XOMA LTD /DE/
Form 10-Q
August 09, 2006
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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 June 30, 2006

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	**(510) 204-7200**
(Address of principal executive offices, including zip code)	**(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 August 3, 2006**

Common shares US$.0005 par value	**97,410,508**

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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)

	June 30, 2006 (unaudited)	December 31, 2005 (note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 11,798	$ 20,804
Short-term investments	23,054	22,732
Receivables, net	5,602	5,186
Related party receivables	96	98
Prepaid expenses	1,217	975
Debt issuance costs	477	493
Total current assets	42,244	50,288
Property and equipment, net	21,940	19,056
Related party receivables long-term	75	93
Debt issuance costs long-term	2,187	2,683
Deposits	457	457
Total assets	$ 66,903	$ 72,577
LIABILITIES AND SHAREHOLDERS EQUITY (NET CAPITAL DEFICIENCY)		
Current liabilities:		
Accounts payable	$ 3,525	$ 5,648
Accrued liabilities	5,613	5,717
Accrued interest	1,472	1,652
Deferred revenue	4,849	3,527
Total current liabilities	15,459	16,544
Deferred revenue long-term	5,075	4,333
Convertible debt long-term	58,109	60,000
Interest bearing obligation long-term	15,793	12,373
Total liabilities	94,436	93,250
Commitments and contingencies		
Shareholders equity (net capital deficiency):		
Preference shares, $.05 par value, 1,000,000 shares authorized		
Series A, 135,000 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, 97,409,289 and 86,312,712 shares outstanding at June 30, 2006 and December 31, 2005, respectively	49	43
Additional paid-in capital	674,698	655,041
Accumulated comprehensive income	(71)	(66)

Accumulated deficit	(702,210)	(675,692)
Total shareholders equity (net capital deficiency)	(27,533)	(20,673)
Total liabilities and shareholders equity (net capital deficiency)	$ 66,903	$ 72,577

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 June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues:				
License and collaborative fees	$ 731	$ 2,655	$ 1,385	$ 3,180
Contract and other revenue	4,681	933	7,775	2,192
Royalties	2,100	1,571	3,956	2,780
Total revenues	7,512	5,159	13,116	8,152
Operating costs and expenses:				
Research and development (including contract related of $2,672 and $4,611, respectively, for the three and six months ended June 30, 2006, and $974 and $1,785 for the three and six months ended June 30, 2005)	12,104	9,547	24,285	19,549
General and administrative	4,386	3,709	9,439	7,460
Total operating costs and expenses	16,490	13,256	33,724	27,009
Loss from operations	(8,978)	(8,097)	(20,608)	(18,857)
Other income (expense):				
Investment and interest income	385	418	842	987
Interest expense	2,681	(1,117)	(6,745)	(1,778)
Other income (expense)	(3)	252	(7)	41,184
Net income (loss) from operations before taxes	(5,915)	(8,544)	(26,518)	21,536
Provision for income taxes		38		38
Net income (loss)	$ (5,915)	$ (8,582)	$ (26,518)	$ 21,498
Basic net income (loss) per common share	$ (0.06)	$ (0.10)	$ (0.29)	$ 0.25
Diluted net income (loss) per common share	$ (0.06)	$ (0.10)	$ (0.29)	$ 0.20
Shares used in computing basic net income (loss) per common share	96,661	86,253	92,326	85,997
Shares used in computing diluted net income (loss) per common share	96,661	86,253	92,326	115,332

See accompanying notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited, in thousands)

	Six Months Ended June 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income (loss)	$ (26,518)	$ 21,498
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	2,383	2,218
Common shares contribution to 401(k) and management incentive plans	1,088	1,304
Share-based compensation expense	647	
Accrued interest on convertible notes and other interest bearing obligations	237	1,563
Revaluation of embedded derivative	3,968	
Amortization of discount, premium and issuance costs of convertible debt	493	205
Amortization of premium on short-term investments	35	
Gain on extinguishment of debt		(40,935)
Loss on disposal/retirement of property and equipment	4	2
Gain on sale of investments		(271)
Other non-cash adjustments	(4)	
Changes in assets and liabilities:		
Receivables and related party receivables	(396)	(3,805)
Prepaid expenses	(242)	(166)
Deposits		(297)
Accounts payable	(2,123)	(103)
Accrued liabilities	(104)	(13,658)
Deferred revenue	2,064	120
Net cash used in operating activities	(18,468)	(32,325)
Cash flows from investing activities:		
Proceeds from sales/maturities of investments	15,734	502
Purchase of investments	(16,091)	
Purchase of property and equipment	(5,271)	(1,461)
Net cash used in investing activities	(5,628)	(959)
Cash flows from financing activities:		
Principal payments of short-term loan		(115)
Payments under capital lease obligations		(133)
Proceeds from issuance of long-term debt	3,003	8,844
Proceeds from issuance of convertible notes	11,969	56,553
Proceeds from issuance of common shares	118	96
Net cash provided by financing activities	15,090	65,245
Net increase (decrease) in cash and cash equivalents	(9,006)	31,961
Cash and cash equivalents at the beginning of the period	20,804	23,808
Cash and cash equivalents at the end of the period	$ 11,798	$ 55,769

See accompanying notes to condensed consolidated financial statements.

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XOMA Ltd.

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 for commercialization 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, 2005, filed with the SEC on March 8, 2006.

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 June 30, 2006, the consolidated results of the Company s operations for the three and six months ended June 30, 2006 and 2005, and the Company s cash flows for the six months then ended. The condensed consolidated balance sheet amounts at December 31, 2005, 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, except as noted below, during the six months ended June 30, 2006, as compared with those previously disclosed in its Annual Report on Form 10-K for the year ended December 31, 2005, filed with the SEC on March 8, 2006.

Contract Revenue

Contract revenue for research and development involves the Company providing research and development for manufacturing processes to collaborative partners or others. The Company recognizes revenue under these arrangements as the related research and development costs are incurred and collectibility is reasonably assured. Revenues for certain contracts are accounted for by a proportional performance, or output based, method where performance is based on agreed progress toward elements defined in the contract.

Share Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Stock-Based Payment (SFAS 123R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company s employees and directors, including employee share options and employee share purchases related to the Employee Share Purchase Plan, on estimated fair values. The Company is using the modified prospective method. Under this method, the Company is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption. 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. Further, 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

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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 Company reviews its valuation assumptions quarterly and, as a result, it is likely to change its valuation assumptions used to value share based awards granted in future periods.

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.

Concentration of Risk

Cash, cash equivalents, short-term investments 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 six months ended June 30, 2006, two customers represented 56% and 30% of total revenues and, as of June 30, 2006, there were billed and unbilled receivables of $5.1 million outstanding from these customers representing 54% and 37% of the balance. For the six months ended June 30, 2005, four customers represented 47%, 25%, 13% and 12% of total revenues and, as of June 30, 2005, there were billed and unbilled receivables of $4.1 million from three of these customers representing 44%, 27% and 19% 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 is 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 June 30, 2006, the Company had approximately 6.5 million shares of common shares reserved for future issuance under its share option plans and ESPP.

Prior to the adoption of SFAS 123R on January 1, 2006, the Company accounted for its share-based compensation plans under the intrinsic value method described in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and related Interpretations as permitted by Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation. (SFAS 123), as amended by Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148). In general, as the exercise price of the options granted under the Company s plans was equal to the market price of the underlying common shares on the grant date, no share-based employee compensation cost was recognized. As required by SFAS 148 prior to the adoption of SFAS 123R, the Company provided pro forma net income (loss) and pro forma net income (loss) per common share disclosures for share-based awards, as if SFAS 123 had been applied.

SFAS 123R requires all share based payments to be recognized in the financial statements based on their fair values. The Company is using the modified prospective method. Under this method, compensation cost recognized during the three and six month periods ended June 30, 2006, includes compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123 amortized on a graded vesting basis over the options vesting period, and compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in

accordance with the provisions of SFAS 123R amortized on a straight-line basis over the options vesting period. The Company elected to use the modified prospective transition method as permitted by SFAS 123R and, therefore, has not restated its financial results for prior periods to reflect expensing of share-based compensation. As a result, the results for the three and six months ended June 30, 2006, are not comparable to the same periods of the prior year.

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(unaudited)

The following table illustrates the effect on net income (loss) and net income (loss) per share had the Company applied the fair value recognition provisions of SFAS 123 to account for its share plans and ESPP for the three and six month periods ended June 30, 2005 (in thousands, except per share amounts):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income (loss) as reported	$ (8,582)	$ 21,498
Deduct: Total share-based employee compensation expense under SFAS 123	(2,733)	(3,163)
Pro forma net income (loss)	$ (11,315)	$ 18,335
Net income (loss) per common share:		
Basic as reported	$ (0.10)	$ 0.25
Basic pro forma	$ (0.13)	$ 0.21
Diluted as reported	$ (0.10)	$ 0.20
Diluted pro forma	$ (0.13)	$ 0.17

The historical pro forma impact of applying the fair value method prescribed by SFAS 123 is not representative of the impact that may be expected in the future due to changes resulting from additional grants in future years and changes in assumptions such as expected life, volatility and interest rates used to estimate fair value of the grants in future years.

The following table shows total share-based compensation expense included in the condensed consolidated statement of operations for the three and six month periods ended June 30, 2006 (in thousands).

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Research and development	$ 114	$ 270
General and administrative	143	377
Total share-based compensation expense	$ 257	$ 647

Basic and diluted net income (loss) per common share is (.01) lower for the six months ended June 30, 2006, than if the Company had not adopted SFAS 123R. There was no capitalized share-based compensation cost as of June 30, 2006. There were no recognized tax benefits during the three and six months ended June 30, 2006. The adoption of 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 and six months ended June 30, 2006 and 2005.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Dividend yield	0%	0%	0%	0%
Expected volatility	78%	83%	80%	83%
Risk-free interest rate	5.18%	3.70%	4.67%	4.10%
Expected life	5.3 years	4.1 years	5.3 years	4.3 years

Prior to the adoption of SFAS 123R, the Company s Board of Directors approved the acceleration of vesting of all outstanding employee share options with an exercise price greater than $3.00 per share. Because the exercise price of all the accelerated options exceeded the market price per share of the common shares as of the new measurement date, the acceleration had no impact on the

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Company s earnings in 2005. Since the accelerated options had exercise prices in excess of the current market value of the Company s common shares, the options had limited economic value and were not fully achieving their original objective of incentive compensation and employee retention. The modification allows expense recognized after the adoption of SFAS 123R to better reflect the Company s compensation strategies.

Share option activity for the six months ended June 30, 2006, is as follows:

	Options	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Options outstanding at December 31, 2005	5,422,096	$ 4.96		
Granted	1,222,300			
Forfeited, expired or cancelled	(563,828)			
Options outstanding at June 30, 2006	6,080,568	$ 4.30	6.77	$ 295,066
Options exercisable at June 30, 2006	4,122,323	$ 5.57	5.58	$ 115,369

Unvested share activity for the six months ended June 30, 2006 and 2005, is summarized below:

	Six Months Ended June 30,			
	2006		2005	
	Unvested			
	Number of Shares	Weighted-Average Grant-Date Fair Value	Unvested Number of Shares	Weighted-Average Grant-Date Fair Value
Unvested balance at December 31	1,234,838	$ 1.56	1,890,034	$ 5.50
Granted	1,222,300	1.68	1,167,100	1.45
Vested	(401,211)	1.52	(1,693,630)	5.58
Forfeited	(97,682)	1.61	(246,804)	3.73
Unvested balance at June 30	1,958,245	$ 1.64	1,116,700	$ 1.54

At June 30, 2006, there was $1.2 million of unrecognized share-based compensation expense related to unvested share options with a weighted average remaining recognition period of 2.9 years.

Comprehensive Income (Loss)

Unrealized gains or losses on the Company s available-for-sale securities are included in other comprehensive income (loss). Comprehensive income (loss) and its components for the three and six months ended June 30, 2006 and 2005, are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income (loss)	$ (5,915)	$ (8,582)	$ (26,518)	$ 21,498
Unrealized gain (loss) on securities available-for-sale	5		(5)	(280)
Comprehensive income (loss)	$ (5,910)	$ (8,582)	$ (26,523)	$ 21,218

Net Income (Loss) Per Common Share

Basic net income (loss) per common share is based on the weighted average number of common shares outstanding during the period. Diluted net income (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 increase (decrease) the net income (loss) per share.

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(unaudited)

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

	June 30,	
	2006	2005
Options for common shares	6,081	5,610
Warrants for common shares	125	125
Convertible preference shares, notes, and related interest, as if converted	37,335	38,827

The following is a reconciliation of the numerators and denominators of the basic and diluted net income (loss) per share (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Numerator				
Net income (loss)	$ (5,915)	$ (8,582)	$ (26,518)	$ 21,498
Interest on convertible long-term debt				1,754
Net income (loss) used for diluted net income (loss) per share	$ (5,915)	$ (8,582)	$ (26,518)	$ 23,252
Denominator				
Weighted average shares outstanding used for basic net income (loss) per share	96,661	86,253	92,326	85,997
Effect of dilutive share options				52
Effect of convertible preference shares				3,818
Effect of convertible long-term debt				25,465
Weighted-average shares outstanding and dilutive securities used for diluted net income (loss) per share	96,661	82,253	92,326	115,332

Receivables

Receivables consist of the following (in thousands):

	June 30, 2006	December 31, 2005
Trade receivables	$ 3,167	$ 2,880
Collaborations	2,138	1,916
Other receivables	297	390
Total	$ 5,602	$ 5,186

Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	June 30, 2006	December 31, 2005
Accrued payroll costs	$ 1,919	$ 2,084
Accrued management incentive compensation	1,091	1,758
Accrued legal fees	1,064	813
Customer advances	1,000	750
Accrued collaborations	272	
Other	267	312
Total	$ 5,613	$ 5,717

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XOMA Ltd.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

2. CONVERTIBLE DEBT

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 are initially convertible into approximately 38.4 million common shares at a conversion rate of 533.4756 of its common shares per $1,000 principal amount of New Notes, which is equivalent to a conversion price of approximately $1.87 per common share. Before February 10, 2010, the Company may not redeem the New Notes. On or after February 10, 2010, the Company may redeem any or all of the New Notes at 100% of the principal amount, plus accrued and unpaid interest. In addition, the Company may automatically convert some or all of the New Notes on or prior to the maturity date if the closing price of its 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 the Company elects to automatically convert, or if holders elect to voluntarily convert, some or all of the New Notes on or prior to February 10, 2010, it must 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, if any, shall 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.

In accounting for the New Notes, the Company applied guidance as set forth in EITF 96-19, SFAS 133, EITF 05-7, EITF 00-19, and EITF 01-6 as follows. The exchange offer is a modification of existing debt, rather than extinguishment. The additional interest payment upon conversion is an embedded derivative requiring separate accounting. The Company considered the provisions of EITF 05-2 and concluded that this is not conventional convertible debt.

In accordance with SFAS 133, the Company has separately accounted for the additional interest payment feature of the New Notes as an embedded derivative instrument, which is measured at fair value and classified on the balance sheet with the convertible debt. Changes in the fair value of the embedded derivative are recognized in earnings as a component of other income (expense). At the time of issuance, the Company estimated the fair value of the additional interest payment feature to be $5.8 million, including approximately $1.0 million related to the New Notes issued for cash, based on current information including share price. For the New Notes issued in the exchange offer and in the new money offering, this amount was subtracted from the carrying value of the debt, reflected as a debt discount, which is amortized as interest expense using the effective interest method, through the date the notes are scheduled to mature, and separately reported as a derivative liability.

Convertible debt consisted of the following (in thousands):

	June 30, 2006	December 31, 2005
Convertible debt	$ 52,229	$ 60,000
Embedded derivative	5,528	
Premium	352	
Total	$ 58,109	$ 60,000

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 are being amortized on a straight-line basis over the 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.

For the three months ended June 30, 2006, $2.9 million of New Notes were converted into 1,972,847 shares of common shares including 407,096 shares related to the additional interest payment feature of the notes. The Company recorded ($4.1) million in interest expense/(benefit) during the quarter ended June 30, 2006, as a benefit arising from the decrease in the fair value of the embedded derivative on its convertible debt of which ($4.3) million of benefit related to the recovery of interest expense from the increase in the fair value of the embedded derivative during the quarter ended March 31, 2006, partially offset by $0.2 million in expense related to the converted notes.

For the six months ended June 30, 2006, $15.5 million of New Notes were converted into 10,385,171 shares of common shares including 2,142,971 shares related to the additional interest payment feature of the notes. The Company recorded $4.0 million in

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(unaudited)

interest expense during the six months ended June 30, 2006, as a result of an increase in the fair value of the embedded derivative on its convertible debt including $2.7 million related to the converted notes.

For the three months ended June 30, 2006 and 2005, the Company incurred $0.9 million and $1.0 million, respectively, in interest expense payable on its convertible debt. For the six months ended June 30, 2006 and 2005, the Company incurred $1.9 million and $1.5 million, respectively, in interest expense payable on its convertible debt. Interest expense is payable on a semi-annual basis. Additionally, the Company amortized a net of $0.3 million and $0.5 million, respectively, in debt issuance costs, premium and discount for the three and six months ended June 30, 2006, and amortized $0.1 million and $0.2 million, respectively, in debt issuance costs for the three and six months ended June 30, 2005.

3. COLLABORATIVE AND OTHER ARRANGEMENTS

In April of 2006, Chiron Corporation (Chiron) announced that its shareholders had approved the amended merger agreement under which Novartis AG (Novartis) would acquire all Chiron shares it did not already own and the acquisition was consummated. Although the Company is continuing to evaluate the impact of this acquisition, it does not yet know what effects this transaction will have on its collaboration.

In May of 2006, the Company entered into a collaboration agreement with the Schering-Plough Research Institute division of Schering Corporation (SPRI) for therapeutic monoclonal antibody discovery and development. Under the agreement, SPRI will make upfront and milestone payments to the Company, fund the Company s R&D and manufacturing activities related to the agreement and pay the Company royalties on sales of products resulting from the collaboration. During the collaboration, the Company will discover therapeutic antibodies against one or more targets selected by SPRI. The Company will recognize revenue on the upfront payment on a straight-line basis over the term of the contract, revenue on the services as they are performed and on the milestones and royalties as they are received.

Beginning in the quarter ended June 30, 2006, the Company became eligible for a royalty from Genentech on worldwide sales of LUCENTIS , a new drug for the treatment of neovascular (wet) age-related macular degeneration. This royalty obligation results from an existing agreement with Genentech related to the licensing of the Company s bacterial cell expression technology.

4. LEGAL PROCEEDINGS

In April of 2005, a complaint was filed in the Circuit Court of Cook County, Illinois, in a lawsuit captioned Hanna v. Genentech, Inc. and XOMA (US) LLC, No. 2005004386, by an alleged participant in one of the clinical trials of RAPTIVA®. The lawsuit was thereafter removed to the United States District Court, Northern District of Illinois, No. 05C 3251. The complaint asserted claims for alleged strict product liability and negligence against Genentech and the Company based on injuries alleged to have occurred as a result of plaintiff s treatment in the clinical trials. The complaint sought unspecified compensatory damages alleged to be in excess of $100,000. In April of 2006, the claimant filed a motion seeking voluntary dismissal of the lawsuit and, in May of 2006, the complaint was dismissed with prejudice.

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 filed for bankruptcy protection under Chapter 11, Title 11 of the U.S. Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware, No. 06-10510 (CSS). XOMA (US) LLC intends to file a proof of claim in this proceeding, as a creditor of Aphton, for approximately $594,000.

5. SUBSEQUENT EVENTS

On July 28, 2006, the Company announced that it had placed its production process development work for Cubist Pharmaceuticals, Inc. (Cubist) on hold and issued a notice of contract termination because of Cubist s decision to cease investment in its HepeX-B product as a result of stringent FDA requirements for regulatory approval. As a result of this termination, the company will recognize all Cubist deferred revenue and a termination fee in the quarter ending September 30, 2006.

On July 31, 2006, the Company announced that it had been awarded a $16.3 million dollar contract (Contract No. HHSN266200600008C/N01-Al-60008) funded with Federal funds from the National Institute of Allergy and Infectious Diseases (NIAID), a part of the National Institutes of Health, Department of Health and Human Services, to produce botulinum neurotoxin monoclonal antibodies for the treatment of botulism to protect U.S. citizens against the harmful effects of botulinum neurotoxins used in bioterrism.

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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 and six months ended June 30, 2006, were $7.5 million and $13.1 million, respectively, compared with $5.2 million and $8.2 million, respectively, for the same periods of 2005.

License and collaborative fee revenues were $0.7 million and $1.4 million, respectively, for the three and six months ended June 30, 2006, compared with $2.7 million and $3.2 million, respectively, for the same periods of 2005. These revenues include amortization of upfront payments, milestone revenues and licensing revenues related to the outlicensing of our products and technologies and other collaborative arrangements. The decreases of $2.0 million and $1.8 million, respectively, for the three and six months ended June 30, 2006, resulted primarily from an outlicensing agreement with Merck & Co. Inc. in the quarter ended June 30, 2005.

Contract revenues were $4.7 million and $7.8 million, respectively, for the three and six months ended June 30, 2006, compared with $0.9 million and $2.2 million, respectively, for the same periods of 2005. The increases of $3.8 million and $5.6 million, respectively, for the three and six months ended June 30, 2006, resulted primarily from an increase in contract manufacturing services performed under our contract with the National Institute of Allergy and Infectious Diseases (NIAID) entered into in March of 2005 to develop three anti-botulinum neurotoxin monoclonal antibody therapeutics offset by a reduction in clinical trial services performed on behalf of Genentech, Inc. (Genentech). The NIAID contract work is being performed over an eighteen month period and is 100% funded with federal funds from NIAID under Contract No. HHSN266200500004C. We are recognizing revenue over the life of the contract as the services are performed on a proportional performance basis and, as per the terms of the contract, a 10% retention on all revenue is being deferred and classified as a receivable until completion of the contract.

Royalties were $2.1 million and $4.0 million, respectively, for the three and six months ended June 30, 2006, compared with $1.6 million and $2.8 million, respectively, for the same periods of 2005. The increases of $0.5 million and $1.2 million, respectively, for the three and six months ended June 30, 2006, resulted primarily from RAPTIVA® royalties earned under our royalty arrangement 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 $12.1 million and $24.3 million, respectively, for the three and six months ended June 30, 2006, compared with $9.5 million and $19.5 million, respectively, for the same periods of 2005, an increase of 27% and 24%, respectively. These increases primarily reflects increases in spending on our contract with NIAID, our development of XOMA 052 and NEUPREX®, and our collaborations with Lexicon Genetics Incorporated (Lexicon) and Schering Plough Research Institute (SPRI), partially offset by decreased spending on our collaboration agreements with Novartis AG (Novartis formerly Chiron Corporation), Genentech and Millennium Pharmaceuticals, Inc. In addition, for the three and six months ended June 30, 2006, we recorded $0.1 million and $0.3 million, respectively, of share-based compensation expense. No share based compensation expense was recorded in 2005.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Earlier stage programs	$ 9,777	$ 7,080	$ 19,044	$ 15,712
Later stage programs	2,327	2,467	5,241	3,837
Total	$ 12,104	$ 9,547	$ 24,285	$ 19,549

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Internal projects	$ 7,387	$ 4,965	$ 15,184	$ 11,258
Collaborative arrangements	4,717	4,582	9,101	8,291
Total	$ 12,104	$ 9,547	$ 24,285	