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 June 30, 1998

or

[ ] TRANSITION REPORTS PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 0-27488

INCYTE PHARMACEUTICALS, INC.
(Exact name of registrant as specified in its charter)

Delaware	94-3136539
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

3174 Porter Drive
Palo Alto, California 94304
(Address of principal executive offices)

(650) 855-0555
(Registrant's telephone number, including area code)

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

The number of outstanding shares of the registrant's Common Stock, $0.001 par value, was 26,663,544 as of June 30, 1998.

INCYTE PHARMACEUTICALS, INC.

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PART I: FINANCIAL INFORMATION
ITEM 1 FINANCIAL STATEMENTS

INCYTE PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands),
(unaudited),

	JUNE 30, 1998	DECEMBER 31, 1997*
ASSETS		
Current assets:		
Cash and cash equivalents.	$ 32,944	$ 55,598
Restricted cash.	4,000	6,000
Marketable securities - available-for-sale . . .	93,766	57,497
Accounts receivable, net	10,970	19,983
Prepaid expenses and other current assets. . . .	5,516	3,836
Total current assets	147,196	142,914
Property and equipment, net.	45,653	38,070
Long-term investments.	21,054	14,800
Deposits and other assets.	5,285	3,305
Total assets	$ 219,188	$ 199,089
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,527	5,791
Accrued and other current liabilities.	13,664	14,608
Deferred revenue	43,213	31,815
Total current liabilities.	60,404	52,214
Non-current portion of accrued rent and other Non-current liabilities.	908	1,173
Total liabilities.	61,312	53,387
Stockholders' equity:		
Capital stock.	27	26
Additional paid-in capital	182,403	175,749
Deferred compensation.	(1,412)	-
Receivable from stockholder.	(49)	-
Accumulated other comprehensive income	7	56
Accumulated deficit.	(23,100)	(30,129)
Total stockholders' equity	157,876	145,702
Total liabilities and stockholders' equity	$ 219,188	$ 199,089

See accompanying notes

INCYTE PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts),
(unaudited),

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	1998	1997	1998	1997
Revenues	$33,093	$21,425	$63,472	$39,423
Costs and expenses:				
Research and development	23,120	17,370	44,819	32,503
Selling, general and administrative	5,722	3,250	10,322	6,103
Acquisition-related charges	-	-	1,171	-
Total costs and expenses	28,842	20,620	56,312	38,606
Income from operations	4,251	805	7,160	817
Interest and other income, net	1,804	572	3,681	1,069
Losses from joint venture	-	-	(640)	-
Income before income taxes	6,055	1,377	10,201	1,886
Provision for income taxes	848	106	1,428	158
Net income	$ 5,207	$ 1,271	$ 8,773	$ 1,728
Basic net income per share	$ 0.20	$ 0.05	$ 0.33	$ 0.07
Shares used in computing basic net income per share	26,610	23,122	26,504	23,059
Diluted net income per share	$ 0.18	$ 0.05	$ 0.30	$ 0.07
Shares used in computing diluted net income per share	28,667	25,209	28,792	25,228

See accompanying notes

INCYTE PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands),
(unaudited),

	SIX MONTHS ENDED JUNE 30,	
	1998	1997
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income.	$ 8,773	$ 1,728
Adjustments to reconcile net income to net cash provided by Operating activities:		
Depreciation and amortization	7,489	4,592
Losses in joint venture	640	-
Amortization of deferred compensation	246	-
Adjustment to conform pooled entity	278	-
Changes in certain assets and liabilities:		
Accounts receivable.	9,233	(1,497)
Prepaid expenses, deposits and other assets. . . .	(3,723)	(1,077)
Accounts payable	(2,078)	(963)
Accrued and other liabilities.	77	3,074
Deferred revenue	12,159	6,178
Net cash provided by operating activities.	33,094	12,035
CASH FLOWS FROM INVESTING ACTIVITIES:		
Long-term investments	(6,894)	(5,000)
Capital expenditures.	(15,325)	(9,136)
Proceeds from sale of assets leased back under Operating leases.	-	1,528
Purchases of marketable securities.	(60,171)	(4,511)
Sales and maturities of marketable securities	23,854	8,539
Net cash used in investing activities.	(58,536)	(8,580)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock.	2,923	4,322
Principal payments on capital lease obligations and Notes payable.	(135)	(53)
Net cash provided by financing activities.	2,788	4,269
Net increase (decrease) in cash and cash equivalents	(22,654)	7,724
Cash and cash equivalents at beginning of period	55,598	9,616
Cash and cash equivalents at end of period	$ 32,944	$17,340
SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION:		
Interest paid.	$ 43	$ 14
Income taxes paid.	$ 340	$ 70

See accompanying notes

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INCYTE PHARMACEUTICALS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 1998
(UNAUDITED)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The condensed consolidated balance sheet as of June 30, 1998 and December 31, 1997, statements of operations for the three and six months ended June 30, 1998 and 1997 and the statements of cash flows for the six months ended June 30, 1998 and 1997 are unaudited, but include all adjustments (consisting of normal recurring adjustments) which the Company considers necessary for a fair presentation of the financial position, operating results and cash flows for the periods presented.

The condensed consolidated financial statements include the accounts of its wholly-owned subsidiaries. In January 1998, all of the outstanding shares of Synteni, Inc. ("Synteni") were acquired by the Company in a business combination accounted for as a pooling-of-interests. Accordingly, all prior financial data have been restated to represent the combined financial results of the previously separate entities (Note 4). Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote information normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

Certain reclassifications were made to prior periods' balances to conform with the 1998 presentation. Results for any interim period are not necessarily indicative of results for any future interim period or for the entire year. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto for the year ended December 31, 1997 included in the Company's Current Report on Form 8-K.

2. REVENUE RECOGNITION

The Company recognizes revenue for database collaboration agreements evenly over the term of the agreement. Revenue is deferred for fees received before earned. Revenues from custom orders, such as satellite databases, are recognized upon shipment. Revenues from reagents and genomic screening products are recognized when shipped, and revenues from genomic screening services are recognized upon completion. Revenues from gene expression microarray services are recognized on completion of key stages in the performance of the service, in proportion to costs incurred. Revenues from software licenses are recognized upon completion of installation and revenues from software maintenance are recognized ratably over the life of the maintenance period.

3. NET INCOME PER SHARE

Basic EPS is computed by dividing net income available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) during the period and excludes the dilutive effect of stock options. Diluted EPS gives effect to all dilutive potential common shares outstanding during a period. In computing diluted EPS, the average stock price for the period is used in determining the number of shares assumed to be purchased from exercise of stock options.

Following is a reconciliation of the numerators and denominators of the basic and diluted EPS computations for the periods presented below.

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	1998	1997	1998	1997
Numerator:				
Net income	$ 5,207	$ 1,271	$ 8,773	$ 1,728
Denominator:				
Denominator for basic earnings Per share - weighted-average shares	26,610	23,122	26,504	23,059
Dilutive potential common shares- Stock options	2,057	2,087	2,288	2,169
Denominator for diluted earnings per Share.	28,667	25,209	28,792	25,228
Basic net income per share.	$ 0.20	$ 0.05	$ 0.33	$ 0.07
Diluted net income per share.	$ 0.18	$ 0.05	$ 0.30	$ 0.07

4. BUSINESS COMBINATIONS

In January 1998, the Company issued 2,340,237 shares of common stock in exchange for all of the capital stock of Synteni, Inc., a privately held microarray-based gene expression company located in Fremont, California. Synteni provides microarray services to the pharmaceutical, biotechnology, and agricultural industries. The merger has been accounted for as a pooling-of-interests and, accordingly, the Company's financial statements and financial data have been restated to include the accounts and operations of Synteni for all periods presented.

The table below presents the separate results of operations for Synteni for the periods prior to the merger. The Company's results of operations include Synteni since the transaction (in thousands):

	Incyte	Synteni	Merger Related Expenses	Total
Three months ended June 30, 1998				
Revenue.	$33,093	-	-	$33,093
Net income (loss).	5,207	-	-	5,207
Three months ended June 30, 1997				
Revenue	$21,192	$ 233	-	$21,425
Net income (loss)	1,942	(671)	-	1,271
Six months ended June 30, 1998				
Revenue	$63,472	-	-	$63,472
Net income (loss)	9,833	-	(1,060)	8,773
Six months ended June 30, 1997				
Revenue	$39,051	$ 372	-	$39,423
Net income (loss)	2,923	(1,195)	-	1,728

5. JOINT VENTURE

In September 1997, the Company formed a joint venture, diaDexus, LLC, ("diaDexus") which will utilize genomic and bioinformatic technologies in the discovery and commercialization of molecular diagnostics. The Company holds a 50 percent equity interest in diaDexus and accounts for the investment under the equity method. A portion of the investment is reflected as restricted cash and in accrued liabilities on the balance sheet since that balance is held in an escrow account and will be distributed to diaDexus as needed.

6. STOCKHOLDERS' EQUITY

In October 1997, the Company's Board of Directors authorized a two-for-one stock split to be effected in the form of a stock dividend payable November 7, 1997 to holders of record on October 17, 1997. All share and per share data have been adjusted retroactively to reflect the split.

7. NEW PRONOUNCEMENTS

In the first quarter of fiscal 1998 the Company adopted FASB Statement No. 130, Reporting Comprehensive Income ("SFAS 130"). SFAS 130 requires companies to disclose, both individually and in the aggregate, the change in equity from non-owner sources. The Company's adjustment to net income to arrive at comprehensive income is comprised of unrealized gains and losses on marketable securities available-for-sale. Comprehensive income was $5,268,000 and $8,725,000 for the three and six months ended June 30, 1998, respectively, and $1,375,000 and $1,771,000 for the respective periods in 1997.

In June 1997, the FASB issued Statement No. 131, Disclosures about Segments of an Enterprise and Related Information ("SFAS 131"). SFAS 131 establishes standards for reporting financial and descriptive information about an enterprise's operating segments in its annual financial statements and selected segment information in interim financial reports. Reclassification or restatement of comparative financial statements or financial information for earlier periods is required upon adoption of SFAS 131. Application of the Statements' disclosure requirements will have no impact on the Company's consolidated financial position, results of operations or earnings per share data as currently reported.

8. LITIGATION

On January 6, 1998, Affymetrix, Inc. ("Affymetrix") filed a lawsuit in the United States District Court for the District of Delaware alleging infringement of U.S. patent number 5,445,934 (the "'934 Patent") by both Synteni and Incyte. The complaint alleges that the '934 Patent has been

infringed by the making, using, selling, importing, distributing or offering to sell in the U.S. high density arrays by Synteni and Incyte and that such infringement was willful. Affymetrix seeks a permanent injunction enjoining Synteni and Incyte from further infringement of the '934 Patent and, in addition, seeks damages, costs and attorney's fees and interest. Affymetrix further requests that any such damages be trebled based on its allegation of willful infringement by Incyte and Synteni. Incyte and Synteni believe they have meritorious defenses and intend to defend the suit vigorously. However, there can be no assurance that Incyte and Synteni will be successful in the defense of this suit, and litigation has resulted and, if a settlement is not reached is expected to continue to result in substantial expenses and diversion of the efforts of management and technical personnel. Further, there can be no assurance that any license that may be required as a result of this suit or the outcome thereof would be made available on commercially acceptable terms, if at all.

PART I: FINANCIAL INFORMATION
ITEM 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and Results of Operations as of June 30, 1998 and for the three and six month periods ended June 30, 1998 and 1997 should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto set forth in Item 1 of this report and the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Current Report on Form 8-K. dated June 12, 1998.

When used in this discussion, the words "expects," "anticipates," "estimates," and similar expressions are intended to identify forward-looking statements. Such statements, which include statements as to expected expenditure levels, the adequacy of capital resources, and growth in operations, are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, those risks discussed below, as well as the extent of utilization of genomic information by the pharmaceutical industry in both research and development; risks relating to the development of new database products and their use by potential collaborators of the Company; the impact of technological advances and competition; the ability of the Company to obtain and retain customers; competition from other entities; early termination of a database collaboration agreement or failure to renew an agreement upon expiration; the ability to successfully integrate the operations of recent business combinations; the cost of accessing technologies developed by other companies; uncertainty as to the scope of coverage, enforceability or commercial protection from patents that issue on gene sequences and other genetic information; developments in and expenses relating to litigation; the results and viability of joint ventures and businesses in which the Company has purchased equity; and the matters discussed below under the caption "-Factors That May Affect Results." These forward-looking statements speak only as of the date hereof. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

OVERVIEW

Incyte Pharmaceuticals, Inc. (the "Company") designs, develops and markets genomic database products, genomic data management software tools, microarray-based gene expression services and related reagents. The Company's genomic databases integrate bioinformatics software with proprietary and, when appropriate, publicly available genetic information to create information-based tools used by pharmaceutical and biotechnology companies in drug discovery and development. In building the databases, the Company utilizes high-throughput, computer-aided gene sequencing and analysis technologies to identify and characterize the expressed genes of the human genome, as well as certain animal, plant and microbial genomes.

Revenues recognized by the Company consist primarily of non-exclusive database access fees related to database collaboration agreements. Revenues also include the sales of genomic screening products and services, gene expression microarray services, fees for custom or "satellite" database services, and genomic data management software tools and maintenance. The Company's database collaboration agreements provide for future milestone payments and royalties from the sale of products derived from proprietary information obtained through the databases. There can be no assurance that any database collaborators will ever generate products from information contained within the databases and thus that the Company will ever receive milestone payments or royalties.

In January 1998, the Company completed the acquisition of Synteni, Inc. ("Synteni"), a privately-held microarray-based gene expression company. The transaction has been accounted for as a pooling-of-interests, and the consolidated financial statements discussed herein and all historical financial information have been restated to reflect the combined operations of both companies. Synteni's ability to contribute to revenues and operating profits will be dependent on the ability of the Company to obtain high volume customers for Synteni's microarray services. Prior to the merger, Synteni's microarray service agreements consisted of small volume pilot or feasibility agreements. In September 1997, the Company formed a joint venture, diaDexus,

LLC ("diaDexus"), with SmithKline Beecham Corporation ("SB") which will utilize genomic and bioinformatic technologies in the discovery and commercialization of molecular diagnostics. The Company and SB each hold a 50 percent equity interest in diaDexus. The investment is accounted for under the equity method and the Company will record its share of diaDexus' earnings and losses on its statement of operations.

The Company's investments in joint ventures and businesses, particularly diaDexus, may require the Company to record losses or expenses related to its proportionate ownership interest in such entities, to record charges for the acquisition of in-process technologies, or to record charges for the recognition of the impairment in the value of the securities underlying such investments. To date, exclusive of losses from joint ventures, the Company has not incurred significant losses on its long-term equity investments. One company in which the company holds an equity investment, OncorMed, Inc. ("OncorMed"), received a report from its independent auditors for the year ended December 31, 1997 which expressed substantial doubt as to OncorMed's ability to continue as a going concern. On July 7, 1998 Gene Logic Inc. ("Gene Logic") announced its that it entered into an agreement to acquire OncorMed in exchange for shares of Gene Logic common stock with a value not to exceed approximately $38 million. Consummation of the acquisition is subject to approval by the stockholders of both companies. The investment in OncorMed is accounted for under the cost method of accounting, and the acquisition supports the Company's carrying value of the investment. The Company will continue to evaluate its investment in OncorMed and all of its long-term equity investments for impairment on a quarterly basis.

The need for continued investment in development of the Company's databases and related products and services and for support of ongoing collaborations results in significant fixed expenses. If revenue in a particular period does not meet expectations, the Company may not be able to adjust significantly its level of expenditures in such period, which would have an adverse effect on the Company's operating results. The Company may also experience difficulty in forecasting levels of operating expenditures for, and integration-related expenses with respect to, subsidiaries acquired through acquisitions, at least until a substantial period of time has passed since the acquisition date. This is particularly true when attempting to forecast expenditure levels for acquired businesses that focus on technologies for which there is not yet an established market. The Company believes that quarterly comparisons of its financial results will not necessarily be meaningful and should not be relied upon as an indication of future performance. Due to the foregoing and other unforeseen factors, it is likely that in some future quarter or quarters the Company's operating results may be below the expectations of public market analysts and investors.

In an effort to broaden its business, the Company is investing in a number of new areas, including microarray services, molecular diagnostics, pharmacogenomics and proteomics. Given that many of these address new markets, or involve untested technologies, it is not known if any of them will generate revenues or if the revenues will be sufficient to provide an adequate return on the investment. Depending on the investment required and the timing of such investments, expenses or losses related to these investments could adversely affect operating results.

The Company has incurred, and unless a settlement is reached, and is likely to continue to incur, substantial expenses in its defense of the lawsuit filed in January 1998 by Affymetrix, Inc. ("Affymetrix") alleging patent infringement by Synteni and Incyte. Affymetrix seeks a permanent injunction enjoining Synteni and Incyte from further infringement and, in addition, seeks damages, costs, attorneys' fees and interest. Affymetrix further requests that any such damages be trebled on its allegation of willful infringement by Incyte and Synteni. Incyte and Synteni believe they have meritorious defenses and intend to defend the suit vigorously. However, there can be no assurance that Incyte and Synteni will be successful in the defense of this suit, and litigation, regardless of the outcome, could result in substantial expenses and diversion of the efforts of management and technical personnel. Further, there can be no assurance that any license that may be required as a result of this suit or the outcome thereof would be made available on commercially acceptable terms, if at all.

RESULTS OF OPERATIONS

Revenues for the three and six months ended June 30, 1998 increased to $33.1 million and $63.5 million, respectively, compared to $21.4 million and $39.4 million for the corresponding periods in 1997. Revenues resulted primarily from database access fees and, to a much lesser extent, from genomic screening products and services, custom satellite database services, microarray-based gene expression services, and genomic data management software tools and maintenance. The increase in revenues was primarily attributed to new, as well as expanded, collaborative database agreements.

Total costs and expenses for the three and six months ended June 30, 1998 increased to $28.8 million and $56.3 million, respectively, compared to $20.6 million and $38.6 million for the corresponding periods in 1997. Total costs and expenses for the six month period ended June 30, 1998 included an acquisition-related charge of $1.2 million for the acquisition of Synteni, Inc. The charge consisted primarily of accounting, legal and investment banking fees. Total costs and expenses are expected to increase in the foreseeable future due to significant growth in microarray production capacity, the continued investment in new product development and bioinformatics, growth in marketing, sales and customer services, and defense of the Affymetrix lawsuit.

Research and development expenses for the three and six months ended June 30, 1998 increased to $23.1 million and $44.8 million, respectively, compared to $17.4 million and $32.5 million for the corresponding periods in 1997. The increase in research and development expenses resulted primarily from an increase in bioinformatics and software development efforts, microarray production and technology development, and continued investment in the growth of the Company's intellectual property portfolio. The Company expects research and development spending to increase over the next few years as the Company continues to pursue the development of new database products and services, invests in new technologies, broadens its microarray production operations and invests in the protection of its intellectual property.

Selling, general and administrative expenses for the three and six months ended June 30, 1998 increased to $5.7 million and $10.3 million, respectively, compared to $3.3 million and $6.1 million for the corresponding periods in 1997. The increase in selling, general and administrative expenses resulted primarily from the growth in marketing, sales and customer support, expenses related to the defense of the Affymetrix lawsuit and increased administrative personnel related to the growing complexity of the Company's business. The Company expects that selling, general and administrative expenses will increase throughout 1998 due particularly to continued growth in marketing, sales and customer support functions, the expansion of the Company's United Kingdom operations, and legal expenses related to the Company's defense of the Affymetrix lawsuit.

Interest and other income, net for the three and six months ended June 30, 1998 increased to $1.8 million and $3.7 million, respectively, from $0.6 million and $1.1 million for the corresponding periods in 1997. This was primarily a result of increased interest income from higher average combined cash, cash equivalent and marketable securities balances due primarily to the completion of a follow-on public offering in August 1997.

Losses from joint venture were $0.6 million for six months ended June 30, 1998 and zero for the three months ended June 30, 1998. The loss represents the Company's equity share of diaDexus' net losses from operations. In the three months ended June 30, 1998, the Company's share in diaDexus' net losses was offset by the amortization of the excess of the Company's share of diaDexus net assets over its basis. The amortization of this amount is expected to approximate the Company's equity share in diaDexus losses through the third quarter of 1998. As diaDexus was formed in September 1997, no losses from joint venture were incurred in the three and six months ended June 30, 1997. The Company expects that losses from joint venture will continue at least through 1999.

The estimated effective annual income tax rate for 1998 is 14%, which represents the provision of federal and state alternative minimum taxes after utilization of net operating loss carryforwards and research and development credits.

Net income and diluted earning per share were $5.2 million and $8.8 million and $0.18 and $0.30 per share for the three and six months ended June 30, 1998, respectively, as compared to $1.3 million and $1.7 million and $0.05 and $0.07 in the same periods a year ago, respectively. Earnings per share were affected by a follow-on public stock offering in August 1997 that resulted in an increase in the number of shares outstanding of 2.8 million shares, including 0.4 million shares issued upon the exercise of the underwriters' over-allotment option. The Company's results of operations and earning per share for the three and six months ended June 30, 1997 have been restated to account for the acquisition of Synteni, which was accounted for as a pooling-of-interests. Previously reported net income and diluted earnings per share for the three and six months ended June 30, 1997 were $1.9 million and $2.9 million, and $0.17 and $0.26, respectively. While the Company has reported net income for the past six quarters, there can be no assurance that the Company can maintain profitability. See "Factors that May Affect Results-History of Operating Losses; Uncertainty of Continued Profitability or Revenues."

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 1998, the Company had $130.7 million in cash, cash equivalents, restricted cash, and marketable securities, compared to $119.1 million as of December 31, 1997. For the six month period ended June 30, 1998, cash provided by operating and financing activities was partially offset by capital expenditures, consisting primarily of purchases of data processing-related computer hardware, laboratory equipment and facilities improvements, as well as investments in research and development alliances. The Company has classified all of its marketable securities as short-term, as the Company may decide not to hold its marketable securities until maturity in order to take advantage of favorable market conditions. Available cash is invested in accordance with the Company's investment policy's primary objectives of liquidity, safety of principal and diversity of investments.

Net cash provided by operating activities was $33.1 million for the six months ended June 30, 1998, as compared to $12.0 million for the six months ended June 30, 1997. The increase in net cash provided by operating activities resulted primarily from the increase in net income and deferred revenues, and the decrease in accounts receivable partially offset by the increase in prepaid expenses, deposits and other assets and the decrease in accounts payable. Net cash generated by operating activities may in the future fluctuate significantly from quarter to quarter due to the timing of large prepayments by database collaborators.

The Company's investing activities, other than purchases, sales and maturities of marketable securities, have mainly consisted of capital expenditures and long-term investments. Capital expenditures for the six months ended June 30, 1998 increased to $15.3 million from $9.1 million for the six months ended June 30, 1997. Long-term investments in companies with which the Company has research and development alliances increased to $6.9 million for the six months ended June 30, 1998 from $5.0 million for the six months ended June 30, 1997. Long-term investments for the period ended June 30, 1998 consisted primarily of a $5.8 million equity investment in Oxford GlycoSciences plc and $0.8 million equity investment in Layton Biosciences, Inc, while long-term investments for the period ended June 30, 1997 consisted of an equity investment in OncorMed. Net cash used by investing activities may in the future fluctuate significantly from quarter to quarter due to the timing of strategic equity investments, capital purchases and maturity/sales and purchases of marketable securities.

Net cash provided by financing activities was $2.8 million for the six months ended June 30, 1998 as compared to $4.3 for the six months ended June 30, 1997. The Company expects its cash requirements to increase through 1998 as it increases its investment in data-processing-related computer hardware in order to support its existing and new database products, continues to seek access to technologies through investments, research and development alliances, license agreements and/or acquisitions, and addresses its needs for larger facilities and/or improvements in existing facilities. The Company has entered into a multi-year lease with respect to a 95,000 square foot building being constructed adjacent to the Company's Palo Alto headquarters. The Company's share of tenant improvements is estimated to be between $10.0 million and $15.0 million, of which approximately $0.9 million have been expended through June 30, 1998. Given the current construction schedule, the Company does not expect to begin to incur significant expenses related to this facility until late 1998 or early 1999. The Company expects to continue to fund future operations with revenues from genomic database products and services in addition to using its current cash, cash equivalents and marketable securities.

Based upon its current plans, the Company believes that its existing resources and anticipated cash flow from operations will be adequate to satisfy its capital needs at least through 1999. However, the Company may be unable to obtain additional collaborators or retain existing collaborators for the Company's databases, genomic products and services, and these database products and services may not produce revenues which, together with the Company's cash, cash equivalents and marketable securities, would be adequate to fund the Company's cash requirements. The Company's cash requirements depend on numerous factors, including the ability of the Company to attract and retain collaborators for its databases and genomic products and services; competing technological and market developments; the cost of filing, prosecuting, defending and enforcing patent claims and other intellectual property rights; the purchase of additional capital equipment, including capital equipment necessary to ensure the Company's sequencing, data processing and microarray operations remain competitive and costs associated with the integration of new operations assumed through mergers and acquisitions. In particular, the Company expects its cash requirements to increase in 1998 as it increases its investment in data processing-related computer hardware in order to support its existing and new database products; continues to seek access to technologies through investments, alliances, license agreements, and/or acquisitions; makes investments associated with integration of acquired companies; and addresses its needs for larger facilities and/or improvements in existing facilities. The Company expects to

continue to fund future operations with revenues from genomic database products and services in addition to using its current cash, cash equivalents and marketable securities. Changes in the Company's research and development plans or other changes affecting the Company's operating expenses may result in changes in the timing and amount of expenditures of the Company's capital resources. If additional capital is raised through the sale of equity or convertible debt securities, the issuance of these securities could result in dilution to the Company's existing stockholders. Additional funding, if necessary, may not be available on favorable terms, if at all. If adequate funds are not available, the Company may be required to curtail operations significantly or to obtain funds through entering into collaborative arrangements that may require the Company to relinquish rights to certain of its technologies, product candidates, products or potential markets.

FACTORS THAT MAY AFFECT RESULTS

Uncertain Effects of the Synteni Merger. The combination of Synteni and the Company involves several potential operating and business risks, including the integration of Synteni's and the Company's businesses and management in a timely, efficient and effective manner, the timely integration of Synteni's microarray technology and services with the Company's database products and services, integration of the respective sales and marketing and research and development efforts, and any resulting loss of efficiency or loss of employees. The combined companies may not realize any revenue enhancements or cost savings or maintain Synteni's business relationships with its customers after the merger. Also, any cost savings that are realized due to the merger may be offset by increases in other expenses or operating losses, including losses due to problems in integrating the two companies. See "-Risks Associated With Acquisitions." Although the Company believes that beneficial synergies will result from the Synteni merger, the combination of the two companies' businesses, even if achieved in an efficient, effective and timely manner, may not result in combined results of operations and financial condition superior to what would have been achieved by each company independently, and may take longer than expected. See "-History of Operating Losses; Uncertainty of Continued Profitability or Revenues."

Risks Associated with Acquisitions. As part of its business strategy, the Company may from time to time acquire assets and businesses principally relating or complementary to its operations. These acquisitions may include acquisitions for the purpose of acquiring specific technology. The Company acquired two companies, Genome Systems, Inc. and Combion, Inc., in 1996 and acquired Synteni in January 1998. If the Company acquires additional businesses that are not located near the Company's Palo Alto, California headquarters, the Company may experience more difficulty integrating and managing the acquired businesses' operations. These and any other acquisitions by the Company involve risks commonly encountered in acquisitions of companies. These risks include, among other things, the following: the Company may be exposed to unknown liabilities of acquired companies; the Company may incur acquisition costs and expenses higher than it anticipated; fluctuations in the Company's quarterly and annual operating results may occur due to the costs and expenses of acquiring and integrating new businesses or technologies; the Company may experience difficulty and expense of assimilating the operations and personnel of the acquired businesses; the Company's ongoing business may be disrupted and its management's time and attention may be diverted; the Company may be unable to integrate successfully or to complete the development and application of acquired technology and may fail to achieve the anticipated financial, operating and strategic benefits from these acquisitions; the Company may experience difficulties in establishing and maintaining uniform standards, controls, procedures and policies; the Company's relationships with key employees and customers of acquired businesses may be impaired, or these key employees and customers may be lost, as a result of changes in management and ownership of the acquired businesses; the Company may incur amortization expenses if an acquisition is accounted for as a purchase; and the Company's stockholders may be diluted if the consideration for the acquisition consists of equity securities. The Company may not overcome these risks or any other problems encountered in connection with acquisitions. If the Company is unsuccessful in doing so, its business, financial condition and results of operations could be materially and adversely affected.

History of Operating Losses; Uncertainty of Continued Profitability or Revenues. For the years ended December 31, 1996 and 1995, the Company had net losses of $7.3 million and $9.9 million, respectively, and as of June 30, 1998, the Company had an accumulated deficit of $23.1 million. The Company has experienced substantial revenue growth since 1995 and has reported quarterly profits only since the first quarter of 1997. However, the Company may not be able to maintain revenue growth or profitability. The Company's continued investment in new product and technology development, obligations under existing and future research and development alliances, and increased investment in marketing, sales and customer service will require a continued increase in expenditures in 1998 and beyond. Synteni's ability to contribute

to the profitability of the Company will be dependent on the ability of the Company and Synteni to obtain high volume customers for Synteni's microarray services and the costs associated with increasing microarray production capacity. Prior to the merger, Synteni's microarray service agreements consist of small volume pilot or feasibility agreements. The Company's ability to achieve and maintain significant revenues will be dependent upon its ability to obtain additional database collaborators, retain existing collaborators, and expand its customer base for microarray services. The Company's ability to maintain profitability will be dependent upon its ability to obtain database collaborators, expand its customer base for microarray services, the level of expenditures necessary for the Company to maintain and support its services to its collaborators, and the extent to which it incurs research and development, investment, acquisition-related or other expenses related to the development and provision of its products and services to database collaborators. While, as of June 1998, the Company had twenty-one database collaborations, the Company may be unable to enter into any additional collaborations. Further, the Company's database collaboration agreements typically have a term of three years. Some of these agreements require the Company to meet certain performance obligations. These agreements may not be renewed upon expiration, and a database collaboration agreement may be terminated earlier by a collaborator if the Company breaches the agreement and fails to cure such breach within a specified period. The loss of revenues from any database collaborator could have a material adverse effect on the Company's business, financial condition and results of operations.

Part of the Company's commercialization strategy is to license to database collaborators the Company's patent rights to individual partial genes or full-length cDNA sequences from the Company's proprietary sequence database, for development as potential pharmaceutical, diagnostic or other products. Any potential product that is the subject of such a license will require several years of further development, clinical testing and regulatory approval prior to commercialization. Accordingly, the Company does not expect to receive any milestone or royalty payments from any such licenses for a substantial period of time, if at all.

Fluctuations in Operating Results. The Company's operating results may fluctuate significantly from quarter to quarter as a result of a variety of factors, including; changes in the demand for the Company's products and services; the pricing of database access to database collaborators; the nature, pricing and timing of other products and services provided to the Company's collaborators; changes in the research and development budgets of the Company's collaborators and potential collaborators; capital expenditures; acquisition and licensing costs and other costs related to the expansion of the Company's operations, including operating losses of acquired businesses such as Synteni; the introduction of competitive databases or services; and expenses related to, and results of, litigation (including the lawsuit filed by Affymetrix described below under "Litigation") and other proceedings relating to intellectual property rights. In particular, the Company has a limited ability to control the timing of database installations, there is a lengthy sales cycle required for the Company's database products, the Company's revenue levels are difficult to forecast, the time required to complete custom orders can vary significantly and the Company's increasing investments in external alliances could result in significant quarterly fluctuations in expenses due to the payment of milestones, license fees or research payments.

The Company's investments in joint ventures and businesses, particularly diaDexus, a joint venture with SB, may require the Company to record losses or expenses related to its proportionate ownership interest in such entities, to record charges for the acquisition of in-process technologies, or to record charges for recognition of the impairment in the value of the securities underlying such investments. To date, exclusive of losses from joint ventures, the Company has not incurred significant losses on its long-term equity investments. One entity in which the Company has made an equity investment, OncorMed, received a report from its independent auditors for the year ended December 31, 1997 which expressed substantial doubt as to OncorMed's ability to continue as a going concern. On July 7, 1998 Gene Logic announced its that it entered into an agreement to acquire OncorMed in exchange for shares of Gene Logic common stock with a value not to exceed approximately $38 million. Consummation of the acquisition is subject to approval by the stockholders of both companies. The investment in OncorMed is accounted for under the cost method of accounting, and the acquisition supports the Company's carrying value of the investment. The Company will continue to evaluate its investment in OncorMed and all of its long-term equity investments for impairment on a quarterly basis. In an effort to broaden its business, the Company is investing in a number of new areas, including microarray services, molecular diagnostics, pharmacogenomics and proteomics. Given that many of these address new markets, or involve untested technologies, it is not known if any of them will generate revenues or if the revenues will be sufficient to provide an adequate return on the investment. Depending on the investment required and the timing of such investments, expenses or losses related to

these investments could adversely affect operating results.

The need for continued investment in development of the Company's databases and related products and services and for extensive ongoing collaborator support capabilities results in significant fixed expenses. If revenue in a particular period does not meet expectations, the Company may not be able to adjust significantly its level of expenditures in such period, which would have an adverse effect on the Company's operating results. The Company may also experience difficulty in forecasting levels of operating expenditures for, and integration-related expenses with respect to, subsidiaries acquired through acquisitions, at least until a substantial period of time has passed since the acquisition date. This is particularly true when attempting to forecast expenditure levels for acquired businesses that focus on technologies for which there is not yet an established market. The Company believes that quarterly comparisons of its financial results will not necessarily be meaningful and should not be relied upon as an indication of future performance. Due to the foregoing and other unforeseen factors, it is likely that in some future quarter or quarters the Company's operating results will be below the expectations of public market analysts and investors. In such event, the price of the Company's Common Stock would likely be materially and adversely affected.

Competition and Technological Changes. There are a finite number of genes in the human genome, and competitors may seek to identify, sequence and determine in the shortest time possible the biological function of a large number of genes in order to obtain a proprietary position with respect to the largest number of new genes discovered. There are a number of companies, other institutions, and government-financed entities engaged in gene sequencing, gene discovery, gene expression analysis, positional cloning and other genomic service businesses. Many of these companies, institutions and entities have greater financial and human resources than the Company. In addition, the Company is aware that other companies have developed genomic databases and are marketing, or have announced their intention to market their data to pharmaceutical companies. The Company expects that additional competitors may attempt to establish gene sequence, gene expression or other genomic databases in the future.

In addition, competitors may discover and establish patent positions with respect to gene sequences in the Company's databases. Further, certain entities engaged in gene sequencing, including Merck & Co., Inc. ("Merck") and The Institute for Genomic Research ("TIGR"), have made the results of their sequencing efforts publicly available. The Perkin-Elmer Corporation, Dr. J. Craig Venter, and TIGR announced in May 1998 the signing of a letter of intent to form a new company that has the goal of sequencing the entire human genome within three years and to make the sequence information publicly available. The public availability of gene sequences or resulting patent positions comprising substantial portions of the human genome or microbial or plant genomes could decrease the potential value of the Company's databases to the Company's collaborators and adversely affect the Company's ability to realize royalties or other revenue from commercialization of products based upon this genetic information.

The gene sequencing machines that are utilized in the Company's high-throughput computer-aided gene sequencing operations are commercially available and are currently being utilized by several competitors. Some of the Company's competitors or potential competitors are in the process of developing, and may successfully develop, proprietary sequencing technologies that may be more advanced than the technology used by the Company. In addition, the Company is aware that there are a number of companies pursuing alternative methods for generating gene expression information, including those that have developed, and are developing, microarray technologies. At least one other company currently offers microarray-based services that might be competitive with those offered by the Company. These advanced sequencing or gene expression technologies, if developed, may not be commercially available for purchase or license by the Company on reasonable terms, if at all.

A number of companies have announced their intent to develop and market software to assist pharmaceutical companies and academic researchers in the management and analysis of their own genomic data, as well as the analysis of sequence data available in the public domain. Some of these entities have access to significantly greater resources than the Company and these products may achieve greater market acceptance than the Company's products.

The Company's databases also require extensive software support and incorporate features determined by database collaborators' needs. If the Company experiences delays or difficulties in implementing its database software or collaborator-requested features, its ability to service its collaborators may be adversely affected, which might have an adverse effect on the Company's business and operating results.

The genomics industry is characterized by extensive research efforts and

rapid technological progress. To remain competitive, the Company will be required to continue to expand its databases and to enhance the functionality of its bioinformatics and database software. New developments are expected to continue and discoveries by others may render the Company's services and potential products noncompetitive.

New and Uncertain Business. The Company's genomic database business and the use of its databases, software tools and related services to assist its collaborators and potentially improve the efficiency of the traditional drug discovery process represent a business for which there is no precedent. In addition, the Company's microarray services business represents a business for which there is no precedent. The Company's collaborators or potential collaborators may determine that the databases, software tools and microarray and related services provided by the Company are not useful or cost-effective. The Company's strategy of using high-throughput sequencing to identify genes rapidly and obtain proprietary rights in as many genes as possible and its strategy of using microarrays to identify differentially expressed genes is unproven. In addition, the Company has limited experience in providing bioinformatics software and database products and services. The Company's ability to sustain profitability depends on attracting additional collaborators and retaining existing collaborators for its database, sequencing and software products and services and microarray services. The nature and price of these database, sequencing and software products and services and microarray services are such that there is a limited number of pharmaceutical and biotechnology companies that are potential collaborators for such products and services. Additional factors that may affect demand for the Company's products and services include the extent to which potential collaborators choose to conduct in-house gene sequencing, bioinformatics analysis, and microarray-based gene expression analysis, the emergence of competitors offering similar services at competitive prices, the ability of the Company to service satisfactorily its existing collaborators, the extent to which the gene and related information in the Company's database is made public by, or is the subject of, patents issued to others, the Company's ability to establish and enforce proprietary rights to its products, and the emergence of technological innovations in gene sequencing, gene expression profiling or bioinformatics and relational database software that are more advanced than the technology used by and available to the Company. The Company may be unable to attract additional collaborators on acceptable terms for its products and services or develop a sustainable profitable business.

Risks Associated with Strategic Investments. The Company has funded and intends in the future to fund strategic equity investments in joint ventures or businesses that complement the business of the Company. These investments, such as the Company's investment in diaDexus, may require the Company to record losses and expenses related to its proportionate ownership interest in such entities, the acquisition of in-process technologies, or the impairment in the value of the securities underlying such investments. These losses may exceed amounts anticipated, which could result in the Company's operating results being below the expectations of public market analysts and investors. These investments may often be made in securities for which there is no public trading market or in securities not registered under the Securities Act of 1933 and therefore subject to trading restrictions, either of which increases the Company's risk of investment and reduces the liquidity of the Company's investment. In addition, the Company could be required to invest greater amounts than initially anticipated or to devote substantial management time to the management of research and development relationships and joint ventures. The occurrence of any of the foregoing could result in a material adverse effect on the Company's business, financial condition and results of operations.

Lengthy Sales Cycle. The ability of the Company to obtain new collaborators for its databases, software tools and microarray and other services depends in significant part upon prospective collaborators' perceptions that the Company's databases, software tools, and microarray services can help accelerate drug discovery efforts. The sales cycle is typically lengthy due to the education effort that is required, as well as the need to effectively sell the benefits of the Company's databases, software tools, and microarray services to a variety of constituencies within potential collaborator companies. In addition, each database collaboration and microarray services agreement involves the negotiation of agreements containing terms that may be unique to each partner, such as the scope of any licenses granted and whether satellite database services or access to multiple database modules is desired. The Company may expend substantial funds and management effort with no assurance that a collaboration will result.

Uncertainty of Protection of Patents and Proprietary Rights. The Company's database business and competitive position are dependent in part upon its ability to protect its proprietary database information and software technology. Despite the Company's efforts to protect its proprietary database information and software technology, unauthorized parties may attempt to obtain and use information that the Company regards as proprietary. Although

the Company's database collaboration agreements require its collaborators to provide adequate security for, and to control access to the Company's databases, policing unauthorized use of the Company's databases and software by the Company or its collaborators is difficult. The Company relies on patent, trade secret, and copyright law, and nondisclosure and other contractual arrangements to protect its proprietary information.

To date, the Company has been issued a number of patents with respect to the gene sequences in the Company's databases and has filed for patents on selected features of its related software, but has not been issued patents or registered copyrights for that software. Patents cannot prevent others from developing, selling or licensing databases that include sequences which might be covered by the Company's patents and copyrights. The Company cannot prevent others from independently developing software that might be covered by any copyrights issued to the Company and trade secret laws do not prevent independent development. Thus, there can be no assurance that others will not independently develop substantially equivalent proprietary information and techniques or otherwise gain access to the Company's proprietary information, that this information will not be disclosed or that the Company can effectively protect its rights to unpatented trade secrets.

The Company pursues a policy of having its employees, consultants and advisors execute proprietary information and invention agreements upon commencement of employment or consulting relationships with the Company. These agreements provide that all confidential information developed or made known to the individual during the course of the relationship shall be kept confidential except in specified circumstances. These agreements may not, however, provide meaningful protection for the Company's trade secrets or other proprietary information in the event of unauthorized use or disclosure of this information.

The Company's current policy is to file patent applications on what it believes to be novel full-length cDNA sequences and partial sequences obtained through the Company's high-throughput computer-aided gene sequencing efforts. The Company has filed U.S. patent applications in which the Company has claimed certain partial gene sequences and has filed patent applications in the U.S. and applications under the Patent Cooperation Treaty ("PCT") designating countries in Europe as well as Canada, Japan, Mexico and New Zealand claiming full-length gene sequences associated with cells and tissues that are the subject of the Company's high-throughput gene sequencing program. To date, the Company holds a number of issued U.S. patents on full-length genes, but no patent has issued from any of the Company's patent applications that claim partial gene sequences. The Company is aware that Merck (in conjunction with Washington University) and TIGR have made certain gene sequences publicly available, which may adversely affect the ability of the Company and others to obtain patents on such genes. The Company's ability to obtain patent protection for certain sequences that have been made publicly available may be adversely affected.

The Company believes that certain of its patent applications claim genes which may also be claimed in patent applications filed by other parties. In some or all of these applications, a determination of priority of inventorship may need to be decided in an interference before the United States Patent and Trademark Office ("USPTO"). The USPTO has declared an interference involving a Company patent application covering one full-length gene, and the Company has been informed that interferences may be declared with respect to applications covering approximately a dozen additional genes.

The patentability of partial gene sequences in general is uncertain, involves complex legal and factual questions, and has recently been the subject of much controversy. As a result, patent applications filed by the Company on such partial gene sequences may not result in issued patents. Even if patents are issued for partial gene sequences, there may be uncertainty as to the scope of the coverage, enforceability or commercial protection provided by any such patents. Certain court decisions suggest that disclosure of a partial sequence may not be sufficient to support the patentability of a full-length sequence and that patent claims to a partial sequence may not cover a full-length sequence inclusive of that partial sequence.

The USPTO has had a substantial backlog of biotechnology patent applications and, in particular, applications that claim gene sequences. In 1996, the USPTO issued guidelines limiting the number of partial gene sequences that can be examined within a single patent application. Many of the Company's patent applications containing multiple partial sequences contain more sequences than the maximum number allowed under the new guidelines. The Company is reviewing its options and, due to the resources needed to comply with the guidelines, may decide to abandon patent applications for some of its partial gene sequences. Given that the Company's cost of filing large numbers of patent applications and maintaining issued patents can be significant, and the Company may choose not to pursue every applications. If the Company does not pursue patent protection for all of its full-length and partial gene

sequences, the value of its intellectual property portfolio could be diminished.

In view of the possible delay in obtaining allowance of some of the Company's patent applications, and the secrecy of patent applications, the Company does not know if other applications that would have priority over the Company's applications have been filed. Furthermore, changes in U.S. patent laws resulting from the General Agreement on Tariffs and Trade ("GATT") became effective in June 1995. Most notably, GATT resulted in U.S. law being amended to change the term of patent protection from seventeen years from patent issuance to twenty years from the earliest effective filing date of the application. Because the average time from filing to issuance of biotechnology applications is at least one year and may be more than three years depending on the subject matter, a twenty-year patent term from the date of filing may result in a substantially shortened term of patent protection, which may adversely affect the Company's period of exclusivity under any patents that may issue to the Company. Pending applications claiming large numbers of gene sequences may, in some situations, need to be refiled while claiming priority to the earliest filing date and, in such situations, the patent term will be measured from the date of the earliest priority application. This would reduce the patent term and have a potentially adverse effect on the Company's period of exclusivity.

Biotechnology patent law outside the United States is even more uncertain and is currently undergoing review and revision in many countries. Further, the laws of certain foreign countries may not protect the Company's intellectual property rights to the same extent as do the laws of the United States. The Company may participate in opposition proceedings to determine the validity of its or its competitors' non-U.S. patents, which could result in substantial costs to and diversion of effort by the Company.

As the biotechnology industry expands, more patents are issued and other companies engage in the business of discovering genes through the use of high speed sequencers and in other genomic-related businesses, such as microarray and gene expression profiling, the risk increases that the Company's potential products or the processes used by the Company to develop these products may be subject to claims that they infringe the patents of others. Certain of these patents are the subject of litigation. Therefore, the Company's operations may require it to obtain licenses under any of these patents or proprietary rights, and these licenses may not be made available on terms acceptable to the Company. Litigation may be necessary to defend against or assert claims of infringement, to enforce patents issued to the Company, to protect trade secrets or know-how owned by the Company, or to determine the scope and validity of the proprietary rights of others. The Company could also be involved in interferences with respect to patent applications. Given the large number of applications filed by the Company, a large number of interferences could be expensive and time consuming. In addition, it is impossible to predict how many, if any, of the interferences would be resolved in the Company's favor. The Company is currently involved in litigation and interference proceedings with respect to patents and intellectual property rights. Litigation or interference proceedings, regardless of the outcome, could result in substantial costs to, and diversion of effort by the Company, and may have a material adverse effect on the Company's business, financial condition and results of operations. In addition, these efforts by the Company may not be successful.

As is typical in the genomics and software industries, the Company has from time to time received, and believes that it likely will receive in the future, notices from third parties alleging infringement claims. The Company believes that it is not infringing the patent rights of any such third party, and in circumstances in which the Company has determined a response to an alleged infringement claim to be appropriate, the Company has notified the claimant to that effect. To date, except as set forth below under "Litigation," no third party has filed suit with respect to an alleged claim against the Company. There can be no assurance that action will not be taken against the Company in the future, either with respect to previously asserted or new claims or that if any action is taken, what the outcome of such action will be.

Litigation. On January 6, 1998, Affymetrix filed a lawsuit in the United States District Court for the District of Delaware alleging infringement of U.S. patent number 5,445,934 (the "'934 Patent") by both Synteni and Incyte. The complaint alleges that the '934 Patent has been infringed by the making, using, selling, importing, distributing or offering to sell in the U.S. high density arrays by Synteni and Incyte and that such infringement was willful. Affymetrix seeks a permanent injunction enjoining Synteni and Incyte from further infringement of the '934 Patent and, in addition, seeks damages, costs and attorney's fees and interest. Affymetrix further requests that any such damages be trebled based on its allegation of willful infringement by Incyte and Synteni. Discovery has commenced, and the court has tentatively scheduled trial for May 1999. Incyte and Synteni believe they have meritorious defenses

and intend to defend the suit vigorously. However, there can be no assurance that Incyte and Synteni will be successful in the defense of this suit, and litigation, regardless of the outcome, has resulted and unless a settlement is reached, is expected to continue to result in substantial expenses and diversion of the efforts of management and technical personnel. Further, there can be no assurance that any license that may be required as a result of this suit or the outcome thereof would be made available on commercially acceptable terms, if at all.

Future Capital Needs; Uncertainty of Additional Funding. The Company believes that its existing cash, cash equivalents and marketable securities should be adequate to satisfy the Company's projected working capital, capital expenditure and other cash requirements at least through June 1999. However, the Company may be unable to obtain additional database collaborators or retain existing collaborators for the Company's databases, and its database products and services may not produce revenues, which together with the Company's cash, cash equivalents, and marketable securities, will be adequate to fund the Company's cash requirements. The Company's cash requirements depend on numerous factors, including the ability of the Company to attract and retain collaborators for its databases and genomic products and services; expenditures in connection with alliances, license agreements and acquisitions of and investments in complementary technologies and businesses; competing technological and market developments; the cost of filing, prosecuting, defending, and enforcing patent claims and other intellectual property rights; the purchase of additional capital equipment or other capital expenditures, including capital equipment necessary to ensure that the Company's sequencing and microarray operations remain competitive; capital expenditures required to expand the Company's and Synteni's facilities; and costs associated with the integration of new operations assumed through mergers and acquisitions. In particular, the Company expects its cash requirements to increase in 1998 as it increases its investment in data processing-related computer hardware in order to support its existing and new database products; continues to seek access to technologies through investments, alliances, license agreements, and/or acquisitions; makes investments associated with integration of acquired companies; and addresses its needs for larger facilities and/or improvements in existing facilities. Changes in the Company's research and development plans, or other changes affecting the Company's operating expenses, may result in changes in the timing and amount of expenditures of the Company's capital resources. If additional capital is raised through the sale of equity or convertible debt securities, the issuance of these securities could result in dilution to the Company's existing stockholders. Additional funding, if necessary, may not be available on favorable terms, if at all. If adequate funds are not available, the Company may be required to curtail operations significantly or to obtain funds through entering into collaborative arrangements that may require the Company to relinquish rights to certain of its technologies, product candidates, products or potential markets.

Management of Growth. The Company has recently experienced, and expects to continue to experience, significant growth in the number of its employees and the scope of its operations. This growth has placed, and may continue to place, a significant strain on the Company's management and operations. The Company's ability to manage effectively this growth will depend upon its ability to broaden its management team and its ability to attract, hire and retain skilled employees. The Company's success will also depend on the ability of its officers and key employees to continue to implement and improve its operational, management information and financial control systems and to expand, train and manage its employee base. In addition, the Company must continue to take steps to provide customer support resources as the number of overall database collaborators and the number of requests from collaborators increases. Further, the Company's database collaborators typically have worldwide operations and may require support at multiple U.S. and foreign sites. Providing this support may require the Company to open offices in addition to its Palo Alto, California headquarters and its offices in St. Louis, Missouri and the United Kingdom, which could result in additional burdens on the Company's systems and resources. The Company's inability to manage growth effectively, including its growth through acquisitions, could have a material adverse effect on the Company's business, financial condition and results of operations.

Dependence on Key Employees. The Company is highly dependent on the principal members of its scientific and management staff, including Roy A. Whitfield, its Chief Executive Officer, and Randal W. Scott, its President and Chief Scientific Officer, the loss of whose services would have a material adverse effect on the Company's business. The Company has not entered into any employment agreements with any of these persons and does not maintain any key person life insurance policy on the life of any employee. The Company's future success also will depend in part on the continued service of its key scientific, software, bioinformatics and management personnel and its ability to identify, hire and retain additional personnel, including personnel in the customer service, marketing and sales areas. The Company experiences intense competition for qualified personnel in the areas of the Company's activities,

especially with respect to experienced bioinformatics and software personnel, and there can be no assurance that the Company will be able to continue to attract and retain personnel necessary for the development of the Company's business. Failure to attract and retain key personnel could have a material adverse effect on the Company's business, financial condition and results of operations.

Dependence on Others. The Company relies on a limited number of suppliers of gene sequencing machines and certain reagents required in connection with the gene sequencing process. Although the Company is evaluating alternative gene sequencing machines, these machines may not be available in sufficient quantities, available at acceptable costs, or prove to be more cost-effective than current machines. Patent right issues concerning certain current and future generation sequencing machines may also arise which could prevent the Company from using them or make their use more expensive. If the Company is unable to obtain additional machines or an adequate supply of reagents or other materials at commercially reasonable rates, its ability to continue to identify genes through gene sequencing would be adversely affected. In addition, although the Company obtains, from a number of sources, tissue samples from which mRNA may be isolated, the loss of access to some of these sources, increased fees for access to these sources or increased restrictions on use of the information generated could adversely affect the Company's business.

The Company's strategy for the development of its database and sequencing business and the commercialization of its portfolio of partial and full-length gene sequences may require the Company to enter into various research and development relationships with corporate and academic collaborators and others. The success of these relationships is dependent upon the performance of outside parties of their responsibilities. The Company may not be able to establish collaborative arrangements or license agreements that the Company deems necessary or acceptable to develop its database and sequencing business or, in the future, to commercialize its portfolio of partial and full-length gene sequences. In addition, these collaborative arrangements or license agreements may not be successful. The Company's collaborators may also be pursuing alternative technologies or developing alternative products either on their own or in collaboration with others, including the Company's competitors.

The Company has relied on scientific, technical, pathology, commercial and other data supplied and disclosed by others, including its academic collaborators and sources of tissue samples, and may rely on these data in the construction of its database. There can be no assurance that these data contain no errors or omissions, or that the sources of these data have acquired the data in compliance with applicable legal requirements, the knowledge of which would adversely change the prospects for the Company's business.

Year 2000 Issue. As a result of computer programs being written using two digits, rather than four, to represent year dates, the performance of the Company's computer systems and those of its suppliers and customers in the Year 2000 is uncertain. Any computer programs that have time-sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in a system failure or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities. The Company plans to initiate a Year 2000 project, using internal and external resources, to evaluate the impact of the Year 2000 on its products and operating systems. This will include the initiation of formal communications with its significant suppliers and customers to determine the extent to which the Company's interface systems are vulnerable to third party failures to remediate their own Year 2000 issues. There can be no guarantee that the systems of other companies on which the Company's systems rely will be timely converted and would not have an adverse effect on the Company's systems. The Company will perform a comprehensive review of all internally used financial and administrative systems as well as internally developed products sold to customers. At this time, given that the Company's internal financial and administrative systems have been installed within the last few years, and all internally developed software-based products sold to customers have been developed over the last few years, the Company does not expect the cost of addressing the Year 2000 issue to have a material impact on the Company's business, results of operations or financial condition. However, there can be no guarantee that if modifications or replacement of portions of the software are necessary, it will be completed in a timely manner.

Hazardous Materials; Environmental Matters. The Company's research and development involves the controlled use of hazardous and radioactive materials and biological waste. The Company is subject to federal, state and local laws and regulations governing the use, manufacture, storage, handling and disposal of these materials and certain waste products. Although the Company believes that its safety procedures for handling and disposing of these materials

comply with the standards prescribed by such laws and regulations, the risk of accidental contamination or injury from these materials cannot be completely eliminated. In the event of such an accident, the Company could be held liable for any damages that result and any such liability could exceed the resources of the Company. Although the Company believes that it is in compliance in all material respects with applicable environmental laws and regulations and currently does not expect to make material additional capital expenditures for environmental control facilities in the near-term, the Company may in the future be required to incur significant costs to comply with environmental laws and regulations, and there can be no assurance that the operations, business or assets of the Company will not be materially or adversely affected by current or future environmental laws or regulations.

Reliance on Pharmaceutical Industry; Uncertainty of Health Care Reform and Related Matters. The Company expects that all of its revenues in the foreseeable future will be derived from products and services provided to the pharmaceutical and biotechnology industries. Accordingly, the Company's success in the foreseeable future is directly dependent upon the success of the companies within those industries and their continued demand for the Company's products and services. The Company's operations may in the future be subject to substantial period-to-period fluctuations as a consequence of reductions and delays in research and development expenditures by companies in these industries resulting from factors such as changes in economic conditions, changes in the regulatory environment affecting health care and health care providers, pricing pressures, market-driven pressures on companies to consolidate and reduce costs, and other factors affecting research and development spending. The occurrence of any of the foregoing factors could have a material adverse effect on the Company's business, financial condition and results of operations.

Risk of Business Interruption. The Company conducts all of its sequencing and other activities at its facilities in Palo Alto, California, and Synteni conducts all of its operations at its facilities in Fremont, California. Both locations are in a seismically active area. Although the Company maintains business interruption insurance, the Company does not currently have, nor does it plan to obtain, earthquake insurance. A major catastrophe (such as an earthquake or other natural disaster) could result in a prolonged interruption of the Company's business.

PART II: OTHER INFORMATION

ITEM 1 Legal Proceedings

On January 6, 1998, Affymetrix, Inc. ("Affymetrix") filed a lawsuit in the United States District Court for the District of Delaware alleging infringement of U.S. patent number 5,445,934 (the "'934 Patent") by both Synteni and Incyte. The complaint alleges that the '934 Patent has been infringed by the making, using, selling, importing, distributing or offering to sell in the U.S. high density arrays by Synteni and Incyte and that such infringement was willful. Affymetrix seeks a permanent injunction enjoining Synteni and Incyte from further infringement of the '934 Patent and, in addition, seeks damages, costs and attorney's fees and interest. Affymetrix further requests that any such damages be trebled based on its allegation of willful infringement by Incyte and Synteni. Incyte and Synteni believe they have meritorious defenses and intend to defend the suit vigorously. However, there can be no assurance that Incyte and Synteni will be successful in the defense of this suit, and litigation has resulted and, if a settlement is not reached is expected to continue to result in substantial expenses and diversion of the efforts of management and technical personnel. Further, there can be no assurance that any license that may be required as a result of this suit or the outcome thereof would be made available on commercially acceptable terms, if at all.

ITEM 2 Changes in Securities

(a) Not applicable
(b) Not applicable
(c) Not applicable
(d) Not applicable

ITEM 3 Defaults upon Senior Securities
None

ITEM 4 Submission of Matters to a Vote of Security Holders

On June 15, 1998, the Company held its Annual Meeting of Stockholders. The following actions were taken at the annual meeting:

	FOR	WITHHELD
a. Roy A. Whitfield . .	23,027,296	110,784
b. Barry M. Bloom . . .	23,021,466	116,614
c. Frederick B. Craves.	23,019,043	119,037
d. Randal W. Scott. . .	23,025,315	112,765
e. Jeffrey J. Collinson	23,026,615	111,465
f. Jon S. Saxe	23,026,896	111,184

1. The following Directors were elected

For. . . .	Against	Abstain	Broker Non-Vote
12,820,634	7,666,888	68,375	5,948,843

2. A proposal to amend the Company's 1991 Stock Plan

For	Against	Abstain	Broker Non-Vote
23,113,143	12,426	12,511	3,366,660

3. The selection of the Company's independent auditors was ratified

ITEM 5 Other Information

To be considered for inclusion in the Company's proxy statement and form of proxy for its 1999 Annual Meeting of Stockholders, a stockholder proposal must be received at the principal executive offices of the Company not later than

January 1, 1999.

A stockholder proposal not included in the Company's proxy statement for the 1999 Annual Meeting will be ineligible for presentation at the meeting unless the stockholder gives timely notice of the proposal in writing to the Secretary of the Company at the principal executive offices of the Company and otherwise complies with the provisions of the Company's Bylaws. To be timely, the Company's Bylaws provide that the Company must have received the stockholder's notice not less than 60 days nor more than 90 days prior to the scheduled date of such meeting. However, if notice or prior public disclosure of the date of the annual meeting is given or made to stockholders less than 70 days prior to the meeting date, the Company must receive the stockholder's notice by the earlier of (i) the close of business on the 10th day after the earlier of the day the Company mailed notice of the annual meeting date or provided such public disclosure of the meeting date and (ii) two days prior to the scheduled date of the annual meeting.

ITEM 6 Exhibits and Reports on Form 8-K.

a) Exhibits
See Exhibit Index on Page 27

b) Reports on Form 8-K

The Company filed one report on Form 8-K during the fiscal quarter covered by this report, as follows:

i) Current Report on Form 8-K, filed on June 12, 1998, reporting under Item 5 the Company's selected consolidated financial data, management's discussion and analysis of financial condition and results of operations, and audited consolidated financial statements as of and for the periods listed therein, which have been restated to reflect the combined results of Incyte, Inc. and Synteni, Inc.

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

INCYTE PHARMACEUTICALS, INC.

Date: August 14, 1998 By: /s/ Roy A. Whitfield

Roy A. Whitfield
Chief Executive Officer

Date: August 14, 1998 By: /s/ Denise M. Gilbert

Denise M. Gilbert
Executive Vice President and
Chief Financial Officer

INCYTE PHARMACEUTICALS, INC.

EXHIBIT INDEX

This document contains summary financial information extracted from Item 1 of Form 10-Q for the period ended June 30, 1998 and is qualified in its entirety by referece to such 10-Q

6-MOS	
DEC-31-1998	
JUN-30-1998	
	32,944
	93,733
	11,270
	300
	0
	147,196
	73,028
	27,375
	219,188
	60,404
	0
	0
	0
	27
	157,849
219,188	
	0
	63,472
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	45,990
	0
	0
	10,201
	1,428
	8,773
	0
	0
	0
	8,773
	0.30
	0.30