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, 1999

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.)

3160 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 28,020,849 as of June 30, 1999.

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, 1999	DECEMBER 31, 1998*
ASSETS		
Current assets:		
Cash and cash equivalents	$ 53,284	$ 50,048
Marketable securities - available-for-sale	52,797	61,185
Accounts receivable, net	4,594	14,318
Prepaid expenses and other current assets	6,688	5,813
Total current assets	117,363	131,364
Property and equipment, net	63,966	54,429
Long-term investments	16,917	20,653
Goodwill and other intangible assets, net	15,760	16,955
Deposits and other assets	10,164	6,889
Total assets	$ 224,170	$ 230,290
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,597	$ 8,244
Accrued and other current liabilities	8,131	7,843
Accrued compensation	5,084	4,786
Deferred revenue	35,042	29,054
Total current liabilities	52,854	49,927
Non-current portion of capital lease obligations and note payable	382	796
Total liabilities	53,236	50,723
Stockholders' equity:		
Common stock	28	28
Additional paid-in capital	210,943	209,192
Deferred compensation	(1,008)	(1,209)
Receivable from stockholders	(29)	(33)
Accumulated other comprehensive income (loss)	(1,302)	(10)
Accumulated deficit	(37,698)	(28,401)
Total stockholders' equity	170,934	179,567
Total liabilities and stockholders' equity	$ 224,170	$ 230,290

* The condensed consolidated balance sheet at December 31, 1998 has been derived from the audited financial statements at that date
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See accompanying notes

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

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	1999	1998	1999	1998
Revenues	$37,893	$33,093	$75,523	$63,472
Costs and expenses:				
Research and development	36,122	23,120	67,366	44,819
Selling, general and administrative	9,497	5,722	17,876	10,322
Acquisition-related charges	-	-	-	1,171
Total costs and expenses	45,619	28,842	85,242	56,312
Income (loss) from operations	(7,726)	4,251	(9,719)	7,160
Interest and other income, net	1,556	1,804	3,015	3,681
Losses from joint venture	(1,217)	-	(2,593)	(640)
Income (loss) before income taxes	(7,387)	6,055	(9,297)	10,201
Provision for income taxes	-	848	-	1,428
Net income (loss)	$(7,387)	$ 5,207	$(9,297)	$ 8,773
Basic net income (loss) per share	$ (0.26)	$ 0.20	$ (0.33)	$ 0.33
Shares used in computing basic net income (loss) per share	27,961	26,610	27,920	26,504
Diluted net income (loss) per share	$ (0.26)	$ 0.18	$ (0.33)	$ 0.30
Shares used in computing diluted net income (loss) per share	27,961	28,667	27,920	28,792

See accompanying notes

INCYTE PHARMACEUTICALS, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)
(unaudited)

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	1999	1998	1999	1998
Net income (loss)	$(7,387)	$5,207	$ (9,297)	$8,773
Other comprehensive income (loss), net of taxes:				
Unrealized gains (losses) on Marketable securities	(693)	61	(1,095)	(47)
Foreign currency translation Adjustments	(47)	-	(197)	(2)
Other comprehensive income (loss)	(740)	61	(1,292)	(49)
Comprehensive income (loss)	$(8,127)	$5,268	$(10,589)	$8,724

See accompanying notes

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

	SIX MONTHS ENDED JUNE 30,	
	1999	1998
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (9,297)	$ 8,773
Adjustments to reconcile net income (loss) to net cash provided by Operating activities:		
Depreciation and amortization	11,626	7,489
Losses in joint venture	2,593	640
Gain on sale of long-term investment	(104)	-
Amortization of deferred compensation	201	246
Adjustment to conform pooled entity	-	278
Changes in certain assets and liabilities:		
Accounts receivable	9,724	9,233
Prepaid expenses, deposits and other assets	(4,150)	(3,723)
Accounts payable	(3,647)	(2,078)
Accrued and other liabilities	778	77
Deferred revenue	5,988	12,159
Net cash provided by operating activities	13,712	33,094
CASH FLOWS FROM INVESTING ACTIVITIES:		
Long-term investments	-	(6,894)
Proceeds from sale of long-term investments	565	-
Capital expenditures	(19,968)	(15,325)
Purchases of marketable securities	(23,013)	(60,171)
Sales and maturities of marketable securities	30,988	23,854
Net cash used in investing activities	(11,428)	(58,536)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	1,751	2,923
Proceeds from repayment of receivable from stockholder	4	-
Principal payments on capital lease obligations and note payable	(606)	(135)
Net cash provided by financing activities	1,149	2,788
Effect of exchange rate on cash and cash equivalents	(197)	-
Net increase (decrease) in cash and cash equivalents	3,236	(22,654)
Cash and cash equivalents at beginning of period	50,048	55,598
Cash and cash equivalents at end of period	$ 53,284	$ 32,944
SUPPLEMENTAL SCHEDULE OF CASH FLOW INFORMATION:		
Interest paid	$ 154	$ 43
Income taxes paid	$ 136	$ 340

See accompanying notes

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, 1999, the statements of operations for the three and six months ended June 30, 1999 and 1998, the statements of comprehensive income (loss) for the three and six months ended June 30, 1999 and 1998 and the statements of cash flows for the six months ended June 30, 1999 and 1998 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, comprehensive income and cash flows for the periods presented.

The condensed consolidated financial statements include the accounts of the Company's wholly-owned subsidiaries. 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.

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 included in the Company's Annual Report on Form 10-K for the year ended December 31, 1998. The condensed consolidated balance sheet at December 31, 1998 has been derived from the audited financial statements at that date.

2. PROPERTY AND EQUIPMENT

Property and equipment consisted of:

	JUNE 30, 1999	DECEMBER 31, 1998
Office equipment	$ 4,251	$ 3,577
Laboratory equipment	28,117	25,665
Computer equipment	41,847	35,209
Leasehold improvements	36,228	26,026
	110,443	90,477
Less accumulated depreciation and amortization	(46,477)	(36,048)
	$ 63,966	$ 54,429

3. REVENUE RECOGNITION

The Company recognizes revenue for database collaboration agreements evenly over the term of each agreement. Revenue is deferred for fees received before earned. Revenues from genomic screening services and reagents are recognized upon completion and shipment. Revenues from contract sequencing are recognized upon completion of milestones. Revenue from gene expression microarray services includes: technology access fees, which are generally recognized ratably over the access term; capacity ramp up charges, which are recognized ratably as capacity is increased; and usage fees which are recognized at the completion of key stages in the performance of the service, in proportion to costs incurred. Generally, software revenue is allocated between license fees and maintenance fees, in accordance with SOP 97-2, with the license revenue being recognized upon installation, and maintenance fees recognized evenly over the maintenance term.

4. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is computed by dividing net income (loss) (numerator) by the weighted average number of common shares outstanding

(denominator) during the period and excludes the dilutive effect of stock options. Diluted net income (loss) per share gives effect to all dilutive potential common shares outstanding during a period. In computing diluted net income (loss) per share, 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 net income (loss) computations for the periods presented below.

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	1999	1998	1999	1998
Numerator:				
Net income (loss)	$(7,387)	$ 5,207	$(9,297)	$ 8,773
Denominator:				
Denominator for basic net income (loss) per share - weighted-average shares	27,961	26,610	27,920	26,504
Dilutive potential common shares-stock options	-	2,057	-	2,288
Denominator for diluted net income (loss) per share	27,961	28,667	27,920	28,792
Basic net income (loss) per share	$ (0.26)	$ 0.20	$ (0.33)	$ 0.33
Diluted net income (loss) per share	$ (0.26)	$ 0.18	$ (0.33)	$ 0.30

Options to purchase 5,053,779 shares of common stock were outstanding at June 30, 1999, but were not included in the computation of diluted net income (loss) per share for the three or six months ended June 30, 1999, as their effect was antidilutive.

5. BUSINESS COMBINATIONS

In September 1998, the Company completed the acquisition of Hexagen Limited ("Hexagen"), a privately held single nucleotide polymorphism (SNP) discovery company based in Cambridge, England. The Company issued 976,130 shares of the Company's common stock and $5.0 million in cash in exchange for all of Hexagen's outstanding capital stock. In addition, the Company assumed Hexagen's stock options, which if fully vested and exercised, would amount to 125,909 shares of its common stock. The transaction was accounted for as a purchase with a portion of the purchase price, $11.0 million, expensed in the third quarter of 1998 as a charge for the purchase of in-process research and development. The remaining portion of the purchase price, approximately $17.6 million, was allocated to goodwill ($16.3 million), developed technology ($0.7 million), and Hexagen's assembled work force ($0.6 million), which are being amortized over 8, 5 and 3 years, respectively.

The Company allocated Hexagen's purchase price based on the relative fair value of the net tangible and intangible assets acquired. In performing this allocation, the Company considered, among other factors, the technology research and development projects in process at the date of acquisition. Hexagen's in-process research and development program consisted of the development of its fSSCP technology for SNP discovery. At the date of the acquisition, Hexagen's research and development program was approximately 80% completed and total continuing research and development commitments to complete the projects were expected to be approximately $1.4 million, and were expected to be successfully completed by mid-2000. The value assigned to purchased in-process R&D was determined by estimating the costs to develop Hexagen's purchased in-process research and development into commercially viable products, estimating the resulting net cash flows from the projects and discounting the net cash flows to their present value. The rates utilized to discount the net cash flows to their

present value were based on Hexagen's weighted average cost of capital. A discount rate of 24.0% was used for valuing the in-process research and development and is intended to be commensurate with Hexagen's corporate maturity and the uncertainties in the economic estimates described above. Additionally, these projects will require maintenance expenditures when and if they reach a state of technological and commercial feasibility. Management believes the Company has positioned itself to complete the research and development program. However, there is risk associated with the completion of the project, which include the inherent difficulties and uncertainties in completing each project and thereby achieving technological feasibility and risks related to the impact of potential changes in future target markets and there is no assurance that the project will meet either technological or commercial success. Failure to complete the development of the fSSCP technology in its entirety, or in a timely manner, could have a material adverse impact on the Company's financial condition and results of operations.

The estimates used by the Company in valuing in-process research and development were based upon assumptions the Company believes to be reasonable but which are inherently uncertain and unpredictable. Accordingly, actual results may vary from the projected results. The Company's assumptions may be incomplete or inaccurate, and no assurance can be given that unanticipated events and circumstances will not occur. To date, there have been no significant changes to the Company's assumptions. Any such variance may result in a material adverse effect on the financial condition and results of operations of the Company. Associated risks include the inherent difficulties and uncertainties in completing each project and thereby achieving technological feasibility and risks related to the impact of potential changes in future target markets. The results of operations of Hexagen have been included in the consolidated results of the Company from the date of acquisition in September 1998.

The table below presents the pro forma results of operations and earnings per share for the combined results of Hexagen and the Company for the three and six months ended June 30, 1998 assuming that the transactions was completed on January 1, 1998.

(In thousands, except per share amounts)	THREE MONTHS ENDED JUNE 30, 1998	SIX MONTHS ENDED JUNE 30, 1998
Revenues	$33,093	$63,472
Net income	$ 3,085	$ 4,847
Pro forma basic net income per share	$ 0.11	$ 0.18
Pro forma diluted net income per share	$ 0.10	$ 0.16
Pro forma shares for basic net income per share	27,586	27,480
Pro forma shares for diluted net income per share	29,643	29,768

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 gene expression microarray 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.

6. JOINT VENTURE

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 holds a 50 percent equity interest in diaDexus and accounts for the investment under the equity method. In July 1999, the Company and SB each invested an additional $2.5 million in diaDexus through convertible notes that mature in April 2000. The notes bear interest at 5.6%, and are subordinate to all other claims. The notes, principal plus accrued interest, will automatically convert into diaDexus Series C Preferred Stock upon the closing of the sale of Series C Preferred Stock of diaDexus that results in aggregate proceeds to diaDexus of at least $10 million, including the $5 million that would result from the conversion of the loans from SB and the Company.

7. SEGMENT REPORTING

The Company operates primarily in one reportable segment: the design, development, and marketing of genomic information based tools, and follows the requirements of SFAS 131, Disclosures about Segments of an Enterprise and Related Information. For the three and six months ended June 30, 1999, the Company recorded revenue from customers throughout the United States and in Canada, Austria, Belgium, France, Germany, Israel, Netherlands, Switzerland, and the United Kingdom. Export revenues were $9,797,000 and $20,580,000 for the three and six months ended June 30, 1999, respectively, and $7,546,000 and $16,639,000 for the three and six months ended June 30, 1998, respectively.

8. NEW PRONOUNCEMENTS

In June 1998, the FASB issued Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. ("SFAS 133"). As modified by Statement No. 137, Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement NO. 133, this statement is effective for fiscal years beginning after June 15, 2000. SFAS 133 established standards for reporting derivative instruments and hedging activities. Application of SFAS 133 is expected to have no impact on the consolidated financial position or results of operations as currently reported.

9. LITIGATION

On January 6, 1998, Affymetrix, Inc. ("Affymetrix") filed a lawsuit in the United States District Court for the District of Delaware, subsequently transferred to the United States District Court for the Northern District of California in November 1998, 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.

In September 1998, Affymetrix filed an additional lawsuit in the United States District Court for the District of Delaware, subsequently transferred to the United States District Court for the Northern District of California in November 1998, alleging infringement of the U.S. patent number 5,800,992 (the "'992 Patent") and U.S. patent number 5,744,305 (the "'305 Patent") by both Synteni and Incyte. The complaint alleges that the '305 Patent has been infringed by the making, using, selling, importing, distributing or offering to sell in the United States high density arrays by Synteni and Incyte, that the '992 Patent has been infringed by the use of Synteni's and Incyte's GEMTM microarray technology to conduct gene expression monitoring using two-color labeling, and that such infringement was willful. Affymetrix seeks a permanent injunction enjoining Synteni and Incyte from further infringement of the '305 and '992 Patents and, in addition, Affymetrix had sought a preliminary injunction enjoining Incyte and Synteni from using Synteni's and Incyte's GEM microarray technology to conduct gene expression monitoring using two-color labeling as described in the '992 Patent. Affymetrix's request for a preliminary injunction was denied in April 1999 and the lawsuit is tentatively scheduled to go to trial in July 2000.

In April 1999, the Board of Patent Appeals and Interferences of United States Patent and Trademark Office (PTO) declared interferences between pending patent applications licensed exclusively to Incyte and the Affymetrix '305 and '992 Patents. An interference proceeding is invoked by the PTO when more than one patent applicant claims the same invention. The Board of Patent Appeals and Interferences evaluates all relevant facts, including those bearing on first to invent, validity, enablement and scope of claims, and then makes a determination as to who, if anyone, is entitled to the patent on the disputed invention.

Incyte and Synteni believe they have meritorious defenses and intend to defend the suits vigorously. However, there can be no assurance that Incyte and Synteni will be successful in the defense of these suits. At this time, the Company cannot reasonably estimate the possible range of any loss resulting from these suits due to uncertainty regarding the ultimate outcome. Regardless of the outcome, this litigation has resulted and 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, 1999 and for the three and six month periods ended June 30, 1999 and 1998 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 Annual Report on Form 10-K for the year ended December 31, 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 net loss, expected expenditure levels, expected cash flows, the adequacy of capital resources, growth in operations and Year 2000 related actions, 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 biotechnology, pharmaceutical, and agricultural industries; risks relating to the development of new 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 and interference proceedings; the results and viability of joint ventures and businesses in which the Company has purchased equity; the ability of the Company to implement in a timely manner the programs and actions related to the Year 2000 issue; and the matters discussed in "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. ("Incyte" and, together with its wholly owned subsidiaries, the "Company") designs, develops and markets genomic information-based tools including database products, genomic data management software tools, microarray-based gene expression services and genomic reagents and related services. 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.

Revenues recognized by the Company consist primarily of non-exclusive database access fees related to database agreements. Revenues also include the sales of genomic screening products and services, fees for microarray-based gene expression services, fees for contract sequencing services, and sales of genomic data management software tools. The Company's database 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 subscriber will ever generate products from information contained within the databases and thus that the Company will ever receive milestone payments or royalties. The Company's ability to maintain and increase revenues will be dependent upon its ability to obtain additional database subscribers, retain and expand its relationships with existing subscribers, and to expand its customer base and production capacity for microarray services. The loss of revenues from any individual database agreement, if terminated or not renewed, could have an adverse impact on the Company's results of operations, although it is not anticipated to have a material adverse impact on the Company's business or financial condition.

The Company is making a significant investment in its genomic sequencing, bioinformatics, mapping and SNP discovery programs in 1999, and as a result the Company has reported a net loss for the first half of 1999 and expects to continue to incur losses through 1999. The Company is anticipating a return to

profitability in the second half of 2000. If the costs of these programs are greater than anticipated, or if these programs take longer to complete, or if the Company's business is affected by factors discussed under "Factors That May Affect Results" the Company may not return to profitability in 2000.

In September 1998, the Company completed the acquisition of Hexagen Limited ("Hexagen"), a privately held SNP discovery company based in Cambridge, England. The Company issued 976,130 shares of its common stock and $5.0 million in cash in exchange for all of Hexagen's outstanding capital stock. In addition, the Company assumed Hexagen's stock options, which if fully vested and exercised, would amount to 125,909 shares of the Company's common stock. The intrinsic value of the stock options was included in the purchase price of Hexagen. The transaction was accounted for as a purchase with a portion of the purchase price, estimated to be approximately $11.0 million, expensed in the third quarter of 1998 as a charge for the purchase of in-process research and development. The remainder of the purchase price, approximately $17.6 million, was allocated to goodwill ($16.3 million), developed technology ($0.7 million), and Hexagen's assembled work force ($0.6 million), which are being amortized over 8, 5 and 3 years, respectively. The Company will continue to evaluate its intangible assets for impairment on a quarterly basis.

The Company allocated Hexagen's purchase price based on the relative fair value of the net tangible and intangible assets acquired. In performing this allocation, the Company considered, among other factors, the technology research and development projects in process at the date of acquisition. Hexagen's in-process research and development program consisted of the development of its fSSCP technology for SNP discovery. At the date of the acquisition, Hexagen's research and development program was approximately 80% completed and total continuing research and development commitments to complete the projects were expected to be approximately $1.4 million. The projects were expected to be successfully completed by mid-2000. The value assigned to purchased in-process R&D was determined by estimating the costs to develop Hexagen's purchased in-process research and development into commercially viable products, estimating the resulting net cash flows from the projects and discounting the net cash flows to their present value. The rates utilized to discount the net cash flows to their present value were based on Hexagen's weighted average cost of capital. A discount rate of 24.0% was used for valuing the in-process research and development and is intended to be commensurate with Hexagen's corporate maturity and the uncertainties in the economic estimates described above. Additionally, this project will require maintenance expenditures when and if it reaches a state of technological and commercial feasibility. Management believes the Company has positioned itself to complete the research and development program. However, there is risk associated with the completion of the project, which includes the inherent difficulties and uncertainties in completing the project and thereby achieving technological feasibility and risks related to the impact of potential changes in future target markets. There is no assurance that the project will meet either technological or commercial success. Failure to complete the development of the fSSCP technology in its entirety, or in a timely manner, could have a material adverse impact on the Company's financial condition and results of operations.

The estimates used by the Company in valuing in-process research and development were based upon assumptions the Company believes to be reasonable but which are inherently uncertain and unpredictable. To date, there have been no significant changes to the Company's assumptions. The Company's assumptions may be incomplete or inaccurate, and no assurance can be given that unanticipated events and circumstances will not occur. Accordingly, actual results may vary from the projected results. Any such variance may result in a material adverse effect on the financial condition and results of operations of the Company.

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. The Company's ability to generate revenues and operating profits from microarray-based gene expression services will be dependent on the ability of the Company to obtain additional high volume customers for microarray services and to expand capacity in a cost-effective manner. 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 bioinformatics 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 records its share of diaDexus' earnings and losses in its statement of operations.

In July 1999, the Company and SB each invested an additional $2.5 million in diaDexus through convertible subordinated notes that mature in April, 2000. The notes bear interest at 5.6% and are subordinate to all other claims. The notes, principal plus accrued interest, will automatically convert into diaDexus stock upon diaDexus obtaining at least $10 million of funding, including the $5 million from that would result from the conversion of the loans from SB and the Company, in the form of Series C Preferred Stock.

The Company has made and intends to continue to make strategic equity investments in, and acquisitions of, technologies and businesses that are complementary to the businesses of the Company. As a result, the Company may record losses or expenses related to the Company's proportionate ownership interest in such long-term equity investments, record charges for the acquisition of in-process technologies, or record charges for the recognition of the impairment in the value of the securities underlying such investments. The market prices of the securities of the companies in which the Company invests are highly volatile and therefore subject to declines in market value. The Company will continue to evaluate its long-term equity investments for impairment on a quarterly basis.

In January 1998, the Company announced a relationship relating to the joint development of proteomics data and related software with Oxford GlycoSciences plc ("OGS"). As part of this relationship, the Company made a $5.0 million initial equity investment and a follow-on investment in April 1998 of approximately $0.8 million as part of the OGS initial public offering of its ordinary shares. As part of the collaborative agreement, the Company has agreed to reimburse OGS for up to $5.0 million in 1999 if revenues are not sufficient to offset OGS' expenses for services rendered.

In an effort to broaden its business, the Company is investing in a number of new areas, including molecular diagnostics, genome sequencing, SNP discovery 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 is likely to continue to incur substantial expenses in its defense of the lawsuits filed in January and September 1998 by Affymetrix, Inc. ("Affymetrix") alleging patent infringement by Synteni and Incyte. Affymetrix seeks a permanent injunction enjoining Incyte and Synteni from further infringement of certain Affymetrix microarray patents. In addition, Affymetrix 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 these suits vigorously. However, there can be no assurance that Incyte and Synteni will be successful in the defense of these suits. At this time, the Company cannot reasonably estimate the possible range of any loss related to these suits due to uncertainty regarding the ultimate outcome. Regardless of the outcome, this litigation has resulted and is expected to continue to result in substantial expenses and diversion of the efforts of management and technical personnel. Any future litigation could result in similar expenses and diversion of efforts. Further, there can be no assurance that any license that may be required as a result of these suits or the outcome thereof would be made available on commercially acceptable terms, if at all.

RESULTS OF OPERATIONS

Net loss and diluted net loss per share were $7.4 million and $9.3 million and $0.26 and $0.33 per share for the three and six months ended June 30, 1999, respectively, as compared to net income and diluted net income per share of $5.2 million and $8.8 million and $0.18 and $0.30 per share in the same periods a year ago, respectively.

Revenues for the three and six months ended June 30, 1999 increased to $37.9 million and $75.5 million, respectively, compared to $33.1 million and $63.5 million for the corresponding periods in 1998. Revenues resulted primarily from database access fees and, to a much lesser extent, from genomic screening products and services, microarray-based gene expression services, contract sequencing, and genomic data management software tools and maintenance. The increase in revenues was primarily attributed to expanded collaborative database agreements, and to a lesser extent, to increased revenues from microarray-based gene expression services.

Total costs and expenses for the three and six months ended June 30, 1999 increased to $45.6 million and $85.2 million, respectively, compared to $28.8 million and $56.3 million for the corresponding periods in 1998. 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 expansion of microarray production capacity, the continued investment in new product development and bioinformatics, and the growth in marketing, sales and customer services.

Research and development expenses for the three and six months ended June 30, 1999 increased to $36.1 million and $67.4 million, respectively, compared to $23.1 million and $44.8 million for the corresponding periods in 1998. The increase in research and development expenses resulted primarily from the ramp up in expenses related to the Company's investment in its genomic sequencing, bioinformatics, gene mapping and SNP discovery programs, increase in its microarray production, and continued investment in the growth of the Company's intellectual property portfolio. The Company expects research and development spending to continue to increase 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, 1999 increased to $9.5 million and $17.9 million, respectively, compared to $5.7 million and $10.3 million for the corresponding periods in 1998. The increase in selling, general and administrative expenses resulted primarily from the expansion of the Company's United Kingdom operations, the growth in sales and marketing activities and increased personnel to support the growing complexity of the Company's operations. The Company's operations for the three and six months ended June 30, 1999 were also impacted by legal expenses from the patent infringement lawsuits filed by Affymetrix of approximately $2.0 million and $4.1 million, respectively. The Company expects that selling, general and administrative expenses will increase throughout 1999 due to continued growth in marketing, sales and customer support functions and increases in personnel to support the Company's growing complexity. Selling, general and administrative expenses could fluctuate from quarter to quarter due to the timing of legal expenses related to the Affymetrix lawsuits.

Interest and other income, net for the three and six months ended June 30, 1999 decreased to $1.6 million and $3.0 million, respectively, from $1.8 million and $3.7 million for the corresponding periods in 1998. The decrease is primarily due to the lower cash, cash equivalent, and marketable security balances in 1999 as compared to 1998.

Losses from joint venture were $1.2 million and $2.6 million for the three and six months ended June 30, 1999, respectively, and zero and $0.6 million for the three and six months ended June 30, 1998, respectively. 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. diaDexus is expected to incur operating losses through at least 2000.

Due to the Company's expected net loss in 1999, the Company expects a minimal effective annual income tax rate. The effective annual income tax rate for 1998 was 14%, which represented the provision of federal and state alternative minimum taxes after utilization of net operating loss carryforwards and research and development credits.

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 1999, the Company had $106.1 million in cash, cash equivalents and marketable securities, compared to $111.2 million as of December 31, 1998. The Company has classified all of its marketable securities as short-term, as the Company may choose 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 $13.7 million for the six months ended June 30, 1999, as compared to $33.1 million for the six months ended June 30, 1998. The decrease in net cash provided by operating activities resulted primarily from the change to a net loss for the six months ended June 30, 1999 from net income in the corresponding period in 1998 as well as the lower increase in deferred revenues in 1999 as compared to 1998, which were partially offset by higher non cash charges from depreciation and amortization and losses in joint venture. 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. Although the Company is expected to be cash flow positive from operations in 1999, due to the significant investment in the Company's genomic sequencing, bioinformatics, mapping and SNP discovery programs, the Company expects a continued significant decrease in cash flows from operations in the remainder of 1999 as compared to 1998.

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, 1999 increased to $20.0 million from $15.3 million for the six months ended June 30, 1998. In 1999, the Company has made no long-term investments in companies with which the Company has research and development alliances as compared to $6.9 million for the six months ended June 30, 1998. 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 $1.1 million for the six months ended June 30, 1999 as compared to $2.8 million for the six months ended June 30, 1998. The decrease was primarily due to lower proceeds from stock option exercises in 1999.

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 the next twelve months. However, the Company may be unable to obtain additional collaborators or retain existing collaborators for its databases, and its 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 other products and services; the cost required to complete the genomic sequencing and human genome mapping programs; 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, including capital equipment necessary to ensure the Company's sequencing and microarray operations remain competitive; capital expenditures required to expand the Company's facilities; and costs associated with the integration of new operations assumed through mergers and acquisitions. 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.

The Company expects to continue to fund future operations with revenues from database products and services and with its current cash, cash equivalents, and marketable securities. Additional funding, if necessary, may not be available on favorable terms, if at all. If adequate funds are not available through the public markets and/or other sources, the Company may be required to curtail operations significantly or to obtain funds by entering into collaborative arrangements that may require the Company to relinquish rights to certain of its technologies, product candidates, products or potential markets.

EURO CONVERSION

A single currency called the euro was introduced in Europe on January 1, 1999. Eleven of the fifteen member countries of the European Union agreed to adopt the euro as their common legal currency on that date. Fixed conversion rates between these participating countries' existing currencies (the "legacy currencies") and the euro were established as of that date. The legacy currencies are scheduled to remain legal tender as denominations of the euro until at least January 1, 2002, but not later than July 1, 2002. During this transition period, parties may settle transactions using either the euro or a participating country's legal currency. The Company does not expect this conversion to have a material impact on its results of operations, financial position or cash flows.

YEAR 2000

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 other normal business activities.

The Company is in the process of evaluating the Year 2000 readiness of the software products sold by the Company ("Products"), the information technology systems used in its operations ("IT Systems"), and its non-IT Systems, such as building security, voice mail, and other systems. The project consists of the following phases: (i) identification of all Products, IT Systems, and non-IT Systems; (ii) assessment of repair or replacement requirements; (iii) repair or replacement; (iv) testing; (v) implementation; and (vi) creation of contingency

plans in the event of Year 2000 failures.

The supplier of the Company's current financial and accounting software has informed the Company that such software is Year 2000 compliant. The Company relies, both domestically and internationally, upon various vendors, government agencies, utility companies, telecommunications service companies, delivery service companies, and other service providers who are outside of the Company's control. There is no assurance that such parties will not suffer a Year 2000 business disruption, which could have a material adverse effect on the Company's financial condition and results of operations.

The Company relies for its successful operation upon goods and services purchased from certain vendors. If these vendors fail to adequately address the Year 2000 such that their delivery of goods and services to the Company is materially impaired, it could have a material adverse impact on the Company's operations and financial results. The Company is in the process of surveying its principal vendors to assess the effect the Year 2000 issue will have on their ability to supply their goods and services without material interruption, and at this time the Company cannot determine or predict the outcome of this effort. Contingency plans will be developed and executed with respect to vendors who will not be Year 2000 ready in a timely manner where such lack of readiness is expected to have a material adverse impact on the Company's operations. However, because the Company cannot be certain that its vendors will be able to supply material goods and services without material interruption, and because the Company cannot be certain that execution of its contingency plans will be capable of implementation or result in a continuous and adequate supply of such goods and services, the Company can give no assurance that these matters will not have a material adverse effect on the Company's future consolidated financial position, results of operations, or cash flows.

If the Company's customers fail to achieve an adequate state of Year 2000 readiness in their own operations, or if their Year 2000 readiness efforts consume significant resources, their ability to purchase the Company's products may be impaired. This could adversely affect demand for the Company's products and, therefore, the Company's future revenues. The Company plans to develop a contingency plan for Year 2000 noncompliant customers and at this time cannot determine the impact it will have, if any.

In the second quarter of 1999, the Company completed its testing of all current versions of its software products, which disclosed nothing that results in Year 2000 non compliance. Even so, whether a complete system or device in which a Product is embedded will operate correctly for an end-user depends in large part on the Year 2000 compliance of the system's other components, most of which are supplied by parties other than the Company. The Company is currently evaluating systems and software used internally at all locations of the Company (including those from third-party vendors) for Year 2000 compliance. The initial assessment as been completed, and all testing and remediation for mission-critical systems is expected to be completed by the end of the third quarter of 1999.

To date, the Company has had expenditures of approximately $0.4 million for external vendors for assistance with its Year 2000 assessment of IT internal systems and for certification of its database and software products. In addition the Company has incurred minimal opportunity cost of time spent by employees of the Company evaluating its financial and accounting software, its products, and general Year 2000 compliance matters. Absent a significant Year 2000 compliance deficiency, management currently estimates that total costs for its Year 2000 compliance programs will be between $1.0 million and $1.5 million, which will total approximately 10% of the total 1999 IT budget and is being expensed as incurred. The Company has not deferred any IT projects due to its efforts to ensure Year 2000 compliance. The Company believes that available cash will be sufficient to cover the projected costs associated with these activities.

The Company intends to develop and implement, if necessary, appropriate contingency plans to mitigate to the extent possible the effects of any Year 2000 noncompliance, and expects to have such plans completed in the second half of 1999. As part of the development of a contingency plan, the Company will evaluate its worst case scenario in the event of Year 2000 noncompliance. Although the full consequences are unknown, the failure of either the Company's critical systems or those of its material third party suppliers to be Year 2000 compliant would result in the interruption of the Company's business, which could have a material adverse effect on the Company's business, financial condition and results of operations.

FACTORS THAT MAY AFFECT RESULTS

The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations.

If any of the following risks actually occur, our business, financial

condition and results of operations could be materially and adversely affected.

WE HAVE HAD ONLY LIMITED PERIODS OF PROFITABILITY, AND WE EXPECT TO INCUR LOSSES IN THE FUTURE AND MAY NOT RETURN TO PROFITABILITY

We had net losses from inception in 1991 through 1996, reported net income in 1997 and 1998, and as anticipated we were unprofitable in the first half of 1999. Because of those losses, we had an accumulated deficit of $37.7 million as of June 30, 1999. Because we intend to make a significant investment in genomic sequencing, mapping and SNP discovery over the next 12 to 18 months, we expect to report a net loss for 1999 and possibly 2000. We may report net losses in future periods as well. We expect that our expenditures will continue to increase, due in part to our continued investment in new product and technology development, including the ramp-up of our genomic sequencing, bioinformatics, mapping and SNP-discovery programs, obligations under existing and future research and development alliances, and our increasing investment in marketing, sales and customer service. Our profitability depends on our ability to increase our revenues:

TO GENERATE SIGNIFICANT REVENUES, WE MUST OBTAIN ADDITIONAL DATABASE COLLABORATORS AND RETAIN EXISTING COLLABORATORS. While we had 22 database agreements as of June 30, 1999, we may be unable to enter into any additional agreements. Although all agreements that have expired to date have been renewed, we cannot assure you that any other agreements will be renewed upon expiration. Our database revenues are also affected by the extent to which existing collaborators expand their agreements with us to include our new database products and to the extent that existing collaborators reduce the number of products or services for which they subscribe. Some of our database agreements require us to meet performance obligations. A database collaborator can terminate its agreement before the end of its scheduled term if we breach the agreement and fail to cure the breach within a specified period.

OUR REVENUES AND PROFITABILITY WILL ALSO DEPEND ON OUR ABILITY TO EXPAND OUR CUSTOMER BASE FOR MICROARRAY SERVICES. We acquired Synteni, Inc. in January 1998 primarily for this purpose. Synteni's contribution to our operating results will depend on whether we can obtain high-volume customers for microarray services, whether we can increase our microarray production capacity in a timely manner and with consistent volumes and quality, and the costs associated with increasing our microarray production capacity. Before we acquired Synteni, its microarray service agreements consisted of small volume pilot or feasibility agreements.

WE DO NOT EXPECT MILESTONE OR ROYALTY PAYMENTS TO CONTRIBUTE TO REVENUES FOR A SUBSTANTIAL PERIOD OF TIME. Part of our strategy is to license to database collaborators our know how and patent rights associated with the gene sequences and related information in our proprietary databases, for use in the discovery and development of 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 before commercialization. Accordingly, we do not expect to receive any milestone or royalty payments from any of these licenses for a substantial period of time, if at all.

OUR OPERATING RESULTS MAY FLUCTUATE SIGNIFICANTLY

Our operating results are unpredictable and may fluctuate significantly from period to period due to a variety of factors, including:

- - changes in the demand for our products and services;

- - the introduction of competitive databases or services;

- - the pricing of access to our databases;

- - the nature, pricing and timing of other products and services provided to our collaborators;

- - changes in the research and development budgets of our collaborators and potential collaborators;

- - depreciation expense from capital expenditures;

- - acquisition, licensing and other costs related to the expansion of our operations, including operating losses of acquired businesses such as Synteni and Hexagen;

- - losses and expenses related to our investments in joint ventures and businesses, including our proportionate share of operating losses of our diaDexus, LLC, joint venture with SmithKline Beecham Corporation;

- - payments of milestones, license fees or research payments under the terms

of our increasing number of external alliances; and

- - expenses related to, and the results of, litigation and other proceedings relating to intellectual property rights (including the lawsuits filed by Affymetrix, Inc. described below).

In particular, revenues from our database business are unpredictable because:

- - the timing of our database installations is determined by our collaborators,

- - the sales cycle for our database products is lengthy, and

- - the time required to complete custom orders can vary significantly.

We expect our microarray services to represent an increasing amount of our revenues. Revenues from these sources depend on volume of usage by our collaborators, and can therefore fluctuate significantly. Also, revenues can be affected by developments in the Affymetrix litigation, which may cause potential customers to postpone or change their decision to use our microarray services.

We are investing in a number of new areas to try to broaden our business. These areas include genomic sequencing and mapping, SNP discovery, molecular diagnostics, and proteomics, or the large scale, high-throughput analysis of protein expression. Because many of these address new markets or involve untested technologies, they may not generate any revenues or provide an adequate return on our investment. In these cases, we may have to recognize expenses or losses.

We have significant fixed expenses, due in part to our need to continue to invest in product development and extensive support for our database collaborators. We may be unable to adjust our expenditures if revenues in a particular period fail to meet our expectations, which would adversely affect our operating results for that period. Forecasting operating and integration expenses for acquired businesses may be particularly difficult, especially where the acquired business focuses on technologies that do not have an established market.

We believe that period-to-period comparisons of our financial results will not necessarily be meaningful. You should not rely on these comparisons as an indication of our future performance. If our operating results in any future period fall below the expectations of securities analysts and investors, our stock price will likely fall, possibly by a significant amount.

WE EXPERIENCE INTENSE COMPETITION AND RAPID TECHNOLOGICAL CHANGE

GENOMIC BUSINESSES ARE INTENSELY COMPETITIVE The human genome contains a finite number of genes. Our competitors may seek to identify, sequence and determine the biological function of numerous genes in order to obtain a proprietary position with respect to new genes. A number of companies, other institutions and government-financed entities are engaged in gene sequencing, gene discovery, gene expression analysis, positional cloning, the study of genetic variation, and other genomic service businesses. Many of these companies, institutions and entities have greater financial and human resources than we do.

Some of our competitors have developed databases containing gene sequence, gene expression, genetic variation or other genomic information and are marketing or plan to market their data to pharmaceutical companies. Additional competitors may attempt to establish databases containing this information in the future. We expect that competition in our industry will continue to intensify. Several large pharmaceutical companies have announced their intent to form a consortium to create a SNPs database and to make all of the information publicly available. The formation of this sort of consortium could delay or reduce the potential revenues related to our SNP-related business.

PATENT POSITIONS OR PUBLIC DISCLOSURES MAY REDUCE THE VALUE OF OUR DATABASES. Competitors may discover and establish patent positions with respect to gene sequences in our databases. Further, certain entities engaged in gene sequencing have made the results of their sequencing efforts publicly available. The Celera Genomics Group of PE Corporation has announced plans to sequence the entire human genome by the end of 2001 and to make the basic human sequence data publicly available. The Human Genome Project, which is coordinated by the U.S. Department of Energy and the National Institutes of Health, has announced that a consortium of laboratories associated with the Project predicts that they will produce at least 90 percent of the human genome sequence in a "working draft form" by the spring of 2000 and that they intend to make the information publicly available. The public availability of gene sequences or resulting patent positions covering substantial portions of the human genome or microbial or plant genomes could reduce the potential value of our databases to our

collaborators. It could also impair our ability to realize royalties or other revenue from any commercialized products based on this genetic information.

COMPETITORS MAY DEVELOP SUPERIOR TECHNOLOGY. The gene sequencing machines used in our computer-aided sequencing operations are commercially available and are being used by at least one competitor. In addition, some of our competitors and potential competitors are developing proprietary sequencing technologies that may be more advanced than ours. PE Corporation has announced that it has begun commercial shipments of a new gel-based sequencing machine, and that a large number of these machines will be provided to Celera Genomics Group. We may be unable to obtain access to these machines on acceptable terms.

In addition, a number of companies are pursuing alternative methods for generating gene expression information, including microarray technologies. These advanced sequencing or gene expression technologies may not be commercially available for us to purchase or license on reasonable terms, if at all. At least one other company currently offers microarray-based services that might be competitive with ours.

Our SNP discovery platform represents a modification of a process that is in the public domain. We are seeking patent protection for these improvements, but have not yet received any patents. Other companies could make similar or superior improvements to this process without infringing our rights, and we may not have access to those improvements. The discovery of SNPs is a competitive area. Other companies may develop or obtain access to different SNP discovery platforms, to which we may not have access, that may make our technology obsolete.

We also face competition from providers of software. A number of companies have announced their intent to develop and market software to assist pharmaceutical companies and academic researchers in managing and analyzing their own genomic data and publicly available data. Some of these entities have access to significantly greater resources than we do, and their products may achieve greater market acceptance than ours.

WE MUST CONTINUE TO INVEST IN NEW TECHNOLOGIES. The genomics industry is characterized by extensive research efforts, resulting in rapid technological progress. To remain competitive, we must continue to expand our databases, improve our software, and invest in new technologies. New developments are expected to continue, and discoveries by others may render our services and potential products noncompetitive.

WE ARE INVOLVED IN PATENT LITIGATION

In January 1998, Affymetrix filed a lawsuit in federal court alleging infringement of U.S. patent number 5,445,934 by both Synteni and Incyte. The complaint alleges that the '934 patent has been infringed by Synteni's and Incyte's making, using, selling, importing, distributing or offering to sell high density arrays in the United States and that this infringement was willful. Affymetrix seeks a permanent injunction enjoining Synteni and Incyte from further infringement of the '934 patent and seeks damages, costs, attorneys' fees and interest. Affymetrix also requests triple damages based on allegedly willful infringement.

In September 1998, Affymetrix filed an additional lawsuit alleging infringement of U.S. patent numbers 5,744,305 and 5,800,992 by Synteni and Incyte. The complaint alleges that the '305 patent has been infringed by Synteni's and Incyte's making, using, selling, importing, distributing or offering to sell high density arrays in the United States. It also alleges that the '992 patent has been infringed by the use of Synteni's and Incyte's GEM microarray technology to conduct gene expression monitoring using two-color labeling and that this infringement was willful. Affymetrix had sought a preliminary injunction enjoining Synteni and Incyte from using GEM microarray technology to conduct this kind of gene expression monitoring, and a permanent injunction enjoining Synteni and Incyte from further infringing the '305 and '992 patents.

The lawsuits were initially filed in the United States District Court for the District of Delaware. In November 1998, the court granted Incyte's motion to transfer the suits to the United States District Court for the Northern District of California. Affymetrix's request for a preliminary injunction was denied in April 1999 and the lawsuit is tentatively scheduled to go to trial in July 2000.

In April 1999, the Board of Patent Appeals and Interferences of United States Patent and Trademark Office declared interferences between pending patent applications licensed exclusively to us and the Affymetrix '305 and '992 patents. An interference proceeding is invoked by the Patent and Trademark Office when more than one patent applicant claims the same invention. The Board of Patent Appeals and Interferences evaluates all relevant facts, including those bearing on first to invent, validity, enablement and scope of claims, and then makes a determination as to who, if anyone, is entitled to the patent on

the disputed invention. At this time, we can not predict the outcome of the interference proceeding.

We believe we have meritorious defenses and intend to defend these suits vigorously. However, our defense may be unsuccessful. At this time, we cannot reasonably estimate the possible range of any loss resulting from these suits due to uncertainty about the ultimate outcome. We have spent and expect to continue to spend a significant amount of money and management time on this litigation. Also, if we are required to license any technology as a result of these suits, we do not know whether we will be able to do so on commercially acceptable terms, if at all.

WE ARE SPENDING A LOT OF MONEY ON NEW AND UNCERTAIN BUSINESSES AND DEMAND FOR OUR PRODUCTS AND SERVICES MAY BE INSUFFICIENT TO COVER OUR COSTS

There is no precedent for our microarray-based gene expression service business or the use of SNP-based genetic variation information. The usefulness of the information generated by these businesses is unproven. Our collaborators and potential collaborators may determine that our databases, software tools and microarray-related services are not useful or cost-effective. Due to the nature and price of the products and services we offer, only a limited number of companies are potential collaborators for our products and services. If we do not develop these new products and services in time to meet market demand or if there is insufficient demand for these products and services, we may not be able to cover our costs of developing these products and services or earn a sufficient return on our investment.

Additional factors that may affect demand for our products and services include:

- - the extent to which pharmaceutical and biotechnology companies conduct these activities in-house or through industry consortia;

- - the emergence of competitors offering similar services at competitive prices;

- - the extent to which the information in our databases is made public or is covered by others' patents;

- - our ability to establish and enforce proprietary rights to our products;

- - regulatory developments or changes in public perceptions relating to the use of genetic information and the diagnosis and treatment of disease based on genetic information; and

- - technological innovations that are more advanced than the technologies that we have developed or that are available to us.

Many of these factors are beyond our control.

OUR NEW PROGRAMS RELATING TO THE ROLE OF GENETIC VARIATION IN DISEASE AND DRUG RESPONSE ARE RISKY

We recently began to focus part of our business on developing databases and other products and services to assist pharmaceutical companies in a new and unproven area: the identification and correlation of genetic variation to disease and drug response. Hexagen, which will be an important part of this business, was founded in 1996 and has generated no revenues to date. We will incur significant costs over the next several years in expanding our research and development in this area. These activities may never generate significant revenues or profitable operations.

This new aspect of our business will focus on SNPs, one type of genetic variation. The role of SNPs in disease and drug response is not fully understood, and relatively few, if any, therapeutic or diagnostic products based on SNPs have been developed and commercialized. Among other things, demand in this area may be adversely affected by ethical and social concerns about the confidentiality of patient-specific genetic information and about the use of genetic testing for diagnostic purposes.

Except for a few anecdotal examples, there is no proof that SNPs have any correlation to diseases or a patient's response to a particular drug or class of drug. Identifying statistically significant correlations is time-consuming and could involve the collection and screening of a large number of patient samples. We do not know if the SNPs we have discovered to date are suitable for these correlation studies. Nor do we currently have access to the patient samples needed or technology allowing us to rapidly and cost-effectively identify pre-determined SNPs in large numbers of patients.

Most SNPs may occur too infrequently to warrant their use in analyzing patients' genetic variation. We may have trouble identifying SNPs that both correlate with diseases or drug responses and occur frequently enough to justify their use by pharmaceutical companies.

Our success will also depend upon our ability to develop, use and enhance new and relatively unproven technologies. Our strategy of using high-throughput mutation detection processes and sequencing to identify SNPs and genes rapidly is unproven. Among other things, we will need to improve the throughput of our SNP-discovery technology. We may not be able to achieve these necessary improvements, and other factors may impair our ability to develop our SNP-related products and services in time to be competitively available.

OUR STRATEGIC INVESTMENTS MAY RESULT IN LOSSES AND OTHER ADVERSE EFFECTS

We make strategic investments in joint ventures or businesses that complement our business. These investments, such as our investment in diaDexus, may:

- - often be made in securities lacking a public trading market or subject to trading restrictions, either of which increases our risk and reduces the liquidity of our investment,

- - require us to record losses and expenses related to our ownership interest,

- - require us to record charges related to the acquisition of in-process technologies or for the impairment in the value of the securities underlying our investment, and

- - require us to invest greater amounts than anticipated or to devote substantial management time to the management of research and development relationships and joint ventures.

The market values of many of these investments fluctuate significantly. We evaluate our long-term equity investments for impairment of their values on a quarterly basis. Impairment could result in future charges to our earnings. These losses and expenses may exceed the amounts that we anticipated.

OUR SALES CYCLE IS LENGTHY

Our ability to obtain new subscribers for our databases, software tools and microarray and other services depends upon prospective subscribers' perceptions that our products and services can help accelerate drug discovery efforts. Our sales cycle is typically lengthy because we need to educate our potential subscribers and sell the benefits of our tools and services to a variety of constituencies within potential subscriber companies. In addition, each database subscription and microarray services agreement involves the negotiation of unique terms. We may expend substantial funds and management effort with no assurance that a subscription or services agreement will result. Actual and proposed consolidations of pharmaceutical companies have affected the timing and progress of our sales efforts. We expect that future proposed consolidations will have similar effects.

PATENTS AND OTHER PROPRIETARY RIGHTS PROVIDE UNCERTAIN PROTECTION

WE MAY BE UNABLE TO PROTECT OUR PROPRIETARY INFORMATION. Our business and competitive position depend upon our ability to protect our proprietary database information and software technology, but our strategy of obtaining proprietary rights in as many genes and SNPs as possible is unproven. Despite our efforts to protect this information and technology, unauthorized parties may attempt to obtain and use information that we regard as proprietary. Although our database subscription agreements require our subscribers to control access to our databases, policing unauthorized use of our databases and software may be difficult.

We have been issued a number of patents with respect to the gene sequences in our databases and have filed for patents on selected features of our software. However, as of the date of this report, we have no issued patents or registered copyrights for that software. We cannot prevent others from independently developing software that might be covered by copyrights issued to us, and trade secret laws do not prevent independent development.

We pursue a policy of having our employees, consultants and advisors execute proprietary information and invention agreements when they begin working for us. However, these agreements may not provide meaningful protection for our trade secrets or other proprietary information in the event of unauthorized use or disclosure.

Our means of protecting our proprietary rights may not be adequate and our competitors may:

- - independently develop substantially equivalent proprietary information and techniques,

- - otherwise gain access to our proprietary information, or

- - design around patents issued to us or our other intellectual property.

OUR PATENT APPLICATIONS MAY CONFLICT WITH OTHERS. Our current policy is to file patent applications on what we believe to be novel full-length and partial gene sequences obtained through our gene sequencing efforts. We have filed U.S. patent applications in which we have claimed certain partial gene sequences. We have also applied for patents in the U.S. and other countries claiming full-length gene sequences associated with cells and tissues involved in our gene sequencing program. We hold a number of issued U.S. patents on full-length genes and one issued U.S. patent claiming multiple partial gene sequences. A number of entities make certain gene sequences publicly available, which may adversely affect our ability to obtain patents on those genes.

We believe that some of our patent applications claim genes that may also be claimed in patent applications filed by others. 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 Board of Patent Appeals and Interferences has declared interferences with respect to two patent applications directed to technology licensed exclusively to us and two Affymetrix patents that are the subject of our litigation with Affymetrix. The Board of Patent Appeals has also declared two interferences involving applications covering Incyte full-length genes, and has advised us of approximately a dozen additional interferences that might be declared. We cannot predict whether any of the interferences would be resolved in our favor. Regardless of the outcome, interferences could be expensive and time-consuming.

ENFORCEMENT OF GENE PATENTS IS UNCERTAIN. One of our strategies is to obtain proprietary rights in as many genes (including partial gene sequences)

and SNPs as possible. While the USPTO has issued patents covering full-length genes, partial gene sequences and SNPs, we do not know whether or how courts may enforce those patents, if that becomes necessary. If a court finds these types of inventions to be unpatentable, or interprets them narrowly, the benefits of our strategy may not materialize.

WE MAY DECIDE TO ABANDON PATENT APPLICATIONS. The USPTO has had a substantial backlog of biotechnology patent applications, particularly those claiming 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 our patent applications contain more partial sequences than the maximum number allowed under these guidelines. Due to the resources needed to comply with the guidelines, we may decide to abandon patent applications for some of our partial gene sequences.

Because filing large numbers of patent applications and maintaining issued patents can be very costly, we may choose not to pursue every application. If we do not pursue patent protection for all of our full-length and partial gene sequences, the value of our intellectual property portfolio could be diminished. Because of the possible delay in obtaining allowance of some of our patent applications, and the secrecy of patent applications, we do not know if other applications having priority over ours have been filed.

WE MAY NEED TO REFILE SOME OF OUR PATENT APPLICATIONS, AND THE PERIOD OF PATENT PROTECTION HAS BEEN SHORTENED. The value of our patents depends in part on their duration. The U.S. patent laws were amended in 1995 to change the term of patent protection from 17 years from patent issuance to 20 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 20-year patent term from the filing date may result in substantially shorter patent protection, which may adversely affect our rights under any patents that obtain. We may need to refile applications claiming large numbers of gene sequences and, in these situations, the patent term will be measured from the date of the earliest priority application. This would shorten our period of patent exclusivity.

INTERNATIONAL PATENT PROTECTION IS PARTICULARLY UNCERTAIN. 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 some foreign countries may not protect our intellectual property rights to the same extent as U.S. laws. We may participate in opposition proceedings to determine the validity of our or our competitors' foreign patents, which could result in substantial costs and diversion of our efforts.

WE MAY BE SUBJECT TO ADDITIONAL LITIGATION AND INFRINGEMENT CLAIMS

The technology that we use to develop our products, and those that we incorporate in our products, may be subject to claims that they infringe the patents or proprietary rights of others. The risk of this occurring will tend to increase as the genomics, biotechnology and software industries expand, more patents are issued and other companies attempt to discover genes and SNPs and engage in other genomic-related businesses.

As is typical in the genomics, biotechnology and software industries, we have received, and we will probably receive in the future, notices from third parties alleging patent infringement. We believe that we are not infringing the patent rights of any such third party. Except for Affymetrix, no third party has filed a patent lawsuit against us.

We may, however, be involved in future lawsuits alleging patent infringement or other intellectual property rights violations. In addition, litigation may be necessary to:

- - assert claims of infringement,

- - enforce our patents,

- - protect our trade secrets or know-how, or

- - determine the enforceability, scope and validity of the proprietary rights of others.

We may be unsuccessful in defending or pursuing these lawsuits. Regardless of the outcome, litigation can be very costly and can divert management's efforts. An adverse determination may subject us to significant liabilities or require us to seek licenses to other parties' patents or proprietary rights. We may also be restricted or prevented from manufacturing or selling our products. Further, we may not be able to obtain the necessary licenses on acceptable terms, if at all.

WE MAY ENCOUNTER PROBLEMS IN MEETING CUSTOMERS' SOFTWARE NEEDS

Our databases also require software support and will need to incorporate features determined by database collaborators. If we experience delays or difficulties in implementing our database software or collaborator-requested features, we may be unable to service our collaborators.

OUR RECENT ACQUISITIONS INVOLVE SEVERAL RISKS

Our acquisitions of Synteni and Hexagen involve several potential operating and business risks, including potential problems and costs associated with integrating Synteni's and Hexagen's businesses, technologies and management with ours. Our integration efforts may also result in the loss of efficiency or employees.

The combined companies may not realize any revenue enhancements or cost savings. Increases in other expenses and operating losses, including losses due to problems in integrating the acquired companies with ours, may offset any cost savings. Our combined operating results and financial condition may not be superior to what we could have achieved without these acquisitions, even if we integrate the acquired business efficiently, effectively and quickly. The combination of these businesses with ours may also take longer than expected.

In particular, we began our integration of Hexagen recently. We will need to integrate Hexagen's technology with our existing technology and improve its throughput, in order to develop SNP programs. We may be unable to achieve the necessary improvements, which could slow our efforts to develop a SNP-related business. Also, since Hexagen is located in England, we may experience difficulties in integrating their operations with our U.S.-based operations. We may also incur an expense if the goodwill and other intangible assets associated with the Hexagen purchase are determined to be impaired in the future.

FUTURE ACQUISITIONS WILL CREATE RISKS AND UNCERTAINTIES

As part of our business strategy, we may acquire other assets, technologies and businesses. We acquired two companies in 1996, Synteni in January 1998, and Hexagen in September 1998.

These and any future acquisitions involve risks such as the following:

- - we may be exposed to unknown liabilities of acquired companies;

- - our acquisition and integration costs may be higher than we anticipated and may cause our quarterly and annual operating results to fluctuate;

- - we may experience difficulty and expense in assimilating the operations and personnel of the acquired businesses, disrupting our business and diverting management's time and attention;

- - we may be unable to integrate or complete the development and application of acquired technology;

- - we may experience difficulties in establishing and maintaining uniform standards, controls, procedures and policies;

- - our relationships with key customers of acquired businesses may be impaired, due to changes in management and ownership of the acquired businesses;

- - we may be unable to retain key employees of the acquired businesses;

- - we may incur amortization expenses if an acquisition results in significant goodwill or other intangible assets; and

- - our stockholders may be diluted if we pay for the acquisition with equity securities.

In addition, if we acquire additional businesses that are not located near our Palo Alto, California headquarters, we may experience more difficulty integrating and managing the acquired businesses' operations.

WE MAY HAVE DIFFICULTY MANAGING OUR GROWTH

We expect to continue to experience significant growth in the number of our employees and the scope of our operations. This growth has placed, and may continue to place, a significant strain on our management and operations. Our ability to manage this growth will depend upon our ability to broaden our management team and our ability to attract, hire and retain skilled employees. Our success will also depend on the ability of our officers and key employees to continue to implement and improve our operational and other systems and to hire, train and manage our employees.

In addition, we must continue to invest in customer support resources as

the number of database collaborators and their requests for support increase. Our database collaborators typically have worldwide operations and may require support at multiple U.S. and foreign sites. To provide this support, we may need to open offices in addition to our Palo Alto, California headquarters and our offices in Fremont, California, St. Louis, Missouri and Cambridge, England, which could result in additional burdens on our systems and resources.

WE DEPEND ON KEY EMPLOYEES IN A COMPETITIVE MARKET FOR SKILLED PERSONNEL

We are highly dependent on the principal members of our management, operations and scientific staff, including Roy A. Whitfield, our Chief Executive Officer, and Randal W. Scott, our President and Chief Scientific Officer. The loss of either of these persons' services would have a material adverse effect on our business. We have not entered into any employment agreement with either of these persons and do not maintain a key person life insurance policy on the life of any employee.

Our future success also will depend in part on the continued service of our key scientific, software, bioinformatics and management personnel and our ability to identify, hire and retain additional personnel, including customer service, marketing and sales staff. We experience intense competition for qualified personnel. We may not be able to continue to attract and retain personnel necessary for the development of our business.

WE DEPEND ON THIRD PARTIES FOR NECESSARY EQUIPMENT, SUPPLIES AND DATA

WE RELY ON A SMALL NUMBER OF SUPPLIERS OF GENE SEQUENCING MACHINES AND REAGENTS REQUIRED FOR GENE SEQUENCING. Although we are evaluating alternative gene sequencing machines, they may not be available in sufficient quantities or at acceptable costs. In addition, if a third party claims that our use of these machines infringes their patent rights, our use of these machines could become more costly or could be prevented. If we are unable to obtain additional machines or an adequate supply of reagents or other materials at commercially reasonable rates, our ability to identify genes and SNPs would be adversely affected.

WE RELY ON OUTSIDE SOURCES FOR TISSUE SAMPLES FROM WHICH WE ISOLATE GENETIC MATERIAL USED IN OUR OPERATIONS. Our business could be adversely affected if we lose access to some of these sources, or if they charged us higher access fees or imposed tighter restrictions on our use of the information generated from the samples.

WE CANNOT CONTROL THE PERFORMANCE OF COLLABORATORS. We may enter into research and development relationships with corporate and academic collaborators and others. The success of these relationships depends upon third parties' performance of their responsibilities. Our ability to develop these relationships is uncertain, and any established relationships may prove unsuccessful. Our collaborators may also be pursuing alternative technologies or developing alternative products on their own or in collaboration with others, including our competitors.

WE RELY ON THIRD-PARTY DATA SOURCES. We rely on scientific and other data supplied by others, including our academic collaborators and sources of tissue samples. These data could contain errors or other defects, which could corrupt our databases. In addition, we cannot guarantee that our data sources acquired this information in compliance with legal requirements. If either of these happen and become known, our business prospects could be adversely affected.

OUR BUSINESS COULD BE AFFECTED BY THE YEAR 2000 ISSUE

As a result of computer programs being written using two digits, rather than four, to represent year dates, the performance of our computer systems and those of our 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 which disrupt our operations, such as a temporary inability to process transactions, send invoices or engage in other normal business activities.

We are evaluating the Year 2000 readiness of the software products that we sell, the information technology systems used in our operations, and our other systems such as building security and voicemail. This project consists of the following phases:

- - identifying all of our software products, information technology systems and other systems;

- - assessing repair or replacement requirements;

- - repair or replacement;

- - testing;

- - implementation; and

- - creating contingency plans in the event of Year 2000 failures.

We have completed testing of all current versions of our software products, which disclosed nothing that results in Year 2000 non compliance. Even so, whether a complete system or device in which a software product is embedded will operate correctly for an end-user depends largely on the Year 2000 compliance of other components, most of which are supplied by third parties.

We rely, both domestically and internationally, upon various vendors, government agencies, utility companies, telecommunications service companies, delivery service companies and other service providers. We have no control over these third parties and they may suffer a Year 2000 business disruption.

We also rely upon goods and services purchased from certain vendors, and our business could be disrupted if they fail to adequately address the Year 2000 issue. We are surveying our principal vendors to assess the potential effect of the Year 2000 issue on their ability to supply us. We cannot currently predict the outcome of this effort. We intend to develop contingency plans regarding vendors whose failure to be Year 2000 ready is expected to have a material adverse impact on our operations. However, our vendors may be unable to supply important goods and services without material interruption and our contingency plans may not keep us adequately supplied.

The demand for our products could also be affected by Year 2000 issues affecting our customers. We plan to develop a contingency plan for customers with Year 2000 problems, but we cannot presently determine what impact, if any, it will have.

We intend to develop and implement, if necessary, appropriate contingency plans to mitigate the effects of any Year 2000 noncompliance. We expect to have these plans completed in the second half of 1999. As part of the development of a contingency plan, we will evaluate our worst case scenario for Year 2000 noncompliance. Although the full consequences are unknown, the failure of our critical systems or those of our material vendors and other business partners to be Year 2000 complaint would interrupt our business.

OUR ACTIVITIES INVOLVE HAZARDOUS MATERIALS AND MAY SUBJECT US TO ENVIRONMENTAL LIABILITY

Our research and development involves the controlled use of hazardous and radioactive materials and biological waste. We are 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 we believe that our safety procedures for handling and disposing of these materials comply with legally prescribed standards, the risk of accidental contamination or injury from these materials cannot be completely eliminated. In the event of an accident, we could be held liable for damages, and this liability could exceed our resources.

We believe that we are in compliance in all material respects with applicable environmental laws and regulations and currently do not expect to make material additional capital expenditures for environmental control facilities in the near term. However, we may have to incur significant costs to comply with current or future environmental laws and regulations.

OUR REVENUES ARE DERIVED PRIMARILY FROM THE PHARMACEUTICAL AND BIOTECHNOLOGY INDUSTRIES

We expect that our revenues in the foreseeable future will be derived primarily from products and services provided to the pharmaceutical and biotechnology industries. Accordingly, our success will depend directly upon the success of the companies within these industries and their demand for our products and services. Our operating results may fluctuate substantially due to reductions and delays in research and development expenditures by companies in these industries. These reductions and delays may result 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.

These factors are not within our control.

WE MAY NEED TO RAISE ADDITIONAL CAPITAL THAT MAY NOT BE AVAILABLE

Based upon our current plans, we believe that our existing resources and anticipated cash flow from operations can satisfy our capital needs for at least the next twelve months. However, our products and services may not produce revenues which, together with our existing cash and other resources, are adequate to meet our cash needs. Our cash requirements depend on numerous factors, including:

- - our ability to attract and retain collaborators for our databases and other products and services;

- - expenditures in connection with alliances, license agreements and acquisitions of and investments in complementary technologies and businesses;

- - the need to increase research and development spending as a result of 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 equipment necessary to process data for our databases and to ensure that our sequencing and microarray operations remain competitive;

- - capital expenditures required to expand our facilities; and

- - costs associated with the integration of acquired operations.

Changes in our research and development plans or other changes affecting our operating expenses may alter the timing and amount of expenditures of our capital resources. If we need additional funding, we may be unable to obtain it on favorable terms, or at all. If adequate funds are not available, we may have to curtail operations significantly or obtain funds by entering into arrangements requiring us to relinquish rights to certain technologies, products or markets. In addition, if we raise funds by selling stock or convertible securities, our existing stockholders could suffer dilution.

OUR BUSINESS COULD BE INTERRUPTED BY NATURAL DISASTERS

We conduct our sequencing and a significant portion of our other activities at our facilities in Palo Alto, California, and conduct our microarray-related activities at our facilities in Fremont, California. Both locations are in a seismically active area. Although we maintain business interruption insurance, we do not have or plan to obtain earthquake insurance. A major catastrophe (such as an earthquake or other natural disaster) could result in a prolonged interruption of our business.

PART I: FINANCIAL INFORMATION
ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to interest rate risk primarily through its investments in short-term marketable securities and its note payable. The Company's investment policy calls for investment in short term, low risk instruments. As of June 30, 1999, investments in marketable securities was $52.8 million. At June 30, 1999, the Company had a fixed rate note payable balance of $0.6 million. Due to the nature of these investments and note, any decrease in rates is not expected to have a material impact on the Company's financial statements.

The Company is exposed to equity price risks on the marketable portion of equity securities included in its portfolio of investments and long-term investments, entered into to further its business and strategic objectives. These investments are in small capitalization stocks in the pharmaceutical/biotech industry sector, in companies which the Company has research and development or licensing agreements. The Company typically does not attempt to reduce or eliminate its market exposure on these securities. As of June 30, 1999, long-term investments, excluding diaDexus, were $12.8 million.

The Company typically does not hedge its foreign currency exposure. Management does not believe that the Company's exposure to foreign currency rate fluctuations is material.

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, subsequently transferred to the United States District Court for the Northern District of California, 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.

In September 1998, Affymetrix filed an additional lawsuit in the United States District Court for the District of Delaware, subsequently transferred to the United States District Court for the Northern District of California in November 1998, alleging infringement of the U.S. patent number 5,800,992 (the "'992 Patent") and U.S. patent number 5,744,305 (the "'305 Patent") by both Synteni and Incyte. The complaint alleges that the '305 Patent has been infringed by the making, using, selling, importing, distributing or offering to sell in the United States high density arrays by Synteni and Incyte, that the '992 Patent has been infringed by the use of Synteni's and Incyte's GEMTM microarray technology to conduct gene expression monitoring using two-color labeling, and that such infringement was willful. Affymetrix seeks a permanent injunction enjoining Synteni and Incyte from further infringement of the '305 and '992 Patents and, in addition, Affymetrix had sought a preliminary injunction enjoining Incyte and Synteni from using Synteni's and Incyte's GEM microarray technology to conduct gene expression monitoring using two-color labeling as described in the '992 Patent. Affymetrix's request for a preliminary injunction was denied in April 1999 and the lawsuit is tentatively scheduled to go to trial in July 2000.

In April 1999, the Board of Patent Appeals and Interferences of United States Patent and Trademark Office (PTO) declared interferences between pending patent applications licensed exclusively to Incyte and the Affymetrix '305 and '992 Patents. An interference proceeding is invoked by the PTO when more than one patent applicant claims the same invention. The Board of Patent Appeals and Interferences evaluates all relevant facts, including those bearing on first to invent, validity, enablement and scope of claims, and then makes a determination as to who, if anyone, is entitled to the patent on the disputed invention.

Incyte and Synteni believe they have meritorious defenses and intend to defend the suits vigorously. However, there can be no assurance that Incyte and Synteni will be successful in the defense of these suits. At this time, the Company cannot reasonably estimate the possible range of any loss resulting from these suits due to uncertainty regarding the ultimate outcome. Regardless of the outcome, this litigation has resulted and 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 8, 1999, the Company held its Annual Meeting of Stockholders. The following actions were taken at the annual meeting:

	For	Withheld
a. Roy A. Whitfield	23,384,886	90,937
b. Randal W. Scott	23,386,998	88,825
c. Barry M. Bloom	23,339,404	136,419
d. Jeffrey J. Collinson	23,352,919	122,904
e. Frederick B. Craves	23,352,482	123,341
f. Jon S. Saxe	23,346,984	128,839

1. The following Directors were elected

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

For	Against	Abstain
16,544,042	6,757,571	53,352

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

For	Against	Abstain
23,427,763	19,648	28,412

ITEM 5 Other Information

None

ITEM 6 Exhibits and Reports on Form 8-K.

a) Exhibits
See Exhibit Index on Page 35

b) Reports on Form 8-K
None

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 4, 1999 By: /s/ Roy A. Whitfield

Roy A. Whitfield
Chief Executive Officer

Date: August 4, 1999 By: /s/ Lee Bendekgey

Lee Bendekgey
Chief Financial Officer

INCYTE PHARMACEUTICALS, INC.

EXHIBIT INDEX

5

6-MOS
DEC-31-1999
JUN-30-1999
53,284
52,797
4,828
234
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117,363
110,443
46,477
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