

ARENA PHARMACEUTICALS INC

Form 10-Q

May 12, 2014

[Table of Contents](#)

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2014**

**or**

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

**For the transition period from to**

**Commission File Number: 000-31161**

**ARENA PHARMACEUTICALS, INC.**

**(Exact name of registrant as specified in its charter)**

<p><b>Delaware</b>  <b>(State or other jurisdiction of</b>    <b>incorporation or organization)</b></p> <p><b>6154 Nancy Ridge Drive, San Diego, CA</b>  <b>(Address of principal executive offices)</b></p>	<p><b>23-2908305</b>  <b>(I.R.S. Employer</b>    <b>Identification No.)</b></p> <p><b>92121</b>  <b>(Zip Code)</b></p> <p><b>858.453.7200</b>    <b>(Registrant's telephone number, including area code)</b></p>
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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.    ☒ Yes    ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).    Yes ☒    No ☐

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

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

The number of shares of common stock outstanding as of the close of business on May 6, 2014:

<b>Class</b>	<b>Number of Shares Outstanding</b>
Common Stock, \$0.0001 par value	219,650,003

**Table of Contents**

**ARENA PHARMACEUTICALS, INC.**

**INDEX**

**PART I FINANCIAL INFORMATION**

Item 1.	<u>Financial Statements</u>	1
	<u>Condensed Consolidated Balance Sheets As of March 31, 2014, and December 31, 2013</u>	1
	<u>Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) Three Months Ended March 31, 2014, and 2013</u>	2
	<u>Condensed Consolidated Cash Flow Statements Three Months Ended March 31, 2014, and 2013</u>	3
	<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	4
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	20
Item 4.	<u>Controls and Procedures</u>	20

**PART II OTHER INFORMATION**

Item 1.	<u>Legal Proceedings</u>	20
Item 1A.	<u>Risk Factors</u>	21
Item 6.	<u>Exhibits</u>	45
	<u>Signatures</u>	46

In this Quarterly Report on Form 10-Q, Arena Pharmaceuticals, Arena, we, us and our refer to Arena Pharmaceuticals Inc., and our wholly owned subsidiaries on a consolidated basis, unless the context otherwise provides. APD is an abbreviation for Arena Pharmaceuticals Development.

Arena Pharmaceuticals®, Arena® and our corporate logo are registered service marks of Arena. BELVIQ® is a registered trademark of Arena Pharmaceuticals GmbH. Any other brand names or trademarks appearing in this Quarterly Report on Form 10-Q are the property of their respective holders.

BELVIQ® (pronounced BEL-VEEK) is the trade name for the finished drug product containing the active pharmaceutical ingredient lorcaserin hydrochloride, or lorcaserin, that is marketed for chronic weight management in the United States. Lorcaserin may in the future be marketed in the United States or in other countries under a different trade name for chronic weight management. Lorcaserin may also be marketed as BELVIQ or under a different trade name for a different indication, in a different formulation or in combination with another drug. In this report, we use BELVIQ to refer to the finished drug product containing lorcaserin and/or, depending on the context, the active pharmaceutical ingredient lorcaserin, and without regard to the current or potential indication, formulation or combination.

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.****ARENA PHARMACEUTICALS, INC.****Condensed Consolidated Balance Sheets****(In thousands)**

	<b>March 31, 2014 (Unaudited)</b>	<b>December 31, 2013<sup>1</sup></b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 203,272	\$ 221,878
Short-term investments, available-for-sale	53,234	0
Accounts receivable	1,552	10,602
Inventory	11,947	12,759
Prepaid expenses and other current assets	6,363	3,571
Total current assets	276,368	248,810
Land, property and equipment, net	78,046	77,388
Intangibles, net	10,071	10,182
Other non-current assets	3,211	3,427
Total assets	\$ 367,696	\$ 339,807
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable and other accrued liabilities	\$ 6,806	\$ 7,317
Payable to Eisai	19,321	19,305
Accrued compensation	3,285	4,205
Current portion of deferred revenues	35,393	37,861
Current portion of lease financing obligations	2,161	2,056
Total current liabilities	66,966	70,744
Deferred rent	281	247
Deferred revenues, less current portion	99,225	101,329
Derivative liabilities	5,002	4,892
Lease financing obligations, less current portion	70,167	70,738
<b>Commitments and contingencies</b>		
Stockholders' equity:		
Common stock	22	22

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Additional paid-in capital	1,299,968	1,293,840
Accumulated other comprehensive income	59,053	5,728
Accumulated deficit	(1,232,988)	(1,207,733)
Total stockholders' equity	126,055	91,857
Total liabilities and stockholders' equity	\$ 367,696	\$ 339,807

- <sup>1</sup> The balance sheet data at December 31, 2013, has been derived from audited financial statements at that date. It does not include, however, all of the information and notes required by US generally accepted accounting principles for complete financial statements.

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**ARENA PHARMACEUTICALS, INC.****Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)****(In thousands, except per share data)****(Unaudited)**

	<b>Three months ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
<b>Revenues:</b>		
Net product sales	\$ 2,882	\$ 0
Eisai collaborative revenue	3,347	1,495
Manufacturing services	448	765
Other collaborative revenue	137	113
Total revenues	6,814	2,373
<b>Operating Costs and Expenses:</b>		
Cost of product sales	831	473
Cost of manufacturing services	496	1,645
Research and development	20,988	14,008
General and administrative	8,037	7,251
Total operating costs and expenses	30,352	23,377
Loss from operations	(23,538)	(21,004)
<b>Interest and Other Income (Expense):</b>		
Interest income	29	24
Interest expense	(1,747)	(1,787)
Gain (Loss) from valuation of derivative liabilities	(110)	3,859
Other	111	32
Total interest and other income (expense), net	(1,717)	2,128
Net loss	\$ (25,255)	\$ (18,876)
<b>Net loss per share:</b>		
Basic	\$ (0.12)	\$ (0.09)
Diluted	\$ (0.12)	\$ (0.09)
<b>Shares used in calculating net loss per share:</b>		
Basic	219,222	217,503

Diluted	219,222	217,503
<b>Comprehensive Income (Loss):</b>		
Net loss	\$ (25,255)	\$ (18,876)
Foreign currency translation gain (loss)	91	(1,588)
Unrealized gain on investment	53,234	0
Comprehensive income (loss)	\$ 28,070	\$ (20,464)

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**ARENA PHARMACEUTICALS, INC.****Condensed Consolidated Cash Flow Statements****(In thousands)****(Unaudited)**

	<b>Three months ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
<b>Operating Activities</b>		
Net loss	\$ (25,255)	\$ (18,876)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,992	1,950
Amortization of intangibles	181	99
Share-based compensation	3,201	1,785
(Gain) Loss from valuation of derivative liabilities	110	(3,859)
Amortization of prepaid financing costs	34	34
Gain on sale of equipment	(45)	0
Changes in assets and liabilities:		
Accounts receivable	8,934	4,013
Inventory	903	(1,300)
Prepaid expenses and other assets	(2,806)	(333)
Accounts payable, payable to Eisai and accrued liabilities	(1,613)	(810)
Deferred revenues	(4,786)	(954)
Deferred rent	34	27
Net cash used in operating activities	(19,116)	(18,224)
<b>Investing Activities</b>		
Purchases of property and equipment	(2,469)	(1,266)
Proceeds from sale of equipment	45	0
Other non-current assets	209	(52)
Net cash used in investing activities	(2,215)	(1,318)
<b>Financing Activities</b>		
Principal payments on lease financing obligations	(466)	(372)
Proceeds from issuance of common stock	2,927	450
Net cash provided by financing activities	2,461	78
Effect of exchange rate changes on cash	264	(377)
Net decrease in cash and cash equivalents	(18,606)	(19,841)
Cash and cash equivalents at beginning of period	221,878	156,091
Cash and cash equivalents at end of period	\$ 203,272	\$ 136,250



See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****ARENA PHARMACEUTICALS, INC.****Notes to Unaudited Condensed Consolidated Financial Statements****1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of Arena Pharmaceuticals, Inc., which include our wholly owned subsidiaries, should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the Securities and Exchange Commission, or SEC, from which we derived our balance sheet as of December 31, 2013. The accompanying financial statements have been prepared in accordance with US generally accepted accounting principles, or GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, since they are interim statements, the accompanying financial statements do not include all of the information and notes required by GAAP for complete financial statements. The accompanying financial statements reflect all adjustments, consisting of normal recurring adjustments, that are, in the opinion of our management, necessary to a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year.

The preparation of financial statements in accordance with GAAP requires our management to make estimates and assumptions that affect the reported amounts (including assets, liabilities, revenues and expenses) and related disclosures. The amounts reported could differ under different estimates and assumptions.

**2. Fair Value Disclosures**

We measure our financial assets and liabilities at fair value, which is defined as the exit price, or the amount that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

We use the following three-level valuation hierarchy that maximizes the use of observable inputs and minimizes the use of unobservable inputs to value our financial assets and liabilities:

Level 1 - Observable inputs such as unadjusted quoted prices in active markets for identical instruments.

Level 2 - Quoted prices for similar instruments in active markets or inputs that are observable for the asset or liability, either directly or indirectly.

Level 3 - Significant unobservable inputs based on our assumptions.

The following tables present our valuation hierarchy for our financial assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2014, and December 31, 2013, in thousands:

<b>Fair Value Measurements at March 31, 2014</b>			
<b>Balance at March 31, 2014</b>	<b>Quoted Prices in Active Markets</b>	<b>Significant Other Observable Inputs</b>	<b>Significant Unobservable Inputs (Level 3)</b>

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		(Level 1)	(Level 2)		
<i>Assets:</i>					
Money market funds <sup>1</sup>	\$ 183,861	\$ 183,861	\$ 0	\$ 0	
TaiGen equity securities <sup>2</sup>	\$ 53,234	\$ 53,234	\$ 0	\$ 0	
<i>Liabilities:</i>					
Warrant derivative liabilities	\$ 5,002	\$ 0	\$ 5,002	\$ 0	

<sup>1</sup> Included in cash and cash equivalents on our condensed consolidated balance sheets.

<sup>2</sup> Included in short-term investments, available-for-sale on our condensed consolidated balance sheets.

**Table of Contents**

Fair Value Measurements at December 31, 2013				
	Balance at December 31, 2013	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>Assets:</i>				
Money market funds <sup>1</sup>	\$ 208,833	\$ 208,833	\$ 0	\$ 0
<i>Liabilities:</i>				
Warrant derivative liabilities	\$ 4,892	\$ 0	\$ 4,892	\$ 0

<sup>1</sup> Included in cash and cash equivalents on our condensed consolidated balance sheets.

**3. Short-term investments, available-for-sale**

We have held an investment in TaiGen Biotechnology Co., Ltd., or TaiGen, that, from December 31, 2011, to January 17, 2014, had a cost basis of zero due to impairment charges. On January 17, 2014, TaiGen completed an initial public offering and its common stock began to trade on the GreTai Securities Listed Market, under the name TaiGen Biopharmaceuticals Holding Limited. Such market is deemed to be comparable to a US over-the-counter market such that the fair value of our investment in TaiGen, which previously had been accounted for as a cost method investment with a cost basis of zero, became readily determinable. Accordingly, on January 17, 2014, we recorded our investment in TaiGen based on its fair value of approximately \$49.1 million, with the unrealized gain of \$49.1 million recorded as a component of accumulated other comprehensive income in the stockholders' equity section of our condensed consolidated balance sheets. At March 31, 2014, our investment in TaiGen had a fair value of approximately \$53.2 million (see Note 2). We began recording our investment in TaiGen at fair value based on the trading price of TaiGen's common stock, and it is revalued on each balance sheet date, with any unrealized gains or losses recorded as a component of accumulated other comprehensive income (loss) in the stockholders' equity section of our condensed consolidated balance sheets.

**4. Inventory**

All of our inventory relates to BELVIQ, and consisted of the following as of March 31, 2014, and December 31, 2013, in thousands:

	March 31, 2014	December 31, 2013
Raw materials	\$ 692	\$ 657
Work in process	4,028	4,104
Finished goods at Arena GmbH	0	0
Finished goods at Eisai	7,227	7,998
Total inventory	\$ 11,947	\$ 12,759

**5. Accounts Payable and Other Accrued Liabilities**

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Accounts payable and other accrued liabilities consisted of the following as of March 31, 2014, and December 31, 2013, in thousands:

	<b>March 31, 2014</b>	<b>December 31, 2013</b>
Accounts payable	\$ 2,863	\$ 3,721
Accrued expenses	1,346	1,477
Accrued clinical and preclinical study fees	2,067	1,317
Loss provision	497	567
Other accrued liabilities	33	235
Total accounts payable and other accrued liabilities	\$ 6,806	\$ 7,317

**Table of Contents****6. Derivative Liabilities**

In August 2008, we issued a warrant to purchase 1,106,344 shares of our common stock at an exercise price of \$7.71 per share that expires on August 14, 2015. As a result of the warrant's anti-dilution provision and certain subsequent equity issuances at prices below the adjustment price of \$6.72 defined in the warrant agreement, the number of shares issuable upon exercise of the warrant increased and the exercise price decreased. As of March 31, 2014, the number of shares issuable upon exercise of the outstanding warrant was 1,965,418 at an exercise price of \$4.34 per share. The outstanding warrant, which was valued at \$5.0 million and \$4.9 million as of March 31, 2014, and December 31, 2013, respectively, is recorded as a long-term derivative liability on our condensed consolidated balance sheets.

Our outstanding warrant is revalued on each balance sheet date, with changes in the fair value between reporting periods recorded in the interest and other income (expense) section of our condensed consolidated statements of operations and comprehensive income (loss). We recognized a loss of \$0.1 million in the three months ended March 31, 2014, and a gain of \$3.9 million in the three months ended March 31, 2013, from revaluation of the warrants outstanding in each period.

**7. Marketing and Supply Agreement with Eisai**

In November 2013, Arena Pharmaceuticals GmbH, or Arena GmbH, our wholly owned subsidiary, and Eisai Inc. and Eisai Inc.'s parent company, Eisai Co., Ltd. (collectively with Eisai Inc., Eisai) entered into the Second Amended and Restated Marketing and Supply Agreement, or Eisai Agreement. The Eisai Agreement amended and restated the previous agreement and expanded Eisai's exclusive commercialization rights for BELVIQ to all of the countries in the world, except for South Korea, Taiwan, Australia, New Zealand and Israel. BELVIQ is approved in the United States for chronic weight management in adults who are overweight with a comorbidity or obese, and it was made available to patients by prescription in the United States by Eisai in June 2013. In addition to providing commercialization rights, which are subject to applicable regulatory approval, we provide Eisai with services related to development and regulatory activities, and manufacture and sell BELVIQ to Eisai. Under the Eisai Agreement, we received an upfront payment and are entitled to receive milestone payments based on the achievement of regulatory filings and approvals, one-time purchase price adjustment payments and other payments, and payments from sales of BELVIQ.

Prior to entering into the Eisai Agreement, Arena GmbH and Eisai Inc. entered into the original marketing and supply agreement in July 2010, under which we granted Eisai Inc. exclusive commercialization rights for BELVIQ solely in the United States and its territories and possessions. In May 2012, Arena GmbH and Eisai Inc. amended and restated such agreement by entering into the first amended agreement, which expanded Eisai Inc.'s exclusive commercialization rights to include most of North and South America.

The following table summarizes the revenues we recognized under our collaboration with Eisai in the three months ended March 31, 2014, and 2013, in thousands:

	<b>March 31,</b>	
	<b>2014</b>	<b>2013</b>
Net product sales	\$ 2,882	\$ 0
Amortization of upfront payments	1,975	861
Reimbursement of research and development expenses	745	2
Milestone payments	500	500

Reimbursement of patent and trademark expenses	127	132
Subtotal Eisai collaborative revenue	3,347	1,495
Total	\$ 6,229	\$ 1,495

The following table summarizes the deferred revenues under our collaboration with Eisai as of March 31, 2014, and December 31, 2013, in thousands:

	<b>March 31, 2014</b>	<b>December 31, 2013</b>
Upfront payments	\$ 100,130	\$ 102,104
Net product sales	27,836	30,299
Total deferred revenues attributable to Eisai	127,966	132,403
Less current portion	(34,839)	(37,301)
Deferred revenues attributable to Eisai, less current portion	\$ 93,127	\$ 95,102

## **Table of Contents**

### **Upfront and Milestone Payments**

In connection with entering into the Eisai Agreement, we received from Eisai an upfront payment of \$60.0 million. This payment is in addition to the \$50.0 million and \$5.0 million in upfront payments we received from Eisai in connection with entering into the original agreement and the first amended agreement, respectively. Revenues from these upfront payments were deferred, as we determined that the exclusive rights did not have standalone value without our ongoing development and regulatory activities. Accordingly, these payments are recognized ratably as revenue over the periods in which we expect the services to be rendered, which are approximately 15 years for the Eisai Agreement and first amended agreement and 16 years for the original agreement. In addition to the upfront payments, we have received from Eisai a total of \$86.5 million in milestones payments, including \$0.5 million earned in March 2014 upon Eisai filing for regulatory approval of BELVIQ in Brazil, and we are eligible to receive up to an aggregate of \$176.0 million in additional regulatory and development milestone payments.

### **Product Purchase Price and Purchase Price Adjustment Payments**

We manufacture BELVIQ at our facility in Switzerland, and sell BELVIQ to Eisai for Eisai's commercialization in the United States and, subject to applicable regulatory approval, in the other territories under the Eisai Agreement (other than Europe, China and Japan) for a purchase price starting at 31.5% and 30.75%, respectively (and starting at 27.5% in Europe, China and Japan), of Eisai's aggregate annual net product sales (which are the gross invoiced sales less certain deductions described in the Eisai Agreement), or the Product Purchase Price, in the respective territory. The Product Purchase Price will increase on a tiered basis in the United States and the other territories (other than Europe, China and Japan) to as high as 36.5% and 35.75%, respectively, on the portion of Eisai's annual aggregate net product sales exceeding \$750.0 million in all territories other than Europe, China and Japan. The Product Purchase Price will increase to 35% in Europe, China and Japan on the portion of Eisai's annual aggregate net product sales exceeding \$500.0 million in such territories. The Product Purchase Price is subject to reduction (for sales in a particular country), including in the event of generic competition in the applicable country. The revenue we recognize for BELVIQ product revenue related to redemption of vouchers is based on our cost of goods sold.

In addition to payments for purchases of BELVIQ, we are eligible to receive up to an aggregate of \$1.56 billion in one-time purchase price adjustment payments and other payments. These payments include up to an aggregate of \$1.19 billion that are based on Eisai's annual net product sales of BELVIQ in all of the territories under the Eisai Agreement on an aggregate basis, with the first and last amounts payable with annual net product sales of \$250.0 million and \$2.5 billion, respectively. Of these payments, Eisai will pay us a total of \$330.0 million for annual net product sales of up to \$1.0 billion. The \$1.56 billion also includes \$370.0 million in one-time purchase price adjustment payments we are eligible to receive based on annual net product sales in the non-US territories, comprised of \$185.0 million based on Eisai's annual net product sales in the non-US territories in North and South America and \$185.0 million based on Eisai's annual net product sales the territories outside of North and South America. The first and last amounts are payable upon first achievement of annual net product sales of \$100.0 million and \$1.0 billion, respectively, with respect to each of the following areas: (i) the non-US territories in North and South America and (ii) the territories outside of North and South America. In addition, we are also eligible to receive certain payments by Eisai if certain annual minimum sales requirements in Mexico, Canada and Brazil are not met during the first ten years after initial commercial sale in such territories.

The amount that Eisai pays us for BELVIQ product supply is based on Eisai's estimated price at the time the order is shipped, which is Eisai's estimate of the Product Purchase Price, and is subject to change on April 1 and October 1 of each year. Eisai's estimate of the Product Purchase Price was changed as of October 1, 2013, and there was no further change as of April 1, 2014. At the end of Eisai's fiscal year (March 31), the estimated price paid to us for product that Eisai sold to their distributors is compared to the Product Purchase Price of such product, and the difference is either



refunded back to Eisai (for overpayments) or paid to us (for underpayments). On a monthly basis, Eisai provides us the total amount of net product sales for the month, details of the total deductions from gross to net product sales and the sales in units. We recognize our revenues monthly based on our percentage of Eisai's monthly net product sales figures. When the revenues we recognize differ from the estimated price that Eisai paid us for such product, the difference is reclassified from deferred revenues to a receivable or payable account, as appropriate. We also adjust the deferred revenues balance for the product supply held at Eisai based on the most current net product sales figures provided to us, with the difference reclassified from deferred revenues to a receivable or payable account.

We recognized total revenues from BELVIQ net product sales of \$2.9 million in the three months ended March 31, 2014, of which \$2.7 million related to sales at the Product Purchase Price and \$0.2 million related to redemptions of vouchers. The Product Purchase Price for the product Eisai has sold to date was lower than the initial estimated price that Eisai paid us for such product, primarily because the price that Eisai paid us did not include deductions for the use of vouchers, savings cards and deductions for certain items related to product launch. These excess payments, which reflect both the amounts Eisai has sold to date and the product supply remaining in Eisai's inventory at March 31, 2014, are included in the \$19.3 million classified as Payable to Eisai on our condensed consolidated balance sheets. On an annual basis, subsequent to the end of Eisai's fiscal year, we will refund to Eisai the portion of these excess payments related to product sold by Eisai to their distributors through March 31.

**Table of Contents****Development Payments**

In connection with the US approval of BELVIQ, the US Food and Drug Administration, or FDA, is requiring (i) an evaluation as part of the cardiovascular outcomes trial, or CVOT, of the effect of long-term treatment with BELVIQ on the incidence of major adverse cardiovascular events, or MACE, in overweight and obese patients with cardiovascular disease or multiple cardiovascular risk factors and (ii) the conduct of postmarketing studies to assess the safety and efficacy of BELVIQ for weight management in obese pediatric patients. In addition to the FDA-required studies, we and Eisai are prioritizing the development areas of smoking cessation, a once-daily formulation, co-administration with phentermine, as well as exploring, including as part of the CVOT, BELVIQ's effect on conversion to type 2 diabetes and improvements in cardiovascular outcomes.

The below chart summarizes the general agreement regarding cost sharing between Eisai and us for significant development activities under the Eisai Agreement. In addition, Eisai or we may from time to time conduct approved development of BELVIQ at such party's own expense. For example, Eisai is responsible for the expenses of the pilot study of 12-week duration to preliminarily assess BELVIQ and phentermine when co-administered.

**Eisai Second Amended and Restated Marketing and Supply Agreement: Cost Sharing for Development**

		Rest of	
	United States	North and South America	Remaining Territories
<b>BELVIQ for weight management</b>	Not Applicable	<b>General</b>	Up to total of \$100.0 million -
- <i>Pre-approval*</i>		Eisai: 90%; Arena: 10%	Eisai: 50%; Arena: 50%
		<b>Certain stability work</b>	Thereafter, Eisai: 100%
		Eisai: 50%; Arena: 50%	
<b>BELVIQ for weight management</b>	<b>General</b> - Eisai: 90%; Arena 10%	<b>General</b>	Up to total of \$50.0 million -
- <i>Post-approval*</i>		Eisai: 90%; Arena: 10%	Eisai: 50%; Arena: 50%
	<b>Non-FDA required portion of CVOT</b>		
	Up to \$80.0 million -	<b>Certain stability work</b>	Thereafter, Eisai: 90%;
	Eisai: 50%; Arena: 50%	Eisai: 50%; Arena: 50%	Arena: 10%
	Thereafter, Eisai: 100%		

**Certain pediatric studies**

Eisai: 50%; Arena: 50%

**Products other than BELVIQ for weight management** Up to total of \$250.0 million (as reduced by up to \$80.0 million for non-FDA required portion of CVOT) -

Eisai: 50%; Arena: 50%

**- Pre-approval**

**Products other than BELVIQ for weight management** Up to a total of \$100.0 million in the aggregate across all additional products -

Eisai: 50%; Arena: 50%

**- Post-approval**

Thereafter, Eisai: 90%; Arena: 10%

\* Development required by a regulatory authority, with the exception of the non-FDA required portions of the CVOT.

**Certain Other Terms**

Please refer to our Annual Report on Form 10-K for the year ended December 31, 2013, for additional information regarding termination, indemnification, product liability, certain limitations and other provisions included in the Eisai Agreement.

**Table of Contents****8. Share-based Activity*****Share-based Compensation***

We recognized share-based compensation expense as follows, in thousands:

	<b>Three months ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Cost of product sales	\$ 0	\$ 17
Research and development	1,781	725
General and administrative	1,420	1,043
Total share-based compensation expense	\$ 3,201	\$ 1,785
Total share-based compensation expense capitalized into inventory	\$ 0	\$ 11

***Share-based Award Activity***

The following table summarizes our stock option activity during the three months ended March 31, 2014, in thousands (except per share data):

	<b>Options</b>	<b>Weighted- Average Exercise Price</b>
Outstanding at January 1, 2014	14,681	\$ 4.99
Granted	2,091	6.81
Exercised	(594)	4.40
Forfeited/cancelled/expired	(10)	10.67
Outstanding at March 31, 2014	16,168	\$ 5.24

The following table summarizes activity with respect to our time-based restricted stock unit awards, or RSUs, during the three months ended March 31, 2014, in thousands (except per share data):

	<b>RSUs</b>	<b>Weighted- Average Grant-Date Fair Value</b>
Unvested at January 1, 2014	369	\$ 7.23
Granted	0	

Vested	(33)	8.81
Forfeited/cancelled	0	
Unvested at March 31, 2014	336	\$ 7.07

In the three months ended March 31, 2014, we granted our executive officers Total Stockholder Return, or TSR, performance restricted stock unit, or PRSU, awards. The PRSUs may be earned and converted into outstanding shares of our common stock based on the TSR of our common stock relative to the TSR over a three-year performance period beginning March 1, 2014, of the NASDAQ Biotechnology Index. In the aggregate, the target number of shares of common stock that may be earned under the PRSUs is 695,000; however, the actual number of shares that may be earned ranges from 0% to 200% of such amount. In addition, there is a cap on the number of shares that can be earned under the PRSUs equal to six times the grant-date fair value of the award, and funding is capped at 100% if the absolute 3-year TSR is negative even if performance is above the median. As these awards contain a market condition, we used a Monte Carlo simulation model to estimate their grant-date fair value, which totaled \$5.0 million and will be recognized over the performance period. The table below sets forth the assumptions used to value the PRSUs granted in 2014 and their estimated grant-date fair value:

Risk-free interest rate	0.7%
Dividend yield	0%
Expected volatility	78%
Remaining performance period (years)	2.99
Estimated fair value per share of PRSUs granted	\$ 7.16

**Table of Contents**

In the three months ended March 31, 2013, we granted our executive officers PRSUs with substantially the same terms as the PRSUs granted in 2014. In the aggregate, the target number of shares of common stock that may be earned under the 2013 PRSUs is 780,000; however, the actual number of shares that may be earned ranges from 0% to 200% of such amount. The three-year performance period for the 2013 PRSUs began March 1, 2013.

All of the PRSUs granted to date were outstanding and unvested at March 31, 2014.

**9. Concentration of Credit Risk and Major Customers**

Financial instruments, which potentially subject us to concentrations of credit risk, consist primarily of cash and cash equivalents. We limit our exposure to credit loss by holding our cash primarily in US dollars or, from time to time, placing our cash and investments in US government, agency and government-sponsored enterprise obligations and in corporate debt instruments that are rated investment grade, in accordance with an investment policy approved by our Board of Directors.

Eisai is the exclusive distributor and our only customer for BELVIQ in the United States, which is the only jurisdiction for which BELVIQ has received regulatory approval for marketing. We also produce drug products for Siegfried AG, or Siegfried, under a manufacturing services agreement, and all of our manufacturing services revenues are attributable to Siegfried.

Percentages of our total revenues are as follows:

	<b>Three months ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Eisai marketing and supply agreement	91.4%	63.0%
Manufacturing services agreement with Siegfried	6.6%	32.2%
Other collaborative agreements	2.0%	4.8%
Total percentage of revenues	100.0%	100.0%

Our investment in TaiGen equity securities is subject to market price volatility. See Note 3. Fluctuations in the market price of publicly traded securities may result from perceived changes in the underlying economic characteristics of the issuer, the relative price of alternative investments, general market conditions and other factors.

**10. Net Loss Per Share**

We calculate basic and diluted net loss per share using the weighted-average number of shares of common stock outstanding during the period.

Since we are in a net loss position, we have excluded from our calculation of diluted net loss per share all potentially dilutive (i) stock options, (ii) RSUs, (iii) PRSUs, (iv) unvested restricted stock in our deferred compensation plan and (v) warrants, and our diluted net loss per share is the same as our basic net loss per share. The table below presents the potentially dilutive securities that were excluded from our calculation of diluted net loss per share for the periods presented, in thousands.

	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2014</b>	<b>2013</b>
Stock options	4,581	5,961
Warrants	679	982
RSUs and unvested restricted stock	99	82
Total	5,359	7,025

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**Table of Contents**

**11. Legal Proceedings**

Beginning on September 20, 2010, a number of complaints were filed in the US District Court for the Southern District of California against us and certain of our current and former employees and directors on behalf of certain purchasers of our common stock. The complaints have been brought as purported stockholder class actions, and, in general, include allegations that we and certain of our current and former employees and directors violated federal securities laws by making materially false and misleading statements regarding our BELVIQ program, thereby artificially inflating the price of our common stock. The plaintiffs are seeking unspecified monetary damages and other relief. On August 8, 2011, the Court consolidated the actions and appointed a lead plaintiff and lead counsel. On November 1, 2011, the lead plaintiff filed a consolidated amended complaint. On December 30, 2011, we filed a motion to dismiss the consolidated amended complaint. On March 28, 2013, the Court granted our motion to dismiss the consolidated amended complaint without prejudice. On May 13, 2013, the lead plaintiff filed a new consolidated amended complaint. On June 14, 2013, we filed a motion to dismiss the new consolidated amended complaint. On November 5, 2013, the Court granted our motion to dismiss the new consolidated amended complaint without prejudice as to all parties except for Robert E. Hoffman, who was dismissed from the action with prejudice. On November 27, 2013, the lead plaintiff filed a motion for leave to amend the now-dismissed new consolidated amended complaint. On March 20, 2014, the Court denied plaintiff's motion for leave to amend and dismissed the consolidated amended complaint with prejudice. On April 18, 2014, the lead plaintiff filed a notice of appeal.

In addition to the class actions, a complaint involving similar legal and factual issues has been brought by an individual stockholder. On December 30, 2011, we filed a motion to dismiss the individual stockholder's complaint in federal court. On March 29, 2013, the Court granted our motion to dismiss, in part without prejudice. On May 13, 2013, the individual stockholder filed a new amended complaint. On June 14, 2013, we filed a motion to dismiss the new amended complaint. On March 20, 2014, the Court granted our motion to dismiss in part and remanded the remaining claims to state court.

Due to the stage of these proceedings, we are not able to predict or reasonably estimate the ultimate outcome or possible losses relating to these claims.



## **Table of Contents**

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

This discussion and analysis should be read in conjunction with our financial statements and notes thereto included in this quarterly report on Form 10-Q, or Quarterly Report, and the audited consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2013, or 2013 Annual Report, as filed with the Securities and Exchange Commission, or SEC. Operating results are not necessarily indicative of results that may occur in future periods.

This Quarterly Report includes forward-looking statements that involve a number of risks, uncertainties and assumptions. These forward-looking statements can generally be identified as such because the context of the statement will include words such as may, will, intend, plan, believe, anticipate, expect, estimate, predict, continue, likely, or opportunity, the negative of these words or other similar words. Similarly, statements that describe our plans, strategies, intentions, expectations, objectives, goals or prospects and other statements that are not historical facts are also forward-looking statements. For such statements, we claim the protection of the Private Securities Litigation Reform Act of 1995. Readers of this Quarterly Report are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the time this Quarterly Report was filed with the SEC. These forward-looking statements are based largely on our expectations and projections about future events and future trends affecting our business, and are subject to risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. These risks and uncertainties include, without limitation, the risk factors identified in our SEC reports, including this Quarterly Report. In addition, past financial or operating performance is not necessarily a reliable indicator of future performance, and you should not use our historical performance to anticipate results or future period trends. We can give no assurances that any of the events anticipated by the forward-looking statements will occur or, if any of them do, what impact they will have on our results of operations and financial condition. Except as required by law, we undertake no obligation to update publicly or revise our forward-looking statements.

BELVIQ® (pronounced BEL-VEEK) is the trade name for the finished drug product containing the active pharmaceutical ingredient lorcaserin hydrochloride, or lorcaserin, that is marketed for chronic weight management in the United States. Lorcaserin may in the future be marketed in the United States or in other countries under a different trade name for chronic weight management. Lorcaserin may also be marketed as BELVIQ or under a different trade name for a different indication, in a different formulation or in combination with another drug. In this report, we use BELVIQ to refer to the finished drug product containing lorcaserin and/or, depending on the context, the active pharmaceutical ingredient lorcaserin, and without regard to the current or potential indication, formulation or combination.

## **OVERVIEW AND RECENT DEVELOPMENTS**

We are a biopharmaceutical company focused on discovering, developing and commercializing novel drugs that target G protein-coupled receptors to address unmet medical needs. Our US operations are located in San Diego, California, and our operations outside of the United States, including our commercial manufacturing facility, are located in Zofingen, Switzerland.

BELVIQ, our internally discovered drug for chronic weight management, is approved for marketing in the United States and was made available by prescription in June 2013 to adults who are overweight with a comorbidity or obese. Eisai is responsible for marketing and distributing BELVIQ in the United States under the Second Amended and Restated Marketing and Supply Agreement, or Eisai Agreement, which is among our wholly owned subsidiary, Arena Pharmaceuticals GmbH, or Arena GmbH, Eisai Inc., and Eisai Inc.'s parent company, Eisai Co., Ltd., which we refer to collectively with Eisai Inc. as Eisai.

With respect to the United States, Eisai is focused on physician awareness and education efforts, securing broad reimbursement coverage, and creating patient awareness and access for BELVIQ. The sales force for BELVIQ totaled approximately 400 representatives around the end of 2013, and Eisai recently announced plans to add approximately 200 more representatives by July 2014, increasing the number of representatives for BELVIQ to approximately 600. Eisai believes this expansion of the sales force will enable Eisai to reach approximately 90,000 physicians in the United States. Eisai also recently announced that its continued work to expand reimbursement has resulted in additional insurance coverage for BELVIQ. In addition, Eisai recently launched a national television advertising campaign for BELVIQ as part of its patient awareness and support campaign that is intended to complement its physician awareness efforts.

Under the Eisai Agreement, Arena GmbH also granted Eisai exclusive commercialization rights for BELVIQ in all of the other countries in the world, except for South Korea, Taiwan, Australia, New Zealand and Israel. Arena GmbH also has marketing and supply agreements with Ildong Pharmaceutical Co., Ltd., or Ildong, for BELVIQ in South Korea, which we refer to as the Ildong BELVIQ Agreement, and with CY Biotech Company Limited, or CYB, in Taiwan, which we refer to as the CYB Agreement. We intend to enter into additional collaborative agreements for the potential regulatory approval and commercialization of BELVIQ in Australia, New Zealand and Israel.

## **Table of Contents**

The marketing of BELVIQ is subject to applicable regulatory approval. BELVIQ has been approved for marketing in the United States, but currently not in any other country.

Our collaborators are responsible for regulatory activities related to obtaining marketing approval of BELVIQ in the territories covered under the respective agreement. Eisai filed applications for regulatory approval of BELVIQ in Mexico and Canada in March and June of 2013, respectively, and in Brazil in February 2014. In addition, Ildong submitted an application for regulatory approval of BELVIQ in South Korea in November 2013. We previously filed applications for marketing approval of BELVIQ with the regulatory authorities for the European Union and Switzerland, and these regulatory authorities notified us that we had not yet satisfactorily addressed their concerns and that our applications would not be approved. We expect to continue to work with Eisai in pursuing regulatory approvals for BELVIQ in Europe and other territories outside the United States. In addition, CYB intends to file an application for regulatory approval of BELVIQ in Taiwan.

In addition to commercializing BELVIQ as a monotherapy for chronic weight management, we intend to explore, with our collaborators or independently, BELVIQ's therapeutic potential in combination with other drugs, for other indications, and using different formulations. Under the Eisai Agreement, we and Eisai have initially prioritized the development areas of smoking cessation, a once-daily formulation, and co-administration with phentermine, as well as exploring BELVIQ's effect on conversion to type 2 diabetes and improvements in cardiovascular outcomes. In March 2014, we and Eisai initiated a Phase 2 clinical trial to evaluate the potential of lorcaserin as a drug candidate for smoking cessation, for which we and Eisai will share equally the expenses. This 12-week trial will enroll approximately 600 active smokers. We have completed an initial study to evaluate the safety, tolerability and pharmacokinetic properties of different formulations of lorcaserin 20 mg extended release tablets, and selected a once-daily formulation for further development. We and Eisai will share equally the expenses related to the once-daily formulation. In November 2013, Eisai initiated dosing, and it recently completed enrollment, in a pilot study of 12-week duration to preliminarily assess as the primary outcome the short-term safety and tolerability of lorcaserin and phentermine when co-administered, for which Eisai is responsible for 100% of the expenses.

In January 2014, Eisai initiated enrollment in the cardiovascular outcomes trial, or CVOT, required by the US Food and Drug Administration, or FDA, as a postmarketing commitment. The CVOT is also referred to as CAMELLIA (Cardiovascular And Metabolic Effects of Lorcaserin In Overweight And Obese Patients). We and Eisai will be responsible for 10% and 90%, respectively, of the expenses for the FDA-required portion of such trial. In addition, CAMELLIA will also evaluate whether lorcaserin reduces the incidence of conversion to type 2 diabetes in patients without type 2 diabetes at baseline and the incidence of MACE+ (MACE or hospitalization for unstable angina or heart failure, or any coronary revascularization), both as compared to placebo. We and Eisai will share equally the expenses for this non-FDA required portion of the trial up to \$40.0 million each, and Eisai will be responsible for 100% of such expenses thereafter. CAMELLIA is expected to run approximately five years.

We also intend to utilize our discovery and development approach focused on G protein-coupled receptors, or GPCRs, to advance other of our internally discovered drug candidates, which include the following clinical-stage, orally available candidates:

APD811, an agonist of the prostacyclin receptor intended for the treatment of pulmonary arterial hypertension, has completed single- and multiple-ascending dose Phase 1 trials and is expected to begin a Phase 2 trial around the middle of 2014.

Temanogrel, an inverse agonist of the serotonin 2A receptor intended for the treatment of thrombotic diseases, has completed single- and multiple-ascending dose Phase 1 trials. Under our Co-Development and License Agreement with Ildong, which we refer to as the Ildong Temanogrel Agreement, we expect Ildong to fund and complete an additional Phase 1 trial in healthy volunteers and potentially a Phase 2a proof-of-concept trial in patients. Ildong initiated the Phase 1 trial in the first quarter of 2014 to evaluate the safety of co-administration of temanogrel with aspirin and clopidogrel.

APD334, an agonist of the sphingosine 1-phosphate subtype 1, or S1P<sub>1</sub>, receptor intended for the treatment of a number of conditions related to autoimmune diseases, which has completed a Phase 1 single-ascending dose trial. We plan to initiate a Phase 1 multiple-ascending dose trial around the middle of 2014.

APD371, an agonist of the cannabinoid-2 receptor intended for the treatment of pain, for which we have initiated a Phase 1 single-ascending dose trial.

Developing marketed drugs is a long, uncertain and expensive process, and our ability to achieve our goals, including furthering our collaborators' commercialization of BELVIQ, and obtaining regulatory approval of, and commercializing, BELVIQ in additional territories, conducting required postmarketing and other studies of BELVIQ, and advancing our drug candidates, depends on numerous factors, many of which we do not control. We will continue to seek to balance the high costs of research, development and manufacturing against the need to maintain our operations long enough to achieve sustained profitability.

We will require substantial cash to achieve our goals. To date, we have generated limited revenues from sales of BELVIQ, which is our first and only drug approved by any regulatory authority. We may continue to incur substantial losses, and do not expect to generate consistent positive operating cash flows for at least the short term. Accordingly, we will need to receive additional funds

**Table of Contents**

under our existing collaborative agreements, under future collaborative agreements for BELVIQ or one or more of our drug candidates or programs, or by raising additional funds through equity, debt or other transactions.

We refer you to our previously filed SEC reports for a more complete discussion of certain of our recent developments.

**RESULTS OF OPERATIONS**

We are providing the following summary of our revenues, research and development expenses and general and administrative expenses to supplement the more detailed discussion below. The dollar values in the following tables are in millions.

**Revenues**

<b>Source of revenue</b>	<b>Three months ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Net product sales	\$ 2.9	\$ 0.0
Amortization of upfront payments from Eisai	2.0	0.9
Reimbursements of development and patent/trademark expenses from Eisai	0.9	0.1
Milestone payment from Eisai	0.5	0.5
Manufacturing services agreement with Siegfried	0.4	0.8
Other collaborative agreements	0.1	0.1
<b>Total revenues</b>	<b>\$ 6.8</b>	<b>\$ 2.4</b>

**Research and development expenses**

<b>Type of expense</b>	<b>Three months ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Salary and other personnel costs (excluding non-cash share-based compensation)	\$ 7.5	\$ 6.8
External clinical and preclinical study fees and internal non-commercial manufacturing costs	7.4	2.1
Facility and equipment costs	2.4	2.6
Non-cash share-based compensation	1.7	0.7
Research supply costs	1.3	1.3
Other	0.7	0.5
<b>Total research and development expenses</b>	<b>\$ 21.0</b>	<b>\$ 14.0</b>

**General and administrative expenses**

Type of expense	Three months ended March 31,	
	2014	2013
Salary and other personnel costs (excluding non-cash share-based compensation)	\$ 3.1	\$ 2.5
Legal, accounting and other professional fees	1.4	2.0
Facility and equipment costs	1.4	1.1
Non-cash share-based compensation	1.4	1.0
Other	0.7	0.7
Total general and administrative expenses	\$ 8.0	\$ 7.3

### THREE MONTHS ENDED MARCH 31, 2014, AND 2013

**Revenues.** We recognized revenues of \$6.8 million for the three months ended March 31, 2014, compared to \$2.4 million for the three months ended March 31, 2013. This increase was primarily due to \$2.9 million from net product sales of BELVIQ and a \$1.1 million increase in amortization of upfront payments from Eisai resulting from the additional \$60.0 million upfront payment we received in connection with expanding our collaboration with Eisai in November 2013.

## Table of Contents

When collaborators pay us before revenues are earned, we record such payments as deferred revenues. As of March 31, 2014, we had a total of \$134.6 million in deferred revenues. Of such amount, \$100.1 million is attributable to upfront payments we received under our collaboration with Eisai, \$27.8 million is attributable to the BELVIQ product supply, \$4.5 million is attributable to the upfront payment we received under the Ildong BELVIQ Agreement and \$2.1 million is attributable to the upfront payment we received under the CYB Agreement.

Absent any new collaborations, we expect our 2014 revenues will primarily consist of (i) revenues from net product sales of BELVIQ, (ii) amortization of the upfront payments we have received from Eisai and (iii) reimbursements from Eisai for development expenses.

Revenues from sales of BELVIQ and for milestones that may be achieved in the future are difficult to predict, and our revenues will likely vary significantly from quarter to quarter and year to year. We expect that this will particularly be the case in the short term as we transition from purely a research and development company to a company with a marketed drug.

With respect to the United States, we expect that Eisai's sales of BELVIQ will increase, but, due to the early stage of commercialization, it is difficult to predict the amount or timing of such sales or the related revenues we will generate. Future sales of BELVIQ will depend on, among other factors, the availability and use of BELVIQ, the effectiveness of Eisai's marketing program, competition and reimbursement coverage. Revenues we generate from Eisai's sales of BELVIQ depend on Eisai's net product sales of BELVIQ, which are the gross invoiced sales less certain deductions described in the Eisai Agreement. Deductions from gross sales to net product sales may vary from period to period, particularly in the near term, depending on the amount and extent of such deductions, which include deductions for vouchers, savings cards or other promotions for free or discounted product. Eisai has reported that a majority of all BELVIQ prescriptions utilized vouchers or savings cards.

In addition to revenues from Eisai's commercialization of BELVIQ in the United States, we expect that any significant revenues in the short term will depend on whether and when BELVIQ receives regulatory approval, and is commercialized, outside of the United States.

**Cost of product sales.** Cost of product sales consists primarily of direct and indirect costs related to manufacturing BELVIQ, including, among other costs, salaries, share-based compensation and other personnel costs, machinery depreciation costs and amortization expense related to our manufacturing facility production licenses. We recognized cost of products sold of \$0.8 million for the three months ended March 31, 2014, and \$0.5 million for the three months ended March 31, 2013, which reflected unused capacity costs for one month in which no BELVIQ manufacturing was performed.

**Cost of manufacturing services.** Cost of manufacturing services consists primarily of direct and indirect costs associated with manufacturing drug products for Siegfried AG, or Siegfried, under our amended manufacturing services agreement, including related salaries, other personnel costs, machinery depreciation costs and amortization expense related to our manufacturing facility production licenses. Cost of manufacturing services decreased by \$1.1 million to \$0.5 million for the three months ended March 31, 2014, from \$1.6 million for the three months ended March 31, 2013, primarily due to our contract loss provision for these services, which is the result of providing the services at sales prices that are less than our costs, as well as the reduced volume of manufacturing services performed.

**Research and development expenses.** Research and development expenses, which account for the majority of our expenses, consist primarily of salaries and other personnel costs, clinical trial costs (including payments to contract research organizations, or CROs), preclinical study fees, manufacturing costs for non-commercial products, costs for

the development of our earlier-stage programs and technologies, research supply costs and facility and equipment costs. We expense research and development costs as they are incurred when these expenditures have no alternative future uses. We generally do not track our earlier-stage, internal research and development expenses by project; rather, we track such expenses by the type of cost incurred.

Research and development expenses increased by \$7.0 million to \$21.0 million for the three months ended March 31, 2014, from \$14.0 million for the three months ended March 31, 2013. This was primarily due to increases of (i) \$5.3 million in external clinical and preclinical study fees and internal non-commercial manufacturing costs, primarily related to manufacturing costs for non-commercial products and the BELVIQ cardiovascular outcomes trial, (ii) \$1.0 million in non-cash share-based compensation expense and (iii) \$0.7 million in salary and personnel costs. We expect to continue to incur substantial research and development expenses in 2014, which we expect will be substantially higher than in 2013. Such expenses will include costs for FDA-required and non-FDA required development work relating to BELVIQ, including CAMELLIA and studies for smoking cessation and a once-daily formulation, as well as our other research and development programs.

Included in the \$7.4 million total external clinical and preclinical study fees and internal non-commercial manufacturing costs noted in the table above for the three months ended March 31, 2014, was \$3.7 million related to non-commercial manufacturing costs, \$2.9 million related to BELVIQ, \$0.4 million related to APD811 and \$0.1 million related to APD334. Included in the \$2.1 million total external clinical and preclinical study fees and internal non-commercial manufacturing costs noted in the table above for the three



## **Table of Contents**

months ended March 31, 2013, was \$1.0 million related to non-commercial manufacturing costs, \$0.5 million related to BELVIQ, \$0.3 million related to APD811 and \$0.1 million related to APD334.

**General and administrative expenses.** General and administrative expenses increased by \$0.7 million to \$8.0 million for the three months ended March 31, 2014, from \$7.3 million for the three months ended March 31, 2013. This was primarily due to increases of (i) \$0.6 million in salary and personnel costs, (ii) \$0.4 million in non-cash share-based compensation and (iii) \$0.3 million in accounting and auditing fees, which were partially offset by a \$0.7 million decrease in patent and trademark fees. We expect that our 2014 general and administrative expenses will be higher than in 2013.

**Interest and other income (expense), net.** Interest and other income (expense), net, decreased to an expense of \$1.7 million for the three months ended March 31, 2014, from income of \$2.1 million for the three months ended March 31, 2013. This \$3.8 million decrease was primarily due to a \$0.1 million non-cash loss from revaluation of our derivative liabilities for the three months ended March 31, 2014, compared to a \$3.9 million gain for the three months ended March 31, 2013.

## **LIQUIDITY AND CAPITAL RESOURCES**

We have accumulated a large deficit since inception that has primarily resulted from the significant research and development expenditures we have made in seeking to identify and validate new drug targets and develop compounds that could become marketed drugs. In June 2013, BELVIQ was made available to patients by prescription in the United States by our collaborator, Eisai. It is difficult to predict the payments we will receive from commercialization of BELVIQ in the United States or in any other territory in which BELVIQ may be approved for marketing. We may incur substantial losses for at least the short term as a result of manufacturing BELVIQ for commercial sale and studies, conducting required postmarketing and other studies of BELVIQ, including other indications and formulations, and advancing our research and development programs.

### *Short term*

As of March 31, 2014, we had \$203.3 million in cash and cash equivalents. We believe our cash and cash equivalents will be sufficient to fund our operations for at least the next 12 months. We expect that our short-term operating expenses will be substantial as we continue to fund BELVIQ-related activities, and, at the same time, advance certain of our research and development programs.

In addition to payments expected from Eisai for purchases of BELVIQ product supply, other potential sources of liquidity in the short term include (i) payments from Eisai upon achievement of additional milestones, (ii) entering into new collaborative, licensing or commercial agreements for BELVIQ in additional territories or for one or more of our drug candidates or programs, (iii) milestone and other payments from collaborators other than Eisai and (iv) the sale or lease of facilities or other assets we own.

Due to impairment charges, our investment in TaiGen Biotechnology Co., Ltd., or TaiGen, has had a cost basis of zero since December 31, 2011. On January 17, 2014, TaiGen completed an initial public offering on the GreTai Securities Listed Market, valuing our investment at a fair value of \$49.1 million. In accordance with generally accepted accounting principles, on January 17, 2014, we recorded our investment in TaiGen at such fair value, with the unrealized gain recorded as a component of accumulated other comprehensive income (loss) in the stockholders equity section of our condensed consolidated balance sheets. As of March 31, 2014, our investment in TaiGen was recorded at its fair value of \$53.2 million, with the unrealized gain recorded in accumulated other comprehensive income (loss).

Eisai is commercializing BELVIQ in the United States, and, subject to applicable regulatory approval, we expect Eisai to commercialize BELVIQ in additional territories under the Eisai Agreement. Eisai and we have regulatory applications for approval of BELVIQ under review in a number of countries outside of the United States. We also expect that Eisai will file additional regulatory applications for approval of BELVIQ in additional territories under the Eisai Agreement, but there is no assurance of whether, where or when Eisai may file any additional applications. There is also no assurance of whether, where or when BELVIQ will be approved for marketing outside of the United States, and, therefore, we expect that all or most of the revenues for BELVIQ sales in the short term will be from Eisai's commercialization of BELVIQ in the United States.

We manufacture BELVIQ at our facility in Switzerland, and sell BELVIQ to Eisai for Eisai's commercialization in the United States and, subject to applicable regulatory approval, in the other territories under the Eisai Agreement (other than Europe, China and Japan) for a purchase price starting at 31.5% and 30.75%, respectively (and starting at 27.5% in Europe, China and Japan), of Eisai's aggregate annual net product sales (which are the gross invoiced sales less certain deductions described in the Eisai Agreement), or the Product Purchase Price, in the respective territory. The Product Purchase Price will increase on a tiered basis in the United States and the other territories (other than Europe, China and Japan) to as high as 36.5% and 35.75%, respectively, on the portion of Eisai's annual aggregate net product sales exceeding \$750.0 million in all territories other than Europe, China and Japan. The Product Purchase Price will increase to 35% in Europe, China and Japan on the portion of Eisai's annual aggregate net product sales exceeding \$500.0 million in such territories. The Product Purchase Price is subject to reduction (for sales in a particular country), including in the event of generic competition in the applicable country. The revenue we recognize for BELVIQ product revenue related to redemption of vouchers is based on our cost of goods sold. Under the Eisai Agreement, we are eligible to receive up to an aggregate of

## **Table of Contents**

\$176.0 million in additional regulatory and development milestone payments. We do not expect to receive the majority (or potentially any) of such payments in the short term.

As part of the US approval of BELVIQ, the FDA is requiring the evaluation of the effect of long-term treatment with BELVIQ on the incidence of major adverse cardiovascular events, or MACE, in overweight and obese patients with cardiovascular disease or multiple cardiovascular risk factors, as well as the conduct of postmarketing studies to assess the safety and efficacy of BELVIQ for weight management in obese pediatric patients. With respect to such studies, which we expect will take several years to complete, Eisai and we will be responsible for 90% and 10%, respectively, of the expenses for the FDA-required portion of the cardiovascular outcomes trial, and we will share equally with Eisai the expenses of certain pediatric studies.

Eisai is responsible for regulatory activities related to the BELVIQ New Drug Application, or NDA, and for the regulatory activities for obtaining marketing approval in any country in the additional territories under the Eisai Agreement. If the regulatory authority for a country in the additional territories requires development work before or following approval of BELVIQ in such country, we and Eisai will share expenses for such work. In addition, Ildong and CYB are responsible for the regulatory approval and, ultimately, marketing and distribution of BELVIQ in South Korea and Taiwan, respectively, including related development costs and other expenses.

We expect to incur additional expenses for the development of lorcaserin products that are in addition to BELVIQ for weight management. We expect Eisai to share such expenses, but, nevertheless, that such expenses will be significant. Under the Eisai Agreement, we and Eisai have initially prioritized the development areas of smoking cessation, a once-daily formulation and co-administration with phentermine, as well as exploring, including as part of CAMELLIA, BELVIQ's effect on conversion to type 2 diabetes and improvements in cardiovascular outcomes.

To date, we have obtained cash and funded our operations primarily through equity financings, payments from collaborators, the issuance of debt and related financial instruments and sale leaseback transactions. Although we expect that payments related to the commercialization of BELVIQ may be substantial in the short term, we expect to continue to evaluate various funding alternatives on an ongoing basis. There is no guarantee that additional funding will be available or that, if available, such funding will be adequate or available on terms that we or our stockholders view as favorable.

### *Long term*

We will need substantial cash to achieve our objectives of discovering, developing and commercializing drugs, and this process typically takes many years and potentially several hundreds of millions of dollars for an individual drug. We may not have adequate available cash, or assets that could be readily turned into cash, to meet these objectives in the long term. We will need to obtain significant funds under our existing collaborations, under new collaborative, licensing or other commercial agreements for BELVIQ or one or more of our drug candidates and programs or patent portfolios, or from other potential sources of liquidity, which may include the public and private financial markets.

We expect to continue to incur substantial costs for BELVIQ, including costs related to manufacturing and required postmarketing and other studies. As described above under short term, we will be responsible for a portion of the expenses for BELVIQ development work required by regulatory agencies. In addition, with respect to any development work not required by the FDA that we may conduct relating to BELVIQ, we would expect to incur additional expenses, which may be significant regardless of whether we share the expenses with Eisai. Expenses for the portion of CAMELLIA not required by the FDA (most of which we do not expect will be incurred for several years, if ever) will be shared equally by Eisai and us up to an aggregate of \$40.0 million each, and, thereafter, Eisai will be responsible for 100% of such expenses.

Subject to applicable regulatory approval, we expect Eisai to commercialize BELVIQ in additional territories under the Eisai Agreement. Under such agreement, in addition to payments for purchases of BELVIQ, we are eligible to receive up to an aggregate of \$1.56 billion in one-time purchase price adjustment payments and other payments. These payments include up to an aggregate of \$1.19 billion that are based on Eisai's annual net product sales of BELVIQ in all of the territories under the Eisai Agreement on an aggregate basis, with the first and last amounts payable with annual net product sales of \$250.0 million and \$2.5 billion, respectively. Of these payments, Eisai will pay us a total of \$330.0 million for annual net product sales of up to \$1.0 billion. The \$1.56 billion also includes \$370.0 million in one-time purchase price adjustment payments we are eligible to receive based on annual net product sales in the non-US territories, comprised of \$185.0 million based on Eisai's annual net product sales in the non-US territories in North and South America and \$185.0 million based on Eisai's annual net product sales in the territories outside of North and South America. The first and last amounts are payable upon first achievement of annual net product sales of \$100.0 million and \$1.0 billion, respectively, with respect to each of the following areas: (i) the non-US territories in North and South America and (ii) the territories outside of North and South America. In addition, we are also eligible to receive certain payments by Eisai if certain annual minimum sales requirements in Mexico, Canada and Brazil are not met during the first ten years after initial commercial sale in such territories.

Under the Ildong BELVIQ Agreement and CYB Agreement, we are