

HALOZYME THERAPEUTICS INC

Form 10-Q

November 08, 2012

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**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 September 30, 2012

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 001-32335

**HALOZYME THERAPEUTICS, INC.**

(Exact name of registrant as specified in its charter)

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<b>Delaware</b> (State or other jurisdiction of incorporation or organization)	<b>88-0488686</b> (I.R.S. Employer Identification No.)
<b>11388 Sorrento Valley Road, San Diego, CA</b> (Address of principal executive offices)	<b>92121</b> (Zip Code)
<b>(858) 794-8889</b> (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. (Check one):

Large accelerated filer ☐ Accelerated filer ☒

Non-accelerated filer ☐ (Do not check if a smaller reporting company) Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

The number of outstanding shares of the registrant's common stock, par value \$0.001 per share, was 112,705,092 as of October 31, 2012.

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****HALOZYME THERAPEUTICS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2012 (Unaudited)</b>	<b>December 31, 2011 (Note)</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 87,614,891	\$ 52,825,527
Accounts receivable, net	4,464,273	2,262,465
Inventories	2,186,063	567,263
Prepaid expenses and other assets	11,353,342	8,332,242
Total current assets	105,618,569	63,987,497
Property and equipment, net	2,363,650	1,771,048
Total Assets	\$ 107,982,219	\$ 65,758,545
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 3,526,839	\$ 7,556,859
Accrued expenses	8,041,673	5,615,574
Deferred revenue, current portion	9,470,247	4,129,407
Total current liabilities	21,038,759	17,301,840
Deferred revenue, net of current portion	34,883,135	36,754,583
Deferred rent, net of current portion	870,548	802,006
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock - \$0.001 par value; 20,000,000 shares authorized; no shares issued and outstanding		
Common stock - \$0.001 par value; 150,000,000 shares authorized; 112,692,527 and 103,989,272 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	112,693	103,990
Additional paid-in capital	345,244,876	255,817,772
Accumulated deficit	(294,167,792)	(245,021,646)
Total stockholders' equity	51,189,777	10,900,116
Total Liabilities and Stockholders' Equity	\$ 107,982,219	\$ 65,758,545

Note: The condensed consolidated balance sheet at December 31, 2011 has been derived from audited financial statements at that date. It does not include, however, all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements.

See accompanying notes to condensed consolidated financial statements.



**Table of Contents****HALOZYME THERAPEUTICS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****(UNAUDITED)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Revenues:				
Product sales, net	\$ 715,354	\$ 1,156,903	\$ 1,427,707	\$ 1,487,822
Revenues under collaborative agreements	4,618,969	21,785,525	19,103,970	52,187,447
Total revenues	5,334,323	22,942,428	20,531,677	53,675,269
Operating expenses:				
Cost of product sales	226,635	11,723	440,516	201,675
Research and development	19,503,491	13,514,352	51,476,329	42,647,265
Selling, general and administrative	5,634,034	4,263,520	17,833,165	12,237,152
Total operating expenses	25,364,160	17,789,595	69,750,010	55,086,092
Operating income (loss)	(20,029,837)	5,152,833	(49,218,333)	(1,410,823)
Interest and other income, net	23,991	12,360	72,187	56,586
Net income (loss)	\$ (20,005,846)	\$ 5,165,193	\$ (49,146,146)	\$ (1,354,237)
Basic and diluted net income (loss) per share	\$ (0.18)	\$ 0.05	\$ (0.44)	\$ (0.01)
Shares used in computing net income (loss) per share:				
Basic	112,305,002	103,223,352	110,658,757	102,282,904
Diluted	112,305,002	105,009,189	110,658,757	102,282,904
Comprehensive income (loss)	\$ (20,005,846)	\$ 5,165,193	\$ (49,146,146)	\$ (1,354,237)

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****HALOZYME THERAPEUTICS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>Operating activities:</b>		
Net loss	\$ (49,146,146)	\$ (1,354,237)
Adjustments to reconcile net loss to net cash used in operating activities:		
Share-based compensation	6,362,372	3,916,329
Depreciation and amortization	796,163	851,613
Gain on disposal of equipment	(6,610)	(992)
Changes in operating assets and liabilities:		
Accounts receivable, net	(2,201,808)	(3,909,636)
Inventories	(1,618,800)	89,979
Prepaid expenses and other assets	(3,021,100)	(576,918)
Accounts payable and accrued expenses	(2,106,754)	(2,183,864)
Deferred rent	62,385	89,453
Deferred revenue	3,469,392	(17,718,311)
 Net cash used in operating activities	 (47,410,906)	 (20,796,584)
<b>Investing activities:</b>		
Purchases of property and equipment	(873,165)	(271,521)
 Net cash used in investing activities	 (873,165)	 (271,521)
<b>Financing activities:</b>		
Proceeds from issuance of common stock, net	81,476,845	
Proceeds from issuance of common stock under equity incentive plans, net	1,596,590	4,141,615
 Net cash provided by financing activities	 83,073,435	 4,141,615
 Net increase (decrease) in cash and cash equivalents	 34,789,364	 (16,926,490)
Cash and cash equivalents at beginning of period	52,825,527	83,255,848
 Cash and cash equivalents at end of period	 \$ 87,614,891	 \$ 66,329,358
<b>Supplemental disclosure of non-cash investing and financing activities:</b>		
Accounts payable for purchases of property and equipment	\$ 508,990	\$ 6,954

See accompanying notes to condensed consolidated financial statements.

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**HALOZYME THERAPEUTICS, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**1. Organization and Business**

Halozyme Therapeutics, Inc. (referred to as we, us, Halozyme or the Company) is a biopharmaceutical company dedicated to developing and commercializing innovative products that advance patient care. Our research targets the extracellular matrix, an area outside the cell that provides structural support in tissues and orchestrates many important biological activities, including cell migration, signaling and survival. Over many years, we have developed unique scientific expertise that allows us to pursue this target-rich environment for the development of future therapies.

Our research focuses primarily on human enzymes that alter the extracellular matrix. Our lead enzyme, recombinant human hyaluronidase ( rHuPH20 ), temporarily degrades hyaluronan, a matrix component in the skin, and facilitates the dispersion and absorption of drugs and fluids. We are also developing novel enzymes that may target other matrix structures for therapeutic benefit. Our Enhanze™ technology is the platform for the delivery of proprietary small and large molecules. We apply our research products in collaboration with other companies as well as for our own proprietary pipeline in therapeutic areas with significant unmet medical need, such as diabetes, oncology and dermatology.

Our operations to date have involved: (i) organizing and staffing our operating subsidiary, Halozyme, Inc.; (ii) acquiring, developing and securing our technology; (iii) undertaking product development for our existing product and a limited number of product candidates; (iv) supporting the development of collaboration product candidates and (v) selling *Hylenex*® recombinant (hyaluronidase human injection). We continue to increase our focus on our proprietary product pipeline and have expanded investments in our proprietary product candidates. We currently have multiple proprietary programs in various stages of research and development. In addition, we currently have license and collaborative agreements with F. Hoffmann-La Roche, Ltd and Hoffmann-La Roche, Inc. ( Roche ), Baxter Healthcare Corporation ( Baxter ), ViroPharma Incorporated ( ViroPharma ), and Intrexon Corporation ( Intrexon ), to apply Enhanze technology to these collaborators' biological therapeutic compounds. Currently, we have received only limited revenue from the sales of *Hylenex* recombinant, in addition to other revenues from our collaborations.

**2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying interim unaudited condensed consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles ( U.S. GAAP ) and with the rules and regulations of the U.S. Securities and Exchange Commission ( SEC ) related to a quarterly report on Form 10-Q. Accordingly, they do not include all of the information and disclosures required by U.S. GAAP for a complete set of financial statements. These interim unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on March 12, 2012. The unaudited financial information for the interim periods presented herein reflects all adjustments which, in the opinion of management, are necessary for a fair presentation of the financial condition and results of operations for the periods presented, with such adjustments consisting only of normal recurring adjustments. Operating results for interim periods are not necessarily indicative of the operating results for an entire fiscal year.

The condensed consolidated financial statements include the accounts of Halozyme Therapeutics, Inc. and our wholly owned subsidiary, Halozyme, Inc. All intercompany accounts and transactions have been eliminated.

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in our consolidated financial statements and



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accompanying notes. On an ongoing basis, we evaluate our estimates and judgments, which are based on historical and anticipated results and trends and on various other assumptions that management believes to be reasonable under the circumstances. By their nature, estimates are subject to an inherent degree of uncertainty and, as such, actual results may differ from management's estimates.

### ***Adoption of Recent Accounting Pronouncements***

Effective January 1, 2012, we adopted Financial Accounting Standards Board's (FASB) Accounting Standards Update (ASU) No. 2011-05, Comprehensive Income (Topic 220): *Presentation of Comprehensive Income* and ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-5*. In these updates, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU No. 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in ASU No. 2011-05 do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The amendments in these updates are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of ASU Nos. 2011-05 and 2011-12 did not have a material impact on our consolidated financial position or results of operations. We have presented comprehensive income (loss) in our condensed consolidated statements of comprehensive income (loss).

Effective January 1, 2012, we prospectively adopted FASB's ASU No. 2011-04, *Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*. The amendments in ASU 2011-04 result in common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards (IFRS). Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. This pronouncement is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The adoption of ASU No. 2011-04 did not have a material effect on our consolidated financial position or results of operations.

### ***Inventories***

Inventories are stated at lower of cost or market. Cost is determined on a first-in, first-out basis. Inventories are reviewed periodically for potential excess, dated or obsolete status. Management evaluates the carrying value of inventories on a regular basis, taking into account such factors as historical and anticipated future sales compared to quantities on hand, the price it expects to obtain for products in their respective markets compared with historical cost and the remaining shelf life of goods on hand.

Raw materials inventories consist of raw materials used in the manufacture of our bulk drug material for *Hylenex* recombinant product. Work-in-process inventories consist of in-process *Hylenex* recombinant. Finished goods inventories consist of finished *Hylenex* recombinant product.

We expense costs relating to the purchase and production of pre-approval inventories for which the sole use is pre-approval products as research and development expense in the period incurred until such time as we believe future commercialization is probable and future economic benefit is expected to be realized. For products that have been approved by regulatory bodies such as the U.S. Food and Drug Administration (FDA), inventories used in clinical trials are expensed at the time the inventories are packaged for the clinical trials. Prior to receiving approval from the FDA or comparable regulatory agencies in foreign countries, costs related to purchases of the active pharmaceutical ingredients (API) and the manufacturing of the product candidate are recorded as research and development expense. All direct manufacturing costs incurred after approval are capitalized as inventory.

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### ***Revenue Recognition***

We generate revenues from product sales and collaborative agreements. Payments received under collaborative agreements may include nonrefundable fees at the inception of the agreements, license fees, milestone payments for specific achievements designated in the collaborative agreements, reimbursements of research and development services and/or royalties on sales of products resulting from collaborative arrangements.

We recognize revenue in accordance with the authoritative guidance on revenue recognition. Revenue is recognized when all of the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the seller's price to the buyer is fixed or determinable; and (4) collectibility is reasonably assured.

**Product Sales** *Hylanex* recombinant was approved for marketing by the FDA in December 2005. From 2005 through January 7, 2011, Baxter had the worldwide market rights for *Hylanex* recombinant under the terms of the amended and restated development and supply agreement with Baxter ( *Hylanex* Collaboration ). Baxter commercially launched *Hylanex* recombinant in October 2009. However, *Hylanex* recombinant was voluntarily recalled in May 2010 because a portion of the product manufactured by Baxter was not in compliance with the requirements of the underlying collaboration. Effective January 7, 2011, we and Baxter mutually agreed to terminate the *Hylanex* Collaboration. During the second quarter of 2011, we submitted the data that the FDA had requested to support the reintroduction of *Hylanex* recombinant to the market. The FDA approved the submitted data and granted the reintroduction of *Hylanex* recombinant.

In December 2011, we reintroduced *Hylanex* recombinant to the market, shipped initial orders to our wholesaler customers and began promoting *Hylanex* recombinant through our sales force. We sell *Hylanex* recombinant in the United States to wholesale pharmaceutical distributors, who sell the product to hospitals and other end-user customers. The wholesale distributors take title to the product, bear the risk of loss of ownership and have economic substance to the inventory. Further, we have no significant obligations for future performance to generate pull-through sales; however, we do allow the wholesale distributors to return product that is damaged or received in error. In addition, we allow for product to be returned beginning six months prior to and ending twelve months following product expiration.

Given our limited history of selling *Hylanex* recombinant and the lengthy return period, we currently cannot reliably estimate expected returns and chargebacks of *Hylanex* recombinant at the time the product is received by the wholesale distributors. Therefore, we do not recognize revenue upon delivery of *Hylanex* recombinant to the wholesale distributor until the point at which we can reliably estimate expected product returns and chargebacks from the wholesale distributors. Shipments of *Hylanex* recombinant are recorded as deferred revenue until evidence exists to confirm that pull-through sales to the hospitals or other end-user customers have occurred. We recognize revenue when the product is sold through from the distributors to the distributors' customers. In addition, the costs of manufacturing *Hylanex* recombinant associated with the deferred revenue are recorded as deferred costs, which are included in inventory, until such time as the related deferred revenue is recognized. We estimate sell-through revenue and certain gross to net sales adjustments based on analysis of third-party information including information obtained from certain distributors with respect to their inventory levels and sell-through to the distributors' customers. At the time we can reliably estimate product returns and chargebacks from the wholesale distributors, we will record a one-time increase in net product sales revenue related to the recognition of product sales revenue previously deferred.

We recognize product sales allowances as a reduction of product sales in the same period the related revenue is recognized. Product sales allowances are based on amounts owed or to be claimed on the related sales. These estimates take into consideration the terms of our agreements with wholesale distributors and hospitals and the levels of inventory within the distribution channels that may result in future discounts taken. We must make significant judgments in determining these allowances. If actual results differ from our estimates, we will be required to make an adjustment to these allowances in the future, which could have an effect on product sales revenue in the period of adjustment. Our product sales allowances include:

**Distribution Fees.** The distribution fees, based on contractually determined rates, arise from contractual agreements we have with certain wholesale distributors for distribution services they provide with respect to *Hylanex* recombinant. At the time the sale is made to the respective wholesale distributors, we record an allowance for distribution fees by reducing our accounts receivable and deferred revenue associated with such product sales.

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**Prompt Payment Discounts.** We offer cash discounts to certain wholesale distributors as an incentive to meet certain payment terms. We expect our customers will take advantage of this discount; therefore, at the time the sale is made to the respective wholesale distributors, we accrue the entire prompt payment discount, based on the gross amount of each invoice, by reducing our accounts receivable and deferred revenue associated with such product sales.

**Chargebacks.** We provide discounts to end-user members of certain group purchasing organizations ( GPO ) under collective purchasing contracts between us and the GPOs. We also provide discounts to certain hospitals who are members of the GPOs with which we do not have contracts. The end-user members purchase products from the wholesale distributors at a contracted discounted price, and the wholesale distributors then charge back to us the difference between the current retail price and the price the end users paid for the product. Given our lack of historical sales data, we recognize chargebacks in the same period the related product sales revenue is recognized and reduce our accounts receivable accordingly. A GPO fee we incur for these transactions is also recorded in the same period the related product sales revenue is recognized and is included in accrued expenses.

**Product Returns.** The product returns reserve is based on management's best estimate of the product sales recognized as revenue during the period that are anticipated to be returned. The product returns reserve is recorded as a reduction of product sales revenue in the same period the related product sales revenue is recognized and is included in accrued expenses.

**Revenues under Collaborative Agreements** We have entered into license and collaboration agreements under which the collaborators obtained worldwide exclusive rights for the use of our proprietary rHuPH20 enzyme in the development and commercialization of the collaborators' biologic compounds. The collaborative agreements contain multiple elements, including nonrefundable payments at the inception of the arrangements, license fees, exclusivity fees, payments based on achievement of specified milestones designated in the collaborative agreements, reimbursements of research and development services, payments for supply of rHuPH20 API for the collaborator and/or royalties on sales of products resulting from collaborative agreements. We analyze each element of the collaborative agreements and consider a variety of factors in determining the appropriate method of revenue recognition of each element.

Prior to the adoption of ASU No. 2009-13, *Multiple-Deliverable Revenue Arrangements*, on January 1, 2011, in order for a delivered item to be accounted for separately from other deliverables in a multiple-element arrangement, the following three criteria had to be met: (i) the delivered item had standalone value to the customer, (ii) there was objective and reliable evidence of fair value of the undelivered items, and (iii) if the arrangement included a general right of return relative to the delivered item, delivery or performance of the undelivered items was considered probable and substantially in the control of the vendor. For the collaborative agreements entered into prior to January 1, 2011, there was no objective and reliable evidence of fair value of the undelivered items. Thus, the delivered licenses did not meet all of the required criteria to be accounted for separately from undelivered items. Therefore, we recognized revenue on nonrefundable upfront payments and license fees from these collaborative agreements over the period of significant involvement under the related agreements.

For new collaborative agreements or material modifications of existing collaborative agreements entered into after December 31, 2010, we follow the provisions of ASU No. 2009-13. In order to account for the multiple-element arrangements, we identify the deliverables included within the agreement and evaluate which deliverables represent units of accounting. Analyzing the arrangement to identify deliverables requires the use of judgment, and each deliverable may be an obligation to deliver services, a right or license to use an asset, or another performance obligation. The deliverables under our collaborative agreements include (i) the license to rHuPH20 technology, (ii) at the collaborator's request, research and development services which are reimbursed at contractually determined rates, and (iii) at the collaborator's request, supply of rHuPH20 API which is reimbursed at our cost plus a margin. A delivered item is considered a separate unit of accounting when the delivered item has value to the collaborator on a standalone basis based on the consideration of the relevant facts and circumstances for each arrangement. Factors considered in this determination include the research capabilities of the collaborator and the availability of research expertise in this field in the general marketplace.

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Arrangement consideration is allocated at the inception of the agreement to all identified units of accounting based on their relative selling price. The relative selling price for each deliverable is determined using vendor specific objective evidence ( VSOE ) of selling price or third-party evidence of selling price if VSOE does not exist. If neither VSOE nor third-party evidence of selling price exists, we use our best estimate of the selling price for the deliverable. The amount of allocable arrangement consideration is limited to amounts that are fixed or determinable. The consideration received is allocated among the separate units of accounting, and the applicable revenue recognition criteria are applied to each of the separate units. Changes in the allocation of the sales price between delivered and undelivered elements can impact revenue recognition but do not change the total revenue recognized under any agreement.

Nonrefundable upfront license fee payments are recognized upon delivery of the license if facts and circumstances dictate that the license has standalone value from the undelivered items, which generally include research and development services and the manufacture of rHuPH20 API, the relative selling price allocation of the license is equal to or exceeds the upfront license fee, persuasive evidence of an arrangement exists, our price to the collaborator is fixed or determinable and collectability is reasonably assured. Upfront license fee payments are deferred if facts and circumstances dictate that the license does not have standalone value. The determination of the length of the period over which to defer revenue is subject to judgment and estimation and can have an impact on the amount of revenue recognized in a given period.

The terms of our collaborative agreements provide for milestone payments upon achievement of certain development and regulatory events and/or specified sales volumes of commercialized products by the collaborator. Effective January 1, 2011, we adopted on a prospective basis the Milestone Method. Under the Milestone Method, we recognize consideration that is contingent upon the achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved only if the milestone is substantive in its entirety. A milestone is considered substantive when it meets all of the following criteria:

1. The consideration is commensurate with either the entity's performance to achieve the milestone or the enhancement of the value of the delivered item(s) as a result of a specific outcome resulting from the entity's performance to achieve the milestone,
2. The consideration relates solely to past performance, and
3. The consideration is reasonable relative to all of the deliverables and payment terms within the arrangement.

A milestone is defined as an event (i) that can only be achieved based in whole or in part on either the entity's performance or on the occurrence of a specific outcome resulting from the vendor's performance, (ii) for which there is substantive uncertainty at the date the arrangement is entered into that the event will be achieved, and (iii) that would result in additional payments being due to the vendor.

Reimbursements of research and development services are recognized as revenue during the period in which the services are performed as long as there is persuasive evidence of an arrangement, the fee is fixed or determinable and collection of the related receivable is probable. Revenue from the manufacture of rHuPH20 API is recognized when the API has met all specifications required for the collaborator's acceptance and title and risk of loss have transferred to the collaborator. We do not directly control when any collaborator will request research and development services or supply of rHuPH20 API; therefore, we cannot predict when we will recognize revenues in connection with research and development services and supply of rHuPH20 API. Royalties to be received based on sales of licensed products by our collaborators incorporating rHuPH20 will be recognized as earned.

The collaborative agreements typically provide the collaborators the right to terminate such agreements in whole or on a product-by-product or target-by-target basis at any time upon 90 days prior written notice to us. There are no performance, cancellation, termination or refund provisions in any of our collaborative agreements that contain material financial consequences to us.

### ***Cost of Product Sales***

Cost of product sales consists primarily of raw materials, third-party manufacturing costs, fill and finish costs, freight costs, internal costs and manufacturing overhead associated with the production of *Hylenex* recombinant. Cost of product sales also consists of the write-down of excess, dated and obsolete inventories.



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Research and development expenses include salaries and benefits, facilities and other overhead expenses, external clinical trial expenses, research related manufacturing services, contract services and other outside expenses. Research and development expenses are charged to operations as incurred when these expenditures relate to our research and development efforts and have no alternative future uses.

Advance payments, including nonrefundable amounts, for goods or services that will be used or rendered for future research and development activities are deferred and capitalized. Such amounts will be recognized as an expense as the related goods are delivered or the related services are performed or at such time when we do not expect the goods to be delivered or services to be performed.

Milestone payments that we make in connection with in-licensed technology or product candidates are expensed as incurred when there is uncertainty in receiving future economic benefits from the licensed technology or product candidates. We consider the future economic benefits from the licensed technology or product candidates to be uncertain until such licensed technology or product candidates are approved for marketing by regulatory bodies such as the FDA or when other significant risk factors are abated. Management has viewed future economic benefits for all of our licensed technology or product candidates to be uncertain and has expensed these amounts as incurred.

***Clinical Trial Expenses***

Expenses related to clinical trials are accrued based on our estimates and/or representations from service providers regarding work performed, including actual level of patient enrollment, completion of patient studies and progress of clinical trials. Other incidental costs related to patient enrollment or treatment are accrued when reasonably certain. If the contracted amounts are modified (for instance, as a result of changes in the clinical trial protocol or scope of work to be performed), we modify our accruals accordingly on a prospective basis. Revisions in the scope of a contract are charged to expense in the period in which the facts that give rise to the revision become reasonably certain.

***Share-Based Compensation***

Total share-based compensation expense related to all of our share-based awards was allocated as follows:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Research and development	\$ 913,946	\$ 890,276	\$ 3,279,940	\$ 1,944,552
Selling, general and administrative	1,008,447	867,083	3,082,432	1,971,777
Share-based compensation expense	\$ 1,922,393	\$ 1,757,359	\$ 6,362,372	\$ 3,916,329
Share-based compensation expense per basic and diluted share	\$ 0.02	\$ 0.02	\$ 0.06	\$ 0.04
Share-based compensation expense from:				
Stock options	\$ 1,164,973	\$ 806,078	\$ 3,491,220	\$ 2,318,728
Restricted stock awards and restricted stock units	757,420	951,281	2,871,152	1,597,601
	\$ 1,922,393	\$ 1,757,359	\$ 6,362,372	\$ 3,916,329

Since we have a net operating loss carryforward as of September 30, 2012, no excess tax benefits for the tax deductions related to share-based awards were recognized in the interim unaudited condensed consolidated

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statements of comprehensive loss for the three and nine months ended September 30, 2012. For the three months ended September 30, 2012 and 2011, employees exercised stock options to purchase 7,055 and 38,511 shares of common stock, respectively, for aggregate proceeds of approximately \$39,000 and \$79,000, respectively. For the nine months ended September 30, 2012 and 2011, employees exercised stock options to purchase 426,277 and 2,713,573 shares of common stock, respectively, for aggregate proceeds of approximately \$1.9 million and \$4.1 million, respectively. In addition, for the nine months ended September 30, 2012, upon vesting of 128,000 restricted stock units ( RSUs ), the RSU holders received net settlement of 81,070 shares of common stock and surrendered 46,930 RSUs to pay for the minimum withholding taxes totaling approximately \$347,000. There were no RSUs vested for the three months ended September 30, 2012 or the three and nine months ended September 30, 2011.

As of September 30, 2012, total unrecognized estimated compensation cost related to non-vested stock options and non-vested restricted stock awards and restricted stock units granted prior to that date was approximately \$9.6 million and \$7.0 million, respectively, which is expected to be recognized over a weighted-average period of approximately 2.7 years and 3.6 years, respectively.

### ***Fair Value of Financial Instruments***

We follow the authoritative guidance for fair value measurements and disclosures which, among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. Fair value is defined as an exit price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability.

The framework for measuring fair value provides a hierarchy that prioritizes the inputs to valuation techniques used in measuring fair value as follows:

- Level 1      Quoted prices (unadjusted) in active markets for identical assets or liabilities,
- Level 2      Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable, and
- Level 3      Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing.

Our financial instruments include cash and cash equivalents, accounts receivable, prepaid expenses, accounts payable and accrued expenses. The carrying amounts of financial instruments approximate their fair values due to their short maturities. Cash equivalents of approximately \$85.0 million and \$51.8 million at September 30, 2012 and December 31, 2011, respectively, are carried at fair value and are classified within Level 1 of the fair value hierarchy because they are valued based on quoted market prices for identical securities. We have no instruments that are classified within Level 2 and Level 3.

### ***Segment Information***

We operate our business in one segment, which includes all activities related to the research, development and commercialization of human enzymes that either transiently modify tissue to facilitate injection of other therapies or correct diseased tissue structures for clinical benefit. This segment also includes revenues and expenses related to (i) research and development activities conducted under our collaborative agreements with third parties and (ii) product sales of *Hylenex* recombinant. The chief operating decision-maker reviews the operating results on an aggregate basis and manages the operations as a single operating segment.

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### **3. Collaborative Agreements**

#### *Roche Collaboration*

In December 2006, we and Roche entered into a license and collaborative agreement under which Roche obtained a worldwide, exclusive license to develop and commercialize product combinations of rHuPH20 and up to thirteen Roche target compounds (the "Roche Collaboration"). As of September 30, 2012, Roche has elected a total of five exclusive targets and retains the option to develop and commercialize rHuPH20 with three additional targets, provided that Roche continues to pay annual maintenance fees to us. As of September 30, 2012, we have received \$57 million from Roche, including the \$20 million upfront license fee payment for the application of rHuPH20 to the initial three Roche exclusive targets, \$20 million in connection with Roche's selection of two additional exclusive targets and annual license maintenance fees for the right to designate the remaining targets as exclusive targets, \$13 million in clinical development milestone payments and a \$4 million regulatory milestone payment. If Roche successfully develops all five exclusive targets and achieves pre-agreed sales targets, we could receive additional milestone payments of up to \$178 million, including up to \$17 million for the achievement of clinical development milestones, up to \$16 million for the achievement of regulatory milestones and up to \$145 million for the achievement of sales-based milestones.

Under the terms of the Roche Collaboration, Roche will also pay us a royalty on each product commercialized under the agreement consisting of a mid-single digit percent of the net sales of such product. Unless terminated earlier in accordance with its terms, the Roche Collaboration continues in effect until the expiration of Roche's obligation to pay royalties. Roche has the obligation to pay royalties with respect to each product in each country, during the period equal to the longer of: (a) the duration of any valid claim of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers the product in such country or (b) ten years following the date of the first commercial sale of such product in such country. For products developed for each of the additional targets, Roche may pay us upfront and milestone payments of up to \$47 million per target, as well as royalties on product sales for each of the additional targets consisting of a mid-single digit percent of the net sales of such products. Additionally, Roche will obtain access to our expertise in developing and applying rHuPH20 to Roche targets. Under the terms of the Roche Collaboration, we were obligated to scale up the production of rHuPH20 and to identify a second source manufacturer that would help meet anticipated production obligations arising from the Roche Collaboration.

Due to our continuing involvement obligations (for example, support activities associated with rHuPH20), revenues from the upfront payment, exclusive designation fees and annual license maintenance fees were deferred and are being recognized over the term of the Roche Collaboration. We have determined that the clinical and regulatory milestones are substantive; therefore, we expect to recognize such clinical and regulatory milestone payments as revenue upon achievement of the milestones. In addition, we have determined that the sales-based milestone payments are similar to royalty payments and are not considered milestone payments under the Milestone Method of revenue recognition; therefore, we will recognize such sales-based milestone payments as revenue upon achievement of the milestones.

There were no milestone payments recognized as revenues under collaborative agreements under the Roche Collaboration for the three months ended September 30, 2012 and 2011. For the nine months ended September 30, 2012 and 2011, we recognized \$4 million and \$5 million, respectively, as revenues under collaborative agreements in accordance with the Milestone Method related to the achievement of certain regulatory and clinical milestones pursuant to the terms of the Roche Collaboration.

#### *Gammagard Collaboration*

In September 2007, we entered into a license and collaborative agreement with Baxter, under which Baxter obtained a worldwide, exclusive license to develop and commercialize a product candidate (currently named HyQ) consisting of rHuPH20 combined with a current Baxter product, GAMMAGARD LIQUID® (the "Gammagard Collaboration"). As of September 30, 2012, we have received \$13 million under the Gammagard Collaboration, including the \$10 million upfront license fee payment and a \$3 million regulatory milestone payment. If Baxter successfully receives marketing approval for the licensed product candidate and achieves pre-agreed sales targets, we could receive additional milestone payments of up to \$34 million for the achievement of sales-based milestones. In addition, Baxter will pay us a royalty on each product commercialized under the agreement consisting of a mid-single



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digit percent of the net sales of such product. The Gammagard Collaboration is applicable to both kit and formulation combinations. Baxter assumes all development, manufacturing, clinical, regulatory, sales and marketing costs under the Gammagard Collaboration, while we are responsible for the supply of rHuPH20 enzyme. We perform research and development activities at the request of Baxter, which are reimbursed by Baxter under the terms of the Gammagard Collaboration. In addition, Baxter has certain product development and commercialization obligations in major markets identified in the Gammagard Collaboration. Unless terminated earlier in accordance with its terms, the Gammagard Collaboration continues in effect until the expiration of Baxter's obligation to pay royalties. Baxter has the obligation to pay royalties, with respect to each product in each country, during the period equal to the longer of: (a) the duration of any valid claim of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers the product in such country or (b) ten years following the date of the first commercial sale of such product in such country.

Due to our continuing involvement obligations (for example, support activities associated with rHuPH20 enzyme), the upfront payment was deferred and is being recognized over the term of the Gammagard Collaboration.

We have determined that sales-based milestone payments are similar to royalty payments and are not considered milestone payments under the Milestone Method of revenue recognition; therefore, such payments will be recognized as revenue upon achievement of the milestones. There were no milestone payments recognized as revenues under collaborative agreements under the Gammagard Collaboration for the three and nine months ended September 30, 2012. For the three and nine months ended September 30, 2011, we recognized zero and \$3 million, respectively, as revenues under collaborative agreements under the Gammagard Collaboration in accordance with the Milestone Method.

### *ViroPharma and Intrexon Collaborations*

Effective May 10, 2011, we and ViroPharma entered into a collaboration and license agreement, under which ViroPharma obtained a worldwide exclusive license for the use of rHuPH20 enzyme in the development of a subcutaneous injectable formulation of ViroPharma's commercialized product, Cinryze® (C1 esterase inhibitor [human]) (the ViroPharma Collaboration). In addition, the license provides ViroPharma with exclusivity to C1 esterase inhibitor and to the hereditary angioedema indication, along with three additional orphan indications. As of September 30, 2012, we have received \$13 million from ViroPharma, including the \$9 million nonrefundable upfront license fee payment, a \$3 million clinical development milestone payment and a \$1 million annual exclusivity fee. If ViroPharma successfully develops the licensed product candidate, we could receive additional milestone payments of up to \$41 million for the achievement of development and regulatory milestones. In addition, so long as the agreement is in effect, we are entitled to receive a nonrefundable annual exclusivity fee of \$1 million which commenced on May 10, 2012 and on each anniversary of the effective date of the agreement thereafter until a certain development event occurs. ViroPharma is solely responsible for the development, manufacturing and marketing of any products resulting from this collaboration. We are entitled to receive payments for research and development services and supply of rHuPH20 API if requested by ViroPharma. In addition, we are entitled to receive additional cash payments potentially totaling \$10 million upon achievement of certain development and regulatory milestones for each product targeting the treatment of any of the three additional orphan indications. We are also entitled to receive a royalty on each product commercialized under the agreement consisting of ten percent of the net sales of such product.

Unless terminated earlier in accordance with its terms, the ViroPharma Collaboration continues in effect until the later of (i) expiration of the last to expire of the valid claims of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers a product developed under the collaboration, and (ii) expiration of the last to expire royalty term for a product developed under the collaboration. The royalty term of a product developed under the ViroPharma Collaboration, with respect to each country, consists of the period equal to the longer of: (a) the duration of any valid claim of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers the product in such country or (b) ten years following the date of the first commercial sale of such product in such country. ViroPharma may terminate the agreement prior to expiration for any reason on a product-by-product basis upon 90 days prior written notice to us. Upon any such termination, the license granted to ViroPharma (in total or with respect to the terminated product, as applicable) will terminate.

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Effective June 6, 2011, we and Intrexon entered into a collaboration and license agreement, under which Intrexon obtained a worldwide exclusive license for the use of rHuPH20 enzyme in the development of a subcutaneous injectable formulation of Intrexon's recombinant human alpha 1-antitrypsin (rHuA1AT) (the "Intrexon Collaboration"). In addition, the license provides Intrexon with exclusivity for a defined indication ("Exclusive Field"). As of September 30, 2012, we have received \$10 million from Intrexon, including a nonrefundable upfront license fee payment of \$9 million and a \$1 million annual exclusivity fee. If Intrexon successfully develops the licensed product candidate and achieves the pre-agreed sales target, we could receive additional milestone payments of up to \$54 million, including \$44 million for the achievement of development and regulatory milestones and \$10 million for the achievement of a sales-based milestone. In addition, so long as the agreement is in effect, we are entitled to receive a nonrefundable annual exclusivity fee of \$1 million which commenced on June 6, 2012 and on each anniversary of the effective date of the agreement thereafter until a certain development event occurs. Intrexon is solely responsible for the development, manufacturing and marketing of any products resulting from this collaboration. We are entitled to receive payments for research and development services and supply of rHuPH20 API if requested by Intrexon. In addition, we are entitled to receive additional cash payments potentially totaling \$10 million for each product for use outside the Exclusive Field upon achievement of development and regulatory milestones. We are also entitled to receive a royalty on each product commercialized under the agreement consisting of a percentage of the net sales of such product ranging from mid-single digits up to low double-digit percent.

Unless terminated earlier in accordance with its terms, the Intrexon Collaboration continues in effect until the later of (i) expiration of the last to expire of the valid claims of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers a product developed under the collaboration, and (ii) expiration of the last to expire royalty term for a product developed under the collaboration. The royalty term of a product developed under the Intrexon Collaboration, with respect to each country, consists of the period equal to the longer of: (a) the duration of any valid claim of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers the product in such country or (b) ten years following the date of the first commercial sale of such product in such country. Intrexon may terminate the agreement prior to expiration for any reason on a product-by-product basis upon 90 days prior written notice to us. Upon any such termination, the license granted to Intrexon (in total or with respect to the terminated product, as applicable) will terminate. Intrexon's chief executive officer, chairman of its board of directors and major shareholder is also a member of our board of directors.

We identified the deliverables at the inception of the ViroPharma and Intrexon agreements which are the license, research and development services and API supply. We have determined that the license, research and development services and API supply individually represent separate units of accounting, because each deliverable has standalone value. The estimated selling prices for these units of accounting were determined based on market conditions, the terms of comparable collaborative arrangements for similar technology in the pharmaceutical and biotech industry and entity-specific factors such as the terms of our previous collaborative agreements, our pricing practices and pricing objectives and the nature of the research and development services to be performed for the collaborators. The arrangement consideration was allocated to the deliverables based on the relative selling price method.

The amount allocable to the delivered unit or units of accounting is limited to the amount that is not contingent upon the delivery of additional items or meeting other specified performance conditions (the noncontingent amount). As such, we excluded from the allocable arrangement consideration the milestone payments, annual exclusivity fees and royalties regardless of the probability of receipt. Based on the results of our analysis, we allocated the \$9 million upfront license fee received from ViroPharma to the license fee deliverable under the ViroPharma arrangement and the \$9 million upfront fee received from Intrexon to the license fee deliverable under the Intrexon arrangement. We determined that the upfront payment was earned upon the granting of the worldwide, exclusive right to our technology to the collaborator in both the ViroPharma Collaboration and Intrexon Collaboration. As a result, we recognized the \$9 million upfront license fee received under the ViroPharma Collaboration and the \$9 million upfront license fee received under the Intrexon Collaboration as revenues under collaborative agreements upon receipt of the upfront license fees.

We recognize the annual exclusivity fees as revenues under collaborative agreements when they are due and payable on each anniversary of the effective date and such amounts are included in the allocable arrangement

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consideration and recognized based on the relative selling price allocation. We recognize amounts allocated to research and development services as revenues under collaborative agreements as the related services are performed. We recognize amounts allocated to the sales of API as revenues under collaborative agreements when such API has met all required specifications by the collaborators and the related title and risk of loss and damages have passed to the collaborators. We cannot predict the timing of delivery of research and development services and API as they are at the collaborators' requests.

We are eligible to receive additional cash payments upon the achievement by the collaborators of specified development, regulatory and sales-based milestones. We have determined that each of the development and regulatory milestones is substantive; therefore, we expect to recognize such development and regulatory milestone payments as revenues under collaborative agreements upon achievement in accordance with the Milestone Method. In addition, we have determined that the sales-based milestone payment is similar to a royalty payment and is not considered a milestone payment under the Milestone Method of revenue recognition; therefore, we will recognize the sales-based milestone payment as revenue upon achievement of the milestone because we have no future performance obligations associated with the milestone.

For the three and nine months ended September 30, 2011, we recognized a \$3 million milestone payment as revenues under collaborative agreements in accordance with the Milestone Method related to the achievement of a development milestone pursuant to the terms of the ViroPharma Collaboration. There were no milestone payments recognized as revenues under collaborative agreements associated with the ViroPharma Collaboration for the three and nine months ended September 30, 2012. There were no milestone payments recognized as revenues under collaborative agreements associated with the Intrexon Collaboration for the three and nine months ended September 30, 2012 and 2011. We recognized the annual exclusivity fee of zero and \$1 million as revenues under collaborative agreements associated with each the ViroPharma and Intrexon Collaborations for the three and nine months ended September 30, 2012, respectively.

**4. Inventories**

Inventories consist of the following:

	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Raw materials	\$ 962,751	\$ 201,822
Work-in-process	715,241	290,647
Finished goods	508,071	74,794
	<b>\$ 2,186,063</b>	<b>\$ 567,263</b>

**5. Property and Equipment, Net**

Property and equipment, net consist of the following:

	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Research equipment	\$ 6,207,401	\$ 5,231,763
Computer and office equipment	1,524,340	1,266,041
Leasehold improvements	1,137,187	1,019,147
	<b>8,868,928</b>	<b>7,516,951</b>
Accumulated depreciation and amortization	<b>(6,505,278)</b>	<b>(5,745,903)</b>
	<b>\$ 2,363,650</b>	<b>\$ 1,771,048</b>

Depreciation and amortization expense totaled approximately \$286,000 and \$239,000 for the three months ended September 30, 2012 and 2011, respectively, and approximately \$796,000 and \$852,000 for the nine months ended September 30, 2012 and 2011, respectively.



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Accrued expenses consist of the following:

	September 30, 2012	December 31, 2011
Accrued outsourced research and development expenses	\$ 3,735,396	\$ 1,910,273
Accrued compensation and payroll taxes	3,339,791	3,223,936
Other accrued expenses	966,486	481,365
	\$ 8,041,673	\$ 5,615,574

**7. Deferred Revenue**

Deferred revenue consists of the following:

	September 30, 2012	December 31, 2011
Collaborative agreements	\$ 44,034,015	\$ 40,716,806
Product sales	319,367	167,184
Total deferred revenue	44,353,382	40,883,990
Less current portion	9,470,247	4,129,407
Deferred revenue, net of current portion	\$ 34,883,135	\$ 36,754,583

**Roche Collaboration.** Under the terms of the Roche Collaboration, Roche paid \$20 million to us in December 2006 as an initial upfront payment for the application of rHuPH20 to three pre-defined Roche biologic targets. As of September 30, 2012, Roche has paid an aggregate of \$20 million in connection with Roche's election of two additional exclusive targets and annual license maintenance fees for the right to designate the remaining targets as exclusive targets. Roche currently retains the option to develop and commercialize rHuPH20 with three additional targets, provided that Roche continues to pay annual license maintenance fees to us.

Due to our continuing involvement obligations (for example, support activities associated with rHuPH20 enzyme), revenues from the upfront payment, exclusive designation fees and annual license maintenance fees were deferred and are being recognized over the term of the Roche Collaboration. We recognized revenue from the upfront payment, exclusive designation fees and annual license maintenance fees under the Roche Collaboration in the amounts of approximately \$503,000 and \$491,000 for the three months ended September 30, 2012 and 2011, respectively, and approximately \$1.5 million for the nine months ended September 30, 2012 and 2011. Deferred revenue relating to the upfront payment, exclusive designation fees and annual license maintenance fees under the Roche Collaboration was \$30.1 million and \$31.7 million as of September 30, 2012 and December 31, 2011, respectively.

During the nine months ended September 30, 2012, we received approximately \$7.0 million in deferred revenue relating to the manufacture of rHuPH20 API for Roche. We recognized approximately \$334,000 as revenues under collaborative agreements from deferred revenue relating to the manufacture of rHuPH20 API for the three and nine months ended September 30, 2012. Deferred revenue relating to the manufacture of rHuPH20 API under the Roche Collaboration was \$6.7 million and zero as of September 30, 2012 and December 31, 2011, respectively.

**Gammagard Collaboration.** Under the terms of the Gammagard Collaboration, Baxter paid us a nonrefundable upfront payment of \$10 million. Due to our continuing involvement obligations (for example, support activities associated with rHuPH20 enzyme), the \$10 million upfront payment was deferred and is being recognized over the term of the Gammagard Collaboration. We recognized revenue from the upfront payment under the Gammagard Collaboration in the amounts of approximately \$121,000 for each of the three months ended September 30, 2012 and 2011 and approximately \$362,000 for the nine months ended September 30, 2012 and 2011. Deferred revenue relating to the upfront payment under the Gammagard Collaboration was \$7.2 million and \$7.6 million as of September 30, 2012 and December 31, 2011, respectively.



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**Hylenex Collaboration.** In February 2007, we and Baxter amended certain existing agreements for *Hylenex* recombinant and entered into the Hylenex Collaboration for kits and formulations with rHuPH20. Effective January 7, 2011, we and Baxter mutually agreed to terminate the Hylenex Collaboration and the associated agreements. On July 18, 2011, we and Baxter entered into an agreement (the Transition Agreement ) setting forth certain rights, data and assets to be transferred by Baxter to us during a transition period. Effective July 18, 2011, we had no future performance obligations to Baxter in connection with the Hylenex Collaboration. Therefore, we recognized the unamortized deferred revenue of approximately \$9.3 million relating to the prepaid product-based payments and the unamortized deferred revenue of approximately \$7.6 million relating to deferred upfront payment from the Hylenex Collaboration as revenues under collaborative agreements for the three months ended September 30, 2011. For the nine months ended September 30, 2011, we recognized revenues under the Hylenex Collaboration from the upfront payment of approximately \$7.8 million and from the product-based payments of approximately \$9.3 million. There were no deferred revenues relating to the Hylenex Collaboration at September 30, 2012 and 2011.

In addition, pursuant to the terms of the Transition Agreement, Baxter no longer had the right to return the *Hylenex* recombinant API previously delivered to Baxter. Accordingly, we recognized approximately \$991,000 of deferred revenue related to such *Hylenex* recombinant API as product sales revenue during the three and nine months ended September 30, 2011.

**8. Net Income (Loss) Per Share**

Basic net income (loss) per common share is computed by dividing net income (loss) for the period by the weighted average number of common shares outstanding during the period, without consideration for common stock equivalents. Diluted net income (loss) per common share is computed by dividing net income (loss) for the period by the weighted-average number of common shares outstanding and potentially dilutive common shares outstanding. Potentially dilutive common shares outstanding, determined using the treasury stock method, principally include shares that may be issued under our stock options, restricted stock awards ( RSAs ) and RSUs. Stock options, unvested RSAs and unvested RSUs are considered common stock equivalents and are only included in the calculation of diluted earnings per common share when their effect is dilutive. For the three and nine months ended September 30, 2012, outstanding stock options, outstanding RSUs and unvested RSAs totaling approximately 7.3 million were excluded from the calculation of diluted net loss per common share because their effect is anti-dilutive. For the three and nine months ended September 30, 2011, outstanding stock options, outstanding RSUs and unvested RSAs totaling approximately 1.9 million and 5.9 million, respectively, were excluded from the calculation of diluted net loss per common share because their effect is anti-dilutive.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net Income (Loss) - Numerator:				
Net income (loss) for basic and diluted EPS	\$ (20,005,846)	\$ 5,165,193	\$ (49,146,146)	\$ (1,354,237)
Shares - Denominator:				
Weighted-average shares for basic EPS	112,305,002	103,223,352	110,658,757	102,282,904
Effect of dilutive stock options, RSAs and RSUs		1,785,837		
Weighted-average shares for diluted EPS	112,305,002	105,009,189	110,658,757	102,282,904
Basic and diluted net income (loss) per share	\$ (0.18)	\$ 0.05	\$ (0.44)	\$ (0.01)

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### **9. Stockholders' Equity**

During the nine months ended September 30, 2012 and 2011, we issued an aggregate of 426,277 and 2,713,573 shares of common stock, respectively, in connection with the exercises of stock options at a weighted average exercise price of \$4.56 and \$1.70 per share, respectively, for net proceeds of approximately \$1.9 million and \$4.1 million, respectively. In addition, for the nine months ended September 30, 2012, we issued 81,070 shares of common stock upon vesting of certain RSUs. The RSU holders surrendered 46,930 RSUs to pay for minimum withholding taxes totaling approximately \$347,000. Options and RSUs to purchase approximately 6.9 million and 6.0 million shares of our common stock were outstanding as of September 30, 2012 and December 31, 2011, respectively. In addition, we issued 375,908 shares of common stock, net of RSAs canceled, in connection with the grants of RSAs during the nine months ended September 30, 2012.

On February 15, 2012, we completed an underwritten public offering and issued 7,820,000 shares of common stock, including 1,020,000 shares sold pursuant to the full exercise of an over-allotment option granted to the underwriter. All of the shares were offered at a public offering price of \$10.61 per share, generating approximately \$81.5 million in net proceeds. Randal J. Kirk, a member of our board of directors, through his affiliates, purchased 1,360,000 shares of common stock in this offering at the public offering price of \$10.61 per share for a total of approximately \$14.4 million.

### **10. Commitments and Contingencies**

From time to time, we may be involved in disputes, including litigation, relating to claims arising out of operations in the normal course of our business. Any of these claims could subject us to costly legal expenses and, while we generally believe that we have adequate insurance to cover many different types of liabilities, our insurance carriers may deny coverage or our policy limits may be inadequate to fully satisfy any damage awards or settlements. If this were to happen, the payment of any such awards could have a material adverse effect on our consolidated results of operations and financial position. Additionally, any such claims, whether or not successful, could damage our reputation and business. We currently are not a party to any legal proceedings, the adverse outcome of which, in management's opinion, individually or in the aggregate, would have a material adverse effect on our consolidated results of operations or financial position.



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

*As used in this report, unless the context suggests otherwise, the terms we, our, ours, and us refer to Halozyme Therapeutics, Inc., and its wholly owned subsidiary, Halozyme, Inc., which are sometimes collectively referred to herein as the Company.*

*The following information should be read in conjunction with the interim unaudited condensed consolidated financial statements and notes thereto included in Item 1 of this Quarterly Report on Form 10-Q. Past financial or operating performance is not necessarily a reliable indicator of future performance, and our historical performance should not be used to anticipate results or future period trends.*

*Except for the historical information contained herein, this report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements reflect management's current forecast of certain aspects of our future. Words such as expect, anticipate, intend, plan, believe, seek, estimate, think, may, could, will, would, should, continue, potential, likely, opportunity and similar expressions or variations of such words are intended to identify forward-looking statements, but are not the exclusive means of identifying forward-looking statements in this report. Additionally, statements concerning future matters such as the development or regulatory approval of new products, enhancements of existing products or technologies, third party performance under key collaboration agreements, revenue and expense levels and other statements regarding matters that are not historical are forward-looking statements. Such statements are based on currently available operating, financial and competitive information and are subject to various risks, uncertainties and assumptions that could cause actual results to differ materially from those anticipated or implied in our forward-looking statements due to a number of factors including, but not limited to, those set forth below under the section entitled Risks Factors and elsewhere in this Quarterly Report on Form 10-Q and our most recent Annual Report on Form 10-K.*

### Overview

We are a biopharmaceutical company dedicated to developing and commercializing innovative products that advance patient care. Our research targets the extracellular matrix, an area outside the cell that provides structural support in tissues and orchestrates many important biological activities, including cell migration, signaling and survival. Over many years, we have developed unique scientific expertise that allows us to pursue this target-rich environment for the development of future therapies.

Our research focuses primarily on human enzymes that alter the extracellular matrix. Our lead enzyme, recombinant human hyaluronidase (rHuPH20), temporarily degrades hyaluronan (HA), a matrix component in the skin, and facilitates the dispersion and absorption of drugs and fluids. We are also developing novel enzymes that may target other matrix structures for therapeutic benefit. Our Enhance™ technology is the platform for the delivery of proprietary small and large molecules. We apply our research to develop products in collaboration with other companies as well as for our own proprietary pipeline in therapeutic areas with significant unmet medical need, such as diabetes, oncology and dermatology.

Our operations to date have involved: (i) organizing and staffing our operating subsidiary, Halozyme, Inc.; (ii) acquiring, developing and securing our technology; (iii) undertaking product development for our existing products and a limited number of product candidates; (iv) supporting the development of collaboration product candidates; and (v) selling Hylenex® recombinant (hyaluronidase human injection). We continue to increase our focus on our proprietary product pipeline and have expanded investments in our proprietary product candidates. We currently have multiple proprietary programs in various stages of research and development. In addition, we currently have license and collaborative agreements with F. Hoffmann-La Roche, Ltd and Hoffmann-La Roche, Inc. (Roche), Baxter Healthcare Corporation (Baxter), ViroPharma Incorporated (ViroPharma) and Intrexon Corporation (Intrexon) to apply Enhance technology to the collaborators' biological therapeutic compounds. Currently, we have received only limited revenue from the sales of Hylenex recombinant, in addition to other revenues from our collaborations.

We and our collaborators have product candidates in the research, preclinical and clinical stages, but future revenues from the sales and/or royalties of these product candidates will depend on our collaborators' abilities and our ability to develop, manufacture, obtain regulatory approvals for and successfully commercialize product

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candidates. It may be years, if ever, before we and our collaborators are able to obtain regulatory approvals for these product candidates. We have incurred net operating losses each year since inception, with an accumulated deficit of approximately \$294.2 million as of September 30, 2012.

### Product and Product Candidates

We have one marketed product and multiple product candidates targeting several indications in various stages of development. The following table summarizes our proprietary product and product candidates as well as our collaboration product candidates:

Product and Product Candidates	Therapeutic Area	Use / Indication(s)	Research/ Pre-Clinical	Phase 1	Phase 2	Phase 3	Filed for Approval	Approved Product
<b>Proprietary Product and Product Candidates</b>								
<i>Hylenex</i> recombinant (hyaluronidase human injection)	Various	Peptide, small molecule and fluid delivery	■	■	■	■	■	■
Analog Insulin-PH20	Endocrinology	Diabetes	■	■	■	■	■	■
PEGPH20	Oncology	Solid tumors	■	■	■	■	■	■
HTI-501	Dermatology	Aesthetic medicine,  other	■	■	■	■	■	■
<b>Collaboration Product Candidates</b>								
Roche (up to 8 targets): Subcutaneous Herceptin®	Oncology	Breast cancer	■	■	■	■	■	■
Subcutaneous MabThera®	Oncology	Non-Hodgkin's lymphoma	■	■	■	■	■	■
Subcutaneous Actemra®	Anti-Inflammatory	Rheumatoid arthritis	■	■	■	■	■	■
Baxter BioScience HyQ (GAMMAGARD LIQUID® with rHuPH20)	Immunology	Primary immunodeficiency	■	■	■	■	■	■
ViroPharma Cinryze® with rHuPH20	Immunology	Hereditary angioedema	■	■	■	■	■	■
Intrexon Alpha 1-antitrypsin with rHuPH20	Immunology	Hereditary emphysema	■	■	■	■	■	■

**Table of Contents*****More Physiologic (Ultrafast) Insulin Program***

Our lead proprietary program focuses on using rHuPH20 with prandial (mealtime or rapid-acting) insulin for the treatment of diabetes mellitus. Diabetes mellitus is an increasingly prevalent, costly condition associated with substantial morbidity and mortality. Attaining and maintaining normal blood sugar levels to minimize the long-term clinical risks is a key treatment goal for people living with diabetes. We have combined rHuPH20 with a rapid acting analog insulin, e.g., insulin lispro (Humalog®) (Lispro-PH20), insulin aspart (Novolog®) (Aspart-PH20), and insulin glulisine (Apidra®), (each such combination, Analog-PH20), to accelerate their action. We have also studied the pre-administration of *Hylanex* recombinant in analog insulin pump therapy at infusion site change (once every 48-72 hours). These Analog-PH20 combinations facilitate faster insulin dispersion in, and absorption from, the subcutaneous space into the vascular compartment, leading to faster insulin response. By making mealtime insulin onset faster, i.e., providing earlier insulin to the blood and thus earlier glucose lowering activity, Analog-PH20 may yield a better profile of insulin effect, more like that found in healthy, non-diabetic people.

The primary goal of our more physiologic insulin program is to develop a best-in-class insulin product, with demonstrated clinical benefits for type 1 and 2 diabetes mellitus patients, in comparison to the current standard of care analog insulin products. With a more rapidly absorbed, faster acting insulin product, we seek to demonstrate one or more significant improvements relative to existing treatment, such as improved glycemic control, less hypoglycemia, and less weight gain. A number of clinical trials investigating the various attributes of our insulin candidates have been completed.

We view the multiple daily injection (MDI) market and the continuous subcutaneous insulin infusion (CSII) or pump market as distinct product opportunities that could be pursued separately. Based on the data we have seen thus far, we believe that a large biotech or pharmaceutical company with global access to the primary care markets would be best positioned to maximize the value of the MDI market and, therefore, entering into a collaboration would be an attractive option for us to leverage this opportunity. We believe that the pre-administration of *Hylanex* recombinant could be the best product offering for the CSII market. We are currently evaluating a variety of strategic options for pursuing this opportunity commercially.

At the American Diabetes Association's (ADA) annual conference in June 2012, we presented three clinical studies from our more physiologic insulin program for two distinct markets – the MDI market and the CSII market. With regard to MDI opportunity, we presented data from two treatment studies – one in type 1 diabetes patients and one in type 2 diabetes patients. Both studies met their primary endpoints of A1C non-inferiority (A1C is a measure of average blood sugar over three months) and improved post-prandial glucose control, compared to patients who were treated with analog insulin alone. Additionally, data from the type 1 diabetes treatment study indicated that Analog-PH20 formulations reduced hypoglycemia compared to analog insulin alone.

For the CSII market, we presented interim data from a study evaluating the use of *Hylanex* recombinant in analog insulin pump therapy that showed pre-administration of *Hylanex* recombinant provided a “faster-on faster-off” more physiologic profile than current rapid insulin analogs. Data from the double-blind cross-over study showed that pre-administration of *Hylanex* recombinant, at the time of infusion set change, not only accelerated the absorption and action of mealtime insulin, but also provided a more consistent insulin action profile over the three days of the infusion set life which resulted in improved post-prandial glucose control.

***PEGPH20***

We are developing an investigational PEGylated form of rHuPH20 (PEGPH20), a new molecular entity, as a candidate for the systemic treatment of tumors that accumulate HA. PEGylation refers to the attachment of polyethylene glycol to rHuPH20, thereby creating PEGPH20. One of the novel properties of PEGPH20 is that it has an extended serum half-life and therefore can be used to treat systemic disease.

Approximately 25% of all solid malignancies accumulate HA, including pancreatic, lung, breast, colon and prostate cancers. Aberrant accumulation of this component of the tumor's infrastructure supports a protective network that surrounds certain tumors. This pathologic accumulation of HA along with other matrix components creates a unique microenvironment for the growth of tumor cells compared to normal cells. We believe that depleting the HA component of the tumor architecture with PEGPH20 disrupts the tumor microenvironment and

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opens the previously constricted vessels to allow anti-cancer therapies to have greater access to the tumor, which may enhance the chemotherapy's treatment effect. Increased blood flow may also enhance radiotherapy treatment effect. We have generated data showing that disrupting the specialized environment around tumors will directly inhibit the growth. Because HA accumulates in about 25% of all solid tumors, we believe that PEGPH20 has the potential to help patients with many different kinds of cancer.

We are currently conducting clinical trials with PEGPH20 in the treatment of solid tumors. The trials incorporate the use of oral dexamethasone as prophylactic treatment for all patients prior to receiving intravenous administration of PEGPH20 and subsequent post-dose oral dexamethasone. Dexamethasone minimizes the side effect of PEGPH20. Our Phase 2 clinical trial, with a Phase 1b run-in period, for patients with metastatic pancreatic cancer is currently ongoing. In the Phase 1b run-in period of the trial, patients receive PEGPH20 in combination with gemcitabine. The objective of Phase 1b is to identify the recommended Phase 2 dose of PEGPH20 in combination with gemcitabine. The Phase 2 portion of the trial will be a randomized, double-blind, placebo-controlled study to assess safety, tolerability, and efficacy of PEGPH20 in combination with certain chemotherapeutic agents versus the chemotherapeutic agents alone. We expect to specify the chemotherapeutic agents we will use in the Phase 2 portion of the trial pending our determination of the chemotherapeutic agents that are most relevant in the treatment of pancreatic cancer.

### ***HTI-501***

HTI-501, a recombinant human proteinase known as cathepsin L, is a lysosomal proteinase that acts by degrading collagen and is our first conditionally-active biologic. Collagen is an abundant protein in the body, particularly in connective tissue, and is present in high amounts in the extracellular matrix in the form of collagen fibers. Collagens are a class of helical proteins that are assembled into macromolecular fibrils and fibers. The collagen fiber network provides a structural scaffolding framework in the extracellular matrix. In the skin, these collagen fibers connect the superficial epithelial tissues to the underlying connective tissues. Collagen abnormalities contribute to a number of conditions, including frozen shoulder, Dupuytren's contracture, Peyronie's disease and cellulite.

A conditionally active biologic is a molecule that is only active under certain physiological conditions. HTI-501 is active under mildly acidic conditions and inactive at the pH normally found in the tissue. The enzyme is combined with a low pH buffer and injected in its active state. The enzyme is only active locally and for a short period of time. Once the mildly acidic conditions of the HTI-501 administration have been neutralized by the body, the enzyme becomes inactive. We intend to harness this conditional activity to exert control over the duration and location of the enzyme's therapeutic activity, potentially improving the efficacy or safety of this product candidate for both medical and aesthetic conditions.

We are exploring HTI-501 as an approach to the treatment of edematous fibrosclerotic panniculopathy, also known as cellulite. The condition affects the great majority of post-adolescent women and is prevalent in all races. We believe that the collagen fibers (fibrous septa) anchor the epidermis against the swelling of subcutaneous fat, which creates the dimpled appearance associated with the condition. We believe that HTI-501 acts by releasing the tension in the collagenous fibrous septa and smoothing the dimpled appearance of the skin. HTI-501 has the potential to be studied as a treatment for other conditions involving collagen, such as frozen shoulder, Dupuytren's contracture, Peyronie's disease, keloids and hypertrophic scarring.

In September 2011, we initiated a Phase 1/2 clinical trial of HTI-501 in women with moderate to severe cellulite. The Phase 1 dose escalation portion of the trial evaluated a single injection of different HTI-501 formulations into dimpled lesions of the skin followed by a Phase 2 portion of the trial where multiple lesions are targeted with the optimal dose and formulation. Up to 48 and 76 subjects may be enrolled in the Phase 1 and Phase 2 portions of the trial, respectively. The interim results from the Phase 1 proof-of-concept and local tolerability study of HTI-501 were presented at the 8<sup>th</sup> World Congress of the International Academy of Cosmetic Dermatology in Cancun, Mexico, which was held from January 31 to February 3, 2012. In the Phase 1 portion of the clinical trial, no serious or severe adverse events were reported and the injection was well tolerated. The most common adverse event was mild to moderate pain at the injection site that was generally bilateral (present at both investigational drug and buffer control injection sites), lasted a few minutes and did not require treatment. Data from this study supported commencement of the Phase 2 portion of the clinical trial, which is currently underway.

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### ***Enhance Technology***

Enhance technology is a proprietary delivery platform using rHuPH20. This enzyme temporarily degrades HA. We believe this temporary degradation creates an opportunistic window for the improved subcutaneous delivery of injectable biologics, such as monoclonal antibodies and other large therapeutic molecules, as well as small molecules and fluids. The HA reconstitutes its normal density within several days and, therefore, we anticipate that any effect of rHuPH20 on the architecture of the subcutaneous space is temporary. By using our rHuPH20 enzyme, many therapeutics that could normally only be injected intravenously can now be administered subcutaneously. This change in the route of delivery to subcutaneous from intravenous (IV), can often improve patient convenience, enhance pharmacokinetics, boost efficacy, extend the product lifecycle and reduce cost.

We currently have Enhance technology collaborations with Roche, Baxter, ViroPharma and Intrexon. We are currently pursuing additional collaborations with biopharmaceutical companies that market drugs requiring or benefiting from injection via the subcutaneous route of administration.

### ***Roche Collaboration***

In December 2006, we and Roche entered into an agreement under which Roche obtained a worldwide, exclusive license to develop and commercialize product combinations of rHuPH20 with up to thirteen Roche target compounds (the Roche Collaboration). Roche initially had the exclusive right to apply rHuPH20 to only three pre-defined Roche biologic targets with the option to exclusively develop and commercialize rHuPH20 with ten additional targets. As of September 30, 2012, Roche has elected a total of five exclusive targets and retains the option to develop and commercialize rHuPH20 with three additional targets through the payment of annual license maintenance fees. Pending the successful completion of various clinical, regulatory and sales events, Roche will be obligated to make milestone payments to us, as well as royalty payments on the sales of products that result from the collaboration.

In March 2012, Roche submitted a Line Extension Application to the European Medicines Agency for a compound, directed at one of the five Roche exclusive targets, formulated with rHuPH20 (subcutaneous Herceptin®). In addition, clinical trials have commenced for compounds directed at two other Roche exclusive targets under the Roche Collaboration. One compound formulated with rHuPH20 (subcutaneous MabThera®) is in a Phase 3 clinical trial and one compound formulated with rHuPH20 (subcutaneous Actemra®) has completed a Phase 1 clinical trial.

In October 2011, Roche announced positive top line results from the Phase 3 clinical trial in women with early HER2-positive breast cancer who received a fixed dose of a new subcutaneously delivered version of Roche's anticancer biologic, Herceptin (trastuzumab) (Herceptin SC). In the study, the subcutaneous formulation showed comparable results to Herceptin given as an IV infusion (Herceptin IV). Herceptin SC takes about 5 minutes to administer whereas Herceptin IV takes about 30-90 minutes to infuse. Roche is also developing an auto-injector device that should further simplify the process and could enable patients to be dosed at home or in the doctor's office rather than at an infusion clinic or hospital. The ready to use formulation may also significantly reduce pharmacy time as no medicine preparation time is required. This Phase 3 clinical trial was an open-label trial involving 596 women with HER2-positive early breast cancer. The trial was designed to compare trastuzumab concentration in the blood (pharmacokinetics), efficacy (pathologic complete response) and safety of Herceptin SC to that of Herceptin IV. The trial met its co-primary endpoints including trastuzumab concentration in the blood (serum concentrations) and efficacy. No new safety signals were observed and adverse events were overall consistent with Herceptin IV. Herceptin is approved to treat HER2-positive breast cancer and currently is given intravenously. Breast cancer is the most common cancer among women worldwide. Each year, more than 1.4 million new cases of breast cancer are diagnosed worldwide, and nearly 450,000 people will die of the disease annually. In HER2-positive breast cancer, increased quantities of the HER2 protein are present on the surface of the tumor cells. This is known as HER2 positivity and affects approximately 15-20% of people with breast cancer. Roche recently announced that data from this trial was presented at the European Breast Cancer Conference in Vienna, which was held in March 2012.

In February 2011, Roche began a Phase 3 clinical trial for a subcutaneous formulation of MabThera (rituximab) (MabThera SC). The study investigates pharmacokinetics, efficacy and safety of MabThera SC. IV administered MabThera is approved for the treatment of non-Hodgkin's lymphoma (NHL) and Chronic Lymphocytic Leukemia (CLL), types of cancer that affect lymphocytes (white blood cells). An estimated 66,000

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new cases of NHL were diagnosed in the U.S. in 2009 with approximately 125,000 new cases reported worldwide. Roche has stated that they will present data from the program in 2012 and they expect to file a marketing application to regulatory authorities in the European Union in 2012.

In 2009, Roche completed a Phase 1 clinical trial for a subcutaneous formulation of Actemra. This trial investigated the safety and pharmacokinetics of subcutaneous Actemra in patients with rheumatoid arthritis. The results from this Phase 1 trial suggest that further exploration may be warranted. Actemra administered intravenously is approved for the treatment of rheumatoid arthritis. Roche is separately developing a subcutaneous form of Actemra that does not use rHuPH20 and is being investigated for weekly or biweekly administration.

Additional information about the Phase 3 subcutaneous Herceptin and Phase 3 subcutaneous MabThera clinical trials can be found at [www.clinicaltrials.gov](http://www.clinicaltrials.gov) and [www.roche-trials.com](http://www.roche-trials.com). Information available on these websites is not incorporated into this report.

### ***Baxter Gammagard Collaboration***

GAMMAGARD LIQUID is a Baxter product that is indicated for the treatment of primary immunodeficiency disorders associated with defects in the immune system. In September 2007, we and Baxter entered into an agreement under which Baxter obtained a worldwide, exclusive license to develop and commercialize a product candidate (HyQ) consisting of rHuPH20 combined with GAMMAGARD LIQUID (the Gammagard Collaboration). Pending the successful completion of various regulatory and sales milestones, Baxter is obligated to make milestone payments to us, as well as royalty payments on the sales of products that result from the collaboration. Baxter is responsible for all development, manufacturing, clinical, regulatory, sales and marketing costs under the Gammagard Collaboration, while we are responsible for the supply of rHuPH20. We perform research and development activities at the request of Baxter, which are reimbursed by Baxter under the terms of the Gammagard Collaboration. In addition, Baxter has certain product development and commercialization obligations in major markets identified in the Gammagard License. In September 2011, Baxter submitted an application to the European Medicines Agency's Committee for Human Medicinal Products seeking marketing approval for HyQ. Baxter filed a biologic license application (BLA) for HyQ in the U.S. in the second quarter of 2011. On August 1, 2012, we announced that the Center for Biologics Evaluation and Research (CBER) of the U.S. Food and Drug Administration (FDA) has issued a complete response letter (CRL) for Baxter's HyQ BLA. The CRL requested additional preclinical data to support the BLA. The primary issues raised in the CRL focused on non-neutralizing antibodies generated against rHuPH20 and the possible effects of these antibodies on reproduction, development and fertility. Elevated anti-rHuPH20 antibody titers were detected in the registration trial, but have not been associated with any adverse events. Pending Baxter and us providing additional preclinical data sufficient to address the regulatory questions, CBER has requested that patients should no longer be dosed with rHuPH20 in the Baxter HyQ program. Baxter has announced that individuals enrolling in ongoing HyQ clinical studies in the U.S. will now be treated with Baxter's immune globulin therapy without rHuPH20. We and Baxter expect these requests will require additional time to complete and will delay the companies' anticipated regulatory review and approval timelines.

### ***ViroPharma Collaboration***

Effective May 10, 2011, we and ViroPharma entered into a license and collaborative agreement under which ViroPharma obtained a worldwide exclusive license for the use of rHuPH20 in the development of a subcutaneous injectable formulation of ViroPharma's commercialized product, Cinryze® (C1 esterase inhibitor [human]) (the ViroPharma Collaboration). In addition, the license provides ViroPharma with exclusivity to C1 esterase inhibitor and to the hereditary angioedema indication, along with three additional orphan indications. ViroPharma is solely responsible for the development, manufacturing, regulatory approval and marketing of any products resulting from the collaboration. We are entitled to receive payments for research and development services and supply of bulk formulation of rHuPH20 (active pharmaceutical ingredient or API), if requested by ViroPharma. We are also entitled to receive milestone payments and royalties on product sales by ViroPharma.

In March 2012, ViroPharma reported positive data from ViroPharma's Phase 2 subcutaneous trial of Cinryze in combination with Enhance technology in patients with hereditary angioedema, a rare, debilitating and potentially fatal genetic disease. These data demonstrate that subcutaneous co-administration of Cinryze with rHuPH20 was easy to administer, well tolerated and resulted in sustained physiologically relevant C1 INH functional concentrations. This innovative combination administered subcutaneously as a single injection will be

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further evaluated for the prevention of hereditary angioedema attacks. The results were presented at the 2012 annual meeting of the American Academy of Allergy Asthma & Immunology, held in March 2012 in Orlando, Florida. The open-label, multiple-dose Phase 2 clinical trial was conducted in 12 subjects with hereditary angioedema. The study was designed to evaluate the safety, pharmacokinetics and pharmacodynamics of subcutaneous administration of Cinryze in combination with rHuPH20. We believe this product candidate could improve flexibility and convenience, and potentially allow prevention-minded patients living with hereditary angioedema to self administer every three or four days, just as they do today with the current IV formulation, but with a single subcutaneous injection.

On August 1, 2012, ViroPharma announced that the FDA had requested that studies of the combination of Cinryze and rHuPH20 be placed on temporary clinical hold pending the FDA's evaluation of potential safety concerns with Halozyme's rHuPH20 enzyme raised by the presence of anti-rHuPH20 non-neutralizing antibodies that were detected in Baxter's HyQ program.

On September 21, 2012, ViroPharma and we announced that the FDA has provided guidance enabling ViroPharma to resume clinical studies of the subcutaneous administration of Cinryze in combination with rHuPH20. The FDA informed ViroPharma that based on their ongoing assessment, the FDA believes the potential safety signals regarding antibodies to rHuPH20 that were detected in Baxter's HyQ clinical development program are limited to that specific program. The FDA has advised ViroPharma to amend the study protocol, allowing for increased laboratory sampling to monitor anti-rHuPH20 antibody levels, and keep the FDA informed of elevated antibody levels during the treatment phase of the study. ViroPharma announced that it plans to initiate a larger Phase 2 clinical trial with the combination of Cinryze and rHuPH20 shortly.

### ***Intrexon Collaboration***

Effective June 6, 2011, we and Intrexon entered into a license and collaborative agreement under which Intrexon obtained a worldwide exclusive license for the use of rHuPH20 enzyme in the development of a subcutaneous injectable formulation of Intrexon's recombinant human alpha 1-antitrypsin (rHuA1AT) (the Intrexon Collaboration). In addition, the license provides Intrexon with exclusivity for a defined indication (Exclusive Field). Intrexon is solely responsible for the development, manufacturing, regulatory approval and marketing of any products resulting from this collaboration. We are entitled to receive payments for research and development services and supply of rHuPH20 API if requested by Intrexon. We are also entitled to receive milestone payments and royalties on product sales.

### ***Hylenex Recombinant***

*Hylenex* recombinant is a formulation of rHuPH20 that has received FDA approval to facilitate subcutaneous fluid administration for achieving hydration, to increase the dispersion and absorption of other injected drugs and, in subcutaneous urography, to improve resorption of radiopaque agents.

### **Revenues**

We generate revenues from product sales and collaborative agreements. Revenue from product sales depends on our ability to develop, manufacture, obtain regulatory approvals for and successfully commercialize our products and product candidates. Payments received under collaborative agreements may include nonrefundable payments at the inception of the arrangement, license fees, exclusivity fees, payments based on achievement of specified milestones designated in the collaborative agreements, reimbursements of research and development services, payments for the manufacture of bulk formulation of rHuPH20 for collaborators and/or royalties, as applicable, on sales of products resulting from collaborative agreements. We analyze each element of our collaborative agreements and consider a variety of factors in determining the appropriate method of revenue recognition. See *Critical Accounting Policies and Estimates Revenue Recognition Revenues Under Collaborative Agreements* below for our revenue recognition policies for payments received under collaborative agreements.

**Table of Contents****Costs and Expenses**

*Cost of Product Sales.* Cost of product sales consists primarily of raw materials, third-party manufacturing costs, fill and finish costs, freight costs, internal costs and manufacturing overhead costs associated with the production of our products. Cost of product sales also consists of the write-down of excess, dated and obsolete inventories.

*Research and Development.* Research and development expenses include salaries and benefits, research related manufacturing services, clinical trials, contract research services, supplies and materials, facilities and other overhead costs and other outside expenses. Research and development expenses are charged to operations as incurred when these expenditures relate to our research and development efforts and have no alternative future uses. Our research and development activities are primarily focused on the development of our various product candidates.

Since our inception in 1998 through September 30, 2012, we have incurred research and development expenses of \$310.6 million. From January 1, 2009 through September 30, 2012, approximately 25% and 16% of our research and development expenses were associated with the development of our ultrafast insulin and PEGPH20 product candidates, respectively. Research and development expenses incurred for the nine months ended September 30, 2012 and 2011 were as follows:

Programs	Nine Months Ended September 30,	
	2012	2011
Product Candidates:		
PEGPH20	\$ 9,085,429	\$ 5,833,649
HYLENEX	8,402,986	2,638,597
Ultrafast Insulin	3,886,571	14,926,849
HTI-501	1,582,740	3,368,582
Enhance partnerships	17,466,229	5,054,061
rHuPH20 platform (1)	6,676,730	8,917,103
Other	4,375,644	1,908,424
<b>Total research and development expenses</b>	<b>\$ 51,476,329</b>	<b>\$ 42,647,265</b>

(1) Includes research, development and manufacturing expenses related to our proprietary recombinant human PH20 enzyme, rHuPH20.

These expenses were not designated to a specific program at the time the expenses were incurred.

Due to the uncertainty in obtaining FDA and other regulatory approvals, our reliance on third parties and competitive pressures, we are unable to estimate with any certainty the additional costs we will incur in the continued development of our proprietary product candidates for commercialization. However, we expect our research and development expenses to increase as our product candidates advance into later stages of clinical development.

Clinical development timelines, likelihood of success and total costs vary widely. We anticipate that we will make ongoing determinations as to which research and development projects to pursue and how much funding to direct to each project on an ongoing basis in response to existing resource levels, the scientific and clinical progress of each product candidate, and other market and regulatory developments. We plan on focusing our resources on those proprietary and collaboration product candidates that represent the most valuable economic and strategic opportunities.



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Product candidate completion dates and costs vary significantly for each product candidate and are difficult to estimate. The lengthy process of seeking regulatory approvals and the subsequent compliance with applicable regulations require the expenditure of substantial resources. Any failure by us to obtain, or any delay in obtaining, regulatory approvals could cause our research and development expenditures to increase and, in turn, have a material adverse effect on our results of operations. We cannot be certain when, or if, our product candidates will receive regulatory approval or whether any net cash inflow from our other product candidates, or development projects, will commence.

*Selling, General and Administrative (SG&A).* Through the second quarter of 2011, our selling expenses, which include sales and marketing costs, primarily consisted of compensation, consulting fees and costs of market research studies related to our product and product candidates. In the third and fourth quarters of 2011, we expanded our commercial infrastructure, including hiring of sales and marketing management and sales representatives. In addition, we began incurring costs related to advertising, marketing and logistics services for *Hylenex* recombinant in connection with the reintroduction of *Hylenex* recombinant in December 2011.

Our general and administrative expenses consist primarily of compensation and other expenses related to our corporate operations and administrative employees, accounting and legal fees, other professional services expenses, as well as other expenses associated with operating as a publicly traded company.

## **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial position and results of operations are based on our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP). The preparation of our consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. We review our estimates on an ongoing basis. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions. We believe the following accounting policies to be critical to the judgments and estimates used in the preparation of our consolidated financial statements.

### ***Revenue Recognition***

We generate revenues from product sales and collaborative agreements. Payments received under collaborative agreements may include nonrefundable fees at the inception of the agreements, license fees, milestone payments for specific achievements designated in the collaborative agreements, reimbursements of research and development services and/or royalties on sales of products resulting from collaborative arrangements.

We recognize revenue in accordance with the authoritative guidance on revenue recognition. Revenue is recognized when all of the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the seller's price to the buyer is fixed or determinable; and (4) collectibility is reasonably assured.

### ***Product Sales***

In December 2011, we reintroduced *Hylenex* recombinant to the market, shipped initial orders to our wholesaler customers and began promoting *Hylenex* recombinant through our sales force. We sell *Hylenex* recombinant in the United States to wholesale pharmaceutical distributors, who sell the product to hospitals and other end-user customers. The wholesale distributors take title to the product, bear the risk of loss of ownership and have economic substance to the inventory. Further, we have no significant obligations for future performance to generate pull-through sales; however, we allow the wholesale distributors to return product that is damaged or received in error. In addition, we allow for product to be returned beginning six months prior to and ending twelve months following product expiration.

Given our limited history of selling *Hylenex* recombinant and the lengthy return period, we currently cannot reliably estimate expected returns and chargebacks of *Hylenex* recombinant at the time the product is received by the wholesale distributors. Therefore, we do not recognize revenue upon delivery of *Hylenex*.

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recombinant to the wholesale distributor until the point at which we can reliably estimate expected product returns and chargebacks from the wholesale distributors. Shipments of *Hylenex* recombinant are recorded as deferred revenue until evidence exists to confirm that pull-through sales to the hospitals or other end-user customers have occurred. We recognize revenue when the product is sold through from the distributors to the distributors' customers. In addition, the costs of manufacturing *Hylenex* recombinant associated with the deferred revenue are recorded as deferred costs, which are included in inventory, until such time as the related deferred revenue is recognized. We estimate sell-through revenue and certain gross to net sales adjustments based on analysis of third-party information including information obtained from certain distributors with respect to their inventory levels and sell-through to the distributors' customers. At the time we can reliably estimate product returns and chargebacks from the wholesale distributors, we will record a one-time increase in net product sales revenue related to the recognition of product sales revenue previously deferred.

We recognize product sales allowances as a reduction of product sales in the same period the related revenue is recognized. Product sales allowances are based on amounts owed or to be claimed on the related sales. These estimates take into consideration the terms of our agreements with wholesaler customers, hospitals and the levels of inventory within the distribution channels that may result in future discounts taken. We must make significant judgments in determining these allowances. If actual results differ from our estimates, we will be required to make an adjustment to these allowances in the future, which could have an effect on product sales revenue in the period of adjustment. Our product sales allowances include:

*Distribution Fees.* The distribution fees, based on contractually determined rates, arise from contractual agreements we have with certain wholesale distributors for distribution services they provide with respect to *Hylenex* recombinant. At the time the sale is made to the respective wholesale distributors, we record an allowance for distribution fees by reducing our accounts receivable and deferred revenue associated with such product sales.

*Prompt Payment Discounts.* We offer cash discounts to certain wholesale distributors as an incentive to meet certain payment terms. We expect our customers to take advantage of this discount. Therefore, at the time the sale is made to the respective wholesale distributors, we accrue the entire prompt payment discount, based on the gross amount of the invoice by reducing our accounts receivable and deferred revenue associated with such product sales.

*Chargebacks.* We provide discounts to end-user members of certain group purchasing organizations ( GPO ) under collective purchasing contracts between us and the GPOs. We also provide discounts to certain hospitals who are members of the GPOs with which we do not have contracts. The end-user members purchase products from the wholesale distributors at a contracted discounted price, and the wholesale distributors then charge back to us the difference between the current retail price and the price the end users paid for the product. Given our lack of historical sales data, we recognize chargebacks in the same period the related product sales revenue is recognized and reduce our accounts receivable accordingly. The GPO fee we incur for these transactions is also recorded in the same period the related product sales revenue is recognized and is included in accrued expenses.

*Product Returns.* The product returns reserve is based on management's best estimate of the product sales recognized as revenue during the period that are anticipated to be returned. The product returns reserve is recorded as a reduction of product sales revenue in the same period the related product sales revenue is recognized and is included in accrued expenses.

### ***Revenues under Collaborative Agreements***

We have entered into license and collaboration agreements under which the collaborators obtained worldwide exclusive rights for the use of our proprietary rHuPH20 enzyme in the development and commercialization of the collaborators' biologic compounds. The collaborative agreements contain multiple elements including nonrefundable payments at the inception of the arrangements, license fees, exclusivity fees, payments based on achievement of specified milestones designated in the collaborative agreements, reimbursements of research and development services, payments for supply of rHuPH20 API for the collaborator and/or royalties on sales of products resulting from collaborative agreements. We analyze each element of the collaborative agreements and consider a variety of factors in determining the appropriate method of revenue recognition of each element.

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Prior to the adoption of ASU No. 2009-13, *Multiple-Deliverable Revenue Arrangements*, on January 1, 2011, in order for a delivered item to be accounted for separately from other deliverables in a multiple-element arrangement, the following three criteria had to be met: (i) the delivered item had standalone value to the customer, (ii) there was objective and reliable evidence of fair value of the undelivered items, and (iii) if the arrangement included a general right of return relative to the delivered item, delivery or performance of the undelivered items was considered probable and substantially in the control of the vendor. For the collaborative agreements entered into prior to January 1, 2011, there was no objective and reliable evidence of fair value of the undelivered items. Thus, the delivered licenses did not meet all of the required criteria to be accounted for separately from undelivered items. Therefore, we recognized revenue on nonrefundable upfront payments and license fees from these collaborative agreements over the period of significant involvement under the related agreements.

For new collaborative agreements or material modifications of existing collaborative agreements entered into after December 31, 2010, we follow the provisions of ASU No. 2009-13. In order to account for the multiple-element arrangements, we identify the deliverables included within the agreement and evaluate which deliverables represent units of accounting. Analyzing the arrangement to identify deliverables requires the use of judgment, and each deliverable may be an obligation to deliver services, a right or license to use an asset, or another performance obligation. The deliverables under our collaborative agreements include (i) the license to rHuPH20 technology, (ii) at the collaborator's request, research and development services which are reimbursed at contractually determined rates, and (iii) at the collaborator's request, supply of rHuPH20 API which is reimbursed at our cost plus a margin. A delivered item is considered a separate unit of accounting when the delivered item has value to the collaborator on a standalone basis based on the consideration of the relevant facts and circumstances for each arrangement. Factors considered in this determination include the research capabilities of the collaborator and the availability of research expertise in this field in the general marketplace.

Arrangement consideration is allocated at the inception of the agreement to all identified units of accounting based on their relative selling price. The relative selling price for each deliverable is determined using vendor specific objective evidence (VSOE) of selling price or third-party evidence of selling price if VSOE does not exist. If neither VSOE nor third-party evidence of selling price exists, we use our best estimate of the selling price for the deliverable. The amount of allocable arrangement consideration is limited to amounts that are fixed or determinable. The consideration received is allocated among the separate units of accounting, and the applicable revenue recognition criteria are applied to each of the separate units. Changes in the allocation of the sales price between delivered and undelivered elements can impact revenue recognition but do not change the total revenue recognized under any agreement.

Nonrefundable upfront license fee payments are recognized upon delivery of the license if facts and circumstances dictate that the license has standalone value from the undelivered items, which generally include research and development services and the manufacture of rHuPH20 API, the relative selling price allocation of the license is equal to or exceeds the upfront license fee, persuasive evidence of an arrangement exists, our price to the collaborator is fixed or determinable and collectability is reasonably assured. Upfront license fee payments are deferred if facts and circumstances dictate that the license does not have standalone value. The determination of the length of the period over which to defer revenue is subject to judgment and estimation and can have an impact on the amount of revenue recognized in a given period.

The terms of our collaborative agreements provide for milestone payments upon achievement of certain development and regulatory events and/or specified sales volumes of commercialized products by the collaborator.

Effective January 1, 2011, we adopted on a prospective basis the Milestone Method. Under the Milestone Method, we recognize consideration that is contingent upon the achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved only if the milestone is substantive in its entirety. A milestone is considered substantive when it meets all of the following criteria:

1. The consideration is commensurate with either the entity's performance to achieve the milestone or the enhancement of the value of the delivered item(s) as a result of a specific outcome resulting from the entity's performance to achieve the milestone,
2. The consideration relates solely to past performance, and
3. The consideration is reasonable relative to all of the deliverables and payment terms within the arrangement.

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A milestone is defined as an event (i) that can only be achieved based in whole or in part on either the entity's performance or on the occurrence of a specific outcome resulting from the vendor's performance, (ii) for which there is substantive uncertainty at the date the arrangement is entered into that the event will be achieved, and (iii) that would result in additional payments being due to the vendor.

Reimbursements of research and development services are recognized as revenue during the period in which the services are performed as long as there is persuasive evidence of an arrangement, the fee is fixed or determinable and collection of the related receivable is probable. Revenue from the manufacture of rHuPH20 API is recognized when the API has met all specifications required for the collaborator's acceptance and title and risk of loss have transferred to the collaborator. We do not directly control when any collaborator will request research and development services or supply of rHuPH20 API; therefore, we cannot predict when we will recognize revenues in connection with research and development services and supply of rHuPH20 API. Royalties to be received based on sales of licensed products by our collaborators incorporating rHuPH20 will be recognized as earned.

The collaborative agreements typically provide the collaborators the right to terminate such agreements in whole or on a product-by-product or target-by-target basis at any time upon 90 days prior written notice to us. There are no performance, cancellation, termination or refund provisions in any of our collaborative agreements that contain material financial consequences to us.

### *Roche Collaboration*

In December 2006, we and Roche entered into the Roche Collaboration under which Roche obtained a worldwide, exclusive license to develop and commercialize product combinations of rHuPH20 with up to thirteen Roche target compounds. As of September 30, 2012, we have received \$57 million from Roche, including the \$20 million upfront license fee payment for the application of rHuPH20 to the initial three Roche exclusive targets, \$20 million in connection with Roche's election of two additional exclusive targets and annual license maintenance fees for the right to designate the remaining targets as exclusive targets, \$13 million in clinical development milestone payments and a \$4 million regulatory milestone payment. If Roche successfully develops all five exclusive targets and achieves pre-agreed sales targets, we could receive additional milestone payments of up to \$178 million, including up to \$17 million for the achievement of clinical development milestones, up to \$16 million for the achievement of regulatory milestones and up to \$145 million for the achievement of sales-based milestones. Under the terms of the Roche Collaboration, Roche will also pay us a royalty on each product commercialized under the agreement consisting of a mid-single digit percent of the net sales of such product. Unless terminated earlier in accordance with its terms, the Roche Collaboration continues in effect until the expiration of Roche's obligation to pay royalties. Roche has the obligation to pay royalties with respect to each product in each country, during the period equal to the longer of: (a) the duration of any valid claim of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers the product in such country or (b) ten years following the date of the first commercial sale of such product in such country.

Roche currently retains the option to develop and commercialize rHuPH20 with three additional targets under the Roche Collaboration, provided that it continues to pay annual maintenance fees to us. For products developed for each of the additional targets, Roche may pay us upfront and milestone payments of up to \$47 million per target, as well as royalties on product sales, for each of the additional targets consisting of a mid-single digit percent of the net sales of such products.

Due to our continuing involvement obligations (for example, support activities associated with rHuPH20), revenues from the upfront payment, exclusive designation fees and annual license maintenance fees were deferred and are being recognized over the term of the Roche Collaboration. We have determined that the clinical and regulatory milestones are substantive; therefore, we expect to recognize such clinical and regulatory milestone payments as revenue upon achievement. In addition, we have determined that the sales-based milestone payments are similar to royalty payments and are not considered milestone payments under the Milestone Method of revenue recognition; therefore, we will recognize such sales-based milestone payments as revenue upon achievement of the milestone. For the three months ended September 30, 2012 and 2011, we recognized no milestone payments as revenues under collaborative agreements in accordance with the Milestone Method. For the nine months ended September 30, 2012 and 2011, we recognized \$4 million and \$5 million, respectively, as revenues under collaborative agreements in accordance with the Milestone Method related to the achievement of certain clinical and regulatory milestones pursuant to the terms of the Roche Collaboration.

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### *Gammagard Collaboration*

In September 2007, we and Baxter entered into the Gammagard Collaboration under which Baxter obtained a worldwide, exclusive license to develop and commercialize HyQ. As of September 30, 2012, we have received \$13 million under the Gammagard Collaboration, including the \$10 million upfront license fee payment and a \$3 million regulatory milestone payment. If Baxter successfully receives marketing approval for the licensed product candidate and achieves pre-agreed sales targets, we could receive additional milestone payments of up to \$34 million for the achievement of sales-based milestones. In addition, Baxter will pay us a royalty on each product commercialized under the agreement consisting of a mid-single digit percent of the net sales of such product. The Gammagard Collaboration is applicable to both kit and formulation combinations. Baxter assumes all development, manufacturing, clinical, regulatory, sales and marketing costs under the Gammagard Collaboration, while we are responsible for the supply of the rHuPH20 enzyme. We perform research and development activities at the request of Baxter, which are reimbursed by Baxter under the terms of the Gammagard Collaboration. In addition, Baxter has certain product development and commercialization obligations in major markets identified in the Gammagard Collaboration. Unless terminated earlier in accordance with its terms, the Gammagard Collaboration continues in effect until the expiration of Baxter's obligation to pay royalties. Baxter has the obligation to pay royalties, with respect to each product in each country, during the period equal to the longer of: (a) the duration of any valid claim of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers the product in such country or (b) ten years following the date of the first commercial sale of such product in such country.

Due to our continuing involvement obligations (for example, support activities associated with rHuPH20), revenue from the upfront payment was deferred and are being recognized over the term of the Gammagard Collaboration. We have determined that sales-based milestone payments are similar to royalty payments and are not considered milestone payments under the Milestone Method of revenue recognition; therefore, such payments will be recognized as revenue upon achievement of the milestone. For the three and nine months ended September 30, 2012, we recognized no milestone payments as revenue in accordance with the Milestone Method of revenue recognition. For the three and nine months ended September 30, 2011, we recognized zero and \$3 million, respectively, as revenues under collaborative agreements in accordance with the Milestone Method of revenue recognition upon achievement of certain regulatory milestone under the terms of the Gammagard Collaboration.

### *ViroPharma and Intrexon Collaborations*

Effective May 2011, we and ViroPharma entered into the ViroPharma Collaboration. As of September 30, 2012, we have received \$13 million from ViroPharma, including the \$9 million nonrefundable upfront license fee payment, a \$3 million clinical development milestone payment and a \$1 million annual exclusivity payment. If ViroPharma successfully develops the licensed product candidate, we could receive additional milestone payments of up to \$41 million for the achievement of development and regulatory milestones. In addition, so long as the agreement is in effect, we are entitled to receive an annual exclusivity fee of \$1 million which commenced May 2012 and on each anniversary of the effective date of the agreement thereafter until a certain development event occurs. We are entitled to receive payments for research and development services and supply of rHuPH20 API if requested by ViroPharma. In addition, we are entitled to receive additional cash payments potentially totaling \$10 million upon achievement of certain development and regulatory milestones for each product targeting the treatment of any of the three additional orphan indications. We are also entitled to receive a royalty on each product commercialized under the agreement consisting of ten percent of the net sales of such product. Unless terminated earlier in accordance with its terms, the ViroPharma Collaboration continues in effect until the later of (i) expiration of the last to expire of the valid claims of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers a product developed under the collaboration, and (ii) expiration of the last to expire royalty term for a product developed under the collaboration. The royalty term of a product developed under the ViroPharma Collaboration, with respect to each country, consists of the period equal to the longer of: (a) the duration of any valid claim of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers the product in such country or (b) ten years following the date of the first commercial sale of such product in such country.

Effective June 2011, we and Intrexon entered into the Intrexon Collaboration. As of September 30, 2012, we have received a nonrefundable upfront license fee payment of \$9 million and an annual exclusivity fee of \$1 million from Intrexon. If Intrexon successfully develops the licensed product candidate and achieves the pre-agreed

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sales target, we could receive additional milestone payments of up to \$54 million, including \$44 million for the achievement of development and regulatory milestones and \$10 million for the achievement of a sales-based milestone. In addition, so long as the agreement is in effect, we are entitled to receive an annual exclusivity fee of \$1 million which commenced in June 2012 and on each anniversary of the effective date of the agreement thereafter until a certain development event occurs. We are entitled to receive payments for research and development services and supply of rHuPH20 API if requested by Intrexon. In addition, we are entitled to receive additional cash payments potentially totaling \$10 million for each product for use outside the Exclusive Field upon achievement of development and regulatory milestones. We are also entitled to receive a royalty on each product commercialized under the agreement consisting of a percentage of the net sales of such product ranging from mid-single digits up to low double-digit percent. Unless terminated earlier in accordance with its terms, the Intrexon Collaboration continues in effect until the later of (i) expiration of the last to expire of the valid claims of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers a product developed under the collaboration, and (ii) expiration of the last to expire royalty term for a product developed under the collaboration. The royalty term of a product developed under the Intrexon Collaboration, with respect to each country, consists of the period equal to the longer of: (a) the duration of any valid claim of our patents covering rHuPH20 or other specified patents developed under the collaboration which valid claim covers the product in such country or (b) ten years following the date of the first commercial sale of such product in such country.

We identified the deliverables at the inception of the ViroPharma and Intrexon Collaborations which are the license, research and development services and API supply. We have determined that the license, research and development services and API supply individually represent separate units of accounting, because each deliverable has standalone value. The estimated selling prices for these units of accounting were determined based on market conditions, the terms of comparable collaborative arrangements for similar technology in the pharmaceutical and biotech industry and entity-specific factors such as the terms of our previous collaborative agreements, our pricing practices and pricing objectives and the nature of the research and development services to be performed for the collaborators. The arrangement consideration was allocated to the deliverables based on the relative selling price method.

The amount allocable to the delivered unit or units of accounting is limited to the amount that is not contingent upon the delivery of additional items or meeting other specified performance conditions (the noncontingent amount). As such, we excluded from the allocable arrangement consideration the milestone payments, annual exclusivity fees and royalties regardless of the probability of receipt. Based on the results of our analysis, we allocated the \$9 million upfront license fee received from ViroPharma to the license fee deliverable under the ViroPharma arrangement and the \$9 million upfront fee received from Intrexon to the license fee deliverable under the Intrexon arrangement. We determined that the upfront payment was earned upon the granting of the worldwide exclusive right to our technology to the collaborator in both the ViroPharma Collaboration and Intrexon Collaboration. As a result, we recognized the \$9 million upfront license fee received under the ViroPharma Collaboration and \$9 million upfront license fee received under the Intrexon Collaboration as revenues under collaborative agreements upon the receipt of such upfront license fees.

We recognize the annual exclusivity fees as revenues under collaborative agreements when they are due and payable on each anniversary of the effective date and such amounts are included in the allocable arrangement consideration and recognized based on the relative selling price allocation. We recognize amounts allocated to research and development services as revenues under collaborative agreements as the related services are performed. We recognize amounts allocated to the sales of API as revenues under collaborative agreements when such API has met all required specifications by the collaborators and the related title and risk of loss and damages have passed to the collaborators. We cannot predict the timing of delivery of research and development services and API as they are at the collaborators' requests.

We are eligible to receive additional cash payments upon the achievement by the collaborators of specified development, regulatory and sales-based milestones. We have determined that each of the development and regulatory milestones is substantive; therefore, we expect to recognize such development and regulatory milestone payments as revenues under collaborative agreements upon achievement in accordance with the Milestone Method. In addition, we have determined that the sales-based milestone payment is similar to a royalty payment and is not considered a milestone payment under the Milestone Method of revenue recognition; therefore, we will recognize the sales-based milestone payment as revenue upon achievement of the milestone because we have no future performance obligations associated with the milestone.

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For the three and nine months ended September 30, 2011, we recognized a \$3 million milestone payment as revenues under collaborative agreements in accordance with the Milestone Method related to the achievement of a development milestone pursuant to the terms of the ViroPharma Collaboration. There were no milestone payments recognized as revenues under collaborative agreements associated with the ViroPharma Collaboration for the three and nine months ended September 30, 2012. There were no milestone payments recognized as revenues under collaborative agreements associated with the Intrexon Collaboration for the three and nine months ended September 30, 2012 and 2011. We recognized the annual exclusivity fee of zero and \$1 million as revenues under collaborative agreements associated with each of the ViroPharma and Intrexon Collaborations for the three and nine months ended September 30, 2012, respectively.

### ***Share-Based Payments***

We use the fair value method to account for share-based payments in accordance with the authoritative guidance for share-based compensation. The fair value of each option award is estimated on the date of grant using a Black-Scholes-Merton option pricing model (Black-Scholes model), that uses assumptions regarding a number of complex and subjective variables. These variables include, but are not limited to, our expected stock price volatility, actual and projected employee stock option exercise behaviors, risk-free interest rates and expected dividends. Expected volatilities are based on the historical volatility of our common stock. The expected term of options granted is based on analyses of historical employee termination rates and option exercises. The risk-free interest rates are based on the U.S. Treasury yields in effect at the time of the grant. Since we do not expect to pay dividends on our common stock in the foreseeable future, we estimated the dividend yield to be 0%. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We estimate pre-vesting forfeitures based on our historical experience.

If factors change and we employ different assumptions for determination of fair value in future periods, the share-based compensation expense that we record may differ significantly from what we have recorded in the current period. There is a high degree of subjectivity involved when using option pricing models to estimate share-based compensation. Certain share-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our consolidated financial statements. Alternatively, values may be realized from these instruments that are significantly in excess of the fair values originally estimated on the grant date and reported in our consolidated financial statements. There is currently no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values. Although the fair value of employee share-based awards is determined in accordance with authoritative guidance on share-based payments using an option-pricing model, such value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

### ***Research and Development Expenses***

Research and development expenses include salaries and benefits, facilities and other overhead expenses, clinical trial expenses, research related manufacturing services, contract services and other outside expenses. Research and development expenses are charged to operations as incurred when these expenditures relate to our research and development efforts and have no alternative future uses.

Advance payments, including nonrefundable amounts, for goods or services that will be used or rendered for future research and development activities are deferred and capitalized. Such amounts will be recognized as an expense as the related goods are delivered or the related services are performed or at such time when we do not expect the goods to be delivered or services to be performed.

Milestone payments that we make in connection with in-licensed technology or product candidates are expensed as incurred when there is uncertainty in receiving future economic benefits from the licensed technology or product candidates. We consider the future economic benefits from the licensed technology or product candidates to be uncertain until such licensed technology or product candidates are approved for marketing by regulatory bodies such as the FDA or when other significant risk factors are abated. Management has viewed future economic benefits for all of our licensed technology or product candidates to be uncertain and has expensed these amounts as incurred.

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Payments made in connection with our clinical trials are often made under contracts with multiple contract research organizations that conduct and manage clinical trials on our behalf. The financial terms of these agreements are subject to negotiation and vary from contract to contract and may result in uneven payment flows. Generally, these agreements set forth the scope of work to be performed at a fixed fee, unit price or on a time-and-material basis. Payments under these contracts depend on factors such as the successful enrollment or treatment of patients or the completion of other clinical trial milestones. Expenses related to clinical trials are accrued based on our estimates and/or representations from service providers regarding work performed, including actual level of patient enrollment, completion of patient studies and progress of clinical trials. Other incidental costs related to patient enrollment or treatment are accrued when reasonably certain. If the contracted amounts are modified (for instance, as a result of changes in the clinical trial protocol or scope of work to be performed), we modify our accruals accordingly on a prospective basis. Revisions in scope of contract are charged to expense in the period in which the facts that give rise to the revision become reasonably certain. Because of the uncertainty of possible future changes to the scope of work in clinical trial contracts, we are unable to quantify an estimate of the reasonably likely effect of any such changes on our consolidated results of operations or financial position. Historically, we have had no material changes in our clinical trial expense accruals that would have had a material impact on our consolidated results of operations or financial position.

## ***Inventories***

Inventories are stated at lower of cost or market. Cost is determined on a first-in, first-out basis. Inventories are reviewed periodically for potential excess, dated or obsolete status. Management evaluates the carrying value of inventories on a regular basis, taking into account such factors as historical and anticipated future sales compared to quantities on hand, the price it expects to obtain for products in their respective markets compared with historical cost and the remaining shelf life of goods on hand.

Raw materials inventories consist of raw materials used in the manufacture of our bulk drug material for *Hylenex* recombinant product. Work-in-process inventories consist of in-process *Hylenex* recombinant. Finished goods inventories consist of finished *Hylenex* recombinant product.

We expense costs relating to the purchase and production of pre-approval inventories for which the sole use is pre-approval products as research and development expense in the period incurred until such time as we believe future commercialization is probable and future economic benefit is expected to be realized. For products that have been approved by regulatory bodies such as the FDA, inventories used in clinical trials are expensed at the time the inventories are packaged for the clinical trials. Prior to receiving approval from the FDA or comparable regulatory agencies in foreign countries, costs related to purchases of the API and the manufacturing of the product candidate are recorded as research and development expense. All direct manufacturing costs incurred after approval are capitalized as inventory.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by U.S. GAAP. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. Please see our audited consolidated financial statements and notes thereto included in Part II, Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2011, which contain accounting policies and other disclosures required by U.S. GAAP.

## **Results of Operations**

### ***Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011***

*Product Sales, Net* Product sales, net were \$715,000 for the three months ended September 30, 2012 compared to \$1.2 million for the three months ended September 30, 2011. The decrease of \$442,000 in product sales, net was primarily due to the recognition of approximately \$991,000 of deferred revenue in the three months ended September 30, 2011 associated with the termination of the collaboration with Baxter for the marketing rights of *Hylenex* recombinant (the *Hylenex* Collaboration). The decrease was partially offset by the increase in product sales of *Hylenex* recombinant in the current period. Based on the reintroduction of *Hylenex* recombinant in December 2011, we expect product sales to increase in 2012 as compared to 2011.



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**Revenues Under Collaborative Agreements** Revenues under collaborative agreements were \$4.6 million for the three months ended September 30, 2012 compared to \$21.8 million for the three months ended September 30, 2011. Revenues under collaborative agreements consisted of recognition of license fees and milestone payments received from our collaborators of approximately \$624,000 and \$20.5 million for the three months ended September 30, 2012 and 2011, respectively. The decrease in revenues from license fees and milestone payments of \$19.9 million was mainly due to the recognition in the prior period of approximately \$16.9 million of the deferred upfront license fee and deferred product-based payments associated with the termination of the Hylenex Collaboration.

Revenues under collaborative agreements also included reimbursements for research and development services from our collaborators of approximately \$4.0 million and \$1.3 million for the three months ended September 30, 2012 and 2011, respectively. The increase of \$2.7 million in reimbursements for research and development services was primarily due to an increase in the manufacturing activities to support potential launches of our collaboration product candidates by Roche. Research and development services rendered by us on behalf of our collaborators are at the request of the collaborators; therefore, the amount of future revenues related to reimbursable research and development services is uncertain. We expect the non-reimbursement revenues under our collaborative agreements to continue to fluctuate in future periods based on our collaborators' abilities to meet various clinical and regulatory milestones set forth in such agreements and our abilities to obtain new collaborative agreements.

**Cost of Product Sales** Cost of product sales were \$227,000 for the three months ended September 30, 2012 compared to \$12,000 for the three months ended September 30, 2011. The increase of \$215,000 in cost of product sales was due to the increased product sales of *Hylenex* recombinant. Based on the reintroduction of *Hylenex* recombinant in December 2011, we expect cost of product sales to increase in 2012 as compared to 2011.

**Research and Development** Research and development expenses were \$19.5 million for the three months ended September 30, 2012 compared to \$13.5 million for the three months ended September 30, 2011. The increase of \$6.0 million, or 44%, was primarily due to an increase in manufacturing activities to support potential launches of our collaboration product candidates by the collaborators. We expect research and development costs to increase in 2012 as compared to 2011 based on increased manufacturing and other research and development activities.

**Selling, General and Administrative** SG&A expenses were \$5.6 million for the three months ended September 30, 2012 compared to \$4.3 million for the three months ended September 30, 2011. The increase of \$1.3 million, or 30%, was primarily due to an increase of \$831,000 in compensation costs, including a \$141,000 increase in stock-based compensation, primarily due to the increased headcount resulting from the expansion of our commercial department. In connection with the reintroduction of *Hylenex* recombinant in December 2011, we expect SG&A expenses to increase in 2012 as compared to 2011.

**Net Income (Loss)** Net loss for the three months ended September 30, 2012 was \$(20.0) million, or \$(0.18) per common share, compared to net income of \$5.2 million, or \$0.05 per common share, for the three months ended September 30, 2011. The increase in net loss was primarily due to the decrease in revenues under collaborative agreements resulting from the recognition of the deferred upfront license fee, deferred product based payments and deferred product sales in connection with the termination of the Hylenex Collaboration totaling \$17.9 million in the prior period and an increase in operating expenses for the three months ended September 30, 2012 as compared to the same period in 2011.

### ***Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011***

**Product Sales, Net** Product sales, net were \$1.4 million for the nine months ended September 30, 2012 compared to \$1.5 million for the nine months ended September 30, 2011. The decrease of \$60,000 in product sales, net was primarily due to the recognition of approximately \$991,000 of deferred revenue in the three months ended September 30, 2011 associated with the termination of the Hylenex Collaboration. The decrease was partially offset by the increase in product sales of *Hylenex* recombinant in the current period. Based on the reintroduction of *Hylenex* recombinant in December 2011, we expect product sales to increase in 2012 as compared to 2011.

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**Revenues Under Collaborative Agreements** Revenues under collaborative agreements were \$19.1 million for the nine months ended September 30, 2012 compared to \$52.2 million for the nine months ended September 30, 2011. Revenues under collaborative agreements consisted of the recognition of license fees and milestone payments received from our collaborators of approximately \$8.3 million and \$48.0 million for the nine months ended September 30, 2012 and 2011, respectively. The decrease in revenues from license fees and milestone payments of \$39.7 million was primarily due to the recognition in the prior period of \$18.0 million in one-time upfront payments we received from the ViroPharma and Intrexon Collaborations and approximately \$17.1 million of the deferred upfront license fee and deferred product-based payments associated with the termination of the Hylenex Collaboration. The decrease was also due to a \$5.0 million decrease in milestone payments recognized from our collaborators.

Revenues under collaborative agreements also included reimbursements for research and development services from our collaborators of approximately \$10.8 million and \$4.2 million for the nine months ended September 30, 2012 and 2011, respectively. The increase of \$6.6 million in reimbursements for research and development services was primarily due to an increase in manufacturing activities to support potential launches of our collaboration product candidates by Baxter and Roche. Research and development services rendered by us on behalf of our collaborators are at the request of the collaborators; therefore, the amount of future revenues related to reimbursable research and development services is uncertain. We expect the non-reimbursement revenues under our collaborative agreements to continue to fluctuate in future periods based on our collaborators' abilities to meet various clinical and regulatory milestones set forth in such agreements and our abilities to obtain new collaborative agreements.

**Cost of Product Sales** Cost of product sales were \$441,000 for the nine months ended September 30, 2012 compared to \$202,000 for the nine months ended September 30, 2011. The increase of \$239,000 was mainly due to the increased product sales of *Hylenex* recombinant. The increase was partially offset by the \$166,000 write-off of obsolete API inventory for *Hylenex* recombinant in the prior period. Based on the reintroduction of *Hylenex* recombinant in December 2011, we expect cost of product sales to increase in 2012 as compared to 2011.

**Research and Development** Research and development expenses were \$51.5 million for the nine months ended September 30, 2012 compared to \$42.6 million for the nine months ended September 30, 2011. The increase of \$8.9 million, or 21%, was primarily due to an increase in manufacturing activities to support potential launches of our collaboration product candidates by the collaborators. We expect research and development costs to increase in 2012 as compared to 2011 based on increased manufacturing activities and other research and development activities.

**Selling, General and Administrative** SG&A expenses were \$17.8 million for the nine months ended September 30, 2012 compared to \$12.2 million for the nine months ended September 30, 2011. The increase of \$5.6 million, or 46%, was primarily due to a \$4.1 million increase in compensation costs, including a \$1.1 million increase in stock-based compensation, and a \$1.0 million increase in sales and marketing expenses mainly associated with the reintroduction of *Hylenex* recombinant in December 2011. The increase in compensation costs was due to an increase in headcount resulting from the expansion of our commercial department. In connection with the reintroduction of *Hylenex* recombinant in December 2011, we expect SG&A expenses to increase in 2012 as compared to 2011.

**Net Loss** Net loss for the nine months ended September 30, 2012 was \$49.1 million, or \$0.44 per common share, compared to \$1.4 million, or \$0.01 per common share for the nine months ended September 30, 2011. The increase in net loss was primarily due to the decrease in revenues under collaborative agreements resulting from the recognition in the prior period of \$18.0 million in one-time upfront payments associated with the ViroPharma and Intrexon Collaborations and \$17.9 million of the deferred upfront license fee, deferred product-based payments and deferred product sales in connection with the termination of the Hylenex Collaboration. The increase in net loss was also due to an increase in operating expenses for the nine months ended September 30, 2012 as compared to the same period in 2011.

## **Liquidity and Capital Resources**

### ***Overview***

Our principal sources of liquidity are our existing cash and cash equivalents. As of September 30, 2012, we had cash and cash equivalents of approximately \$87.6 million. We will continue to have significant cash

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requirements to support product development activities. The amount and timing of cash requirements will depend on the success of our clinical development programs, regulatory and market acceptance, and the resources we devote to research and other commercialization activities.

We believe that our current cash and cash equivalents will be sufficient to fund our operations for at least the next twelve months. Currently, we anticipate total net cash burn of approximately \$60 to \$65 million for the year ending December 31, 2012, depending on the progress of various preclinical and clinical programs, the timing of our manufacturing scale up and the achievement of various milestones under our existing collaborative agreements. We do not expect our revenues to be sufficient to fund operations until 2014, at the earliest. We expect to fund our operations going forward with existing cash resources, anticipated revenues from our existing collaborations and cash that we may raise through future transactions. We may finance future cash needs through any one of the following financing vehicles: (i) the public offering of securities; (ii) new collaborative agreements; (iii) expansions or revisions to existing collaborative relationships; (iv) private financings; and/or (v) other equity or debt financings.

We are currently a Well-Known Seasoned Issuer and may file automatic shelf registration statements at any time with the SEC. In February 2012, we filed an automatic shelf registration statement on Form S-3 (Registration No. 333-179444) with the SEC. On February 15, 2012, we sold approximately 7.8 million shares of our common stock at a public offering price of \$10.61 per share, generating approximately \$81.5 million in net proceeds. We may, in the future, offer and sell equity, debt securities and warrants to purchase any of such securities, either individually or in units to raise capital to fund the continued development of our product candidates, the commercialization of our products or for other general corporate purposes.

Our existing cash and cash equivalents may not be adequate to fund our operations until we become cash flow positive, if ever. We cannot be certain that additional financing will be available when needed or, if available, financing will be obtained on favorable terms. If we are unable to raise sufficient funds, we may need to delay, scale back or eliminate some or all of our research and development programs, delay the launch of our product candidates, if approved, and/or restructure our operations. If we raise additional funds by issuing equity securities, substantial dilution to existing stockholders could result. If we raise additional funds by incurring debt financing, the terms of the debt may involve significant cash payment obligations, the issuance of warrants that may ultimately dilute existing stockholders when exercised and covenants that may restrict our ability to operate our business.

### ***Cash Flows***

Net cash used in operations was \$47.4 million during the nine months ended September 30, 2012 compared to \$20.8 million during the nine months ended September 30, 2011. This change was primarily due to the increase in net loss of \$47.8 million adjusted for non-cash items including stock-based compensation and depreciation and amortization, in addition to changes in working capital for the nine months ended September 30, 2012 as compared to the same period in 2011. The increase in net loss was due to the decrease in revenues under collaborative agreements resulting from the recognition in the prior period of \$18.0 million in one-time upfront payments associated with the ViroPharma and Intrexon Collaborations and \$17.9 million of the deferred upfront license fee, deferred product-based payments and deferred product sales in connection with the termination of the Hylenex Collaboration and an increase in operating expenses for the nine months ended September 30, 2012 as compared to the same period in 2011.

Net cash used in investing activities was \$873,000 during the nine months ended September 30, 2012 compared to net cash used in investing activities of \$272,000 during the nine months ended September 30, 2011. This was due to an increase in purchases of property and equipment during the nine months ended September 30, 2012.

Net cash provided by financing activities was \$83.1 million during the nine months ended September, 2012 compared to \$4.1 million during the nine months ended September 30, 2011. Net cash provided by financing activities for the nine months ended September 30, 2012 consisted of \$81.5 million in net proceeds from the sale of our common stock in February 2012 and \$1.9 million in net proceeds from stock option exercises. Net cash provided by financing activities for the nine months ended September 30, 2011 consisted of proceeds from stock option exercises.

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### ***Off-Balance Sheet Arrangements***

As of September 30, 2012, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we did not engage in trading activities involving non-exchange traded contracts. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

### ***Recent Accounting Pronouncements***

See Note 2, *Summary of Significant Accounting Policies – Adoption of Recent Accounting Pronouncements*, in the Notes to Condensed Consolidated Financial Statements for a discussion of recent accounting pronouncements and their effect, if any, on us.

### **Risk Factors**

#### ***Risks Related To Our Business***

**We have generated only minimal revenue from product sales to date; we have a history of net losses and negative cash flow, and we may never achieve or maintain profitability.**

Relative to expenses incurred in our operations, we have generated only minimal revenues from product sales, licensing fees, milestone payments and research reimbursements to date and we may never generate sufficient revenues from future product sales, licensing fees and milestone payments to offset expenses. Even if we ultimately do achieve significant revenues from product sales, licensing fees, research reimbursements and/or milestone payments, we expect to incur significant operating losses over the next few years. We have never been profitable, and we may never become profitable. Through September 30, 2012, we have incurred aggregate net losses of approximately \$294.2 million.

**If our product candidates do not receive and maintain regulatory approvals, or if approvals are not obtained in a timely manner, such failure or delay would substantially impair our ability to generate revenues.**

Approval from the FDA is necessary to manufacture and market pharmaceutical products in the United States, and the other countries in which we anticipate doing business have similar requirements. The process for obtaining FDA and other regulatory approvals is extensive, time-consuming, risky and costly, and there is no guarantee that the FDA or other regulatory bodies will approve any applications that may be filed with respect to any of our product candidates, or that the timing of any such approval will be appropriate for the desired product launch schedule for a product candidate. We, and our collaborators, attempt to provide guidance as to the timing for the filing and acceptance of such regulatory approvals, but such filings and approvals may not occur when we or our collaborators expect or at all. The FDA or other foreign regulatory agency may refuse or delay approval of our product candidates for failure to collect sufficient clinical or animal safety data and require us or our collaborators to conduct additional clinical or animal safety studies which may cause lengthy delays and increased costs to our programs. For example, we announced on August 1, 2012 that the FDA has issued a CRL for Baxter's HyQ BLA. The CRL requested additional preclinical data to support the BLA. The primary issues raised in the letter focused on non-neutralizing antibodies generated against rHuPH20 and the possible effects of these antibodies on reproduction, development and fertility. Elevated anti-rHuPH20 antibody titers were detected in the registration trial, but have not been associated with any adverse events. Pending Baxter and us providing additional preclinical data sufficient to address the regulatory questions, the FDA has requested that patients should no longer be dosed with rHuPH20 in the Baxter clinical studies. In view of the issues raised in the HyQ CRL, we have contacted the FDA regarding the impact on *Hylenex* recombinant. After reviewing the applicable data submitted by us, FDA has confirmed that there is no need for actions against *Hylenex* recombinant or clinical programs in the *Hylenex* recombinant investigational new drug.

There can be no assurance that Baxter and we will be able to resolve the issues raised by the FDA in a timely manner which could result in a delay or failure to gain regulatory approval for the HyQ product candidate. Furthermore, although we do not believe at this time that the issues raised by the FDA with respect to the HyQ BLA will have a significant impact on our proprietary and other collaboration product candidates, there can be no assurance that these concerns will not also be raised by the FDA or other health authorities in the future.

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Only two of our collaboration product candidates are currently in the regulatory approval process and there are no proprietary product candidates currently in the regulatory approval process. We and our collaborators may not be successful in obtaining such approvals for any potential products in a timely manner, or at all. See risk factor titled *Our proprietary and collaboration product candidates may not receive regulatory approvals for a variety of reasons, including unsuccessful clinical trials* for additional information relating to the approval of product candidates.

Additionally, in order to continue to manufacture and market pharmaceutical products, we must maintain our regulatory approvals. If we or any of our collaborators are unsuccessful in maintaining our regulatory approvals, our ability to generate revenues would be adversely affected.

**If our contract manufacturers are unable to manufacture and supply to us API in the quantity and quality required by us or our collaborators for use in our products and product candidates, our product development and commercialization efforts could be delayed or stopped and our collaborations could be damaged.**

We have existing supply agreements with contract manufacturing organizations Avid Bioservices, Inc. (Avid) and Cook Pharmica LLC (Cook) to produce bulk API. These manufacturers each produce API under current Good Manufacturing Practices (cGMP) for clinical uses. In addition, Avid currently produces API for *Hylanex* recombinant. In addition to supply obligations, Avid and Cook will also provide support for the chemistry, manufacturing and controls sections for FDA and other regulatory filings. We rely on their ability to successfully manufacture these batches according to product specifications, and Cook has relatively limited experience manufacturing our API. In addition, as a result of our contractual obligations to Roche, we have been required to significantly scale up our commercial API production at Cook during the last two years. If Cook is unable to obtain status as a cGMP-approved manufacturing facility, or if either Avid or Cook: (i) is unable to retain status as cGMP-approved manufacturing facilities; (ii) is unable to otherwise successfully scale up our API production; (iii) fails to manufacture and supply API in the quantity and quality required by us or our collaborators for use in our proprietary and collaboration products and product candidates for any other reason, or (iv) provides the necessary support for the chemistry, manufacturing and controls sections for FDA and other regulatory filings, our business will be adversely affected. In addition, a significant change in such parties' business or financial condition could adversely affect their abilities to fulfill their contractual obligations to us. In particular, due to announced adverse clinical results, Avid's parent, Peregrine Pharmaceuticals, Inc., has recently experienced a significant decline in its stock price, a lender has recently recalled a loan to the company, and the company is currently party to multiple securities lawsuits. We have not established, and may not be able to establish, favorable arrangements with additional API manufacturers and suppliers of the ingredients necessary to manufacture the API should the existing manufacturers and suppliers become unavailable or in the event that our existing manufacturers and suppliers are unable to adequately perform their responsibilities. We have attempted to mitigate the impact of supply interruption through the establishment of excess API inventory, but there can be no assurances that this safety stock will be maintained or that it will be sufficient to address any delays, interruptions or other problems experienced by Avid and/or Cook. Any delays, interruptions or other problems regarding the ability of Avid and/or Cook to supply API on a timely basis could: (i) cause the delay of clinical trials or otherwise delay or prevent the regulatory approval of proprietary or collaboration product candidates; (ii) delay or prevent the effective commercialization of proprietary or collaboration products; and/or (iii) cause us to breach contractual obligations to deliver API to our collaborators. Such delays would likely damage our relationship with our collaborators under our key collaboration agreements, and they would have a material adverse effect on our business and financial condition.

**If any party to a key collaboration agreement, including us, fails to perform material obligations under such agreement, or if a key collaboration agreement, or any other collaboration agreement, is terminated for any reason, our business could significantly suffer.**

We have entered into multiple collaboration agreements under which we may receive significant future payments in the form of maintenance fees, milestone payments and royalties. In the event that a party fails to perform under a key collaboration agreement, or if a key collaboration agreement is terminated, the reduction in anticipated revenues could delay or suspend our product development activities for some of our product candidates,

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as well as our commercialization efforts for some or all of our products. In addition, the termination of a key collaboration agreement by one of our collaborators could materially impact our ability to enter into additional collaboration agreements with new collaborators on favorable terms, if at all. In certain circumstances, the termination of a key collaboration agreement would require us to revise our corporate strategy going forward and reevaluate the applications and value of our technology.

### **Most of our current proprietary and collaboration products and product candidates rely on the rHuPH20 enzyme.**

rHuPH20 is a key technological component of Enhance technology and our most advanced proprietary and collaboration products and product candidates, including the product candidates under our Roche, Baxter, ViroPharma and Intrexon collaborations, our ultrafast insulin program, our PEGPH20 program and *Hylenex* recombinant. An adverse development for rHuPH20 (e.g., an adverse regulatory determination relating to rHuPH20, if we are unable to obtain sufficient quantities of rHuPH20, if we are unable to obtain or maintain material proprietary rights to rHuPH20 or if we discover negative characteristics of rHuPH20) would substantially impact multiple areas of our business, including current and potential collaborations, as well as proprietary programs. For example, we announced on August 1, 2012 that the FDA has issued a CRL for Baxter's HyQ BLA. The CRL requested additional preclinical data to support the BLA. The primary issues raised in the letter focused on non-neutralizing antibodies generated against rHuPH20 and the possible effects of these antibodies on reproduction, development and fertility. Elevated anti-rHuPH20 antibody titers were detected in the registration trial, but have not been associated with any adverse events. Pending Baxter and us providing additional preclinical data sufficient to address the regulatory questions, the FDA has requested that patients should no longer be dosed with rHuPH20 in the Baxter clinical studies. Although we do not believe at this time that the issues raised by the FDA with respect to the HyQ BLA will have a significant impact on our proprietary and other collaboration product candidates, there can be no assurance that these concerns will not also be raised by the FDA or other health authorities in the future.

### **Our proprietary and collaboration product candidates may not receive regulatory approvals for a variety of reasons, including unsuccessful clinical trials.**

Clinical testing of pharmaceutical products is a long, expensive and uncertain process, and the failure or delay of a clinical trial can occur at any stage. Even if initial results of preclinical and nonclinical studies or clinical trial results are promising, we or our collaborators may obtain different results in subsequent trials or studies that fail to show the desired levels of safety and efficacy, or we may not, or our collaborators may not, obtain applicable regulatory approval for a variety of other reasons. Preclinical, nonclinical, and clinical trials for any of our proprietary or collaboration product candidates could be unsuccessful, which would delay or prohibit regulatory approval and commercialization of the product candidates. In the United States and other jurisdictions, regulatory approval can be delayed, limited or not granted for many reasons, including, among others:

clinical results may not meet prescribed endpoints for the studies or otherwise provide sufficient data to support the efficacy of our product candidates;

clinical and nonclinical test results may reveal side effects, adverse events or unexpected safety issues associated with the use of our product candidates;

regulatory review may not find a product candidate safe or effective enough to merit either continued testing or final approval;

regulatory review may not find that the data from preclinical testing and clinical trials justifies approval, or they may require additional studies that would significantly delay or make continued pursuit of approval commercially unattractive;

a regulatory agency may reject our trial data or disagree with our interpretations of either clinical trial data or applicable regulations;

the cost of clinical trials required for product approval may be greater than what we originally anticipate, and we may decide to not pursue regulatory approval for such a product;



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a regulatory agency may not approve our manufacturing processes or facilities, or the processes or facilities of our collaborators, our contract manufacturers or our raw material suppliers;

a regulatory agency may identify problems or other deficiencies in our existing manufacturing processes or facilities, or the existing processes or facilities of our collaborators, our contract manufacturers or our raw material suppliers;

a regulatory agency may change its formal or informal approval requirements and policies, act contrary to previous guidance, adopt new regulations or raise new issues or concerns late in the approval process; or

a product candidate may be approved only for indications that are narrow or under conditions that place the product at a competitive disadvantage, which may limit the sales and marketing activities for such product candidate or otherwise adversely impact the commercial potential of a product.

If a proprietary or collaboration product candidate is not approved in a timely fashion on commercially viable terms, or if development of any product candidate is terminated due to difficulties or delays encountered in the regulatory approval process, it could have a material adverse impact on our business, and we will become more dependent on the development of other proprietary or collaboration product candidates and/or our ability to successfully acquire other products and technologies. There can be no assurances that any proprietary or collaboration product candidate will receive regulatory approval in a timely manner, or at all.

We anticipate that certain proprietary and collaboration products will be marketed, and perhaps manufactured, in foreign countries. The process of obtaining regulatory approvals in foreign countries is subject to delay and failure for the reasons set forth above, as well as for reasons that vary from jurisdiction to jurisdiction. The approval process varies among countries and jurisdictions and can involve additional testing. The time required to obtain approval may differ from that required to obtain FDA approval. Foreign regulatory agencies may not provide approvals on a timely basis, if at all. Approval by the FDA does not ensure approval by regulatory authorities in other countries or jurisdictions, and approval by one foreign regulatory authority does not ensure approval by regulatory authorities in other foreign countries or jurisdictions or by the FDA.

**Our third party collaborators are responsible for providing certain proprietary materials that are essential components of our collaboration product candidates, and any failure to supply these materials could delay the development and commercialization efforts for these collaboration product candidates and/or damage our collaborations.**

Our development and commercialization collaborators are responsible for providing certain proprietary materials that are essential components of our collaboration product candidates. For example, Roche is responsible for producing the Herceptin and MabThera required for its subcutaneous product candidates and Baxter is responsible for producing the GAMMAGARD LIQUID for its product candidate. If a collaborator, or any applicable third party service provider of a collaborator, encounters difficulties in the manufacture, storage, delivery, fill, finish or packaging of the collaboration product candidate or component of such product candidate, such difficulties could (i) cause the delay of clinical trials or otherwise delay or prevent the regulatory approval of collaboration product candidates; and/or (ii) delay or prevent the effective commercialization of collaboration products. Such delays could have a material adverse effect on our business and financial condition. For example, Baxter received a Warning Letter from the FDA in January 2010 regarding Baxter's GAMMAGARD LIQUID manufacturing facility in Lessines, Belgium. The FDA indicated in March 2010 that the issues raised in the Warning Letter had been addressed by Baxter, and we do not expect these issues to impact the development of the GAMMAGARD LIQUID product candidate.

**We rely on third parties to prepare, fill, finish and package our products and product candidates, and if such third parties should fail to perform, our commercialization and development efforts for our products and product candidates could be delayed or stopped.**

We rely on third parties to store and ship API on our behalf and to also prepare, fill, finish and package our products and product candidates prior to their distribution. If we are unable to locate third parties to perform these functions on terms that are acceptable to us, or if the third parties we identify fail to perform their obligations, the



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progress of clinical trials could be delayed or even suspended and the commercialization of approved product candidates could be delayed or prevented. For example, *Hylenex* recombinant was voluntarily recalled in May 2010 because a portion of the *Hylenex* recombinant manufactured by Baxter was not in compliance with the requirements of the underlying *Hylenex* recombinant agreements. During the second quarter of 2011, we submitted the data that the FDA had requested to support the reintroduction of *Hylenex* recombinant. The FDA approved the submitted data and granted the reintroduction of *Hylenex* recombinant, and we reintroduced *Hylenex* recombinant to the market in December 2011. In June 2011, we entered into a commercial manufacturing and supply agreement with Baxter, under which Baxter will fill, finish and package *Hylenex* recombinant product for us. Under our commercial manufacturing and supply agreement with Baxter, Baxter has agreed to fill and finish *Hylenex* recombinant product for us for a limited period of time. The initial term of the commercial manufacturing and supply agreement with Baxter expires on December 31, 2013. However, upon regulatory approval of a second filling line, the initial term will automatically be extended to December 31, 2015, subject to further extensions in accordance with the terms and conditions of the agreement. In June 2011, we entered into a services agreement with a third party manufacturer for the technology transfer and manufacture of *Hylenex* recombinant. While we expect to enter into a commercial manufacturing and supply agreement with a new manufacturer of *Hylenex* recombinant, if we are unable to find a suitable manufacturer of *Hylenex* recombinant prior to the expiration of the commercial manufacturing and supply agreement with Baxter or if a new manufacturer encounters difficulties in the manufacture, fill, finish or packaging of *Hylenex* recombinant, our business and financial condition could be adversely effected.

**If we are unable to sufficiently develop our sales, marketing and distribution capabilities or enter into successful agreements with third parties to perform these functions, we will not be able to fully commercialize our products.**

We may not be successful in marketing and promoting our approved product, *Hylenex* recombinant or any other products we develop or acquire in the future. Our sales, marketing and distribution capabilities are very limited. In order to commercialize any products successfully, we must internally develop substantial sales, marketing and distribution capabilities or establish collaborations or other arrangements with third parties to perform these services. We do not have extensive experience in these areas, and we may not be able to establish adequate in-house sales, marketing and distribution capabilities or engage and effectively manage relationships with third parties to perform any or all of such services. To the extent that we enter into co-promotion or other licensing arrangements, our product revenues are likely to be lower than if we directly marketed and sold our products, and any revenues we receive will depend upon the efforts of third parties, whose efforts may not meet our expectations or be successful. These third parties would be largely responsible for the speed and scope of sales and marketing efforts, and may not dedicate the resources necessary to maximize product opportunities. Our ability to cause these third parties to increase the speed and scope of their efforts may also be limited. In addition, sales and marketing efforts could be negatively impacted by the delay or failure to obtain additional supportive clinical trial data for our products. In some cases, third party collaborators are responsible for conducting these additional clinical trials, and our ability to increase the efforts and resources allocated to these trials may be limited. For example, in January 2011, we and Baxter mutually agreed to terminate the *Hylenex* Collaboration and the associated agreements.

**If we or our collaborators fail to comply with regulatory requirements applicable to promotion, sale and manufacturing of approved products, regulatory agencies may take action against us or them, which could significantly harm our business.**

Any approved products, along with the manufacturing processes, post-approval clinical data, labeling, advertising and promotional activities for these products, are subject to continual requirements and review by the FDA, state and foreign regulatory bodies. Regulatory authorities subject a marketed product, its manufacturer and the manufacturing facilities to continual review and periodic inspections. We, our collaborators and our respective contractors, suppliers and vendors, will be subject to ongoing regulatory requirements, including complying with regulations and laws regarding advertising, promotion and sales of drug products, required submissions of safety and other post-market information and reports, registration requirements, cGMP regulations (including requirements relating to quality control and quality assurance, as well as the corresponding maintenance of records and documentation), and the requirements regarding the distribution of samples to physicians and recordkeeping requirements. Regulatory agencies may change existing requirements or adopt new requirements or policies. We, our collaborators and our respective contractors, suppliers and vendors, may be slow to adapt or may not be able to adapt to these changes or new requirements.

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In particular, regulatory requirements applicable to pharmaceutical products make the substitution of suppliers and manufacturers costly and time consuming. We have minimal internal manufacturing capabilities and are, and expect to be in the future, entirely dependent on contract manufacturers and suppliers for the manufacture of our products and for their active and other ingredients. The disqualification of these manufacturers and suppliers through their failure to comply with regulatory requirements could negatively impact our business because the delays and costs in obtaining and qualifying alternate suppliers (if such alternative suppliers are available, which we cannot assure) could delay clinical trials or otherwise inhibit our ability to bring approved products to market, which would have a material adverse effect on our business and financial condition. Likewise, if we, our collaborators and our respective contractors, suppliers and vendors involved in sales and promotion of our products do not comply with applicable laws and regulations, for example off-label or false or misleading promotion, this could materially harm our business and financial condition.

Failure to comply with regulatory requirements, may result in any of the following:

restrictions on our products or manufacturing processes;

warning letters;

withdrawal of the products from the market;

voluntary or mandatory recall;

fines;

suspension or withdrawal of regulatory approvals;

suspension or termination of any of our ongoing clinical trials;

refusal to permit the import or export of our products;

refusal to approve pending applications or supplements to approved applications that we submit;

product seizure;

injunctions; or

the imposition of civil or criminal penalties.

**We may wish to raise additional capital in the next twelve months and there can be no assurance that we will be able to obtain such funds.**

## Edgar Filing: HALOZYME THERAPEUTICS INC - Form 10-Q

During the next twelve months, we may wish to raise additional capital to continue the development of our product candidates or for other current corporate purposes. Our current cash reserves and expected revenues during the next few years may not be sufficient for us to continue the development of our proprietary product candidates, to fund general operations and conduct our business. In addition, if we engage in acquisitions of companies, products or technologies in order to execute our business strategy, we may need to raise additional capital. We may raise additional capital in the future through one or more financing vehicles that may be available to us including (i) the public or private issuance of securities; (ii) new collaborative agreements; and/or (iii) expansions or revisions to existing collaborative relationships.

In view of our stage of development, business prospects, the nature of our capital structure and general market conditions, if we are required to raise additional capital in the future, the additional financing may not be available on favorable terms, or at all. If additional capital is not available on favorable terms when needed, we will be required to raise capital on adverse terms or significantly reduce operating expenses through the restructuring of our operations. If we raise additional capital, a substantial number of additional shares may be issued, and these shares will dilute the ownership interest of our current investors.

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**If proprietary or collaboration product candidates are approved for marketing but do not gain market acceptance, our business may suffer and we may not be able to fund future operations.**

Assuming that our proprietary or collaboration product candidates obtain the necessary regulatory approvals for commercial sale, a number of factors may affect the market acceptance of these existing product candidates or any other products which are developed or acquired in the future, including, among others:

the price of products relative to other therapies for the same or similar treatments;

the perception by patients, physicians and other members of the health care community of the effectiveness and safety of these products for their prescribed treatments relative to other therapies for the same or similar treatments;

our ability to fund our sales and marketing efforts and the ability and willingness of our collaborators to fund sales and marketing efforts;

the degree to which the use of these products is restricted by the approved product label;

the effectiveness of our sales and marketing efforts and the effectiveness of the sales and marketing efforts of our collaborators;

the introduction of generic competitors; and

the extent to which reimbursement for our products and related treatments will be available from third party payors including government insurance programs (Medicare and Medicaid) and private insurers.

If these products do not gain market acceptance, we may not be able to fund future operations, including the development or acquisition of new product candidates and/or our sales and marketing efforts for our approved products, which would cause our business to suffer.

In addition, our proprietary and collaboration product candidates will be restricted to the labels approved by FDA and applicable regulatory bodies, and these restrictions may limit the marketing and promotion of the ultimate products. If the approved labels are restrictive, the sales and marketing efforts for these products may be negatively affected.

**Developing and marketing pharmaceutical products for human use involves significant product liability risks for which we currently have limited insurance coverage.**

The testing, marketing and sale of pharmaceutical products involves the risk of product liability claims by consumers and other third parties. Although we maintain product liability insurance coverage, product liability claims can be high in the pharmaceutical industry, and our insurance may not sufficiently cover our actual liabilities. If product liability claims were to be made against us, it is possible that the liabilities may exceed the limits of our insurance policy, or our insurance carriers may deny, or attempt to deny, coverage in certain instances. If a lawsuit against us is successful, then the lack or insufficiency of insurance coverage could materially and adversely affect our business and financial condition. Furthermore, various distributors of pharmaceutical products require minimum product liability insurance coverage before purchase or acceptance of products for distribution. Failure to satisfy these insurance requirements could impede our ability to achieve broad distribution of our proposed products, and higher insurance requirements could impose additional costs on us. In addition, since many of our collaboration product candidates include the pharmaceutical products of a third party, we run the risk that problems with the third party pharmaceutical product will give rise to liability claims against us.

**Our inability to attract, hire and retain key management and scientific personnel could negatively affect our business.**

## Edgar Filing: HALOZYME THERAPEUTICS INC - Form 10-Q

Our success depends on the performance of key management and scientific employees with relevant experience. We depend substantially on our ability to hire, train, motivate and retain high quality personnel, especially our scientists and management team. Particularly in view of the small number of employees on our staff

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to cover our numerous programs and key functions, if we are unable to retain existing personnel or identify or hire additional personnel, we may not be able to research, develop, commercialize or market our products and product candidates as expected or on a timely basis and we may not be able to adequately support current and future alliances with strategic collaborators.

Furthermore, if we were to lose key management personnel, such as Gregory Frost, Ph.D., our President and Chief Executive Officer, we would likely lose some portion of our institutional knowledge and technical know-how, potentially causing a substantial delay in one or more of our development programs until adequate replacement personnel could be hired and trained. For example, Dr. Frost has been with us from soon after our inception, and he possesses a substantial amount of knowledge about our development efforts and business. If we were to lose his services, we would experience delays in meeting our product development schedules. We currently have a severance policy applicable to all employees and a change in control policy applicable to senior executives. We have not adopted any other policies or entered into any other agreements specifically designed to motivate officers or other employees to remain with us.

We do not have key man life insurance policies on the lives of any of our employees, including Dr. Frost.

### **Our operations might be interrupted by the occurrence of a natural disaster or other catastrophic event.**

Our operations, including laboratories, offices and other research facilities, are located in three buildings in San Diego, California. We depend on our facilities and on our collaborators, contractors and vendors for the continued operation of our business. Natural disasters or other catastrophic events, interruptions in the supply of natural resources, political and governmental changes, wildfires and other fires, floods, explosions, actions of animal rights activists, earthquakes and civil unrest could disrupt our operations or those of our collaborators, contractors and vendors. Even though we believe we carry commercially reasonable business interruption and liability insurance, and our contractors may carry liability insurance that protect us in certain events, we may suffer losses as a result of business interruptions that exceed the coverage available under our and our contractors' insurance policies or for which we or our contractors do not have coverage. Any natural disaster or catastrophic event could have a significant negative impact on our operations and financial results. Moreover, any such event could delay our research and development programs.

### **If we or our collaborators do not achieve projected development, clinical or regulatory goals in the timeframes we publicly announce or otherwise expect, the commercialization of our products and the development of our product candidates may be delayed and, as a result, our stock price may decline, and we may face lawsuits relating to such declines.**

From time to time, we may publicly articulate the estimated timing for the accomplishment of certain scientific, clinical, regulatory and other product development goals. The accomplishment of any goal is typically based on numerous assumptions, and the achievement of a particular goal may be delayed for any number of reasons both within and outside of our control. If scientific, regulatory, strategic or other factors cause us to not meet a goal, regardless of whether that goal has been publicly articulated or not, our stock price may decline rapidly. Such stock price decline may trigger direct or derivative shareholder lawsuits. As with any litigation proceeding, the eventual outcome of any legal action is difficult to predict. If any such lawsuits occur, we will incur expenses in connection with the defense of these lawsuits, and we may have to pay substantial damages or settlement costs in connection with any resolution thereof. Although we have insurance coverage against which we may claim recovery against some of these expenses and costs, the amount of coverage may not be adequate to cover the full amount or certain expenses and costs may be outside the scope of the policies we maintain. In the event of an adverse outcome or outcomes, our business could be materially harmed from depletion of cash resources, negative impact on our reputation, or restrictions or changes to our governance or other processes that may result from any final disposition of the lawsuit. Moreover, responding to and defending pending litigation significantly diverts management's attention from our operations.

In addition, the consistent failure to meet publicly announced milestones may erode the credibility of our management team with respect to future milestone estimates.

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### **Future acquisitions could disrupt our business and harm our financial condition.**

In order to augment our product pipeline or otherwise strengthen our business, we may decide to acquire additional businesses, products and technologies. As we have limited experience in evaluating and completing acquisitions, our ability as an organization to make such acquisitions is unproven. Acquisitions could require significant capital infusions and could involve many risks, including, but not limited to, the following:

we may have to issue convertible debt or equity securities to complete an acquisition, which would dilute our stockholders and could adversely affect the market price of our common stock;

an acquisition may negatively impact our results of operations because it may require us to amortize or write down amounts related to goodwill and other intangible assets, or incur or assume substantial debt or liabilities, or it may cause adverse tax consequences, substantial depreciation or deferred compensation charges;

we may encounter difficulties in assimilating and integrating the business, products, technologies, personnel or operations of companies that we acquire;

certain acquisitions may impact our relationship with existing or potential collaborators who are competitive with the acquired business, products or technologies;

acquisitions may require significant capital infusions and the acquired businesses, products or technologies may not generate sufficient value to justify acquisition costs;

we may take on liabilities from the acquired company such as debt, legal liabilities or business risk which could be significant;

an acquisition may disrupt our ongoing business, divert resources, increase our expenses and distract our management;

acquisitions may involve the entry into a geographic or business market in which we have little or no prior experience; and

key personnel of an acquired company may decide not to work for us.

If any of these risks occurred, it could adversely affect our business, financial condition and operating results. There is no assurance that we will be able to identify or consummate any future acquisitions on acceptable terms, or at all. If we do pursue any acquisitions, it is possible that we may not realize the anticipated benefits from such acquisitions or that the market will not view such acquisitions positively.

### ***Risks Related To Ownership of Our Common Stock***

#### **Our stock price is subject to significant volatility.**

We participate in a highly dynamic industry which often results in significant volatility in the market price of common stock irrespective of company performance. As a result, our high and low sales prices of our common stock during the twelve months ended September 30, 2012 were \$13.50 and \$3.86, respectively. We expect our stock price to continue to be subject to significant volatility and, in addition to the other risks and uncertainties described elsewhere in this quarterly report on Form 10-Q and all other risks and uncertainties that are either not known to us at this time or which we deem to be immaterial, any of the following factors may lead to a significant drop in our stock price:

a dispute regarding our failure, or the failure of one of our third party collaborators, to comply with the terms of a collaboration agreement;

the termination, for any reason, of any of our collaboration agreements;



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the sale of common stock by any significant stockholder, including, but not limited to, direct or indirect sales by members of management or our Board of Directors;

the resignation, or other departure, of members of management or our Board of Directors;

general negative conditions in the healthcare industry;

general negative conditions in the financial markets;

the failure, for any reason, to obtain regulatory approval for any of our proprietary or collaboration product candidates;

the failure, for any reason, to secure or defend our intellectual property position;

for those products that are not yet approved for commercial sale, the failure or delay of applicable regulatory bodies to approve such products;

identification of safety or patient tolerability issues;

failure of clinical trials to meet efficacy endpoints;

suspensions or delays in the conduct of clinical trials;

our failure, or the failure of our third party collaborators, to successfully commercialize products approved by applicable regulatory bodies such as the FDA;

our failure, or the failure of our third party collaborators, to generate product revenues anticipated by investors;

problems with an API contract manufacturer or a fill and finish manufacturer for any product or product candidate;

the sale of additional debt and/or equity securities by us;

our failure to obtain financing on acceptable terms; or

a restructuring of our operations.

**Future transactions where we raise capital may negatively affect our stock price.**

## Edgar Filing: HALOZYME THERAPEUTICS INC - Form 10-Q

We are currently a "Well-Known Seasoned Issuer" and may file automatic shelf registration statements at any time with the SEC. In addition, we currently have the ability to offer and sell additional equity, debt securities and warrants to purchase such securities, either individually or in units, under an effective automatic shelf registration statement. Sales of substantial amounts of shares of our common stock or other securities under our shelf registration statements could lower the market price of our common stock and impair our ability to raise capital through the sale of equity securities. In the future, we may issue additional options, warrants or other derivative securities convertible into our common stock.

**Trading in our stock has historically been limited, so investors may not be able to sell as much stock as they want to at prevailing market prices.**

Our stock has historically traded at a low daily trading volume. If low trading volume continues, it may be difficult for stockholders to sell their shares in the public market at any given time at prevailing prices.

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### ***Risks Related To Our Industry***

**Our products must receive regulatory approval before they can be sold, and compliance with the extensive government regulations is expensive and time consuming and may result in the delay or cancellation of product sales, introductions or modifications.**

Extensive industry regulation has had, and will continue to have, a significant impact on our business. All pharmaceutical companies, including ours, are subject to extensive, complex, costly and evolving regulation by the health regulatory agencies including the FDA (and with respect to controlled drug substances, the U.S. Drug Enforcement Administration (DEA)) and equivalent foreign regulatory agencies and state and local/regional government agencies. The Federal Food, Drug and Cosmetic Act, the Controlled Substances Act and other domestic and foreign statutes and regulations govern or influence the testing, manufacturing, packaging, labeling, storing, recordkeeping, safety, approval, advertising, promotion, sale and distribution of our products. We are dependent on receiving FDA and other governmental approvals prior to manufacturing, marketing and shipping our products. Consequently, there is always a risk that the FDA or other applicable governmental authorities will not approve our products or may impose onerous, costly and time-consuming requirements such as additional clinical or animal testing. The FDA or other foreign regulatory agency may, at any time, halt our and our collaborators' development and commercialization activities due to safety concerns. In addition, even if our products are approved, regulatory agencies may also take post-approval action limiting or revoking our ability to sell our products. Any of these regulatory actions may adversely affect the economic benefit we may derive from our products and therefore harm our financial condition.

Under certain of these regulations, we and our contract suppliers and manufacturers are subject to periodic inspection of our or their respective facilities, procedures and operations and/or the testing of products by the FDA, the DEA and other authorities, which conduct periodic inspections to confirm that we and our contract suppliers and manufacturers are in compliance with all applicable regulations. The FDA also conducts pre-approval and post-approval reviews and plant inspections to determine whether our systems, or our contract suppliers' and manufacturers' processes, are in compliance with cGMP and other FDA regulations. If we, or our contract supplier, fail these inspections, we may not be able to commercialize our product in a timely manner without incurring significant additional costs, or at all.

In addition, the FDA imposes a number of complex regulatory requirements on entities that advertise and promote pharmaceuticals including, but not limited to, standards and regulations for direct-to-consumer advertising, off-label promotion, industry-sponsored scientific and educational activities, and promotional activities involving the internet.

**We may be required to initiate or defend against legal proceedings related to intellectual property rights, which may result in substantial expense, delay and/or cessation of the development and commercialization of our products.**

We primarily rely on patents to protect our intellectual property rights. The strength of this protection, however, is uncertain. For example, it is not certain that:

we will be able to obtain patent protection for our products and technologies;

the scope of any of our issued patents will be sufficient to provide commercially significant exclusivity for our products and technologies;

others will not independently develop similar or alternative technologies or duplicate our technologies and obtain patent protection before we do; and

any of our issued patents, or patent pending applications that result in issued patents, will be held valid, enforceable and infringed in the event the patents are asserted against others.

We currently own or license several patents and also have pending patent applications applicable to rHuPH20 and other proprietary materials. There can be no assurance that our existing patents, or any patents issued to us as a result of our pending patent applications, will provide a basis for commercially viable products, will provide us with



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any competitive advantages, or will not face third party challenges or be the subject of further proceedings limiting their scope or enforceability. A European patent, EP1603541, claiming rHuPH20 was granted to us on November 11, 2009 with claims to the human PH20 glycoprotein, PEGylated variants, a method of producing the glycoprotein produced by recombinant methods, and pharmaceutical compositions with other agents, including antibodies, insulins, cytokines, a chemotherapeutic agent and additional therapeutic classes. A third party opposed this patent in the European Patent Office in 2010; however, the opposition has been resolved with claims maintained in amended form. Any weaknesses or limitations in our patent portfolio could have a material adverse effect on our business and financial condition. In addition, if any of our pending patent applications do not result in issued patents, or result in issued patents with narrow or limited claims, this could result in us having no or limited protection against generic or biosimilar competition against our product candidates which would have a material adverse effect on our business and financial condition.

We may become involved in interference proceedings in the U.S. Patent and Trademark Office, or other proceedings in other jurisdictions, to determine the priority, validity or enforceability of our patents. In addition, costly litigation could be necessary to protect our patent position.

We also rely on trademarks to protect the names of our products (e.g. *Hylenex* recombinant). We may not be able to obtain trademark protection for any proposed product names we select. In addition, product names for pharmaceutical products must be approved by health regulatory authorities such as the FDA in addition to meeting the legal standards required for trademark protection and product names we propose may not be timely approved by regulatory agencies which may delay product launch. In addition, our trademarks may be challenged by others. If we enforce our trademarks against third parties, such enforcement proceedings may be expensive.

We also rely on trade secrets, unpatented proprietary know-how and continuing technological innovation that we seek to protect with confidentiality agreements with employees, consultants and others with whom we discuss our business. Disputes may arise concerning the ownership of intellectual property or the applicability or enforceability of these agreements, and we might not be able to resolve these disputes in our favor.

In addition to protecting our own intellectual property rights, third parties may assert patent, trademark or copyright infringement or other intellectual property claims against us. If we become involved in any intellectual property litigation, we may be required to pay substantial damages, including but not limited to treble damages, attorneys' fees and costs, for past infringement if it is ultimately determined that our products infringe a third party's intellectual property rights. Even if infringement claims against us are without merit, defending a lawsuit takes significant time, may be expensive and may divert management's attention from other business concerns. Further, we may be stopped from developing, manufacturing or selling our products until we obtain a license from the owner of the relevant technology or other intellectual property rights. If such a license is available at all, it may require us to pay substantial royalties or other fees.

**Patent protection for protein-based therapeutic products and other biotechnology inventions is subject to a great deal of uncertainty, and if patent laws or the interpretation of patent laws changes, our competitors may be able to develop and commercialize products based on our discoveries.**

Patent protection for protein-based therapeutic products is highly uncertain and involves complex legal and factual questions. In recent years, there have been significant changes in patent law, including the legal standards that govern the scope of protein and biotechnology patents. Standards for patentability of full-length and partial genes, and their corresponding proteins, are changing. Recent court decisions have made it more difficult to obtain patents, by making it more difficult to satisfy the requirement of non-obviousness, have decreased the availability of injunctions against infringers, and have increased the likelihood of challenging the validity of a patent through a declaratory judgment action. Taken together, these decisions could make it more difficult and costly for us to obtain, license and enforce our patents. In addition, the Leahy-Smith America Invents Act (HR 1249) was signed into law in September 2011, which among other changes to the U.S. patent laws, changes patent priority from first to invent to first to file, implements a post-grant opposition system for patents and provides for a prior user defense to infringement. These judicial and legislative changes have introduced significant uncertainty in the patent law landscape and may potentially negatively impact our ability to procure, maintain and enforce patents to provide exclusivity for our products.

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There also have been, and continue to be, policy discussions concerning the scope of patent protection awarded to biotechnology inventions. Social and political opposition to biotechnology patents may lead to narrower patent protection within the biotechnology industry. Social and political opposition to patents on genes and proteins may lead to narrower patent protection, or narrower claim interpretation, for genes, their corresponding proteins and inventions related to their use, formulation and manufacture. Patent protection relating to biotechnology products is also subject to a great deal of uncertainty outside the United States, and patent laws are evolving and undergoing revision in many countries. Changes in, or different interpretations of, patent laws worldwide may result in our inability to obtain or enforce patents, and may allow others to use our discoveries to develop and commercialize competitive products, which would impair our business.

### **If third party reimbursement and customer contracts are not available, our products may not be accepted in the market.**

Our ability to earn sufficient returns on our products will depend in part on the extent to which reimbursement for our products and related treatments will be available from government health administration authorities, private health insurers, managed care organizations and other healthcare providers.

Third-party payors are increasingly attempting to limit both the coverage and the level of reimbursement of new drug products to contain costs. Consequently, significant uncertainty exists as to the reimbursement status of newly approved healthcare products. Third party payors may not establish adequate levels of reimbursement for the products that we commercialize, which could limit their market acceptance and result in a material adverse effect on our financial condition.

Customer contracts, such as with group purchasing organizations and hospital formularies, will often not offer contract or formulary status without either the lowest price or substantial proven clinical differentiation. If our products are compared to animal-derived hyaluronidases by these entities, it is possible that neither of these conditions will be met, which could limit market acceptance and result in a material adverse effect on our financial condition.

### **The rising cost of healthcare and related pharmaceutical product pricing has led to cost containment pressures that could cause us to sell our products at lower prices, resulting in less revenue to us.**

Any of the proprietary or collaboration products that have been, or in the future are, approved by the FDA may be purchased or reimbursed by state and federal government authorities, private health insurers and other organizations, such as health maintenance organizations and managed care organizations. Such third party payors increasingly challenge pharmaceutical product pricing. The trend toward managed healthcare in the United States, the growth of such organizations, and various legislative proposals and enactments to reform healthcare and government insurance programs, including the Medicare Prescription Drug Modernization Act of 2003, could significantly influence the manner in which pharmaceutical products are prescribed and purchased, resulting in lower prices and/or a reduction in demand. Such cost containment measures and healthcare reforms could adversely affect our ability to sell our products.

In March 2010, the United States adopted the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Affordability Reconciliation Act (the Healthcare Reform Act). This law substantially changes the way healthcare is financed by both governmental and private insurers, and significantly impacts the pharmaceutical industry. The Healthcare Reform Act contains a number of provisions that are expected to impact our business and operations, in some cases in ways we cannot currently predict. Changes that may affect our business include those governing enrollment in federal healthcare programs, reimbursement changes, fraud and abuse and enforcement. These changes will impact existing government healthcare programs and will result in the development of new programs, including Medicare payment for performance initiatives and improvements to the physician quality reporting system and feedback program.

Additional provisions of the Healthcare Reform Act, some of which became effective in 2011, may negatively affect our revenues in the future. For example, the Healthcare Reform Act imposes a non-deductible excise tax on pharmaceutical manufacturers or importers that sell branded prescription drugs to U.S. government programs that we believe will impact our revenues from our products. In addition, as part of the Healthcare Reform Act's provisions closing a funding gap that currently exists in the Medicare Part D prescription drug program, we

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will also be required to provide a 50% discount on branded prescription drugs dispensed to beneficiaries under this prescription drug program. We expect that the Healthcare Reform Act and other healthcare reform measures that may be adopted in the future could have a material adverse effect on our industry generally and on our ability to maintain or increase our product sales or successfully commercialize our product candidates or could limit or eliminate our future spending on development projects.

Furthermore, individual states have become increasingly aggressive in passing legislation and implementing regulations designed to control pharmaceutical product pricing, including price or patient reimbursement constraints, discounts, restrictions on certain product access, importation from other countries and bulk purchasing. Legally mandated price controls on payment amounts by third party payors or other restrictions could negatively and materially impact our revenues and financial condition. We anticipate that we will encounter similar regulatory and legislative issues in most other countries outside the United States.

**We face intense competition and rapid technological change that could result in the development of products by others that are superior to our proprietary and collaboration products under development.**

Our proprietary and collaboration products have numerous competitors in the United States and abroad including, among others, major pharmaceutical and specialized biotechnology firms, universities and other research institutions that have developed competing products. The competitors for *Hylenex* recombinant include, but are not limited to Bausch & Lomb Inc. For our Analog-PH20 product candidates, such competitors may include Biontech Inc., Eli Lilly, Sanofi Aventis, Novo Nordisk Inc. and Mannkind Corporation. These competitors may develop technologies and products that are more effective, safer, or less costly than our current or future proprietary and collaboration product candidates or that could render our technologies and product candidates obsolete or noncompetitive. Many of these competitors have substantially more resources and product development, manufacturing and marketing experience and capabilities than we do. In addition, many of our competitors have significantly greater experience than we do in undertaking preclinical testing and clinical trials of pharmaceutical product candidates and obtaining FDA and other regulatory approvals of products and therapies for use in healthcare.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Our primary exposure to market risk is interest income sensitivity, which is affected by changes in the general level of U.S. interest rates, particularly because the majority of our investments are in short-term marketable securities. The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significantly increasing risk. Some of the securities may be subject to market risk. This means that a change in prevailing interest rates may cause the value of the investment to fluctuate. For example, if we purchase a security that was issued with a fixed interest rate and the prevailing interest rate later rises, the value of our investment will probably decline. To minimize this risk, we typically invest all, or substantially all, of our cash in money market funds that invest primarily in government securities. Our investment policy also permits investments in a variety of securities including commercial paper and government and non-government debt securities. In general, money market funds are not subject to market risk because the interest paid on such funds fluctuates with the prevailing interest rate. As of September 30, 2012, we did not have any holdings of derivative financial or commodity instruments, or any foreign currency denominated transactions, and all of our cash and cash equivalents were in money market mutual funds and other investments that we believe to be highly liquid. If a 10% change in interest rates were to have occurred on September 30, 2012, this change would not have had a material effect on the fair value of our investment portfolio as of that date or on our net loss for the three months then ended. Due to the short holding period of our investments, we have concluded that we do not have a material financial market risk exposure.

### **Item 4. Controls and Procedures**

#### ***Evaluation of Disclosure Controls and Procedures***

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the timelines specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as

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appropriate, to allow timely decision regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can only provide reasonable assurance of achieving the desired control objectives, and in reaching a reasonable level of assurance, management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

***Changes in Internal Control Over Financial Reporting***

There have been no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time, we may be involved in disputes, including litigation, relating to claims arising out of operations in the normal course of our business. Any of these claims could subject us to costly legal expenses and, while we generally believe that we have adequate insurance to cover many different types of liabilities, our insurance carriers may deny coverage or our policy limits may be inadequate to fully satisfy any damage awards or settlements. If this were to happen, the payment of any such awards could have a material adverse effect on our consolidated results of operations and financial position. Additionally, any such claims, whether or not successful, could damage our reputation and business. We currently are not a party to any legal proceedings, the adverse outcome of which, in management's opinion, individually or in the aggregate, would have a material adverse effect on our consolidated results of operations or financial position.

**Item 1A. Risk Factors**

We have provided updated Risk Factors in the section labeled "Risk Factors" in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations". The "Risk Factors" section provides updated information in certain areas, particularly with respect to uncertainties regarding the regulatory approval of proprietary and collaboration product candidates. We do not believe the updates have materially changed the type or magnitude of the risks we face in comparison to the disclosure provided in our most recent Annual Report on Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Not applicable.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

Not applicable.

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### **Item 6. Exhibits**

<b>Exhibit</b>	<b>Title</b>
2.1	Agreement and Plan of Merger, dated November 14, 2007, by and between the Registrant and the Registrant's predecessor Nevada corporation (1)
3.1	Amended and Restated Certificate of Incorporation, as filed with the Delaware Secretary of State on October 7, 2007 (2)
3.2	Certificate of Designation, Preferences and Rights of the terms of the Series A Preferred Stock (1)
3.3	Bylaws, as amended (2)
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following materials from the Halozyme Therapeutics, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2012 formatted in eXtensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Comprehensive Loss, (iii) the Condensed Consolidated Statements of Cash Flows and (iv) related notes, tagged as block of text*.

\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

- (1) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed November 20, 2007 (File No. 001-32335).
- (2) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed December 12, 2011 (File No. 001-32335).

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**SIGNATURES**

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.

Halozyme Therapeutics, Inc.,  
a Delaware corporation

Dated: November 8, 2012

/s/ Gregory I. Frost, Ph.D.  
Gregory I. Frost, Ph.D.  
President and Chief Executive Officer  
(Principal Executive Officer)

Dated: November 8, 2012

/s/ Kurt A. Gustafson  
Kurt A. Gustafson  
Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)