Epizyme, Inc.
Form 10-Q
August 13, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2014

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: 001-35945

EPIZYME, INC.

(Exact name of registrant as specified in its charter)

Delaware	**26-1349956**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
400 Technology Square, Cambridge, Massachusetts	**02139**
(Address of principal executive offices)	**(Zip code)**

617-229-5872

(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 x 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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 definitions of accelerated filer, large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer ¨
Non-accelerated filer x (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 x

The number of shares outstanding of the registrant s common stock as of August 8, 2014: 33,583,533 shares.

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PART I - FINANCIAL INFORMATION

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

EPIZYME, INC.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Amounts in thousands except share and per share data)

	June 30, 2014	December 31, 2013
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 229,872	$ 123,564
Accounts receivable	2,191	33,667
Prepaid expenses and other current assets	2,656	2,421
Total current assets	234,719	159,652
Property and equipment, net	2,642	2,157
Restricted cash and other assets	1,010	1,179
Total Assets	$ 238,371	$ 162,988
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 4,516	$ 4,698
Accrued expenses	6,285	6,632
Current portion of deferred revenue	12,983	23,243
Total current liabilities	23,784	34,573
Deferred revenue, net of current portion	24,502	23,629
Other long-term liabilities	481	473
Commitments and contingencies		
Stockholders Equity:		
Preferred stock, $0.0001 par value; 5,000,000 shares authorized; 0 shares issued and outstanding		
Common stock, $0.0001 par value; 125,000,000 shares authorized; 33,371,665 shares and 28,494,447 shares issued, respectively; 33,371,665 shares and 28,488,892 shares outstanding, respectively	3	3
Additional paid-in capital	265,951	160,390
Accumulated deficit	(76,350)	(56,080)
Total stockholders equity	189,604	104,313

Total Liabilities and Stockholders	Equity	$ 238,371	$ 162,988

See notes to consolidated financial statements.

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EPIZYME, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS (UNAUDITED)

(Amounts in thousands except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Collaboration revenue	$ 9,494	$ 14,839	$ 22,885	$ 23,721
Operating expenses:				
Research and development	17,499	13,937	32,846	27,298
General and administrative	5,306	3,079	10,262	6,077
Total operating expenses	22,805	17,016	43,108	33,375
Operating loss	(13,311)	(2,177)	(20,223)	(9,654)
Other income (expense):				
Interest income	26	15	42	34
Other income (expense), net	12	(50)	24	(89)
Other income (expense), net	38	(35)	66	(55)
Loss before income taxes	(13,273)	(2,212)	(20,157)	(9,709)
Income tax expense	113		113	
Net loss	$ (13,386)	$ (2,212)	$ (20,270)	$ (9,709)
Less: accretion of redeemable convertible preferred stock to redemption value		107		264
Loss allocable to common stockholders	$ (13,386)	$ (2,319)	$ (20,270)	$ (9,973)
Loss per share allocable to common stockholders:				
Basic	$ (0.40)	$ (0.25)	$ (0.63)	$ (1.82)
Diluted	$ (0.40)	$ (0.25)	$ (0.63)	$ (1.82)
Weighted average shares outstanding:				
Basic	33,156	9,146	32,064	5,489
Diluted	33,156	9,146	32,064	5,489
Comprehensive loss	$ (13,386)	$ (2,212)	$ (20,270)	$ (9,709)

See notes to consolidated financial statements.

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EPIZYME, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Amounts in thousands)

	Six Months Ended June 30,	
	2014	**2013**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (20,270)	$ (9,709)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	362	363
Stock-based compensation	3,095	950
Changes in operating assets and liabilities:		
Accounts receivable	31,476	(5,979)
Prepaid expenses and other current assets	(235)	(1,206)
Accounts payable	(142)	290
Accrued expenses	(410)	39
Deferred revenue	(9,387)	(12,508)
Restricted cash and other assets	169	(773)
Other long-term liabilities	8	(1,152)
Net cash provided by (used in) operating activities	4,666	(29,685)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(824)	(230)
Net cash used in investing activities	(824)	(230)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from public offering, net of commissions	101,283	82,491
Proceeds from stock options exercised	1,334	168
Excess tax benefit from stock option plan	28	
Issuance of shares under employee stock purchase plan	201	
Payment of public offering costs	(649)	(2,036)
Proceeds from reimbursement of public offering costs	269	
Net cash provided by financing activities	102,466	80,623
Net increase in cash and cash equivalents	106,308	50,708
Cash and cash equivalents, beginning of period	123,564	97,981
Cash and cash equivalents, end of period	$ 229,872	$ 148,689

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Conversion of redeemable convertible preferred stock to common stock		76,420
Purchases of property and equipment unpaid at period end	113	
Accretion of redeemable convertible preferred stock to redemption value		264
Public offering costs incurred but unpaid at period end		767

See notes to consolidated financial statements.

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EPIZYME, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Overview and Basis of Presentation

Epizyme, Inc. (collectively referred to with its wholly owned, controlled subsidiary, Epizyme Securities Corporation, as Epizyme or the Company) is a clinical stage biopharmaceutical company that discovers, develops and plans to commercialize innovative personalized therapeutics for patients with genetically defined cancers. The Company has built a proprietary product platform that it uses to create small molecule inhibitors of a 96-member class of enzymes known as histone methyltransferases (HMTs). Genetic alterations can result in changes to the activity of HMTs, making them oncogenic. The Company s therapeutic strategy is to inhibit oncogenic HMTs to treat the underlying causes of the associated genetically defined cancers.

The consolidated financial statements of the Company included herein have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted from this report, as is permitted by such rules and regulations. Accordingly, these consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2013 (the Annual Report).

The unaudited consolidated financial statements include the accounts of Epizyme and its subsidiary. All intercompany transactions and balances of subsidiaries have been eliminated in consolidation. In the opinion of management, the information furnished reflects all adjustments, all of which are of a normal and recurring nature, necessary for a fair presentation of the results for the reported interim periods. The Company considers events or transactions that occur after the balance sheet date but before the financial statements are issued to provide additional evidence relative to certain estimates or to identify matters that require additional disclosure. The three months ended June 30, 2014 and 2013 are referred to as the second quarter of 2014 and 2013, respectively. The results of operations for interim periods are not necessarily indicative of results to be expected for the full year or any other interim period.

In February 2014, the Company completed a public offering of its common stock, which resulted in the sale of 3,673,901 shares, including all additional shares available to cover over-allotments, at a price of $29.25 per share. The Company received net proceeds before expenses from this offering of $101.3 million after deducting underwriting discounts and commissions paid by the Company.

2. Summary of Significant Accounting Policies

There have been no material changes to the significant accounting policies previously disclosed in the Company s Annual Report.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-09, *Revenue From Contracts With Customers*. ASU 2014-09 amends Accounting Standards Codification (ASC) 605, *Revenue Recognition*, by outlining a single comprehensive model for entities to use in accounting for revenue arising

from contracts with customers. ASU 2014-09 will be effective for the Company for interim and annual periods beginning after December 15, 2016. The Company is evaluating the impact that this ASU may have on its consolidated financial statements, if any.

3. Fair Value Measurements

The Company classifies fair value based measurements using a three-level hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows: Level 1, quoted market prices in active markets for identical assets or liabilities; Level 2, observable inputs other than quoted market prices included in Level 1 such as quoted

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market prices for markets that are not active or other inputs that are observable or can be corroborated by observable market data; and Level 3, unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities, including certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

The Company s financial instruments as of June 30, 2014 and December 31, 2013 consisted primarily of cash and cash equivalents, accounts receivable and accounts payable. As of June 30, 2014 and December 31, 2013, the Company s financial assets recognized at fair value consisted of the following:

	Fair Value as of June 30, 2014			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Cash equivalents	$ 222,010	$ 222,010	$	$
Total	$ 222,010	$ 222,010	$	$

	Fair Value as of December 31, 2013			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Cash equivalents	$ 121,424	$ 121,424	$	$
Total	$ 121,424	$ 121,424	$	$

4. Accrued Expenses

Accrued expenses consisted of the following:

	June 30, 2014	December 31, 2013
	(In thousands)	
Employee compensation and benefits	$ 1,967	$ 2,607
Contract termination obligation	186	355
Research and development and professional expenses	4,132	3,670
Accrued expenses	$ 6,285	$ 6,632

Contract termination obligation includes estimated lease exit charges related to the Company s former facility at 325 Vassar Street in Cambridge, Massachusetts. As of December 31, 2013, the Company had a recorded contract termination obligation of $0.4 million. During the six months ended June 30, 2014, the Company made cash payments of $0.5 million and recorded sublease income of $0.3 million, resulting in total remaining contract termination obligations of $0.2 million as of June 30, 2014.

5. Income Taxes

The Company recorded $0.1 million of income tax expense in the three and six months ended June 30, 2014 due to provision-to-return adjustments identified related to the year ended December 31, 2013. The Company did not record a federal or state income tax provision or benefit for the three or six months ended June 30, 2014 related to the year ending December 31, 2014, due to the expected loss before income taxes to be incurred for the year ending December 31, 2014, as well as the Company s continued maintenance of a full valuation allowance against its net deferred tax assets.

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The Company did not record a federal or state income tax provision or benefit for the three or six months ended June 30, 2013 due to the expected loss before income taxes to be incurred for the year ended December 31, 2013, as well as the Company s continued maintenance of a full valuation allowance against its net deferred tax assets.

6. Collaborations

Celgene

In April 2012, the Company entered into a collaboration and license agreement with Celgene Corporation and Celgene International Sàrl (collectively, Celgene) to discover, develop and commercialize, in all countries other than the United States, small molecule HMT inhibitors targeting the DOT1L HMT, including the Company s product candidate EPZ-5676, and any other HMT targets from the Company s product platform for patients with genetically defined cancers, excluding targets already selected by the Company s two other existing therapeutic collaborations (the available targets).

Agreement Structure

Under the terms of the agreement, the Company recorded a $65.0 million upfront payment and $25.0 million from the sale of its series C redeemable convertible preferred stock to an affiliate of Celgene, of which $3.0 million was considered a premium and included as collaboration arrangement consideration for a total upfront payment of $68.0 million. In addition, the Company has recorded a $25.0 million clinical development milestone payment and $3.2 million of global development co-funding through June 30, 2014. The Company is also eligible to receive up to $35.0 million in additional substantive clinical development milestone payments and up to $100.0 million in substantive regulatory milestone payments related to DOT1L as well as up to $65.0 million in payments, including a combination of substantive clinical development milestone payments and an option exercise fee for each selected target, and up to $100.0 million in substantive regulatory milestone payments for each available target as to which Celgene exercises its option during an initial option period ending in July 2015. Celgene has the right to extend the option period until July 2016 by making a significant option extension payment. As to DOT1L and each available target as to which Celgene exercises its option, the Company retains all product rights in the United States and is eligible to receive royalties for each target at defined percentages ranging from the mid-single digits to the mid-teens on net product sales outside of the United States subject to reduction in specified circumstances. Due to the uncertainty of pharmaceutical development and the high historical failure rates generally associated with drug development, the Company may not receive any additional milestone or royalty payments from Celgene. The next potential milestone payment that the Company might be entitled to receive under this agreement is a $35.0 million substantive milestone for the initiation of a pivotal clinical trial, as defined in the agreement, for its DOT1L inhibitor.

The Company is obligated to conduct and solely fund research and development costs of the Phase 1 clinical trials for EPZ-5676. For all development costs other than the development costs of the Phase 1 clinical trials for EPZ-5676, Celgene and the Company will equally co-fund global development and each party will solely fund territory-specific development costs for its territory. The Company is obligated to conduct and solely fund research and development costs through the effectiveness of the first investigational new drug application (IND) for an HMT inhibitor directed to each available target selected by Celgene, after which point Celgene and the Company will equally co-fund global development and each party will solely fund territory-specific development costs for its territory. In the second quarter of 2014, the Company recorded accounts receivable of $0.6 million related to non-Phase 1 global development costs subject to the co-funding provisions of the agreement. Co-funded amounts received or receivable from Celgene are recorded as a reduction to research and development expense.

Collaboration Revenue

Through June 30, 2014, in addition to amounts allocated to Celgene s purchase of shares of the Company s series C redeemable convertible preferred stock, the Company had recorded a total of $96.2 million in cash and accounts receivable under the Celgene agreement, including the $3.0 million implied premium on Celgene s purchase of shares of the Company s series C redeemable convertible preferred stock. Through June 30, 2014, the Company has recognized $64.6 million of collaboration revenue, including $1.2 million and $2.9 million in the three and six months ended June 30, 2014, respectively, and $3.6 million and $7.2 million in the three and six months ended June 30, 2013, respectively, and $3.2 million of global development co-funding as a reduction to research and development expense, including $0.9 million and $1.3 million in the three and six months ended June 30, 2014, in the consolidated statements of operations and comprehensive loss related to this agreement. Revenue recognized in the three and six months ended June 30, 2014 reflects the Company s current plan to reach

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IND effectiveness for a licensed compound from the other potential DOT1L product candidates by mid-2016. As a result, the remaining deferred revenue of approximately $6.1 million attributed to this deliverable as of June 30, 2014 will be recognized ratably through June 30, 2016. As of June 30, 2014 and December 31, 2013, the Company had deferred revenue of $28.4 million and $31.3 million, respectively, related to this agreement.

Eisai

In April 2011, the Company entered into a collaboration and license agreement with Eisai Co. Ltd. (Eisai) under which the Company granted Eisai an exclusive worldwide license to its small molecule HMT inhibitors directed to the EZH2 HMT, including the Company s product candidate EPZ-6438, while retaining an opt-in right to co-develop, co-commercialize and share profits with Eisai as to licensed products in the United States. Additionally, as part of the research collaboration, the Company agreed to provide research and development services related to the licensed compounds through December 31, 2014.

Agreement Structure

Under the terms of the agreement, the Company recorded a $3.0 million upfront payment, $7.0 million in preclinical research and development milestone payments, a $6.0 million clinical development milestone payment and $20.8 million for research and development services through June 30, 2014. The Company is eligible to receive up to $25.0 million in additional clinical development milestone payments, including substantive milestone payments of up to $10.0 million, up to $55.0 million in regulatory milestone payments and up to $115.0 million in sales-based milestone payments. The Company is also eligible to receive royalties at a percentage in the mid-single digits on any net product sales outside of the United States and at a percentage from the mid-single digits to low double-digits on any product sales in the United States, subject to reduction in specified circumstances. Due to the uncertainty of pharmaceutical development and the high historical failure rates generally associated with drug development, the Company may not receive any additional milestone payments or royalty or profit share payments from Eisai. The next potential milestone payment that the Company might be entitled to receive under this agreement is a $10.0 million substantive milestone for the initiation of the Phase 2 portion of the ongoing Phase 1/2 clinical trial of EPZ-6438.

Eisai solely funds all research, development and commercialization costs for licensed compounds, except for the cost obligations that the Company will undertake if it exercises its opt-in right to co-develop, co-commercialize and share profits with Eisai as to licensed products in the United States. If the Company exercises its opt-in right to a licensed compound, the licensed compound would become a shared product as to which (i) Eisai s obligation to pay royalties to the Company as to such shared product in the United States will terminate; (ii) Eisai and the Company will share in net profits or losses with respect to such shared product in the United States; (iii) 25.0% of specified past development costs will become creditable by Eisai against future milestones or royalties due to the Company, subject to certain limitations specified in the agreement; (iv) all subsequent milestone payments that become payable by Eisai after the Company exercises its opt-in right will be decreased by 50.0% in certain circumstances; and (v) Eisai and the Company will share equally in subsequent development costs allocated to the United States.

Collaboration Revenue

Through June 30, 2014, the Company recorded a total of $36.8 million in cash and accounts receivable under the Eisai agreement. Through June 30, 2014, the Company has recognized $36.0 million of collaboration revenue in the consolidated statements of operations and comprehensive loss related to this agreement, including $2.0 million and $3.6 million in the three and six months ended June 30, 2014, respectively, and $8.2 million and $10.5 million in the three and six months ended June 30, 2013, respectively, with a $6.0 million clinical development milestone achieved and recognized as collaboration revenue in the three and six months ended June 30, 2013. As of June 30, 2014 and

December 31, 2013, the Company had deferred revenue of $0.8 million and $1.6 million, respectively, related to this agreement.

GSK

In January 2011, the Company entered into a collaboration and license agreement with Glaxo Group Limited, an affiliate of GlaxoSmithKline (GSK), to discover, develop and commercialize novel small molecule HMT inhibitors directed to available targets from the Company s platform. Under the terms of the agreement, the Company granted GSK exclusive worldwide license rights to HMT inhibitors directed to three targets. Additionally, as part of the research collaboration, the Company agreed to provide research and development services related to the licensed targets pursuant to agreed upon research plans until

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the earlier of the achievement of development candidate selection for a target or the end of the research term on January 8, 2015. During 2013, development candidate selection was achieved for the first target under the collaboration and license agreement, and, accordingly, the Company is no longer providing research and development services related to this target as of June 30, 2014.

In March 2014, the Company and GSK amended certain terms of this agreement for the third target, revising the license terms with respect to candidate compounds and amending the corresponding financial terms, including reallocating milestone payments and increasing royalty rates as to the third target. In connection with the execution of this amendment, the Company recorded a $3.0 million upfront payment. This $3.0 million upfront payment has been allocated equally to the remaining two targets for which the Company is actively providing research and development services, as these remaining two targets are at similar stages of development, have equal probabilities of success and the remaining research services are expected to be performed concurrently on a ratable basis over the research term. The $3.0 million is being recognized as collaboration revenue, on a target-by-target basis, ratably from the execution of the amendment, in March 2014, through the end of the research term, or earlier if a target reaches development candidate selection.

Agreement Structure

Under the agreement, the Company recorded a $20.0 million upfront payment, a $3.0 million payment upon the execution of the March 2014 agreement amendment, $6.0 million of fixed research funding, $15.0 million of preclinical research and development milestone payments and $6.7 million for research and development services through June 30, 2014. The Company is eligible to receive up to $18.0 million in additional substantive preclinical research and development milestone payments, up to $109.0 million in clinical development milestone payments, up to $275.0 million in regulatory milestone payments and up to $218.0 million in sales-based milestone payments. In addition, GSK is required to pay the Company royalties, at percentages from the mid-single digits to the low double-digits, on a licensed product-by-licensed product basis, on worldwide net product sales, subject to reduction in specified circumstances. Due to the uncertainty of pharmaceutical development and the high historical failure rates generally associated with drug development, the Company may not receive any additional milestone payments or royalty payments from GSK. Due to the varying stages of development of each licensed target, the Company is not able to determine the next milestone that might be achieved under this agreement, if any.

For each selected target in the collaboration, the Company is primarily responsible for research until the selection of the development candidate, and GSK is solely responsible for subsequent development and commercialization. GSK provided a fixed amount of research funding during the second and third years of the research term and is obligated to provide research funding equal to 100.0% of research and development costs, subject to specified limitations, for research activities conducted by the Company in the fourth year of the research term.

Collaboration Revenue

Through June 30, 2014, the Company recorded a total of $50.7 million in payments under the GSK agreement. Through June 30, 2014, the Company has recognized $42.5 million of collaboration revenue in the consolidated statements of operations and comprehensive loss related to this agreement, including $6.3 million and $16.4 million in the three and six months ended June 30, 2014, respectively, and $3.0 million and $6.0 million in the three and six months ended June 30, 2013, respectively, with a $1.0 million preclinical research and development milestone achieved and recognized as collaboration revenue in the three months ended June 30, 2014 and an additional $2.0 million preclinical research and development milestone achieved and recognized as collaboration revenue in the six months ended June 30, 2014. As of June 30, 2014 and December 31, 2013, the Company had deferred revenue of $8.2 million and $13.9 million, respectively, related to this agreement.

Companion Diagnostics

Roche

In December 2012, Eisai and the Company entered into an agreement with Roche Molecular Systems, Inc. (Roche) under which Eisai and the Company are funding Roche s development of a companion diagnostic to identify patients who possess certain point mutations in EZH2. In October 2013, this agreement was amended to include additional point mutations in EZH2. The development costs under the agreement with Roche are the responsibility of Eisai until such time, if any, as the Company exercises its opt-in right under the collaboration agreement with Eisai. Under the terms of the amended agreement, Eisai agreed to pay Roche defined milestone payments of up to $21.5 million to develop and to make commercially available the companion

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diagnostic. As a result, the cost of the companion diagnostic agreement, prior to the Company s potential future exercise of its opt-in right under the Eisai collaboration, will not be reflected in the Company s consolidated statements of operations and comprehensive loss. If the Company exercises its opt-in right to co-develop, co-commercialize and share profits in the United States as to EPZ-6438, Eisai will be entitled to offset up to 25.0% of the funding amount it has previously paid to Roche against future milestone payments and royalties that Eisai may be obligated to pay to the Company under the Eisai collaboration and license agreement, and the Company will become obligated to fund up to half of the defined milestones that remain payable to Roche as of the time the Company opts-in.

Abbott

In February 2013, the Company entered into an agreement with Abbott Molecular Inc. (Abbott) under which the Company agreed to fund Abbott s development of a companion diagnostic to identify patients with the mixed lineage leukemia (MLL-r) genetic alteration targeted by the Company s EPZ-5676 product candidate. Under the terms of the agreement, the Company paid Abbott an upfront payment of $0.9 million upon the execution of the agreement, is obligated to make aggregate milestone-based development payments of up to $6.0 million and is obligated to reimburse Abbott for specified costs not to exceed $0.9 million.

7. Stock-Based Compensation

Total stock-based compensation expense related to stock options, restricted stock and the employee stock purchase plan was $1.6 million and $0.6 million for the three months ended June 30, 2014 and 2013, respectively, and $3.1 million and $1.0 million for the six months ended June 30, 2014 and 2013, respectively.

Stock-based compensation expense is classified in the consolidated statements of operations and comprehensive loss as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(In thousands)			
Research and development	$ 815	$ 246	$ 1,496	$ 401
General and administrative	817	369	1,599	549
Total	$ 1,632	$ 615	$ 3,095	$ 950

Stock Options

The weighted-average fair value of options, estimated as of the grant date using the Black-Scholes option pricing model, was $17.15 and $18.10 per option for those options granted during the three months ended June 30, 2014 and 2013, respectively, and $22.53 and $6.19 per option for those options granted during the six months ended June 30, 2014 and 2013, respectively. Key assumptions used to apply this pricing model were as follows:

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013

Risk-free interest rate	1.6%	0.9%
Expected life of options	6.0 years	6.0 years
Expected volatility of underlying stock	93.4%	96.2%
Expected dividend yield	0.0%	0.0%

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The following is a summary of stock option activity for the six months ended June 30, 2014:

	Number of Options	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2013	4,728,503	$ 3.13		
Granted	579,737	29.67		
Exercised	(1,195,515)	1.12		
Forfeited or expired	(38,889)	14.88		
Outstanding at June 30, 2014	4,073,836	$ 7.38	7.6	$ 96,893
Exercisable at June 30, 2014	2,118,418	$ 1.36	6.5	$ 63,043

As of June 30, 2014, there was $19.6 million of unrecognized compensation cost related to stock options that are expected to vest. These costs are expected to be recognized over a weighted average remaining vesting period of 2.7 years.

Restricted Stock

The following is a summary of restricted stock activity for the six months ended June 30, 2014:

	Number of Shares	Weighted Average Grant Date Fair Value per Share
Outstanding at December 31, 2013	5,555	$ 0.60
Vested	(5,555)	0.60
Outstanding at June 30, 2014		$

8. Loss Per Share

Basic (loss) earnings per share is computed by dividing (loss) income allocable to common stockholders by the weighted average number of common shares outstanding. During periods of income, participating securities are allocated a proportional share of income determined by dividing total weighted average participating securities by the sum of the total weighted average common shares and participating securities (the two-class method). The Company s

restricted stock and, prior to its automatic conversion, redeemable convertible preferred stock participate in any dividends declared by the Company and are therefore considered to be participating securities. Participating securities have the effect of diluting both basic and diluted earnings per share during periods of income. During periods of loss, no loss is allocated to participating securities since they have no contractual obligation to share in the losses of the Company. Diluted (loss) earnings per share is computed after giving consideration to the dilutive effect of stock options that are outstanding during the period, except where such non-participating securities would be anti-dilutive.

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Basic and diluted loss per share allocable to common stockholders are computed as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(In thousands except per share data)			
Net loss	$ (13,386)	$ (2,212)	$ (20,270)	$ (9,709)
Less: accretion of redeemable convertible preferred stock to redemption value		107		264
Loss allocable to common stockholders	$ (13,386)	$ (2,319)	$ (20,270)	$ (9,973)
Weighted average shares outstanding	33,156	9,146	32,064	5,489
Basic and diluted loss per share allocable to common stockholders	$ (0.40)	$ (0.25)	$ (0.63)	$ (1.82)

In June 2013, the Company issued 5,913,300 shares of common stock in connection with its initial public offering (IPO) and 20,633,046 shares of common stock in connection with the automatic conversion of its redeemable convertible preferred stock upon the closing of the IPO. In February 2014, the Company issued an additional 3,673,901 shares of common stock in connection with a public offering. The issuance of these shares contributed to a significant increase in the Company s shares outstanding, to 33,371,665 shares as of June 30, 2014, and in the weighted average shares outstanding for the three and six months ended June 30, 2014 when compared to the comparable prior year periods and is expected to continue to impact the year-over-year comparability of the Company s (loss) earnings per share calculations through 2014.

The following common stock equivalents were excluded from the calculation of diluted loss per share allocable to common stockholders because their inclusion would have been anti-dilutive:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(In thousands)			
Stock options	4,074	4,637	4,074	4,637
Unvested restricted stock		14		14
Shares issuable under employee stock purchase plan	7		7	
	4,081	4,651	4,081	4,651

9. Related Party Transactions

The Company s collaboration partner Celgene has made a series of equity investments in the Company, owning 3,334,640 shares of common stock as of December 31, 2013. In the first quarter of 2014, in connection with the Company s public offering of common stock, Celgene made an additional investment in the Company, acquiring an additional 340,000 shares of the Company s common stock, maintaining an ownership percentage representing 9.8% of

the Company s fully diluted equity and 11.0% of the voting interests of the Company as of June 30, 2014. Refer to Note 6, *Collaborations*, for additional information regarding this collaboration agreement.

Under the Celgene collaboration agreement, the Company recognized $1.2 million and $2.9 million of collaboration revenue in the three and six months ended June 30, 2014 and $3.6 million and $7.2 million of collaboration revenue in the three and six months ended June 30, 2013, respectively, and as of June 30, 2014 and December 31, 2013, had recorded $28.4 million and $31.3 million of deferred revenue related to the Celgene collaboration arrangement, respectively. Additionally, in the three and six months ended June 30, 2014, the Company recorded $0.9 million and $1.3 million, respectively, in global development co-funding from Celgene. As of June 30, 2014 and December 31, 2013, the Company had accounts receivable of $0.6 million and $26.2 million related to this collaboration arrangement.

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

Forward-looking Information

This Quarterly Report on Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. These statements may be identified by such forward-looking terminology as anticipate, believe, estimate, expect, intend, may, plan, predict, project, target, potential, will, would, could, should, continue, and similar statements or variations of such terms. Our forward-looking statements are based on a series of expectations, assumptions, estimates and projections about our company, are not guarantees of future results or performance and involve substantial risks and uncertainty. We may not actually achieve the plans, intentions or expectations disclosed in our forward-looking statements. Actual results or events could differ materially from the plans, intentions and expectations disclosed in these forward-looking statements. Our business and our forward-looking statements involve substantial known and unknown risks and uncertainties, including the risks and uncertainties inherent in our statements regarding:

- *our plans to develop and commercialize personalized therapeutics for patients with genetically defined cancers;*
- *our ongoing and planned clinical trials, including the timing of anticipated results;*
- *our ability to receive research funding and achieve anticipated milestones under our collaborations;*
- *the timing of and our ability to obtain and maintain regulatory approvals for our product candidates;*
- *the rate and degree of market acceptance and clinical utility of our products;*
- *our commercialization, marketing and manufacturing capabilities and strategy;*
- *our intellectual property position;*
- *our ability to identify additional products or product candidates with significant commercial potential that are consistent with our commercial objectives; and*
- *our estimates regarding expenses, future revenue, capital requirements and needs for additional financing.*

All of our forward-looking statements are as of the date of this Quarterly Report on Form 10-Q only. In each case, actual results may differ materially from such forward-looking information. We can give no assurance that such expectations or forward-looking statements will prove to be correct. An occurrence of or any material adverse change in one or more of the risk factors or risks and uncertainties referred to in this Quarterly Report on Form 10-Q or

included in our other public disclosures or our other periodic reports or other documents or filings filed with or furnished to the Securities and Exchange Commission, or the SEC, could materially and adversely affect our business, prospects, financial condition and results of operations. Except as required by law, we do not undertake or plan to update or revise any such forward-looking statements to reflect actual results, changes in plans, assumptions, estimates or projections or other circumstances affecting such forward-looking statements occurring after the date of this Quarterly Report on Form 10-Q, even if such results, changes or circumstances make it clear that any forward-looking information will not be realized. Any public statements or disclosures by us following this Quarterly Report on Form 10-Q which modify or impact any of the forward-looking statements contained in this Quarterly Report on Form 10-Q will be deemed to modify or supersede such statements in this Quarterly Report on Form 10-Q.

Management Overview

We are a clinical stage biopharmaceutical company that discovers, develops and plans to commercialize innovative personalized therapeutics for patients with genetically defined cancers. We have built a proprietary product platform that we use to create small molecule inhibitors of a 96-member class of enzymes known as histone methyltransferases, or HMTs. Genetic alterations can result in changes to the activity of HMTs, making them oncogenic. Our therapeutic strategy is to inhibit oncogenic HMTs to treat the underlying causes of the associated genetically defined cancers. The three months ended June 30, 2014 and 2013 are referred to as the second quarter of 2014 and 2013, respectively. Unless the context indicates otherwise, all references herein to our company include our wholly-owned subsidiary.

Our management s discussion and analysis of our financial condition and results of operations are based upon our unaudited consolidated financial statements included in this Quarterly Report on Form 10-Q, which have been prepared by us in accordance with accounting principles generally accepted in the United States of America, or GAAP, for interim periods and

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with Regulation S-X promulgated under the Securities Exchange Act of 1934, as amended, or the Exchange Act. This discussion and analysis should be read in conjunction with these unaudited consolidated financial statements and the notes thereto as well as in conjunction with our Annual Report on Form 10-K for the fiscal year ended December 31, 2013, or our Annual Report.

We commenced active operations in early 2008, and since inception, have incurred significant operating losses. As we are a clinical stage company, we expect to continue to incur significant expenses and operating losses over the next several years. Since our inception and through June 30, 2014, we have raised an aggregate of $441.5 million to fund our operations, of which $181.7 million was non-equity funding through our collaboration agreements, $183.8 million was from the sale of common stock in our public offerings and $76.0 million was from the sale of redeemable convertible preferred stock. In addition, as of June 30, 2014, we were entitled to receive $2.2 million in non-equity funding through our collaboration agreements. As of June 30, 2014, we had $229.9 million in cash and cash equivalents.

We are a leader in the translation of the science of epigenetics into first-in-class personalized therapeutics for patients with genetically defined cancers and currently have two HMT inhibitors in clinical development for the treatment of patients with genetically defined cancers. We believe we are the first company to conduct a clinical trial of an HMT inhibitor. We are conducting a Phase 1 clinical trial of our most advanced product candidate, EPZ-5676, an inhibitor targeting the DOT1L HMT, being developed for the treatment of acute leukemias with genetic alterations of the *MLL* gene, referred to as MLL-r or MLL-PTD, and plan to disclose adult Phase 1 dose escalation and expansion stage data in the fourth quarter of 2014. In May 2014, we initiated a Phase 1b study in pediatric patients with MLL-r leukemia, which is considered to be one of the last inadequately treated pediatric acute leukemias. This Phase 1b study is designed to evaluate the safety, pharmacokinetics and pharmacodynamics of escalating doses of EPZ-5676 in patients between the ages of 3 months and 18 years and also provide a preliminary assessment of efficacy. With this pediatric study, we now have ongoing assessments of proof-of-concept in three genetically defined cancer patient groups in the EPZ-5676 clinical program: adult MLL-r, adult MLL-PTD and pediatric MLL-r. We are also conducting a Phase 1/2 clinical trial of our second most advanced product candidate, EPZ-6438, an inhibitor targeting the EZH2 HMT, being developed for the treatment of a genetically defined subtype of non-Hodgkin lymphoma and solid tumors including INI1-deficient tumors such as synovial sarcoma and malignant rhabdoid tumors, or MRT. In August 2014, we disclosed early clinical observations from the Phase 1 portion of this Phase 1/2 study and plan to disclose further data from the Phase 1 portion of this Phase 1/2 study in the fourth quarter of 2014. Pending the final results of the Phase 1 portion of the ongoing Phase 1/2 study, we plan to initiate Phase 2 development, enrolling two proof-of-concept studies, one in non-Hodgkin lymphoma patients and one in patients with INI1-deficient tumors. In addition to our clinical programs, we also have a pipeline of other HMT inhibitors that are in preclinical development that target our other prioritized HMTs. These programs are directed to genetically defined cancers, both hematological and solid tumors.

The clinical development plan for each of our therapeutic product candidates is directed towards patients with a particular genetically defined cancer. For many of our therapeutic product candidates, we plan to develop a companion diagnostic for the identification of patients with the genetically defined cancers that we seek to treat with our therapeutic product candidates. We plan to include patients with the particular genetically defined cancer in our clinical trials beginning in Phase 1 with a view to assessing possible early evidence of potential therapeutic effect. As we are tailoring our personalized therapeutics for discrete patient populations with genetically defined cancers, we believe that many of our products may qualify for orphan drug designation in the United States, the European Union and other regions.

We have entered into strategic collaborations for certain of our therapeutic programs and corresponding companion diagnostics. Our three primary collaboration partners for our therapeutic programs are Celgene Corporation and

Celgene International Sàrl, collectively, Celgene; Eisai Co., Ltd., or Eisai; and Glaxo Group Limited, an affiliate of GlaxoSmithKline, or GSK. We retain all product rights in the United States under the Celgene collaboration and an opt-in right to co-develop, co-commercialize and share profits as to licensed products in the United States under the Eisai collaboration.

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The following table summarizes key information about our two most advanced product candidates:

Product Candidate	Clinical Populations	Stage of Development	Commercial Rights	Diagnostic Collaborator
EPZ-5676 (DOT1L inhibitor)	Acute leukemias with alterations in the *MLL* gene	Phase 1 MLL-r and MLL-PTD adult patient trial ongoing	Epizyme: United States Celgene: Rest of world	Abbott (MLL-r)
	MLL-r subtype of acute myeloid leukemia, or AML, and acute lymphoblastic leukemia, or ALL, in adult patients	Dose escalation stage fully enrolled in MLL-r adult patient trial		
	(Chromosomal translocation involving the *MLL* gene)			
	MLL partial tandem duplication, or MLL-PTD, subtype of AML in adult patients	MLL-r / MLL-PTD only adult expansion stage enrolling		
	(Partial tandem duplication of the *MLL* gene)			
	MLL-r in pediatric patients	Phase 1b MLL-r pediatric patient trial enrolling		
	(Chromosomal translocation involving the *MLL* gene)			
EPZ-6438 (EZH2 inhibitor)	Non-Hodgkin lymphomas, including germinal center diffuse large B-cell lymphoma, primary mediastinal B-cell	Phase 1/2 clinical trial ongoing	Eisai: Worldwide rights, subject to Epizyme s opt-in on 50.0% of United	Roche (Non-Hodgkin lymphoma with

lymphoma and follicular lymphoma (EZH2)	Phase 1 dose escalation enrolling Phase 2 trial for non-Hodgkin lymphoma patients expected to initiate in 2014 pending our review of data from the Phase 1 dose escalation trial	States rights	EZH2 point mutations)
Other solid tumors, such as synovial sarcoma and MRT (INI1-deficient)	Phase 2 trial for patients with INI1-deficient tumors expected to initiate in 2014 pending our review of data from the Phase 1 dose escalation trial		

Program highlights for the six months ended June 30, 2014 include:

For EPZ-5676, we continued enrollment in the expansion stage of our Phase 1 trial which is limited to patients with MLL-r and MLL-PTD. In May 2014, we initiated our Phase 1b trial of EPZ-5676 in pediatric MLL-r patients.

For EPZ-6438, which Eisai refers to as E7438, we continued enrollment in the Phase 1 portion of our Phase 1/2 clinical trial. In August 2014, we disclosed early clinical observations from the Phase 1 portion of this Phase 1/2 study as well as findings characterizing the activity of EPZ-6438 in preclinical models of non-Hodgkin lymphoma, both as a single agent and in combination with current standards of care. These early clinical observations further substantiate our preclinical findings that EPZ-6438 demonstrates activity both in germinal center B-cell lymphomas with EZH2 point mutations as well as in germinal center B-cell lymphomas with wild-type EZH2. In a report that we commissioned, Clarion Healthcare estimated that the annual incidence rate in the major markets of both mutant and wild-type EZH2 germinal center B-cell lymphomas is approximately 72,000 patients. Many of these patients survive beyond the year in which they are diagnosed. Accordingly, we believe that the prevalence of potential EPZ-6438 patients is significantly higher than the annual incidence. Additionally, in April 2014, the United States Patent and Trademark Office granted our U.S. Patent No. 8,691,507 with claims that cover the diagnosis and treatment of cancers associated with EZH2 mutation.

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For our discovery and preclinical stage product programs, we continued to progress the target programs partnered with GSK, collectively earning $3.0 million in preclinical research and development milestones upon the February 2014 selection of a lead candidate for the second of the three targets under the agreement and the April 2014 selection of a lead candidate for the third of the three targets under the agreement. We also continued to progress a number of other research programs directed to high priority HMTs in our pipeline.

Collaborations

The key terms of our primary collaboration agreements are as follows:

Celgene

In April 2012, we entered into a collaboration and license agreement with Celgene, to discover, develop and commercialize, in all countries other than the United States, small molecule HMT inhibitors targeting DOT1L, including EPZ-5676, and any other HMT targets from our product platform for patients with genetically defined cancers, excluding targets already selected by our two other existing collaborations, which we refer to as the available targets.

Agreement Structure

Under the terms of the agreement, we recorded a $65.0 million upfront payment and $25.0 million from the sale of our series C redeemable convertible preferred stock to an affiliate of Celgene, of which $3.0 million was considered a premium and included as collaboration arrangement consideration for a total upfront payment of $68.0 million. In addition, we have recorded a $25.0 million clinical development milestone payment and $3.2 million of global development co-funding through June 30, 2014. We are also eligible to receive up to $35.0 million in additional clinical development milestone payments and up to $100.0 million in regulatory milestone payments related to DOT1L as well as up to $65.0 million in payments, including a combination of clinical development milestone payments and an option exercise fee for each selected target, and up to $100.0 million in regulatory milestone payments for each available target as to which Celgene exercises its option during an initial option period ending in July 2015. Celgene has the right to extend the option period until July 2016 by making a significant option extension payment. As to DOT1L and each available target as to which Celgene exercises its option, we retain all product rights in the United States and are eligible to receive royalties for each target at defined percentages ranging from the mid-single digits to the mid-teens on net product sales outside of the United States, subject to reductions in specified circumstances. Due to the uncertainty of pharmaceutical development and the high historical failure rates generally associated with drug development, we may not receive any additional milestone or royalty payments from Celgene. The next potential milestone payment that we might be entitled to receive under this agreement is $35.0 million for the initiation of a pivotal clinical trial, as defined in the agreement, for our DOT1L inhibitor.

We are obligated to conduct and solely fund research and development costs of the Phase 1 clinical trials for EPZ-5676. For all development costs other than the development costs of the Phase 1 clinical trials for EPZ-5676, Celgene and we will equally co-fund global development and each party will solely fund territory-specific development costs for its territory. We are obligated to conduct and solely fund research and development costs through the effectiveness of the first investigational new drug application for an HMT inhibitor directed to each available target selected by Celgene, after which point Celgene and we will equally co-fund global development and each party will solely fund territory-specific development costs for its territory. In the second quarter of 2014, we recorded accounts receivable of $0.6 million related to non-Phase 1 global development costs subject to the co-funding provisions of this agreement. Co-funded amounts received or receivable from Celgene are recorded as a

reduction to research and development expense.

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Collaboration Revenue

Through June 30, 2014, in addition to amounts allocated to Celgene s purchase of shares of our series C redeemable convertible preferred stock, we had recorded a total of $96.2 million in cash and accounts receivable under the Celgene agreement, including the $3.0 million implied premium on Celgene s purchase of our series C redeemable convertible preferred stock. Through June 30, 2014, we have recognized $64.6 million of collaboration revenue, including $1.2 million and $2.9 million in the three and six months ended June 30, 2014, respectively, and $3.6 million and $7.2 million in the three and six months ended June 30, 2013, respectively, and $3.2 million of global development co-funding as a reduction to research and development expense, including $0.9 million and $1.3 million in the three and six months ended June 30, 2014, in the consolidated statements of operations and comprehensive loss related to this agreement. As of June 30, 2014 and December 31, 2013, we had deferred revenue of $28.4 million and $31.3 million, respectively, related to this agreement.

Eisai

In April 2011, we entered into a collaboration and license agreement with Eisai under which we granted Eisai an exclusive worldwide license to our small molecule HMT inhibitors directed to EZH2, including EPZ-6438, while retaining an opt-in right to co-develop, co-commercialize and share profits with Eisai as to licensed products in the United States. Additionally, as part of the research collaboration, we agreed to provide research and development services related to the licensed compounds through December 31, 2014.

Agreement Structure

Under the terms of the agreement, we recorded a $3.0 million upfront payment, $7.0 million in preclinical research and development milestone payments, a $6.0 million clinical development milestone payment and $20.8 million for research and development services through June 30, 2014. We are eligible to receive up to $25.0 million in additional clinical development milestone payments, up to $55.0 million in regulatory milestone payments and up to $115.0 million in sales-based milestone payments. We are also eligible to receive royalties at a percentage in the mid-single digits on any net product sales outside of the United States and at a percentage from the mid-single digits to low double-digits on any net product sales in the United States, subject to reduction in specified circumstances. Due to the uncertainty of pharmaceutical development and the high historical failure rates generally associated with drug development, we may not receive any additional milestone payments or royalty or profit share payments from Eisai. The next potential milestone payment that we might be entitled to receive under this agreement is $10.0 million for the initiation of the Phase 2 portion of the ongoing Phase 1/2 clinical trial of EPZ-6438.

Eisai solely funds all research, development and commercialization costs for licensed compounds, except for the cost obligations that we will undertake if we exercise our opt-in right to co-develop, co-commercialize and share profits with Eisai as to licensed products in the United States. If we exercise our opt-in right as to a licensed compound, the licensed compound would become a shared product as to which (i) Eisai s obligation to pay royalties to us as to such shared product in the United States will terminate; (ii) Eisai and we will share in net profits or losses with respect to such shared product in the United States; (iii) 25.0% of specified past development costs will become creditable by Eisai against future milestones or royalties due to us, subject to certain limitations specified in the agreement; (iv) all subsequent milestone payments that become payable by Eisai to us after we exercise our opt-in right will be decreased by 50.0% in certain circumstances; and (v) Eisai and we will share equally in subsequent development costs allocated to the United States.

Collaboration Revenue

Through June 30, 2014, we recorded a total of $36.8 million in cash and accounts receivable under the Eisai agreement. Through June 30, 2014, we have recognized $36.0 million of collaboration revenue in the consolidated statements of operations and comprehensive loss related to this agreement, including $2.0 million and $3.6 million in the three and six months ended June 30, 2014, respectively, and $8.2 million and $10.5 million in the three and six months ended June 30, 2013, respectively, with a $6.0 million clinical development milestone achieved and recognized as collaboration revenue in the three and six months ended June 30, 2013. As of June 30, 2014 and December 31, 2013, we had deferred revenue of $0.8 million and $1.6 million, respectively, related to this agreement.

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GSK

In January 2011, we entered into a collaboration and license agreement with GSK to discover, develop and commercialize novel small molecule HMT inhibitors directed to available targets from our product platform. Under the terms of the agreement, we granted GSK exclusive worldwide license rights to HMT inhibitors directed to three targets. Additionally, as part of the research collaboration provided for in the agreement, we agreed to provide research and development services related to the licensed targets pursuant to agreed upon research plans until the earlier of the achievement of development candidate selection for a target or the end of the research term on January 8, 2015. During 2013, development candidate selection was achieved for the first target under the collaboration and license agreement, and, accordingly, we are no longer providing research and development services related to this target as of June 30, 2014.

In March 2014, we and GSK amended certain terms of this agreement for the third target, revising the license terms with respect to candidate compounds and amending the corresponding financial terms, including reallocating milestone payments and increasing royalty rates as to the third target. In connection with the execution of this amendment, we recorded a $3.0 million upfront payment.

Agreement Structure

Under the agreement, we recorded a $20.0 million upfront payment, a $3.0 million payment upon the execution of the March 2014 agreement amendment, $6.0 million of fixed research funding, $15.0 million of preclinical research and development milestone payments and $6.7 million for research and development services through June 30, 2014. We are eligible to receive up to $18.0 million in additional preclinical research and development milestone payments, up to $109.0 million in clinical development milestone payments, up to $275.0 million in regulatory milestone payments and up to $218.0 million in sales-based milestone payments. In addition, GSK is required to pay us royalties at percentages from the mid-single digits to the low double-digits, on a licensed product-by-licensed product basis, on worldwide net product sales, subject to reductions in specified circumstances. Due to the uncertainty of pharmaceutical development and the high historical failure rates generally associated with drug development, we may not receive any additional milestone payments or royalty payments from GSK. Due to the varying stages of development of each licensed target, we are not able to determine the next milestone that might be achieved, if any.

For each selected target in the collaboration, we are primarily responsible for research until the selection of the development candidate, and GSK is solely responsible for subsequent development and commercialization. GSK provided a fixed amount of research funding during the second and third years of the research term and is obligated to provide research funding equal to 100.0% of research and development costs, subject to specified limitations, for research activities we conduct in the fourth year of the research term.

Collaboration Revenue

Through June 30, 2014, we recorded a total of $50.7 million in cash and accounts receivable under the GSK agreement. Through June 30, 2014, we have recognized $42.5 million of collaboration revenue in the consolidated statements of operations and comprehensive loss related to this agreement, including $6.3 million and $16.4 million in the three and six months ended June 30, 2014, respectively, and $3.0 million and $6.0 million in the three and six months ended June 30, 2013, respectively, with a $1.0 million preclinical research and development milestone achieved and recognized as collaboration revenue in the three months ended June 30, 2014 and an additional $2.0 million preclinical research and development milestone achieved and recognized as collaboration revenue in the six months ended June 30, 2014. As of June 30, 2014 and December 31, 2013, we had deferred revenue of $8.2 million and $13.9 million, respectively, related to this agreement.

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Results of Operations

Collaboration Revenue

The following is a comparison of collaboration revenue for the three and six months ended June 30, 2014 and 2013:

	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Decrease	2014	2013	Decrease
	(In millions)					
Collaboration revenue	$ 9.5	$ 14.8	$ (5.3)	$ 22.9	$ 23.7	$ (0.8)

Our revenue consists of collaboration revenue, including amounts recognized from deferred revenue related to upfront payments for licenses or options to obtain licenses in the future, research and development services revenue earned and milestone payments earned under collaboration and license agreements with our collaboration partners.

During the three months ended June 30, 2014, collaboration revenue consisted of $4.1 million recognized from deferred revenue related to upfront payments for licenses, $1.0 million in milestone revenue and $4.4 million in research and development funding. This revenue compares to $6.4 million recognized from deferred revenue related to upfront payments for licenses, $6.0 million in milestone revenue and $2.4 million in research and development funding recognized in the three months ended June 30, 2013.

Collaboration revenue recognized from deferred revenue in the three months ended June 30, 2014 comprised $1.2 million under our Celgene agreement, $0.4 million under our Eisai agreement and $2.5 million under our GSK agreement, as compared to $3.6 million under our Celgene agreement, $0.4 million under our Eisai agreement and $2.4 million under our GSK agreement in the three months ended June 30, 2013. Milestone revenue in the three months ended June 30, 2014 consisted of a $1.0 million preclinical research and development milestone achieved under our GSK agreement in April 2014, as compared to a $6.0 million clinical development milestone achieved under our Eisai agreement in June 2013. Collaboration revenue recognized for research and development services in the three months ended June 30, 2014 comprised $1.6 million under our Eisai agreement and $2.8 million under our GSK agreement, as compared to $1.8 million under our Eisai agreement and $0.6 million under our GSK agreement in the three months ended June 30, 2013.

During the six months ended June 30, 2014, collaboration revenue consisted of $10.9 million recognized from deferred revenue related to upfront payments for licenses, $3.0 million in milestone revenue and $9.0 million in research and development funding. This revenue compares to $12.8 million recognized from deferred revenue related to upfront payments for licenses, $6.0 million in milestone revenue and $4.9 million in research and development funding recognized in the six months ended June 30, 2013.

Collaboration revenue recognized from deferred revenue in the six months ended June 30, 2014 comprised $2.9 million under our Celgene agreement, $0.8 million under our Eisai agreement and $7.2 million under our GSK agreement, as compared to $7.2 million under our Celgene agreement, $0.8 million under our Eisai agreement and $4.8 million under our GSK agreement in the six months ended June 30, 2013. Milestone revenue in the six months ended June 30, 2014 consisted of $3.0 million in preclinical research and development milestones achieved under our GSK agreement, as compared to a $6.0 million clinical development milestone achieved under our Eisai agreement. Collaboration revenue recognized for research and development services in the six months ended June 30, 2014 comprised $2.8 million under our Eisai agreement and $6.2 million under our GSK agreement, as compared to $3.7 million under our Eisai agreement and $1.2 million under our GSK agreement in the six months ended June 30, 2013.

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Research and Development

The following is a comparison of research and development expenses for the three and six months ended June 30, 2014 and 2013:

	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Increase	2014	2013	Increase
	(In millions)					
Research and development	$ 17.5	$ 13.9	$ 3.6	$ 32.8	$ 27.3	$ 5.5

Research and development expenses consist of expenses incurred in performing research and development activities, including compensation and benefits for full-time research and development employees, facilities expenses, overhead expenses, clinical trial and related clinical manufacturing expenses, fees paid to third party clinical research organizations, or CROs, and other outside expenses. As we advance our product platform, we are conducting research on several prioritized HMT targets. Our research and development team is organized such that the strategy, design, management and evaluation of results of all of our research and development plans is accomplished internally while some of our research and development activities are executed using our multinational network of CROs. In the early phases of development, our research and development costs are often devoted to enhancing our product platform and are not necessarily allocable to specific targets. In circumstances, such as our Celgene collaboration, where our collaboration and license agreements provide for equally co-funded global development under joint risk sharing collaborations, amounts received from collaboration partners for such co-funding are recorded as a reduction to research and development expense.

The following table illustrates the components of our research and development expenses:

Product Program (Phase as of the latest period end)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(In millions)			
External research and development expenses:				
EPZ-5676 (Phase 1) and related DOT1L programs	$ 3.4	$ 2.9	$ 6.5	$ 6.0
EPZ-6438 (Phase 1/2) and related EZH2 programs	0.9	1.1	1.5	2.3
Discovery and preclinical stage product programs, collectively	7.0	5.2	12.7	10.0
Internal research and development expenses	6.2	4.7	12.1	9.0
Total research and development expenses	$ 17.5	$ 13.9	$ 32.8	$ 27.3

During the three and six months ended June 30, 2014, our total research and development expenses increased by $3.6 million and $5.5 million, respectively, compared to the same periods of 2013, primarily due to the expansion of our product platform and the advancement of our EPZ-5676 clinical trial and related DOT1L programs. Research and development expenses for EPZ-5676 for the three and six months ended June 30, 2014 are net of $0.9 million and $1.3 million, respectively, of global development co-funding from Celgene.

Most of our research and development costs have been external costs, which we began tracking on a program-by-program basis in the first quarter of 2010. Our internal research and development costs are primarily

compensation expenses for our full-time research and development employees. We do not track internal research and development costs on a program-by-program basis. However, by employing a multinational network of CROs, our employees are able to dedicate significant amounts of their time to the expansion and development of our product platform while managing the research performed by our CROs. Our internal research and development expenses increased by $1.5 million and $3.1 million in the three and six months ended June 30, 2014, respectively, including increases of $0.6 million and $1.1 million, respectively, in stock-based compensation expense, as compared to the same periods of the prior year as the number of our research and development employees grew from 51 employees as of June 30, 2013 to 64 employees as of June 30, 2014.

External research and development expenses for EPZ-5676 and related DOT1L programs focused on the advancement of the ongoing EPZ-5676 Phase 1 clinical trial, with expenses increasing from $2.9 million in the second quarter of 2013 to $3.4 million in the second quarter of 2014, including $0.9 million of global development co-funding from Celgene in the second quarter of 2014, which is recorded as a reduction to research and development expense. The Company did not record any global development co-funding from Celgene in the second quarter of 2013. External research and development expenses for

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EPZ-6438 and related EZH2 programs focused on the EPZ-6438 Phase 1/2 clinical trial, with expenses decreasing from $1.1 million in the second quarter of 2013 to $0.9 million in the second quarter of 2014, as additional phases of development shifted to Eisai. External research and development expenses for discovery and preclinical stage product programs, including the three target programs partnered with GSK, increased from $5.2 million in the second quarter of 2013 to $7.0 million in the second quarter of 2014 as we advanced the research and development of these programs. Research and development expenses in the six months ended June 30, 2014 reflect similar advancement and expansion of our product programs when compared to the same period of 2013.

External research and development expenses from January 1, 2010 through June 30, 2014 was $39.0 million for EPZ-5676 and related DOT1L programs and $14.3 million for EPZ-6438 and related EZH2 programs. We did not maintain program-specific external cost information prior to January 1, 2010.

We expect that research and development expenses will increase in 2014, when compared to 2013, as we continue to progress and expand our ongoing clinical trials and as we continue to build our product platform and advance our other discovery and preclinical stage product programs.

General and Administrative

The following is a comparison of general and administrative expenses for the three and six months ended June 30, 2014 and 2013:

	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	Increase	2014	2013	Increase
	(In millions)					
General and administrative	$ 5.3	$ 3.1	$ 2.2	$ 10.3	$ 6.1	$ 4.2

General and administrative expenses consist primarily of salaries and related benefits, including stock-based compensation, related to our executive, finance, intellectual property, business development and support functions. Other general and administrative expenses include allocated facility-related costs not otherwise included in research and development expenses, travel expenses and professional fees for auditing, tax and legal services, including intellectual property-related legal services.

For the three and six months ended June 30, 2014, our general and administrative expenses increased compared to the same periods of the prior year, primarily related to additional professional fees, insurance and other costs associated with public company operation as well as increased stock-based compensation expense and other costs to support our growing organization.

We expect that general and administrative expenses will increase in 2014, when compared to 2013, as we expand our operating activities and incur a full year of costs as a publicly traded company.

Other Income (Expense), net

Other income (expense), net consists of interest income earned on our cash equivalents, offset by interest and other expense. The change to other income, net in the three and six months ended June 30, 2014 from other expense, net in the three and six months ended June 30, 2013 reflects the recognition of interest expense in the three and six months ended June 30, 2013 on a contract termination obligation that we incurred in the second quarter of 2012 and paid in full in the second quarter of 2013.

Income Tax Expense

We recorded $0.1 million of income tax expense in the three and six months ended June 30, 2014 due to provision-to-return adjustments identified related to the year ended December 31, 2013. We did not record a federal or state income tax provision or benefit for the three or six months ended June 30, 2014 related to the year ending December 31, 2014, due to the expected loss before income taxes to be incurred for the year ending December 31, 2014, as well as our continued maintenance of a full valuation allowance against our net deferred tax assets.

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We did not record a federal or state income tax provision or benefit for the three or six months ended June 30, 2013 due to the expected loss before income taxes to be incurred for the year ended December 31, 2013, as well as our continued maintenance of a full valuation allowance against our net deferred tax assets.

Accretion of Redeemable Convertible Preferred Stock to Redemption Value

Our redeemable convertible preferred stock automatically converted into common stock upon the closing of our initial public offering in June 2013. Our preferred stock was redeemable beginning in 2017 at its original issue prices per share plus any declared but unpaid dividends upon a specified vote of the preferred stockholders. Accretion of preferred stock reflected the periodic accretion of issuance costs and premiums on each series of preferred stock, where applicable, to their respective redemption values. We recorded $0.1 million and $0.3 million of accretion in the three and six months ended June 30, 2013, respectively. As a result of the conversion into common stock, as of June 30, 2014 and December 31, 2013, we did not have any preferred stock outstanding and will not record any additional accretion of preferred stock related to the shares of redeemable convertible preferred stock previously issued.

Liquidity and Capital Resources

In February 2014, we completed an offering of 3,673,901 shares of our common stock, at a price of $29.25 per share. We received net proceeds before expenses from this offering of $101.3 million after deducting underwriting discounts and commissions paid by us.

Since our inception and through June 30, 2014, we have raised an aggregate of $441.5 million to fund our operations, of which $181.7 million was non-equity funding through our collaboration agreements, $183.8 million was from the sale of common stock in our public offerings and $76.0 million was from the sale of redeemable convertible preferred stock. In addition, as of June 30, 2014, we were entitled to receive $2.2 million in non-equity funding through our collaboration agreements. As of June 30, 2014, we had $229.9 million in cash and cash equivalents.

In addition to our existing cash and cash equivalents, we receive research and development funding and are eligible to earn a significant amount of option exercise and milestone payments under our collaboration agreements. Our ability to earn these payments and the timing of earning these payments is dependent upon the outcome of our research and development activities and is uncertain at this time. Our rights to payments under our collaboration agreements are our only committed external sources of funds.

Funding Requirements

Our primary uses of capital are, and we expect will continue to be, compensation and related expenses, third party clinical research and development services, laboratory and related supplies, clinical costs, legal and other regulatory expenses and general corporate costs. We believe our multinational network of CROs provides us with flexibility in managing our spending and limits our cost commitments at any point in time.

Because our product candidates are in various stages of clinical and preclinical development and the outcome of these efforts is uncertain, we cannot estimate the actual amounts necessary to successfully complete the development and commercialization of our product candidates or whether, or when, we may achieve profitability. Until such time, if ever, as we can generate substantial product revenues, we expect to finance our cash needs through a combination of equity or debt financings and collaboration arrangements. Except for any obligations of our collaborators to reimburse us for research and development expenses or to make option exercise, milestone or royalty payments under our agreements with them, we do not have any committed external sources of liquidity. To the extent that we raise

additional capital through the future sale of equity or debt, the ownership interest of our stockholders will be diluted, and the terms of these securities may include liquidation or other preferences that adversely affect the rights of our existing common stockholders. Our ability to enter into collaboration agreements for additional HMT targets is significantly limited until the end of the option period under the Celgene agreement and may continue to be limited after the end of the option period depending on how many other HMT targets Celgene elects to license, if any. If we raise additional funds through collaboration arrangements in the future, we may have to relinquish valuable rights to our technologies, future revenue streams or product candidates or grant licenses on terms that may not be favorable to us. If we are unable to raise any additional funds that may be needed through equity or debt financings when needed, we may be required to delay, limit, reduce or terminate our product development or future commercialization efforts or grant rights to develop and market product candidates that we would otherwise prefer to develop and market ourselves.

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Outlook

Based on our research and development plans and our timing expectations related to the progress of our programs, we believe that our existing cash and cash equivalents as of June 30, 2014 and research funding that we expect to receive under our existing collaborations will enable us to fund our operating expenses and capital expenditure requirements until at least mid-2016, without giving effect to any potential option exercise fees or milestone payments we may receive under our collaboration agreements. We have based this estimate on assumptions that may prove to be wrong, particularly as the process of testing drug candidates in clinical trials is costly and the timing of progress in these trials is uncertain. As a result, we could use our capital resources sooner than we expect.

Cash Flows

The following is a summary of cash flows for the six months ended June 30, 2014 and 2013:

	Six Months Ended June 30,	
	2014	2013
	(In millions)	
Net cash provided by (used in) operating activities	$ 4.7	$ (29.7)
Net cash used in investing activities	(0.8)	(0.2)
Net cash provided by financing activities	102.5	80.6

Net cash provided by (used in) operating activities

Net cash provided by operating activities was $4.7 million during the six months ended June 30, 2014 compared to net cash used in operating activities of $29.7 million during the six months ended June 30, 2013. The change from net cash used in operating activities to net cash provided by operating activities reflects the collection of $46.2 million in non-equity funding, comprising $32.0 million in milestone payments, $3.0 million in upfront payments and $11.2 million in research reimbursements, during the six months ended June 30, 2014, partially offset by cash used in operating activities during the six months ended June 30, 2014.

Net cash used in investing activities

Net cash used in investing activities during each of the six months ended June 30, 2014 and 2013 relates solely to purchases of property and equipment in both periods presented and represents general maintenance capital.

Net cash provided by financing activities

Net cash provided by financing activities of $102.5 million during the six months ended June 30, 2014 primarily reflects net cash received from our February 2014 public offering of our common stock as well as cash received for stock option exercises and the purchase of shares under our employee stock purchase plan. Net cash provided by financing activities of $80.6 million during the six months ended June 30, 2013 reflects net cash received from our initial public offering as well as cash received from stock option exercises.

Critical Accounting Policies

Our critical accounting policies are those policies which require the most significant judgments and estimates in the preparation of our consolidated financial statements. Management has determined that our most critical accounting

policies are those relating to revenue recognition and stock-based compensation. There have been no significant changes to our critical accounting policies discussed in the Annual Report.

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Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-09, *Revenue From Contracts With Customers*. ASU 2014-09 amends Accounting Standards Codification (ASC) 605, *Revenue Recognition*, by outlining a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. ASU 2014-09 will be effective for us for interim and annual periods beginning after December 15, 2016. We are evaluating the impact that this ASU may have on our consolidated financial statements, if any.

Contractual Obligations

There were no material changes to our contractual obligations during the second quarter of 2014. For a complete discussion of our contractual obligations, please refer to our *Management s Discussion and Analysis of Financial Condition and Results of Operations* in the Annual Report.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The market risk inherent in our financial instruments and in our financial position represents the potential loss arising from adverse changes in interest rates. As of June 30, 2014, we had cash equivalents of $222.0 million consisting of interest-bearing money market accounts and prime money market funds. Our primary exposure to market risk is interest rate sensitivity, which is affected by changes in the general level of U.S. interest rates. Due to the short-term maturities of our cash equivalents and the low risk profile of these investments, an immediate 100 basis point change in interest rates at levels as of June 30, 2014 would not have a material effect on the fair market value of our cash equivalents.

We contract with CROs and manufacturers internationally. Transactions with these providers are predominantly settled in U.S. dollars and, therefore, we believe that we have only minimal exposure to foreign currency exchange risks. We do not hedge against foreign currency risks.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Company has established disclosure controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and is accumulated and communicated to management, including the principal executive officer (our Chief Executive Officer) and principal financial officer (our Chief Financial Officer), to allow timely decisions regarding required disclosure.

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Management recognizes that any disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives. Our disclosure controls and procedures have been designed to provide reasonable assurance of achieving their objectives. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of June 30, 2014.

Changes in Internal Control over Financial Reporting

No change in the Company s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the three months ended June 30, 2014 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1A. Risk Factors

Careful consideration should be given to the following risk factors, in addition to the other information set forth in this Quarterly Report on Form 10-Q and in other documents that we file with the SEC, in evaluating the Company and our business. Investing in our common stock involves a high degree of risk. If any of the following risks and uncertainties actually occurs, our business, prospects, financial condition and results of operations could be materially and adversely affected. The risks described below are not intended to be exhaustive and are not the only risks facing the Company. New risk factors can emerge from time to time, and it is not possible to predict the impact that any factor or combination of factors may have on our business, prospects, financial condition and results of operations.

Risks Related to the Discovery and Development of Our Product Candidates

Our research and development is focused on the creation of personalized therapeutics for patients with genetically defined cancers, which is a rapidly evolving area of science, and the approach we are taking to discover and develop drugs is novel and may never lead to marketable products.

The discovery of personalized drug therapeutics for patients with genetically defined cancers is an emerging field, and the scientific discoveries that form the basis for our efforts to discover and develop product candidates are relatively new. The scientific evidence to support the feasibility of developing product candidates based on these discoveries is both preliminary and limited. Although epigenetic regulation of gene expression plays an essential role in biological function, very few drugs premised on epigenetics have been discovered. Moreover, those drugs based on an epigenetic mechanism that have received marketing approval are in a different target class than HMTs, where our research and development is focused. Although preclinical studies suggest that genetic alterations in HMTs cause them to drive particular human cancers, to date no company has translated these biological observations into systematic drug discovery that has yielded a drug that has received marketing approval. We believe that we are the first company to conduct a clinical trial of an HMT inhibitor. Therefore, we do not know if our approach of inhibiting HMTs to treat patients with genetically defined cancers will be successful.

We are early in our development efforts and have only two product candidates in clinical trials. All of our other product candidates are still in preclinical development. If we are unable to commercialize our product candidates or experience significant delays in doing so, our business will be materially harmed.

We are very early in our development efforts and have only two product candidates in clinical trials. All of our other product candidates are still in preclinical development. We have invested substantially all of our efforts and financial resources in the identification and preclinical development of HMT inhibitors. Our ability to generate product revenues, which we do not expect will occur for many years, if ever, will depend heavily on the successful development and eventual commercialization of our product candidates. The success of our product candidates will depend on several factors, including the following:

- successful completion of preclinical studies and clinical trials;
- receipt of marketing approvals from applicable regulatory authorities;

obtaining and maintaining patent and trade secret protection and regulatory exclusivity for our product candidates;

making arrangements with third party manufacturers for, or establishing, commercial manufacturing capabilities;

launching commercial sales of the products, if and when approved, whether alone or in collaboration with others;

acceptance of the products, if and when approved, by patients, the medical community and third party payors;

effectively competing with other therapies;

obtaining and maintaining healthcare coverage and adequate reimbursement;

protecting our rights in our intellectual property portfolio; and

maintaining a continued acceptable safety profile of the products following approval.

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If we do not achieve one or more of these factors in a timely manner or at all, we could experience significant delays or an inability to successfully commercialize our product candidates, which would materially harm our business.

We may not be successful in our efforts to use and expand our product platform to build a pipeline of product candidates.

A key element of our strategy is to use and expand our product platform to build a pipeline of small molecule inhibitors of HMT targets and progress these product candidates through clinical development for the treatment of a variety of different types of cancer. Although our research and development efforts to date have resulted in a pipeline of programs directed at specific HMT targets, we may not be able to develop product candidates that are safe and effective HMT inhibitors. Even if we are successful in continuing to build our pipeline, the potential product candidates that we identify may not be suitable for clinical development, including as a result of being shown to have harmful side effects or other characteristics that indicate that they are unlikely to be products that will receive marketing approval and achieve market acceptance. If we do not successfully develop and commercialize product candidates based upon our technological approach, we will not be able to obtain product revenues in future periods, which likely would result in significant harm to our financial position and adversely affect our stock price.

Clinical drug development involves a lengthy and expensive process, with an uncertain outcome. We may incur additional costs or experience delays in completing, or ultimately be unable to complete, the development and commercialization of our product candidates.

Two of our product candidates are in early clinical development, and our remaining product candidates are in preclinical development. The risk of failure for each of our product candidates is high. It is impossible to predict when or if any of our product candidates will prove effective or safe in humans or will receive regulatory approval. Before obtaining marketing approval from regulatory authorities for the sale of any product candidate, we must complete preclinical development and then conduct extensive clinical trials to demonstrate the safety and efficacy of our product candidates in humans. Clinical testing is expensive, difficult to design and implement, can take many years to complete and is uncertain as to outcome. A failure of one or more clinical trials can occur at any stage of testing. The outcome of preclinical testing and early clinical trials may not be predictive of the success of later clinical trials, and interim results of a clinical trial do not necessarily predict final results. For example, it is important to note that the objective responses observed in the fourth dose cohort of the dose escalation stage of our Phase 1 clinical trial of EPZ-5676 were observed in only two of the MLL-r patients enrolled in the trial through the fourth cohort, were achieved in an open-label setting, are not statistically significant and might not be achieved by any other patient treated with EPZ-5676. Moreover, preclinical and clinical data are often susceptible to varying interpretations and analyses, and many companies that have believed their product candidates performed satisfactorily in preclinical studies and clinical trials have nonetheless failed to obtain marketing approval of their products.

We may experience numerous unforeseen events during, or as a result of, clinical trials that could delay or prevent our ability to receive marketing approval or commercialize our product candidates, including:

- regulators or institutional review boards may not authorize us or our investigators to commence a clinical trial or conduct a clinical trial at a prospective trial site;

- we may experience delays in reaching, or fail to reach, agreement on acceptable clinical trial contracts or clinical trial protocols with prospective trial sites;

clinical trials of our product candidates may produce negative or inconclusive results, and we may decide, or regulators may require us, to conduct additional clinical trials or abandon product development programs;

the number of patients required for clinical trials of our product candidates may be larger than we anticipate, enrollment in these clinical trials may be slower than we anticipate or participants may drop out of these clinical trials at a higher rate than we anticipate;

our third party contractors may fail to comply with regulatory requirements or meet their contractual obligations to us in a timely manner, or at all;

we may have to suspend or terminate clinical trials of our product candidates for various reasons, including a finding that the participants are being exposed to unacceptable health risks;

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regulators or institutional review boards may require that we or our investigators suspend or terminate clinical research for various reasons, including noncompliance with regulatory requirements or a finding that the participants are being exposed to unacceptable health risks;

the cost of clinical trials of our product candidates may be greater than we anticipate;

the supply or quality of our product candidates or other materials necessary to conduct clinical trials of our product candidates may be insufficient or inadequate; and

our product candidates may have undesirable side effects or other unexpected characteristics, causing us or our investigators, regulators or institutional review boards to suspend or terminate the trials.

If we are required to conduct additional clinical trials or other testing of our product candidates beyond those that we currently contemplate, if we are unable to successfully complete clinical trials of our product candidates or other testing, if the results of these trials or tests are not positive or are only modestly positive or if there are safety concerns, we may:

be delayed in obtaining marketing approval for our product candidates;

not obtain marketing approval at all;

obtain approval for indications or patient populations that are not as broad as intended or desired;

obtain approval with labeling or a risk evaluation mitigation strategy that includes significant use or distribution restrictions or safety warnings;

be subject to additional post-marketing testing requirements; or

have the product removed from the market after obtaining marketing approval.

Our product development costs will also increase if we experience delays in clinical testing or in obtaining marketing approvals. We do not know whether any of our preclinical studies or clinical trials will begin as planned, will need to be restructured or will be completed on schedule, or at all. Significant preclinical or clinical trial delays also could shorten any periods during which we may have the exclusive right to commercialize our product candidates or allow our competitors to bring products to market before we do and impair our ability to successfully commercialize our product candidates and may harm our business and results of operations.

If we experience delays or difficulties in the enrollment of patients in clinical trials, our receipt of necessary regulatory approvals could be delayed or prevented.

We may not be able to initiate or continue clinical trials for our product candidates if we are unable to locate and enroll a sufficient number of eligible patients to participate in these trials as required by the United States Food and Drug Administration, or FDA, or similar regulatory authorities outside of the United States. In particular, because we are focused on patients with genetically defined cancers, our ability to enroll eligible patients may be limited or may result in slower enrollment than we anticipate. For example, enrollment in our Phase 1 clinical trial of EPZ-5676 was slower than we expected because of delays in establishing trial sites. In addition, some of our competitors have ongoing clinical trials for product candidates that treat the broader patient populations within which our product candidates are being developed for the treatment of a subset of identifiable patients with genetically defined cancers, and patients who would otherwise be eligible for our clinical trials may instead enroll in clinical trials of our competitors product candidates.

Patient enrollment is affected by other factors including:

- the severity of the disease under investigation;
- the eligibility criteria for the trial in question;
- the perceived risks and benefits of the product candidate under trial;
- the efforts to facilitate timely enrollment in clinical trials;
- the patient referral practices of physicians;
- the ability to monitor patients adequately during and after treatment; and
- the proximity and availability of clinical trial sites for prospective patients.

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Our inability to enroll a sufficient number of patients for our clinical trials would result in significant delays and could require us to abandon one or more clinical trials altogether. Enrollment delays in our clinical trials may result in increased development costs for our product candidates, which would cause the value of our company to decline and limit our ability to obtain additional financing.

Following our general product development strategy, we have designed our ongoing clinical trials of EPZ-5676 and EPZ-6438, and expect to design future trials, to include some patients with the applicable genetic alteration that causes the disease with a view to assessing possible early evidence of potential therapeutic effect. If we are unable to include patients with the applicable genetic alteration, this could compromise our ability to seek participation in FDA expedited review and approval programs, including breakthrough therapy and fast track designation, or otherwise to seek to accelerate clinical development and regulatory timelines.

If serious adverse or unacceptable side effects are identified during the development of our product candidates, we may need to abandon or limit our development of some of our product candidates.

If our product candidates are associated with undesirable side effects in clinical trials or have characteristics that are unexpected, we may need to abandon their development or limit development to more narrow uses or subpopulations in which the undesirable side effects or other characteristics are less prevalent, less severe or more acceptable from a risk-benefit perspective. In pharmaceutical development, many compounds that initially show promise in early stage testing for treating cancer are later found to cause side effects that prevent further development of the compound.

We may expend our limited resources to pursue a particular product candidate or indication and fail to capitalize on product candidates or indications that may be more profitable or for which there is a greater likelihood of success.

Because we have limited financial and managerial resources, we focus on research programs and product candidates that we identify for specific indications. As a result, we may forego or delay pursuit of opportunities with other product candidates or for other indications that later prove to have greater commercial potential. Our resource allocation decisions may cause us to fail to capitalize on viable commercial products or profitable market opportunities. Our spending on current and future research and development programs and product candidates for specific indications may not yield any commercially viable products. If we do not accurately evaluate the commercial potential or target market for a particular product candidate, we may relinquish valuable rights to that product candidate through collaboration, licensing or other royalty arrangements in cases in which it would have been more advantageous for us to retain sole development and commercialization rights to such product candidate.

If we are unable to successfully develop companion diagnostics for our therapeutic product candidates, or experience significant delays in doing so, we may not achieve marketing approval or realize the full commercial potential of our therapeutic product candidates.

We plan to develop companion diagnostics for our therapeutic product candidates. We expect that, at least in some cases, the FDA and similar regulatory authorities outside of the United States may require the development and regulatory approval of a companion diagnostic as a condition to approving our therapeutic product candidates. We do not have experience or capabilities in developing or commercializing diagnostics and plan to rely in large part on third parties to perform these functions. For example, in December 2012, Eisai and we entered into an agreement with Roche to develop and commercialize a companion diagnostic for use with EPZ-6438 for non-Hodgkin lymphoma patients with EZH2 point mutations. In February 2013, we entered into a similar agreement with Abbott to develop and commercialize a companion diagnostic for use with EPZ-5676 in MLL-r patients. We may seek to enter into a similar agreement with a third party to create a companion diagnostic for use with EPZ-5676 in MLL-PTD patients.

However, the MLL-PTD genetic alteration is not currently identified as part of standard diagnostic care, and as a result, it may be more difficult to enter into an agreement with a diagnostic company to create a companion diagnostic for this potential indication or to obtain comparable diagnostic results from those methods being used by sites enrolling MLL-PTD patients in our ongoing Phase 1 trial of EPZ-5676.

We generally expect to enter into similar agreements for our other therapeutic product candidates and possible expansion indications for EPZ-5676 and EPZ-6438. Companion diagnostics are subject to regulation by the FDA and similar regulatory authorities outside of the United States as medical devices and require separate regulatory approval prior to commercialization.

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If we, or any third parties that we engage to assist us, are unable to successfully develop companion diagnostics for our therapeutic product candidates, or experience delays in doing so:

- the development of our therapeutic product candidates may be adversely affected if we are unable to appropriately select patients for enrollment in our clinical trials;
- our therapeutic product candidates may not receive marketing approval if their safe and effective use depends on a companion diagnostic; and
- we may not realize the full commercial potential of any therapeutic product candidates that receive marketing approval if, among other reasons, we are unable to appropriately identify patients with the specific genetic alterations targeted by our therapeutic product candidates.

If any of these events were to occur, our business would be harmed, possibly materially.

Risks Related to Our Financial Position and Need For Additional Capital

We have incurred significant losses since our inception. We expect to incur losses over the next several years and may never achieve or maintain profitability.

Since inception, we have incurred significant operating losses. Our net loss was $20.3 million for the six months ended June 30, 2014. As of June 30, 2014, we had an accumulated deficit of $76.4 million. To date, we have financed our operations primarily through our collaborations, our initial public offering, our follow-on public offering and private placements of our preferred stock. All of our revenue to date has been collaboration revenue. We have devoted substantially all of our financial resources and efforts to research and development, including preclinical studies and, beginning in 2012, clinical trials. We are still in the early stages of development of our product candidates, and we have not completed development of any drugs. We expect to continue to incur significant expenses and operating losses over the next several years. Our net losses may fluctuate significantly from quarter to quarter and year to year. We anticipate that our expenses will increase substantially over the next several years as we:

- continue our Phase 1 clinical trial of EPZ-5676 for treatment of patients with MLL-r and patients with MLL-PTD;
- continue, together with Eisai, the Phase 1/2 clinical trial of EPZ-6438 for treatment of patients with a genetically defined subtype of non-Hodgkin lymphoma, and seek to treat additional indications, including INI1-deficient tumors, such as synovial sarcoma and malignant rhabdoid tumors;
- continue our Phase 1b clinical trial of EPZ-5676 in pediatric patients with MLL-r;
- initiate our planned Phase 2 clinical trial of EPZ-6438 in patients with INI1-deficient tumors;

continue the research and development of our other product candidates;

seek to discover and develop additional product candidates;

seek regulatory approvals for any product candidates that successfully complete clinical trials;

ultimately establish a sales, marketing and distribution infrastructure and scale up external manufacturing capabilities to commercialize any products for which we may obtain regulatory approval;

maintain, expand and protect our intellectual property portfolio;

hire additional clinical, quality control and scientific personnel; and

add operational, financial and management information systems and personnel, including personnel to support our product development and planned future commercialization efforts.

To become and remain profitable, we must succeed in developing, and eventually commercializing, products that generate significant revenue. The ability to achieve this success will require us to be effective in a range of challenging activities, including completing preclinical testing and clinical trials of our product candidates, discovering additional product candidates, obtaining regulatory approval for these product candidates and manufacturing, marketing and selling any products for which we may obtain regulatory approval. We are only in the preliminary stages of most of these activities. We may never succeed in these activities and, even if we do, may never generate revenues that are significant enough to achieve profitability.

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Because of the numerous risks and uncertainties associated with pharmaceutical product development, we are unable to accurately predict the timing or amount of increased expenses or when, or if, we will be able to achieve profitability. If we are required by the FDA, the European Medicines Agency, or EMA, or other regulatory authorities to perform studies in addition to those currently expected, or if there are any delays in completing our clinical trials or the development of any of our product candidates, our expenses could increase.

Even if we do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis. Our failure to become and remain profitable would depress the value of our company and could impair our ability to raise capital, expand our business, maintain our research and development efforts, diversify our product offerings or even continue our operations. A decline in the value of our company could cause our stockholders to lose all or part of their investment in our company.

We will need substantial additional funding. If we are unable to raise capital when needed, we could be forced to delay, reduce or eliminate our product development programs or commercialization efforts.

We expect our expenses to increase in connection with our ongoing activities, particularly as we continue the Phase 1 clinical trial of EPZ-5676 in MLL-r and MLL-PTD adult patients, the Phase 1b clinical trial of EPZ-5676 in pediatric patients with MLL-r and the Phase 1/2 clinical trial of EPZ-6438, subject to our opt-in right, initiate our planned Phase 2 clinical trial of EPZ-6438 in patients with INI1-deficient tumors, subject to our opt-in right, and continue research and development and initiate additional clinical trials of, and seek regulatory approval for, these product candidates and other product candidates. In addition, if we obtain regulatory approval for any of our product candidates, we expect to incur significant commercialization expenses related to product manufacturing, marketing, sales and distribution. Accordingly, we will need to obtain substantial additional funding in connection with our continuing operations. If we are unable to raise capital when needed or on acceptable terms, we could be forced to delay, reduce or eliminate our research and development programs or any future commercialization efforts.

Based on our research and development plans and our timing expectations related to the progress of our programs, we believe that our existing cash and cash equivalents as of June 30, 2014 and research funding that we expect to receive under our existing collaborations, will enable us to fund our operating expenses and capital expenditure requirements until at least mid-2016, without giving effect to any potential option exercise fees or milestone payments we may receive under our collaboration agreements. Prior to such time, we expect to complete four ongoing and planned proof-of-concept trials in the following five genetically defined cancer patient groups: MLL-r adult patients, MLL-PTD adult patients, MLL-r pediatric patients, non-Hodgkin lymphoma patients and patients with INI1-deficient tumors. We have based these expectations on assumptions that may prove to be wrong, and we could use our capital resources sooner than we expect. Our future capital requirements will depend on many factors, including:

- our collaboration agreements remaining in effect and our ability to obtain research funding and achieve milestones under these agreements;

- the progress and results of our ongoing Phase 1 and Phase 1b clinical trials of EPZ-5676 and Phase 1/2 clinical trial of EPZ-6438 and our planned trials of EPZ-6438;

- the number and development requirements of additional indications for EPZ-5676 and EPZ-6438 and other product candidates that we may pursue, including the scope, progress, results and costs of preclinical

development, laboratory testing and clinical trials for such product candidates;

the costs, timing and outcome of regulatory review of our product candidates;

the costs and timing of future commercialization activities, including product manufacturing, marketing, sales and distribution for any of our product candidates for which we receive marketing approval;

the revenue, if any, received from commercial sales of our product candidates for which we receive marketing approval;

the costs and timing of preparing, filing and prosecuting patent applications, maintaining and enforcing our intellectual property rights and defending any intellectual property-related claims; and

the extent to which we acquire or in-license other products and technologies.

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Identifying potential product candidates and conducting preclinical testing and clinical trials is a time-consuming, expensive and uncertain process that takes years to complete, and we may never generate the necessary data or results required to obtain regulatory approval and achieve product sales. In addition, our product candidates, if approved, may not achieve commercial success. Our commercial revenues, if any, will be derived from sales of products that we do not expect to be commercially available for many years, if at all. Accordingly, we will need to continue to rely on additional financing to achieve our business objectives. Adequate additional financing may not be available to us on acceptable terms, or at all. In addition, we may seek additional capital due to favorable market conditions or strategic considerations, even if we believe we have sufficient funds for our current or future operating plans.

Raising additional capital may cause dilution to our stockholders, restrict our operations or require us to relinquish rights to our technologies or product candidates.

Until such time, if ever, as we can generate substantial product revenues, we expect to finance our cash needs through a combination of equity offerings, debt financings and license and development agreements with collaboration partners. We do not have any committed external source of funds other than research funding under our existing collaborations. To the extent that we raise additional capital through the sale of equity or convertible debt securities, the ownership interest of our existing stockholders will be diluted and the terms of these securities may include liquidation or other preferences that adversely affect the rights of our common stockholders. Debt financing and preferred equity financing, if available, may involve agreements that include covenants limiting or restricting our ability to take specific actions, such as incurring additional debt, making capital expenditures or declaring dividends.

If we raise additional funds through collaborations, strategic alliances or marketing, distribution or licensing arrangements with third parties, we may have to relinquish valuable rights to our technologies, future revenue streams, research programs or product candidates or grant licenses on terms that may not be favorable to us. If we are unable to raise additional funds through equity or debt financings when needed, we may be required to delay, limit, reduce or terminate our product development or future commercialization efforts or grant rights to develop and market product candidates that we would otherwise prefer to develop and market ourselves.

Our limited operating history may make it difficult to evaluate the success of our business to date and to assess our future viability.

We commenced active operations in early 2008, and our operations to date have been limited to organizing and staffing our company, business planning, raising capital, developing our technology, identifying potential product candidates, undertaking preclinical studies and, beginning in 2012, conducting clinical trials. All but two of our product candidates are still in preclinical development. We are conducting Phase 1 and Phase 1b clinical trials of EPZ-5676, our most advanced product candidate, and a Phase 1/2 clinical trial of EPZ-6438, our second most advanced product candidate, but have not completed enrollment in any of these trials. We have not yet demonstrated our ability to successfully complete any clinical trials, obtain regulatory approvals, manufacture a commercial scale product, or arrange for a third party to do so on our behalf, or conduct sales and marketing activities necessary for successful product commercialization. Consequently, any predictions about our future success or viability may not be as accurate as they could be if we had a longer operating history.

In addition, as a young business, we may encounter unforeseen expenses, difficulties, complications, delays and other known and unknown factors. We will need to transition at some point from a company with a research and development focus to a company capable of supporting commercial activities. We may not be successful in such a transition.

We expect our financial condition and operating results to continue to fluctuate significantly from quarter-to-quarter and year-to-year due to a variety of factors, many of which are beyond our control. Accordingly, the results of any quarterly or annual periods should not be relied upon as indications of future operating performance.

We have broad discretion over the use of our cash and cash equivalents and may not use them effectively.

Our management has broad discretion to use our cash and cash equivalents to fund our operations and could spend these funds in ways that do not improve our results of operations or enhance the value of our common stock. The failure by our management to apply these funds effectively could result in financial losses that could have a material adverse effect on our business, cause the price of our common stock to decline and delay the development of our product candidates. Pending their use to fund operations, we may invest our cash and cash equivalents in a manner that does not produce income or that loses value.

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Risks Related to the Commercialization of Our Product Candidates

Even if any of our product candidates receives marketing approval, it may fail to achieve the degree of market acceptance by physicians, patients, third party payors and others in the medical community necessary for commercial success.

If any of our product candidates receives marketing approval, it may nonetheless fail to gain sufficient market acceptance by physicians, patients, third party payors and others in the medical community. For example, current cancer treatments like chemotherapy and radiation therapy are well established in the medical community, and doctors may continue to rely on these treatments. If our product candidates do not achieve an adequate level of acceptance, we may not generate significant product revenues and we may not become profitable. The degree of market acceptance of our product candidates, if approved for commercial sale, will depend on a number of factors, including:

- the efficacy and potential advantages compared to alternative treatments;
- our ability to offer our products for sale at competitive prices;
- the convenience and ease of administration compared to alternative treatments;
- the willingness of the patient population to try new therapies and of physicians to prescribe these therapies;
- the strength of marketing and distribution support;
- the availability of third party coverage and adequate reimbursement;
- the prevalence and severity of any side effects; and
- any restrictions on the use of our products together with other medications.

If we are unable to establish sales, marketing and distribution capabilities, we may not be successful in commercializing our product candidates if and when they are approved.

We do not have a sales or marketing infrastructure and have no experience in the sale, marketing or distribution of pharmaceutical products. To achieve commercial success for any product for which we have obtained marketing approval, we will need to establish a sales and marketing organization.

In the future, we expect to build a focused sales and marketing infrastructure to market or co-promote some of our product candidates in the United States, if and when they are approved. There are risks involved with establishing our own sales, marketing and distribution capabilities. For example, recruiting and training a sales force is expensive and time consuming and could delay any product launch. If the commercial launch of a product candidate for which we

recruit a sales force and establish marketing capabilities is delayed or does not occur for any reason, we would have prematurely or unnecessarily incurred these commercialization expenses. These efforts may be costly, and our investment would be lost if we cannot retain or reposition our sales and marketing personnel.

Factors that may inhibit our efforts to commercialize our products on our own include:

- our inability to recruit, train and retain adequate numbers of effective sales and marketing personnel;
- the inability of sales personnel to obtain access to physicians or persuade adequate numbers of physicians to prescribe any future products;
- the lack of complementary products to be offered by sales personnel, which may put us at a competitive disadvantage relative to companies with more extensive product lines; and
- unforeseen costs and expenses associated with creating an independent sales and marketing organization.

If we are unable to establish our own sales, marketing and distribution capabilities and enter into arrangements with third parties to perform these services, our product revenues and our profitability, if any, are likely to be lower than if we were to market, sell and distribute any products that we develop ourselves. In addition, we may not be successful in entering into

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arrangements with third parties to sell, market and distribute our product candidates or may be unable to do so on terms that are acceptable to us. We likely will have little control over such third parties, and any of them may fail to devote the necessary resources and attention to sell and market our products effectively. If we do not establish sales, marketing and distribution capabilities successfully, either on our own or in collaboration with third parties, we will not be successful in commercializing our product candidates.

We face substantial competition, which may result in others discovering, developing or commercializing products before or more successfully than we do.

The development and commercialization of new drug products is highly competitive. We face competition with respect to our current product candidates, and will likely face competition with respect to any product candidates that we may seek to develop or commercialize in the future, from major pharmaceutical companies, specialty pharmaceutical companies and biotechnology companies worldwide. There are a number of large pharmaceutical and biotechnology companies that currently market and sell products or are pursuing the development of products for the treatment of the disease indications for which we are developing our product candidates. Some of these competitive products and therapies are based on scientific approaches that are the same as or similar to our approach, and others are based on entirely different approaches. Potential competitors also include academic institutions, government agencies and other public and private research organizations that conduct research, seek patent protection and establish collaborative arrangements for research, development, manufacturing and commercialization.

Specifically, there are a large number of companies developing or marketing treatments for cancer, including many major pharmaceutical and biotechnology companies. In addition, many companies are developing cancer therapeutics that work by targeting epigenetic mechanisms other than HMTs, and some companies, including Celgene and Eisai, are marketing such treatments. There are also a number of companies that we believe are developing new epigenetic treatments for cancer that target HMTs, including GSK, Novartis AG, Pfizer, Inc. and Genentech, Inc.

Our commercial opportunity could be reduced or eliminated if our competitors develop and commercialize products that are safer, more effective, have fewer or less severe side effects, are more convenient or are less expensive than any products that we may develop. Our competitors also may obtain FDA or other regulatory approval for their products more rapidly than we may obtain approval for ours, which could result in our competitors establishing a strong market position before we are able to enter the market. In addition, our ability to compete may be affected in many cases by insurers or other third party payors seeking to encourage the use of generic products. Generic products are currently on the market for the indications that we are pursuing, and additional products are expected to become available on a generic basis over the coming years. If our product candidates achieve marketing approval, we expect that they will be priced at a significant premium over competitive generic products.

Many of the companies against which we are competing or against which we may compete in the future have significantly greater financial resources and expertise in research and development, manufacturing, preclinical testing, conducting clinical trials, obtaining regulatory approvals and marketing approved products than we do.

Mergers and acquisitions in the pharmaceutical and biotechnology industries may result in even more resources being concentrated among a smaller number of our competitors. Smaller and other early stage companies may also prove to be significant competitors, particularly through collaborative arrangements with large and established companies. These third parties compete with us in recruiting and retaining qualified scientific and management personnel, establishing clinical trial sites and patient registration for clinical trials, as well as in acquiring technologies complementary to, or necessary for, our programs.

Even if we are able to commercialize any product candidates, the products may become subject to unfavorable pricing regulations, third party reimbursement practices or healthcare reform initiatives, which could harm our business.

The regulations that govern marketing approvals, pricing, coverage and reimbursement for new drug products vary widely from country to country. Current and future legislation may significantly change the approval requirements in ways that could involve additional costs and cause delays in obtaining approvals. Some countries require approval of the sale price of a drug before it can be marketed. In many countries, the pricing review period begins after marketing or product licensing approval is granted. In some foreign markets, prescription pharmaceutical pricing remains subject to continuing governmental control even after initial approval is granted. As a result, we might obtain marketing approval for a product in a particular country, but then be subject to price regulations that delay our commercial launch of the product, possibly for lengthy time periods, and

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negatively impact the revenues we are able to generate from the sale of the product in that country. Adverse pricing limitations may hinder our ability to recoup our investment in one or more product candidates, even if our product candidates obtain marketing approval.

Our ability to commercialize any product candidates successfully also will depend in part on the extent to which coverage and adequate reimbursement for these products and related treatments will be available from government health administration authorities, private health insurers and other organizations. Government authorities and third party payors, such as private health insurers and health maintenance organizations, decide which medications they will pay for and establish reimbursement levels. A primary trend in the U.S. healthcare industry and elsewhere is cost containment. Government authorities and third party payors have attempted to control costs by limiting coverage and the amount of reimbursement for particular medications. Increasingly, third party payors are requiring that drug companies provide them with predetermined discounts from list prices and are challenging the prices charged for medical products. Coverage and reimbursement may not be available for any product that we commercialize and, even if these are available, the level of reimbursement may not be satisfactory. Reimbursement may affect the demand for, or the price of, any product candidate for which we obtain marketing approval. Obtaining and maintaining adequate reimbursement for our products may be difficult. We may be required to conduct expensive pharmacoeconomic studies to justify coverage and reimbursement or the level of reimbursement relative to other therapies. If coverage and adequate reimbursement are not available or reimbursement is available only to limited levels, we may not be able to successfully commercialize any product candidate for which we obtain marketing approval.

There may be significant delays in obtaining reimbursement for newly approved drugs, and coverage may be more limited than the purposes for which the drug is approved by the FDA or similar regulatory authorities outside of the United States. Moreover, eligibility for reimbursement does not imply that a drug will be paid for in all cases or at a rate that covers our costs, including research, development, manufacture, sale and distribution. Interim reimbursement levels for new drugs, if applicable, may also not be sufficient to cover our costs and may not be made permanent. Reimbursement rates may vary according to the use of the drug and the clinical setting in which it is used, may be based on reimbursement levels already set for lower cost drugs and may be incorporated into existing payments for other services. Net prices for drugs may be reduced by mandatory discounts or rebates required by government healthcare programs or private payors and by any future relaxation of laws that presently restrict imports of drugs from countries where they may be sold at lower prices than in the United States. Third party payors often rely upon Medicare coverage policy and payment limitations in setting their own reimbursement policies. Our inability to promptly obtain coverage and adequate reimbursement rates from both government-funded and private payors for any approved products that we develop could have a material adverse effect on our operating results, our ability to raise capital needed to commercialize products and our overall financial condition.

Product liability lawsuits against us could cause us to incur substantial liabilities and to limit commercialization of any products that we may develop.

We face an inherent risk of product liability exposure related to the testing of our product candidates in human clinical trials and will face an even greater risk if we commercially sell any products that we may develop. If we cannot successfully defend ourselves against claims that our product candidates or products caused injuries, we will incur substantial liabilities. Regardless of merit or eventual outcome, liability claims may result in:

- decreased demand for any product candidates or products that we may develop;

injury to our reputation and significant negative media attention;

withdrawal of clinical trial participants;

significant costs to defend any related litigation;

substantial monetary awards to trial participants or patients;

loss of revenue;

reduced resources of our management to pursue our business strategy; and

the inability to commercialize any products that we may develop.

We currently hold $5.0 million in product liability insurance coverage in the aggregate, with a per incident limit of $5.0 million, which may not be adequate to cover all liabilities that we may incur. We may need to increase our insurance coverage as we expand our clinical trials or if we commence commercialization of our product candidates. Insurance coverage is increasingly expensive. We may not be able to maintain insurance coverage at a reasonable cost or in an amount adequate to satisfy any liability that may arise.

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Risks Related to Our Dependence on Third Parties

Our existing therapeutic collaborations are important to our business, and future collaborations may also be important to us. If we are unable to maintain any of these collaborations, or if these collaborations are not successful, our business could be adversely affected.

We have limited capabilities for drug development and do not yet have any capability for sales, marketing or distribution. Accordingly, we have entered into therapeutic collaborations with other companies that we believe can provide such capabilities, including our collaboration and license agreements with Celgene, Eisai and GSK. These collaborations also have provided us with important funding for our development programs and product platform and we expect to receive additional funding under these collaborations in the future. Our existing therapeutic collaborations, and any future collaborations we enter into, may pose a number of risks, including the following:

- collaborators have significant discretion in determining the efforts and resources that they will apply to these collaborations;
- collaborators may not perform their obligations as expected;
- collaborators may not pursue development and commercialization of any product candidates that achieve regulatory approval or may elect not to continue or renew development or commercialization programs based on clinical trial results, changes in the collaborators strategic focus or available funding, or external factors, such as an acquisition, that may divert resources or create competing priorities;
- collaborators may delay clinical trials, provide insufficient funding for a clinical trial program, stop a clinical trial or abandon a product candidate, repeat or conduct new clinical trials or require a new formulation of a product candidate for clinical testing;
- collaborators could independently develop, or develop with third parties, products that compete directly or indirectly with our products and product candidates if the collaborators believe that the competitive products are more likely to be successfully developed or can be commercialized under terms that are more economically attractive than ours;
- product candidates discovered in collaboration with us may be viewed by our collaborators as competitive with their own product candidates or products, which may cause collaborators to cease to devote resources to the commercialization of our product candidates;
- a collaborator may fail to comply with applicable regulatory requirements regarding the development, manufacture, distribution or marketing of a product candidate or product;

a collaborator with marketing and distribution rights to one or more of our product candidates that achieve regulatory approval may not commit sufficient resources to the marketing and distribution of such product or products;

disagreements with collaborators, including disagreements over proprietary rights, contract interpretation or the preferred course of development, might cause delays or terminations of the research, development or commercialization of product candidates, might lead to additional responsibilities for us with respect to product candidates, or might result in litigation or arbitration, any of which would be time-consuming and expensive;

collaborators may not properly maintain or defend our intellectual property rights or may use our proprietary information in such a way as to invite litigation that could jeopardize or invalidate our intellectual property or proprietary information or expose us to potential litigation;

collaborators may infringe the intellectual property rights of third parties, which may expose us to litigation and potential liability; and

collaborations may be terminated for the convenience of the collaborator, and, if terminated, we could be required to raise additional capital to pursue further development or commercialization of the applicable product candidates.

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If our therapeutic collaborations do not result in the successful development and commercialization of products or if one of our collaborators terminates its agreement with us, we may not receive any future research funding or milestone or royalty payments under the collaboration. If we do not receive the funding we expect under these agreements, our development of our product platform and product candidates could be delayed and we may need additional resources to develop product candidates and our product platform. All of the risks relating to product development, regulatory approval and commercialization described in this Quarterly Report on Form 10-Q also apply to the activities of our therapeutic collaborators.

Each of our existing three therapeutic collaborations contains a restriction on our engaging in activities that are the subject of the collaboration with third parties for specified periods of time. In addition, under our collaboration agreement with Celgene, during the option period specified in the agreement, which could extend to July 2016, Celgene has the right to exercise its option to acquire a license to additional targets other than DOT1L until the effectiveness of an investigational new drug application, or IND, for an HMT inhibitor directed to such additional target. This option effectively covers all HMT targets that are not currently subject to our Eisai and GSK collaborations. As a result, our ability to enter into collaboration agreements for additional HMT targets is significantly limited until the end of the option period under the Celgene agreement and may continue to be limited after that time depending on how many targets Celgene elects to license, if any. These restrictions may have the effect of preventing us from undertaking development and other efforts that may appear to be attractive to us.

Additionally, subject to its contractual obligations to us, if a collaborator of ours is involved in a business combination, the collaborator might deemphasize or terminate the development or commercialization of any product candidate licensed to it by us. If one of our collaborators terminates its agreement with us, we may find it more difficult to attract new collaborators and our perception in the business and financial communities could be adversely affected.

For some of our product candidates or for some HMT targets, we may in the future determine to collaborate with pharmaceutical and biotechnology companies for development and potential commercialization of therapeutic products. We face significant competition in seeking appropriate collaborators. Our ability to reach a definitive agreement for a collaboration will depend, among other things, upon our assessment of the collaborator s resources and expertise, the terms and conditions of the proposed collaboration and the proposed collaborator s evaluation of a number of factors. If we are unable to reach agreements with suitable collaborators on a timely basis, on acceptable terms, or at all, we may have to curtail the development of a product candidate, reduce or delay its development program or one or more of our other development programs, delay its potential commercialization or reduce the scope of any sales or marketing activities, or increase our expenditures and undertake development or commercialization activities at our own expense. If we elect to fund and undertake development or commercialization activities on our own, we may need to obtain additional expertise and additional capital, which may not be available to us on acceptable terms or at all. If we fail to enter into collaborations and do not have sufficient funds or expertise to undertake the necessary development and commercialization activities, we may not be able to further develop our product candidates or bring them to market or continue to develop our product platform and our business may be materially and adversely affected.

Failure of our third party collaborators to successfully commercialize companion diagnostics developed for use with our therapeutic product candidates could harm our ability to commercialize these product candidates.

We do not plan to develop companion diagnostics internally and, as a result, we are dependent on the efforts of our third party collaborators to successfully commercialize these companion diagnostics. Our collaborators:

may not perform their obligations as expected;

may encounter production difficulties that could constrain the supply of the companion diagnostics;

may have difficulties gaining acceptance of the use of the companion diagnostics in the clinical community;

may not pursue commercialization of any therapeutic product candidates that achieve regulatory approval;

may elect not to continue or renew commercialization programs based on changes in the collaborators strategic focus or available funding, or external factors such as an acquisition, that divert resources or create competing priorities;

may not commit sufficient resources to the marketing and distribution of such product or products; and

may terminate their relationship with us.

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If companion diagnostics for use with our therapeutic product candidates fail to gain market acceptance, our ability to derive revenues from sales of our therapeutic product candidates could be harmed. If our collaborators fail to commercialize these companion diagnostics, we may not be able to enter into arrangements with another diagnostic company to obtain supplies of an alternative diagnostic test for use in connection with our therapeutic product candidates or do so on commercially reasonable terms, which could adversely affect and delay the development or commercialization of our therapeutic product candidates.

We rely, and expect to continue to rely, on third parties to conduct our clinical trials, and those third parties may not perform satisfactorily, including failing to meet deadlines for the completion of such trials.

We currently rely on third party clinical research organizations, or CROs, to conduct our ongoing Phase 1 and Phase 1b clinical trials of EPZ-5676 and our ongoing Phase 1/2 clinical trial of EPZ-6438 and do not plan to independently conduct clinical trials of our other product candidates. We expect to continue to rely on third parties, such as CROs, clinical data management organizations, medical institutions and clinical investigators, to conduct our clinical trials. These agreements might terminate for a variety of reasons, including a failure to perform by the third parties. If we need to enter into alternative arrangements, our product development activities might be delayed.

Our reliance on these third parties for research and development activities will reduce our control over these activities but will not relieve us of our responsibilities. For example, we will remain responsible for ensuring that each of our clinical trials is conducted in accordance with the general investigational plan and protocols for the trial. Moreover, the FDA requires us to comply with standards, commonly referred to as good clinical practices, or GCPs, for conducting, recording and reporting the results of clinical trials to assure that data and reported results are credible and accurate and that the rights, integrity and confidentiality of trial participants are protected. We also are required to register ongoing clinical trials and post the results of completed clinical trials on a government-sponsored database, ClinicalTrials.gov, within specified timeframes. Failure to do so can result in fines, adverse publicity and civil and criminal sanctions.

Furthermore, these third parties may also have relationships with other entities, some of which may be our competitors. If these third parties do not successfully carry out their contractual duties, meet expected deadlines or conduct our clinical trials in accordance with regulatory requirements or our stated protocols, we will not be able to obtain, or may be delayed in obtaining, marketing approvals for our product candidates and will not be able to, or may be delayed in our efforts to, successfully commercialize our product candidates.

We also expect to rely on other third parties to store and distribute drug supplies for our clinical trials. Any performance failure on the part of our distributors could delay clinical development or marketing approval of our product candidates or commercialization of our products, producing additional losses and depriving us of potential product revenue.

We contract with third parties for the manufacture of our product candidates for preclinical and clinical testing and expect to continue to do so for commercialization. This reliance on third parties increases the risk that we will not have sufficient quantities of our product candidates or products or such quantities at an acceptable cost or quality, which could delay, prevent or impair our development or commercialization efforts.

We do not have any manufacturing facilities or personnel. We rely, and expect to continue to rely, on third parties for the manufacture of our product candidates for preclinical and clinical testing, as well as for commercial manufacture if any of our product candidates receive marketing approval. This reliance on third parties increases the risk that we will not have sufficient quantities of our product candidates or products or such quantities at an acceptable cost or quality, which could delay, prevent or impair our development or commercialization efforts.

We also expect to rely on third party manufacturers or third party collaborators for the manufacture of commercial supply of any other product candidates for which our collaborators or we obtain marketing approval.

We may be unable to establish any agreements with third party manufacturers or to do so on acceptable terms. Even if we are able to establish agreements with third party manufacturers, reliance on third party manufacturers entails additional risks, including:

- reliance on the third party for regulatory compliance and quality assurance;
- the possible breach of the manufacturing agreement by the third party;

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the possible misappropriation of our proprietary information, including our trade secrets and know-how; and

the possible termination or nonrenewal of the agreement by the third party at a time that is costly or inconvenient for us.

Third party manufacturers may not be able to comply with current good manufacturing practices, or cGMP, regulations or similar regulatory requirements outside of the United States. Our failure, or the failure of our third party manufacturers, to comply with applicable regulations could result in sanctions being imposed on us, including clinical holds, fines, injunctions, civil penalties, delays, suspension or withdrawal of approvals, license revocation, seizures or recalls of product candidates or products, operating restrictions and criminal prosecutions, any of which could significantly and adversely affect supplies of our products.

Our product candidates and any products that we may develop may compete with other product candidates and products for access to manufacturing facilities. There are a limited number of manufacturers that operate under cGMP regulations and that might be capable of manufacturing for us.

Any performance failure on the part of our existing or future manufacturers could delay clinical development or marketing approval. We do not currently have arrangements in place for redundant supply or a second source for bulk drug substance. If our current contract manufacturers cannot perform as agreed, we may be required to replace such manufacturers. Although we believe that there are several potential alternative manufacturers who could manufacture our product candidates, we may incur added costs and delays in identifying and qualifying any such replacement.

Our current and anticipated future dependence upon others for the manufacture of our product candidates or products may adversely affect our future profit margins and our ability to commercialize any products that receive marketing approval on a timely and competitive basis.

Risks Related to Our Intellectual Property

If we are unable to obtain and maintain patent protection for our technology and products or if the scope of the patent protection obtained is not sufficiently broad, our competitors could develop and commercialize technology and products similar or identical to ours, and our ability to successfully commercialize our technology and products may be impaired.

Our success depends in large part on our ability to obtain and maintain patent protection in the United States and other countries with respect to our proprietary technology and products. We seek to protect our proprietary position by filing patent applications in the United States and abroad related to our novel technologies and product candidates.

The patent prosecution process is expensive and time-consuming, and we may not be able to file and prosecute all necessary or desirable patent applications at a reasonable cost or in a timely manner. It is also possible that we will fail to identify patentable aspects of our research and development output before it is too late to obtain patent protection. Moreover, in some circumstances, we do not have the right to control the preparation, filing and prosecution of patent applications, or to maintain the patents, covering technology that we license from third parties. Therefore, these patents and applications may not be prosecuted and enforced in a manner consistent with the best interests of our business.

The patent position of biotechnology and pharmaceutical companies generally is highly uncertain, involves complex legal and factual questions and has in recent years been the subject of much litigation. In addition, the laws of foreign countries may not protect our rights to the same extent as the laws of the United States. For example, European patent

law restricts the patentability of methods of treatment of the human body more than United States law does. Publications of discoveries in the scientific literature often lag behind the actual discoveries, and patent applications in the United States and other jurisdictions are typically not published until 18 months after filing, or in some cases at all. Therefore, we cannot know with certainty whether we were the first to make the inventions claimed in our owned or licensed patents or pending patent applications, or that we were the first to file for patent protection of such inventions. As a result, the issuance, scope, validity, enforceability and commercial value of our patent rights are highly uncertain. Our pending and future patent applications may not result in patents being issued which protect our technology or products, in whole or in part, or which effectively prevent others from commercializing competitive technologies and products. Changes in either the patent laws or interpretation of the patent laws in the United States and other countries may diminish the value of our patents or narrow the scope of our patent protection.

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Recent patent reform legislation could increase the uncertainties and costs surrounding the prosecution of our patent applications and the enforcement or defense of our issued patents. On September 16, 2011, the Leahy-Smith America Invents Act, or the Leahy-Smith Act, was signed into law. The Leahy-Smith Act includes a number of significant changes to United States patent law. These changes include provisions that affect the way patent applications are prosecuted and may also affect patent litigation. The United States Patent Office recently developed new regulations and procedures to govern administration of the Leahy-Smith Act, and many of the substantive changes to patent law associated with the Leahy-Smith Act, and in particular, the first to file provisions, only became effective on March 16, 2013. Accordingly, it is not clear what, if any, impact the Leahy-Smith Act will have on the operation of our business. However, the Leahy-Smith Act and its implementation could increase the uncertainties and costs surrounding the prosecution of our patent applications and the enforcement or defense of our issued patents, all of which could have a material adverse effect on our business and financial condition.

Moreover, we may be subject to a third party preissuance submission of prior art to the U.S. Patent and Trademark Office, or become involved in opposition, derivation, reexamination, *inter partes* review, post-grant review or interference proceedings challenging our patent rights or the patent rights of others. An adverse determination in any such submission, proceeding or litigation could reduce the scope of, or invalidate, our patent rights, allow third parties to commercialize our technology or products and compete directly with us, without payment to us, or result in our inability to manufacture or commercialize products without infringing third party patent rights. In addition, if the breadth or strength of protection provided by our patents and patent applications is threatened, it could dissuade companies from collaborating with us to license, develop or commercialize current or future product candidates.

Even if our owned and licensed patent applications issue as patents, they may not issue in a form that will provide us with any meaningful protection, prevent competitors from competing with us or otherwise provide us with any competitive advantage. Our competitors may be able to circumvent our owned or licensed patents by developing similar or alternative technologies or products in a non-infringing manner.

The issuance of a patent is not conclusive as to its inventorship, scope, validity or enforceability, and our owned and licensed patents may be challenged in the courts or patent offices in the United States and abroad. Such challenges may result in loss of exclusivity or freedom to operate or in patent claims being narrowed, invalidated or held unenforceable, in whole or in part, which could limit our ability to stop others from using or commercializing similar or identical technology and products, or limit the duration of the patent protection of our technology and products. Given the amount of time required for the development, testing and regulatory review of new product candidates, patents protecting such candidates might expire before or shortly after such candidates are commercialized. As a result, our owned and licensed patent portfolio may not provide us with sufficient rights to exclude others from commercializing products similar or identical to ours.

We may become involved in lawsuits to protect or enforce our patents or other intellectual property, which could be expensive, time consuming and unsuccessful.

Competitors may infringe our issued patents or other intellectual property. To counter infringement or unauthorized use, we may be required to file infringement claims, which can be expensive and time consuming. Any claims we assert against perceived infringers could provoke these parties to assert counterclaims against us alleging that we infringe their patents. In addition, in a patent infringement proceeding, a court may decide that a patent of ours is invalid or unenforceable, in whole or in part, construe the patent s claims narrowly or refuse to stop the other party from using the technology at issue on the grounds that our patents do not cover the technology in question. An adverse result in any litigation proceeding could put one or more of our patents at risk of being invalidated or interpreted narrowly.

We may need to license certain intellectual property from third parties, and such licenses may not be available or may not be available on commercially reasonable terms.

A third party may hold intellectual property, including patent rights, that are important or necessary to the development of our products. It may be necessary for us to use the patented or proprietary technology of third parties to commercialize our products, in which case we may be required to obtain a license from these third parties on commercially reasonable terms, or our business could be harmed, possibly materially.

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Third parties may initiate legal proceedings alleging that we are infringing their intellectual property rights, the outcome of which would be uncertain and could have a material adverse effect on the success of our business.

Our commercial success depends upon our ability, and the ability of our collaborators, to develop, manufacture, market and sell our product candidates and use our proprietary technologies without infringing the proprietary rights of third parties. There is considerable intellectual property litigation in the biotechnology and pharmaceutical industries. We may become party to, or threatened with, future adversarial proceedings or litigation regarding intellectual property rights with respect to our products and technology, including interference or derivation proceedings before the U.S. Patent and Trademark Office. Third parties may assert infringement claims against us based on existing patents or patents that may be granted in the future.

If we are found to infringe a third party s intellectual property rights, we could be required to obtain a license from such third party to continue developing and marketing our products and technology. However, we may not be able to obtain any required license on commercially reasonable terms or at all. Even if we were able to obtain a license, it could be non-exclusive, thereby giving our competitors access to the same technologies licensed to us. We could be forced, including by court order, to cease commercializing the infringing technology or product. In addition, we could be found liable for monetary damages, including treble damages and attorneys fees if we are found to have willfully infringed a patent. A finding of infringement could prevent us from commercializing our product candidates or force us to cease some of our business operations, which could materially harm our business. Claims that we have misappropriated the confidential information or trade secrets of third parties could have a similar negative impact on our business.

If we fail to comply with our obligations in our intellectual property licenses and funding arrangements with third parties, we could lose rights that are important to our business.

We are party to a license agreement and a research agreement that impose, and we may enter into additional licensing and funding arrangements with third parties that may impose, diligence, development and commercialization timelines, milestone payment, royalty, insurance and other obligations on us. Under our existing licensing and funding agreements, we are obligated to pay royalties on net product sales of product candidates or related technologies to the extent they are covered by the agreement. We also had diligence and development obligations under those agreements that we have satisfied. If we fail to comply with our obligations under current or future license and funding agreements, our counterparties may have the right to terminate these agreements, in which event we might not be able to develop, manufacture or market any product that is covered by these agreements or may face other penalties under the agreements. Such an occurrence could materially adversely affect the value of the product candidate being developed under any such agreement. Termination of these agreements or reduction or elimination of our rights under these agreements may result in our having to negotiate new or reinstated agreements with less favorable terms, or cause us to lose our rights under these agreements, including our rights to important intellectual property or technology.

We may be subject to claims by third parties asserting that our employees or we have misappropriated their intellectual property, or claiming ownership of what we regard as our own intellectual property.

Many of our employees were previously employed at universities or other biotechnology or pharmaceutical companies, including our competitors or potential competitors. Although we try to ensure that our employees do not use the proprietary information or know-how of others in their work for us, we may be subject to claims that these employees or we have used or disclosed intellectual property, including trade secrets or other proprietary information, of any such employee s former employer. Litigation may be necessary to defend against these claims.

In addition, while it is our policy to require our employees and contractors who may be involved in the development of intellectual property to execute agreements assigning such intellectual property to us, we may be unsuccessful in executing such an agreement with each party who in fact develops intellectual property that we regard as our own. Our and their assignment agreements may not be self-executing or may be breached, and we may be forced to bring claims against third parties, or defend claims they may bring against us, to determine the ownership of what we regard as our intellectual property.

If we fail in prosecuting or defending any such claims, in addition to paying monetary damages, we may lose valuable intellectual property rights or personnel. Even if we are successful in prosecuting or defending against such claims, litigation could result in substantial costs and be a distraction to management.

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Intellectual property litigation could cause us to spend substantial resources and distract our personnel from their normal responsibilities.

Even if resolved in our favor, litigation or other legal proceedings relating to intellectual property claims may cause us to incur significant expenses, and could distract our technical and management personnel from their normal responsibilities. In addition, there could be public announcements of the results of hearings, motions or other interim proceedings or developments and if securities analysts or investors perceive these results to be negative, it could have a substantial adverse effect on the price of our common stock. Such litigation or proceedings could substantially increase our operating losses and reduce the resources available for development activities or any future sales, marketing or distribution activities. We may not have sufficient financial or other resources to conduct such litigation or proceedings adequately. Some of our competitors may be able to sustain the costs of such litigation or proceedings more effectively than we can because of their greater financial resources. Uncertainties resulting from the initiation and continuation of patent litigation or other proceedings could compromise our ability to compete in the marketplace.

If we are unable to protect the confidentiality of our trade secrets, our business and competitive position would be harmed.

In addition to seeking patents for some of our technology and product candidates, we also rely on trade secrets, including unpatented know-how, technology and other proprietary information, to maintain our competitive position. We seek to protect these trade secrets, in part, by entering into non-disclosure and confidentiality agreements with parties who have access to them, such as our employees, corporate collaborators, outside scientific collaborators, contract manufacturers, consultants, advisors and other third parties. We also enter into confidentiality and invention or patent assignment agreements with our employees and consultants. Despite these efforts, any of these parties may breach the agreements and disclose our proprietary information, including our trade secrets, and we may not be able to obtain adequate remedies for such breaches. Enforcing a claim that a party illegally disclosed or misappropriated a trade secret is difficult, expensive and time-consuming, and the outcome is unpredictable. In addition, some courts inside and outside of the United States are less willing or unwilling to protect trade secrets. If any of our trade secrets were to be lawfully obtained or independently developed by a competitor, we would have no right to prevent them, or those to whom they communicate it, from using that technology or information to compete with us. If any of our trade secrets were to be disclosed to or independently developed by a competitor, our competitive position would be harmed.

Risks Related to Regulatory Approval of Our Product Candidates and Other Legal Compliance Matters

If we are not able to obtain, or if there are delays in obtaining, required regulatory approvals, we will not be able to commercialize our product candidates, and our ability to generate revenue will be materially impaired.

Our product candidates and the activities associated with their development and commercialization, including their design, testing, manufacture, safety, efficacy, recordkeeping, labeling, storage, approval, advertising, promotion, sale and distribution, are subject to comprehensive regulation by the FDA and other regulatory agencies in the United States and by the EMA and similar regulatory authorities outside of the United States. Failure to obtain marketing approval for a product candidate will prevent us from commercializing the product candidate. We have not received approval to market any of our product candidates from regulatory authorities in any jurisdiction. We have only limited experience in filing and supporting the applications necessary to gain marketing approvals and expect to rely on third party CROs to assist us in this process. Securing marketing approval requires the submission of extensive preclinical and clinical data and supporting information to regulatory authorities for each therapeutic indication to establish the product candidate s safety and efficacy. Securing marketing approval also requires the submission of information about the product manufacturing process to, and inspection of manufacturing facilities by, the regulatory authorities. Our

product candidates may not be effective, may be only moderately effective or may prove to have undesirable or unintended side effects, toxicities or other characteristics that may preclude our obtaining marketing approval or prevent or limit commercial use. New cancer drugs frequently are indicated only for patient populations that have not responded to an existing therapy or have relapsed. If any of our product candidates receives marketing approval, the accompanying label may limit the approved use of our drug in this way, which could limit sales of the product.

The process of obtaining marketing approvals, both in the United States and abroad, is expensive, may take many years if additional clinical trials are required, if approval is obtained at all, and can vary substantially based upon a variety of factors, including the type, complexity and novelty of the product candidates involved. Changes in marketing approval policies during the development period, changes in or the enactment of additional statutes or regulations, or changes in regulatory review for each submitted product application, may cause delays in the approval or rejection of an application. Regulatory authorities

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have substantial discretion in the approval process and may refuse to accept any application or may decide that our data is insufficient for approval and require additional preclinical, clinical or other studies. In addition, varying interpretations of the data obtained from preclinical and clinical testing could delay, limit or prevent marketing approval of a product candidate. Any marketing approval we ultimately obtain may be limited or subject to restrictions or post-approval commitments that render the approved product not commercially viable.

If we experience delays in obtaining approval or if we fail to obtain approval of our product candidates, the commercial prospects for our product candidates may be harmed and our ability to generate revenues will be materially impaired.

We may not be able to obtain orphan drug exclusivity for our product candidates.

Regulatory authorities in some jurisdictions, including the United States and Europe, may designate drugs for relatively small patient populations as orphan drugs. Under the Orphan Drug Act, the FDA may designate a product as an orphan drug if it is a drug intended to treat a rare disease or condition, which is generally defined as a patient population of fewer than 200,000 individuals annually in the United States.

Generally, if a product with an orphan drug designation subsequently receives the first marketing approval for the indication for which it has such designation, the product is entitled to a period of marketing exclusivity, which precludes the EMA or the FDA from approving another marketing application for the same drug for that time period. The applicable period is seven years in the United States and ten years in Europe. The European exclusivity period can be reduced to six years if a drug no longer meets the criteria for orphan drug designation or if the drug is sufficiently profitable so that market exclusivity is no longer justified. Orphan drug exclusivity may be lost if the FDA or EMA determines that the request for designation was materially defective or if the manufacturer is unable to assure sufficient quantity of the drug to meet the needs of patients with the rare disease or condition.

Even if we obtain orphan drug exclusivity for a product, that exclusivity may not effectively protect the product from competition because different drugs can be approved for the same condition. Even after an orphan drug is approved, the FDA can subsequently approve the same drug for the same condition if the FDA concludes that the later drug is clinically superior in that it is shown to be safer, more effective or makes a major contribution to patient care.

A fast track designation by the FDA may not actually lead to a faster development or regulatory review or approval process.

We intend to seek fast track designation for some of our product candidates. If a drug is intended for the treatment of a serious or life-threatening condition and the drug demonstrates the potential to address unmet medical needs for this condition, the drug sponsor may apply for FDA fast track designation. The FDA has broad discretion whether or not to grant this designation, so even if we believe a particular product candidate is eligible for this designation, we cannot assure that the FDA would decide to grant it. Even if we do receive fast track designation, we may not experience a faster development process, review or approval compared to conventional FDA procedures. The FDA may withdraw fast track designation if it believes that the designation is no longer supported by data from our clinical development program.

A breakthrough therapy designation by the FDA for our product candidates may not lead to a faster development or regulatory review or approval process, and it does not increase the likelihood that our product candidates will receive marketing approval.

We may seek a breakthrough therapy designation for some of our product candidates. A breakthrough therapy is defined as a drug that is intended, alone or in combination with one or more other drugs, to treat a serious or life-threatening disease or condition, and preliminary clinical evidence indicates that the drug may demonstrate substantial improvement over existing therapies on one or more clinically significant endpoints, such as substantial treatment effects observed early in clinical development. For drugs and biologics that have been designated as breakthrough therapies, interaction and communication between the FDA and the sponsor of the trial can help to identify the most efficient path for clinical development while minimizing the number of patients placed in ineffective control regimens. Drugs designated as breakthrough therapies by the FDA are also eligible for accelerated approval.

Designation as a breakthrough therapy is within the discretion of the FDA. Accordingly, even if we believe one of our product candidates meets the criteria for designation as a breakthrough therapy, the FDA may disagree and instead determine not to make such designation. Even if we receive breakthrough therapy designation, the receipt of such designation for a product

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candidate may not result in a faster development process, review or approval compared to drugs considered for approval under conventional FDA procedures and does not assure ultimate approval by the FDA. In addition, even if one or more of our product candidates qualify as breakthrough therapies, the FDA may later decide that the products no longer meet the conditions for qualification or decide that the time period for FDA review or approval will not be shortened.

Failure to obtain marketing approval in international jurisdictions would prevent our product candidates from being marketed abroad.

In order to market and sell our products in the European Union and many other jurisdictions, we or our third party collaborators must obtain separate marketing approvals and comply with numerous and varying regulatory requirements. The approval procedure varies among countries and can involve additional testing. The time required to obtain approval may differ substantially from that required to obtain FDA approval. The regulatory approval process outside of the United States generally includes all of the risks associated with obtaining FDA approval. In addition, in many countries outside of the United States, it is required that the product be approved for reimbursement before the product can be approved for sale in that country. We or these third parties may not obtain approvals from regulatory authorities outside of the United States 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 regulatory authority outside of the United States does not ensure approval by regulatory authorities in other countries or jurisdictions or by the FDA. We may not be able to file for marketing approvals and may not receive necessary approvals to commercialize our products in any market.

Any product candidate for which we obtain marketing approval could be subject to post-marketing restrictions or withdrawal from the market and we may be subject to penalties if we fail to comply with regulatory requirements or if we experience unanticipated problems with our products, when and if any of them are approved.

Any product candidate for which we obtain marketing approval, along with the manufacturing processes, post-approval clinical data, labeling, advertising and promotional activities for such product, will be subject to continual requirements of and review by the FDA and other regulatory authorities. These requirements include submissions of safety and other post-marketing information and reports, registration and listing requirements, cGMP requirements relating to manufacturing, quality control, quality assurance and corresponding maintenance of records and documents, requirements regarding the distribution of samples to physicians and recordkeeping. Even if marketing approval of a product candidate is granted, the approval may be subject to limitations on the indicated uses for which the product may be marketed or to the conditions of approval, including the requirement to implement a risk evaluation and mitigation strategy. New cancer drugs frequently are indicated only for patient populations that have not responded to an existing therapy or have relapsed. If any of our product candidates receives marketing approval, the accompanying label may limit the approved use of our drug in this way, which could limit sales of the product.

The FDA may also impose requirements for costly post-marketing studies or clinical trials and surveillance to monitor the safety or efficacy of the product. The FDA closely regulates the post-approval marketing and promotion of drugs to ensure drugs are marketed only for the approved indications and in accordance with the provisions of the approved labeling. The FDA imposes stringent restrictions on manufacturers communications regarding off-label use, and if we do not market our products for their approved indications, we may be subject to enforcement action for off-label marketing. Violations of the Federal Food, Drug, and Cosmetic Act relating to the promotion of prescription drugs may lead to investigations alleging violations of federal and state health care fraud and abuse laws, as well as state consumer protection laws.

In addition, later discovery of previously unknown adverse events or other problems with our products, manufacturers or manufacturing processes, or failure to comply with regulatory requirements, may yield various results, including:

restrictions on such products, manufacturers or manufacturing processes;

restrictions on the labeling or marketing of a product;

restrictions on product distribution or use;

requirements to conduct post-marketing studies or clinical trials;

warning letters;

withdrawal of the products from the market;

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

recall of products;

fines, restitution or disgorgement of profits or revenues;

suspension or withdrawal of marketing approvals;

refusal to permit the import or export of our products;

product seizure; or

injunctions or the imposition of civil or criminal penalties.

Non-compliance with European Union requirements regarding safety monitoring or pharmacovigilance, and with requirements related to the development of products for the pediatric population, can also result in significant financial penalties. Similarly, failure to comply with the European Union s requirements regarding the protection of personal information can also lead to significant penalties and sanctions.

Our relationships with customers and third party payors will be subject to applicable anti-kickback, fraud and abuse and other healthcare laws and regulations, which, in the event of a violation, could expose us to criminal sanctions, civil penalties, contractual damages, reputational harm and diminished profits and future earnings.

Healthcare providers, physicians and third party payors will play a primary role in the recommendation and prescription of any product candidates for which we obtain marketing approval. Our future arrangements with third party payors and customers may expose us to broadly applicable fraud and abuse and other healthcare laws and regulations that may constrain the business or financial arrangements and relationships through which we market, sell and distribute any products for which we obtain marketing approval. Restrictions under applicable federal and state healthcare laws and regulations include the following:

the federal Anti-Kickback Statute prohibits, among other things, persons from knowingly and willfully soliciting, offering, receiving or providing remuneration, directly or indirectly, in cash or in kind, to induce or reward, or in return for, either the referral of an individual for, or the purchase, order or recommendation of, any good or service, for which payment may be made under a federal healthcare program such as Medicare and Medicaid;

the federal False Claims Act imposes criminal and civil penalties, including civil whistleblower or *qui tam* actions, against individuals or entities for knowingly presenting, or causing to be presented, to the federal government, claims for payment that are false or fraudulent or making a false statement to avoid, decrease or conceal an obligation to pay money to the federal government;

the federal Health Insurance Portability and Accountability Act of 1996, or HIPAA, imposes criminal and civil liability for executing a scheme to defraud any healthcare benefit program or making false statements relating to healthcare matters;

HIPAA, as amended by the Health Information Technology for Economic and Clinical Health Act and its implementing regulations, also imposes obligations, including mandatory contractual terms, with respect to safeguarding the privacy, security and transmission of individually identifiable health information;

federal law requires applicable manufacturers of covered drugs to report payments and other transfers of value to physicians and teaching hospitals, with data collection beginning in August 2013; and

analogous state and foreign laws and regulations, such as state anti-kickback and false claims laws, may apply to sales or marketing arrangements and claims involving healthcare items or services reimbursed by non-governmental third party payors, including private insurers.

Some state laws require pharmaceutical companies to comply with the pharmaceutical industry s voluntary compliance guidelines and the relevant compliance guidance promulgated by the federal government and may require drug manufacturers to report information related to payments and other transfers of value to physicians and other healthcare providers or marketing expenditures. State and foreign laws also govern the privacy and security of health information in some circumstances, many of which differ from each other in significant ways and often are not preempted by HIPAA, thus complicating compliance efforts.

Efforts to ensure that our business arrangements with third parties will comply with applicable healthcare laws and regulations will involve substantial costs. It is possible that governmental authorities will conclude that our business practices may not

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comply with current or future statutes, regulations or case law involving applicable fraud and abuse or other healthcare laws and regulations. If our operations are found to be in violation of any of these laws or any other governmental regulations that may apply to us, we may be subject to significant civil, criminal and administrative penalties, damages, fines, imprisonment, exclusion of products from government funded healthcare programs, such as Medicare and Medicaid, and the curtailment or restructuring of our operations. If any of the physicians or other healthcare providers or entities with whom we expect to do business is found to be not in compliance with applicable laws, they may be subject to criminal, civil or administrative sanctions, including exclusions from government funded healthcare programs.

Recently enacted and future legislation may increase the difficulty and cost for us to obtain marketing approval of and commercialize our product candidates and affect the prices we may obtain.

In the United States and some foreign jurisdictions, there have been a number of legislative and regulatory changes and proposed changes regarding the healthcare system that could prevent or delay marketing approval of our product candidates, restrict or regulate post-approval activities and affect our ability to profitably sell any product candidates for which we obtain marketing approval.

In the United States, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, or the MMA, changed the way Medicare covers and pays for pharmaceutical products. The legislation expanded Medicare coverage for drug purchases by the elderly and introduced a new reimbursement methodology based on average sales prices for physician-administered drugs. In addition, this legislation provided authority for limiting the number of drugs that will be covered in any therapeutic class. Cost reduction initiatives and other provisions of this legislation could decrease the coverage and price that we receive for any approved products. While the MMA applies only to drug benefits for Medicare beneficiaries, private payors often follow Medicare coverage policy and payment limitations in setting their own reimbursement rates. Therefore, any reduction in reimbursement that results from the MMA may result in a similar reduction in payments from private payors.

More recently, in March 2010, President Obama signed into law the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Affordability Reconciliation Act, or collectively, the PPACA, a sweeping law intended to broaden access to health insurance, reduce or constrain the growth of healthcare spending, enhance remedies against fraud and abuse, add new transparency requirements for the healthcare and health insurance industries, impose new taxes and fees on the health industry and impose additional health policy reforms.

Among the provisions of the PPACA of importance to our potential product candidates are the following:

- an annual, nondeductible fee on any entity that manufactures or imports specified branded prescription drugs and biologic agents;

- an increase in the statutory minimum rebates a manufacturer must pay under the Medicaid Drug Rebate Program;

- expansion of healthcare fraud and abuse laws, including the False Claims Act and the Anti-Kickback Statute, new government investigative powers, and enhanced penalties for noncompliance;

a new Medicare Part D coverage gap discount program, in which manufacturers must agree to offer 50% point-of-sale discounts off negotiated prices;

extension of manufacturers Medicaid rebate liability;

expansion of eligibility criteria for Medicaid programs;

expansion of the entities eligible for discounts under the Public Health Service pharmaceutical pricing program;

new requirements to report financial arrangements with physicians and teaching hospitals;

a new requirement to annually report drug samples that manufacturers and distributors provide to physicians; and

a new Patient-Centered Outcomes Research Institute to oversee, identify priorities in, and conduct comparative clinical effectiveness research, along with funding for such research.

In addition, other legislative changes have been proposed and adopted since the PPACA was enacted. These changes include aggregate reductions to Medicare payments to providers of up to 2% per fiscal year, starting in 2013. In January 2013, President Obama signed into law the American Taxpayer Relief Act of 2012, which, among other things, reduced Medicare

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payments to several providers, and increased the statute of limitations period for the government to recover overpayments to providers from three to five years. These new laws may result in additional reductions in Medicare and other healthcare funding.

We expect that the PPACA, as well as other healthcare reform measures that may be adopted in the future, may result in more rigorous coverage criteria and in additional downward pressure on the price that we receive for any approved product. Any reduction in reimbursement from Medicare or other government programs may result in a similar reduction in payments from private payors. The implementation of cost containment measures or other healthcare reforms may prevent us from being able to generate revenue, attain profitability, or commercialize our products.

Legislative and regulatory proposals have been made to expand post-approval requirements and restrict sales and promotional activities for pharmaceutical products. We cannot be sure whether additional legislative changes will be enacted, or whether the FDA regulations, guidance or interpretations will be changed, or what the impact of such changes on the marketing approvals of our product candidates, if any, may be. In addition, increased scrutiny by the U.S. Congress of the FDA s approval process may significantly delay or prevent marketing approval, as well as subject us to more stringent product labeling and post-marketing testing and other requirements.

Governments outside of the United States tend to impose strict price controls, which may adversely affect our revenues, if any.

In some countries, particularly the countries of the European Union, the pricing of prescription pharmaceuticals is subject to governmental control. In these countries, pricing negotiations with governmental authorities can take considerable time after the receipt of marketing approval for a product. To obtain reimbursement or pricing approval in some countries, we may be required to conduct a clinical trial that compares the cost-effectiveness of our product candidate to other available therapies. If reimbursement of our products is unavailable or limited in scope or amount, or if pricing is set at unsatisfactory levels, our business could be harmed, possibly materially.

If we fail to comply with environmental, health and safety laws and regulations, we could become subject to fines or penalties or incur costs that could harm our business.

We are subject to numerous environmental, health and safety laws and regulations, including those governing laboratory procedures and the handling, use, storage, treatment and disposal of hazardous materials and wastes. Our operations involve the use of hazardous and flammable materials, including chemicals and biological materials. Our operations also produce hazardous waste products. We generally contract with third parties for the disposal of these materials and wastes. We cannot eliminate the risk of contamination or injury from these materials. In the event of contamination or injury resulting from our use of hazardous materials, we could be held liable for any resulting damages, and any liability could exceed our resources. We also could incur significant costs associated with civil or criminal fines and penalties for failure to comply with such laws and regulations.

Although we maintain workers compensation insurance to cover us for costs and expenses we may incur due to injuries to our employees resulting from the use of hazardous materials, this insurance may not provide adequate coverage against potential liabilities. We do not maintain insurance for environmental liability or toxic tort claims that may be asserted against us in connection with our storage or disposal of biological, hazardous or radioactive materials.

In addition, we may incur substantial costs in order to comply with current or future environmental, health and safety laws and regulations. These current or future laws and regulations may impair our research, development or production efforts. Our failure to comply with these laws and regulations also may result in substantial fines, penalties or other sanctions.

Risks Related to Employee Matters and Managing Growth

Our future success depends on our ability to retain key executives and to attract, retain and motivate qualified personnel.

We are highly dependent on the research and development, clinical and business development expertise of Robert J. Gould, Ph.D., our Chief Executive Officer, Jason P. Rhodes, our President, Chief Financial Officer and Treasurer, Robert A. Copeland, Ph.D., our Executive Vice President and Chief Scientific Officer, and Eric E. Hedrick, M.D., our Chief Medical Officer, as well as the other principal members of our management, scientific and clinical team. Although we have entered into employment letter agreements with our executive officers, each of them may terminate their employment with us at any time. We do not maintain key person insurance for any of our executives or other employees.

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Recruiting and retaining qualified scientific, clinical, manufacturing and sales and marketing personnel will also be critical to our success. The loss of the services of our executive officers or other key employees could impede the achievement of our research, development and commercialization objectives and seriously harm our ability to successfully implement our business strategy. Furthermore, replacing executive officers and key employees may be difficult and may take an extended period of time because of the limited number of individuals in our industry with the breadth of skills and experience required to successfully develop, gain regulatory approval of and commercialize products. Competition to hire from this limited pool is intense, and we may be unable to hire, train, retain or motivate these key personnel on acceptable terms given the competition among numerous pharmaceutical and biotechnology companies, universities and research institutions for similar personnel. In addition, we rely on consultants and advisors, including scientific and clinical advisors, to assist us in formulating our research and development and commercialization strategy. Our consultants and advisors may be employed by employers other than us and may have commitments under consulting or advisory contracts with other entities that may limit their availability to us. If we are unable to continue to attract and retain high quality personnel, our ability to pursue our growth strategy will be limited.

We expect to expand our development and regulatory capabilities and potentially implement sales, marketing and distribution capabilities, and as a result, we may encounter difficulties in managing our growth, which could disrupt our operations.

We expect to experience significant growth in the number of our employees and the scope of our operations, particularly in the areas of drug development, regulatory affairs and, if any of our product candidates receives marketing approval, sales, marketing and distribution. To manage our anticipated future growth, we must continue to implement and improve our managerial, operational and financial systems, expand our facilities and continue to recruit and train additional qualified personnel. Due to our limited financial resources and the limited experience of our management team in managing a company with such anticipated growth, we may not be able to effectively manage the expansion of our operations or recruit and train additional qualified personnel. The expansion of our operations may lead to significant costs and may divert our management and business development resources. Any inability to manage growth could delay the execution of our business plans or disrupt our operations.

Risks Related to Our Common Stock

Our executive officers and directors and their affiliates, if they choose to act together, have the ability to significantly influence all matters submitted to stockholders for approval.

As of July 31, 2014, our executive officers and directors and their affiliates beneficially own, in the aggregate, shares representing approximately 44.1% of our common stock. As a result, if these stockholders were to choose to act together, they would be able to significantly influence all matters submitted to our stockholders for approval, as well as our management and affairs. For example, these persons, if they choose to act together, would significantly influence the election of directors and approval of any merger, consolidation or sale of all or substantially all of our assets.

This concentration of ownership control may:

- delay, defer or prevent a change in control;

entrench our management and board of directors; or

impede a merger, consolidation, takeover or other business combination involving us that other stockholders may desire.

Provisions in our corporate charter documents, under Delaware law and in our collaboration agreements could make an acquisition of our company, which may be beneficial to our stockholders, more difficult and may prevent attempts by our stockholders to replace or remove our current management.

Provisions in our certificate of incorporation and our bylaws may discourage, delay or prevent a merger, acquisition or other change in control of our company that stockholders may consider favorable, including transactions in which stockholders might otherwise receive a premium for their shares. These provisions could also limit the price that investors might be willing to pay in the future for shares of our common stock, thereby depressing the market price of our common stock. In addition,

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because our board of directors is responsible for appointing the members of our management team, these provisions may frustrate or prevent any attempts by our stockholders to replace or remove our current management by making it more difficult for stockholders to replace members of our board of directors. Among other things, these provisions:

- establish a classified board of directors such that only one of three classes of directors is elected each year;
- allow the authorized number of our directors to be changed only by resolution of our board of directors;
- limit the manner in which stockholders can remove directors from our board of directors;
- establish advance notice requirements for stockholder proposals that can be acted on at stockholder meetings and nominations to our board of directors;
- require that stockholder actions must be effected at a duly called stockholder meeting and prohibit actions by our stockholders by written consent;
- limit who may call stockholder meetings;
- authorize our board of directors to issue preferred stock without stockholder approval, which could be used to institute a poison pill that would work to dilute the stock ownership of a potential hostile acquirer, effectively preventing acquisitions that have not been approved by our board of directors; and
- require the approval of the holders of at least 75% of the votes that all our stockholders would be entitled to cast to amend or repeal specified provisions of our certificate of incorporation or bylaws.

Moreover, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, which prohibits a person who owns in excess of 15% of our outstanding voting stock from merging or combining with us for a period of three years after the date of the transaction in which the person acquired in excess of 15% of our outstanding voting stock, unless the merger or combination is approved in a prescribed manner.

Some provisions in our collaboration agreements with Celgene and Eisai could deter potential buyers of our company from proposing an acquisition and could make us a less attractive target for them. These provisions include the following:

- We granted Celgene an exclusive license, for all countries other than the United States, to HMT inhibitors directed to DOT1L and an option, on a target-by-target basis, to exclusively license, for all countries of the world other than the United States, rights to HMT inhibitors directed to any other HMT targets during the

option period, excluding targets covered by our two other existing therapeutic collaborations. During the option period specified in the agreement, which could extend until July 2016, Celgene has the right to exercise its option to license non-U.S. rights to additional targets other than DOT1L until the effectiveness of an IND for an HMT inhibitor directed to such additional target. This option effectively covers all HMT targets that are not currently subject to our Eisai and GSK collaborations. The decision to exercise the options for available targets is in Celgene s sole discretion.

Under our collaboration agreement with Celgene, we granted to Celgene a right of first negotiation with respect to business combination transactions that we may desire to pursue with third parties during the option period, including any extension of this period. During the option period, we are required to notify Celgene if we desire to pursue a specified business combination transaction with a third party prior to negotiating terms with the third party, and after so notifying Celgene, we have agreed not to, directly or indirectly, solicit, initiate or encourage proposals from, discuss or negotiate with, or provide any information to, any third party related to the proposed transaction for a specified period from the date we first notify Celgene of such proposed transaction, or the Celgene negotiation period. If Celgene notifies us that it is interested in entering into the proposed transaction, we have agreed to negotiate in good faith with Celgene during the Celgene negotiation period. Following the Celgene negotiation period, if we have not entered into the proposed transaction with Celgene, or if Celgene does not notify us that it is interested in entering into the proposed transaction, we are free to enter into the proposed transaction with a third party for a period of 225 days following the expiration of the Celgene negotiation period, but we are obligated to re-offer the proposed transaction to Celgene if, during the option term, we propose to enter into the proposed transaction with a third party on terms that, in specified respects, are less favorable to us than the terms last offered by Celgene.

Under our collaboration agreement with Eisai, if we undergo a specified change of control event in which we are acquired by or combine with an entity with a specified competing business, or if following a change of control event we materially breach the agreement, Eisai will have the right to terminate our co-development, co-commercialization and profit sharing option and, if we have previously exercised our option, our co-development, co-commercialization and profit sharing rights.

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An active trading market for our common stock may not be sustained.

Although our common stock is listed on The NASDAQ Global Market, an active trading market for our shares may not be sustained. If an active market for our common stock does not continue, it may be difficult for our stockholders to sell their shares without depressing the market price for the shares or sell their shares at all. Any inactive trading market for our common stock may also impair our ability to raise capital to continue to fund our operations by selling shares and may impair our ability to acquire other companies or technologies by using our shares as consideration.

The price of our common stock has been and may in the future be volatile and fluctuate substantially.

Our stock price has been and may in the future be volatile. From May 31, 2013 to July 31, 2014, the sale price of our common stock as reported on the NASDAQ Global Market ranged from a high of $45.72 per share to a low of $18.10 per share. The stock market in general and the market for smaller biopharmaceutical companies in particular have experienced extreme volatility that has often been unrelated to the operating performance of particular companies. The market price for our common stock may be influenced by many factors, including:

- the success of competitive products or technologies;
- results of clinical trials of our product candidates or those of our competitors;
- regulatory or legal developments in the United States and other countries;
- developments or disputes concerning patent applications, issued patents or other proprietary rights;
- the recruitment or departure of key personnel;
- the level of expenses related to any of our product candidates or clinical development programs;
- the results of our efforts to discover, develop, acquire or in-license additional product candidates or products;
- actual or anticipated changes in estimates as to financial results, development timelines or recommendations by securities analysts;
- variations in our financial results or the financial results of companies that are perceived to be similar to us;
- changes in the structure of healthcare payment systems;

market conditions in the pharmaceutical and biotechnology sectors;

general economic, industry and market conditions; and

the other factors described in this *Risk Factors* section.

We are an emerging growth company, and the reduced disclosure requirements applicable to emerging growth companies may make our common stock less attractive to investors.

We are an emerging growth company, as defined in the Jumpstart Our Business Startups Act of 2012, or the JOBS Act, and may remain an emerging growth company through 2018. For so long as we remain an emerging growth company, we are permitted and intend to rely on exemptions from certain disclosure requirements that are applicable to other public companies that are not emerging growth companies. These exemptions include:

not being required to comply with the auditor attestation requirements in the assessment of our internal control over financial reporting;

not being required to comply with any requirement that may be adopted by the Public Company Accounting Oversight Board regarding mandatory audit firm rotation or a supplement to the auditor s report providing additional information about the audit and the financial statements;

reduced disclosure obligations regarding executive compensation; and

exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and stockholder approval of any golden parachute payments not previously approved.

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We cannot predict whether investors will find our common stock less attractive if we rely on these exemptions. If some investors find our common stock less attractive, as a result, there may be a less active trading market for our common stock and our stock price may be more volatile. In addition, the JOBS Act provides that an emerging growth company can take advantage of an extended transition period for complying with new or revised accounting standards. This provision allows an emerging growth company to delay the adoption of these accounting standards until they would otherwise apply to private companies. We have irrevocably elected not to avail ourselves of this exemption and, therefore, we will be subject to the same new or revised accounting standards as other public companies that are not emerging growth companies.

We will continue to incur increased costs as a result of operating as a public company, and our management will be required to devote substantial time to compliance initiatives and corporate governance practices.

As a public company, and particularly after we are no longer an emerging growth company, we will continue to incur significant legal, accounting and other expenses. The Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act, the listing requirements of The NASDAQ Global Market and other applicable securities rules and regulations impose various requirements on public companies, including establishment and maintenance of effective disclosure and financial controls and corporate governance practices. Our management and other personnel will need to continue to devote a substantial amount of time to these compliance initiatives. Moreover, these rules and regulations will increase our legal and financial compliance costs and make some activities more time-consuming and costly.

We cannot predict or estimate the amount of additional costs we may incur to continue to operate as a public company, nor can we predict the timing of such costs. These rules and regulations are often subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies which could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, or Section 404, we are required to furnish a report by our management on our internal control over financial reporting. However, while we remain an emerging growth company, we are not required to include an attestation report on internal control over financial reporting issued by our independent registered public accounting firm. To achieve compliance with Section 404 within the prescribed period, we are engaged in a process to document and evaluate our internal control over financial reporting, which is both costly and challenging. In this regard, we will need to continue to dedicate internal resources, potentially engage outside consultants and adopt a detailed work plan to assess and document the adequacy of internal control over financial reporting, continue steps to improve control processes as appropriate, validate through testing that controls are functioning as documented and implement a continuous reporting and improvement process for internal control over financial reporting. If we identify one or more material weaknesses, it could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements.

Because we do not anticipate paying any cash dividends on our capital stock in the foreseeable future, capital appreciation, if any, will be the sole source of gain for our stockholders.

We have never declared or paid cash dividends on our capital stock. We currently intend to retain all of our future earnings, if any, to finance the growth and development of our business. In addition, the terms of any future debt agreements may preclude us from paying dividends. As a result, capital appreciation, if any, of our common stock will be the sole source of gain for our stockholders for the foreseeable future.

If securities or industry analysts do not continue to publish research or publish inaccurate or unfavorable research about our business, our share price and trading volume could decline.

The trading market for our common stock may be impacted, in part, by the research and reports that securities or industry analysts publish about us or our business. There can be no assurance that analysts will cover us, continue to cover us or provide favorable coverage. If one or more analysts downgrade our stock or change their opinion of our stock, our share price may decline. In addition, if one or more analysts cease coverage of our company or fail to regularly publish reports on us, we could lose visibility in the financial markets, which could cause our share price or trading volume to decline.

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Item 2. Use of Proceeds

Use of Proceeds from Initial Public Offering

In June 2013, we issued and sold 5,913,300 shares of our common stock, including 771,300 shares of common stock sold pursuant to the underwriters full exercise of their option to purchase additional shares, in our initial public offering (the IPO) at a public offering price of $15.00 per share, for aggregate gross proceeds of $88.7 million. All of the shares issued and sold in the IPO were registered under the Securities Act of 1933, as amended (the Securities Act) pursuant to a Registration Statement on Form S-1 (File No. 333-187982), which was declared effective by the SEC on May 30, 2013, and a Registration Statement on Form S-1 (File No. 333-188962) filed pursuant to Rule 462(b) of the Securities Act on May 31, 2013. Citigroup Global Markets Inc., Cowen and Company, LLC and Leerink Swann LLC acted as joint book-running manager of the offering and as representatives of the underwriters. JMP Securities LLC and Wedbush Securities Inc. acted as co-managers for the offering. The offering commenced on May 30, 2013 and did not terminate until the sale of all of the shares offered.

The net offering proceeds to us, after deducting underwriting discounts of $6.2 million and offering expenses totaling $2.8 million, were approximately $79.7 million. No offering expenses were paid directly or indirectly to any of our directors or officers (or their associates) or persons owning 10.0% or more of any class of our equity securities or to any other affiliates.

As of June 30, 2014, we have used all of the net offering proceeds to fund the clinical development of EPZ-5676 and EPZ-6438, to fund research and development to build our product platform and advance our pipeline of preclinical product candidates and for working capital and general corporate purposes.

Item 6. Exhibits

10.3	Amendment to Collaboration and License Agreement dated as of April 17, 2014 by and between the Registrant and Glaxo Group Limited (1)
31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2)
31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2)
32.1	Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002, by Robert J. Gould, Ph.D., Chief Executive Officer of the Company, and Jason P. Rhodes, President, Chief Financial Officer and Treasurer of the Company. (2)
101.INS	XBRL Instance Document. ¥
101.SCH	XBRL Schema Document. ¥
101.CAL	XBRL Calculation Linkbase Document. ¥
101.LAB	XBRL Labels Linkbase Document. ¥
101.PRE	XBRL Presentation Linkbase Document. ¥
101.DEF	XBRL Definition Linkbase Document. ¥

(1) Incorporated by reference to the Registrant s Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 14, 2014.

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(2) Filed with this Form 10-Q.

¥ Pursuant to Rule 406T of Regulation S-T, these interactive data files are furnished and not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act or Section 18 of the Exchange Act and otherwise are not subject to liability under these sections.

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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.

Dated: August 13, 2014

EPIZYME, INC.

By: /s/ Jason P. Rhodes
Jason P. Rhodes
President, Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

respectively. Our effective tax rate was lower than the statutory tax rate of 35.0% primarily due to the mix of pre-tax income earned in foreign jurisdictions and the partial release of our valuation allowance during 2010. Our effective tax rate was more beneficial than the statutory tax rate of 35.0% primarily due to the partial release of our valuation allowance and tax accrual adjustments during 2009. Excluding the release of our valuation allowance, our effective tax rates would have been 33.9% and (25.5)% for the years ended December 31, 2010 and 2009, respectively.

As of December 31, 2010 and 2009, a valuation allowance of $66.4 million and $86.4 million, respectively, had been provided for net operating loss carryforwards and other deferred tax assets in certain jurisdictions. We record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. For the year ended December 31, 2010, we recorded changes in the valuation allowance on deferred tax assets as a result of our assessed ability to realize the tax benefit of our net operating loss carryforwards in the United States and France. We reduced our valuation allowance by $20.0 million in 2010 of which $22.8 million represents the benefit of utilizing net operating losses in 2010, partially offset by a $2.8 million increase in our valuation allowance to account for changes in other comprehensive income. We consider the reversal of deferred tax liabilities within the net operating loss carryforward period, projected future taxable income and tax planning strategies in making this assessment.

Net Income (Loss)

Net income was $96.7 million or $3.07 per diluted share for the year ended December 31, 2010, an increase of $97.0 million compared to a net loss of $0.3 million or $(0.01) per diluted share in the same period in 2009. For the year ended December 31, 2009, we realized a gain on the extinguishment of debt that amounted to $1.20 per diluted share. The impact of the release of our valuation allowance increased our diluted earnings per share by $0.73 and $0.05 for the years ended December 31, 2010 and 2009, respectively.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make assumptions and estimates that directly affect the amounts reported in the consolidated financial statements. Certain critical accounting policies requiring significant judgments, estimates, and assumptions are detailed in this section. We consider an accounting estimate to be critical if (1) it requires assumptions to be made that are uncertain at the time the estimate is made, and (2) changes to the estimate or different estimates that could have reasonably been used would have materially changed our consolidated financial statements.

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We believe the current assumptions and other considerations used to estimate amounts reflected in our consolidated financial statements are appropriate. However, should our actual experience differ from these assumptions and other considerations used in estimating these amounts, the impact of these differences could have a material impact on our consolidated financial statements.

Allowance for Doubtful Accounts. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing receivables and is determined based on our assessment of the credit worthiness of individual customers, historical write-off experience and global economic data. We review the allowance for doubtful accounts quarterly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. We do not have any off-balance sheet credit exposure related to our customers.

Inventories. Our inventory is principally comprised of finished goods inventory. Inventories are stated at the lower of cost or market as determined on a first-in, first-out basis. We evaluate the carrying cost of our inventory on a quarterly basis for this purpose. If the cost of the inventories exceeds their market value, provisions are made for the difference between the cost and the market value.

Property, Plant and Equipment. Property, plant and equipment are recorded at cost. Major renewals and improvements that extend the useful lives of equipment are capitalized. Repair and maintenance costs are expensed as incurred. Disposals are removed at carrying cost less accumulated depreciation with any resulting gain or loss reflected in earnings. We capitalize interest costs which are incurred as part of the cost of constructing major facilities and equipment. Approximately $2.3 million, $0.5 million and $0.0 million of interest cost were capitalized in 2011, 2010 and 2009, respectively. Depreciation is recognized using the straight-line method over the following estimated useful lives:

Machinery and equipment	20 years
Building and land improvements	20 years
Manufacturing Control Equipment	10 years
Office equipment	5 years
Research equipment and facilities	5 years
Vehicles	5 years
Computer hardware/information systems	3 years

Long-Lived Assets. In accordance with Impairment or Disposal of Long-Lived Assets Subsections of FASB ASC Subtopic 360-10, *Property, Plant, and Equipment Overall*, (FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets)*, long-lived assets, such as property, plant, and equipment, and purchased intangible assets subject to amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If circumstances require a long-lived asset or asset group be tested for possible impairment, we first compare undiscounted cash flows expected to be generated by that asset or asset group to its carrying value. If the carrying value of the long-lived asset or asset group is not recoverable on an undiscounted cash flow basis, an impairment is recognized to the extent that the carrying value exceeds its fair value. Fair value is determined through various valuation techniques including discounted cash flow models, quoted market values and third-party independent appraisals, as considered necessary.

Asset Retirement Obligations (ARO). Our ARO consists of estimated costs of dismantlement, removal, site reclamation and similar activities associated with our facilities. We recognize the fair value of a liability for an ARO in the period in which we have an existing legal obligation associated with the retirement of our facilities and the obligation can reasonably be estimated. The associated asset retirement cost is capitalized as part of the carrying cost of the asset. The recognition of an ARO requires that management make numerous estimates, assumptions and judgments regarding such factors as the existence of a legal obligation for an ARO;

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estimated probabilities, amounts and timing of settlements; the credit-adjusted risk-free rate to be used; discount rate and inflation rates. In periods subsequent to initial measurement of the ARO, we recognize changes in the liability resulting from the accretion of the liability to its non-discounted amount and revisions to either the timing or the amount of the original estimate of undiscounted cash flows. Revisions also result in increases or decreases in the carrying cost of these assets. Increases in the ARO liability due to accretion is charged to depreciation and amortization expense. The related capitalized cost, including revisions thereto, is charged to depreciation and amortization expense. Our ARO totaled $9.0 million at December 31, 2011. See Note 11 *Commitments and Contingencies* (subsection (c)) to the consolidated financial statements.

Contingencies. We are routinely involved in other litigation, claims and disputes incidental to our business, which at times involve claims for significant monetary amounts, some of which would not be covered by insurance. In the opinion of management, none of these other existing litigation matters or claims or disputes will have a material adverse effect on our financial position, results of operations or cash flows. However, a substantial settlement payment or judgment in excess of our accruals could have a material adverse effect on our financial position, results of operations or cash flows.

Share-Based Compensation. Share-based compensation cost is measured at the grant date based on the fair value of the award. We recognize these costs using the straight-line method over the requisite service period. The Kraton Performance Polymers, Inc. Equity Incentive Plan (the Equity Plan) allows for the grant to key employees, independent contractors, and eligible non-employee directors of incentive stock options, non-qualified stock options (which together with the incentive stock options, are referred to herein as (Options)), stock appreciation rights, restricted stock awards and restricted stock unit awards, in addition to other equity or equity-based awards as our board determines from time to time. We estimate the fair value of stock options using the Black-Scholes valuation model. Since our equity interests were privately held prior to the initial public offering, the estimated volatility is based on the historical volatility of similar companies stock that is publicly traded. Until such time we have enough publicly traded stock history, we will continue to estimate volatility of options granted (including options granted in 2011) based on the historical volatility of similar companies stock that is publicly traded. The expected term of options represents the period of time that options granted are expected to be outstanding. For all periods presented, we used the simplified method to calculate the expected term of options. The risk free interest rate for the periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. For all periods presented, the dividend yield is assumed to be zero based on historical and expected dividend activity. Forfeitures are based substantially on the history of cancellations of similar awards granted in prior years. See Note 3 *Share-Based Compensation* to the consolidated financial statements.

Income Taxes. We conduct operations in separate legal entities in different jurisdictions. As a result, income tax amounts are reflected in our consolidated financial statements for each of those jurisdictions.

Net operating losses and credit carryforwards are recorded in the event such benefits are expected to be realized. Deferred taxes result from differences between the financial and tax bases of our assets and liabilities and are adjusted for changes in tax rates and tax laws when changes are enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized. In determining whether a valuation allowance is required, the company evaluates primarily (a) the impact of cumulative losses in past years, and (b) current and/or recent losses. A recent trend in earnings despite cumulative losses is a prerequisite to considering not recording a valuation allowance.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, we believe

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it is more likely than not that we will realize the benefits of these deductible differences, net of the existing valuation allowances.

Benefit Plan Valuations. We sponsor a noncontributory defined benefit pension plan (Pension Plan), a non-qualified defined benefit pension plan, and an additional post-retirement benefit plan (Retiree Medical Plan). Management annually evaluates significant assumptions related to the benefits and obligations of these plans. Management s estimation of the projected benefit obligations and related benefit expense requires that certain assumptions be made regarding such variables as expected return on plan assets, discount rates, rates of future compensation increases, estimated future employee turnover rates and retirement dates, distribution election rates, mortality rates, retiree utilization rates for health care services and health care cost trend rates. The determination of the appropriate assumptions requires considerable judgment concerning future events and has a significant impact on the amount of the obligations and expense recorded. Our management relies in part on actuarial studies when determining the appropriateness of certain of the assumptions used in determining the benefit obligations and the annual expenses for these plans.

The discount rates are determined annually and are based on rates of return of high-quality long-term fixed income securities currently available with maturities consistent with the projected benefit payout period. The expected long-term rate of return on assets is derived from a review of anticipated future long-term performance of individual asset classes and consideration of an appropriate asset allocation strategy, given the anticipated requirements of the Pension Plan, to determine the average rate of earnings expected on the funds invested to provide for the pension plan benefits. Management also considers recent fund performance and historical returns in establishing the expected rate of return.

Movements in the capital markets impact the market value of the investment assets used to fund our Pension Plan. Future changes in plan asset returns, assumed discount rates and various other factors related to our pension and post-retirement plans will impact future pension expenses and liabilities.

The estimated effect of alternate assumptions on the 2012 estimated annual expense for the Pension Plan and Retiree Medical Plan were performed at varying discount rates, expected return on assets, expected salary increase, and, in the case of our Retiree Medical Plan, health care cost increases.

The measurement date of the Pension Plan s assets and obligations was December 31, 2011. Management applied a 4.83% discount rate, assumed an 8.5% long term rate of return on plan assets and assumed an expected salary rate increase of 3.0%. The percentage of equity securities in our Pension Plan as of December 31, 2011 was approximately 44.6%, up from approximately 38.0% as of December 31, 2010, and the percentage of debt securities as of December 31, 2011 was approximately 44.9%, down from approximately 52.8% as of December 31, 2010. The plan s strategic target asset allocation as of December 31, 2011 was 50% equity, 30% debt and 20% other, with the other component consisting of real estate funds, hedge funds and commodity funds. We have assumed that the funds in the other category together would behave similarly to debt and therefore included the 20% other as bonds in our assessment. Our management estimated a range of returns on the plan assets using a historical stochastic simulation model that determines the compound average annual return (assuming these asset classes stocks, bonds and cash) over a 20-year historical period (the approximate duration of our liabilities under the Pension Plan). The distribution of results from these simulations provides the best estimate range, 25% of the simulations lie above and 25% of the simulations lie below this range. Based on the plan s current target asset allocation, the reasonably anticipated range for asset returns (before non-investment expenses) was 6.5% to 10.5%. The asset return assumption set for determining the 2012 FASB ASC 715 expense was 8.5%, after non-investment expenses paid by the Trust. This is equivalent to a gross assumption of an 8.8% rate of return, less 0.3% for non-investment expenses, resulting in a return of 8.5% net of expenses. This assumed 8.8% rate falls within the best-estimate range, between the 50th and 75th percentile. For the Pension Plan, a 100 basis point decrease in the assumed discount rate would result in a corresponding increase of $2.1 million in our estimated Pension Plan expense for 2012. A 100 basis point decrease from 8.5% in the rate of return on plan assets would result in a corresponding increase of $0.7 million, and a 100 basis point

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increase in the expected salary rate would result in a corresponding increase of $1.0 million in expenses for 2012, in each case holding all other assumptions and factors constant.

For the Retiree Medical Plan, a 100 basis point decrease in the assumed discount rate would result in a corresponding increase of $0.3 million in our estimated expense and a 100 basis point increase in the assumed health care trend rate would result in a corresponding increase of $0.1 million in our estimated expense for 2012, in each case holding all other assumptions and factors constant. For additional information about our benefit plans, See Note 12 *Employee Benefits* to the consolidated financial statements.

Revenue Recognition. Sales are recognized in accordance with the provisions of ASC 605, *Revenue Recognition Overall*, when the revenue is realized or realizable, and has been earned. Revenue for product sales is recognized when risk and title to the product transfer to the customer, which usually occurs at the time shipment is made. Our products are generally sold free on board shipping point or, with respect to countries other than the United States, an equivalent basis. As such, title to the product passes when the product is delivered to the freight carrier. Our standard terms of delivery are included in our contracts of sale, order confirmation documents and invoices. Shipping and other transportation costs charged to customers are recorded in both sales and cost of sales.

We have entered into agreements with some of our customers whereby they earn rebates from us when the volume of their purchases of our product reach certain agreed upon levels. We recognize the rebate obligation ratably, as a reduction of revenue.

LIQUIDITY AND CAPITAL RESOURCES

Known Trends and Uncertainties

Kraton Performance Polymers, Inc. is a holding company without any operations or assets other than the operations of its subsidiaries.

Based upon current and anticipated levels of operations, we believe that cash flows from operations of our subsidiaries, cash on hand, and borrowings available to us will be sufficient to fund our working capital requirements, scheduled debt payments, interest payments, capital expenditures, benefit plan contributions, and income tax obligations. However, these cash flows are subject to a number of factors, including, but not limited to, earnings, sensitivities to the cost of raw materials, seasonality and fluctuations in foreign currency exchange rates. Because feedstock costs generally represent approximately 50% of our cost of goods sold (58.8% in 2011), in periods of rising feedstock costs, we consume cash in operating activities due to increases in accounts receivable and inventory costs, partially offset by increased value of accounts payable. Conversely, during periods in which feedstock costs are declining, we generate cash flow from decreases in working capital.

Going forward there can be no assurance that our business will generate sufficient cash flow from operations or that future borrowings will be available under the senior secured credit facility to fund liquidity needs and enable us to service our indebtedness. At December 31, 2011, we had $88.6 million of cash and cash equivalents. Our available cash and cash equivalents are held in accounts managed by third-party financial institutions and consist of cash invested in interest bearing funds and operating accounts. To date, we have not experienced any losses or lack of access to our invested cash or cash equivalents; however, we cannot provide any assurances that adverse conditions in the financial markets will not impact access to our invested cash and cash equivalents.

We have in place a $350 million senior secured credit agreement that provides for financing consisting of a $200 million senior secured revolving credit facility, a $150 million senior secured term loan facility and an option to raise up to $125 million of incremental term loans or incremental revolving credit commitments. We have borrowed substantially all of the available commitments under the term loan portion of our credit facility.

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Under the terms of our senior secured credit facility, we are subject to certain financial covenants, including maintenance of a maximum consolidated net leverage ratio, a minimum consolidated net interest coverage ratio and maximum capital expenditures. Our failure to comply with any of these financial covenants would give rise to a default under the senior secured credit facility. The maintenance of these financial ratios is based on our level of profitability. If factors arise that negatively impact our profitability, we may not be able to satisfy our covenants. If we are unable to satisfy such covenants or other provisions at any future time we would need to seek an amendment or waiver of such financial covenants or other provisions. The respective lenders under our senior secured credit facility may not consent to any amendment or waiver requests that we may make in the future, and, if they do consent, they may not do so on terms that are favorable to us. In the event that we were unable to obtain any such waiver or amendment and we were not able to refinance or repay our senior secured credit facility, our inability to meet the financial covenants or other provisions of our senior secured credit facility would constitute an event of default under our senior secured credit facility, which would permit the bank lenders to accelerate the senior secured credit facility. Such acceleration may in turn constitute an event of default under our senior notes or other debt instruments.

As of the date of the filing of this report, we have no outstanding draws under the revolving portion of our senior secured credit facility and therefore have available to us, upon covenant compliance under the credit agreement, $200.0 million under such revolving portion. While we expect to meet the conditions required to provide us full access to the revolving portion of the senior secured credit facility, we cannot guarantee that all of the counterparties contractually committed to fund a revolving credit draw request will actually fund future requests, although we currently believe that each of the counterparties would meet their funding requirements. The term loan and revolving portions of the facility mature in February 2016. For additional information regarding our credit agreement, see Senior Secured Credit Agreement in Note 7 *Long-Term Debt* to the consolidated financial statements, which is incorporated herein by reference.

We currently expect 2012 capital expenditures will be approximately $70.0 million to $80.0 million. Included in this estimate is approximately $20.0 million related to the semi-works plant and health, safety and environmental infrastructure and maintenance projects which typically range from $16.0 million to $22.0 million. The remaining 2012 capital expenditures are primarily associated with projects to optimize the production capabilities of our manufacturing assets. In addition, we currently estimate our share of the funding for the joint venture with FPCC to be approximately $70.0 million in 2012. This estimate is dependent on a number of factors, including final project cost, timing, and the extent to which the project can be funded through third party debt financing, which will impact the equity contributions to be made by us and FPCC. We currently anticipate funding our 2012 contributions with available liquidity and/or through alternative incremental funding sources.

We made contributions of $7.4 million to our pension plan in fiscal year 2011 and expect total contributions to be $9.8 million in 2012. If the market value of these assets does not improve during 2012, higher levels of contributions could be required in 2013 and beyond.

As of December 31, 2011, we had $82.5 million of cash and short-term investments related to foreign operations that management asserts are permanently reinvested. As a result of certain net operating loss carryforwards, management estimates approximately $1.7 million of additional tax expense would be incurred if this cash were repatriated.

Turbulence in U.S. and international markets and economies may adversely affect our liquidity and financial condition, and the liquidity and financial condition of our customers, and our ability to timely replace maturing liabilities and access the capital markets to meet liquidity needs, resulting in adverse effects on our financial condition and results of operations. However, to date we have been able to access borrowings available to us in amounts sufficient to fund liquidity needs.

Our ability to pay principal and interest on our indebtedness, fund working capital, make anticipated capital expenditures and fund our investment in the joint venture with FPCC depends on our future performance, which is subject to general economic conditions and other factors, some of which are beyond our control. See *Part I, Item 1A. Risk Factors* for further discussion.

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Operating Cash Flows

Net cash provided by operating activities totaled $64.8 million and $55.4 million for the years ended December 31, 2011 and 2010, respectively. This represents a net increase of $9.4 million of which $8.1 million was driven by changes in working capital including:

- $23.5 million due to lower value added taxes receivable largely due to timing;
- $14.6 million due to improved collection of accounts receivables; and
- $7.3 million increase in trade accounts payable primarily due to increases in the cost of raw materials and the timing of payments; partially offset by
- $28.3 million higher inventories of products, materials and supplies, largely due to increases in the cost of raw materials; and
- $12.1 million due to the timing of payments associated with employee related costs, maintenance and payments to our joint venture in Japan.

Cash and cash equivalents decreased to $88.6 million at December 31, 2011 from $92.8 million at December 31, 2010. Amounts undrawn on the revolving portion of our credit facility amounted to $200.0 million and $80.0 million at December 31, 2011 and 2010, respectively. Therefore, liquidity amounted to $288.6 million and $172.8 million at December 31, 2011 and 2010, respectively.

Net cash provided by operating activities totaled $55.4 million for the year ended December 31, 2010 compared to $72.8 million for the year ended December 31, 2009. This represents a decline of $17.4 million or 24.0% largely due to higher levels of working capital, partially offset by higher net earnings. Net income for the year ended December 31, 2010 was $97.0 million higher than the year ended December 31, 2009. After adjusting net income for certain items, including, but not limited to, depreciation and amortization, the gain on extinguishment of debt and deferred taxes that are necessary to reconcile net income to cash provided by operating activities, we generated $113.6 million more cash in 2010 than in 2009. However, this increase was more than offset by higher levels of working capital which consumed $101.8 million of cash in the year ended December 31, 2010 compared to providing $29.2 million of cash in 2009. This $131.0 million decrease in cash flows period over period was primarily driven by:

- a $90.8 million increase in inventories of products, materials and supplies, largely due to increases in the cost of raw materials and inventory quantity;
- a $24.6 million increase in other assets; and
- a $14.4 million decrease in other payables and accruals.

Cash and cash equivalents increased to $92.8 million at December 31, 2010 from $69.3 million at December 31, 2009. Amounts undrawn on the revolving portion of our credit facility, amounted to $80.0 million at December 31, 2010 and 2009, respectively. Therefore, liquidity, amounted to $172.8 million and $149.3 million and at December 31, 2010 and 2009, respectively.

Investing Cash Flows

Net cash used in investing activities totaled $64.4 million and $55.7 million for the years ended December 31, 2011 and 2010, respectively. Capital projects in 2011 included the following:

$14.0 million to replace IR production from the closure of our Pernis facility;

$7.2 million related to the Asia HSBC facility;

$4.1 million for IRL expansion at our Paulinia facility; and

$3.2 million for the multi-year systems and control upgrades at our Belpre facility.

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The remaining 2011 capital expenditures were primarily associated with projects to optimize the production capabilities of our manufacturing assets and ongoing health, safety and environmental infrastructure and maintenance projects.

Net cash used in investing activities totaled $55.7 million in 2010 compared to net cash used in investing activities of $49.6 million during the same period in 2009. Capital projects in 2010 included the following:

- $13.9 million associated with transferring IR production from Pernis to our Belpre facility;
- $8.2 million for upgrades of certain systems and operating controls at our Belpre facility;
- $6.7 million for the IRL debottleneck and expansion project at our Paulinia facility.

The remaining 2010 capital expenditures were primarily associated with projects to optimize the production capabilities of our manufacturing assets and ongoing health, safety and environmental infrastructure and maintenance projects.

Financing Cash Flows and Liquidity

Our consolidated capital structure as of December 31, 2011 was approximately 56.9% equity and 43.1% debt compared to approximately 54.2% equity and 45.8% debt as of December 31, 2010.

Net cash used in financing activities totaled $0.1 million and cash provided by financing activities totaled $16.5 million for the years ended December 31, 2011 and 2010, respectively. The $16.6 million decrease was driven primarily by:

- $15.2 million paid for debt issuance costs related to the debt refinancing in February 2011; and
- $10.7 million in net proceeds from the exercise of the underwriters over-allotment option in January 2010 related to our initial public offering in December 2009; partially offset by
- $9.1 million increase in net proceeds from debt.

Net cash provided by financing activities totaled $16.5 million in 2010 compared to $40.6 million net cash used in financing activities during the same period in 2009. The $57.1 million increase was driven primarily by:

- $10.7 million in net proceeds from the exercise, in January 2010, of the underwriters over-allotment option related to our initial public offering;
- $8.0 million of proceeds received from employees exercising of stock options; and
- In 2009, $11.2 million of cash was used to purchase and extinguish $30.7 million face value of our senior subordinated notes; and cash repayments of $50.0 million and $100 million were made on the senior secured credit facility in June 2009 and December 2009, respectively; partially offset by

$126.7 million in proceeds from the issuance of common stock from our initial public offering in December 2009.

2011 Refinancing

On February 11, 2011, we refinanced our existing indebtedness by completing an offering of $250.0 million in aggregate principal amount of 6.75% Senior Notes due 2019 and entering into our $350.0 million senior secured credit agreement, which is described above. The notes are unsecured obligations of our subsidiaries Kraton Polymers LLC and Kraton Polymers Capital Corporation, guaranteed by us and all of our wholly owned domestic subsidiaries. Prior to March 1, 2015, we may redeem some or all of the notes for their principal amount plus a make-whole premium. After that date we can redeem some or all of the notes for 103.375% of their principal amount and decreasing premiums each year thereafter to par. Prior to March 1, 2014, we may redeem up to 35% of the notes with proceeds from certain equity offerings at 106.75% of their principal amount. The

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notes and our credit agreement contain restrictions on our and our subsidiaries ability to, among other things, place liens on our or our subsidiaries assets; make investments other than permitted investments; incur additional indebtedness; merge, consolidate or dissolve; sell assets; engage in transactions with affiliates; change the nature of our business; change our or our subsidiaries fiscal year or organizational documents; and make restricted payments (including certain equity issuances). See Note 7 *Long-Term Debt* to the consolidated financial statements accompanying this report for further discussion.

Other Contingencies

As a chemicals manufacturer, our operations in the United States and abroad are subject to a wide range of environmental laws and regulations at both the national and local levels. These laws and regulations govern, among other things, air emissions, wastewater discharges, solid and hazardous waste management, site remediation programs and chemical use and management.

Pursuant to these laws and regulations, our facilities are required to obtain and comply with a wide variety of environmental permits for different aspects of their operations. Generally, many of these environmental laws and regulations are becoming increasingly stringent, and the cost of compliance with these various requirements can be expected to increase over time.

In the context of the separation in February 2001, Shell Chemicals agreed to indemnify us for specific categories of environmental claims brought with respect to matters occurring before the separation. However, the indemnity from Shell Chemicals is subject to dollar and time limitations. Coverage under the indemnity also varies depending upon the nature of the environmental claim, the location giving rise to the claim and the manner in which the claim is triggered. Therefore, if claims arise in the future related to past operations, we cannot give assurances that those claims will be covered by the Shell Chemicals indemnity and also cannot be certain that any amounts recoverable will be sufficient to satisfy claims against us.

In addition, we may in the future be subject to claims that arise solely from events or circumstances occurring after February 2001, which would not, in any event, be covered by the Shell Chemicals indemnity. While we recognize that we may in the future be held liable with respect for remediation activities beyond those identified to date, at present we are not aware of any circumstances that are reasonably expected to give rise to remediation claims that would have a material adverse effect on our results of operations or cause us to exceed our projected level of anticipated capital expenditures.

The EPA issued new MACT standards for controlling hazardous air emissions from industrial boilers. The Boiler MACT standards are required under Sections 112 of the Clean Air Act. The Boiler MACT rule applies to the coal-burning boilers at our Belpre, Ohio, facility. The final rule was published in the Federal Register on March 21, 2011 and was to have become effective 60 days later on May 20, 2011, if it was not otherwise changed or delayed. On May 16, 2011, the EPA announced a stay and reconsideration of the Boiler MACT rule and established a new comment period, which was open until July 15, 2011, in order to allow the EPA to continue to seek additional public comment before proposing a revised Boiler MACT rule. In December 2011, the EPA proposed a reconsidered Boiler MACT rule in lieu of the March 2011 version that was subject to a 60-day comment period. Litigation against the EPA by environmental interest groups resulted in the EPA s delay notice being vacated by the Federal court in January 2012. The Boiler MACT rule will likely impact the operation of the Belpre coal-burning boilers after the compliance date. Capital expenditures necessary to comply with the Boiler MACT rule are estimated to be $40.0 million to $50.0 million, of which approximately $0.9 million was incurred in 2011, $2.2 million is expected to be incurred in 2012 and the balance is expected to be incurred between 2013 and 2015, if the above rule is finalized.

Except for the foregoing, we currently estimate that any expenses incurred in maintaining compliance with environmental laws and regulations will not materially affect our results of operations or cause us to exceed our

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level of anticipated capital expenditures. However, we cannot give assurances that regulatory requirements or permit conditions will not change, and we cannot predict the aggregate costs of additional measures that may be required to maintain compliance as a result of such changes or expenses.

We had no material operating expenditures for environmental fines, penalties, government imposed remedial or corrective actions during the years ended December 31, 2011, 2010, or 2009. Management believes that we are in material compliance with all current environmental laws and regulations.

Off-Balance Sheet Arrangements

We are not a party to any material off-balance sheet arrangements as of December 31, 2011.

Contractual Obligations

Our principal outstanding contractual obligations relate to the term loan under the senior secured credit facility and the senior notes, the operating leases of some of our facilities and the feedstock contracts with Shell Chemicals, or its affiliates, LyondellBasell and others to provide us with styrene, butadiene and isoprene. The following table summarizes our contractual cash obligations for the periods indicated. Contractual Obligations as of December 31, 2011 are as follows:

		Payments Due by Period					
Dollars in Millions	**Total**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017 and after**
Long-term debt obligations	$ 392.5	$ 7.5	$ 11.2	$ 15.0	$ 108.8	$ 0	$ 250.0
Estimated interest payments on debt	147.6	23.6	23.5	24.7	20.8	18.4	36.6
Operating lease obligations(2)	50.0	11.2	6.2	5.1	4.9	4.2	18.4
Purchase obligations(1)(2)	2,058.9	153.9	114.6	88.0	89.8	82.1	1,530.5
Estimated Pension obligations(3)	34.5	8.1	5.8	5.8	5.0	4.5	5.3
Total contractual cash obligations	$ 2,683.5	$ 204.3	$ 161.3	$ 138.6	$ 229.3	$ 109.2	$ 1,840.8

(1) Pursuant to the styrene and butadiene feedstock supply contracts with Shell Chemicals and its affiliates, we are obligated to purchase minimum quantities. The contracts do not contain a stated penalty for failure to purchase the minimum quantities. However, if we do not purchase the minimum requirements, it is required under the terms of the contracts that we meet with Shell Chemicals in an effort to determine a resolution equitable to both parties.

(2) Pursuant to production agreements with LyondellBasell, we are currently paying the costs incurred by them in connection with the operation and maintenance of, and other services related to, our European facilities. These obligations are not included in this table. The terms of these agreements range between 20 years and 40 years and each agreement includes bilateral renewal rights.

(3) This represents our future pension contributions utilizing the following assumptions:

The plan was frozen at December 31, 2011;
All assets at December 31, 2011 were moved into a portfolio of high quality bonds whose cash flow matches the expected cash flow of the frozen plan and assets were assumed to remain in such portfolio until all obligations of the plan were paid out;
An estimated Pension Protection Act of 2006 effective rate as of January 1, 2012 of 5.7%;
All contributions are made at the latest date allowable by law; and
All other assumptions as used in the 2011 funding actuarial valuation of the plan are met.

Impact of Inflation. Our results of operations and financial condition are presented based on historical cost. While it is difficult to accurately measure the impact of inflation due to the imprecise nature of the estimates required, we believe the effects of inflation, if any, on our results of operations and financial condition have been immaterial.

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Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

We are exposed to certain market risks, including risks from changes in interest rates, foreign currency exchange rates, and commodity prices, which could impact our financial condition, results of operations and cash flows. We manage our exposure to these and other market risks through regular operating and financing activities as well as through the use of market risk sensitive instruments. We use such financial instruments as risk management tools and not for speculative investment purposes. The market risk sensitive instruments that we have entered into as of December 31, 2011 consist of an interest rate swap to hedge our variable rate debt, foreign currency option contracts and forward contracts to purchase raw materials.

Interest Rate Risk. We are exposed to interest rate risk as a result of our outstanding variable rate debt under our senior secured credit agreement. Periodically, we enter into interest rate swap agreements to hedge or otherwise protect against interest rate fluctuations on a portion of our variable rate debt. These interest rate swap agreements are designated as cash flow hedges on the exposure of the variability of future cash flows. In June 2011, we entered into a $75.0 million notional amount interest rate swap agreement. This agreement was effective as of July 15, 2011 and matures on June 15, 2014. The interest rate swap agreement provides for a fixed rate of 1.0%; therefore, including the current 3.0% margin on our Term Loan, our current hedged fixed rate is 4.0%. We recorded an unrealized loss of $0.8 million in accumulated other comprehensive income (loss) related to the effective portion of this interest rate swap for the year ended December 31, 2011. This financial instrument is recorded at its fair value as of December 31, 2011, which is driven by the 30-day LIBOR forward curve. We performed a hypothetical analysis to determine the impact to our financial position if the LIBOR forward rates increased or decreased by 10 basis points, from the rates as of December 31, 2011 for the life of the interest rate swap agreement. This hypothetical scenario would result in a change of $0.2 million in accumulated other comprehensive income (loss) as of December 31, 2011.

Foreign Currency Risk. We conduct operations in many countries around the world. Our results of operations are subject to both currency transaction risk and currency translation risk. We incur currency transaction risk when we enter into either a purchase or sale transaction using a currency other than the local currency of the transacting entity. We are subject to currency translation risk because our financial condition and results of operations are measured and recorded in the relevant domestic currency and then translated into U.S. dollars for inclusion in our historical consolidated financial statements. As of December 31, 2011, we did not have any material foreign exchange financial instruments.

Commodity Price Risk. We are exposed to commodity price risk due to our forward contractual purchase commitments for raw materials. Styrene, butadiene and isoprene are primarily supplied by a portfolio of suppliers under long-term supply contracts and arrangements with various expiration dates. We are subject to future purchase commitments for commodities under minimum purchase contracts for raw materials. Based on pricing as of December 31, 2011, a hypothetical 10.0% change in the market price for these raw materials would change our 2012 cost of goods sold by $49.3 million.

Item 8. Financial Statements and Supplementary Data.

The financial statements are set forth herein commencing on page F-5 of this report.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

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Item 9A. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

An evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15 under the Securities Exchange Act of 1934) was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer. As of December 31, 2011, based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective.

Management s Annual Report on Internal Control Over Financial Reporting

See *Management s Annual Report on Internal Control Over Financial Reporting* under Item 8 of this Form 10-K.

Attestation Report of the Registered Public Accounting Firm

See *Report of Independent Registered Public Accounting Firm* under Item 8 of this Form 10-K.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting that occurred during the three months ended December 31, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information.

None.

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PART III

Item 10. Directors, Executive Officers and Corporate Governance.
Information in response to this item is incorporated by reference from our Proxy Statement relating to our 2012 annual meeting of shareholders. The Proxy Statement will be filed with the SEC within 120 days after the end of the fiscal year covered by this Form 10-K pursuant to Regulation 14A under the Exchange Act.

Item 11. Executive Compensation.
Information in response to this item is incorporated by reference from our Proxy Statement relating to our 2012 annual meeting of shareholders. The Proxy Statement will be filed with the SEC within 120 days after the end of the fiscal year covered by this Form 10-K pursuant to Regulation 14A under the Exchange Act.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.
Information in response to this item is incorporated by reference from our Proxy Statement relating to our 2012 annual meeting of shareholders.

Item 13. Certain Relationships and Related Transactions, and Director Independence.
Information in response to this item is incorporated by reference from our Proxy Statement relating to our 2012 annual meeting of shareholders.

Item 14. Principal Accountant Fees and Services.
Information in response to this item is incorporated by reference from our Proxy Statement relating to our 2012 annual meeting of shareholders.

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PART IV

Item 15. Exhibits and Financial Statement Schedules.

(a) 1. Financial Statements

The following financial statements are included in Item 8:

Kraton Performance Polymers, Inc.

(i) The reports of KPMG LLP, Independent Registered Public Accounting Firm

(ii) Consolidated Balance Sheets as of December 31, 2011 and 2010

(iii) Consolidated Statements of Operations years ended December 31, 2011, 2010, and 2009

(iv) Consolidated Statements of Changes in Stockholders and Member s Equity and Other Comprehensive Income years ended December 31, 2011, 2010, and 2009

(v) Consolidated Statements of Cash Flows years ended December 31, 2011, 2010, and 2009

(vi) Notes to consolidated financial statements

2. Exhibits

The exhibits listed on the accompanying Exhibit Index are filed as part of this report and are on file with us.

(b) Exhibits

See Item 15(a) 2 above.

(c) Financial Statement Schedule

See Schedule II.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: February 29, 2012

Kraton Performance Polymers, Inc.

/S/ KEVIN M. FOGARTY

Kevin M. Fogarty

President and Chief Executive Officer

This report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on February 29, 2012.

Signature	Title
/s/ KEVIN M. FOGARTY **Kevin M. Fogarty**	President, Chief Executive Officer and a Director (Principal Executive Officer)
/S/ STEPHEN E. TREMBLAY **Stephen E. Tremblay**	Vice President and Chief Financial Officer (Principal Financial Officer)
/S/ JASON P. CLARK **Jason P. Clark**	Chief Accounting Officer (Principal Accounting Officer)
/S/ RICHARD C. BROWN* **Richard C. Brown**	Director
/S/ ANNA C. CATALANO* **Anna C. Catalano**	Director
/S/ STEVEN J. DEMETRIOU* **Steven J. Demetriou**	Director
Dominique Fournier	Director
/S/ JOHN J. GALLAGHER, III*	Director

John J. Gallagher

/S/ BARRY J. GOLDSTEIN* Director

Barry J. Goldstein

/S/ FRANCIS S. KALMAN * Director

Francis S. Kalman

/S/ DAN F. SMITH* Director

Dan F. Smith

/S/ KAREN A. TWITCHELL* Director

Karen A. Twitchell

*By: /s/ STEPHEN E. TREMBLAY

Stephen E. Tremblay

As attorney-in-fact

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KRATON PERFORMANCE POLYMERS, INC.

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Management s Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934, as amended. Internal control over financial reporting, no matter how well designed, has inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation to assess the effectiveness of our internal control over financial reporting as of December 31, 2011 based upon criteria set forth in the *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment, we believe that, as of December 31, 2011, our internal control over financial reporting is effective.

The effectiveness of our internal control over financial reporting as of December 31, 2011 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report that is included herein.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Kraton Performance Polymers, Inc.:

We have audited Kraton Performance Polymers, Inc. s internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Kraton Performance Polymers, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Kraton Performance Polymers, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Kraton Performance Polymers, Inc. and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in stockholders and member s equity and other comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2011, and our report dated February 29, 2012 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Houston, Texas

February 29, 2012

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Kraton Performance Polymers, Inc.:

We have audited the accompanying consolidated balance sheets of Kraton Performance Polymers, Inc. and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in stockholders and member s equity and other comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2011. These consolidated financial statements are the responsibility of Kraton Performance Polymers, Inc. s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Kraton Performance Polymers, Inc. and subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Kraton Performance Polymers, Inc. s internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 29, 2012 expressed an unqualified opinion on the effectiveness of Kraton Performance Polymers, Inc. s internal control over financial reporting.

/s/ KPMG LLP

Houston, Texas

February 29, 2012

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

	December 31, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 88,579	$ 92,750
Receivables, net of allowances of $549 and $947	142,696	136,132
Inventories of products, net	394,796	325,120
Inventories of materials and supplies, net	9,996	9,631
Deferred income taxes	2,140	0
Other current assets	27,328	38,749
Total current assets	665,535	602,382
Property, plant and equipment, less accumulated depreciation of $281,442 and $252,387	372,973	365,366
Identifiable intangible assets, less accumulated amortization of $58,530 and $50,123	66,184	70,461
Investment in unconsolidated joint venture	13,350	13,589
Debt issuance costs	11,106	3,172
Other long-term assets	24,608	25,753
Total assets	$ 1,153,756	$ 1,080,723
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 7,500	$ 2,304
Accounts payable-trade	88,026	86,699
Other payables and accruals	51,253	60,782
Deferred income taxes	0	595
Due to related party	14,311	19,264
Total current liabilities	161,090	169,644
Long-term debt, net of current portion	385,000	380,371
Deferred income taxes	6,214	14,089
Other long-term liabilities	83,658	64,242
Total liabilities	635,962	628,346
Commitments and contingencies (note 11)		
Stockholders equity:		
Preferred stock, $0.01 par value; 100,000 shares authorized; none issued		
Common stock, $0.01 par value; 500,000 shares authorized; 32,092 shares issued and outstanding at December 31, 2011; 31,390 shares issued and outstanding at December 31, 2010	321	314
Additional paid in capital	347,455	334,457
Retained earnings	187,636	96,711
Accumulated other comprehensive income (loss)	(17,618)	20,895

Total stockholders equity	517,794	452,377
Total liabilities and stockholders equity	$ 1,153,756	$ 1,080,723

See Notes to Consolidated Financial Statements

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Years ended December 31,		
	2011	**2010**	**2009**
Operating revenues:			
Sales	$ 1,437,479	$ 1,228,425	$ 920,362
Other	0	0	47,642
Total operating revenues	1,437,479	1,228,425	968,004
Cost of goods sold	1,121,293	927,932	792,472
Gross profit	316,186	300,493	175,532
Operating expenses:			
Research and development	27,996	23,628	21,212
Selling, general and administrative	101,606	92,305	79,504
Depreciation and amortization	62,735	49,220	66,751
Total operating expenses	192,337	165,153	167,467
Gain (loss) on extinguishment of debt	(2,985)	0	23,831
Earnings of unconsolidated joint venture	529	487	403
Interest expense, net	29,884	23,969	33,956
Income (loss) before income taxes	91,509	111,858	(1,657)
Income tax expense (benefit)	584	15,133	(1,367)
Net income (loss)	$ 90,925	$ 96,725	$ (290)
Earnings (loss) per common share:			
Basic	$ 2.85	$ 3.13	$ (0.01)
Diluted	$ 2.81	$ 3.07	$ (0.01)
Weighted average common shares outstanding:			
Basic	31,786	30,825	19,808
Diluted	32,209	31,379	19,808

See Notes to Consolidated Financial Statements

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS AND MEMBER S EQUITY AND OTHER COMPREHENSIVE INCOME

(In thousands)

	Common Stock	Additional Paid in Capital	Retained Earnings (post 12/17/2009)	Common Equity (pre 12/17/2009)	Accumulated Other Comprehensive Income (loss)	Total
Balance at January 1, 2009	$ 0	$ 0	$ 0	$ 182,553	$ 5,823	$ 188,376
Net loss	0	0	(14)	(276)	0	(290)
Other comprehensive income:						
Foreign currency translation adjustments, net of tax	0	0	0	0	14,023	14,023
Decrease in unrealized loss of interest rate swaps	0	0	0	0	3,158	3,158
Reclassification of gain on interest rate swap into earnings	0	0	0	0	(2,827)	(2,827)
Decrease in pension liability, net of tax	0	0	0	0	16,659	16,659
Total comprehensive income						30,723
Non-cash compensation related to equity awards	0	0	0	2,160	0	2,160
Liquidation of Kraton Polymers Management LLC	0	0	0	(1,760)	0	(1,760)
Non-cash contribution from member	0	0	0	2,560	0	2,560
Equity conversion December 16, 2009	194	185,043	0	(185,237)	0	0
Public stock offering, December 17, 2009	103	126,622	0	0	0	126,725
Balance at December 31, 2009	$ 297	$ 311,665	$ (14)	$ 0	$ 36,836	$ 348,784
Net income	0	0	96,725	0	0	96,725
Other comprehensive income:						
Foreign currency translation adjustments, net of tax	0	0	0	0	(5,364)	(5,364)
Decrease in unrealized loss of interest rate swaps	0	0	0	0	1,157	1,157
Reclassification of gain on interest rate swap into earnings	0	0	0	0	(450)	(450)
Decrease in fair value of foreign currency net investment hedge	0	0	0	0	899	899
Increase in pension liability, net of tax	0	0	0	0	(12,183)	(12,183)
Total comprehensive income						80,784
Issuance of common stock	9	11,188	0	0	0	11,197
Costs associated with the issuance of common stock	0	(534)	0	0	0	(534)
Exercise of stock options	8	8,666	0	0	0	8,674
Non-cash compensation related to equity awards	0	3,472	0	0	0	3,472
Balance at December 31, 2010	$ 314	$ 334,457	$ 96,711	$ 0	$ 20,895	$ 452,377
Net income	0	0	90,925	0	0	90,925
Other comprehensive income:						
Foreign currency translation adjustments, net of tax	0	0	0	0	(20,851)	(20,851)
Decrease in unrealized loss of interest rate swaps	0	0	0	0	264	264
Increase in pension liability, net of tax	0	0	0	0	(17,926)	(17,926)
Total comprehensive income						52,412
Exercise of stock options	7	7,539	0	0	0	7,546
Non-cash compensation related to equity awards	0	5,459	0	0	0	5,459

Balance at December 31, 2011	$ 321	$ 347,455	$ 187,636	$ 0	$ (17,618)	$ 517,794

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Years ended December 31,		
	2011	**2010**	**2009**
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	$ 90,925	$ 96,725	$ (290)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	62,735	49,220	66,751
Amortization of debt issuance costs	6,722	2,071	4,090
Accretion of debt discount	0	0	5
Inventory impairment	0	0	1,769
(Gain) loss on disposal of fixed assets	90	(54)	348
(Gain) loss on extinguishment of debt	2,985	0	(23,831)
Gain on settlement of insurance note payable	0	(131)	0
Reclassification of gain on interest rate swap into earnings	0	(450)	(2,827)
Net distributed earnings from unconsolidated joint venture	(14)	(84)	30
Deferred income tax expense (benefit)	(10,461)	6,389	(4,623)
Share-based compensation	5,459	3,472	2,160
Decrease (increase) in:			
Accounts receivable	(7,704)	(22,315)	(16,680)
Inventories of products, materials and supplies	(74,965)	(46,711)	44,060
Other assets	7,841	(24,871)	(305)
Increase (decrease) in:			
Accounts payable-trade, other payables and accruals, and other long-term liabilities	(12,727)	(6,055)	8,328
Due to related party	(6,111)	(1,846)	(6,180)
Net cash provided by operating activities	64,775	55,360	72,805
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of property, plant and equipment	(60,311)	(53,435)	(38,101)
Purchase of software	(4,129)	(2,242)	(15,322)
Proceeds from sale of property, plant and equipment	0	30	3,870
Net cash used in investing activities	(64,440)	(55,647)	(49,553)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from debt	400,000	69,000	144,000
Repayments of debt	(393,160)	(71,304)	(308,131)
Proceeds from issuance of common stock	0	11,197	126,725
Costs associated with the issuance of common stock	0	(534)	0
Proceeds from the exercise of stock options	8,271	7,974	0
Proceeds from insurance note payable	4,734	3,518	3,706
Repayments of insurance note payable	(4,734)	(3,387)	(3,706)
Debt issuance costs	(15,231)	0	(3,216)
Net cash provided by (used in) financing activities	(120)	16,464	(40,622)
Effect of exchange rate differences on cash	(4,386)	7,282	(14,735)

Net increase (decrease) in cash and cash equivalents	(4,171)	23,459	(32,105)
Cash and cash equivalents, beginning of period	92,750	69,291	101,396
Cash and cash equivalents, end of period	$ 88,579	$ 92,750	$ 69,291
Supplemental disclosures			
Cash paid during the period for income taxes, net of refunds received	$ 6,817	$ 4,625	$ 9,164
Cash paid during the period for interest, net of capitalized interest	$ 22,829	$ 23,723	$ 34,707

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KRATON PERFORMANCE POLYMERS, INC.

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1. Description of Business, Basis of Presentation, and Significant Accounting Policies

Description of Business. We are a leading global producer of styrenic block copolymers (SBCs) and other engineered polymers. We market our products under the Kraton® brand. SBCs are highly-engineered synthetic elastomers, which we invented and commercialized almost 50 years ago, that enhance the performance of numerous end use products, by imparting greater flexibility, resilience, strength, durability and processability. Our polymers are typically formulated or compounded with other products to achieve improved, customer specific performance characteristics in a variety of applications. Our SBC products are found in many everyday applications, including disposable diapers, the rubberized grips of toothbrushes, razor blades, power tools and asphalt formulations used to pave roads. We also produce Cariflex™ isoprene rubber (IR) and isoprene rubber latex (IRL). Our Cariflex™ products are highly-engineered, non-SBC synthetic substitutes for natural rubber latex. Our IRL products, which have not been found to contain the proteins present in natural rubber latex and are, therefore, not known to cause allergies, are used in applications such as surgical gloves and condoms. We believe the versatility of IRL provides opportunities for new, high-margin applications. In addition to IRL, we have a portfolio of innovations at various stages of development and commercialization, including PVC alternatives for wire, cable and medical applications, and polymers used in slush molding for automotive applications, and our Nexar™ family of membrane polymers for water filtration and breathable fabrics. We manufacture our polymers at five manufacturing facilities globally, including our flagship facility in Belpre, Ohio, as well as facilities in Germany, France, Brazil, and Japan. The facility in Japan is operated by an unconsolidated manufacturing joint venture. The terms Kraton, our company, we, our, ours and us as used in this report re collectively to Kraton Performance Polymers, Inc. and its consolidated subsidiaries.

Basis of Presentation. The accompanying consolidated financial statements presented herein are for us and our consolidated subsidiaries, each of which is a wholly-owned subsidiary. Polymer Holdings LLC (Polymer Holdings,) and its consolidated subsidiaries are treated as our predecessor entity for financial statement reporting purposes. The consolidated financial statements present our historical financial statements and the historical financial statements of our predecessor. Accordingly the information for periods prior to December 22, 2009, is that of Polymer Holdings. The historical consolidated financial statements presented for the years ended December 31, 2011, 2010, and 2009 have been derived from our audited consolidated financial statements.

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KRATON PERFORMANCE POLYMERS, INC.

Notes to Consolidated Financial Statements (Continued)

Significant Accounting Policies. These financial statements reflect all normal recurring adjustments that are, in the opinion of management, necessary to fairly present our results of operations and financial position.

Use of Estimates. The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant items subject to such estimates and assumptions include the useful lives of fixed assets; allowances for doubtful accounts and sales returns; the valuation of derivatives, deferred tax assets, property, plant and equipment, inventory, investments and share-based compensation; and liabilities for employee benefit obligations, asset retirement obligations (ARO), income tax uncertainties and other contingencies.

Reclassifications. Certain amounts reported in the consolidated financial statements and notes to the consolidated financial statements for the prior periods have been reclassified to conform to the current reporting presentation.

Cash and Cash Equivalents. It is our policy to invest our excess cash in investment instruments whose value is not subject to market fluctuations, such as bank deposits or certificates of deposit. Other permitted investments include commercial paper of major U.S. corporations with ratings of A1 by Standard & Poor s Ratings Group or P1 by Moody s Investor Services, Inc., loan participations of major U.S. corporations with a short term credit rating of A1/P1 and direct obligations of the U.S. government or its agencies. We consider all investments having a remaining maturity of three months or less to be cash equivalents.

Receivables. Receivables are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing receivables and is determined based on our assessment of the credit worthiness of individual customers, historical write-off experience and global economic data. We review the allowance for doubtful accounts quarterly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. We do not have any off-balance sheet credit exposure related to our customers.

Inventories. Our inventory is principally comprised of finished goods inventory. Inventories are stated at the lower of cost or market as determined on a first-in, first-out basis. We evaluate the carrying cost of our inventory on a quarterly basis for this purpose. If the cost of the inventories exceeds their market value, provisions are made for the differences between the cost and the market value.

Derivative Instruments and Hedging Activities. We account for derivatives and hedging activities in accordance with ASC 815, *Derivatives and Hedging,* which requires entities to recognize all derivative instruments as either assets or liabilities in the balance sheet at their respective fair values. For derivatives designated in cash flow hedging relationships, changes in the fair value are either offset through earnings against the change in fair value of the hedged item attributable to the risk being hedged or recognized in accumulated other comprehensive income (loss), to the extent the derivative is effective at offsetting the changes in cash flows being hedged until the hedged item affects earnings.

For all hedging relationships, we formally document the hedging relationship and our risk-management objective and strategy for undertaking the hedge, the hedging instrument, the hedged transaction, the nature of the risk being hedged, how the hedging instrument s effectiveness in offsetting the hedged risk will be assessed prospectively and retrospectively, and a description of the method used to measure ineffectiveness. We also

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Notes to Consolidated Financial Statements (Continued)

formally assess both at the inception of the hedging relationship and on an ongoing basis, whether the derivatives that are used in hedging relationships are highly effective in offsetting changes in cash flows of hedged transactions. For derivative instruments that are designated and qualify as part of a cash flow hedging relationship, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

We discontinue hedge accounting prospectively when we determine that the derivative is no longer effective in offsetting cash flows attributable to the hedged risk, the derivative expires or is sold, terminated, or exercised, the cash flow hedge is de-designated because a forecasted transaction is not probable of occurring, or management removes the designation of the cash flow hedge.

In all situations in which hedge accounting is discontinued and the derivative remains outstanding, we continue to carry the derivative at its fair value on the balance sheet and recognize any subsequent changes in its fair value in earnings. When it is probable that a forecasted transaction will not occur, we discontinue hedge accounting and recognize immediately in earnings gains and losses that were accumulated in other comprehensive income related to the hedging relationship.

Property, Plant and Equipment. Property, plant and equipment are recorded at cost. Major renewals and improvements which extend the useful lives of equipment are capitalized. Repair and maintenance costs are expensed as incurred. Disposals are removed at carrying cost less accumulated depreciation with any resulting gain or loss reflected in earnings. We capitalize interest costs which are incurred as part of the cost of constructing major facilities and equipment. Approximately $2.3 million, $0.5 million and $0.0 million of interest cost were capitalized in 2011, 2010 and 2009, respectively. Depreciation is recognized using the straight-line method over the following estimated useful lives:

Machinery and equipment	20 years
Building and land improvements	20 years
Manufacturing control equipment	10 years
Office equipment	5 years
Research equipment and facilities	5 years
Vehicles	5 years
Computer hardware and information systems	3 years

Major Maintenance Activities. Major maintenance or turnaround costs are expensed as incurred.

Asset Retirement Obligations. We account for ARO s pursuant to the provisions of ASC 410-20, *Asset Retirement Obligations.* ASC 410-20 requires us to record the fair value of an ARO as a liability in the period in which we have a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The ARO is also capitalized as part of the carrying cost of the asset and is depreciated over the life of the asset. Subsequent to the initial measurement of the ARO, the obligation is to be adjusted at the end of each period to reflect accretion of the liability to its non-discounted amount and changes in either the timing or the amount of the original estimated future cash flows underlying the obligation.

We have no assets that are legally restricted for purposes of settling ARO s. We have determined that we have contractual or regulatory requirements to decommission and perform other remediation for many of our

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manufacturing facilities and other assets upon retirement. These manufacturing facilities have historically been profitable, and we plan to continue to upgrade these assets and expand the manufacturing capacity in conjunction with the growing market for our products. We plan to operate our manufacturing facilities for the foreseeable future and there are no current plans to close or convert these assets for use in the manufacture of fundamentally different products. Unlike our manufacturing assets in the United States and Brazil, our manufacturing assets in Europe are all located on leased land. For these assets, we used the lease termination dates as the estimate for when our ARO s related to those assets will be settled.

Long-Lived Assets. In accordance with the Impairment or Disposal of Long-Lived Assets Subsections of ASC 360-10, *Property, Plant, and Equipment Overall,* long-lived assets, such as property, plant, and equipment, and purchased intangible assets subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If circumstances require a long-lived asset or asset group be tested for possible impairment, we first compare undiscounted cash flows expected to be generated by that asset or asset group to its carrying value. If the carrying value of the long-lived asset or asset group is not recoverable on an undiscounted cash flow basis, an impairment is recognized to the extent that the carrying value exceeds its fair value. Fair value is determined through various valuation techniques including discounted cash flow models, quoted market values and third-party independent appraisals, as considered necessary.

Identifiable Intangible Assets. We have identifiable intangible assets related to technology, tradenames/trademarks, customer relationships and software as detailed in Note 5 *Detail of Certain Balance Sheet Accounts* to the consolidated financial statements. Identifiable intangible assets are amortized on the straight-line method over the estimated useful lives of the assets. The estimated useful life of technology, tradenames/trademarks and customer relationships is 15 years, while the estimated useful life of software is 10 years.

Pension and Other Postretirement Plans. We have a noncontributory defined benefit pension plan covering substantially all of our employees upon their retirement. The benefits are based on age, years of service and the level of compensation during the five years before retirement. We also sponsor a defined benefit health care plan for substantially all retirees and full-time employees.

We record annual amounts relating to our pension and postretirement plans based on calculations that incorporate various actuarial and other assumptions, including discount rates, mortality rates, assumed rates of return, compensation increases, turnover rates and healthcare cost trend rates. We review our assumptions on an annual basis and make modifications to the assumptions based on current rates and trends when it is appropriate to do so. The effect of modifications to the assumptions is recorded in accumulated other comprehensive income (loss) and amortized to net periodic pension cost over future periods using the corridor method. We believe that the assumptions utilized in recording our obligations under our plans are reasonable based on our experience and market conditions.

The net periodic pension costs are recognized as employees render the services necessary to earn the postretirement benefits.

Investment in Unconsolidated Joint Venture. Our 50% equity investment in a manufacturing joint venture at our Kashima site is accounted for under the equity method with our share of the operating results of the joint venture classified within earnings of unconsolidated joint venture.

We evaluate our equity method investment for impairment when events or changes in circumstances indicate, in management s judgment, that the carrying value of such investment may have experienced an other-

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than-temporary decline in value. When evidence of loss in value has occurred, management compares the estimated fair value of the investment to the carrying value of the investment to determine whether an impairment has occurred. Management assesses the fair value of its equity method investment using commonly accepted techniques, and may use more than one method, including, but not limited to, recent third party comparable sales, internally developed analysis and analysis from outside advisors. If the estimated fair value is less than the carrying value and management considers the decline in value to be other than temporary, the excess of the carrying value over the estimated fair value is recognized in the financial statements as an impairment.

Debt Issuance Costs. We capitalize financing fees and other costs related to issuing long-term debt. We amortize these costs using the effective interest method, except for costs related to revolving debt, which are amortized using the straight-line method and recorded in interest expense.

Contingencies. We are routinely involved in other litigation, claims and disputes incidental to our business, which at times involve claims for significant monetary amounts, some of which would not be covered by insurance. In the opinion of management, none of these other existing litigation matters or claims or disputes will have a material adverse effect on our financial position, results of operations or cash flows. However, a substantial settlement payment or judgment in excess of our accruals could have a material adverse effect on our financial position, results of operations or cash flows.

Environmental Costs. Environmental costs are expensed as incurred unless the expenditures extend the economic useful life of the relevant assets. Costs that extend the economic useful life of assets are capitalized and depreciated over the remaining life of those assets. Liabilities are recorded when environmental assessments, or remedial efforts are probable, and the cost can be reasonably estimated.

Disclosures about Fair Value of Financial Instruments. For cash and cash equivalents, receivables, accounts payable and certain accrued expenses the carrying amount approximates fair value due to the short maturities of these instruments. For long-term debt instruments and the interest rate swap agreements fair value is estimated based upon market values (if applicable) or on the current interest rates available to us for debt with similar terms and remaining maturities. Considerable judgment is required in developing these estimates.

Revenue Recognition. Operating revenues are recognized in accordance with the provisions of ASC 605, *Revenue Recognition Overall,* when the revenue is realized or realizable, and has been earned. Revenue for product sales is recognized when risk and title to the product transfer to the customer, which usually occurs at the time shipment is made. Our products are generally sold free on board shipping point or, with respect to countries other than the United States, an equivalent basis. As such, title to the product passes when the product is delivered to the freight carrier. Our standard terms of delivery are included in our contracts of sale, order confirmation documents and invoices. Shipping and other transportation costs charged to customers are recorded in both sales and cost of sales.

We have entered into agreements with some of our customers whereby they earn rebates from us when the volume of their purchases of our product reach certain agreed upon levels. We recognize the rebate obligation ratably, as a reduction of revenue.

Research and Development Expenses. Research and development expenses are expensed as incurred.

Share-Based Compensation. Share-based compensation cost is measured at the grant date based on the fair value of the award. We recognize these costs using the straight-line method over the requisite service period. The Kraton Performance Polymers, Inc. Equity Incentive Plan (the Equity Plan) allows for the grant to key

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employees, independent contractors, and eligible non-employee directors of incentive stock options, non-qualified stock options (which together with the incentive stock options, are referred to herein as (Options)), stock appreciation rights, restricted stock awards and restricted stock unit awards, in addition to other equity or equity-based awards as our board determines from time to time. We estimate the fair value of stock options using the Black-Scholes valuation model. Since our equity interests were privately held prior to the initial public offering, the estimated volatility is based on the historical volatility of similar companies stock that is publicly traded. Until such time we have enough publicly traded stock history, we will continue to estimate volatility of options granted (including options granted in 2011) based on the historical volatility of similar companies stock that is publicly traded. The expected term of options represents the period of time that options granted are expected to be outstanding. For all periods presented, we used the simplified method to calculate the expected term of options. The risk free interest rate for the periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. For all periods presented, the dividend yield is assumed to be zero based on historical and expected dividend activity. Forfeitures are based substantially on the history of cancellations of similar awards granted in prior years. See Note 3 *Share-Based Compensation* to the consolidated financial statements.

Leases. All leases entered into as of December 31, 2011 are classified as operating leases. For those leases which contain escalating rent payment clauses, we use the straight-line method to record lease expense.

Income Taxes. We conduct operations in separate legal entities; as a result, income tax amounts are reflected in these consolidated financial statements for each of those jurisdictions.

Net operating losses and credit carryforwards are recorded in the event such benefits are expected to be realized. Deferred taxes result from differences between the financial and tax bases of our assets and liabilities and are adjusted for changes in tax rates and tax laws when changes are enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, we believe it is more likely than not that we will realize the benefits of these deductible differences, net of the existing valuation allowances.

Foreign Currency Translation and Foreign Currency Exchange Rates. Financial statements of our operations outside the United States where the local currency is considered to be the functional currency are translated into U.S. dollars using the exchange rate at each balance sheet date for assets and liabilities and the average exchange rate for each period for revenues, expenses, gains, losses and cash flows. The effects of translating such operations into U.S. dollars are included as a component of accumulated other comprehensive income (loss).

2. New Accounting Pronouncements

Adoption of Accounting Standards. We have implemented all new accounting pronouncements that are in effect and that management believes would materially impact our financial statements and do not believe that there are any other new accounting pronouncements that have been issued that might have a material impact on our financial position or results of operations.

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Notes to Consolidated Financial Statements (Continued)

Future Adoption of Accounting Standards. The following new accounting pronouncements have been issued, but have not yet been adopted as of December 31, 2011:

In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities* (ASU 2011-11). This newly issued accounting standard requires an entity to disclose both gross and net information about instruments and transactions eligible for offset in the statement of financial position as well as instruments and transactions executed under a master netting or similar arrangement and was issued to enable users of financial statements to understand the effects or potential effects of those arrangements on its financial position. This ASU is required to be applied retrospectively and is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. As this accounting standard only requires enhanced disclosure, the adoption of this standard is not expected to have a material impact on our financial position or results of operations.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (ASU 2011-05). This newly issued accounting standard (1) eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders equity; (2) requires the presentation of each component of net income along with total net income and each component of other comprehensive income along with a total for other comprehensive income, either in a single continuous statement of comprehensive income or in two separate but consecutive statements; and (3) requires an entity to present reclassification adjustments on the face of the financial statements from other comprehensive income to net income. The amendments in this ASU 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 nor do the amendments affect how earnings per share is calculated or presented. In December 2011, the FASB issued ASU No. 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income* (ASU No. 2011-05), which defers the requirement within ASU 2011-05 to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. During the deferral, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to the issuance of ASU 2011-05. These ASUs are required to be applied retrospectively and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, which for us means January 1, 2012. As these accounting standards 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 adoption of these standards is not expected to have a material impact on our financial position or results of operations.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (ASU 2011-04). This newly issued accounting standard requires additional disclosures for the transfers between Level 1 and Level 2 of the fair value hierarchy and Level 3 fair value measurements. For Level 3 fair value measurements, these additional disclosures are required: (1) quantitative information about significant unobservable inputs used for all Level 3 measurements; (2) a qualitative discussion about the sensitivity of the fair value measurement to changes in the unobservable inputs and the interrelationship between inputs; and (3) a description of the entity s valuation process. This ASU is effective on a prospective basis for annual and interim reporting periods beginning on or after December 15, 2011, which for us means January 1, 2012. The adoption of this standard is not expected to have a material impact on our financial position or results of operations.

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3. Share-Based Compensation

We account for share-based awards under the provisions of ASC 718, *Share-Based Payment,* which established the accounting for share-based awards exchanged for employee services. Accordingly, share-based compensation cost is measured at the grant date based on the fair value of the award and we expense these costs using the straight-line method over the requisite service period. Share-based compensation expense was approximately $5.5 million, $3.4 million and $1.4 million, net of tax effects of $0.0 million, $0.1 million, and $0.8 million, for the years ended December 31, 2011, 2010 and 2009, respectively. We record these costs in selling, general and administrative expenses. At December 31, 2011, there was approximately $6.7 million of unrecognized compensation expense related to nonvested option awards to be recognized over a weighted-average period of 2.68 years, and $3.8 million of unrecognized compensation expense related to restricted stock awards and restricted stock units expected to be recognized over a weighted-average period of 2.18 years.

Kraton Performance Polymers, Inc. 2009 Equity Incentive Plan. On November 30, 2009, our board of directors and our stockholders approved the Kraton Performance Polymers, Inc. Equity Incentive Plan (the Equity Plan) and on May 25, 2011, our board of directors and stockholders approved the amendment and restatement of the Equity Plan. The Equity Plan allows for the grant to key employees, independent contractors, and eligible non-employee directors of incentive stock options, non-qualified stock options (which together with the incentive stock options, are referred to herein as (Options)), stock appreciation rights, restricted stock awards and restricted stock unit awards, in addition to other equity or equity-based awards as our board determines from time to time.

Under this plan, there were 3,158,536 and 3,599,484 shares of common stock available for issuance as of December 31, 2011 and 2010, respectively. There are a total of 4,350,000 shares of common stock reserved for issuance. We awarded 129,328 and 22,202 shares of restricted stock to our employees, which are subject to a three-year cliff vesting, during the years ended December 31, 2011 and 2010, respectively. We issued 19,731 and 32,517 shares of restricted stock to members of the board of directors during the years ended December 31, 2011 and 2010, respectively, which vested on the grant date. We granted 432,155, 641,789 and 0 options to our employees during the years ended December 31, 2011, 2010 and 2009, respectively. These options have a ten year term and vest in equal installments over three or five years. The weighted-average grant-date fair value of options granted during the years ended December 31, 2011 and 2010 were $17.15 and $7.98, respectively.

Stock Option Activity

Option activities for the year ended December 31, 2011 are as follows:

	Options (in thousands)	Weighted Average Exercise Price
Outstanding at December 31, 2010	1,559	$ 14.31
Granted	432	35.95
Exercised	556	13.57
Forfeited	142	16.85
Outstanding at December 31, 2011.	1,293	21.57
Exercisable at December 31, 2011	477	$ 13.94

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There were 555,619 and 644,185 options exercised during the years ended December 31, 2011 and 2010, respectively. The total intrinsic value of the options exercised was $11.3 million and $8.7 million for the years ended December 31, 2011 and 2010, respectively. No options were exercised in the year ended December 31, 2009.

The following table summarizes additional information regarding the outstanding and exercisable options at December 31, 2011.

	Options (in thousands)	Weighted Average Exercise Price	Aggregate Intrinsic Value(1) (in thousands)	Weighted Average Remaining Contractual Term (in years)
Outstanding options	1,293	$ 21.57	$ 4,891	7.62
Exercisable options	477	$ 13.94	$ 3,035	5.76

(1) The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option as of December 31, 2011.

Weighted-Average Assumptions for Option Pricing

	2011	2010	2009
Risk-free interest rate	2.46%	3.01%	n/a
Expected dividend yield	0%	0.00%	n/a
Expected volatility	0.47	0.50	n/a
Expected term	6.0 years	6.4 years	n/a

Since our equity interests were privately held prior to our initial public offering, the estimated volatility is based on the historical volatility of similar companies stock that is publicly traded. Until such time we have enough publicly traded stock history, we will continue to estimate volatility of options granted based on the historical volatility of similar companies stock that is publicly traded. The expected term of options represents the period of time that options granted are expected to be outstanding. For all periods presented, we used the simplified method to calculate the expected term of options. The risk free interest rate for the periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. For all periods presented, the dividend yield is assumed to be zero based on historical and expected dividend activity.

We may grant time-vested restricted stock awards and time-vested restricted stock units to certain employees. Holders of restricted stock units do not have any beneficial ownership in the underlying restricted stock units and the grant represents an unsecured promise to deliver restricted stock on a future date. Actual stock units underlying the restricted stock units will not be issued until the earlier of a change in control or the termination of the grantee s employment.

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The following table represents the nonvested restricted stock awards and restricted stock units granted, vested and forfeited during 2011.

	Shares (in thousands)	Weighted-average Grant-date Fair Value
Nonvested shares at December 31,2010	118	$ 13.51
Granted	149	35.51
Vested	35	23.66
Forfeited	33	16.12
Nonvested shares at December 31, 2011	199	$ 27.75

The total fair value of shares vested during the years ended December 31, 2011 and 2010 was $0.8 million and $0.4 million, respectively.

4. Restructuring and Restructuring-related Costs

As part of our ongoing efforts to improve efficiencies and increase productivity, we have implemented a number of restructuring initiatives in recent years.

European Office Consolidation. In the third quarter of 2010, we consolidated our transactional functions as well as much of our European management to a new European central office in Amsterdam, the Netherlands. We completed this consolidation during the first quarter of 2011 and our aggregate total cost was $1.1 million and $4.6 million for the years ended December 31, 2011 and 2010, respectively. These restructuring charges were primarily comprised of employee severance, consulting expenses and other charges, which are recorded in selling, general and administrative expenses. The following is a summary of the activity associated with our European office consolidation.

	Europe Restructuring (in thousands)
Accrued European office consolidation restructuring at December 31, 2009	$ 0
Restructuring costs	4,588
Payments	(3,199)
Accrued European office consolidation restructuring at December 31, 2010	$ 1,389
Restructuring costs	1,137
Payments	(2,157)
Accrued European office consolidation restructuring at December 31, 2011	$ 369

Pernis Restructuring. We ceased production at our Pernis, the Netherlands, facility on December 31, 2009, where, prior to the exit, we manufactured isoprene rubber. In connection with the exit, in 2009 we incurred $3.9 million in ARO, $6.0 million in restructuring costs and a $1.1 million non-cash charge to write-down our inventory of spare parts. We recorded the ARO in depreciation and amortization and the

restructuring costs and write-down of inventory in cost of goods sold.

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Notes to Consolidated Financial Statements (Continued)

5. Detail of Certain Balance Sheet Accounts

	December 31, 2011	2010
	(in thousands)	
Inventories of products, net:		
Finished products	$ 289,921	$ 252,056
Work in progress	5,048	4,319
Raw materials	99,827	68,745
	$ 394,796	$ 325,120
Property, plant and equipment:		
Land	$ 11,021	$ 11,176
Buildings	43,135	39,111
Plant and equipment	562,512	527,418
Construction in progress	37,747	40,048
	654,415	617,753
Less accumulated depreciation	281,442	252,387
	$ 372,973	$ 365,366
Identifiable intangible assets:		
Cost:		
Technology	$ 44,726	$ 44,726
Customer relationships	35,145	35,145
Tradenames/trademarks	23,149	23,149
Software	21,694	17,564
	124,714	120,584
Accumulated amortization:		
Technology	$ 23,924	$ 20,953
Customer relationships	18,798	16,463
Tradenames/trademarks	12,403	10,862
Software	3,405	1,845
	58,530	50,123
	$ 66,184	$ 70,461

Aggregate depreciation expense for property, plant and equipment was approximately $54.3 million, $41.8 million and $60.2 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Aggregate amortization expense for intangible assets was approximately $8.4 million, $7.4 million and $6.6 million for the years ended December 31, 2011, 2010 and 2009, respectively. Estimated amortization expense for each of the next five years is approximately $9.1 million.

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	December 31, 2011	2010
	(in thousands)	
Other payables and accruals:		
Employee related	$ 11,639	$ 17,807
Income taxes payable	12,254	7,258
Other	27,360	35,717
	$ 51,253	$ 60,782
Other long-term liabilities:		
Pension	$ 74,304	$ 59,479
Other	9,354	4,763
	$ 83,658	$ 64,242
Accumulated other comprehensive income (loss) consists of the following:		
Foreign currency adjustments	$ 29,550	$ 50,401
Net unrealized loss on interest rate swaps	(809)	(1,073)
Net unrealized gain on investment hedge	899	899
Pension liability	(47,258)	(29,332)
	$ (17,618)	$ 20,895

6. Earnings per Common Share

Basic earnings per share (EPS) is computed by dividing net income by the weighted-average number of common shares outstanding during the period.

Diluted EPS is computed by dividing net income by the diluted weighted-average number of common shares outstanding during the period and, accordingly, reflects the potential dilution that could occur if securities or other agreements to issue common stock, such as stock options, were exercised, settled or converted into common stock and were dilutive. The diluted weighted-average number of common shares used in our diluted EPS calculation is determined using the treasury stock method.

Unvested awards of share-based payments with rights to receive dividends or dividend equivalents, such as our restricted stock awards are considered to be participating securities and therefore the two-class method is used for purposes of calculating EPS. Under the two-class method, a portion of net income is allocated to these participating securities and therefore is excluded from the calculation of EPS allocated to common stock. Restricted stock awards outstanding totaled 199,615, 118,413 and 119,892 at December 31, 2011, 2010 and 2009, respectively. These shares are subject to forfeiture and restrictions on transfer until vested and have identical voting, income and distribution rights to the unrestricted common shares outstanding. Our weighted average restricted stock awards outstanding were 171,101, 127,237 and 35,758 for the years ended December 31, 2011, 2010 and 2009, respectively.

Restricted share units in the amount of 29,491, 35,098 and 137,229 and stock options in the amount of 1,292,751, 1,559,354 and 1,584,970 were outstanding at December 31, 2011, 2010 and 2009, respectively. For the years ended December 31, 2011 and 2010, our weighted average restricted share units outstanding were 31,089 and 35,098, respectively, and are included in the computation of our diluted EPS.

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The computation of diluted earnings per share excludes the effect of the potential exercise of stock options that are anti-dilutive. The number of stock options excluded from the computation was 418,662, 150,000 and 1,584,970 for the years ended December 31, 2011, 2010 and 2009, respectively. Our weighted average restricted share units for the year ended December 31, 2009 were 78,197, which were excluded from our computation of diluted earnings per share as a result of the losses incurred for the year ended December 31, 2009.

The effects of share-based compensation awards on the diluted weighted- average number of shares outstanding used in calculating diluted EPS are as follows:

	Year ended December 31, 2011		
	Net Income	Weighted Average Shares Outstanding	Earnings Per Share
	(in thousands, except per share data)		
Basic:			
As reported	$ 90,925	31,957	
Less: amounts allocated to unvested restricted shares	(487)	(171)	
Amounts available to common stockholders	$ 90,438	31,786	$ 2.85
Diluted:			
Add: amounts allocated to unvested restricted shares	487	171	
Restricted share units non participating		31	
Stock options added to the denominator under the treasury stock method		392	
Less: amounts reallocated to unvested restricted shares	(480)	(171)	
Amounts available to common stockholders and assumed conversions	$ 90,445	32,209	$ 2.81

	Year ended December 31, 2010		
	Net Income	Weighted Average Shares Outstanding	Earnings Per Share
	(in thousands, except per share data)		
Basic:			
As reported	$ 96,725	30,952	
Less: amounts allocated to unvested restricted shares	(396)	(127)	
Amounts available to common stockholders	$ 96,329	30,825	$ 3.13
Diluted:			
Add: amounts allocated to unvested restricted shares	396	127	
Restricted share units non participating		35	
Stock options added to the denominator under the treasury stock method		519	
Less: amounts reallocated to unvested restricted shares	(388)	(127)	

Amounts available to common stockholders and assumed conversions	$ 96,337	31,379	$ 3.07

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	Year ended December 31, 2009		
	Net Income	Weighted Average Shares Outstanding	Earnings Per Share
	(in thousands, except per share data)		
Basic:			
As reported	$ (290)	19,844	
Less: amounts allocated to unvested restricted shares	1	(36)	
Amounts available to common stockholders	$ (289)	19,808	$ (0.01)
Diluted:			
Add: amounts allocated to unvested restricted shares	(1)	36	
Restricted share units non participating		0	
Stock options added to the denominator under the treasury stock method		0	
Less: amounts reallocated to unvested restricted shares	1	(36)	
Amounts available to common stockholders and assumed conversions	$ (289)	19,808	$ (0.01)

7. Long-Term Debt

On February 11, 2011, we refinanced our existing indebtedness by completing an offering of $250.0 million in aggregate principal amount of 6.75% senior notes due 2019 through an institutional private placement and entering into a $350.0 million senior secured credit agreement with a maturity date of February 11, 2016. The credit agreement provides for senior secured financing consisting of:

a $200.0 million senior secured revolving credit facility;

a $150.0 million senior secured term loan facility; and

an option to raise up to $125.0 million of incremental term loans or incremental revolving credit commitments.

In connection with this refinancing we repaid in full all outstanding borrowings under our previously existing term and revolving loans. In addition, we purchased $151.0 million principal amount of our outstanding 8.125% senior notes through a tender offer and redeemed the remaining $12.0 million principal amount of these notes. We also redeemed the remaining $0.3 million outstanding principal amount of our 12% Discount Notes. In these notes to the consolidated financial statements, the loans made under the current or former revolving credit facility are referred to as the Revolving Loans, and the loans made under the current or former term loan facility are referred to as the Term Loans.

Long-term debt consists of the following:

	December 31,	
	2011	2010
	(in thousands)	
Term loans	$ 142,500	$ 219,425
6.75% unsecured notes	250,000	0
12.0% discount notes	0	250
8.125% notes	0	170,000
8.125% notes held in treasury	0	(7,000)
Total debt	392,500	382,675
Less current portion of long-term debt	7,500	2,304
Total long-term debt	$ 385,000	$ 380,371

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Senior Secured Credit Agreement. Kraton Polymers LLC is the borrower under our senior secured credit agreement effective as of February 11, 2011, which is unconditionally guaranteed by Kraton Performance Polymers, Inc. and the wholly-owned domestic subsidiaries of Kraton Polymers LLC, and is required to be guaranteed by all future direct and indirect material domestic subsidiaries. Borrowings under the Revolving Loans bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the federal funds rate plus 0.50% and (2) the prime rate of Bank of America, N.A., in each case plus a margin of 2.00% through December 31, 2011 and thereafter 1.75% to 2.25% depending on a consolidated net leverage ratio, or (b) a LIBOR rate determined by reference to the costs of funds for U.S. dollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs plus a margin of 3.00% through December 31, 2011 and thereafter 2.75% to 3.25% depending on a consolidated net leverage ratio.

Borrowings under the Term Loans bear interest at a rate per annum equal to, at our option, either (a) a base rate determined by reference to the higher of (1) the federal funds rate plus 0.50% and (2) the prime rate of Bank of America, N.A., in each case plus a margin of 2.00% per annum, or (b) a LIBOR rate determined by reference to the costs of funds for U.S. dollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs plus a margin of 3.00% per annum. The average effective interest rates, including debt issuance costs, on the Term Loans for the years ended December 31, 2011 and 2010 were 6.2% (4.0% excluding a $2.4 million write-off of debt issuance costs related to the term loan and a $1.0 million payment to exit an interest rate swap agreement related to the debt refinancing that occurred in the first quarter of 2011) and 3.8%, respectively.

In addition to paying interest on outstanding principal under the Revolving Loans and Term Loans, we are required to pay a commitment fee ranging from 0.50% to 0.75%, depending on our consolidated net leverage ratio, related to the unutilized commitments under the Revolving Loans, as well as pay customary letter of credit fees and agency fees.

6.75% Senior Notes due 2019. Kraton Polymers LLC and its wholly-owned financing subsidiary Kraton Polymers Capital Corporation issued $250.0 million aggregate principal amount of 6.75% senior notes that mature on March 1, 2019 pursuant to an indenture, dated as of February 11, 2011. The indenture provides that the notes are general unsecured, senior obligations and will be unconditionally guaranteed on a senior unsecured basis. We will pay interest on the notes at 6.75% per annum, semi-annually in arrears on March 1 and September 1. In June 2011, we completed a registered exchange offer for all of our outstanding 6.75% senior notes, which were not registered under the Securities Act of 1933, as amended, for an equal principal amount of our 6.75% senior notes, which have been registered under the Securities Act. The entire $250.0 million aggregate principal amount of the senior notes was tendered and exchanged in the exchange offer.

Debt Maturities. The principal payments on our outstanding total debt as of December 31, 2011, are as follows:

December 31:	Principal Payments (in thousands)
2012	$ 7,500
2013	$ 11,250
2014	$ 15,000
2015	$ 108,750
Thereafter	$ 250,000
Total debt	$ 392,500

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Notes to Consolidated Financial Statements (Continued)

As of December 31, 2011, we were in compliance with the applicable financial ratios and the other covenants for the senior secured credit facility and the indentures governing the 6.75% senior notes.

See Note 9 *Financial Instruments and Credit Risk* to the consolidated financial statements.

8. Debt Issuance Costs

We capitalize the debt issuance costs related to issuing long-term debt and amortize these costs using the effective interest method, except for costs related to revolving debt, which are amortized using the straight-line method. We had net debt issuance costs of $13.7 million and $5.2 million (of which $2.6 million and $2.1 million were included in other current assets) as of December 31, 2011 and 2010, respectively. In connection with the refinancing of our indebtedness in the first quarter of 2011, we charged to interest expense approximately $4.2 million of unamortized debt issuance costs related to extinguished indebtedness and we capitalized $15.2 million of debt issuance costs related to the new indebtedness. We amortized $2.5 million (which excludes the $4.2 million of accelerated amortization), $2.1 million, and $4.1 million of debt issuance costs in the years ended 2011, 2010, and 2009, respectively.

9. Financial Instruments and Credit Risk

Financial Instruments

Interest Rate Swap Agreements. Periodically, we enter into interest rate swap agreements to hedge or otherwise protect against interest rate fluctuations on a portion of our variable rate debt. These interest rate swap agreements are designated as cash flow hedges on the exposure of the variability of future cash flows.

In June 2011, we entered into a $75.0 million notional amount interest rate swap agreement with respect to a portion of our outstanding Term loans. This agreement was effective as of July 15, 2011 and matures on June 15, 2014. The interest rate swap agreement provides for a fixed rate of 1.0%; therefore, including the current 3.0% margin on our Term Loan, our current hedged fixed rate is 4.0%. We recorded an unrealized loss of $0.8 million in accumulated other comprehensive income (loss) related to the effective portion of this interest rate swap for the year ended December 31, 2011.

In June 2010, we entered into a $215.0 million notional amount interest rate swap agreement. This agreement was effective on January 3, 2011 and was set to expire on January 3, 2012. However, on February 10, 2011, in connection with the refinancing of our previously existing indebtedness, we terminated and settled the interest rate swap agreement, and as a result, recognized $1.0 million of interest expense.

In May 2009, we entered into a $310 million notional amount interest rate swap agreement. This agreement was effective on January 4, 2010 and expired on January 3, 2011 and had a fixed rate of 1.53%; therefore, including the margin of 2.00% on the previously existing term loan agreement, our hedged fixed rate was 3.53%. In December 2009, we made a $100.0 million payment of outstanding indebtedness under the Term Loans reducing the principal amount outstanding from approximately $323.0 million to $223.0 million. As a result, we were required to discontinue hedge accounting prospectively as the hedging relationship failed to meet all of the criteria set forth in ASC 815, *Derivatives and Hedging* specifically the notional amount of the swap and the principal amount of the debt were no longer equal and the forecasted transaction was no longer probable of occurring based on the original hedge documentation. During 2010, we elected to re-designate the cash flow hedge relationship for approximately $218.0 million notional amount out of the total $310.0 million notional amount interest rate swap agreement. Interest expense of $3.1 million and $0.8 million were recorded in the Consolidated Statements of Operations for the ineffective portion of the hedge for the years ended December 31, 2010 and 2009, respectively. Additionally, we recorded a gain of $2.1 million as a component of accumulated other comprehensive income (loss) for the effective portion of the hedge for the year ended December 31, 2010.

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Net Investment Hedges. In May 2010, we entered into multiple non-deliverable forward contracts to reduce our exposure to fluctuations in the Brazilian Real to the U.S. dollar associated with the funding of the debottleneck and expansion of our IRL capacity at our Paulina, Brazil, facility, for the notional amounts of R$2.7 million, R$7.1 million, and R$7.8 million with expiration dates of June 30, September 30, and December 31, 2010, respectively. The non-deliverable forward contracts qualified for hedge accounting and were designated as net investment hedges in accordance with ASC 815-35 *Net Investment Hedges.* We recorded a $0.9 million gain in accumulated other comprehensive income (loss) related to the effective portion of the hedge for the year ended December 31, 2010.

Foreign Currency Hedges. Periodically, we enter into foreign currency agreements to hedge or otherwise protect against fluctuation in foreign currency exchange rates. These typically do not qualify for hedge accounting and gains/losses resulting from both the up-front premiums and/or settlement of the hedges at expiration of the agreements are recognized in the period in which they are incurred. In the fourth quarter of 2011, we entered into four foreign currency option contracts to reduce our exposure to fluctuations in the Euro to U.S. dollar exchange rate. The option contracts were structured such that underlying foreign exchange gains/losses would be offset by the mark-to-market impact of the hedging instruments and reduce the impact of foreign exchange volatility. The option contracts did not qualify for hedge accounting. We settled these hedges and recorded an aggregate loss of $1.7 million, which offset underlying foreign exchange gains and were recorded in selling, general, and administrative expenses.

Fair Value of Financial Instruments. ASC 820, *Fair Value Measurements and Disclosures* defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. ASC 820 requires entities to, among other things, maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

ASC 820 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions. In accordance with ASC 820, these two types of inputs have created the following fair value hierarchy:

Level 1 Quoted unadjusted prices for identical instruments in active markets.

Level 2 Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.

Level 3 Model-derived valuations in which one or more significant inputs or significant value drivers are unobservable.

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Notes to Consolidated Financial Statements (Continued)

The following table presents the carrying values and approximate fair values of our long-term debt at December 31, 2011 and December 31, 2010:

	December 31, 2011		December 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	(in thousands)			
Term Loans	$ 142,500	$ 142,500	$ 219,425	$ 219,425
6.75% unsecured notes	$ 250,000	$ 234,063	$ 0	$ 0
12.00% discount notes	$ 0	$ 0	$ 250	$ 324
8.125% notes	$ 0	$ 0	$ 163,000	$ 164,630
8.125% notes held as treasury bonds	$ 0	$ 0	$ 7,000	$ 7,070

The Term Loans are variable interest rate instruments, and as such, the fair value approximates their carrying value.

The financial assets and liabilities measured at fair value on a recurring basis are included below:

			Fair Value Measurements at Reporting Date Using		
	Balance Sheet Location	December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
			(in thousands)		
Derivative liability 2011 interest rate swap	Other payables and accruals	$ 434	$ 0	$ 434	$ 0
Derivative liability 2011 interest rate swap	Other long-term liabilities	375	0	375	0
Total		$ 809	$ 0	$ 809	$ 0

			Fair Value Measurements at Reporting Date Using		
	Balance Sheet Location	December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

			(in thousands)			
Derivative liabilities	2009 interest rate swap	Other payables and accruals	$ 362	$ 0	$ 362	$ 0
Derivative liabilities	2010 interest rate swap	Other payables and accruals	1,073	0	1,073	0
Total			$ 1,435	$ 0	$ 1,435	$ 0

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties. In the event of a default by one of our counterparties, we may not receive payments provided for under the terms of our derivatives.

Credit Risk. Our customers are diversified by industry and geography with more than 800 customers in over 60 countries and as a result, we do not have material concentrations of credit risk. We analyze the counterparties financial condition prior to extending credit and we establish credit limits and monitor the appropriateness of those limits on an ongoing basis. We also obtain cash, letters of credit or other acceptable forms of security from customers to provide credit support, where appropriate, based on our financial analysis of the customer and the contractual terms and conditions applicable to each transaction.

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10. Income Taxes

Income taxes are recorded utilizing an asset and liability approach. This method gives consideration to the future tax consequences associated with the differences between the financial accounting and tax basis of the assets and liabilities as well as the ultimate realization of any deferred tax asset resulting from such differences.

Our income tax expense was $0.6 million and $15.1 million for the years ended December 31, 2011 and 2010, respectively. Our effective tax rates for the years ended December 31, 2011 and 2010 were 0.6% and 13.5%, respectively. Our effective tax rates were lower than the U.S. statutory tax rate of 35.0% primarily due to the mix of pre-tax income earned in foreign jurisdictions and the partial release of our valuation allowance during these periods. Excluding the release of our valuation allowance, our effective tax rates would have been 19.5% and 33.9% for the years ended December 31, 2011 and 2010, respectively.

The expense (benefit) for income taxes is comprised of the following:

	Years ended December 31,		
	2011	2010	2009
		(in thousands)	
Current tax provision:			
U.S.	$ 228	$ 690	$ 422
Foreign	10,817	8,054	8,239
Total current tax provision	11,045	8,744	8,661
Deferred tax provision:			
U.S.	(9,211)	0	(285)
Foreign	(1,250)	6,389	(9,743)
Total deferred tax provision	(10,461)	6,389	(10,028)
Total income tax expense (benefit)	$ 584	$ 15,133	$ (1,367)

Income (loss) before income taxes is comprised of the following:

	Years ended December 31,		
	2011	2010	2009
		(in thousands)	
Income (loss) before income taxes:			
U.S.	$ 5,860	$ 55,350	$ 9,656
Foreign	85,649	56,508	(11,313)
Total income (loss) before income taxes	$ 91,509	$ 111,858	$ (1,657)

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The income tax expense (benefit) differs from the amount computed by applying the U.S. statutory income tax rate to income (loss) before income taxes for the reasons set forth below:

	Years ended December 31,		
	2011	2010	2009
		(in thousands)	
Income taxes at the statutory rate	$ 32,028	$ 39,153	$ (580)
Foreign tax rate differential	(13,683)	(4,261)	(97)
State taxes, net of federal benefit	84	52	(225)
Permanent differences	(1,552)	648	(832)
Differences in foreign earnings remitted	0	0	4,165
Tax benefit related to foreign losses	0	0	(2,597)
Tax credits	(140)	(610)	(122)
Uncertain tax positions	(1,083)	2,413	55
Valuation allowance	(17,303)	(22,834)	(945)
Other	2,233	572	(189)
Income tax expense (benefit)	$ 584	$ 15,133	$ (1,367)

	Years ended December 31,		
	2011	2010	2009
Income taxes at the statutory rate	35.0%	35.0%	35.0%
Foreign tax rate differential	(15.0)	(3.8)	5.9
State taxes, net of federal benefit	0.1	0.0	13.6
Permanent differences	(1.7)	0.6	50.2
Differences in foreign earnings remitted	0.0	0.0	(251.4)
Tax benefit related to foreign losses	0.0	0.0	156.7
Tax credits	(0.2)	(0.6)	7.4
Uncertain tax positions	(1.2)	2.2	(3.3)
Valuation allowance	(18.9)	(20.4)	57.0
Other	2.5	0.5	11.4
Effective tax rate	0.6%	13.5%	82.5%

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Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes, as well as net operating loss and tax credit carryforwards. The tax effects of temporary differences that gave rise to significant components of deferred tax assets and liabilities are as follows:

	December 31,	
	2011	2010
	(in thousands)	
Deferred tax assets:		
Net operating loss carryforwards	$ 93,254	$ 104,254
Inventory	12,477	11,208
Pension accrual	20,969	17,659
Other accruals and reserves	8,202	6,130
	134,902	139,251
Valuation allowance for deferred tax assets	(54,227)	(66,444)
Total deferred tax assets	$ 80,675	$ 72,807
Deferred tax liabilities:		
Property, plant and equipment	$ (79,968)	$ (81,756)
Identifiable intangibles	(4,781)	(3,502)
Exchange rate differences	0	(2,233)
Total deferred tax liabilities	(84,749)	(87,491)
Net deferred tax liabilities	$ (4,074)	$ (14,684)

	December 31	
	2011	2010
	(in thousands)	
Net deferred tax liabilities consist of:		
Current deferred tax assets	$ 34,624	$ 20,354
Non-current deferred tax assets	115,611	122,910
Current deferred tax liabilities	(32,484)	(20,949)
Non-current deferred tax liabilities	(121,825)	(136,999)
Net deferred tax liabilities	$ (4,074)	$ (14,684)

As of December 31, 2011, we had $254.3 million of net operating loss carryforwards, of which $65.7 million relates to foreign jurisdictions and $188.6 million relates to the United States, which will expire in 2024, 2025, 2026 and 2027, if not utilized. We expect to generate sufficient taxable income in future years that will allow utilization of the portion of the net operating loss carryforwards for which no valuation allowance has been provided.

As of December 31, 2011 and 2010, a valuation allowance of $54.2 million and $66.4 million, respectively, has been provided for net operating loss carryforwards and other deferred tax assets in certain jurisdictions. We record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. For the year ended December 31, 2011, we have recorded changes in the valuation allowance for deferred tax assets as a result of our assessed ability to realize the tax benefit of our net operating loss carryforwards in the United States and France. We reduced our valuation allowance by $12.2 million in 2011 of which $17.3 million represents the benefit of utilizing net operating losses in 2011 and the assessment of the

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Notes to Consolidated Financial Statements (Continued)

ability to utilize net operating losses in future periods partially offset by a $5.1 million increase in our valuation allowance to account for changes in other comprehensive income. We consider the reversal of deferred tax liabilities within the net operating loss carryforward period, projected future taxable income and tax planning strategies in making this assessment.

For the period ending December 31, 2011, the unremitted earnings of our foreign subsidiaries are permanently reinvested in the corresponding country of origin. Accordingly, we have not provided deferred taxes for the differences between the book basis and underlying tax basis in those subsidiaries or on the foreign currency translation adjustment amounts related to such operations.

We file income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. For our U.S. federal income tax returns, the statute of limitations has expired through the tax year ended December 31, 2003. As a result of net operating loss carryforwards from 2004, the statute remains open for all years subsequent to 2003. In addition, open tax years for state and foreign jurisdictions remain subject to examination.

We are currently under review by the Internal Revenue Service for our 2009 U.S. federal income tax return. The outcome of this review cannot be predicted with accuracy at this time. However, we do not expect the final resolution of this matter to have a material impact on our financial position or results of operations.

We recognize the tax impact of certain tax positions only when it is more likely than not that such positions are sustainable. The taxes are recorded in accordance with ASC 740-10, *Accounting for Uncertainty in Income Taxes*, which prescribes the minimum recognition threshold.

As of January 1, 2011, we had total unrecognized tax benefits of approximately $3.7 million. During the year ended December 31, 2011, we had a decrease in uncertain tax positions of $3.0 million due to the settlement of our Netherlands tax audit and an increase of $2.1 million primarily related to uncertain tax positions in Europe. We recorded interest and penalties related to unrecognized tax benefits within the provision for income taxes. As of December 31, 2011, we had $2.8 million of unrecognized tax benefits related to uncertain foreign tax positions, all of which, if recognized, would impact the effective tax rate. We believe that no current tax positions that have resulted in unrecognized tax benefits will significantly increase or decrease within one year.

The following presents a rollforward of our unrecognized tax benefits and associated interest and penalties.

	Unrecognized Tax Benefits	Interest and Penalties	Total
		(in thousands)	
Balance at December 31, 2009	$ 1,155	$ 121	$ 1,276
Decrease in prior year tax positions	(1,155)	(121)	(1,276)
Increase in prior year tax positions	3,689	0	3,689
Balance at December 31, 2010	$ 3,689	$ 0	$ 3,689
Decrease in prior year tax positions	(3,040)	0	(3,040)
Increase in prior year tax positions	370	18	388
Increase in current year tax positions	1,773	0	1,773
Balance at December 31, 2011	$ 2,792	$ 18	$ 2,810

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11. Commitments and Contingencies

(a) Lease Commitments

We have entered into various long-term non-cancelable operating leases. Future minimum lease commitments at December 31, 2011, are as follows: 2012 $11.2 million; 2013 $6.2 million; 2014 $5.1 million, 2015 $4.9 million, 2016 $4.2 million and 2017 and thereafter $18.4 million. For the years ended December 31, 2011, 2010, and 2009, we recorded $9.7 million, $6.6 million, and $4.1 million in rent expense, respectively.

(b) Environmental and Safety Matters

Our finished products are not generally classified as hazardous under U.S. environmental laws. However, our operations involve the handling, transportation, treatment, and disposal of potentially hazardous materials that are extensively regulated by environmental, health and safety laws, regulations and permit requirements. Environmental permits required for our operations are subject to periodic renewal and can be revoked or modified for cause or when new or revised environmental requirements are implemented. Changing and increasingly strict environmental requirements can affect the manufacturing, handling, processing, distribution and use of our chemical products and the raw materials used to produce such products and, if so affected, our business and operations may be materially and adversely affected. In addition, changes in environmental requirements can cause us to incur substantial costs in upgrading or redesigning our facilities and processes, including waste treatment, disposal, and other waste handling practices and equipment.

We conduct environmental management programs designed to maintain compliance with applicable environmental requirements at all of our facilities. We routinely conduct inspection and surveillance programs designed to detect and respond to leaks or spills of regulated hazardous substances and to correct identified regulatory deficiencies. However, a business risk inherent with chemical operations is the potential for personal injury and property damage claims from employees, contractors and their employees, and nearby landowners and occupants. While we believe our business operations and facilities generally are operated in compliance, in all material respects, with all applicable environmental and health and safety requirements, we cannot be sure that past practices or future operations will not result in material claims or regulatory action, require material environmental expenditures, or result in exposure or injury claims by employees, contractors and their employees, and the public. Some risk of environmental costs and liabilities are inherent in our operations and products, as it is with other companies engaged in similar businesses.

Our Paulinia, Brazil and Belpre, Ohio facilities are subject to a number of actual and/or potential environmental liabilities primarily relating to contamination caused by former operations at those facilities. Some environmental laws could impose on us the entire costs of cleanup regardless of fault, legality of the original disposal, or ownership of the disposal site. In some cases, the governmental entity with jurisdiction could seek an assessment for damage to the natural resources caused by contamination from those sites. Shell Chemicals has agreed, subject to certain limitations, in time and amounts, to indemnify us against most environmental liabilities related to the acquired facilities that arise from conditions existing prior to the closing.

We had no material operating expenditures for environmental fines, penalties, government imposed remedial or corrective actions in each of the years ended December 31, 2011, 2010, and 2009.

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(c) Asset Retirement Obligations

In 2011, the U.S. Environmental Protection Agency (EPA) issued new maximum achievable control technology (MACT) standards for controlling hazardous air emissions from industrial boilers. The Boiler MACT standards are required under Sections 112 of the Clean Air Act. The Boiler MACT rule applies to the coal-burning boilers at our Belpre, Ohio, facility. The final rule was published in the Federal Register on March 21, 2011 and was to have become effective 60 days later on May 20, 2011, if it was not otherwise changed or delayed. On May 16, 2011, the EPA announced a stay and reconsideration of the Boiler MACT rule and established a new comment period, which was open until July 15, 2011, in order to allow the EPA to continue to seek additional public comment before proposing a revised Boiler MACT rule. In December 2011, the EPA proposed a reconsidered Boiler MACT rule in lieu of the March 2011 version that was subject to a 60-day comment period. Litigation against the EPA by environmental interest groups resulted in the EPA s delay notice being vacated by the Federal court in January 2012.

For the year ended December 31, 2011, we incurred approximately $0.9 million for capital expenditures necessary to comply with the Boiler MACT rule. We also accelerated the depreciation of the coal-burning boilers (net book value of $12.8 million as of January 31, 2011) by changing the remaining useful lives from 128 months to 36 months such that these assets will be fully depreciated by January 2014. For the year ended December 31, 2011, we recorded depreciation expense associated with our existing coal-burning boilers of $4.0 million, of which $2.8 million related to accelerated depreciation. In addition, we also recorded $1.5 million of depreciation expense associated with the ARO. We recorded an ARO of $5.0 million in the year ended December 31, 2011 related to replacing the existing coal-burning boilers at Belpre with new boilers fired primarily with natural gas and distillate fuel oil.

Our ARO as of December 31, 2011 includes ARO s for our Berre, France, Wesseling, Germany, and Houston, Texas (Shell Westhollow Technology Center) facilities. Approximately $5.2 million is related to Belpre, $1.9 million to Wesseling, $1.3 million to Berre and $0.6 million to Westhollow.

The changes in the aggregate carrying amount of our ARO liability are as follows:

	2011	2010
	(in thousands)	
Asset Retirement Obligations:		
Beginning balance	$ 3,378	$ 4,171
Additional accruals	5,553	3,024
Accretion expense	441	57
Obligations settled	0	(2,583)
Revisions in estimated cash flows	(394)	(1,291)
Ending balance	$ 8,978	$ 3,378

(d) Legal Proceedings

Kraton and LyondellBasell have negotiated and concluded the terms of an agreed arbitration proceeding (to take place in London, England) to determine the ongoing effect of a multi-year term sheet that had been reached between the parties and put into effect in January 2009, covering certain terms and conditions applicable to operations and butadiene sales by LyondellBasell (for and to Kraton) at Berre, France and Wesseling, Germany. The parties had been dealing with one another in accordance with the term sheet from January 2009 until

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LyondellBasell notified Kraton on September 9, 2010 that LyondellBasell would no longer be governed by the term sheet. Since receiving the September 9, 2010 notice, Kraton has been paying an increased net amount to LyondellBasell on a monthly basis (under protest) to reflect the pre-term sheet arrangements between the parties.

The outcome of the arbitration cannot be predicted with accuracy at this time. However, we do not believe it is probable that LyondellBasell will prevail in the arbitration, and we do not expect the final resolution of this matter to have a material impact on our ongoing business or operations. For the year ended December 31, 2011, we recognized $5.7 million, on a pre-tax basis, to cost of goods sold for the net excess payments to LyondellBasell.

In 2011, we were notified by the tax authorities in France that we owed an additional 6.9 million related to the 2009 tax year. The tax authorities claim that we did not timely file forms that serve to cap taxes for 2009. We believe that all such forms were timely filed and we are otherwise in compliance with all filing requirements, and we are owed a refund of 0.3 million. While the outcome of this proceeding cannot be predicted with certainty, we do not expect this matter to have a material adverse effect upon our financial position, results of operations or cash flows.

We and certain of our subsidiaries, from time to time, are parties to various other legal proceedings, claims and disputes that have arisen in the ordinary course of business. These claims may involve significant amounts, some of which would not be covered by insurance. While the outcome of these proceedings cannot be predicted with certainty, our management does not expect any of these other existing matters, individually or in the aggregate, to have a material adverse effect upon our financial position, results of operations or cash flows. Furthermore, Shell Chemicals has agreed, subject to certain limitations, to indemnify us for certain claims brought with respect to matters occurring before February 28, 2001. As of the date of this Form 10-K, we have not been named as parties in any of these claims. Our right to indemnification from Shell Chemicals is subject to certain time limitations. A substantial settlement payment or judgment in excess of our accruals could have a material adverse effect on our financial position, results of operations or cash flows.

12. Employee Benefits

(a) U.S. Retirement Benefit Plan. We have a U.S. noncontributory defined benefit pension plan *(Pension Plan)* which covers all salaried and hourly wage employees in the United States, who were employed by us on or before December 31, 2005. Employees who began their employment with us after December 31, 2005 are not covered by our Pension Plan. The benefits under the Pension Plan are based primarily on years of service and employees pay near retirement. For our employees who were employed as of March 1, 2001 and who: (1) were previously employed by Shell Chemicals; and (2) elected to transfer their pension assets to us, we consider the total combined Shell Chemicals and Kraton service when calculating the employee s pension benefit. For those employees who: (1) elected to retire from Shell Chemicals; or (2) elected not to transfer their pension benefit, only Kraton service (since March 1, 2001) is considered when calculating benefits.

The 2011 measurement date of the Pension Plan s assets and obligations was December 31, 2011. Based on the funded status of our defined benefit pension plan as of December 31, 2011, we reported a decrease in our accumulated other comprehensive income (loss) of approximately $15.7 million and a related increase in accrued pension obligations.

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Notes to Consolidated Financial Statements (Continued)

Information concerning the pension obligation, plan assets, amounts recognized in our financial statements and underlying actuarial and other assumptions are as follows:

	December 31, 2011	2010
	(in thousands)	
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 91,322	$ 76,889
Service cost	2,605	2,285
Interest cost	5,135	4,863
Benefits paid	(2,814)	(2,489)
Actuarial (gain) loss	15,700	9,774
Benefit obligation at end of year	$ 111,948	$ 91,322
Change in plan assets:		
Fair value at beginning of year	$ 58,223	$ 50,321
Actual return on plan assets	4,368	7,079
Employer contributions	7,400	3,312
Benefits paid	(2,814)	(2,489)
Fair value at end of year	$ 67,177	$ 58,223
Funded status at end of year	$ (44,771)	$ (33,099)
Amounts recognized on balance sheet:		
Noncurrent liabilities	$ (44,771)	$ (33,099)
Amounts recognized in accumulated other comprehensive income (loss):		
Prior service cost	$ 0	$ 0
Net actuarial loss	36,170	20,515
	$ 36,170	$ 20,515

The accumulated benefit obligation for the Pension Plan was $101.9 million and $83.0 million at December 31, 2011, and 2010, respectively.

We expect to contribute $9.8 million to our Pension Plan in 2012.

Estimated Future Benefit Payments.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	(in thousands)
2012	2,876
2013	3,118
2014	3,444
2015	3,795
2016	4,239
Years 2017-2021	28,432
	$ 45,904

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Net periodic pension costs consist of the following components:

	Years ended December 31,		
	2011	2010	2009
	(in thousands)		
Service cost benefits earned during the period	$ 2,605	$ 2,285	$ 2,813
Interest on prior year s projected benefit obligation	5,135	4,863	4,690
Expected return on plan assets	(5,239)	(4,845)	(4,680)
Amortization of net actuarial (gain)/loss	916	0	514
Net periodic pension costs	$ 3,417	$ 2,303	$ 3,337

Discount rates are determined annually and are based on rates of return of high-quality long-term fixed income securities currently available and expected to be available during the maturity of the pension benefits.

	December 31,	
	2011	2010
Weighted average assumptions used to determine benefit obligations:		
Measure date	12/31/2011	12/31/2010
Discount rate	4.83%	5.68%
Rates of increase in salary compensation level	3.00%	3.00%
Weighted average assumptions used to determine net periodic benefit cost:		
Discount rate	5.68%	6.38%
Rates of increase in salary compensation level	3.00%	3.00%
Expected long-term rate of return on plan assets	8.50%	8.50%

Our management relied in part on actuarial studies in establishing the expected long-term rate of return on assets assumption. The study includes a review of anticipated future long-term performance of individual asset classes and consideration of the appropriate asset allocation strategy given the anticipated requirements of the Pension Plan to determine the average rate of earnings expected on the funds invested to provide for the Pension Plan benefits. While the study gives appropriate consideration to recent fund performance and historical returns, the assumption is primarily a long-term, prospective rate. Based on our most recent study, the expected long-term return assumption for our Pension Plan effective for 2012 will remain at 8.5%.

Pension Plan Assets. We maintain target allocation percentages among various asset classes based on an investment policy established for the pension plan. The target allocation is designed to achieve long term objectives of return, while mitigating against downside risk and considering expected cash flows. The plan s strategic target allocation as of December 31, 2011 was 50% equity, 30% debt and 20% consisting of real estate funds, hedge funds and commodity funds, the latter was assumed to behave similar to debt securities and therefore we included this 20% asset allocation as bonds in the model. Our investment policy is reviewed from time to time to ensure consistency with our long term objective.

Our Pension Plan asset allocations at December 31, 2011, and 2010, by asset category are as follows:

	Percentage of Plan Assets at December 31,	
	2011	2010
Equity securities	44.6%	38.0%
Debt securities	44.9%	52.8%
Real estate	3.0%	3.0%
Other	7.5%	6.2%
Total	100.0%	100.0%

No pension assets were invested in debt or equity securities of Kraton at December 31, 2011, and 2010.

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The fair value of our Pension Plan assets at December 31, 2011, by asset category are as follows:

	Pension Plan Assets			
	Fair Value Measurements at December 31, 2011			
	Total	Quoted Prices In Active Markets Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)			
Equity Mutual Funds:				
Dodge & Cox Stock Fund(a)	2,702	2,702	0	0
Harbor Cap Appreciation Fund(b)	2,683	2,683	0	0
Harding Loevner Emerging Markets Fund(c)	2,016	2,016	0	0
Matthews Asian Growth & Income Fund(d)	673	673	0	0
Aberdeen Emerging Markets Institutional Fund(s)	1,346	1,346	0	0
Gateway Fund Class Y(t)	2,341	2,341	0	0
Total	11,761	11,761	0	0
Debt Mutual Funds:				
Eaton Vance Global Macro Fund I(e)	4,016	4,016	0	0
PIMCO Emerging Local Bond Fund(f)	2,010	2,010	0	0
PIMCO Extended Duration Fund(g)	5,387	5,387	0	0
Vanguard Inflation Protected Bond Fund(i)	2,666	2,666	0	0
Total	14,079	14,079	0	0
Equity Commingled Pools:				
FMTC US Equity Index Pool(j)	6,716	0	6,716	0
Pyramis International Growth Commingled Pool(k)	6,785	0	6,785	0
Pyramis Large Cap Core Commingled Pool(l)	2,016	0	2,016	0
Pyramis Small Company Commingled Pool(m)	2,694	0	2,694	0
Total	18,211	0	18,211	0
Debt Commingled Pools:				
Pyramis Emerging Market Debt Commingled Pool(n)	1,335	0	1,335	0
Pyramis Long Corp. A or Better Commingled Pool(o)	4,693	0	4,693	0
Pyramis Long Duration(p)	10,049	0	10,049	0
Total	16,077	0	16,077	0
Real Estate:				
Virtus Real Estate SEC I Fund(q)	2,014	2,014	0	0
Total	2,014	2,014	0	0
Other:				
Money Market Mutual Fund	334	334	0	0
Credit Suisse Commodity Return Strategy Fund(r)	1,336	1,336	0	0

RS Global Natural Resources Fund(u)	679	679	0	0
Steelpath MLP Select 40 I FD(v)	2,686	2,686	0	0
Total	5,035	5,035	0	0
Total	$ 67,177	$ 32,889	$ 34,288	$ 0

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Notes to Consolidated Financial Statements (Continued)

The fair value of our pension plan assets at December 31, 2010, by asset category are as follows:

	Pension Plan Assets			
	Fair Value Measurements at December 31, 2010			
	Total	Quoted Prices In Active Markets Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)			
Equity Mutual Funds:				
Dodge & Cox Stock Fund(a)	2,327	2,327	0	0
Harbor Cap Appreciation Fund(b)	2,318	2,318	0	0
Harding Loevner Emerging Markets Fund(c)	1,753	1,753	0	0
Matthews Asian Growth & Income Fund(d)	584	584	0	0
Total	6,982	6,982	0	0
Debt Mutual Funds:				
Eaton Vance Global Macro Fund I(e)	4,650	4,650	0	0
PIMCO Emerging Local Bond Fund(f)	1,750	1,750	0	0
PIMCO Extended Duration Fund(g)	4,748	4,748	0	0
PIMCO Short Term Institutional Fund(h)	2,906	2,906	0	0
Vanguard Inflation Protected Bond Fund(i)	2,629	2,629	0	0
Total	16,683	16,683	0	0
Equity Commingled Pools:				
FMTC US Equity Index Pool(j)	5,811	0	5,811	0
Pyramis International Growth Commingled Pool(k)	5,242	0	5,242	0
Pyramis Large Cap Core Commingled Pool(l)	1,744	0	1,744	0
Pyramis Small Company Commingled Pool(m)	2,316	0	2,316	0
Total	15,113	0	15,113	0
Debt Commingled Pools:				
Pyramis Emerging Market Debt Commingled Pool(n)	1,164	0	1,164	0
Pyramis Long Corp. A or Better Commingled Pool(o)	4,110	0	4,110	0
Pyramis Long Duration(p)	8,808	0	8,808	0
Total	14,082	0	14,082	0
Real Estate:				
Virtus Real Estate SEC I Fund(q)	1,739	1,739	0	0
Total	1,739	1,739	0	0
Other:				
Money Market Mutual Fund	80	80	0	0
Credit Suisse Commodity Return Strategy Fund(r)	3,544	3,544	0	0

Total	3,624	3,624	0	0
Total	$ 58,223	$ 29,028	$ 29,195	$ 0

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(a) Portfolio with the primary objective to invest in common stocks that appear to be temporarily undervalued by the stock market but have a favorable outlook for long-term growth.
(b) Portfolio with the primary objective to seek long-term growth of capital by investing in mid to large cap growth stocks.
(c) Portfolio with the primary objective to seek long-term capital appreciation through investment in equity securities of companies based in emerging markets.
(d) Portfolio with the primary objective to seek long-term capital appreciation and some current income through investment in equity securities of companies located in Asia.
(e) Portfolio with the primary objective to seek total return by investing in securities, derivatives, and other instruments to establish long and short investment exposure around the world.
(f) Portfolio with the primary objective to seek maximum total return, consistent with preservation of capital and prudent investment management by investing in fixed income securities denominated in currencies of non-U.S. countries.
(g) Portfolio with the primary objective to seek maximum total return, consistent with prudent investment management by investing in long-term maturity fixed income securities.
(h) Portfolio with the primary objective to seek maximum current income, consistent with preservation of capital and daily liquidity by investing in short-term investment grade bonds (average duration less than or equal to one year).
(i) Portfolio with the primary objective to protect investors from the eroding effect of inflation by investing in bonds that are backed by the federal government and whose principal is adjusted quarterly based on inflation.
(j) Portfolio with the primary objective to provide investment results that correspond to the total return performance of common stocks publicly traded in the United States.
(k) Portfolio with the primary objective to seek long-term growth of capital primarily through investments in foreign equity securities.
(l) Portfolio with the primary objective to achieve excess return relative to the S&P 500 Index.
(m) Portfolio with the primary objective to achieve long-term growth of capital, principally by investing in the equity securities of smaller, growing companies.
(n) Portfolio with the primary objective to achieve superior total returns primarily through investments in debt securities of emerging countries.
(o) Portfolio with the primary objective to provide investment returns in excess of the Barclays Capital® Long Corporate A or Better Index through investments in fixed income securities and commingled vehicles.
(p) Portfolio with the primary objective to generate returns that exceed the Barclays Capital® US Long Government/Credit Bond Index through investments in investment-grade fixed-income securities and commingled vehicles.
(q) Portfolio with the primary objective to provide exposure to the equity REITs market, which has historically had a lower correlation to traditional asset classes.
(r) Portfolio with the primary objective to achieve positive total return relative to the performance of the Dow Jones UBS Commodity Index total return.
(s) Portfolio with the primary objective to seek long-term capital appreciation by investing primarily in equity securities of emerging market country issuers.
(t) Portfolio with the primary objective to capture the majority of the returns associated with equity market investments and normally invests in a broadly diversified portfolio of common stocks, while also selling index call options.
(u) Portfolio with the primary objective to seek long-term capital appreciation by principally engaged in natural resources industries.
(v) Portfolio with the primary objective to diversify exposure to the energy infrastructure MLPs.

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(b) Other Retirement Benefit Plans. Certain employees are eligible to participate in a non-qualified defined benefit restoration plan and/or a non-qualified defined contribution restoration plan (BRP) which are intended to restore certain benefits under the Pension Plan in the United States and the Kraton Savings Plan in the United States, which would otherwise be lost due to certain limitations imposed by law on tax-qualified plans. We made $0.0 million, $0.0 million and $0.9 million in contributions to the BRP for the years ended December 31, 2011, 2010, and 2009, respectively. As of December 31, 2011 and 2010, amounts recognized as a component of other long-term liabilities for the benefit restoration plans were $1.5 million and $1.1 million, respectively.

(c) Postretirement Benefits Other Than Pensions. Health and welfare benefits are provided to benefit eligible employees in the United States who retire from Kraton and were employed by us prior to January 1, 2006. Retirees under the age of 65 are eligible for the same medical, dental, and vision plans as active employees, but with an annual cap on premiums that varies based on years of service and ranges from $7,000 to $10,000 per employee. Our subsidy schedule for medical plans is based on accredited service at retirement. Retirees are responsible for the full cost of premiums for postretirement dental and vision coverage. In general, the plans stipulate that health and welfare benefits are paid as covered expenses as incurred. We accrue the cost of these benefits during the period in which the employee renders the necessary service.

Employees who were retirement eligible as of February 28, 2001, have the option to participate in either Shell Chemicals or Kraton postretirement health and welfare plans.

ASC 715, *Compensation-Retirement Benefits,* requires that we measure the plans assets and obligations that determine our funded status at the end of each fiscal year and the 2011 measurement date of the plans assets and obligations was December 31, 2011. We are also required to recognize as a component of accumulated other comprehensive income (loss) the changes in funded status that occurred during the year that are not recognized as part of new periodic benefit cost.

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Based on the funded status of our postretirement benefit plan as of December 31, 2011, we reported a decrease in our accumulated other comprehensive income (loss) of approximately $2.6 million and a related increase in accrued pension obligations.

Information concerning the plan obligation, the funded status and amounts recognized in our financial statements and underlying actuarial and other assumptions are as follows:

	December 31, 2011	2010
	(in thousands)	
Change in benefit obligation:		
Benefit obligation at beginning of period	$ 22,992	$ 18,474
Service cost	414	364
Interest cost	1,246	1,213
Benefits and expenses paid (premiums)	(980)	(801)
Part D subsidy received	0	7
Actuarial loss	3,012	3,735
Benefit obligation at end of period	$ 26,684	$ 22,992
Reconciliation of plan assets(1):		
Employer contributions	$ 980	$ 794
Part D subsidy received	0	7
Benefits paid	(980)	(801)
	$ 0	$ 0
Funded status at end of year	$ (26,684)	$ (22,992)

(1) Shell Chemicals has committed to a future cash payment related to retiree medical expenses based on a specified dollar amount per employee, if certain contractual commitments are met. We have recorded an asset of approximately $8.4 million and $7.5 million as our estimate of the present value of this commitment as of December 31, 2011 and 2010, respectively.

	December 31, 2011	2010
	(in thousands)	
Amounts recognized in the balance sheet:		
Noncurrent liabilities	26,684	22,992
Amounts recognized in accumulated other comprehensive income (loss):		
Prior service cost	$ 0	$ 0
Net actuarial loss	10,023	7,423

	$ 10,023	$ 7,423

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KRATON PERFORMANCE POLYMERS, INC.

Notes to Consolidated Financial Statements (Continued)

Net periodic benefit costs consist of the following components:

	Years ended December 31,		
	2011	2010	2009
	(in thousands)		
Service cost	$ 414	$ 364	$ 392
Interest cost	1,246	1,213	1,058
Amortization of net actuarial loss	412	253	231
Net periodic benefit costs	$ 2,072	$ 1,830	$ 1,681

	December 31,	
	2011	2010
Weighted average assumptions used to determine benefit obligations:		
Measurement date	12/31/2011	12/31/2010
Discount rate	4.65%	5.46%
Rates of increase in salary compensation level	N/A	N/A
Weighted average assumptions used to determine net periodic benefit cost:		
Discount rate	5.46%	6.17%
Rates of increase in salary compensation level	N/A	N/A
Expected long-term rate of return on plan assets	N/A	N/A

	December 31,	
	2011	2010
Assumed health care cost trend rates:		
Health care cost trend rate assumed for next year	7.50%	8.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2016	2016

Discount rates are determined annually and are based on rates of return of high-quality long-term fixed income securities currently available and expected to be available during the maturity of the postretirement benefit plan.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 1% change in assumed health care cost trend rates would have the following effect (in thousands):

	1% Increase	1% Decrease
Effect on total of service and interest cost components	$ 65	$ (58)
Effect on postretirement benefit obligation	1,007	(800)

(d) Kraton Savings Plan. The Kraton Savings Plan, as adopted on March 1, 2001, covers substantially all U.S. employees, including executive officers. Through automatic payroll deduction, participants have the option to defer up to 60% of eligible earnings in any combination of pretax and/or post-tax contributions, subject to annual dollar limitations set forth in the Internal Revenue Code. Under this plan, we have two types of employer contributions:

(1) For our standard contributions, we make matching contributions of 50% of the first 6% contributed by the employee after completing one year of service, and we make matching contributions of 100% of the first 6% contributed by the employee after completing five years of service.

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KRATON PERFORMANCE POLYMERS, INC.

Notes to Consolidated Financial Statements (Continued)

(2) For our enhanced contributions, we make employer contributions of 3% for employees who have less than five years of service and a 4% contribution for employees who have five or more years of service.

For our employees who were employed as of February 28, 2001, and who were previously employed by Shell Chemicals, we recognize their Shell Chemicals years of service for purposes of determining employer contributions under our Plan. Our contributions to the plan for the years ended December 31, 2011, 2010, and 2009, were $3.2 million, $2.6 million, and $2.7 million, respectively.

13. Industry Segment and Foreign Operations

We operate in one segment for the manufacture and marketing of engineered polymers. In accordance with the provisions of ASC 280, Segment Reporting, our chief operating decision-maker has been identified as the President and Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the entire company. Since we operate in one segment and in one group of similar products, all financial segment and product line information required by ASC 280 can be found in the consolidated financial statements.

We manufacture our products along the following primary product lines based upon polymer chemistry and process technologies:

unhydrogenated SBCs (USBCs);

hydrogenated SBCs (HSBCs);

isoprene rubber (IR) and isoprene rubber latex (IRL); and

compounds.

Sales revenue for our four primary product lines are as follows(1):

	Years ended December 31,		
	2011	2010	2009
		(in thousands)	
USBCs	$ 852,070	$ 725,716	$ 520,740
HSBCs	454,835	382,868	290,739
IR and IRL	99,412	92,082	84,082
Compounds	26,578	27,759	24,801
	$ 1,432,895	$ 1,228,425	$ 920,362

(1) Our product line sales revenue excludes $4.6 million of other sales in 2011 and $47.6 million of by-product sales reported as other in 2009. During the years ended December 31, 2011, 2010, and 2009, no single customer accounted for 10.0% or more of our total operating revenues.

For geographic reporting, operating revenues are attributed to the geographic location in which the customers facilities are located. Long-lived assets consist primarily of property, plant, and equipment, which are attributed to the geographic location in which they are located, and are presented at historical cost.

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Notes to Consolidated Financial Statements (Continued)

Operating revenues and long-lived assets by geographic region are as follows:

	Years ended December 31,		
	2011	2010	2009
	(in thousands)		
Operating revenues:			
United States	$ 490,373	$ 421,856	$ 304,265
Germany	212,079	162,260	121,959
Japan	91,788	89,987	73,055
China	61,039	53,359	37,123
Brazil	50,777	47,387	40,438
Italy	49,484	46,386	35,934
France	46,233	36,122	27,342
Belgium	43,339	24,081	16,273
United Kingdom	40,644	29,214	27,425
The Netherlands	36,991	33,093	66,027
Thailand	32,209	34,647	28,779
Turkey	25,004	23,767	12,990
Canada	22,703	20,855	16,168
Austria	21,498	14,583	8,170
Poland	19,084	10,836	15,537
Taiwan	17,378	20,446	15,711
Malaysia	16,592	9,829	6,769
Sweden	15,830	15,096	11,292
South Korea	13,742	13,598	9,928
Argentina	13,502	11,334	10,854
Australia	13,146	13,973	9,124
Mexico	11,437	11,431	11,029
All other countries	92,607	84,285	61,812
	$ 1,437,479	$ 1,228,425	$ 968,004

	December 31,		
	2011	2010	2009
	(in thousands)		
Long-lived assets, at cost:			
United States	$ 387,022	$ 334,081	$ 317,719
Germany	47,125	47,059	42,724
Japan	1,893	1,582	482
France	115,169	136,449	125,839
The Netherlands	13,355	12,539	36,971
Brazil	81,021	78,260	64,385
China	4,394	3,190	2,334
All other countries	4,436	4,593	964
	$ 654,415	$ 617,753	$ 591,418

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KRATON PERFORMANCE POLYMERS, INC.

Notes to Consolidated Financial Statements (Continued)

14. Related Party Transactions

We own a 50% equity investment in a SBC manufacturing joint venture with JSR Corporation (JSR) under the name of Kraton JSR Elastomers K.K. (KJE) located in Kashima, Japan. We and JSR separately, but with equal rights, participate as distributors in the sales of the thermoplastic rubber produced by KJE.

The aggregate amounts of related-party transactions were as follows:

	December 31,		
	2011	2010	2009
Purchases from related party	$ 34,610	$ 35,384	$ 27,763

Our due to related party is solely related to our commercial arrangement with KJE, which requires payment by each party within 150 days of invoice.

15. Supplemental Guarantor Information

Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Performance Polymers, Inc. and Elastomers Holdings LLC, a U.S. holding company and wholly-owned subsidiary of Kraton Polymers LLC, collectively, the Guarantors, fully and unconditionally guarantee on a joint and several basis, the Issuers obligations under the 6.75% senior notes. Our remaining subsidiaries are not guarantors of the 6.75% senior notes. We do not believe that separate financial statements and other disclosures concerning the Guarantor Subsidiaries would provide any additional information that would be material to investors in making an investment decision.

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATING BALANCE SHEET

December 31, 2011

(In thousands, except par value)

	Kraton	Kraton Polymers LLC(1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS						
Current assets:						
Cash and cash equivalents	$ 0	$ 0	$ 6,030	$ 82,549	$ 0	$ 88,579
Receivables, net of allowances	0	0	54,905	87,791	0	142,696
Inventories of products, net	0	0	222,783	172,013	0	394,796
Inventories of materials and supplies, net	0	0	7,654	2,342	0	9,996
Deferred income taxes	0	0	1,881	259	0	2,140
Other current assets	0	3,365	344	23,619	0	27,328
Total current assets	0	3,365	293,597	368,573	0	665,535
Property, plant and equipment, less accumulated depreciation	0	66,095	205,562	101,316	0	372,973
Identifiable intangible assets, less accumulated amortization	0	47,961	18,223	0	0	66,184
Investment in consolidated subsidiaries	535,412	1,218,793	0	0	(1,754,205)	0
Investment in unconsolidated joint venture	0	813	0	12,537	0	13,350
Debt issuance costs	0	11,106	0	0	0	11,106
Other long-term assets	0	5,451	511,452	121,961	(614,256)	24,608
Total assets	$ 535,412	$ 1,353,584	$ 1,028,834	$ 604,387	$ (2,368,461)	$ 1,153,756
LIABILITIES AND STOCKHOLDERS AND MEMBER S EQUITY						
Current liabilities:						
Current portion of long-term debt	0	7,500	0	0	0	7,500
Accounts payable-trade	0	841	42,252	44,933	0	88,026
Other payables and accruals	0	7,832	14,125	29,296	0	51,253
Due to related party	0	0	0	14,311	0	14,311
Total current liabilities	0	16,173	56,377	88,540	0	161,090
Long-term debt, net of current portion	0	385,000	0	0	0	385,000
Deferred income taxes	0	14,505	(7,330)	(961)	0	6,214
Other long-term liabilities	0	401,573	78,754	217,587	(614,256)	83,658
Total liabilities	0	817,251	127,801	305,166	(614,256)	635,962
Commitments and contingencies (note 11)						
Stockholders and member s equity:						
Preferred stock, $.01 par value; 100,000 shares authorized; none issued						
Common stock, $.01 par value; 500,000 shares authorized; 32,092 shares issued and outstanding	321	0	0	0	0	321
Additional paid in capital	347,455	0	0	0	0	347,455
Member s equity	0	535,412	942,032	276,761	(1,754,205)	0

Retained earnings	187,636	0	0	0	0	187,636
Accumulated other comprehensive income (loss)	0	921	(40,999)	22,460	0	(17,618)
Total stockholders and member s equity	535,412	536,333	901,033	299,221	(1,754,205)	517,794
Total liabilities and stockholders and member s equity	$ 535,412	$ 1,353,584	$ 1,028,834	$ 604,387	$ (2,368,461)	$ 1,153,756

(1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATING BALANCE SHEET

December 31, 2010

(In thousands, except par value)

	Kraton	Kraton Polymers LLC(1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS						
Current assets:						
Cash and cash equivalents	$ 0	$ 0	$ 31,421	$ 61,329	$ 0	$ 92,750
Receivables, net of allowances	731	161	48,623	86,617	0	136,132
Inventories of products, net	0	0	171,989	153,131	0	325,120
Inventories of materials and supplies, net	0	0	6,988	2,643	0	9,631
Other current assets	0	2,933	728	35,088	0	38,749
Total current assets	731	3,094	259,749	338,808	0	602,382
Property, plant and equipment, less accumulated depreciation	0	75,632	186,611	103,123	0	365,366
Identifiable intangible assets, less accumulated amortization	0	54,528	15,933	0	0	70,461
Investment in consolidated subsidiaries	431,001	1,064,238	0	0	(1,495,239)	0
Investment in unconsolidated joint venture	0	813	0	12,776	0	13,589
Debt issuance costs	0	3,172	0	0	0	3,172
Deferred income taxes	0	0	0	2,376	(2,376)	0
Other long-term assets	0	439	514,860	196,866	(686,412)	25,753
Total assets	$ 431,732	$ 1,201,916	$ 977,153	$ 653,949	$ (2,184,027)	$ 1,080,723
LIABILITIES AND STOCKHOLDERS AND MEMBER S EQUITY						
Current liabilities:						
Current portion of long-term debt	0	2,304	0	0	0	2,304
Accounts payable-trade	0	0	51,653	35,046	0	86,699
Other payables and accruals	0	7,967	27,864	24,951	0	60,782
Deferred income taxes	0	0	0	595	0	595
Due to related party	0	0	0	19,264	0	19,264
Total current liabilities	0	10,271	79,517	79,856	0	169,644
Long-term debt, net of current portion	250	380,121	0	0	0	380,371
Deferred income taxes	0	16,465	0	0	(2,376)	14,089
Other long-term liabilities	0	363,333	69,784	317,537	(686,412)	64,242
Total liabilities	250	770,190	149,301	397,393	(688,788)	628,346
Commitments and contingencies (note 11)						
Stockholders and member s equity:						
Preferred stock, $.01 par value; 100,000 shares authorized; none issued						
Common stock, $.01 par value; 500,000 shares authorized; 31,390 shares issued and outstanding	314	0	0	0	0	314
Additional paid in capital	334,457	0	0	0	0	334,457

Member s equity	0	431,001	855,209	209,029	(1,495,239)	0
Retained earnings	96,711	0	0	0	0	96,711
Accumulated other comprehensive income (loss)	0	725	(27,357)	47,527	0	20,895
Total stockholders and member s equity	431,482	431,726	827,852	256,556	(1,495,239)	452,377
Total liabilities and stockholders and member s equity	$ 431,732	$ 1,201,916	$ 977,153	$ 653,949	$ (2,184,027)	$ 1,080,723

(1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATING STATEMENT OF OPERATIONS

Year Ended December 31, 2011

(In thousands)

	Kraton	Kraton Polymers LLC(1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales revenue	$ 0	$ 0	$ 718,700	$ 862,885	$ (144,106)	$ 1,437,479
Cost of goods sold	0	1,585	554,881	708,933	(144,106)	1,121,293
Gross profit (loss)	0	(1,585)	163,819	153,952	0	316,186
Operating expenses						
Research and development	0	0	17,537	10,459	0	27,996
Selling, general and administrative	0	(178)	69,954	31,830	0	101,606
Depreciation and amortization	0	16,383	32,973	13,379	0	62,735
Total operating expenses	0	16,205	120,464	55,668	0	192,337
Loss on extinguishment of debt	0	2,985	0	0	0	2,985
Earnings in consolidated subsidiaries	90,925	148,674	0	0	(239,599)	0
Earnings of unconsolidated joint venture	0	0	0	529	0	529
Interest expense (income), net	0	38,096	(14,987)	6,775	0	29,884
Income before income taxes	90,925	89,803	58,342	92,038	(239,599)	91,509
Income tax expense (benefit)	0	(1,122)	(9,954)	11,660	0	584
Net income	$ 90,925	$ 90,925	$ 68,296	$ 80,378	$ (239,599)	$ 90,925

(1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATING STATEMENT OF OPERATIONS

Year Ended December 31, 2010

(In thousands)

	Kraton	Kraton Polymers LLC(1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Sales revenue	$ 0	$ 0	$ 632,234	$ 721,004	$ (124,813)	$ 1,228,425
Cost of goods sold	0	297	455,287	597,161	(124,813)	927,932
Gross profit (loss)	0	(297)	176,947	123,843	0	300,493
Operating expenses						
Research and development	0	0	14,616	9,012	0	23,628
Selling, general and administrative	0	(2,414)	66,134	28,585	0	92,305
Depreciation and amortization	0	14,901	24,983	9,336	0	49,220
Total operating expenses	0	12,487	105,733	46,933	0	165,153
Earnings in consolidated subsidiaries	96,759	88,799	0	0	(185,558)	0
Earnings of unconsolidated joint venture	0	0	0	487	0	487
Interest expense (income), net	0	32,948	(12,169)	3,190	0	23,969
Income before income taxes	96,759	43,067	83,383	74,207	(185,558)	111,858
Income tax expense (benefit)	34	(53,692)	7,141	61,650	0	15,133
Net income	$ 96,725	$ 96,759	$ 76,242	$ 12,557	$ (185,558)	$ 96,725

(1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATING STATEMENT OF OPERATIONS

Year Ended December 31, 2009

(In thousands)

	Kraton	Kraton Polymers LLC(1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Operating revenues:						
Sales	$ 0	$ 0	$ 480,438	$ 591,309	$ (151,385)	$ 920,362
Other	0	0	74	47,568	0	47,642
Total operating revenues	0	0	480,512	638,877	(151,385)	968,004
Cost of goods sold	0	(15,654)	376,543	582,968	(151,385)	792,472
Gross profit	0	15,654	103,969	55,909	0	175,532
Operating expenses						
Research and development	0	0	13,150	8,062	0	21,212
Selling, general and administrative	0	(1,430)	45,497	35,437	0	79,504
Depreciation and amortization	0	22,039	21,598	23,114	0	66,751
Total operating expenses	0	20,609	80,245	66,613	0	167,467
Gain on extinguishment of debt	0	23,831	0	0	0	23,831
Earnings in consolidated subsidiaries	(288)	29,893	0	0	(29,605)	0
Earnings of unconsolidated joint venture	0	0	0	403	0	403
Interest expense (income), net	5	40,818	(11,156)	4,289	0	33,956
Income (loss) before income taxes	(293)	7,951	34,880	(14,590)	(29,605)	(1,657)
Income tax expense (benefit)	(3)	8,239	(876)	(8,727)	0	(1,367)
Net income (loss)	$ (290)	$ (288)	$ 35,756	$ (5,863)	$ (29,605)	$ (290)

(1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATING STATEMENT OF CASH FLOWS

Year Ended December 31, 2011

(In thousands)

	Kraton	Kraton Polymers LLC(1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash flows provided by (used in) operating activities	$ 0	$ (26,158)	$ 16,973	$ 73,960	$ 0	$ 64,775
Cash flows provided by (used in) investing activities:						
Proceeds from intercompany loans	0	26,278	0	0	(26,278)	0
Purchase of property, plant and equipment, net of proceeds from sales	0	0	(44,591)	(15,720)	0	(60,311)
Purchase of software	0	0	(4,072)	(57)	0	(4,129)
Net cash provided by (used in) investing activities	0	26,278	(48,663)	(15,777)	(26,278)	(64,440)
Cash flows provided by (used in) financing activities:						
Proceeds from debt	0	400,000	0	0	0	400,000
Repayments of debt	0	(393,160)	0	0	0	(393,160)
Cash contribution from member	0	8,271	0	0	(8,271)	0
Cash distribution to member	(8,271)	0	0	0	8,271	0
Proceeds from the exercise of stock options	8,271	0	0	0	0	8,271
Proceeds from insurance note payable	0	4,734	0	0	0	4,734
Repayments of insurance note payable	0	(4,734)	0	0	0	(4,734)
Debt issuance costs	0	(15,231)	0	0	0	(15,231)
Proceeds from (payments on) intercompany loans	0	0	6,300	(32,578)	26,278	0
Net cash provided by (used in) financing activities	0	(120)	6,300	(32,578)	26,278	(120)
Effect of exchange rate differences on cash	0	0	0	(4,386)	0	(4,386)
Net increase (decrease) in cash and cash equivalents	0	0	(25,390)	21,219	0	(4,171)
Cash and cash equivalents, beginning of period	0	0	31,420	61,330	0	92,750
Cash and cash equivalents, end of period	$ 0	$ 0	$ 6,030	$ 82,549	$ 0	$ 88,579

(1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATING STATEMENT OF CASH FLOWS

Year Ended December 31, 2010

(In thousands)

	Kraton	Kraton Polymers LLC(1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash flows provided by (used in) operating activities	$ 0	$ (20,392)	$ 57,625	$ 18,127	$ 0	$ 55,360
Cash flows provided by (used in) investing activities:						
Proceeds from intercompany loans	0	3,928	0	0	(3,928)	0
Purchase of property, plant and equipment, net of proceeds from sales	0	0	(38,938)	(14,467)	0	(53,405)
Purchase of software	0	0	(2,242)	0	0	(2,242)
Net cash provided by (used in) investing activities	0	3,928	(41,180)	(14,467)	(3,928)	(55,647)
Cash flows provided by (used in) financing activities:						
Proceeds from debt	0	69,000	0	0	0	69,000
Repayments of debt	0	(71,304)	0	0	0	(71,304)
Cash contribution from member	0	18,637	0	0	(18,637)	0
Cash distribution to member	(18,637)	0	0	0	18,637	0
Proceeds from issuance of common stock	11,197	0	0	0	0	11,197
Costs associated with the issuance of common stock	(534)	0	0	0	0	(534)
Proceeds from the exercise of stock options	7,974	0	0	0	0	7,974
Proceeds from insurance note payable	0	3,518	0	0	0	3,518
Repayments of insurance note payable	0	(3,387)	0	0	0	(3,387)
Proceeds from (payments on) intercompany loans	0	0	(21,592)	17,664	3,928	0
Net cash provided by (used in) financing activities	0	16,464	(21,592)	17,664	3,928	16,464
Effect of exchange rate differences on cash	0	0	0	7,282	0	7,282
Net increase (decrease) in cash and cash equivalents	0	0	(5,147)	28,606	0	23,459
Cash and cash equivalents, beginning of period	0	0	36,567	32,724	0	69,291
Cash and cash equivalents, end of period	$ 0	$ 0	$ 31,420	$ 61,330	$ 0	$ 92,750

(1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

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KRATON PERFORMANCE POLYMERS, INC.

CONSOLIDATING STATEMENT OF CASH FLOWS

Year Ended December 31, 2009

(In thousands)

	Kraton	Kraton Polymers LLC(1)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash flows provided by (used in) operating activities	$ 0	$ (39,221)	$ 53,247	$ 58,779	$ 0	$ 72,805
Cash flows provided by (used in) investing activities:						
Proceeds from intercompany loans	0	79,843	0	0	(79,843)	0
Purchase of property, plant and equipment, net of proceeds from sales	0	0	(28,226)	(6,005)	0	(34,231)
Purchase of software	0	0	(15,322)	0	0	(15,322)
Net cash provided by (used in) investing activities	0	79,843	(43,548)	(6,005)	(79,843)	(49,553)
Cash flows used in financing activities:						
Proceeds from debt	0	144,000	0	0	0	144,000
Repayments of debt	0	(308,131)	0	0	0	(308,131)
Cash contribution from member	0	126,725	0	0	(126,725)	0
Cash distribution to member	(126,725)	0	0	0	126,725	0
Proceeds from issuance of common stock	126,725	0	0	0	0	126,725
Proceeds from insurance note payable	0	3,706	0	0	0	3,706
Repayments of insurance note payable	0	(3,706)	0	0	0	(3,706)
Debt issuance costs	0	(3,216)	0	0	0	(3,216)
Payments on intercompany loans	0	0	(38,592)	(41,251)	79,843	0
Net cash used in financing activities	0	(40,622)	(38,592)	(41,251)	79,843	(40,622)
Effect of exchange rate differences on cash	0	0	0	(14,735)	0	(14,735)
Net decrease in cash and cash equivalents	0	0	(28,893)	(3,212)	0	(32,105)
Cash and cash equivalents, beginning of period	0	0	65,460	35,936	0	101,396
Cash and cash equivalents, end of period	$ 0	$ 0	$ 36,567	$ 32,724	$ 0	$ 69,291

(1) Kraton Polymers LLC and Kraton Polymers Capital Corporation, a financing subsidiary, collectively, the Issuers, are co-issuers of the 6.75% senior notes due March 1, 2019. Kraton Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be material to investors in making an investment decision.

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KRATON PERFORMANCE POLYMERS, INC.

Notes to Consolidated Financial Statements (Continued)

16. Selected Quarterly Financial Data (Unaudited)

The following table sets forth a summary of Kraton Performance Polymers, Inc. s quarterly financial information for each of the four quarters ended December 31, 2011 and December 31, 2010:

	First Quarter(1)	Second Quarter(2)	Third Quarter(3)	Fourth Quarter(4)	Total
	(in thousands, except per share data)				
2011					
Operating revenues	$ 344,828	$ 386,428	$ 401,993	$ 304,230	$ 1,437,479
Gross profit	86,851	108,395	101,454	19,486	316,186
Operating income (loss)	38,452	57,913	52,224	(24,740)	123,849
Net income (loss)	21,877	46,977	43,093	(21,022)	90,925
Earnings (loss) per common share					
Basic	0.69	1.47	1.34	(0.66)	2.85
Diluted	0.68	1.44	1.33	(0.66)	2.81
Weighted average common shares outstanding					
Basic	31,609	31,757	31,880	31,892	31,786
Diluted	32,197	32,339	32,215	31,892	32,209
2010					
Operating revenues	$ 272,732	$ 332,086	$ 335,442	$ 288,165	$ 1,228,425
Gross profit	69,127	89,113	82,881	59,372	300,493
Operating income	30,035	49,800	38,910	16,595	135,340
Net income	19,795	38,595	28,036	10,299	96,725
Earnings per common share					
Basic	0.64	1.25	0.90	0.33	3.13
Diluted	0.64	1.24	0.88	0.32	3.07
Weighted average common shares outstanding					
Basic	30,539	30,668	30,916	31,147	30,825
Diluted	30,728	31,106	31,590	31,910	31,379

(1) During the first quarter of 2011, we recognized costs of $0.5 million associated with our secondary public offering and $0.9 million associated with our European office consolidation, which are recorded in selling, general and administrative expenses. In connection with the refinancing of our indebtedness in the first quarter of 2011, we recorded approximately $4.2 million of accelerated amortization of deferred debt issuance costs and a $1.0 million payment to exit an interest rate swap agreement to interest expense and a $3.0 million loss, which we recorded to loss on extinguishment of debt. During the first quarter of 2010, we recorded a $1.3 million reduction of depreciation associated with exiting the Pernis, the Netherlands facilities two months earlier than anticipated, which is included in depreciation and amortization expenses. In addition, we recognized costs of $0.2 million associated with our European office consolidation, which is included in selling, general and administrative expenses.

(2) During the second quarter of 2011, we recognized costs of $0.1 million associated with our secondary public offering, which is included in selling, general and administrative expenses. During the second quarter of 2010, we recognized costs of $0.6 million associated with our European office consolidation, which is included in selling, general and administrative expenses.

(3) During the third quarter of 2011, we recognized costs of $0.2 million associated with our European office consolidation, which are included in selling, general and administrative expenses. During the third quarter of 2010, we recognized costs of $1.1 million associated with our European office consolidation as well as $0.8 million in costs associated with our secondary public offering, which are included

in selling, general and administrative expenses.

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KRATON PERFORMANCE POLYMERS, INC.

Notes to Consolidated Financial Statements (Continued)

(4) During the fourth quarter of 2011, we had no unusual or infrequently occurring items. During the fourth quarter of 2010, we recognized costs of $2.7 million associated with our European office consolidation and $1.0 million of costs associated with evaluating an acquisition, which are included in selling, general and administrative.

Basic and diluted earnings per share are computed independently for each of the quarters presented. Therefore, the sum of quarterly basic and diluted per share information may not equal annual basic and diluted earnings per share.

17. Subsequent Events

We have evaluated significant events and transactions that occurred after the balance sheet date and determined that there were no events or transactions other than those disclosed above that would require recognition or disclosure in our consolidated financial statements for the period ended December 31, 2011.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Kraton Performance Polymers, Inc.:

Under date of February 29, 2012, we reported on the consolidated balance sheets of Kraton Performance Polymers, Inc. and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in stockholders and member s equity and other comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2011, which are included in Kraton Performance Polymers, Inc. s annual report on Form 10-K. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related consolidated financial statement schedule in Kraton Performance Polymers, Inc. s annual report on Form 10-K. This financial statement schedule is the responsibility of Kraton Performance Polymers, Inc. s management. Our responsibility is to express an opinion on this financial statement schedule based on our audits.

In our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Houston, Texas

February 29, 2012

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KRATON PERFORMANCE POLYMERS, INC.

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS AND RESERVES

For the Years Ended December 31, 2011, 2010, and 2009

(In thousands)

	Balance at Beginning of Period	Net Expenses	Write-offs	Balance at End of Period
Allowance for doubtful accounts:				
Year ended December 31, 2011	$ 947	$ (26)	$ (372)	$ 549
Year ended December 31, 2010	$ 1,335	$ (336)	$ (52)	$ 947
Year ended December 31, 2009	$ 2,512	$ (857)	$ (320)	$ 1,335

	Balance at Beginning of Period	Net Expenses	Foreign Currency	Balance at End of Period
Inventory reserves:				
Year ended December 31, 2011	$ 8,269	$ 3,485	$ 89	$ 11,843
Year ended December 31, 2010	$ 6,135	$ 2,292	$ (158)	$ 8,269
Year ended December 31, 2009	$ 5,063	$ 1,526	$ (454)	$ 6,135

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EXHIBIT INDEX

Item 15. Exhibits

The following is a list of all exhibits filed as a part of this annual report on Form 10-K, including those incorporated by reference.

Exhibit No	Description of Exhibits
3.1	Certificate of Incorporation of Kraton Performance Polymers, Inc. (incorporated by reference to Exhibit 3.1 to Kraton Performance Polymers, Inc. s Form S-1/A filed with the SEC on September 20, 2010)
3.2	Bylaws of Kraton Performance Polymers, Inc. (Incorporated by reference to Exhibit 3.2 to Kraton Performance Polymers, Inc. s Form S-1/A filed with the SEC on September 20, 2010)
4.1	Specimen Stock Certificate of Kraton Performance Polymers, Inc. s Common Stock, par value $0.01 per share (incorporated by reference to Exhibit 4.1 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on December 10, 2009)
4.2	Indenture, dated as of February 11, 2011, among Kraton Polymers LLC, Kraton Polymers Capital Corporation, the Guarantors named therein and Wells Fargo Bank, National Association, as trustee, relating to the 6.75% Senior Notes due 2019 (incorporated by reference to Exhibit 4.1 to Kraton Performance Polymers, Inc. s Current Report on Form 8-K filed with the SEC on February 15, 2011).
4.3	First Supplemental Indenture, dated as of February 10, 2011 among Kraton Polymers LLC, Kraton Polymers Capital Corporation, the Guarantors named therein and Wells Fargo Bank, National Association, as trustee, relating to the 8.125% Senior Subordinated Notes due 2014 (incorporated by reference to Exhibit 4.3 to Kraton Performance Polymers, Inc. s Current Report on Form 8-K filed with the SEC on February 15, 2011).
4.4	Registration Rights Agreement dated as of February 11, 2011 by and among Kraton Polymers LLC, Kraton Polymers Capital Corporation, Kraton Performance Polymers, Inc., Elastomers Holdings LLC and Kraton Polymers U.S. LLC, and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Goldman, Sachs & Co., Morgan Stanley & Co. Incorporated and Macquarie Capital (USA) Inc. (incorporated by reference to Exhibit 4.2 to Kraton Performance Polymers, Inc. s Current Report on Form 8-K filed with the SEC on February 15, 2011).
10.1	Credit Agreement dated as of February 11, 2011 among Kraton Performance Polymers, Inc., as a Guarantor, Kraton Polymers LLC, as Borrower, the other Guarantors named therein, the Lenders named therein and Bank of America, N.A., as Administrative Agent (incorporated by reference to Exhibit 10.1 to Kraton Performance Polymers, Inc. s Current Report on Form 8-K filed with the SEC on February 15, 2011).
10.2	Pledge Agreement dated as of February 11, 2011 among Kraton Polymers LLC, as Borrower, Kraton Performance Polymers, Inc. and other parties, as Pledgors, and Bank of America, N.A., as Collateral Agent for the holders of the Secured Obligations (incorporated by reference to Exhibit 10.2 to Kraton Performance Polymers, Inc. s Current Report on Form 8-K filed with the SEC on February 15, 2011).
10.3	Security Agreement dated as of February 11, 2011 among Kraton Polymers LLC, as Borrower, Kraton Performance Polymers, Inc. and other parties, as Grantors, and Bank of America N.A. as Collateral Agent for the holders of the Secured Obligations (incorporated by reference to Exhibit 10.3 to Kraton Performance Polymers, Inc. s Current Report on Form 8-K filed with the SEC on February 15, 2011).

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Exhibit No	Description of Exhibits
10.4	Contribution Agreement dated February 28, 2001, between Shell Oil Company and Shell Elastomers (portions of this exhibit have been omitted pursuant to a request for confidential treatment) (incorporated by reference to Exhibit 10.44 to Amendment No. 1 to Kraton Performance Polymers, Inc. s Annual Report on Form 10-K/A filed with the SEC on October 28, 2011)
10.5	Contribution Agreement dated February 28, 2001, between Shell Internationale Research Maatschappij B.V. and Kraton Polymers Research B.V. (portions of this exhibit have been omitted pursuant to a request for confidential treatment) (incorporated by reference to Exhibit 10.45 to Amendment No. 2 to Kraton Performance Polymers, Inc. s Annual Report on Form 10-K/A filed with the SEC on February 3, 2012)
10.6	Amended and Restated Belpre Facility Sharing and Operating Agreement dated July 1, 1999, among Infineum USA LP, Shell Oil Kraton and Shell Elastomers LLC (portions of this exhibit have been omitted pursuant to a request for confidential treatment) (incorporated by reference to Exhibit 10.31 to Amendment No. 1 to Kraton Performance Polymers, Inc. s Annual Report on Form 10-K/A filed with the SEC on October 28, 2011)
10.7	Amendment No. 1 dated January 23, 2007 to Amended and Restated Belpre Facility Sharing and Operating Agreement (incorporated by reference to Exhibit 10.69 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on November 20, 2009)
10.8	Amendment No. 2 dated January 1, 2009 to Amended and Restated Belpre Facility Sharing and Operating Agreement (incorporated by reference to Exhibit 10.70 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on November 20, 2009)
10.9	Manufacturing Facility Lease dated August 24, 2000, between Shell Chemie and Kravis (Berre-Kraton D) (incorporated by reference to Exhibit 10.47 to Kraton Polymers LLC s Registration Statement on Form S-4 filed with the SEC on April 1, 2005)
10.10	Manufacturing Facility Lease dated August 24, 2000, between Shell Chimie and Kraton Polymers France SAS (Berre-Kraton G) (incorporated by reference to Exhibit 10.48 to Kraton Polymers LLC s Registration Statement on Form S-4 filed with the SEC on April 1, 2005)
10.11	First Amended and Restated Site Services, Utilities, Materials and Facilities Agreement dated February 28, 2001, between Shell Chimie S.A. and Kraton Polymers France S.A.S. (Berre) (portions of this exhibit have been omitted pursuant to a request for confidential treatment) (incorporated by reference to Exhibit 10.30 to Amendment No. 1 to Kraton Performance Polymers, Inc. s Annual Report on Form 10-K/A filed with the SEC on October 28, 2011)
10.12	First Amended and Restated Operations and Maintenance Services Agreement dated February 28, 2001, between Kraton Polymers France S.A.S. and Shell Chimie S.A. (Berre) (portions of this exhibit have been omitted pursuant to a request for confidential treatment) (incorporated by reference to Exhibit 10.36 to Amendment No. 2 to Kraton Polymers LLC s Registration Statement on Form S-4 filed with the SEC on July 15, 2005)
10.13	Business Lease dated March 31, 2000, between Elenac GmbH and Kraton Polymers GmbH (Wesseling) (portions of this exhibit have been omitted pursuant to a request for confidential treatment) (incorporated by reference to Exhibit 10.49 to Kraton Polymers LLC s Registration Statement on Form S-4 filed with the SEC on April 1, 2005)
10.14	Amendment to the Business Lease dated March 31, 2000, between Bassell Polyolefine GmbH (previously Elenac GmbH) and Kraton Polymers GmbH (incorporated by reference to Exhibit 10.49(a) to Kraton Polymers LLC s Registration Statement on Form S-4 filed with the SEC on April 1, 2005)

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Exhibit No	Description of Exhibits
10.15	Production Agreement (Elastomers) dated March 31, 2000, between Elenac GmbH and Kraton Polymers GmbH (Wesseling) (portions of this exhibit have been omitted pursuant to a request for confidential treatment) (incorporated by reference to Exhibit 10.37 to Amendment No. 2 to Kraton Polymers LLC s Registration Statement on Form S-4 filed with the SEC on July 15, 2005)
10.16	1,3-Butadiene Agreement dated December 1, 1999, between Deutsche Shell Chemie GmbH and MWW Achtundzwanzigste Vermoegensverwaltungs GmbH (portions of this exhibit have been omitted pursuant to a request for confidential treatment) (incorporated by reference to Exhibit 10.37 to Amendment No. 1 to Kraton Performance Polymers, Inc. s Annual Report on Form 10-K/A filed with the SEC on October 28, 2011)
10.17+	Savings Deferred Compensation and Restoration Plan dated December 31, 2008, restated (incorporated by reference to Exhibit 10.28 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on November 20, 2009)
10.18+	Pension Benefit Restoration Plan dated December 31, 2008, restated (incorporated by reference to Exhibit 10.29 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on December 2, 2009)
10.19+	Kraton Polymers LLC Executive Deferred Compensation Plan dated December 31, 2008 (incorporated by reference to Exhibit 10.30 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on December 2, 2009)
10.20+	Polymer Holdings LLC Executive Deferred Compensation Plan dated November 30, 2009 (incorporated by reference to Exhibit 10.52 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on December 2, 2009)
10.23+	TJ Chemical Holdings LLC 2004 Option Plan (as amended and restated November 30, 2009) (incorporated by reference to Exhibit 10.53 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on December 2, 2009)
10.24+*	Kraton Performance Polymers, Inc. 2009 Equity Incentive Plan (as amended and restated February 16, 2012)
10.25+*	Form of Kraton Performance Polymers, Inc. Restricted Stock Grant Agreement under the 2009 Equity Incentive Plan
10.26+*	Form of Kraton Performance Polymers, Inc. Option Grant Agreement under the 2009 Equity Incentive Plan
10.27+*	Polymer Holdings LLC Cash Incentive Plan dated effective December 16, 2009
10.28+*	First Amendment to Polymer Holdings LLC Cash Incentive Plan dated February 26, 2012
10.29+	Summary of Terms of 2011 Polymer Holdings LLC Cash Incentive Plan (incorporated by reference to Kraton Performance Polymers, Inc. s Current Report on Form 8-K filed with the SEC on February 1, 2011)
10.30+*	Kraton Performance Polymers, Inc. Executive Severance Program effective as of November 1, 2011
10.31+*	Form of Employee Confidentiality and Non-Competition Agreement entered into by executives participating in the Executive Severance Program
10.32+	Notional Unit Award Grant Agreement dated July 15, 2005, between Kevin M. Fogarty and Kraton Polymers LLC (incorporated by reference to Exhibit 10.56 to Amendment No. 3 to Kraton Polymers LLC s Registration Statement on Form S-4 filed with the SEC on August 30, 2005)
10.33+	Amendment No. 1 dated December 18, 2008 to the Notional Unit Award Grant Agreement, between Kevin M. Fogarty and Kraton Polymers LLC (incorporated by reference to Exhibit 10.23 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on November 20, 2009)

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Exhibit No	Description of Exhibits
10.34+	Amendment No. 2 dated December 8, 2009 to the Notional Unit Award Grant Agreement, between Kevin M. Fogarty and Kraton Polymers LLC (incorporated by reference to Exhibit 10.47 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on December 10, 2009)
10.35+	Amendment No.1 dated December 8, 2009 to the Restricted Unit Award Grant Agreement dated as of June 19, 2008, between Kraton Polymers LLC and Kevin M. Fogarty (incorporated by reference to Exhibit 10.54 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on December 10, 2009)
10.36+	Amendment to Outstanding Option Grant Agreements (incorporated by reference to Exhibit 10.92 to the Kraton Performance Polymers, Inc. s Form S-1 filed with the SEC on December 2, 2009)
10.37+	First Amendment to Employment Agreement (Kevin M. Fogarty) (incorporated by reference to Exhibit 99.1 to Kraton Performance Polymers, Inc. s Current Report on Form 8-K filed with the SEC on February 1, 2011)
10.38+*	Termination of Employment Agreement and Release Agreement (Fogarty) dated effective as of October 31, 2011
10.39+*	Termination of Employment Agreement and Release Agreement (Tremblay) dated effective as of October 31, 2011
10.40+*	Termination of Employment Agreement and Release Agreement (Duffy) dated effective as of October 31, 2011
10.41+*	Termination of Employment Agreement and Release Agreement (Freund) dated effective as of October 31, 2011
10.42+	Employment Agreement (Lee) dated effective as of January 1, 2011 (incorporated by reference to Exhibit 10.54 to Kraton Performance Polymers, Inc. s Annual Report on Form 10-K filed with the SEC on March 7, 2011)
10.43+*	Termination of Employment Agreement and Release Agreement (Lee) dated effective as of October 31, 2011
10.44+*	Termination of Employment Agreement and Release Agreement (Ott) dated effective as of October 31, 2011
10.45+	Separation Agreement dated effective as of May 31, 2011 by and between Larry R. Frazier and Kraton Polymers LLC and Kraton Performance Polymers, Inc. (incorporated by reference to Exhibit 10.3 to Kraton Performance Polymers, Inc. s Quarterly Report on Form 10-Q filed with the SEC on August 4, 2011)
10.46+*	Form of Indemnification Agreement (incorporated by reference to Exhibit 10.1 to Kraton Performance Polymers, Inc. s Current Report on Form 8-K filed with the SEC on December 16, 2011)
12.1*	Statement of Computation of Ratio of Earnings to Fixed Charges
21.1*	List of Significant Subsidiaries
23.1*	Consent of Independent Registered Public Accounting Firm
24.1*	Powers of Attorney
31.1*	Certification by CEO pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification by CFO pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

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Exhibit No	Description of Exhibits
32.1*	Certification by CEO and CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

+ Denotes management contract or compensatory plan or arrangement.
* Filed herewith.