

GENENCOR INTERNATIONAL INC  
Form 10-Q  
August 13, 2003

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
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FORM 10-Q

(MARK ONE)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2003

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 000-31167

GENENCOR INTERNATIONAL, INC.  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)  
-----

DELAWARE

(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

16-13

(I.R.S.  
IDENTIFICAT

925 PAGE MILL ROAD  
PALO ALTO, CALIFORNIA 94304  
(650) 846-7500  
(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE  
NUMBER, INCLUDING AREA CODE, OF REGISTRANT'S PRINCIPAL EXECUTIVE OFFICES)  
-----

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 REPORT(S), AND (2) HAS BEEN SUBJECT TO SUCH  
FILING REQUIREMENTS FOR THE PAST 90 DAYS

YES  NO

INDICATE BY CHECK MARK WHETHER THE REGISTRANT IS AN ACCELERATED  
FILER (AS DEFINED IN RULE 12b-2 OF THE EXCHANGE ACT).

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YES [ X ] NO [ ]  
-----

INDICATE THE NUMBER OF SHARES OUTSTANDING OF EACH OF THE ISSUER'S CLASSES OF COMMON STOCK, AS OF THE LATEST PRACTICABLE DATE.

| CLASS                                    | NUMBER OF SHARES OUTSTANDING AT |
|--|---------------------------------|
| COMMON STOCK, PAR VALUE \$0.01 PER SHARE | 58,980,489                      |

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This Report contains forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. These include statements concerning plans, objectives, goals, strategies, future events or performance and all other statements which are other than statements of historical fact, including without limitation, statements containing the words "believes," "anticipates," "expects," "estimates," "projects," "will," "may," "might" and words of a

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similar nature. The forward-looking statements contained in this Report reflect the Company's current beliefs and expectations on the date of this Report. Actual results, performance or outcomes may differ materially from those expressed in the forward-looking statements. Some of the important factors which, in the view of the Company, could cause actual results to differ from those expressed in the forward-looking statements are discussed in Part I, Item 2 of this Report and in the Company's 2002 Annual Report on Form 10-K. The Company disclaims any obligation to publicly announce any revisions to these forward-looking statements to reflect facts or circumstances of which the Company becomes aware after the date hereof.

Unless otherwise specified, all references in this Report to the "Company", "we", "us", "our", and "ourselves" refer to Genencor International, Inc. and its subsidiaries collectively, as appropriate in the context of the disclosure.

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### PART I. FINANCIAL INFORMATION

#### ITEM 1. FINANCIAL STATEMENTS

##### GENENCOR INTERNATIONAL, INC. AND SUBSIDIARIES

##### CONDENSED CONSOLIDATED UNAUDITED BALANCE SHEETS (AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

|   |    | JUNE<br>20<br>-- |
|---|----|------------------|
| <b>ASSETS</b>   |    |                  |
| Current assets:   |    |                  |
| Cash and cash equivalents.....  | \$ | 15               |
| Trade accounts receivable, net .....                                    |    | 5                |
| Inventories.....  |    | 5                |
| Other current assets.....   |    | 4                |
| Total current assets.....   |    | 30               |
| Property, plant and equipment, net.....                                 |    | 22               |
| Goodwill.....   |    | 2                |
| Intangible assets, net.....   |    | 4                |
| Other assets.....   |    | 6                |
| Total assets.....   | \$ | 66               |
| <b>LIABILITIES, REDEEMABLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY</b> |    |                  |
| Current liabilities:  |    |                  |
| Notes payable.....  | \$ |                  |
| Current maturities of long-term debt.....                               |    | 2                |
| Accounts payable and accrued expenses.....                              |    | 4                |
| Other current liabilities.....  |    | 1                |

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|   |       |
|---|-------|
| Total current liabilities.....  | 9     |
| Long-term debt.....   | 5     |
| Other long-term liabilities.....  | 3     |
|   | ----- |
| Total liabilities.....  | 19    |
|   | ----- |
| Redeemable preferred stock:   |       |
| 7 1/2% cumulative series A preferred stock, without par value, authorized   |       |
| 1 shares, 1 shares issued and outstanding.....                              | 17    |
|   | ----- |
| Stockholders' equity:   |       |
| Common stock, par value \$0.01 per share, 200,000 shares authorized, 60,578 |       |
| and 60,251 shares issued at June 30, 2003 and                               |       |
| December 31, 2002, respectively.....  |       |
| Additional paid-in capital.....   | 35    |
| Treasury stock, 1,780 shares at cost at June 30, 2003 and                   |       |
| December 31, 2002.....  | (2)   |
| Deferred stock-based compensation.....                                      | (     |
| Accumulated deficit.....  | (     |
| Accumulated other comprehensive loss.....                                   | (2)   |
|   | ----- |
| Total stockholders' equity.....   | 30    |
|   | ----- |
| Total liabilities, redeemable preferred stock and stockholders' equity....  | \$ 66 |
|   | ===== |

The accompanying notes are an integral part of the condensed consolidated unaudited financial statements.

GENENCOR INTERNATIONAL, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF OPERATIONS  
(AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

|                                | THREE MONTHS ENDED |           |       |
|--------------------------------|--------------------|-----------|-------|
|                                | JUNE 30,           |           |       |
|                                | -----              |           |       |
|                                | 2003               | 2002      |       |
|                                | ----               | ----      |       |
| Revenues:                      |                    |           |       |
| Product revenue.....           | \$ 89,744          | \$ 85,470 | \$    |
| Fees and royalty revenues..... | 6,603              | 5,162     |       |
|                                | -----              | -----     | ----- |
| Total revenues.....            | 96,347             | 90,632    |       |
| Operating expenses:            |                    |           |       |
| Cost of products sold.....     | 51,786             | 46,096    |       |

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|   |          |          |       |
|---|----------|----------|-------|
| Research and development.....                           | 16,833   | 17,310   |       |
| Sales, marketing and business development.....          | 7,902    | 8,566    |       |
| General and administrative.....                         | 7,982    | 8,264    |       |
| Amortization of intangible assets.....                  | 1,498    | 1,327    |       |
| Restructuring and related charges                       | --       | 85       |       |
| Other expense/(income).....                             | 54       | (2,110)  |       |
|   | -----    | -----    |       |
| Total operating expenses.....                           | 86,055   | 79,538   |       |
|   | -----    | -----    |       |
| Operating income.....                                   | 10,292   | 11,094   |       |
| Non operating expenses/(income):                        |          |          |       |
| Investment expense.....                                 | 1,018    | --       |       |
| Interest expense.....                                   | 1,569    | 2,044    |       |
| Interest income.....                                    | (1,558)  | (1,311)  |       |
|   | -----    | -----    |       |
| Total non operating expenses/(income).....              | 1,029    | 733      |       |
|   | -----    | -----    |       |
| Income before income taxes.....                         | 9,263    | 10,361   |       |
| Provision for/(benefit from) income taxes.....          | 1,644    | 5,578    |       |
|   | -----    | -----    |       |
| Net income.....   | \$ 7,619 | \$ 4,783 | \$    |
|   | =====    | =====    | ===== |
| Net income available to holders of common<br>stock..... | \$ 5,800 | \$ 2,964 | \$    |
|   | =====    | =====    | ===== |
| Earnings per common share:                              |          |          |       |
| Basic.....  | \$ 0.10  | \$ 0.05  | \$    |
|   | =====    | =====    | ===== |
| Diluted.....  | \$ 0.10  | \$ 0.05  | \$    |
|   | =====    | =====    | ===== |
| Weighted average common shares:                         |          |          |       |
| Basic.....  | 58,570   | 59,679   |       |
|   | =====    | =====    | ===== |
| Diluted.....  | 60,230   | 60,147   |       |
|   | =====    | =====    | ===== |

The accompanying notes are an integral part of the condensed consolidated unaudited financial statements.

GENENCOR INTERNATIONAL, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF CASH FLOWS  
(AMOUNTS IN THOUSANDS)

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|   |            |
|---|------------|
| Cash flows from operating activities:   |            |
| Net income.....   | \$ 14,139  |
| Adjustments to reconcile net income to net cash provided by operating activities: |            |
| Depreciation and amortization.....  | 17,702     |
| Amortization of deferred stock-based compensation.....                            | 554        |
| Loss on disposition of property, plant and equipment.....                         | 521        |
| Loss from impairment of investment in marketable equity securities.....           | 1,018      |
| Non-cash portion of restructuring and related charges .....                       | -          |
| (Increase) decrease in operating assets:  |            |
| Trade accounts receivable.....  | (1,648)    |
| Inventories.....  | 2,307      |
| Other assets.....   | (13,260)   |
| Decrease in operating liabilities:  |            |
| Accounts payable and accrued expenses.....  | (4,491)    |
| Other liabilities.....  | (963)      |
|   | -----      |
| Net cash provided by operating activities.....                                    | 15,879     |
|   | -----      |
| Cash flows from investing activities:   |            |
| Purchases of property, plant and equipment.....                                   | (10,553)   |
| Purchases of intangible assets.....   | -          |
| Proceeds from sale of business.....   | 1,145      |
| Payment to acquire equity securities.....   | -          |
| Acquisition of business, net of cash acquired.....                                | -          |
|   | -----      |
| Net cash used in investing activities.....  | (9,408)    |
|   | -----      |
| Cash flows from financing activities:   |            |
| Proceeds from exercise of stock options.....                                      | 1,876      |
| Proceeds from employee stock purchase plan.....                                   | 732        |
| Net proceeds (payments) on revolving credit facility.....                         | 91         |
| Net payments on notes payable of foreign affiliate .....                          | -          |
| Payment of long-term debt.....  | (28,123)   |
|   | -----      |
| Net cash used in financing activities.....  | (25,424)   |
|   | -----      |
| Effect of exchange rate changes on cash.....                                      | 5,333      |
|   | -----      |
| Net decrease in cash and cash equivalents.....                                    | (13,620)   |
| Cash and cash equivalents -- beginning of period.....                             | 169,001    |
|   | -----      |
| Cash and cash equivalents -- end of period.....                                   | \$ 155,381 |
|   | =====      |

The accompanying notes are an integral part of the condensed consolidated unaudited financial statements.

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NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS  
(AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

### 1 -- BASIS OF PRESENTATION

The condensed consolidated unaudited financial statements should be read in conjunction with the Company's audited consolidated financial statements and related footnotes for the year ended December 31, 2002, as included in the Company's Annual Report on Form 10-K. These interim financial statements have been prepared in conformity with the rules and regulations of the U.S. Securities and Exchange Commission. Certain disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations pertaining to interim financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for fair presentation of the interim financial statements have been included therein. The results of operations of any interim period are not necessarily indicative of the results of operations for the full year.

### 2 -- NEW ACCOUNTING PRONOUNCEMENTS

In April 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This Statement amends SFAS No. 133 for decisions made (1) as part of the Derivatives Implementation Group process that effectively required amendments to SFAS No. 133, (2) in connection with other FASB projects dealing with financial instruments, and (3) in connection with implementation issues raised in relation to the application of the definition of a derivative. This Statement is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. All provisions of this Statement are to be applied prospectively. The Company will apply the provisions of this statement as of July 1, 2003. The adoption of SFAS No. 149 will not have a material impact on the Company's financial position or results of operations.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This statement establishes standards for how the Company classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that the Company classify a financial instrument within its scope as a liability. Some of the provisions of this Statement are consistent with the current definition of liabilities in FASB Concepts Statement No. 6, "Elements of Financial Statements." The remaining provisions of this Statement are consistent with the FASB's proposal to revise that definition to encompass certain obligations that a reporting entity can or must settle by issuing its own equity shares, depending on the nature of the relationship established between the holder and the issuer. This Statement is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company is currently assessing the impact of this new standard on its financial statements.

### 3 -- EARNINGS PER SHARE

SFAS No. 128, "Earnings per Share," requires the disclosure of basic and diluted earnings per share. Basic earnings per share is computed based on the weighted average number of common shares outstanding during the period. In arriving at net income available to holders of common stock, undeclared and

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unpaid dividends on redeemable preferred stock of \$1,819 and \$3,638 were deducted from net income for each quarter presented and for each six-month period presented, respectively.

Diluted earnings per common share reflects the potential dilution that could occur if dilutive securities and other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the net income available to holders of common stock of the Company. As a result of stock options outstanding under the Company's 2002 Omnibus Incentive Plan, successor to the Company's Stock Option and Stock Appreciation Right Plan, there were dilutive securities for the three and sixth months ended June 30, 2003 and 2002. The

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weighted-average impact of these has been reflected in the calculation of diluted earnings per common share for the respective periods presented.

The following table reflects the calculation of basic and diluted earnings per common share for the three and sixth months ended June 30, 2003 and 2002:

|   | THREE MONTHS ENDED<br>JUNE 30,<br>----- |                   | SIX MONTHS<br>JUNE 30,<br>----- |             |
|---|---|-------------------|---------------------------------|-------------|
|   | 2003<br>----                            | 2002<br>----      | 2003<br>----                    |             |
| Net income .....                                      | \$ 7,619                                | \$ 4,783          | \$ 14,139                       | \$          |
| Less: Accrued dividends on preferred stock .....      | (1,819)                                 | (1,819)           | (3,638)                         | (           |
| Net income available to holders of common stock ..... | \$ 5,800<br>=====                       | \$ 2,964<br>===== | \$ 10,501<br>=====              | \$<br>===== |
| Weighted average common shares:                       |   |                   |                                 |             |
| Basic .....   | 58,570                                  | 59,679            | 58,534                          | 5           |
| Effect of stock options .....                         | 1,660                                   | 468               | 981                             |             |
| Diluted .....   | 60,230<br>=====                         | 60,147<br>=====   | 59,515<br>=====                 | 6<br>=====  |
| Earnings per common share:                            |   |                   |                                 |             |
| Basic .....   | \$ 0.10<br>=====                        | \$ 0.05<br>=====  | \$ 0.18<br>=====                | \$<br>===== |
| Diluted .....   | \$ 0.10<br>=====                        | \$ 0.05<br>=====  | \$ 0.18<br>=====                | \$<br>===== |

4 -- STOCK-BASED COMPENSATION

The Company adopted the disclosure provisions of SFAS No. 148 effective January 1, 2003. The Company uses the intrinsic value method to account for stock-based employee compensation in accordance with Accounting Principles Board (APB) Opinion No. 25 "Accounting for Stock Issued to Employees" and has no current plans to convert to the fair value method.



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On a pro forma basis, had compensation cost for the Company's stock option plans been determined based on the weighted average fair value at the grant date, the Company's net income and earnings per share would have been reduced to the pro forma amounts shown below for the three and sixth months ended June 30, 2003 and 2002:

|   | THREE MONTHS ENDED<br>JUNE 30, |          |
|---|--------------------------------|----------|
|   | 2003                           | 2002     |
|   | -----                          | -----    |
| Net income available to holders of common stock -<br>as reported.....   | \$ 5,800                       | \$ 2,964 |
| Add: Stock-based employee compensation expense<br>included in reported net income available,<br>net of related tax .....                              | 124                            | 218      |
| Deduct: Total stock-based employee compensation<br>expense determined under fair value based<br>method for all awards, net of related tax effect..... | (1,324)                        | (1,340)  |
|   | -----                          | -----    |
| Net income available to holders of common stock -<br>pro forma .....  | \$ 4,600                       | \$ 1,842 |
|   | =====                          | =====    |
| Basic - as reported .....   | \$ 0.10                        | \$ 0.05  |
| Basic - pro forma .....   | \$ 0.08                        | \$ 0.03  |
| Diluted - as reported .....   | \$ 0.10                        | \$ 0.05  |
| Diluted - pro forma .....   | \$ 0.08                        | \$ 0.03  |

The pro forma figures in the preceding table may not be representative of pro forma amounts in future quarters.

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On June 6, 2003, the Company granted 47 shares of restricted common stock to certain executive officers. These restricted shares were granted at fair market value at the date of grant and the restrictions on these awards expire three years from the grant date. Deferred compensation of \$675 was recorded in connection with these awards and was determined based on the number of granted restricted shares and the fair market value on the grant date. This amount was recorded as a component of stockholders' equity and will be amortized as a charge to operations over the vesting period of the awards.

5 -- INVENTORIES

Inventories consist of the following:

| JUNE 30, | DECEMBER 31, |
|----------|--------------|
| 2003     | 2002         |
| ----     | ----         |

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|                       |          |          |
|-----------------------|----------|----------|
| Raw materials .....   | \$ 8,686 | \$ 8,373 |
| Work-in-progress..... | 7,876    | 8,003    |
| Finished goods .....  | 39,011   | 37,839   |
|                       | -----    | -----    |
| Inventories .....     | \$55,573 | \$54,215 |
|                       | =====    | =====    |

During the quarter ended June 30, 2003, the Company sustained damage to its finished bioproduct inventory as a result of an accident in a third party warehouse in Rotterdam, the Netherlands. While there has been no material interruption in product flow to customers, the Company reduced its inventories by \$7,487 to reflect the estimated amount of product that was lost. In addition, \$1,041 of other costs were incurred as a result of the accident. These amounts have been recorded in other current assets as a receivable from the Company's insurer. Certain reduced profits and additional costs, such as production inefficiencies, additional freight and use of overtime are reflected in the results of operations during the quarter ended June 30, 2003. While the Company believes that these reduced profits and additional costs will be subject to insurance recovery, the Company is unable to estimate the ultimate recovery at this time.

6 -- GOODWILL AND OTHER INTANGIBLE ASSETS

The Company adopted the provisions of SFAS No. 142 effective as of January 1, 2002. Accordingly, the Company no longer amortizes goodwill or other intangible assets with indefinite useful lives. The Company has identified such other indefinite-lived intangible assets to include certain previously acquired technology. The Company will periodically evaluate its indefinite-lived intangible assets for impairment in accordance with the provisions of SFAS No. 142. The Company also has other intangible assets, such as patents, licenses, and customer lists, which will continue to be amortized using the straight-line method. These assets are expected to have no residual value once they are fully amortized.

The following table summarizes the changes in each major class of intangible assets from December 31, 2002 through June 30, 2003:

|  | INTANGIBLE ASSETS |                                |
|--|-------------------|--------------------------------|
|  | TECHNOLOGY        | OTHER<br>AMORTIZABLE<br>ASSETS |
|  | -----             | -----                          |
| Balances, December 31, 2002                                | \$ 15,617         | \$ 65,429                      |
| Foreign currency translation<br>and other adjustments..... | -                 | 1,705                          |
|  | -----             | -----                          |
| Balances, June 30, 2003.....                               | \$ 15,617         | 67,134                         |
|  | =====             |                                |
| Less: Accumulated<br>amortization.....                     |                   | (38,681)                       |
|  |                   | -----                          |
| Intangible assets, net.....                                |                   | \$ 28,453                      |
|  |                   | =====                          |

In conjunction with the acquisition discussed in Note 10, the Company

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acquired certain intangible assets on December 31, 2002. The Company is currently in the process of segregating these intangible assets among the major classes. As such, the estimated value of these intangible assets has been included in other amortizable intangible assets and will be segregated among the major classes once the Company completes its allocation of the purchase price.

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The foreign currency translation and other adjustments of \$1,705 consists of \$2,802 of foreign currency translation. Also included are additional acquisition costs of \$48 to acquire the assets and the sale of certain acquired assets for \$1,145, which were sold at fair market value resulting in no gain or loss on the sale.

Estimated fiscal year amortization expense is as follows:

|           |  |
|-----------|--|
| 2003..... |  |
| 2004..... |  |
| 2005..... |  |
| 2006..... |  |
| 2007..... |  |

### 7 --STOCKHOLDERS' EQUITY

Accumulated other comprehensive loss consists of the following:

|                                  | FOREIGN<br>CURRENCY<br>TRANSLATION<br>ADJUSTMENT<br>----- | MARKETABLE<br>SECURITIES<br>VALUATION<br>ADJUSTMENT<br>----- |
|----------------------------------|---|--|
| Balances, December 31, 2002..... | \$ (39,200)   | \$ (3,463)   |
| Current period change.....       | 17,911  | 1,456  |
|                                  | -----   | -----  |
| Balances, June 30, 2003.....     | \$ (21,289)   | \$ (2,007)   |
|                                  | =====   | =====  |

The change in the marketable securities valuation adjustment for the six months ended June 30, 2003 includes unrealized holding gains of \$1,172, (\$1,864 pre-tax) on the Company's available-for-sale securities. The remaining \$284 (\$451 pre-tax) relates to a reduction to other comprehensive loss resulting from the investment loss discussed in Note 8.

### 8 -- INVESTMENT EXPENSE

During the second quarter of 2003, the Company recorded an investment loss

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of \$1,018 as a result of the Company's assessment of an "other than temporary" decline in the fair market value of an investment in certain common stock. This amount is included in investment expense as part of total non operating expense/(income) for the period. There were no sales of marketable equity securities during the six months ended June 30, 2003.

### 9-- INCOME TAXES

The effective income tax rate for the six months ended June 30, 2003 was a 25% tax expense, compared to a 326% tax benefit for the six months ended June 30, 2002, which reflects the Company's assessment of its annual effective income tax rate. Factors affecting the Company's estimated annual effective income tax rate include increased research and development expenditures in the United States, the statutory income tax rates and mix of earnings among tax jurisdictions, amortization of certain intangible assets and other items which are not deductible for tax purposes, and research and experimentation tax credits. In addition, the estimated annual effective rate for the six months ended June 30, 2003 included the effect of estimated valuation allowances, since the Company does not have the ability to carry back or anticipate the ability to carry forward its United States net operating losses. The effective rate for the six months ended June 30, 2002 included the effect of restructuring and related charges. Accordingly, the tax benefit related to the restructuring and related charges of approximately \$6,000 was recorded in the first quarter of 2002.

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### 10 -- ACQUISITION

On December 31, 2002, the Company acquired the brewing and enzyme business of Rhodia Food UK Limited for a total cash purchase price of \$8,925. The acquisition included technology, product lines and personnel. The acquisition expanded the Company's Bioproducts portfolio and technical service capabilities in the food, feed and specialty enzyme market sector. No facilities were included in the transaction. The acquisition has been accounted for under the purchase method in accordance with SFAS No. 141, "Business Combinations." The results of operations of the acquired business were consolidated with the Company's results of operations beginning January 1, 2003.

According to the Company's preliminary allocation of the purchase price on December 31, 2002, the \$8,925 consists solely of intangible assets. Due to the effect of foreign currency translation, additional acquisition costs and the sale of certain acquired assets, the intangible assets are \$8,703 at June 30, 2003. The Company is continuing to evaluate the allocation of the purchase price for the acquisition, including the segregation of separately identifiable intangible assets. The Company anticipates that this process will be completed during 2003.

### 11 -- RESTRUCTURING AND RELATED CHARGES

During February 2002, as a result of the acquisition of Enzyme Bio-Systems Ltd. (EBS), now known as Genencor International Wisconsin, Inc., from Corn Products International, Inc. and general economic conditions in Latin America, including the devaluation of the Argentine Peso, the Company engaged in a plan to restructure its overall supply infrastructure by ceasing operations at its Elkhart, Indiana plant and downsizing its Argentine facilities. As a result of the plan, restructuring and related charges of \$16,379 were recorded in the Company's operating earnings in the six months ended June 30, 2002. This

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restructuring was completed during 2002.

12 -- SEGMENT REPORTING

The Company has adopted SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information." Segments were determined based on products and services provided by each segment. Accounting policies for the segments are the same as those described in Note 1, "Summary of Significant Accounting Policies" of the Company's Annual Report on Form 10-K for the year ended December 31, 2002. Performance of the segments is evaluated based on operating income of the segment. No items below operating income are allocated to the segments. The Company accounts for transactions, if any, between the segments as though they were transactions with third parties at approximate market prices. There were no material inter-segment transactions in the periods presented. During the first quarter of 2003, the Company modified its managerial financial reporting to reflect two operating segments: Bioproducts and Health Care. Accordingly, the Company is providing data in this new financial structure for the three months and six months ended June 30, 2003 and 2002.

The Bioproducts segment develops and delivers products and services to the industrial, consumer and agri-processing markets to a global customer base. All of the Company's current product revenues are derived from this segment.

The Health Care segment is focused on expanding the Company's current technology and product platforms into the health care market. This segment is primarily engaged in the performance of research and development, the securing of intellectual property and the establishment of strategic investments and collaborations.

The following table provides information by business segment; information for 2002 has been restated to reflect the reorganized business segments:

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FOR THE THREE MONTHS ENDED JUNE 30, 2003  
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|                              | Bioproducts | Health Care | Segment Subtotal | Corporate and Other | Consolidated Totals |
|------------------------------|-------------|-------------|------------------|---------------------|---------------------|
| Product revenue .....        | \$89,744    | \$ -        | \$89,744         | \$ -                | \$89,744            |
| Fees and royalty revenues .. | 6,453       | 150         | 6,603            | -                   | 6,603               |
| Total revenues .....         | 96,197      | 150         | 96,347           | -                   | 96,347              |
| Research and development ... | 10,914      | 5,919       | 16,833           | -                   | 16,833              |
| Operating income/(loss) .... | 17,737      | (7,536)     | 10,201           | 91                  | 10,292              |

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FOR THE THREE MONTHS ENDED JUNE 30, 2002  
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|  | Bioproducts | Health Care | Segment Subtotal | Corporate and Other | Consolidated Totals |
|--|-------------|-------------|------------------|---------------------|---------------------|
|--|-------------|-------------|------------------|---------------------|---------------------|

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|                              |          |         |           |       |           |
|------------------------------|----------|---------|-----------|-------|-----------|
| Product revenue .....        | \$85,470 | \$ -    | \$ 85,470 | \$ -  | \$ 85,470 |
| Fees and royalty revenues .. | 5,162    | -       | 5,162     | -     | 5,162     |
| Total revenues .....         | 90,632   | -       | 90,632    | -     | 90,632    |
| Research and development ... | 10,282   | 7,028   | 17,310    | -     | 17,310    |
| Operating income/(loss) .... | 18,798   | (9,669) | 9,129     | 1,965 | 9,129     |

FOR THE SIX MONTHS ENDED JUNE 30, 2003

|                              | Bioproducts | Health Care | Segment Subtotal | Corporate and Other | Consolidated Total |
|------------------------------|-------------|-------------|------------------|---------------------|--------------------|
| Product revenue .....        | \$179,782   | \$ -        | \$179,782        | \$ -                | \$179,782          |
| Fees and royalty revenues .. | 12,001      | 225         | 12,226           | -                   | 12,226             |
| Total revenues .....         | 191,783     | 225         | 192,008          | -                   | 192,008            |
| Research and development ... | 21,234      | 12,059      | 33,293           | -                   | 33,293             |
| Operating income/(loss) .... | 36,795      | (15,442)    | 21,353           | (298)               | 21,055             |

FOR THE SIX MONTHS ENDED JUNE 30, 2002

|                              | Bioproducts | Health Care | Segment Subtotal | Corporate and Other | Consolidated Total |
|------------------------------|-------------|-------------|------------------|---------------------|--------------------|
| Product revenue .....        | \$161,018   | \$ -        | \$161,018        | \$ -                | \$161,018          |
| Fees and royalty revenues .. | 10,349      | 75          | 10,424           | -                   | 10,424             |
| Total revenues .....         | 171,367     | 75          | 171,442          | -                   | 171,442            |
| Research and development ... | 18,756      | 14,186      | 32,942           | -                   | 32,942             |
| Operating income/(loss) .... | 18,575      | (19,391)    | (816)            | 3,542               | 2,368              |

DECEMBER 31, 2002

|                               | Bioproducts | Health Care | Segment Subtotal | Corporate and Other | Consolidated Total |
|-------------------------------|-------------|-------------|------------------|---------------------|--------------------|
| Total assets .....            | \$467,782   | \$ 5,719    | \$473,501        | \$181,421           | \$654,921          |
| Depreciation and amortization | 31,127      | 2,064       | 33,191           | -                   | 33,191             |
| Capital additions .....       | 18,153      | 1,397       | 19,550           | -                   | 19,550             |

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The following table provides a reconciliation of segment information to total consolidated information:

|  | THREE MONTHS ENDED |          |         |
|--|--------------------|----------|---------|
|  | JUNE 30,           |          |         |
|  | JUNE 30,           | JUNE 30, | JUNE    |
|  | 2003               | 2002     | 2003    |
|  | ----               | ----     | ----    |
| Net income:  |                    |          |         |
| Operating income/(loss) for reportable segments... | \$ 10,201          | \$ 9,129 | \$ 21,3 |
| Other (income)/expense .....                       | (91)               | (1,965)  | 2       |
| Investment expense .....                           | 1,018              | --       | 1,0     |
| Interest expense .....                             | 1,569              | 2,044    | 3,5     |
| Interest (income) .....                            | (1,558)            | (1,311)  | (2,4    |
| Provision for/(benefit from) income taxes.....     | 1,644              | 5,578    | 4,7     |
|  | -----              | -----    | -----   |
| Consolidated net income .....                      | \$ 7,619           | \$ 4,783 | \$ 14,1 |
|  | =====              | =====    | =====   |

Total assets:

|   |    |          |
|---|----|----------|
| Total assets for reportable segments.....                         | \$ | DECEMBER |
| Cash and cash equivalents not allocated to business segments..... |    | 2        |
| Deferred tax assets.....  |    | -        |
|   |    | -----    |
| Total consolidated assets.....                                    | \$ | =====    |

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and the notes to those statements included in our 2002 Annual Report on Form 10-K and the condensed consolidated unaudited financial statements and related notes included elsewhere in this report. In addition to disclosing results for the three months and six months ended June 30, 2003 and 2002 that are determined in accordance with Generally Accepted Accounting Principles ("GAAP"), the Company also discloses non-GAAP financial measures that exclude the effects of restructuring and related charges recorded in the 2002 period on consolidated net income available to common stockholders and diluted earnings per share and on the operating income of its Bioproducts segment. The Company is presenting non-GAAP financial measures excluding the effects of the restructuring and related charges because the Company believes it is useful for

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investors in assessing the Company's financial results compared to the same period in the prior year. Within the text, in connection with each non-GAAP financial measure presented, the Company has presented the most directly comparable financial measure calculated in accordance with GAAP and has provided a reconciliation of the differences between the non-GAAP financial measure with its most directly comparable financial measure calculated and presented in accordance with GAAP.

### OVERVIEW

We are a diversified biotechnology company that develops and delivers products and services to the industrial, consumer, agri-processing and health care markets. Our current revenues result primarily from the sale of enzyme products to the cleaning, grain processing and textile industries, with the remainder of our revenues from research funding, fees and royalties. We intend to apply our proven and proprietary technologies and manufacturing capabilities to expand sales in our existing markets and address new opportunities in the health care, agri-processing, industrial, and consumer markets. We have formed, and plan to continue to form, strategic alliances with market leaders to collaborate with us to develop and launch products.

We manufacture our products at our eight manufacturing facilities located in the United States, Finland, Belgium, China and Argentina. These products are then marketed to the industrial, consumer and agri-processing markets through our direct sales organization and other distribution channels. For the year ended December 31, 2002, we derived approximately 50% of our revenues from our foreign operations. For the six months ended June 30, 2003, we derived approximately 55% of our revenues from foreign operations.

### SUMMARY OF RESULTS

For the three months ended June 30, 2003, we reported net income available to common stockholders of \$5.8 million, or \$0.10 per diluted share, compared to net income available to common stockholders of \$3.0 million, or \$0.05 per diluted share for the three months ended June 30, 2002. For the six months ended June 30, 2003, net income available for common stockholders was \$10.5 million, or \$0.18 per diluted share, compared to approximately breakeven, for the six months ended June 30, 2002. During the six months ended June 30, 2002, we recorded restructuring and related charges of \$16.4 million, or \$10.3 million on an after-tax basis. Before these charges, we would have reported net income available to common stockholders of \$10.5 million, or \$0.17 per diluted share for the six months ended June 30, 2002.

### RESULTS OF OPERATIONS

Comparison of the Three Months Ended June 30, 2003 and 2002

Revenues. Total revenues for the three-month period ended June 30, 2003 increased \$5.7 million, or 6%, to \$96.3 million from the three-month period ended June 30, 2002, due to increases in product revenues and fees and royalty revenues.

Product Revenues. Product revenues for the three months ended June 30, 2003 increased \$4.2 million, or 5%, to \$89.7 million from the three months ended June 30, 2002. For the three months ended June 30, 2003, unit volume/mix increased 2% and the impact of foreign currency increased revenues 8% while average prices fell 5%. Volume/mix increased primarily in our food, feed and specialties markets, partially offset by a decrease in our grain processing markets.



Regionally, North American product revenues for the three months ended June 30, 2003 decreased \$2.8 million, or 7%, to \$39.1 million from the three months ended June 30, 2002, driven primarily by decreased sales to our cleaning and fabric care and grain processing markets, partially offset by increased sales to our food, feed and specialties markets. Product revenues in Europe, Africa and the Middle East for the three months ended June 30, 2003 increased \$7.5 million, or 27%, to \$35.8 million from the three months ended June 30, 2002, driven primarily by increased sales to our food, feed and specialties markets and cleaning and fabric care markets. Our product revenues in the Asia Pacific region decreased \$0.2 million, or 2%, to \$11.3 million for three months ended June 30, 2003 from the three months ended June 30, 2002 due primarily to decreased sales to our grain processing markets. Our product revenues in Latin America for the three months ended June 30, 2003 decreased \$0.3 million, or 8%, to \$3.5 million from the three months ended June 30, 2002, primarily due to decreased sales to our cleaning and fabric care markets, partially offset by increased sales to our grain processing markets.

**Fees and Royalty Revenues.** Fees and royalty revenues increased \$1.4 million, or 27%, to \$6.6 million, for the three months ended June 30, 2003 from the three months ended June 30, 2002, due to increases in government and customer funded research.

Funded research revenues for the three months ended June 30, 2003 increased \$1.1 million, or 22%, to \$6.1 million from the three months ended June 30, 2002. Revenues generated by research funding result from collaborative agreements with various parties, including the U.S. Government, whereby we perform research activities and receive revenues that partially reimburse us for expenses incurred. Under such agreements, we retain a proprietary interest in the products and technology developed.

Our funded research revenue as it relates to U.S. Government collaborations increased \$0.8 million, or 89%, to \$1.7 million for the three months ended June 30, 2003 from the three months ended June 30, 2002 primarily due to funding provided by the National Renewable Energy Laboratory to develop an enzymatic process to convert biomass into bioethanol. Funded research revenues provided by customers increased \$0.3 million, or 7%, to \$4.4 million for the three months ended June 30, 2003 from the three months ended June 30, 2002, primarily driven by funding from our strategic alliance with the Dow Corning Corporation.

Royalties increased \$0.2 million to \$0.4 million for the three months ended June 30, 2003 from the three months ended June 30, 2002, due primarily to the timing of customer royalty payments that are based on the sales of the customers' products produced using our technology. License fees were \$0.1 million for the three months ended June 30, 2003. There were no such fees for the three months ended June 30, 2002.

#### Operating Expenses

**Cost of Products Sold.** Cost of products sold increased \$5.7 million, or 12%, to \$51.8 million for the three months ended June 30, 2003 from the three months ended June 30, 2002. Our expanded sales volume/mix increased costs \$3.2 million, along with increases due to the impact of the U.S. Dollar against foreign currencies, primarily the Euro, of \$4.5 million. These increases were partially offset by a decrease of \$2.0 million due to the sale of lower cost inventories.

**Gross Profit and Margins from Products Sold.** Gross profit from products

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sold decreased \$1.5 million, or 4%, to \$37.9 million for the three months ended June 30, 2003 from the three months ended June 30, 2002 and gross margin decreased to 42.3% for the three months ended June 30, 2003 from 46.1% for the three months ended June 30, 2002. The overall decrease was primarily driven by a decline in average selling prices. Also, while our gross profit benefited by \$2.1 million due to the impact of the U.S. Dollar against foreign currencies, primarily the Euro, this resulted in a 1% decline in gross margin.

**Research and Development.** Research and development expenses primarily consist of the personnel-related, consulting, and facilities costs incurred in connection with our research activities conducted in Palo Alto, California and Leiden, the Netherlands. These expenses decreased \$0.5 million, or 3%, to \$16.8 million for the three months ended June 30, 2003 from the three months ended June 30, 2002, due primarily to decreases in outside services of \$1.3 million and supply costs of \$0.5 million, partially offset by an increase in personnel-related costs, including salaries, benefits and travel expenses and other costs of \$1.2 million. As a part of total research and development expenses, estimated expenses related to research collaborations partially funded by customers decreased \$0.7 million, or 18%, to \$3.1 million for the three months ended June 30, 2003 from the three months ended June 30, 2002.

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**Sales, Marketing and Business Development.** Sales, marketing and business development expenses primarily consist of the personnel-related and marketing costs incurred by our global sales force. These expenses decreased \$0.7 million, or 8%, to \$7.9 million for the three months ended June 30, 2003 from the three months ended June 30, 2002, due primarily to decreases in outside services of \$0.8 million and incentive compensation of \$0.2 million, partially offset by an increase in personnel-related costs, including salaries, benefits, commissions and travel expenses of \$0.5 million.

**General and Administrative.** General and administrative expenses include the costs of our corporate executive, finance, information technology, legal, human resources, and communications functions. In total, these expenses decreased \$0.3 million, or 4%, to \$8.0 million for the three months ended June 30, 2003 from the three months ended June 30, 2002, due primarily to decreases in outside services of \$0.9 million and advertising and promotions of \$0.2 million, partially offset by an increase in personnel-related costs, including salaries, benefits, travel expenses and incentive compensation of \$0.8 million.

**Amortization of Intangible Assets.** We amortize our definite-lived intangible assets, consisting of patents, licenses, customer lists and other contractual agreements on a straight-line basis over their estimated useful lives. Amortization expense increased \$0.2 million, or 15%, to \$1.5 million for the three months ended June 30, 2003 from the three months ended June 30, 2002 primarily due to additional amortization of newly acquired intangible assets.

**Other Expense and Income.** Other expense and income relates primarily to foreign currency exchange gains and losses on transactions denominated in other than the functional currency of the entity in which the transaction occurred. Other expense for the three months ended June 30, 2003 was \$0.1 million as compared with other income of \$2.1 million for the three months ended June 30, 2002. This \$2.2 million decrease in income was due mainly to Argentine Peso and Euro-driven foreign currency transaction gains during the three months ended June 30, 2002.

**Deferred Compensation.** We measure deferred compensation for options granted to employees as the difference between the grant price and the fair value of our common stock on the date we granted the options.

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On June 6, 2003, we granted 0.05 million shares of restricted common stock to certain executive officers. These restricted shares were granted at fair market value at the date of grant and the restrictions on these awards expire three years from the date of grant. Deferred compensation expense of \$0.7 million was recorded in connection with these awards and was determined based on the number of granted restricted shares and the fair market value on the grant date. This amount was recorded as a component of stockholders' equity and will be amortized as a charge to operations over the vesting period of the awards.

Amortization of deferred stock-based compensation expense was \$0.2 million and \$0.7 million for the three months ended June 30, 2003 and 2002, respectively, and was reported in our Consolidated Statements of Operations as follows (in millions):

|   | 2003   |
|---|--------|
|   | ----   |
| Cost of products sold.....                          | \$ -   |
| Research and development.....                       | 0.1    |
| Sales, marketing and business development.....      | -      |
| General and administrative.....                     | 0.1    |
|   | -----  |
| Total amortization of deferred compensation expense | \$ 0.2 |
|   | =====  |

Non Operating Expense and Income

Investment Expense. We recorded an investment loss of \$1.0 million in the three months ended June 30, 2003, as a result of our assessment of an "other than temporary" decline in the fair market value of an investment in certain common stock. There was no such investment income or loss in the three months ended June 30, 2002.

Interest Income. Interest income increased \$0.3 million, or 23%, to \$1.6 million for the three months ended June 30, 2003 from the three months ended June 30, 2002, due primarily to interest received on the settlement of a tax refund claim, partially offset by a reduction in interest received due to our lower cash balances, as discussed under the heading "Liquidity and Capital Resources."

Income Taxes. The effective income tax rate for the three months ended June 30, 2003 was an 18% tax expense, compared to a 54% tax expense for the three months ended June 30, 2002, which reflects our assessment of the annual effective income tax rate. Factors affecting our estimated annual effective income tax rate include increased research and development expenditures in the United States, the statutory income tax rates and mix of earnings among tax jurisdictions, amortization of certain intangible assets and other items which are not deductible for tax purposes, and research and experimentation tax credits. In addition, the estimated annual effective rate in the three months ended June 30, 2003 included the effect of estimated valuation allowances, since we do not have the ability to carry back or anticipate the ability to carry forward our United States net operating losses.

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### Comparison of the Six Months Ended June 30, 2003 and 2002

Revenues. Total revenues for the six months ended June 30, 2003 increased \$20.6 million, or 12%, to \$192.0 million from the six months ended June 30, 2002, due to increases in both product revenues and fees and royalty revenues.

Product Revenues. Product revenues in the six months ended June 30, 2003 increased \$18.8 million, or 12%, to \$179.8 million from the six months ended June 30, 2002. For the six months ended June 30, 2003, unit volume/mix grew 8% along with increased currency impact of 8%, while average prices fell 4%. Volume/mix increased in our grain processing, cleaning and fabric care and food, feed, and specialties markets.

Regionally, North American product revenues for the six months ended June 30, 2003 decreased \$1.2 million, or 2%, to \$76.8 million from the six months ended June 30, 2002, driven primarily by a decrease in sales to our cleaning and fabric care markets, partially offset by an increase in sales to our food, feed and specialties and grain processing markets. Product revenues in Europe, Africa and the Middle East for the six months ended June 30, 2003 increased \$15.7 million, or 28%, to \$71.8 million from the six months ended June 30, 2002, driven primarily by increased sales to our food, feed and specialties markets, grain processing and cleaning and fabric care markets including protease enzymes sales to a major customer. Our product revenues in Latin America for the six months ended June 30, 2003 increased \$0.3 million, or 5%, to \$6.8 million from the six months ended June 30, 2002 due primarily to increased sales to our grain processing and food, feed and specialties markets, partially offset by decreased sales to our cleaning and fabric care markets. Product revenues in the Asia Pacific region increased \$4.0 million, or 20%, to \$24.4 million for the six months ended June 30, 2003 from the six months ended June 30, 2002, due mainly to increased sales to our food, feed and specialties, grain processing and cleaning and fabric care markets.

Fees and Royalty Revenues. Fees and royalty revenues increased \$1.8 million, or 17%, to \$12.2 million for the six months ended June 30, 2003 from the six months ended June 30, 2002, due primarily to an increase in government and customer funded research revenues.

Funded research revenues increased \$1.4 million, or 14%, to \$11.2 million for the six months ended June 30, 2003 from the six months ended June 30, 2002. Revenues generated by research funding result from collaborative agreements with various parties, including the U.S. Government, whereby we perform research activities and receive revenues that partially reimburse us for expenses incurred. Under such agreements, we retain a proprietary interest in the products and technology developed. Our funded research revenue as it relates to U.S. Government collaborations increased \$0.9 million, or 47%, to \$2.8 million for the six months ended June 30, 2003 from the six months ended June 30, 2002, primarily due to funding provided by the National Renewable Energy Laboratory to develop an enzymatic process to convert biomass into bioethanol. Funded research revenues provided by customers increased \$0.5 million, or 6%, to \$8.4 million for the six months ended June 30, 2003 from the six months ended June 30, 2002, primarily driven by funding from our strategic alliance with the Dow Corning Corporation.

Royalties increased \$0.4 million, or 80%, to \$0.9 million for the six months ended June 30, 2003 from the six months ended June 30, 2002, due primarily to the timing of customer royalty payments that are based on the sales of the customers' products produced using our technology. License fees increased \$0.1 million to \$0.2 million for the six months ended June 30, 2003 from the six months ended June 30, 2002.

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### Operating Expenses

Cost of Products Sold. Cost of products sold increased \$14.4 million, or 16%, to \$102.6 million for the six months ended June 30, 2003 from the six months ended June 30, 2002. Our expanded sales volume/mix increased costs \$8.2

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million, along with increases of \$7.4 million due to the impact of the U.S. Dollar against foreign currencies, primarily the Euro. These increases were partially offset by a \$1.2 million decrease due to the sale of lower cost inventories.

Gross Profit and Margins from Products Sold. Gross profit from products sold increased \$4.4 million, or 6%, to \$77.2 million for the six months ended June 30, 2003 from the six months ended June 30, 2002. This overall increase was caused by significant product revenue related factors including an 8% increase in volume/mix processed through our plants, partially offset by an average price decline of 4%. This net increase in gross profit was also driven by a \$5.1 million increase due to the impact of the U.S. Dollar against foreign currencies, primarily the Euro. As a result of these factors however, gross margin on product revenue decreased to 42.9% for the six months ended June 30, 2003 from 45.2% for the six months ended June 30, 2002, primarily driven by price reductions.

Research and Development. Research and development expenses increased \$0.4 million, or 1%, to \$33.3 million for the six months ended June 30, 2003 from the six months ended June 30, 2002, primarily due to increases in personnel-related costs, including salaries, benefits and travel expenses of \$2.8 million, partially offset by decreases in outside services of \$2.1 million and supply costs. As a part of total research and development expenses, estimated expenses related to research collaborations partially funded by customers decreased \$1.5 million, or 20%, to \$6.2 million for the six months ended June 30, 2003 from the six months ended June 30, 2002.

Sales, Marketing and Business Development. Sales, marketing and business development expenses decreased \$0.1 million, or 1%, to \$15.6 million for the six months ended June 30, 2003 from the six months ended June 30, 2002, primarily due to decreases in incentive compensation of \$0.5 million and outside services of \$0.4 million, partially offset by an increase in personnel-related costs, including salaries, benefits, commissions and travel expenses of \$0.7 million.

General and Administrative. General and administrative expenses decreased \$0.5 million, or 3%, to \$15.8 million for the six months ended June 30, 2003 from the six months ended June 30, 2002, due primarily to decreases in outside services of \$1.6 million and advertising and promotion of \$0.4 million, partially offset by an increase in personnel-related costs, including salaries, benefits, and travel expenses of \$1.6 million.

Amortization of Intangible Assets. Amortization expense increased \$0.3 million, or 12%, to \$2.9 million for the six months ended June 30, 2003 from the six months ended June 30, 2002, primarily due to additional amortization of newly acquired intangible assets.

Other Expense and Income. Other expense for the six months ended June 30, 2003 was \$0.8 million as compared to \$3.5 million of other income for the six months ended June 30, 2002. This difference in income of \$4.3 million was primarily due to Argentine Peso and Euro-driven foreign currency transaction gains during the six months ended June 30, 2002.

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Deferred Compensation. We measure deferred compensation for options granted to employees as the difference between the grant price and the fair value of our common stock on the date we granted the options.

On June 6, 2003, we granted 0.05 million shares of restricted common stock to certain executive officers. These restricted shares were granted at fair market value at the date of grant and the restrictions on these awards expire three years from the date of grant. Deferred compensation expense of \$0.7 million was recorded in connection with these awards and was determined based on the number of granted restricted shares and the fair market value on the grant date. This amount was recorded as a component of stockholders' equity and will be amortized as a charge to operations over the vesting period of the awards.

Amortization of deferred stock-based compensation expense was \$0.6 million and \$1.6 million for the six months ended June 30, 2003 and 2002, respectively, and was reported in our Consolidated Statements of Operations as follows (in millions):

|   |    | 2003  |
|---|----|-------|
|   |    | ----  |
| Cost of products sold.....                          | \$ | -     |
| Research and development.....                       |    | 0.3   |
| Sales, marketing and business development.....      |    | -     |
| General and administrative.....                     |    | 0.3   |
|   |    | ----- |
| Total amortization of deferred compensation expense | \$ | 0.6   |
|   |    | ===== |

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### Non Operating Expense and Income

Investment Expense. We recorded an investment loss of \$1.0 million in the six months ended June 30, 2003, as a result of our assessment of an "other than temporary" decline in the fair market value of an investment in certain common stock. There was no such investment income or loss in the six months ended June 30, 2002

Interest Income. Interest income decreased \$0.3 million, or 11%, to \$2.4 million for the six months ended June 30, 2003 from the six months ended June 30, 2002 due mainly to the reduction of interest received due to our lower cash balances, discussed below under the heading "Liquidity and Capital Resources."

Income Taxes. The effective income tax rate for the six months ended June 30, 2003 was a 25% tax expense, compared to a 326% tax benefit for the six months ended June 30, 2002, which reflects our assessment of the annual effective income tax rate. Factors affecting our estimated annual effective income tax rate include increased research and development expenditures in the United States, the statutory income tax rates and mix of earnings among tax jurisdictions, amortization of certain intangible assets and other items which are not deductible for tax purposes, and research and experimentation tax credits. In addition, the estimated annual effective rate for the six months ended June 30, 2003 included the effect of estimated valuation allowances, since

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we do not have the ability to carry back or anticipate the ability to carry forward our United States net operating losses. The effective rate for the six months ended June 30, 2002 included the effect of restructuring and related charges. Accordingly, the tax benefit related to the restructuring and related charges of approximately \$6.0 million was recorded in the first quarter of 2002.

### FINANCIAL RESULTS BY SEGMENT

During the three months ended March 31, 2003, we modified our managerial financial reporting to provide information that aligns with the two-segment structure of Bioproducts and Health Care. Accordingly, we provided historical financial data in this new financial segment-reporting format for the three months and the six months ended June 30, 2003 and 2002.

The Bioproducts segment develops and delivers products and services for the industrial, consumer and agri-processing markets to a global customer base. All of our current product revenues are derived from this segment. For the three months ended June 30, 2003, the Bioproducts segment achieved operating income of \$17.7 million as compared to an operating income of \$18.8 million for the three months ended June 30, 2002. For the six months ended June 30, 2003, the Bioproducts segment achieved operating income of \$36.8 million as compared to an operating income of \$18.6 million for the six months ended June 30, 2002. For the six months ended June 30, 2002, Bioproducts recorded restructuring and related costs of \$16.4 million. Before these restructuring and related charges, the segment would have reported operating income of \$35.0 million for the three months ended June 30, 2002.

The Health Care segment is focused on expanding our current technology and product platforms into the health care market. This segment is primarily engaged in the performance of research and development, the securing of intellectual property and the establishment of strategic investments and collaborations. For the three months ended June 30, 2003, the Health Care segment experienced an operating loss of \$7.5 million as compared to an operating loss of \$9.7 million for the three months ended June 30, 2002. For the six months ended June 30, 2003, the Health Care segment experienced an operating loss of \$15.4 million as compared to an operating loss of \$19.4 million for the six months ended June 30, 2002.

### ACQUISITION

On December 31, 2002, we acquired the brewing and enzyme business of Rhodia Food UK Limited for a total cash purchase price of \$8.9 million. The acquisition included technology, product lines and personnel. The acquisition expanded our Bioproducts portfolio and technical service capabilities in the food, feed and specialty enzyme market sector. No facilities were included in the transaction. The acquisition has been accounted for under the purchase method in accordance with SFAS No. 141, "Business Combinations." The results of operations of the acquired business were consolidated with our results of operations beginning January 1, 2003.

According to our preliminary allocation of the purchase price on December 31, 2002, the \$8.9 million consists solely of intangible assets. Due to the effect of foreign currency translation, additional acquisition costs and the sale of certain acquired assets, the intangible assets are \$8.7 million at June 30, 2003. We are continuing to evaluate the allocation of the

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purchase price for the acquisition, including the segregation of separately identifiable intangible assets. We anticipate that this process will be completed during 2003.

### RESTRUCTURING AND RELATED CHARGES

During February 2002, as a result of the acquisition of EBS and general economic conditions in Latin America, including the devaluation of the Argentine Peso, we engaged in a plan to restructure our overall supply infrastructure by ceasing operations at our Elkhart, Indiana plant and downsizing our Argentine facilities. As a result of the plan, restructuring and related charges of \$16.4 million were recorded in our operating earnings for the six months ended June 30, 2002. This restructuring was completed during 2002.

### WAREHOUSE INVENTORY LOSS

During the quarter ended June 30, 2003, we sustained damage to our finished bioproduct inventory as a result of an accident in a third party warehouse in Rotterdam, the Netherlands. While there has been no material interruption in product flow to our customers, we reduced our inventories by approximately \$7.5 million to reflect the estimated amount of product that was lost. In addition, approximately \$1.0 million of other costs were incurred as a result of the accident. These amounts have been recorded in other current assets as a receivable from our insurer. Certain reduced profits and additional costs, such as production inefficiencies, additional freight and use of overtime are reflected in the results of operations during the second quarter ended June 30, 2003. While we believe that these reduced profits and additional costs will be subject to insurance recovery, we are unable to estimate the ultimate recovery at this time.

### LIQUIDITY AND CAPITAL RESOURCES

Our funding needs consist primarily of capital expenditures, research and development activities, sales and marketing expenses, and general corporate purposes. We have financed our operations primarily through cash from the sale of products, the sale of stock, research and development funding from partners, government grants, and short-term and long-term borrowings.

We believe that our current cash and cash equivalent balances plus funds to be provided from our current year operating activities, together with those available under our lines of credit, will satisfy our funding needs over the next twelve months. Factors that could negatively impact our cash position include, but are not limited to, future levels of product revenues, fees and royalty revenues, expense levels, capital expenditures, acquisitions, and foreign currency exchange rate fluctuations.

As of June 30, 2003, cash and cash equivalents totaled \$155.4 million. The funds were invested in short-term instruments, including A-1/P1 and A-2/P2 rated commercial paper, AAA and AA rated medium term notes, institutional money market funds, auction rate preferred securities and bank deposits.

Cash provided by operations was \$15.9 million and \$10.2 million for the six months ended June 30, 2003 and 2002, respectively. The increase of \$5.7 million in 2003 from 2002 was generated principally by operating income, net of non-cash items such as depreciation and amortization, and changes in operating assets and liabilities.



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Cash used in investing activities was \$9.4 million and \$44.8 million for the six months ended June 30, 2003 and 2002, respectively. This decrease of \$35.4 million was driven primarily by the EBS acquisition of \$35.8 million and the equity investment in Seattle Genetics, Inc. of \$3.0 million during the six months ended June 30, 2002. Cash used in investing activities for the six months ended June 30, 2003 included \$1.1 million in proceeds from the sale of certain acquired assets as discussed above in Acquisitions. Capital expenditures for the six months ended June 30, 2003 were \$10.6 million in 2003 compared with \$5.9 million in 2002. A significant portion of the capital spending included process improvement projects at our manufacturing and research and development facilities and information technology enhancements. We also continued our construction of a facility for the clinical-scale manufacture of human therapeutic proteins in Rochester, New York during the six months ended June 30, 2003.

Cash used in financing activities was \$25.4 million and \$27.0 million for the six months ended June 30, 2003 and 2002, respectively. This decrease of \$1.6 million was primarily driven by proceeds received from the exercise of stock options

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during the six months ended June 30, 2003. While we are permitted to pay dividends to our common stockholders, we currently intend to utilize our resources to finance the expansion of our business. Any future determination to pay cash dividends to our common stockholders will be at the discretion of our board of directors and will depend upon our financial condition, results of operations, capital requirements, general business conditions and other factors that the board of directors may deem relevant, including covenants in our debt instruments that may limit our ability to declare and pay cash dividends on our capital stock. Covenants in our senior note agreement restrict the payment of dividends or other distributions in cash or other property to the extent the payment puts us in default of these covenants. Such covenants include, but are not limited to, maintaining a debt to total capitalization of no greater than 55% and a maximum ratio of debt to earnings before interest, taxes, depreciation and amortization (EBITDA) of 3.5:1.

At June 30, 2003, we had a \$40.0 million revolving credit facility with a syndicate of banks, which is available for general corporate purposes. The facility, which consists of a credit agreement, makes available to the Company \$40.0 million of committed borrowings, which expires on January 31, 2004. The facility carries fees of 0.35% on the amount of unborrowed principal under the agreement. As of June 30, 2003, there were no borrowings under the facility.

Our long-term debt consists primarily of the 6.82% senior notes issued in 1996 to certain institutional investors. The remaining principal amount of these notes is \$84.0 million. Annual installment payments of \$28.0 million commenced on March 30, 2002. We are currently in compliance with the financial covenants included in the senior note agreement.

### NEW ACCOUNTING PRONOUNCEMENTS

In April 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This Statement amends SFAS No. 133 for decisions made (1) as part of the Derivatives Implementation Group process that effectively required amendments to SFAS No. 133, (2) in connection with other FASB projects dealing with financial instruments, and (3) in connection with implementation issues raised in relation

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to the application of the definition of a derivative. This Statement is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. All provisions of this Statement are to be applied prospectively. We will apply the provisions of this statement as of July 1, 2003. The adoption of SFAS No. 149 will not have a material impact on our financial position or results of operations.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This statement establishes standards for how we classify and measure certain financial instruments with characteristics of both liabilities and equity. It requires that we classify a financial instrument within its scope as a liability. Some of the provisions of this Statement are consistent with the current definition of liabilities in FASB Concepts Statement No. 6, "Elements of Financial Statements." The remaining provisions of this Statement are consistent with the FASB's proposal to revise that definition to encompass certain obligations that a reporting entity can or must settle by issuing its own equity shares, depending on the nature of the relationship established between the holder and the issuer. This Statement is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We are currently assessing the impact of this new standard on our financial statements.

### MARKET RISK

Foreign currency risk and interest rate risk are the primary sources of our market risk. Foreign operations, mainly denominated in Euros, accounted for approximately 55% of our revenues for the six months ended June 30, 2003. We believe that we mitigate this risk by locating our manufacturing facilities so that the costs are denominated in the same currency as our product revenues. We may manage the foreign currency exposures that remain through the use of foreign currency forward contracts, currency options and off-setting currency positions in assets and liabilities where deemed appropriate. We do not use these instruments for speculative purposes. There were no material foreign currency gains in connection with these types of contracts recorded in the statement of operations for the six months ended June 30, 2003.

As of June 30, 2003, cash and cash equivalents totaled \$155.4 million. Of this amount, \$64.4 million was denominated in Euros. The remainder, or \$91.0 million, was primarily denominated in U.S. Dollars. Short-term debt was mainly comprised of our third installment of \$28.0 million due March 30, 2004 under our 6.82% senior notes discussed under the heading "Liquidity and Capital Resources" in this Report and \$8.0 million of short-term debt held by our Chinese affiliate.

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We expect to refinance all of the debt held by our Chinese affiliate. To the extent U.S. Dollar and Euro interest rates fluctuate either up or down, the return on the cash investments will also fluctuate. To the extent such Euro cash investments remain outstanding, we will be subject to the risks of future foreign exchange fluctuations and the impact on the translation of these cash investments into U.S. Dollars.

### Interest Rates

Our interest income is sensitive to changes in the general level of

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short-term interest rates primarily in the United States and Europe. In this regard, changes in the U.S. Dollar and Euro currency rates affect the interest earned on our cash equivalents, short-term investments, and long-term investments. Our interest expense is generated primarily from fixed rate debt. The \$84.0 million 6.82% senior notes outstanding at June 30, 2003 mature evenly in installments of \$28.0 million per year. Annual installment payments commenced March 30, 2002.

### Foreign Currency Exposure

We conduct business throughout the world. During the six month period ended June 30, 2003, we derived approximately 55% of our revenues from foreign operations, and these foreign operations generated income that offset net losses in U.S. operations during the same six month period. Economic conditions in countries where we conduct business and changing foreign currency exchange rates affect our financial position and results of operations. We are exposed to changes in exchange rates in Europe, Latin America, and Asia. The Euro and Argentine Peso present our most significant foreign currency exposure risk. Changes in foreign currency exchange rates, especially the strengthening of the U.S. Dollar, may have an adverse effect on our financial position and results of operations as they are expressed in U.S. Dollars. Our manufacturing and administrative operations for Latin America are located in Argentina. A significant part of our Latin American revenues are denominated in U.S. Dollars. Net foreign exchange losses from US Dollar/Euro and US Dollar/ Argentine Peso transactions were \$0.4 million for the six months ended June 30, 2003.

Management monitors foreign currency exposures and may in the ordinary course of business enter into foreign currency forward contracts or options contracts related to specific foreign currency transactions or anticipated cash flows. These contracts generally cover periods of nine months or less and are not material. We recorded a gain of \$0.1 million in the statement of operations for the six months ended June 30, 2003 from foreign currency contracts. We do not hedge the translation of financial statements of consolidated subsidiaries that maintain their local books and records in foreign currencies.

### RISK FACTORS

If any of the following risks actually occur, they could harm our business, financial condition, and/or results of operations.

IF WE FAIL TO DEVELOP PRODUCTS FOR THE HEALTH CARE AND BIOPRODUCTS MARKETS WE ARE TARGETING, THEN WE MAY NEVER ACHIEVE A RETURN ON OUR RESEARCH AND DEVELOPMENT EXPENDITURES OR REALIZE PRODUCT REVENUES FROM THESE MARKETS.

A key element of our business strategy is to utilize our technologies for the development and delivery of new products to the Health Care market and new segments of the Bioproducts market. We intend to significantly increase our investment in research and development to develop products for these markets. The successful development of products is highly uncertain and is dependent on numerous factors, many of which are beyond our control, and may include the following:

- The product may be ineffective or have undesirable side effects in preliminary and commercial testing or, specifically in the Health Care area, in preclinical and clinical trials;
- The product may fail to receive necessary governmental and regulatory approvals, or the government may delay regulatory approvals significantly;
- The product may not be economically viable because of manufacturing costs or other factors;

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- The product may not gain acceptance in the marketplace; or

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- The proprietary rights of others or competing products or technologies for the same application may preclude us from commercializing the product.
- Due to these factors we may never achieve a return on our research and development expenditures or realize product revenues from the Health Care and new Bioproducts markets that we are targeting.

IF WE FAIL TO ENTER INTO STRATEGIC ALLIANCES WITH PARTNERS IN OUR TARGET MARKETS OR INDEPENDENTLY RAISE ADDITIONAL CAPITAL, WE WILL NOT HAVE THE RESOURCES NECESSARY TO CAPITALIZE ON ALL OF THE MARKET OPPORTUNITIES AVAILABLE TO US.

We do not currently possess the resources necessary to independently develop and commercialize products for all of the market opportunities that may result from our technologies. We intend to form strategic alliances with industry leaders in our target markets to gain access to funding for research and development, expertise in areas we lack and distribution channels. We may fail to enter into the necessary strategic alliances or fail to commercialize the products anticipated from the alliances. Our alliances could be harmed if:

- We fail to meet our agreed upon research and development objectives;
- We disagree with our strategic partners over material terms of the alliances, such as intellectual property or manufacturing rights; or
- Our strategic partners become competitors or enter into agreements with our competitors.

New strategic alliances that we enter into, if any, may conflict with the business objectives of our current strategic partners and negatively impact existing relationships. In addition, to capitalize on the market opportunities we have identified, we may need to seek additional capital, either through private or public offerings of debt or equity securities. Due to market and other conditions beyond our control, we may not be able to raise additional capital on acceptable terms or conditions, if at all.

IF THE DEMAND FOR PROTEIN DEGRADING ENZYMES DECREASES OR IF MAJOR CUSTOMERS REDUCE OR TERMINATE BUSINESS WITH US, OUR REVENUES COULD SIGNIFICANTLY DECLINE.

Our largest selling family of products, protein degrading enzymes, or proteases, accounted for approximately 52% of our 2002 revenue. If the demand for proteases decreases or alternative proteases render our products noncompetitive, our revenues could significantly decline.

In addition, our five largest customers collectively accounted for over 51% of our 2002 product revenues, with our largest customer, The Procter & Gamble Company, accounting for over 35% of such revenues. Our five largest customers in 2002 were Benckiser N.V., Cargill, Incorporated, Danisco Animal Nutrition - the feed ingredients business unit of Danisco A/S which was formerly known as Finnfeeds, The Procter & Gamble Company, and Unilever N.V. Any one of these customers may reduce their level of business with us. Should any of our largest customers decide to reduce or terminate business with us, our revenues and profitability could decline significantly.

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We have arrangements of various durations with our major customers and are routinely involved in discussions regarding the status of these relationships. These discussions may lead to extensions or new commercial arrangements, or may be unsuccessful. Our customer relationships involve uncertainty by virtue of economic conditions, customer needs, competitive pressures, our production capabilities and other factors. Consequently, our customer base will change over time as will the nature of our relationships with individual customers, including major customers. For example, we currently expect that our business with Corn Products International, Inc., combined with decreased volume with Unilever N.V., may cause Corn Products to qualify as one of our five largest customers for 2003.

WE INTEND TO ACQUIRE BUSINESSES, TECHNOLOGIES AND PRODUCTS, BUT WE MAY FAIL TO REALIZE THE ANTICIPATED BENEFITS OF SUCH ACQUISITIONS AND WE MAY INCUR COSTS THAT COULD SIGNIFICANTLY NEGATIVELY IMPACT OUR PROFITABILITY.

In the future, we may acquire other businesses, technologies and products that we believe are a strategic fit with our business. If we undertake any transaction of this sort, we may not be able to successfully integrate any businesses, products, technologies or personnel that we might acquire without a significant expenditure of operating, financial and management resources, if at all. Further, we may fail to realize the anticipated benefits of any acquisition. Future acquisitions could dilute

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our stockholders' interest in us and could cause us to incur substantial debt, expose us to contingent liabilities and could negatively impact our profitability.

IF WE FAIL TO SECURE ADEQUATE INTELLECTUAL PROPERTY PROTECTION OR BECOME INVOLVED IN AN INTELLECTUAL PROPERTY DISPUTE, IT COULD SIGNIFICANTLY HARM OUR FINANCIAL RESULTS AND ABILITY TO COMPETE.

The patent positions of biotechnology companies, including our patent positions, can be highly uncertain and involve complex legal and factual questions, and, therefore, enforceability is uncertain. We will be able to protect our proprietary rights from unauthorized use by third parties only to the extent that we protect our technologies with valid and enforceable patents or as trade secrets. We rely in part on trade secret protection for our confidential and proprietary information by entering into confidentiality agreements and non-disclosure policies with our employees and consultants. Nonetheless, confidential and proprietary information may be disclosed, and others may independently develop substantially equivalent information and techniques or otherwise gain access to our trade secrets.

We file patent applications in the United States and in foreign countries as part of our strategy to protect our proprietary products and technologies. The loss of significant patents or the failure of patents to issue from pending patent applications that we consider significant could impair our operations. In addition, third parties could successfully challenge, invalidate or circumvent our issued patents or patents licensed to us so that our patent rights would not create an effective competitive barrier. Further, we may not obtain the patents or licenses to technologies that we will need to develop products for our target markets. The laws of some foreign countries may also not protect our intellectual property rights to the same extent as United States law.

Extensive litigation regarding patents and other intellectual property

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rights is common in the biotechnology industry. In the ordinary course of business, we periodically receive notices of potential infringement of patents held by others and patent applications that may mature to patents held by others. The impact of such claims of potential infringement, as may from time to time become known to us, are difficult to assess. In the event of an intellectual property dispute, we may become involved in litigation. Intellectual property litigation can be expensive and may divert management's time and resources away from our operations. The outcome of any such litigation is inherently uncertain. Even if we are successful, the litigation can be costly in terms of dollars spent and diversion of management time.

If a third party successfully claims an intellectual property right to technology we use, it may force us to discontinue an important product or product line, alter our products and processes, pay license fees, pay damages for past infringement or cease certain activities. Under these circumstances, we may attempt to obtain a license to this intellectual property; however, we may not be able to do so on commercially reasonable terms, or at all. In addition, regardless of the validity of such a claim, its mere existence may affect the willingness of one or more customers to use or continue to use our products and, thereby, materially impact us.

Those companies with which we have entered or may enter into strategic alliances encounter similar risks and uncertainties with respect to their intellectual property. To the extent that any such alliance companies suffer a loss or impairment of their respective technologies, we may suffer a corresponding loss or impairment that may materially and adversely affect our investments.

### FOREIGN CURRENCY FLUCTUATIONS AND ECONOMIC AND POLITICAL CONDITIONS IN FOREIGN COUNTRIES COULD CAUSE OUR REVENUES AND PROFITS TO DECLINE.

In 2002, we derived approximately 50% of our product revenues from our foreign operations. Our foreign operations generate sales and incur expenses in local currency. As a result, we are exposed to market risk related to unpredictable interest rates and foreign currency exchange rate fluctuations. We recognize foreign currency gains or losses arising from our operations in the period incurred. As a result, currency fluctuations between the U.S. Dollar and the currencies in which we do business could cause our revenues and profits to decline.

Product revenues denominated in Euros accounted for approximately 34% of total 2002 product revenues, and the fluctuations in the currency exchange rate against the U.S. Dollar can have a significant impact on our reported product revenues.

We expect to continue to operate in foreign countries and that our international sales will continue to account for a significant percentage of our revenues. As such, we are subject to certain risks arising from our international business

operations that could be costly in terms of dollars spent, the diversion of management's time, and revenues and profits, including:

- Difficulties and costs associated with staffing and managing foreign operations;

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- Unexpected changes in regulatory requirements;
- Difficulties of compliance with a wide variety of foreign laws and regulations;
- Changes in our international distribution network and direct sales forces;
- Political trade restrictions and exchange controls;
- Political, social, or economic unrest including armed conflict and acts of terrorism;
- Labor disputes including work stoppages, strikes and embargoes;
- Inadequate and unreliable services and infrastructure;
- Import or export licensing or permit requirements; and
- Greater risk on credit terms and long accounts receivable collection cycles in some foreign countries.

IF THE OWNERSHIP OF OUR COMMON STOCK CONTINUES TO BE HIGHLY CONCENTRATED, IT MAY PREVENT OTHER STOCKHOLDERS FROM INFLUENCING SIGNIFICANT CORPORATE DECISIONS AND MAY RESULT IN CONFLICTS OF INTEREST THAT COULD CAUSE OUR STOCK PRICE TO DECLINE.

After our initial public offering and continuing to the present, Eastman Chemical Company and Danisco A/S and their affiliates, referred to as our majority stockholders, each own in excess of 40% of our outstanding common stock. The majority stockholders will therefore have the ability, acting together, to control fundamental corporate transactions requiring stockholder approval, including the election of a majority of our directors, approval of merger transactions involving us and the sale of all or substantially all of our assets or other business combination transactions. The concentration of ownership of our common stock may have the effect of either delaying or preventing a change to our control favored by our other stockholders or accelerating or approving a change to our control opposed by our other stockholders. In addition, the majority stockholders' control over our management could create conflicts of interest between the majority stockholders and us with respect to the allocation of corporate opportunities and between the majority stockholders and other stockholders.

IF EXISTING STOCKHOLDERS SELL LARGE NUMBERS OF SHARES OF OUR COMMON STOCK, OUR STOCK PRICE COULD DECLINE.

The market price of our common stock could decline as a result of sales by our existing stockholders or holders of stock options of a large number of shares of our common stock in the public market or the perception that these sales could occur. Our two majority stockholders, for example, hold over 80% of our common stock, and all of these shares are subject to registration rights. In addition, we issued stock options to our officers, directors and employees pursuant to our 2002 Omnibus Incentive Plan, approved by our stockholders in May 2002, and its predecessor plan.

OUR STOCK PRICE HAS BEEN, AND MAY CONTINUE TO BE, PARTICULARLY VOLATILE.

The stock market from time to time, has experienced significant price and volume fluctuations that are unrelated to the operating performance of companies. The market prices for securities of biotechnology companies, including ours, have been highly volatile in the period since our initial public offering in July 2000 and may continue to be highly volatile in the future. Our stock may be affected by this type of market volatility, as well as by our own

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performance. The following factors, among other risk factors, may have a significant effect on the market price of our common stock:

- Developments in our relationships with current or future strategic partners;
- Conditions or trends in the biotechnology industry;
- Announcements of technological innovations or new products by us or our competitors;

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- Announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- Developments in patent or other intellectual proprietary rights or announcements relating to these matters;
- Investor concern regarding the public acceptance of the safety of biotechnology products or announcements relating to these matters;
- Litigation or governmental proceedings or announcements relating to these matters;
- Economic and other external factors or other disaster or crisis;
- Future royalties from product sales, if any, by our licensees;
- Sales of our common stock or other securities in the open market; and
- Period-to-period fluctuations in our operating results.

WE EXPECT THAT OUR QUARTERLY RESULTS OF OPERATIONS WILL FLUCTUATE, AND THIS FLUCTUATION COULD CAUSE OUR STOCK PRICE TO DECLINE, CAUSING INVESTOR LOSSES.

A large portion of our expenses, including expenses for facilities, equipment and personnel, are relatively fixed. Accordingly, if product revenue declines or does not grow as we anticipate or non-product revenue declines due to the expiration or termination of strategic alliance agreements or the failure to obtain new agreements or grants, we may not be able to correspondingly reduce our operating expenses in any particular quarter. Our quarterly revenue and operating results have fluctuated in the past and are likely to do so in the future. If our operating results in some quarters fail to meet the expectations of stock market analysts and investors, our stock price would likely decline. Some of the factors that could cause our revenue and operating results to fluctuate include:

- The ability and willingness of strategic partners to commercialize products derived from our technology or containing our products on expected timelines;
- Our ability to successfully commercialize products developed independently and the rate of adoption of such products;
- Fluctuations in consumer demand for products containing our technologies or products, such as back to school sales of blue jeans and other denim products, resulting in an increase in the use of textile processing



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enzymes, and fluctuations in laundry detergent use due to promotional campaigns run by consumer products companies; and

- Fluctuations in geographic conditions including currency and other economic conditions such as economic crises in Latin America or Asia and increased energy and related transportation costs.

We also have incurred significant infrequently occurring charges within given quarters, such as those incurred in conjunction with restructuring activities, and recognized investment income from sales of available-for-sale marketable securities.

CONCERNS ABOUT GENETICALLY ENGINEERED PRODUCTS COULD RESULT IN OUR INABILITY TO COMMERCIALIZE PRODUCTS.

We produce a significant amount of our products from genetically modified microorganisms. We cannot predict public attitudes and acceptance of existing or future products made from genetically modified microorganisms. As a result, if we are not able to overcome the ethical, legal and social concerns relating to safety and environmental hazards of genetic engineering, the general public may not accept our products and this may prevent us from commercializing products dependent on our technologies or inventions. In addition, public attitudes may influence laws and regulations governing the ownership or use of genetic material, which could result in greater government regulation of genetic research and bioengineered products.

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IF WE ARE SUBJECT TO A COSTLY PRODUCT LIABILITY DAMAGE CLAIM OR AWARD, OUR PROFITS COULD DECLINE.

We may be held liable if any product we develop, or any product that a third party makes with the use or incorporation of any of our products, causes injury or is found otherwise unsuitable during product testing, manufacturing, marketing or sale. Our current product liability insurance may not cover our potential liabilities. Inability to obtain sufficient insurance coverage in the future at an acceptable cost or otherwise to protect against potential liability claims could prevent or inhibit the commercialization of products developed by us or our strategic partners. If a third party sues us for any injury caused by our products, our liability could exceed our insurance coverage amounts and total assets and our profits could decline.

IF WE ARE SUBJECT TO COSTLY ENVIRONMENTAL LIABILITY DUE TO THE USE OF HAZARDOUS MATERIALS IN OUR BUSINESS, OUR PROFITS COULD DECLINE.

Our research and development processes involve the controlled use of hazardous materials, including chemical, radioactive and biological materials. Our operations also generate potentially hazardous waste. We cannot eliminate entirely the risk of contamination or the discharge of hazardous materials and any resultant injury from these materials. Federal, state, local and foreign laws and regulations govern the use, manufacture, storage, handling and disposal of these materials. Third parties may sue us for any injury or contamination that results from our use or the third party's use of these materials. Any accident could partially or completely shut down our research and manufacturing facilities and operations. In addition, if we are required to comply with any additional applicable environmental laws and regulations, we may incur additional costs, and any such current or future environmental regulations may

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impair our research, development or production efforts.

IF WE FAIL TO ATTRACT AND RETAIN QUALIFIED PERSONNEL, WE MAY NOT BE ABLE TO ACHIEVE OUR STATED CORPORATE OBJECTIVES.

Our ability to manage our anticipated growth, if realized, effectively depends on our ability to attract and retain highly qualified executive officers and technology and business personnel. In particular, our product development programs depend on our ability to attract and retain highly skilled researchers. Competition for such individuals is intense. If we fail to attract and retain qualified individuals, we will not be able to achieve our stated corporate objectives.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information presented in Item 2 of Part I of this Report on Form 10-Q under the heading "Market Risk" is hereby incorporated by reference.

### ITEM 4. CONTROLS AND PROCEDURES

#### Quarterly Evaluation of the Company's Disclosure Controls and Internal Controls

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including Jean-Jacques Bienaime, the Company's Chairman, Chief Executive Officer and President, and Raymond J. Land, the Company's Senior Vice President and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (Disclosure Controls) pursuant to Securities and Exchange Commission Rule 13a-15 under the Securities Exchange Act of 1934 (Exchange Act). Based upon that evaluation, Mr. Bienaime and Mr. Land concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company's periodic filing with the Securities and Exchange Commission. There were no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

#### Disclosure Controls and Internal Controls

Disclosure Controls are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Exchange Act such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure Controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding

required disclosure. "Internal Controls" are procedures which are designed with the objective of providing reasonable assurance that (1) our transactions are properly authorized; (2) our assets are safeguarded against unauthorized or improper use; and (3) our transactions are properly recorded and reported, all to permit the preparation of our financial statements in conformity with

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accounting principles generally accepted in the United States of America.

### Limitations on the Effectiveness of Controls

The Company's management does not expect that our Disclosure Controls or our Internal Controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

Nothing to report

### ITEM 2. CHANGE IN SECURITIES AND USE OF PROCEEDS

The information presented in Item 2 of Part I of this Report on Form 10-Q under the heading "Liquidity and Capital Resources" is hereby incorporated by reference. The Company's Registration Statement on Form S-1 (Registration No. 333-36452) was effective as of July 27, 2000.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Nothing to report

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### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Stockholders of the Company was held on May 29, 2003. At that meeting, the stockholders elected directors and approved the selection of PricewaterhouseCoopers LLP as independent auditors for the fiscal year ended December 31, 2003. The total votes at the meeting were as follows:

- (i) To elect directors to serve a three-year term.

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| Nominee               | For        |
|-----------------------|------------|
| Jean-Jacques Bienaime | 57,374,593 |
| Bruce C. Cozadd       | 57,421,798 |
| Norbert G. Riedel     | 57,005,233 |

There were no broker non-votes.

Directors whose term in office continued after the meeting:

Term expiring in 2004: Theresa K. Lee, Robert H. Mayer, Jorgen Rosenlund

Term expiring in 2005: Soren Bjerre-Nielsen, Joseph A. Mollica, Gregory O. Nelson, James P. Rogers

- (ii) To approve the selection of PricewaterhouseCoopers LLP as independent auditors for the fiscal year ending December 31, 2003.

| Votes      |         |         |
|------------|---------|---------|
| For        | Against | Abstain |
| 57,443,312 | 355,056 | 326,288 |

There were no broker non-votes.

ITEM 5. OTHER INFORMATION

Nothing to report

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

- a. EXHIBITS

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(10) Material Contracts  
-----

+10.1 First Amendment to Supply Agreement by and between the Company and The Procter & Gamble Company entered into as of January 1, 2003.

10.2 First Amendment to Research Agreement and Technology Transfer Agreement by and between the Company and The Procter & Gamble Company entered into as of June 23, 2003.

(31) Rule 13a-14(a)/15d-14(a) Certifications  
-----

31.1 Rule 13a-14(a)/15d-14(a) Certifications

(32) Section 1350 Certifications  
-----

32.1 Section 1350 Certifications  
-----

+ Confidential Treatment requested as to certain information, which has been separately filed with the Securities and Exchange Commission pursuant to an application for such treatment.

b. REPORTS ON FORM 8-K

On May 1, 2003 the Company filed a Current Report on Form 8-K regarding its press release concerning financial results for the first quarter of 2003. The report included condensed financial statements and other financial information.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

GENENCOR INTERNATIONAL, INC.

August 13, 2003  
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By: /s/ Raymond J. Land  
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Date

Raymond J. Land  
Senior Vice President and  
Chief Financial Officer  
(Principal Financial Officer)

August 13, 2003  
-----

By: /s/ Darryl L. Canfield  
-----

Date

Darryl L. Canfield  
Vice President and Corporate Controller  
(Chief Accounting Officer)

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EXHIBIT INDEX

|       |  |
|-------|--|
| (10)  | Material Contracts<br>-----  |
| +10.1 | First Amendment to Supply Agreement by and between the Company and The Procter & Gamble Company entered into as of January 1, 2003.  |
| 10.2  | First Amendment to Research Agreement and Technology Transfer Agreement by and between the Company and The Procter & Gamble Company entered into as of June 23, 2003.                  |
| (31)  | Rule 13a-14(a)/15d-14(a) Certifications<br>-----   |
| 31.1  | Rule 13a-14(a)/15d-14(a) Certifications  |
| (32)  | Section 1350 Certifications<br>-----   |
| 32.1  | Section 1350 Certifications<br>-----   |
| +     | Confidential Treatment requested as to certain information, which has been separately filed with the Securities and Exchange Commission pursuant to an application for such treatment. |

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