INCYTE CORP
Form 10-Q
November 01, 2007

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 September 30, 2007

or

o **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 CORPORATION

(Exact name of registrant as specified in its charter)

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

Experimental Station, Route 141 & Henry Clay Road,
Building E336, Wilmington, DE 19880

(Address of principal executive offices)
(302) 498-6700
(Registrant s telephone number, including area code)

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

x Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. Check one:

Large Accelerated Filer o Accelerated Filer x Non-accelerated Filer o

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

o Yes x No

The number of outstanding shares of the registrant s Common Stock, $0.001 par value, was 84,248,252 as of October 25, 2007.

INCYTE CORPORATION

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

INCYTE CORPORATION

Condensed Consolidated Balance Sheets

(in thousands, except share amounts)

		September 30, 2007 (unaudited)		December 31, 2006*
ASSETS				
Current assets:				
Cash and cash equivalents	$	95,629	$	18,861
Marketable securities available-for-sale		169,315		299,712
Accounts receivable, net		1,276		2,073
Prepaid expenses and other current assets		4,634		7,115
Total current assets		270,854		327,761
Marketable securities available-for-sale		917		11,237
Property and equipment, net		3,874		5,890
Intangible and other assets, net		7,038		8,715
Total assets	$	282,683	$	353,603
LIABILITIES AND STOCKHOLDERS DEFICIT				
Current liabilities:				
Accounts payable	$	6,421	$	5,916
Accrued compensation		7,027		6,879
Interest payable		1,758		4,668
Accrued and other current liabilities		7,199		4,024
Deferred revenue		5,995		22,883
Accrued restructuring and acquisition costs		4,814		4,970
Total current liabilities		33,214		49,340
Convertible senior notes		120,076		113,981
Convertible subordinated notes		257,427		257,122
Deferred revenue				348
Other liabilities		13,439		17,720
Total liabilities		424,156		438,511
Stockholders deficit:				
Preferred stock				
Common stock, $0.001 par value; 200,000,000 shares authorized; 84,228,330 and 83,972,726 shares issued and outstanding as of September 30, 2007 and December 31, 2006, respectively		84		84
Additional paid-in capital		837,392		828,936
Accumulated other comprehensive loss		(356)		(415)
Accumulated deficit		(978,593)		(913,513)

Total stockholders deficit		(141,473)		(84,908)
Total liabilities and stockholders deficit	$	282,683	$	353,603

* The condensed consolidated balance sheet at December 31, 2006 has been derived from the audited financial statements at that date.

See accompanying notes.

INCYTE CORPORATION

Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Revenues:				
Contract revenues	$ 5,909	$ 6,249	$ 20,916	$ 18,069
License and royalty revenues	781	1,019	3,772	2,518
Total revenues	6,690	7,268	24,688	20,587
Costs and expenses:				
Research and development	25,044	19,558	72,251	64,037
Selling, general and administrative	3,587	3,454	10,814	10,750
Other expenses	(566)	13	(532)	3,105
Total costs and expenses	28,065	23,025	82,533	77,892
Loss from operations	(21,375)	(15,757)	(57,845)	(57,305)
Interest and other income, net (1)	2,883	3,996	10,663	15,470
Interest expense	(6,002)	(4,077)	(17,898)	(11,828)
Net loss	$ (24,494)	$ (15,838)	$ (65,080)	$ (53,663)
Basic and diluted net loss per share:	$ (0.29)	$ (0.19)	$ (0.77)	$ (0.64)
Shares used in computing basic and diluted net loss per share	84,213	83,852	84,111	83,755

(1) Includes an impairment charge of $1.3 million and a gain on sale of securities of $5.5 million for the nine months ended September 30, 2006. The aforementioned transactions were all considered related party transactions under SFAS 57.

See accompanying notes.

INCYTE CORPORATION

Condensed Consolidated Statements of Comprehensive Loss

(in thousands)

(unaudited)

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Net loss	$ (24,494)	$ (15,838)	$ (65,080)	$ (53,663)
Other comprehensive gain (loss):				
Unrealized gain (loss) on marketable securities	(49)	2,330	59	(707)
Comprehensive loss	$ (24,543)	$ (13,508)	$ (65,021)	$ (54,370)

See accompanying notes.

INCYTE CORPORATION

Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	Nine Months Ended September 30, 2007	2006
Cash flows from operating activities:		
Net loss	$ (65,080)	$ (53,663)
Adjustments to reconcile net loss to net cash used in operating activities:		
Non-cash restructuring charges	(532)	(299)
Depreciation and amortization	9,713	4,140
Compensation expense on executive loans		18
Stock-based compensation	7,442	6,640
Realized gain on long-term investment		(5,459)
Impairment of long-term investments		1,312
Changes in operating assets and liabilities:		
Accounts receivable	797	33
Prepaid expenses and other assets	2,732	3,367
Accounts payable	505	131
Accrued and other current liabilities	(3,491)	(9,441)
Deferred revenue	(17,236)	25,036
Net cash used in operating activities	(65,150)	(28,185)
Cash flows from investing activities:		
Capital expenditures	(461)	(569)
Purchases of marketable securities	(44,107)	(498,213)
Sales and maturities of marketable securities	185,473	508,510
Net cash provided by investing activities	140,905	9,728
Cash flows from financing activities:		
Proceeds from issuance of common stock under stock plans	1,013	977
Proceeds from issuance of convertible senior notes and convertible subordinated notes		121,907
Net cash provided by financing activities	1,013	122,884
Net increase in cash and cash equivalents	76,768	104,427
Cash and cash equivalents at beginning of period	18,861	11,494
Cash and cash equivalents at end of period	$ 95,629	$ 115,921

See accompanying notes.

INCYTE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2007

(Unaudited)

1. Organization and business

Incyte Corporation (Incyte, we, us, or our) is a drug discovery and development company focused on developing proprietary small molecule drugs to treat serious unmet medical needs. We have a pipeline with programs in human immunodeficiency virus (HIV), diabetes, oncology and inflammation.

2. Summary of significant accounting policies

Basis of presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The condensed consolidated balance sheet as of September 30, 2007, condensed consolidated statements of operations, comprehensive loss, and cash flows for the three and nine months ended September 30, 2007 and 2006, are unaudited, but include all adjustments, consisting only of normal recurring adjustments, which we consider necessary for a fair presentation of the financial position, operating results and cash flows for the periods presented. The condensed consolidated balance sheet at December 31, 2006 has been derived from audited financial statements.

Although we believe 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 accounting principles generally accepted in the United States 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 our Annual Report on Form 10-K for the year ended December 31, 2006.

Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We adopted FIN 48 on January 1, 2007. The adoption of FIN 48 did not have a material impact on our condensed consolidated financial statements.

3. Marketable securities

Marketable securities consist of investments in investment-grade corporate bonds, U.S. government agency debt securities and mortgage and asset-backed securities that are classified as available-for-sale. We classify marketable securities available to fund current operations as current assets on the condensed consolidated balance sheet. Marketable securities are classified as long-term assets on the consolidated balance sheet if (i) they have been in an unrealized loss position for longer than six months and (ii) we have the ability to hold them until the carrying value is recovered and such holding period may be longer than one year. As of September 30, 2007, approximately $0.9 million of marketable securities were classified as long-term assets on the consolidated balance sheet as they have been in an unrealized loss position for longer than six months and we have the ability to hold them until the carrying value recovers, which may be longer than one year.

4. Revenues

For the three and nine months ended September 30, 2007, one customer contributed 88% and 85% of revenues, respectively. For the three and nine months ended September 30, 2006, one customer contributed 86% and 88% of revenues, respectively.

Three customers comprised 72% of the accounts receivable balance at September 30, 2007. Three customers comprised 78% of the accounts receivable balance at December 31, 2006.

5. Collaborative research and license agreement

Effective in January 2006, we entered a collaborative research and license agreement with Pfizer Inc. (Pfizer) for the pursuit of our CCR2 antagonist program. Pfizer gained worldwide development and commercialization rights to our portfolio of CCR2 antagonist compounds. Pfizer s rights extend to the full scope of potential indications, with the exception of multiple sclerosis and autoimmune nephritides, where we retained worldwide rights, along with certain compounds. We do not have obligations to Pfizer on pre-clinical development candidates we select for pursuit in these indications.

Contract revenues related to the upfront consideration received of approximately $5.2 million and $15.5 million were recognized for the three and nine months ended September 30, 2007, respectively, while contract revenues related thereto of approximately $5.2 million and $15.2 million were recognized for the three and nine months ended September 30, 2006, respectively. In addition, we received a $3.0 million milestone payment from Pfizer in the three months ended June 30, 2007 that is also included in contract revenues. All milestone payments are recognized upon the achievement of the associated milestone.

We also recognized contract revenues of approximately $0.3 million and $1.1 million for the three and nine months ended September 30, 2007, respectively, and $0.7 million and $1.8 million for the three and nine months ended September 30, 2006, respectively, in connection with research services provided to Pfizer. We recognize contract revenues in connection with research services provided to Pfizer as earned. Also, in connection with the $10.0 million convertible subordinated note Pfizer purchased from us in February 2006 (the Pfizer Note), the difference between the cash received and the present value of the Pfizer Note, which equals the face value less the non interest bearing portion and beneficial conversion feature, represents additional consideration from Pfizer under the agreement. We have accounted for this additional consideration as deferred revenue and will recognize it over two years, our estimated performance period under the agreement. Contract revenues related thereto of approximately $0.4 million and $1.3 million were recognized for the three and nine months ended September 30, 2007, respectively, and $0.4 million and $1.1 million for the three and nine months ended September 30, 2006, respectively.

At September 30, 2007, approximately $0.4 million was receivable from Pfizer for reimbursement of expenses incurred by us pursuant to the agreement.

6. Stock compensation

Under the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS 123R), we recorded $2.6 million and $7.4 million of stock compensation expense on our unaudited condensed consolidated statement of operations for the three and nine months ended September 30, 2007, respectively. We recorded $2.1 million and $6.6 million of stock compensation expense on our unaudited condensed consolidated statement of operations for the three and nine months ended September 30, 2006, respectively. We utilized the Black-Scholes valuation model for estimating the fair value of the stock compensation granted, with the following weighted-average assumptions:

Employee Stock Options				Employee Stock Purchase Plan			
For the Three Months Ended		For the Nine Months Ended		For the Three Months Ended		For the Nine Months Ended	
September 30,				September 30,			
2007	2006	2007	2006	2007	2006	2007	2006

Average risk-free interest rates	4.24%	5.03%	4.84%	4.42%	4.32%	4.80%	4.32%	4.80%
Average expected life (in years)	2.93	3.15	2.91	3.17	0.50	0.50	0.50	0.50
Volatility	64%	76%	65%	76%	52%	72%	52%	72%
Weighted-average fair value (in dollars)	2.67	2.32	3.21	2.79	1.21	1.38	1.21	1.38

The risk-free interest rate is derived from the U.S. Federal Reserve rate in effect at the time of grant. The expected life calculation is based on the observed and expected time to the exercise of options by our employees based on historical exercise patterns for similar type options. Expected volatility is based on the historical volatility of our common stock over the period commensurate with the expected life of the options. A dividend yield of zero is assumed based on the fact that we have never paid cash dividends and have no present intention to pay cash dividends. Options granted in 2007 have a seven-year term and vest over a three-year period with a one-year cliff (i.e., vesting occurs as to one-third (1/3) at the end of the first year and in equal monthly installments on a monthly basis for the remaining two years). This is a change from the Company s prior option grants of options with a ten-year term that vest over a four-year period with a one-year cliff.

Based on our historical experience, we have assumed an annualized forfeiture rate of 5% for our options. Under the true-up provisions of SFAS 123R, we will record additional expense if the actual forfeiture rate is lower than we estimated, and will record a recovery of prior expense if the actual forfeiture is higher than we estimated.

The amortization of stock compensation under SFAS 123R for the period after its adoption was calculated in accordance with FASB

Interpretation (FIN) No. 28. Total compensation cost of options granted but not yet vested, as of September 30, 2007, was $8.2 million, which is expected to be recognized over the weighted average period of 3.13 years.

The following table summarizes activity under all stock option plans:

	Shares Available for Grant	Number Outstanding		Weighted Average Exercise Price per Share
Balance at December 31, 2006	3,790,481	10,094,147	$	7.94
Options authorized	3,000,000			
Options granted	(2,837,975)	2,837,975		7.05
Options exercised		(64,505)		5.07
Options cancelled	237,750	(237,750)		6.44
Balance at September 30, 2007	4,190,256	12,629,867	$	7.79
Exercisable, September 30, 2007		7,410,883	$	8.49

7. Net loss per share

For all periods presented, both basic and diluted net loss per common share are computed by dividing the net loss by the number of weighted average common shares outstanding during the period. Stock options and potential common shares issuable upon conversion of our 3½% convertible senior notes due 2011 (the 3½% Senior Notes), 3½% convertible subordinated notes due 2011 (the 3½% Subordinated Notes), Pfizer Note and 5.5% convertible subordinated notes due 2007 (the 5.5% Convertible Notes) were excluded from the computation of diluted net loss per share, as their share effect was anti-dilutive for all periods presented. The potential common shares that were excluded from the diluted net loss per share computation are as follows:

	September 30, 2007	September 30, 2006
Outstanding stock options	12,629,867	10,160,178
Common shares issuable upon conversion of 3½% Senior Notes	13,531,224	13,531,224
Common shares issuable upon conversion of 3½% Subordinated Notes	22,284,625	22,284,625
Common shares issuable upon conversion of Pfizer Note	1,461,496	1,461,496
Common shares issuable upon conversion of 5.5% Convertible Notes(1)		1,358,865
Total potential common shares excluded from diluted net loss per share computation	49,907,212	48,796,388

(1) All of the outstanding 5.5% Convertible Notes were redeemed on October 16, 2006.

8. Segment reporting

Our operations are treated as one operating segment, drug discovery and development, in accordance with FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131).

9. Other expenses

Below is a summary of the activity related to other expenses recorded for the periods in which activity related to our restructuring programs has taken place through the nine months ended September 30, 2007. The estimates below have been made based upon management s best estimate of the amounts and timing of certain events included in the restructuring plan that will occur in the future. It is possible that the actual outcome of certain events may differ from the estimates. Adjustments will be made to the restructuring accrual at the point that the changes become determinable.

2004 Restructuring

	Original Charge	Accrual Balance at December 31, 2006	2007 Charges to Operations (in thousands)	2007 Charges Utilized	Accrual Balance at September 30, 2007
Lease commitment and related costs	$ 20,207	$ 11,472	$ 458	$ 2,143	$ 9,787
Other costs			97	97	
Restructuring expenses	$ 20,207	$ 11,472	$ 555	$ 2,240	$ 9,787

2002 Restructuring

	Original Charge	Accrual Balance at December 31, 2006	2007 Charges to Operations (in thousands)	2007 Charges Utilized	Accrual Balance at September 30, 2007
Lease commitment and related costs	$ 17,924	$ 10,000	$ (246)	$ 1,667	$ 8,087

Maxia Acquisition Costs

Original Charge	Accrual Balance at December 31, 2006	2007 Charges to