XOMA LTD /DE/
Form 10-Q
May 10, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2007

Commission File No. 0-14710

XOMA Ltd.

(Exact name of registrant as specified in its charter)

Bermuda	**52-2154066**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
2910 Seventh Street, Berkeley, California 94710	
(Address of principal executive offices, including zip code)	**(510) 204-7200** **(Telephone Number)**

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ¨ Accelerated Filer x Non-Accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act of 1934). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at May 07, 2007**

Common shares US$.0005 par value	**131,690,515**

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PART I - FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

XOMA Ltd.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

	March 31, 2007 (unaudited)	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17,513	$ 28,002
Short-term investments	16,068	18,381
Restricted cash	1,619	4,330
Receivables	9,204	13,446
Prepaid expenses	1,370	1,061
Debt issuance costs	254	668
Total current assets	46,028	65,888
Property and equipment, net	22,818	22,434
Debt issuance costs long-term	913	2,661
Deposits and Other	495	495
Total assets	$ 70,254	$ 91,478
LIABILITIES AND SHAREHOLDERS EQUITY (NET CAPITAL DEFICIENCY)		
Current liabilities:		
Accounts payable	$ 4,328	$ 4,186
Accrued liabilities	5,916	7,086
Accrued interest	360	1,794
Deferred revenue	7,359	9,601
Total current liabilities	17,963	22,667
Deferred revenue long-term	11,528	8,768
Convertible debt long-term		46,823
Interest bearing obligation long-term	46,686	51,393
Total liabilities	76,177	129,651
Commitments and contingencies		
Shareholders equity (net capital deficiency):		
Preference shares, $.05 par value, 1,000,000 shares authorized		
Series A, 210,000 designated, no shares issued and outstanding		
Series B, 8,000 designated, 2,959 shares issued and outstanding; aggregate liquidation preference of $29.6 million	1	1
Common shares, $.0005 par value, 210,000,000 shares authorized, 131,670,777 and 105,454,389 shares outstanding at March 31, 2007 and December 31, 2006, respectively	66	53

Additional paid-in capital	737,471	689,315
Accumulated comprehensive loss	(1)	(9)
Accumulated deficit	(743,460)	(727,533)
Total shareholders equity (net capital deficiency)	(5,923)	(38,173)
Total liabilities and shareholders equity (net capital deficiency)	$ 70,254	$ 91,478

See accompanying notes to condensed consolidated financial statements.

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XOMA Ltd.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited, in thousands, except per share amounts)

	Three Months Ended March 31,	
	2007	**2006**
Revenues:		
License and collaborative fees	$ 4,418	$ 654
Contract and other revenue	4,359	3,094
Royalties	3,475	1,856
Total revenues	12,252	5,604
Operating costs and expenses:		
Research and development (including contract related of $3,562 and $1,939, respectively)	15,929	12,181
General and administrative	4,909	5,053
Total operating costs and expenses	20,838	17,234
Loss from operations	(8,586)	(11,630)
Other income (expense):		
Investment and interest income	601	457
Interest expense	(7,933)	(9,426)
Other expense	(10)	(4)
Net loss	$ (15,928)	$ (20,603)
Basic and diluted net loss per common share	$ (0.14)	$ (0.23)
Shares used in computing basic and diluted net loss per common share	116,196	87,943

See accompanying notes to condensed consolidated financial statements.

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XOMA Ltd.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in thousands)

	Three Months Ended March 31,	
	2007	**2006**
Cash flows from operating activities:		
Net loss	$ (15,928)	$ (20,603)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,482	1,160
Common shares contributed to 401(k) and management incentive plans	1,321	1,088
Share-based compensation expense	762	390
Accrued interest on convertible notes and other interest bearing obligations	(1,433)	(871)
Revaluation of embedded derivative	6,101	8,018
Interest paid on conversion of convertible debt	(5,172)	
Amortization of discount, premium and issuance costs of convertible debt	394	232
Amortization of premium on short-term investments	(3)	16
Loss on disposal/retirement of property and equipment	14	4
Other non-cash adjustments	(1)	(2)
Changes in assets and liabilities:		
Receivables and related party receivables	4,242	(815)
Prepaid expenses	(309)	(381)
Accounts payable	142	(1,399)
Accrued liabilities	(1,171)	(1,227)
Deferred revenue	518	737
Net cash used in operating activities	(9,041)	(13,653)
Cash flows from investing activities:		
Proceeds from sales/maturities of investments	9,225	8,360
Purchase of investments	(6,900)	(9,391)
Transfer of restricted cash	2,711	
Purchase of property and equipment	(1,879)	(3,412)
Net cash provided by (used in) investing activities	3,157	(4,443)
Cash flows from financing activities:		
Proceeds from issuance of convertible notes		11,967
Principal payments of long-term debt	(4,707)	
Proceeds from issuance of common shares	102	40
Net cash provided by (used in) financing activities	(4,605)	12,007
Net decrease in cash and cash equivalents	(10,489)	(6,089)
Cash and cash equivalents at the beginning of the period	28,002	20,804
Cash and cash equivalents at the end of the period	$ 17,513	$ 14,715

See accompanying notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business

XOMA Ltd. (XOMA or the Company), a Bermuda company, is a biopharmaceutical company that discovers and develops antibodies and other genetically-engineered protein products to treat immunological and inflammatory disorders, cancer and infectious diseases. The Company s products are presently in various stages of development and most are subject to regulatory approval before they can be introduced commercially. The Company receives royalties from Genentech, Inc. (Genentech) on two approved products, RAPTIVA®, for the treatment of moderate-to-severe plaque psoriasis, and LUCENTIS®, for the treatment of neovascular (wet) age-related macular degeneration. XOMA s pipeline includes both proprietary products and collaborative programs at various stages of preclinical and clinical development.

Basis of Presentation

The condensed consolidated financial statements include the accounts of XOMA and its subsidiaries. All significant intercompany accounts and transactions were eliminated during consolidation. The unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q. These financial statements and related disclosures have been prepared with the assumption that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year. Accordingly, these statements should be read in conjunction with the audited Consolidated Financial Statements and related Notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006, filed with the SEC on March 8, 2007.

In the opinion of management, the unaudited condensed consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, which are necessary to present fairly the Company s consolidated financial position as of March 31, 2007, the consolidated results of the Company s operations for the three months ended March 31, 2007 and 2006, and the Company s cash flows for the three months then ended. The condensed consolidated balance sheet amounts at December 31, 2006, have been derived from audited consolidated financial statements. The interim results of operations are not necessarily indicative of the results that may occur for the full fiscal year or future periods.

Critical Accounting Policies

There have been no significant changes in critical accounting policies during the three months ended March 31, 2007, except as noted below, as compared with those previously disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2006, filed with the SEC on March 8, 2007.

Income Taxes

The Company accounts for uncertain tax positions in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), an interpretation of FASB Statement No. 109, Accounting for Income Taxes (FAS 109) The application of income tax law is inherently complex and the laws and regulations in this area are voluminous and are often ambiguous. As such, the Company is required to make many subjective assumptions and judgments regarding the Company s income tax exposures. Interpretations of and guidance surrounding income tax laws and regulations change over time. As such, changes in the Company s subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of income.

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, if any, at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

In February of 2007, the Company announced that pursuant to the terms of its collaboration agreement with Chiron Corporation (subsequently acquired by Novartis AG (Novartis), entered into in February of 2004, the parties mutual exclusivity obligation to

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conduct antibody discovery, development and commercialization work in oncology had ended. The expiration of this mutual obligation has no impact on the existing collaboration projects which have reached the development stage and the parties may continue to collaborate on a non-exclusive basis. Unamortized deferred revenue of $4.3 million, at December 31, 2006, associated with the upfront collaboration fee of $10.0 million was recognized during the first quarter of 2007 due to the change in estimate from five years to three years.

Recent Accounting Pronouncements

In September of 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). SFAS 157 provides guidance for using fair value to measure assets and liabilities and responds to investors requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value and the effect of fair value measurements on earnings. SFAS 157 applies whenever other standards require or permit assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances. SFAS will be effective beginning with the first annual period after November 15, 2007. The Company is still evaluating what impact, if any, the adoption of this standard will have on its financial position or results of operations.

In February of 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issuance costs. The fair value election is irrevocable and generally made on an instrument by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, and is required to be adopted by XOMA in the first quarter of fiscal 2008. XOMA is currently determining whether fair value accounting is appropriate for any of its eligible items and cannot estimate the impact, if any, which SFAS 159 will have on its financial position or results of operations.

Concentration of Risk

Cash, cash equivalents, short-term investments, restricted cash and accounts receivable are financial instruments, which potentially subject the Company to concentrations of credit risk. The Company maintains money market funds and short-term investments that bear minimal risk. The Company has not experienced any significant credit losses and does not generally require collateral on receivables. For the three months ended March 31, 2007, three customers represented 35%, 28% and 13% of total revenues. Two of these customers and two additional customers represented 38%, 21%, 20% and 12% of the $8.4 million billed and unbilled receivables outstanding at March 31, 2007. For the three months ended March 31, 2006, two customers represented 54% and 33% of total revenues and, as of March 31, 2006, there were billed and unbilled receivables of $5.6 million outstanding from these customers representing 60% and 34% of the balance.

Share-Based Compensation

The Company grants qualified and non-qualified share options, shares and other share related awards under various plans to directors, officers, employees and other individuals. To date, share-based compensation issued under these plans consists of qualified and non-qualified incentive share options and shares. Share options are granted at exercise prices of not less than the fair market value of the Company s common shares on the date of grant. Generally, share options granted to employees fully vest four years from the grant date and expire ten years from the date of the grant or three months from the date of termination of employment (longer in case of death or certain retirements). Certain options granted to directors fully vest on the date of grant and certain options may fully vest upon a change of control of the Company. Additionally, the Company has an Employee Share Purchase Plan (ESPP) that allows employees to purchase Company shares at a purchase price equal to 95% of the closing price on the exercise date. For ESPP periods beginning prior to December 31, 2004, the purchase price per common share was 85% of fair market value at the lower of either the first day of the 24 month offering period or the last day of the period. As of March 31, 2007, the Company had approximately 4.9 million common shares reserved for future issuance under its share option plans and ESPP.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), using the modified prospective transition method.

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The following table shows total share-based compensation expense included in the condensed consolidated statements of operations for the three months ended March 31, 2007 and 2006 (in thousands).

	Three Months Ended March 31,	
	2007	2006
Research and development	$ 281	$ 156
General and administrative	481	234
Total share-based compensation expense	$ 762	$ 390

Basic and diluted net loss per common share was $0.01 higher for the three months ended March 31, 2007 as a result of SFAS 123R. Basic and diluted net loss per common share was not impacted for the three months ended March 31, 2006 as a result of SFAS 123R. There was no capitalized share-based compensation cost as of March 31, 2007. There were no recognized tax benefits during the three months ended March 31, 2007 and 2006. SFAS 123R had no impact on cash flows from operations or financing.

To estimate the value of an award, the Company uses the Black-Scholes option pricing model. This model requires inputs such as expected life, expected volatility and risk-free interest rate. The forfeiture rate also impacts the amount of aggregate compensation. These inputs are subjective and generally require significant analysis and judgment to develop. While estimates of expected life, volatility and forfeiture rate are derived primarily from the Company s historical data, the risk-free rate is based on the yield available on U.S. Treasury zero-coupon issues.

The fair value of share based awards was estimated using a Black-Scholes model with the following weighted-average assumptions for the three months ended March 31, 2007 and 2006.

	Three Months Ended March 31,	
	2007	2006
Dividend yield	0%	0%
Expected volatility	73%	81%
Risk-free interest rate	4.69%	4.61%
Expected life	5.3years	5.3 years

Share option activity for the three months ended March 31, 2007, is as follows:

	Options	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Options outstanding at December 31, 2006	6,229,864	$ 4.22		
Granted	1,471,800	3.36		
Exercised	(26,668)	1.53		
Forfeited, expired or canceled	(391,493)	5.12		
Options outstanding at March 31, 2007	7,283,503	$ 4.01	6.98	$ 3,215
Options exercisable at March 31, 2007	4,276,565	$ 5.07	5.37	$ 1,306

Total intrinsic value of the options exercised for the three months ended March 31, 2007 was $29,000.

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Unvested share activity for the three months ended March 31, 2007 is summarized below:

	Unvested Number of Shares	Weighted-Average Grant-Date Fair Value
Unvested balance at December 31, 2006	1,984,128	$ 1.66
Granted	1,471,800	3.36
Vested	(338,848)	1.66
Forfeited, expired or cancelled	(110,142)	1.76
Unvested balance at March 31, 2007	3,006,938	$ 2.49

At March 31, 2007, there was $3.1 million of unrecognized share-based compensation expense related to unvested share options with a weighted average remaining recognition period of 2.8 years.

Comprehensive Loss

Unrealized gains or losses on the Company s available-for-sale securities are included in accumulated comprehensive loss. Comprehensive loss and its components for the three months ended March 31, 2007 and 2006, are as follows (in thousands):

	Three Months Ended March 31,	
	2007	2006
Net loss	$ (15,928)	$ (20,603)
Unrealized gain (loss) on securities available-for-sale	8	(10)
Comprehensive loss	$ (15,920)	$ (20,613)

Net Loss Per Common Share

Basic net loss per common share is based on the weighted average number of common shares outstanding during the period. Diluted net loss per common share is based on the weighted average number of common shares and other dilutive securities outstanding during the period, provided that including these dilutive securities does not decrease the net loss per share.

The following outstanding securities were considered in the computation of diluted net loss per share. Those that are antidilutive were not included in the computation of diluted net loss per share (in thousands):

	March 31,	
	2007	2006
Options for common shares	7,284	6,247
Warrants for common shares	125	125
Convertible preference shares, notes and related interest, as if converted	3,818	35,552

Receivables

Receivables consist of the following (in thousands):

	March 31, 2007	December 31, 2006
Trade receivables	$ 8,698	$ 12,915
Unbilled receivables	187	148
Other receivables	319	383
Total	$ 9,204	$ 13,446

Total related parties receivables were $76,000 and $94,000 for the three months ended March 31, 2007 and December 31, 2006, respectively, of which $38,000 and $56,000 are included in Other receivables for the three months ended March 31, 2007 and December 31, 2006, respectively.

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Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	March 31, 2007	December 31, 2006
Accrued co-development	$ 2,242	$ 1,952
Accrued payroll costs	1,964	2,015
Accrued management incentive compensation	778	2,053
Accrued legal fees	602	535
Accrued accounting fees	103	341
Other	227	190
Total	$ 5,916	$ 7,086

2. CONVERTIBLE NOTES AND OTHER ARRANGEMENTS

In February of 2006, the Company completed an exchange offer with holders of its 6.5% convertible senior notes due 2012 in which the Company exchanged $60.0 million aggregate principal amount of its new 6.5% Convertible SNAPs$_{SM}$ due 2012 (the New Notes) for all $60.0 million aggregate principal amount of its then outstanding convertible senior notes due 2012. The Company also issued an additional $12.0 million of New Notes to the public for cash at a public offering price of 104% of principal, or $12.5 million. The New Notes were initially convertible into approximately 38.4 million common shares at a conversion rate of 533.4756 of common shares per $1,000 principal amount of New Notes, which is equivalent to a conversion price of approximately $1.87 per common share. The Company was able to automatically convert some or all of the New Notes on or prior to the maturity date if the closing price of its common shares exceeded 150% of the conversion price then in effect for at least 20 trading days during any consecutive 30 trading day period ending within five trading days prior to the notice of auto-conversion. If the Company elected to automatically convert, or if holders elected to voluntarily convert, some or all of the New Notes on or prior to February 10, 2010, it was required to pay or provide for additional interest equal to four years worth of interest less any interest paid or provided for (additional interest payment feature), on the principal amount so converted, prior to the date of conversion. Additional interest could be paid in cash or, solely at the Company s option and subject to certain limitations, in its common shares valued at the conversion price then in effect.

The Company separately accounted for the additional interest payment feature of the New Notes as an embedded derivative instrument, which was measured at fair value and classified on the balance sheet with the convertible debt. Changes in the fair value of the embedded derivative were recognized in earnings as a component of other income (expense). The initial fair value of the derivative was subtracted from the carrying value of the debt, reflected as a debt discount, which was amortized as interest expense using the effective interest method through the date the notes were scheduled to mature, and separately reported as a derivative liability.

The additional New Notes were issued to the initial purchasers for net proceeds of $11.8 million. Debt issuance costs related to the New Notes of approximately $0.7 million were being amortized on a straight-line basis over the original 72 month life of the notes. Additional debt issuance costs of $2.0 million, related to the modification of the existing debt, were expensed as incurred with $1.1 million and $0.9 million expensed during the quarters ended March 31, 2006 and December 31, 2005, respectively.

At the time of note conversion, unamortized discount, premium and debt issuance costs related to the converted notes were charged to shareholders equity.

At December 31, 2006 convertible debt consisted of the following (in thousands):

	March 31, 2007	December 31, 2006
Convertible debt	$	$ 41,363

Embedded derivative		5,207
Premium		253
Total	$	$ 46,823

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During the first quarter of 2007, $42.0 million of New Notes were voluntarily converted by holders through March 7, 2007, at which time the Company announced that it had elected the automatically convert 100% of the remaining $2.5 million of New Notes outstanding. As a result, during the quarter 25,640,187 shares were issued to effect the conversion of the principal balances. Additionally, the Company issued 1,889,317 shares and $5.2 million in cash to satisfy the remaining additional interest payment feature related to these converted New Notes. The Company recorded a $6.1 million charge to interest expense during the quarter ended March 31, 2007 as a result of the revaluation of the embedded derivative related to the additional interest feature of the convertible notes.

For the quarter ended March 31, 2006, $12.5 million of New Notes were converted into 8,412,324 common shares including 1,735,877 shares related to the additional interest payment feature of the notes. The Company recorded $8.0 million charge to interest expense as a result of an increase in the fair value of the embedded derivative instrument on its convertible debt including $2.5 million related to the converted notes.

For the three months ended March 31, 2007 and 2006, the Company incurred $0.2 million and $1.0 million, respectively, in interest expense payable on its convertible debt. Interest expense was payable on a semi-annual basis. Additionally, the Company amortized a net of $0.1 million and $0.2 million in debt issuance costs, premium and discount for the three months ended March 31, 2007 and 2006, respectively.

On November 9, 2006, XOMA (US) LLC entered into a five-year, $35.0 million term loan facility (the facility) with Goldman Sachs Specialty Lending Holdings Inc. and borrowed the full amount thereunder. The loan is guaranteed by the Company. Indebtedness under the facility will bear interest at an annual rate equal to six-month LIBOR plus 5.25%, which was 10.57% at March 31, 2007, and is secured by all rights to receive payments due XOMA (US) LLC relating to RAPTIVA®, LUCENTIS® and CIMZIA and other assets of the Company. Payments received by XOMA (US) LLC in respect of these payment rights, in addition to a standing reserve of the next semi-annual interest payment, will be held in a custodial account which is classified as restricted cash. This cash account and the interest earned thereon can be used solely for the payment of the semi-annual interest amounts due in March and September of each year and, at that time, amounts in excess of the interest reserve requirement may be used to pay down principal or be distributed back to the Company, at the discretion of the lender. XOMA (US) LLC may prepay indebtedness under the facility at any time, subject to certain prepayment premiums. XOMA (US) LLC is required to comply with a debt covenant determined by the ratio of royalties collected to interest payable. Proceeds from the loan will be used for general corporate purposes.

At March 31, 2007, the outstanding principal amount under this loan totaled $30.3 million and related restricted cash was $1.6 million. Debt issuance costs of $1.5 million are being amortized over the five year life of the loan and are disclosed as current and long-term debt issuance costs on the balance sheet. For the quarter ended March 31, 2007, the lender took down $4.7 million in principal and the Company incurred interest expense payable of $0.9 million and amortization of debt issuance costs of $0.3 million.

3. COLLABORATIVE AND OTHER ARRANGEMENTS

On February 28, 2007, the Company and Takeda announced that they had amended their existing collaboration agreement to increase the number of potential therapeutic antibody programs in oncology under the collaboration initiated in November of 2006. Under the agreement, Takeda will make upfront, annual maintenance and milestone payments to the Company, fund its R&D and manufacturing activities for preclinical and early clinical supplies and pay royalties on sales of products resulting from the collaboration. Takeda will be responsible for clinical trials and commercialization of drugs after an Investigational New Drug Application (IND) submission and is granted the right to manufacture once the product enters into Phase II clinical trials.

4. INCOME TAXES

On January 1, 2007, the Company adopted FIN 48 which clarifies the accounting for uncertainty in income taxes recognized in the Company s financial statements in accordance with FAS 109 and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 did not have a material effect on the Company.

The Company files income tax returns in the U.S. federal jurisdiction, state of California and Ireland. The Company s federal income tax returns for tax years 2003 and beyond remain subject to examination by the Internal Revenue Service. The Company s California and Irish income tax returns for tax years 2002 and beyond remain subject to examination by the Franchise Tax Board and Irish Revenue. In connection with the adoption of FIN 48, the Company will recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

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5. LEGAL PROCEEDINGS

In September of 2004, XOMA (US) LLC entered into a collaboration with Aphton for the treatment of gastrointestinal and other gastrin-sensitive cancers using anti-gastrin monoclonal antibodies. In May of 2006, Aphton Corporation (Aphton) filed for bankruptcy protection under Chapter 11, Title 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware, No. 06-10510 (CSS). XOMA (US) LLC filed a proof of claim in the proceeding, as an unsecured creditor of Aphton, for approximately $594,000. Aphton and the Official Committee of Unsecured Creditors filed a Proposed Plan of Reorganization that would result in a liquidation of Aphton. The creditors have voted in favor of the plan, and the bankruptcy court has confirmed it. It is not presently known what, if any, distributions will be made to holders of unsecured claims.

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

The accompanying discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements and the related disclosures, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates, assumptions and judgments that affect the reported amounts in our consolidated financial statements and accompanying notes. On an on-going basis, we evaluate our estimates, including those related to terms of research collaborations, investments, share compensation, impairment issues and the estimated useful life of assets and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Results of Operations

Revenues

Total revenues for the three months ended March 31, 2007 and 2006, were $12.3 million and $5.6 million, respectively.

License and collaborative fees were $4.4 million for the three months ended March 31, 2007, compared with $0.7 million for the three months ended March 31, 2006. These revenues include upfront and milestone payments related to the outlicensing of our products and technologies and other collaborative arrangements. The $3.7 million increase resulted primarily from the recognition, during the first quarter of 2007, of $4.3 million dollars in revenue remaining from the $10.0 million upfront collaboration fee received from Novartis AG (Novartis) in February of 2004. In February of 2007, we announced that pursuant to the terms of our collaboration agreement with Novartis, the mutual exclusivity obligation to conduct antibody discovery, development and commercialization work in oncology had ended. The expiration of this mutual obligation has no impact on the existing collaboration projects which have reached the development stage and the parties may continue to collaborate on a non-exclusive basis. Prior to the expiration of the exclusivity period, the upfront fee was being amortized over the expected five-year term of the exclusivity provision, or at a rate of $0.5 million a quarter.

Contract revenues were $4.4 million for the three months ended March 31, 2007, compared with $3.1 million for the three months ended March 31, 2006. The increase of $1.3 million resulted primarily from our contracts with Attenuon, LLC (Attenuon), AVEO Pharmaceuticals, Inc. (AVEO), Schering Plough Research Institute (SPRI), Taligen Therapeutics Inc. (Taligen), Takeda Pharmaceutical Company Limited (Takeda) and our July 2006 contract with the National Institute of Allergy and Infectious Diseases (NIAID), a part of the National Institutes of Health, Department of Health and Human Services which is being funded with federal funds under Contract No. HHSN26620060008C/N01-A1-60008. This increase was partially offset by the completion of our contract, in October of 2006, with NIAID. The contract was entered into in March of 2005 and was 100% funded with federal funds from NIAID under Contract No. HHSN26620050004C.

Royalties were $3.5 million for the three months ended March 31, 2007, compared with $1.9 million for the three months ended March 31, 2006. The increase of $1.6 million resulted primarily from LUCENTIS® royalties which began in June of 2006 and, to a lesser extent, increases in RAPTIVA® royalties earned under our royalty arrangements with Genentech.

Operating Costs and Expenses

Research and development expenses consist of direct and research-related allocated overhead costs such as salaries and related personnel costs, patents, materials and supplies in addition to costs related to clinical trials to validate our testing processes and procedures and related overhead expenses. Research and development expenses include independent research and development and costs associated with collaborative research and development as well as contract research and development arrangements. Research and development expenses were $15.9 million for the three months ended March 31, 2007, compared with $12.2 million for the three months ended March 31, 2006. The $3.7 million increase primarily reflects an increase in spending for the development of XOMA 052, our collaborations with SPRI, our July 2006 contract with NIAID and our contracts with AVEO and Taligen, partially offset by decreased spending on our March 2005 NIAID contract and our collaboration agreement with Novartis.

Our research and development activities can be divided into earlier stage programs, which include molecular biology, process development, pilot-scale production and preclinical testing, and later stage programs, which include clinical testing, regulatory affairs

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and manufacturing clinical supplies. Using the current costing methods, the costs associated with these programs approximate the following (in thousands):

	Three Months Ended March 31,	
	2007	2006
Earlier stage programs	$ 13,548	$ 9,267
Later stage programs	2,381	2,914
Total	$ 15,929	$ 12,181

Our research and development activities can also be divided into those related to our internal projects and those projects related to collaborative and contract arrangements. The costs related to internal projects versus collaborative and contract arrangements approximate the following (in thousands):

	Three Months Ended March 31,	
	2007	2006
Internal projects	$ 11,122	$ 7,797
Collaborative and contract arrangements	4,807	4,384
Total	$ 15,929	$ 12,181

For the three months ended March 31, 2007, one development program (XOMA 052) accounted for more than 10% but less than 20%, and no development program accounted for more than 20% of our total research and development expenses. For the three months ended March 31, 2006, two development programs (Novartis and NIAID) accounted for more than 10% but less than 20% and no development program accounted for more than 20% of our total research and development expenses.

We currently anticipate that research and development expenses will continue to increase in 2007 as compared with 2006. We expect our spending on our oncology collaboration with Novartis and Lexicon Pharmaceuticals, Inc. (Lexicon) to continue as well as increases in spending on our collaborations with SPRI and Takeda, our contracts with NIAID, Taligen and AVEO, our development of XOMA 052, NEUPREX® and XOMA 629 and other new projects. Future research and development spending may also be impacted by potential new licensing or collaboration arrangements, as well as the termination of existing agreements. Beyond this, the scope and magnitude of future research and development expenses are difficult to predict at this time.

General and administrative expenses include salaries and related personnel costs, facilities costs and professional fees. General and administrative expenses for the three months ended March 31, 2007 and 2006, were $4.9 million and $5.1 million, respectively. The $0.2 million decrease primarily resulted from a decrease in legal and bank fees related to the conversion of the New Notes. This decrease is partially offset by the increases in compensation expense, professional fees and share-based compensation expense.

Other Income (Expense)

Investment and interest income for the three months ended March 31, 2007, was $0.6 million compared with $0.5 million for the three months ended March 31, 2006. Investment and interest income consists primarily of interest earned on our cash and investment balances.

Interest expense for the three months ended March 31, 2007, was $7.9 million compared with $9.4 million for the three months ended March 31, 2006. Interest expense for the three months ended March 31, 2007, consists of $6.1 million from the revaluation of the embedded derivative related to the additional interest feature of our convertible debt, of which $5.2 million was paid in cash as a result of the limitation on shares available and the remainder in share, $0.2 million of interest payable on our convertible debt, $0.1 million in net amortization of debt issuance

costs, discount and premium on our convertible debt, $0.9 million of interest payable on our Goldman Sachs Specialty Lending Holding Inc. (Goldman Sachs) loan, $0.3 million in amortization of debt issuance costs on Goldman Sachs loan and $0.3 million of interest payable on our note with Novartis.

Interest expense for the three months ended March 31, 2006, was $9.4 million, compared with $0.7 million for the same period of 2005. Our 2006 interest expense consists of $8.0 million from the revaluation of the embedded derivative related to the additional interest feature of our convertible debt, $1.0 million of interest payable on our convertible debt, $0.2 million in net amortization of debt issuance costs, discount and premium on our convertible debt and $0.2 million of interest payable on our note with Novartis.

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Accounting for Share-Based Compensation

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), using the modified prospective transition method

During the three months ended March 31, 2007, we recognized $0.8 million in share-based compensation expense, as compared to $0.4 million for the three months ended March 31, 2006. At March 31, 2007, there was $3.1 million of unrecognized share-based compensation expense related to unvested shares with a weighted average remaining recognition period of 2.8 years.

Income Taxes

On January 1, 2007, we adopted Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), an interpretation of FASB Statement No. 109, Accounting for Income Taxes (FAS 109), which clarifies the accounting for uncertainty in income taxes recognized in our financial statements in accordance with FAS 109 and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 did not have a material effect on us.

We file income tax returns in the U.S. federal jurisdiction, state of California and Ireland. Our federal income tax returns for tax years 2003 and beyond remain subject to examination by the Internal Revenue Service. Our California and Irish income tax returns for tax years 2002 and beyond remain subject to examination by the Franchise Tax Board and Irish Revenue. In connection with the adoption of FIN 48, we will recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

Liquidity and Capital Resources

Cash, cash equivalents and short-term investments at March 31, 2007, was $33.6 million compared with $46.4 million at December 31, 2006. This $12.8 million decrease primarily reflects cash used in operations of $9.0 million, cash used for $4.7 million in principal payments on our Goldman Sachs term loan and cash used in the purchase of fixed assets of $1.9 million partially offset by cash transferred from restricted cash of $2.7 million.

Cash used in operations for the three months ended March 31, 2007, consisted of a net loss of $15.9 million with non-cash addbacks for the revaluation of our embedded derivative of $6.1 million, depreciation and amortization of $1.9 million, equity related compensation of $2.1 million and a net decrease in assets of $3.9 million partially offset by cash payments for the additional interest feature of our convertible debt of $5.2 million, a decrease in net accrued interest of $1.4 million and a net decrease in liabilities of $0.5 million. During the three months ended March 31, 2007, we made payments of $6.6 million for interest on our convertible debt, $1.2 million for interest on our Goldman Sachs term loan, $0.3 million for interest on our note with Novartis and $0.6 million for our Management Incentive Compensation Program (MICP), which is paid in March of each year.

Cash used in operations for the three months ended March 31, 2006, consisted of a net loss of $20.6 million with non-cash addbacks for the revaluation of our embedded derivative of $8.0 million, depreciation and amortization of $1.4 million and equity related compensation of $1.5 million, offset by a net decrease in accrued interest of $0.9 million, an increase in assets of $1.2 million and a net decrease in liabilities of $1.9 million. During the three months ended March 31, 2006, we made payments of $2.6 million for debt issuance costs on our convertible debt, $2.0 million for interest on our convertible debt and $1.1 million for our MICP.

Net cash provided by investing activities for the three months ended March 31, 2007, was $3.2 million compared with $4.4 million used in investing activities for the three months ended March 31, 2006. The $7.6 million increase in cash for 2007 compared with 2006 reflected a $3.4 million increase in sales, net of purchases, of investments, a $1.5 million decrease in purchases of property and equipment and a transfer from restricted cash of $2.7 million.

Net cash used in financing activities for the three months ended March 31, 2007, was $4.6 million compared with net cash provided by financing activities of $12.0 million for the three months ended March 31, 2006. Financing activities for the three months ended March 31, 2007, consisted of $4.7 million in principal pay down of for the Goldman Sachs term loan partially offset by $0.1 million in proceeds from the issuance of common shares related to stock-option exercises. Financing activities for the three months ended March 31, 2006, consisted of $12.5 million in proceeds from the issuance of convertible notes, offset by $0.5 million in debt issuance costs.

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On November 9, 2006, XOMA (US) LLC entered into a five-year, $35.0 million term loan facility (the facility) with Goldman Sachs and borrowed the full amount thereunder. The loan is guaranteed by XOMA. Indebtedness under the facility will bear interest at an annual rate equal to six-month LIBOR plus 5.25%, which was 10.57% at March 31, 2007, and is secured by all rights to receive payments due XOMA (US) LLC relating to RAPTIVA®, LUCENTIS® and CIMZIA and other assets. Payments received by XOMA (US) LLC in respect of these payment rights, in addition to a standing reserve of the next semi-annual interest payment, will be held in a custodial account which is classified as restricted cash. This cash account and the interest earned thereon can be used solely for the payment of the interest amounts in March and September of each year and, at that time, amounts in excess of the interest reserve requirement may be used to pay down principal or be distributed back to us, at the discretion of the lender. XOMA (US) LLC may prepay indebtedness under the facility at any time, subject to certain prepayment premiums. XOMA (US) LLC is required to comply with a debt covenant determined by the ratio of royalties collected to interest payable. Proceeds from the loan will be used for general corporate purposes.

At March 31, 2007, the outstanding principal amount under this loan totaled $30.3 million and the balance in restricted cash was $1.6 million. Debt issuance costs of $1.5 are being amortized on a straight-line basis over the five year life of the loan and are disclosed as current and long-term debt issuance costs on the balance sheet. For the three months ended March 31, 2007, the lender took down $4.7 million in principal and we incurred interest expense payable of $0.9 million and amortization of debt issuance costs of $0.3 million.

In February of 2006, we completed an exchange offer with holders of our 6.5% convertible senior notes due 2012 in which we exchanged $60.0 million aggregate principal amount of our new 6.5% Convertible SNAPs$_{SM}$ due 2012 (the New Notes) for all $60.0 million aggregate principal amount of our then outstanding convertible senior notes due 2012. We also issued an additional $12.0 million of New Notes to the public for cash at a public offering price of 104% of principal, or $12.5 million. The New Notes were initially convertible into approximately 38.4 million common shares at a conversion rate of 533.4756 of common shares per $1,000 principal amount of New Notes, which is equivalent to a conversion price of approximately $1.87 per common share. In addition, we were able to automatically convert some or all of the New Notes on or prior to the maturity date if the closing price of our common shares has exceeded 150% of the conversion price then in effect for at least 20 trading days during any consecutive 30 trading day period ending within five trading days prior to the notice of auto-conversion. If we elected to automatically convert, or if holders elected to voluntarily convert, some or all of the New Notes on or prior to February 10, 2010, we were required to pay or provide for additional interest equal to four years worth of interest less any interest paid or provided for, on the principal amount so converted, prior to the date of conversion. Additional interest could be paid in cash or, solely at our option and subject to certain limitations, in our common shares valued at the conversion price then in effect.

We separately accounted for the additional interest payment feature of the New Notes as an embedded derivative instrument, which was measured at fair value and classified on the balance sheet with the convertible debt. Changes in the fair value of the embedded derivative were recognized in earnings as a component of other income (expense). The initial fair value of the derivative was subtracted from the carrying value of the debt, reflected as a debt discount, which was amortized as interest expense using the effective interest method through the date the notes were scheduled to mature, and separately reported as a derivative liability.

The additional New Notes were issued to the initial purchasers for net proceeds of $11.8 million. Debt issuance costs related to the New Notes of approximately $0.7 million were being amortized on a straight-line basis over the original 72 month life of the notes. Additional debt issuance costs of $2.0 million, related to the modification of the existing debt, were expensed as incurred with $1.1 million and $0.9 million expensed during the quarters ended March 31, 2006 and December 31, 2005, respectively.

At the time of note conversion, unamortized discount, premium and debt issuance costs related to the converted notes was charged to shareholder s equity.

During the first quarter of 2007, $42.0 million of New Notes were voluntarily converted by holders through March 7, 2007, at which time we announced that we had elected to automatically convert 100% of the remaining $2.5 million of New Notes outstanding. As a result, during the quarter 25,640,187 shares were issued to effect the conversion of the principal balances. Additionally, we issued 1,889,317 shares and $5.2 million in cash to satisfy the remaining additional interest payment feature related to these converted New Notes. We recorded a $6.1 million charge to interest expense during the quarter ended March 31, 2007 as a result of the revaluation of the embedded derivative related to the additional interest feature of the convertible notes.

For the three months ended March 31, 2006, $12.5 million of New Notes were converted into 8,412,324 common shares including 1,735,877 shares related to the additional interest payment feature of the notes. We recorded $8.0 million in interest expense as a result of an increase in the fair value of the embedded derivative instrument on our convertible debt including $2.5 million related to the converted notes.

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For the three months ended March 31, 2007 and 2006, we incurred $0.2 million and $1.0 million, respectively, in interest expense payable on our convertible debt. Interest expense was payable on a semi-annual basis. Additionally, we amortized a net of $0.1 million and $0.2 million, respectively, in debt issuance costs, premium and discount for the three months ended March 31, 2007 and 2006.

We expect our cash, cash equivalents and short-term investments to decrease during 2007 as a result of the use of cash to fund ongoing operations and capital investments. Additional licensing and antibody discovery collaboration agreements may positively impact our cash balances.

Based on current spending levels, anticipated revenues, collaborator funding, proceeds from our convertible note offerings in February of 2005 and February of 2006, proceeds from our November 2006 term loan and other sources of funding we believe to be available, we estimate that we have sufficient cash resources to meet our anticipated net cash needs through at least 2008. Any significant revenue shortfalls, increases in planned spending on development programs or more rapid progress of development programs than anticipated, as well as the unavailability of anticipated sources of funding, could shorten this period. Progress or setbacks by potentially competing products may also affect our ability to raise new funding on acceptable terms. For a further discussion of the risks related to our business and their effects on our cash flow and ability to raise new funding on acceptable terms, see Risk Factors included in Item 1A.

Critical Accounting Policies

Critical accounting policies are those that require significant judgment and/or estimates by management at the time that the financial statements are prepared such that materially different results might have been reported if other assumptions had been made. We consider certain accounting policies related to revenue recognition and recognition of research and development expenses to be critical policies. There have been no significant changes in our critical accounting policies during the three months ended March 31, 2007, except as noted below, as compared with those previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2007, filed with the SEC on March 8, 2007.

Income Taxes

We account for uncertain tax positions in accordance with FIN 48. The application of income tax law is inherently complex and the laws and regulations in this area are voluminous and often ambiguous. As such, we are required to make many subjective assumptions and judgments regarding our income tax exposures. Interpretations of and guidance surrounding income tax laws and regulations change over time. As such, changes in our subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of income.

Recent Accounting Pronouncements

In September of 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). SFAS 157 provides guidance for using fair value to measure assets and liabilities and responds to investors requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value and the effect of fair value measurements on earnings. SFAS 157 applies whenever other standards require or permit assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances. SFAS will be effective beginning with the first annual period after November 15, 2007. We are still evaluating what impact, if any, the adoption of this standard will have on our financial position or results of operations.

In February of 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issuance costs. The fair value election is irrevocable and generally made on an instrument by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007, and is required to be adopted by XOMA in the first quarter of fiscal 2008. We are currently determining whether fair value accounting is appropriate for any of its eligible items and cannot estimate the impact, if any, which SFAS 159 will have on our consolidated results of operations and financial condition.

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Recent Developments

In February of 2007, Takeda and we announced that we amended our existing agreement to increase the number of potential therapeutic antibody programs under the collaboration initiated in November of 2006.

On April 12, 2007, we announced plans to initiate clinical testing of XOMA 052, a potent anti-inflammatory monoclonal antibody targeting Interleukin I-beta (IL-1ß), in Type 2 diabetes patients. We plan to initiate two Phase I clinical trials this year in Type 2 diabetes patients addressing the role of IL-1ß in the disease. One trial will run in the U.S. and the other in Europe. We are currently evaluating plans to expand the development of XOMA 052 into additional autoimmune/inflammatory indications including osteoarthritis, rheumatoid arthritis, systemic juvenile idiopathic arthritis and others.

Forward-Looking Information And Cautionary Factors That May Affect Future Results

Certain statements contained herein related to the sufficiency of our cash resources, levels of future revenues, losses, expenses and cash, future sales of approved products, as well as other statements related to current plans for product development and existing and potential collaborative and licensing relationships, or that otherwise relate to future periods, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements are based on assumptions that may not prove accurate. Actual results could differ materially from those anticipated due to certain risks inherent in the biotechnology industry and for companies engaged in the development of new products in a regulated market. Among other things, the period for which our cash resources are sufficient could be shortened if expenditures are made earlier or in larger amounts than anticipated or are unanticipated, if anticipated revenues or cost sharing arrangements do not materialize, if funds are not otherwise available on acceptable terms; revenue levels may be other than as expected if sales of approved products are lower than expected; losses may be other than as expected for any of the reasons affecting revenues and expenses; expense levels and cash utilization may be other than as expected due to unanticipated changes in our research and development programs; and the sales efforts for approved products may not be successful if the parties responsible for marketing and sales fail to meet their commercialization goals, due to the strength of the competition, if physicians do not adopt the product as treatment for their patients or if remaining regulatory approvals are not obtained. These and other risks, including those related to the results of pre-clinical testing; the timing or results of pending and future clinical trials (including the design and progress of clinical trials; safety and efficacy of the products being tested; action, inaction or delay by the FDA, European or other regulators or their advisory bodies; and analysis or interpretation by, or submission to, these entities or others of scientific data); changes in the status of existing collaborative relationships; the ability of collaborators and other partners to meet their obligations; our ability to meet the demand of the United States government agency with which we have entered our first government contract; competition; market demands for products; scale-up and marketing capabilities; availability of additional licensing or collaboration opportunities; international operations; share price volatility; our financing needs and opportunities; uncertainties regarding the status of biotechnology patents; uncertainties as to the costs of protecting intellectual property; and risks associated with our status as a Bermuda company, are described in more detail in Item 1A Risk Factors .

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio and our loan facilities. By policy, we make our investments in high quality debt securities, limit the amount of credit exposure to any one issuer, limit duration by restricting the term of the instrument and hold investments to maturity except under rare circumstances. We do not invest in derivative financial instruments.

In November of 2006, we entered into a five-year senior term loan facility in the aggregate amount of $35.0 million with the principal due at maturity. As of March 31, 2007, $30.3 million was outstanding under this facility. Interest on the facility will be at a rate of USD six month LIBOR plus 5.25%, which was 10.57% at March 31, 2007.

In February of 2005, we issued $60.0 million of 6.5% convertible senior notes due 2012. In February of 2006, we completed an exchange offer for all $60.0 million of our 6.5% convertible senior notes due 2012 for $60.0 million of 6.5% convertible SNAPs℠ due 2012 (the New Notes) and issued an additional $12.0 million of New Notes to the public for cash. The interest rate and amount of principal of the previously outstanding notes and the New Notes were fixed. The New Notes included an additional interest feature which was accounted for as an embedded derivative which was measured at fair value. Changes in the fair value of the embedded derivative were recognized in earnings as interest expense. As of March 31, 2007, all of these notes had been converted into common shares.

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As of March 31, 2007, we have drawn down $16.4 million against the Novartis $50.0 million loan facility that is due in 2015 at an interest rate of USD six month LIBOR plus 2% which was 7.37% at March 31, 2007.

We estimate that a hypothetical 100 basis point change in interest rates could increase or decrease our interest expense by approximately $473,000 on an annualized basis.

We hold interest-bearing instruments that are classified as cash, cash equivalents and short-term investments. Fluctuations in interest rates can affect the principal values and yields of fixed income investments. If interest rates in the general economy were to rise rapidly in a short period of time, our fixed income investments could lose value. The following table presents the amounts and related weighted interest rates of our cash and investments at March 31, 2007 and December 31, 2006, (in thousands, except interest rate):

	Maturity	Carrying Amount (in thousands)	Fair Value (in thousands)	Average Interest Rate
March 31, 2007				
Cash and cash equivalents	Daily	$ 17,513	$ 17,513	5.62%
Short-term investments	Less than 1 year	16,069	16,068	5.30%
December 31, 2006				
Cash and cash equivalents	Daily	$ 28,002	$ 28,002	4.91%
Short-term investments	Less than 1 year	18,392	18,381	4.30%

ITEM 4 CONTROLS AND PROCEDURES

Evaluation of Controls and Procedures

Under the supervision and with the participation of our management, including our Chairman of the Board, President and Chief Executive Officer and our Vice President, Finance and Chief Financial Officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based on this evaluation, our Chairman of the Board, President and Chief Executive Officer and our Vice President, Finance and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to us and our consolidated subsidiaries required to be included in our periodic SEC filings.

Changes in Internal Control

There have been no changes in our internal controls over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In September of 2004, XOMA (US) LLC entered into a collaboration with Aphton Corporation (Aphton) for the treatment of gastrointestinal and other gastrin-sensitive cancers using anti-gastrin monoclonal antibodies. In May of 2006, Aphton filed for bankruptcy protection under Chapter 11, Title 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware, No. 06-10510 (CSS). XOMA (US) LLC filed a proof of claim in the proceeding, as an unsecured creditor of Aphton, for approximately $594,000. Aphton and the Official Committee of Unsecured Creditors filed a Proposed Plan of Reorganization that would result in a liquidation of Aphton. The creditors have voted in favor of the plan, and the bankruptcy court has confirmed it. It is not presently known what, if any, distributions will be made to holders of unsecured claims.

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ITEM 1a. RISK FACTORS

The following risk factors and other information included in this quarterly report should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us also may impair our business operations. If any of the following risks occur, our business, financial condition, operating results and cash flows could be materially adversely affected.

Our present and future revenues rely significantly on sales of products marketed and sold by others.

Currently, our revenues rely significantly upon sales of RAPTIVA® and LUCENTIS®, in which we have only royalty interests. RAPTIVA® was approved by the FDA on October 27, 2003, for the treatment of chronic moderate-to-severe plaque psoriasis in adults who are candidates for systemic therapy or phototherapy. Genentech and Merck Serono S.A. (previously Serono, S.A.) (Serono), Genentech s international marketing partner for RAPTIVA®, are responsible for the marketing and sales effort in support of this product. In September of 2004, Serono announced that RAPTIVA® had received approval for use in the European Union and the product was launched in several European Union countries in the fourth quarter of 2004. We are evaluating the impact of Merck KGaA s acquisition of Serono S.A., in January of 2007, but do not yet know what effect it will have on sales of RAPTIVA®. LUCENTIS® was approved by the FDA on June 30, 2006, and in the European Union in January of 2007, for the treatment of age-related macular degeneration. Genentech and Novartis, Genentech s international marketing partner for LUCENTIS®, are responsible for the marketing and sales effort in support of this product. We have no role in marketing and sales efforts, and Genentech, Serono and Novartis do not have an express contractual obligation to us regarding the marketing or sales of RAPTIVA® or LUCENTIS®.

Under our current arrangements with Genentech, we are entitled to receive royalties on worldwide sales of RAPTIVA® and LUCENTIS®. Successful commercialization of these products is subject to a number of risks, including, but not limited to:

- Genentech s, Serono s and Novartis willingness and ability to implement their marketing and sales effort and achieve sales;
- the strength of competition from other products being marketed or developed to treat psoriasis and age-related macular degeneration;
- the occurrence of adverse events which may give rise to safety concerns;
- physicians and patients acceptance of RAPTIVA® as a treatment for psoriasis and LUCENTIS® as a treatment for age-related macular degeneration;
- Genentech s ability to provide manufacturing capacity to meet demand for the products; and
- pricing and reimbursement issues.

According to Genentech, United States sales of RAPTIVA® for the first quarter of 2007 were $23.8 million, compared with $21.4 million for the first quarter of 2006. Serono s quarterly sales figures for RAPTIVA® are no longer publicly available. According to Genentech, United States sales of LUCENTIS® were $210.6 million for the first quarter of 2007. LUCENTIS® sales began on June 30, 2006, upon its approval by regulatory agencies. Given our current reliance on RAPTIVA® and LUCENTIS® as principal sources of our revenues, any material adverse developments with respect to the commercialization of RAPTIVA® or LUCENTIS® may cause our revenues to decrease and may cause us to incur losses in the future.

Because our products are still being developed, we will require substantial funds to continue; we cannot be certain that funds will be available and, if they are not available, we may have to take actions which could adversely affect your investment.

If adequate funds are not available, we may have to raise additional funds in a manner that may dilute or otherwise adversely affect the rights of existing shareholders, curtail or cease operations, or file for bankruptcy protection in extreme circumstances. We have spent, and we expect to

continue to spend, substantial funds in connection with:

- research and development relating to our products and production technologies,
- expansion of our production capabilities,

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various human clinical trials, and

protection of our intellectual property.

Based on current spending levels, anticipated revenues, collaborator funding, proceeds from our convertible note offerings in February of 2005 and February of 2006, proceeds from our November 2006 term loan and other sources of funding we believe to be available, we estimate that we have sufficient cash resources to meet our anticipated net cash needs through at least 2008. Any significant revenue shortfalls, increases in planned spending on development programs or more rapid progress of development programs than anticipated, as well as the unavailability of anticipated sources of funding, could shorten this period. Progress or setbacks by potentially competing products may also affect our ability to raise new funding on acceptable terms. As a result, we do not know when or whether:

operations will generate meaningful funds,

additional agreements for product development funding can be reached,

strategic alliances can be negotiated, or

adequate additional financing will be available for us to finance our own development on acceptable terms, or at all.

Cash balances and operating cash flow are influenced primarily by the timing and level of payments by our licensees and development partners, as well as by our operating costs.

Our level of leverage and debt service obligations could adversely affect our financial condition.

As of March 31, 2007, we (including our subsidiaries) had approximately $46.7 million of indebtedness outstanding. We may not be able to generate cash sufficient to pay the principal of, interest on and other amounts due in respect of our indebtedness when due. We and our subsidiaries may also incur additional debt that may be secured. In connection with our collaboration with Novartis, Novartis has extended a line of credit to us (through our U.S. subsidiary) for $50.0 million to fund up to 75% of our expenses thereunder, of which $16.4 million was drawn as of March 31, 2007. This line of credit is secured by a pledge of our interest in the collaboration. On November 9, 2006, XOMA (US) LLC entered into a five-year, $35.0 million term loan facility with Goldman Sachs and borrowed the full amount thereunder. As of March 31, 2007, $30.3 million was outstanding under this facility. The loan is guaranteed by XOMA and is secured by the payment rights due to XOMA (US) LLC relating to RAPTIVA®, LUCENTIS® and CIMZIA. As a result, these assets will not be available to XOMA or any other lender to secure future indebtedness.

Our level of debt and debt service obligations could have important effects on us and our investors. These effects may include:

making it more difficult for us to satisfy our obligations with respect to our debt;

limiting our ability to obtain additional financing or renew existing financing at maturity on satisfactory terms to fund our working capital requirements, capital expenditures, acquisitions, investments, debt service requirements and other general corporate requirements;