

LEXICON PHARMACEUTICALS, INC./DE  
Form 10-Q  
August 09, 2011  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the Quarterly Period Ended June 30, 2011

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-30111

Lexicon Pharmaceuticals, Inc. (Exact Name of Registrant as Specified in its Charter)	
Delaware (State or Other Jurisdiction of Incorporation or Organization)	76-0474169 (I.R.S. Employer Identification Number)

8800 Technology Forest Place  
The Woodlands, Texas 77381  
(Address of Principal Executive Offices and Zip Code)

(281) 863-3000  
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer      Accelerated filer        Non-accelerated filer      Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes      No     

As of August 4, 2011, 337,677,864 shares of the registrant’s common stock, par value \$0.001 per share, were outstanding.

---

Table of Contents

Lexicon Pharmaceuticals, Inc.

Table of Contents

	Page
<u>Factors Affecting Forward-Looking Statements</u>	<u>2</u>
<u>Part I – Financial Information</u>	<u>3</u>
Item 1. <u>Financial Statements</u>	<u>3</u>
<u>Consolidated Balance Sheets – June 30, 2011 (unaudited) and December 31, 2010</u>	<u>3</u>
<u>Consolidated Statements of Operations (unaudited) – Three and Six Months Ended June 30, 2011 and 2010</u>	<u>4</u>
<u>Consolidated Statements of Stockholders’ Equity (unaudited) – Six Months Ended June 30, 2011 and 2010</u>	<u>5</u>
<u>Consolidated Statements of Cash Flows (unaudited) – Six Months Ended June 30, 2011 and 2010</u>	<u>6</u>
<u>Notes to Consolidated Financial Statements (unaudited)</u>	<u>7</u>
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>14</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>19</u>
Item 4. <u>Controls and Procedures</u>	<u>19</u>
<u>Part II – Other Information</u>	<u>20</u>
Item 1. <u>Legal Proceedings</u>	<u>20</u>
Item 1A. <u>Risk Factors</u>	<u>20</u>
Item 6. <u>Exhibits</u>	<u>22</u>
<u>Signatures</u>	<u>23</u>

The Lexicon name and logo, OmniBank® and LexVision® are registered trademarks and Genome5000™ is a trademark of Lexicon Pharmaceuticals, Inc.

---

Factors Affecting Forward Looking Statements

This quarterly report on Form 10-Q contains forward-looking statements. These statements relate to future events or our future financial performance. We have attempted to identify forward-looking statements by terminology including “anticipate,” “believe,” “can,” “continue,” “could,” “estimate,” “expect,” “intend,” “may,” “plan,” “potential,” “predict,” “show” or “will,” and other comparable terminology. These statements are only predictions and involve known and unknown risks, uncertainties and other factors, including the risks outlined under “Part II, Item 1A. - Risk Factors,” that may cause our or our industry’s actual results, levels of activity, performance or achievements to be materially different from any future results, levels or activity, performance or achievements expressed or implied by these forward-looking statements.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We are not under any duty to update any of the forward-looking statements after the date of this quarterly report on Form 10-Q to conform these statements to actual results, unless required by law.

Table of Contents

## Part I – Financial Information

## Item 1. Financial Statements

## Lexicon Pharmaceuticals, Inc.

## Consolidated Balance Sheets

(In thousands, except par value)

	As of June 30, 2011 (unaudited)	As of December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	\$20,328	\$47,208
Short-term investments, including restricted investments of \$430	144,486	163,903
Accounts receivable, net of allowances of \$35	505	744
Prepaid expenses and other current assets	3,874	2,883
Total current assets	169,193	214,738
Property and equipment, net of accumulated depreciation and amortization of \$78,680 and \$80,323, respectively	48,370	53,427
Goodwill	44,543	44,543
Other intangible assets	53,557	53,557
Other assets	253	619
Total assets	\$315,916	\$366,884
Liabilities and Equity		
Current liabilities:		
Accounts payable	\$3,671	\$3,159
Accrued liabilities	8,037	6,264
Current portion of deferred revenue	138	214
Current portion of long-term debt	1,380	1,138
Total current liabilities	13,226	10,775
Deferred revenue, net of current portion	14,212	14,212
Long-term debt	24,188	27,345
Deferred tax liabilities	18,745	18,745
Other long-term liabilities	51,357	48,783
Total liabilities	121,728	119,860
Commitments and contingencies		
Equity:		
Preferred stock, \$.01 par value; 5,000 shares authorized; no shares issued and outstanding	—	—
Common stock, \$.001 par value; 900,000 shares authorized; 337,895 and 337,566 shares issued, respectively	338	338
Additional paid-in capital	923,797	920,324
Accumulated deficit	(729,673)	(673,406)
Accumulated other comprehensive gain	71	5
Treasury stock, at cost, 218 and 158 shares, respectively	(345)	(237)
Total equity	194,188	247,024
Total liabilities and equity	\$315,916	\$366,884

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

Table of Contents

Lexicon Pharmaceuticals, Inc.

Consolidated Statements of Operations  
(In thousands, except per share amounts)  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Revenues:				
Collaborative research	\$461	\$1,164	\$977	\$2,805
Subscription and license fees	94	69	174	69
Total revenues	555	1,233	1,151	2,874
Operating expenses:				
Research and development, including stock-based compensation of \$818, \$809, \$1,657 and \$1,615, respectively	20,145	20,239	44,066	41,327
Increase in fair value of Symphony Icon, Inc. purchase liability	1,804	—	2,862	—
General and administrative, including stock-based compensation of \$632, \$511, \$1,265 and \$1,010, respectively	4,532	5,068	9,285	10,587
Total operating expenses	26,481	25,307	56,213	51,914
Loss from operations	(25,926 )	(24,074 )	(55,062 )	(49,040 )
Gain on investments, net	—	53	—	141
Interest income	68	200	155	417
Interest expense	(810 )	(729 )	(1,417 )	(1,456 )
Other income (expense), net	30	(643 )	57	(1,325 )
Consolidated net loss	\$(26,638 )	\$(25,193 )	\$(56,267 )	\$(51,263 )
Consolidated net loss per common share, basic and diluted	\$(0.08 )	\$(0.07 )	\$(0.17 )	\$(0.19 )
Shares used in computing consolidated net loss per common share, basic and diluted	337,668	337,404	337,598	267,709

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

Table of Contents

Lexicon Pharmaceuticals, Inc.

Consolidated Statements of Stockholders' Equity

(In thousands)

(Unaudited)

	Lexicon Pharmaceuticals, Inc. Stockholders								
	Common Shares	Stock Par Value	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Gain	Treasury Stock	Total	Noncontrolling Interest	Total Equity
Balance at December 31, 2009	175,785	\$ 176	\$ 733,874	\$ (570,175 )	\$ —	\$ (88 )	\$ 163,787	\$ (290 )	\$ 163,497
Deconsolidation of Symphony Icon	—	—	—	—	—	—	—	290	290
Cumulative-effect adjustment for adoption of new accounting principle	—	—	—	(1,456 )	—	—	(1,456 )	—	(1,456 )
Stock-based compensation	—	—	2,625	—	—	—	2,625	—	2,625
Issuance of common stock, net of fees	161,770	162	181,312	—	—	—	181,474	—	181,474
Exercise of common stock options	7	—	17	—	—	—	17	—	17
Repurchase of common stock	—	—	—	—	—	(149 )	(149 )	—	(149 )
Net loss	—	—	—	(51,263 )	—	—	(51,263 )	—	(51,263 )
Balance at June 30, 2010	337,562	\$ 338	\$ 917,828	\$ (622,894 )	\$ —	\$ (237 )	\$ 295,035	\$ —	\$ 295,035
Balance at December 31, 2010	337,566	\$ 338	\$ 920,324	\$ (673,406 )	\$ 5	\$ (237 )	\$ 247,024	\$ —	\$ 247,024
Stock-based compensation	—	—	2,922	—	—	—	2,922	—	2,922
Grant of stock in lieu of bonus	201	—	363	—	—	—	363	—	363
Exercise of common stock options	128	—	188	—	—	—	188	—	188
Repurchase of common stock	—	—	—	—	—	(108 )	(108 )	—	(108 )
Net loss	—	—	—	(56,267 )	—	—	(56,267 )	—	(56,267 )
Unrealized gain on investments	—	—	—	—	66	—	66	—	66

Comprehensive loss							(56,201 )		(56,201 )	
Balance at June 30, 2011	337,895	\$ 338	\$923,797	\$(729,673 )	\$ 71		\$(345 )	\$194,188	\$ —	\$194,188

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



Table of Contents

Lexicon Pharmaceuticals, Inc.

## Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2011	2010
Cash flows from operating activities:		
Consolidated net loss	\$(56,267	) \$(51,263
Adjustments to reconcile consolidated net loss to net cash used in operating activities:		
Depreciation	2,571	2,745
Impairment of fixed assets	800	—
Amortization of Symphony Icon, Inc. purchase option	—	1,357
Change in fair value of Symphony Icon, Inc. purchase liability	2,862	—
Stock-based compensation	2,922	2,625
Net gain on auction rate securities ("ARS") and ARS Rights	—	(141
Gain on disposal of property and equipment	(15	) (10
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	239	(851
(Increase) decrease in prepaid expenses and other current assets	(991	) 3,053
Decrease in other assets	366	49
Increase (decrease) in accounts payable and other liabilities	2,360	(1,459
Decrease in deferred revenue	(76	) (428
Net cash used in operating activities	(45,229	) (44,323
Cash flows from investing activities:		
Purchases of property and equipment	(815	) (562
Proceeds from disposal of property and equipment	2,516	29
Purchases of investments	(64,126	) —
Maturities of investments	83,609	32,600
Net cash provided by investing activities	21,184	32,067
Cash flows from financing activities:		
Proceeds from issuance of common stock	188	181,491
Repurchase of common stock	(108	) (149
Proceeds from debt borrowings	—	11,377
Repayment of debt borrowings	(2,915	) (33,319
Net cash provided by (used in) financing activities	(2,835	) 159,400
Net increase (decrease) in cash and cash equivalents	(26,880	) 147,144
Cash and cash equivalents at beginning of period	47,208	100,554
Cash and cash equivalents at end of period	\$20,328	\$247,698
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$1,385	\$1,220
Supplemental disclosure of non-cash investing and financing activities:		
Unrealized gain on investments	\$66	\$—

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



Table of Contents

Lexicon Pharmaceuticals, Inc.

Notes to Consolidated Financial Statements  
(Unaudited)

## 1. Basis of Presentation

The accompanying unaudited consolidated financial statements of Lexicon Pharmaceuticals, Inc. (“Lexicon” or the “Company”) have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the six-month period ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ended December 31, 2011.

The accompanying consolidated financial statements include the accounts of Lexicon and its wholly-owned subsidiaries. Intercompany transactions and balances are eliminated in consolidation. For further information, refer to the financial statements and footnotes thereto included in Lexicon’s annual report on Form 10-K for the year ended December 31, 2010, as filed with the SEC.

## 2. Net Loss Per Share

Net loss per share is computed using the weighted average number of shares of common stock outstanding during the applicable period and excludes outstanding unvested restricted shares or units. Shares associated with stock options, restricted stock units and warrants are not included because they are antidilutive. There are no differences between basic and diluted net loss per share for all periods presented.

## 3. Stock-Based Compensation

The Company recorded \$1.5 million and \$1.3 million of stock-based compensation expense for the three months ended June 30, 2011 and 2010, respectively, and \$2.9 million and \$2.6 million of stock-based compensation expense for the six months ended June 30, 2011 and 2010, respectively. The Company utilized the Black-Scholes valuation model for estimating the fair value of the stock compensation granted, with the following weighted-average assumptions for options granted in the six months ended June 30, 2011 and 2010:

	Expected Volatility	Risk-free Interest Rate	Expected Term	Dividend Rate
June 30, 2011:				
Employees	88	% 2.2	% 5	0%
Officers and non-employee directors	78	% 3.2	% 8	0%
June 30, 2010:				
Employees	86	% 2.4	% 5	0%
Officers and non-employee directors	80	% 3.3	% 8	0%

Table of Contents

The following is a summary of option activity under Lexicon's stock-based compensation for the six months ended June 30, 2011:

	Options (in thousands)	Weighted Average Exercise Price
Outstanding at December 31, 2010	19,598	\$3.46
Granted	2,970	1.80
Exercised	(129)	) 1.46
Expired	(1,136)	) 8.35
Forfeited	(189)	) 1.78
Outstanding at June 30, 2011	21,114	2.99
Exercisable at June 30, 2011	13,022	\$3.74

During the six months ended June 30, 2011, Lexicon granted its officers 200,277 shares of stock bonus awards in lieu of cash bonus awards. The stock bonus awards had a weighted average grant date fair value of \$1.81 per share and vested immediately.

During the six months ended June 30, 2011, Lexicon granted its employees restricted stock units in lieu of or in addition to annual stock option awards. These restricted stock units vest in four annual installments. The following is a summary of restricted stock units activity under Lexicon's stock-based compensation plans for the six months ended June 30, 2011:

	Shares (in thousands)	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2010	—	\$—
Granted	2,196	1.81
Forfeited	(6)	) 1.81
Nonvested at June 30, 2011	2,190	\$1.81

During 2010, Lexicon granted certain employees restricted stock units with a performance condition. The shares subject to the restricted stock units granted in 2010 vest upon the dosing of the first patient in a pivotal human clinical trial in any country, the results of which could be used to establish safety and efficacy of a pharmaceutical product discovered or developed by Lexicon as a basis for a New Drug Application. Stock-based compensation expense for awards with performance conditions is recognized over the period from the date the performance condition is determined to be probable of occurring through the time the applicable condition is met. The following is a summary of performance-based restricted stock units activity under Lexicon's stock-based compensation plans for the six months ended June 30, 2011:

	Shares (in thousands)	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2010	361	\$1.90
Nonvested at June 30, 2011	361	\$1.90

#### 4. Recent Accounting Pronouncements

In October 2009, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2009-13, "Multiple-Deliverable Revenue Arrangements", which amends FASB ASC Topic 605. ASU No. 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contain more than one unit of

accounting and how to allocate consideration to each unit of accounting in the arrangement. This pronouncement replaces all references to fair value as the measurement criteria with the term selling price and establishes a hierarchy for determining the selling price of a deliverable. The pronouncement also eliminates the use of the residual value method for determining the allocation of arrangement consideration, and requires additional disclosures. This pronouncement should be applied prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. Lexicon adopted this pronouncement in 2011 and there was no material impact to its consolidated results of operations and financial condition.

Table of Contents

In April 2010, the FASB issued ASU No. 2010-17, "Milestone Method of Revenue Recognition", which amends FASB ASC Topic 605. ASU No. 2010-17 provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. Research or development arrangements frequently include payment provisions whereby a portion or all of the consideration is contingent upon milestone events such as successful completion of phases in a study or achieving a specific result from the research or development efforts. The amendments in this ASU provide guidance on the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. ASU 2010-17 is effective for fiscal years and interim periods within those years beginning on or after June 15, 2010, with early adoption permitted. Lexicon adopted this pronouncement in 2011 and there was no material impact to its consolidated results of operations and financial condition.

In June 2011, the FASB issued ASU No. 2011-05, "Presentation of Comprehensive Income", which improves the comparability, consistency, and transparency of financial reporting and increases the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this standard require that all nonowner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Under either method, adjustments must be displayed for items that are reclassified from other comprehensive income ("OCI") to net income, in both net income and OCI. The standard does not change the current option for presenting components of OCI gross or net of the effect of income taxes, provided that such tax effects are presented in the statement in which OCI is presented or disclosed in the notes to the financial statements. Additionally, the standard does not affect the calculation or reporting of earnings per share. This pronouncement should be applied retrospectively for fiscal years beginning after December 15, 2011, with early adoption permitted. Management does not expect the adoption of this standard to have a material impact on Lexicon's consolidated financial statements.

## 5. Cash and Cash Equivalents and Investments

The fair value of cash and cash equivalents and investments held at June 30, 2011 and December 31, 2010 are as follows:

	As of June 30, 2011			
	Amortized Cost  (in thousands)	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and cash equivalents	\$20,328	\$—	\$—	\$20,328
Securities maturing within one year:				
Certificates of deposit	545	—	—	545
U.S. treasury securities	143,870	72	(1 )	143,941
Total short-term investments	\$144,415	\$72	\$(1 )	\$144,486
Total cash and cash equivalents and investments	\$164,743	\$72	\$(1 )	\$164,814
	As of December 31, 2010			
	Amortized Cost  (in thousands)	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and cash equivalents	\$47,207	\$1	\$—	\$47,208
Securities maturing within one year:				
Certificates of deposit	545	—	—	545

Edgar Filing: LEXICON PHARMACEUTICALS, INC./DE - Form 10-Q

U.S. treasury securities	163,354	10	(6	)	163,358
Total short-term investments	\$163,899	\$10	\$(6	)	\$163,903
Total cash and cash equivalents and investments	\$211,106	\$11	\$(6	)	\$211,111

There were no realized gains or losses for the three and six months ended June 30, 2011 and 2010. The cost of securities sold is based on the specific identification method.

Table of Contents

## 6. Fair Value Measurements

The Company uses various inputs in determining the fair value of its investments and measures these assets on a recurring basis. Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized by the level of objectivity associated with the inputs used to measure their fair value. The following levels are directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities:

Level 1 - quoted prices in active markets for identical investments

Level 2 - other significant observable inputs (including quoted prices for similar investments, market corroborated inputs, etc.)

Level 3 - significant unobservable inputs (including the Company's own assumptions in determining the fair value of investments)

The inputs or methodology used for valuing securities are not necessarily an indication of the credit risk associated with investing in those securities. The following table provides the fair value measurements of applicable Company assets and liabilities that are measured at fair value on a recurring basis according to the fair value levels described above as of June 30, 2011 and December 31, 2010.

	Assets and Liabilities at Fair Value as of June 30, 2011			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Assets				
Cash and cash equivalents	\$20,328	\$—	\$—	\$20,328
Short-term investments	144,486	—	—	144,486
Total cash and cash equivalents and investments	\$164,814	\$—	\$—	\$164,814
Liabilities				
Other long-term liabilities	\$—	\$—	\$51,129	\$51,129
Total liabilities	\$—	\$—	\$51,129	\$51,129
	Assets and Liabilities at Fair Value as of December 31, 2010			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Assets				
Cash and cash equivalents	\$47,208	\$—	\$—	\$47,208
Short-term investments	163,903	—	—	163,903
Total cash and cash equivalents and investments	\$211,111	\$—	\$—	\$211,111
Liabilities				
Other long-term liabilities	\$—	\$—	\$48,267	\$48,267
Total liabilities	\$—	\$—	\$48,267	\$48,267

The Company did not have any Level 3 financial assets during the six months ended June 30, 2011. In 2010, Lexicon held auction rate securities and related rights that permitted Lexicon to require the investment bank that sold Lexicon the auction rate securities to purchase its auction rate securities at par value. On June 30, 2010, Lexicon exercised the rights and the investment bank purchased Lexicon's remaining auction rate securities at par value on July 1, 2010. The table presented below summarizes the change in consolidated balance sheet carrying value associated with these Level 3 financial assets for the six months ended June 30, 2010.





Table of Contents

	Short-term Investments (in thousands)
Balance at December 31, 2009	\$56,034
Unrealized gains included in earnings as gain on investments, net	141
Net sales and settlements	(32,600 )
Balance at June 30, 2010	\$23,575

The Company's Level 3 liabilities are estimated using a probability-based income approach utilizing an appropriate discount rate. Subsequent changes in the fair value of the Symphony Icon purchase consideration liability are recorded as an increase or decrease in Symphony Icon purchase liability expense in the accompanying consolidated statements of operations. The following table summarizes the change in consolidated balance sheet carrying value associated with Level 3 liabilities for the six months ended June 30, 2011.

	Other Long-term Liabilities (in thousands)
Balance at December 31, 2010	\$48,267
Change in valuation of purchase consideration payable to former Symphony Icon stockholders	2,862
Balance at June 30, 2011	\$51,129

The Company also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include goodwill associated with the acquisitions of Coelacanth Corporation in 2001 and Symphony Icon on July 30, 2010 and intangible assets associated with the acquisition of Symphony Icon on July 30, 2010. For these assets, measurement at fair value in periods subsequent to their initial recognition is applicable if one or more is determined to be impaired.

During the six months ended June 30, 2011, the Company determined that one of its buildings was impaired and therefore recorded an impairment loss of \$800,000 in addition to an impairment loss of \$900,000 recorded in the year ended December 31, 2010, which was recorded as research and development expense in the accompanying consolidated statement of operations. The fair value of the impaired building was estimated using offers received from potential purchasers of the building. In June 2011, the Company sold this building with an immaterial additional loss on the sale.

## 7. Debt Obligations

**Mortgage Loan.** In April 2004, Lexicon obtained a \$34.0 million mortgage on its facilities in The Woodlands, Texas. The mortgage loan has a ten-year term with a 20-year amortization and bears interest at a fixed rate of 8.23%. The mortgage had a principal balance outstanding of \$25.6 million as of June 30, 2011. Net proceeds from the sale of the building as discussed in Note 6, "Fair Value Measurements," were used to pay down the mortgage principal in June 2011 in the amount of \$2.4 million. The fair value of Lexicon's mortgage loan approximates its carrying value. The fair value of Lexicon's mortgage loan is estimated using discounted cash flow analysis, based on the Company's current incremental borrowing rate.

## 8. Arrangements with Symphony Icon, Inc.

On June 15, 2007, Lexicon entered into a series of related agreements providing for the financing of the clinical development of certain of its drug candidates, including LX1031, LX1032 and LX1033, along with any other pharmaceutical compositions modulating the same targets as those drug candidates (the "Programs"). The agreements included a Novated and Restated Technology License Agreement pursuant to which the Company licensed to Symphony Icon, a then wholly-owned subsidiary of Symphony Icon Holdings LLC ("Holdings"), the Company's intellectual property rights related to the Programs. Holdings contributed \$45 million to Symphony Icon in order to

fund the clinical development of the Programs.

Under a Share Purchase Agreement, dated June 15, 2007, between the Company and Holdings, the Company issued and sold to Holdings 7,650,622 shares of its common stock on June 15, 2007 in exchange for \$15 million and the Purchase Option (as defined below).

Under a Purchase Option Agreement, dated June 15, 2007, among the Company, Symphony Icon and Holdings, the Company received from Holdings an exclusive purchase option (the "Purchase Option") that gave the Company the right to acquire all of the equity of Symphony Icon, thereby allowing the Company to reacquire all of the Programs. Lexicon originally calculated

Table of Contents

the value of the Purchase Option as the difference between the fair value of the common stock issued to Holdings of \$23.6 million (calculated at the time of issuance) and the \$15.0 million in cash received from Holdings for the issuance of the common stock. Lexicon recorded the value of the Purchase Option as an asset, and was amortizing this asset over the four-year option period. Upon the adoption of a new accounting pronouncement regarding variable interest entities (formerly SFAS No. 167) on January 1, 2010, \$2.3 million of structuring and legal fees originally allocated to noncontrolling interest was allocated to the value of the Purchase Option. This resulted in a cumulative-effect adjustment to retained earnings of \$1.5 million, representing the additional amortization expense that would have been recorded through December 31, 2009. Upon the exercise of the Purchase Option on July 30, 2010 as discussed below, the remaining balance was amortized immediately. The amortization expense of \$1,357,000 is recorded in other expense, net in the accompanying consolidated statement of operations for the six months ended June 30, 2010.

On July 30, 2010, Lexicon entered into an Amended and Restated Purchase Option Agreement with Symphony Icon and Holdings and simultaneously exercised the Purchase Option, thereby reacquiring the Programs. Pursuant to the amended terms of the Purchase Option, Lexicon paid Holdings \$10 million and agreed to make up to \$80 million in additional base and contingent payments.

The base payments will be in an amount equal to \$50 million less 50% of the expenses Lexicon incurs after its exercise of the Purchase Option for the development of LX1031, LX1032, LX1033 and other pharmaceutical compositions modulating the same target as those drug candidates (the "LG103 Programs"), subject to certain exceptions and up to an aggregate reduction of \$15 million. The base payments are payable in Lexicon's discretion at any time before July 30, 2013.

The contingent payments will consist of 50% of any consideration Lexicon receives pursuant to any licensing transaction under which Lexicon grants a third party rights to commercialize a drug candidate from the LG103 Programs (a "Licensing Transaction"), subject to certain exceptions and up to a maximum of \$30 million plus the amount of any reduction in the base payments for Lexicon's development expenses for the LG103 Programs (the "Recapture Eligible Amount"). The contingent payments will be due if and when Lexicon receives such consideration from a Licensing Transaction. In the event Lexicon receives regulatory approval in the United States for the marketing and sale of any product resulting from the LG103 Programs prior to entering into a Licensing Transaction for the commercialization of such product in the United States, in lieu of any contingent payment from such a Licensing Transaction, Lexicon will pay Holdings the sum of \$15 million and any Recapture Eligible Amount attributable to the development of such product, reduced by up to 50% of such sum for the amount of any contingent payments paid prior to such United States regulatory approval attributable to any such Licensing Transaction outside of the United States with respect to such product. In the event Lexicon makes any such payment upon United States regulatory approval, Lexicon will have no obligation to make subsequent contingent payments attributable to any such Licensing Transactions for the commercialization of such product outside the United States until the proceeds of such Licensing Transactions exceed 50% of the payment made as a result of such United States regulatory approval.

The base payments and the contingent payments may be paid in cash, common stock, or a combination of cash and common stock, in Lexicon's discretion, provided that at least 50% of any payment made on or prior to July 30, 2012 will be paid in common stock and no more than 50% of any payment made after such date will be paid in common stock.

Lexicon accounted for the exercise of the Purchase Option and acquisition of Symphony Icon as a business combination. In connection with its acquisition of Symphony Icon, Lexicon paid \$10.0 million in cash, and has also agreed to pay Holdings additional base and contingent payments as discussed above. The fair value of the base and contingent consideration payments was \$45.6 million at the date of acquisition and was estimated by applying a probability-based income approach utilizing an appropriate discount rate. This estimation was based on significant

inputs that are not observable in the market, referred to as Level 3 inputs. Key assumptions include: (1) a discount rate of 14% for the base payments; (2) a discount rate of 18% for the contingent payments; and (3) a probability adjusted contingency. Subsequent changes in the fair value of the Symphony Icon purchase consideration liability are recorded as an increase or decrease in fair value of Symphony Icon purchase liability expense in the accompanying consolidated statements of operations. During the six months ended June 30, 2011, the fair value of the Symphony Icon purchase consideration liability increased by \$2.9 million.

#### 9. Commitments and Contingencies

**Operating Lease Obligations:** A Lexicon subsidiary leases laboratory and office space in Hopewell, New Jersey under an agreement which expires in June 2013. The lease provides for two five-year renewal options at 95% of the fair market rent and includes escalating lease payments. Rent expense is recognized on a straight-line basis over the original lease term. Lexicon is the guarantor of the obligations of its subsidiary under this lease. The maximum potential amount of future payments the Company could be required to make under this agreement is \$5.2 million without taking into account the exercise of the renewal options. The Company is required to maintain restricted investments to collateralize a standby letter of credit for this lease. The Company had \$0.4 million in restricted investments as collateral as of June 30, 2011 and December 31, 2010. Additionally, Lexicon leases certain equipment under operating leases.

Table of Contents

Legal Proceedings. Lexicon is from time to time party to claims and legal proceedings that arise in the normal course of its business and that it believes will not have, individually or in the aggregate, a material adverse effect on its results of operations, financial condition or liquidity.

10. Other Capital Stock Agreements

Common Stock: In March 2010, Lexicon completed the public offering and sale and concurrent private placement of an aggregate of 161,770,206 shares of its common stock at a price of \$1.15 per share, resulting in net proceeds of \$181.5 million, after deducting underwriting discounts and commissions of \$4.3 million and offering expenses of \$0.3 million. Invus, L.P. and its affiliate Invus C.V., Lexicon's largest stockholders, purchased 94,270,206 of these shares. All of the net proceeds of this offering are reflected as issuance of common stock in the accompanying financial statements.

11. Collaboration and License Agreements

Lexicon has derived substantially all of its revenues from drug discovery and development collaborations, target validation collaborations for the development and, in some cases, analysis of the physiological effects of genes altered in knockout mice, government grants and contracts, technology licenses, subscriptions to its databases and compound library sales. Revenues generated from third parties under collaborative arrangements are recorded on a gross basis on the consolidated statements of operations as Lexicon is the principal participant for these transactions for the purpose of accounting for these arrangements.

Lexicon established an alliance with Organon in May 2005 to jointly discover, develop and commercialize novel biotherapeutic drugs. There was no revenue recognized under this agreement for the three months ended June 30, 2011 and 2010, respectively. Revenue recognized under this agreement was none and \$0.2 million for the six months ended June 30, 2011 and 2010, respectively.

Lexicon established an alliance with Taconic Farms in November 2005 for the marketing, distribution and licensing of certain lines of knockout mice and entered into extended collaborations with Taconic in July 2009 and May 2011. Revenue recognized under these agreements was \$0.2 million and \$0.8 million for the three months ended June 30, 2011 and 2010, respectively, and \$0.4 million and \$1.5 million for the six months ended June 30, 2011 and 2010, respectively.

Table of Contents

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

Overview

We are a biopharmaceutical company focused on the discovery and development of breakthrough treatments for human disease. We have used gene knockout technologies and an integrated platform of advanced medical technologies to identify and validate, in vivo, more than 100 targets with promising profiles for drug discovery. For targets that we believe have high pharmaceutical value, we engage in programs for the discovery and development of potential new drugs. We have four drug programs for which we have completed or are presently conducting Phase 2 clinical trials. We have advanced three other drug candidates into preclinical development and have small molecule compounds from a number of additional drug discovery programs in various stages of preclinical research.

We are working both independently and through strategic collaborations and alliances to capitalize on our technology, drug target discoveries and drug discovery and development programs. Consistent with this approach, we seek to retain exclusive rights to the benefits of certain of our small molecule drug programs by developing drug candidates from such programs internally and to collaborate with third parties with respect to the discovery, development and commercialization of small molecule and biotherapeutic drug candidates for other targets, particularly when the collaboration provides us with access to expertise and resources that we do not possess internally or are complementary to our own. We have established drug discovery and development collaborations with a number of leading pharmaceutical and biotechnology companies which generated near-term cash while offering us the potential to retain economic participation in products our collaborators develop through the collaboration. In addition, we have established collaborations and license agreements with other leading pharmaceutical and biotechnology companies, research institutes and academic institutions under which we received fees and, in some cases, are eligible to receive milestone and royalty payments, in return for granting access to some of our technologies and discoveries.

We derive substantially all of our revenues from drug discovery and development collaborations and other collaborations and technology licenses. To date, we have generated a substantial portion of our revenues from a limited number of sources.

Our operating results and, in particular, our ability to generate additional revenues are dependent on many factors, including our success in establishing new collaborations and technology licenses, the success rate of our discovery and development efforts leading to opportunities for new collaborations and licenses, as well as milestone payments and royalties, the timing and willingness of collaborators to commercialize products that would result in milestone payments and royalties and their success in such efforts, and general and industry-specific economic conditions which may affect research and development expenditures. Future revenues from our existing collaborations and technology licenses are uncertain because they depend, to a large degree, on the achievement of milestones and payment of royalties we earn from any future products developed under the collaboration. As a result, we depend, in part, on securing new collaborations and license agreements. Our ability to secure future revenue-generating agreements will depend upon our ability to address the needs of our potential future collaborators and licensees, and to negotiate agreements that we believe are in our long-term best interests. We may determine, as we have with our four most advanced clinical drug candidates, that our interests are better served by retaining rights to our discoveries and advancing our therapeutic programs to a later stage, which could limit our near-term revenues. Because of these and other factors, our operating results have fluctuated in the past and are likely to do so in the future, and we do not believe that period-to-period comparisons of our operating results are a good indication of our future performance.

Since our inception, we have incurred significant losses and, as of June 30, 2011, we had an accumulated deficit of \$729.7 million. Our losses have resulted principally from costs incurred in research and development, general and administrative costs associated with our operations, and non-cash stock-based compensation expenses associated with stock options and restricted stock granted to employees and consultants. Research and development expenses consist

primarily of salaries and related personnel costs, external research costs related to our preclinical and clinical efforts, material costs, facility costs, depreciation on property and equipment and other expenses related to our drug discovery and development programs. General and administrative expenses consist primarily of salaries and related expenses for executive and administrative personnel, professional fees and other corporate expenses including information technology, facilities costs and general legal activities. In connection with the continued expansion of our drug discovery and development programs, we expect to continue to incur significant research and development costs. As a result, we will need to generate significantly higher revenues to achieve profitability.

#### Critical Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make judgments, estimates and assumptions in the preparation of our consolidated financial statements and accompanying notes. Actual results could differ from those estimates. We believe there have been no significant changes in our critical accounting policies as discussed in our Annual Report on Form 10-K for the year ended December 31, 2010.



Table of Contents

## Recent Accounting Pronouncements

See Note 4, Recent Accounting Pronouncements, of the Notes to Consolidated Financial Statements, for a discussion of the impact of the new accounting standards on our consolidated financial statements.

## Results of Operations

## Revenues

Total revenues and dollar and percentage changes as compared to the corresponding periods in the prior year are as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Total revenues	\$0.6	\$1.2	\$1.2	\$2.9
Dollar decrease	\$(0.7	)	\$(1.7	)
Percentage decrease	(55	)%	(60	)%

Collaborative research – Revenue from collaborative research for the three months ended June 30, 2011 decreased 60% to \$0.5 million, and for the six months ended June 30, 2011 decreased 65% to \$1.0 million, as compared to the corresponding periods in 2010, primarily due to reduced revenues under our alliance with Taconic Farms.

Subscription and license fees – Revenue from subscriptions and license fees for the three months ended June 30, 2011 increased 36% to \$0.1 million, and for the six months ended June 30, 2011 increased 152% to \$0.2 million, as compared to the corresponding periods in 2010, primarily due to an increase in technology license fees.

## Research and Development Expenses

Research and development expenses and dollar and percentage changes as compared to the corresponding periods in the prior year are as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Total research and development expense	\$20.1	\$20.2	\$44.1	\$41.3
Dollar increase (decrease)	\$(0.1	)	\$2.7	
Percentage increase (decrease)	0	%	7	%

Research and development expenses consist primarily of salaries and other personnel-related expenses, third-party and other services, facility and equipment costs, laboratory supplies, and stock-based compensation expenses.

Personnel – Personnel costs for the three months ended June 30, 2011 decreased 5% to \$7.6 million, and for the six months ended June 30, 2011 increased 3% to \$16.6 million, as compared to the corresponding periods in 2010, primarily due to a reduction in our personnel in February 2011 and associated severance costs. Salaries, bonuses, employee benefits, payroll taxes, recruiting and relocation costs are included in personnel costs.

Third-party and other services – Third-party and other services for the three months ended June 30, 2011 increased 7% to \$5.9 million, and for the six months ended June 30, 2011 increased 17% to \$13.5 million, as compared to the corresponding periods in 2010, primarily due to an increase in external preclinical research and development costs.

Facilities and equipment – Facilities and equipment costs for the three months ended June 30, 2011 were \$3.4 million, consistent with the corresponding period in 2010. Facilities and equipment costs for the six months ended June 30,

2011 increased 7% to \$7.5 million, as compared to the corresponding period in 2010, primarily due to an impairment of buildings due to excess capacity.

Laboratory supplies – Laboratory supplies expense for the three months ended June 30, 2011 decreased 12% to \$1.4 million, and for the six months ended June 30, 2011 decreased 14% to \$2.6 million, as compared to the corresponding periods in 2010, primarily due to reductions in early-stage research activities.

Table of Contents

Stock-based compensation – Stock-based compensation expense for the three months ended June 30, 2011 was \$0.8 million, consistent with the corresponding period in 2010. Stock-based compensation expense for the six months ended June 30, 2011 increased 3% to \$1.7 million, as compared to the corresponding period in 2010.

Other – Other costs for the three months ended June 30, 2011 increased 11% to \$1.1 million, and for the six months ended June 30, 2011 increased 9% to \$2.2 million, as compared to the corresponding periods in 2010.

#### Increase in Fair Value of Symphony Icon Liability

The increase in fair value of the Symphony Icon purchase liability was \$2.9 million for the six months ended June 30, 2011 (see Note 8, Arrangements with Symphony Icon, Inc., of the Notes to Consolidated Financial Statements, for more information).

#### General and Administrative Expenses

General and administrative expenses and dollar and percentage changes as compared to the corresponding periods in the prior year are as follows (dollar amounts are presented in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Total general and administrative expense	\$4.5	\$5.1	\$9.3	\$10.6
Dollar decrease	\$(0.5	)	\$(1.3	)
Percentage decrease	(11	)%	(12	)%

General and administrative expenses consist primarily of salaries and other personnel-related expenses, professional fees such as legal fees, facility and equipment costs, and stock-based compensation expenses.

Personnel – Personnel costs for the three months ended June 30, 2011 decreased 7% to \$2.1 million, and for the six months ended June 30, 2011 decreased 8% to \$4.6 million, as compared to the corresponding periods in 2010, primarily due to a reduction in our personnel in February 2011. Salaries, bonuses, employee benefits, payroll taxes, recruiting and relocation costs are included in personnel costs.

Professional fees – Professional fees for the three months ended June 30, 2011 decreased 27% to \$0.8 million, and for the six months ended June 30, 2011 decreased 37% to \$1.5 million, as compared to the corresponding periods in 2010, primarily due to decreased patent-related, other legal and consulting costs.