LEXICON GENETICS INC/TX
Form 424B5
July 24, 2003

Filed Pursuant to Rule 424(b)(5)
Registration No. 333-101549

PROSPECTUS SUPPLEMENT

(To Prospectus dated December 6, 2002)

10,000,000 Shares

(LEXICON GENETICS INCORPORATED LOGO)

Lexicon Genetics Incorporated
COMMON STOCK

WE ARE OFFERING 10,000,000 SHARES OF OUR COMMON STOCK.

OUR COMMON STOCK IS QUOTED ON THE NASDAQ NATIONAL MARKET UNDER THE SYMBOL "LEXG." ON JULY 23, 2003, THE REPORTED LAST SALE PRICE OF OUR COMMON STOCK ON THE NASDAQ NATIONAL MARKET WAS $5.50 PER SHARE.

INVESTING IN OUR COMMON STOCK INVOLVES RISKS. SEE "RISK FACTORS" BEGINNING ON PAGE S-7 OF THIS PROSPECTUS SUPPLEMENT.

PRICE $5.25 A SHARE

	PRICE TO PUBLIC	UNDERWRITING DISCOUNTS AND COMMISSIONS	PROCEEDS TO LEXICON GENETICS
Per Share	$5.250	$.315	$4.935
Total	$52,500,000	$3,150,000	$49,350,000

We have granted the underwriters the right to purchase up to an additional 1,500,000 shares to cover over-allotments.

The Securities and Exchange Commission and state securities regulators have not approved or disapproved these securities, or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The underwriters expect to deliver the shares to purchasers on July 29, 2003.

MORGAN STANLEY UBS INVESTMENT BANK

CIBC WORLD MARKETS PUNK, ZIEGEL & COMPANY

July 23, 2003

TABLE OF CONTENTS

This prospectus supplement and the accompanying prospectus relate to the offer and sale by us of up to 10,000,000 shares of our common stock, and up to an additional 1,500,000 shares if the underwriters exercise their over-allotment option. You should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. Neither we nor the underwriters have authorized anyone to provide you with information different from that contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. We are offering to sell the shares of common stock, and are seeking offers to buy the shares of common stock, only in jurisdictions where offers and sales are permitted. The information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus is accurate only as of the date of this prospectus supplement, or the documents incorporated by reference, regardless of the time of delivery of this

prospectus supplement and the accompanying prospectus or any sales of the shares of common stock.

In this prospectus supplement and the accompanying prospectus, unless otherwise indicated, "Lexicon," "Lexicon Genetics," "we," "us" and "our" refer to Lexicon Genetics Incorporated and its subsidiary, Lexicon Pharmaceuticals (New Jersey), Inc. We own or have rights to trademarks or trade names that we use in connection with the operation of our business. The Lexicon name and logo, LexVision(R) and OmniBank(R) are registered trademarks and Genome5000(TM) is a trademark of Lexicon Genetics Incorporated. This prospectus supplement and the accompanying prospectus also include trademarks owned by other persons.

PROSPECTUS SUPPLEMENT SUMMARY

This summary does not contain all of the information that you should consider before investing in our common stock. You should read this entire prospectus supplement and the accompanying prospectus carefully, including "Risk Factors," the financial statements and other information incorporated by reference in this prospectus supplement and the accompanying prospectus, before making an investment decision.

LEXICON GENETICS

Lexicon Genetics is a biopharmaceutical company focused on the discovery of breakthrough treatments for human disease. We use proprietary gene knockout technology to systematically discover the physiological functions of genes in mice and to identify which corresponding human genes encode potential targets for therapeutic intervention, or drug targets. For those targets that we consider to have high pharmaceutical value, we engage in programs for the discovery and development of potential small molecule drugs, therapeutic antibodies and therapeutic proteins. Our physiology-based approach to understanding gene function and our use of mouse models in our drug discovery efforts allow us to make highly-informed decisions throughout the drug discovery and development process, which we believe will increase our likelihood of success in discovering breakthrough therapeutics.

The scope of our gene knockout technology, combined with the size and sophistication of our facilities and our evaluative technologies, provides us with what we believe to be a significant competitive advantage. We have completed our analysis of over 20% of the 5,000 genes in our Genome5000 program, and we expect to complete the analysis of the remaining genes by the end of 2007. We focus our discovery efforts in five therapeutic areas--metabolic disorders, cardiovascular disease, cancer, immune system disorders and neurological disorders--and we have established significant internal expertise in each of these areas. To date, we have advanced into drug discovery programs more than 20 targets, each of which we have validated in living mammals, or in vivo. We have highlighted 15 of our most advanced programs below.

		STAGE	
THERAPEUTIC AREA/TARGET NAME	INDICATION	PRIMARY IN VIVO VALIDATION	ADVANCED RESEARCH
METABOLIC DISORDERS			
LG653	Obesity/Diabetes		

LG747	Obesity/Diabetes
CARDIOVASCULAR DISEASE	
LG914	Atherosclerosis
LG101	Thrombosis
CANCER	
LG152	Solid Tumors
IMMUNE SYSTEM DISORDERS	
LG293	Autoimmune Disease
LG688	Inflammation
NEUROLOGICAL DISORDERS	
LG617	Cognitive Disorders
LG726	Depression
LG487	Depression
LG324	Depression
LG317	Parkinson's Disease
LG915	Anxiety
LG752	Pain
LG470	Pain

The most advanced drug discovery programs in each of our therapeutic areas include:

Lead Metabolic Program--LG653. Our physiological analysis of LG653 in knockout mice suggests that LG653 plays a role in the regulation of metabolism. LG653 knockout mice displayed a 30% to 44% reduction in body fat, exhibited an increased metabolic rate and on average consumed 19% more food than normal mice. We have completed high-throughput screening against LG653 and have identified two series of potential lead compounds, which we are currently optimizing.

Lead Cardiovascular Program--LG914. Our physiological analysis of LG914 in knockout mice suggests that LG914 is involved in the regulation of certain cellular events associated with atherosclerosis and other coronary artery diseases. LG914 knockout mice exhibited reduced arterial thickening in response to an inflammatory stimulus compared to normal mice, and the inhibition of LG914 in mice with a genetic predisposition to atherosclerotic plaque resulted in a significant decrease in plaque formation. We are working in collaboration with Abgenix, Inc. to develop monoclonal antibodies to inhibit LG914.

Lead Cancer Program--LG152. Our physiological analysis of LG152 in knockout mice suggests that LG152 plays a significant role in the regulation of cell growth. LG152 knockout mice displayed a reduction in cell growth and proliferation, while over-expression of LG152 in mouse cell lines resulted in tumor formation. We have also observed over-expression of LG152 in human tumor cells isolated from melanomas and breast, colon, bladder and ovarian tumors. We have completed high-throughput screening against LG152 and have identified five series of hits, which we are currently analyzing.

Lead Immunology Program--LG293. Our physiological analysis of LG293 in knockout mice suggests that LG293 is involved in the regulation of immune system function and the maturation and proliferation of T and B cells, which are vital components of the immune system. LG293 knockout mice exhibited lower levels of circulating T and B cells, resulting in a

reduction in the inflammatory response. Furthermore, LG293 knockout mice accepted transplanted tissues and mounted a significantly reduced inflammatory response when challenged. We have completed high-throughput screening against LG293 and have identified three series of potential lead compounds, which we are currently optimizing.

Lead Neurology Program--LG617. Our physiological analysis of LG617 in knockout mice suggests that LG617 plays a role in learning, attention and memory. LG617 knockout mice exhibited an increased amount of learned responses when challenged with a conditioned stimulus and demonstrated a significant increase in olfactory discrimination and exploratory behavior, each of which are widely accepted tests of learning and memory. We have completed high-throughput screening against LG617 and have identified six series of hits, which we are currently analyzing.

We are working both independently and through strategic collaborations and alliances to commercialize our technology and turn our discoveries into drugs. We have established multiple collaborations with leading pharmaceutical and biotechnology companies, as well as research institutes and academic institutions. We are working with Genentech, Inc. to discover the functions of secreted proteins and potential antibody targets identified through Genentech's internal drug discovery research. We are working with Abgenix to discover and develop therapeutic antibodies for in vivo-validated drug targets identified in our own research. We are also working with Incyte Corporation to discover and develop therapeutic proteins. In addition, we have established collaborations and license agreements with many other leading pharmaceutical and biotechnology companies under which we receive fees and, in many cases, are eligible to receive milestone and royalty payments, in return for granting access to some of our technologies and discoveries for use in such companies' own drug discovery efforts.

We were incorporated in Delaware in July 1995, and we commenced operations in September 1995. Our principal executive offices are located at 8800 Technology Forest Place, The Woodlands, Texas 77381, and our telephone number is (281) 863-3000. Our corporate website is located at www.lexicon-genetics.com. The information found on our website is not incorporated by reference into this prospectus supplement or the accompanying prospectus, and you should not consider it to be a part of this document.

THE OFFERING

Common stock offered.....	10,000,000 shares
Common stock to be outstanding after this offering.....	62,537,748 shares
Use of proceeds.....	The net proceeds of this offering are estimated to be approximately $49.0 million. We currently intend to use the net proceeds for research and development. We may also use a portion of the net proceeds to acquire or invest in complementary products and technologies or for general corporate purposes. See "Use of Proceeds."
Nasdaq National Market symbol.....	LEXG

The foregoing information is based on 52,537,748 shares of our common stock outstanding as of July 23, 2003 and excludes:

- -- 12,840,699 shares of common stock issuable upon the exercise of outstanding options at a weighted average exercise price per share of $6.14;
- -- 16,483 shares of common stock issuable upon the exercise of outstanding warrants at a weighted average exercise price per share of $11.93; and
- -- 1,102,832 shares of common stock available for future grant or issuance under our stock option plans, which will automatically be increased annually in accordance with the provisions of our stock option plans, except as may be limited by our board of directors.

Except as otherwise indicated, all information in this prospectus supplement assumes no exercise of the underwriters' over-allotment option in this offering.

SUMMARY FINANCIAL DATA

The statement of operations data for the year ended December 31, 2002 has been derived from our financial statements that have been audited by Ernst & Young LLP, independent auditors. The statements of operations data for each of the four years in the period ended December 31, 2001 have been derived from our audited financial statements that have been audited by Arthur Andersen LLP, independent public accountants who have ceased operations. The statements of operations data for the three months ended March 31, 2002 and 2003, and the balance sheet data as of March 31, 2003, are unaudited but include, in the opinion of management, all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of such data. Our historical results for any prior or interim periods are not necessarily indicative of results to be expected for any future period.

The data presented below has been prepared in accordance with accounting principles generally accepted in the United States and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this prospectus supplement and with our financial statements and related notes incorporated by reference in this prospectus supplement and the accompanying prospectus.

	YEAR ENDED DECEMBER 31,				
	1998	1999	2000	2001	2002
	(IN THOUSANDS, EXCEPT PER SHARE DATA				
STATEMENTS OF OPERATIONS DATA:					
Revenues	$ 2,242	$ 4,738	$ 14,459	$ 30,577	$ 35,200
Operating expenses:					
Research and development(1)	8,410	14,646	31,647	53,355	74,859
General and administrative(2)	2,024	2,913	18,289	20,861	23,234
Total operating expenses	10,434	17,559	49,936	74,216	98,093

Loss from operations	(8,192)	(12,821)	(35,477)	(43,639)	(62,893)
Interest and other income, net	711	346	9,483	8,467	3,223
Net loss	(7,481)	(12,475)	(25,994)	(35,172)	(59,670)
Accretion on redeemable convertible preferred stock	(357)	(536)	(134)	--	--
Net loss attributable to common stockholders	$(7,838)	$(13,011)	$(26,128)	$(35,172)	$(59,670)
Net loss per common share, basic and diluted	$ (0.32)	$ (0.53)	$ (0.63)	$ (0.70)	$ (1.14)
Shares used in computing net loss per common share, basic and diluted	24,445	24,530	41,618	50,213	52,263

	AS OF MARCH 31, 2003	
	ACTUAL	AS ADJUSTED(4)
	(UNAUDITED) (IN THOUSANDS)	
BALANCE SHEET DATA:		
Cash, cash equivalents, restricted cash and investments(3)	$ 107,587	$ 156,537
Working capital(3)	99,197	148,147
Total assets	181,967	230,917
Long-term debt, net of current portion	4,000	4,000
Accumulated deficit	(166,890)	(166,890)
Stockholders' equity	155,321	204,271

---

(1) Includes stock-based compensation of $10,883 in 2000, $5,539 in 2001, $5,155 in 2002, $1,307 for the three months ended March 31, 2002 and $1,270 for the three months ended March 31, 2003.

(2) Includes stock-based compensation of $9,958 in 2000, $5,231 in 2001, $5,113 in 2002, $1,282 for the three months ended March 31, 2002 and $1,276 for the three months ended March 31, 2003.

(3) Includes restricted cash and investments of $57,710 as of March 31, 2003.

(4) Reflects the net proceeds from the sale of 10,000,000 shares of common stock in this offering at the public offering price of $5.25 per share after deducting underwriting discounts and commissions and estimated offering expenses.

RISK FACTORS

An investment in our common stock involves risks. You should carefully consider the following risk factors, together with all of the other information included in, or incorporated by reference into, this prospectus supplement and

the accompanying prospectus in evaluating an investment in our common stock. If any of the following risks were to occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock could decline and you could lose all or part of your investment.

RISKS RELATED TO OUR COMPANY AND BUSINESS

WE HAVE A HISTORY OF NET LOSSES, AND WE EXPECT TO CONTINUE TO INCUR NET LOSSES AND MAY NOT ACHIEVE OR MAINTAIN PROFITABILITY.

We have incurred net losses since our inception, including net losses of $59.7 million for the year ended December 31, 2002 and $17.1 million for the three months ended March 31, 2003. As of March 31, 2003, we had an accumulated deficit of $166.9 million. We are unsure when we will become profitable, if ever. The size of our net losses will depend, in part, on the rate of growth, if any, in our revenues and on the level of our expenses.

We derive substantially all of our revenues from subscriptions to our LexVision database and our OmniBank library, drug discovery alliances, target validation collaborations for the development and, in some cases, analysis of the physiological effects of genes altered in knockout mice and technology licenses, and will continue to do so for the foreseeable future. Our future revenues from database subscriptions, alliances and collaborations are uncertain because our existing agreements have fixed terms or relate to specific projects of limited duration. Our future revenues from technology licenses are uncertain because they depend, in part, on securing new agreements. Our ability to secure future revenue-generating agreements will depend upon our ability to address the needs of our potential future subscribers, collaborators and licensees, and to negotiate agreements that we believe are in our long-term best interests. We may determine that our interests are better served by retaining rights to our discoveries and advancing our therapeutic programs to a later stage, which could limit our near-term revenues. Given the early-stage nature of our operations, we do not currently derive any revenues from sales of pharmaceuticals.

A large portion of our expenses is fixed, including expenses related to facilities, equipment and personnel. In addition, we expect to spend significant amounts to fund research and development and to enhance our core technologies. As a result, we expect that our operating expenses will continue to increase significantly in the near term and, consequently, we will need to generate significant additional revenues to achieve profitability. Even if we do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis.

WE WILL NEED ADDITIONAL CAPITAL IN THE FUTURE AND, IF IT IS NOT AVAILABLE, WE WILL HAVE TO CURTAIL OR CEASE OPERATIONS.

Our future capital requirements will be substantial and will depend on many factors, including:

- our ability to obtain alliance, database subscription, collaboration and technology license agreements;
- the amount and timing of payments under such agreements;
- the level and timing of our research and development expenditures;
- market acceptance of products that we successfully develop and commercially launch; and
- the resources we devote to developing and supporting such products.

Our capital requirements will increase substantially to the extent we advance potential therapeutics into preclinical and clinical development. Our capital requirements will also be affected by any expenditures we make in connection with license agreements and acquisitions of and investments in complementary products and technologies.

We anticipate that the net proceeds of this offering, our existing capital resources and the revenues we expect to derive from drug discovery alliances, subscriptions to our databases, target validation collaborations and technology licenses will enable us to fund our currently planned operations for approximately the next 24 months. However, we may generate less revenues than we expect, and changes may occur that would consume available capital resources more rapidly than we expect. If our capital resources are insufficient to meet future capital requirements, we will have to raise additional funds to continue the development of our technologies and complete the commercialization of products, if any, resulting from our technologies. Any sale of additional equity securities may result in additional dilution to our stockholders, and we cannot be certain that additional financing, whether debt or equity, will be available in amounts or on terms acceptable to us, if at all. In addition, any of such additional equity securities may be senior to our common stock. We may be unable to raise sufficient additional capital; if so, we will have to curtail or cease operations.

WE ARE AN EARLY-STAGE COMPANY, AND WE HAVE NOT SUCCESSFULLY DEVELOPED OR COMMERCIALIZED ANY THERAPEUTICS OR DRUG TARGETS THAT WE HAVE IDENTIFIED.

Our business strategy of using our technology platform and, specifically, the discovery of the functions of genes using knockout mice to select promising drug targets and developing and commercializing drugs based on our discoveries, in significant part through collaborations and alliances, is unproven. Our success will depend upon our ability to successfully develop potential therapeutics for drug targets we consider to have pharmaceutical value, whether on our own or through collaborations, and to select an appropriate commercialization strategy for each potential therapeutic we choose to pursue.

Biotechnology and pharmaceutical companies have successfully developed and commercialized only a limited number of genomics-derived pharmaceutical products to date. We have not proven our ability to develop or commercialize therapeutics or drug targets that we identify, nor have we advanced any drug candidates to preclinical or clinical trials. We do not know that any pharmaceutical products based on our drug target discoveries can be successfully commercialized. In addition, we may experience unforeseen technical complications in the processes we use to generate gene knockout mice, conduct in vivo analyses, generate compound libraries, develop screening assays for drug targets or conduct screening of compounds against those drug targets. These complications could materially delay or limit the use of those resources, substantially increase the anticipated cost of generating them or prevent us from implementing our processes at appropriate quality and throughput levels. Finally, the information that we learn from knockout mice may prove not to be useful in identifying pharmaceutically-important drug targets or safe and effective therapies.

WE FACE SUBSTANTIAL COMPETITION IN THE DISCOVERY OF THE DNA SEQUENCES OF GENES AND THEIR FUNCTIONS AND IN OUR DRUG DISCOVERY AND PRODUCT DEVELOPMENT EFFORTS.

There are a finite number of genes in the human genome, and we believe that the majority of such genes have been identified and that virtually all will be identified within the next few years. We face substantial competition in our efforts to discover and patent the sequence and other information derived from such genes from entities using alternative, and in some cases higher volume and larger scale, approaches for the same purpose.

We also face competition from other companies in our efforts to discover the functions of genes. A large number of universities and other not-for-profit institutions, many of which are funded by the United States and foreign governments, are also conducting research to discover the functions of genes. Competitors could discover and establish patents on genes or gene products that we identify as promising drug targets, which might hinder or prevent our ability to capitalize on such targets.

We may not be able to use our patent rights to prevent competition in the creation and use of knockout mice to discover the function of genes. Patent litigation is very expensive and time-consuming, and, therefore, it may not be cost-effective or otherwise expedient to pursue litigation if another entity infringes our patent rights relating to the creation and use of knockout mice. Our patent rights generally do not extend outside of the United States. We therefore are generally unable to prevent entities outside of the United States from using our knockout mouse technology or, in certain circumstances, from importing into the United States

products developed using this technology. Furthermore, other methods for conducting target validation research may ultimately prove superior, in some or all respects, to the use of knockout mice. In addition, technologies more advanced than or superior to our gene targeting and gene trapping technologies may be developed, thereby rendering those technologies obsolete.

We face significant competition from other companies, as well as from universities and other not-for-profit institutions, in our drug discovery and product development efforts. Many of our competitors have substantially greater financial, scientific and human resources than we do. As a result, our competitors may succeed in developing products earlier than we do, obtaining regulatory approvals faster than we do and developing products that are more effective or safer than any that we may develop.

WE RELY HEAVILY ON OUR COLLABORATORS TO DEVELOP AND COMMERCIALIZE PHARMACEUTICAL PRODUCTS BASED ON GENES THAT WE IDENTIFY AS PROMISING CANDIDATES FOR DEVELOPMENT AS DRUG TARGETS.

Since we do not currently possess the resources necessary to develop, obtain approvals for or commercialize potential pharmaceutical products based on all of the genes that we identify as promising candidates for development as drug targets or therapeutic proteins, we must enter into collaborative arrangements to develop and commercialize some of these products. We have limited or no control over the resources that any collaborator may devote to this effort. Any of our present or future collaborators may not perform their obligations as expected. These collaborators may breach or terminate their agreements with us or otherwise fail to conduct product discovery, development or commercialization activities successfully or in a timely manner. Further, our collaborators may elect not to develop pharmaceutical products arising out of our collaborative arrangements or may not devote sufficient resources to the development, approval, manufacture, marketing or sale of these products. If any of these events occurs, we may not be able to develop or commercialize potential pharmaceutical products.

Some of our existing collaboration agreements contain, and collaborations that we enter into in the future may contain, exclusivity agreements by us or other limitations on our activities. These agreements may have the effect of limiting our flexibility and may cause us to forego attractive business opportunities.

WE RELY ON SEVERAL KEY COLLABORATORS FOR A SIGNIFICANT PORTION OF OUR REVENUES.

Most of our revenues in 2002 and the first quarter of 2003 were derived from a limited number of collaborators. For the fiscal year ended December 31, 2002, Incyte accounted for approximately 28% of our revenues, Bristol-Myers Squibb Company accounted for approximately 14% of our revenues and Millennium Pharmaceuticals, Inc. accounted for approximately 11% of our revenues. For the three months ended March 31, 2003, Incyte accounted for approximately 31% of our revenues, Bristol-Myers Squibb accounted for approximately 16% of our revenues and Genentech accounted for approximately 9% of our revenues. In general, we cannot predict with certainty which, if any, of our major collaborators will continue to generate revenues for us. The loss of any of these large collaborators would likely significantly decrease our revenues and future prospects, which could materially and adversely affect our business, financial condition and results of operations.

CANCELLATIONS BY OR CONFLICTS WITH OUR COLLABORATORS COULD HARM OUR BUSINESS.

Our alliance and collaboration agreements may not be renewed and may be terminated in the event either party fails to fulfill its obligations under these agreements. Failures to renew or cancellations by collaborators could mean a significant loss of revenues and could adversely affect our reputation in the business and scientific communities.

In addition, we may pursue opportunities in fields that could conflict with those of our collaborators. Moreover, disagreements could arise with our collaborators over rights to our intellectual property or our rights to share in any of the future revenues of compounds or therapeutic approaches developed by our collaborators. These kinds of disagreements could result in costly and time-consuming litigation. Conflicts with our collaborators could reduce our ability to obtain future collaboration agreements and could have a negative impact on our relationship with existing collaborators, adversely affecting our business and revenues. Some of

our collaborators are also potential competitors or may become competitors in the future. Our collaborators could develop competing products, preclude us from entering into collaborations with their competitors or terminate their agreements with us prematurely. Any of these events could harm our product development efforts.

WE HAVE NO EXPERIENCE IN DEVELOPING AND COMMERCIALIZING PHARMACEUTICAL PRODUCTS ON OUR OWN.

Our ability to develop and commercialize pharmaceutical products on our own will depend on our ability to internally develop preclinical, clinical, regulatory and sales and marketing capabilities, or enter into arrangements with third parties to provide these functions. It will be expensive and will require significant time for us to develop these capabilities internally. We may not be successful in developing these capabilities or entering into agreements with third parties on favorable terms, or at all. Further, our reliance upon third parties for these capabilities could reduce our control over such activities and could make us dependent upon these parties. Our inability to develop or contract for these capabilities would significantly impair our ability to develop and commercialize pharmaceutical products.

WE LACK THE CAPABILITY TO MANUFACTURE COMPOUNDS FOR PRECLINICAL STUDIES, CLINICAL TRIALS OR COMMERCIAL SALES AND WILL RELY ON THIRD PARTIES TO MANUFACTURE OUR POTENTIAL PRODUCTS.

We currently do not have the manufacturing capabilities or experience

necessary to produce materials for preclinical studies, clinical trials or commercial sales and intend to rely on collaborators and third-party contractors to produce such materials. We will rely on selected manufacturers to deliver materials on a timely basis and to comply with applicable regulatory requirements, including the current Good Manufacturing Practices of the United States Food and Drug Administration, or FDA, which relate to manufacturing and quality control activities. These manufacturers may not be able to produce material on a timely basis or manufacture material at the quality level or in the quantity required to meet our development timelines and applicable regulatory requirements. In addition, there are a limited number of manufacturers that operate under the FDA's current Good Manufacturing Practices and that are capable of producing such materials, and we may experience difficulty finding manufacturers with adequate capacity for our needs. If we are unable to contract for the production of sufficient quantity and quality of materials on acceptable terms, our product development and commercialization efforts may be delayed. Moreover, noncompliance with the FDA's current Good Manufacturing Practices can result in, among other things, fines, injunctions, civil and criminal penalties, product recalls or seizures, suspension of production, failure to obtain marketing approval and withdrawal, suspension or revocation of marketing approvals.

WE MAY ENGAGE IN FUTURE ACQUISITIONS, WHICH MAY BE EXPENSIVE AND TIME CONSUMING AND FROM WHICH WE MAY NOT REALIZE ANTICIPATED BENEFITS.

We may acquire additional businesses, technologies and products if we determine that these businesses, technologies and products complement our existing technology or otherwise serve our strategic goals. We currently have no commitments or agreements with respect to any acquisitions. If we do undertake any transactions of this sort, the process of integrating an acquired business, technology or product may result in operating difficulties and expenditures and may absorb significant management attention that would otherwise be available for ongoing development of our business. Moreover, we may never realize the anticipated benefits of any acquisition. Future acquisitions could result in potentially dilutive issuances of our equity securities, the incurrence of debt and contingent liabilities and amortization expenses related to intangible assets, which could adversely affect our results of operations and financial condition.

IF WE LOSE OUR KEY PERSONNEL OR ARE UNABLE TO ATTRACT AND RETAIN ADDITIONAL PERSONNEL, WE MAY BE UNABLE TO PURSUE COLLABORATIONS OR DEVELOP OUR OWN PRODUCTS.

We are highly dependent on Arthur T. Sands, M.D., Ph.D., our president and chief executive officer, as well as other principal members of our management and scientific staff. The loss of any of these personnel could have a material adverse effect on our business, financial condition or results of operations and could inhibit our product development and commercialization efforts. Although we have entered into employment

agreements with some of our key personnel, including Dr. Sands, these employment agreements are all at-will. In addition, not all key personnel have employment agreements.

Recruiting and retaining qualified scientific personnel to perform future research and development work will be critical to our success. Competition for experienced scientists is intense. Failure to recruit and retain scientific personnel on acceptable terms could prevent us from achieving our business objectives.

BECAUSE ALL OF OUR TARGET VALIDATION OPERATIONS ARE LOCATED AT A SINGLE

FACILITY, THE OCCURRENCE OF A DISASTER COULD SIGNIFICANTLY DISRUPT OUR BUSINESS.

Our OmniBank mouse clone library and its backup are stored in liquid nitrogen freezers located at our facility in The Woodlands, Texas, and our knockout mouse research operations are carried out entirely at the same facility. While we have developed redundant and emergency backup systems to protect these resources and the facilities in which they are stored, they may be insufficient in the event of a severe fire, flood, hurricane, tornado, mechanical failure or similar disaster. If such a disaster significantly damages or destroys the facility in which these resources are maintained, our business could be disrupted until we could regenerate the affected resources and, as a result, our stock price could decline. Our business interruption insurance may not be sufficient to compensate us in the event of a major interruption due to such a disaster.

OUR QUARTERLY OPERATING RESULTS HAVE BEEN AND LIKELY WILL CONTINUE TO FLUCTUATE, AND WE BELIEVE THAT QUARTER-TO-QUARTER COMPARISONS OF OUR OPERATING RESULTS ARE NOT A GOOD INDICATION OF OUR FUTURE PERFORMANCE.

Our operating results and, in particular, our ability to generate additional revenues are dependent on many factors, including:

- -- our ability to establish new database subscriptions, research collaborations and technology licenses, and the timing of such arrangements;
- -- the expiration or other termination of database subscriptions and research collaborations with our collaborators, which may not be renewed or replaced;
- -- the success rate of our discovery efforts leading to opportunities for new research collaborations and licenses, as well as milestone payments and royalties;
- -- the timing and willingness of our collaborators to commercialize pharmaceutical products that would result in milestone payments and royalties; and
- -- general and industry-specific economic conditions, which may affect our and our collaborators' research and development expenditures.

Because of these and other factors, including the risks and uncertainties described in this section, our quarterly operating results have fluctuated in the past and are likely to do so in the future. Due to the likelihood of fluctuations in our revenues and expenses, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance.

RISKS RELATED TO OUR INDUSTRY

OUR ABILITY TO PATENT OUR INVENTIONS IS UNCERTAIN BECAUSE PATENT LAWS AND THEIR INTERPRETATION ARE HIGHLY UNCERTAIN AND SUBJECT TO CHANGE.

The patent positions of biotechnology firms generally are highly uncertain and involve complex legal and factual questions that will determine who has the right to develop or use a particular technology or product. No clear policy has emerged regarding the scope of protection provided in biotechnology patents. The biotechnology patent situation outside the United States is similarly uncertain. Changes in, or different interpretations of, patent laws in the United States or other countries might allow others to use our inventions or to develop and commercialize any technologies or products that we may develop without any

compensation to us. We anticipate that these uncertainties will continue for a significant period of time.

OUR PATENT APPLICATIONS MAY NOT RESULT IN PATENT RIGHTS.

Our disclosures in our patent applications may not be sufficient to meet the statutory requirements for patentability. Our ability to obtain patent protection based on genes or gene sequences will depend, in part, upon identification of a use for the gene or gene sequences sufficient to meet the statutory requirements that an invention have utility and that a patent application enable one to make and use the invention. While the United States Patent and Trademark Office has issued guidelines for the examination of patent applications claiming gene sequences, their therapeutic uses and novel proteins encoded by such genes, the impact of these guidelines is uncertain and may delay or negatively affect our patent position. Furthermore, biologic data in addition to that obtained by our current technologies may be required for issuance of patents covering any potential human therapeutic products that we may develop. If required, obtaining such biologic data could delay, add substantial costs to, or affect our ability to obtain patent protection for such products. There can be no assurance that the disclosures in our current or future patent applications, including those we may file with our collaborators, will be sufficient to meet these requirements. Even if patents are issued, there may be current or future uncertainty as to the scope of the coverage or protection provided by any such patents.

Some court decisions indicate that disclosure of a partial sequence may not be sufficient to support the patentability of a full-length sequence. These decisions have been confirmed by recent pronouncements of the United States Patent and Trademark Office. We believe that these court decisions and the uncertain position of the United States Patent and Trademark Office present a significant risk that the United States Patent and Trademark Office will not issue patents based on patent disclosures limited to partial gene sequences. In addition, we are uncertain about the scope of the coverage, enforceability and commercial protection provided by any patents issued primarily on the basis of gene sequence information.

IF OTHER COMPANIES AND INSTITUTIONS OBTAIN PATENTS RELATING TO OUR DRUG TARGET OR PRODUCT CANDIDATE DISCOVERIES, WE MAY BE UNABLE TO OBTAIN PATENTS FOR OUR INVENTIONS BASED UPON THOSE DISCOVERIES AND MAY BE BLOCKED FROM USING OR DEVELOPING SOME OF OUR TECHNOLOGIES AND PRODUCTS.

Many other entities have filed or may file patent applications on genes or gene sequences, uses of those genes or genes sequences, gene products and drug targets, assays for identifying potential therapeutic products, potential therapeutic products and methods of treatment which are identical or similar to some of our filings. Some of these applications attempt to assign biologic function to the genes and proteins based on predictions of function based upon similarity to other genes and proteins or patterns of gene expression. There is the significant possibility that patents claiming the functional uses of such genes and gene products will be issued to our competitors based on such information. If any such patents are issued to other entities, we will be unable to obtain patent protection for the same or similar discoveries that we make. Moreover, we may be blocked from using or developing some of our existing or proposed technologies and products, or may be required to obtain a license that may not be available on reasonable terms, if at all.

Alternatively, the United States Patent and Trademark Office could decide competing patent claims in an interference proceeding. Any such proceeding would be costly, and we may not prevail. In this event, the prevailing party may

require us or our collaborators to stop using a particular technology or pursuing a potential product or may require us to negotiate a license arrangement to do so. We may not be able to obtain a license from the prevailing party on acceptable terms, or at all.

The Human Genome Project, as well as many companies and institutions, have identified genes and deposited partial gene sequences in public databases and are continuing to do so. The entire human genome and the entire mouse genome are now publicly known. These public disclosures might limit the scope of our claims or make unpatentable subsequent patent applications on partial or full-length genes or their uses.

ISSUED OR PENDING PATENTS MAY NOT FULLY PROTECT OUR DISCOVERIES, AND OUR COMPETITORS MAY BE ABLE TO COMMERCIALIZE TECHNOLOGIES OR PRODUCTS SIMILAR TO THOSE COVERED BY OUR ISSUED OR PENDING PATENTS.

Pending patent applications do not provide protection against competitors because they are not enforceable until they issue as patents. Issued patents may not provide commercially meaningful protection. If anyone infringes upon our or our collaborators' patent rights, enforcing these rights may be difficult, costly and

time-consuming. Others may be able to design around these patents or develop unique products providing effects similar to any products that we may develop. Other companies or institutions may challenge our or our collaborators' patents or independently develop similar products that could result in an interference proceeding in the United States Patent and Trademark Office or a legal action.

In addition, others may discover uses for genes, drug targets or therapeutic products other than those covered in our issued or pending patents, and these other uses may be separately patentable. Even if we have a patent claim on a particular gene, drug target or therapeutic product, the holder of a patent covering the use of that gene, drug target or therapeutic product could exclude us from selling a product that is based on the same use of that product.

WE MAY BE INVOLVED IN PATENT LITIGATION AND OTHER DISPUTES REGARDING INTELLECTUAL PROPERTY RIGHTS AND MAY REQUIRE LICENSES FROM THIRD PARTIES FOR OUR DISCOVERY AND DEVELOPMENT AND PLANNED COMMERCIALIZATION ACTIVITIES. WE MAY NOT PREVAIL IN ANY SUCH LITIGATION OR OTHER DISPUTE OR BE ABLE TO OBTAIN REQUIRED LICENSES.

Our discovery and development efforts as well as our potential products and those of our collaborators may give rise to claims that they infringe the patents of others. This risk will increase as the biotechnology industry expands and as other companies and institutions obtain more patents covering the sequences, functions and uses of genes and the drug targets they encode. We are aware that other companies and institutions have conducted research on many of the same targets that we have identified. These other companies and institutions have filed and may in the future file patent applications potentially covering many of the genes and encoded drug targets that are the focus of our drug discovery programs, including each of the targets of our most advanced drug discovery programs. In some cases, patents have issued from these applications. In addition, many companies and institutions have well-established patent portfolios directed to common techniques, methods and means of developing, producing and manufacturing pharmaceutical products. Other companies or institutions could bring legal actions against us or our collaborators for damages or to stop us or our collaborators from engaging in certain discovery or development activities or from manufacturing and marketing any resulting therapeutic products. If any of these actions are successful, in addition to our potential liability for damages, these entities would likely require us or our

collaborators to obtain a license in order to continue engaging in the infringing activities or to manufacture or market the resulting therapeutic products or may force us to terminate such activities or manufacturing and marketing efforts. We may also determine to seek licenses from these entities in order to avoid the cost and expense of litigation.

We may need to pursue litigation against others to enforce our patents and intellectual property rights and may be the subject of litigation brought by third parties to enforce their patent and intellectual property rights. In addition, we may become involved in litigation based on intellectual property indemnification undertakings that we have given to certain of our collaborators. Patent litigation is expensive and requires substantial amounts of management attention. The eventual outcome of any such litigation is uncertain and involves substantial risks. For example, each time we sue for patent infringement we face the risk that the patent will be held invalid or unenforceable. Such a determination is binding on us for all future litigation involving that patent.

We believe that there will continue to be significant litigation in our industry regarding patent and other intellectual property rights. We have expended and many of our competitors have expended and are continuing to expend significant amounts of time, money and management resources on intellectual property litigation. If we become involved in future intellectual property litigation, it could consume a substantial portion of our resources and could negatively affect our results of operations.

In 2000, we filed lawsuits against Deltagen, Inc. relating to infringement of a number of United States patents licensed to us. In September 2001, we and Deltagen settled the litigation. Under the terms of the settlement, Deltagen obtained a sublicense under the patents and we obtained a subscription to Deltagen's DeltaBase product, including perpetual licenses to approximately 1,250 drug targets in DeltaBase at the time or expected to be added to DeltaBase over the subsequent four years. In October 2002, we notified Deltagen of its failure to perform under our agreements related to the settlement, and in April 2003, we asserted certain

claims against Deltagen under those agreements. In accordance with the dispute resolution provisions of those agreements, arbitration proceedings have been initiated to resolve these matters.

In June 2003, Deltagen publicly asserted that we made our claims for competitive reasons in an attempt to interfere with Deltagen's financing efforts and with Deltagen's negotiations with current and prospective customers. Deltagen has also stated that it will hold us fully responsible for the damage allegedly done to Deltagen by our actions. On June 27, 2003, Deltagen filed for Chapter 11 bankruptcy protection, and the arbitration proceedings were automatically stayed. We believe that Deltagen's assertion regarding the reason for our claims and Deltagen's statements of purported illegal conduct on our part are without merit.

Furthermore, in light of recent United States Supreme Court precedent, our ability to enforce our patents against state agencies, including state sponsored universities and research laboratories, is limited by the Eleventh Amendment to the United States Constitution. In addition, opposition by academicians and the government may hamper our ability to enforce our patents against academic or government research laboratories. Finally, enforcement of our patents may cause our reputation in the academic community to be injured.

WE USE INTELLECTUAL PROPERTY THAT WE LICENSE FROM THIRD PARTIES. IF WE DO NOT COMPLY WITH THESE LICENSES, WE COULD LOSE OUR RIGHTS UNDER THEM.

We rely, in part, on licenses to use certain technologies that are important to our business. We do not own the patents that underlie these licenses. Our rights to use these technologies and practice the inventions claimed in the licensed patents are subject to our abiding by the terms of those licenses and the licensors not terminating them. In many cases, we do not control the filing, prosecution or maintenance of the patent rights to which we hold licenses and rely upon our licensors to prosecute infringement of those rights. The scope of our rights under our licenses may be subject to dispute by our licensors or third parties.

WE HAVE NOT SOUGHT PATENT PROTECTION OUTSIDE OF THE UNITED STATES FOR SOME OF OUR INVENTIONS, AND SOME OF OUR LICENSED PATENTS ONLY PROVIDE COVERAGE IN THE UNITED STATES.

We have decided not to pursue patent protection with respect to some of our inventions outside the United States, both because we do not believe it is cost-effective and because of confidentiality concerns. Accordingly, our international competitors could develop, and receive foreign patent protection for, genes or gene sequences, uses of those genes or gene sequences, gene products and drug targets, assays for identifying potential therapeutic products, potential therapeutic products and methods of treatment for which we are seeking United States patent protection. In addition, most of our gene trapping patents and our licensed gene targeting patents cover only the United States and do not apply to discovery activities conducted outside of the United States or, in some circumstances, to importing into the United States products developed using this technology.

WE MAY BE UNABLE TO PROTECT OUR TRADE SECRETS.

Significant aspects of our intellectual property are not protected by patents. As a result, we seek to protect the proprietary nature of this intellectual property as trade secrets through proprietary information agreements and other measures. While we have entered into proprietary information agreements with all of our employees, consultants, advisers and collaborators, we may not be able to prevent the disclosure of our trade secrets. In addition, other companies or institutions may independently develop substantially equivalent information and techniques.

OUR EFFORTS TO DISCOVER, EVALUATE AND VALIDATE POTENTIAL TARGETS FOR THERAPEUTIC INTERVENTION AND OUR DRUG DISCOVERY PROGRAMS ARE SUBJECT TO EVOLVING DATA AND OTHER RISKS INHERENT IN THE DRUG DISCOVERY PROCESS.

We are employing our knockout technology and integrated drug discovery platform to systematically discover, evaluate and validate potential targets for therapeutic intervention and to develop drugs to address those targets. The drug discovery and development process involves significant risks of delay or failure due, in

part, to evolving data and the uncertainties involved with the applications of new technologies. As we refine and advance our efforts, it is likely that the resulting data will cause us to change our targets from time to time and, therefore, that the targets that we believe at any time to be promising may prove not to be so. These developments can occur at any stage of the drug discovery and development process.

WE ARE SUBJECT TO EXTENSIVE AND UNCERTAIN GOVERNMENT REGULATORY REQUIREMENTS, WHICH COULD ADVERSELY AFFECT OUR ABILITY TO OBTAIN, IN A TIMELY MANNER OR AT ALL, GOVERNMENT APPROVAL OF PRODUCTS BASED ON GENES THAT WE IDENTIFY, OR TO COMMERCIALIZE SUCH PRODUCTS.

We must obtain approval from the FDA in order to conduct clinical trials and sell our future product candidates in the United States and from foreign regulatory authorities in order to conduct clinical trials and sell our future product candidates in other countries. In order to obtain regulatory approvals for the commercial sale of any products that we may develop, we will be required to complete extensive clinical trials in humans to demonstrate the safety and efficacy of our drug candidates. We may not be able to obtain authority from the FDA or other equivalent foreign regulatory agencies to initiate or complete any clinical trials. In addition, we have limited internal resources for making regulatory filings and dealing with regulatory authorities.

The results from preclinical testing of a drug candidate that is under development may not be predictive of results that will be obtained in human clinical trials. In addition, the results of early human clinical trials may not be predictive of results that will be obtained in larger scale, advanced stage clinical trials. A number of companies in the pharmaceutical industry have suffered significant setbacks in advanced clinical trials, even after achieving positive results in earlier trials. Negative or inconclusive results from a preclinical study or a clinical trial could cause us, one of our collaborators or the FDA to terminate a preclinical study or clinical trial or require that we repeat it. Furthermore, we, one of our collaborators or a regulatory agency with jurisdiction over the trials may suspend clinical trials at any time if the subjects or patients participating in such trials are being exposed to unacceptable health risks or for other reasons.

Any preclinical or clinical test may fail to produce results satisfactory to the FDA or foreign regulatory authorities. Preclinical and clinical data can be interpreted in different ways, which could delay, limit or prevent regulatory approval. The FDA or institutional review boards at the medical institutions and healthcare facilities where we sponsor clinical trials may suspend any trial indefinitely if they find deficiencies in the conduct of these trials. We must conduct clinical trials in accordance with the FDA's current Good Clinical Practices. The FDA and these institutional review boards have authority to oversee our clinical trials, and the FDA may require large numbers of test subjects. In addition, we must manufacture, or contract for the manufacture of, the product candidates that we use in our clinical trials under the FDA's current Good Manufacturing Practices.

The rate of completion of clinical trials is dependent, in part, upon the rate of enrollment of patients. Patient accrual is a function of many factors, including the size of the patient population, the proximity of patients to clinical sites, the eligibility criteria for the study, the nature of the study, the existence of competitive clinical trials and the availability of alternative treatments. Delays in planned patient enrollment may result in increased costs and prolonged clinical development, which in turn could allow our competitors to bring products to market before we do and impair our ability to commercialize our products or potential products.

We may not be able to successfully complete any clinical trial of a potential product that we may initiate within any specified time period. In some cases, we may not be able to complete the trial at all. Moreover, clinical trials may not show our potential products to be both safe and effective. Thus, the FDA and other regulatory authorities may not approve any products that we develop for any indication or may limit the approved indications or impose other conditions.

IF WE OBTAIN REGULATORY APPROVAL FOR OUR POTENTIAL PRODUCTS, WE WILL REMAIN SUBJECT TO EXTENSIVE AND RIGOROUS ONGOING REGULATION.

If we obtain initial regulatory approvals from the FDA or foreign regulatory authorities for any products that we may develop, we will be subject to extensive and rigorous ongoing domestic and foreign government regulation of, among other things, the research, development, testing, manufacture, labeling, promotion, advertising, distribution and marketing of our products and product candidates. Our failure to comply with these requirements or the identification of safety problems during commercial marketing could lead to the need for product marketing restrictions, product withdrawal or recall or other voluntary or regulatory action, which could delay further marketing until the product is brought into compliance. Our failure to comply with these requirements may also subject us to stringent penalties.

Moreover, several of our product development areas involve relatively new technology and have not been the subject of extensive product testing in humans. The regulatory requirements governing these products and related clinical procedures remain uncertain and the products themselves may be subject to substantial review by foreign governmental regulatory authorities that could prevent or delay approval in those countries. Regulatory requirements ultimately imposed on any products that we may develop could limit our ability to test, manufacture and, ultimately, commercialize such products.

THE UNCERTAINTY OF PHARMACEUTICAL PRICING AND REIMBURSEMENT MAY DECREASE THE COMMERCIAL POTENTIAL OF ANY PRODUCTS THAT WE OR OUR COLLABORATORS MAY DEVELOP AND AFFECT OUR ABILITY TO RAISE CAPITAL.

Our ability and the ability of our collaborators to successfully commercialize pharmaceutical products will depend, in part, on the extent to which reimbursement for the cost of such products and related treatment will be available from government health administration authorities, private health coverage insurers and other organizations. The pricing, availability of distribution channels and reimbursement status of newly approved pharmaceutical products is highly uncertain. As a result, adequate third-party coverage may not be available for us to maintain price levels sufficient for realization of an appropriate return on our investment in product discovery and development.

In certain foreign markets, pricing or profitability of healthcare products is subject to government control. In the United States, there have been, and we expect that there will continue to be, a number of federal and state proposals to implement similar governmental control. In addition, an increasing emphasis on managed care in the United States has increased and will continue to increase the pressure on pharmaceutical pricing. While we cannot predict the adoption of any such legislative or regulatory proposals or the effect such proposals or managed care efforts may have on our business, the announcement of such proposals or efforts could harm our ability to raise capital, and the adoption of such proposals or efforts could harm our results of operations. Further, to the extent that such proposals or efforts harm other pharmaceutical companies that are our prospective collaborators, our ability to establish corporate collaborations would be impaired. In addition, third-party payers are increasingly challenging the prices charged for medical products and services. We do not know whether consumers, third-party payers and others will consider any products that we or our collaborators develop to be cost-effective or that reimbursement to the consumer will be available or will be sufficient to allow us or our collaborators to sell such products on a profitable basis.

WE USE HAZARDOUS CHEMICALS AND RADIOACTIVE AND BIOLOGICAL MATERIALS IN OUR BUSINESS; ANY DISPUTES RELATING TO IMPROPER HANDLING, STORAGE OR DISPOSAL OF THESE MATERIALS COULD BE TIME CONSUMING AND COSTLY.

Our research and development processes involve the use of hazardous materials, including chemicals and radioactive and biological materials. Our operations also produce hazardous waste products. We cannot eliminate the risk

of accidental contamination or discharge or any resultant injury from these materials. Federal, state and local laws and regulations govern the use, manufacture, storage, handling and disposal of these materials. We could be subject to civil damages in the event of an improper or unauthorized release of, or exposure of individuals to, these hazardous materials. In addition, claimants may sue us for injury or contamination that results from our use or the use by third parties of these materials, and our liability may

exceed our total assets. Compliance with environmental laws and regulations may be expensive, and current or future environmental regulations may impair our research, development or production efforts.

WE MAY BE SUED FOR PRODUCT LIABILITY.

We or our collaborators may be held liable if any product that we or our collaborators develop, or any product that is made with the use or incorporation of any of our technologies, causes injury or is found otherwise unsuitable during product testing, manufacturing, marketing or sale. Although we currently have and intend to maintain product liability insurance, this insurance may become prohibitively expensive or may not fully cover our potential liabilities. Our inability to obtain sufficient insurance coverage at an acceptable cost or otherwise to protect against potential product liability claims could prevent or inhibit the commercialization of products developed by us or our collaborators. If we are sued for any injury caused by our or our collaborators' products, our liability could exceed our total assets.

PUBLIC PERCEPTION OF ETHICAL AND SOCIAL ISSUES MAY LIMIT OR DISCOURAGE THE USE OF OUR TECHNOLOGIES, WHICH COULD REDUCE OUR REVENUES.

Our success will depend, in part, upon our ability to develop products discovered through our knockout mouse technologies. Governmental authorities could, for ethical, social or other purposes, limit the use of genetic processes or prohibit the practice of our knockout mouse technologies. Claims that genetically engineered products are unsafe for consumption or pose a danger to the environment may influence public perceptions. The subject of genetically modified organisms, like knockout mice, has received negative publicity and aroused public debate in some countries. Ethical and other concerns about our technologies, particularly the use of genes from nature for commercial purposes and the products resulting from this use, could adversely affect the market acceptance of our technologies.

RISKS RELATED TO THIS OFFERING

WE HAVE BROAD DISCRETION IN THE USE OF THE NET PROCEEDS FROM THIS OFFERING AND MAY NOT USE THEM EFFECTIVELY.

As of the date of this prospectus supplement, we cannot specify with certainty the particular uses for the net proceeds we will receive from this offering. Management will have broad discretion in the application of the net proceeds, including any of the purposes described in "Use of Proceeds." The failure by our management to apply these funds effectively could have a material adverse effect on our business.

OUR STOCK PRICE COULD BE EXTREMELY VOLATILE, AND YOU MAY NOT BE ABLE TO RESELL YOUR SHARES AT OR ABOVE THE PUBLIC OFFERING PRICE.

The stock market has experienced significant price and volume fluctuations, and the market prices of technology companies, particularly life science companies such as ours, have been highly volatile. Since January 1, 2001, the

market price of our common stock has ranged from a high of $17.25 on January 2, 2001 to a low of $2.97 on October 7, 2002. In addition, broad market and industry fluctuations that are not within our control may adversely affect the trading price of our common stock. As a result, you may not be able to resell your shares at or above the public offering price.

CONCENTRATION OF OWNERSHIP AMONG OUR DIRECTORS AND EXECUTIVE OFFICERS ENABLES THEM TO SIGNIFICANTLY INFLUENCE IMPORTANT CORPORATE DECISIONS.

Following this offering, our directors and executive officers will beneficially own, or have voting rights with respect to, approximately 24.7% of our outstanding common stock. These stockholders as a group will be able to exert significant influence on the election of our directors and officers, the management and affairs of our company and the outcome of most matters requiring the approval of our stockholders, including any merger, consolidation or sale of all or substantially all of our assets and any other significant corporate transaction. This concentration of ownership may also prevent a change of control of our company at a

premium price if these stockholders oppose it. Please read "Principal Stockholders" for details on our stock ownership.

PROVISIONS CONTAINED IN OUR CHARTER DOCUMENTS AND DELAWARE LAW MAY INHIBIT A TAKEOVER ATTEMPT, WHICH COULD REDUCE OR ELIMINATE THE LIKELIHOOD OF A CHANGE OF CONTROL TRANSACTION AND, THEREFORE, THE ABILITY OF OUR STOCKHOLDERS TO SELL THEIR SHARES FOR A PREMIUM.

Provisions in our corporate charter and bylaws and applicable provisions of the Delaware General Corporation Law may make it more difficult for a third party to acquire control of us without the approval of our board of directors. These provisions include:

- a classified board of directors;
- limitations on the removal of directors;
- limitations on stockholder proposals at meetings of stockholders;
- the inability of stockholders to act by written consent or to call special meetings; and
- the ability of our board of directors to designate the terms of and issue new series of preferred stock without stockholder approval.

These provisions may discourage transactions that otherwise could involve the payment of a premium over prevailing market prices of our common stock.

THE AVAILABILITY OF SHARES OF OUR COMMON STOCK FOR FUTURE SALE COULD DEPRESS OUR STOCK PRICE.

Upon completion of this offering, we will have outstanding an aggregate of 62,537,748 shares of common stock, assuming no exercise of outstanding options or warrants. Of these shares, 47,474,357 shares are freely tradable. The holders of the remaining 15,063,391 shares have demand and piggyback registration rights with respect to such shares. We have received a request for the registration of an aggregate of 5,000,000 shares, which we will include in a registration statement to be filed after the expiration of the 90-day lock-up period described below.

Sales of a substantial number of shares of our common stock in the public markets following this offering, or the perception that such sales might occur, could have a material adverse effect on the price of our common stock or could impair our future ability to obtain capital through offerings of our equity securities.

Our executive officers, directors and certain of our stockholders have agreed pursuant to "lock-up" agreements that, for a period of 90 days from the date of this prospectus supplement, they will not sell any shares of common stock without the prior written consent of Morgan Stanley & Co. Incorporated. See "Underwriting."

OUR FORMER INDEPENDENT PUBLIC ACCOUNTANT, ARTHUR ANDERSEN LLP, HAS BEEN FOUND GUILTY OF A FEDERAL OBSTRUCTION OF JUSTICE CHARGE, AND YOU MAY BE UNABLE TO EXERCISE EFFECTIVE REMEDIES AGAINST IT IN ANY LEGAL ACTION.

Our former independent public accountant, Arthur Andersen LLP, provided us with auditing services for prior fiscal periods through December 31, 2001, including issuing an audit report with respect to our audited consolidated financial statements as of and for the years ended December 31, 2000 and 2001 included in our Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated by reference in this prospectus supplement and the accompanying prospectus. On June 15, 2002, a jury in Houston, Texas found Arthur Andersen LLP guilty of a federal obstruction of justice charge arising from the federal government's investigation of Enron Corp. On August 31, 2002, Arthur Andersen LLP ceased practicing before the Securities and Exchange Commission, or the SEC.

We were unable to obtain Arthur Andersen LLP's consent to include its report with respect to our audited consolidated financial statements as of and for the years ended December 31, 2000 and 2001 in our Annual Report on Form 10-K for the year ended December 31, 2002 or to incorporate by reference such report in this prospectus supplement and the accompanying prospectus. Rule 437a under the Securities Act of

1933, or the Securities Act, permits us to dispense with the requirement to file their consent. As a result, you may not have an effective remedy against Arthur Andersen LLP in connection with a material misstatement or omission with respect to our audited consolidated financial statements that are incorporated by reference in this prospectus supplement or any other filing we may make with the SEC, including, with respect to this offering or any other offering registered under the Securities Act, any claim under Section 11 of the Securities Act. In addition, even if you were able to assert such a claim, as a result of its conviction and other lawsuits, Arthur Andersen LLP may fail or otherwise have insufficient assets to satisfy claims made by investors or by us that might arise under federal securities laws or otherwise relating to any alleged material misstatement or omission with respect to our audited consolidated financial statements.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus supplement, the accompanying prospectus and the documents incorporated by reference into this prospectus supplement and the accompanying prospectus contain certain information regarding our financial projections, plans and strategies that are forward-looking statements within the meaning of Section 27A of the Securities Act and 21E of the Securities Exchange Act of 1934. We have attempted to identify forward-looking statements by terminology including "anticipate," "believe," "can," "continue," "could," "estimate,"

"expect," "intend," "may," "plan," "potential," "predict," "should" or "will" or the negative of these terms or other comparable terminology. These statements, which are only predictions and involve known and unknown risks, uncertainties and other important factors may include, among other things, statements which address our strategy and operating performance, events or developments that we expect or anticipate will occur in the future, such as projections of our future results of operations or of our financial condition, the status of any collaborative agreements, our research and development efforts and anticipated trends in our business. Discussions containing forward-looking statements may be found, among other places, in "Business" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this prospectus supplement.

We have based these forward-looking statements on our current expectations and projections about future events. However, there may be events in the future that we are not able to predict accurately or which we do not fully control that could cause actual results to differ materially from those expressed or implied in our forward-looking statements. Many important factors could cause actual results to differ materially from those expressed or implied by these forward-looking statements, including those discussed under "Risk Factors" in this prospectus supplement and other sections of the documents incorporated by reference into this prospectus supplement and the accompanying prospectus. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this prospectus supplement.

USE OF PROCEEDS

We estimate that the net proceeds from the sale of the 10,000,000 shares of common stock that we are offering will be approximately $49.0 million, based on the public offering price of $5.25 per share, after deducting underwriting discounts and commissions and estimated offering expenses. If the underwriters exercise their option to purchase 1,500,000 additional shares in this offering, we estimate the aggregate net proceeds to us will be approximately $56.4 million. We currently intend to use the net proceeds from this offering for research and development, particularly to continue to discover what we believe to be pharmaceutically attractive drug targets, to screen compounds against these targets to identify potential therapeutic products and to advance the most promising of these potential products into preclinical testing and clinical trials. We may also use a portion of the net proceeds to acquire or invest in complementary products and technologies or for general corporate purposes. We have no current plans or commitments as to any such acquisition or investment.

The amounts that we actually expend for research and development, acquisitions, investments or general corporate purposes will vary significantly depending on a number of factors, including our future revenues, the amount of cash we generate from operations and the progress of our product development efforts. Accordingly, our management will retain broad discretion in the allocation of the net proceeds from this offering.

Pending such uses, we intend to invest the net proceeds from this offering in interest-bearing, investment-grade securities.

PRICE RANGE OF COMMON STOCK

Our common stock is quoted on the Nasdaq National Market under the symbol "LEXG." The following table sets forth, for the periods indicated, the range of the high and low sales prices per share for our common stock as reported on the Nasdaq National Market.

	HIGH	LOW
YEAR ENDED DECEMBER 31, 2001		
First Quarter	$17.25	$5.63
Second Quarter	13.25	5.41
Third Quarter	12.80	5.45
Fourth Quarter	12.14	6.96
YEAR ENDED DECEMBER 31, 2002		
First Quarter	13.00	7.94
Second Quarter	9.10	4.12
Third Quarter	6.44	3.45
Fourth Quarter	5.30	2.97
YEAR ENDED DECEMBER 31, 2003		
First Quarter	5.29	3.00
Second Quarter	7.00	3.98
Third Quarter (through July 23)	7.45	5.38

As of June 30, 2003, there were approximately 253 holders of record of our common stock. On July 23, 2003, the reported last sale price of our common stock on the Nasdaq National Market was $5.50 per share.

DIVIDEND POLICY

We have never paid cash dividends on our common stock. We anticipate that we will retain all of our future earnings, if any, for use in the expansion and operation of our business and do not anticipate paying cash dividends in the foreseeable future. In addition, our synthetic lease agreement contains restrictions that may limit our ability to pay dividends.

CAPITALIZATION

The following table presents our unaudited capitalization and other data as of March 31, 2003 on an actual basis and as adjusted to give effect to the sale by us of 10,000,000 shares of common stock in this offering at the public offering price of $5.25 per share, after deducting underwriting discounts and commissions and estimated offering expenses. You should read the following table in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this prospectus supplement and the consolidated financial statements and the related notes incorporated by reference into this prospectus supplement and the accompanying prospectus.

	AS OF MARCH 31, 2003	
	ACTUAL	AS ADJUSTED
	(IN THOUSANDS, EXCEPT SHARE DATA)	
Cash, cash equivalents, restricted cash and investments	$ 107,587	$ 156,537
Long-term debt, net of current portion	$ 4,000	$ 4,000

Stockholders' equity:		
Preferred stock, $0.01 par value; 5,000,000 shares authorized, no shares issued and outstanding.....	--	--
Common stock, $0.001 par value; 120,000,000 shares authorized, 52,374,095 shares issued and outstanding, actual; 62,374,095 shares issued and outstanding, as adjusted.....	52	62
Additional paid-in capital.....	330,666	379,606
Deferred stock compensation.....	(8,507)	(8,507)
Accumulated deficit.....	(166,890)	(166,890)
Total stockholders' equity.....	155,321	204,271
Total capitalization.....	$ 159,321	$ 208,271

DILUTION

As of March 31, 2003, our net tangible book value was approximately $125.6 million, or approximately $2.40 per share. Net tangible book value per share represents the amount of our total tangible assets, excluding goodwill and other intangible assets, less total liabilities divided by the 52,374,095 shares of our common stock outstanding as of March 31, 2003. After giving effect to our sale of 10,000,000 shares of common stock in this offering at the public offering price of $5.25 per share, after deducting underwriting discounts and commissions and estimated offering expenses, the net tangible book value as of March 31, 2003 would have been approximately $174.5 million, or approximately $2.80 per share. This represents an immediate increase in net tangible book value of $.40 per share to existing stockholders and an immediate dilution in net tangible book value of $2.45 per share to new investors purchasing shares of common stock at the public offering price.

The following table illustrates this dilution on a per share basis:

Public offering price per share.....		$5.25
Net tangible book value per share as of March 31, 2003....	$2.40	
Increase in net tangible book value per share attributable to new investors.....	.40	
Net tangible book value per share as of March 31, 2003 after giving effect to this offering.....		2.80
Dilution in net tangible book value per share to new investors.....		$2.45

As of March 31, 2003, there were outstanding options to purchase a total of 12,740,214 shares of common stock at a weighted average exercise price of $6.14 per share and outstanding warrants to purchase a total of 266,482 shares of common stock at a weighted average exercise price of $3.08 per share. To the extent that any of these options or warrants are exercised, there will be further dilution to new public investors.

SELECTED FINANCIAL DATA

The statement of operations data for the year ended December 31, 2002 and the balance sheet data as of December 31, 2002 have been derived from our financial statements that have been audited by Ernst & Young LLP, independent auditors. The statements of operations data for each of the four years in the period ended December 31, 2001 and the balance sheet data as of December 31, 1998 through 2001 have been derived from our audited financial statements that have been audited by Arthur Andersen LLP, independent public accountants who have ceased operations. The statements of operations data for the three months ended March 31, 2002 and 2003, and the balance sheet data as of March 31, 2003, are unaudited but include, in the opinion of management, all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of such data. Our historical results for any prior or interim period are not necessarily indicative of results to be expected for any future period.

The data presented below has been prepared in accordance with accounting principles generally accepted in the United States and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this prospectus supplement and with our financial statements and related notes incorporated by reference in this prospectus supplement and the accompanying prospectus.

	YEAR ENDED DECEMBER 31,				
	1998	1999	2000	2001	2002
	(IN THOUSANDS, EXCEPT PER SHARE DA				
STATEMENTS OF OPERATIONS DATA:					
Revenues	$ 2,242	$ 4,738	$ 14,459	$ 30,577	$ 35,200
Operating expenses:					
Research and development(1)	8,410	14,646	31,647	53,355	74,859
General and administrative(2)	2,024	2,913	18,289	20,861	23,234
Total operating expenses	10,434	17,559	49,936	74,216	98,093
Loss from operations	(8,192)	(12,821)	(35,477)	(43,639)	(62,893)
Interest and other income, net	711	346	9,483	8,467	3,223
Net loss	(7,481)	(12,475)	(25,994)	(35,172)	(59,670)
Accretion on redeemable convertible preferred stock	(357)	(536)	(134)	--	--
Net loss attributable to common stockholders	$(7,838)	$(13,011)	$(26,128)	$(35,172)	$(59,670)
Net loss per common share, basic and diluted	$ (0.32)	$ (0.53)	$ (0.63)	$ (0.70)	$ (1.14)
Shares used in computing net loss per common share, basic and diluted	24,445	24,530	41,618	50,213	52,263

	AS OF DECEMBER 31,

	1998	1999	2000	2001	
			(IN THOUSANDS)		
BALANCE SHEET DATA:					
Cash, cash equivalents, restricted cash and investments(3)	$ 19,422	$ 9,156	$202,680	$166,840	$1
Working capital(3)	18,102	2,021	194,801	147,663	1
Total assets	28,516	22,295	220,693	239,990	2
Long-term debt, net of current portion	5,024	3,577	1,834	--	
Redeemable convertible preferred stock	29,515	30,050	--	--	
Accumulated deficit	(16,434)	(28,909)	(54,903)	(90,075)	(1
Stockholders' equity (deficit)	(9,035)	(21,937)	207,628	218,372	1

---

(1) Includes stock-based compensation of $10,883 in 2000, $5,539 in 2001, $5,155 in 2002, $1,307 for the three months ended March 31, 2002 and $1,270 for the three months ended March 31, 2003.

(2) Includes stock-based compensation of $9,958 in 2000, $5,231 in 2001, $5,113 in 2002, $1,282 for the three months ended March 31, 2002 and $1,276 for the three months ended March 31, 2003.

(3) Includes restricted cash and investments of $13,879 as of December 31, 2000, $43,338 as of December 31, 2001, $57,710 as of December 31, 2002 and $57,710 as of March 31, 2003.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion and analysis together with our consolidated financial statements, related notes and other financial information incorporated by reference in this prospectus supplement and the accompanying prospectus. In addition to historical information, the following discussion and analysis and other parts of this prospectus supplement and the accompanying prospectus contain forward-looking information that involves risks and uncertainties. Our actual results could differ materially from those anticipated by such forward-looking information due to competitive factors and other factors discussed under "Special Note Regarding Forward-Looking Statements," "Risk Factors" and elsewhere in this prospectus supplement and the accompanying prospectus.

OVERVIEW

We are a biopharmaceutical company focused on the discovery of breakthrough treatments for human disease. We use proprietary gene knockout technology to systematically discover the physiological functions of genes in mice and to identify which corresponding human genes encode potential targets for therapeutic intervention, or drug targets. The study of mice can be a very powerful tool for understanding human genetics because of the close similarity of gene function and physiology in mice and humans. Approximately 99% of all human genes have a counterpart in the mouse genome. Our patented gene trapping and gene targeting technologies enable us to rapidly generate these knockout mice by altering the DNA of genes in a special variety of mouse cells, called embryonic stem cells, which can be cloned and used to generate mice with the altered gene. We then employ an integrated platform of advanced medical technologies to systematically discover and validate, in vivo, the physiological

functions and pharmaceutical utility of the genes we have knocked out and the drug targets they encode.

We are working both independently and with our drug discovery collaborators to discover potential small molecule drugs, therapeutic antibodies and therapeutic proteins for those in vivo-validated drug targets that we consider to have high pharmaceutical value. We are working with Genentech to discover the functions of secreted proteins and potential antibody targets identified through Genentech's internal drug discovery research. We are working with Abgenix to discover and develop therapeutic antibodies for in vivo-validated drug targets identified in our own research. We are also working with Incyte to discover and develop therapeutic proteins. In addition, we have established collaborations and license agreements with many other leading pharmaceutical and biotechnology companies under which we receive fees and, in many cases, are eligible to receive milestone and royalty payments, in return for granting access to some of our technologies and discoveries for use in such companies' own drug discovery efforts.

We derive substantially all of our revenues from drug discovery alliances, subscriptions to our databases, target validation collaborations for the development and, in some cases, analysis of the physiological effects of genes altered in knockout mice, and technology licenses. To date, we have generated a substantial portion of our revenues from a limited number of sources and have not generated any revenue from sales of pharmaceuticals.

Our operating results and, in particular, our ability to generate additional revenues are dependent on many factors, including:

- -- our ability to establish new database subscriptions, research collaborations and technology licenses, and the timing of such arrangements;

- -- the expiration or other termination of database subscriptions and research collaborations with our collaborators, which may not be renewed or replaced;

- -- the success rate of our discovery efforts leading to opportunities for new research collaborations and licenses, as well as milestone payments and royalties;

- -- the timing and willingness of our collaborators to commercialize pharmaceutical products that would result in milestone payments and royalties; and

- -- general and industry-specific economic conditions, which may affect our and our collaborators' research and development expenditures.

Our future revenues from database subscriptions, collaborations and alliances are uncertain because our existing agreements have fixed terms or relate to specific projects of limited duration. Our future revenues from technology licenses are uncertain because they depend, in part, on securing new agreements. Our ability to secure future revenue-generating agreements will depend upon our ability to address the needs of our potential future subscribers, collaborators and licensees, and to negotiate agreements that we believe are in our long-term best interests. We may determine that our interests are better served by retaining rights to our discoveries and advancing our therapeutic programs to a later stage, which could limit our near-term revenues. Because of these and other factors, our quarterly operating results have fluctuated in the past and are likely to do so in the future, and we do not believe that quarter-to-quarter

comparisons of our operating results are a good indication of our future performance.

Since our inception, we have incurred significant losses and, as of March 31, 2003, we had an accumulated deficit of $166.9 million. Our losses have resulted principally from costs incurred in research and development, general and administrative costs associated with our operations, and non-cash stock-based compensation expenses associated with stock options granted to employees and consultants prior to our April 2000 initial public offering. Research and development expenses consist primarily of salaries and related personnel costs, material costs, facility costs, depreciation on property and equipment, legal expenses resulting from intellectual property prosecution, and other expenses related to our drug discovery and LexVision programs, the development and analysis of knockout mice and our other target validation research efforts, and the development of compound libraries. General and administrative expenses consist primarily of salaries and related expenses for executive, finance and other administrative personnel, professional fees and other corporate expenses, including business development and general legal activities. In connection with the expansion of our drug discovery programs and our target validation research efforts, we expect to incur increasing research and development and general and administrative costs. As a result, we will need to generate significantly higher revenues to achieve profitability.

CRITICAL ACCOUNTING POLICIES

REVENUE RECOGNITION

We recognize revenues when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed and determinable, and collectability is reasonably assured. Payments received in advance under these arrangements are recorded as deferred revenue until earned.

Fees for access to our databases and other target validation resources are recognized ratably over the subscription or access period. Collaborative research payments are recognized as revenue as we perform our obligations related to such research to the extent such fees are non-refundable. Milestone-based fees are recognized upon completion of specified milestones according to contract terms. Non-refundable technology license fees are recognized as revenue upon the grant of the license to third parties, when performance is complete and there is no continuing involvement.

Revenues recognized from multiple element contracts are allocated to each element of the arrangement based on the relative fair value of the elements. The determination of fair value of each element is based on objective evidence. When revenues for an element are specifically tied to a separate earnings process, revenue is recognized when the specific performance obligation associated with the element is completed. When revenues for an element are not specifically tied to a separate earnings process, they are recognized ratably over the term of the agreement.

A change in our revenue recognition policy or changes in the terms of contracts under which we recognize revenues could have an impact on the amount and timing of our recognition of revenues.

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses consist of costs incurred for company-sponsored as well as collaborative research and development activities. These costs include direct and research-related overhead expenses and are

expensed as incurred. Patent costs and technology license fees for technologies that are utilized in research and development and have no alternative future use are expensed when incurred.

STOCK-BASED COMPENSATION

Deferred stock-based compensation and related amortization represents the difference between the exercise price of stock options granted and the fair value of our common stock on the applicable date of grant. Stock-based compensation is amortized as research and development expense or general and administrative expense, as appropriate, over the vesting period of the individual stock options for which it was recorded, generally four years. If employees and consultants continue to vest in accordance with their individual stock option agreements subsequent to March 31, 2003, we expect to record amortization expense for deferred stock-based compensation of $7.6 million during the last nine months of 2003 and $.9 million during 2004. The amount of stock-based compensation expense to be recorded in future periods may decrease if unvested stock options for which deferred stock-based compensation has been recorded are subsequently canceled or forfeited or may increase if additional stock options are granted to individuals other than employees or directors.

GOODWILL IMPAIRMENT

Goodwill is not amortized, but is tested at least annually for impairment at the reporting unit level. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The first step in the impairment process is to determine the fair value of the reporting unit and then compare it to the carrying value, including goodwill. If the fair value exceeds the carrying value, no further action is required and no impairment loss is recognized. Additional impairment assessments may be performed on an interim basis if we encounter events or changes in circumstances that would indicate that, more likely than not, the carrying value of goodwill has been impaired.

RECENT ACCOUNTING PRONOUNCEMENTS

In November 2002, the Emerging Issues Task Force, or EITF, reached a consensus on EITF Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." This consensus requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if the delivered items have value to the customer on a standalone basis, there is objective and reliable evidence of fair value of the undelivered items and, if the arrangement includes a general right of return, performance of the undelivered item is considered probable and substantially in our control. The final consensus will be applicable to agreements entered into in fiscal periods beginning after June 15, 2003, with early adoption permitted.

In December 2002, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 148, "Accounting for Stock-Based Compensation--Transition and Disclosure." This statement amends SFAS 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based accounting for employee compensation and the effect of the method used on reported results. We are currently evaluating whether to adopt the fair value based method.

In January 2003, the FASB issued Interpretation, or FIN, No. 46, "Consolidation of Variable Interest Entities." FIN 46 requires that unconsolidated variable interest entities be consolidated by their primary beneficiaries. A primary beneficiary is the party that absorbs a majority of the

entity's expected losses or residual benefits. FIN 46 applies immediately to variable interest entities created after January 31, 2003 and to existing variable interest entities in the periods beginning after June 15, 2003. In October 2000, we entered into a synthetic lease agreement under which the lessor purchased our existing laboratory and office buildings

and animal facility in The Woodlands, Texas and agreed to fund the construction of an additional laboratory and office building and a second animal facility. The synthetic lease agreement was subsequently expanded to include funding for the construction of a central plant facility for the distribution of utilities and related services among our facilities. As adopted on July 1, 2003, FIN 46 will require us to consolidate the lessor under our synthetic lease. Accordingly, our balance sheet would reflect as assets additional property and equipment approximating the $55.0 million funded under the synthetic lease for property and improvements, less accumulated depreciation, and a similar amount as a liability. We would be required to depreciate such improvements over their useful lives. In addition, our income statement will reflect a charge of approximately $2.3 million for depreciation through June 30, 2003, as a cumulative effect of an accounting change. We believe that the consolidation of the lessor would not have a material adverse effect on our financial condition or results of operations. However, we are currently seeking to replace the synthetic lease. See "--Liquidity and Capital Resources."

RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2003 AND 2002

Revenues. Total revenues increased 6% to $8.1 million in the three months ended March 31, 2003 from $7.7 million in the corresponding period in 2002. The increase of $.4 million was primarily the result of revenues recognized under our drug discovery alliance with Genentech, entered in December 2002, offset, in part, by reduced revenues under technology license agreements.

During the three months ended March 31, 2003, Incyte, Bristol-Myers Squibb and Genentech represented 31%, 16% and 9% of revenues, respectively. During the three months ended March 31, 2002, Incyte, Bristol-Myers Squibb and Immunex Corporation represented 33%, 16% and 9% of revenues, respectively.

Research and Development Expenses. Research and development expenses increased 18% to $19.8 million in the three months ended March 31, 2003 from $16.9 million in the corresponding period in 2002. The increase of $2.9 million was primarily attributable to increased personnel costs and facilities costs to support the expansion of our drug discovery programs, the development and analysis of knockout mice and our other target validation research efforts. Research and development expenses for each of these three-month periods included $1.3 million of stock-based compensation primarily relating to option grants made prior to our April 2000 initial public offering.

General and Administrative Expenses. General and administrative expenses decreased 3% to $5.8 million in the three months ended March 31, 2003 from $6.0 million in the corresponding period in 2002. General and administrative expenses for each of these three-month periods included $1.3 million of stock-based compensation primarily relating to option grants made prior to our April 2000 initial public offering.

Interest and Other Income. Interest and other income decreased 58% to $.5 million in the three months ended March 31, 2003 from $1.1 million in the corresponding period in 2002. The decrease resulted from lower average cash and investment balances and lower average interest rates on our investments during the 2003 period.

Net Loss and Net Loss Per Common Share. Net loss increased 22% to $17.1 million in the three months ended March 31, 2003 from $14.1 million in the corresponding period in 2002. Net loss per common share increased to $.33 in the three months ended March 31, 2003 from $.27 in the corresponding period of 2002. As a complement to reporting net loss and net loss per common share in accordance with generally accepted accounting principles, or GAAP, we provide net loss and net loss per common share excluding non-cash, stock-based compensation. We use these results in establishing budgets and believe it is useful to investors in measuring the performance of our business. Excluding stock-based compensation expense of $2.5 million and $2.6 million in the three months ended March 31, 2003 and 2002, respectively, we would have had a net loss of $14.6 million and net loss per common share of $.28 in the three months ended March 31, 2003, as compared to a net loss of $11.5 million and net loss per common share of $.22 in the corresponding period in 2002.

Our quarterly operating results have fluctuated in the past and are likely to do so in the future, and we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance.

YEARS ENDED DECEMBER 31, 2002 AND 2001

Revenues. Total revenues increased 15% to $35.2 million in 2002 from $30.6 million in 2001. The increase of $4.6 million was primarily attributable to a $5.9 million increase in revenues from target validation collaborations and our drug discovery alliance with Incyte and a $3.1 million increase in revenues from database subscription and technology license fees, offset in part by a $4.4 million decrease in compound libraries and other revenue. We did not make our compound libraries available for purchase in 2002 and, subject to limited exceptions, do not intend to make our compound libraries available for purchase in the future.

In 2002, Incyte, Bristol-Myers Squibb and Millennium Pharmaceuticals represented 28%, 14% and 11% of revenues, respectively. In 2001, Incyte, Bristol-Myers Squibb and Merck & Co., Inc. represented 16%, 13% and 12% of revenues, respectively.

Research and Development Expenses. Research and development expenses increased 40% to $74.9 million in 2002 from $53.4 million in 2001. The increase of $21.5 million was primarily attributable to increased personnel and facility costs to support the expansion of our drug discovery programs, including a full year of medicinal chemistry operations that we obtained in our July 2001 acquisition of Coelacanth Corporation, the development and analysis of knockout mice and our other target validation research efforts. Research and development expenses for 2002 and 2001 included $5.2 million and $5.5 million, respectively, of stock-based compensation primarily relating to option grants made prior to our April 2000 initial public offering.

General and Administrative Expenses. General and administrative expenses increased 11% to $23.2 million in 2002 from $20.9 million in 2001. The increase of $2.3 million was due primarily to additional personnel costs offset by a reduction in legal costs as a result of the September 2001 settlement of our patent infringement litigation against Deltagen, Inc. General and administrative expenses for 2002 and 2001 included $5.1 million and $5.2 million, respectively, of stock-based compensation primarily relating to option grants made prior to our April 2000 initial public offering.

Interest and Other Income. Interest and other income decreased 63% to $3.2 million in 2002 from $8.8 million in 2001. This decrease resulted from lower

cash and investment balances and lower average interest rates on our investments during 2002.

Net Loss and Net Loss Per Common Share. Net loss attributable to common stockholders increased to $59.7 million in 2002 from $35.2 million in 2001. Net loss per common share increased to $1.14 in 2002 from $.70 in 2001. Excluding stock-based compensation expense of $10.3 million and $10.8 million in 2002 and 2001, respectively, we would have had a net loss of $49.4 million and net loss per common share of $.95 in 2002, as compared to a net loss of $24.4 million and net loss per common share of $.49 in 2001.

YEARS ENDED DECEMBER 31, 2001 AND 2000

Revenues. Total revenues increased 111% to $30.6 million in 2001 from $14.5 million in 2000. The increase of $16.1 million was primarily attributable to a $10.2 million increase in revenues from database subscription and technology license fees, a $1.7 million increase in revenues from target validation collaborations and our drug discovery alliance with Incyte and revenues of $4.5 million from compound library sales, offset in part by a $.3 million decrease in other revenue.

In 2001, Incyte, Bristol-Myers Squibb and Merck represented 16%, 13% and 12% of revenues, respectively. In 2000, the Merck Genome Research Institute and Millennium Pharmaceuticals represented 35% and 14% of revenues, respectively.

Research and Development Expenses. Research and development expenses increased 69% to $53.4 million in 2001 from $31.6 million in 2000. The increase of $21.8 million was attributable to continued growth of

research and development activities, primarily related to increased personnel costs to support the expansion of our drug discovery programs, the development and analysis of knockout mice and our other target validation research efforts, offset in part by lower stock-based compensation in 2001. Research and development expenses for 2001 and 2000 included $5.5 million and $10.9 million, respectively, of stock-based compensation primarily relating to option grants made prior to our April 2000 initial public offering.

General and Administrative Expenses. General and administrative expenses increased 14% to $20.9 million in 2001 from $18.3 million in 2000. The increase of $2.6 million was due primarily to additional personnel costs for business development and finance and administration, as well as expenses associated with our patent infringement litigation against Deltagen, offset in part by lower stock-based compensation in 2001. General and administrative expenses for 2001 and 2000 included $5.2 million and $10.0 million, respectively, of stock-based compensation primarily relating to option grants made prior to our April 2000 initial public offering.

Interest and Other Income. Interest income decreased 11% to $8.8 million in 2001 from $9.9 million in 2000. This decrease resulted from lower cash and investment balances and lower average interest rates on our investments during 2001.

Net Loss and Net Loss Per Common Share. Net loss attributable to common stockholders increased to $35.2 million in 2001 from $26.1 million in 2000. Net loss per common share increased to $.70 in 2001 from $.63 in 2000.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations from inception primarily through sales of

common and preferred stock, contract and milestone payments to us under our drug discovery alliance, database subscription, collaboration and license agreements, equipment financing arrangements and leasing arrangements. From our inception through March 31, 2003, we had received net proceeds of $242.7 million from issuances of common and preferred stock, including $203.2 million of net proceeds from the initial public offering of our common stock in April 2000. In addition, from our inception through March 31, 2003, we received $108.1 million in cash payments from drug discovery alliances, database subscription and technology license fees, target validation collaborations, sales of compound libraries and reagents, and government grants, of which $96.6 million had been recognized as revenues through March 31, 2003.

As of March 31, 2003, we had $107.6 million in cash, cash equivalents and short-term investments, including $57.7 million of restricted cash and investments, as compared to $123.1 million as of December 31, 2002. We used cash of $14.8 million in operations during the three months ended March 31, 2003. This consisted primarily of the net loss for the period of $17.1 million offset by non-cash charges of $2.5 million related to stock-based compensation expense, $2.5 million related to depreciation expense and $300,000 related to amortization of intangible assets other than goodwill. Investing activities provided cash of $14.6 million in the three months ended March 31, 2003, principally as a result of net maturities of short-term investments, offset in part by an increase in restricted cash.

As of December 31, 2002, we had $123.1 million in cash, cash equivalents and short-term and long-term investments, including $57.7 million of restricted cash and investments, as compared to $166.8 million, including $43.3 million of restricted cash and investments, as of December 31, 2001. We used cash of $28.8 million in operations in 2002. This consisted primarily of the net loss for the year of $59.7 million offset by non-cash charges of $10.3 million related to stock-based compensation expense, $9.1 million related to depreciation expense and $1.2 million related to amortization of intangible assets other than goodwill, a $5.6 million increase in deferred revenue, and changes in other operating assets and liabilities of $4.5 million. Investing activities provided cash of $47.2 million in 2002, principally as a result of net maturities of short-term investments and the sale of long-term investments, offset by an increase in restricted cash and purchases of property and equipment. We received cash of $4.6 million in financing activities in 2002, consisting principally of proceeds from a $4.0 million loan and stock option exercises.

In October 2000, we entered into a synthetic lease agreement under which the lessor purchased our existing laboratory and office buildings and animal facility in The Woodlands, Texas and agreed to fund the construction of an additional laboratory and office building and a second animal facility. The synthetic lease agreement was subsequently expanded to include funding for the construction of a central plant facility for the distribution of utilities and related services among our facilities. Including the purchase price for our existing facilities, the synthetic lease, as amended, provided for funding of up to $55.0 million in property and improvements. The term of the agreement is six years, which includes the construction period and a lease period, and may be extended at our option for up to seven additional one-year terms. Alternatively, the lease may be terminated at an earlier date if we elect to (1) purchase the properties for a price equal to the $55.0 million funded under the synthetic lease for property and improvements plus the amount of any accrued but unpaid lease payments, (2) arrange for the sale of the properties to a third party or (3) surrender the properties to the lessor. If we elect to arrange for the sale of the properties or surrender the properties to the lessor, we have guaranteed approximately 86% of the total original cost as the residual fair value of the properties. Lease payments for the new facilities began upon completion of

construction, which occurred at the end of the first quarter of 2002. Lease payments are subject to fluctuation based on LIBOR rates. Based on a LIBOR rate of 1.3% at March 31, 2003, our total lease payments would be approximately $.9 million per year. We are required to maintain restricted cash and investments to collateralize amounts funded under the synthetic lease agreement. In addition, we have agreed to maintain cash and investments of at least $12.0 million in excess of our restricted cash and investments. If our cash and investments fall below that level, we may be required to seek a waiver of that agreement or to purchase the properties or arrange for their sale to a third party. Because our cost to purchase the properties would not materially exceed the $55.0 million funded under the synthetic lease for property and improvements and would likely be less than the amount of restricted cash and investments we are required to maintain under the synthetic lease, we believe that any requirement that we do so would not have a material adverse effect on our financial condition. As of March 31, 2003 and December 31, 2002, we maintained restricted cash and investments of $57.2 million to collateralize funding for property and improvements under the synthetic lease of $55.0 million.

We intend to replace our synthetic lease agreement covering all of our facilities in The Woodlands, Texas, and we are currently engaged in discussions to do so. We expect that any such new arrangement would require us to maintain substantially lower amounts of restricted cash and investments while increasing our payments with respect to these facilities, as compared to our synthetic lease agreement.

In May 2002, our subsidiary, Lexicon Pharmaceuticals (New Jersey), Inc., signed a ten-year lease for a 76,000 square-foot laboratory and office facility in Hopewell, New Jersey. Our subsidiary has exercised its option under the lease to obtain $2.0 million in tenant improvement funds from the landlord. The lease provides that the expiration of the term of the lease will be extended to June 30, 2013, the tenth anniversary of the date on which the landlord provided the tenant improvement funds, and that such funds will be amortized over a ten-year period. Accordingly, we expect that the escalating yearly base rent payment under the lease will increase to a range of approximately $2.1 million in the first year following the funding of the tenant improvements on June 30, 2003 to approximately $2.4 million in the tenth year. We are the guarantor of the obligations of our subsidiary under the lease.

In December 2002, we borrowed $4.0 million under a convertible promissory note we issued to Genentech. The proceeds of the loan are to be used to fund research efforts under our alliance with Genentech for the discovery of therapeutic proteins and antibody targets. The note matures on or before December 31, 2005, but we may prepay it at any time. We may repay the note, at our option, in cash or in shares of our common stock valued at the then-current market value, or in a combination of cash and shares, subject to certain limitations. The note accrues interest at an annual rate of 8%, compounded quarterly.

Including the lease and debt obligations described above, we had incurred the following contractual obligations as of March 31, 2003:

PAYMENTS DUE BY PERIOD
