ 8.5	$ 10.9
Facility and equipment costs	3.7	4.0
External clinical and preclinical study fees and expenses	3.1	23.3
Research supplies	0.9	2.2
Non-cash share-based compensation	0.9	0.9
Other	1.2	1.3
Total research and development expenses	$ 18.3	$ 42.6

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General and administrative expenses

Type of expense	Three months ended March 31, 2010	2009
Salary and other personnel costs (excluding non-cash share-based compensation)	$ 2.3	$ 2.6
Legal, accounting and other professional fees	1.8	2.4
Non-cash share-based compensation	1.0	1.1
Facility and equipment costs	0.9	1.0
Other	1.0	0.5
Total general and administrative expenses	$ 7.0	$ 7.6

THREE MONTHS ENDED MARCH 31, 2010 AND 2009

Revenues. We recorded revenues of $2.5 million during the three months ended March 31, 2010, compared to $2.7 million during the three months ended March 31, 2009. Our revenues for the three months ended March 31, 2010 included $2.0 million under our manufacturing services agreement with Siegfried Ltd, or Siegfried, an increase of $0.6 million from the $1.4 million of manufacturing services revenues recorded in the three months ended March 31, 2009. Our revenues for the three months ended March 31, 2010 also included $0.5 million for patent activities, primarily related to our collaboration with Ortho-McNeil-Janssen Pharmaceuticals, Inc., or Ortho-McNeil-Janssen, compared to $1.3 million of such revenues recorded in the three months ended March 31, 2009.

Absent any new collaborations or achievement of a milestone in an existing collaboration, we expect our 2010 revenues will consist of reimbursement for patent activities from Ortho-McNeil-Janssen, recognition of the deferred revenues from our license agreement with TaiGen Biotechnology Co., Ltd., or TaiGen, and revenue under our manufacturing services agreement with Siegfried. Under such Siegfried agreement, until at least December 31, 2010, Siegfried may sub-contract to us the manufacture of certain drug products it previously manufactured for its customers, and we agreed to perform such manufacturing up to certain specified amounts. Also under such agreement, Siegfried guarantees a minimum level of cost absorption through the end of 2010, which we will record as revenues, of CHF 6.6 million for all of 2010. Using the exchange rate in effect on March 31, 2010, this would result in approximately $4.2 million in additional manufacturing services revenues for the balance of 2010.

Revenues from collaborators for milestones that may be achieved in the future are difficult to predict, and our revenues may vary significantly from quarter to quarter and year to year. We expect that any significant revenues for at least the short term will depend on whether we enter into an agreement with a pharmaceutical company or companies to commercialize lorcaserin or to collaborate on any of our other current or future drug candidates, as well as the clinical success of our collaboration with Ortho-McNeil-Janssen. Ultimately, we expect our revenues in the long term to primarily depend upon the regulatory approval and commercialization of our drug candidates.

Cost of manufacturing services. Cost of manufacturing services is comprised of direct costs associated with manufacturing drug products for Siegfried under our manufacturing services agreement, including related salaries, other personnel costs and machinery depreciation costs. Cost of manufacturing services of $1.9 million and $1.4 million were recorded for the three months ended March 31, 2010 and 2009, respectively.

Research and development expenses. Research and development expenses, which account for the majority of our expenses, consist primarily of salaries and other personnel costs, clinical trial costs (including payments to contract research organizations, or CROs), preclinical study fees, manufacturing costs, costs for the development of our earlier-stage programs and technologies, research supply costs and facility and equipment costs. We expense research and development costs to operations as they are incurred when these expenditures relate to our research and development efforts and have no alternative future uses. Other than external expenses for our clinical and preclinical programs, we generally do not track our research and development expenses by project; rather, we track such expenses by the type of cost incurred.

Research and development expenses decreased by $24.3 million to $18.3 million for the three months ended March 31, 2010, from $42.6 million for the three months ended March 31, 2009. The decrease was due primarily to decreases of (i) $20.2 million in external clinical and preclinical study fees and expenses due to completing our pivotal Phase 3 clinical trials and the refund of a fee we paid to the FDA in 2009 for their review of the NDA for lorcaserin and (ii) $2.4 million in salary and other personnel costs due to the workforce reduction we completed in June 2009. Although we expect to continue to incur substantial research and development expenses in 2010, including expenses related to lorcaserin manufacturing and our BLOOM-DM (Behavioral modification and Lorcaserin for Overweight and Obesity Management in Diabetes Mellitus)

trial, we expect our research and development expenses to be significantly lower than the 2009 level due to completion of our lorcaserin pivotal Phase 3 trials. We expect to incur substantial manufacturing

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costs for lorcaserin in 2010 and beyond, whether we market and commercialize lorcaserin independently or with a pharmaceutical company or companies. In late March 2010, we initiated a Phase 1 clinical trial of APD916, our drug candidate for the treatment of narcolepsy and cataplexy. This trial, which is expected to enroll up to 72 patients, will cost substantially less than the more expensive pivotal Phase 3 trials we conducted for lorcaserin.

Included in the $3.1 million total external clinical and preclinical study fees and expenses noted in the table above for the three months ended March 31, 2010 was $2.5 million related to our lorcaserin program, $0.3 million related to our APD811 program for the treatment of pulmonary arterial hypertension and $0.1 million related to our APD916 program. Included in the $23.3 million total external clinical and preclinical study fees and expenses noted in the table above for the three months ended March 31, 2009 was $22.7 million related to our lorcaserin program and $0.3 million related to APD125, which we previously studied for insomnia.

General and administrative expenses. General and administrative expenses decreased by $0.6 million to $7.0 million for the three months ended March 31, 2010, from $7.6 million for the three months ended March 31, 2009. This decrease was due primarily to decreases of (i) $0.7 million in legal and other professional fees, primarily patent fees, and (ii) $0.3 million in salary and other personnel costs as a result of our 2009 workforce reduction. These decreases were partially offset by a $0.5 million increase in market research expenses. We expect that, unless another company pays for commercialization expenses related to lorcaserin, our 2010 general and administrative expenses will increase significantly as a result of such expenses.

Amortization of acquired technology and other intangibles. We recorded $0.5 million for amortization of acquired technology and other intangibles for the three months ended March 31, 2010, compared to $0.6 million for the three months ended March 31, 2009. The amortization expense recorded in the three months ended March 31, 2010 relates to the manufacturing facility production licenses we acquired from Siegfried in January 2008, which are being amortized over their estimated useful life of 20 years, and the Melanophore technology, our primary screening technology, which is being amortized over its estimated useful life of 10 years. Using the exchange rate in effect on March 31, 2010, we expect to record amortization expense of approximately $0.5 million in the balance of 2010 and $0.6 million per year through 2027 for the manufacturing facility production licenses. We also expect to record remaining amortization expense related to our Melanophore technology of $1.2 million in the balance of 2010 and $0.3 million in 2011. We amortized the workforce we acquired from Siegfried in January 2008 through the