GENOME THERAPEUTICS CORP
Form 10-Q
May 14, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the Quarterly Period Ended: March 30, 2002

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File No: 0-10824

GENOME THERAPEUTICS CORP.

(Exact name of registrant as specified in its charter)

MASSACHUSETTS	04-2297484
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification no.)

100 BEAVER STREET;
WALTHAM, MASSACHUSETTS 02453

(Address of principal executive offices) (Zip code)

Registrant's telephone number: (781) 398-2300

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

COMMON STOCK $.10 PAR VALUE	22,837,403 Outstanding May 10, 2002

Genome Therapeutics Corp. and Subsidiary

Index to Financial Information and Other Information

GENOME THERAPEUTICS CORP. AND SUBSIDIARY
CONSOLIDATED CONDENSED BALANCE SHEETS (UNAUDITED)

	December 31, 2001	March 30, 2002
Assets:		
Current Assets:		
Cash and cash equivalents	$24,805,385	$42,764,885
Short-term investments	29,961,540	32,752,766
Interest receivable	1,074,726	478,742
Accounts receivable	513,885	212,862
Unbilled costs and fees	164,465	1,135,706
Prepaid expenses and other current assets	1,583,320	1,288,167
Total current assets	58,103,321	78,633,128
Property and Equipment, at cost:		
Laboratory and scientific equipment	20,918,535	20,611,213
Leasehold improvements	8,798,842	8,885,789

Equipment and furniture	1,267,854	1,277,780
	30,985,231	30,774,782
Less--Accumulated depreciation	19,091,703	18,776,055
	11,893,528	11,998,727
Restricted Cash	200,000	-
Long-term Investments	12,374,324	517,571
Other Assets	168,425	1,100,352
	$82,739,598	$92,249,778
Liabilities and Shareholders' Equity:		
Current Liabilities:		
Current maturities of long-term obligations	3,571,578	3,052,990
Accounts payable	2,092,593	1,205,468
Accrued expenses	4,832,713	7,097,379
Deferred revenue	3,449,959	1,344,718
Total current liabilities	13,946,843	12,700,555
Long-term obligations, net of current maturities	2,060,817	19,013,713
Shareholders' Equity	66,731,938	60,535,510
	$82,739,598	$92,249,778

See Notes to Consolidated Condensed Financial Statements

GENOME THERAPEUTICS CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Thirteen-Week Period Ended	
	March 24, 2001	March 30, 2002
Revenue:		
BioPharmaceutical	$ 3,557,570	$ 2,433,725
GenomeVision(TM) Services	4,532,678	3,730,792
Total revenue	8,090,248	6,164,517
Costs and Expenses:		
Cost of services	3,680,816	3,392,777
Research and development	3,822,329	7,813,973
Selling, general and administrative	1,634,922	2,057,385
Total costs and expenses	9,138,067	13,264,135

Loss from operations	(1,047,819)	(7,099,618)
Interest Income (Expense):		
Interest income	1,143,795	530,932
Interest expense	(169,342)	(216,090)
Net interest income	974,453	314,842
Net loss	$ (73,366)	$(6,784,776)
Net Loss per Common Share:		
Basic and diluted	$ -	$ (0.30)
Weighted Average Common Shares Outstanding:		
Basic and diluted	22,409,501	22,798,224

See Notes to Consolidated Condensed Financial Statements

GENOME THERAPEUTICS CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Thir
	March 24, 2001
Cash Flows from Operating Activities:	
Net loss	($73,366)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	1,123,532
Gain on disposal of equipment and leasehold improvements	(7,653)
Amortization of deferred compensation	141,065
Changes in assets and liabilities:	
Interest receivable	92,640
Accounts receivable	(1,275,379)
Unbilled costs and fees	(1,017,145)
Prepaid expenses and other current assets	21,491
Accounts payable	(246,326)
Accrued expenses	(715,024)
Deferred revenue	(1,048,990)
Net cash used in operating activities	(3,005,155)
Cash Flows from Investing Activities:	
Purchases of investments	(15,240,138)
Proceeds from sale of investments	25,994,216

Purchases of property and equipment	(499,037)
Decrease in restricted cash	-
Decrease (increase) in other assets	15,075
Net cash provided by investing activities	10,270,116
Cash Flows from Financing Activities:	
Proceeds from exercise of stock options	609,717
Proceeds from issuance of stock under the employee stock purchase plan	-
Proceeds from convertible notes payable	-
Proceeds from borrowings under equipment financing arrangements	1,410,587
Note receivable from officer	(130,157)
Payments on long-term obligations	(1,033,735)
Net cash provided by financing activities	856,412
Net Increase in Cash and Cash Equivalents	8,121,373
Cash and Cash Equivalents, beginning of period	10,095,817
Cash and Cash Equivalents, end of period	$18,217,190
Supplemental Disclosure of Cash Flow Information:	
Interest paid during period	$169,342
Income tax paid during period	$32,500
Supplemental Disclosure of Non-cash Investing and Financing Activities:	
Property and equipment acquired under capital leases	$1,410,587
Unrealized gain on marketable securities	$ -

See Notes to Consolidated Condensed Financial Statements.

GENOME THERAPEUTICS CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (unaudited)

(1) Basis of Presentation

These consolidated condensed financial statements have been prepared by the Company without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of the Company's management, the unaudited consolidated condensed financial statements have been prepared on the same basis as the audited consolidated financial statements and include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of results for the interim period. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The Company

believes, however, that its disclosures are adequate to make the information presented not misleading. The accompanying consolidated condensed financial statements should be read in conjunction with the Company's Form 10-K, which was filed with the Securities and Exchange Commission on April 1, 2002.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated condensed financial statements reflect the application of certain accounting policies, as described in this note and elsewhere in the accompanying notes to the consolidated condensed financial statements.

(a) Principles of Consolidation

The accompanying consolidated condensed financial statements include the accounts of the Company and its wholly owned subsidiary, Collaborative Securities Corp. (a Massachusetts Securities Corporation). All intercompany accounts and transactions have been eliminated in consolidation.

(b) Revenue Recognition

BioPharmaceutical revenues consist of license fees, contract research and milestone payments from alliances with pharmaceutical companies. GenomeVision Services revenues are from government grants, fees received from custom gene sequencing and analysis services and subscription fees from the PathoGenome(TM) Database. Revenues from contract research, government grants, the PathoGenome Database subscription fees, and custom gene sequencing and analysis services are recognized over the respective contract periods as the services are provided. License fees and milestone payments are recognized in accordance with Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition. Milestone payments will be recognized upon achievements of the milestone as long as the milestone is deemed to be substantive and the Company has no other performance obligations related to the milestone. License fees are recognized ratable over the term of the license. Unbilled costs and fees represent revenue recognized prior to billing. Deferred revenue represents amounts received prior to revenue recognition.

(c) Net Loss Per Share

Basic and diluted earnings per share were determined by dividing net loss by the weighted average shares outstanding during the period. Diluted loss per share is the same as basic loss per share for all periods presented, as the effect of the potential common stock is antidilutive. Antidilutive securities which consist of stock options, directors' deferred stock and unvested restricted stock that are not included in diluted net loss per share were 3,257,068 shares and 3,949,380 shares at March 24, 2001 and March 30, 2002, respectively.

(d) Concentration of Credit Risk

SFAS No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, requires disclosure of any significant off-balance-sheet and credit risk concentrations. The Company has no off-balance-sheet or concentrations of credit risk such as

foreign exchange contracts, options contracts or other foreign hedging

arrangements. The Company maintains its cash and cash equivalents and investment balances with several nonaffiliated institutions.

The Company maintains reserves for the potential write-off of accounts receivable. To date, the Company has not written off any significant accounts receivable.

The following table summarizes the number of customers that individually comprise greater than 10% of total revenues and their aggregate percentage of the Company's total revenues:

	Number of Significant Customers	A	B
Thirteen-week period ended:			
March 24, 2001	2	36%	35%
March 30, 2002	2	30%	48%

The following table summarizes the number of customers that individually comprise greater than 10% of total accounts receivable and their aggregate percentage of the Company's total accounts receivable:

	Percentage of Total Accounts Receivable							
	A	B	C	D	E	F	G	H
As of:								
December 31, 2001	-	-	37%	29%	-	-	-	-
March 30, 2002	-	-	6%	7%	14%	25%	15%	13%

(e) Use of Estimates

The preparation of consolidated condensed 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 consolidated condensed financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(f) Comprehensive Income (Loss)

The Company has adopted SFAS No. 130, Reporting Comprehensive Income. SFAS No. 130 requires disclosure of all components of comprehensive income (loss) on an annual and interim basis. Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. At March 30, 2002, the Company recorded approximately $78,000 to comprehensive income related to the value of common shares received from Versicor, Inc. in connection with the exercise of a warrant, which are classified in short-term investments in the accompanying balance sheet. See Note 3 for further discussion.

(g) Segment Reporting

The Company adopted SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. SFAS No. 131 establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS No. 131 also establishes

standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, in making decisions as to how to allocate resources and assess performance. The Company's chief decision makers, as defined under SFAS No. 131, are the chief executive officer and chief financial officer. To date, the Company has viewed its operations and manages its business as principally two operating segments: GenomeVision Services and BioPharmaceutical. As a result, the financial information disclosed herein represents all of the material financial information related to the Company's two operating segments. All of the Company's revenues are generated in the United States and all assets are located in the United States.

	GenomeVision(TM) Services	BioPharmaceutical	Tot
Thirteen-week period ended March 24, 2001-			
Revenues	$4,532,678	3,557,570	$8,0
Gross profit	851,862	1,989,662	2,8
Company-funded research & development	--	2,254,421	2,2
Thirteen-week period ended March 30, 2002-			
Revenues	$3,730,792	2,433,725	$6,1
Gross profit	338,015	942,724	1,2
Company-funded research & development	--	6,322,972	6,3

The Company does not allocate assets by its operating segments.

(3) CASH EQUIVALENTS AND INVESTMENTS

The Company applies the provisions of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. At December 31, 2001 and March 30, 2002, the Company's investments primarily include short-term and long-term investments which are classified as held-to-maturity, as the Company has the positive intent and ability to hold these securities to maturity. Cash equivalents are short-term, highly liquid investments with original maturities of 90 days or less. The Company's short-term and long-term investments include marketable securities with original maturities of greater than 90 days. Cash equivalents are carried at cost, which approximates market value, and consist of debt securities. Short-term and long-term investments are recorded at amortized cost, which approximates market value and consist of commercial paper and U.S. government debt securities. The average maturity of the Company's investments is approximately 7.3 months and 7.5 months at March 30, 2002 and December 31, 2001, respectively. At March 30, 2002, the Company had an unrealized gain of approximately $230,000, which is the difference between the amortized cost and the fair market value of the held to maturity investments.

The Company's investments also include the purchase, pursuant to the exercise of a warrant, of 45,000 shares of common stock of Versicor, Inc. in connection with its collaboration agreement with Versicor, Inc. dated March 10, 1997. The Company is accounting for the shares in accordance with SFAS No. 115 as available for sale securities and as a result, the shares are recorded at fair value. The shares are subject to restrictions under the securities regulations

and cannot be liquidated until March 2003. At March 30, 2002, the Company had recorded an unrealized gain of $614,000 in accumulated other comprehensive income in its consolidated statements of shareholders' equity related to the appreciation in value of the shares.

At December 31, 2001 and March 30, 2002, the Company's cash and cash equivalents and investments consisted of the following:

	December 31, 2001	March 30, 2002
Cash and cash equivalents:		
Cash	$21,801,201	$40,764,885
Debt securities	3,004,184	2,000,000
Total cash and cash equivalents	$24,805,385	$42,764,885
Investments:		
Short-term investments	$29,961,540	$32,752,766
Long-term investments	12,374,324	517,571
Total investments	$42,335,864	$33,270,337

The Company also had $200,000 in restricted cash at December 31, 2001 in connection with certain capital lease obligations.

(4) LONG-TERM OBLIGATIONS

On March 5, 2002, the Company sold convertible notes payable to two institutional investors in a private placement transaction, raising $15 million in gross proceeds. The convertible notes payable may be converted into shares of the Company's common stock at the option of the holder, at a price of $8.00 per share, subject to certain adjustments. The maturity date of the convertible notes payable is December 31, 2004, provided, that if any time on or after December 31, 2003, the Company maintains a net cash balance (i.e., cash and cash equivalents less obligations for borrowed money bearing interest) of less than $35 million, then the holders of the convertible notes payable can require that all or any part of the outstanding principal balance of the convertible notes payable plus all accrued but unpaid interest be repaid. Interest on the convertible notes payable accrues at 6% annually. The investors also received the right to receive a warrant to purchase up to an aggregate of 487,500 shares of common stock at an exercise price of $8.00 per share, subject to certain adjustments. The warrants will only be issued at the time the convertible notes payable are converted or if certain other redemptions or repayments of the convertible note payable occur. Additionally, the Company issued a warrant to purchase up to 100,000 shares of common stock at an exercise price of $15.00 per share to its placement agent. The warrant is exercisable over a three-year term commencing upon issuance. The warrant was valued, using the Block-Scholes option pricing model in accordance with EITF 96-18, at $244,000. This amount is included in deferred issuance costs and will be amortized to interest expense over the term of the convertible notes payable.

In February 2002, the Company entered into an additional line of credit for $3,500,000, of which $500,000 will be used to refinance a portion of an existing line of credit. This line of credit is payable in twelve consecutive quarterly payments at the prevailing LIBOR rate (2.08% at February 28, 2002) plus 1 1/2 %. The Company is required to maintain certain financial covenants pertaining to minimum cash balances. As of March 30, 2002, the Company was in compliance with all of the covenants.

In February 2000, the Company entered into an equipment line of credit under which it may finance up to $4,000,000 of laboratory, computer and office equipment. In December 2000, the Company increased the line of credit by $2,712,000 to $6,712,000. The Company, at its discretion, can enter into either operating or capital leases. The borrowings under the operating leases are payable in 24 monthly installments and capital leases are payable in 36 monthly installments. As of December 31, 2001, the Company had entered into $256,000 in operating leases and $6,456,000 in capital leases. The interest rates under the capital leases range from 7.55% to 10.37%. The Company had no additional borrowing capacity under this line of credit at March 30, 2002. There are no covenants related to this agreement.

(5) ALLIANCES - BIOPHARMACEUTICAL

(a) ASTRAZENECA

In August 1995, the Company entered into a strategic alliance with AstraZeneca (Astra), formerly Astra Hassle AB, to develop drugs, vaccines and diagnostic products effective against peptic ulcers or any other disease caused by H. pylori. The Company granted Astra exclusive access to the Company's H. pylori genomic sequence database and exclusive worldwide rights to make, use and sell products based on the Company's H. pylori technology. The agreement provided for a four-year research alliance (which ended in August 1999) to further develop and annotate the Company's H. pylori genomic sequence database, identify therapeutic and vaccine targets and develop appropriate biological assays.

Under this agreement, Astra agreed to pay the Company, subject to the achievement of certain product development milestones, up to $23.3 million (and possibly a greater amount if more than one product is developed under the agreement) in license fees, expense allowances, research funding and milestone payments. The Company has received a total of $13.5 million in license fees, expense allowances, milestone payments and research funding under the Astra agreement through March 30, 2002.

The Company will also be entitled to receive royalties on Astra's sale of products protected by the claims of patents licensed exclusively to Astra by the Company pursuant to the agreement or the discovery of which was enabled in a significant manner by the genomic database licensed to Astra by the Company. The Company has the right, under certain circumstances, to convert Astra's license to a nonexclusive license in the event that Astra is not actively pursuing commercialization of the technology.

(b) SCHERING-PLOUGH

In December 1995, the Company entered into a strategic alliance and license agreement (the December 1995 agreement) with Schering Corporation and Schering-Plough Ltd. (collectively, Schering-Plough) providing for the use by Schering-Plough of the genomic sequence of Staph. aureus to identify and

validate new gene targets for development of drugs to target Staph. aureus and other pathogens that have become resistant to current antibiotics. As part of this agreement, the Company granted Schering-Plough exclusive access to the Company's proprietary Staph. aureus genomic sequence database. The Company agreed to undertake certain research efforts to identify bacteria-specific genes essential to microbial survival and to develop biological assays to be used by Schering-Plough in screening natural product and compound libraries to identify antibiotics with new mechanisms of action.

Under this agreement, Schering-Plough paid an initial license fee and agreed to fund the research program through March 31, 2002. Under this agreement, Schering-Plough agreed to pay the Company a minimum of $21.4 million in an up-front license fee, research funding and milestone payments. Subject to the achievement of additional product development milestones, Schering-Plough agreed to pay the Company up to an additional $24.0 million in milestone payments.

The agreement grants Schering-Plough exclusive worldwide rights to make, use and sell pharmaceutical and vaccine products based on the genomic sequence databases licensed to Schering-Plough and on the technology developed in the course of the research program. The Company will be entitled to receive royalties on Schering-Plough's sale of therapeutic products and vaccines developed using the technology licensed. As of March 30, 2002, the Company had completed its research obligations under this alliance and had turned over validated drug targets and assays to Schering-Plough for high-throughput screening. A total of $21.4 million has been received through March 30, 2002.

Under the December 1995 agreement, the Company recognized approximately $397,000 and $126,000 in revenue during the thirteen-week period ended March 24, 2001 and March 30, 2002, respectively.

In December 1996, the Company entered into its second strategic alliance and license agreement (the December 1996 agreement) with Schering-Plough. This agreement calls for the use of genomics to discover new pharmaceutical products for treating asthma. As part of the agreement, the Company will employ its high-throughput disease gene identification, bioinformatics, and genomics sequencing capabilities to identify genes and associated proteins that can be utilized by Schering-Plough to develop pharmaceuticals and vaccines for treating asthma. Under this agreement, the Company has granted Schering-Plough exclusive access to (i) certain gene sequence databases made available under this research program, (ii) information made available to the Company under certain third-party research agreements, and (iii) an exclusive worldwide right and license to make, use and sell pharmaceutical and vaccine products based on the rights to develop and commercialize diagnostic products that may result from this alliance.

Under this agreement (and subsequent extensions), Schering-Plough paid an initial license fee and an expense allowance to the Company and agreed to fund the research program through at least December 2002. In addition, upon completion of certain scientific developments, Schering-Plough has made or will potentially make milestone payments, as well as pay royalties based upon sales of therapeutics products developed from this collaboration. If all milestones are met and the research program continues for its full term, total payments to the Company will approximate $81.0 million, excluding royalties. Of the total potential payments, approximately $36.5 million represents license fees and research payments, and $44.5 million represent milestone payments based on achievement of research and product development milestones. A total of $38.5 million has been received through March 30, 2002.

Under the December 1996 agreement, the Company recognized approximately $2,118,000 in revenue during the thirteen-week period ended March 24, 2001, which consisted of alliance research revenue and a milestone payment. The Company recognized approximately $1,730,000 in revenue during the thirteen-week

period ended March 30, 2002, which consisted of alliance research revenue.

In September 1997, the Company entered into a third strategic alliance and license agreement (the September 1997 agreement) with Schering-Plough to use genomics to discover and develop new pharmaceutical products to treat fungal infections.

Under this agreement, the Company will employ its bioinformatics, high-throughput sequencing and functional genomics capabilities to identify and validate genes and associated proteins as drug discovery targets that can be utilized by Schering-Plough to develop novel antifungal treatments. Schering-Plough will receive exclusive access to the genomic information developed in the alliance related to two fungal pathogens, Candida albicans and Aspergillus fumigatus. Schering-Plough will also receive exclusive worldwide rights to make, use and sell products based on the technology developed during the course of the research program. In return, Schering-Plough agreed to fund a research program through March 31, 2002. If all milestones are met and the research program continues for its full term, total payments to the Company will approximate $33.2 million, excluding royalties. Of the total potential payments, approximately $10.2 million represents contract research payments and $23.0 million represents milestone payments based on achievement of research and product development milestones. As of March 30, 2002, the Company had completed its research obligations under this alliance and had turned over validated drug targets and assays to Schering-Plough for high-throughput screening. A total of $12.2 million has been received through March 30, 2002.

Under the September 1997 agreement, the Company recognized approximately $385,000 and $6,000 in revenue during the thirteen-week period ended March 24, 2001 and March 30, 2002, respectively.

Under certain circumstances, the Company may have an obligation to give Schering-Plough a right of first negotiation to develop with the Company certain of its asthma and infectious disease related discoveries if it decides to seek a third party collaborator to develop such discovery.

(c) BIOMERIEUX ALLIANCE

In September 1999, the Company entered into a strategic alliance with bioMerieux to develop, manufacture and sell in vitro diagnostic products for human clinical and industrial applications. As part of the alliance, bioMerieux purchased a subscription to the Company's PathoGenome Database (see Note 6(a)), paid an up-front license fee, agreed to fund a research program for at least four years and pay royalties on future products. In addition, bioMerieux purchased $3.75 million of the Company's common stock. The total amount of research and development funding, excluding subscription fees, approximates $5.2 million for the four-year term of this agreement. The research and development funding will be recognized as the research services are performed over the four-year term of the agreement. Approximately $3.4 million has been received through March 30, 2002.

The Company recognized approximately $282,000 and $297,000 in revenue during the thirteen-week period ended March 24, 2001 and March 30, 2002, respectively, which consisted of alliance research revenue and amortization of the up-front license fees.

(d) WYETH-AYERST LABORATORIES

In December 1999, the Company entered into a strategic alliance with Wyeth-Ayerst Laboratories to develop novel therapeutics for the prevention and treatment of osteoporosis. The alliance will focus on developing therapeutics, utilizing targets based on the characterization of a gene associated with a unique high bone mass trait.

The agreement provides for the Company to employ its established capabilities in positional cloning, bioinformatics and functional genomics in conjunction with Wyeth-Ayerst's drug discovery capabilities and its expertise in bone biology and the osteoporotic disease process to develop new pharmaceuticals. Under the terms of the agreement, Wyeth-Ayerst paid the Company an up-front license fee, and funded a multi-year research program, which includes milestone payments and royalties on sales of therapeutics products developed from this alliance. If the research program continues for its full term and substantially all of the milestone payments are met, total payments to the Company, excluding royalties, would exceed $118 million. Approximately $8.4 million has been received through March 30, 2002.

The Company recognized approximately $360,000 in revenue during the thirteen-week period ended March 24, 2001, which consisted of alliance research revenue and amortization of the up-front license fees. The Company recognized approximately $261,000 in revenue during the thirteen-week period ended March 30, 2002, which consisted of alliance research revenue.

(6) GENOMEVISION(TM) SERVICES

GenomeVision(TM) Services revenues are from government grants, fees received from custom gene sequencing and analysis and subscription fees from PathoGenome(TM) Database.

(a) DATABASE SUBSCRIPTIONS

The Company has entered into a number of PathoGenome Database subscriptions. The database subscriptions provide nonexclusive access to the Company's proprietary genome sequence database, PathoGenome Database, and associated information relating to microbial organisms. These agreements call for the Company to provide periodic data updates, analysis tools and software support. Under the subscription agreements, the customer pays an annual subscription fee and will pay royalties on any molecules developed as a result of access to the information provided by the PathoGenome Database. The Company retains all rights associated with protein therapeutic, diagnostic and vaccine use of bacterial genes or gene products.

(b) NATIONAL HUMAN GENOME RESEARCH INSTITUTE

In July 1999, the Company was named as one of the nationally funded DNA sequencing centers of the international Human Genome Project. The Company is entitled to receive funding from the National Human Genome Research Institute (NHGRI) of up to $17.4 million through February 2003, of which all funds have been appropriated.

In October 1999, the NHGRI named the Company as a pilot center to the Mouse Genome Sequencing Network. The Company is entitled to receive $13.4 million in funding through February 2003 with respect to this agreement, of which all funds have been appropriated. In August 2000, the Company was named one of two primary centers for the Rat Sequencing Program from NHGRI. As part of the agreement, the Company will use remaining funding under the mouse award, as well as a portion

of the remaining funding under the human award, to participate in this rat genome initiative.

Funding under our government grants and research contracts is subject to appropriation each year by the U.S. Congress and can be discontinued or reduced at any time. In addition, we cannot be certain that we will receive additional grants or contracts in the future.

(7) PRODUCT DEVELOPMENT

In October 2001, the Company acquired an exclusive license in the United States and Canada for a novel antibiotic, Ramoplanin, from Biosearch Italia S.p.A (Biosearch Italia). The Company will assume responsibility for the product development in the United States of Ramoplanin, currently in Phase III clinical trials. The agreement provides the Company with exclusive rights to develop and market oral Ramoplanin in the U.S. and Canada. Biosearch Italia will provide the bulk material for manufacture of the product and will retain all other rights to market and sell Ramoplanin.

Under the terms of this agreement, the Company paid Biosearch Italia an initial license fee of $2 million and is obligated to make payments of up to $8 million in a combination of cash and notes convertible into Company stock upon the achievement of specified milestones. In addition, the Company is obligated to purchase bulk material from Biosearch Italia and fund the completion of clinical trials and pay a royalty on product sales. The combined total of bulk product sales and royalties is expected to be 26% of the Company's net product sales.

The Company expended approximately $3.1 million during the thirteen-week period ended March 30, 2002, which consisted of clinical development expenses.

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

OVERVIEW

We are a biopharmaceutical company focused on the discovery and development of pharmaceutical and diagnostic products. We have eight established product development programs. Our lead product candidate, Ramoplanin, is in Phase III clinical trials for the prevention of bloodstream infections caused by vancomycin-resistant enterococci (VRE). We have six alliances with pharmaceutical companies including Schering-Plough, AstraZeneca, Wyeth-Ayerst and bioMerieux, and a joint venture with ArQule. In addition to these eight projects, we have a portfolio of earlier stage internal drug discovery programs. We also maintain an active service business, GenomeVision(TM) Services, providing drug discovery services to pharmaceutical and biotechnology companies and to the National Human Genome Research Institute.

We receive payments under our bioPharmaceutical business from our product discovery alliances based on license fees, contract research and milestone payments during the term of the alliance. We also receive payments under our GenomeVision Services business from selling, as a contract service business, high quality genomic sequencing information to our customers, including pharmaceutical companies, biotechnology companies, governmental agencies, and academic institutions. In addition, under our GenomeVision Services business, subscribers to our PathoGenome(TM) Database pay access fees for the information they obtain. We anticipate that our alliances will result in the discovery and commercialization of novel pharmaceutical, vaccine and diagnostic products. In

order for a product to be commercialized based on our research, it will be necessary for our product discovery partner to conduct preclinical tests and clinical trials, obtain regulatory clearances, manufacture, sell, and distribute the product. Accordingly, we do not expect to receive royalties based upon product revenues for many years, if at all.

Our primary sources of revenue are from alliance agreements with pharmaceutical company partners, subscription agreements to our PathoGenome Database and government research grants and contracts. Currently, we have six product discovery alliances and one joint venture, of which we currently receive contract research funding from three of these alliances. In August 1995, we entered into an alliance with AstraZeneca to develop pharmaceutical, vaccine and diagnostic products effective against gastrointestinal infections or any other disease caused by H. pylori. In August 1999, the contract research under the alliance concluded and the program transitioned into AstraZeneca's pipeline. We are entitled to receive additional milestone payments and royalties based upon the development by AstraZeneca of any products from the research alliance. In December 1995, we entered into an alliance with Schering-Plough. Under this alliance, Schering-Plough can use our Staph. aureus genomic database to identify new gene targets for the development of novel antibiotics. As of March 30, 2002, we had completed our research obligations under this alliance and had turned over validated drug targets and assays to Schering-Plough for high-throughput screening. In December 1996, we entered into our second research alliance with Schering-Plough to identify genes and associated proteins that Schering-Plough can utilize to develop new pharmaceuticals for treating asthma. In September 1997, we established our third research alliance with Schering-Plough for the development of new pharmaceutical products to treat fungal infections. As of March 30, 2002, we had completed our research obligations under this alliance and had turned over validated drug targets and assays to Schering-Plough for high-throughput screening. In September 1999, we entered into a strategic alliance with bioMerieux to develop, manufacture and sell in vitro pathogen diagnostic products for human clinical and industrial applications. As part of the strategic alliance, bioMerieux purchased a subscription to our PathoGenome Database and made an equity investment. In December 1999, we entered into a strategic alliance with Wyeth-Ayerst to develop drugs based on our genetic research to treat osteoporosis. In September 2000, we entered into a joint venture with ArQule, Inc. to identify novel anti-infective drug compounds.

In May 1997, we introduced our PathoGenome Database and sold our first subscription. Since that date, we have continued to contract with subscribers on a non-exclusive basis, and, as of March 30, 2002, we had seven subscribers. Under our agreements, the subscribers receive non-exclusive access to information relating to microbial organisms in our PathoGenome Database. Subscriptions to the database generate revenue over the term of the subscription with the potential for royalty payments to us from future product sales. We do expect to see a revenue

decline in subscription fees over the next two years as subscribers substantially complete data mining of PathoGenome.

Since 1989, the United States government has awarded us a number of research grants and contracts related to government genomics programs. The scope of the research covered by grants and contracts encompasses technology development, sequencing production, technology automation, and disease gene identification. These programs strengthen our genomics technology base and enhance the expertise of our scientific personnel. In July 1999, we were named as one of the nationally funded DNA sequencing centers of the international Human Genome

Project. We are entitled to receive funding from the National Human Genome Research Institute (NHGRI) of up to $17.4 million through February 2003, of which all funds have been appropriated and $12.5 million had been received through March 30, 2002. In October 1999, the NHGRI named us as a pilot center to the Mouse Genome Sequencing Network. We are entitled to receive $13.4 million in funding over forty-one months with respect to this agreement, of which all funds have been appropriated and $12.3 million had been received through March 30, 2002. In August 2000, we were named one of two primary centers for the Rat Sequencing Program from NHGRI. As part of the agreement, we will use remaining funding under the mouse award, as well as a portion of the remaining funding under the human award, to participate in this rat genome initiative.

In October 2001, we acquired an exclusive license in the United States and Canada for a novel antibiotic, Ramoplanin, from Biosearch Italia S.p.A (Biosearch). We will assume responsibility for the product development in the United States of Ramoplanin, currently in Phase III clinical trials. The agreement provides us with exclusive rights to develop and market oral Ramoplanin in the U.S. and Canada. Biosearch will retain all other rights to market and sell Ramoplanin. In addition, we are obligated to purchase bulk material from Biosearch and fund the completion of clinical trials, purchase bulk material, and pay a royalty on product sales. The combined total of bulk product purchases and royalties is expected to be approximately 26% of our net product sales.

We have incurred significant operating losses since our inception. As of March 30, 2002, we had an accumulated deficit of approximately $88.8 million. Our losses are primarily from costs associated with prior operating businesses and research and development expenses. These costs have often exceeded our revenues generated by our alliances, subscription agreements and government grants. Our results of operations have fluctuated from period to period and may continue to fluctuate in the future based upon the timing, amount and type of funding. We expect to incur additional operating losses in the future.

We are subject to risks common to companies in our industry including unproven technology and business strategy, reliance upon collaborative partners and others, uncertainty of regulatory approval, uncertainty of pharmaceutical pricing, rapid technological change, history of operating losses, need for future capital, competition, patent and proprietary rights, dependence on key personnel, healthcare reform and related matters, availability of, and competition for, unique family resources, and volatility of our stock.

CRITICAL ACCOUNTING POLICIES

We considered the disclosure requirement requirements of FR-60 regarding critical accounting policies and FR-61 regarding liquidity and capital resources, certain trading activities and related party/certain other disclosures, and concluded that nothing materially changed during the quarter that would warrant further disclosure under these releases.

RESULTS OF OPERATIONS

Thirteen-Week Periods Ended March 24, 2001 and March 30, 2002

Revenue

Total revenue decreased 24% from $8,090,000 for the thirteen-week period ended March 24, 2001 to $6,165,000 for the thirteen-week period ended March 30, 2002. BioPharmaceutical revenue decreased 32% from $3,558,000 for the

thirteen-week period ended March 24, 2001 to $2,434,000 for the thirteen-week period ended March 30, 2002 primarily due to the timing of milestone payments. The decrease in BioPharmaceutical revenue was principally attributable to a milestone payment earned in the first quarter of last year under our product discovery alliance with Schering-Plough.

Revenue from GenomeVision Services decreased 18% from $4,533,000 for the thirteen-week period ended March 24, 2001 to $3,731,000 for the thirteen-week period ended March 30, 2002 primarily due to a decrease in subscription fees earned on our PathoGenome database business as a result of third parties not renewing our database subscription.

Costs and Expenses

Total costs and expenses increased 45% from $9,138,000 for the thirteen-week period ended March 24, 2001 to $13,264,000 for the thirteen-week period ended March 30, 2002.

Cost of services decreased 8% from $3,681,000 for the thirteen-week period ended March 24, 2001 to $3,393,000 for the thirteen-week period ended March 30, 2002 due partially to a decrease in revenues from GenomeVision Services.

Research and development expenses include internal research and development, research funded pursuant to arrangements with our strategic alliance partners, as well as clinical development costs and expenses. Research and development expenses increased 105% from $3,822,000 for the thirteen-week period ended March 24, 2001 to $7,814,000 for the thirteen-week period ended March 30, 2002. This planned increase was primarily due to expenses incurred in the clinical development of Ramoplanin of approximately $3,109,000, as well as increased investment in our internal drug discovery programs, specifically in the area of anti-infectives and chronic human diseases, of $960,000.

Selling, general and administrative expenses increased 26% from $1,635,000 for the thirteen-week period ended March 24, 2001 to $2,057,000 for the thirteen-week period ended March 30, 2002 reflecting an expansion in the areas of corporate development and sales and marketing. The increase consisted of an increase in payroll and related expenses.

Interest Income and Expense

Interest income decreased 54% from $1,144,000 for the thirteen-week period ended March 24, 2001 to $531,000 for the thirteen-week period ended March 30, 2002 reflecting fluctuation in interest rates, as well as lower funds made available for investment.

Interest expense increased 28% from $169,000 for the thirteen-week period ended March 24, 2001 to $216,000 for the thirteen-week period ended March 30, 2002. The increase was due to an increase in our outstanding balances under long-term obligations from approximately $8.2 million at March 24, 2001 to $22.1 million at March 30, 2002. The increase in our long-term obligations resulted primarily from the sale of convertible notes payable in March 2002 in a private placement transaction, which resulted in gross proceeds of $15 million.

Liquidity and Capital Resources

Our primary sources of cash have been payments received from product

discovery alliances, subscription fees, government grants, borrowings under equipment lending facilities and capital leases and proceeds from sale of securities.

As of March 30, 2002, we had cash, cash equivalents, restricted cash and short-term and long-term investments of approximately $76,035,000. On March 5, 2002, we sold convertible notes payable to two institutional investors in a private placement transaction, raising $15 million in gross proceeds. The convertible notes payable may be converted into shares of our common stock at the option of the holder, at a price of $8.00 per share, subject to certain adjustments. The maturity date of the convertible notes payable is December 31, 2004, provided, that if any time on or after December 31, 2003 we maintain a net cash balance (i.e., cash and cash equivalents less obligations for borrowed money bearing interest) of less than $35 million, then the holders of the convertible notes payable can require that all or any part of the outstanding principal balance of the notes payable plus all accrued but unpaid interest be repaid. Interest on the notes payable accrues at 6% annually. The investors also received the right to receive a warrant to purchase up to an aggregate of 487,500 shares of common stock at an exercise price of $8.00 per share, subject to certain adjustments. The warrants will only be issued at the time the convertible notes payable are converted or if certain other redemptions or repayments of the convertible notes payable occur. Additionally, the Company issued a warrant to purchase up to 100,000 shares of common stock at an exercise price of $15.00 per share to its placement agent in this transaction. The warrant is exercisable over a three year term commencing upon issuance. The warrant was valued, using Black-Scholes option pricing model in accordance with EITF 96-18, at $244,000. This amount is included in deferred issuance costs and will be amortized to interest expense over the term of the convertible notes payable.

In 2001, we sold 127,500 shares of common stock in a series of transactions through the Nasdaq National Market, resulting in proceeds received of approximately $1,706,000, net of issuance costs. In 2001, we also issued 325,950 shares of common stock related to the exercise of stock options and our employee stock purchase plan, resulting in total proceeds of approximately $1,204,000.

We had various arrangements under which we financed certain office and laboratory equipment and leasehold improvements. We had an aggregate of approximately $7,067,000 outstanding under these borrowing arrangements at March 30, 2002. This amount is repayable over the next 35 months, of which $3,053,000 is repayable over the next 12 months. Under these arrangements, we are required to maintain certain financial ratios, including minimum levels of unrestricted cash. We had no additional borrowing capacity under these capital lease agreements at March 30, 2002.

Our operating activities used cash of approximately $5,904,000 for the thirteen-week period ended March 30, 2002 primarily due to an increase in our net loss, unbilled costs and fees, and lower accounts payable and deferred revenue. These uses of cash were partially offset by a decrease in accounts receivable, interest receivable, prepaids and other current assets, as well as an increase in accrued liabilities. Our operating activities used cash of approximately $3,005,000 for the thirteen-week period ended March 24, 2001.

Our investing activities provided cash of approximately $7,163,000 for the thirteen-week period ended March 30, 2002 through the conversion of marketable securities to cash and cash equivalents, partially offset by purchases of marketable securities, equipment and additions to leasehold improvements and an

increase in other assets. Our investing activities provided cash of approximately $10,270,000 for the thirteen week period ended March 24, 2001 through the conversion of marketable securities to cash and cash equivalents, partially offset by purchases of marketable securities and equipment and additions to leasehold.

Capital expenditures totaled $1,249,000 for the thirteen-week period ended March 30, 2002 consisting of leasehold improvements and purchases of laboratory, computer, and office equipment. We utilized an existing line of credit to finance all of these capital expenditures. We currently estimate that we will acquire approximately $5,000,000 in capital equipment in 2002 consisting primarily of computers, laboratory equipment, and additions to leasehold improvement.

Our financing activities provided cash of approximately $16,700,000 for the thirteen-week period ended March 30, 2002 primarily from proceeds received from the sale of convertible notes payable totaling $15 million in gross proceeds, as well as proceeds received from entering into an additional credit line for $3,500,000, of which $500,000 was used to refinance a portion of an existing line of credit. These financing activities were partially offset by payments of long-term obligations of $2,066,000. Our financing activities provided cash of approximately $856,000 for the thirteen week period ended March 24, 2001 primarily from proceeds received from an equipment financing arrangement and the exercise of stock options, partially offset by payments of long-term obligations and notes receivable from an officer.

At December 31, 2001, we had net operating loss and tax credits (investment and research) carryforwards of approximately $93,767,000 and $6,642,000, respectively, available to reduce federal taxable income and federal income taxes, respectively, if any. Net operating loss carryforwards are subject to review and possible adjustment by the Internal Revenue Service and may be limited, in the event of certain cumulative changes in ownership interests of significant shareholders over a three-year period in excess of 50%. Additionally, certain of these losses are expiring due to the limitations of the carryforward period.

We believe that our existing capital resources are adequate for approximately two years under our current rate of investment in research and development. There is no assurance, however, that changes in our plans or events affecting our operations will not result in accelerated or unexpected expenditures.

We plan to continue to invest in our internal research and development programs, including our lead candidate, Ramoplanin, currently in Phase III clinical development.

We expect to seek additional funding in the future through public or private financing. Additional financing may not be available when needed, or if available, it may not be on terms acceptable to us. To the extent that we raise additional capital by issuing equity or convertible debt securities, ownership dilution to stockholders will result.

We generally place our marketable security investments in high quality credit instruments, as specified in our investment policy guidelines; the policy also limits the amount of credit exposure to any one issue, issuer, and type of instrument. We do not expect any material loss from our marketable security investments and therefore believe that our potential interest rate exposure is limited.

This Form 10-Q and documents we have filed with the Securities and Exchange Commission contain forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements represent our management's judgment regarding future

events. Forward-looking statements typically are identified by use of terms such as "may," "will," "should," "plan," "expect," "intend," "anticipate," "estimate," and similar words, although some forward-looking statements are expressed differently. All forward-looking statements, other than statements of historical fact, included in this report regarding our financial position, business strategy and plans or objectives for future operations are forward-looking statements. We cannot guarantee the accuracy of the forward-looking statements, nor do we plan to update these forward-looking statements. You should be aware that our actual results could differ materially from those contained in the forward looking statements due to a number of risks affecting our business, including our inability to obtain, or delays in obtaining, the regulatory approvals necessary to commercialize our lead candidate, Ramoplanin, or our inability or the inability of our alliance partners to (i) successfully develop products based on the Company's genomics

information, (ii) obtain the necessary regulatory approvals, (iii) effectively commercialize any products developed before our competitors are able to commercialize competing products or (iv) obtain and enforce intellectual property rights, as well as the risk factors set forth in the Exhibit 99.1 to the Company's Annual Report on Form 10-K for the year ended December 31, 2001 and those set forth in other filings that we may make with the Securities and Exchange commission from time to time.

Part II

Item 1. Legal Proceedings

None

Item 2. Changes In Securities

On March 5, 2002, pursuant to the private placement exemption under Section 4(2) of the Securities Act of 1933, as amended, the Company issued to two institutional investors (i) warrants to purchase up to an aggregate 487,500 shares of the Company's common stock at an exercise price of $8.00 per share, subject to certain adjustments, and (ii) 6% Convertible Notes, raising $15 million in gross proceeds. The warrants only become exercisable to the extent the notes are converted or if certain other redemptions or repayments of the notes occur. The notes may be converted into shares of the Company's common stock at the option of the holder, at a price of $8.00 per share, subject to certain adjustments. On March 5, 2002, as partial payment of the placement fee, the Company also issued, pursuant to the private placement exemption under Section 4(2) of the Securities Act of 1933, as amended, to the placement agent, Ladenburg Thalmann & Co, warrants to purchase 100,000 shares of the Company's common stock at an exercise price of $15.00 per share, subject to customary adjustments. The warrants issued to the placement agent are exercisable over a three year term commencing upon issuance. Additional information on the transaction is available on our Current Report on Form 8-K filed on March 6, 2002.

Item 3. Defaults Upon Senior Securities

None

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

a) Exhibits:

4.1 Purchase Agreement by and among Genome Therapeutics Corp. and certain Purchasers dated March 5, 2002.*

4.2 Form of Note*

4.3 Form of Warrant*

4.4 Form of Registration Rights Agreement*

b) Reports on Form 8-K

Current Report on Form 8-K was filed on March 6, 2002 under Item 5 relating to the Company's sale to two institutional investors of convertible notes and warrants to purchase common stock.

* Filed as an exhibit to the Company's Current Report on Form 8-K filed on March 6, 2002.

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has caused this report to be signed on its behalf by the undersigned thereunto duly authorized who also serves in the capacity of principal financial officer.

Genome Therapeutics Corp.

/s/ Stephen Cohen

Stephen Cohen, SVP & CFO
(Principal Financial Officer)

Date: May 14, 2002