EXELIXIS INC
Form 10-Q
August 05, 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 July 2, 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: 000-30235

Exelixis, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**04-3257395**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

170 Harbor Way

P.O. Box 511

South San Francisco, California 94083

(Address of Principal Executive Offices) (Zip Code)

(650) 837-7000

(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 ¨

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 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. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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 ¨ No x

As of July 30, 2010, there were 108,655,580 shares of the registrant s common stock outstanding.

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EXELIXIS, INC.

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JULY 2, 2010

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EXELIXIS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	June 30, 2010 (unaudited)	December 31, 2009 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 157,202	$ 86,796
Marketable securities	55,593	116,290
Other receivables	6,028	11,864
Prepaid expenses and other current assets	16,025	15,050
Total current assets	234,848	230,000
Restricted cash and investments	6,399	6,444
Long-term investments	89,422	11,463
Property and equipment, net	20,923	29,392
Goodwill	63,684	63,684
Other assets	4,449	2,427
Total assets	$ 419,725	$ 343,410
LIABILITIES, NONCONTROLLING INTEREST AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	$ 3,343	$ 7,403
Accrued clinical trial liabilities	29,200	24,000
Other accrued liabilities	20,243	16,399
Accrued compensation and benefits	11,459	16,677
Current portion of notes payable and bank obligations	9,772	11,204
Current portion of convertible loans	28,050	28,050
Deferred revenue	119,948	103,385
Total current liabilities	222,015	207,118
Notes payable and bank obligations	89,422	11,463
Convertible loans	108,900	28,900
Other long-term liabilities	23,606	17,325
Deferred revenue	190,476	242,329
Total liabilities	634,419	507,135
Commitments		
Stockholders equity (deficit):		
Exelixis, Inc. stockholders deficit:		
Common stock	109	108
Additional paid-in-capital	940,765	925,736

Accumulated other comprehensive income	18	155
Accumulated deficit	(1,155,586)	(1,089,724)
Total Exelixis, Inc. stockholders deficit	(214,694)	(163,725)
Noncontrolling interest		
Total stockholders deficit	(214,694)	(163,725)
Total liabilities and stockholders deficit	$ 419,725	$ 343,410

(1) The condensed consolidated balance sheet at December 31, 2009 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

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

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EXELIXIS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenues:				
Contract	$ 12,308	$ 6,299	$ 32,048	$ 13,006
License	24,542	21,103	49,107	39,699
Collaboration reimbursements	10,746		8,640	
Total revenues	47,596	27,402	89,795	52,705
Operating expenses:				
Research and development	54,237	55,036	118,988	110,380
General and administrative	9,571	8,739	18,406	17,268
Collaboration cost sharing		1,639		(158)
Restructuring charge	9,419		25,484	
Total operating expenses	73,227	65,414	162,878	127,490
Loss from operations	(25,631)	(38,012)	(73,083)	(74,785)
Other income (expense):				
Interest income and other, net	393	367	709	921
Interest expense	(673)	(2,118)	(1,285)	(4,234)
Gain on sale of business	3,297	1,800	7,797	1,800
Loss on deconsolidation of Symphony Evolution, Inc.		(9,826)		(9,826)
Total other income (expense), net	3,017	(9,777)	7,221	(11,339)
Consolidated loss before taxes	(22,614)	(47,789)	(65,862)	(86,124)
Income tax benefit		846		846
Consolidated net loss	(22,614)	(46,943)	(65,862)	(85,278)
Loss attributable to noncontrolling interest.		2,181		4,337
Net loss attributable to Exelixis, Inc.	$ (22,614)	$ (44,762)	$ (65,862)	$ (80,941)
Net loss per share, basic and diluted, attributable to Exelixis, Inc.	$ (0.21)	$ (0.42)	$ (0.61)	$ (0.76)
Shares used in computing basic and diluted loss per share amounts	108,476	106,840	108,226	106,612

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EXELIXIS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended June 30,	
	2010	2009
Cash flows from operating activities:		
Consolidated net loss	$ (65,862)	$ (85,278)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	5,873	6,441
Stock-based compensation expense	11,281	11,573
Impairment of assets due to restructuring	2,481	
Gain on sale of business	(7,797)	(1,800)
Loss on deconsolidation of Symphony Evolution, Inc.		9,826
Other	1,653	195
Changes in assets and liabilities:		
Other receivables	5,836	(3,702)
Prepaid expenses and other current assets	(1,429)	(1,170)
Other assets	(1,701)	741
Accounts payable and other accrued expenses	(3,626)	(3,096)
Restructure liability	11,135	
Other long-term liabilities	(1,029)	885
Deferred revenue	(35,290)	10,838
Net cash used in operating activities	(78,475)	(54,547)
Cash flows from investing activities:		
Purchases of investments held by Symphony Evolution, Inc.		(49)
Proceeds on sale of investments held by Symphony Evolution, Inc.		4,497
Purchases of property and equipment	(831)	(842)
Proceeds from sale of property and equipment	168	
Proceeds on sale of business	8,600	
Increase (decrease) in restricted cash and investments	45	(729)
Proceeds from maturities of marketable securities	72,030	5,363
Proceeds from sale of marketable securities	12,780	
Purchases of marketable securities	(103,563)	(43,020)
Net cash used in investing activities	(10,771)	(34,780)
Cash flows from financing activities:		
Proceeds from exercise of stock options and warrants	1,004	2
Proceeds from employee stock purchase plan	2,122	2,150
Proceeds from note payable and bank obligations	162,508	
Principal payments on notes payable and bank obligations	(5,981)	(7,586)
Repayments, net from deconsolidation of Symphony Evolution, Inc.		(25)
Net cash provided by (used in) financing activities	159,653	(5,459)
Net increase in cash and cash equivalents	70,407	(94,786)
Cash and cash equivalents, at beginning of period	86,796	247,698

Cash and cash equivalents, at end of period	$ 157,203	$ 152,912

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

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2010

(unaudited)

NOTE 1. Organization and Summary of Significant Accounting Policies

Organization

Exelixis, Inc. (Exelixis, we, our or us) is committed to developing innovative therapies for cancer and other serious diseases. Through our drug discovery and development activities, we are building a portfolio of novel compounds that we believe have the potential to be high-quality, differentiated pharmaceutical products. Our most advanced pharmaceutical programs focus on drug discovery and development of small molecules in cancer.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and pursuant to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (GAAP) for complete financial statements. In our opinion, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the results of operations and cash flows for the period presented have been included.

Exelixis has adopted a 52- or 53-week fiscal year that ends on the Friday closest to December 31st of each year. Fiscal year 2009, a 52-week year, ended on January 1, 2010, and fiscal year 2010, a 52-week year, will end on December 31, 2010. For convenience, references in these Condensed Consolidated Financial Statements and Notes as of and for the fiscal year ended January 1, 2010 are indicated on a calendar year basis as ended December 31, 2009 and as of and for the fiscal quarters ended July 3, 2009 and July 2, 2010 are indicated as ended June 30, 2009 and 2010, respectively.

Operating results for the three and six months ended June 30, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2010 or for any future period. These financial statements and notes should be read in conjunction with the consolidated financial statements and notes thereto for the fiscal year ended December 31, 2009 included in our Annual Report on Form 10-K filed with the SEC on March 10, 2010.

Basis of Consolidation

The consolidated financial statements include the accounts of Exelixis and our wholly owned subsidiaries as well as one variable interest entity, Symphony Evolution, Inc. (SEI), for which we are the primary beneficiary. As of June 9, 2009, our purchase option for SEI expired and as a result, we were no longer considered to be the primary beneficiary (refer to Note 6 of the financial statements included in our Annual Report on Form 10-K filed with the SEC on March 10, 2010). All significant intercompany balances and transactions have been eliminated.

Cash and Investments

We consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. We invest in high-grade, short-term commercial paper and money market funds, which are subject to minimal credit and market risk.

All marketable securities are classified as available-for-sale and are carried at fair value. We view our available-for-sale portfolio as available for use in current operations. Accordingly, we have classified certain investments as short-term marketable securities, even though the stated maturity date may be one year or more beyond the current balance sheet date. Available-for-sale securities are stated at fair value based upon quoted market prices of the securities. We have classified certain investments as cash and cash equivalents or marketable securities that collateralize loan balances. However, they are not restricted to withdrawal. Unrealized gains and losses on available-for-sale investments are reported as a separate component of stockholders equity. Realized gains and losses, net, on available-for-sale securities are included in interest income. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as

available-for-sale are included in interest income.

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2010

(unaudited)

The following summarizes available-for-sale securities included in cash and cash equivalents and restricted cash and investments as of June 30, 2010 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Money market funds	$ 160,384	$	$	$ 160,384
Commercial paper	21,373			21,373
Corporate bonds	35,403	26	(14)	35,415
U.S. government agency securities	7,014	3		7,017
Government sponsored enterprises	83,426	4	(1)	83,429
Municipal bonds	2,430			2,430
Total	$ 310,030	$ 33	$ (15)	$ 310,048

As of June 30, 2010, debt securities had remaining maturities of less than one year.

The following summarizes available-for-sale securities included in cash and cash equivalents and restricted cash and investments as of December 31, 2009 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Money market funds	$ 74,465			$ 74,465
Commercial paper	24,277			24,277
Corporate bonds	55,808	152	(17)	55,943
U.S. government agency securities	11,077	8		11,085
Government sponsored enterprises	37,990	17	(1)	38,006
Municipal bonds	17,769		(3)	17,766
Total	$ 221,386	177	(21)	$ 221,542

Foreign Currency Forward Contract

We have entered into foreign currency forward contracts to reduce our net exposure to Eurodollar currency fluctuations. The original contract had a notional amount of approximately $7.0 million and expired in June 2010. In June 2010, we settled this contract for a net cash receipt of $0.7 million and entered into another foreign contract for a notional amount of $6.1 million that expires in October 2010. The fair value of the foreign currency contracts is estimated based on pricing models using readily observable inputs from actively quoted markets. As of June 30, 2010, the fair value of the current foreign currency forward contract was a loss of approximately $12,000, The net unrealized gain / loss on our foreign currency forward contracts, neither of which is designated as a hedge, is recorded in our statement of operations as Interest income and other (net).

Fair Value Measurements

The fair value of our financial instruments reflects the amounts that would be received upon sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The fair value hierarchy has the following three levels:

Level 1 quoted prices in active markets for identical assets and liabilities.

Level 2 observable inputs other than quoted prices in active markets for identical assets and liabilities.

Level 3 unobservable inputs.

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2010

(unaudited)

Our financial instruments are valued using quoted prices in active markets or based upon other observable inputs. The following tables set forth the fair value of our financial assets for the periods ended June 30, 2010 and December 31, 2009, respectively (in thousands):

As of June 30, 2010:

	Level 1	Level 2	Level 3	Total
Money market funds	$ 160,384	$	$	$ 160,384
Commercial paper		21,374		21,374
Corporate bonds		35,415		35,415
U.S. government agency securities		7,017		7,017
Government sponsored enterprises		83,429		83,429
Municipal bonds		2,430		2,430
Foreign currency forward contract [(1)]		(12)		(12)
Total	$ 160,384	$ 149,653	$	$ 310,037

(1) As of June 30, 2010, the fair value of our Level 2 current assets includes approximately $12,000 in unrealized losses related to a foreign exchange forward contract established during the quarter ended June 30, 2010.

As of December 31, 2009:

	Level 1	Level 2	Level 3	Total
Money market funds	$ 74,465	$	$	$ 74,465
Commercial paper		24,277		24,277
Corporate bonds		55,943		55,943
U.S. government agency securities		11,085		11,085
Government sponsored enterprises		38,006		38,006
Municipal bonds		17,766		17,766
Total	$ 74,465	$ 147,077	$	$ 221,542

We have estimated the fair value of our long-term debt instruments using the net present value of the payments discounted at an interest rate that is consistent with our current borrowing rate for similar long-term debt. The estimated fair value of our outstanding debt was as follows (in thousands):

	June 30, 2010	December 31, 2009

GlaxoSmithKline loan	$ 52,624	$ 50,191
Equipment lines of credit	19,061	22,530
Silicon Valley Bank Loan	77,287	
Deerfield convertible debt	80,000	
Total	$ 228,972	$ 72,721

At June 30, 2010 and December 31, 2009, we had debt outstanding of $236.1 million and $79.6 million, respectively. Our payment commitments associated with these debt instruments are generally fixed during the corresponding terms and are comprised of interest payments, principal payments or a combination thereof. The fair value of our debt will fluctuate with movements of interest rates, increasing in periods of declining rates of interest, and declining in periods of increasing rates of interest.

Collaboration Arrangements

Collaborative agreement reimbursement revenue or collaboration cost sharing expenses are recorded as earned or owed based on the performance requirements by both parties under the respective contracts. Under our 2008 cancer collaboration with Bristol-Myers Squibb Company (Bristol-Myers Squibb), both parties have been actively involved with compound development and certain research and development expenses were partially reimbursable to us on a net basis by compound. On an annual basis, amounts owed by Bristol-Myers Squibb to us, net of amounts reimbursable to Bristol-Myers Squibb by us on those projects, are recorded as collaboration reimbursement revenue. Conversely, research and development expenses may include the net settlement of amounts we owe Bristol-Myers Squibb for research and development expenses that Bristol-Myers Squibb incurred on joint development projects,

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2010

(unaudited)

less amounts reimbursable to us by Bristol-Myers Squibb on these projects. In 2009, when net research and development funding payments were payable to Bristol-Myers Squibb, these payments were presented as collaboration cost-sharing expense. However, during the fiscal year ending December 31, 2010 and in future fiscal years, we expect to be in a net receivable position, and will therefore present reimbursement payments as collaboration reimbursement revenue. Revenue and expenses from collaborations that are not co-development agreements are recorded as contract revenue or research and development expenses in the period incurred.

Recent Accounting Pronouncements

In March 2010, Accounting Standards Codification Topic 605, *Revenue Recognition* (ASC 605) was amended to define a milestone and clarify that the milestone method of revenue recognition is a valid application of the proportional performance model when applied to research or development arrangements. Accordingly, a company can make an accounting policy election to recognize a payment that is contingent upon the achievement of a substantive milestone in its entirety in the period in which the milestone is achieved. We will adopt this guidance in the third quarter of 2010 on a prospective basis. We are assessing the impact of this guidance on our consolidated results of operations and financial condition and do not expect it to have a material effect on our financial statements.

Accounting Standards Update No. 2009-13, Revenue Recognition Topic 605: *Multiple Deliverable Revenue Arrangements A Consensus of the FASB Emerging Issues Task Force* (ASU 2009-13) provides application guidance on whether multiple deliverables exist, how the deliverables should be separated and how the consideration should be allocated to one or more units of accounting. This update establishes a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor-specific objective evidence, if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific or third-party evidence is available. We expect to adopt this guidance prospectively beginning on January 1, 2011. We are assessing the impact of this guidance on our consolidated results of operations and financial condition.

In February 2010, Accounting Standards Codification Topic 855*, Subsequent Events* (ASC 855) was amended by Accounting Standards Update No. 2010-09 (ASU 2010-09), which removed the requirement that an entity disclose the date through which it evaluated subsequent events in its financial statements. ASU 2010-09 was effective upon issuance in February 2010 and did not have a material effect on our financial statements.

NOTE 2. Comprehensive Loss

Comprehensive loss represents consolidated net loss plus the results of certain stockholders equity changes, which are comprised of unrealized gains and losses on available-for-sale securities, not reflected in the consolidated statements of operations. Comprehensive loss was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Consolidated net loss	$ (22,614)	$ (46,943)	$ (65,862)	$ (85,278)
Increase in unrealized gains (losses) on available-for-sale securities	(81)	17	(138)	20
Comprehensive loss	(22,695)	(46,926)	(66,000)	(85,258)
Comprehensive loss attributable to the noncontrolling interest		2,181		4,337
Comprehensive loss attributable to Exelixis	$ (22,695)	$ (44,745)	$ (66,000)	$ (80,921)

NOTE 3. Stock-Based Compensation

We recorded and allocated employee stock-based compensation expenses as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Research and development expense	$ 3,023	$ 4,533	$ 6,672	$ 7,809
General and administrative expense	1,738	1,940	3,590	3,738
Restructuring-related stock compensation expense	(34)		961	
Total employee stock-based compensation expense	$ 4,727	$ 6,473	$ 11,223	$ 11,547

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2010

(unaudited)

We use the Black-Scholes option pricing model to value our stock options. The expected life computation is based on historical exercise patterns and post-vesting termination behavior. We considered implied volatility as well as our historical volatility in developing our estimate of expected volatility. The fair value of employee share-based payments awards was estimated using the following assumptions and weighted average fair values:

	Stock Options Three Months Ended June 30,		ESPP Three Months Ended June 30,	
	2010	2009	2010	2009
Weighted average fair value of awards	$ 3.50	$ 2.76	$ 2.01	$ 1.69
Risk-free interest rate	2.14%	2.20%	0.21%	0.18%
Dividend yield	0%	0%	0%	0%
Volatility	74%	67%	68%	65%
Expected life	5.2 years	5.6 years	0.5 years	0.2 years

	Stock Options Six Months Ended June 30,		ESPP Six Months Ended June 30,	
	2010	2009	2010	2009
Weighted average fair value of awards	$ 3.60	$ 2.67	$ 1.96	$ 1.77
Risk-free interest rate	2.25%	2.23%	0.18%	0.15%
Dividend yield	0%	0%	0%	0%
Volatility	70%	67%	63%	66%
Expected life	5.2 years	5.6 years	0.5 years	0.1 years

A summary of all stock option activity for the six months ended June 30, 2010 is presented below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Options outstanding at December 31, 2009	24,393,598	$ 7.46		
Granted	243,500	6.28		
Exercised	(192,267)	5.22		
Cancelled	(1,197,957)	6.94		
Options outstanding at June 30, 2010	23,246,874	$ 7.49	5.7 years	$ 7,703
Exercisable at June 30, 2010	11,527,336	$ 8.78	4.2 years	$ 4,020

As of June 30, 2010, $18.7 million of total unrecognized compensation expense related to employee stock options was expected to be recognized over a weighted-average period of 1.76 years.

A summary of all restricted stock unit (RSU) activity for the six months ended June 30, 2010 is presented below:

	Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
RSUs outstanding at December 31, 2009	2,679,224	$ 7.46		
Awarded	120,375	6.76		
Forfeited	(481,425)	7.49		
Awards outstanding at June 30, 2010	2,318,174	$ 7.42	1.84 years	$ 8,229,518

As of June 30, 2010, $11.8 million of total unrecognized compensation expense related to employee RSUs was expected to be recognized over a weighted-average period of 3.62 years.

NOTE 4. Collaborations

Bristol-Myers Squibb

2008 Cancer Collaboration. In December 2008, we entered into a worldwide collaboration with Bristol-Myers Squibb for XL184 and XL281. Upon effectiveness of the agreement, Bristol-Myers Squibb made an upfront cash payment of $195.0 million and

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

June 30, 2010

(unaudited)

additional license payments of $45.0 million, which were received in 2009. On June 18, 2010, we regained full rights to develop and commercialize XL184 following receipt of notice from Bristol-Myers Squibb of its decision to terminate the 2008 collaboration, solely as to XL184, on a worldwide basis.

Bristol-Myers Squibb received an exclusive worldwide license to develop and commercialize XL281. We will carry out certain clinical trials of XL281 which may include a backup program on XL281. Bristol-Myers Squibb is responsible for funding all future development on XL281, including our activities. We are eligible for development and regulatory milestones of up to $315.0 million on XL281, sales performance milestones of up to $150.0 million and double-digit royalties on worldwide sales of XL281.

The upfront payment of $195.0 million and the license payments of $45.0 million are being recognized ratably from the effective date of the agreement over the estimated development term and recorded as license revenue. Any milestone payments that we may receive under the agreement will be recognized ratably over the remaining development term but recorded as contract revenue. We record as operating expense 100% of the cost incurred for work performed by us under the collaboration. Prior to the termination of the collaboration as to XL184, there were periods during which Bristol-Myers Squibb partially reimbursed us for certain research and development expenses, and other periods during which we owed Bristol-Myers Squibb for research and development expenses that Bristol-Myers Squibb incurred on joint development projects, less amounts reimbursable to us by Bristol-Myers Squibb on these projects. For the year ended December 31, 2009, we incurred a net payable to Bristol-Myers Squibb and presented these payments as collaboration cost sharing expense. However, during the fiscal year ending December 31, 2010 and in future fiscal years, we expect to be in a net receivable position, and will therefore present these reimbursement payments as collaboration reimbursement revenue.

As a result of the termination of the 2008 collaboration with respect to XL184, we regained full rights to develop and commercialize XL184 and on June 28, 2010, in connection with the termination, we received a $17.0 million transition payment from Bristol-Myers Squibb. This transition payment was made in satisfaction of Bristol-Myers Squibb s obligations under the collaboration to continue to fund its share of development costs for XL184 for a period of three months following the notice of termination. As Bristol-Myers Squibb had already prepaid second quarter expenses, the $17.0 million will be recognized as collaboration reimbursement revenue in the third quarter of 2010. As a result of the termination, Bristol-Myers Squibb s license relating to XL184 has terminated and its rights to XL184 have reverted to us, and we will receive, subject to certain terms and conditions, licenses from Bristol-Myers Squibb to research, develop and commercialize XL184. The collaboration remains in full force and effect with respect to XL281. We have revised our estimated performance obligation under this agreement and reduced the term with which we ratably recognize the upfront and license fees from five years to four years and 8.5 months.

Amounts attributable to both programs under the 2008 Bristol-Myers Squibb collaboration agreement consisted of the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009 (2)	2010	2009 (2)
Exelixis research and development expenses (1)	$ 19,217	$ 9,908	$ 40,475	$ 19,769
Net amount due from (owed to) collaboration partner	10,746	$ (1,639)	8,640	158

(1) Total research and development expenses attributable to us include direct third party expenditures plus estimated internal personnel costs.
(2) The net amount owed to the collaborative partner is classified as an increase in operating expenses for the three months ended June 30, 2009. The net amount due from the collaborative partner is classified as a reduction in operating expenses for the six months ended June 30, 2009.

sanofi-aventis

On May 27, 2009, we entered into a global license agreement with sanofi-aventis for XL147 and XL765, and a broad collaboration for the discovery of inhibitors of phosphoinositide-3 kinase (PI3K) for the treatment of cancer. The license agreement and collaboration agreement became effective on July 7, 2009. The effectiveness of the license and collaboration on July 20, 2009 triggered upfront payments of $140.0 million ($120.0 million for the license and $20.0 million for the collaboration), which we received during the third quarter of fiscal 2009.

Under the license agreement, sanofi-aventis received a worldwide exclusive license to XL147 and XL765, which are currently in phase 1, phase 1b/2 and phase 2 clinical trials, and has sole responsibility for all subsequent clinical, regulatory, commercial and

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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manufacturing activities. It is expected that we will continue to participate in the conduct of ongoing and potential future clinical trials and manufacturing activities. Sanofi-aventis is responsible for funding all future development activities with respect to XL147 and XL765, including our activities. Under the collaboration agreement, the parties are combining efforts in establishing several preclinical PI3K programs and jointly share responsibility for research and preclinical activities related to isoform-selective inhibitors of PI3K-a and -ß. Sanofi-aventis will provide us with guaranteed annual research and development funding during the research term and is responsible for funding all development activities for each product following approval of the investigational new drug application filed with the applicable regulatory authorities for such product. Sanofi-aventis will have sole responsibility for all subsequent clinical, regulatory, commercial and manufacturing activities of any products arising from the collaboration; however, we may be requested to conduct certain clinical trials at sanofi-aventis expense. The research term under the collaboration is three years, although sanofi-aventis has the right to extend the term for an additional one-year period upon prior written notice.

In addition to the aggregate upfront cash payments for the license and collaboration agreements, we are entitled to receive guaranteed research funding of $21.0 million over three years to cover certain of our costs under the collaboration agreement. For both the license and the collaboration combined, we will be eligible to receive development, regulatory and commercial milestones of over $1.0 billion in the aggregate, as well as royalties on sales of any products commercialized under the license or collaboration. The aggregate upfront payments of $140.0 million will be recognized over the estimated research and development term of four years, and recorded as license revenue, from the effective date of the agreements. For the six months ended June 30, 2010, we recognized $17.5 million in license revenue related to such upfront payments. Any milestone payments that we may receive under the agreements will be amortized over the remaining research and development term and recorded as contract revenue. We will record as operating expenses all costs incurred for work performed by us under the agreements. Reimbursements we receive from sanofi-aventis under the agreements will be recorded as contract revenue as earned, commencing as of the effective date, including reimbursements for costs incurred under the license from the date of signing. In addition, the guaranteed research funding that we expect to receive over the three year research term under the collaboration will be recorded as contract revenue commencing as of the effective date of the collaboration. For the six months ended June 30, 2010, we recognized $21.9 million in contract revenue related to cost reimbursement and guaranteed research funding.

Sanofi-aventis may, upon certain prior notice to us, terminate the license as to products containing XL147 or XL765. In the event of such termination election, sanofi-aventis license relating to such product would terminate and revert to us, and we would receive, subject to certain terms, conditions and potential payment obligations, licenses from sanofi-aventis to research, develop and commercialize such products.

The collaboration will automatically terminate under certain circumstances upon the expiration of the research term, in which case all licenses granted by the parties to each other would terminate and revert to the respective party, subject to sanofi-aventis right to receive, under certain circumstances, the first opportunity to obtain a license from us to any isoform-selective PI3K inhibitor. In addition, sanofi-aventis may, upon certain prior written notice to us, terminate the collaboration in whole or as to certain products following expiration of the research term, in which case we would receive, subject to certain terms, conditions and potential payment obligations by us, licenses from sanofi-aventis to research, develop and commercialize such products.

Boehringer Ingelheim

On May 7, 2009, we entered into a collaboration agreement with Boehringer Ingelheim International GmbH (Boehringer Ingelheim) to discover, develop and commercialize products that consist of agonists of the sphingosine-1-phosphate type 1 receptor (S1P1R), a central mediator of multiple pathways implicated in a variety of autoimmune diseases.

Under the terms of the agreement, Boehringer Ingelheim paid us an upfront cash payment of $15.0 million for the development and commercialization rights to our S1P1R agonist program. We share responsibility for discovery activities under the collaboration. The agreement provides that the parties will each conduct research under a mutually agreed upon research plan until such time that we submit a compound that has met agreed-upon criteria, or such later time as agreed upon by the parties. The parties are responsible for their respective costs and expenses

incurred in connection with performing research under the collaboration. Under the collaboration, Boehringer Ingelheim also has the right, at its own expense, to conduct additional research on S1P1R agonists outside of the scope of the research plan agreed to by the parties. The agreement further provides that Boehringer Ingelheim will receive an exclusive worldwide license to further develop, commercialize and manufacture compounds developed under the collaboration and will have sole responsibility for, and shall bear all costs and expenses associated with, all subsequent preclinical, clinical, regulatory, commercial and manufacturing activities. In return, we will potentially receive up to $339.0 million in further development, regulatory and commercial milestones and are eligible to receive royalties on worldwide sales of products commercialized under the collaboration. The upfront payment is being recognized ratably over the estimated research term and recorded as license revenue from the effective date of the agreement. During the first half of 2010, the expected research term was extended from eleven months to twenty three months through March 2011, resulting in an extension of the term for revenue recognition purposes and a corresponding decrease in license revenue recognized each quarter. As of June 30, 2010, we had recognized a total of $12.9 million in license revenue under this agreement.

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Boehringer Ingelheim may, upon certain prior notice to us, terminate the agreement as to any product developed under the collaboration. In the event of such termination election, Boehringer Ingelheim s license relating to such product would terminate and revert to us, and we would receive, subject to certain terms and conditions, licenses from Boehringer Ingelheim to research, develop and commercialize such product.

NOTE 5: 2010 Restructuring Charge

On March 8, 2010, we implemented a restructuring plan that resulted in a reduction of our workforce by approximately 40%, or 270 employees. A small number of the terminated employees were subsequently recalled and the termination of a small group of employees has been delayed, all of whom continue to provide services to us. The remaining impacted employees were terminated immediately upon implementation of the plan or by March 31, 2010. The decision to restructure our operations was based on our recently announced corporate strategy to focus our efforts on our lead clinical compounds, XL184, XL147 and XL765, by dedicating the majority of our resources to aggressively drive these drug candidates through development towards commercialization.

In connection with the 2010 restructuring plan, we recorded a charge of approximately $16.1 million in the first quarter of 2010 primarily related to one-time termination benefits, which includes the modification of certain stock option awards previously granted to the terminated employees. The modification accelerates the vesting of any stock options that would have vested over the period beginning from cessation of employment through August 5, 2010. Employees who were terminated in March also received an additional two months to exercise their options, for which a small charge was taken. The remainder of the charge was for the impairment of various assets and for non-cash charges relating to the closure of our facility in San Diego, California. The total impairment charge of $2.5 million was due to the disposal and write-down to estimated fair-market value of fixed assets that were deemed redundant or will have a reduced useful life as a result of us vacating our San Diego facility and our planned exit of one of our South San Francisco facilities. The fair-value of the fixed assets impaired assumed that we would exit the South San Francisco building by June 30, 2010, which subsequently occurred. We recorded further restructuring expenses of approximately $9.4 million during the second quarter of 2010 associated primarily with lease-exit costs in connection with the sublease and exit of our South San Francisco building, partially offset by a reduction in one-time termination benefits following the recall of certain employees that were originally terminated under the restructuring plan and the continued delay in the termination of the small group of employees referred to above.

We expect that the restructuring plan will result in total cash expenditures of approximately $24.8 million, of which approximately $14.3 million is expected to be paid in 2010. The balance will be paid over an additional five years and primarily relates to net payments due under the lease for our South San Francisco building that we exited during the second quarter of 2010, partially offset by payments due to us under our sublease agreement that we signed in July 2010.

The outstanding restructuring liability is included in Accrued Compensation and Benefits , Other Accrued Expenses , and Other Long-Term Liabilities on our Condensed Consolidated Balance Sheet as of June 30, 2010 and the components are summarized in the following table (in thousands):

	Employee Severance And Other Benefits	Facility Charges	Asset Impairment	Legal and Other Fees	Total
Restructuring charge recorded in the three months ended March 31, 2010	$ 12,224	$ 1,216	$ 2,475	$ 150	$ 16,065
Restructuring charge recorded in the three months ended June 30 2010	(686)	10,218	7	(120)	9,419
Cash payments	(10,418)	(948)		(10)	(11,376)
	(1,082)	613	(2,482)		(2,951)

Adjustments or non-cash credits including stock compensation expense						
Ending accrual balance as of June 30, 2010	$	38	$ 11,099	$	$ 20	$ 11,157

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EXELIXIS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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NOTE 6: Debt

Silicon Valley Bank Loan and Security Agreement

In May 2002, we entered into a loan and security agreement with Silicon Valley bank for an equipment line of credit of up to $16.0 million with a draw down period of one year. Each draw on the line of credit has a payment term of 48 months and bears interest at the bank s published prime rate. We extended the draw down period on the line-of-credit for an additional year in June 2003 and increased the principal amount of the line of credit from $16.0 million to $19.0 million in September 2003. This equipment line of credit was fully drawn as of December 31, 2004 and was fully paid off as of December 31, 2007.

In December 2004, we entered into a loan modification agreement to the loan and security agreement originally entered into in May 2002. The terms associated with the original $16.0 million line of credit under the May 2002 agreement were not modified. The loan modification agreement provided for an additional equipment line of credit in the amount of up to $20.0 million with a draw down period of one year. Pursuant to the terms of the modified agreement, we were required to make interest only payments through February 2006 at an annual rate of 0.70% on all outstanding advances. This equipment line of credit was fully drawn as of March 31, 2006 and was fully paid off as of March 31, 2010.

In December 2006, we entered into a second loan modification agreement to the loan and security agreement originally entered into in May 2002. The terms associated with the original line of credit under the May 2002 agreement and December 2004 loan modification agreement were not modified. The December 2006 loan modification agreement provided for an additional equipment line of credit in the amount of up to $25.0 million with a draw down period of approximately one year. Each advance must be repaid in 48 equal, monthly installments of principal, plus accrued interest, at an annual rate of 0.85% fixed and is subject to a prepayment penalty of 1.0%. The loan facility is secured by a non-interest bearing certificate of deposit account with the bank, in an amount equal to at least 100% of the outstanding obligations under the line of credit. This equipment line of credit was fully drawn as of December 31, 2008. The collateral balance of $6.4 million is recorded in the accompanying consolidated balance sheet as cash and cash equivalents and marketable securities as the deposit account is not restricted as to withdrawal. The outstanding obligation under the line of credit as of June 30, 2010 and 2009 was $5.8 million and $12.1 million, respectively.

In December 2007, we entered into a third loan modification agreement to the loan and security agreement originally entered into in May 2002. The terms associated with the original line of credit under the May 2002 agreement and the subsequent loan modifications were not modified. The December 2007 loan modification agreement provides for an additional equipment line of credit in the amount of up to $30.0 million with a draw down period of approximately 2 years. Each advance must be repaid in 48 equal, monthly installments of principal, plus accrued interest, at an annual rate of 0.75% fixed. In December 2009, we amended the agreement and extended the draw down period on the line-of-credit for an additional 18 months through June 2011 and increased the principal amount of the line of credit from $30.0 million to $33.6 million. Pursuant to the terms of the amendment, we are required to make minimum draws of $2.5 million every 6 months through June 2011, for total additional draws of $7.5 million. We drew down 2.5 million in accordance with the terms of the modified agreement in June 2010. The loan facility requires security in the form of a non-interest bearing certificate of deposit account with the bank, in an amount equal to at least 100% of the outstanding obligations under the line of credit. In June 2008, we drew down $13.6 million under this agreement and in December 2009, we drew down $5.0 million. The collateral balance of $13.7 million is recorded in the accompanying consolidated balance sheet as cash and cash equivalents and marketable securities as the deposit account is not restricted as to withdrawal. The outstanding obligation under the line of credit as of June 30, 2010 and 2009 was $13.4 million and $10.0 million, respectively.

On June 2, 2010, we amended our loan and security agreement with Silicon Valley Bank to provide for a new seven-year term loan in the amount of $80.0 million. The principal amount outstanding under the term loan accrues interest at 1.00% per annum, which interest is due and payable monthly. We are required to repay the term loan in one balloon principal payment, representing 100% of the principal balance and accrued and unpaid interest, on May 31, 2017. We have the option to prepay all, but not less than all, of the amounts advanced under the term loan, provided that we pay all unpaid accrued interest thereon that is due through the date of such prepayment and the interest on the entire

principal balance of the term loan that would otherwise have been paid after such prepayment date until the maturity date of the term loan. We are required to maintain at all times on deposit in a non-interest bearing demand deposit account(s) with Silicon Valley Bank or one of its affiliates a compensating balance, which constitutes support for the obligations under the term loan, with a principal balance in value equal to at least 100% of the outstanding principal balance of the term loan. Any amounts outstanding under the term loan during the continuance of an event of default under the loan and security agreement will, at the election of Silicon Valley Bank, bear interest at a per annum rate equal to 6.00%. If one or more events of default under the loan and security agreement occurs and continues beyond any applicable cure period, Silicon Valley Bank may declare all or part of the obligations under the loan and security agreement to be immediately due and payable and stop advancing money or extending credit to us under the loan and security agreement.

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Deerfield Financing

On June 2, 2010, we entered into a note purchase agreement with Deerfield Private Design Fund, L.P. and Deerfield Private Design International, L.P. (collectively, Deerfield Entities), pursuant to which, on July 1, 2010, we sold to the Deerfield Entities an aggregate of $124.0 million initial principal amount of our secured convertible notes due June 2015 for an aggregate purchase price of $80.0 million, less closing fees and expenses of approximately $2.0 million. The outstanding principal amount of the notes bears interest in the annual amount of $6.0 million, payable quarterly in arrears. We will be required to make mandatory prepayments on the notes on an annual basis in 2013, 2014 and 2015 equal to 15% of certain revenues from our collaborative arrangements received during the prior fiscal year, subject to a maximum annual prepayment amount of $27.5 million and, for payments due in January 2013 and 2014, a minimum prepayment amount of $10.0 million. We may also prepay all or a portion (not less than $5.0 million) of the principal amount of the notes at an optional prepayment price based on a discounted principal amount (during the first three years of the term, subject to a prepayment premium) determined as of the date of prepayment, plus accrued and unpaid interest, plus in the case of a prepayment of the full principal amount of the notes (other than prepayments upon the occurrence of specified transactions relating to a change of control or a substantial sale of assets), all accrued interest that would have accrued between the date of such prepayment and the next anniversary of the note purchase agreement. At any time after July 1, 2011, subject to certain limitations (including a cap on the number of shares issuable under the note purchase agreement), we have the right to convert all or a portion of the principal amount of the notes into, or satisfy all or any portion of the optional prepayment amounts or mandatory prepayment amounts (other than the first $10.0 million of mandatory prepayments required in 2013 and 2014) with shares of our common stock. Additionally, in lieu of making any payment of accrued and unpaid interest in respect of the notes in cash, at any time after July 1, 2011, subject to certain limitations, we may elect to satisfy any such payment with shares of our common stock. The number of shares of our common stock issuable upon conversion or in settlement of principal and interest obligations will be based upon the discounted trading price of our common stock over a specified trading period. Upon certain changes of control of our company, a sale or transfer of assets in one transaction or a series of related transactions for a purchase price of more than $400 million or a sale or transfer of more than 50% of our assets, the Deerfield Entities may require us to prepay the notes at the optional prepayment price, plus accrued and unpaid interest and any other accrued and reimbursable expenses (the Put Price). Upon an event of default, the Deerfield Entities may declare all or a portion of the Put Price to be immediately due and payable.

We also entered into a security agreement in favor of the Deerfield Entities which provides that our obligations under the notes will be secured by substantially all of our assets except intellectual property. The note purchase agreement and the security agreement include customary representations and warranties and covenants made by us, including restrictions on the incurrence of additional indebtedness.

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

The following discussion and analysis contains forward-looking statements. These statements are based on our current expectations, assumptions, estimates and projections about our business and our industry, and involve known and unknown risks, uncertainties and other factors that may cause our or our industry s results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied in, or contemplated by, the forward-looking statements. Words such as believe, anticipate, expect, intend, plan, will, determine, may, could, would, estimate, goal, predict, potential, continue or the negative of such terms or other similar expressions identify forward-looking statements. Our actual results and the timing of events may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a difference include those discussed in Part II, Item 1A of this Form 10-Q, as well as those discussed elsewhere in this report.

This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in this report and the financial statements and accompanying notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, filed with the Securities and Exchange Commission, or SEC, on March 10, 2010. Operating results are not necessarily indicative of results that may occur in future periods. We undertake no obligation to update any forward-looking statement to reflect events after the date of this report.

Overview

We are committed to discovering, developing and commercializing innovative therapies for the treatment of cancer and other serious diseases. Through our integrated drug discovery and development activities, we are building a portfolio of novel compounds that we believe have the potential to be high-quality, differentiated pharmaceutical products that can make a meaningful difference in the lives of patients. The majority of our programs focus on discovery and development of small molecule drugs for cancer.

We have established a leading discovery platform that has enabled us to efficiently and rapidly identify highly qualified drug candidates that meet our extensive development criteria. Our goal has been to generate a diverse and deep pipeline while focusing our resources on those drug candidates that we believe have the highest therapeutic and commercial potential. The rapid development of three of those drug candidates is a primary focus of the company.

XL184, our most advanced drug candidate, inhibits MET, VEGFR2 and RET, proteins that are key drivers of tumor growth and/or vascularization. XL184 is the most advanced inhibitor of MET in clinical development and is being evaluated in a broad development program encompassing multiple solid tumor indications. A global phase 3 registration trial of XL184 as a potential treatment for medullary thyroid cancer is currently enrolling. Assuming positive results from this registration trial, we currently expect to submit a new drug application, or NDA, for XL184 as a treatment for medullary thyroid cancer in the United States in the second half of 2011. In addition to advancing our ongoing phase 3 trial in medullary thyroid cancer, we are currently planning to initiate a phase 3 registration trial of XL184 as a potential treatment for recurrent glioblastoma by the end of 2010, based on encouraging data from the ongoing phase 2 clinical evaluation in this indication presented at the American Society of Clinical Oncology conference in June 2010. An immediate priority for us is to generate additional data in the five leading cohorts of hepatocellular carcinoma, melanoma, non-small cell lung cancer, ovarian cancer and prostate cancer in our ongoing randomized discontinuation trial to support the prioritization of our clinical and commercial options for XL184. Additional phase 2 clinical trials of XL184 in glioblastoma, non-small cell lung cancer and other solid tumor indications are also ongoing.

We are also actively pursuing the development of XL147 and XL765, leading inhibitors of phosphoinositide-3 kinase, or PI3K, that we out-licensed to sanofi-aventis in 2009. XL147 is a selective inhibitor of PI3K while XL765 is a dual inhibitor of PI3K and mTOR. Sanofi-aventis is responsible for funding all development activities with respect to XL147 and XL765, including our activities. We currently are conducting the majority of the clinical trials for these compounds. XL147 and XL765 are currently being evaluated in a series of phase 1b/2 clinical trials for a variety of solid tumor indications and a broad phase 2 clinical trial program that commenced in early 2010.

We also have several earlier novel drug candidates in clinical development for the treatment of cancer, and preclinical programs for cancer, metabolic disease and inflammation. Based on the strength of our expertise in biology, drug discovery and development, we have established collaborations with leading pharmaceutical and biotechnology companies, including Bristol-Myers Squibb, sanofi-aventis, Genentech, Boehringer Ingelheim GmbH, GlaxoSmithKline and Daiichi-Sankyo that allow us to retain economic participation in compounds and support additional development of our pipeline. Our collaborations generally fall into one of two categories: collaborations in which we co-develop compounds with a partner, share development costs and profits from commercialization and may have the right to co-promote products in the United States, and collaborations in which we out-license compounds to a partner for further development and commercialization, have no further unreimbursed cost obligations and are entitled

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to receive milestones and royalties or a share of profits from commercialization. Under either form of collaboration, we may also be entitled to license fees, research funding and milestone payments from research results and subsequent product development activities. Reimbursement revenues and expenses under co-development collaborations are recorded as collaboration reimbursement revenue and collaboration cost-sharing expenses, respectively, while reimbursement revenues and expenses under other collaborations are recorded as contract revenue and research and development expenses in the period incurred.

Our Strategy

Our business strategy is to leverage our biological expertise and integrated research and development capabilities to generate a pipeline of development compounds with significant therapeutic and commercial potential for the treatment of cancer and potentially other serious diseases.

Our strategy consists of three principal elements:

Focus on lead clinical compounds We are focusing our development efforts on XL184, XL147 and XL765. These drug candidates are the most advanced in our pipeline, and we believe that they have the greatest near-term therapeutic and commercial potential. As a result, we are dedicating the majority of our resources to aggressively advance these drug candidates through development toward commercialization.

Partner compounds We continue to pursue new collaborations with leading pharmaceutical and biotechnology companies for the development and ultimate commercialization of some of our preclinical and clinical compounds, particularly those drug candidates for which we believe that the capabilities and resources of a partner can accelerate development and help to fully realize their therapeutic and commercial potential. Collaborations provide us with a means of shifting all or a portion of the development costs related to partnered drug candidates and provide financial resources that we can apply to fund our share of the development of our lead clinical compounds and other areas of our pipeline. Our goal is to increase the portion of our development expenses that are reimbursed by partners while maintaining financial upside from potential downstream milestones and royalties if these drug candidates are marketed in the future.

Control costs We are committed to managing our costs, and we continually analyze our expenses to align expenses with our cash resources. We are selective with respect to funding our clinical development programs and have established definitive go/no-go criteria to ensure that we commit our resources only to those programs that we believe have the greatest therapeutic and commercial potential.

We are conducting a comprehensive evaluation of various options for advancing XL184 in light of emerging clinical data and the recent termination of our collaboration with Bristol-Myers Squibb with respect to this compound, as described in more detail below. The evaluation includes a review of the clinical data and priorities, potential partnering scenarios, regulatory strategies, the competitive landscape and financial considerations. Our goal remains to appropriately deploy our resources in a manner that is designed to maximize the therapeutic and commercial potential of XL184.

Our Pipeline

Overview

We have an extensive pipeline of compounds in various stages of development that will potentially treat cancer and various metabolic, cardiovascular and inflammatory disorders. All of our development compounds were generated through our internal drug discovery efforts, although we are developing certain of these compounds in collaboration with partners and have out-licensed others. We are focusing our development efforts on our lead clinical compounds, XL184, XL147 and XL765. These drug candidates are the most advanced in our pipeline, and we believe that they have the greatest near-term therapeutic and commercial potential. As a result, we are dedicating the majority of our resources to aggressively advance these drug candidates through development towards commercialization.

The following table sets forth compounds that we are developing independently or are co-developing with a partner:

Compound	Partner	Principal Targets	Indication	Stage of Development
XL184	Unpartnered	MET, VEGFR2, RET	Cancer	Phase 3
XL139	Bristol-Myers Squibb	Hedgehog	Cancer	Phase 1b
XL888	Unpartnered	HSP90	Cancer	Phase 1
XL499	Unpartnered	PI3K-d	Cancer and inflammation	Preclinical

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The following table sets forth those compounds that we have out-licensed to third parties:

Compound	Partner	Principal Targets	Indication	Stage of Development
XL880	GlaxoSmithKline	MET, VEGFR2	Cancer	Phase 2
XL147	sanofi-aventis	PI3K	Cancer	Phase 1b/2
XL765	sanofi-aventis	PI3K, mTOR	Cancer	Phase 1b/2
XL518	Genentech	MEK	Cancer	Phase 1b
XL281	Bristol-Myers Squibb	RAF	Cancer	Phase 1
XL652	Bristol-Myers Squibb	LXR	Metabolic and cardiovascular diseases	Phase 1
XL041	Bristol-Myers Squibb	LXR	Metabolic and cardiovascular diseases	Phase 1
XL550	Daiichi-Sankyo	MR	Metabolic and cardiovascular diseases	Preclinical
FXR	Pfizer	FXR	Metabolic and liver disorders	Preclinical
S1P1R	Boehringer Ingelheim	S1P1R (agonist)	Inflammation	Preclinical
Isoform Selective PI3Ka and PI3Kb	sanofi-aventis	PI3Ka and PI3Kb	Cancer	Preclinical

The following table sets forth those compounds for which we are pursuing collaborations or other external opportunities:

Compound	Principal Targets	Indication	Stage of Development
XL228	IGF1R , ABL, SRC	Cancer	Phase 1
XL388	TORC1 & 2	Cancer	IND
XL541	S1P1R (antagonist)	Cancer	Preclinical
XL475	TGR5 (agonist)	Metabolic disease	Preclinical

Recent Developments

Entry into Sublease

On July 9, 2010, in connection with our restructuring plan announced in March 2010, we entered into a sublease with Onyx Pharmaceuticals, Inc., or Onyx, with respect to approximately 68,738 square feet of the property located at 249 East Grand Avenue, South San Francisco, California. The subleased premises comprise substantially all of the 71,746 square feet of the property currently leased by us. The term of the sublease will commence on the later to occur of September 1, 2010 and 25 days after delivery of the premises to Onyx, and will expire on November 30, 2015, the end of our lease term. Under the sublease, Onyx will pay us monthly base rent for the subleased premises in addition to certain operating expenses. In connection with the execution and delivery of the sublease, we also entered into an amendment to our lease with the landlord, pursuant to which, among other things, our right to extend the term of the lease was terminated.

Appointment of New President and Chief Executive Officer

On June 29, 2010, our Board of Directors named Michael Morrissey, Ph.D. to serve as our President and Chief Executive Officer, effective July 15, 2010. In conjunction with his appointment as President and Chief Executive Officer, Dr. Morrissey also serves as a member of our Board of Directors. Prior to his appointment, Dr. Morrissey served as our President of Research and Development, a position he held since January 2007. Dr. Morrissey has served in numerous other positions with us since February 2000. From January 2006 to December 2006, Dr. Morrissey served as Executive Vice President, Discovery, from January 2003 to December 2005, he served as Senior Vice President, Discovery and from February 2000 to December 2002, he served as Vice President of Discovery Research. Dr. Morrissey replaces George Scangos, Ph.D., who resigned effective July 15, 2010 to become President and Chief Executive Officer of Biogen Idec, Inc.

Rights to XL184 Regained

On June 18, 2010, we regained full rights to develop and commercialize XL184 under our 2008 collaboration agreement with Bristol-Myers Squibb. Under the collaboration, we had agreed to co-develop XL184 with Bristol-Myers Squibb and Bristol-Myers

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Squibb received an exclusive worldwide license to develop and commercialize XL281. On June 18, 2010, we received a notice from Bristol-Myers Squibb of its decision to terminate the 2008 collaboration, solely as to XL184, on a worldwide basis. Bristol-Myers Squibb informed us that the termination was based upon its review of XL184 in the context of Bristol-Myers Squibb s overall research and development priorities and pipeline products. On June 28, 2010, in connection with the termination, we received a $17.0 million transition payment from Bristol-Myers Squibb, which we will recognize as collaboration reimbursement revenue in the third quarter of 2010. The transition payment was made in satisfaction of Bristol-Myers Squibb s obligations under the collaboration to continue to fund its share of development costs for XL184 for a period of three months following the notice of termination. As a result of the termination, Bristol-Myers Squibb s license relating to XL184 has terminated and its rights to XL184 have reverted to us, and we will receive, subject to certain terms and conditions, licenses from Bristol-Myers Squibb to research, develop and commercialize XL184. The collaboration remains in full force and effect with respect to XL281.

Amendment to Loan Agreement with Silicon Valley Bank

On June 2, 2010, we amended our loan and security agreement with Silicon Valley Bank to provide for a new seven-year term loan in the amount of $80.0 million. The principal amount outstanding under the term loan accrues interest at 1.00% per annum, which interest is due and payable monthly. We are required to repay the term loan in one balloon principal payment, representing 100% of the principal balance and accrued and unpaid interest, on May 31, 2017. We have the option to prepay all, but not less than all, of the amounts advanced under the term loan, *provided* that we pay all unpaid accrued interest thereon that is due through the date of such prepayment and the interest on the entire principal balance of the term loan that would otherwise have been paid after such prepayment date until the maturity date of the term loan. We are required to maintain at all times on deposit in a non-interest bearing demand deposit account(s) with Silicon Valley Bank or one of its affiliates a compensating balance, which constitutes support for the obligations under the term loan, with a principal balance in value equal to at least 100% of the outstanding principal balance of the term loan. Any amounts outstanding under the term loan during the continuance of an event of default under the loan and security agreement will, at the election of Silicon Valley Bank, bear interest at a per annum rate equal to 6.00%. If one or more events of default under the loan and security agreement occurs and continues beyond any applicable cure period, Silicon Valley Bank may declare all or part of the obligations under the loan and security agreement to be immediately due and payable and stop advancing money or extending credit to us under the loan and security agreement.

Deerfield Financing

On June 2, 2010, we entered into a note purchase agreement with Deerfield Private Design Fund, L.P. and Deerfield Private Design International, L.P., or the Deerfield Entities, pursuant to which, on July 1, 2010, we sold to the Deerfield Entities an aggregate of $124.0 million initial principal amount of our secured convertible notes due June 2015 for an aggregate purchase price of $80.0 million, less closing fees and expenses of approximately $2.0 million. The outstanding principal amount of the notes bears interest in the annual amount of $6.0 million, payable quarterly in arrears. We will be required to make mandatory prepayments on the notes on an annual basis in 2013, 2014 and 2015 equal to 15% of certain revenues from our collaborative arrangements received during the prior fiscal year, subject to a maximum annual prepayment amount of $27.5 million and, for payments due in January 2013 and 2014, a minimum prepayment amount of $10.0 million. We may also prepay all or a portion (not less than $5.0 million) of the principal amount of the notes at an optional prepayment price based on a discounted principal amount (during the first three years of the term, subject to a prepayment premium) determined as of the date of prepayment, plus accrued and unpaid interest, plus in the case of a prepayment of the full principal amount of the notes (other than prepayments upon the occurrence of specified transactions relating to a change of control or a substantial sale of assets), all accrued interest that would have accrued between the date of such prepayment and the next anniversary of the note purchase agreement. At any time after July 1, 2011, subject to certain limitations (including a cap on the number of shares issuable under the note purchase agreement), we have the right to convert all or a portion of the principal amount of the notes into, or satisfy all or any portion of the optional prepayment amounts or mandatory prepayment amounts (other than the first $10.0 million of mandatory prepayments required in 2013 and 2014) with shares of our common stock. Additionally, in lieu of making any payment of accrued and unpaid interest in respect of the notes in cash, at any time after July 1, 2011, subject to certain limitations, we may elect to satisfy any such payment with shares of our common stock. The number of shares of our common stock issuable upon conversion or in settlement of principal and interest obligations will be based upon the discounted trading price of our common stock over a specified trading period. Upon certain changes of control of our company, a sale or transfer of assets in one transaction or a series of related transactions for a purchase price of more than $400 million or a sale or transfer of more than 50% of our assets, the Deerfield Entities may require us to prepay the notes at the optional prepayment price, plus accrued and unpaid interest and any other accrued and reimbursable expenses, or the Put Price. Upon an event of default, the Deerfield Entities may declare all or a portion of the Put Price to be immediately due and payable.

We also entered into a security agreement in favor of the Deerfield Entities which provides that our obligations under the notes will be secured by substantially all of our assets except intellectual property. The note purchase agreement and the security agreement include customary representations and warranties and covenants made by us, including restrictions on the incurrence of additional indebtedness.

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Certain Factors Important to Understanding Our Financial Condition and Results of Operations

Successful development of drugs is inherently difficult and uncertain. Our business requires significant investments in research and development over many years, often for products that fail during the research and development process. Our long-term prospects depend upon our ability and the ability of our partners to successfully commercialize new therapeutics in highly competitive areas such as cancer treatment. Our financial performance is driven by many factors, including those described below.

Limited Sources of Revenues

We currently have no pharmaceutical products that have received marketing approval, and we have generated no revenues to date from the sale of such products. We do not expect to generate revenues from the sale of pharmaceutical products in the near term and expect that all of our near term revenues, such as research and development funding, license fees and milestone payments and royalty revenues, will be generated from collaboration agreements with our current and potential future partners. Milestones under these agreements may be tied to factors that are outside of our control, such as significant clinical or regulatory events with respect to compounds that have been licensed to our partners.

Clinical Trials

We currently have multiple compounds in clinical development and expect to expand the development programs for our compounds. Our compounds may fail to show adequate safety or efficacy in clinical testing. Furthermore, predicting the timing of the initiation or completion of clinical trials is difficult, and our trials may be delayed due to many factors, including factors outside of our control. The future development path of each of our compounds depends upon the results of each stage of clinical development. In general, we will incur increased operating expenses for compounds that advance in clinical development, whereas expenses will end for compounds that do not warrant further clinical development.

We are responsible for all development costs for compounds in our pipeline that are not partnered and for a portion of development costs for those compounds that we are co-developing with partners. We share development costs with partners in our co-development collaborations and have no unreimbursed cost obligations with respect to compounds that we have out-licensed.

Liquidity

As of June 30, 2010, we had $308.6 million in cash and cash equivalents and short-term and long-term marketable securities, which included restricted cash and investments of $6.4 million. We anticipate that our current cash and cash equivalents, short-term and long-term marketable securities and funding that we expect to receive from collaborators, which includes anticipated cash from additional business development activity, will enable us to maintain our operations for a period of at least 12 months following the filing date of this report. However, our future capital requirements will be substantial and depend on many factors, including the following:

- whether we repay amounts outstanding under our loan and security agreement with GlaxoSmithKline (described below) in cash or shares of our common stock;
- whether we elect to issue shares of our common stock in respect of any conversion of our principal, prepayments or payments of interest in connection with the secured convertible notes we issued to the Deerfield Entities under the note purchase agreement;
- the progress and scope of the development activity with respect to XL184, our most advanced compound;
- the progress and scope of other research and development activities conducted by us;
- the level of payments received under existing collaboration agreements, licensing agreements and other arrangements;

the degree to which we conduct funded development activity on behalf of partners to whom we have out-licensed compounds; and

whether we enter into new collaboration agreements, licensing agreements or other arrangements (including in particular with respect to XL184) that provide additional capital.

Our minimum liquidity needs are also determined by financial covenants in our loan and security agreement, as amended, with GlaxoSmithKline, our loan and security agreement with Silicon Valley Bank and our note purchase agreement with the Deerfield

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Entities, as well as other factors, which are described under Liquidity and Capital Resources Cash Requirements . In particular, our loan and security agreement with Silicon Valley Bank requires that we maintain $80.0 million at all times on deposit in a non-interest bearing demand deposit account(s) as support for our obligations under the loan and security agreement.

Our ability to raise additional funds may be severely impaired if any of our product candidates fails to show adequate safety or efficacy in clinical testing.

sanofi-aventis

In May 2009, we entered into a global license agreement with sanofi-aventis for XL147 and XL765 and a broad collaboration for the discovery of inhibitors of PI3K for the treatment of cancer. The license agreement and collaboration agreement became effective on July 7, 2009. In connection with the effectiveness of the license and collaboration on July 20, 2009, we received upfront payments of $140.0 million ($120.0 million for the license and $20.0 million for the collaboration), less applicable withholding taxes of $7.0 million, for a net receipt of $133.0 million. We expect to receive a refund payment from the French government in 2010 with respect to the withholding taxes previously withheld.

Under the license agreement, sanofi-aventis received a worldwide exclusive license to XL147 and XL765, which are currently in phase 1, phase 1b/2 and phase 2 clinical trials, and has sole responsibility for all subsequent clinical, regulatory, commercial and manufacturing activities. It is expected that we will continue to participate in the conduct of ongoing and potential future clinical trials and manufacturing activities. Sanofi-aventis is responsible for funding all future development activities with respect to XL147 and XL765, including our activities. Under the collaboration agreement, the parties are combining efforts in establishing several pre-clinical PI3K programs and jointly share responsibility for research and preclinical activities related to isoform-selective inhibitors of PI3K-a and -ß. Sanofi-aventis will provide us with guaranteed annual research and development funding during the research term and is responsible for funding all development activities for each product following approval of the investigational new drug application filed with the applicable regulatory authorities for such product. Sanofi-aventis will have sole responsibility for all subsequent clinical, regulatory, commercial and manufacturing activities of any products arising from the collaboration; however, we may be requested to conduct certain clinical trials at sanofi-aventis expense. The research term under the collaboration is three years, although sanofi-aventis has the right to extend the term for an additional one-year period upon prior written notice.

In addition to the aggregate upfront cash payments for the license and collaboration agreements, we are entitled to receive guaranteed research funding of $21.0 million over three years to cover certain of our costs under the collaboration agreement. For both the license and the collaboration combined, we will be eligible to receive development, regulatory and commercial milestones of over $1.0 billion in the aggregate, as well as royalties on sales of any products commercialized under the license or collaboration.

Sanofi-aventis may, upon certain prior notice to us, terminate the license as to products containing XL147 or XL765. In the event of such termination election, sanofi-aventis license relating to such product would terminate and revert to us, and we would receive, subject to certain terms, conditions and potential payment obligations, licenses from sanofi-aventis to research, develop and commercialize such products.

The collaboration will automatically terminate under certain circumstances upon the expiration of the research term, in which case all licenses granted by the parties to each other would terminate and revert to the respective party, subject to sanofi-aventis right to receive, under certain circumstances, the first opportunity to obtain a license from us to any isoform-selective PI3K inhibitor. In addition, sanofi-aventis may, upon certain prior written notice to us, terminate the collaboration in whole or as to certain products following expiration of the research term, in which case we would receive, subject to certain terms, conditions and potential payment obligations by us, licenses from sanofi-aventis to research, develop and commercialize such products.

2008 Cancer Collaboration with Bristol-Myers Squibb

In December 2008, we entered into a worldwide collaboration with Bristol-Myers Squibb for XL184 and XL281. Upon effectiveness of the agreement in December 2008, Bristol-Myers Squibb made an upfront cash payment of $195.0 million for the development and commercialization rights to both programs. The agreement required Bristol-Myers Squibb to make additional license payments to us of $45.0 million, which were received during 2009. On June 18, 2010, we regained full rights to develop and commercialize XL184 under our collaboration agreement with Bristol-Myers Squibb following receipt of notice from Bristol-Myers Squibb of its decision to terminate the 2008 collaboration, solely as to XL184, on a worldwide basis, as described above under Recent Developments Rights to XL184 Regained.

We and Bristol-Myers Squibb agreed to co-develop XL184, and potentially a backup program for XL184. The companies were obligated to share worldwide (except for Japan) development costs for XL184. We were responsible for 35% of such costs and Bristol-Myers Squibb was responsible for 65% of such costs, except that we were responsible for funding the initial $100.0 million of

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combined costs and had the option to defer payments for development costs above certain thresholds. We completed our required funding of the initial $100.0 million of the combined costs during the second quarter of 2010, after which we were responsible for 35% of the combined costs going forward. In return, we would share 50% of the commercial profits and losses (including pre-launch commercialization expenses) in the United States and have the option to co-promote XL184 in the United States. Bristol-Myers Squibb was responsible for all costs intended to support regulatory approval in Japan. We had the right to defer payment for certain early commercialization and other related costs above certain thresholds. We were eligible to receive sales performance milestones of up to $150.0 million and double-digit royalties on sales on XL184 outside the United States. The clinical development of XL184 was directed by a joint committee.

Under the terms of the collaboration, Bristol-Myers Squibb received an exclusive worldwide license to develop and commercialize XL281. We will carry out certain clinical trials of XL281 which may include a backup program on XL281. Bristol-Myers Squibb is responsible for funding all future development of XL281, including our activities. We are eligible for development and regulatory milestones of up to $315.0 million on XL281, sales performance milestones of up to $150.0 million and double-digit royalties on worldwide sales of XL281.

The upfront payment of $195.0 million we received upon effectiveness of the collaboration agreement and the license payments of $20.0 million and $25.0 million that we received in the first quarter and second quarter of 2009, respectively, will be recognized ratably over the estimated development term, and recorded as license revenue, from the effective date of the agreement in December 2008. During the second quarter of 2010, we revised the development term from five years to four years and 8.5 months, which is our current estimate of the term of our performance obligation under the collaboration. Any milestone payments that we may receive under the agreement will be recognized ratably over the same revised period but will be recorded as contract revenue. We will record as operating expense 100% of the cost incurred for work performed by us on XL281.

Prior to the termination of the collaboration by Bristol-Myers Squibb as to XL184, there were periods during which Bristol-Myers Squibb partially reimbursed us for certain research and development expenses, and other periods during which we owed Bristol-Myers Squibb for research and development expenses that Bristol-Myers Squibb incurred on joint development projects, less amounts reimbursable to us by Bristol-Myers Squibb on these projects. To the extent that net research and development funding payments were received from Bristol-Myers Squibb, these payments were presented as collaboration reimbursement revenue. In periods when net research and development funding payments were payable to Bristol-Myers Squibb, these payments were presented as collaboration cost sharing expense. Notwithstanding termination by Bristol-Myers Squibb, revenues from the collaboration will continue to be determined and reflected on an annual basis. As we fulfilled our responsibility for funding the initial $100.0 million of combined costs in the second quarter of 2010 and received reimbursements from Bristol-Myers Squibb prior to the termination of the collaboration as to XL184, we expect to be in a net receivable position for the fiscal year ending December 31, 2010 and in future fiscal years, and will therefore present reimbursement payments as collaboration reimbursement revenue.

GlaxoSmithKline Loan Repayment Obligations

In October 2002, we entered into a collaboration with GlaxoSmithKline to discover and develop novel therapeutics in the areas of vascular biology, inflammatory disease and oncology. As part of the collaboration, we entered into a loan and security agreement with GlaxoSmithKline, pursuant to which we borrowed $85.0 million for use in our efforts under the collaboration. The loan bears interest at a rate of 4.0% per annum and is secured by certain intellectual property, technology and equipment created or utilized pursuant to the collaboration. As of June 30, 2010, the aggregate principal and interest outstanding under our GlaxoSmithKline loan was $72.0 million, after giving effect to a cash payment we made to GlaxoSmithKline of $34.7 million on October 27, 2009 for the first of three annual installments of principal and accrued interest due under the loan. The second and third installments of principal and accrued interest under the loan are due on October 27, 2010 and October 27, 2011, respectively. Repayment of all or any of the amounts advanced to us under the loan agreement may, at our election, be made in the form of our common stock at fair market value, subject to certain conditions, or cash. Following the conclusion on October 27, 2008 of the development term under our collaboration with GlaxoSmithKline, we are no longer eligible to receive selection milestone payments from GlaxoSmithKline to credit against outstanding loan amounts, and in the event the market price for our common stock is depressed, we may not be able to repay the loan in full using shares of our common stock due to restrictions in the agreement on the number of shares we may issue. In addition, the issuance of shares of our common stock to repay the loan may result in significant dilution to our stockholders. As a result, we may need to obtain additional funding to satisfy our repayment obligations. There can be no assurance that we will have sufficient funds to repay amounts outstanding under the loan when due or that we will satisfy the conditions to our ability to repay the loan in shares of our common stock.

We believe that the capital provided by our June 2010 financing transactions with Silicon Valley Bank and the Deerfield Entities will enable us to meet our remaining obligations under the loan.

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Critical Accounting Estimates

Our consolidated financial statements and related notes are prepared in accordance with U.S. generally accepted accounting principles, or GAAP, which require us to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and related disclosure of contingent assets and liabilities. We have based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our senior management has discussed the development, selection and disclosure of these estimates with the Audit Committee of our Board of Directors. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is considered to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the financial statements. We believe the following critical accounting policies reflect the more significant estimates and assumptions used in the preparation of our consolidated financial statements.

Revenue Recognition

Our revenues are derived from three primary sources: license fees, milestone payments and collaborative agreement reimbursements.

Revenues from license fees and milestone payments primarily consist of up-front license fees and milestone payments received under various collaboration agreements. We initially recognize upfront fees received from third party collaborators as unearned revenue and then recognize these amounts on a ratable basis over the expected term of the research collaboration. Therefore, any changes in the expected term of the research collaboration will impact revenue recognition for the given period. For example, in the second quarter of 2010, the estimated research term under the Boehringer Ingelheim agreement was extended through March 2011, resulting in an extension in the period over which we will recognize license revenue and decreasing our license revenue recognized in the period to $0.7 million. Often, the total research term is not contractually defined and an estimate of the term of our total obligation must be made. For example, under the 2008 cancer collaboration with Bristol-Myers Squibb, we have estimated our term to be four years and eight and a half months, or through the completion of our performance obligations for XL281. We estimate that this is the period over which we are obligated to perform services and therefore the appropriate term with which to ratably recognize any license fees. This estimate was reduced from five years following notice from Bristol-Myers Squibb of its decision to terminate the 2008 collaboration as to XL184. License fees are classified as license revenue in our consolidated statement of operations.

Although milestone payments are generally non-refundable once the milestone is achieved, we recognize milestone revenues on a straight-line basis over the expected research term of the arrangement. This typically results in a portion of a milestone being recognized on the date the milestone is achieved, with the balance being recognized over the remaining research term of the agreement. There is diversity in practice on the recognition of milestone revenue. Other companies have adopted an alternative milestone revenue recognition policy, whereby the full milestone fee is recognized upon completion of the milestone. If we had adopted such a policy, our revenues recorded to date would have increased and our deferred revenues would have decreased by a material amount compared to total revenue recognized. In certain situations, we may receive milestone payments after the end of our period of continued involvement. In such circumstances, we would recognize 100% of the milestone revenue when the milestone is achieved. Milestones are classified as contract revenue in our consolidated statement of operations.

Collaborative agreement reimbursement revenue consists of research and development support received from collaborators. Collaborative agreement reimbursement revenue is recorded as earned based on the performance requirements by both parties under the respective contracts. Under the 2008 cancer collaboration with Bristol-Myers Squibb and prior to its termination by Bristol-Myers Squibb as to XL184, certain research and development expenses were partially reimbursable to us. On an annual basis, the amounts that Bristol-Myers Squibb owed us, net of amounts reimbursable to Bristol-Myers Squibb by us on those projects, were recorded as revenue. Conversely, research and development expenses included the net settlement of amounts we owed Bristol-Myers Squibb for research and development expenses that Bristol-Myers Squibb incurred on joint development projects, less amounts reimbursable to us by Bristol-Myers Squibb on such projects. In annual periods when net research and development funding payments were payable to Bristol-Myers Squibb, these payments were presented as collaboration cost-sharing expense. Reimbursements under co-development agreements were classified as collaboration reimbursement revenue, while reimbursements under other arrangements were classified as contract revenue in our consolidated statement of operations. Notwithstanding termination by Bristol-Myers Squibb, revenues from the 2008 cancer collaboration will continue to be determined and reflected on an annual basis.

Some of our research and licensing arrangements have multiple deliverables in order to meet our customer s needs. For example, the arrangements may include a combination of intellectual property rights and research and development services. Multiple

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element revenue agreements are evaluated to determine whether the delivered item has value to the customer on a stand-alone basis and whether objective and reliable evidence of the fair value of the undelivered item exists. Deliverables in an arrangement that do not meet the separation criteria are treated as one unit of accounting for purposes of revenue recognition. Generally, the revenue recognition guidance applicable to the final deliverable is followed for the combined unit of accounting. For certain arrangements, the period of time over which certain deliverables will be provided is not contractually defined. Accordingly, management is required to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. In 2008, under our collaboration with GlaxoSmithKline, we accelerated $18.5 million in previously deferred revenue as a result of the development term concluding on the earliest scheduled end date of October 27, 2008, instead of the previously estimated end date of October 27, 2010.

Clinical Trial Accruals

Substantial portions of our preclinical studies and all of our clinical trials have been performed by third-party contract research organizations, or CROs, and other vendors. We accrue expenses for preclinical studies performed by our vendors based on certain estimates over the term of the service period and adjust our estimates as required. We accrue costs for clinical trial activities performed by CROs based upon the estimated amount of work completed on each study. For clinical trial expenses, the significant factors used in estimating accruals include the number of patients enrolled, the number of active clinical sites, and the duration for which the patients will be enrolled in the study. We monitor patient enrollment levels and related activities to the extent possible through internal reviews, correspondence with CROs and review of contractual terms. We base our estimates on the best information available at the time. However, additional information may become available to us which will allow us to make a more accurate estimate in future periods. In this event, we may be required to record adjustments to research and development expenses in future periods when the actual level of activity becomes more certain. Such increases or decreases in cost are generally considered to be changes in estimates and will be reflected in research and development expenses in the period first known.

Stock Option Valuation

Our estimate of compensation expense requires us to determine the appropriate fair value model and a number of complex and subjective assumptions including our stock price volatility, employee exercise patterns, future forfeitures and related tax effects. The most significant assumptions are our estimates of the expected volatility and the expected term of the award. We have limited historical information available to support the underlying estimates of certain assumptions required to value stock options. The value of a stock option is derived from its potential for appreciation. The more volatile the stock, the more valuable the option becomes because of the greater possibility of significant changes in stock price. Because there is a market for options on our common stock, we have considered implied volatilities as well as our historical realized volatilities when developing an estimate of expected volatility. The expected option term also has a significant effect on the value of the option. The longer the term, the more time the option holder has to allow the stock price to increase without a cash investment and thus, the more valuable the option. Further, lengthier option terms provide more opportunity to exploit market highs. However, empirical data shows that employees, for a variety of reasons, typically do not wait until the end of the contractual term of a nontransferable option to exercise. Accordingly, companies are required to estimate the expected term of the option for input to an option-pricing model. As required under the accounting rules, we review our valuation assumptions at each grant date and, as a result, from time to time we will likely change the valuation assumptions we use to value stock based awards granted in future periods. The assumptions used in calculating the fair value of share-based payment awards represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and recognize expense only for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. As of June 30, 2010, $18.7 million of total unrecognized compensation expense related to stock options was expected to be recognized over a weighted-average period of 1.76 years in addition to $11.8 million of total unrecognized compensation expense relating to RSUs, which was expected to be recognized over 3.62 years. See Note 3 to the Consolidated Financial Statements for a further discussion on stock-based compensation.

Fiscal Year Convention

We have adopted a 52- or 53-week fiscal year that ends on the Friday closest to December 31st of each year. Fiscal year 2009, a 52-week year, ended on January 1, 2010, and fiscal year 2010, a 52-week year, will end on December 31, 2010. For convenience, references in this report as of and for the fiscal year ended January 1, 2010 are indicated on a calendar year basis, ended December 31, 2009, and as of and for the fiscal quarters ended July 3, 2009 and July 2, 2010 are indicated as ended June 30, 2009 and 2010, respectively.

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Results of Operations

Revenues

Total revenues by category, as compared to the prior year period, were as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Contract revenue:				
Research and development funding	$ 10.9	$ 1.6	$ 22.1	$ 3.6
Milestones	1.4	4.7	10.0	9.4
License revenue, amortization of upfront payments, including amortization of premiums for equity purchases	24.6	21.1	49.1	39.7
Collaboration reimbursements	10.7		8.6	
Total revenues	$ 47.6	$ 27.4	$ 89.8	$ 52.7
Dollar increase	$ 20.2		$ 37.1	
Percentage increase	74%		70%	

Total revenues by customer, as compared to the prior year period, were as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Sanofi-aventis	$ 19.7	$	$ 39.4	$
Bristol-Myers Squibb	27.2	20.6	41.3	41.1
Genentech		4.2	7.0	8.5
GlaxoSmithKline				0.5
Boehringer Ingelheim	0.7	2.5	2.1	2.5
SEI		0.1		0.1
Total revenues	$ 47.6	$ 27.4	$ 89.8	$ 52.7
Dollar increase	$ 20.2		$ 37.1	
Percentage increase	74%		70%	

The increase in revenues for the three and six months ended June 30, 2010, as compared to the comparable periods for the prior year, was primarily due to our May 2009 collaboration agreements with sanofi-aventis for XL147, XL765 and the discovery of inhibitors of P13K. In addition to the increase resulting from the agreements with sanofi-aventis, we also recognized an increase of $10.7 and $8.6 million for the three and six months ended June 30, 2010 due to increased reimbursement revenue relating to our 2008 cancer collaboration agreement with Bristol Myers-Squibb for XL184 and XL281. These increases in revenue were partially offset by a reduction in revenues related to our MEK collaboration with Genentech which ended in 2009, our 2007 cancer collaboration with Bristol-Myers Squibb, and the completion of revenue recognition under our LXR collaboration with Bristol-Myers Squibb.

Collaboration reimbursement revenue consisted of research and development expenses and reimbursements related to our 2008 cancer collaboration agreement with Bristol Myers-Squibb for XL184 and XL281. To the extent that net annual research and development funding payments are expected to be received from Bristol-Myers Squibb, these payments will be presented as collaboration reimbursement revenue. In 2009, when net research and development funding payments were expected to be payable to Bristol-Myers Squibb, these payments were presented as collaboration cost sharing expense. For the fiscal year ending December 31, 2009, we expected to be in a net payable position and therefore showed the net receivable for the three months ended June 30, 2009, as a reduction in operating expenses. However, for the year ending December 31, 2010, we expect to receive net collaboration reimbursements and have recorded collaboration reimbursement revenue of $10.7 million and $8.6 million for the three and six months ended June 30, 2010, respectively.

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Research and Development Expenses

Total research and development expenses, as compared to the prior year period, were as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Research and development expenses	$ 54.2	$ 55.0	$ 119.0	$ 110.4
Dollar (decrease)/increase	$ (0.8)		$ 8.6	
Percentage (decrease)/increase	(1%)		8%	

Research and development expenses consist primarily of personnel expenses, clinical trials, consulting, laboratory supplies and facilities costs.

The decrease for the three months ended June 30, 2010, as compared to the comparable period in 2009, resulted primarily from the following:

Personnel Personnel expense, which includes salaries, bonuses, related fringe benefits, recruiting and relocation costs, decreased by $4.9 million, or 27%, primarily due to a reduction in headcount resulting from our restructuring implemented in March 2010.

Laboratory Supplies Laboratory supplies decreased by $1.8 million, or 51%, primarily due to the decrease in headcount and other cost cutting measures.

Stock-Based Compensation Stock-based compensation expense decreased by $1.5 million or 33% as a result of our reduction in headcount resulting from our restructuring implemented in March 2010.

These decreases were partially offset by an increase in clinical trial expenses. Clinical trial expenses, which include services performed by third-party contract research organizations and other vendors, increased by $9.3 million, or 74%, primarily due to the increase in phase 2 and phase 3 clinical trial activity for XL184 and increased clinical trial activity for XL147, XL228 and XL281. These increases were partially offset by reduced activities associated with XL888, XL820 and XL019, as well as no 2010 activity for XL999.

The increase for the six months ended June 30, 2010, as compared to the comparable period in 2009, resulted primarily from the following:

Clinical Trials Clinical trial expenses increased by $18.7 million, or 71%, primarily due to the increase in phase 2 and phase 3 clinical trial activity for XL184, increased clinical trial activity for XL147 and activity in preparation for the initiation of a phase 1 clinical trial for XL388. These increases were partially offset by the wind down of activities associated with XL647, XL999 and XL019 and reduced activities associated with XL888 and XL820.

Cost Reimbursement Under our 2007 contract research agreement with Agrigenetics, Inc., we received additional research and development funding of $3.4 million that was recognized as a reduction to research and development expense in 2009. This agreement ended in 2009, resulting in a reduction in reimbursement of $2.8 million, or 81%. The 2010 research and development funding relates to our agreement with a third party with respect to the sale of a portion of the Exelixis Plant Sciences business.

These increases in research and development expenses were offset by decreases in the following:

Personnel Personnel expense decreased by $6.2 million, or 17%, primarily due to a reduction in headcount related to our restructuring implemented in March 2010.

General Corporate Costs There was a decrease of $2.1 million, or 10%, in the allocation of general corporate costs (such as facilities costs, property taxes and insurance) to research and development, primarily as a result of a decrease in personnel as a result of our March restructuring plan and the resulting decrease in costs to be allocated.

We do not track total research and development expenses separately for each of our research and development programs. We group our research and development expenses into three categories: drug discovery, development and other. Our drug discovery group utilizes a variety of high-throughput technologies to enable the rapid discovery, optimization and extensive characterization of lead compounds such that we are able to select development candidates with the best potential for further evaluation and advancement into clinical development. Drug discovery expenses relate primarily to personnel expense, lab supplies and general corporate costs. Our

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development group leads the development and implementation of our clinical and regulatory strategies and prioritizes disease indications in which our compounds may be studied in clinical trials. Development expenses relate primarily to clinical trial, personnel and general corporate costs. The other category primarily includes stock compensation expense.

In addition to reviewing the three categories of research and development expenses described above, we principally consider qualitative factors in making decisions regarding our research and development programs. Such factors include enrollment in clinical trials for our drug candidates, the results of and data from clinical trials, the potential indications for our drug candidates and the clinical and commercial potential for our drug candidates and competitive dynamics. We also make our research and development decisions in the context of our overall business strategy, which includes the pursuit of commercial collaborations with major pharmaceutical and biotechnology companies for the development of our drug candidates.

The expenditures summarized in the following table reflect total research and development expenses by category, including allocations for general and administrative expense (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,		Inception to date (1)
	2010	2009	2010	2009	
Drug discovery	$ 13.2	$ 21.3	$ 33.8	$ 44.7	$ 418.3
Development	37.4	27.3	76.8	54.8	514.9
Other	3.6	6.4	8.4	10.9	88.9
Total	$ 54.2	$ 55.0	$ 119.0	$ 110.4	$ 1022.1

(1) Inception is as of January 1, 2006, the date on which we began tracking research and development expenses by category.

While we do not track total research and development expenses separately for each program, beginning in fiscal 2006, we began tracking third party expenditures directly relating to each program as a way of monitoring external costs. Our third party research and development expenditures relate principally to our clinical trial and related development activities, such as preclinical and clinical studies and contract manufacturing, and represent only a portion of the costs related to each program. Third party expenditures for programs initiated prior to the beginning of fiscal 2006 have not been tracked from project inception, and therefore such expenditures from the actual inception for most of our programs are not available. We do not accumulate on a program-specific basis internal research and development expenses, such as salaries and personnel expenses, facilities overhead expenses and external costs not directly attributable to a specific project. Nevertheless, we believe that third party expenditures by program provide a reasonable estimate of the percentage of our total research and development expenses that are attributable to each such program. For the six months ended June 30, 2010, the programs representing the greatest portion of our external third party research and development expenditures were XL184 (65%), XL147 (14%), XL765 (7%), XL281 (4%) and XL228 (4%), respectively. The expenses for these programs were primarily included in the development category of our research and development expenses and exclude the impact of any amounts reimbursed by our partners.

We currently do not have reliable estimates regarding the timing of our clinical trials. We currently estimate that typical phase 1 clinical trials last approximately one year, phase 2 clinical trials last approximately one to two years and phase 3 clinical trials last approximately two to four years. However, the length of time may vary substantially according to factors relating to the particular clinical trial, such as the type and intended use of the drug candidate, the clinical trial design and the ability to enroll suitable patients. In general, we will incur increased research and development expenses for compounds that advance in clinical development, whereas expenses will end for compounds that do not warrant further clinical development.

We currently do not have reliable estimates of total costs for a particular drug candidate to reach the market. Our potential therapeutic products are subject to a lengthy and uncertain regulatory process that may involve unanticipated additional clinical trials and may not result in receipt of the necessary regulatory approvals. Failure to receive the necessary regulatory approvals would prevent us from commercializing the product candidates affected. In addition, clinical trials of our potential products may fail to demonstrate safety and efficacy, which could prevent or significantly delay regulatory approval.

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General and Administrative Expenses

Total general and administrative expenses, as compared to the prior year period, were as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
General and administrative expenses	$ 9.6	$ 8.7	$ 18.4	$ 17.3
Dollar increase	$ 0.8		$ 1.1	
Percentage increase	10%		7%	

General and administrative expenses consist primarily of personnel expenses, employee stock-based compensation expense, facility costs and consulting and professional expenses, such as legal and accounting fees. The increase in expenses for the three and six months ended June 30, 2010, as compared to the comparable periods in 2009, was primarily due to increases in patent costs and a change in our overhead allocations following our March 2010 restructuring, offset by decreases in facility-related expenses.

Collaboration Reimbursement Revenue (Cost-Sharing Expenses)

Total collaboration reimbursement revenue (cost-sharing expenses), as compared to the prior year period, were as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Collaboration reimbursement revenue (cost-sharing expenses)	$ 10.7	$ (1.6)	$ 8.6	$ 0.2
Dollar change	$ 12.3		$ 8.4	
Percentage change	Not meaningful		Not meaningful	

Collaboration reimbursement revenue (cost-sharing expenses) consist of research and development expenses and reimbursements related to our 2008 cancer collaboration agreement with Bristol Myers-Squibb for XL184 and XL281. To the extent that net annual research and development funding payments are expected to be received from Bristol-Myers Squibb, these payments will be presented as collaboration reimbursement revenue. In 2009, when net research and development funding payments were expected to be payable to Bristol-Myers Squibb, these payments were presented as collaboration cost-sharing expenses. For the fiscal year ending December 31, 2009, we expected to be in a net payable position and therefore showed the net receivable for the three months ended June 30, 2009, as a reduction in operating expenses. However, for the year ending December 31, 2010, we expect to receive net collaboration reimbursements and have recorded collaboration reimbursement revenue of $10.7 million and $8.6 million for the three and six months ended June 30, 2010 respectively.

Restructuring Charge

On March 8, 2010, we implemented a restructuring plan that resulted in a reduction of our workforce by approximately 40%, or 270 employees. A small number of the terminated employees were subsequently recalled and the termination of a small group of employees has been delayed, all of whom continue to provide services for us. The remaining impacted employees were terminated immediately upon implementation of the plan or by March 31, 2010. The decision to restructure our operations was based on our recently announced corporate strategy to focus our efforts on our lead clinical compounds, XL184, XL147 and XL765, by dedicating the majority of our resources to aggressively drive these drug candidates through development towards commercialization.

In connection with the 2010 restructuring plan, we recorded a charge of approximately $16.1 million in the first quarter of 2010 primarily related to one-time termination benefits, which includes the modification of certain stock option awards previously granted to the terminated employees. The modification accelerates the vesting of any stock options that would have vested over the period beginning from cessation of employment through August 5, 2010. Employees also received an additional two months to exercise their options, for which a small charge was taken. The remainder of the charge was for the impairment of various assets and for non-cash charges relating to the closure of our facility in San Diego, California. We recorded additional restructuring expenses of approximately $9.4 million during the second quarter of 2010, primarily due to facility-related charges in connection with the sublease and exit of one of our buildings in South San Francisco, California. This charge was partially offset by a decrease in legal fees and one-time

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termination benefits relating to the recall of certain employees that were originally terminated under the restructuring plan and continued delay in the termination of the small group of employees described above. Our restructuring liability is recorded on discounted basis, using a credit-adjusted risk-free borrowing rate. We expect further restructuring expenses totaling approximately $2.2 million, which will be incurred on a quarterly basis over the period beginning in the third quarter of 2010 and continuing through the fourth quarter of 2015 due to interest expenses related to the exit of the South San Francisco building during the second quarter of 2010, partially offset by payments due to us under a sublease agreement that we signed in July 2010.

We expect that the restructuring plan will result in total cash expenditures of approximately $24.8 million, of which approximately $14.3 million is expected to be paid in 2010. The balance will be paid over an additional five years and primarily relates to net payments due under the lease for the building we exited in South San Francisco.

Total Other Income (Expense), Net

Total other income (expense), net as compared to the prior year period, was as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Total other income (expense), net	$ 3.0	$ (9.8)	$ 7.2	$ (11.3)
Dollar change	$ 12.8		$ 18.5	
Percentage change	Not meaningful		Not meaningful	

Total other income (expense), net consists primarily of interest income earned on our marketable securities and gains on asset sales, offset by interest expense incurred on our notes payable, bank obligations, capital lease obligations, convertible notes and loans and credit facility. The change in total other income for the three and six months ended June 30, 2010, as compared to the comparable period in 2009, resulted primarily from the recording of a $9.8 million loss upon deconsolidation of Symphony Evolution, Inc., or SEI, as a result of the expiration of our purchase option for SEI in June 2009. In addition, we recorded an increase of $2.7 million and $7.2 million relating to the gain on the sale of our plant trait business for the three- and six-month period ending June 30, 2010, as well as a net gain of our cell factory business in the second quarter of 2010.

Income Tax Provision

The income tax provision for the three- and six month period ended June 30, 2009 is a result of a $0.8 million tax credit recorded as a result of the Housing and Economic Recovery Act of 2008 that was extended through 2009. There is no tax credit recorded for 2010.

Noncontrolling Interest in Symphony Evolution, Inc.

In 2005, we licensed three of our compounds, XL647, XL784 and XL999, to SEI in return for an $80.0 million investment for the clinical development of these compounds. As part of the agreement, we received an exclusive purchase option to acquire all of the equity of SEI, thereby allowing us to reacquire XL647, XL784 and XL999 at our sole discretion. The purchase option expired on June 9, 2009. The expiration of the purchase option triggered a reconsideration event regarding our need to consolidate SEI, a variable interest entity. Upon the expiration of the purchase option, we no longer held a variable interest in the variable interest entity. Accordingly, we deconsolidated SEI and derecognized the SEI assets, liabilities and noncontrolling interest from our financial statements. For the three months ended June 30, 2010 and 2009, the losses attributed to the noncontrolling interest holders were $0 and $2.2 million, respectively. For the six months ended June 30, 2010 and 2009, the losses attributed to the noncontrolling interest holders were $0 and $4.3 million, respectively. The decrease in the losses attributable to noncontrolling interest holders was due to the deconsolidation of SEI in June 2009.

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Liquidity and Capital Resources

Sources and Uses of Cash

The following table summarizes our cash flow activities for the six months ended June 30, 2010 and 2009, respectively (dollar amounts presented in thousands):

	Six Months Ended June 30,	
	2010	2009
Consolidated net loss	$ (65,862)	$ (85,278)
Adjustments to reconcile net loss to net cash provided by operating activities	13,491	26,235
Changes in operating assets and liabilities	(26,104)	4,496
Net cash used in operating activities	(78,475)	(54,547)
Net cash used in investing activities	(10,771)	(34,780)
Net cash provided by (used in) financing activities	159,653	(5,459)
Net decrease in cash and cash equivalents	70,407&night">	620
Proceeds from deferred purchase price receivable	312	731	214	735
Increase in other assets	(2,576)	(4,833)	(14,025)	(3,404)
Decrease in recourse liability	(6,529)	(5,269)	(1,872)	(2,708)
Increase in accounts payable and other liabilities	6,488	3,200	3,812	8,718
Net cash provided by (used in) operating activities	18,167	8,606	(8,841)	(7,642)
Cash Flows From Investing Activities				
(Increase) decrease in restricted cash	(4,413)	(3,205)	3,636	(6,874)
Purchase of investment securities	(4,107)	(37,622)		
Origination and purchase of loans	(306,814)	(269,825)	(101,835)	(144,146)
Principal collections on loans	75,571	54,245	11,683	34,201
Proceeds from sale of repossessed houses	12,665	11,942	978	5,083
Capital expenditures	(2,085)	(660)	(127)	(811)
Net cash used in investing activities	(229,183)	(245,125)	(85,665)	(112,547)
Cash Flows From Financing Activities				
Net proceeds from issuance of preferred stock		95		
Net proceeds from issuance of common stock		72,176	141,616	
Retirement of restricted stock	(449)			
Redemption of preferred interests in Origen Securitization Company, LLC			(45,617)	
Repayment of note payable-Sun Home Services			(63,055)	
Proceeds from minority interest investment				43,955
Dividends paid	(5,608)	(9,966)		
Proceeds upon termination of hedging transaction	2,749			

Payment upon termination of hedging transaction	(410)	(1,876)	
Proceeds from securitizations	320,567	368,801	
Repayment of notes payable securitizations	(70,498)	(40,428)	
Proceeds from advances under repurchase agreements	5,243	25,676	28,915

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	Origen Financial, Inc.			Origen Financial L.L.C.
	Year Ended December 31, 2005	Year Ended December 31, 2004	Period from October 8 through December 31, 2003	Period from January 1 through October 7, 2003
Repayment of advances under repurchase agreements	(1,814)	(5,523)		(170,000)
Proceeds from warehouse financing	282,591	341,380	75,735	640,824
Repayment of warehouse financing	(324,553)	(507,412)	(11,633)	(422,584)
Change in servicing advances, net	2,212	(4,037)	3,208	
Net cash provided by financing activities	210,030	238,886	100,254	121,110
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(986)	2,367	5,748	921
Cash and cash equivalents, beginning of period	9,293	6,926	1,178	257
Cash and cash equivalents, end of period	$ 8,307	$ 9,293	$ 6,926	$ 1,178
Supplemental disclosures of cash flow information:				
Interest paid	$ 27,381	$ 13,368	$ 2,003	$ 8,312
Non cash financing activities:				
Restricted stock issued as unearned compensation	$ 2,191	$ 3,791	$ 1,225	$
Loans transferred from repossessed assets and held for sale	$ 20,233	$ 22,330	$ 2,534	$ 9,541

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

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 1 Summary of Significant Accounting Policies

Nature of Operations

The Company was formed on October 8, 2003 with the completion of a private placement of 15,000,000 shares of its common stock. The consolidated statements of operations and cash flows are presented for the years ending December 31, 2005 and 2004, the period from October 8, 2003 through December 31, 2003 and the period from January 1, 2003 through October 7, 2003.

The Company is a Delaware corporation which has elected to be taxed as a real estate investment trust (REIT) commencing with its taxable year ended December 31, 2003. The Company s business is to originate, purchase and service manufactured housing loans. The Company s manufactured housing loans are generally conventionally amortizing loans that generally range in amounts from $10,000 to $250,000 and have terms of seven to thirty years and are located throughout the United States. Currently, most of the Company s activities are conducted through Origen Financial L.L.C., which is a wholly-owned subsidiary. The Company conducts the rest of its business operations through one or more other subsidiaries, including taxable REIT subsidiaries, to take advantage of certain business opportunities and to ensure compliance with the federal income tax rules applicable to REITs.

The Company generally securitizes or places the manufactured housing loans it originates with institutional investors and retains the rights to service the loans on behalf of those investors.

Basis of Financial Statement Presentation

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The accompanying consolidated financial statements include the financial position, results of operations and cash flows of the Company, its wholly-owned qualified REIT and taxable REIT subsidiaries. All significant intercompany amounts have been eliminated. Certain amounts for prior periods have been reclassified to conform with current financial statement presentation.

Revenue Recognition

Interest and origination fee revenue from loans receivable is recognized using the interest method. Certain loan origination costs on loans receivable are deferred and amortized using the interest method over the term of the related loans as a reduction of interest income on loans. The accrual of interest on loans receivable is discontinued at the time a loan is determined to be impaired. Servicing fees are recognized when earned.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period, including significant estimates regarding allowances for loan losses, recourse liabilities, impairment of retained interests and goodwill. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents represent short-term highly liquid investments with original maturities of three months or less and include cash and interest bearing deposits at banks. The Company has restricted cash related to loans serviced for others that is held in trust for subsequent payment to the owners of those loans.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 1 Summary of Significant Accounting Policies, continued:

Loans Receivable

Loans receivable consist of manufactured housing loans under contracts collateralized by the borrowers manufactured houses and in some instances, related land. All loans receivable are classified as held for investment and are carried at amortized cost, except for loans purchased with evidence of deterioration of credit quality since origination, which are accounted for as described below. Interest on loans is credited to income when earned. Loans receivable include accrued interest and are presented net of deferred loan origination costs and an allowance for estimated loan losses.

Allowance for Credit Losses

The allowance for possible credit losses is maintained at a level believed adequate by management to absorb losses on loans in the Company s loan portfolio. In accordance with Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, the Company provides an accrual for loan losses when it is probable that a loan asset has been impaired and the amount of such loss can be reasonably estimated. The Company s loan portfolio is comprised of homogenous manufactured housing loans with average loan balances of less than $50,000. The allowance for credit losses is developed at a portfolio level and the amount of the allowance is determined by applying a probability weighting to a calculated range of losses. A range of probable losses is calculated by applying historical loss rate factors to the loan portfolio on a stratified basis using the Company s current portfolio performance and delinquency levels (0-30 days, 31-60 days, 61-90 days and more than 90 days delinquent) and by the extrapolation of probable loan impairment based on the correlation of historical losses by vintage year of origination. Based on Financial Accounting Standards Board Interpretation No. 14, Reasonable Estimation of the Amount of a Loss an interpretation of FASB Statement No. 5, the Company then makes a determination of the best estimate within the calculated range of credit losses. Such determination may include, in addition to historical charge-off experience, the impact of changed circumstances on current impairment of the loan portfolio. The accrual of interest is discontinued when a loan becomes more than 90 days past due. Cash receipts on impaired loans are applied first to accrued interest and then to principal. Impaired loans, or portions thereof, are charged off when deemed uncollectible. The allowance for credit losses represents an unallocated allowance. There are no elements of the allowance allocated to specific individual loans or to impaired loans.

Investment Securities

Except for debt securities acquired with evidence of deterioration of credit quality since origination, which are accounted for as described below, the Company follows the provisions of Statement of Financial Accounting Standards No. 115 (SFAS 115), Accounting For Certain Investments in Debt and Equity Securities, in reporting its investments. The securities are classified as held-to-maturity and are carried on the Company s balance sheet at amortized cost. The securities are regularly measured for impairment through the use of a discounted cash flow analysis based on the historical performance of the underlying loans that collateralize the securities. If it is determined that there has been a decline in fair value below amortized cost and the decline is other-than-temporary, the cost basis of the security is written down to fair value as a new cost basis and the amount of the write-down is included in earnings.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 1 Summary of Significant Accounting Policies, continued:

Loan Pools and Debt Securities Acquired with Evidence of Deterioration of Credit Quality

The Company accounts for loan pools and debt securities acquired with evidence of deterioration of credit quality at the time of acquisition in accordance with the provisions of the American Institute of Certified Public Accountants (AICPA) Practice Bulletin 6 (PB 6), Amortization of Discounts on Certain Acquired Loans, as well as the AICPA s Statement of Position 03-3 (SOP 03-3), Accounting for Certain Loans or Debt Securities Acquired in a Transfer . The carrying values of such purchased loan pools and debt securities were approximately $35.1 million and $8.6 million, respectively, at December 31, 2005 and $40.1 million and $2.8 million, respectively, at December 31, 2004, and are included in loans receivable and investments held to maturity, respectively, in the consolidated balance sheet.

The Company adopted the provisions of SOP 03-3 in January 2005 and applies those provisions to loan pools and debt securities acquired after December 31, 2004. The provisions of SOP 03-3 that relate to decreases in expected cash flows amend PB 6 for consistent treatment and apply prospectively to receivables acquired before January 1, 2005. Purchased loans and debt instruments acquired before January 1, 2005 will continue to be accounted for under PB 6, as amended, for provisions related to decreases in expected cash flows.

Under the provisions of SOP 03-3, each static pool of loans and debt securities is statistically modeled to determine its projected cash flows. The Company considers historical cash collections for loan pools and debt securities with similar characteristics as well as expected prepayments and estimates the amount and timing of undiscounted expected principal, interest and other cash flows for each pool of loans and debt security. An internal rate of return is calculated for each static pool of receivables based on the projected cash flows and applied to the balance of the static pool. The resulting revenue recognized is based on the internal rate of return applied to the remaining balance of each static pool of accounts. Each static pool is analyzed at least quarterly to assess the actual performance compared to the expected performance. To the extent there are differences in actual performance versus expected performance, the internal rate of return is adjusted prospectively to reflect the revised estimate of cash flows over the remaining life of the static pool. Beginning January 2005, if revised cash flow estimates are less than the original estimates, SOP 03-3 requires that the internal rate of return remain unchanged and an immediate impairment be recognized. For loans acquired with evidence of deterioration of credit quality, if cash flow estimates increase subsequent to recording an impairment, SOP 03-3 requires reversal of the previously recognized impairment before any increases to the internal rate of return are made. For any remaining increases in estimated future cash flows for loan pools or debt securities acquired with evidence of deterioration of credit quality, the Company adjusts the amount of accretable yield recognized on a prospective basis over the remaining life of the loan pool or debt security.

Application of the interest method of accounting requires the use of estimates to calculate a projected internal rate of return for each pool. These estimates are based on historical cash collections. If future cash collections are materially different in amount or timing than projected cash collections, earnings could be affected, either positively or negatively. Higher collection amounts or cash collections that occur sooner than projected cash collections will have a favorable impact on yields and revenues. Lower collection amounts or cash collections that occur later than projected cash collections will have an unfavorable impact and result in an immediate impairment being recognized.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 1 Summary of Significant Accounting Policies, continued:

Furniture, Fixtures and Equipment

Furniture, fixtures and equipment are stated at cost less accumulated depreciation. Depreciation is recognized on a straight-line basis over the estimated useful lives of the assets as follows:

Furniture and fixtures	7 years
Computers	5 years
Software	3 years
Leasehold improvements	Shorter of useful life or lease term

Goodwill

The Company has recorded goodwill in connection with the acquisition of Origen Financial L.L.C. at the time of the formation transaction on October 8, 2003. The net assets acquired were recorded at fair value, which resulted in goodwill of $32.3 million. Goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. SFAS 142, Goodwill and Other Intangible Assets, requires the Company to test its recorded goodwill for impairment on an annual basis or whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. For purposes of testing impairment, the Company has determined that it is a single reporting unit and the goodwill was allocated accordingly. The initial and ongoing estimate of the fair value of the Company is based on assumptions and projections prepared by the Company. This amount is then compared to the net book value of the Company. If the estimated fair value is less than the carrying amount of the goodwill, then an impairment charge is recorded to reduce the asset to its estimated fair value. No impairment was recorded in 2005 or 2004.

Other Assets

Other assets are comprised of prepaid expenses, deferred financing costs, servicing rights, repossessed houses, retained interests in loan securitizations and other miscellaneous receivables. Prepaid expenses are amortized over the expected service period. Deferred financing costs are capitalized and amortized over the life of the corresponding obligation.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 1 Summary of Significant Accounting Policies, continued:

Servicing Rights

The Company recognizes the fair value of loan servicing rights purchased or on loans originated and sold, by recognizing a separate servicing asset or liability. Management is required to make complex judgments when establishing the assumptions used in determining fair values of servicing assets. The fair value of servicing assets is determined by calculating the present value of estimated future net servicing cash flows, using assumptions of prepayments, defaults, servicing costs and discount rates that the Company believes market participants would use for similar assets. These assumptions are reviewed on a monthly basis and changed based on actual and expected performance.

The Company stratifies its servicing assets based on the predominant risk characteristics of the underlying loans, which are loan type, interest rate and loan size. Servicing assets are amortized in proportion to and over the expected servicing period.

The carrying amount of loan servicing rights is assessed for impairment by comparison to fair value and a valuation allowance is established through a charge to earnings in the event the carrying amount exceeds the fair value. Fair value is estimated based on the present value of expected future cash flows and periodically by independent appraisal. There was no valuation allowance recognized at December 31, 2005 or 2004. Loan servicing rights are included in other assets in the consolidated balance sheet.

Repossessed Houses

Manufactured houses acquired through foreclosure or similar proceedings are recorded at the lesser of the related loan balance or the estimated fair value of the house. The balance of repossessed houses was approximately $3.5 million and $3.4 million as of December 31, 2005 and 2004, respectively, and is included in other assets in the consolidated balance sheet.

Retained Interests in Loan Securitizations

Retained interests are carried at estimated fair value, which is determined by discounting the projected cash flows over the expected life of the receivables sold, using the Company s current prepayment, default, loss and interest rate assumptions. Changes in the fair value of retained interests are recorded as a component of other comprehensive income unless there has been a decline in value that is other than temporary. Under current accounting rules (pursuant to Emerging Issues Task Force Consensus Number 99-20) declines in value of the Company s retained interests are considered other than temporary and recognized in earnings when the timing and/or amount of cash expected to be received has changed adversely from the previous valuation which determined the carrying value of the retained interest. When declines in value occur that are considered to be other than temporary, the amortized cost is reduced to fair value and a loss is recognized in the statement of operations. The assumptions used to determine new values are based on internal evaluations and consultations with independent advisors having significant experience in valuing such retained interests. As of December 31, 2005 and 2004 retained interests in loan securitizations amounted to $0 and approximately $724,000, respectively, and are included in other assets in the consolidated balance sheet.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 1 Summary of Significant Accounting Policies, continued:

Derivative Financial Instruments

The Company has periodically used derivative instruments, including forward sales of U.S. Treasury securities, U.S. Treasury rate locks and forward interest rate swaps to mitigate interest rate risk related to the company s loans receivable and anticipated securitizations. The Company follows the provisions of SFAS 133. All derivatives are recorded on the balance sheet at fair value. On the date a derivative contract is entered into, the Company designates the derivative as a hedge of either a forecasted transaction or the variability of cash flow to be paid (cash flow hedge). Changes in the fair value of a derivative that is qualified, designated and highly effective as a cash flow hedge are recorded in other comprehensive income until earnings are affected by the forecasted transaction or the variability of cash flow and are then reported in current earnings. Any ineffectiveness is recorded in current earnings.

The Company has formally documented all relationships between hedging instruments and hedged items, as well as the risk-management objectives and strategy for undertaking the hedge transaction. This process includes linking cash flow hedges to specific forecasted transactions or variability of cash flow.

The Company also formally assesses, both at the hedge s inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flow of hedged items. When it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, we discontinue hedge accounting prospectively, in accordance with SFAS 133.

Derivative financial instruments that do not qualify for hedge accounting are carried at fair value and changes in fair value are recognized currently in earnings.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 1 Summary of Significant Accounting Policies, continued:

Per Share Data

Basic earnings per share (EPS) is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted EPS incorporates the potential dilutive effect of common stock equivalents outstanding on an average basis during the period. Dilutive common shares primarily consist of employee stock options and restricted common stock. The effects of the exercise of options, warrants, conversion of convertible securities or restricted common stock have not been included in diluted loss per share for the years ended December 31, 2005 and 2004 as their effect would have been anti-dilutive. The following table presents a reconciliation of basic and diluted EPS for the periods presented (in thousands, except earnings per share):

	Origen Financial, Inc.			Origen Financial L.L.C
	Year Ended December 31, 2005	Year Ended December 31, 2004	Period from October 8 through December 31, 2003	Period from January 1 through October 7, 2003
Numerator:				
Net income (loss)	$ (2,659)	$ (2,966)	$ 1,497	N/A
Preferred stock dividends	(16)	(16)		
Income (loss) available to common shareholders	$ (2,675)	$ (2,982)	$ 1,497	N/A
Denominator:				
Weighted average common shares for basic EPS	24,878,116	21,439,029	15,060,000	N/A
Effect of dilutive securities:				
Weighted avg. restricted stk. awards			111,364	N/A
Weighted average common shares for diluted EPS	24,878,116	21,439,029	15,171,364	N/A
Basic EPS	$ (0.11)	$ (0.14)	$ 0.10	N/A
Diluted EPS	$ (0.11)	$ (0.14)	$ 0.10	N/A

Had the Company recognized net income for the years ended December 31, 2005 and 2004, incremental shares attributable to non-vested common stock awards would have increased diluted shares by approximately 390,000 and 164,000 for the years ended December 31, 2005 and 2004, respectively.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 1 Summary of Significant Accounting Policies, continued:

Stock Options

As allowed under the provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended, the Company has chosen to continue to recognize compensation expense using the intrinsic value-based method of valuing stock options prescribed in APB No. 25, Accounting for Stock Issued to Employees and related interpretations. Under the intrinsic value-based method, compensation cost is measured as the amount by which the quoted market price of the Company s stock at the date of grant exceeds the stock option exercise price. All options granted by the Company have been granted at a fixed price not less than the market value of the underlying common stock on the date of grant and, therefore, were not included in compensation expense as allowed by current US GAAP. The value of the restricted stock awards issued by the Company have been reflected in compensation expense.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for the periods presented (in thousands, except per share data):

	Origen Financial, Inc.			Origen Financial L.L.C
	Year Ended December 31, 2005	Year Ended December 31, 2004	Period from October 8 through December 31, 2003	Period from January 1 through October 7, 2003
Net income (loss) available to common shareholders	$ (2,675)	$ (2,982)	$ 1,497	N/A
Stock option compensation cost	21	21	2	N/A
Pro forma net income available to common shareholders	$ (2,696)	$ (3,003)	$ 1,495	N/A
Basic income (loss) per share as reported	$ (0.11)	$ (0.14)	$ 0.10	N/A
Pro forma basic income (loss) per share	$ (0.11)	$ (0.14)	$ 0.10	N/A
Diluted income (loss) per share as reported	$ (0.11)	$ (0.14)	$ 0.10	N/A
Pro forma diluted income (loss) per share	$ (0.11)	$ (0.14)	$ 0.10	N/A

Advertising Expense

Advertising costs are expensed as incurred. Advertising expenses were approximately $270,000 and $477,000 for the years ended December 31, 2005 and 2004, respectively.

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Origen Financial, Inc.
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Note 1 Summary of Significant Accounting Policies, continued:

Recent Accounting Pronouncements

Accounting for Share-Based Payments

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment, that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise s equity instruments or that may be settled by the issuance of such equity instruments. Under the FASB s statement, all forms of share-based payments to employees, including employee stock options, must be treated the same as other forms of compensation by recognizing the related cost in the income statement. The expense of the award would generally be measured at fair value at the grant date. Previous accounting guidance required that the expense relating to so-called fixed plan employee stock options only be disclosed in the footnotes to the financial statements. The statement eliminates the ability to account for share-based compensation transactions using Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees for options granted after June 15, 2005. On April 14, 2005, the SEC announced it would permit companies to implement SFAS No. 123(R) at the beginning of their next fiscal year. The Company plans to adopt the new rules reflected in SFAS No. 123(R) using the modified-prospective method effective January 1, 2006. Management has determined that the impact of the adoption of SFAS No. 123(R) will not have a material effect on the Company s financial position or results of operations.

Accounting Changes and Error Corrections

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 . This statement replaces APB No. 20, Accounting Changes , and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. The statement applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. The statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Management believes that the impact of adoption of SFAS No. 154 will not have a material effect on the Company s financial position or results of operations.

Note 2 Company Formation

The Company was incorporated on July 31, 2003. On October 8, 2003, the Company completed a private placement of $150 million of its common stock to certain institutional and accredited investors. In connection with and as a condition to the October 2003 private placement, the Company acquired all of the equity interests of Origen Financial L.L.C. in a transaction accounted for as a purchase. As part of these transactions the Company took steps to qualify Origen Financial, Inc. as a REIT. Currently, most of the Company s activities are conducted through Origen Financial L.L.C., which is a wholly owned subsidiary. The Company conducts the rest of its business operations through one or more other subsidiaries, including taxable REIT subsidiaries, to take advantage of certain business opportunities and ensure that the Company complies with the federal income tax rules applicable to REITs.

Note 3 Investments

Except for debt securities acquired with evidence of deterioration of credit quality since origination, which are accounted for under the provisions of the American Institute of Certified Public Accountants (AICPA) Statement of Position 03-3 (SOP 03-3), Accounting for Certain Loans or Debt Securities Acquired in a Transfer, the

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Origen Financial, Inc.
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Company follows the provisions of Statement of Financial Accounting Standards No. 115 (SFAS 115), Accounting For Certain Investments in Debt and Equity Securities, in reporting its investments. The Company s investments consisted of three asset backed securities with principal amounts of $32.0 million, $6.8 million and $8.6 million, respectively, at December 31, 2005, and $32.0 million, $3.1 million and $6.1 million, respectively, at December 31, 2004. The securities are collateralized by manufactured housing loans and are classified as held-to-maturity. They have contractual maturity dates of July 28, 2033, December 28, 2033 and December 28, 2033, respectively. The securities are carried on the Company s balance sheet at an amortized cost of $41.9 million and $37.6 million at December 31, 2005 and 2004, respectively, which approximates their fair value. As prescribed by the provisions of SFAS 115 the Company has both the intent and ability to hold the securities to maturity. The securities will not be sold in response to changing market conditions, changing fund sources or terms, changing availability and yields on alternative investments or other asset liability management reasons. The securities are regularly measured for impairment through the use of a discounted cash flow analysis based on the historical performance of the underlying loans that collateralize the securities. If it is determined that there has been a decline in fair value below amortized cost and the decline is other-than temporary, the cost basis of the security is written down to fair value as a new cost basis and the amount of the write-down is included in earnings. No impairment was recorded in 2005 or 2004. The carrying value of debt securities accounted for under the provisions of SOP 03-3 was approximately $8.6 million at December 31, 2005. See Note 5 Loans and Debt Securities Acquired with Evidence of Deterioration of Credit Quality for further discussion.

Note 4 Loans Receivable

The carrying amounts and fair value of loans receivable consisted of the following at December 31 (in thousands):

		2005	2004
Manufactured housing loans	securitized	$ 695,701	$ 401,995
Manufactured housing loans	unsecuritized	85,949	170,978
Accrued interest receivable		4,078	3,285
Deferred fees		(2,100)	(3,100)
Discount on purchased loans		(4,773)	(4,575)
Allowance for purchased loans		(428)	
Allowance for loan loss		(10,017)	(5,315)
		$ 768,410	$ 563,268

The following table sets forth the average per loan balance, weighted average loan yield, and weighted average initial term at December 31 (dollars in thousands):

	2005	2004
Number of loans receivable	17,277	13,358
Average loan balance	$ 45	$ 43
Weighted average loan yield	9.56%	9.86%
Weighted average initial term	20 years	20 years

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 4 Loans Receivable, continued:

The following table sets forth the concentration by state of the manufactured housing loan portfolio at December 31 (dollars in thousands):

	2005		2004	
	Principal	Percent	Principal	Percent
California	$ 225,675	28.9%	$ 137,514	24.1%
Texas	87,018	11.1%	74,381	13.0%
New York	46,501	6.0%	32,142	5.6%
Michigan	36,933	4.7%	35,372	6.2%
Alabama	29,288	3.8%	23,868	4.2%
Georgia	26,938	3.4%	22,580	4.0%
Other	329,297	42.1%	247,116	42.9%
Total	$ 781,650	100.0%	$ 572,973	100.0%

The following table sets forth the number and value of loans for various original terms for the manufactured housing loan portfolio at December 31 (dollars in thousands):

	2005		2004	
Original Term In Years	Number of Loans	Principal Balance	Number of Loans	Principal Balance
5 or less	17	$ 145	8	$ 90
6-10	1,420	28,119	1,048	20,422
11-12	181	4,382	123	2,796
13-15	4,551	135,319	3,403	97,296
16-20	8,450	454,556	6,258	314,015
21-25	1,111	51,386	1,238	56,373
26-30	1,547	107,743	1,280	81,981
Total	17,277	$ 781,650	13,358	$ 572,973

Delinquency statistics for the manufactured housing loan portfolio are as follows at December 31 (dollars in thousands):

	2005			2004		
Days Delinquent	No. of Loans	Principal Balance	% of Portfolio	No. of Loans	Principal Balance	% of Portfolio
31-60	215	$8,182	1.0%	146	$5,253	0.9%
61-90	68	2,561	0.3%	80	3,014	0.5%
Greater than 90	192	7,480	1.0%	195	7,637	1.3%

The Company defines non-performing loans as those loans that are greater than 90 days delinquent in contractual principal payments. For the years ended December 31, 2005 and 2004, the average total outstanding principal balance of non-performing loans was approximately $6.9 million and $6.8 million respectively.

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Origen Financial, Inc.
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Note 5 Loan Pools and Debt Securities Acquired with Evidence of Deterioration of Credit Quality

The Company has loan pools and debt securities that were acquired, for which there was at acquisition, evidence of deterioration of credit quality, and for which it was probable, at acquisition, that all contractually required payments would not be collected. These loan pools and debt securities are accounted for under the provisions of the American Institute of Certified Public Accountants (AICPA) Statement of Position 03-3 (SOP 03-3), Accounting for Certain Loans or Debt Securities Acquired in a Transfer.

Loan Pools Acquired with Evidence of Deterioration of Credit Quality

The carrying amount of loan pools acquired with evidence of deterioration of credit qualify was as follows at December 31, 2005 (in thousands):

	2005
Outstanding balance	$38,933
Carrying amount, net of allowance of $428	35,149

Accretable yield represents the excess of expected future cash flows over the remaining carrying value of the purchased portfolio, which is recognized as interest income on a level-yield basis over the life of the loan portfolio. Nonaccretable difference represents the difference between the remaining expected cash flows and the total contractual obligation outstanding of the purchased receivables. Changes in accretable yield for the year ended December 31, 2005 were as follows (in thousands):

	2005
Beginning balance	$ 17,674
Accretion	(3,269)
Additions due to purchases during the period	1,375
Reclassifications from non-accretable yield	364
Ending balance	$ 16,144

During the year ended December 31, 2005, the Company increased the allowance by a charge to the income statement of approximately $428,000. No allowances were reversed in 2005.

Loans acquired during the year ended December 31, 2005 for which it was probable at acquisition that all contractually required payments would not be collected are as follows (in thousands):

	2005
Contractually required payments receivable at acquisition	$ 5,129
Cash flows expected to be collected at acquisition	2,962
Basis in acquired loans at acquisition	1,586

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 5 Loan Pools and Debt Securities Acquired with Evidence of Deterioration of Credit Quality, continued:

Debt Securities Acquired with Evidence of Deterioration of Credit Quality

The carrying amount of debt securities acquired with evidence of deterioration of credit quality was as follows at December 31, 2005 (in thousands):

	2005
Outstanding balance	$8,550
Carrying amount, net	3,740

Accretable yield represents the excess of expected future cash flows over the remaining carrying value of the debt securities, which is recognized as interest income on a level-yield basis over the life of the debt securities. Nonaccretable difference represents the difference between the remaining expected cash flows and the total contractual obligation outstanding of the debt securities. Changes in accretable yield for the year ended December 31, 2005 were as follows (in thousands):

	2005
Beginning balance	$ 7,834
Accretion	(664)
Additions due to purchases during the period	3,173
Reclassifications from non-accretable yield	(14)
Ending balance	$ 10,329

Debt securities acquired during the year ended December 31, 2005 for which it was probable at acquisition that all contractually required payments would not be collected are as follows (in thousands):

	2005
Contractually required payments receivable at acquisition	$4,999
Cash flows expected to be collected at acquisition	4,129
Basis in acquired loans at acquisition	956

Note 6 Allowance for Credit Losses and Recourse Liability

The allowance for credit losses and related additions and deductions to the allowance were as follows (in thousands):

	Origen Financial, Inc.			Origen Financial L.L.C
	Year Ended December 31, 2005	Year Ended December 31, 2004	Period from October 8 through December 31, 2003	Period from January 1 through October 7, 2003
Balance at beginning of period	$ 5,315	$ 3,614	$ 3,509	$ 2,743
Provision for loan losses	12,691	7,053	768	4,765
Transfers from recourse liability	2,036	5,195	1,486	2,125

Gross charge-offs	(20,769)	(19,385)	(3,290)	(10,942)
Recoveries	10,744	8,838	1,141	4,818
Balance at end of period	$ 10,017	$ 5,315	$ 3,614	$ 3,509

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 6 Allowance for Credit Losses and Recourse Liability, continued:

The recourse liability and related additions and transfers out of the recourse liability were as follows (in thousands):

	Origen Financial, Inc.			Origen Financial L.L.C
	Year Ended December 31, 2005	Year Ended December 31, 2004	Period from October 8 through December 31, 2003	Period from January 1 through October 7, 2003
Balance at beginning of period	$ 6,603	$ 8,740	$ 10,612	$ 13,320
Termination of Vanderbilt recourse	(4,491)			
Provision for recourse liabilities	218	3,132		
Reimbursements for losses per recourse agreements	(2)	(74)	(386)	(583)
Transfers to allowance for credit losses	(2,036)	(5,195)	(1,486)	(2,125)
Balance at end of period	$ 292	$ 6,603	$ 8,740	$ 10,612

During July 2005, Origen negotiated a buy-out of its recourse obligation with Vanderbilt Mortgage and Finance, Inc. (Vanderbilt). At the time of the buy-out the remaining principal balance and recourse liability related to the loans sold to Vanderbilt was approximately $40.7 million and $4.5 million, respectively. The buy-out, which eliminated all loan recourse with Vanderbilt, was consummated on July 26, 2005, and resulted in a charge against earnings of approximately $0.8 million. The remaining principal balance of loans sold with recourse at December 31, 2005 was $4.6 million versus $51.5 million at December 31, 2004, a decrease of 91.1%.

Note 7 Furniture, Fixtures and Equipment

Furniture, fixtures and equipment are summarized as follows at December 31 (in thousands):

	2005	2004
Furniture and fixtures	$ 1,666	$ 1,523
Leasehold improvements	763	253
Computer equipment	1,087	922
Capitalized software	1,229	544
	4,745	3,242
Less: accumulated depreciation	1,187	906
Balance at end of period	$ 3,558	$ 2,336

Depreciation expense was approximately $864,000, $804,000, $208,000 and $703,000 for the years ended December 31, 2005 and 2004 and for the periods ended December 31, 2003 and October 7, 2003, respectively.

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Origen Financial, Inc.
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Note 8 Servicing Rights

Changes in servicing rights are summarized as follows (in thousands):

	Origen Financial, Inc.			Origen Financial L.L.C.
	Year Ended December 31, 2005	Year Ended December 31, 2004	Period from October 8 through December 31, 2003	Period from January 1 through October 7, 2003
Balance at beginning of period	$ 4,097	$ 5,131	$ 5,892	$ 7,327
Loan portfolio repurchased			(494)	
Write down to market value				(434)
Amortization	(994)	(1,034)	(267)	(1,001)
Balance at end of period	$ 3,103	$ 4,097	$ 5,131	$ 5,892

The Company services the manufactured housing loans it originates and holds in its loan portfolio as well as manufactured housing loans it originated and securitized or sold with the servicing rights retained. The principal balances of manufactured housing loans serviced totaled approximately $1.6 billion, $1.4 billion, $1.3 billion and $1.2 billion at December 31, 2005, December 31, 2004, December 31, 2003 and October 7, 2003, respectively. Loan servicing rights are included in other assets in the consolidated balance sheet.

Note 9 Derivatives

During 2005 and 2004 the Company entered into six forward starting interest rate swaps for the purpose of locking in the designated benchmark interest rate on portions of forecasted securitization transactions. The Company designated the swaps as cash flow hedges for accounting purposes. A rise in rates during the period between the time that the Company entered into the swaps and the commencement of the planned securitization would increase the Company s borrowing cost in the securitization, but this increase would be offset by the increased value in the right to pay a lower fixed rate during the term of the securitized transaction. Details of the six forward starting interest rate swaps entered into by the Company during 2005 and 2004 are as follows:

In February 2005, the Company entered into a forward starting interest rate swap for the purpose of locking in the designated benchmark interest rate, in this case LIBOR, on a portion of its planned 2005-A securitization transaction completed in May 2005. Under the terms of the swap the Company paid a fixed rate of 4.44% and received a floating rate equal to the one month LIBOR rate on a beginning notional balance of $132.9 million. The cost to terminate this hedge in May 2005 was approximately $410,000. The unamortized portion of the swap approximates a liability of $361,000 at December 31, 2005. Amortization for the year ended December 31, 2005 related to the swaps was approximately $49,000. Amortization over the next twelve months is expected to be approximately $64,000.

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Origen Financial, Inc.
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Note 9 Derivatives, continued:

In May 2005 and September 2005, the Company entered into four forward starting interest rate swaps for the purpose of locking in the designated benchmark interest rate, in this case LIBOR, on a portion of its planned 2005-B securitization transaction completed in December 2005. These hedging transactions were structured at inception to meet the criteria set forth in SFAS 133 in order to allow the Company to assume that no ineffectiveness exists. As a result, all changes in the fair value of the derivatives were included in other comprehensive income and began to be amortized over the expected life of the related securitization transaction upon commencement of the planned securitization transaction. Under the terms of the swaps the Company paid fixed rates of 4.21%, 4.47%, 4.37% and 4.12% and received a floating rate equal to the one month LIBOR rate on beginning notional balances of $53.0 million, $47.0 million, $17.0 million and $14.0 million, respectively. As a result of the termination of the hedges during December 2005 the Company received approximately $2.7 million. The unamortized portion of these four swaps approximates $2.7 million at December 31, 2005. Amortization for the year ended December 31, 2005 related to these four swaps was approximately $13,000. Amortization over the next twelve months is expected to be approximately $431,000.

In August 2004, the Company entered into a forward starting interest rate swap for the purpose of locking in the designated benchmark interest rate, in this case LIBOR, on a portion of its planned 2004-A securitization transaction completed in September 2004. Under the terms of the swap the Company paid a fixed rate of 4.15% and received a floating rate equal to the one month LIBOR rate on a beginning notional balance of $170.0 million. The cost to terminate this hedge in September 2004 was approximately $1.9 million. The unamortized portion of the swap approximates $1.5 million and $1.8 million at December 31, 2005 and 2004, respectively. Amortization for the years ended December 31, 2005 and 2004, related to the swaps was approximately $338,000 and $69,000, respectively. Amortization over the next twelve months is expected to be approximately $352,000.

Additionally, in conjunction with the loan funding facility with Citigroup, the Company previously entered into six interest rate swap agreements in an effort to manage interest rate risk on its floating rate notes payable. The interest rate swaps expired on April 12, 2004. The interest rate swaps were structured to be hedges against changes in the benchmark interest rate, in this case LIBOR, of the floating rate notes. The swaps were designated as hedges for accounting purposes. The hedges were highly effective and had a minimal impact on the results of operations.

At December 31, 2005 and 2004, the Company had no open derivative positions.

Note 10 Loan Securitizations

Periodically the Company securitizes manufactured housing loans. The Company records each transaction based on its legal structure. Under the current legal structure of the securitization program, the Company exchanges manufactured housing loans it originates and purchases with a trust for cash. The trust then issues ownership interests to investors in asset-backed bonds secured by the loans.

The Company structured all loan securitizations occurring prior to 2003 as loan sales and all loan securitizations in 2004 and later as financings for accounting purposes. When securitizations are structured as financings no gain or loss is recognized, nor is any allocation made to residual interests or servicing rights. Rather, the loans securitized continue to be carried by the Company as assets, and the asset-backed bonds secured by the loans are carried as a liability. Additionally, all of the 2005 and 2004 securitizations were structured to issue classes of bonds with different estimated maturity dates and average lives in order to better meet investor demands.

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Origen Financial, Inc.
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Note 10 Loan Securitizations, continued:

On May 12, 2005, the Company completed a securitized financing transaction for approximately $190.0 million in principle balance of manufactured housing loans, which was funded by issuing bonds of approximately $165.3 million, at a duration-weighted average interest cost of 5.30%. Net proceeds from the transaction totaled approximately $165.3 million, of which approximately $156.2 million was used to reduce the aggregate balances of notes outstanding under the Company s short-term securitization facility.

On December 15, 2005, the Company completed a securitized financing transaction for approximately $175.0 million in principle balance of manufactured housing loans, which was funded by issuing bonds of approximately $156.2 million, at a duration-weighted average interest cost of 6.15%. Net proceeds from the transaction totaled approximately $155.3 million, of which approximately $148.4 million was used to reduce the aggregate balances of notes outstanding under the Company s short-term securitization facility.

On February 11, 2004, the Company completed a securitized financing transaction for approximately $238.0 million in principle balance of manufactured housing loans, which was funded by issuing bonds of approximately $200.0 million, at a duration-weighted average interest cost of 5.12%. Net proceeds from the transaction totaled approximately $199.2 million, of which approximately $176.7 million was used to reduce the aggregate balances of notes outstanding under the Company s short-term securitization facility.

On September 29, 2004, the Company completed a securitized financing transaction for approximately $200.0 million in principle balance of manufactured housing loans, which was funded by issuing bonds of approximately $169.0 million, at a duration-weighted average interest cost of 5.27%. Net proceeds from the transaction totaled approximately $168.2 million, of which approximately $143.6 million was used to reduce the aggregate balances of notes outstanding under the Company s short-term securitization facility.

The total principal balance of loans serviced by the Company and which the Company has previously securitized and accounted for as a sale was approximately $150.3 million and $176.8 million at December 31, 2005 and 2004, respectively. Delinquency statistics (including repossessed inventory) on those loans are as follows at December 31 (dollars in thousands):

	2005			2004		
Days delinquent	No. of Loans	Principal Balance	% of Portfolio	No. of Loans	Principal Balance	% of Portfolio
31-60	93	$3,605	2.4%	125	$ 4,988	2.8%
61-90	43	1,658	1.1%	57	2,149	1.2%
Greater than 90	203	8,895	5.9%	237	10,708	6.1%

Note 11 Debt

Total debt outstanding was as follows at December 31 (in thousands):

	2005	2004
Warehouse financing	$ 65,411	$ 107,373
Securitization financing	578,503	328,388
Repurchase agreements	23,582	20,153
Notes payable servicing advances	2,212	
	$ 669,708	$ 455,914

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Origen Financial, Inc.
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Note 11 Debt, continued:

Warehouse Financing Citigroup - The Company, through its operating subsidiary Origen Financial L.L.C., currently has a short term securitization facility used for warehouse financing with Citigroup Global Markets Realty Corporation (Citigroup). Under the terms of the agreement, originally entered into in March 2003 and amended periodically, most recently in April 2005, the Company pledges loans as collateral and in turn is advanced funds. The facility has a maximum advance amount of $200 million, an advance rate equal to approximately 85% of the unpaid principal balance of the pool of loans pledged and an annual interest rate equal to LIBOR plus a spread. Additionally, the facility includes a $15 million supplemental advance amount that is collateralized by the Company s residual interests in the 2004-A, 2004-B, 2005-A and 2005-B securitizations. The facility matures on March 23, 2006. The outstanding balance on the facility was approximately $65.4 million and $107.4 million at December 31, 2005 and 2004, respectively. It is anticipated that the facility will be renewed with terms no less favorable than the current terms. At December 31, 2005 all financial covenants were met.

Securitization Financing 2004-A Securitization - On February 11, 2004, the Company completed a securitization of approximately $238.0 million in principal balance of manufactured housing loans. The securitization was accounted for as a financing. As part of the securitization the Company, through a special purpose entity, issued $200.0 million in notes payable. The notes are stratified into six different classes and pay interest at a duration-weighted average rate of approximately 5.12%. The notes have a contractual maturity date of October 2013 with respect to the Class A-1 notes; August 2017, with respect to the Class A-2 notes; December 2020, with respect to the Class A-3 notes; and January 2035, with respect to the Class A-4, Class M-1 and Class M-2 notes. The outstanding balance on the 2004-A securitization notes was approximately $138.3 million and $167.9 million at December 31, 2005 and 2004, respectively.

Securitization Financing 2004-B Securitization On September 29, 2004, the Company completed a securitization of approximately $200.0 million in principal balance of manufactured housing loans. The securitization was accounted for as a financing. As part of the securitization the Company, through a special purpose entity, issued $169.0 million in notes payable. The notes are stratified into seven different classes and pay interest at a duration-weighted average rate of approximately 5.27%. The notes have a contractual maturity date of June 2013 with respect to the Class A-1 notes; December 2017, with respect to the Class A-2 notes; August 2021, with respect to the Class A-3 notes; and November 2035, with respect to the Class A-4, Class M-1, Class M-2 and Class B-1 notes. The outstanding balance on the 2004-B securitization notes was approximately $136.2 million and $141.8 million at December 31, 2005 and 2004, respectively.

Securitization Financing 2005-A Securitization - On May 12, 2005, the Company completed a securitization of approximately $190.0 million in principal balance of manufactured housing loans. The securitization was accounted for as a financing. As part of the securitization the Company, through a special purpose entity, issued $165.3 million in notes payable. The notes are stratified into seven different classes and pay interest at a duration-weighted average rate of approximately 5.30%. The notes have a contractual maturity date of July 2013 with respect to the Class A-1 notes; May 2018, with respect to the Class A-2 notes; October 2021, with respect to the Class A-3 notes; and June 2036, with respect to the Class A-4, Class M-1, Class M-2 and Class B notes. The outstanding balance on the 2005-A securitization notes was approximately $150.5 million at December 31, 2005.

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Origen Financial, Inc.
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Note 11 Debt, continued:

Securitization Financing 2005-B Securitization December 15, 2005, the Company completed a securitization of approximately $175.0 million in principal balance of manufactured housing loans. The securitization was accounted for as a financing. As part of the securitization the Company, through a special purpose entity, issued $156.2 million in notes payable. The notes are stratified into eight different classes and pay interest at a duration-weighted average rate of approximately 6.15%. The notes have a contractual maturity date of February 2014 with respect to the Class A-1 notes; December 2018, with respect to the Class A-2 notes; May 2022, with respect to the Class A-3 notes; and January 2037, with respect to the Class A-4, Class M-1, Class M-2 , Class B-1 and B-2 notes. The outstanding balance on the 2005-B securitization notes was approximately $153.5 million at December 31, 2005.

Repurchase Agreements Citigroup - The Company has entered into four repurchase agreements with Citigroup. Three of the repurchase agreements are for the purpose of financing the purchase of investments in three asset backed securities with principal balances of $32.0 million, $3.1 million and $3.7 million respectively. The fourth repurchase agreement is for the purpose of financing the Company s residual interest in the 2004-B securitization with a principal balance of $4.0 million. Under the terms of the agreements the Company sells its interest in the securities with an agreement to repurchase them at a predetermined future date at the principal amount sold plus an interest component. The securities are financed at an amount equal to 75% of their current market value as determined by Citigroup. Typically the repurchase agreements are rolled over for 30 day periods when they expire. The annual interest rates on the agreements are equal to LIBOR plus a spread. The repurchase agreements had outstanding principal balances of approximately $16.8 million, $1.7 million, $2.1 million and $3.0 million, respectively, at December 31, 2005, and $18.4 million, $1.8 million, $0 and $0, respectively, at December 31, 2004.

Notes Payable Servicing Advances JPMorgan Chase Bank, N.A. The Company currently has a revolving credit facility with JPMorgan Chase Bank, N.A. Under the terms of the facility the Company can borrow up to $5.0 million for the purpose of funding required principal and interest advances on manufactured housing loans that are serviced for outside investors. Borrowings under the facility are repaid upon the collection by the Company of monthly payments made by borrowers under such manufactured housing loans. The bank s prime interest rate is payable on the outstanding balance. To secure the loan, the Company has granted JPMorgan Chase a security interest in substantially all its assets excluding securitized assets. The expiration date of the facility is December 31, 2006. The outstanding balance on the facility was approximately $2.2 million at December 31, 2005. There was no outstanding balance at December 31, 2004. At December 31, 2005 all financial covenants were met.

The average balance and average interest rate of outstanding debt was as follows at December 31 (dollars in thousands):

	2005		2004	
	Average Balance	Average Rate	Average Balance	Average Rate
Warehouse financing Citigroup	$139,539	5.2%	$139,115	3.9%
Securitization financing 2004-A securitization	154,295	4.9%	163,088	4.4%
Securitization financing 2004-B securitization	149,499	5.1%	42,299	4.8%
Securitization financing 2005-A securitization	101,441	5.1%		
Securitization financing 2005-B securitization	7,228	5.5%		
Repurchase agreements Citigroup	22,793	4.2%	17,573	2.3%
Note payable servicing advances JPMorgan Chase, N.A.	710	7.5%	553	7.0%

At December 31, 2005, the total of maturities and amortization of debt during the next five years are approximately as follows: 2006 $150.8 million; 2007 $87.8 million; 2008 - $63.3 million; 2009 $55.1 million; 2010 $47.8 million and $264.9 million thereafter.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 12 Employee Benefits

The Company maintains a 401(k) plan covering substantially all employees who meet certain minimum requirements. Participating employees can make salary contributions to the plan up to Internal Revenue Code limits. The Company matches up to $0.50 for each dollar contributed by each eligible participant in the plan up to 6% of each eligible participant s pay. The Company s related expense was approximately $151,000, $162,000 and $150,000, respectively for the years ended December 31, 2005, 2004 and 2003.

The Company is primarily self-insured for health care costs, however, it maintains a stop-loss coverage of $85,000 per individual. Amounts for claims filed and estimates for claims incurred but not reported were approximately $121,000 and $92,000 at December 31, 2005 and 2004, respectively.

Note 13 Equity Incentive Plan

The Company s equity incentive plan has approximately 1.7 million shares of common stock reserved for issuance as either stock options or stock grants. Under the plan, the exercise price of the options will not be less than the fair market value of the common stock on the date of grant. The date on which the options are first exercisable is determined by the Compensation Committee of the Board of Directors as the administrator of the Company s equity incentive plan, and options that have been issued to date generally vest over a two-year period. As of December 31, 2005, 255,500 options were outstanding under the plan at an exercise price of $10.00.

Data pertaining to the Company s stock options are as follows:

	2005	2004	2003
Options outstanding, beginning of period	267,500	95,000	
Options granted		198,000	95,000
Option price		$ 10.00	$ 10.00
Options exercised			
Option price			
Options forfeited	12,000	25,500	
Options outstanding, December 31	255,500	267,500	95,000
Option price	$ 10.00	$ 10.00	$ 10.00

The following table summarizes additional information concerning outstanding and exercisable stock options at December 31, 2005:

Number of Options Outstanding	Remaining Contractual Life In Years	Exercise Price	Number of Options Exercisable
95,000	7.8	$ 10.00	63,333
160,500	8.1	$ 10.00	107,000
255,500			170,333

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 13 Equity Incentive Plan, continued:

The Company has adopted the disclosure requirements of SFAS 123. Accordingly, the fair value of each option granted in 2004 was estimated using a binomial option- pricing model based on the assumptions stated below: There were no stock option grants in 2005.

Estimated weighted average fair value per share of options granted	$ 0.40
Assumptions:	
Annualized dividend yield	12.00%
Common stock price volatility	15.00%
Weighted average risk free rate of return	4.00%
Weighted average expected option term (in years)	5.0

Note 14 Stockholders Equity

Effective January 1, 2004, the Company sold 125 shares of its Series A Cumulative Redeemable Preferred Stock directly to 125 investors at a per share price of $1,000. The transaction resulted in net proceeds to the Company of $95,000. These shares pay dividends quarterly at an annual rate of 12.5%.

On February 4, 2004, the Company completed a private placement of 1,000,000 shares of its common stock to one institutional investor. The offering provided net proceeds to the Company of approximately $9.4 million.

On May 6, 2004, the Company completed an initial public offering of 8.0 million shares of its common stock. In June 2004 the underwriters of the initial public offering purchased an additional 625,900 shares of the Company s common stock pursuant to an underwriter s over-allotment option. Net proceeds from these transactions were $72.2 million after discount and expenses, which were used primarily to pay down the aggregate balances of the notes outstanding under the Company s loan funding facility with Citigroup and to fund new loan originations.

On January 29, 2004, March 23, 2004, August 5, 2004, May 8, 2005 and October 26, 2005, the Company issued 207,000, 113,000, 111,750, 299,000 and 5,000 restricted stock awards, respectively, under its equity incentive plan to certain directors, officers and employees. The stock awards were issued at $10.00, $10.00, $7.50, $7.21 and $7.06 per share on January 29, 2004, March 23, 2004, August 5, 2004, May 8, 2005 and October 26, 2005, respectively. 8,334 and 24,750 stock awards were forfeited and 254,160 and 100,829 were fully vested during the years ended December 31, 2005 and 2004, respectively. The stock awards are being amortized over their estimated service period. Compensation cost recognized for the restricted stock awards was approximately $2.5 million, $2.1 million and $0.1 million for the years ended December 31, 2005, 2004 and 2003, respectively. Amortization over the next twelve months is expected to be approximately $1.4 million.

Data pertaining to the Company s distributions declared and paid to common stockholders during 2005 and 2004 are as follows:

Declaration Date	Record Date	Date Paid	Distribution per share	Total Distribution (thousands)
March 14, 2005	March 24, 2005	March 31, 2005	$ 0.04	$ 1,008
April 27, 2005	May 25, 2005	May 31, 2005	$ 0.06	$ 1,528
July 18, 2005	August 22, 2005	August 31, 2005	$ 0.06	$ 1,528
October 26, 2005	November 21, 2005	November 30, 2005	$ 0.06	$ 1,528
March 16, 2004	March 16, 2004	June 6, 2004	$ 0.04	$ 656
July 22, 2004	August 2, 2004	August 30, 2004	$ 0.06	$ 1,507
November 12, 2004	November 22, 2004	November 29, 2004	$ 0.25	$ 6,304

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 15 Income Taxes

The Company has elected to be taxed as a REIT as defined under Section 856(c)(1) of the Internal Revenue Code of 1986, as amended (the Code). In order for the Company to qualify as a REIT, at least ninety-five percent (95%) of the Company s gross income in any year must be derived from qualifying sources. In addition, a REIT must distribute at least ninety percent (90%) of its REIT taxable net income to its stockholders.

Qualification as a REIT involves the satisfaction of numerous requirements (some on an annual and quarterly basis) established under highly technical and complex Code provisions for which there are only limited judicial or administrative interpretations, and involves the determination of various factual matters and circumstances not entirely within the Company s control. In addition, frequent changes occur in the area of REIT taxation, which requires the Company continually to monitor its tax status.

The Company has received a legal opinion to the effect that based on various assumptions and qualifications set forth in the opinion, Origen Financial, Inc. has been organized and has operated in conformity with the requirements for qualification as a REIT under the Code for its taxable year ended December, 31, 2005. There is no assurance that the Internal Revenue Service will not decide differently from the views expressed in counsel s opinion and such opinion represents only the best judgment of counsel and is not binding on the Internal Revenue Service or the courts.

As a REIT, the Company generally will not be subject to U.S. Federal income taxes at the corporate level on the ordinary taxable income it distributes to its stockholders as dividends. If the Company fails to qualify as a REIT in any taxable year, its taxable income will be subject to U.S. Federal income tax at regular corporate rates (including any applicable alternative minimum tax). Even if the Company qualifies as a REIT, it may be subject to certain state and local income taxes and to U.S. Federal income and excise taxes on its undistributed taxable income. In addition, taxable income from non-REIT activities managed through taxable REIT subsidiaries, if any, is subject to federal and state income taxes.

For income tax purposes, distributions paid to common stockholders consist of ordinary income and return of capital. Distributions paid were taxable as follows for the years and period ended December 31 (dollars in thousands):

	2005		2004		2003	
	Amount	Percentage	Amount	Percentage	Amount	Percentage
Ordinary income	$ 1,242	22.2%	$ 4,496	53.1%	$ 1,484	100.0%
Return of capital	4,350	77.8%	3,971	46.9%		
	$ 5,592	100.0%	$ 8,467	100.0%	$ 1,484	100.0%

A portion of the Company s income from a qualified REIT subsidiaries that would otherwise be classified as a taxable mortgage pool, may be treated as excess inclusion income, which would be subject to the distribution requirements that apply to the Company and could therefore adversely affect its liquidity. Generally, a stockholder s share of excess inclusion income would not be allowed to be offset by any operating losses otherwise available to the stockholder. Tax exempt entities that own shares in a REIT must treat their allocable share of excess inclusion income as unrelated business taxable income. Any portion of a REIT dividend paid to foreign stockholders that is allocable to excess inclusion income will not be eligible for exemption from the 30% withholding tax (or reduced treaty rate) on dividend income. For the year ended December 31, 2005, approximately 22.2% of distributions paid represents excess inclusion income.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 16 Liquidity Risks and Uncertainties

The risks associated with the Company s business become more acute in any economic slowdown or recession. Periods of economic slowdown or recession may be accompanied by decreased demand for consumer credit and declining asset values. In the manufactured housing business, any material decline in collateral values increases the loan-to-value ratios of loans previously made, thereby weakening collateral coverage and increasing the size of losses in the event of default. Delinquencies, foreclosures and losses generally increase during economic slowdowns or recessions.

For the Company s finance customers, loss of employment, increases in cost-of-living or other adverse economic conditions would impair their ability to meet their payment obligations. Higher industry inventory levels of repossessed manufactured houses may affect recovery rates and result in future impairment charges and provision for losses. In addition, in an economic slowdown or recession, servicing and litigation costs generally increase. Any sustained period of increased delinquencies, foreclosures, losses or increased costs would adversely affect the Company s financial condition and results of operations.

Management believes that it will have sufficient sources of capital to allow the Company to continue its operations including loan originations in the near term; however, the Company s future cash flow requirements depend on numerous factors, many of which are outside of its control.

Cash generated from operations, borrowings under our Citigroup facility, which matures on March 23, 2006 and we anticipate will be renewed with terms no less favorable than the current terms, loan securitizations, borrowings against our securitized loan residuals, convertible debt, equity interests or additional debt financing arrangements (either pursuant to our shelf registration on Form S-3 or otherwise) will enable us to meet our liquidity needs for at least the next twelve months depending on market conditions which may affect loan origination volume, loan purchases opportunities and the availability of securitizations. If market conditions require or if loan purchase opportunities become available, we may seek additional funds through additional credit facilities or additional sales of our common or preferred stock.

The Company s ability to obtain funding from operations may be adversely impacted by, among other things, market and economic conditions in the manufactured housing financing markets generally, including decreased sales of manufactured houses. The ability to obtain funding from loan sales and securitizations may be adversely impacted by, among other things, the price and credit quality of the Company s loans, conditions in the securities markets generally (and specifically in the manufactured housing asset-backed securities market), compliance of loans with the eligibility requirements for a particular securitization and any material negative rating agency action pertaining to certificates issued in the Company s securitizations. The ability to obtain funding from sales of securities or debt financing arrangements may be adversely impacted by, among other things, market and economic conditions in the manufactured housing financing markets generally and the Company s financial condition and prospects.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 17 Lease Commitments

The Company leases office facilities and equipment under leasing agreements that expire at various dates. These leases generally contain scheduled rent increases or escalation clauses and/or renewal options. Future minimum rental payments at December 31, 2005 (in thousands) were:

2006	$1,090
2007	1,060
2008	669
2009	478
2010	473
Thereafter	551

For the years ended December 31, 2005, 2004 and the periods ended December 31, 2003 and October 7, 2003, rental and operating lease expense amounted to approximately $1.1 million, $1.1 million, $0.2 million and $0.9 million, respectively.

Note 18 Fair Value of Financial Instruments

Statement of Financial Accounting Standards No. 107 Disclosures About Fair Value of Financial Instruments , requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate such value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques.

The following table shows the carrying amount and estimated fair values of the Company s financial instruments at December 31 (in thousands):

	2005		2004	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets				
Cash and equivalents	$ 8,307	$ 8,307	$ 9,293	$ 9,293
Restricted cash	13,635	13,635	9,222	9,222
Loans receivable	768,410	776,272	563,268	572,672
Loan sale proceeds receivable			2,057	2,057
Servicing rights	3,103	3,310	4,097	5,023
Liabilities				
Accounts payable and accrued expenses	23,052	23,052	16,564	16,564
Recourse liability	292	292	6,603	6,603
Warehouse financing	65,411	65,411	107,373	107,373
Securitization financing	578,503	569,813	328,388	324,126
Repurchase agreements	23,582	23,582	20,153	20,153
Note payable servicing advances	2,212	2,212		

The carrying amounts for cash and cash equivalents and restricted cash are reasonable estimates of their fair value.

Fair values for the Company s loans are estimated using market prices for loans with similar interest rates, terms and borrowers credit quality as those being offered by the Company.

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Origen Financial, Inc.
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The carrying amount of accrued interest approximates its fair value. Due to their short maturity, accounts payable and accrued expense carrying values approximate fair value.

The fair value of the Company s recourse liability approximates its carrying value. The fair value is based on a discounted cash flow analysis with prepayment assumptions based on historical performance and industry standards.

The fair value of the Company s debt, other than securitization financing, is based on its carrying amount.

The fair value of the Company s securitization financing is estimated using quoted market prices.

Note 19 Related Party Transactions

Gary A. Shiffman, one of the Company s directors, is the Chairman of the Board, President and Chief Executive Officer of Sun Communities, Inc. (Sun Communities). Sun Communities owns approximately 20% of the Company s outstanding common stock. Mr. Shiffman beneficially owns approximately 20% of the Company s outstanding stock, which amount includes his deemed beneficial ownership of the stock owned by Sun Communities. Mr. Shiffman and his affiliates beneficially own approximately 12% of the outstanding common stock of Sun Communities. He is the President of Sun Home Services, Inc. (Sun Homes), of which Sun Communities is the sole beneficial owner.

Origen Servicing, Inc., a wholly owned subsidiary of Origen Financial L.L.C., serviced approximately $19.6 million and $16.0 million in manufactured housing loans for Sun Homes as of December 31, 2005 and 2004, respectively. Servicing fees paid by Sun Homes to Origen Servicing, Inc. were approximately $0.3 million, $0.2 million and $0.2 million during the years ended December 31, 2005, 2004 and 2003, respectively.

The Company has agreed to fund loans that meet Sun Homes underwriting guidelines and then transfer those loans to Sun Homes pursuant to a commitment fee arrangement. The Company recognizes no gain or loss on the transfer of these loans. The Company funded approximately $7.2 million, $4.7 million and $2.8 million in loans and transferred approximately $7.2 million, $4.8 million and $2.7 million in loans under this agreement during the three years ended December 31, 2005, 2004 and 2003, respectively.

Sun Homes has purchased certain repossessed houses owned by the Company and located in manufactured housing communities owned by Sun Homes, subject to Sun Homes prior approval. Under this agreement, the Company sold to Sun Homes approximately $2.2 million, $3.1 million and $2.4 million of repossessed houses during years ended December 31, 2005, 2004 and 2003, respectively. This program allows the Company to further enhance recoveries on repossessed houses and allows Sun Homes to retain houses for resale in its communities.

The Company leases its executive offices in Southfield, Michigan from an entity in which Mr. Shiffman and certain of his affiliates beneficially own approximately a 21% interest. Ronald A. Klein, a director and the Chief Executive Officer of the Company, beneficially owns an approximate 1% interest in the landlord entity. William M. Davidson, the sole member of Woodward Holding, LLC, which owns approximately 7% of the Company s common stock, beneficially owns an approximate 25% interest in the landlord entity. The Company recorded rental expense for these offices of approximately $408,000, $398,000 and $283,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

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Origen Financial, Inc.
Notes to Consolidated Financial Statements

Note 20 Selected Quarterly Financial Data (UNAUDITED)

Selected unaudited quarterly financial data for 2005 is as follows (in thousands, except share data):

	Quarter Ended			
	December 31	September 30	June 30	March 31
Net interest income before loan losses and impairment	$7,532	$ 7,694	$7,941	$7,756
Provision for credit losses and impairment	2,319	7,125	1,645	2,030
Non interest income	4,101	3,874	3,396	3,280
Non interest expense	8,411	10,525	8,179	7,999
Net income (loss)	903	(6,082)	1,513	1,007
Earnings (loss) per share basic and diluted (2)	$ 0.04	$ (0.24)	$ 0.06	$ 0.04

Selected unaudited quarterly financial data for 2004 is as follows (in thousands, except share data):

	Quarter Ended (1)			
	December 31	September 30	June 30	March 31
Net interest income before loan losses and impairment	$ 7,481	$ 7,489	$6,738	$5,751
Provision for credit losses and impairment	2,131	1,500	1,531	1,891
Non interest income	2,314	2,976	3,014	2,880
Non interest expense	13,694	7,556	6,829	6,477
Net income (loss)	(6,030)	1,409	1,392	263
Earnings (loss) per share basic and diluted (2)	$ (0.24)	$ 0.06	$ 0.07	$ 0.02

(1) Certain reclassifications have been made to the quarterly data to conform with the annual presentation with no net effect to net income or per share amounts.

(2) Quarterly and year-to-date computations of per share amounts are made independently; therefore, the sum of per share

amounts for the quarters may not equal per share amounts for the year.

Note 21 Subsequent Events

In January 2006, the Company entered into a forward starting interest rate swap for the purpose of locking in the designated benchmark interest rate, in this case LIBOR, on a portion of a planned securitization transaction to be completed mid-2006. The Company has designated the swaps as cash flow hedges for accounting purposes. Under the terms of the swap the Company will pay a fixed rate of 4.79% and receive a floating rate equal to the one month LIBOR rate on a beginning notional balance of $44.0 million. The first payment is scheduled for June 30, 2006. A rise in rates during the interim period would increase the Company s borrowing cost in the securitization, but this increase would be offset by the increased value in the right to pay a lower fixed rate during the term of the securitized transaction. The hedging transaction was structured at inception to meet the criteria set forth in SFAS 133 in order to allow the Company to assume that no ineffectiveness exists. As a result, all changes in the fair value of the derivatives are included in other comprehensive income and such amounts will be amortized into earnings upon commencement of the planned transaction. In the event the Company is unable to or declines to enter into the securitization transaction or if the commencement of the securitization transaction is significantly delayed, some or all of the amounts included in other comprehensive income may be immediately included in earnings, as required under SFAS 133.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable

ITEM 9A. CONTROLS AND PROCEDURES

Disclosures Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer have concluded that the design and operation of our disclosure controls and procedures are effective as of December 31, 2005. This conclusion is based on an evaluation conducted under the supervision and with the participation of management. Disclosure controls and procedures are those controls and procedures which ensure that information required to be disclosed in this filing is accumulated and communicated to management and is recorded, processed, summarized and reported in a timely manner and in accordance with Securities and Exchange Commission rules and regulations.

Internal Controls Over Financial Reporting

Management s Report on Internal Control Over Financial Reporting regarding the effectiveness of internal controls over financial reporting is presented on page 46. The Report of Independent Registered Accounting Firm is presented on page 48. During the quarter ended December 31, 2005, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable

PART III

The information required by Items 10-14 will be included in our proxy statement for our 2006 Annual Meeting of Shareholders, and is incorporated by reference herein.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed herewith as part of this Form 10-K:

(1) The following financial statements are set forth in Part II, Item 8 of this report

(2) Not applicable

(3) A list of the exhibits required by Item 601 of Regulation S-K to be filed as a part of this Form 10-K is shown on the Exhibit Index filed herewith.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: March 15, 2006

ORIGEN FINANCIAL, INC., a Delaware corporation

By: /s/ Ronald A. Klein
Ronald A. Klein, Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ Ronald A. Klein Ronald A, Klein	Chief Executive Officer and Director	March 15, 2006
/s/ W. Anderson Geater, Jr. W. Anderson Geater, Jr.	Chief Financial Officer and Principal Accounting Officer	March 15, 2006
/s/ Paul A. Halpern Paul A. Halpern	Chairman of the Board	March 15, 2006
/s/ Richard H. Rogel Richard H. Rogel	Director	March 15, 2006
/s/ Gary A. Shiffman Gary A. Shiffman	Director	March 15, 2006
/s/ Michael J. Wechsler Michael J. Wechsler	Director	March 15, 2006
/s/ James A. Williams	Director	March 15, 2006

James A. Williams

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EXHIBIT INDEX

Exhibit Number	Description	Method of Filing
1.1	Sales Agreement dated August 29, 2005 between Origen Financial, Inc. (Origen), and Brinson Patrick Securities Corporation	(2)
3.1.1	Second Amended and Restated Certificate of Incorporation of Origen, filed October 7, 2003, and currently in effect	(1)
3.1.2	Certificate of Designations for Origen s Series A Cumulative Redeemable Preferred Stock	(1)
3.2	By-laws of Origen	(6)
4.1	Form of Common Stock Certificate	(1)
4.2	Registration Rights Agreement dated as of October 8, 2003 among Origen, Lehman Brothers Inc., on behalf of itself and as agent for the investors listed on Schedule A thereto and those persons listed on Schedule B thereto	(1)
4.3	Registration Rights Agreement dated as of February 4, 2004 between Origen and DB Structured Finance Americas, LLC	(1)
4.4	Form of Senior Indenture	(2)
4.5	Form of Subordinated Indenture	(2)
10.1	Contribution Agreement, dated October 8, 2003, among Origen and the entities set forth on Appendix I thereto	(1)
10.2	Common Stock Purchase Agreement dated October 8, 2003 between Lehman Brothers Inc. and Origen	(1)
10.3	Concurrent Private Placement Agreement dated October 8, 2003 among Origen and the Purchasers (as defined therein)	(1)
10.4	Private Placement Agreement dated February 4, 2004 between Origen and DB Structured Finance Americas, LLC	(1)
10.5	2003 Equity Incentive Plan of Origen#	(1)
10.6	First Amendment to 2003 Equity Incentive Plan of Origen#	(5)
10.7	Form of Non-Qualified Stock Option Agreement#	(1)
10.8	Form of Restricted Stock Award Agreement#	(1)
10.9		(1)

	Employment Agreement between Origen, Origen Financial L.L.C. and W. Anderson Geater#	
10.10	Employment Agreement between Origen, Origen Financial L.L.C. and Ronald A. Klein#	(1)
10.11	Employment Agreement between Origen, Origen Financial L.L.C. and Mark Landschulz#	(1)
10.12	Employment Agreement between Origen, Origen Financial L.L.C. and J. Peter Scherer#	(1)

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Exhibit Number	Description	Method of Filing
10.13	Employment Agreement between Origen, Origen Financial L.L.C. and Benton Sergi#	(4)
10.14	Origen Financial L.L.C. Endorsement Split-Dollar Plan dated November 14, 2003#	(1)
10.15	Origen Financial L.L.C. Capital Accumulation Plan#	(1)
10.16	First Amendment to Origen Financial L.L.C. Capital Accumulation Plan#	(1)
10.17	Services and Interest Rebate Agreement dated October 8, 2003 between Origen Financial L.L.C. and Sun Communities, Inc.	(1)
10.18	Credit Agreement dated July 25, 2002 between Origen Financial L.L.C. and Bank One, NA	(1)
10.19	First Amendment to Credit Agreement between Origen Financial L.L.C. and Bank One, NA dated June 27, 2003	(1)
10.20	Second Amendment to Credit Agreement between Origen Financial L.L.C. and Bank One, NA dated October 23, 2003	(1)
10.21	Third Amendment to Credit Agreement between Origen Financial L.L.C. and Bank One, NA dated December 31, 2003	(1)
10.22	Fourth Amendment to Credit Agreement effective as of December 31, 2004 between Origen Financial L.L.C. and JPMorgan Chase Bank, N.A. (as successor by merger to Bank One, NA)	(3)
10.23	Fifth Amendment to Credit Agreement effective as of December 23, 2005 between Origen Financial L.L.C. and JPMorgan Chase Bank, N.A.	(6)
10.24	Lease dated October 18, 2002 between American Center LLC and Origen Financial L.L.C.	(1)
10.25	Agency Agreement between American Modern Home Insurance Company, American Family Home Insurance Company and OF Insurance Agency, Inc. dated December 31, 2003	(1)
21.1	List of Origen s Subsidiaries.	(6)
23.1	Consent of Grant Thornton LLP	(6)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	(6)
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	(6)
32.1		(6)

	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	
99.1	Amended and Restated Charter of the Audit Committee of the Origen Board of Directors and Audit Committee of the Origen Board of Directors	(1)
99.2	Charter of the Compensation Committee of the Origen Board of Directors	(1)

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Exhibit Number	Description	Method of Filing
99.3	Charter of the Nominating and Governance Committee of the Origen Board of Directors	(1)
99.4	Charter of the Executive Committee of the Origen Board of Directors	(1)
99.5	Corporate Governance Guidelines	(1)
99.6	Code of Business Conduct	(1)
99.7	Financial Code of Ethics	(1)

(1) Incorporated by reference to Origen Financial, Inc. s Registration Statement on Form S-11 No. 33-112516, as amended.

(2) Incorporated by reference to Origen Financial, Inc. s Registration Statement on Form S-3 No. 33-127931.

(3) Incorporated by reference to Origen Financial, Inc. s Annual Report on Form 10-K for the year ended December 31, 2004.

(4) Incorporated by reference to Origen Financial, Inc. s Amendment to

Annual Report on Form 10-K/A for the year ended December 31, 2004.

(5) Incorporated by reference to Origen Financial, Inc. s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.

(6) Filed herewith.

Management contract or compensatory plan or arrangement.