

INCYTE CORP  
Form 10-Q  
August 01, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2013

or

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from      to

Commission File Number: 0-27488

**INCYTE CORPORATION**

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(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**94-3136539**  
(IRS Employer  
Identification No.)

**Experimental Station, Route 141 & Henry Clay Road,**  
**Building E336, Wilmington, DE 19880**  
(Address of principal executive offices)

**19880**  
(Zip Code)

**(302) 498-6700**

(Registrant's telephone number, including area code)

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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

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

The number of outstanding shares of the registrant's Common Stock, \$0.001 par value, was 153,061,917 as of July 25, 2013.

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Table of Contents**PART I: FINANCIAL INFORMATION****Item 1. Financial Statements****INCYTE CORPORATION****Condensed Consolidated Balance Sheets**

(in thousands)

	<b>June 30, 2013 (unaudited)</b>	<b>December 31, 2012*</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 258,202	\$ 224,057
Marketable securities available-for-sale	19,251	4,361
Accounts receivable, net	27,522	70,951
Inventory	133	278
Prepaid expenses and other current assets	8,261	9,867
<b>Total current assets</b>	<b>313,369</b>	<b>309,514</b>
Inventory	11,410	8,475
Property and equipment, net	6,236	6,348
Intangible and other assets, net	3,204	6,082
<b>Total assets</b>	<b>\$ 334,219</b>	<b>\$ 330,419</b>
<b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 13,471	\$ 13,961
Accrued compensation	14,327	22,899
Interest payable	3,044	4,750
Accrued and other current liabilities	33,087	28,385
Deferred revenue-Collaborative agreements	39,029	66,079
<b>Total current liabilities</b>	<b>102,958</b>	<b>136,074</b>
Convertible senior notes	214,530	322,043
Convertible subordinated note	9,287	9,033
Other liabilities	3,433	
Deferred revenue-Collaborative agreements	31,797	38,226
<b>Total liabilities</b>	<b>362,005</b>	<b>505,376</b>
Stockholders deficit:		
Preferred stock, \$0.001 par value; 5,000,000 shares authorized; none issued or outstanding as of June 30, 2013 and December 31, 2012		
Common stock, \$0.001 par value; 400,000,000 shares authorized; 152,915,117 and 133,462,185 shares issued and outstanding as of June 30, 2013 and December 31, 2012,	153	133

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respectively

Additional paid-in capital	1,642,198	1,476,922
Accumulated other comprehensive gain	1,993	1,878
Accumulated deficit	(1,672,130)	(1,653,890)
Total stockholders' deficit	(27,786)	(174,957)
Total liabilities and stockholders' deficit	\$ 334,219	\$ 330,419

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\* The condensed consolidated balance sheet at December 31, 2012 has been derived from the audited financial statements at that date.

See accompanying notes.

Table of Contents**INCYTE CORPORATION****Condensed Consolidated Statements of Operations**

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
<b>Revenues:</b>				
Product revenues, net	\$ 54,099	\$ 29,727	\$ 102,388	\$ 49,006
Product royalty revenues	5,800		11,709	
Contract revenues	41,737	56,737	58,474	73,474
Other revenues	39	78	181	242
<b>Total revenues</b>	<b>101,675</b>	<b>86,542</b>	<b>172,752</b>	<b>122,722</b>
<b>Costs and expenses:</b>				
Cost of product revenues	157	16	308	27
Research and development	60,950	51,588	113,713	100,548
Selling, general and administrative	23,249	19,719	45,509	41,115
<b>Total costs and expenses</b>	<b>84,356</b>	<b>71,323</b>	<b>159,530</b>	<b>141,690</b>
Income (loss) from operations	17,319	15,219	13,222	(18,968)
Interest and other income, net	245	315	444	366
Interest expense	(10,293)	(11,430)	(22,022)	(22,720)
Debt exchange expense	(9,771)		(9,771)	
<b>Income (loss) before income taxes</b>	<b>\$ (2,500)</b>	<b>\$ 4,104</b>	<b>\$ (18,127)</b>	<b>\$ (41,322)</b>
Provision for income taxes	71	67	113	67
<b>Net income (loss)</b>	<b>\$ (2,571)</b>	<b>\$ 4,037</b>	<b>\$ (18,240)</b>	<b>\$ (41,389)</b>
<b>Net income (loss) per share:</b>				
Basic	\$ (0.02)	\$ 0.03	\$ (0.13)	\$ (0.32)
Diluted	\$ (0.02)	\$ 0.03	\$ (0.13)	\$ (0.32)
<b>Shares used in computing basic and diluted net income (loss) per share</b>				
Basic	142,284	129,224	138,315	128,214
Diluted	142,284	137,969	138,315	128,214

See accompanying notes.



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**INCYTE CORPORATION**

**Condensed Consolidated Statements of Comprehensive Income (Loss)**

(in thousands)

(unaudited)

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>2013</b>	<b>June 30, 2012</b>	<b>2013</b>	<b>June 30, 2012</b>
Net income (loss)	\$ (2,571)	\$ 4,037	\$ (18,240)	\$ (41,389)
Other comprehensive gain (loss):				
Unrealized (loss) gain on marketable securities	(6)	(215)	115	78
Other comprehensive (loss) gain	(6)	(215)	115	78
Comprehensive income (loss)	\$ (2,577)	\$ 3,822	\$ (18,125)	\$ (41,311)

See accompanying notes.



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## INCYTE CORPORATION

## Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	Six Months Ended June 30,	
	2013	2012
<b>Cash flows from operating activities:</b>		
Net loss	\$ (18,240)	\$ (41,389)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization of debt discounts	15,787	14,638
Stock-based compensation	19,130	19,843
Debt exchange expense	9,771	
Changes in operating assets and liabilities:		
Accounts receivable	43,429	(7,426)
Prepaid expenses and other assets	3,476	8,448
Inventory	(2,790)	(796)
Accounts payable	(490)	(3,837)
Accrued and other current liabilities	(3,775)	(8,350)
Deferred revenue		6,661
Deferred revenue Collaborative agreements	(33,479)	(33,469)
Net cash provided by (used in) operating activities	32,819	(45,677)
<b>Cash flows from investing activities:</b>		
Capital expenditures	(1,447)	(1,503)
Purchases of marketable securities	(15,010)	
Sales and maturities of marketable securities	(3)	264
Net cash used in investing activities	(16,460)	(1,239)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock under stock plans	27,557	31,315
Paid in connection with exchange of 4.75% convertible senior notes due 2015	(9,771)	
Net cash provided by financing activities	17,786	31,315
Net increase (decrease) in cash and cash equivalents	34,145	(15,601)
Cash and cash equivalents at beginning of period	224,057	273,164
Cash and cash equivalents at end of period	\$ 258,202	\$ 257,563
<b>Supplemental Schedule of Cash Flow Information</b>		
Interest paid	\$ 9,500	\$ 9,500
Income taxes paid	\$ 140	\$ 1
Non-cash reclassification to additional paid in capital in connection with exchange of 4.75% convertible senior notes due 2015	\$ 118,593	\$

See accompanying notes.



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**INCYTE CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

(Unaudited)

**1. Organization and business**

Incyte Corporation ( Incyte, we, us, our or the Company ) is a biopharmaceutical company focused on developing and commercializing proprietary small molecule drugs for oncology and inflammation. Our pipeline includes compounds in various stages, ranging from preclinical to late stage development, and a commercialized product, JAKAFI® (ruxolitinib).

**2. Summary of significant accounting policies**

***Basis of presentation***

The accompanying unaudited condensed consolidated 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 and Article 10 of Regulation S-X. The condensed consolidated balance sheet as of June 30, 2013 and the condensed consolidated statements of operations, comprehensive loss and cash flows for the three and six months ended June 30, 2013 and 2012, are unaudited, but include all adjustments, consisting only of normal recurring adjustments, which we consider necessary for a fair presentation of the financial position, operating results and cash flows for the periods presented. The condensed consolidated balance sheet at December 31, 2012 has been derived from audited financial statements.

Although we believe that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote information normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States ( U.S. GAAP ) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

Results for any interim period are not necessarily indicative of results for any future interim period or for the entire year. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012.

**Revenue Recognition.** Revenues are recognized when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the price is fixed or determinable and (4) collectability is reasonably assured. Revenues are deferred for fees received

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before earned or until no further obligations exist. We exercise judgment in determining that collectability is reasonably assured or that services have been delivered in accordance with the arrangement. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectability based primarily on the customer's payment history and on the creditworthiness of the customer.

### Product Revenues

Our product revenues consist of U.S. sales of JAKAFI and are recognized once we meet all four revenue recognition criteria described above. In November 2011, we began shipping JAKAFI to our specialty pharmacy customers, which in turn dispense JAKAFI to patients in fulfillment of prescriptions. From November 2011 to June 2012, as JAKAFI was a new and novel product, the first approved treatment for intermediate or high-risk myelofibrosis, and the first commercial product for Incyte, we determined we could not reasonably assess potential product returns. As a result of our inability to initially estimate product returns, the price of JAKAFI was not deemed fixed or determinable, and we deferred the recognition of revenues on product shipments of JAKAFI until the product was shipped by our specialty pharmacy customers to patients.

Based on our actual experience with product returns through the three months ended September 30, 2012, we had the ability to estimate product returns and the price of JAKAFI is now deemed fixed or determinable. As a result, during the three months ended September 30, 2012, we began to recognize revenue for product sales of JAKAFI at the time the product was received by our specialty pharmacy customers.

We recognize revenues for product received by our specialty pharmacy customers net of allowances for customer credits, including estimated rebates, chargebacks, discounts, returns, distribution service fees, patient assistance programs, and Medicare Part D coverage gap reimbursements. Product shipping and handling costs are included in cost of product revenues.

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*Customer Credits:* Our specialty pharmacy customers are offered various forms of consideration, including allowances, service fees and prompt payment discounts. We expect our specialty pharmacy customers will earn prompt payment discounts and, therefore, we deduct the full amount of these discounts from total product sales when revenues are recognized. Service fees are also deducted from total product sales as they are earned.

*Rebates:* Allowances for rebates include mandated discounts under the Medicaid Drug Rebate Program. Rebate amounts are based upon contractual agreements or legal requirements with public sector (e.g. Medicaid) benefit providers. Rebates are amounts owed after the final dispensing of the product to a benefit plan participant and are based upon contractual agreements or legal requirements with public sector benefit providers. The allowance for rebates is based on statutory discount rates and expected utilization. Our estimates for expected utilization of rebates are based on data received from our specialty pharmacy customers. Rebates are generally invoiced and paid in arrears so that the accrual balance consists of an estimate of the amount expected to be incurred for the current quarter's activity, plus an accrual balance for known prior quarters' unpaid rebates. If actual future rebates vary from estimates, we may need to adjust prior period accruals, which would affect revenue in the period of adjustment.

*Chargebacks:* Chargebacks are discounts that occur when contracted customers purchase directly from a specialty pharmacy, or an intermediary distributor. Contracted customers, which currently consist primarily of Public Health Service institutions, non-profit clinics, and Federal government entities purchasing via the Federal Supply Schedule, generally purchase the product at a discounted price. The specialty pharmacy or distributor, in turn, charges back to us the difference between the price initially paid by the specialty pharmacy or distributor and the discounted price paid to the specialty pharmacy or distributor by the customer. The allowance for chargebacks is based on known sales to contracted customers.

*Medicare Part D Coverage Gap:* Medicare Part D prescription drug benefit mandates manufacturers to fund 50% of the Medicare Part D insurance coverage gap for prescription drugs sold to eligible patients. Our estimates for the expected Medicare Part D coverage gap are based on historical invoices received and in part from data received from our specialty pharmacy customers. Funding of the coverage gap is generally invoiced and paid in arrears so that the accrual balance consists of an estimate of the amount expected to be incurred for the current quarter's activity, plus an accrual balance for known prior quarters. If actual future funding varies from estimates, we may need to adjust prior period accruals, which would affect revenue in the period of adjustment.

*Co-payment assistance:* Patients who have commercial insurance and meet certain eligibility requirements may receive co-payment assistance. We accrue a liability for co-payment assistance based on actual program participation and estimates of program redemption using data provided by third-party administrators.

Product Royalty Revenues

Royalty revenues on commercial sales for ruxolitinib (marketed as JAKAVI® outside the United States) by Novartis Pharmaceutical International Ltd. (Novartis) are based on net sales of licensed products in licensed territories as provided by Novartis. We recognize royalty revenues in the period the sales occur.

Contract and License Revenues

Under agreements involving multiple deliverables, services and/or rights to use assets that we entered into prior to January 1, 2011, the multiple elements are divided into separate units of accounting when certain criteria are met, including whether the delivered items have stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered items. When separate units of accounting exist, consideration is allocated among the separate elements based on their respective fair values. The determination of fair value of each element is based on objective evidence from historical sales of the individual elements by us to other customers. If such evidence of fair value for each undelivered element of the arrangement does not exist, all revenue from the arrangement is deferred until such time that evidence of fair value for each undelivered element does exist or until all elements of the arrangement are delivered. When elements are specifically tied to a separate earnings process, revenue is recognized when the specific performance obligation tied to the element is completed. When revenues for an element are not specifically tied to a separate earnings process, they are recognized ratably over the term of the agreement. We assess whether a substantive milestone exists at the inception of our agreements. For all milestones within our arrangements that are considered substantive, we recognize revenue upon the achievement of the associated milestone. If a milestone is not considered substantive, we would recognize the applicable milestone payment over the remaining period of performance under the arrangement. Further information about our collaborative arrangements can be found below in Note 6, *License Agreements*. As of June 30, 2013, all remaining potential milestones under our collaborative arrangements are considered substantive.

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On January 1, 2011, updated guidance on the recognition of revenues for agreements with multiple deliverables became effective and applies to any agreements we may enter into on or after January 1, 2011. This updated guidance (i) relates to whether multiple deliverables exist, how the deliverables in a revenue arrangement should be separated and how the consideration should be allocated; (ii) requires companies to allocate revenues in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence or third-party evidence of selling price; and (iii) eliminates the use of the residual method and requires companies to allocate revenues using the relative selling price method. During three and six months ended June 30, 2013, we did not enter into any agreements that are subject to this updated guidance. If we enter into an agreement with multiple deliverables after January 1, 2011 or amend existing agreements, this updated guidance could have a material effect on our financial statements.

Inventory

Inventories are determined at the lower of cost or market value with cost determined under the specific identification method and may consist of raw materials, work in process and finished goods. We began capitalizing inventory in mid-November 2011 once the U.S. Food and Drug Administration ( FDA ) approved JAKAFI as the related costs were expected to be recoverable through the commercialization of the product. Costs incurred prior to approval of JAKAFI have been recorded as research and development expense in our statements of operations. As a result, inventory balances and cost of product revenue for the next several quarters will reflect a lower average per unit cost of materials.

The raw materials and work-in-process inventory is not subject to expiration and the shelf life for finished goods inventory is 24 or 36 months from the start of manufacturing of the finished goods. We evaluate for potential excess inventory by analyzing current and future product demand relative to the remaining product shelf life. We build demand forecasts by considering factors such as, but not limited to, overall market potential, market share, market acceptance and patient usage. We classify inventory as current on the consolidated balance sheets when we expect inventory to be consumed for commercial use within the next twelve months.

**3. Fair value of financial instruments**

Financial Accounting Standards Board ( FASB ) accounting guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability ( the exit price ) in an orderly transaction between market participants at the measurement date. The standard outlines a valuation framework and creates a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and the related disclosures. In determining fair value we use quoted prices and observable inputs. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of us. The fair value hierarchy is broken down into three levels based on the source of inputs as follows:

Level 1 Valuations based on unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 Valuations based on observable inputs and quoted prices in active markets for similar assets and liabilities.

Level 3 Valuations based on inputs that are unobservable and models that are significant to the overall fair value measurement.

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Our marketable securities consist of investments in U.S. Treasury notes, other U.S. government agency and non-agency mortgage-backed securities and a certificate of deposit that are classified as available-for-sale.

At June 30, 2013 and December 31, 2012, our Level 2 mortgage-backed securities are valued using readily available pricing sources which utilize market observable inputs, including the current interest rate and other characteristics for similar types of instruments.

The following fair value hierarchy table presents information about each major category of our financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2013 (in thousands):

	<b>Fair Value Measurement at Reporting Date Using:</b>			<b>Balance as of</b>
	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>	<b>June 30, 2013</b>
Cash and cash equivalents	\$ 258,202	\$	\$	\$ 258,202
Certificate of deposit	15,010			15,010
Mortgage-backed securities		4,241		4,241
<b>Total assets</b>	<b>\$ 273,212</b>	<b>\$ 4,241</b>	<b>\$</b>	<b>\$ 277,453</b>



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The following fair value hierarchy table presents information about each major category of our financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2012 (in thousands):

	Fair Value Measurement at Reporting Date Using:			Balance as of December 31, 2012
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Cash and cash equivalents	\$ 224,057	\$	\$	\$ 224,057
Mortgage-backed securities			4,361	4,361
<b>Total assets</b>	<b>\$ 224,057</b>	<b>\$ 4,361</b>	<b>\$</b>	<b>\$ 228,418</b>

The following is a summary of our marketable securities portfolio as of June 30, 2013 and December 31, 2012, respectively.

	Amortized Cost	Net Unrealized Gains (in thousands)		Net Unrealized Losses	Estimated Fair Value
	<b>June 30, 2013</b>				
Certificate of deposit	\$ 15,010	\$	\$	\$	\$ 15,010
Mortgage backed securities	2,248	1,993	\$	\$	4,241
	\$ 17,258	\$ 1,993	\$	\$	\$ 19,251
<b>December 31, 2012</b>					
Mortgage backed securities	\$ 2,483	\$ 1,878	\$	\$	\$ 4,361
	\$ 2,483	\$ 1,878	\$	\$	\$ 4,361

Because of the potential for prepayment on mortgage-backed securities, they are not categorized by contractual maturity.

#### 4. Concentration of Credit Risk

In December 2009, we entered into a license, development and commercialization agreement with Eli Lilly and Company ( Lilly ). In November 2009, we entered into a collaboration and license agreement with Novartis. The concentration of credit risk related to our collaborative partners is as follows:

	Percentage of Total Contract Revenues for the Three Months Ended June 30,		Percentage of Total Contract Revenues for the Six Months Ended June 30,	
	2013	2012	2013	2012
Collaboration Partner A	92%	94%	89%	91%
Collaboration Partner B	8%	6%	11%	9%

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Collaboration Partner A and Collaboration Partner B comprised in the aggregate 25% and 73% of the accounts receivable balance as of June 30, 2013 and December 31, 2012, respectively.

In November 2011, we began commercialization and distribution of JAKAFI to a limited number of specialty pharmacies. Our product revenues are concentrated in a limited number of specialty pharmacy customers. The concentration of credit risk related to our specialty pharmacy customers is as follows:

	Percentage of Total Net Product Revenues for the Three Months Ended June 30,		Percentage of Total Net Product Revenues for the Six Months Ended June 30,	
	2013	2012	2013	2012
Customer A	29%	27%	28%	30%
Customer B	19%	22%	19%	23%
Customer C	12%	15%	12%	15%
Customer D	11%	15%	11%	14%

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We are exposed to risks associated with extending credit to specialty pharmacy customers related to the sale of products. Customer A, Customer B, Customer C and Customer D comprised in the aggregate 55% and 17% of the accounts receivable balance as of June 30, 2013 and December 31, 2012, respectively.

**5. Inventory**

Our inventory balance consists of the following:

	June 30, 2013	(in thousands)	December 31, 2012
Raw materials	\$ 591		\$ 591
Work-in-process	10,819		7,884
Finished goods	133		278
	11,543		8,753
Inventories current	133		278
Inventories non-current	\$ 11,410		\$ 8,475

Inventories, stated at the lower of cost or market, consist of raw materials, work in process and finished goods. At June 30, 2013, \$0.1 million of inventory was classified as current on the consolidated balance sheets as we expect this inventory to be consumed for commercial use within the next twelve months. At June 30, 2013, \$11.4 million of inventory was classified as non-current on the consolidated balance sheets as we did not expect this inventory to be consumed for commercial use within the next twelve months. We obtain a number of inventory components from single source suppliers due to technology, availability, price, quality or other considerations. The loss of a single source supplier, the deterioration of its relationship with a single source supplier, or any unilateral violation of the contractual terms under which we are supplied components by a single source supplier could adversely affect our total revenues and gross margins.

The raw materials and work-in-process inventory is not subject to expiration and the shelf life for finished goods inventory is 24 or 36 months from the start of manufacturing of the finished goods. We evaluate for potential excess inventory by analyzing current and future product demand relative to the remaining product shelf life. We build demand forecasts by considering factors such as, but not limited to, overall market potential, market share, market acceptance and patient usage.

**6. License agreements***Novartis*

In November 2009, we entered into a Collaboration and License Agreement with Novartis. Under the terms of the agreement, Novartis received exclusive development and commercialization rights outside of the United States to our JAK inhibitor ruxolitinib and certain back-up compounds for hematologic and oncology indications, including all hematological malignancies, solid tumors and myeloproliferative diseases.

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We retained exclusive development and commercialization rights to JAKAFI (ruxolitinib) in the United States and in certain other indications. Novartis also received worldwide exclusive development and commercialization rights to our c-MET inhibitor compound INCB28060 and certain back-up compounds in all indications. We retained options to co-develop and to co-promote INCB28060 in the United States.

Under this agreement, we received an upfront payment and immediate milestone payment totaling \$210.0 million and were initially eligible to receive up to \$1.1 billion in milestone payments across multiple indications upon the achievement of pre-specified events, including up to \$162.0 million for the achievement of development milestones, up to \$450.0 million for the achievement of regulatory milestones and up to \$500.0 million for the achievement of commercialization milestones. During the three months ended June 30, 2013, we recognized and received a \$25.0 million development milestone payment under this agreement based on the formal initiation by Novartis of a Phase II clinical trial evaluating c-MET inhibitor INCB28060. In 2012, we recognized and received a \$40.0 million regulatory milestone payment under this agreement for the achievement of a predefined milestone for the European Union regulatory approval of Jakavi. In 2011, we recognized and received a \$15.0 million development milestone payment under this agreement for the achievement of a predefined milestone in the Phase I dose-escalation trial for INCB28060 in patients with solid tumors and a \$10.0 million regulatory milestone payment for the JAKAFI approval in the United States. We determined the 2013, 2012 and 2011 milestones to be substantive as their achievement required substantive efforts by us and were at risk until the milestones were ultimately achieved. We also could receive tiered, double-digit royalties ranging from the upper-teens to the mid-twenties on future ruxolitinib net sales outside of the United States. In addition, should Novartis receive reimbursement and pricing approval for ruxolitinib in a specified number of countries, we will be obligated to pay to Novartis tiered royalties in the low single digits on future ruxolitinib net sales within the United States. Each company is responsible for costs relating to the development and commercialization of the JAK inhibitor compound in its respective territories, with costs of collaborative studies shared equally. Novartis is responsible for all costs relating to the

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development and commercialization of the c-MET inhibitor compound after the initial Phase I clinical trial, which has been completed.

The Novartis agreement will continue on a program-by-program basis until Novartis has no royalty payment obligations with respect to such program or, if earlier, the termination of the agreement or any program in accordance with the terms of the agreement. Royalties are payable by Novartis on a product-by-product and country-by-country basis until the latest to occur of (1) the expiration of the last valid claim of the licensed patent rights covering the licensed product in the relevant country, (2) the expiration of regulatory exclusivity for the licensed product in such country and (3) a specified period from first commercial sale in such country of the licensed product by Novartis or its affiliates or sublicensees. The agreement may be terminated in its entirety or on a program-by-program basis by Novartis for convenience. The agreement may also be terminated by either party under certain other circumstances, including material breach.

We determined that there were two deliverables under the agreement: (i) the ex U.S. license for ruxolitinib and (ii) our obligations in connection with our participation on the joint development committee for myelofibrosis and polycythemia vera/ essential thrombocythemia. We concluded that these deliverables should be accounted for as a single unit of accounting and the \$150.0 million upfront payment received in December 2009 and the immediate \$60.0 million milestone payment received in January 2010 should be recognized on a straight line basis through December 2013 when we estimate we will complete our obligations in connection with our participation on the joint development committee, our estimated performance period under the agreement. We have no further substantive obligations to Novartis after the completion of our obligations in connection with the joint development committee.

At December 31, 2009, we recorded \$10.9 million of reimbursable costs incurred prior to the effective date of the agreement as deferred revenue on the condensed consolidated balance sheet. These costs will be recognized on a straight line basis through December 2013 consistent with the aforementioned upfront and milestone payments. Future reimbursable costs incurred after the effective date of the agreement with Novartis will be recorded net against the related research and development expenses. At June 30, 2013 and December 31, 2012, \$1.1 million and \$2.1 million, respectively, of reimbursable costs were included in accounts receivable on the condensed consolidated balance sheets. Research and development expenses for the three and six months ended June 30, 2013 were net of \$1.0 million and \$1.9 million, respectively, of costs reimbursed by Novartis. Research and development expenses for each of the three and six months ended June 30, 2012 were net of \$0.5 million of costs reimbursed by Novartis.

Contract revenue under the Novartis agreement was \$38.5 million and \$52.0 million for the three and six months ended June 30, 2013, respectively, and included a \$25.0 million milestone payment for INCB28060 that was earned in the three months ended June 30, 2013. Contract revenue under the Novartis agreement was \$53.5 million and \$67.0 million for the three and six months ended June 30, 2012, respectively, and included a \$40.0 million milestone payment for the achievement of a predefined milestone for the European Union regulatory approval of Jakavi that was earned in the three months ended June 30, 2012.

*Lilly*

In December 2009, we entered into a License, Development and Commercialization Agreement with Lilly. Under the terms of the agreement, Lilly received exclusive worldwide development and commercialization rights to our JAK inhibitor baricitinib, and certain back-up compounds for inflammatory and autoimmune diseases. We received an upfront payment of \$90.0 million, and were initially eligible to receive up to \$665.0 million in substantive milestone payments across multiple indications upon the achievement of pre-specified events, including up to \$150.0 million for the achievement of development milestones, up to \$365.0 million for the achievement of regulatory milestones and up to \$150.0 million for the achievement of commercialization milestones. In 2012, we recognized a \$50.0 million development milestone under this agreement for the achievement of a predefined milestone for the initiation of the rheumatoid arthritis Phase III program for baricitinib. In 2010,

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we recognized and received a \$30.0 million development milestone payment based upon the initial three month data in the Phase IIa clinical trial of baricitinib for the treatment of rheumatoid arthritis and a \$19.0 million development milestone payment for the Phase IIb clinical trial initiation of baricitinib for the treatment of rheumatoid arthritis. We determined the 2012 and 2010 milestones to be substantive as their achievement required substantive efforts by us and was at risk until the milestones were ultimately achieved. We also could receive tiered, double-digit royalty payments on future global net sales with rates ranging up to 20% if the product is successfully commercialized.

We retained options to co-develop our JAK inhibitors with Lilly on a compound-by-compound and indication-by-indication basis. Lilly will be responsible for all costs relating to the development and commercialization of the compounds unless we elect to co-develop any compounds or indications. If we elect to co-develop any compounds and/or indications, we would be responsible for funding 30% of the associated future global development costs from the initiation of a Phase IIb trial through regulatory approval. We would receive an incremental royalty rate increase across all tiers resulting in effective royalty rates ranging up to the high twenties on potential future global net sales for compounds and/or indications that we elect to co-develop. We also retained an option to co-promote products in the United States. In July 2010, we elected to co-develop baricitinib with Lilly in rheumatoid arthritis and we are responsible for funding 30% of the associated future global development costs for this indication from the initiation of the Phase IIb

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trial through regulatory approval. We have retained certain mechanisms to give us cost protection as baricitinib advances in clinical development. We can defer our portion of co-development study costs by indication if they exceed a predetermined level. This deferment would be credited against future milestones or royalties and we would still be eligible for the full incremental royalties related to the co-development option. In addition, even if we have started co-development funding for any indication, we can at any time opt out and stop future co-development cost sharing. If we elect to do this we would still be eligible for our base royalties plus an incremental pro-rated royalty commensurate with our contribution to the total co-development cost for those indications for which we co-funded. The Lilly agreement will continue until Lilly no longer has any royalty payment obligations or, if earlier, the termination of the agreement in accordance with its terms. Royalties are payable by Lilly on a product-by-product and country-by-country basis until the latest to occur of (1) the expiration of the last valid claim of the licensed patent rights covering the licensed product in the relevant country, (2) the expiration of regulatory exclusivity for the licensed product in such country and (3) a specified period from first commercial sale in such country of the licensed product by Lilly or its affiliates or sublicensees. The agreement may be terminated by Lilly for convenience, and may also be terminated under certain other circumstances, including material breach.

We determined that there were two deliverables under the agreement: (i) the worldwide license and (ii) our obligations in connection with a co-development option. We concluded that these deliverables should be accounted for as a single unit of accounting and the \$90.0 million upfront payment should be recognized on a straight line basis as revenue through December 2016, our estimated performance period under the agreement. Reimbursable costs incurred after the effective date with Lilly will be recorded net against the related research and development expenses.

Contract revenue under the Lilly agreement was \$3.2 million and \$6.4 million for each of the three and six months ended June 30, 2013 and 2012, respectively.

**7. Stock compensation**

We recorded \$9.9 million and \$19.1 million of stock compensation expense on our unaudited condensed consolidated statements of operations for the three and six months ended June 30, 2013, respectively. We recorded \$9.9 million and \$19.8 million of stock compensation expense on our unaudited condensed consolidated statements of operations for the three and six months ended June 30, 2012, respectively.

Stock compensation expense included within our condensed consolidated statements of operations included research and development expense of \$6.7 million, \$13.2 million, \$6.5 million and \$13.2 million for the three and six months ended June 30, 2013 and 2012, respectively. Stock compensation expense included within our condensed consolidated statements of operations also included selling, general and administrative expense of \$3.2 million, \$5.9 million, \$3.4 million and \$6.6 million for the three and six months ended June 30, 2013 and 2012, respectively.

We utilized the Black-Scholes valuation model for estimating the fair value of the stock compensation granted, with the following weighted-average assumptions:

<b>Employee Stock Options</b>		<b>Employee Stock Purchase Plan</b>	
<b>For the</b>	<b>For the</b>	<b>For the</b>	<b>For the</b>
<b>Three</b>	<b>Six</b>	<b>Three</b>	<b>Six</b>

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	Months Ended		Months Ended		Months Ended		Months Ended	
	2013	June 30, 2012	2013	June 30, 2012	2013	June 30, 2012	2013	June 30, 2012
Average risk-free interest rates	0.72%	0.60%	0.57%	0.49%	0.36%	0.33%	0.26%	0.29%
Average expected life (in years)	4.71	4.36	4.25	3.86	0.50	0.50	0.50	0.50
Volatility	47%	52%	47%	58%	45%	45%	43%	49%
Weighted-average fair value (in dollars)	8.91	8.82	7.10	7.82	3.11	3.11	3.33	3.47

The risk-free interest rate is derived from the U.S. Federal Reserve rate in effect at the time of grant. The expected life calculation is based on the observed and expected time to the exercise of options by our employees based on historical exercise patterns for similar type options. Expected volatility is based on the historical volatility of our common stock over the period commensurate with the expected life of the options. A dividend yield of zero is assumed based on the fact that we have never paid cash dividends and have no present intention to pay cash dividends.



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Based on our historical experience, we have assumed an annualized forfeiture rate of 5% for our options. Under the true-up provisions of the stock based compensation guidance, we will record additional expense if the actual forfeiture rate is lower than we estimated, and will record a recovery of prior expense if the actual forfeiture is higher than we estimated.

Total compensation cost of options granted but not yet vested, as of June 30, 2013, was \$34.0 million, which is expected to be recognized over the vesting period of 3 years.

The following table summarizes activity under all stock option plans:

	Shares Available for Grant	Number Outstanding	Weighted Average Exercise Price per Share
Balance at December 31, 2012	5,406,277	21,816,611	\$ 12.05
Additional authorized	5,200,000		
Options granted	(4,973,500)	4,973,500	18.65
Options exercised		(2,833,583)	8.70
Options cancelled	257,756	(258,040)	17.25
Balance at June 30, 2013	5,890,533	23,698,488	\$ 13.78
Exercisable, June 30, 2013		14,837,911	\$ 11.25

## 8. Debt

The carrying amount and fair value of our convertible notes are as follows (in thousands):

	June 30, 2013		December 31, 2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Pfizer convertible subordinated note due 2014	\$ 9,287	\$ 17,379	\$ 9,033	\$ 13,573
4.75% convertible senior notes due 2015	214,530	643,152	322,043	798,040
	\$ 223,817	\$ 660,531	\$ 331,076	\$ 811,613

In May and June 2013, we entered into separately negotiated agreements with certain holders of our 4.75% Convertible Senior Notes due 2015 (the 4.75% Senior Notes) pursuant to which such holders agreed to exchange \$143,701,000 in aggregate principal amount of 4.75% Senior Notes for the shares of our common stock into which such 4.75% Senior Notes were convertible, aggregating 16,376,175 shares, and \$9.8 million in cash. The net carrying value of the converted 4.75% Senior Notes and related accrued interest was reclassified to additional paid in capital on the condensed consolidated balance sheets upon conversion of the 4.75% Senior Notes and the related cash payment was recorded as debt exchange expense on the condensed consolidated statements of operations.

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The fair values of the 4.75% Senior Notes are based on quoted prices in an active market and, therefore, these convertible senior notes are classified within Level 1 in the fair value hierarchy. The fair value of the convertible subordinated note issued to Pfizer (the Pfizer Note ) is based on a fair value model that incorporates both observable and unobservable inputs, including the quoted price of our common stock and an estimated discount rate, and, therefore, the Pfizer Note is classified as Level 3 in the fair value hierarchy.

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Net income (loss) per share was calculated as follows for the periods indicated:

(in thousands, except per share data)	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
<b>Basic Net Income (Loss) Per Share</b>				
Net income (loss)	\$ (2,571)	\$ 4,037	\$ (18,240)	\$ (41,389)
Weighted average common shares outstanding	142,284	129,224	138,315	128,214
Basic net income (loss) per share	\$ (0.02)	\$ 0.03	\$ (0.13)	\$ (0.32)
<b>Diluted Net Income (Loss) Per Share</b>				
Diluted net income (loss)	\$ (2,571)	\$ 4,037	\$ (18,240)	\$ (41,389)
Common shares outstanding (weighted average)	142,284	129,224	138,315	128,214
Dilutive stock options		8,745		
Weighted average shares used to compute diluted net income (loss) per share	142,284	137,969	138,315	128,214
Diluted net income (loss) per share	\$ (0.02)	\$ 0.03	\$ (0.13)	\$ (0.32)

The following potential common shares were excluded from the calculations as their effect would be anti-dilutive:

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Stock options	23,698,488	5,200,264	23,698,488	23,274,688
Common shares issuable upon conversion of 4.75% Senior Notes(1)	29,207,639	45,584,040	29,207,639	45,584,040
Common shares issuable upon conversion of Pfizer Note due 2013(2)		1,461,496		1,461,496
Common shares issuable upon conversion of Pfizer Note due 2014	1,025,641	1,025,641	1,025,641	1,025,641
Total potential common shares excluded from diluted net loss per share computation	53,931,768	53,271,441	53,931,768	71,345,865

(1) In May and June 2013, we entered into separately negotiated agreements with certain holders of the 4.75% Senior Notes to convert \$143.7 million principal amount into 16,376,175 shares of common stock.

(2) In December 2012, the holder of the Pfizer Note due 2013 elected to convert all \$10.0 million principal amount into 1,461,496 shares of common stock.



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**10. Grant Agreement**

In April 2013, the Company entered into a grant agreement with the state of Delaware under which the Company is entitled to receive a grant of up to approximately \$11.0 million primarily related to the retention and expansion of its workforce in the state of Delaware. The Company received \$5.0 million of the proceeds for this grant in the three months ended June 30, 2013 and expects to receive the remaining proceeds by the end of 2013. The \$5.0 million of cash received during the three months ended June 30, 2013 was recorded within other liabilities on the condensed consolidated balance sheets and is being recognized ratably within interest and other income, net on the condensed consolidated statements of operations over the estimated performance period of the grant.

**11. Contingencies**

In April 2013, the Company entered into a contingent new 15 year facility lease agreement for approximately 190,000 square feet of laboratory and office space in Wilmington, Delaware. The lease agreement is conditioned on a number of contingencies that must be resolved prior to the lease agreement becoming effective, including the landlord's ability to design the build-out of the facility based on a targeted construction budget and the landlord's ability to secure funding for its obligations in connection with the build-out of the facility. Should the lease agreement become effective, the Company expects the facility to be available for occupancy in 2014.

In March and April 2013, two lawsuits were filed in the United States District Court for the District of Delaware against the Company, its chief executive officer, its former chief commercial officer, and its chief drug development and medical officer. The complaints each allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 on behalf of a purported class of purchasers of the Company's stock between April 26, 2012 and August 1, 2012. In general, the complaints allege that the defendants issued materially false or misleading statements concerning the Company's business and prospects relating to the commercial launch of JAKAFI. The complaints seek damages in an unspecified amount, equitable relief of an unspecified nature, and costs and expenses of litigation. The Company believes it has meritorious defenses and intends to vigorously defend itself against these lawsuits. The Company is unable to estimate the possible loss or range of loss, if any, at this time.

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

*The following discussion of our financial condition and results of operations as of and for the three and six months ended June 30, 2013 should be read in conjunction with the financial statements and notes to those statements included elsewhere in this Quarterly Report on Form 10-Q and our audited financial statements as of and for the year ended December 31, 2012 included in our Annual Report on Form 10-K previously filed with the SEC.*

*This report contains forward-looking statements that involve risks and uncertainties. These statements relate to future periods, future events or our future operating or financial plans or performance. Often, these statements include the words believe, expect, target, anticipate, intend, plan, seek, estimate, potential, or words of similar meaning, or future or conditional verbs such as will, would, should, could, might, or may, or the negative of these terms, and other similar expressions. These forward-looking statements include statements as to:*

- *the discovery, development, formulation, manufacturing and commercialization of our compounds, our drug candidates and JAKAFI®/JAKAVI® (ruxolitinib);*
- *conducting clinical trials internally, with collaborators, or with clinical research organizations;*
- *our collaboration and strategic relationship strategy; anticipated benefits and disadvantages of entering into collaboration agreements;*
- *our licensing, investment and commercialization strategies, including our plans to commercialize JAKAFI;*
- *the regulatory approval process, including obtaining U.S. Food and Drug Administration and other international health authorities approval for our products in the United States and abroad;*
- *the safety, effectiveness and potential benefits and indications of our drug candidates and other compounds under development;*
- *the timing and size of our clinical trials; the compounds expected to enter clinical trials; timing of clinical trial results;*

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- *our ability to manage expansion of our drug discovery and development operations;*
- *future required expertise relating to clinical trials, manufacturing, sales and marketing;*
- *obtaining and terminating licenses to products, compounds or technology, or other intellectual property rights;*
- *the receipt from or payments pursuant to collaboration or license agreements resulting from milestones or royalties;*
- *plans to develop and commercialize products on our own;*
- *plans to use third party manufacturers;*
- *expected expenses and expenditure levels; expected uses of cash; expected revenues and sources of revenues;*
- *expected losses; fluctuation of losses;*
- *our profitability; the adequacy of our capital resources to continue operations;*
- *the need to raise additional capital;*
- *the costs associated with resolving matters in litigation;*
- *our expectations regarding competition;*
- *our investments, including anticipated expenditures, losses and expenses;*





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- *our patent prosecution and maintenance efforts; and*
- *our indebtedness, and debt service obligations.*

*These forward-looking statements reflect our current views with respect to future events, are based on assumptions and are subject to risks and uncertainties. These risks and uncertainties could cause actual results to differ materially from those projected and include, but are not limited to:*

- *our ability to successfully commercialize JAKAFI;*
- *our ability to maintain at anticipated levels, reimbursement for JAKAFI from government health administration authorities, private health insurers and other organizations;*
- *our ability to establish and maintain effective sales, marketing and distribution capabilities;*
- *the risk of reliance on other parties to manufacture JAKAFI, which could result in a short supply of JAKAFI, increased costs, and withdrawal of regulatory approval;*
- *our ability to maintain regulatory approvals to market JAKAFI;*
- *our ability to achieve a significant market share in order to achieve or maintain profitability;*
- *the risk of civil or criminal penalties if we market JAKAFI in a manner that violates health care fraud and abuse and other applicable laws, rules and regulations;*
- *our ability to discover, develop, formulate, manufacture and commercialize our other drug candidates;*

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- *the risk of unanticipated delays in research and development efforts;*
- *the risk that previous preclinical testing or clinical trial results are not necessarily indicative of future clinical trial results;*
- *risks relating to the conduct of our clinical trials;*
- *changing regulatory requirements;*
- *the risk of adverse safety findings;*
- *the risk that results of our clinical trials do not support submission of a marketing approval application for our drug candidates;*
- *the risk of significant delays or costs in obtaining regulatory approvals;*
- *risks relating to our reliance on third party manufacturers, collaborators, and clinical research organizations;*
- *risks relating to the development of new products and their use by us and our current and potential collaborators;*
- *risks relating to our inability to control the development of out-licensed drug compounds or drug candidates;*
- *risks relating to our collaborators' ability to develop and commercialize product candidates;*
- *costs associated with prosecuting, maintaining, defending and enforcing patent claims and other intellectual property rights;*
- *our ability to maintain or obtain adequate product liability and other insurance coverage;*



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- *the risk that our drug candidates may not obtain or maintain regulatory approval;*
- *the impact of technological advances and competition;*
- *the ability to compete against third parties with greater resources than ours;*
- *risks relating to changes in pricing and reimbursements in the markets in which we may compete;*
- *competition to develop and commercialize similar drug products;*
- *our ability to obtain patent protection and freedom to operate for our discoveries and to continue to be effective in expanding our patent coverage;*
- *the impact of changing laws on our patent portfolio;*
- *developments in and expenses relating to litigation;*
- *our ability to in-license compounds or drug candidates or other technology;*
- *our substantial leverage and limitations on our ability to incur additional indebtedness and incur liens on our assets imposed by our debt obligations;*
- *our ability to obtain additional capital when needed;*
- *fluctuations in net cash provided and used by operating, financing and investing activities;*

- *our history of operating losses; and*
- *the risks set forth under Risk Factors.*

*Given these risks and uncertainties, you should not place undue reliance on these forward-looking statements. Except as required by federal securities laws, we undertake no obligation to update any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.*

*In this report all references to Incyte, we, us, our or the Company mean Incyte Corporation and our subsidiaries, except where it is made clear that the term means only the parent company.*

*Incyte and JAKAFI are our registered trademarks. We also refer to trademarks of other corporations and organizations in this Quarterly Report on Form 10-Q.*

## **Overview**

Incyte is a biopharmaceutical company focused on the discovery, development and commercialization of proprietary small molecule drugs to treat serious unmet medical needs. We began our drug discovery and development operations in 2001 and have focused our research efforts primarily in the areas of oncology and inflammation where we believe our expertise in medicinal chemistry, target selection, and preclinical and clinical development can be most effectively leveraged.

In 2003, we initiated a research and development program to explore the inhibition of enzymes called janus associated kinases (JAK). The JAK family is composed of four tyrosine kinases JAK1, JAK2, JAK3 and Tyk2 that are involved in the signaling of a number of cytokines and growth factors. JAKs are central to a number of biologic processes, including the formation and development of blood cells and the regulation of immune functions. Dysregulation of the JAK-STAT signaling pathway has been associated with a number of diseases, including myeloproliferative neoplasms, other hematological malignancies, solid tumors, rheumatoid arthritis, psoriasis and other chronic inflammatory diseases. Myeloproliferative neoplasms are a closely related group of blood diseases in which blood cells, specifically platelets, white blood cells, and red blood cells, grow or act abnormally in the bone marrow. These diseases include myelofibrosis, polycythemia vera and essential thrombocythemia.

We have discovered multiple potent, selective and orally bioavailable JAK inhibitors that are selective for JAK 1 or JAK1 and JAK2. Our most advanced compound, JAKAFI® (ruxolitinib), an oral JAK inhibitor, was synthesized in 2005, and in November 2011, it was

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approved by the U.S. Food and Drug Administration (FDA) as a treatment for patients with intermediate or high-risk myelofibrosis (MF), including primary MF, post-polycythemia vera MF and post-essential thrombocythemia MF.

JAKAFI was the first FDA-approved JAK inhibitor for any indication and the first product approved for use in MF. The FDA has also granted JAKAFI orphan drug status for MF as well as polycythemia vera and essential thrombocythemia. The European Commission has also granted the compound orphan drug status for MF. In addition, we hold patents that cover the formulation and use of JAKAFI through 2026, excluding potential patent term extensions.

JAKAFI is sold outside of the United States by Novartis International Pharmaceutical Ltd. under the name JAKAVI® (ruxolitinib). Novartis received exclusive development and commercialization rights to ruxolitinib outside of the United States for all hematologic and oncologic indications, including hematological malignancies, solid tumors and myeloproliferative neoplasms. Pursuant to the terms of the collaboration agreement with Novartis, we retained all development and commercialization rights to JAKAFI in the United States and are eligible to receive development milestones and royalties from product sales outside the United States. In August 2012, the European Commission approved JAKAVI for the treatment of disease-related splenomegaly or symptoms in adult patients with primary MF (also known as chronic idiopathic MF), post-polycythemia vera MF or post-essential thrombocythemia MF.

Following the FDA approval of JAKAFI as a treatment for patients with intermediate or high-risk MF in November 2011, we began its commercialization in the United States. We estimate there are between 16,000 and 18,500 myelofibrosis patients in the United States. Based on the modern prognostic scoring systems referred to as International Prognostic Scoring System and Dynamic International Prognostic Scoring System, we believe intermediate and high-risk patients represent 80 percent to 90 percent of all MF patients in the United States and encompass patients over the age of 65, or patients who have or have ever had any of the following: anemia, constitutional symptoms, elevated white blood cell or blast counts, or platelet counts less than 100,000 per microliter of blood.

In addition to its development as a treatment for MF, Incyte and Novartis believe ruxolitinib may have potential as a treatment for other cancers. Several additional clinical programs are ongoing, including two global Phase III trials in patients with advanced polycythemia vera, a Phase II trial in patients with pancreatic cancer, and an open-label Phase I trial of ruxolitinib in combination with chemotherapy in patients with advanced solid tumors. Multiple investigator-sponsored trials evaluating ruxolitinib are also ongoing, including a Phase I/II trial in adults with advanced hematologic malignancies (acute myeloid leukemia, acute lymphocytic leukemia, myelodysplastic syndrome and chronic myelogenous leukemia); a Phase I/II trial in patients with relapsed or refractory acute leukemia; a Phase I trial in young patients with chronic myeloproliferative disorders, leukemia, myelodysplastic syndromes or myelodysplastic/myeloproliferative neoplasms; a Phase II trial in patients with lymphoma; and two Phase II trials in patients with breast cancer.

We have a second oral JAK1 and JAK2 inhibitor, baricitinib, which is subject to a collaboration agreement with Eli Lilly and Company in which Lilly received exclusive worldwide development and commercialization rights for the compound for inflammatory and autoimmune diseases. We could receive tiered, double-digit royalty payments on future global sales of products subject to the agreement with rates ranging up to 20% if the products are successfully commercialized. This collaboration also contains an option for us to co-develop compounds for any inflammatory and autoimmune disease, whereby we fund 30% of development costs from Phase IIb through regulatory approval for that indication in exchange for tiered royalties ranging up to the high twenties on potential future sales. We exercised our co-development option for the development of baricitinib in rheumatoid arthritis in 2010. The Phase III program of baricitinib in patients with rheumatoid arthritis is ongoing, and the compound is also in Phase II trials for patients with moderate-to-severe psoriasis and patients with diabetic nephropathy.

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We have a JAK1 inhibitor, INCB39110, which is being evaluated in three proof-of-concept studies in patients with myelofibrosis, psoriasis and rheumatoid arthritis. The results of these studies are expected to inform us as to the most appropriate indications for further development.

We have several other orally available small molecule compounds that are in various stages of development, including a second JAK1 inhibitor, INCB47986, which is in Phase I clinical development. We intend to continue our investment in drug discovery to expand our pipeline.

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Our current pipeline includes the following compounds:

Target/Drug Compound	Indication	Status
<b>JAK1 and JAK2</b>		
JAKAFI(1)	Intermediate or High-Risk Myelofibrosis(6)	FDA Approved Marketed
Ruxolitinib(1)	Polycythemia Vera	Phase III
Ruxolitinib(1)	Pancreatic Cancer	Phase II
Ruxolitinib(1)	Solid Tumors and Other Hematologic Malignancies(7)	Phase I and Phase II
Baricitinib(2)	Rheumatoid Arthritis	Phase III
Baricitinib(3)	Psoriasis	Phase IIb
Baricitinib(4)	Diabetic Nephropathy	Phase II
<b>c-MET</b>		
INCB28060(5)	Solid Tumors	Phase II
<b>IDO</b>		
INCB24360	Solid Tumors	Phase II
<b>JAK1</b>		
INCB39110	Myelofibrosis	Phase II
INCB39110	Rheumatoid Arthritis	Phase II
INCB39110	Psoriasis	Phase II
INCB47986		Phase I

- 
- (1) We licensed rights outside the United States to Novartis and retained U.S. rights.
  
  - (2) We licensed worldwide rights to Lilly, have elected to co-develop with Lilly and retained a co-promotion option.
  
  - (3) We licensed worldwide rights to Lilly and retained a co-promotion option.
  
  - (4) We licensed worldwide rights to Lilly and retained co-development and co-promotion options.
  
  - (5) We licensed worldwide rights to Novartis and retained co-development and co-promotion options.
  
  - (6) Several clinical trials in patients with myelofibrosis are ongoing, including long-term extension studies, joint global trials with Novartis and trials in patients with low platelet counts.
  
  - (7) These studies include investigator-sponsored trials.



The therapeutic and commercial value of new medicines is difficult to predict, and conducting clinical trials for our drug candidates in development is a lengthy, time-consuming and expensive process. Therefore, if we are unable to successfully commercialize JAKAFI or develop and commercialize some of our other drug candidates over the next several years, our business, financial condition and results of operations would be adversely impacted. To date, we have not, and we may never, achieve sustained revenues sufficient to offset expenses. We may incur net losses in future periods, and we may never achieve or maintain profitability. We also expect that our operating results may fluctuate from period to period and that those fluctuations may be substantial.

#### **Critical Accounting Policies and Significant Estimates**

The preparation of financial statements requires us to make estimates, assumptions and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, we evaluate our estimates. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances, the results of which form our 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 those estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our condensed consolidated financial statements:

- Revenue recognition;
  
- Research and development costs;
  
- Stock compensation;

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- Investments; and
- Inventory.

**Revenue Recognition.** Revenues are recognized when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the price is fixed or determinable and (4) collectability is reasonably assured. Revenues are deferred for fees received before earned or until no further obligations exist. We exercise judgment in determining that collectability is reasonably assured or that services have been delivered in accordance with the arrangement. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectability based primarily on the customer's payment history and on the creditworthiness of the customer.

Our product revenues consist of U.S. sales of JAKAFI and are recognized once we meet all four revenue recognition criteria described above. In November 2011, we began shipping JAKAFI to our specialty pharmacy customers, which in turn dispense JAKAFI to patients in fulfillment of prescriptions. From November 2011 to June 2012, as JAKAFI was a new and novel product, the first approved treatment for intermediate or high-risk myelofibrosis, and the first commercial product for Incyte, we determined we could not reasonably assess potential product returns. As a result of our inability to initially estimate product returns, the price of JAKAFI was not deemed fixed or determinable, and we deferred the recognition of revenues on product shipments of JAKAFI until the product was shipped by our specialty pharmacy customers to patients.

Based on our actual experience with product returns through the three months ended September 30, 2012, we had the ability to estimate product returns and the price of JAKAFI is now deemed fixed or determinable. As a result, during the three months ended September 30, 2012, we began to recognize revenue for product sales of JAKAFI at the time the product was received by our specialty pharmacy customers.

We recognize revenues for product received by our specialty pharmacy net of allowances for customer credits, including estimated rebates, chargebacks, discounts, returns, distribution service fees, patient assistance programs, and Medicare Part D coverage gap reimbursements. Product shipping and handling costs are included in cost of product revenues.

**Customer Credits:** Our specialty pharmacy customers are offered various forms of consideration, including allowances, service fees and prompt payment discounts. We expect our specialty pharmacy customers will earn prompt payment discounts and, therefore, we deduct the full amount of these discounts from total product sales when revenues are recognized. Service fees are also deducted from total product sales as they are earned.

**Rebates:** Allowances for rebates include mandated discounts under the Medicaid Drug Rebate Program. Rebate amounts are based upon contractual agreements or legal requirements with public sector (e.g. Medicaid) benefit providers. Rebates are amounts owed after the final dispensing of the product to a benefit plan participant and are based upon contractual agreements or legal requirements with public sector benefit providers. The allowance for rebates is based on statutory discount rates and expected utilization. Our estimates for expected utilization of rebates are based on data received from our specialty pharmacy customers. Rebates are generally invoiced and paid in arrears so that the accrual balance consists of an estimate of the amount expected to be incurred for the current quarter's activity, plus an accrual balance for known prior quarters' unpaid rebates. If actual future rebates vary from estimates, we may need to adjust prior period accruals, which would affect revenue in the period of adjustment.

*Chargebacks:* Chargebacks are discounts that occur when contracted customers purchase directly from a specialty pharmacy, or an intermediary distributor. Contracted customers, which currently consist primarily of Public Health Service institutions, non-profit clinics, and Federal government entities purchasing via the Federal Supply Schedule, generally purchase the product at a discounted price. The specialty pharmacy or distributor, in turn, charges back to us the difference between the price initially paid by the specialty pharmacy or distributor and the discounted price paid to the specialty pharmacy or distributor by the customer. The allowance for chargebacks is based on known sales to contracted customers.

*Medicare Part D Coverage Gap:* Medicare Part D prescription drug benefit mandates manufacturers to fund 50% of the Medicare Part D insurance coverage gap for prescription drugs sold to eligible patients. Our estimates for the expected Medicare Part D coverage gap are based on historical invoices received and in part from data received from our specialty pharmacy customers. Funding of the coverage gap is generally invoiced and paid in arrears so that the accrual balance consists of an estimate of the amount expected to be incurred for the current quarter's activity, plus an accrual balance for known prior quarters. If actual future funding varies from estimates, we may need to adjust prior period accruals, which would affect revenue in the period of adjustment.

*Co-payment assistance:* Patients who have commercial insurance and meet certain eligibility requirements may receive co-payment assistance. We accrue a liability for co-payment assistance based on actual program participation and estimates of program redemption using data provided by third-party administrators.

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Product Royalty Revenues

Royalty revenues on commercial sales for JAKAVI by Novartis are estimated based on information provided by Novartis. We exercise judgment in determining whether the information provided is sufficiently reliable for us to base our royalty revenue recognition thereon. If actual royalties vary from estimates, we may need to adjust prior period which would affect royalty revenue in the period of adjustment.

Contract and License Revenues

Under agreements involving multiple deliverables, services and/or rights to use assets that we entered into prior to January 1, 2011, the multiple elements are divided into separate units of accounting when certain criteria are met, including whether the delivered items have stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered items. When separate units of accounting exist, consideration is allocated among the separate elements based on their respective fair values. The determination of fair value of each element is based on objective evidence from historical sales of the individual elements by us to other customers. If such evidence of fair value for each undelivered element of the arrangement does not exist, all revenue from the arrangement is deferred until such time that evidence of fair value for each undelivered element does exist or until all elements of the arrangement are delivered. When elements are specifically tied to a separate earnings process, revenue is recognized when the specific performance obligation tied to the element is completed. When revenues for an element are not specifically tied to a separate earnings process, they are recognized ratably over the term of the agreement. We assess whether a substantive milestone exists at the inception of our agreements. For all milestones within our arrangements that are considered substantive, we recognize revenue upon the achievement of the associated milestone. If a milestone is not considered substantive, we would recognize the applicable milestone payment over the remaining period of performance under the arrangement. As of June 30, 2013, all remaining potential milestones under our collaborative arrangements are considered substantive.

On January 1, 2011, updated guidance on the recognition of revenues for agreements with multiple deliverables became effective and applies to any agreements we may enter into on or after January 1, 2011. This updated guidance (i) relates to whether multiple deliverables exist, how the deliverables in a revenue arrangement should be separated and how the consideration should be allocated; (ii) requires companies to allocate revenues in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence or third-party evidence of selling price; and (iii) eliminates the use of the residual method and requires companies to allocate revenues using the relative selling price method. During three and six months ended June 30, 2013 and 2012 we did not enter into any agreements that are subject to this updated guidance. If we enter into an agreement with multiple deliverables after January 1, 2011 or amend existing agreements, this updated guidance could have a material effect on our financial statements.

Our collaborations often include contractual milestones, which typically relate to the achievement of pre-specified development, regulatory and commercialization events. These three categories of milestone events reflect the three stages of the life-cycle of our drugs, which we describe in more detail in the following paragraphs.

The regulatory review and approval process, which includes preclinical testing and clinical trials of each drug candidate, is lengthy, expensive and uncertain. Securing approval by the U.S. Food and Drug Administration (FDA) requires the submission of extensive preclinical and clinical data and supporting information to the FDA for each indication to establish a drug candidate's safety and efficacy. The approval process takes many years, requires the expenditure of substantial resources, involves post-marketing surveillance and may involve ongoing requirements for post-marketing studies. Before commencing clinical investigations of a drug candidate in humans, we must submit an Investigational New Drug application (IND), which must be reviewed by the FDA.

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The steps generally required before a drug may be marketed in the United States include preclinical laboratory tests, animal studies and formulation studies, submission to the FDA of an IND for human clinical testing, performance of adequate and well-controlled clinical trials in three phases, as described below, to establish the safety and efficacy of the drug for each indication, submission of a new drug application (NDA) to the FDA for review and FDA approval of the NDA.

Similar requirements exist within foreign regulatory agencies as well. The time required to satisfy the FDA requirements or similar requirements of foreign regulatory agencies may vary substantially based on the type, complexity and novelty of the product or the targeted disease.

Preclinical testing includes laboratory evaluation of product pharmacology, drug metabolism, and toxicity, which includes animal studies, to assess potential safety and efficacy as well as product chemistry, stability, formulation, development, and testing. The results of the preclinical tests, together with manufacturing information and analytical data, are submitted to the FDA as part of an IND. The FDA may raise safety concerns or questions about the conduct of the clinical trials included in the IND, and any of these

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concerns or questions must be resolved before clinical trials can proceed. We cannot be sure that submission of an IND will result in the FDA allowing clinical trials to commence. Clinical trials involve the administration of the investigational drug or the marketed drug to human subjects under the supervision of qualified investigators and in accordance with good clinical practices regulations covering the protection of human subjects. Clinical trials typically are conducted in three sequential phases, but the phases may overlap or be combined. Phase I usually involves the initial introduction of the investigational drug into healthy volunteers to evaluate its safety, dosage tolerance, absorption, metabolism, distribution and excretion. Phase II usually involves clinical trials in a limited patient population to evaluate dosage tolerance and optimal dosage, identify possible adverse effects and safety risks, and evaluate and gain preliminary evidence of the efficacy of the drug for specific indications. Phase III clinical trials usually further evaluate clinical efficacy and safety by testing the drug in its final form in an expanded patient population, providing statistical evidence of efficacy and safety, and providing an adequate basis for labeling. We cannot guarantee that Phase I, Phase II or Phase III testing will be completed successfully within any specified period of time, if at all. Furthermore, we, the institutional review board for a trial, or the FDA may suspend clinical trials at any time on various grounds, including a finding that the subjects or patients are being exposed to an unacceptable health risk.

Generally, the milestone events contained in our collaboration agreements coincide with the progression of our drugs from development, to regulatory approval and then to commercialization. The process of successfully discovering a new development candidate, having it approved and successfully commercialized is highly uncertain. As such, the milestone payments we may earn from our partners involve a significant degree of risk to achieve. Therefore, as a drug candidate progresses through the stages of its life-cycle, the value of the drug candidate generally increases.

**Research and Development Costs.** Our policy is to expense research and development costs as incurred. We often contract with clinical research organizations (CROs) to facilitate, coordinate and perform agreed upon research and development of a new drug. To ensure that research and development costs are expensed as incurred, we record monthly accruals for clinical trials and preclinical testing costs based on the work performed under the contract.

These CRO contracts typically call for the payment of fees for services at the initiation of the contract and/or upon the achievement of certain clinical trial milestones. In the event that we prepay CRO fees, we record the prepayment as a prepaid asset and amortize the asset into research and development expense over the period of time the contracted research and development services are performed. Most professional fees, including project and clinical management, data management, monitoring, and medical writing fees are incurred throughout the contract period. These professional fees are expensed based on their percentage of completion at a particular date. Our CRO contracts generally include pass through fees. Pass through fees include, but are not limited to, regulatory expenses, investigator fees, travel costs, and other miscellaneous costs, including shipping and printing fees. We expense the costs of pass through fees under our CRO contracts as they are incurred, based on the best information available to us at the time. The estimates of the pass through fees incurred are based on the amount of work completed for the clinical trial and are monitored through correspondence with the CROs, internal reviews and a review of contractual terms. The factors utilized to derive the estimates include the number of patients enrolled, duration of the clinical trial, estimated patient attrition, screening rate and length of the dosing regimen. CRO fees incurred to set up the clinical trial are expensed during the setup period. Reimbursable costs incurred in connection with collaborative license agreements are recorded as a reduction of research and development expenses.

**Stock Compensation.** Share-based payment transactions with employees, including grants of employee stock options, are recognized as compensation expense over the requisite service period based on their estimated fair values. The accounting guidance also requires significant judgment and the use of estimates, particularly surrounding Black-Scholes assumptions such as stock price volatility over the option term and expected option lives, as well as expected option forfeiture rates, to value equity-based compensation and requires the recognition of the fair value of stock compensation in the statement of operations. We recorded \$9.9 million and \$19.1 million of stock compensation expense on our unaudited condensed consolidated statements of operations for the three and six months ended June 30, 2013, respectively. We recorded \$9.9 million and \$19.8 million of stock compensation expense on our unaudited condensed consolidated statements of operations for the three and six months ended June 30, 2012, respectively.



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**Investments.** We carry our investments at their respective fair values. We periodically evaluate the fair values of our investments to determine whether any declines in the fair value of investments represent an other-than-temporary impairment. This evaluation consists of a review of several factors, including the length of time and extent that a security has been in an unrealized loss position, the existence of an event that would impair the issuer's future repayment potential, the near term prospects for recovery of the market value of a security and if we intend to sell or if it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. If management determines that such an impairment exists, we would recognize an impairment charge. Because we may determine that market or business conditions may lead us to sell a short-term investment or marketable security prior to maturity, we classify our short-term investments and marketable securities as available-for-sale. Investments in securities that are classified as available-for-sale and have readily determinable fair values are measured at fair market value in the balance sheets, and unrealized holding gains and losses for these investments are reported as a separate component of stockholders' equity until realized. We classify those marketable securities that may be used in operations within one year as short-term investments. Those marketable securities in which we have both the ability to hold until maturity and have a maturity date beyond one year from our most recent consolidated balance sheet date are classified as long-term marketable securities.

**Inventory.** Inventories are determined at the lower of cost or market value with cost determined under the specific identification method and may consist of raw materials, work in process and finished goods. We began capitalizing inventory in mid-November 2011 once the FDA approved JAKAFI as the related costs were expected to be recoverable through the commercialization of the product. Costs incurred prior to approval of JAKAFI have been recorded as research and development expense in our statements of operations. As a result, inventory balances and cost of product revenue for the next several quarters will reflect a lower average per unit cost of materials.

The raw materials and work-in-process inventory is not subject to expiration and the shelf life for finished goods inventory is 24 or 36 months from the start of manufacturing of the finished goods. We evaluate for potential excess inventory by analyzing current and future product demand relative to the remaining product shelf life. We build demand forecasts by considering factors such as, but not limited to, overall market potential, market share, market acceptance and patient usage. We classify inventory as current on the consolidated balance sheets when we expect inventory to be consumed for commercial use within the next twelve months.

**Results of Operations**

We recorded net loss of \$2.6 million, or \$0.02 per share (basic and diluted), for the three months ended June 30, 2013, as compared to net income of \$4.0 million, or \$0.03 per share (basic and diluted), for the same period in 2012. The net loss for the six months ended June 30, 2013 was \$18.2 million, or \$0.13 per share (basic and diluted), as compared to \$41.4 million, or \$0.32 per share (basic and diluted), for the same period in 2012.

**Revenues.**

	For the three months ended,			For the six months ended,				
	2013	June 30, (in millions)	2012	2013	June 30, (in millions)	2012		
Product revenues, net	\$	54.1	\$	29.7	\$	102.4	\$	49.0
Product royalty revenues		5.8				11.7		
Contract revenues		41.7		56.7		58.5		73.5
Other revenues		0.1		0.1		0.2		0.2



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Total revenues	\$	101.7	\$	86.5	\$	172.8	\$	122.7
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Our product revenues, net from JAKAFI for the three and six months ended June 30, 2013, were \$54.1 million and \$102.4 million, respectively. Our product revenues, net from JAKAFI for the three and six months ended June 30, 2012, were \$29.7 million and \$49.0 million, respectively. Product revenues from the sale of JAKAFI are recorded net of estimated product returns, pricing discounts including rebates offered pursuant to mandatory federal and state government programs and chargebacks, prompt pay discounts and distribution fees and co-pay assistance. Our revenue recognition policies require estimates of the aforementioned sales allowances each period.

Prior to the three months ended September 30, 2012, we used the sell-through method for revenue recognition as we had limited historical data on product returns. Under the sell-through method, we deferred revenue until the patients received JAKAFI. In the three months ended September 30, 2012, we determined that we had sufficient experience with product returns and transitioned to the sell-in method for recognizing revenue, under which we recognize revenue for product sales of JAKAFI at the time the product is received by our specialty pharmacy customers.

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The following table provides a summary of activity with respect to the Company's sales allowances and accruals for the six months ended June 30, 2013 (in thousands):

Six Months Ended June 30, 2013	Discounts and Distribution Fees	Government Rebates and Chargebacks	Co-Pay Assistance and Other Discounts	Product Returns	Total
Balance at January 1, 2013	\$ 464	\$ 1,815	\$ 103	\$ 256	\$ 2,638
Allowances for current period sales	2,992	7,366	372	12	10,742
Allowances for prior period sales		(526)	(4)	(149)	(679)
Credits/payments for current period sales	(2,650)	(4,579)	(308)	(4)	(7,541)
Credits/payments for prior period sales	(99)	(1,219)	(66)	(31)	(1,415)
Balance at June 30, 2013	\$ 707	\$ 2,857	\$ 97	\$ 84	\$ 3,745

Product royalty revenues on commercial sales of JAKAVI by Novartis are based on estimated net sales of licensed products in licensed territories as provided by Novartis. Our net product royalty revenues for the three and six months ended June 30, 2013, were \$5.8 million and \$11.7 million, respectively. Our net product royalty revenues for the three and six months ended June 30, 2012, were \$0.0 million.

Our contract revenues were \$41.7 million and \$58.5 million for the three and six months ended June 30, 2013, respectively. For the three and six months ended June 30, 2013 contract revenues included a \$25.0 million milestone payment from Novartis for INCB28060. Our contract revenues were \$56.7 million and \$73.5 million for the three and six months ended June 30, 2012, respectively. For the three and six months ended June 30, 2012 contract revenues included a \$40.0 million milestone payment from Novartis related to European Union regulatory approval of JAKAVI.

Contract revenues were also derived from the straight line recognition of revenue associated with the Novartis and Lilly upfront fees over the estimated performance periods as well as milestone payments earned during the periods. The upfront fees related to the Novartis agreement included a \$150.0 million upfront payment received in 2009, a \$60.0 million immediate milestone payment received in 2010 and \$10.9 million of reimbursable costs incurred prior to the effective date of the agreement. The upfront fees related to the Lilly agreement consisted of a \$90.0 million upfront payment received in 2010.

**Cost of Product Revenues**

We began capitalizing inventory in mid-November 2011 once the FDA approved JAKAVI as the related costs were expected to be recoverable through the commercialization of the product. Costs incurred prior to FDA approval have been recorded as research and development expenses in our statement of operations. As a result, cost of product revenues for the next several quarters will reflect a lower average per unit cost of materials. Cost of product revenues was \$0.2 million and \$0.3 million for the three and six months ended June 30, 2013, respectively. Cost of product revenues were de minimis for each of the three and six months ended June 30, 2012.

**Operating Expenses.**

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*Research and development expenses.*

	For the three months ended,			For the six months ended,				
	2013	June 30, (in millions)	2012	2013	June 30, (in millions)	2012		
Salary and benefits related	\$	16.8	\$	15.1	\$	33.9	\$	30.9
Stock compensation		6.7		6.5		13.2		13.2
Clinical research and outside services		30.2		24.3		53.0		44.2
Occupancy and all other costs		7.2		5.7		13.6		12.2
Total research and development expenses	\$	60.9	\$	51.6	\$	113.7	\$	100.5

We currently track research and development costs by natural expense line and not costs by project. Salary and benefits related expense increased from the three and six months ended June 30, 2012 to the three and six months ended June 30, 2013 due to increased development headcount to sustain our development pipeline. Stock compensation expense may fluctuate from period to period based on the number of options granted, stock price volatility and expected option lives, as well as expected option forfeiture rates which are used to value equity-based compensation. The increase in clinical research and outside services expense from the three

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and six months ended June 30, 2012 to the three and six months ended June 30, 2013 was primarily the result of increased development costs. Research and development expenses for the three and six months ended June 30, 2013 and 2012 were net of \$1.0 million, \$1.9 million, \$0.5 million and \$0.5 million, respectively, of costs reimbursed by our collaborative partners. Research and development expenses may fluctuate from period to period depending upon the stage of certain projects and the level of pre-clinical and clinical trial related activities. Many factors can affect the cost and timing of our clinical trials, including requests by regulatory agencies for more information, inconclusive results requiring additional clinical trials, slow patient enrollment, adverse side effects among patients, insufficient supplies for our clinical trials and real or perceived lack of effectiveness or safety of our investigational drugs in our clinical trials. In addition, the development of all of our products will be subject to extensive governmental regulation. These factors make it difficult for us to predict the timing and costs of the further development and approval of our products.

In July 2010, we elected to co-develop baricitinib with Lilly in rheumatoid arthritis and we are responsible for funding 30% of the associated future global development costs for this indication from the initiation of the Phase IIB trial through regulatory approval. We have retained certain mechanisms to give us cost protection as baricitinib advances in clinical development. We can defer our portion of co-development study costs by indication if they exceed a predetermined level. This deferment would be credited against future milestones or royalties and we would still be eligible for the full incremental royalties related to the co-development option. In addition, even if we have started co-development funding for any indication, we can at any time opt out, which will stop future co-development cost sharing. If we elect to do this we would still be eligible for our base royalties plus an incremental pro-rated royalty commensurate with our contribution to the total co-development cost for those indications for which we contributed funding.

*Selling, general and administrative expenses.*

	For the three months ended,			For the six months ended,				
	2013	June 30, (in millions)	2012	2013	June 30, (in millions)	2012		
Salary and benefits related	\$	7.8	\$	7.5	\$	16.1	\$	15.1
Stock compensation		3.2		3.4		5.9		6.6
Other contract service and outside costs		12.2		8.8		23.5		19.4
<b>Total selling, general and administrative expenses</b>	<b>\$</b>	<b>23.2</b>	<b>\$</b>	<b>19.7</b>	<b>\$</b>	<b>45.5</b>	<b>\$</b>	<b>41.1</b>

Salary and benefits related expense increased from the three and six months ended June 30, 2012 to the three and six months ended June 30, 2013 due to increased headcount. This increased headcount was due to the commercialization efforts related to JAKAFI for intermediate or high-risk myelofibrosis. Stock compensation expense may fluctuate from period to period based on the number of options granted, stock price volatility and expected option lives, as well as expected option forfeiture rates which are used to value equity-based compensation. The increase in other contract services and outside costs was primarily the result of marketing activities for JAKAFI for intermediate or high-risk myelofibrosis.

**Interest Expense.** Interest expense for the three and six months ended June 30, 2013, was \$10.3 million and \$22.0 million, respectively, as compared to \$11.4 million and \$22.7 million, respectively, for the comparable periods in 2012. Also included in interest expense for the three and six months ended June 30, 2013, were \$6.2 million and \$13.2 million, respectively, of non-cash charges to amortize the discount on our 4.75% convertible senior notes due 2015, as compared to \$6.7 million and \$13.2 million, respectively, for the same periods in 2012.

**Debt exchange expense.** Debt exchange expense for the quarter and six months ended June 30, 2013, was \$9.8 million related to the exchange of \$143.7 million aggregate principal amount of our 4.75% convertible senior notes due 2015 for the underlying shares of common stock and cash.

### **Liquidity and Capital Resources**

We had net losses from inception in 1991 through 1996 and in 1999 through June 30, 2013. Because of those losses, we had an accumulated deficit of \$1.7 billion as of June 30, 2013. We have funded our research and development operations through sales of equity securities, the issuance of convertible notes, cash received from customers, and collaborative arrangements. At June 30, 2013, we had available cash, cash equivalents, a certificate of deposit and marketable securities of \$277.5 million. Our cash and marketable securities balances are held in a variety of interest-bearing instruments, including money market accounts, U.S. government agency and non-agency mortgage-backed securities, and a certificate of deposit. Available cash is invested in accordance with our investment policy's primary objectives of liquidity, safety of principal and diversity of investments.

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Net cash provided by operating activities was \$32.8 million for the six months ended June 30, 2013, compared to \$45.7 million used in operating activities for the three months ended June 30, 2012. The \$78.5 million increase was due primarily to our lower net loss and changes in accounts receivable.

Our investing activities, other than purchases, sales and maturities of marketable securities, have consisted predominantly of capital expenditures. Net cash used in investing activities was \$16.5 million for the six months ended June 30, 2013, which represented a certificate of deposit purchase of \$15.0 million and capital expenditures of \$1.5 million. Net cash used in investing activities was \$1.2 million for the six months ended June 30, 2012, which represented primarily sales and maturities of marketable securities of \$0.3 million offset by capital expenditures of \$1.5 million. In the future, net cash used by investing activities may fluctuate significantly from period to period due to the timing of capital expenditures, maturities/sales and purchases of marketable securities and acquisitions.

Net cash provided by financing activities was \$17.8 million for the six months ended June 30, 2013 representing \$27.6 million of proceeds from the issuance of common stock under our stock plans and employee stock purchase plan offset by \$9.8 million related to the conversion of \$143.7 million aggregate principal amount of our 4.75% convertible senior notes due 2015. Net cash provided by financing activities was \$31.3 million for the six months ended June 30, 2012 representing proceeds from the issuance of common stock under our stock plans.

The following summarizes our significant contractual obligations as of June 30, 2013 and the effect those obligations are expected to have on our liquidity and cash flow in future periods (in millions):

	Total	Less Than 1 Year	Years 1 - 3	Years 4 - 5	Over 5 Years
<b>Contractual Obligations:</b>					
Principal on convertible subordinated debt	\$ 10.0	\$ 10.0	\$	\$	\$
Principal on convertible senior debt	256.3		256.3		
Interest on convertible senior debt	30.4	12.1	18.3		
<b>Non-cancelable operating lease obligations:</b>					
Related to corporate headquarters	3.8	3.8			
<b>Total contractual obligations</b>	<b>\$ 300.5</b>	<b>\$ 25.9</b>	<b>\$ 274.6</b>	<b>\$</b>	<b>\$</b>

The table above excludes certain commitments that are contingent upon future events. The most significant of these contractual commitments that we consider to be contingent obligations are summarized below.

In April 2013, the Company entered into a new facility lease agreement for approximately 190,000 square feet of laboratory and office space in Wilmington, Delaware. The lease agreement is contingent on the landlord's ability to design the build-out of the facility based on a targeted construction budget and the landlord's ability to secure funding for its obligations in connection with the build-out of the facility.

We have entered into and may in the future seek to license additional rights relating to technologies or drug development candidates in connection with our drug discovery and development programs. Under these licenses, we may be required to pay up-front fees, milestone payments, and royalties on sales of future products.

We believe that our cash, cash equivalents and marketable securities will be adequate to satisfy our capital needs for at least the next twelve months. Our cash requirements depend on numerous factors, including our expenditures in connection with our drug discovery and development programs and commercialization operations; expenditures in connection with litigation or other legal proceedings; competing technological and market developments; the cost of filing, prosecuting, defending and enforcing patent claims and other intellectual property rights; our receipt of any milestone or other payments under any collaborative agreements we may enter into, including the agreements with Novartis, Lilly and Pfizer; the extent to which commercialization of JAKAFI is successful; and expenditures in connection with strategic relationships and license agreements. Changes in our research and development or commercialization plans or other changes affecting our operating expenses may result in changes in the timing and amount of expenditures of our capital resources.

Until we can generate a sufficient amount of product revenues to finance our cash requirements, which we may never do, we expect to finance future cash needs primarily through public or private equity offerings, debt financings, borrowings or strategic collaborations. The sale of equity or additional convertible debt securities in the future may be dilutive to our stockholders, and may provide for rights, preferences or privileges senior to those of our holders of common stock. Debt financing arrangements may require us to pledge certain assets or enter into covenants that could restrict our operations or our ability to incur further indebtedness. The

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indenture under which our 4.75% convertible senior notes due 2015 are issued contains a covenant that, among other things, limits our ability and the ability of any of our subsidiaries to incur additional indebtedness, create liens, or sell, lease, license, transfer or otherwise dispose of certain of our or their assets. We do not know whether additional funding will be available on acceptable terms, if at all. If we are not able to secure additional funding when needed, we may have to scale back our operations, delay or eliminate one or more of our research or development programs, or attempt to obtain funds by entering into an agreement with a collaborator or licensee that would result in terms that are not favorable to us or relinquishing our rights in certain of our proprietary technologies or drug candidates.

**Off Balance Sheet Arrangements**

We have no off-balance sheet arrangements other than those that are discussed above.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Our investments in marketable securities, which are composed primarily of U.S. government agency and non-agency mortgage-backed securities and money market funds, are subject to default, changes in credit rating and changes in market value. These investments are also subject to interest rate risk and will decrease in value if market rate interest rates increase. As of June 30, 2013, cash, cash equivalents and marketable securities were \$277.5 million. Due to the nature of these investments, if market interest rates were to increase immediately and uniformly by 10% from levels as of June 30, 2013, the decline in fair value would not be material.

**Item 4. Controls and Procedures**

*Evaluation of disclosure controls and procedures.* We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.



*Changes in internal control over financial reporting.* There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) for the three months ended June 30, 2013, that materially affected or are reasonably likely to materially affect our internal control over financial reporting.

**PART II: OTHER INFORMATION**

**Item 1. Legal Proceedings**

In March and April 2013, two lawsuits were filed in the United States District Court for the District of Delaware against the Company, its chief executive officer, its former chief commercial officer, and its chief drug development and medical officer. The complaints each allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 on behalf of a purported class of purchasers of the Company's stock between April 26, 2012 and August 1, 2012. In general, the complaints allege that the defendants issued materially false or misleading statements concerning the Company's business and prospects relating to the commercial launch of JAKAFI. The complaints seek damages in an unspecified amount, equitable relief of an unspecified nature, and costs and expenses of litigation. The Company believes it has meritorious defenses and intends to vigorously defend itself against these lawsuits.

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**Item 1A. Risk Factors**

**RISKS RELATING TO OUR LEAD PRODUCT JAKAFI**

*We depend heavily on our lead product, JAKAFI (ruxolitinib), which is marketed as JAKAVI outside the United States. If we are unable to successfully commercialize JAKAFI in its approved indication or to successfully obtain regulatory approval for and commercialize ruxolitinib for the treatment of additional indications, or if we are significantly delayed or limited in doing so, our business may be materially harmed.*

In November 2011, we received approval from the U.S. Food and Drug Administration, or FDA, to market JAKAFI in the United States for the treatment of intermediate or high-risk myelofibrosis. JAKAFI is our first product to be approved for sale in the United States. Although we have received this regulatory approval, such approval does not guarantee future revenues. The commercial success of JAKAFI and our ability to generate and maintain revenues from the sale of JAKAFI will depend on a number of factors, including:

- the number of patients with intermediate or high-risk myelofibrosis who are diagnosed with the disease and the number of such patients that may be treated with JAKAFI;
- the acceptance of JAKAFI by patients and the healthcare community;
- whether physicians, patients and healthcare payors view JAKAFI as therapeutically effective and safe relative to cost and any alternative therapies;
- the ability to obtain and maintain sufficient coverage or reimbursement by third-party payors;
- the ability of our third-party manufacturers to manufacture JAKAFI in sufficient quantities with acceptable quality;
- the ability of our company and our third-party providers to provide marketing and distribution support for JAKAFI;
- the label and promotional claims allowed by the FDA;

- the maintenance of regulatory approval for the treatment of intermediate or high-risk myelofibrosis in the United States; and
- our ability to develop, obtain regulatory approval for and commercialize ruxolitinib in the United States for additional indications.

If we are not successful in commercializing JAKAFI in the United States, or are significantly delayed or limited in doing so, our business may be materially harmed and we may need to delay other drug discovery and development initiatives or even significantly curtail operations.

In addition, our receipt of royalties under our collaboration agreement with Novartis for sales of JAKAVI outside the United States will depend on factors similar to those listed above for jurisdictions outside the United States.

***If we are unable to obtain, or maintain at anticipated levels, reimbursement for JAKAFI from government health administration authorities, private health insurers and other organizations, our pricing may be affected or our product sales, results of operations or financial condition could be harmed.***

We may not be able to sell JAKAFI on a profitable basis or our profitability may be reduced if we are required to sell JAKAFI at lower than anticipated prices or reimbursement is unavailable or limited in scope or amount. JAKAFI is expensive and almost all patients will require some form of third party coverage to afford its cost. Our future revenues and profitability will be adversely affected if we cannot depend on government and other third-party payors to defray the cost of JAKAFI to the patient. In the United States, there have been, and we expect there will continue to be, efforts to control and reduce healthcare costs. Government and other third-party payors are challenging the prices charged for healthcare products and increasingly limiting and attempting to limit both coverage and level of reimbursement for prescription drugs. If these entities refuse to provide coverage and reimbursement with respect to JAKAFI, determine to provide a lower level of coverage and reimbursement than anticipated, or reduce previously approved levels of coverage and reimbursement, then our pricing or reimbursement for JAKAFI may be affected and our product sales, results of operations or financial condition could be harmed.

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***We depend upon a limited number of specialty pharmacies for a significant portion of any revenues from JAKAFI, and the loss of, or significant reduction in sales to, any one of these specialty pharmacies could adversely affect our operations and financial condition.***

We sell JAKAFI primarily to specialty pharmacies, which in turn dispense JAKAFI to patients in fulfillment of prescriptions. We do not promote JAKAFI to specialty pharmacies, and specialty pharmacies will not set or determine demand for JAKAFI. Our ability to successfully commercialize JAKAFI will depend, in part, on the extent to which we are able to provide adequate distribution of JAKAFI to patients. Although we have contracted with a number of specialty pharmacies, these specialty pharmacies are expected generally to carry a very limited inventory and may be reluctant to be part of our distribution network in the future if demand for the product does not increase. Further, it is possible that these specialty pharmacies could decide to change their policies or fees, or both, at some time in the future. This could result in their refusal to carry smaller volume products such as JAKAFI, or cause higher product costs, lower margins or the need to find alternative methods of distributing our product. Although we believe we can find alternative channels to distribute JAKAFI on relatively short notice, our revenue during that period of time may suffer and we may incur additional costs to replace any such specialty pharmacy. The loss of any large specialty pharmacy as part of our distribution network, a significant reduction in sales we make to specialty pharmacies, or any failure to pay for the products we have shipped to them could materially and adversely affect our results of operations and financial condition.

***If we are unable to establish and maintain effective sales, marketing and distribution capabilities, or to enter into agreements with third parties to do so, we will not be able to successfully commercialize JAKAFI.***

Prior to our commercialization of JAKAFI, we had no experience selling and marketing drug products and with pricing and obtaining adequate third-party reimbursement for drug products. Under our collaboration and license agreement with Novartis, we have retained commercialization rights to JAKAFI in the United States. We have established commercial capabilities in the United States, but cannot guarantee that we will be able to maintain our own capabilities or enter into and maintain any marketing, distribution or third-party logistics agreements with third-party providers on acceptable terms, if at all. We may not be able to correctly judge the size and experience of the sales and marketing force and the scale of distribution capabilities necessary to successfully market and sell JAKAFI. Establishing and maintaining sales, marketing and distribution capabilities are expensive and time-consuming. Competition for personnel with experience in sales and marketing can be high. Our expenses associated with building and maintaining the sales force and distribution capabilities may be disproportional compared to the revenues we may be able to generate on sales of JAKAFI.

***Our reliance on other parties to manufacture JAKAFI could result in a short supply of JAKAFI, increased costs, and withdrawal of regulatory approval.***

We do not currently operate manufacturing facilities for commercial production of JAKAFI. Accordingly, we will be subject to the risks described below under **Other Risks Relating to Our Business**. Our reliance on other parties to manufacture our drug products and drug candidates could result in a short supply of the drugs, delays in clinical trials or drug development, increased costs, and withdrawal or denial of a regulatory authority's approval.

***If we fail to comply with applicable laws and regulations, we could lose our approval to market JAKAFI or be subject to other governmental enforcement activity.***

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We cannot guarantee that we will be able to maintain regulatory approval to market JAKAFI in the United States. If we do not maintain our regulatory approval to market JAKAFI, our results of operations will be materially harmed. We and our current collaborators, third-party manufacturers and suppliers are subject to rigorous and extensive regulation by the FDA and other federal and state agencies. These regulations continue to apply after product marketing approval, and cover, among other things, testing, manufacturing, quality control, labeling, advertising, promotion, risk mitigation, and adverse event reporting requirements.

Our commercialization of JAKAFI is subject to post-regulatory approval product surveillance, and JAKAFI may have to be withdrawn from the market or subject to restrictions if previously unknown problems occur. Regulatory agencies may also require additional clinical trials or testing for JAKAFI, and JAKAFI may be recalled or may be subject to reformulation, additional studies, changes in labeling, warnings to the public and negative publicity.

Failure to comply with the laws and requirements, including statutes and regulations, administered by the FDA or other agencies could result in:

- administrative and judicial sanctions, including warning letters;
- fines and other civil penalties;

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- withdrawal of regulatory approval to market JAKAFI;
- interruption of production;
- operating restrictions;
- product recall or seizure;
- injunctions; and
- criminal prosecution.

The occurrence of any such event may have a material adverse effect on our business.

***If the use of JAKAFI harms patients, or is perceived to harm patients even when such harm is unrelated to JAKAFI, our regulatory approval could be revoked or otherwise negatively impacted or we could be subject to costly and damaging product liability claims.***

The testing of JAKAFI and the manufacturing, marketing and sale of JAKAFI expose us to product liability and other risks. Side effects and other problems experienced by patients from the use of JAKAFI could:

- lessen the frequency with which physicians decide to prescribe JAKAFI;
- encourage physicians to stop prescribing JAKAFI to their patients who previously had been prescribed JAKAFI;
- cause serious harm to patients that may give rise to product liability claims against us; and

- result in our need to withdraw or recall JAKAFI from the marketplace.

If JAKAFI is used by a wide patient population, new risks and side effects may be discovered, the rate of known risks or side effects may increase, and risks previously viewed as less significant could be determined to be significant.

Previously unknown risks and adverse effects of JAKAFI may also be discovered in connection with unapproved, or off-label, uses of JAKAFI. We are prohibited by law from promoting or in any way supporting or encouraging the promotion of JAKAFI for off-label uses, but physicians are permitted to use products for off-label purposes. In addition, we are studying and expect to continue to study JAKAFI in diseases other than intermediate or high-risk myelofibrosis in controlled clinical settings, and independent investigators are doing so as well. In the event of any new risks or adverse effects discovered as new patients are treated for intermediate or high-risk myelofibrosis and as JAKAFI is studied in or used by patients for off-label indications, regulatory authorities may delay or revoke their approvals, we may be required to conduct additional clinical trials, make changes in labeling of JAKAFI, reformulate JAKAFI or make changes and obtain new approvals. We may also experience a significant drop in the potential sales of JAKAFI, experience harm to our reputation and the reputation of JAKAFI in the marketplace or become subject to lawsuits, including class actions. Any of these results could decrease or prevent any sales of JAKAFI or substantially increase the costs and expenses of commercializing JAKAFI.

Patients who have been enrolled in our clinical trials or who may use JAKAFI in the future often have severe and advanced stages of disease and known as well as unknown significant pre-existing and potentially life-threatening health risks. During the course of treatment, patients may suffer adverse events, including death, for reasons that may or may not be related to JAKAFI. Such events could subject us to costly litigation, require us to pay substantial amounts of money to injured patients, delay, negatively impact or end our opportunity to receive or maintain regulatory approval to market JAKAFI, or require us to suspend or abandon our commercialization efforts. Even in a circumstance in which we do not believe that an adverse event is related to JAKAFI, the investigation into the circumstance may be time consuming or inconclusive. These investigations may interrupt our sales efforts, impact and limit the type of regulatory approvals JAKAFI receives or maintains, or delay the regulatory approval process for our collaborator Novartis in other countries.

Factors similar to those listed above also apply to our collaboration partner Novartis for jurisdictions outside the United States.

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*If we market JAKAFI in a manner that violates various federal and state health care related laws and regulations, we may be subject to civil or criminal penalties.*

In addition to FDA and related regulatory requirements, we are subject to health care fraud and abuse laws, such as the federal False Claims Act, the anti-kickback provisions of the federal Social Security Act, and other state and federal laws and regulations. Federal and state anti-kickback laws prohibit, among other things, knowingly and willfully offering, paying, soliciting or receiving remuneration to induce, or in return for purchasing, leasing, ordering or arranging for the purchase, lease or order of any health care item or service reimbursable under Medicare, Medicaid, or other federally- or state-financed health care programs. Federal false claims laws prohibit any person from knowingly presenting, or causing to be presented, a false claim for payment to the federal government, or knowingly making, or causing to be made, a false statement to get a false claim paid. Pharmaceutical companies have been prosecuted under these laws for a variety of alleged promotional and marketing activities.

Although physicians are permitted, based on their medical judgment, to prescribe products for indications other than those approved by the FDA, manufacturers are prohibited from promoting their products for such off-label uses. We market JAKAFI for intermediate or high-risk myelofibrosis and provide promotional materials to physicians regarding the use of JAKAFI for this indication. Although we believe that our promotional materials for physicians do not constitute off-label promotion of JAKAFI, the FDA or other agencies may disagree. If the FDA or another agency determines that our promotional materials or other activities constitute off-label promotion of JAKAFI, it could request that we modify our promotional materials or other activities or subject us to regulatory enforcement actions, including the issuance of a warning letter, injunction, seizure, civil fine and criminal penalties. It is also possible that other federal, state or foreign enforcement authorities might take action if they believe that the alleged improper promotion led to the submission and payment of claims for an unapproved use, which could result in significant fines or penalties under other statutory authorities, such as laws prohibiting false claims for reimbursement. Even if it is later determined we are not in violation of these laws, we may be faced with negative publicity, incur significant expenses defending our position and have to divert significant management resources from other matters.

The majority of states also have statutes or regulations similar to the federal anti-kickback law and false claims laws, which apply to items and services reimbursed under Medicaid and other state programs, or, in several states, apply regardless of the payor. In recent years, several states and localities, including California, Connecticut, the District of Columbia, Massachusetts, Minnesota, Nevada, New Mexico, Texas, Vermont, and West Virginia, have enacted legislation requiring pharmaceutical companies to establish marketing compliance programs, file periodic reports with the state or make periodic public disclosures on sales, marketing, pricing, clinical trials, and other activities. Similar legislation is being considered in other states. Additionally, as part of the Patient Protection and Affordable Care Act, the federal government has enacted the Physician Payment Sunshine provisions. The Sunshine provisions will require manufacturers to begin collecting data in 2013 and to publicly report starting in 2014 certain payments or other transfers of value made to physicians and teaching hospitals. Many of these requirements are new and uncertain, and the penalties for failure to comply with these requirements are unclear. Nonetheless, if we are found not to be in full compliance with these laws, we could face enforcement action and fines and other penalties, and could receive adverse publicity. See also *Other Risks Relating to our Business*. If we fail to comply with the extensive legal and regulatory requirements affecting the health care industry, we could face increased costs, penalties and a loss of business below.

**OTHER RISKS RELATING TO OUR BUSINESS**

*We may be unsuccessful in our efforts to discover and develop drug candidates and commercialize drug products.*



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None of our drug candidates, other than JAKAFI/JAKAVI, has received regulatory approval. Our ability to discover and develop drug candidates and to commercialize additional drug products will depend on our ability to:

- hire and retain key employees;
- identify high quality therapeutic targets;
- identify potential drug candidates;
- develop products internally or license drug candidates from others;
- identify and enroll suitable human subjects, either in the United States or abroad, for our clinical trials;
- complete laboratory testing and clinical trials on humans;
- obtain and maintain necessary intellectual property rights to our products;

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- obtain and maintain necessary regulatory approvals for our products, both in the United States and abroad;
- enter into arrangements with third parties to provide services or to manufacture our products on our behalf;
- deploy sales and marketing resources effectively or enter into arrangements with third parties to provide these functions in compliance with all applicable laws;
- obtain appropriate coverage and reimbursement levels for the cost of our products from governmental authorities, private health insurers and other third party payors;
- lease facilities at reasonable rates to support our growth; and
- enter into arrangements with third parties to license and commercialize our products.

We have limited experience with the activities listed above and may not be successful in discovering, developing, or commercializing drug products. Discovery and development of drug candidates are expensive and time-consuming, and we do not know if our efforts will lead to discovery of any drug candidates that can be successfully developed and marketed. Of the compounds that we identify as potential drug products or that we may in-license from other companies, only a few, if any, are likely to lead to successful drug development programs and commercialized drug products.

***We depend heavily on the success of our most advanced drug candidates. We might not be able to commercialize any of our drug candidates successfully, and we may spend significant time and money attempting to do so.***

We have invested significant resources in the development of our most advanced drug candidates. In addition to the commercial launch of JAKAFI for the treatment of intermediate or high-risk myelofibrosis, ruxolitinib is also in a Phase III clinical trial for the treatment of polycythemia vera as well as in other clinical trials. Further, we have a number of drug candidates in Phase I and Phase II clinical trials. Our ability to generate product revenues will depend on the successful development and eventual commercialization of our most advanced drug candidates. We, or our collaborators or licensees, may decide to discontinue development of any or all of our drug candidates at any time for commercial, scientific or other reasons. For example, in March 2008, we announced that we would not advance our lead CCR5 antagonist into Phase IIB trials and, in September 2011, we announced that we had discontinued development of our lead sheddase inhibitor, INCB7839, for the treatment of breast cancer. If a product is developed, but is not marketed, we may have spent significant amounts of time and money on it, which could adversely affect our operating results and financial condition.

*The success of our drug discovery and development efforts may depend on our ability to find suitable collaborators to fully exploit our capabilities. If we are unable to establish collaborations or if these future collaborations are unsuccessful in the development and commercialization of our drug candidates, our research, development and commercialization efforts may be unsuccessful, which could adversely affect our results of operations and financial condition.*

An important element of our business strategy is to enter into collaborative or license arrangements with other parties, such as our collaborations with Novartis and Lilly for our JAK inhibitors, under which we license our drug candidates to those parties for development and commercialization. We are evaluating strategic relationships with respect to several of our other programs and may enter into an agreement with respect to one or more of these programs in the future. However, because collaboration and license arrangements are complex to negotiate, we may not be successful in our attempts to establish these arrangements. Also, we may not have drug candidates that are desirable to other parties, or we may be unwilling to license a drug candidate because the party interested in it is a competitor. The terms of any such arrangements that we establish may not be favorable to us. Alternatively, potential collaborators may decide against entering into an agreement with us because of our financial, regulatory or intellectual property position or for scientific, commercial or other reasons. If we are not able to establish collaboration or license arrangements, we may not be able to develop and commercialize a drug product, which could adversely affect our business and our revenues.

In order for any of these collaboration or license arrangements to be successful, we must first identify potential collaborators or licensees whose capabilities complement and integrate well with ours. We may rely on these arrangements for not only financial resources, but also for expertise or economies of scale that we expect to need in the future relating to clinical trials, manufacturing, sales and marketing, and for licenses to technology rights. However, it is likely that we will not be able to control the amount and timing of resources that our collaborators or licensees devote to our programs or drug candidates. If our collaborators or licensees prove difficult to work with, are less skilled than we originally expected, do not devote adequate resources to the program, or do not agree with our approach to development or manufacturing of the drug candidate, the relationship could be unsuccessful. If a business combination involving a collaborator or licensee and a third party were to occur, the effect could be to terminate or cause delays in development of a drug candidate.

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***We depend on our collaborators and licensees for the future development and commercialization of some of our drug candidates. Conflicts may arise between our collaborators and licensees and us, or our collaborators and licensees may choose to terminate their agreements with us, which may adversely affect our business.***

We have licensed to Novartis rights to ruxolitinib outside of the United States and worldwide rights to our c-MET inhibitor compounds and licensed to Lilly worldwide rights to baricitinib. We have also licensed to Pfizer our portfolio of CCR2 antagonist compounds. Under the terms of our agreements with these collaborators, we have no or limited control over the further clinical development of these drug candidates and any revenues we may receive if these drug candidates receive regulatory approval and are commercialized will depend primarily on the development and commercialization efforts of others. We intend to seek other collaborative or licensing arrangements with respect to other of our drug candidates, but do not know whether we will be able to enter into any such arrangement on acceptable terms, if at all.

Conflicts may arise with our current or future collaborators and licensees if they pursue alternative technologies or develop alternative products either on their own or in collaboration with others as a means for developing treatments for the diseases that we have targeted. Competing products and product opportunities may lead our collaborators and licensees to withdraw their support for our drug candidates. Any failure of our collaborators and licensees to perform their obligations under our agreements with them or otherwise to support our drug candidates could negatively impact the development of our compounds and drug candidates, lead to our loss of potential revenues from product sales and milestones and delay our achievement, if any, of profitability. Additionally, conflicts may arise if, among other things, there is a dispute about the achievement and payment of a milestone amount or the ownership of intellectual property that is developed during the course of a collaborative relationship.

Our existing collaborative and license agreements can be terminated by our collaborators and licensees for convenience, among other circumstances. If any of our collaborators or licensees terminates its agreement with us, or terminates its rights with respect to certain indications or compounds, we may not be able to find a new collaborator for them, and our business could be adversely affected. Should an agreement be terminated before we have realized the benefits of the collaboration or license, our reputation could be harmed, we may not obtain revenues that we anticipated receiving, and our business could be adversely affected.

***Although we obtained a special protocol assessment agreement for ruxolitinib for polycythemia vera, a special protocol assessment agreement does not guarantee any particular outcome from regulatory review, including any regulatory approval.***

We have obtained a special protocol assessment, or SPA, agreement for the registration trial for ruxolitinib for the treatment of polycythemia vera in the United States. The SPA process allows for FDA evaluation of a clinical trial protocol intended to form the primary basis of an efficacy claim in support of a New Drug Application, or NDA, and provides a product sponsor with an agreement confirming that the design and size of a trial will be appropriate to form the primary basis of an efficacy claim for an NDA if the trial is performed according to the SPA. Even if we believe that the data from a clinical trial are supportive, an SPA is not a guarantee of approval, and we cannot be certain that the design of, or data collected from, a trial will be adequate to demonstrate safety and efficacy, or otherwise be sufficient to support regulatory approval. There can be no assurance that the terms of an SPA will ultimately be binding on the FDA, and the FDA is not obligated to approve an NDA, if any, even if the clinical outcome is positive. The FDA retains significant latitude and discretion in interpreting the terms of an SPA and the data and results from a clinical trial, and can require trial design changes or additional studies if issues arise essential to determining safety or efficacy. Data may subsequently become available that causes the FDA to reconsider the previously agreed upon scope of review and the FDA may have subsequent safety or efficacy concerns that override an SPA, and we can give no assurance that as clinical trials proceed or as part of an NDA review process, if any, the FDA will determine that a previously approved SPA is still valid.

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Additionally, an SPA may be changed only with the written agreement of the FDA, and any further changes we may propose to the protocol will remain subject to the FDA's approval. The FDA may not agree to any such amendment and, even if they agree, they may request other amendments to the trial design that could require additional cost and time, as well as increase the degree of difficulty in reaching clinical endpoints. As a result, even with an SPA, we cannot be certain that the trial results will be found to be adequate to support an efficacy claim and product approval.

*Even if a drug candidate that we develop receives regulatory approval, we may decide not to commercialize it if we determine that commercialization of that product would require more money and time than we are willing to invest.*

Even if any of our drug candidates receives regulatory approval, it could be subject to post-regulatory surveillance, and may have to be withdrawn from the market or subject to restrictions if previously unknown problems occur. Regulatory agencies may also require additional clinical trials or testing, and the drug product may be recalled or may be subject to reformulation, additional studies, changes in labeling, warnings to the public and negative publicity. As a result, we may not continue to commercialize a product even though it has obtained regulatory approval. Further, we may decide not to continue to commercialize a product if the market does not accept the product because it is too expensive or because third parties such as insurance companies or Medicare have not approved it

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for substantial reimbursement. In addition, we may decide not to continue to commercialize a product if competitors develop and commercialize similar or superior products or have proprietary rights that preclude us from ultimately marketing our products.

***If we fail to enter into additional licensing agreements or if these arrangements are unsuccessful, our business and operations might be adversely affected.***

In addition to establishing collaborative or license arrangements under which other parties license our drug candidates for development and commercialization, we may explore opportunities to develop our clinical pipeline by in-licensing drug candidates that fit within our expertise and research and development capabilities. We may be unable to enter into any additional in-licensing agreements because suitable drug candidates that are within our expertise may not be available to us on terms that are acceptable to us or because competitors with greater resources seek to in-license the same drug candidates. Drug candidates that we would like to develop may not be available to us because they are controlled by competitors who are unwilling to license the rights to the drug candidate to us. In addition, we may enter into license agreements that are unsuccessful and our business and operations might be adversely affected by the termination of a drug candidate and termination and winding down of the related license agreement. We may also need to license drug delivery or other technology in order to continue to develop our drug candidate pipeline. If we are unable to enter into additional agreements to license drug candidates, drug delivery technology or other technology or if these arrangements are unsuccessful, our research and development efforts could be adversely affected.

***Any approved drug product that we bring to the market may not gain market acceptance by physicians, patients, healthcare payors and others in the medical community.***

Even if we are successful in gaining regulatory approval of any of our drug candidates in addition to JAKAFI for the treatment of intermediate or high-risk myelofibrosis in the United States, we may not generate significant product revenues and we may not become profitable if these drug products do not achieve an adequate level of acceptance. Physicians may not recommend our drug products until longer-term clinical data or other factors demonstrate the safety and efficacy of our drug products as compared to other alternative treatments. Even if the clinical safety and efficacy of our drug products is established, physicians may elect not to prescribe these drug products for a variety of reasons, including the reimbursement policies of government and other third-party payors and the effectiveness of our competitors in marketing their products.

Market acceptance of our drug products, if approved for commercial sale, will depend on a number of factors, including:

- the willingness and ability of patients and the healthcare community to use our products;
  
- the ability to manufacture our drug products in sufficient quantities with acceptable quality and to offer our drug products for sale at competitive prices;
  
- the perception of patients and the healthcare community, including third-party payors, regarding the safety, efficacy and benefits of our drug products compared to those of competing products or therapies;

- the label and promotional claims allowed by the FDA;
- the pricing and reimbursement of our drug products relative to existing treatments; and
- marketing and distribution support for our drug products.

*We have limited expertise with and capacity to conduct preclinical testing and clinical trials, and our resulting dependence on other parties could result in delays in and additional costs for our drug development efforts.*

We have limited experience with, and internal resources and capacity to perform, preclinical testing and clinical trials. As part of our development strategy, we often hire clinical research organizations, or CROs, to perform preclinical testing and clinical trials for drug candidates. If the CROs that we hire to perform our preclinical testing and clinical trials do not meet deadlines, do not follow proper procedures, or a conflict arises between us and our CROs, our preclinical testing and clinical trials may take longer than expected, may cost more, may be delayed or may be terminated. If we were forced to find a replacement entity to perform any of our preclinical testing or clinical trials, we may not be able to find a suitable entity on favorable terms, or at all. Even if we were able to find another company to perform a preclinical test or clinical trial, the delay in the test or trial may result in significant additional expenditures. Events such as these may result in delays in our obtaining regulatory approval for our drug candidates or our ability to commercialize our products and could result in increased expenditures that would adversely affect our operating results.

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*If we are unable to obtain regulatory approval for our drug candidates in the United States and foreign jurisdictions, we will not be permitted to commercialize products resulting from our research.*

In order to commercialize drug products in the United States, our drug candidates will have to obtain regulatory approval from the FDA. Satisfaction of regulatory requirements typically takes many years. To obtain regulatory approval, we must first show that our drug candidates are safe and effective for target indications through preclinical testing (animal testing) and clinical trials (human testing). Preclinical testing and clinical development are long, expensive and uncertain processes, and we do not know whether the FDA will allow us to undertake clinical trials of any drug candidates in addition to our compounds currently in clinical trials.

Completion of clinical trials may take several years and failure may occur at any stage of testing. The length of time required varies substantially according to the type, complexity, novelty and intended use of the drug candidate. Interim results of a preclinical test or clinical trial do not necessarily predict final results, and acceptable results in early clinical trials may not be repeated in later clinical trials. For example, a drug candidate that is successful at the preclinical level may cause harmful or dangerous side effects when tested at the clinical level. Our rate of commencement and completion of clinical trials may be delayed by many factors, including:

- the high degree of risk associated with drug development;
- our inability to formulate or manufacture sufficient quantities of materials for use in clinical trials;
- variability in the number and types of patients available for each study;
- difficulty in maintaining contact with patients after treatment, resulting in incomplete data;
- unforeseen safety issues or side effects;
- poor or unanticipated effectiveness of drug candidates during the clinical trials; or
- government or regulatory delays.



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Data obtained from clinical trials are susceptible to varying interpretation, which may delay, limit or prevent regulatory approval. Many companies in the pharmaceutical industry, including biotechnology companies, have suffered significant setbacks in advanced clinical trials, even after achieving promising results in earlier clinical trials. In addition, regulatory authorities may refuse or delay approval as a result of other factors, such as changes in regulatory policy during the period of product development and regulatory agency review. For example, the FDA has in the past required and could in the future require that we conduct additional trials of any of our drug candidates, which would result in delays.

We have licensed to other companies certain rights to our JAK1 and JAK2 inhibitor compounds and c-MET inhibitor compounds and our portfolio of CCR2 antagonist compounds. We have no or limited control over the further clinical development of any compounds we licensed to these collaborators. Compounds developed by us or with or by our collaborators may not prove to be safe and effective in clinical trials and may not meet all of the applicable regulatory requirements needed to receive marketing approval. If regulatory approval of a product is granted, this approval will be limited to those disease states and conditions for which the product is demonstrated through clinical trials to be safe and effective. Failure to obtain regulatory approval would delay or prevent us from commercializing products.

Outside the United States, our ability to market a product is contingent upon receiving a marketing authorization from the appropriate regulatory authorities. This foreign regulatory approval process typically includes all of the risks associated with the FDA approval process described above and may also include additional risks. The requirements governing the conduct of clinical trials, product licensing, pricing and reimbursement vary greatly from country to country and may require us to perform additional testing and expend additional resources. Approval by the FDA does not ensure approval by regulatory authorities in other countries, and approval by one foreign regulatory authority does not ensure approval by regulatory authorities in other countries or by the FDA.

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***We face significant competition for our drug discovery and development efforts, and if we do not compete effectively, our commercial opportunities will be reduced or eliminated.***

The biotechnology and pharmaceutical industries are intensely competitive and subject to rapid and significant technological change. Our drug discovery and development efforts may target diseases and conditions that are already subject to existing therapies or that are being developed by our competitors, many of which have substantially greater resources, larger research and development staffs and facilities, more experience in completing preclinical testing and clinical trials, and formulation, marketing and manufacturing capabilities. As a result of these resources, our competitors may develop drug products that render our products obsolete or noncompetitive by developing more effective drugs or by developing their products more efficiently. Our ability to develop competitive products would be limited if our competitors succeeded in obtaining regulatory approvals for drug candidates more rapidly than we were able to or in obtaining patent protection or other intellectual property rights that limited our drug development efforts. Any drug products resulting from our research and development efforts, or from our joint efforts with collaborators or licensees, might not be able to compete successfully with our competitors' existing and future products, or obtain regulatory approval in the United States or elsewhere.

***Our reliance on other parties to manufacture our drug products and drug candidates could result in a short supply of the drugs, delays in clinical trials or drug development, increased costs, and withdrawal or denial of a regulatory authority's approval.***

We do not currently operate manufacturing facilities for clinical or commercial production of JAKAFI and our other drug candidates. We currently hire third parties to manufacture the raw materials, API and finished drug product of JAKAFI and our other drug candidates for clinical trials. In addition, we expect to continue to rely on third parties for the manufacture of commercial supplies of raw materials, API and finished drug product for any drugs that we successfully develop. For JAKAFI and most of our drug candidates, we hire third parties to manufacture the raw materials, another third party to manufacture the API and another to make the finished drug product and to package and label the finished product. The FDA requires that the raw materials, API and finished product for JAKAFI and our other drug candidates be manufactured according to its current Good Manufacturing Practices regulations and regulatory authorities in other countries have similar requirements. There are only a limited number of manufacturers that comply with these requirements. Failure to comply with current Good Manufacturing Practices and the applicable regulatory requirements of other countries in the manufacture of our drug candidates and products could result in the FDA or foreign regulatory authority halting our clinical trials, withdrawing or denying regulatory approval of our drug product, enforcing product recalls or other enforcement actions, which could have a material adverse effect on our business.

We may not be able to obtain sufficient quantities of our drug candidates or any drug products we may develop if our designated manufacturers do not have the capacity or capability to manufacture them according to our schedule and specifications. In addition, we may not be able to arrange for our drug candidates or any drug products that we may develop to be manufactured by one of these parties on reasonable terms, if at all. Also, required raw materials may only be available from a limited number of suppliers and, in the case of JAKAFI, are currently supplied by a single source. As noted above, generally, we have only single sources that are qualified to supply each of the API and finished product of JAKAFI and our other drug candidates. If any of these single source suppliers were to become unable or unwilling to supply us with raw materials, API or finished product that complies with applicable regulatory requirements, we could incur significant delays in our clinical trials or interruption of commercial supply that could have a material adverse effect on our business. We are currently in the process of qualifying a second source of supply for the API for JAKAFI, however, there is no assurance that we will be able to identify and qualify a second source of supply for JAKAFI. If we have promised delivery of a drug candidate or drug product and are unable to meet the delivery requirement due to manufacturing difficulties, our development programs could be delayed, we may have to expend additional sums in order to ensure that manufacturing capacity is available when we need it even if we do not use all of the manufacturing capacity, and our business and operating results could be harmed.

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Manufacturers of pharmaceutical products often encounter difficulties in production, especially in scaling up initial production. These problems include difficulties with production costs and yields, quality control and assurance and shortages of qualified personnel, as well as compliance with strictly enforced federal, state and foreign regulations.

In order to obtain approval of our products by the FDA and foreign regulatory agencies, we need to complete testing on both the API and on the finished product in the packaging we propose for commercial sales. This includes testing of stability, identification of impurities and testing of other product specifications by validated test methods. In addition, we will be required to consistently produce the API in commercial quantities and of specified quality on a repeated basis and document our ability to do so. This requirement is referred to as process validation.

We may not be able to adequately manage and oversee the manufacturers we choose, they may not perform as agreed or they may terminate their agreements with us. Foreign manufacturing approval processes typically include all of the risks associated with the FDA approval process for manufacturing and may also include additional risks.

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***If we fail to comply with the extensive legal and regulatory requirements affecting the health care industry, we could face increased costs, penalties and a loss of business.***

Our activities, and the activities of our collaborators, partners and third party providers, are subject to extensive government regulation and oversight both in the United States and in foreign jurisdictions. The FDA and comparable agencies in other jurisdictions directly regulate many of our most critical business activities, including the conduct of preclinical and clinical studies, product manufacturing, advertising and promotion, product distribution, adverse event reporting and product risk management. States increasingly have been placing greater restrictions on the marketing practices of healthcare companies. In addition, pharmaceutical and biotechnology companies have been the target of lawsuits and investigations alleging violations of government regulations, including claims asserting submission of incorrect pricing information, impermissible off-label promotion of pharmaceutical products, payments intended to influence the referral of federal or state healthcare business, submission of false claims for government reimbursement, antitrust violations, violations of the Foreign Corrupt Practices Act, or violations related to environmental matters. Violations of governmental regulation may be punishable by criminal and civil sanctions, including fines and civil monetary penalties and exclusion from participation in government programs, including Medicare and Medicaid. In addition to penalties for violation of laws and regulations, we could be required to repay amounts we received from government payors, or pay additional rebates and interest if we are found to have miscalculated the pricing information we have submitted to the government. Whether or not we have complied with the law, an investigation into alleged unlawful conduct could increase our expenses, damage our reputation, divert management time and attention and adversely affect our business.

***Health care reform measures could impact the pricing and profitability of pharmaceuticals, and adversely affect the commercial viability of our drug candidates. Our ability to generate revenues will be diminished if we are unable to obtain an adequate level of reimbursement from private insurers, government insurance programs or other third-party payors of health care costs, which could be affected by recent healthcare reform legislation.***

Our ability to commercialize our drug candidates successfully will depend in part on the extent to which adequate reimbursement levels for the cost of our products and related treatment are obtained from third-party payors, such as private insurers, government insurance programs, including Medicare and Medicaid, health maintenance organizations (HMOs) and other health care related organizations. The continuing efforts of these third-party payors to contain or reduce the costs of health care by challenging the prices charged for medical products and services may affect our future revenues and profitability, and the future revenues and profitability of our potential customers, suppliers, collaborators and licensees and the availability of capital.

In recent years, through legislative and regulatory actions, the federal government has made substantial changes to various payment systems under the Medicare and other federal health care programs. Comprehensive reforms to the U.S. healthcare system were recently enacted, including changes to the methods for, and amounts of, Medicare reimbursement. These reforms could significantly reduce payments from Medicare and Medicaid. Reforms or other changes to these payment systems, may change the availability, methods and rates of reimbursements from Medicare, private insurers and other third-party payors for our drug candidates. Some of these changes and proposed changes could result in reduced reimbursement rates, which could reduce the price that we or any of our collaborators or licensees receive for any products, if commercialized, in the future, and which would adversely affect our business strategy, operations and financial results. Further federal and state proposals and health care reforms are possible, which could limit the prices that can be charged for any of our drug candidates and may further limit the commercial viability of our drug candidates. In certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. If reimbursement for our products, if commercialized, is unavailable, limited in scope or amount, or if pricing is set at unsatisfactory levels, our business could be materially harmed. There may be future changes that result in reductions in current coverage and reimbursement levels for our drug candidates, and we cannot predict the scope of any future changes or the impact that those changes would have on our operations.

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Third-party payors are increasingly challenging the prices charged for medical products and services. Also, the trend toward managed health care in the United States, the organizations for which could control or significantly influence the purchase of health care services and products, as well as legislative proposals to reform health care or reduce government insurance programs, may all result in lower prices for or rejection of our products. Adoption of our drug candidates by the medical community may be limited without adequate reimbursement for our products. Cost control initiatives may decrease coverage and payment levels for our drug candidates and, in turn, the price that we will be able to charge for any product, if commercialized. Our drug candidates may not be considered cost-effective, and coverage and reimbursement may not be available or sufficient to allow us to sell our products on a profitable basis. We are unable to predict all changes to the coverage or reimbursement methodologies that will be applied by private or government payors to our drug candidates.

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The cost containment measures that health care payors and providers are instituting and any denial of private or government payor coverage or inadequate reimbursement for our drug candidates could materially and adversely affect our business strategy, operations and financial results.

***As our drug discovery and development operations are conducted at our headquarters in Wilmington, Delaware, the loss of access to this facility would negatively impact our business.***

Our facility in Wilmington, Delaware is our headquarters and is also where we conduct all of our drug discovery, research, development and marketing activities. Our lease contains provisions that provide for its early termination upon the occurrence of certain events of default or upon a change of control. Further, our headquarters facility is located in a large research and development complex that may be temporarily or permanently shut down if certain environmental or other hazardous conditions were to occur within the complex. In addition, natural disasters or actions of activists opposed to aspects of pharmaceutical research may disrupt our experiments or our ability to access or use our facilities. The loss of access to or use of our Wilmington, Delaware, facility, either on a temporary or permanent basis, or early termination of our lease would result in an interruption of our business and, consequently, would adversely affect our overall business.

***We depend on key employees in a competitive market for skilled personnel, and the loss of the services of any of our key employees or our inability to attract and retain additional personnel would affect our ability to expand our drug discovery and development programs and achieve our objectives.***

We are highly dependent on the members of our executive management team and principal members of our commercial, development, medical, operations and scientific staff. We experience intense competition for qualified personnel. Our future success also depends in part on the continued service of our executive management team and key personnel and our ability to recruit, train and retain essential personnel for our drug discovery and development programs, and for our medical affairs and commercialization activities. If we lose the services of any of these people or if we are unable to recruit sufficient qualified personnel, our research and product development goals, and our commercialization efforts could be delayed or curtailed. We do not maintain key person insurance on any of our employees.

***If we fail to manage our growth effectively, our ability to develop and commercialize products could suffer.***

We expect that if our drug discovery efforts continue to generate drug candidates, our clinical drug candidates continue to progress in development, and we continue to build our development, medical and commercial organizations, we will require significant additional investment in personnel, management and resources. Our ability to achieve our research, development and commercialization objectives depends on our ability to respond effectively to these demands and expand our internal organization, systems, controls and facilities to accommodate additional anticipated growth. If we are unable to manage our growth effectively, our business could be harmed and our ability to execute our business strategy could suffer.

***If product liability lawsuits are brought against us, we could face substantial liabilities and may be required to limit commercialization of our products and our results of operations could be harmed.***

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In addition to the risks described above under If the use of JAKAFI harms patients, or is perceived to harm patients even when such harm is unrelated to JAKAFI, our regulatory approval could be revoked or otherwise negatively impacted or we could be subject to costly and damaging product liability claims, the conduct of clinical trials of medical products that are intended for human use entails an inherent risk of product liability. If any product that we or any of our collaborators or licensees develops causes or is alleged to cause injury during clinical trials or commercialization, we may be held liable. If we cannot successfully defend ourselves against product liability claims, we may incur substantial liabilities, including substantial damages to be paid to the plaintiffs and legal costs, or we may be required to limit further development and commercialization of our products. Additionally, any product liability lawsuit could cause injury to our reputation, participants and investigators to withdraw from clinical trials, and potential collaborators or licensees to seek other partners, any of which could impact our results of operations.

Our product liability insurance policy may not fully cover our potential liabilities. In addition, we may determine that we should increase our coverage, and this insurance may be prohibitively expensive to us or our collaborators or licensees and may not fully cover our potential liabilities. Our inability to obtain sufficient product liability insurance at an acceptable cost to protect against potential product liability claims could prevent or inhibit the development or commercialization of our drug candidates and products.

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*Because our activities involve the use of hazardous materials, we may be subject to claims relating to improper handling, storage or disposal of these materials that could be time consuming and costly.*

We are subject to various environmental, health and safety laws and regulations governing, among other things, the use, handling, storage and disposal of regulated substances and the health and safety of our employees. Our research and development processes involve the controlled use of hazardous and radioactive materials and biological waste resulting in the production of hazardous waste products. We cannot completely eliminate the risk of accidental contamination or discharge and any resultant injury from these materials. If any injury or contamination results from our use or the use by our collaborators or licensees of these materials, we may be sued and our liability may exceed our insurance coverage and our total assets. Further, we may be required to indemnify our collaborators or licensees against all damages and other liabilities arising out of our development activities or products produced in connection with these collaborations or licenses. Compliance with the applicable environmental and workplace laws and regulations is expensive. Future changes to environmental, health, workplace and safety laws could cause us to incur additional expense or may restrict our operations or impair our research, development and production efforts.

### **RISKS RELATING TO OUR FINANCIAL RESULTS**

*We expect to incur losses in the future and we may not achieve or maintain profitability in the future.*

We had net losses from inception in 1991 through 1996 and in 1999 through June 30, 2013. Because of those losses, we had an accumulated deficit of \$1.7 billion as of June 30, 2013. We intend to continue to spend significant amounts on our efforts to discover and develop drugs. As a result, we could continue to incur losses in 2013 and in future periods as well.

We anticipate that our drug discovery and development efforts and related expenditures will increase as we focus on the studies, including preclinical tests and clinical trials prior to seeking regulatory approval, that are required before we can sell a drug product.

The development of drug products will require us to spend significant funds on research, development, testing, obtaining regulatory approvals, manufacturing and marketing. To date, we do not have any drug products that have generated significant revenues and we cannot assure you that we will generate significant revenues from the drug candidates that we license or develop, including JAKAFI, for several years, if ever.

We cannot be certain whether or when we will achieve profitability because of the significant uncertainties relating to our ability to generate commercially successful drug products. Even if we are successful in obtaining regulatory approvals for manufacturing and commercializing drug products in addition to JAKAFI, we expect that we will continue to incur losses if our drug products do not generate significant revenues. If we achieve profitability, we may not be able to sustain or increase profitability.

*We will need additional capital in the future. If we are unable to generate sufficient funds from operations, the capital markets may not permit us to raise additional capital at the time that we require it, which could result in limitations on our research and development or commercialization efforts or the loss of certain of our rights in our technologies or drug candidates.*



Our future funding requirements will depend on many factors and we anticipate that we may need to raise additional capital to fund our business plan and research and development efforts going-forward and to repay our indebtedness.

Additional factors that may affect our future funding requirements include:

- the amount of revenues generated from our business activities;
- any changes in the breadth of our research and development programs;
- the results of research and development, preclinical testing and clinical trials conducted by us or our current or future collaborators or licensees, if any;
- our exercise of any co-development options with collaborators that may require us to fund future development;
- the acquisition of technologies, if any;
- our ability to maintain and establish new corporate relationships and research collaborations;
- competing technological and market developments;

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- the time and costs involved in filing, prosecuting, defending and enforcing patent and intellectual property claims;
- the receipt of contingent licensing or milestone fees or royalties on product sales from our current or future collaborative and license arrangements, if established; and
- the timing of regulatory approvals, if any.

If we require additional capital at a time when investment in companies such as ours, or in the marketplace generally, is limited due to the then prevailing market or other conditions, we may have to scale back our operations, eliminate one or more of our research or development programs, or attempt to obtain funds by entering into an agreement with a collaborator or licensee that would result in terms that are not favorable to us or relinquishing our rights in certain of our proprietary technologies or drug candidates. If we are unable to raise funds at the time that we desire or at any time thereafter on acceptable terms, we may not be able to continue to develop our drug candidates. The sale of equity or additional convertible debt securities in the future may be dilutive to our stockholders, and debt financing arrangements may require us to pledge certain assets or enter into covenants that could restrict our operations or our ability to incur further indebtedness.

***We have a large amount of debt and our debt service obligations may prevent us from taking actions that we would otherwise consider to be in our best interests.***

As of June 30, 2013, the aggregate principal amount of our total consolidated debt was \$266.3 million and our stockholders' deficit was \$27.8 million. Our substantial leverage could have significant negative consequences for our future operations, including:

- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our ability to obtain additional financing for working capital, capital and research and development expenditures, and general corporate purposes;
- requiring the dedication of a substantial portion of our expected cash flow or our existing cash to service our indebtedness, thereby reducing the amount of our cash available for other purposes, including working capital, capital expenditures and research and development expenditures;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we compete; or

- placing us at a possible competitive disadvantage compared to less leveraged competitors and competitors that have better access to capital resources.

We may not generate sufficient cash flow from our operations in the future to enable us to meet our anticipated fixed charges, including our obligations with respect to our outstanding convertible senior notes. As of June 30, 2013, a \$10.0 million aggregate principal amount non-interest bearing convertible subordinated note due in 2014 and held by Pfizer was outstanding. As of June 30, 2013, \$256.3 million aggregate principal amount of our 4.75% convertible senior notes due 2015 was outstanding and due in October 2015. Annual interest payments for our 4.75% convertible senior notes through 2015, assuming that none of these notes are converted, repurchased or exchanged, are \$12.2 million. If we are unable to generate cash from our operations or raise additional cash through financings sufficient to meet the remaining obligations under our 4.75% convertible senior notes or under our note held by Pfizer, we will need to use existing cash or liquidate marketable securities in order to fund these obligations, which may delay or curtail our research, development and commercialization programs.

The indenture governing our 4.75% convertible senior notes includes limitations on our ability to incur additional indebtedness, issue certain preferred stock, and incur liens on our assets, including on intellectual property concerning our JAK inhibitor program. These limitations could interfere with our ability to raise additional capital in the future or engage in activities that may be in our long-term best interest.

***Our marketable securities are subject to certain risks that could adversely affect our overall financial position.***

We invest our cash in accordance with an established internal policy and customarily in instruments and money market funds which historically have been highly liquid and carried relatively low risk. Recently similar types of investments and money market funds have experienced losses in value or liquidity issues which differ from their historical pattern.

Should a portion of our cash or marketable securities lose value or have their liquidity impaired, it could adversely affect our overall financial position by imperiling our ability to fund our operations and forcing us to seek additional financing sooner than we would otherwise. Such financing, if available, may not be available on commercially attractive terms.

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*Our current revenues are derived from JAKAFI product sales, JAKAVI product royalties, collaborations and from licensing our intellectual property. If we are unable to achieve milestones, develop products or renew or enter into new collaborations, our revenues may decrease, and future milestone and royalty payments may not contribute significantly to revenues for several years, and may never result in revenues.*

We derived all of our revenues for the three and six months ended June 30, 2013 from JAKAFI product revenues, JAKAVI product royalties and our collaborations and licensing our intellectual property to others. Future revenues from research and development collaborations depend upon continuation of the collaborations, the achievement of milestones and royalties we earn from any future products developed from our research. If we are unable to successfully achieve milestones or our collaborators fail to develop successful products, we will not earn the future revenues contemplated under our collaborative agreements.

**RISKS RELATING TO INTELLECTUAL PROPERTY AND LEGAL MATTERS**

*If we are subject to arbitration, litigation and infringement claims, they could be costly and disrupt our drug discovery and development efforts.*

The technology that we use to make and develop our drug products, the technology that we incorporate in our products, and the products we are developing may be subject to claims that they infringe the patents or proprietary rights of others. The success of our drug discovery and development efforts will also depend on our ability to develop new compounds, drugs and technologies without infringing or misappropriating the proprietary rights of others. We are aware of patents and patent applications filed in certain countries claiming intellectual property relating to some of our drug discovery targets and drug candidates. While the validity of issued patents, patentability of pending patent applications and applicability of any of them to our programs are uncertain, if any of these patents are asserted against us or if we choose to license any of these patents, our ability to commercialize our products could be harmed or the potential return to us from any product that may be successfully commercialized could be diminished.

From time to time we have received, and we may in the future receive, notices from third parties offering licenses to technology or alleging patent, trademark, or copyright infringement, claims regarding trade secrets or other contract claims. Receipt of these notices could result in significant costs as a result of the diversion of the attention of management from our drug discovery and development efforts. Parties sending these notices may have brought and in the future may bring litigation against us or seek arbitration relating to contract claims.

We may be involved in future lawsuits or other legal proceedings alleging patent infringement or other intellectual property rights or contract violations. In addition, litigation or other legal proceedings may be necessary to:

- assert claims of infringement;
- enforce our patents or trademarks;

- protect our trade secrets or know-how; or
- determine the enforceability, scope and validity of the proprietary rights of others.

We may be unsuccessful in defending or pursuing these lawsuits, claims or other legal proceedings. Regardless of the outcome, litigation or other legal proceedings can be very costly and can divert management's efforts. For example, we settled patent litigation with Invitrogen Corporation in 2006. We incurred significant expenses related to this litigation and, as part of the settlement, paid Invitrogen \$3.4 million. An adverse determination may subject us to significant liabilities or require us or our collaborators or licensees to seek licenses to other parties' patents or proprietary rights. We or our collaborators or licensees may also be restricted or prevented from manufacturing or selling a drug or other product that we or they develop. Further, we or our future collaborators or licensees may not be able to obtain any necessary licenses on acceptable terms, if at all. If we are unable to develop non-infringing technology or license technology on a timely basis or on reasonable terms, our business could be harmed.

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***We may be unable to adequately protect or enforce our proprietary information, which may result in its unauthorized use, a loss of revenue under a collaboration agreement or loss of sales to generic versions of our products or otherwise reduce our ability to compete in developing and commercializing products.***

Our business and competitive position depends in significant part upon our ability to protect our proprietary technology, including any drug products that we create. Despite our efforts to protect this information, unauthorized parties may attempt to obtain and use information that we regard as proprietary. For example, one of our collaborators may disclose proprietary information pertaining to our drug discovery efforts. In addition, while we have filed numerous patent applications with respect to our drug candidates in the United States and in foreign countries, our patent applications may fail to result in issued patents. In addition, because patent applications can take several years to issue as patents, there may be pending patent applications of others that may later issue as patents that cover some aspect of our drug candidates. Our existing patents and any future patents we may obtain may not be broad enough to protect our products or all of the potential uses of our products, or otherwise prevent others from developing competing products or technologies. In addition, our patents may be challenged and invalidated or may fail to provide us with any competitive advantages if, for example, others were first to invent or first to file a patent application for the technologies and products covered by our patents.

Additionally, when we do not control the prosecution, maintenance and enforcement of certain important intellectual property, such as a drug compound in-licensed to us or subject to a collaboration with a third party, the protection of the intellectual property rights may not be in our hands. If we do not control the intellectual property rights in-licensed to us with respect to a compound and the entity that controls the intellectual property rights does not adequately protect those rights, our rights may be impaired, which may impact our ability to develop, market and commercialize the in-licensed compound.

Our means of protecting our proprietary rights may not be adequate, and our competitors may:

- independently develop substantially equivalent proprietary information, products and techniques;
- otherwise gain access to our proprietary information; or
- design around patents issued to us or our other intellectual property.

We pursue a policy of having our employees, consultants and advisors execute proprietary information and invention agreements when they begin working for us. However, these agreements may not provide meaningful protection for our trade secrets or other proprietary information in the event of unauthorized use or disclosure. If we fail to maintain trade secret and patent protection, our potential, future revenues may be decreased.

***If the effective term of our patents is decreased due to changes in the United States patent laws or if we need to refile some of our patent applications, the value of our patent portfolio and the revenues we derive from it may be decreased.***

The value of our patents depends in part on their duration. A shorter period of patent protection could lessen the value of our rights under any patents that we obtain and may decrease the revenues we derive from our patents. The United States patent laws were amended in 1995 to change the term of patent protection from 17 years from patent issuance to 20 years from the earliest effective filing date of the application. Because the time from filing to issuance of biotechnology applications may be more than three years depending on the subject matter, a 20-year patent term from the filing date may result in substantially shorter patent protection.

Additionally, United States patent laws were amended in 2011 with the enactment of the America Invents Act and third parties are now able to challenge the validity of issued U.S. patents through various review proceedings; thus rendering the validity of U.S. patents more uncertain. We may be obligated to participate in review proceedings to determine the validity of our U.S. patents. We cannot predict the ultimate outcome of these proceedings, the conduct of which could result in substantial costs and diversion of our efforts and resources. If we are unsuccessful in these proceedings some or all of our claims in the patents may be narrowed or invalidated and the patent protection for our drugs and drug candidates in the United States could be substantially shortened. Further, if all of the patents covering one of our products are invalidated, the FDA could approve requests to manufacture a generic version of that product prior to the expiration date of those patents.

Other changes in the United States patent laws or changes in the interpretation of patent laws could diminish the value of our patents or narrow the scope of our patent protection. For example, the Supreme Court of the United States recently ruled that isolated DNA sequences cannot be patented. Although we no longer receive significant revenues generated from our former information products business, the majority of our gene patent portfolio from that business consists of patents on isolated DNA sequences, and this ruling limits our ability to derive additional revenues from our gene patent portfolio. Additionally, the Supreme Court recently resolved a split among the circuit courts of appeals regarding antitrust challenges to settlements of patent infringement lawsuits under the Hatch-

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Waxman Act between brand-name drug companies and generic drug companies. The Court rejected the scope of the patent test and ruled that settlements involving reverse payments from brand-name drug companies to generic drug companies should be analyzed under the rule of reason. This ruling may create uncertainty and make it more difficult to settle patent litigation if a company seeking to manufacture a generic version of one of our products challenges the patents covering that product prior to the expiration date of those patents.

***International patent protection is particularly uncertain and costly, and our involvement in opposition proceedings in foreign countries may result in the expenditure of substantial sums and management resources.***

Biotechnology and pharmaceutical patent law outside the United States is even more uncertain and costly than in the United States and is currently undergoing review and revision in many countries. Further, the laws of some foreign countries may not protect our intellectual property rights to the same extent as United States laws. For example, certain countries do not grant patent claims that are directed to the treatment of humans. We may participate in opposition proceedings to determine the validity of our foreign patents or our competitors' foreign patents, which could result in substantial costs and diversion of our efforts. For example, there is a patent opposition proceeding against our European patent that covers the composition of matter and use of certain Janus Kinase inhibitors, including ruxolitinib phosphate, for the treatment of myeloid proliferative disorders, cancer, immune-related diseases, skin disorders, and other diseases. Successful challenges to our patent or other intellectual property rights through these proceedings could result in a loss of rights in the relevant jurisdiction and allow third parties to use our proprietary technologies without a license from us or our collaborators, which may also result in loss of future royalty payments. In addition, successful challenges may jeopardize or delay our ability to enter into new collaborations or commercialize potential products, which could harm our business and results of operations.



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**Item 6. Exhibits**

Exhibit Number	Description of Document
3.1	Bylaws of the Company (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed April 18, 2013)
10.1#	Incyte Corporation Amended and Restated 2010 Stock Incentive Plan (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed June 5, 2013)
31.1	Rule 13a-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a) Certification of Chief Financial Officer
32.1*	Statement of the Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)
32.2*	Statement of the Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**	XBRL Taxonomy Presentation Linkbase Document
101.DEF**	XBRL Taxonomy Definition Linkbase Document

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# Indicates management contract or compensatory plan or arrangement.

\* In accordance with Item 601(b)(32)(ii) of Regulation S-K and SEC Release No. 34-47986, the certifications furnished in Exhibits 32.1 and 32.2 hereto are deemed to accompany this Form 10-Q and will not be deemed filed for purposes of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act.

\*\* In accordance with Rule 406T of Regulation S-T, the information furnished in these exhibits will not be deemed filed for purposes of Section 18 of the Exchange Act. Such exhibits will not be deemed to be incorporated by reference into any filing under the Securities Act or Exchange Act.

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**SIGNATURES**

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

INCYTE CORPORATION

Dated: August 1, 2013

By: /s/ PAUL A. FRIEDMAN  
PAUL A. FRIEDMAN  
Chief Executive Officer  
(Principal Executive Officer)

Dated: August 1, 2013

By: /s/ DAVID C. HASTINGS  
DAVID C. HASTINGS  
Chief Financial Officer  
(Principal Financial Officer)

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**INCYTE CORPORATION**

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description of Document</b>
3.1	Bylaws of the Company (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed April 18, 2013)
10.1#	Incyte Corporation Amended and Restated 2010 Stock Incentive Plan (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed June 5, 2013)
31.1	Rule 13a-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a) Certification of Chief Financial Officer
32.1*	Statement of the Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)
32.2*	Statement of the Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**	XBRL Taxonomy Presentation Linkbase Document
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