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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2002

Commission File Number 000-31141

DISCOVERY PARTNERS INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**33-0655706** **(I.R.S. employer identification number)**
9640 Towne Centre Drive **San Diego, California 92121** **(Address of principal executive offices and zip code)**	**(858) 455-8600** **(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 [X] No [ ]

As of August 9, 2002 a total of 24,366,362 shares of the Registrant's Common Stock, $0.001 par value, were issued and outstanding.

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DISCOVERY PARTNERS INTERNATIONAL, INC.

PART I
FINANCIAL INFORMATION

Item 1. ***Financial Statements***

Discovery Partners International, Inc.
Condensed Consolidated Balance Sheets

	June 30, 2002	December 31, 2001
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 28,778,897	$ 50,915,481
Short-term investments	45,338,717	26,349,756
Accounts receivable	6,947,342	10,143,648
Inventories	3,235,997	8,174,755
Prepaid and other current assets	1,472,272	1,401,914
Total current assets	85,773,225	96,985,554
Restricted cash	897,770	861,352
Property and equipment, net	10,868,772	10,641,664
Goodwill, net	50,918,089	50,918,089
Patent, license rights and other intangible assets, net	7,908,432	6,400,268
Other assets, net	1,117,305	1,215,184
Total assets	$157,483,593	$ 167,022,111
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 3,298,952	$ 3,816,132
Contract loss accrual	1,485,000	—
Current portion of obligations under capital leases, equipment notes payable, line of credit and promissory notes	1,205,661	738,170
Deferred revenue	3,026,215	3,880,817
Total current liabilities	9,015,828	8,435,119
Obligations under capital leases, equipment notes payable, and promissory notes, less current portion	602,656	1,082,257
Deferred rent	102,890	95,300
Minority interest in Structural Proteomics	152,157	367,881
Stockholders' equity:		
Preferred stock, $.001 par value, 1,000,000 shares authorized, no shares issued and outstanding at June 30, 2002 and December 31, 2001	—	—
Common stock, $.001 par value, 99,000,000 shares authorized, 24,340,556 and 24,262,181 issued and outstanding at June 30, 2002 and December 31, 2001, respectively	24,359	24,262
Treasury stock, at cost, 35,000 shares	(119,250)	(119,250)
Additional paid-in capital	200,678,002	200,533,917
Deferred compensation	(510,919)	(882,964)
Note receivable from stockholder	(240,000)	(240,000)
Accumulated other comprehensive income	782,015	302,987
Accumulated deficit	(53,004,145)	(42,577,398)
Total stockholders' equity	147,610,062	157,041,554
Total liabilities and stockholders' equity	$157,483,593	$ 167,022,111

See accompanying notes.

Discovery Partners International, Inc.
Condensed Consolidated Statements of Operations
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2002	June 30, 2001	June 30, 2002	June 30, 2001
Revenues	$ 8,395,348	$11,051,122	$ 18,415,720	$20,575,073
Cost of revenues	6,261,881	5,495,272	12,182,985	9,959,550
Provision for discontinued products	5,781,262	—	5,781,262	—
Anticipated contract loss	1,485,000	—	1,485,000	—
Gross margin	(5,132,795)	5,555,850	(1,033,527)	10,615,523
Operating expenses:				
Research and development	1,904,619	2,975,096	3,846,384	6,867,926
Selling, general and administrative	3,040,745	2,716,929	6,309,188	5,514,389
Amortization of stock-based compensation	174,406	275,109	372,044	599,497
Amortization of goodwill	—	1,405,386	—	2,904,953
Total operating expenses	5,119,770	7,372,520	10,527,616	15,886,765
Loss from operations	(10,252,565)	(1,816,670)	(11,561,143)	(5,271,242)
Interest income (expense), net	496,799	827,663	981,692	1,983,137
Foreign currency gains (losses)	(51,615)	27,490	(63,019)	63,354
Minority interest in Structural Proteomics	144,262	73,802	215,723	135,789
Net loss	$ (9,663,119)	$ (887,715)	$(10,426,747)	$ (3,088,962)
Net loss per share, basic and diluted	$ (0.40)	$ (0.04)	$ (0.43)	$ (0.13)
Weighted average shares outstanding, basic and diluted	24,312,924	23,996,418	24,296,152	23,885,483
The composition of stock-based compensation is as follows:				
Cost of revenues	$ 2,454	$ 4,076	$ 5,314	$ 8,557
Research and development	70,840	116,888	151,709	253,639
Selling, general and administrative	101,112	154,145	215,021	337,301
	$ 174,406	$ 275,109	$ 372,044	$ 599,497

See accompanying notes.

Discovery Partners International, Inc.
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six Months ended	
	June 30, 2002	June 30, 2001
OPERATING ACTIVITIES		
Net loss	$(10,426,747)	$ (3,088,962)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:		
Depreciation and amortization	2,671,094	2,864,768
Amortization of goodwill	—	2,904,953
Provision for discontinued products	5,781,262	—
Anticipated contract loss	1,485,000	—
Amortization of deferred compensation	372,044	599,497
Minority interest in Structural Proteomics, Inc.	(215,723)	(135,789)
Change in operating assets and liabilities:		
Accounts receivable	2,590,946	(829,877)
Inventories	(713,458)	(2,627,562)
Prepaid and other current assets	(59,572)	357,242
Accounts payable and accrued expenses	(573,960)	(2,611,040)
Deferred revenue	(915,979)	(1,682,439)
Deferred rent	7,590	24,204
Restricted cash	—	200,000
Net cash provided by (used in) operating activities	2,497	(4,025,005)
INVESTING ACTIVITIES		
Purchases of property and equipment	(1,913,862)	(2,264,138)
Other assets	179,410	473,288
Purchase of patents, license rights and other intangible assets	(2,070,590)	(2,045,221)
Additional cash consideration for acquisition of Discovery Technologies Ltd.	—	(894,300)
Purchases of short-term investments	(18,988,961)	(10,167,876)
Purchase of Systems Integration Drug Discovery Company, Inc., net of cash acquired	—	(12,011,297)
Purchase of Xenometrix, Inc., net of cash acquired	—	(1,795,077)
Net cash used in investing activities	(22,794,003)	(28,704,621)
FINANCING ACTIVITIES		
Proceeds from borrowings (principal payments) on capital leases, equipment notes payable, line of credit and promissory notes	(176,633)	304,182
Issuance of common stock, net of purchases	144,182	329,402
Net cash provided by (used in) financing activities	(32,451)	633,584
Effect of exchange rate changes	687,373	(118,686)
Net decrease in cash and cash equivalents	(22,136,584)	(32,214,728)
Cash and cash equivalents at beginning of period	50,915,481	97,690,236
Cash and cash equivalents at end of period	$ 28,778,897	$ 65,475,508
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Interest paid	$ 43,747	$ 63,163
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Fair value of assets acquired	$ —	$ 17,726,858
Cash paid for capital stock	—	(15,002,448)
Liabilities assumed	$ —	$ 2,724,410

See accompanying notes.

DISCOVERY PARTNERS INTERNATIONAL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
JUNE 30, 2002

1. 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. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The condensed consolidated balance sheet as of June 30, 2002, condensed consolidated statements of operations for the three and six months ended June 30, 2002 and 2001, and the condensed consolidated statements of cash flows for the six months ended June 30, 2002 and 2001 are unaudited, but include all adjustments (consisting of normal recurring adjustments) which the Company considers necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. The results of operations for the three and six months ended June 30, 2002 shown herein are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. For more complete financial information, these financial statements, and notes thereto, should be read in conjunction with the audited consolidated financial statements for the year ended December 31, 2001 included in the Company's Form 10-K filed with the Securities and Exchange Commission.

The consolidated financial statements include all the accounts of the Company and its wholly owned subsidiaries, IRORI Europe, Ltd., Discovery Partners International AG (DPI AG), ChemRx Advanced Technologies, Inc., Systems Integration Drug Discovery Company, Inc. and Xenometrix, Inc., and its majority owned subsidiary, Structural Proteomics, Inc. All intercompany accounts and transactions have been eliminated.

Certain prior period balances have been reclassified to conform to the current period presentation.

2. Net Loss Per Share

Basic and diluted net loss per common share are presented in conformity with SFAS No. 128, *Earnings per Share*. In accordance with SFAS No. 128, basic and diluted net loss per share has been computed using the weighted average number of shares of common stock outstanding during the period, less shares subject to repurchase. The Company has also excluded the as exercised effects of, outstanding stock options and warrants from the calculation of diluted net loss per common share because all such securities are anti-dilutive for all applicable periods presented.

3. Comprehensive Loss

SFAS No. 130, *Reporting Comprehensive Income,* requires the Company to report, in addition to net loss, comprehensive income (loss) and its components. A summary follows:

Consolidated Statements of Comprehensive Loss
(Unaudited)

	Three months ended		Six months ended	
	June 30, 2002	June 30, 2001	June 30, 2002	June 30, 2001
Comprehensive loss:				
Foreign currency translation adjustment	$ 497,357	$ (147,634)	$ 561,063	$ (550,340)
Unrealized gain (loss) on investments	216,328	(68,756)	38,664	(68,756)
Net loss	(9,663,119)	(877,715)	(10,426,747)	(3,088,962)
Comprehensive loss	$(8,949,434)	$(1,094,105)	$ (9,827,020)	$(3,708,058)

DISCOVERY PARTNERS INTERNATIONAL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)
JUNE 30, 2002

4. Inventory

Inventories are recorded at the lower of weighted average cost or market. Inventories consist of the following:

	June 30, 2002	December 31, 2001
		(Audited)
Raw materials	$ 1,305,293	$ 1,304,113
Work-in-process	1,821,183	848,664
Finished goods	18,129,977	17,441,612
	21,256,453	19,594,389
Less reserves	(18,020,456)	(11,419,634)
	$ 3,235,997	$ 8,174,755

During the six months ended June 30, 2002, the Company identified changes in the market for chemical compound libraries including a shift in demand from diverse purified compounds to purified targeted compounds and an increased demand to bring proprietary assets into drug discovery collaborations. As a result, the Company has made a decision to cease selling its chemical compounds on a stand-alone basis to third parties and, instead, will make these compounds available only as part of collaborations with future partners of the Company; however, there are no assurances that this strategy will be successful. Accordingly, the Company has increased its inventory reserve by approximately $5.8 million to fully reserve for the chemical compound libraries as of June 30, 2002.

Although the Company will not market these compounds in the future, it will fulfill its current contractual obligations, which expire in June of 2003, to supply chemical compounds. The Company has estimated that it will incur a loss of approximately $1.5 million on the delivery of these compounds and has, therefore, provided for this anticipated contract loss in the results of operations for the three months ended June 30, 2002.

5. Deferred Stock Compensation

In conjunction with the Company's initial public offering completed in July 2000, the Company recorded deferred stock compensation totaling approximately $2.7 million and $1.0 million during the years ended December 31, 2000 and 1999, respectively, representing the difference at the date of grant between the exercise or purchase price and estimated fair value of the Company's common stock as estimated by the Company's management for financial reporting purposes in accordance with Accounting Principles Board (APB) No. 25 and its related interpretation. Deferred compensation is included as a reduction of stockholders' equity and is being amortized to expense on an accelerated basis in accordance with Financial Accounting Standards Board Interpretation No. 28 over the vesting period of the options and restricted stock. During the three months ended June 30, 2002 and 2001, the Company recorded amortization of stock-based compensation expense of approximately $174,000 and $275,000, respectively. During the six months ended June 30, 2002 and 2001, the Company recorded amortization of stock-based compensation expense of approximately $372,000 and $600,000, respectively.

6. Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board (FASB) issued FASB Statements Nos. 141 and 142 (SFAS 141 and SFAS 142), *Business Combinations* and *Goodwill and Other Intangible Assets.* SFAS 141 replaces prior accounting standards and eliminates pooling-of-interests accounting prospectively. It also provides guidance on purchase accounting related to the recognition of intangible assets and accounting for negative goodwill. SFAS 142 changes the accounting for goodwill from an amortization method to an impairment write-off approach. Under SFAS 142, goodwill will be tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. SFAS 141 and SFAS 142 are effective for all business combinations completed after June 30, 2001. Additionally, effective January 1, 2002 amortization of goodwill recorded for business combinations consummated prior to July 1, 2001 ceased, and intangible assets acquired prior to July 1, 2001 that do not meet the

DISCOVERY PARTNERS INTERNATIONAL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)
JUNE 30, 2002

criteria for separate recognition under SFAS 141 have been reclassified to goodwill. The Company adopted SFAS 142 as of January 1, 2002. Accordingly, the Company ceased the amortization of goodwill and certain other intangibles resulting from acquisitions prior to July 1, 2001. The Company has determined that as of January 1, 2002 there was no impairment of goodwill.

The following pro forma information reconciles the net loss and loss per share reported for the three and six months ended June 30, 2001 to adjusted net loss and loss per share which reflects the adoption of SFAS 142 and compares the adjusted information to the current year results:

	Three months ended June 30		Six months ended June 30	
	2002	2001	2002	2001
		(Pro Forma)		(Pro Forma)
Reported net loss	$(9,663,119)	$(2,201,247)	$(10,426,747)	$(3,088,962)
Goodwill and other intangible asset amortization	—	1,600,089	—	3,265,151
Adjusted net loss	$(9,663,119)	$ (601,158)	$(10,426,747)	$ 176,189
Basic and diluted loss per share:				
Reported net loss	$ (0.40)	$ (0.09)	$ (0.43)	$ (0.13)
Goodwill and other intangible asset amortization	—	0.06	—	0.14
Adjusted net loss per share	$ (0.40)	$ (0.03)	$ (0.43)	$ 0.01

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* which addresses financial reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of,* and the accounting and reporting provisions of APB No. 30, *Reporting the Results of Operations* for a disposal of a segment of a business. Adoption of SFAS No. 144, effective January 1, 2002, did not have a significant impact on the Company's financial condition or results of operations.

DISCOVERY PARTNERS INTERNATIONAL, INC.

PART I
FINANCIAL INFORMATION (continued)

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

THIS FORM 10-Q CONTAINS CERTAIN STATEMENTS THAT ARE NOT STRICTLY HISTORICAL AND ARE "FORWARD-LOOKING" STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND INVOLVE A HIGH DEGREE OF RISK AND UNCERTAINTY. OUR ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE PROJECTED IN THE FORWARD-LOOKING STATEMENTS DUE TO RISKS AND UNCERTAINTIES THAT EXIST IN OUR OPERATIONS, DEVELOPMENT EFFORTS AND BUSINESS ENVIRONMENT, INCLUDING THOSE DESCRIBED BELOW UNDER THE HEADING "RISKS AND UNCERTAINTIES" AND THOSE DESCRIBED IN OUR FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2001 AND OTHER REPORTS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION.

Overview

We sell a broad range of products and services to pharmaceutical and biotechnology companies to make the drug discovery process for our customers faster, less expensive and more effective at generating drug candidates. We focus on the portion of the drug discovery process that begins after identification of a drug target through when a drug candidate is ready for clinical trials. Our major products and services are as follows:

- We develop, produce and sell collections of chemical compounds in collaborations with pharmaceutical and biotechnology companies to be used to test for their potential use as new drugs or for use as the chemical starting point for new drugs.
- We develop, manufacture and sell proprietary instruments and the associated line of consumable supplies that are used by the pharmaceutical and biotechnology industries in their own in-house drug discovery chemistry operations.
- We provide assay development and screening services to our customers in which chemical compounds are tested for their biological activity as potential drugs.
- We provide access to computational software tools that guide the entire process of chemical compound design, development and testing.
- We license our proprietary gene profiling system that characterizes a cell's response upon exposure to compounds and other agents by the pattern of gene expression in the cell.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an ongoing basis, we evaluate our estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates, and the estimates themselves might be different if we used different assumptions.

We believe the following critical accounting policies involve significant judgments and estimates that are used in the preparation of our financial statements.

Revenue recognition. Revenue from product sales, which include the sale of instruments, related consumables, and chemical compound libraries, is recorded as products are shipped. Certain of our contracts for product sales include customer acceptance provisions that give our customers the right of replacement if the delivered product does not meet specified criteria, however, we have reliably demonstrated that the products meet the specified criteria and we have no material history of customers exercising their right of replacement. Development contract revenues and high-throughput screening service revenues are recognized on a percentage of completion basis. Advances received under these development contracts and high-throughput screening service agreements are initially recorded as deferred revenue, which is then recognized as costs are incurred over the term of the contract. Certain of these contracts may allow the customer the right to reject acceptance of work performed, however, we have no material history of such rejections. Revenue from drug discovery and chemistry service agreements is recognized on a monthly basis and is based upon the number of full time equivalent (FTE) employees that actually worked on each agreement and the agreed-upon rate per FTE per month.

Long-lived assets. We periodically assess the recoverability of our long-lived assets by determining whether the carrying value of such assets exceeds its fair value. If impairment is indicated, we reduce the carrying value of the asset to fair value. While our current and historical operating and cash flow losses are potential indicators of impairment, we believe the future cash flows to be received from our business and long-lived assets will exceed the assets' carrying value, and accordingly, we have not recognized any impairment losses through June 30, 2002.

Inventory. Inventories are recorded at cost or market. We write-down our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than we have projected, additional inventory write-downs may be required. During the six months ended June 30, 2002, we identified changes in the market for chemical compound libraries including a shift in demand from diverse purified compounds to purified targeted compounds and an increased demand to bring proprietary assets into drug discovery collaborations. As a result, we have made a decision to cease selling our proprietary chemical compounds on a stand-alone basis to third parties and, instead, will make these compounds available only as part of collaborations with our future partners; however, there are no assurances that this strategy will be successful. We will expense the development and production of any compound that is created for exclusive use as part of collaborations with our future partners.

Results of Operations For The Three Months Ended June 30, 2002 and 2001

Revenue. Total revenues decreased 24% from the three months ended June 30, 2001 to the three months ended June 30, 2002. The revenue decline was primarily due to significantly lower revenues from the sale of chemical compounds. This decrease was partially offset by increased revenue related to collaboration agreements with large pharmaceutical companies and other service type contracts.

Cost of Revenues. Cost of revenues for the second quarter of 2002 includes a charge of $5.8 million related to provisions for discontinued products. During the six months ended June 30, 2002, we identified changes in the market for chemical compound libraries including a shift in demand from diverse purified compounds to purified targeted compounds and an increased demand to bring proprietary assets into drug discovery collaborations. As a result, we have made a decision to cease selling our proprietary chemical compounds on a stand-alone basis to third parties and, instead, will make these compounds available only as part of collaborations with our future partners; however, there are no assurances that this strategy will be successful. Accordingly, we have increased our inventory reserve by approximately $5.8 million to fully reserve for the chemical compound libraries as of June 30, 2002 and recorded this charge as cost of revenue.

Additionally, the cost of revenues for the second quarter of 2002 includes a provision for contract losses estimated at approximately $1.5 million. The associated contracts obligate us to deliver compounds each quarter through the second quarter of 2003. The pricing of the compounds included in these contracts assumed that we would sell these compounds, under certain conditions, to multiple other customers too. As a result of our decision to cease selling these compounds on a stand-alone basis these secondary sales will not be realized thus a loss is anticipated for these existing contacts.

Gross margin. Gross margin as a percentage of revenues (excluding a charge of $5.8 million related to discontinued products and $1.5 million of anticipated contract losses) decreased from 50% for the three months ended June 30, 2001 to 25% for the three months ended June 30, 2002. The reduction in gross margin for the second quarter 2002 was due to previously anticipated changes in the product and services mix, which resulted in a redeployment of company funded research and development efforts and resources to direct revenue generating activities, as well as unabsorbed biology operations capacity and non-recurring inefficiencies associated with ramping up our chemistry purification facility.

Research and development expenses. Research and development expenses consist primarily of salaries and benefits, supplies and expensed development materials, and facilities costs and equipment depreciation. Research and development expenses decreased 36% ($1.1 million) from the three months ended June 30, 2001 to the three months ended June 30, 2002. Research and development expenses decreased primarily due to the redeployment of company funded research and development efforts and resources to direct revenue generating activities.

Selling, general and administrative expenses. Selling, general and administrative expenses consist primarily of salaries and benefits for sales and marketing and administrative personnel, advertising and promotional expenses, professional services, and facilities costs. Selling, general and administrative expenses increased 12% ($324,000) from the three months ended June 30, 2001 to the three months ended June 30, 2002, due to additional personnel hired during mid to late 2001 and to a payment to a strategic consulting firm.

Stock-based compensation. During 1999 and 2000, we granted stock options with exercise prices that were less than the estimated fair value of the underlying shares of common stock on the date of grant. As a result, we have recorded deferred stock-based compensation to be amortized over the period that these options vest. The deferred stock-based compensation expense for the three months ended June 30, 2002 was approximately $174,000, compared to approximately $275,000 for the three months ended June 30, 2001.

Amortization of goodwill. We recognized no goodwill amortization expense for the three months ended June 30, 2002 compared to approximately $1.4 million in goodwill amortization expense recognized during the three months ended June 30, 2001. This decrease is due to the adoption of SFAS 142, *Goodwill and Other Intangible Assets*, effective January 1, 2002. SFAS 142 required that we cease the periodic amortization of goodwill and certain other intangibles resulting from acquisitions prior to July 1, 2001.

Interest income. We realized net interest income of approximately $497,000 for the three months ended June 30, 2002, as compared to net interest income of approximately $828,000 for the three months ended June 30, 2001. This decrease is primarily due to a decline in U.S. interest rates from the second quarter 2001 to the second quarter 2002.

Results of Operations For The Six Months Ended June 30, 2002 and 2001

Revenue. Total revenues decreased 10% from the six months ended June 30, 2001 to the six months ended June 30, 2002. The revenue decline was primarily due to significantly lower revenues from the sale of chemical compounds. This decrease was partially offset by increased revenue related to collaboration agreements with large pharmaceutical companies and other service type contracts.

Cost of Revenues. Cost of revenues for the six months ended June 30, 2002 includes a charge of $5.8 million related to provisions for discontinued products. During the six months ended June 30, 2002, we identified changes in the market for chemical compound libraries including a shift in demand from diverse purified compounds to purified targeted compounds and an increased demand to bring proprietary assets into drug discovery collaborations. As a result, we have made a decision to cease selling our chemical compounds on a stand-alone basis to third parties and, instead, will make these compounds available only as part of collaborations with our future partners; however, there are no assurances that this strategy will be successful. Accordingly, we have increased our inventory reserve by approximately $5.8 million to fully reserve for the chemical compound libraries as of June 30, 2002 and recorded this charge as cost of revenue.

Additionally, the cost of revenues for the second quarter of 2002 includes a provision for contract losses estimated at approximately $1.5 million. The associated contracts obligate us to deliver compounds each quarter

through the second quarter of 2003. The pricing of the compounds included in these contracts assumed that we would sell these compounds, under certain conditions, to multiple other customers too. As a result of our decision to cease selling these compounds on a stand-alone basis these secondary sales will not be realized thus a loss is anticipated for these existing contacts.

Gross margin. Gross margin as a percentage of revenues (excluding a charge of $5.8 million related to discontinued products and $1.5 million of anticipated contract losses) decreased from 52% for the six months ended June 30, 2001 to 34% for the six months ended June 30, 2002. The reduction in gross margin for the first half of 2002 was due to previously anticipated changes in the product and services mix, which resulted in a redeployment of company funded research and development efforts and resources to direct revenue generating activities, as well as unabsorbed biology operations capacity and non-recurring inefficiencies associated with ramping up our chemistry purification facility.

Research and development expenses. Research and development expenses consist primarily of salaries and benefits, supplies and expensed development materials, and facilities costs and equipment depreciation. Research and development expenses decreased 44% ($3.0 million) from the six months ended June 30, 2001 to the six months ended June 30, 2002. Research and development expenses decreased primarily due to the redeployment of company funded research and development efforts and resources to direct revenue generating activities.

Selling, general and administrative expenses. Selling, general and administrative expenses consist primarily of salaries and benefits for sales and marketing and administrative personnel, advertising and promotional expenses, professional services, and facilities costs. Selling, general and administrative expenses increased 14% ($795,000) from the six months ended June 30, 2001 to the six months ended June 30, 2002, due to additional personnel hired during mid to late 2001 and to a payment to a strategic consulting firm.

Stock-based compensation. During 1999 and 2000, we granted stock options with exercise prices that were less than the estimated fair value of the underlying shares of common stock on the date of grant. As a result, we have recorded deferred stock-based compensation to be amortized over the period that these options vest. The deferred stock-based compensation expense for the six months ended June 30, 2002 was approximately $372,000, compared to approximately $600,000 for the six months ended June 30, 2001.

Amortization of goodwill. We recognized no goodwill amortization expense for the six months ended June 30, 2002 compared to approximately $2.9 million in goodwill amortization expense recognized during the six months ended June 30, 2001. This decrease is due to the adoption of SFAS 142, *Goodwill and Other Intangible Assets*, effective January 1, 2002. SFAS 142 required that we cease the periodic amortization of goodwill and certain other intangibles resulting from acquisitions prior to July 1, 2001.

Interest income. We realized net interest income of approximately $982,000 for the six months ended June 30, 2002, as compared to net interest income of approximately $2.0 million for the six months ended June 30, 2001. This decrease is primarily due to a decline in U.S. interest rates.

Liquidity and Capital Resources

Since inception of the Company, we have funded our operations principally with $39.0 million of private equity financings and $94.7 million of net proceeds from our initial public offering in July/August 2000.

At June 30, 2002, cash and cash equivalents and short-term investments totaled approximately $74.1 million, compared to $77.3 million at December 31, 2001.

We currently anticipate investing between $2.0 million and $3.0 million between July 1, 2002 and December 31, 2002 for leasehold improvements and capital equipment necessary to support future revenue growth. Our actual future capital requirements will depend on a number of factors, including our success in increasing sales of both existing and new products and services, expenses associated with any unforeseen litigation, regulatory changes, competition and technological developments, and potential future merger and acquisition activity.

In April 2002, we paid $2 million in prepaid royalties as required under our exclusive Micro Arrayed Compound Screening (#ARCS) license agreement with Abbott Laboratories, which we carry on the balance sheet as other intangible assets. No other such license fees are payable for the remainder of 2002. If the Company elects to continue the exclusive license agreement with Abbott into 2003, a payment of $2 million will be due in April 2003.

RISKS AND UNCERTAINTIES

In addition to the other information contained herein, you should carefully consider the following risk factors in evaluating our company.

Risks Related To Our Business

We have a significant percentage of our revenues concentrated with a single customer and are contractually required to fulfill specific obligations. We need to continue to satisfy the customer or else we will be unable to recognize a significant portion of revenues.

We anticipate that a significant portion of our revenues for 2002 and beyond will be derived from our chemistry collaboration we entered into with Pfizer in December 2001. This collaboration requires the Company to deliver a large number of chemical compounds of guaranteed minimum purity with higher minimum weight quantity than we have historically been required to produce and deliver to other customers. We face the risk that, to the extent such minimum weight quantity and purity levels are not achieved in production, scheduled compound deliveries may be delayed, or additional costs may be required to reproduce or re-purify the compounds so that the minimum specifications are achieved, which could defer or eliminate revenues while increasing cost of revenues. We also face the risk of failing to deliver the minimum required number of compounds that Pfizer expects, which would increase the risk of Pfizer exercising its right to terminate the contract. In any event Pfizer has a contractual right to terminate the contract, with or without cause, upon six months notice beginning on January 1, 2003.

We have acquired several businesses and face risks associated with integrating these businesses and potential future acquisitions.

We completed the acquisitions of Systems Integration Drug Discovery Company, Inc. (SIDDCO) and Xenometrix last year and are in the process of integrating these businesses. We plan to continue to review potential acquisition candidates in the ordinary course of our business, and our strategy includes building our business through acquisitions. Acquisitions involve numerous risks, including, among others, difficulties and expenses incurred in the consummation of acquisitions and assimilation of the operations, personnel and services or products of the acquired companies, difficulties of operating new businesses, the diversion of management's attention from other business concerns and the potential loss of key employees of the acquired company. In addition, acquired businesses may have management structures incompatible with our own and may experience difficulties in maintaining their existing levels of business after joining us. If we do not successfully integrate and grow the businesses we have acquired or any businesses we may acquire in the future, our business will suffer. Additionally, acquisition candidates may not be available in the future or may not be available on terms and conditions acceptable to us. Acquisitions of foreign companies also may involve additional risks of assimilating different business practices, overcoming language and cultural barriers and foreign currency translation. We currently have no agreements or commitments with respect to any acquisition, and we may never successfully complete any additional acquisitions.

We may not achieve or sustain profitability in the future.

We have incurred operating and net losses since our inception. As of June 30, 2002, we had an accumulated deficit of $53 million. For the years ended December 31, 1999, 2000 and 2001 and for the six months ended June 30, 2002, we had net losses of $3.4 million, $11.7 million, $11.1 million, and $10.4 million, respectively. We may also in the future incur operating and net losses and negative cash flow from operations, due in part to acquisitions of businesses and technologies and expansion of our sales and marketing capabilities. We may not be able to achieve or maintain profitability. Moreover, if we do achieve profitability, the level of any profitability cannot be predicted and may vary significantly from quarter to quarter.

If our products and services do not become widely used in the pharmaceutical and biotechnology industries, it is unlikely that we will succeed.

We have a limited history of offering our products and services, including our collections of chemical compounds, informatics tools, biology services, micro Arrayed Compound Screening, toxicology services and NanoKan Systems. It is uncertain whether our current customers will continue to use these products and services or whether new customers will use these products and services. In order to be successful, our products and services must meet the requirements of the pharmaceutical and biotechnology industries, and we must convince potential customers to use our products and services instead of competing technologies and offerings. Moreover, we cannot thrive unless we can achieve economies of scale on our various offerings. Market acceptance will depend on many factors, including our ability to:

- convince potential customers that our technologies are attractive alternatives to other technologies for drug discovery;
- manufacture products and conduct services in sufficient quantities with acceptable quality and at an acceptable cost;
- convince potential customers to purchase drug discovery products and services from us rather than developing them internally; and
- place and service sufficient quantities of our products.

Because of these and other factors, some of which are beyond our control, our products and services may not gain sufficient market acceptance. Moreover, if market acceptance of our chemical compounds is not sufficient, it could increase the potential for additional obsolescence charges to our results of operations.

We may fail to expand customer relationships through integration of products and services.

We may not be successful in selling our offerings in combination across the range of drug discovery disciplines we serve because integrated combinations of our products and services may not achieve time and cost efficiencies for our customers, especially our large pharmaceutical company customers. On the other hand, biotechnology companies may desire our integrated offerings but are often not sufficiently financed to pay for these services. In addition, we may not succeed in further integrating our offerings. We may not be able to use existing relationships with customers in individual areas of our business to sell products and services in multiple areas of drug discovery. If we do not achieve integration of our products and services, we may not be able to take advantage of potential revenue opportunities and differentiate ourselves from competitors.

Our success will depend on our ability to manage growth and expansion.

Growth in our operations has placed and, if we grow in the future, will continue to place a significant strain on our operational, human and financial resources. In the past two and one half years we have acquired five new businesses, and we intend to continue to grow our business internally and by acquisition. As and if we expand our operations we will not necessarily have in place infrastructure and personnel sufficient to accommodate the increased size of our business. Our ability to manage effectively any growth through acquisitions or any internal growth will depend, in large part, on our ability to hire, train and assimilate additional management, professional, scientific and technical personnel and our ability to expand, improve and effectively use our operating, management, marketing and financial systems to accommodate our expanded operations. These tasks are made more difficult as we acquire businesses in geographically disparate locations, such as our acquisitions of Discovery Partners International AG in Switzerland, Axys Advanced Technologies (now part of ChemRx Advanced Technologies) in the San Francisco area, Structural Proteomics in New Jersey, SIDDCO in Tucson, Arizona and Xenometrix in Boulder, Colorado.

Additionally, as a result of these acquisitions, we have a significant amount of goodwill and we may be subject to significant impairment charges in the future if goodwill pertaining to any acquisition becomes impaired.

All our products and services have lengthy sales cycles and involve significant scientific risk of fulfillment, which could cause our operating results to fluctuate significantly from quarter to quarter.

Sales of all our products and services typically involve significant technical evaluation and commitment of expense or capital by our customers. Accordingly, the sales cycles, or the time from finding a prospective customer through closing the sale, associated with these products or collaborations, range from six to eighteen months. Sales of these products and the formation of these collaborations are subject to a number of significant risks, including customers' budgetary constraints and internal acceptance reviews that are beyond our control. Due to these lengthy and unpredictable sales cycles, our operating results could fluctuate significantly from quarter to quarter. We expect to continue to experience significant fluctuations in quarterly operating results due to a variety of factors, such as general and industry specific economic conditions, that may affect the research and development expenditures of pharmaceutical and biotechnology companies.

A large portion of our revenues rely upon the specific success, either on the customer's part in the form of delivering specified proteins for assay development or chemistry library design ideas for chemical compound development and production, or on our part in the form of assay or compound development or compound production, of scientific projects. To the extent that either we experience delays in receiving specific deliverables required for us to complete our objectives or we encounter delays in our ability meet our scientific obligations, we may be unable to recognize revenues in accordance with our expectations.

A large portion of our expenses, including expenses for facilities, equipment and personnel, is relatively fixed. Accordingly, if revenues decline or do not grow as anticipated, we might not be able to correspondingly reduce our operating expenses. Failure to achieve anticipated levels of revenues could therefore significantly harm our operating results for a particular fiscal period.

Due to the possibility of fluctuations in our revenues (on an absolute basis and relative to our expenses), we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance.

Our decision to discontinue the non-exclusive chemical compound supply product line places more emphasis on integrated drug discovery collaborations, an area of higher risk and complexity.

As a result of our decision to limit access to our proprietary chemistry compounds and capabilities solely to companies that enter into integrated drug discovery, chemistry or screening and optimization collaborations with us, we now rely on this relatively complex form of customer engagement to deliver value for the Company. As a result of the inherent complexity of such collaborations, we have an increased risk of being unable to reach agreement with the prospective customer for such collaborations or of structuring sub-optimal arrangements that fail to adequately compensate us for the risks inherent in such collaborations.

Our customers may restrict our use of scientific information, which could prevent us from using this information for additional revenue.

We plan to generate and use information that is not proprietary to our customers and which we derive from performing drug discovery services for our customers. However, our customers may not allow us to use information such as the general interaction between types of chemistries and types of drug targets that we generate when performing drug discovery services for them. Our current contracts restrict our use of certain scientific information we generate for our customers, such as the biological activity of chemical compounds with respect to drug targets, and future contracts also may restrict our use of additional scientific information. To the extent that our use of information is restricted, we may not be able to collect and aggregate scientific data and take advantage of potential revenue opportunities.

Our operations could be interrupted by damage to our facilities.

Our results of operations are dependent upon the continued use of our highly specialized laboratories and equipment. Our operations are primarily concentrated in facilities in San Diego, California, near San Francisco, California, near Basel, Switzerland and in Tucson, Arizona. Natural disasters, such as earthquakes, or terrorist acts could damage our laboratories or equipment and these events may materially interrupt our business. We maintain business interruption insurance to cover lost revenues caused by such occurrences. However, this insurance would not compensate us for the loss of opportunity and potential adverse impact on relations with existing customers created by an inability to meet our customers' needs in a timely manner, and may not compensate us for the physical damage to our facilities.

We may incur exchange losses when foreign currency used in international transactions is converted into U.S. dollars.

Currency fluctuations between the U.S. dollar and the currencies in which we do business including the British pound, the Japanese yen, the Swiss franc and the Euro will cause foreign currency translation gains and losses. We cannot predict the effects of exchange rate fluctuations on our future operating results because of the number of currencies involved, changes in the percentage of our revenue that will be invoiced in foreign currencies, the variability of currency exposure and the potential volatility of currency exchange rates. We do not currently engage in foreign exchange hedging transactions to manage our foreign currency exposure, however, during 2002, we expect to begin hedging certain transactions between the Swiss franc and other currencies that are invoiced from our Swiss affiliate in order to minimize foreign exchange transaction gains and losses.

Risks Related to Operating in Our Industry

The concentration of the pharmaceutical industry and the current trend toward increasing consolidation could hurt our business prospects.

The pharmaceutical company side of the market for our products and services is highly concentrated, with approximately 50 large pharmaceutical companies conducting drug discovery research. The continuation of the current trend toward consolidation of the pharmaceutical industry may reduce the number of our potential customers even further. Accordingly, we expect that a relatively small number of customers will account for a substantial portion of our revenues.

Additional risks associated with a highly concentrated customer base include:

- fewer customers for our products and services;
- larger companies may develop and utilize in-house technology and expertise rather than using our products and services;
- larger customers may negotiate price discounts or other terms for our products and services that are unfavorable to us; and
- the market for our products and services may become saturated.

For example, because of the heavy concentration of the pharmaceutical industry and the high cost of our NanoKan System, we expect to place only a small number of NanoKan Systems before we saturate the market for this product. We have not filled an order for a NanoKan System since 2000. When we are no longer able to sell additional NanoKan Systems, we will be dependent upon the sale of consumables for revenue from this product line.

Our success will depend on the prospects of the pharmaceutical and biotechnology industries and the extent to which these industries engage third parties to perform one or more aspects of their drug discovery process.

Our revenues depend to a large extent on research and development expenditures by the pharmaceutical, biotechnology and agricultural industries and companies in these industries outsourcing research and development projects. These expenditures are based on a wide variety of factors, including the resources available for purchasing research equipment, the spending priorities among various types of research and policies regarding expenditures during recessionary periods. General economic downturns in our customers' industries or any decrease in research and development expenditures could harm our operations, as could increased popularity of management theories that counsel against outsourcing of critical business functions. In addition, the popularity of scientific thinking that disfavors expensive products (such as large diversity libraries) could negatively impact our revenues or our sales mix. Any decrease in drug discovery spending by pharmaceutical and biotechnology companies could cause our revenues to decline and adversely impact our profitability.

The drug discovery industry is competitive and subject to technological change, and we may not have the resources necessary to compete successfully.

We compete with companies in the United States and abroad that engage in the development and production of drug discovery products and services. These competitors include companies engaged in the following areas of drug discovery:

- Assay, development and screening, including Cerep, Evotec Biosciences, Oncogene Sciences, Neogenesis, Pharmacopeia, Tripos and 3D Pharmaceuticals;
- Combinatorial chemistry instruments, including Argonaut and Mimotopes;
- Compound libraries and lead optimization, including Albany Molecular Research, Pharmacopeia, Array Biopharma and Arqule;
- Informatics, including Accelrys and Tripos; and
- Gene profiling, including Affimetrix and Gene Logic.

Academic institutions, governmental agencies and other research organizations also conduct research in areas in which we provide services, either on their own or through collaborative efforts. Also, essentially all of our pharmaceutical company customers have internal departments that provide some or all of the products and services we sell, so these customers may have limited needs for our products and services. Many of our competitors, including Pharmacopeia, have access to greater financial, technical, research, marketing, sales, distribution, service and other resources than we do. In some of our functional areas we believe we are not yet large enough to achieve optimal efficiencies, particularly in comparison to some competitors.

Moreover, the pharmaceutical and biotechnology industries are characterized by continuous technological innovation. We anticipate that we will face increased competition in the future as new companies enter the market and our competitors make advanced technologies available. Technological advances or entirely different approaches that we or one or more of our competitors develop may render our products, services and expertise obsolete or uneconomical. For example, advances in informatics and virtual screening may render some of our technologies, such as our large compound libraries, obsolete. Additionally, the existing approaches of our competitors or new approaches or technologies that our competitors develop may be more effective than those we develop. We currently are investing in micro ARCS technology to improve screening processes. However, we may be unable to successfully develop this technology and sell it to customers and we may never recover the cost of our investment including the prepaid royalty to Abbott, which is carried on our balance sheet as other intangible assets in an amount equal to approximately $4.0 million and which could grow to over $6.0 million during 2003. We may not be able to compete successfully with existing or future competitors.

Our success will depend on technological improvements to the process of drug discovery and on improvements to our customers' expected return on investment (ROI) of investments in the phases of the drug discovery and development process that we participate in.

The drug discovery and development process can be broadly separated into the following stages: Target identification; target validation; lead discovery; lead optimization; pre-clinical development; IND filing; clinical trials, phases I-III; new drug application (NDA); and post market surveillance. The company currently participates in the areas of lead discovery and lead optimization. Current market studies indicate that, on average, less than one in fifty leads discovered ultimately result in an NDA. Moreover, based on current averages, for the isolated phases of lead discovery and lead optimization, the cost of acquiring a validated target plus the costs of lead discovery and lead optimization are greater than the expected proceeds of out-licensing a potential drug candidate during the pre-clinical phase of drug development. It is estimated that currently, a positive expected ROI on drug discovery and development does not occur until the drug candidate has successfully passed through phase II of clinical trials. Such conditions place increased risk on the Company's ability to solicit profitable business from collaboration partners who are unable to fund the development of drug candidates through phase II of clinical trials.

Our success will depend on our ability to attract and retain key executives, and experienced scientists and sales personnel.

Our future success will depend to a significant extent on our ability to attract, retain and motivate highly skilled scientists and sales personnel. In addition, our business would be significantly harmed if we lost the services of Riccardo Pigliucci, our chief executive officer. Our ability to maintain, expand or renew existing engagements with our customers, enter into new engagements and provide additional services to our existing customers depends, in large part, on our ability to hire and retain scientists with the skills necessary to keep pace with continuing changes in drug discovery technologies and sales personnel who are highly motivated. Additionally, it is difficult for us to find qualified sales personnel in light of the fact that our sales personnel generally hold Ph.D's. Our employees are "at will," which means that they may resign at any time, and we may dismiss them at any time. We believe that there is a shortage of, and significant competition for, scientists with the skills and experience in the sciences necessary to perform the services we offer. We compete with pharmaceutical companies, biotechnology companies, combinatorial chemistry companies, contract research companies and academic institutions for new personnel. We may not be successful in attracting new scientists or sales personnel or in retaining or motivating our existing personnel.

The intellectual property rights we rely on to protect the technology underlying our products and techniques may not be adequate, which could enable third parties to use our technology or very similar technology and could reduce our ability to compete in the market.

Our success will depend on our ability to obtain, protect and enforce patents on our technology and to protect our trade secrets. We also depend, in part, on patent rights that third parties license to us. Any patents we own or license may not afford meaningful protection for our technology and products. Others may challenge our patents or the patents of our licensors and, as a result, these patents could be narrowed, invalidated or rendered unenforceable. In addition, current and future patent applications on which we depend may not result in the issuance of patents in the United States or foreign countries. Competitors may develop products similar to ours that are not covered by our patents. Further, since there is a substantial backlog of patent applications at the U.S. Patent and Trademark Office, the approval or rejection of our or our competitors' patent applications may take several years.

In addition to patent protection, we also rely on copyright protection, trade secrets, know-how, continuing technological innovation and licensing opportunities. In an effort to maintain the confidentiality and ownership of our trade secrets and proprietary information, we require our employees, consultants and advisors to execute confidentiality and proprietary information agreements. However, these agreements may not provide us with adequate protection against improper use or disclosure of confidential information, and there may not be adequate remedies in the event of unauthorized use or disclosure. Furthermore, like many technology companies, we may from time to time hire scientific personnel formerly employed by other companies involved in one or more areas similar to the activities conducted by us. In some situations, our confidentiality and proprietary information

agreements may conflict with, or be subject to, the rights of third parties with whom our employees, consultants or advisors have prior employment or consulting relationships. Although we require our employees and consultants to maintain the confidentiality of all confidential information of previous employers, their prior affiliations may subject us or these individuals to allegations of trade secret misappropriation or other similar claims. Finally, others may independently develop substantially equivalent proprietary information and techniques, or otherwise gain access to our trade secrets. Our failure to protect our proprietary information and techniques may inhibit or limit our ability to exclude certain competitors from the market.

The drug discovery industry has a history of intellectual property litigation and we may be involved in intellectual property lawsuits, which may be expensive.

In order to protect or enforce our patent rights, we may have to initiate legal proceedings against third parties. In addition, others may sue us for infringing their intellectual property rights, or we may find it necessary to initiate a lawsuit seeking a declaration from a court that we are not infringing the proprietary rights of others. The patent positions of pharmaceutical, biotechnology and drug discovery companies are generally uncertain. A number of pharmaceutical companies, biotechnology companies, independent researchers, universities and research institutions may have filed patent applications or may have been granted patents that cover technologies similar to the technologies owned by, or licensed to, us or our collaborators. A number of patents may have been issued or may be issued in the future that could cover certain aspects of our technology and that could prevent us from using technology that we use or expect to use. In addition, we are unable to determine all of the patents or patent applications that may materially affect our ability to make, use or sell any potential products. Legal proceedings relating to intellectual property would be expensive, take significant time and divert management's attention from other business concerns, no matter whether we win or lose. The cost of such litigation could affect our profitability.

Further, an unfavorable judgment in an infringement lawsuit brought against us, in addition to any damages we might have to pay, could require us to stop the infringing activity or obtain a license. Any required license may not be available to us on acceptable terms, or at all. In addition, some licenses may be nonexclusive, and therefore, our competitors may have access to the same technology that is licensed to us. If we fail to obtain a required license or are unable to design around a patent, we may be unable to sell some of our products or services.

We may be subject to liability regarding hazardous materials.

Our products and services as well as our research and development processes involve the controlled use of hazardous materials. For example, we sometimes use acids, bases, oxidants, and flammable materials. Acids include trifluoroacetic acid and hydrochloric acid, bases include sodium hydroxide and triethylamine, oxidants include peracids and potassium permanganate, and flammable solvents include methanol, hexane and tetrahydrofuran. We are subject to federal, state and local laws and regulations governing the use, manufacture, storage, handling and disposal of such materials and certain waste products. We cannot completely eliminate the risk of accidental contamination or injury from these materials. In the event of such an accident, we could be held liable for any damages that result, and any such liability could exceed our resources and disrupt our business. In addition, we may have to incur significant costs to comply with environmental laws and regulations related to the handling or disposal of such materials or waste products in the future, which would require us to spend substantial amounts of money.

Other Risks and Uncertainties

Our stock price likely will be volatile.

The trading price of our common stock likely will be volatile and could be subject to fluctuations in price in response to various factors, many of which are beyond our control, including:

- actual or anticipated variations in quarterly operating results;
- announcements of technological innovations by us or our competitors;
- new products or services introduced or announced by us or our competitors;

- changes in financial estimates by securities analysts;
- conditions or trends in the pharmaceutical and biotechnology industries or in the drug discovery “tools” industry;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- the implementation or wind-down of stock buyback programs;
- additions or departures of key personnel;
- economic and political factors; and
- sales of our common stock.

In addition, price and volume fluctuations in the stock market in general, and the Nasdaq National Market and the market for technology companies in particular, have often been unrelated or disproportionate to the operating performance of those companies. Further, the market prices of securities of life sciences companies have been particularly volatile. Conditions or trends in the pharmaceutical and biotechnology industries generally may cause further volatility in the trading price of our common stock, because the market may incorrectly perceive us as a pharmaceutical or biotechnology company. These broad market and industry factors may harm the market price of our common stock, regardless of our operating performance. In the past, plaintiffs have often instituted securities class action litigation following periods of volatility in the market price of a company’s securities. A securities class action suit against us could result in potential liabilities, substantial costs and the diversion of management’s attention and resources, regardless of whether we win or lose.

Because it is unlikely that we will pay dividends, our stockholders will only be able to benefit from holding our stock if the stock price appreciates.

We have never paid cash dividends on our capital stock and do not anticipate paying any cash dividends in the foreseeable future.

Anti-takeover provisions in our charter and bylaws could make a third-party acquisition of us difficult.

Our certificate of incorporation and bylaws contain provisions that could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. These provisions could limit the price that investors might be willing to pay in the future for shares of our common stock. In addition, as a result of our acquisition of Axys Advanced Technologies, we have a standstill agreement with Axys Pharmaceuticals, which prevents Axys Pharmaceuticals (and prevents its subsequent acquiror, the Celera Genomics business of Applera Corporation) from making a hostile effort to acquire us.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Short-term investments. Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since a significant portion of our investments are and will be in short-term marketable securities, U.S. government securities and corporate bonds. Due to the nature and maturity of our short-term investments, we have concluded that there is no material market risk exposure to our principal. The average maturity of our investment portfolio is six months. A 1% change in interest rates throughout a one-year period would have an annual effect of approximately $389,000 on our income.

Foreign currency rate fluctuations. The functional currency for our Discovery Partners International AG (DPI AG) group is the Swiss franc. DPI AG accounts are translated from their local currency to the U.S. dollar using the current exchange rate in effect at the balance sheet date for the balance sheet accounts, and using the average

exchange rate during the period for revenues and expense accounts. The effects of translation for our Discovery Partners International AG group are recorded as a separate component of stockholders' equity (accumulated other comprehensive income (loss)). DPI AG conducts its business with customers in local currencies. Exchange gains and losses arising from these transactions are recorded using the actual exchange differences on the date of the transaction. We have not in the past taken any action to reduce our exposure to changes in foreign currency exchange rates, such as options or futures contracts, with respect to transactions with DPI AG or transactions with our worldwide customers, but anticipate that we will begin to hedge against foreign exchange transaction gains and losses resulting from non-Swiss franc invoices issued to customers by DPI AG during 2002. A 10% change in the value of the Swiss franc relative to the U.S. dollar throughout the first half of 2002 would have resulted in a 1% change in revenue for the six months ended June 30, 2002.

Inflation. We do not believe that inflation has had a material impact on our business or operating results during the periods presented.

PART II
OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 2. Changes in Securities and Use of Proceeds

On August 1, 2000, we closed the sale of 5,000,000 shares of our Common Stock, $0.001 par value, in our initial public offering (the "Offering"), and on August 30, 2000 we closed the sale of an additional 750,000 shares of Common Stock pursuant to the exercise of the underwriters' overallotment option in the Offering. The shares of Common Stock sold in the Offering were registered under the 1933 Act on a Registration Statement on Form S-1 (Reg. No. 333-36638) that was declared effective by the SEC on July 27, 2000.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

The Company held its annual meeting of stockholders on May 15, 2002.

The following matters were voted upon at the meeting:

1. The stockholders elected two Directors to hold office for a term expiring upon the 2005 Annual Meeting of Stockholders:

Name of Director Elected	Shares Voting in Favor	Shares Withheld
Alan J. Lewis	20,613,275	258,155
John P. Walker	20,613,275	258,155

The following individuals are continuing directors with terms expiring upon the 2003 Annual Meeting of Stockholders: Riccardo Pigliucci and Harry F. Hixson. The following individuals are continuing directors with terms expiring upon the 2004 Annual Meeting of Stockholders: Dieter Hoehn and Colin Dollery.

2. The stockholders ratified the appointment of Ernst & Young LLP as the Company's independent auditors for the fiscal year ending December 31, 2002:

	Votes
For	20,832,830
Against	36,900
Abstaining	1,700

Item 5. Other Information

In June 2002, the Company hired Taylor J. Crouch and in July 2002 he was appointed its President and Chief Operating Officer. In connection with Mr. Crouch's employment offer, the Company agreed to assist him in his relocation from Massachusetts to California. On July 29, 2002, we loaned Mr. Crouch $300,000 against his full recourse non-interest bearing promissory note.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit Number	Exhibit Description
10.57	Offer letter between us and Taylor J. Crouch, dated June 18, 2002.
10.58	Promissory Note issued by Taylor J. Crouch, dated July 29, 2002.
99.1	Certification under Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K:

None.

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.

DISCOVERY PARTNERS INTERNATIONAL, INC.

Date: August 8, 2002

By: /s/ Riccardo Pigliucci

Riccardo Pigliucci
Chief Executive Officer
(Duly Authorized Officer)

Date: August 8, 2002

By: /s/ Craig Kussman

Craig Kussman
Chief Financial Officer, Vice President Finance
and Administration and Secretary
(Principal Financial and Accounting Officer)

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EXHIBIT INDEX

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Exhibit 10.57

June 18, 2002

Mr. Taylor J. Crouch
83 Belcher Drive
Sudbury, MA 01776

Dear Taylor:

On behalf of Discovery Partners International (DPI), I am pleased to offer you the position of President and Chief Operating Officer. You will report directly to Riccardo Pigliucci, Chairman and Chief Executive Officer and will be based in San Diego, California.

Your annual base salary will be $325,000 and you will be eligible for a year-end incentive cash bonus with a target payout of 35% of base salary based on accomplishment of established performance objectives. For 2002, the base salary will be prorated and the bonus eligibility will be based on a percentage of the prorated base salary.

Subject to Board approval, we will grant you Stock Options representing 300,000 shares of DPI common stock subject to standard four year vesting (one year cliff and then monthly) and other standard terms. These will be ISO to the extent allowed by current tax regulations. It is our intention to have the Board approve this grant as soon as possible after you join the Company. The vesting commencement date will be your first day of work, the option term will begin on the date the Board acts to grant the options and the exercise price will be 100% of the closing market price on the date the Board grants the options.

You will be provided a relocation package inclusive of closing costs, moving expenses and reasonable real estate expenses including commissions with the agreement that should you be terminated for cause or voluntarily resign your position before your one year anniversary with DPI, you will reimburse us all amounts paid for relocation.

In order to assist you with relocating from Sudbury to San Diego, DPI will provide you with a five year fully secured interest free loan of up to $300,000 providing you roll all your equity from your existing homes into your new home.

Health benefits will be provided during your employment in accordance with DPI's health plan. You will also be entitled to other DPI fringe benefits, which includes accruing 4.0 weeks paid time-off per year and participation in our 401(k) plan. Details of our benefit plans will be provided to you through Human Resources.

Should the Company terminate you other than for cause, you will be entitled to 6 months base salary continuation severance pay if such termination occurs in the first 6 months of employment and to one year thereafter. Should your loan with the Company be still outstanding at the time of termination, your loan will be due by the end of the severance period.

Should a change in control coupled with a material reduction in responsibilities occur in the first 12 months of your employment, then you would be eligible for 1 year of severance pay and your loan would be due the latter of the end of the severance period or July 1, 2004.

Any and all taxes on the compensation, benefits and other items described in this letter are your sole responsibility, other than FUTA.

Your duties will include overall responsibility for the operational management of DPI and its subsidiaries.

Employment with the Company is conditional on your signing of a standard employee inventions agreement and providing proof of employment eligibility. You will be subject to all company employee policies and procedures including the

insider trading policy. Subject to the terms and conditions of this offer letter, the Company reserves the right to terminate your employment at any time and for any reason. Similarly, the employee has the right to cease company employment at any time. Any legal disagreements with the Company will be settled by binding arbitration in San Diego (AAA rules).

The "at-will" nature of your employment described in this letter shall constitute the entire agreement between you and DPI concerning the nature of your employment. Any modification or alteration of the "at-will" term of your employment can be made only in writing and signed by you and the current Chairman and CEO of DPI.

If you accept this offer and agree to all of the terms stated in this letter, please return to Janell Jackson, DPI's Director of Human Resources, a signed copy of this letter by Wednesday, June 19, 2002. This offer, if not accepted, will expire on that date.

Taylor, we're looking forward to you joining the DPI team. I am personally very pleased that you are considering joining our Company and am looking forward to working with you.

Sincerely,

Riccardo Pigliucci
Chairman and Chief Executive Officer

RP:dlb

Agreed by:

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Taylor J. Crouch	Date

Exhibit 10.58

PROMISSORY NOTE

$300,000.00

San Diego, CA July 29, 2002

For value received, the undersigned hereby promises to pay to Discovery Partners International, Inc., a Delaware corporation, or order (the "Holder") at 9640 Towne Centre Drive, San Diego, CA 92121, the principal amount of Three Hundred Thousand Dollars ($300,000.00), plus interest accrued thereon.

This Promissory Note shall bear no interest until due (upon maturity or acceleration), and after it is due (upon maturity or acceleration) shall bear interest at 10 percent per annum.

All principal shall be due and payable in a lump sum on July 29, 2007.

This Promissory Note may be prepaid at any time, without premium or penalty; provided, that any such prepayment must be of the entire principal amount.

Upon the happening of any of the following events, Holder may, at its option, declare immediately due and payable the entire unpaid principal amount of this Promissory Note, plus any other amounts payable at the time of such declaration pursuant to this Promissory Note. Such events are the following: (1) the maker of this Promissory Note ("Maker") shall admit in writing his inability to pay his debts as they become due, shall make a general assignment for the benefit of creditors or shall file any petition or action for relief under any bankruptcy, reorganization, insolvency or moratorium law, or any other law or laws for the relief of, or relating to, debtors; or (2) an involuntary petition shall be filed against Maker under any bankruptcy, reorganization, insolvency or moratorium law, or any other law or laws for the relief of, or relating to, debtors unless such petition shall be dismissed or vacated within sixty (60) days of the date thereof; or (3) Maker breaches his promise set forth in the following paragraph; or (4) Maker dies; or (5) Maker's employment with the Holder shall, for any reason whatsoever, cease, provided that, in such event, Holder agrees to defer such declaration until the later of (a) the end of Maker's severance period in the event Maker is terminated by Holder; or (b) July 1, 2004, if, in the event of a change in control of the Company, Maker is either (i) terminated by Holder, or (ii) Maker suffers a material reduction in responsibilities.

Maker represents to Holder that Maker intends to purchase, within the next 2 months, a home in San Diego County; and Maker agrees that immediately upon such purchase he shall deliver to Holder a deed of trust covering such property, to secure all of Maker's obligations under this Promissory Note. Nothing in this Promissory Note shall be construed as a right for Maker to remain in Holder's employee; such employment can be terminated by Maker or by Holder at any time, for any reason.

This is a full-recourse Promissory Note. The Holder shall not be required to proceed first against the deed of trust collateral.

The acceptance by Holder of any payment hereunder which is less than the payment in full of all amounts due and payable at the time of such payment shall not constitute a waiver of the right to accelerate at that time or any subsequent time or nullify any prior acceleration without the express consent of Holder except as and to the extent otherwise provided by law.

The Maker of this Promissory Note waives diligence, presentment, protest and demand and also notice of protest, demand, dishonor and nonpayment of this Promissory Note, and expressly agrees that this Promissory Note, or any payment hereunder, may be extended from time to time and consents to the acceptance of security, if any, or the release of security, if any, from this Promissory Note, all without in any way affecting the liability of the Maker.

The right to plead any and all statutes of limitations as a defense to any demand on this Promissory Note, or any instrument securing this Promissory Note, or any and all obligations or liabilities arising out of or in connection with this Promissory Note, is expressly waived by Maker to the fullest extent

permitted by law.

If Holder should institute collection efforts, of any nature whatsoever, to attempt to collect any and all amounts due hereunder upon the default of Maker, Maker shall be liable to pay to Holder immediately and without demand all reasonable costs and expenses of collection incurred by Holder, including without limitation reasonable attorneys fees, whether or not suit or other action or proceeding be instituted and specifically including but not limited to collection efforts that may be made on appeal or through a bankruptcy court, and all such sums shall be fully secured by all instruments, if any, securing this Promissory Note.

The provisions of this Promissory Note are intended by Maker to be severable and divisible and the invalidity or unenforceability of a provision or term herein shall not invalidate or render unenforceable the remainder of this Promissory Note or any part thereof.

This Promissory Note shall be governed by and construed and interpreted in accordance with the internal laws of the State of California.

/s/ TAYLOR J. CROUCH

Taylor J. Crouch

Exhibit 99.1

CERTIFICATION UNDER SECTION 906 OF THE SABARNES-OXLEY ACT OF 2002

Riccardo Pigliucci and Craig Kussman hereby certify that:

1. They are the Chief Executive Officer and Chief Financial Officer, respectively, of Discovery Partners International, Inc.

2. The Form 10-Q report of Discovery Partners International, Inc., which accompanies this certification, fully complies with the requirements of section 13(a) of the Securities Exchange Act of 1934.

3. The information contained in the Form 10-Q report of Discovery Partners International, Inc., which accompanies this certification, fairly presents, in all material respects, the financial condition and results of operations of Discovery Partners International, Inc.

/s/ Riccardo Pigliucci	/s/ Craig Kussman
Riccardo Pigliucci	Craig Kussman
Chief Executive Officer	Chief Financial Officer

Date: August 8, 2002