

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2003

or,

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

For the transition period from _____ to _____

Commission File Number: 0-23556

NEKTAR THERAPEUTICS

(Exact name of registrant as specified in its charter)

Delaware

(State of other jurisdiction of incorporation or organization)

94-3134940

(IRS Employer Identification No.)

150 Industrial Road

San Carlos, California 94070

(Address of principal executive offices)

650-631-3100

(Registrant's telephone number, including area code)

Inhale Therapeutic Systems, Inc.

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12B-2 of the Exchange Act). Yes No

Applicable Only to Corporate Issuers

The number of outstanding shares of the registrant's Common Stock, \$0.0001 par value, was 55,690,924 as of April 30, 2003.

**NEKTAR THERAPEUTICS
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Forward - - Looking Statements

This report includes “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the “1933 Act”) and Section 21E of the Securities Exchange Act of 1934, as amended (the “1934 Act”). All statements other than statements of historical fact are “forward-looking statements” for purposes of this periodic report, including any projections of earnings, revenues or other financial items, any statements of the plans and objectives of management for future operations, any statements concerning proposed new products or services, any statements regarding future economic conditions or performance and any statement of assumptions underlying any of the foregoing. In some cases, forward-looking statements can be identified by the use of terminology such as “may,” “will,” “expects,” “plans,” “anticipates,” “estimates,” “potential,” or “continue,” or the negative thereof or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements contained herein are reasonable, there can be no assurance that such expectations or any of the forward-looking statements will prove to be correct and actual results could differ materially from those projected or assumed in the forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to inherent risks and uncertainties, including but not limited to the risk factors set forth below and for the reasons described elsewhere in this periodic report. All forward-looking statements and reasons why results may differ included in this report are made as of the date hereof and we do not intend to update any forward-looking statements except as required by law or applicable regulations.

NEKTAR THERAPEUTICS CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share information)

| | March 31, 2003 (unaudited) | December 31, 2002 * |
|---|-------------------------------|------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 21,526 | \$ 34,879 |
| Short-term investments | 229,986 | 259,090 |
| Accounts receivable | 6,775 | 4,370 |
| Other current assets | 12,150 | 12,650 |
| Total current assets | 270,437 | 310,989 |
| Property and equipment, net | 142,706 | 143,452 |
| Goodwill | 130,120 | 130,120 |
| Other intangible assets, net | 14,343 | 15,470 |
| Deposits and other assets | 6,338 | 6,607 |
| Total assets | \$ 563,944 | \$ 606,638 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 6,593 | \$ 8,655 |
| Accrued research and development | 8,071 | 10,359 |
| Accrued general and administrative | 4,396 | 5,758 |
| Accrued compensation | 7,695 | 11,617 |
| Other accrued liabilities | 368 | 466 |
| Interest payable | 4,617 | 3,762 |
| Capital lease obligations - current | 1,062 | 1,008 |
| Deferred revenue | 8,322 | 22,040 |
| Total current liabilities | 41,124 | 63,665 |
| Convertible subordinated notes and debentures | 299,149 | 299,149 |
| Capital lease obligations - noncurrent | 31,488 | 31,862 |
| Other long-term liabilities | 2,796 | 3,159 |
| Accrued rent | 2,052 | 2,033 |
| Commitments and contingencies | — | — |
| Stockholders' equity: | | |
| Preferred Stock, 10,000 shares authorized | | |
| Series A, \$0.0001 par value: 3,100 shares designated; no shares issued or outstanding at March 31, 2003 and December 31, 2002. | — | — |
| Convertible Series B, \$0.0001 par value: 40 shares designated; 40 shares issued and outstanding at March 31, 2003 and December 31, 2002, respectively. Liquidation preference of \$40,000 at March 31, 2003 and December 31, 2002. | 40,000 | 40,000 |
| Common stock, \$0.0001 par value; 300,000 authorized; 55,676 shares and 55,553 shares issued and outstanding at March 31, 2003 and December 31, 2002, respectively. | 6 | 6 |
| Capital in excess of par value | 715,273 | 714,680 |
| Deferred compensation | (128) | (239) |
| Accumulated other comprehensive income | 1,478 | 1,668 |

| | | |
|--|------------|------------|
| Accumulated deficit | (569,294) | (549,345) |
| Total stockholders' equity | 187,335 | 206,770 |
| Total liabilities and stockholders' equity | \$ 563,944 | \$ 606,638 |

(*) The balance sheet at December 31, 2002 has been derived from the audited financial statements at that date which are included in our Form 10-K for the year ended December 31, 2002 as filed with the Securities and Exchange Commission and as amended. This balance sheet does not include all the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

See accompanying notes.

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NEKTAR THERAPEUTICS
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share information)
(unaudited)

| | Three-Months Ended March 31, | |
|---|------------------------------|-------------|
| | 2003 | 2002 |
| Revenue: | | |
| Contract research revenue | \$ 18,393 | \$ 21,301 |
| Product sales | 7,135 | 5,445 |
| Total revenue | 25,528 | 26,746 |
| Operating costs and expenses: | | |
| Cost of goods sold | 4,622 | 1,890 |
| Research and development | 32,141 | 41,927 |
| General and administrative | 5,178 | 5,381 |
| Amortization of other intangible assets | 1,127 | 1,127 |
| Total operating costs and expenses | 43,068 | 50,325 |
| Loss from operations | (17,540) | (23,579) |
| Other income/(expense), net | 119 | (88) |
| Interest income | 1,624 | 2,800 |
| Interest expense | (4,152) | (4,189) |
| Net loss | \$ (19,949) | \$ (25,056) |
| Basic and diluted net loss per share | \$ (0.36) | \$ (0.45) |
| Shares used in computing basic and diluted net loss per share | 55,601 | 55,143 |

See accompanying notes.

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NEKTAR THERAPEUTICS
CONSOLIDATED STATEMENTS OF CASH FLOWS
Increase/(Decrease) in Cash and Cash Equivalents
(in thousands)
(unaudited)

| | Three-Months Ended March 31, | |
|--|------------------------------|-------------|
| | 2003 | 2002 |
| Cash flows used in operating activities: | | |
| Net loss | \$ (19,949) | \$ (25,056) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation | 3,014 | 3,111 |
| Amortization of other intangible assets | 1,127 | 1,127 |
| Amortization of debt issuance costs | 318 | 317 |
| Amortization of deferred compensation | 111 | 175 |
| Non-cash compensation for employee retirement plans | 259 | 249 |
| Stock-based compensation for services rendered | 22 | 30 |
| Changes in assets and liabilities: | | |
| (Increase)/decrease in accounts receivable, other current assets, and other assets | (1,808) | 1,128 |
| (Decrease) in accounts payable and other accrued liabilities | (9,228) | (2,885) |
| Increase/(decrease) in deferred revenue | (13,771) | 2,775 |
| Net cash used in operating activities | (39,905) | (19,029) |
| Cash flows from investing activities: | | |
| Purchases of short-term investments | (54,733) | (94,714) |

| | | |
|--|------------------|------------------|
| Sales of short-term investments | 13,533 | 40,408 |
| Maturities of short-term investments | 70,125 | 57,995 |
| Purchases of property and equipment | (2,331) | (4,720) |
| Net cash provided by/(used in) investing activities | <u>26,594</u> | <u>(1,031)</u> |
| Cash flows from financing activities: | | |
| Payments of loan and capital lease obligations | (354) | (279) |
| Issuance of preferred stock | — | 40,000 |
| Issuance of common stock, net of issuance costs | 312 | 254 |
| Net cash provided by/ (used in) financing activities | <u>(42)</u> | <u>39,975</u> |
| Net increase/(decrease) in cash and cash equivalents | (13,353) | 19,915 |
| Cash and cash equivalents at beginning of period | 34,879 | 30,814 |
| Cash and cash equivalents at end of period | <u>\$ 21,526</u> | <u>\$ 50,729</u> |

See accompanying notes.

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NEKTAR THERAPEUTICS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2003
(unaudited)

Note 1 – Organization and Summary of Significant Accounting Policies

Organization and Basis of Presentation

On January 15, 2003 we changed our name from Inhale Therapeutic Systems, Inc. to Nektar Therapeutics. We believe our new name better reflects our broadened capabilities and approach to drug delivery. Our new corporate identity represents the integration of our three proprietary technology platforms developed through our internal research and development efforts as well as our acquisitions of Shearwater Corporation (now referred to as Nektar AL) and Bradford Particle Design, Ltd. (now referred to as Nektar UK).

We are working to become one of the world's leading drug delivery products based companies by providing a portfolio of technologies and expertise that will enable us and our pharmaceutical partners to improve drug performance throughout the drug development process. We have been unprofitable since inception and forecast incurring substantial operating losses over the next few years.

The accompanying unaudited condensed consolidated financial statements of Nektar have been prepared by management in accordance with generally accepted accounting principles for interim financial information and the instructions for Form 10-Q and Article 10 of Regulation S-X. The condensed consolidated balance sheet as of March 31, 2003, the condensed consolidated statements of operations for the three-months ended March 31, 2003 and 2002, and the consolidated statements of cash flows for the three-months ended March 31, 2003 and 2002 have been prepared by us without audit, but include all adjustments (consisting only of normal recurring adjustments) which we consider necessary for a fair presentation of the financial position at such dates and the operating results and cash flows for those periods. Although we believe that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information normally included in financial statements and related footnotes prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2002, as filed with the SEC and as amended.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Results for any interim period presented are not necessarily indicative of results for any other interim period or for the entire year.

Principles of Consolidation

Our consolidated financial statements include the financial statements of our subsidiaries: Nektar Therapeutics AL, Corporation ("Nektar AL"), formerly Shearwater Corporation; Nektar Therapeutics UK, Ltd. ("Nektar UK"), formerly Bradford Particle Design, Ltd.; Inhale Therapeutic Systems Deutschland GmbH ("Inhale Germany"); and Inhale Therapeutic Systems, U.K. Limited ("Inhale UK"), as well as the financial statements of a real estate partnership lessor.

Our consolidated financial statements are denominated in U.S. dollars. Accordingly, changes in exchange rates between the applicable foreign currency and the U.S. dollar will affect the translation of each foreign subsidiary's financial results into U.S. dollars for purposes of reporting our consolidated financial results. The process by which each foreign subsidiary's financial results are translated into U.S. dollars is as follows: income statement accounts are translated at average exchange rates for the period; balance sheet asset and liability accounts are translated at end of period exchange rates; and equity accounts are translated at historical exchange rates. Translation of the balance sheet in this manner affects consolidated balance sheet in accumulated other comprehensive gain/loss of the stockholders' equity section. To date such cumulative translation adjustments have not been material to our consolidated financial position.

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Significant Concentrations

Cash equivalents and short-term investments are financial instruments that potentially subject us to concentration of risk to the extent of the amounts recorded in the consolidated balance sheet. We limit our concentration of risk by diversifying our investment amount among a variety of industries and issuers. Our professional portfolio managers adhere to this investment policy as approved by our Board of Directors.

Our account receivable balance contains trade receivables from product sales and collaborative research agreements. At March 31, 2003, four partners each represented over 10% of our accounts receivable balance for a combined total of 81% of this balance. At December 31, 2002, two partners each represented over 10% of our accounts receivable. We have not experienced significant credit losses from our accounts receivable or collaborative research agreements, and none are currently expected. We perform a regular review of our customer's activity and associate credit risks and do not require collateral from our customers.

In addition, we are dependent on our partners, vendors and contract manufacturers to provide raw materials, drugs and devices of appropriate quality and reliability and to meet applicable regulatory requirements. Consequently, in the event that supplies are delayed or interrupted for any reason, our ability to develop our products could be impaired, which could have a material adverse effect on our business, financial position and results of operation.

We are dependent on Pfizer Inc. as the source of a significant proportion of our revenue. Contract research revenue from Pfizer represented 54% and 60% of our revenue for the three-months ended March 31, 2003 and 2002, respectively. Since Pfizer advances the costs of research at the beginning of each quarter, they are not a component of our accounts receivable at March 31, 2003. The termination of this collaboration could have a material adverse effect on our financial position and results of operations.

Should the Pfizer collaboration be discontinued prior to the launch of inhalable insulin, we will need to find alternative funding sources to replace the collaborative revenue and will need to reassess the realizability of assets capitalized. Additionally, we would have contingent payments to our contract manufacturers including reimbursing them for their capital outlay to the extent that they cannot re-deploy their assets and we may also incur additional liabilities.

Recent Accounting Pronouncements

In June 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which addresses accounting for restructuring, discontinued operations, plant closings, or other exit or disposal activities. SFAS 146 requires companies to recognize costs related to exiting an activity or to a restructuring not be recognized until the liability is incurred rather than at the date of a commitment to an exit or disposal plan. SFAS 146 will be applied prospectively to exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS 146 on January 1, 2003 did not have a material impact on our financial position or results of operations.

In November 2002, the FASB issued Interpretation ("FIN") No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN 45 elaborates on the existing disclosure requirements for most guarantees, including residual value guarantees issued in conjunction with operating lease agreements, and provides new disclosure requirements regarding indemnification provisions, including indemnification provisions typically included in a license arrangement. It also clarifies that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under that guarantee and that the company must disclose that information in its financial statements. However, the provisions related to recognizing a liability at inception of the guarantee for the fair value of the guarantor's obligations does not apply to product warranties or to guarantees accounted for as derivatives. The initial recognition and initial measurement provisions apply on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. Our adoption of FIN 45 did not have a material impact on our financial position or results of operations.

In December 2002, the FASB issued SFAS 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*. SFAS 148 amends SFAS 123, *Accounting for Stock-Based Compensation* to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure provisions of SFAS 123 and Accounting Principles Board ("APB") Opinion No. 28, *Interim Financial Reporting*, to require disclosure in the summary of significant accounting policies of the effects of an entity's accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. The statement does not amend SFAS 123 to require companies to account for employee stock options using the fair value method. The Statement's amendment of the transition and annual disclosure requirement of SFAS 123 are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002.

We have elected to continue to follow the intrinsic value method of accounting as prescribed by APB 25, *Accounting for Stock Issued to Employee*, to account for employee stock options. Under APB 25, no compensation expense is recognized unless the exercise price of our employee stock options is less than the market price of the underlying stock on the date of grant. We have not recorded such expenses in the periods presented because we granted options at the fair market value of the underlying stock on the date of grant.

In January 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities*. FIN 46 requires a variable interest entity to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. In October 2000, we entered into a build-to-suit lease transaction with a real estate partnership to finance and manage construction of our San Carlos research and office facility. We have fully consolidated this entity in our consolidated financial statements since inception. Accordingly, the adoption of FIN 46 does not have an impact on our financial position or results of operations.

Cash, Cash Equivalents and Investments

We consider all highly liquid investments with a maturity at date of purchase of three months or less to be cash equivalents. Cash and cash equivalents include demand deposits held in banks, interest bearing money market funds and repurchase agreements. All other investments are classified as short-term investments. Short-term investments consist of federal and municipal government securities, corporate bonds and commercial paper with A1 or P1 short-term ratings and A+ or better long-term ratings with remaining maturities at date of purchase of greater than 90 days and less than two years.

At March 31, 2003, all investments are designated as available-for-sale and are carried at fair value, with unrealized gains and losses reported in stockholders' equity as accumulated other comprehensive income/(loss). The amortized cost of securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included in interest income. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities, if any, are included in interest income. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest income.

Inventories

Inventories are included in other current assets on the balance sheet and consist primarily of raw materials, work-in-process and finished goods of our Nektar AL location. Inventories are stated at the lower of cost (first-in, first-out method) or market, and consists of the following (in thousands):

| | March 31, 2003 | December 31, 2002 |
|-------------------|-------------------|----------------------|
| Raw material | \$ 3,267 | \$ 2,825 |
| Work-in-process | 400 | 228 |
| Finished goods | 2,157 | 3,256 |
| Total inventories | <u>\$ 5,824</u> | <u>\$ 6,309</u> |

Property and Equipment

Property and equipment are stated at cost. Major improvements are capitalized, while maintenance and repairs are expensed when incurred. Laboratory and other equipment are depreciated using the straight-line method over estimated useful lives of three to seven years. Leasehold improvements and buildings, which are subject to the terms of a build-to-suit lease, are depreciated using the straight-line method over the shorter of the estimated useful life or the remaining term of the lease.

We have expensed certain plant design, engineering and validation costs based on our evaluation that it is unclear whether such costs are ultimately recoverable.

Goodwill

We currently operate as a single reporting unit and all of our goodwill is associated with the entire company. Goodwill is tested for impairment at least annually, or on an interim basis if an event occurs or circumstances change that would more-likely-than-not reduce the fair value below our carrying value. Goodwill is tested for impairment using a two-step approach. The first step is to compare our fair value to our carrying amount, including goodwill. If the fair value is greater than the carrying amount, goodwill is not considered impaired and the second step is not required. If the fair value is less than the carrying amount, the second step of the impairment test measures the amount of the impairment loss, if any. The second step of the impairment test is to compare the implied fair value of goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, an impairment loss is recognized equal to that excess. The implied fair value of goodwill is calculated in the same manner that goodwill is calculated in a business combination, whereby the fair value is allocated to all of the assets and liabilities (including any unrecognized intangible assets) as if they had been acquired in a business combination and the fair value was the purchase price. The excess "purchase price" over the amounts assigned to assets and liabilities would be the implied fair value of goodwill.

In conjunction with the implementation of SFAS 142, we performed an impairment test of goodwill as of January 1, 2002, which did not result in an impairment charge upon adoption. We performed the annual test as of October 1, 2002, which did not result in an impairment charge. We will perform this annual test on October 1 of future years or more frequently if indicators of potential impairment exist. As of March 31, 2003, no indicators of potential impairment existed. No such impairment losses have been recorded to date.

Other Intangible Assets

Acquired technology and other intangible assets with definite useful lives are amortized on a straight-line basis over a period of five years. Other intangible assets include proprietary technology, intellectual property, and supplier and customer relationships acquired from third parties or in business combinations. Intangible assets are tested for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable from future undiscounted cash flows. We periodically evaluate whether changes have occurred that would require revision of the remaining estimated useful lives of these assets or otherwise render the assets unrecoverable. If such an event occurred, we would determine whether the other intangibles are impaired. As of March 31, 2003, no indicators of potential impairment existed. No such impairment losses have been recorded to date.

Comprehensive Gain/Loss

Comprehensive loss is comprised of net loss and other comprehensive gain/loss for the three-months ended March 31, 2003 and 2002. Other comprehensive gain included unrealized gains/losses on available-for-sale securities, translation adjustments and unrealized gains/losses on available-for-sale securities using the specific identification method. The comprehensive loss consists of the following components (in thousands):

| | Three-Months Ended March 31, | |
|---|---------------------------------|--------------------|
| | 2003 | 2002 |
| Net loss | \$ (19,949) | \$ (25,056) |
| Changes in net unrealized gains/(losses) on available for sale securities | (9) | (1,466) |
| Net unrealized loss reclassified into earnings | (18) | (102) |
| Translation adjustment | (163) | (148) |
| Total comprehensive loss | <u>\$ (20,139)</u> | <u>\$ (26,772)</u> |

The components of accumulated other comprehensive income are as follows (in thousands):

| | | | | |
|---|----|--------------|----|--------------|
| Unrealized gains on available-for-sale securities | \$ | 1,247 | \$ | 1,273 |
| Translation adjustment | | 231 | | 395 |
| Total accumulated other comprehensive income | \$ | <u>1,478</u> | \$ | <u>1,668</u> |

Stock-Based Compensation

We grant stock options to our employees at an exercise price equal to the fair value of the shares at the date of grant and we account for these stock option grants in accordance with APB 25, *Accounting for Stock Issued to Employees* and related interpretations. Under this opinion, no stock-based employee compensation expense is charged for options that were granted at an exercise price that was equal to the market value of the underlying Common Stock on the date of grant. Pro forma information regarding net income and earnings per share is required by SFAS 123, which also requires that the information be determined as if we had accounted for our employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option-pricing model with the following weighted-average assumptions:

| | Three-Months Ended March 31, | |
|--------------------------------|---------------------------------|---------|
| | 2003 | 2002 |
| Risk-free interest rate | 2.9% | 3.8% |
| Dividend yield | 0.0% | 0.0% |
| Volatility Factor | 0.795 | 0.743 |
| Weighted average expected life | 5 years | 5 years |

The Black-Scholes options valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because our employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in our opinion, the existing models do not necessarily provide a reliable single measure of the fair value of our employee and director stock options. However, we have presented the pro forma net loss and pro forma basic and diluted net loss per common share using the assumptions noted above.

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation (in thousands, except per share information):

| | Three-Months Ended March 31, | |
|--|---------------------------------|-------------|
| | 2003 | 2002 |
| Net loss, as reported | \$ (19,949) | \$ (25,056) |
| Add: stock-based employee compensation included in reported net loss | 111 | 175 |
| Deduct: total stock-based employee compensation expense determined under fair value methods for all awards | (10,760) | (17,252) |
| Pro forma net loss | \$ (30,598) | \$ (42,133) |
| Earnings per share | | |
| Basic and diluted, as reported | \$ (0.36) | \$ (0.45) |
| Basic and diluted, pro forma | \$ (0.55) | \$ (0.76) |

Stock compensation expense for options granted to non-employees has been determined in accordance with SFAS 123 and Emerging Issues Task Force No. 96-18 as the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured. The fair value of options granted to non-employees is re-measured as the underlying options vest.

Revenue Recognition

Contract revenue from collaborative research agreements is recorded when earned based on the performance requirements of the contract. Revenue from non-refundable upfront license fees and certain guaranteed payments where we continue involvement through collaborative development are deferred and recognized as revenue over the period of continuing involvement. Revenue from grants and feasibility arrangements are recognized as the related costs are incurred. Our research revenue is derived primarily from clients in the pharmaceutical and biotechnology industries and consists of reimbursement of development costs, reimbursement of certain expenses, payment of clinical supplies and amortization of milestones. Costs of contract research revenue approximate such revenue and are included in research and development expenses. Payments received from milestone achievements are deferred and recorded as revenue

ratably over the next period of continued development. Advance payments for research and development revenue received in excess of amounts earned are classified as deferred revenue until earned.

Revenue from product sales is recognized when there is persuasive evidence that an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectability is reasonably assured. Allowances, if any, are established for uncollectible amounts, estimated product returns and discounts.

Research and Development

Research and development costs are expensed as incurred and include salaries, benefits, and other operating costs. We perform research and development for others pursuant to feasibility agreements and development and license agreements. Under these feasibility agreements, we are generally reimbursed for the cost of work performed. Feasibility agreements are designed to evaluate the applicability of our technologies to a particular molecule and therefore are generally completed in less than one year. Under our development and license agreements, products developed using our technologies are commercialized with a collaborative partner. Under these development agreements, we may be reimbursed for development costs, may also be entitled to

milestone payments when and if certain development milestones are achieved, are compensated for the manufacture and supply of clinical and commercial product and receive royalties on sales of commercialized products. All of our research and development agreements are generally cancelable by the partner without significant financial penalty.

Segment Reporting

We report segments in accordance with SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*. SFAS 131 requires the use of a management approach in identifying segments of an enterprise. We are organized and operate as one operating segment.

Our research revenue is derived primarily from clients in the pharmaceutical and biotechnology industries. Contract research revenue from Pfizer represented 54% and 60% of our revenue for the three-months ended March 31, 2003 and 2002, respectively. Product sales relate to sale of our manufactured Advanced PEGylation products.

Our accounts receivable balance contains trade receivables from product sales and collaborative research agreements. At March 31, 2003, four partners each represented over 10% of our accounts receivable balance for a combined total of 81% of this balance. At December 31, 2002, two partners each represented over 10% of our accounts receivable.

Net Loss Per Share

In accordance with SFAS 128, *Earnings Per Share*, basic and diluted net loss per share have been computed using the weighted average number of shares of common stock outstanding during the period, less shares subject to repurchase. Had we been in a net income position, diluted earnings per share would have included outstanding options, warrants and convertible debentures and notes.

Accounting for Income Taxes

We account for income taxes under SFAS No. 109, *Accounting for Income Taxes*. Under SFAS 109, the liability method is used in accounting for income taxes. Currently there is no provision for income taxes as we have only incurred operating losses to date.

Note 2 - - Other Intangible Assets

The components of our other intangible assets at March 31, 2003, are as follows (in thousands, except for years):

| | Useful Life in Years | Gross Carrying Amount | Accumulated Amortization | Net |
|---------------------------------|----------------------------|-----------------------------|-----------------------------|------------------|
| Core technology | 5 | \$ 8,100 | \$ 2,835 | \$ 5,265 |
| Developed product technology | 5 | 2,900 | 1,015 | 1,885 |
| Intellectual property | 5-7 | 7,301 | 3,262 | 4,039 |
| Supplier and customer relations | 5 | 5,140 | 1,986 | 3,154 |
| Total | | \$ 23,441 | \$ 9,098 | \$ 14,343 |

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Amortization expense related to other intangible assets totaled \$1.1 million for each of the three-months ended March 31, 2003 and 2002. The following table shows expected future amortization expense for other intangible assets until they are fully amortized (in thousands):

| Years Ending December 31, | |
|---------------------------|------------------|
| Remainder of 2003 | \$ 3,380 |
| 2004 | 4,507 |
| 2005 | 4,507 |
| 2006 | 1,949 |
| Total | \$ 14,343 |

Note 3 - Restructuring

In December 2002, we recorded a charge of \$2.6 million related to a workforce reduction of 73 employees, which represents about 10% of our base employees. The \$2.6 million charge included \$1.7 million in severance compensation, \$0.5 million in health benefits and \$0.3 million in out placement services. Approximately \$0.1 million was non-cash related to stock compensation. During December 2002, \$0.9 million was paid out associated with severance and other employee benefits. At December 31, 2002, we had a remaining accrual of \$1.6 million of which \$1.4 million was paid out during the three-months ended March 31, 2003. The remaining \$0.2 million is expected to be paid out during the three-months ending June 30, 2003. The activity in the restructuring balance was as follows at March 31, 2003 (in thousands):

| | Employee Severance and Other Benefits |
|----------------------------------|---|
| Balance at December 31, 2002 | \$ 1,577 |
| Cash payments | (1,351) |
| Balance at March 31, 2003 | \$ 226 |

Note 4 - - Commitments and Contingencies

On August 30, 2002, a complaint was filed by David F. Kachensky in the Circuit Court of Madison County, Alabama, against J. Milton Harris, James R. Hudson, Jr., Inhale Therapeutic Systems, Inc. (now Nektar Therapeutics), and Shearwater Corporation (now Nektar Therapeutics AL, Corporation). Dr. Harris is the president of our Nektar Therapeutics AL, Corporation. Among other things, the Complaint alleged that the Defendants breached an agreement allegedly entered into by and between certain of the defendants and the plaintiff prior to our acquisition of Shearwater, whereby the defendants allegedly agreed, among

other things, to convey to the plaintiff five percent (5%) of the capital stock of Shearwater outstanding as of December 1997 in exchange for certain work and consideration from plaintiff. The Complaint sought damages in the amount of approximately \$15 million. On October 7, 2002, the defendants filed answers to the Complaint denying the allegations and asserting affirmative defenses. On April 1, 2003, the defendants filed a motion for summary judgment as to all claims. On April 2, 2003, the parties engaged in a mediation that resulted in a settlement of all claims and an agreement to dismiss the complaint. The dismissal should be filed shortly. The settlement was reflected in our results of operations for the three-months ended March 31, 2003, and did not have a material effect on our business.

From time to time, we may be involved in other lawsuits, claims, investigations and proceedings, consisting of intellectual property, commercial, employment and other matters, which arise in the ordinary course of business. In accordance with the SFAS 5, *Accounting for Contingencies*, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impact of negotiations, settlements, ruling, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. However, we believe that we have valid defenses with respect to the legal matters pending against us, as well as adequate provisions for any probable and estimable losses. If any unfavorable ruling were to occur in any specific period, there exists the possibility of a material adverse impact on the results of operations of that period. We believe that, given our current liquidity and cash and investment balances, even if we receive an adverse judgment with respect to litigation that we are currently a party to, such judgment would not have a material impact on cash and investments or liquidity.

Note 5 - Guarantees and Indemnification

The following is a summary of our agreements that we have determined are within the scope of the FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Other's* which are specifically grandfathered because the guarantees were in effect prior to December 31, 2002. In accordance with this interpretation, we have no liabilities recorded for these agreements as of March 31, 2003, except as noted below.

Director and Officer Indemnifications

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have a Director and Officer insurance policy that may limit our exposure and may enable us to recover a portion of any future amounts paid. Assuming the applicability of this coverage, the willingness of the insurer to assume coverage and subject to certain retention, loss limits and other policy provisions, we believe any obligations to our directors and officers are not material. However, no assurances can be given that the covering insurers will not attempt to dispute the validity, applicability or amount of coverage without expensive litigation against these insurers, in which case we may incur substantial liabilities as a result of these indemnification obligations.

Lease Restoration

We have several operating leases for our facilities in multiple locations. In the event that we do not exercise our option to extend the term of a lease, we guarantee certain costs to restore the property to certain conditions in place at the time of lease. We believe the estimated fair value of this guarantee is minimal.

Strategic Alliance—Enzon Pharmaceuticals, Inc.

In January 2002, we announced a broad strategic alliance with Enzon Pharmaceuticals, Inc that included a collaboration to develop three products using our particle engineering technologies. Under the terms of the agreement, we are responsible for the development of drug formulations for the agreed upon pharmaceutical agents. We are required to self-fund a portion of these costs. As of March 31, 2003, we are required to internally fund \$15.4 million in the coming years without reimbursement for research and development expenses. Costs incurred to date of \$1.6 million have been included in our research and development expenses. After our funding requirement has been met, Enzon will provide research and development funding as well as milestone payments as the program progresses through clinical testing.

Manufacturing and Supply Agreement with Contract Manufacturers

In August 2000, we entered into a Manufacturing and Supply Agreement with our contract manufacturers to provide for the manufacturing of our pulmonary inhaler for Exubera[®] (inhalable insulin). Under the terms of the Agreement, we may be obligated to reimburse the contract manufacturers for the actual unamortized and unrecovered portion of any equipment procured or facilities established and the interest accrued for their capital overlay, or under certain circumstances, to the extent that the contract manufactures cannot re-deploy the assets in the event that Exubera does not gain FDA approval. While we would expect such payments would be significant, at the present time it is not possible to accurately estimate the loss that will occur should Exubera not be approved. We have also agreed to defend, indemnify and hold harmless the contract manufacturers from and against third party liability arising out of the Agreement, including product liability and infringement of intellectual property. There is no limitation on the potential amount of future payments we could be required to make under these indemnification obligations. We have never incurred costs to defend lawsuits or settle claims related to these indemnification obligations. If any of our indemnification obligations is triggered, we may incur substantial liabilities.

Security Agreement with Pfizer Inc.

In connection with the Collaboration, Development and License Agreement ("CDLA") dated January 18, 1995 that we entered into with Pfizer Inc, for the development of the Exubera product, we entered into a Security Agreement pursuant to which our obligations under the CDLA and certain Manufacturing and Supply Agreements related to the manufacture and supply of powdered insulin and pulmonary inhaler devices for the delivery of powdered insulin, are secured. Our default under any of these agreements triggers Pfizer's rights with respect to property relating solely to, or used or which will be used solely in connection with, the development, manufacture, use and sale of Exubera including proceeds from the sale or other disposition of the property.

Collaboration Agreements for Pulmonary Products

As part of our collaboration agreements with our partners for the development, manufacture and supply of products based on our pulmonary delivery system, we generally agree to defend, indemnify and hold harmless our partners from and against third party liabilities arising out of the agreement, including product liability and infringement of intellectual property. The term of these indemnification obligations is generally perpetual any time after execution of the agreement. There is no limitation on the potential amount of future payments we could be required to make under these indemnification obligations. We have never incurred costs to defend lawsuits or settle claims related to these indemnification obligations. If any of our indemnification obligations is triggered, we may incur substantial liabilities.

License, Manufacturing and Supply Agreements for Products Based on our Advanced PEGylation Technology

As part of our license, manufacturing and supply agreements with our partners for the development and/or manufacture and supply of polyethylene glycol ("PEG") reagents based on our Advanced PEGylation technology, we generally agree to defend, indemnify and hold harmless our partners from and against third party liabilities arising out of the agreement, including product liability and infringement of intellectual property. The term of these indemnification obligations is generally perpetual any time after execution of the agreement. There is no limitation on the potential amount of future payments we could be required to make under these indemnification obligations. We have never incurred costs to defend lawsuits or settle claims related to these indemnification obligations. If any of our indemnification obligations is triggered, we may incur substantial liabilities.

Note 6 - Preferred Stock

We have authorized 10,000,000 shares of Preferred Stock, each share having a par value of \$0.0001. Three million one hundred thousand (3,100,000) shares of Preferred Stock are designated Series A Junior Participating Preferred Stock (the "Series A Preferred Stock") and forty thousand (40,000) shares of Preferred Stock are designated as Series B Convertible Preferred Stock (the "Series B Preferred Stock").

Series A Preferred Stock

On June 1, 2001 the Board of Directors approved the adoption of a Share Purchase Rights Plan (the "Plan"). Terms of the Plan provide for a dividend distribution of one preferred share purchase right (a "Right") for each outstanding share of our Common Stock (the "Common Shares"). The Rights have certain anti-takeover effects and will cause substantial dilution to a person or group that attempts to acquire the Company on terms not approved by our Board of Directors. The dividend distribution was payable on June 22, 2001 (the "Record Date") to the stockholders of record on that date. Each Right entitles the registered holder to purchase from us one one-hundredth of a share of Series A Preferred Stock at a price of \$225.00 per one one-hundredth of a share of Series A Preferred Stock (the "Purchase Price"), subject to adjustment. Each one one-hundredth of a share of Series A Preferred Stock has designations and powers, preferences and rights, and the qualifications, limitations and restrictions which make its value approximately equal to the value of a Common Share.

The Rights are not exercisable until the Distribution Date (as defined in the Certificate of Designation for the Series A Preferred Stock). The Rights will expire on June 1, 2011, unless the Rights are earlier redeemed or exchanged by us. Each share of Series A Preferred Stock will be entitled to a minimum preferential quarterly dividend payment of \$1.00 but will be entitled to an aggregate dividend of 100 times the dividend declared per Common Share. In the event of liquidation, the holders of the Series A Preferred Stock would be entitled to a minimum preferential liquidation payment of \$100 per share, but would be entitled to receive an aggregate payment equal to 100 times the payment made per Common Share. Each share of Series A Preferred Stock will have 100 votes, voting together with the Common Shares. Finally, in the event of any merger, consolidation or other transaction in which Common Shares are exchanged, each share of Series A Preferred Stock will be entitled to receive 100 times the amount of consideration received per Common Share. Because of the nature of the Series A Preferred Stock dividend and liquidation rights, the value of one one-hundredth of a share of Series A Preferred Stock should approximate the value of one Common Share. The Series A Preferred Stock ranks junior to the Series B Preferred Stock and would rank junior to any other series of preferred stock. Until a Right is exercised, the holder thereof, as such, will have no rights as a stockholder, including, without limitation, the right to vote or to receive dividends.

Series B Convertible Preferred Stock

In connection with a strategic alliance with Enzon Pharmaceuticals, Inc., we entered into a Preferred Stock Purchase Agreement pursuant to which we sold to Enzon and Enzon purchased from us forty thousand (40,000) shares of non-voting Series B Preferred Stock at a purchase price of one thousand dollars (\$1,000) per share for an aggregate purchase price of forty million dollars (\$40,000,000). A Certificate of Designation filed with the Secretary of State of Delaware sets forth the rights, privileges and preferences of the Series B Preferred Stock. Pursuant to the Certificate of Designation, the Series B Preferred Stock does not have voting rights. The Series B

Preferred Stock is convertible, in whole or in part, into that number of shares of our Common Stock (the "Conversion Shares") equal to the quotient of \$1,000 per share divided by the Conversion Price. The "Conversion Price" shall initially be equal to \$22.79 per share or 125% of the Closing Price and at no time can the Preferred Stock convert into shares of Common Stock at a discount to the Closing Price. The "Closing Price" equals \$18.23 per share and was based upon the average of our closing bid prices as listed on the NASDAQ National Market for the twenty (20) trading days preceding the date of the closing of the transaction.

The Series B Preferred Stock is convertible at the option of the holder after the first anniversary of the original issuance of the Series B Preferred Stock (the "Original Issue Date") or, if earlier, upon a Change in Control (as defined in the Certificate of Designation). Except with respect to an automatic conversion as described below, the Conversion Price shall be equal to 125% of the Closing Price until the third anniversary of the Original Issue Date. Upon the third anniversary of the Original Issue Date, the Conversion Price shall be adjusted to be equal to either (i) the Closing Price, in the event that the average of the closing bid prices of our Common Stock as quoted on the NASDAQ National Market for the twenty (20) trading days preceding the third anniversary of the original issuance (the "Future Price") is less than or equal to the Closing Price; (ii) the Future Price (as defined above) if the Future Price is greater than the Closing Price but less than 125% of the Closing Price; or (iii) 125% of the Closing Price if the Future Price is equal to or greater than 125% of the Closing Price.

To the extent not previously converted, the Series B Preferred Stock will automatically convert into shares of our Common Stock, based on the then effective Conversion Price, upon the earliest of (i) the fourth anniversary of the Original Issue Date; (ii) immediately prior to an Asset Transfer or Acquisition (as defined in the Certificate of Designation); or (iii) with the consent of the holders of a majority of the then outstanding Series B Preferred Stock immediately prior

to a liquidation, dissolution or winding up of Nektar. In the event of an automatic conversion pursuant to an asset transfer, acquisition or liquidation, the adjustment mechanism described above will be applied immediately prior to the automatic conversion.

In the event of our liquidation, dissolution or winding down, either voluntary or involuntary, following the payment of any distributions due the holders of any class of capital stock or series of preferred stock that ranks senior to the Series B Preferred Stock, the holders of the Series B Preferred Stock shall be entitled to receive, prior and in preference to any distribution of any of our assets or surplus funds to the holders of our Common Stock or any class of capital stock or series of preferred stock that does not rank senior to or on parity with the Series B Preferred Stock, an amount per share (as adjusted for any combinations, consolidations, stock distributions or stock dividends with respect to the Series B Preferred Stock) equal to up to \$1,000.

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

The following discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this section as well as factors under the heading "Risk Factors" at the end of this section.

Overview

On January 15, 2003 we changed our name from Inhale Therapeutic Systems, Inc. to Nektar Therapeutics. We believe our new name better reflects our broadened capabilities and approach to drug delivery. Our new corporate identity represents the integration of our proprietary technology platforms developed through our internal research and development efforts as well as our acquisitions of Shearwater Corporation (now referred to as Nektar AL) and Bradford Particle Design, Ltd. (now referred to as Nektar UK).

We are working to become one of the world's leading drug delivery products based companies by providing a portfolio of technologies and expertise that will enable us and our pharmaceutical partners to improve drug performance throughout the drug development process. We have been unprofitable since inception and forecast incurring substantial operating losses over the next few years. We forecast that research and development expenses will continue at current levels or higher through at least the next couple of years. We forecast a decrease in internally funded research spending in the next three to five years, due to the combination of the completion of scale up and commercial readiness spending, the shifting of infrastructure spending to cost of goods sold for commercial product sales, and the anticipated partnering of our proprietary projects. To date, except for sales from four products using Nektar Molecule Engineering based on our Advanced PEGylation technology, we have not sold any commercial products. For the period from inception through March 31, 2003, we incurred a cumulative net loss of approximately \$569.3 million. The sources of our working capital have been equity offerings and convertible debt financings, financings of equipment acquisitions and tenant improvements, interest earned on investments of cash, and revenues from product sales, short-term research and feasibility agreements and development contracts. To date we have been primarily dependent upon equity and convertible debt financings to fund our working capital.

We have generally been compensated for research and development expenses during initial feasibility work performed under collaborative arrangements. In a typical collaboration, our partner will provide the drug, fund clinical and formulation development, obtain regulatory approvals and market the resulting commercial product. We will supply the drug delivery approach and drug formulation. We will receive revenues from drug formulation manufacturing and other manufacturing activities, as well as royalties from sales of certain commercial products. In addition, for products using Nektar Delivery Solutions technology, we expect to receive revenues from the supply of our pulmonary inhaler device for the product along with any applicable drug processing. Partners that enter into collaborative agreements generally fund research and development through expense reimbursements and/or payments as we achieve certain key development and regulatory milestones. To achieve and sustain profitable operations, we, alone or with others, must successfully develop, obtain regulatory approval for, manufacture, introduce, market and sell products using our drug delivery systems. There can be no assurance that we can generate sufficient product or contract research revenue to become profitable or to sustain profitability.

Recent Developments

In March 2003, we announced that Pharmacia Corporation's (acquired by Pfizer Inc.) Somavert[®] received FDA approval for the treatment of certain patients diagnosed with acromegaly. This product has already been approved in Europe. Under the terms of our agreement with Pharmacia, we will receive manufacturing revenue based on the sale of the PEG regent.

In March 2003, we announced that we have created a new executive position to drive development and implementation of management and operations processes to achieve our growth and profitability objectives. Brigid A. Makes, our former Chief Financial Officer and Vice President of Finance and Administration, was named to this new senior management position, Vice President of Operations Management. Ajay Bansal has joined us as our new Chief Financial Officer and Vice President of Finance and Administration.

In January 2003, we announced an agreement with The Straumann Group to license, manufacture and supply our PEG-based hydrogel technology for dental regeneration products. Under the agreement, Straumann will license and source our PEG-based hydrogel technology material exclusively for proprietary formulation. We will receive milestone and manufacturing payments as well as royalties on commercialized products.

In January 2003, during Pfizer's quarterly financial results conference call, Pfizer commented that it would not file an NDA for approval of Exubera in 2003. There can be no assurance that Pfizer will file for an NDA approval of Exubera, on a timely basis, if at all, and, if such filing is made, there can be no assurance that Pfizer will obtain FDA approval to market Exubera. The failure to file in a timely manner for or obtain regulatory approval of Exubera would significantly harm our business.

Recent Accounting Pronouncements

In June 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which addresses accounting for restructuring, discontinued operations, plant closings, or other exit or disposal activities. SFAS 146 requires companies to recognize costs related to exiting an activity or to a restructuring not be recognized until the liability is

incurred rather than at the date of a commitment to an exit or disposal plan. SFAS 146 will be applied prospectively to exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS 146 on January 1, 2003 did not have a material impact on our financial position or results of operations.

In November 2002, the FASB issued Interpretation (“FIN”) No. 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN 45 elaborates on the existing disclosure requirements for most guarantees, including residual value guarantees issued in conjunction with operating lease agreements, and provides new disclosure requirements regarding indemnification provisions, including indemnification provisions typically included in a license arrangement. It also clarifies that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under that guarantee and that the company must disclose that information in its financial statements. However, the provisions related to recognizing a liability at inception of the guarantee for the fair value of the guarantor’s obligations does not apply to product warranties or to guarantees accounted for as derivatives. The initial recognition and initial measurement provisions apply on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. Our adoption of FIN 45 did not have a material impact on our financial position or results of operations.

In December 2002, the FASB issued SFAS 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*. SFAS 148 amends SFAS 123, *Accounting for Stock-Based Compensation* to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure provisions of SFAS 123 and Accounting Principles Board (“APB”) Opinion No. 28, *Interim Financial Reporting*, to require disclosure in the summary of significant accounting policies of the effects of an entity’s accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. The statement does not amend SFAS 123 to require companies to account for employee stock options using the fair value method. The Statement’s amendment of the transition and annual disclosure requirement of SFAS 123 are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. We have elected to continue to follow the intrinsic value method of accounting as prescribed by APB 25, *Accounting for Stock Issued to Employee*, to account for employee stock options. Under APB 25, no compensation expense is recognized unless the exercise price of our employee stock options is less than the market price of the underlying stock on the date of grant. We have not recorded such expenses in the periods presented because we grant options at the fair market value of the underlying stock on the date of grant.

In January 2003, the FASB issued FIN 46, *Consolidation of Variable Interest Entities*. FIN 46 requires a variable interest entity to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. In October 2000, we entered into a build-to-suit lease transaction with a real estate partnership to finance and manage construction of our San Carlos research and office facility. We have fully consolidated this entity in our consolidated financial statements since inception. Accordingly, the adoption of FIN 46 does not have an impact on our financial position or results of operations.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States. It requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

We consider certain accounting policies related to revenue recognition, stock based compensation, impairment of goodwill and intangible assets, and accrued liabilities to be critical to our business operations and the understanding of our results of operations.

Revenue Recognition

Contract revenue from collaborative research agreements is recorded when earned based on the performance requirements of the contract. Revenue from non-refundable upfront license fees and certain guaranteed payments where we continue involvement through collaborative development are deferred and recognized as revenue over the period of continuing involvement. Revenue from grants and feasibility arrangements are recognized when the cash has been received and the final product has been delivered to the customer. Our research revenue is derived primarily from clients in the pharmaceutical and biotechnology industries and consists of reimbursement of development costs, reimbursement of certain expenses, payment of clinical supplies and amortization of milestones. Payments received for milestones achieved are deferred and recorded as revenue ratably over the next period of continued development. Advance payments for research and development revenue received in excess of amounts earned are classified as deferred revenue until earned.

Revenue from product sales is recorded when there is persuasive evidence that an arrangement exists, delivery has occurred, the price is fixed and determinable and collectability is reasonably assured. Allowances, if any, are established for uncollectible amounts, estimated product returns and discounts.

Stock-Based Compensation

We grant stock options to our employees and we account for these stock option grants in accordance with APB 25, *Accounting for Stock Issued to Employees* and related interpretations. Under APB 25, when stock options are issued with an exercise price equal to the market price of the underlying stock on the date of grant, no compensation expense is recognized in the income statement (See Note 1, Organization and Summary of Significant Accounting Policies of Part I, Item 1, of this Form 10-Q).

Impairment of Goodwill and Intangible Assets

In accordance with SFAS 142 on *Goodwill and Other Intangible Assets*, assembled workforce was reclassified as goodwill and is subject to an impairment assessment. We have adopted a policy for measuring goodwill on an annual basis and between annual tests in certain circumstances. To date, no such impairment losses have been recorded.

Accrued Liabilities

Certain accrued liabilities, such as accrued research and development, accrued general and administrative, accrued compensation and other accrued liabilities, reflect management's best estimates based on our specific historical experience and understanding of industry practice. The basis for accounting estimates has been consistently applied and reviewed on a quarterly as well as annual basis. We record a reserve for these matters when the outcome is probable and the amount of the potential liability can be reasonably estimated.

Results of Operations

Three-Months Ended March 31, 2003 and 2002

Revenue

Revenues for the three-months ended March 31, 2003 was approximately \$25.5 million compared to approximately \$26.7 million for the three-months ended March 31, 2002, a decrease of 5%. The decrease in revenue reported during the three-months ended March 31, 2003 compared to the three-months ended March 31, 2002 is due primarily to lower clinical drug and device sales for our partnered projects. Contract research revenue included reimbursed research and development expenses as well as the amortization of deferred up-front signing and progress payments received from our collaborative partners. Contract revenues are expected to fluctuate from year to year, and future contract revenue cannot be predicted accurately. The level of contract revenues depends in part upon future success in obtaining timely completion of feasibility studies, the continuation of existing collaborations, and achievement of milestones under current and future agreements. Product sales accounted for approximately 28% of revenue for the three-months ended March 31, 2003, as compared to approximately 20% for the three-months ended March 31, 2002. The increase in product sales was based upon the regulatory approval of new products and higher demand for clinical shipments of our PEG reagents. Future sales are dependent upon the acceptance of these and other products in the market and cannot be accurately predicted.

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Costs of Goods Sold

Cost of goods sold is associated with product sales and was approximately \$4.6 million for the three-months ended March 31, 2003 based on product sales of approximately \$7.1 million. Cost of goods sold for three-months ended March 31, 2002 was approximately \$1.9 million based on product sales of approximately \$5.4 million. The 142% increase in cost of goods sold for the three-months ended March 31, 2003 as compared to the three-months ended March 31, 2002 was primarily driven by the 31% increase in product sales, the initiation of royalty payments on certain PEGylated products as well as changes in the mix of products sold for the three months ended March 31, 2003 as compared to the same period in 2002. The combination of our various products will drive the fluctuation in the relationship between product sales and cost of goods sold.

Research and Development Expenses

Research and development expenses are associated with three general categories: (i) collaborative agreements under which spending is reimbursed by our partners; (ii) spending attributed to internally funded programs; and (iii) commercial readiness and infrastructure costs associated with commercial operations for our drug and third-party device manufacturing. Research and development expenses were approximately \$32.1 million for the three-months ended March 31, 2003, as compared to approximately \$41.9 million for the three-months ended March 31, 2002. The 23% decrease for the three-months ended March 31, 2003 as compared to the three-months ended March 31, 2002, can be partially attributed to a one time payment of approximately \$5.3 million to Alliance Pharmaceuticals for the rights beyond pulmonary application for PulmoSphere[®] technology in the three-months ended March 31, 2002. In addition, our research and development expenses related to the scale-up and commercial readiness costs associated with the Exubera inhaled insulin project decreased for the three-months ended March 31, 2003 as compared to the three-months ended March 31, 2002. We forecast that research and development expenses will continue at current levels or higher through at least the next couple of years. We forecast a decrease in internally funded research spending in the next three to five years, due to the combination of the completion of scale up and commercial readiness spending, the shifting of infrastructure spending to cost of goods sold for commercial product sales, and the anticipated partnering of our proprietary projects.

General and Administrative Expenses

General and administrative expenses are associated with administrative staffing, business development and marketing efforts. General and administrative expenses were approximately \$5.2 million and \$5.4 million for the three-months ended March 31, 2003 and 2002, respectively.

Amortization of Other Intangible Assets

Amortization of other intangible assets expenses was approximately \$1.1 million for both the three-months ended March 31, 2003 and the three-months ended March 31, 2002.

Other Income/ (Expense), Net

Other income/ (expense), net was approximately \$0.1 million income for the three-months ended March 31, 2003, as compared to approximately \$0.1 million expense for the three-months ended March 31, 2002.

Interest Income

Interest income was approximately \$1.6 million for the three-months ended March 31, 2003, as compared to approximately \$2.8 million for the three-months ended March 31, 2002. The approximate \$1.2 million decrease in interest income was due to lower cash and investment balances and lower interest rates. We expect interest income to correlate with the increase or decrease of our cash and investment balances and interest rates for the remainder of the year.

Interest Expense

Interest expense is related to convertible subordinated notes and debentures, an obligation for our build-to suit lease transaction with our real estate partnership and other equipment loans. Interest expense was relatively unchanged at approximately \$4.2 million for both the three-months ended March 31, 2003 and the three-months ended March 31, 2002.

Liquidity and Capital Resources

We have financed our operations primarily through public and private placements of our debt and equity securities, revenue from development contracts, product sales and short-term research and feasibility agreements, financing of equipment acquisitions and tenant improvements, and interest income earned on our investments of cash. We do not utilize off-balance sheet financing arrangements as a source of liquidity or financing. At March 31, 2003, we had cash, cash equivalents, and short-term investments of approximately \$251.5 million.

Our operations used cash of \$39.9 million for the three-months ended March 31, 2003 as compared to \$19.0 million for the three-months ended March 31, 2002. For the three-months ended March 31, 2003, the cash used in operations primarily reflects the net loss for the three-months ended March 31, 2003, of \$19.9 million and changes in the balance sheet including the reduction of deferred revenue that is dependent upon the timing of partner advance payments. In the three-months ended March 31, 2003 we made cash disbursements on several liabilities carried on the balance sheet at December 31, 2002. In relation to employee severance and other benefits for the restructuring announced on December 11, 2002, we paid out \$1.4 million in the three-months ended March 31, 2003. We also made cash disbursements of \$1.3 million in the three-months ended March 31, 2003 related to our name change. For the three-months ended March 31, 2002, cash used in operations of \$19.0 million primarily reflected our net loss of \$25.1 million for the three-months ended March 31, 2002, offset by depreciation and other changes in the balance sheet. Cash used in operations increased by \$20.9 million in the three-months ended March 31, 2003 as compared to the three-months ended March 31, 2002 primarily due to the changes in deferred revenue that is contingent on the timing of partner advance payments, the decrease in accounts payable and other accrued liabilities, and the increase in accounts receivable for the periods presented.

Cash provided by investing activities was \$26.6 million for the three-months ended March 31, 2003 as compared to \$1.0 million cash used by investing activities for the three-months ended March 31, 2002. Cash provided in the three-months ended March 31, 2003 was generated primarily by the sale and maturity of investment securities. These cash proceeds were either reinvested or used in operations. We purchased \$2.3 million in property and equipment for the three-months ended March 31, 2003. Cash used for investing for the three-months ended March 31, 2002 of \$1.0 million was primarily related to the purchase of approximately \$4.7 million of property and equipment and the purchase of short-term investments that were offset by the sale and maturity of short-term investment securities.

Cash used in financing activities was \$42,000 for the three-months ended March 31, 2003 compared to \$40.0 million cash provided by financing activities for the three-months ended March 31, 2002. The difference between three-months ended March 31, 2003 and 2002 is primarily due to a \$40.0 million investment by Enzon Pharmaceuticals, Inc., in our preferred stock related to a strategic alliance entered into in January 2002.

Given our current cash requirements, we forecast that we will have sufficient cash to meet our net operating expense requirements for at least the next two years. We plan to continue to invest in our growth and the need for cash will be dependent upon the timing of these investments. Our capital needs will depend on many factors, including continued scientific progress in our research and development arrangements, progress with preclinical and clinical trials, the time and costs involved in obtaining regulatory approvals, the costs of developing and the rate of scaling up each manufacturing operation of our technologies, the timing and cost of our late stage clinical and early commercial production facility, the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims, the need to acquire licenses to new technologies and the status of competitive products. Of our convertible subordinated notes and debentures, \$7.8 million and \$291.4 million will mature in 2006 and 2007, respectively. We do not expect to be able to satisfy these obligations through cash flow generated by our operations. To satisfy our long-term obligations and operating expense needs, we intend to seek additional funding, as necessary, from corporate partners and from the sale of securities and to potentially attempt to refinance and restructure our existing debt obligations. Because we are an early stage biotechnology company, we do not qualify to issue investment grade debt or have access to certain credit facilities. As a result, any financing we undertake will likely involve the issuance of equity, convertible debt instruments or high-yield debt to fund our working capital. To date we have been primarily dependent upon equity and convertible debt financings for capital and have incurred substantial debt as a result of our issuances of subordinated notes and debentures that are convertible into our Common Stock. Our substantial debt, the market price of our securities and the general economic climate, among other factors, could have material consequences for our financial position and could affect our sources of short-term and long-term funding. There can be no assurance that additional funds, if and when required, will be available to us on favorable terms, if at all.

Approval of Non-Audit Services

During the quarter ended March 31, 2003, the Audit Committee of the Board of Directors approved non-audit services for ex-patriate tax services to be provided by Ernst & Young LLP, our independent accountants.

RISK FACTORS

The following risk factors should be read carefully in connection with evaluating our business. Any of the following risks could materially and adversely affect our business, operating results or financial condition.

If our collaborative partners that we depend on to obtain regulatory approvals and commercialization of our products are not successful, or if such collaboration fails, then our product development or commercialization of our products may be delayed or unsuccessful.

Because we are in the business of developing technology for improving drug formulations and methods for drug delivery, and licensing these technologies to companies that make and sell drugs, we do not have the people and other resources to do the following things:

- synthesize active pharmaceutical ingredients to be used as medicines;
- design and conduct large scale clinical studies;
- prepare and file documents necessary to obtain government approval to sell a given drug product; or

- market and sell our products when and if they are approved.

When we sign a collaborative development agreement or license agreement to develop a product with a drug or biotechnology company, the drug or biotechnology company agrees to do some or all of the things described above.

Reliance on collaborative relationships poses a number of risks, including:

- the potential inability to control whether and the extent to which our collaborative partners will devote sufficient resources to our programs or products;
- disputes which may arise in the future with respect to the ownership of rights to technology and/or intellectual property developed with collaborative partners;
- disagreements with collaborative partners which could lead to delays in or termination of the research, development or commercialization of product candidates, or result in litigation or arbitration;
- the potential for contracts with our collaborative partners to fail to provide significant protection or to be effectively enforced if one of these partners fails to perform. Collaborative partners have considerable discretion in electing whether to pursue the development of any additional products and may pursue alternative technologies or products either on their own or in collaboration with our competitors;
- the potential for collaborative partners with marketing rights to choose to devote fewer resources to the marketing of our products than they do to products of their own development;
- risks related to the ability of our distributors and corporate partners to pay us; and
- the potential for collaborative partners to unilaterally terminate their agreements with us for any or no reason.

Given these risks, there is a great deal of uncertainty regarding the success of our current and future collaborative efforts.

We have entered into collaborations in the past that have been subsequently terminated. If other collaborations are suspended or terminated, our ability to successfully commercialize certain of our other proposed products would also be negatively impacted. If these efforts fail, our product development or commercialization of products could be delayed and our financial condition and results of operation would be significantly harmed.

If Pfizer does not file a New Drug Application (“NDA”) for approval of Exubera, if the FDA does not timely approve the NDA for Exubera or if our collaboration with Pfizer is discontinued prior to the launch of Exubera, then our financial position and results of operations will be significantly harmed.

We are developing with Pfizer an inhaleable version of insulin, Exubera, for the treatment of Type 1 and Type 2 diabetes that will be administered using our pulmonary delivery system. Exubera is currently in Phase III clinical trials. We currently depend on Pfizer as the source of a significant portion of our revenues. For the three-months ended March 31, 2003, and 2002, contract research revenue from Pfizer accounted for 54% and 60% of our revenue, respectively. Delays in the filing of the Exubera NDA will result in a delay in the FDA approval, and there can be no assurance that even if the NDA is filed, Exubera will be approved for marketing and commercial use. Among the factors that may delay the filing or approval of the NDA, or the commercial launch of Exubera, are the following:

- Pfizer is currently conducting studies to generate controlled long-term safety data with respect to Exubera, in particular its affect on lung function, and the results of the studies may impact the filing or approval of the NDA;
- We may experience difficulties with respect to the processing of the dry powder formulation of inhaleable insulin, and the filling and packaging of the inhaleable insulin powder for the Exubera product. We may not be able to successfully transfer the filling and packaging technology to Pfizer for the large scale commercial production of the Exubera product; and
- We, with our contract manufacturers, may experience difficulties with respect to the production of the pulmonary inhaler device for Exubera, including in connection with the design, scale up and automation of the commercial manufacture of the pulmonary inhaler device for Exubera, and any such difficulties may delay the filing and approval of the NDA. Our contract manufacturers may also experience difficulties with respect to manufacturing the device in high volumes for commercial use.

Pfizer has indicated that it would not file the NDA for approval of Exubera in 2003. If the filing or approval of the NDA is substantially further delayed, we may not have the financial ability to continue supporting the Exubera program or be able to meet our contractual obligations relating to the commercial launch of Exubera. In the event of any such delay, we may also elect to divert resources away from Exubera related activities or otherwise reduce our activities relating to the Exubera program. Any material delay in the filing for regulatory approval or material delay in receiving regulatory approval, or failure to receive regulatory approval of Exubera at all, would, whether or not we elect to take such actions, likely affect our contract research revenue from Pfizer, may result in the payment of substantial reimbursements to the contract manufacturers of our proprietary inhaler device, and would significantly negatively impact our financial position and results of operations. Furthermore, should the collaboration with Pfizer be discontinued prior to the launch of Exubera, our financial position and results of operations may be substantially harmed.

If we fail to establish future successful collaborative relationships, then our financial results may suffer and our product development efforts may be delayed or unsuccessful.

We intend to seek future collaborative relationships with pharmaceutical and biotechnology partners to fund some of our research and development expenses and to develop and commercialize potential products. Further, we anticipate that the timing of drug development programs under existing collaborative agreements with our partners will continue to affect our revenues from such agreements. We may not be able to negotiate acceptable collaborative arrangements

in the future, and any arrangements we do negotiate may not be successful. If we fail to establish additional collaborative relationships, we will be required to undertake research, development, marketing and manufacturing of our proposed products at our own expense or discontinue or reduce these activities.

If our drug delivery technologies are not commercially feasible, then our revenues and results of operations will be impacted negatively.

We are in an early stage of development with respect to many of our products. There is a risk that our technologies will not be commercially feasible. Even if these drug delivery technologies are commercially feasible, they may not be commercially accepted across a range of large and small molecule drugs. We have tested 12 drug formulations based on our pulmonary delivery systems in humans, but many of our potential formulations have not been tested in clinical trials. Our Advanced PEGylation technology is currently being used in the development of 35 drugs. While our Advanced PEGylation technology has been incorporated in five products that the FDA has approved for marketing, and three other products using our Advanced PEGylation technology are in Phase II/III pivotal trials, many of the drug formulations with which we are incorporating this technology are in the early stages of feasibility or preclinical testing or in human clinical trials. Our supercritical fluids technology is also primarily in an early stage of feasibility. This technology represents a new method of manufacturing drug particles and is still in research and development, with only one formulation having entered human clinical testing.

Our potential products require extensive research, development and preclinical and clinical testing. Our potential products also may involve lengthy regulatory reviews and require regulatory approval before they can be sold. We do not know if, and cannot assure that, any of our potential products will prove to be safe and effective, accomplish the objectives that we and our collaborative partners are

seeking through the use of our technologies, meet regulatory standards or continue to meet such standards if already approved. There is a risk that we and our collaborative partners may not be able to produce any of our potential products in commercial quantities at acceptable costs, or market them successfully. Failure to achieve commercial feasibility, demonstrate safety, achieve clinical efficacy, obtain regulatory approval or, together with partners, successfully market products will negatively impact our revenues and results of operations.

If our research and development efforts are delayed or unsuccessful, then we will experience delay or be unsuccessful in having our products commercialized, and our business will suffer.

Except for our products that have already been approved by the FDA, our product candidates are still in research and development, including preclinical testing and clinical trials. Preclinical testing and clinical trials are long, expensive and uncertain processes. It may take us or our collaborators several years to complete this testing, and failure can occur at any stage in the process. Success in preclinical testing and early clinical trials does not ensure that later clinical trials will be successful. A number of companies in the pharmaceutical and biotechnology industries have suffered significant setbacks in later stage clinical trials, even after promising results in earlier trials.

Any clinical trial may fail to produce results satisfactory to us, our collaborative partners or the FDA. Preclinical and clinical data can be interpreted in different ways, which could delay, limit or prevent regulatory approval or commercialization. Negative or inconclusive results or adverse medical events during a clinical trial could cause a clinical trial to be repeated or a program to be terminated. We typically rely on collaborative partners and third-party clinical investigators to conduct clinical trials of our products and, as a result, we may face additional delaying factors outside our control.

We do not know if any of our research and development efforts, including preclinical testing or clinical trials will adhere to our planned schedules or be completed on a timely basis or at all. Typically, there is a high rate of attrition for product candidates in preclinical and clinical trials.

If our drug delivery technologies do not satisfy certain basic feasibility requirements such as total system efficiency, then our products may not be competitive.

We may not be able to achieve the total system efficiency for products based on our pulmonary delivery system that is needed to be competitive with alternative routes of delivery or formulation technologies. We determine total system efficiency by the amount of drug loss during manufacture, in the delivery system, and in reaching the ultimate site at which the drug exhibits its activity.

Deep lung bioavailability is the percentage of a drug that is absorbed into the bloodstream when that drug is delivered directly to the lungs as compared to when the drug is delivered by injection. Relative bioavailability is the initial screen for determining whether deep lung delivery of any drug, based on our pulmonary delivery systems, is commercially feasible. We would not consider a drug to be a good candidate for development and commercialization using our pulmonary delivery systems if drug loss is excessive at any one stage or cumulatively in the manufacturing and delivery process.

Our ability to efficiently attach PEG polymer chains to a drug molecule is the initial screen for determining whether drug formulations using our Advanced PEGylation technology are commercially feasible. We would not consider a drug formulation to be a good candidate for development and commercialization using our Advanced PEGylation technology if we could not efficiently attach a PEG polymer chain to such drug without destroying or impairing the drug's activity.

For our supercritical fluids technology, solubility characteristics of a drug and the solvents, which may be incorporated in the manufacturing process, provide the initial screen for whether drug formulations using this technology are commercially feasible. We would not consider a drug to be a good candidate for this technology if its solubility characteristics were such that the application of our technology results in very low efficiency in manufacturing of drug powders.

If our drug formulations are not stable, then we will not be able to develop or commercialize products.

We may not be able to identify and produce powdered or other formulations of drugs that retain the physical and chemical properties needed to work effectively with our inhaler devices for deep lung delivery using our pulmonary delivery systems, or through other methods of drug delivery using Advanced PEGylation or supercritical fluids technologies. Formulation stability is the physical and chemical stability of the drug over time and under various storage, shipping and usage conditions. Formulation stability will vary with each drug formulation and the type and amount of ingredients that are used in the formulation. Since our drug formulation technology is new and largely unproven, we do not know if our drug formulations will retain the needed physical and chemical properties and performance of the drugs. Problems with formulated drug powder stability in particular would negatively impact our ability to develop

products based on our pulmonary delivery systems or supercritical fluids technology, or obtain regulatory approval for or market such products.

If our drug delivery technologies are not safe, then regulatory approval of our products may not be obtained, or our products may not be developed or marketed.

We or our collaborative partners may not be able to prove that potential products using our drug delivery technologies are safe. Our products require lengthy laboratory, animal and human testing. Most of our products are in preclinical testing or the early stage of human testing. Since most of our products are in an early stage of testing and have not completed clinical trials, we cannot be certain that these products, and our technology that developed these products, are safe or will not produce unacceptable adverse side effects. The safety of our formulations will vary with each drug and the ingredients used in our formulation. If any product is found not to be safe, the product will not be approved for marketing or commercialization.

If product liability lawsuits are brought against us, we may incur substantial liabilities.

The manufacture, testing, marketing and sale of medical products entail an inherent risk of product liability. If product liability costs exceed our liability insurance coverage, we may incur substantial liabilities. Whether or not we were ultimately successful in product liability litigation, such litigation would consume substantial amounts of our financial and managerial resources, and might result in adverse publicity, all of which would impair our business. We may not be able to maintain our clinical trial insurance or product liability insurance at an acceptable cost, if at all, and this insurance may not provide adequate coverage against potential claims or losses.

If our products using our pulmonary delivery systems do not provide consistent doses of medicine, then we will not be able to develop, obtain regulatory approval for and commercialize products.

We may not be able to provide reproducible dosing of stable formulations of drug compounds. Reproducible dosing is the ability to deliver a consistent and predictable amount of drug into the bloodstream over time both for a single patient and across patient groups. Reproducible dosing of drugs based on our pulmonary delivery systems requires the development of:

- an inhalation or other device that consistently delivers predictable amounts of dry powder to the deep lung;
- accurate unit dose packaging of dry powder; and
- moisture resistant packaging.

Since our pulmonary delivery systems are still in development and are yet to be used in commercialized products, we cannot be certain that we will be able to develop reproducible dosing of any potential product. The failure to do so means that we would not consider such a product as a good candidate for development and commercialization.

If we or our partners do not obtain regulatory approval for our products on a timely basis, then our revenues and results of operations may be affected negatively.

There is a risk that we or our partners will not obtain regulatory approval for our unapproved products on a timely basis, or at all. Our unapproved products must undergo rigorous animal and human testing and an extensive FDA mandated or equivalent foreign authorities review process. This process generally takes a number of years and requires the expenditure of substantial resources and the time required for completing such testing and obtaining such approvals is uncertain. The FDA and other U.S. and foreign regulatory agencies also have substantial discretion to terminate clinical trials, require additional testing, delay or withhold registration and marketing approval and mandate product withdrawals including recalls. The FDA has approved for marketing five products with our Advanced PEGylation technology for specific uses in the United States. Further, another product using our Advanced PEGylation technology has been approved in Europe. Even though our partners have obtained regulatory approval for some of our products, these products and our manufacturing processes are subject to continued review by the FDA and other regulatory authorities. Even if our partners receive regulatory approval of a product, the approval may limit the indicated uses for which our partners may market the product. In addition, our partners' marketed products, our manufacturing facilities and we, as the manufacturer in certain instances, will be subject to continual review and periodic inspections. Later discovery from such review and inspection of previously unknown problems may result in restrictions on our partners' products or on us, including withdrawal of our partners' products from the market. The failure to obtain timely regulatory approval of our partners' products, any product marketing limitations or a product withdrawal would negatively impact our revenues and results of operations.

In addition, we may encounter delays or rejections based upon changes in FDA regulations or policies, including policy relating to current good manufacturing practice compliance, or "cGMP", during the period of product development. We may encounter similar delays in other countries.

If our technologies cannot be integrated successfully to bring products to market, then our ability to develop, and our partners' ability to obtain approval or market our products, may be delayed or unsuccessful.

We may not be able to integrate all of the relevant technologies to provide complete drug delivery and formulation systems. In particular, our development of drugs based on our pulmonary delivery systems relies upon several different but related technologies:

- dry powder formulations;
- dry powder processing technology;
- dry powder packaging technology; and
- deep lung delivery devices.

Our other technologies may face similar challenges relating to the integration of drug formulation, processing, packaging and delivery device technologies. At the same time we must:

- establish collaborations with partners;
- perform laboratory and clinical testing of potential products; and
- scale-up our manufacturing processes.

We must accomplish all of these steps without delaying any aspect of technology development. Any delay in one component of product or business development could delay our ability to develop, and our partners' ability to obtain approval or market products using our delivery and formulation technologies.

If we are not able to manufacture our products in commercially feasible quantities or at commercially feasible costs, then our products will not be successfully commercialized.

Advanced PEGylation and Supercritical Fluids Technologies

Except for the five approved products incorporating our Advanced PEGylation technology, all of the drug formulations with which we are incorporating our Advanced PEGylation and supercritical fluids technologies are in various stages of feasibility testing or human clinical trials. We anticipate having to expand our Advanced PEGylation technology as well as supercritical fluids technology manufacturing facilities. If we are not able to scale-up to large clinical trials or commercial manufacturing for products incorporating either of these technologies in a timely manner or at a commercially reasonable cost, we risk not meeting our customers' supply requirements or our contractual obligations. Our failure to solve any of these problems could delay or prevent late stage clinical testing and commercialization of our products and could negatively impact our revenues and results of operations.

Pulmonary Delivery Systems

Powder Processing. We have no experience manufacturing powder processing products for commercial purposes. With respect to drugs based on our pulmonary delivery systems, we have only performed powder processing on the scale needed for testing formulations, and for early stage and larger clinical trials. We may encounter manufacturing and control problems as we attempt to scale-up powder processing facilities. We may not be able to achieve such scale-up in a timely manner or at a commercially reasonable cost, if at all, and the powder processing system we implement may not be applicable for other drugs. Our failure to solve any of these problems could delay or prevent some late stage clinical testing and commercialization of our products and could negatively impact our revenues and results of operations.

To date, we rely primarily on one particular method of powder processing. There is a risk that this technology will not work with all drugs or that the cost of drug production will preclude the commercial viability of certain drugs. Additionally, there is a risk that any alternative powder processing methods we may pursue will not be commercially practical for aerosol drugs or that we will not have, or be able to acquire the rights to use, such alternative methods.

Powder Packaging. Our fine particle powders and small quantity packaging utilized for drugs based on our pulmonary delivery systems require special handling. We have designed and qualified automated filling equipment for small and moderate quantity packaging of fine powders. We face significant technical challenges in scaling-up an automated filling system that can handle the small dose and particle sizes of our powders in commercial quantities. There is a risk that we will not be able to scale-up our automated filling equipment in a timely manner or at commercially reasonable costs. Any failure or delay in such scale-up would delay product development or bar commercialization of products based on our pulmonary delivery systems and would negatively impact our revenues and results of operations.

There can be no assurance we will be able to successfully manufacture product on our autofiller system in a timely manner or at a commercially reasonable cost; any delay or failure in further developing such technology would delay product development or inhibit commercialization of our products and would have a materially adverse effect on us.

Inhaler Devices. We face many technical challenges in developing our pulmonary inhaler devices to work with a broad range of drugs, to produce such devices in sufficient quantities and to adapt the devices to different powder formulations. Our inhaler device being used with the Exubera inhaleable insulin product is still in clinical testing and production scale-up work is underway. Further design and development work is underway to enable commercial manufacturing and additional work may be required to optimize the device for regulatory approval, field reliability or other issues that may be important to its commercial success. Additional design and development work may lead to a delay in regulatory approval and delay efforts to seek regulatory approval for any product that incorporates the device or the time the device could be ready for commercial launch. In addition, we are attempting to develop a smaller inhaler device, which presents particular technical challenges. There is a risk that we will not successfully achieve any of these challenges. Our failure to overcome any of these challenges would negatively impact our revenues and results of operations.

For late stage clinical trials and initial commercial production, we intend to use one or more contract manufacturers to produce our pulmonary inhaler devices. There is a risk that we will not be able to maintain arrangements with our contract manufacturers on commercially acceptable terms or at all, or effectively scale-up production of our pulmonary inhaler devices through contract manufacturers. Our failure to do so would negatively impact our revenues and results of operations. Dependence on third parties for the manufacture of our pulmonary inhaler devices and their supply chain may adversely affect our cost of goods and ability to develop and commercialize products on a timely or competitive basis. Because our manufacturing processes and those of our contract manufacturers are very complex and subject to lengthy governmental approval processes, alternative qualified production sources or capacity may not be available on a timely basis or at all. Disruptions or delays in our manufacturing processes or those of our contract manufacturers for existing or new products could result in increased costs, loss of revenues or market share, or damage to our reputation.

There is no assurance that devices designed by us and built by contract manufacturers will be approved or will meet approval requirements on a timely basis or at all, or that any of our device development will be successful or commercially viable.

We depend on sole or exclusive suppliers for our pulmonary inhaler devices, bulk active pharmaceutical ingredients and PEG polymer chains and if such suppliers fail to supply when required, then our product development efforts may be delayed or unsuccessful.

We agreed to subcontract the manufacture of our pulmonary inhaler being used with the Exubera inhaleable insulin product before commercial production of that product. We have identified contract manufacturers that we believe have the technical capabilities and production capacity to manufacture such device and which can meet the requirements of cGMP. We are not certain that we will be able to maintain satisfactory contract manufacturing on commercially acceptable terms, if at all. Our failure to maintain ongoing commercial relationships with our existing contract manufacturers may subject us to significant reimbursement obligations upon termination of such relationships. Our dependence on third parties for the manufacture of our pulmonary inhaler may negatively impact our cost of goods and our ability to develop and commercialize products based on our pulmonary delivery systems on a timely and competitive basis.

For the most part, we obtain the bulk active pharmaceutical ingredients we use to manufacture products using our technologies from sole or exclusive sources of supply. For example, with respect to our source of bulk insulin, we have entered into a collaborative agreement with Pfizer that has, in turn, entered into an agreement with Aventis Pharma to manufacture regular human insulin. Under the terms of their agreement, Pfizer and Aventis Pharma agreed to construct a jointly owned manufacturing plant in Frankfurt, Germany. Until needed, Pfizer will provide us with insulin from Aventis Pharma's existing plant. We have also entered into an agreement with one supplier for a significant portion of the PEG polymer chains we use in our products that incorporate our Advanced PEGylation technology. NOF Corporation is our predominant supplier of pharmaceutical grade PEGylation materials pursuant to an exclusive supply agreement.

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If our sole or exclusive source suppliers fail to provide either active pharmaceutical ingredients or PEGylation materials in sufficient quantities when required, our revenues and results of operations will be negatively impacted.

If the market does not accept products using our drug delivery technologies, then our revenues and results of operations will be adversely affected.

The commercial success of our potential products depends upon market acceptance by health care providers, third-party payors like health insurance companies and Medicare and patients. Our products under development use new drug delivery technologies and there is a risk that the market will not accept our potential products. Market acceptance will depend on many factors, including:

- the safety and efficacy of products demonstrated in clinical trials;
- favorable regulatory approval and product labeling;
- the frequency of product use;
- the availability of third-party reimbursement;
- the availability of alternative technologies; and
- the price of our products relative to alternative technologies.

There is a risk that health care providers, patients or third-party payors will not accept product using our drug delivery and formulation technologies. If the market does not accept our potential products, our revenues and results of operations would be significantly and negatively impacted.

If our products are not cost effective, then government and private insurance plans may not pay for them.

In both domestic and foreign markets, sales of our products under development will depend in part upon the availability of reimbursement from third-party payors, such as government health administration authorities, managed care providers, private health insurers and other organizations. In addition, such third-party payors are increasingly challenging the price and cost effectiveness of medical products and services. Significant uncertainty exists as to the reimbursement status of newly approved health care products. Legislation and regulations affecting the pricing of pharmaceuticals may change before regulatory agencies approve our proposed products for marketing. Adoption of such legislation and regulations could further limit reimbursement for medical products. A government or third-party payor decision to not provide adequate coverage and reimbursements for our products would limit market acceptance of such products.

If our competitors develop and sell better drug delivery and formulation technologies, then our products or technologies may be uncompetitive or obsolete and our revenues and results of operations will be adversely affected.

We are aware of other companies engaged in developing and commercializing drug delivery and formulation technologies similar to ours. Some of our competitors with regard to our pulmonary delivery systems include AeroGen, Inc., Alkermes, Inc. and Aradigm Corporation. Aerogen and Aradigm are developing liquid drug delivery systems, and Alkermes is working on a dry powder delivery system. Our competitors with regard to our Advanced PEGylation technology include Valentis, Inc., Mountain View Pharmaceuticals, Inc. and SunBio PEG-SHOP, as well as several pharmaceutical and biotechnology companies with in-house PEGylation expertise. Some of our competitors with regard to our supercritical fluids technology include Alkermes, Battelle Memorial Institute, Ethypharm SA, Ferro Corp., Lavipharm SA and RxKinetics. Some of these companies license or provide the technology to other companies, while others are developing the technology for internal use. Many of these companies have greater research and development capabilities, experience, manufacturing, marketing, financial and managerial resources than we do and represent significant competition for us. Acquisitions of or collaborations with competing drug delivery companies by large pharmaceutical or biotechnology companies could enhance our competitors' financial, marketing and other resources. Accordingly, our competitors may succeed in developing competing technologies, obtaining regulatory approval for products or gaining market acceptance before us. Developments by others could make our products or technologies uncompetitive or obsolete. Our competitors may introduce products or processes competitive with or superior to ours.

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If any of our patents are invalid or pending patents do not issue or following issuance are deemed not valid, then we may lose key intellectual property right protection. If our products infringe on third-party's rights, then we will suffer adverse effects on our ability to develop and commercialize products

as well as our revenues and results of operations.

We have filed patent applications covering certain aspects of our inhalation devices, powder processing technology, powder formulations and deep lung route of delivery for certain molecules as well as for our Advanced PEGylation and supercritical fluids technologies, and we plan to file additional patent applications. We currently have 463 issued U.S. and foreign patents that cover certain aspects of our technologies and we have a number of patent applications pending. There is a risk that many of the patents applied for will not issue, or that any patents that issue or have issued will not be held valid and enforceable. Enforcing our patent rights would be time consuming and costly.

Our access or our partners' access to the drugs to be formulated using our technologies will affect our ability to develop and commercialize our technologies. Many drugs, including powder formulations of certain drugs that are presently under development by us, and our drug formulation technologies are subject to issued and pending U.S. and foreign patents that may be owned by competitors. We know that there are issued patents and pending patent applications relating to the formulation and delivery of large and small molecule drugs, including several for which we are developing formulations using our various technologies. This situation is highly complex, and the ability of any one company, including us, to commercialize a particular drug is unpredictable.

We intend generally to rely on the ability of our partners to provide access to the drugs that we formulate for deep lung and other forms of delivery. There is a risk that our partners will not be able to provide access to such drug candidates. Even if our partners provide such access, there is a risk that third parties will accuse, and possibly a court or a governmental agency will determine, our partners or us to be infringing a third-party's patent rights, and we will be prohibited from working with the drug or be found liable for damages that may not be subject to indemnification, or we may choose to pay such third party royalties under a license to such patent rights. Any such restriction on access to drug candidates, liability for damages or payment of royalties would negatively impact our revenues and results of operations.

We may incur material litigation costs, which may adversely affect our business and results of operations.

We are party to various litigation matters including, several which relate to our patent and intellectual property rights. We cannot predict with certainty the eventual outcome of any pending litigation or potential future litigation, and we might have to incur substantial expense in defending these or future lawsuits or indemnifying third parties with respect to the results of such litigation.

If earthquakes, tornadoes, hurricanes and other catastrophic events strike, our business may be negatively affected.

Our corporate headquarters, including a substantial portion of our research and development operations, are located in the Silicon Valley area of Northern California, a region known for seismic activity. A significant natural disaster such as an earthquake could have a material adverse impact on our business, operating results, and financial condition. Certain of our other facilities, such as our facility in Huntsville, Alabama and certain of our collaborative partners located elsewhere may also be subject to catastrophic events such as hurricanes and tornadoes, any of which could have a material adverse effect on our business, operating results, and financial condition.

Investors should be aware of industry-wide risks, which are applicable to us and may affect our revenues and results of operations.

In addition to the risks associated specifically with us described above, investors should also be aware of general risks associated with drug development and the pharmaceutical and biotechnology industries. These include, but are not limited to:

- changes in and compliance with government regulations;
- handling and disposal of hazardous materials;
- workplace health and safety requirements;
- hiring and retaining qualified people; and
- insuring against product liability claims.

If we do not generate sufficient cash flow through increased revenues or raising additional capital, then we may not be able to meet our substantial debt obligations.

As of March 31, 2003, we had approximately \$299.2 million in long term convertible subordinated notes and debentures, \$31.5 million in noncurrent capital lease obligations and \$2.8 million in other long-term liabilities. Our substantial indebtedness has and will continue to impact us by:

- making it more difficult to obtain additional financing; and
- constraining our ability to react quickly in an unfavorable economic climate.

Currently, we are not generating positive cash flow. Delay in the approval of Exubera, or other adverse occurrences related to our product development efforts will adversely impact our ability to meet our obligations to repay the principal amounts on our convertible notes and debentures when due. In addition, because of the decline in the market price of our Common Stock, it has become highly unlikely that the holders of our convertible notes and debentures will convert such securities to equity in accordance with their existing terms. If we are unable to satisfy our debt service requirements, substantial liquidity problems could result. As of March 31, 2003 we had cash, cash equivalents and short-term investments valued at approximately \$251.5 million. We expect to use substantially all of these assets to fund our on-going operations over the next few years. In October 2006, we will have an obligation to repay \$7.8 million, in February 2007, we will have an obligation to repay \$61.4 million and in October 2007, we will have an obligation to repay \$230.0 million of our long-term convertible subordinated notes and debentures. We may not generate sufficient cash from operations to satisfy these significant obligations when they become due and may have to raise additional financing from the sale of equity or debt securities or otherwise restructure our obligations in order to do so. There can no assurance that any such financing or restructuring will be available to us on commercially acceptable terms, if at all.

If we cannot raise additional capital our financial condition may suffer.

We forecast that our existing capital resources will enable us to maintain currently planned operations through at least the next two years. However, this expectation is based on our current operating plan, which may change as a result of certain factors, and may result in additional funding requirements sooner than anticipated. In addition, we may choose to raise additional capital due to market conditions or strategic considerations, even if we believe we have sufficient funds for our current or future operating plans. To the extent that additional capital is raised through the sale of equity or convertible debt securities, the issuance of such securities could result in dilution to our stockholders.

We have no material credit facility or other material committed sources of capital. To the extent operating and capital resources are insufficient to meet future requirements, we will have to raise additional funds to continue the development and commercialization of our technologies and products. Such funds may not be available on favorable terms, or at all. In particular, our substantial leverage may limit our ability to obtain additional financing. In addition, as an early stage biotechnology company, we do not qualify to issue investment grade debt and therefore any financing we do undertake will likely involve the issuance of equity, convertible debt instruments or high-yield debt. These sources of capital may not be available to us in the event additional financing is required. If adequate funds are not available on reasonable terms, we may be required to curtail operations significantly or to obtain funds by entering into financing, supply or collaboration agreements on unattractive terms. Our inability to raise capital could negatively impact our business.

If we fail to manage our growth effectively, our business may suffer.

Our ability to offer commercially viable products, achieve our expansion objectives, manage our growth effectively and satisfy our commitments under our collaboration agreements depends on a variety of factors, all of which must be successfully managed. Key factors include our ability to develop products internally, enter into strategic partnerships with collaborators, attract and retain skilled employees and effectively expand our internal organization to accommodate anticipated growth including integration of any potential businesses that we may acquire. If we are unable to manage some or all of these factors effectively, our business could grow too slowly or too quickly to be successfully sustained, thereby resulting in material adverse effects on our business, financial condition and results of operations.

If we do not effectively integrate personnel and operations relating to our acquisitions of Bradford Particle Design and Shearwater, our business and management may suffer disruptions.

Our relatively recent acquisitions of Bradford Particle Design and Shearwater may present unique risks related to our business. We may not be able to successfully assimilate the additional personnel, operations, acquired technology and products into our business. In particular, we need to assimilate and retain key management, research and engineering personnel. Key personnel from acquired companies such as Bradford Particle Design and Shearwater often decide to pursue other opportunities. In addition, there may be complications if we attempt to integrate any of the technology acquired from these companies with our other technologies, and it is uncertain whether we may accomplish this easily or at all. These integration difficulties could disrupt our ongoing business, distract

management and employees or increase expenses. Acquisitions are inherently risky, and we may also face unexpected costs, which may adversely affect operating results in any quarter. Additionally we face additional risks related to cross-border acquisitions and international operations, including foreign legal and regulatory restrictions and potential economic instability. Due diligence conducted in connection with our acquisitions may not have uncovered all the potential problems or liabilities we may have assumed in these transactions. Any of these risks could have a significant impact on our ability to continue our research and development efforts, and regulatory and commercialization efforts on a competitive and timely basis.

If we acquire additional companies, products or technologies, we may face risks similar to those faced in our other acquisitions.

We may continue to acquire or make investments in complementary companies, products or technologies. We may not realize the anticipated benefits of any other acquisition or investment. If we acquire another company, we will likely face some or all of the same risks, uncertainties, earnings and disruptions as discussed above with respect to our recent acquisitions. We may face risks relating to difficult integrations of personnel, technology and operations, uncertainty whether any integration will be successful and whether earnings will be negatively affected, and potential distractions to our management with respect to these acquisitions. In addition, our earnings may suffer because of acquisition-related costs.

We expect to continue to lose money for the next few years and may not reach profitability if our products do not generate sufficient revenue.

We have never been profitable and, through March 31, 2003 we have an accumulated deficit of approximately \$569.3 million. We expect to continue to incur substantial and potentially increasing losses over at least the next few years as we expand our research and development efforts, testing activities and manufacturing operations, and as we further expand our late stage clinical and early commercial production facility. Most of our potential products are in the early stages of development. Except for the approved products incorporating our Advanced PEGylation technology, we have generated no revenues from product sales. Our revenues to date have consisted primarily of payments under short-term research and feasibility agreements and development contracts. To achieve and sustain profitable operations, we must, alone or with others, successfully develop, obtain regulatory approval for, manufacture, introduce, market and sell products using our drug delivery technologies. There is risk that we will not generate sufficient product or contract research revenue to become profitable or to sustain profitability.

We expect our stock price to remain volatile.

Our stock price is volatile. In the last twelve-month period ending April 30, 2003, based on closing prices on the NASDAQ National Market, our stock price ranged from \$4.13 to \$9.49. We expect it to remain volatile. A variety of factors may have a significant effect on the market price of our common stock, including:

- clinical trial results or product development delays or delays in product approval or launch;
- announcements by collaboration partners as to their plan or expectations related to products using our technologies;
- announcement or termination of collaborative relationships by us or our competitors;
- fluctuations in our operating results;

- developments in patent or other proprietary rights;
- announcements of technological innovations or new therapeutic products;
- governmental regulation;
- public concern as to the safety of drug formulations developed by us or others; and
- general market conditions.

Any litigation brought against us as a result of this volatility could result in substantial costs and a diversion of our management's attention and resources, which could negatively impact our financial condition, revenues and results of operations.

Anti-takeover provisions in our charter documents and under Delaware law may make it more difficult to acquire us, even though such anti-takeover provisions may be beneficial to our stockholders.

Provisions of our certificate of incorporation and bylaws, as well as provisions of Delaware law, could make it more difficult for a third party to acquire us, even though such anti-takeover provisions may be beneficial to our stockholders. These provisions include:

- establishment of a classified board of directors such that not all members of the board may be elected at one time;
- lack of a provision for cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;
- the ability of our board to authorize the issuance of "blank check" preferred stock to increase the number of outstanding shares and thwart a takeover attempt;
- prohibition on stockholder action by written consent, thereby requiring all stockholder actions to be taken at a meeting of stockholders;
- establishment of advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings; and
- limitations on who may call a special meeting of stockholders.

Further, we have in place a preferred share purchase rights plan, commonly known as a "poison pill." The provisions described above, our "poison pill" and provisions of the Delaware Law relating to business combinations with interested stockholders may discourage, delay or prevent a third party from acquiring us. These provisions may discourage, delay or prevent a third party from acquiring a large portion of our securities, or initiating a tender offer or proxy contest, even if our stockholders might receive a premium for their shares in the acquisition over then current market prices.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in reported market risks since December 31, 2002.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, we have, as of a date within 90 days before the filing date of this quarterly report (the "Evaluation Date") evaluated the effectiveness of our "disclosure controls and procedures." Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the 1934 Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective in ensuring that information required to be disclosed in such reports is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Controls

There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their last evaluation.

Limitations on the Effectiveness of Controls

Our management, including the Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all errors 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. 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 errors or mistakes. 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

On August 30, 2002, a complaint was filed by David F. Kachensky in the Circuit Court of Madison County, Alabama, against J. Milton Harris, James R. Hudson, Jr., Inhale Therapeutic Systems, Inc. (now Nektar Therapeutics), and Shearwater Corporation (now Nektar Therapeutics AL, Corporation). Dr. Harris is the president of our Nektar Therapeutics AL, Corporation. Among other things, the Complaint alleges that the Defendants breached an agreement allegedly entered into by and between certain of the defendants and the plaintiff prior to our acquisition of Shearwater, whereby the defendants allegedly agreed, among other things, to convey to the plaintiff five percent (5%) of the capital stock of Shearwater outstanding as of December 1997 in exchange for certain work and consideration from plaintiff. The Complaint sought damages in the amount of approximately \$15 million. On October 7, 2002, the defendants filed answers to the Complaint denying the allegations and asserting affirmative defenses. On April 1, 2003, the defendants filed a motion for summary judgment as to all claims. On April 2, 2003, the parties engaged in a mediation that resulted in a settlement of all claims and an agreement to dismiss the complaint. The dismissal should be filed shortly. The settlement was reflected in our results of operations for the three-months ended March 31, 2003, and did not have a material effect on our business.

From time to time, we may be involved in other lawsuits, claims, investigations and proceedings, consisting of intellectual property, commercial, employment and other matters, which arise in the ordinary course of business. In accordance with the Statement of Financial Accounting Standards ("SFAS") No. 5, *Accounting for Contingencies*, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impact of negotiations, settlements, ruling, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. However, we believe that we have valid defenses with respect to the legal matters pending against us, as well as adequate provisions for any probable and estimable losses. If any unfavorable ruling were to occur in any specific period, there exists the possibility of a material adverse impact on the results of operations of that period. We believe that, given our current liquidity and cash and investment balances, even if we receive an adverse judgment with respect to litigation that we are currently a party to, such judgment would not have a material impact on cash and investments or liquidity.

Item 2. Changes in Securities and Use of Proceeds-None

Item 3. Defaults Upon Senior Securities-None

Item 4. Submission of Matters to a Vote of Security Holders-None

Item 5. Other Information

We file electronically with the Securities and Exchange Commission ("SEC") our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K pursuant to Section 13(a) or 15(d) of the 1934 Act. The public may read or copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information statements, and other information regarding issuers that file electronically with the SEC. The address of that site is <http://www.sec.gov>.

You may obtain a free copy of our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K and amendments to those reports on the day of filing with the SEC on our website at <http://www.nektar.com>, by contacting the Investor Relations Department at our corporate offices by calling (650) 631-3100 or by sending an e-mail message to investors@nektar.com.

In 2003, we intend to adopt a code of ethics that applies to our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. We intend to post the text of our code of ethics on our website at <http://www.nektar.com> in connection with "Investor Relations" materials. In addition, we intend to promptly disclose (1) the nature of any amendment to our code of ethics that applies to our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and (2) the nature of any waiver, including an implicit waiver, from a provision of our code of ethics that is granted to one of these specified officers, the name of such person who is granted the waiver and the date of the waiver on our website in the future.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Except as so indicated in Exhibit 99.1, the following exhibits are filed as part of, or incorporated by reference into, this Form 10-Q.

Exhibit Index

| Exhibit Number | Description of Documents |
|-----------------------|---|
| 3.1 | (1) Certificate of Incorporation of Inhale Therapeutic Systems (Delaware), Inc. |

- 3.2 (1) Bylaws of Nektar Therapeutics.
- 3.3 (8) Certificate of Amendment of the Amended Certificate of Incorporation of Nektar Therapeutics.
- 3.4 (11) Certificate of Designation of Series A Junior Participating Preferred Stock of Nektar Therapeutics.
- 3.5 (12) Certificate of Designation of Series B Convertible Preferred Stock of Nektar Therapeutics.
- 3.6 (14) Certificate of Ownership and Merger of Nektar Therapeutics.
- 4.1 Reference is made to Exhibits 3.1, 3.2, 3.3, 3.4, 3.5 and 3.6.
- 4.2 (2) Restated Investor Rights Agreement, dated April 29, 1993, as amended October 29, 1993, by and among Nektar Therapeutics and certain other persons named therein.
- 4.3 (3) Stock Purchase Agreement, dated January 18, 1995, by and between Nektar Therapeutics and Pfizer Inc.
- 4.4 (4) Form of Purchase Agreement, dated January 28, 1997, by and among Nektar Therapeutics and the individual Purchasers.
- 4.5 (5) Stock Purchase Agreement, dated December 8, 1998, by and between Nektar Therapeutics and Capital Research and Management Company.
- 4.6 (6) Purchase Agreement, dated October 6, 1999, by and among Nektar Therapeutics, Lehman Brothers Inc., Deutsche Bank Securities Inc. and U.S. Bancorp Piper Jaffray Inc.
- 4.7 (6) Resale Registration Rights Agreement, dated October 13, 1999, by and among Nektar Therapeutics, Lehman Brothers Inc., Deutsche Bank Securities Inc. and U.S. Bancorp Piper Jaffray Inc.
- 4.8 (6) Indenture, dated October 13, 1999, by and between Nektar Therapeutics, as Issuer, and Chase Manhattan Bank and Trust Company, National Association, as Trustee.
- 4.9 (6) Form of Inhale Registration Rights Agreement, dated January 25, 2000, by and between Nektar Therapeutics and Alliance Pharmaceutical Corp.
- 4.10 (7) Purchase Agreement, dated February 2, 2000, by and among Nektar Therapeutics, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Deutsche Bank Securities Inc., Lehman Brothers Inc. and U.S. Bancorp Piper Jaffray Inc.
- 4.11 (7) Resale Registration Rights Agreement, dated February 8, 2000, by and among Nektar Therapeutics, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Deutsche Bank Securities Inc., Lehman Brothers Inc. and U.S. Bancorp Piper Jaffray Inc.
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- 4.14 (9) Specimen warrants to purchase shares of Common Stock.
- 4.15 (10) Purchase Agreement, dated October 11, 2000, by and among Nektar Therapeutics, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Deutsche Bank Securities Inc., Lehman Brothers Inc. and U.S. Bancorp Piper Jaffray Inc.
- 4.16 (10) Resale Registration Rights Agreement, dated October 17, 2000, by and among Nektar Therapeutics, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Deutsche Bank Securities, Inc., Lehman Brothers Inc. and U.S. Bancorp Piper Jaffray Inc.
- 4.17 (10) Indenture, dated October 17, 2000, by and between Nektar Therapeutics, as Issuer, and Chase Manhattan Bank and Trust Company, National Association, as Trustee.
- 4.18 (11) Rights Agreement, dated as of June 1, 2001, by and between Nektar Therapeutics and Mellon Investor Services LLC., as Rights Agent.
- 4.19 (11) Form of Right Certificate.
- 4.20 (12) Preferred Stock Purchase Agreement, dated January 7, 2002, by and between Nektar Therapeutics and Enzon Pharmaceuticals, Inc.
- 4.21 (13) Common Stock Purchase Agreement, dated June 7, 2002, by and between Nektar Therapeutics and AFAC Equity L.P.

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- 4.22 (13) Common Stock Purchase Agreement, dated July 9, 2002, by and between Nektar Therapeutics and AFAC Equity L.P.
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- 10.48++ (16) Letter Agreement dated January 28, 2003, by and between Nektar Therapeutics and Mr. Ajay Bansal.

**OFFICER CERTIFICATION
PURSUANT TO SECTION 302(A)
OF THE SARBANES-OXLEY ACT OF 2002**

I, Ajit S. Gill certify that:

1. I have reviewed this quarterly report on Form 10-Q of Nektar Therapeutics;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 13, 2003

/s/ AJIT S. GILL
Ajit S. Gill
Chief Executive Officer, President
and Director

**OFFICER CERTIFICATION
PURSUANT TO SECTION 302(A)
OF THE SARBANES-OXLEY ACT OF 2002**

I, Ajay Bansal certify that:

1. I have reviewed this quarterly report on Form 10-Q of Nektar Therapeutics;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

- c) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - d) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 13, 2003

/s/ AJAY BANSAL

 Ajay Bansal
 Chief Financial Officer and Vice
 President, Finance and
 Administration

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- 10.48++ (16) Letter Agreement dated January 28, 2003, by and between Nektar Therapeutics and Mr. Ajay Bansal.
- 10.49++ (16) Employee Relocation Repayment Agreement, dated April 2, 2003, by Mr. Ajay Bansal.
- 10.50++ (16) Addendum to the Offer of Employment, dated April 3, 2003, by and between Nektar Therapeutics and Mr. Ajay Bansal.
- 99.1 (16) Certification of Officers Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

++ Management contract or compensatory plan or arrangement

- (1) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Quarterly Report on Form 10-Q for the quarter ended June 30, 1998.
- (2) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Registration Statement on Form S-1 (No. 33-75942), as amended.
- (3) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Registration Statement on Form S-1 (No. 33-89502), as amended.
- (4) Incorporated by reference to Nektar Therapeutics' Registration Statement on Form S-3 (No. 333-20787).
- (5) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Registration Statement on Form S-3 (No. 333-68897), as amended.
- (6) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Registration Statement on Form S-3 (No. 333-94161), as amended.
- (7) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Annual Report on Form 10-K for the year ended December 31, 1999.
- (8) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Quarterly Report on Form 10-Q for the quarter ended June 30, 2000.
- (9) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Quarterly Report on Form 10-Q for the quarter ended September 30, 2000.
- (10) Incorporated by reference to Nektar Therapeutics' Registration Statement on Form S-3 (No. 333-53678), filed on January 12, 2001.

- (11) Incorporated by reference to Nektar Therapeutics' Current Report on Form 8-K, filed on June 4, 2001.
- (12) Incorporated by reference to Nektar Therapeutics' Current Report on Form 8-K, filed on January 8, 2002.
- (13) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Quarterly Report on Form 10-Q for the quarter ended September 30, 2002.
- (14) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Current Report on Form 8-K, filed on January 23, 2003.
- (15) Incorporated by reference to the indicated exhibit in Nektar Therapeutics' Annual Report on Form 10-K for the year ended December 31, 2002.
- (16) Filed herewith.

Ajay Bansal

January 28, 2003

Dear Ajay,

I am pleased and excited to offer you the position of Chief Financial Officer at Nektar Therapeutics, reporting to me. Your targeted compensation will be \$368,000.00 on an annual basis. Of this amount, your fixed compensation will be \$276,000.00 and your target variable compensation at 25% will be \$92,000.00 per year.

In addition, you will receive a sign-on bonus of \$100,000.00, which will be paid to you in your first paycheck. This amount will be subject to payroll withholding and deductions. If your employment terminates other than "without cause" by Nektar or if you resign before your first anniversary, you agree to reimburse Nektar for the full amount of this sign-on bonus.

You are also eligible to participate in the Nektar Stock Option Plan. Subject to the approval of the Option Grant Subcommittee, you will be granted an option to purchase 70,000 shares in accordance with this plan. In addition, you will also be granted Supplemental Options in the amount of 20,000 shares, the purpose of which is to offset the forfeiture of the sign on bonus to your current employer. The price of the shares from the Stock Option Plan and the Supplemental Options will be set at the closing price of Nektar's stock on the day preceding your date of hire. You will also be eligible to participate in Nektar's benefits program including Medical, Dental and Vision Insurance, Term Life Insurance, 401(k), Flexible Health Spending Account and Short & Long Term Disability.

Nektar will provide you with the following relocation items:

- Partial shipment of your household goods from Berkeley Heights, NJ to the SF Bay Area upon your employment with Nektar.
- Shipment of the remainder of your household goods from Berkeley Heights, NJ to the SF Bay Area upon your final move.
- Temporary housing and storage of your household goods for you and your family up to 60 days (The cost of this housing is taxable to you and will be included in your total W-2 income)
- Travel for you and your family to the SF Bay Area
- Use of a rental car for up to 2 weeks or until your car arrives
- 2 trips a month to New Jersey up through December, 2003
- 3 Family house-hunting trips from New Jersey to Northern California.

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- Provide normal and customary closing costs on the sale of your home in, Berkeley Heights, NJ. Those items considered not deductible for income tax purposes will be "grossed up" and added to those costs considered deductible. (That portion is subject to withholding.) We estimate these closing costs to be \$39,000.00. We will provide you an amount up to 6% of the sale price.
 - Provide normal and customary closing costs, loan discount points not to exceed 1%, on the purchase of a home in the Bay Area. Those items considered not deductible for income tax purposes will be "grossed up" and added to those costs considered deductible. (That portion is subject to withholding.) We estimate these costs to be \$33,000.00. We will provide you an amount up to 3% of the purchase price.

In the event that you should voluntarily terminate your employment with Nektar or be terminated other than "without cause" by Nektar within one (1) year after these closing costs have been reimbursed, you agree to repay pro-rated relocation dollars prorated monthly over a 12 month period. (Including all expenses and closing costs that were directly billed to Nektar). (See attached Relocation Policy).

Nektar will also provide you with the following mortgage or rent differential:

- 1st year: \$35,000.00 (paid over 24 pay periods and subject to withholding)
- 2nd year: \$27,000.00 (paid over 24 pay periods and subject to withholding)
- 3rd year: \$20,000.00 (paid over 24 pay periods and subject to withholding)

Ajay, we are delighted to offer you an opportunity to be part of Nektar. As a key member of the Senior Management team, we expect you will play an important role in building our company. In a rapidly growing company like Nektar, quality and committed people like you are the major ingredients of success.

Your employment is by continued mutual agreement and may be terminated without cause by either you or the company at any time without any obligation or compensation by either party.

In compliance with the terms of the Federal Immigration Reform and Control Act, you will be required to provide us with proof of authorization to work and proof of identity.

This offer is valid through February 6, 2003.

Sincerely,

/s/ Ajit Gill

Ajit Gill
President & CEO

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OFFER ACCEPTED:

/s/ Ajay Bansal
Ajay Bansal

2/2/03
Date

To be determined (but before or on 4/1/03)
Start Date

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EMPLOYEE RELOCATION REPAYMENT AGREEMENT

According to NEKTAR THERAPEUTICS policy, I am eligible to receive reimbursement for specified relocation expenses. Before receiving any reimbursements and/or advances, I agree to and understand the following:

In the event that I cease to be employed by NEKTAR THERAPEUTICS, or any of its affiliated companies, within twelve (12) months of the date a relocation expense was incurred on my behalf, for reasons other than death, disability or a decision by NEKTAR THERAPEUTICS that my services are no longer required, I agree to reimburse NEKTAR THERAPEUTICS, or any of its affiliated companies, all relocation expenses paid by NEKTAR THERAPEUTICS on the effective date of my termination according to the following scale:

| Length of Service from Date Relocation Expense Was Incurred | |
|--|---------------|
| <u>Length of Services</u> | <u>Amount</u> |
| 9 months or less | 100 % |
| 9-10 months | 75 % |
| 10-11 months | 50 % |
| 11-12 months | 25 % |

/s/ Ajay Bansal 4/2/03
 Signed Date

Ajay Bansal
 Print Name

Addendum to Offer of Employment

Ajay Bansal

April 03, 2003

Dear Ajay,

This letter is to inform you of an addendum to your Offer of Employment signed in February 2003, with Nektar Therapeutics.

In addition to all other terms and agreements provided in your signed Offer of Employment and to assist you with your relocation to the San Francisco Bay Area, Nektar agrees to pay to you the sum of \$10,000.00 in relocation allowance. This amount will be subject to payroll withholding and deductions.

Per the terms of the Nektar relocation policy supplied to you in your original Offer of Employment, in the event that you should voluntarily terminate your employment with Nektar or be terminated other than "without cause" by Nektar within one (1) year after this allowance has been paid to you, you agree to repay pro-rated relocation dollars. (Including all expenses and closing costs that were directly billed to Nektar).

All other terms and conditions of your Offer of Employment are and will remain in effect.

Sincerely,

/s/ Elizabeth G. Frisby

Elizabeth G. Frisby
VP, Human Resources

OFFER ACCEPTED:

/s/ Ajay Bansal

Ajay Bansal

4/3/03

Date

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
AND CHIEF FINANCIAL OFFICER PURSUANT
TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002***

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C § 1350, as adopted), Ajit S. Gill, Chief Executive Officer and President of Nektar Therapeutics (the "Company"), and Ajay Bansal, Chief Financial Officer and Vice President, Finance and Administration of the Company, each hereby certifies that, to the best of his knowledge:

1. The Company's Quarterly Report on Form 10-Q for the period ended March 31, 2003, to which this Certification is attached as Exhibit 99.1 (the "Periodic Report"), fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended; and

2. The information contained in the Periodic Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Periodic Report and results of operations of the Company for the period covered by the Periodic Report.

Dated: May 13, 2003

/s/ Ajit S. Gill

Ajit S. Gill
Chief Executive Officer, President and Director

/s/ Ajay Bansal

Ajay Bansal
Chief Financial Officer and Vice President, Finance and Administration

A signed original of this written statement required by Section 906 has been provided to Nektar Therapeutics and will be retained by Nektar Therapeutics and furnished to the Securities and Exchange Commission ("SEC") or its staff upon request.

* This certification accompanies the Form 10-Q to which it relates, is not deemed filed with the SEC and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.