CODEXIS INC
Form 10-Q
November 07, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

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: 001-34705

Codexis, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**71-0872999**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
200 Penobscot Drive, Redwood City	**94063**
(Address of principal executive offices)	**(Zip Code)**

(650) 421- 8100

(Registrant s telephone number, including area code)(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant 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 x 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. (Check one)

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	x (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 x

As of October 31, 2011, there were 35,948,053 shares of the registrant s Common Stock, par value $0.0001 per share, outstanding.

Table of Contents

Codexis, Inc.

Quarterly Report on Form 10-Q

For The Three Months Ended September 30, 2011

INDEX

Table of Contents

Codexis, Inc.

Condensed Consolidated Balance Sheets

(Unaudited)

(In Thousands)

	September 30, 2011	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 30,132	$ 72,396
Marketable securities	19,503	
Accounts receivable, net of allowances of $58 at September 30, 2011 and December 31, 2010, respectively	19,325	15,333
Inventories	5,240	2,817
Prepaid expenses and other current assets	2,837	1,646
Total current assets	77,037	92,192
Restricted cash	1,511	1,466
Non-current marketable securities	21,020	1,650
Property and equipment, net	23,321	21,452
Intangible assets, net	17,372	20,158
Goodwill	3,241	3,241
Other non-current assets	1,120	1,141
Total assets	$ 144,622	$ 141,300
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 7,509	$ 9,208
Accrued compensation	6,165	8,107
Other accrued liabilities	12,100	5,630
Deferred revenues	8,632	4,539
Total current liabilities	34,406	27,484
Deferred revenues, net of current portion	1,871	5,074
Other long-term liabilities	1,870	1,381
Commitments and contingencies		
Stockholders equity:		
Common stock	4	4
Additional paid-in capital	285,650	275,540
Accumulated other comprehensive income (loss)	223	(34)
Accumulated deficit	(179,402)	(168,149)
Total stockholders' equity	106,475	107,361
Total liabilities and stockholders' equity	$ 144,622	$ 141,300

3

Table of Contents

Codexis, Inc.

Condensed Consolidated Statements of Operations

(Unaudited)

(In Thousands, Except Per Share Amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues:				
Product	$ 12,199	$ 9,491	$ 33,528	$ 24,250
Collaborative research and development	19,201	17,243	54,073	49,450
Government grants	1,882	379	2,771	3,593
Total revenues	33,282	27,113	90,372	77,293
Costs and operating expenses:				
Cost of product revenues	9,958	8,563	28,713	19,856
Research and development	16,786	13,070	45,502	39,056
Selling, general and administrative	8,871	7,940	27,160	25,192
Total costs and operating expenses	35,615	29,573	101,375	84,104
Loss from operations	(2,333)	(2,460)	(11,003)	(6,811)
Interest income	76	61	195	135
Interest expense and other, net	(411)	(35)	(378)	(1,047)
Loss before provision for income taxes	(2,668)	(2,434)	(11,186)	(7,723)
Provision for income taxes	74	298	68	324
Net loss	$ (2,742)	$ (2,732)	$ (11,254)	$ (8,047)
Net loss per share of common stock, basic and diluted	$ (0.08)	$ (0.08)	$ (0.32)	$ (0.38)
Weighted average common shares used in computing net loss per share of common stock, basic and diluted	35,919	34,200	35,576	21,272

Table of Contents

Codexis, Inc.

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(In Thousands)

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Operating activities:		
Net loss	$ (11,254)	$ (8,047)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of intangible assets	2,787	402
Depreciation and amortization of property and equipment	5,678	5,298
Revaluation of redeemable convertible preferred stock warrant liability		677
Gain from extinguishment of asset retirement obligation	(124)	
Loss on disposal of property and equipment	31	
Stock-based compensation	7,393	6,466
Accretion of asset retirement obligation	27	
Amortization of debt discount		70
Accretion (amortization) of premium/discount on marketable securities	501	511
Changes in operating assets and liabilities:		
Accounts receivable	(3,991)	(8,132)
Inventories	(2,423)	(331)
Prepaid expenses and other current assets	(844)	(213)
Other assets	20	2,602
Accounts payable	(1,699)	(1,360)
Accrued compensation	(1,942)	(472)
Other accrued liabilities	7,355	(4,247)
Deferred revenues	891	(9,276)
Net provided by (used in) in operating activities	2,406	(16,052)
Investing activities:		
Change in restricted cash	(46)	65
Purchase of property and equipment	(7,813)	(4,740)
Purchase of marketable securities	(50,900)	(49,051)
Proceeds from sale of marketable securities	5,008	1,605
Proceeds from maturities of marketable securities	6,500	70,696
Net provided by (used in) in investing activities	(47,251)	18,575
Financing activities:		
Principal payments on financing obligations		(3,979)
Payments in preparation for initial public offering		(3,870)
Proceeds from issuance of common stock on IPO		72,551
Proceeds from exercises of stock options	2,476	279
Net cash provided by (used in) financing activities	2,476	64,981
Effect of exchange rate changes on cash and cash equivalents	105	(15)
Net increase (decrease) in cash and cash equivalents	(42,264)	67,489
Cash and cash equivalents at the beginning of the period	72,396	31,785
Cash and cash equivalents at the end of the period	$ 30,132	$ 99,274

Reclassification of preferred stock warrant from liability to additional paid-in capital	$	$ 2,686
Conversion of preferred stock to common stock and additional paid-in capital	$	$ 179,672

5

Table of Contents

Codexis, Inc.

Notes to Condensed Consolidated Financial Statements

(UNAUDITED)

1. Description of Business

Codexis, Inc. (us , we or Codexis) is a developer of proprietary biocatalysts, which are enzymes or microbes that initiate or accelerate chemical reactions. We are currently selling our biocatalysts to customers in the pharmaceutical industry and are engaged in a multi-year research and development collaboration with Equilon Enterprises LLC dba Shell Oil Products US (Shell) to develop biocatalysts for use in producing advanced biofuels. We are also pursuing opportunities in the bio-based chemicals market, including developing sustainable detergent alcohol for use in the household products market in collaboration with Chemtex, a wholly owned subsidiary of Italy s Gruppo Mossi & Ghisolfi (M&G). Additionally, we are using our technology platform to pursue biocatalyst-enabled solutions in other bioindustrial markets, including carbon management and water treatment. We were incorporated in Delaware in January 2002.

2. Summary of Significant Accounting Policies

Basis of Presentation and Consolidation

The accompanying interim condensed consolidated balance sheet as of September 30, 2011 and the interim condensed consolidated statements of operations for the three and nine months ended September 30, 2011 and 2010 and cash flows for the nine months ended September 30, 2011 and 2010 are unaudited. These interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and the applicable rules and regulations of the Securities and Exchange Commission (SEC) for interim financial information. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. These interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in our Annual Report on Form 10-K filed with the SEC on February 10, 2011. The December 31, 2010 condensed consolidated balance sheet included herein was derived from the audited financial statements as of that date, but does not include all disclosures including notes required by GAAP for complete financial statements.

The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and, in the opinion of management, reflect all adjustments of a normal recurring nature considered necessary to present fairly our financial position as of September 30, 2011 and results of our operations for the three and nine months ended September 30, 2011 and 2010, and cash flows for the nine months ended September 30, 2011 and 2010. The interim results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

The unaudited interim condensed consolidated financial statements include the accounts of Codexis and our wholly-owned subsidiaries. We have subsidiaries in United States, Brazil, Germany, Hungary, India, Mauritius, The Netherlands and Singapore. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and such differences may be material to the condensed consolidated financial statements.

Table of Contents

Foreign Currency Translation

The assets and liabilities of foreign subsidiaries, where the local currency is the functional currency, are translated from their respective functional currencies into U.S. dollars at the exchange rates in effect at the balance sheet date, with resulting foreign currency translation adjustments recorded in accumulated other comprehensive income (loss) in the condensed consolidated balance sheets. Revenue and expense amounts are translated at average rates during the period. For the nine months ended September 30, 2011 and 2010, we recorded a translation adjustment gain of $13,000 and loss of $25,000, respectively. For the three months ended September 30, 2011 and 2010, we recorded a translation adjustment loss of $31,000 and gain of $41,000, respectively. Where the U.S. dollar is the functional currency, nonmonetary assets and liabilities originally acquired or assumed in other currencies are recorded in U.S. dollars at the exchange rates in effect at the date they were acquired or assumed. Monetary assets and liabilities denominated in other currencies are translated into U.S. dollars at the exchange rates in effect at the balance sheet date with resulting foreign currency translation amounts recorded as part of interest expenses and other net in the condensed consolidated statements of operations.

Fair Value of Financial Instruments

The carrying amounts of certain of our financial instruments, including cash and cash equivalents, restricted cash, accounts receivable and accounts payable, approximate fair value due to their short maturities.

Fair value is considered to be the price at which an asset could be exchanged or a liability transferred (an exit price) in an orderly transaction between knowledgeable, willing parties in the principal or most advantageous market for the asset or liability. Where available, fair value is based on or derived from observable market prices or other observable inputs. Where observable prices or inputs are not available, valuation models are applied. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency for the instruments or market and the instruments complexity.

Cash, Cash Equivalents and Marketable Securities

We consider all highly liquid investments with maturity dates of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents consist of cash on deposit with banks and money market funds. The majority of our cash and cash equivalents are maintained with major financial institutions in North America. Deposits with these financial institutions may exceed the amount of insurance provided on such deposits. Marketable securities included in current assets are primarily comprised of commercial paper and corporate bonds. Marketable securities included in non-current assets are primarily comprised of corporate bonds, government-sponsored enterprise securities and U.S. Treasury obligations that have a maturity date greater than 1 year. Our investment in common shares of CO_2 Solution, Inc. (CO_2 Solution) is also included in non-current marketable securities.

Our investments in debt and equity securities are classified as available-for-sale and are carried at estimated fair value. Unrealized gains and losses are reported as a component of accumulated other comprehensive income (loss). Amortization of purchase premiums and accretion of purchase discounts, realized gains and losses of debt securities and declines in value deemed to be other than temporary, if any, are included in interest income or interest expense and other, net. The cost of securities sold is based on the specific-identification method. There were no significant realized gains or losses from sales of marketable securities during the three months and nine months ended September 30, 2011 and 2010. At September 30, 2011, we did not have any other than temporary declines in the fair value of our marketable securities.

Restricted Cash

Restricted cash consisted of amounts invested in money market accounts primarily for purposes of securing a standby letter of credit as collateral for our Redwood City, California facility lease agreement and for the purpose of securing a working capital line of credit.

Revenue Recognition

In October 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards for multiple-element revenue arrangements (ASU 2009-13) to:

- provide updated guidance on whether multiple deliverables exist, how the elements in an arrangement should be separated, and how the consideration should be allocated;

require an entity to allocate revenue in an arrangement using estimated selling prices (ESP) of each element if a vendor does not have vendor-specific objective evidence of selling price (VSOE) or third-party evidence of selling price (TPE); and

eliminate the use of the residual method and require a vendor to allocate revenue using the relative selling price method.

7

Table of Contents

In April 2010, the FASB amended the accounting standards for revenue recognition related to milestones (ASU 2010-17) to:

- provide updated guidance on accounting for revenue using the milestone method, clarifying that the milestone method is a valid application of the proportional performance model when applied to research or development arrangements. We already applied a milestone method approach to its research or development arrangements, established the milestone method and provided guidance to the substantive nature of the milestone.

We adopted the above accounting guidance on January 1, 2011, for applicable arrangements entered into or materially modified after January 1, 2011 (the beginning of our fiscal year). We have determined that adoption of this new guidance did not have a material impact on our results of operations, cash flows or financial position. The potential future impact of the adoption of the ASU 2009-13 guidance will depend on the nature of any new arrangements or material modifications of existing arrangements that are entered into in the future.

Our primary sources of revenues consist of collaborative research and development agreements, product revenues and government grants. Collaborative research and development agreements typically provide us with multiple revenue streams, including up-front fees for licensing, exclusivity and technology access, fees for full-time employee equivalent (FTE) services and the potential to earn milestone payments upon achievement of contractual criteria and royalty fees based on future product sales or cost savings by our customers. Our collaborative research and development revenues consist of revenues from related parties and revenues from other customers with collaborative research and development agreements.

For each source of collaborative research and development revenues, product revenues and grant revenues, we apply the following revenue recognition criteria:

- Up-front fees received in connection with collaborative research and development agreements, including license fees, technology access fees, and exclusivity fees, are deferred upon receipt, are not considered a separate unit of accounting and are recognized as revenues over the relevant performance periods.

- Revenues related to FTE services are recognized as research services are performed over the related performance periods for each contract. We are required to perform research and development activities as specified in each respective agreement. The payments received are not refundable and are based on a contractual reimbursement rate per FTE working on the project. When up-front payments are combined with FTE services in a single unit of accounting, we recognize the up-front payments using the proportionate performance method of revenue recognition based upon the actual amount of research and development labor hours incurred relative to the amount of the total expected labor hours to be incurred by us, up to the amount of cash received. In cases where the planned levels of research services fluctuate substantially over the research term, we are required to make estimates of the total hours required to perform our obligations. Research and development expenses related to FTE services under the collaborative research and development agreements approximate the research funding over the term of the respective agreements.

- A payment that is contingent upon the achievement of a substantive milestone is recognized in its entirety in the period in which the milestone is achieved. A milestone is an event (i) that can only be achieved based in whole or in part on either our performance or on the occurrence of a specific outcome resulting from our performance, (ii) for which there is substantive uncertainty at the date the arrangement is entered into that the event will be achieved and (iii) results in additional payments being due to us. Milestones are considered substantive when the consideration earned from the achievement of the milestone (i) is commensurate with either our performance to achieve the milestone or the enhancement of value of the item delivered as a result of a specific outcome resulting from our performance; (ii) relates solely to past performance and (iii) is reasonable relative to all deliverable and payment terms in the arrangement.

- Other payments received for which such payments are contingent solely upon the passage of time or the result of a collaborative partner s performance are recognized as revenue when earned in accordance with the contract terms and when such payments can be reasonably estimated and collectability is reasonably assured.

We recognize revenues from royalties based on licensees sales of products using our technologies. Royalties are recognized as earned in accordance with the contract terms when royalties from licensees can be reasonably estimated and collectability is reasonably assured.

Product revenues are recognized once passage of title and risk of loss has occurred and contractually specified acceptance criteria have been met, provided all other revenue recognition criteria have also been met. Product revenues consist of sales of biocatalysts, intermediates, active pharmaceutical ingredients and Codex Biocatalyst Panels and Kits. Cost of product revenues includes both internal and third party fixed and variable costs including amortization of purchased technology, materials and supplies, labor, facilities and other overhead costs associated with our product revenues.

We license mutually agreed upon third party technology for use in our research and development collaboration with Shell. We record the license payments to research and development expense and offset related reimbursements received from Shell. These payments made by Shell to us are direct reimbursements of our costs. We account for these direct reimbursable costs as a net amount, whereby no expense or revenue is recorded for the costs reimbursed by Shell. For any payments not reimbursed by Shell, we will recognize these as expenses in the statement of operations. We elected to present the reimbursement from Shell as a component of our research and development expense since presenting the receipt of payment from Shell as revenues does not reflect the substance of the arrangement.

Table of Contents

We receive payments from government entities in the form of government grants. Government grants are agreements that generally provide us with cost reimbursement for certain types of expenditures in return for research and development activities over a contractually defined period. Revenues from government grants are recognized in the period during which the related costs are incurred, provided that the conditions under which the government grants were provided have been met and we have only perfunctory obligations outstanding.

Shipping and handling costs charged to customers are recorded as revenues. Shipping costs are included in our cost of product revenues. Such charges were not significant in any of the periods presented.

Income Taxes

We use the liability method of accounting for income taxes. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets are recognized for deductible temporary differences, along with net operating loss (NOL) carryforwards, if it is more likely than not that the tax benefits will be realized. To the extent a deferred tax asset cannot be recognized under the preceding criteria, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled.

We recognize the financial statement effects of an uncertain tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination.

Stock-Based Compensation

We account for stock-based transactions based on the fair value of the stock awards granted. We use the straight-line method to allocate stock-based compensation expense to the appropriate reporting periods. We account for stock options issued to non-employees based on their estimated fair value determined using the Black-Scholes option-pricing model. The fair value of the options granted to non-employees is remeasured as they vest, and the resulting change in value, if any, is recognized as an increase or decrease in stock compensation expense during the period the related services are rendered.

Comprehensive Loss

Comprehensive loss consists of net loss, unrealized gain (loss) on marketable securities and foreign currency translation adjustments. The following table presents comprehensive loss (in thousands):

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Net loss	$ (2,742)	$ (2,732)	$ (11,254)	$ (8,047)
Currency translation adjustments	(31)	41	13	(25)
Unrealized gain (loss) on marketable securities	(161)	(225)	244	229
Comprehensive loss	$ (2,934)	$ (2,916)	$ (10,997)	$ (7,843)

Table of Contents

Net Loss per Share of Common Stock

Basic and diluted net loss per share of common stock is computed by dividing the net loss by the weighted average number of shares of common stock outstanding during the period, less the weighted-average number of shares common stock that remain subject to our right to repurchase. Basic and diluted net loss per share of common stock was the same for each period presented, because inclusion of all potential common shares outstanding was anti-dilutive. The following table presents the calculation of basic and diluted net loss per share of common stock (in thousands, except per share amounts):

The following table presents the securities not included in the net loss per share calculations for the three and nine months ended September 30, 2011 and 2010 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Numerator:				
Net loss	$ (2,742)	$ (2,732)	$ (11,254)	$ (8,047)
Denominator:				
Weighted-average shares of common stock outstanding	35,919	34,202	35,576	21,276
Less: Weighted-average shares of common stock subject to repurchase		(2)		(4)
Weighted-average shares of common stock used in computing net loss per share of common stock, basic and diluted	35,919	34,200	35,576	21,272
Net loss per share of common stock, basic and diluted	$ (0.08)	$ (0.08)	$ (0.32)	$ (0.38)

The following table presents the equity instruments excluded from the EPS calculations (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Common stock subject to repurchase		2		2
Options to purchase common stock	8,079	8,516	8,079	8,516
Unvested restricted stock units	561		561	
Warrants to purchase common stock	266	297	266	297
Total	8,906	8,815	8,906	8,815

Table of Contents

Reclassifications

Certain amounts in prior period financial statements including the related party collaboration revenue (see Note 3), related party receivable, related party deferred revenue, our investment in CO_2 Solution (See Note 4), asset retirement obligation (see Note 8) and the composition of our deferred tax assets have been reclassified to conform to the current period presentation.

3. Collaborative Research and Development Agreements

Shell

In November 2006, we entered into a collaborative research agreement and a license agreement with Shell to develop biocatalysts and associated processes that use such biocatalysts.

In November 2007, we entered into a new and expanded five-year collaborative research agreement and a license agreement with Shell. In connection with the new and expanded collaborative research agreement and license agreement, Shell paid us a $20.0 million up-front exclusivity fee, purchased Series E redeemable convertible preferred stock for gross proceeds of $30.5 million, and agreed to pay us (1) research funding at specified rates per FTE working on the project during the research term, (2) milestone payments upon the achievement of milestones and (3) royalties on future product sales.

In March 2009, we amended our collaborative research agreement and license agreement with Shell. In connection with these amendments Shell purchased Series F redeemable convertible preferred stock for gross proceeds of $30.0 million and agreed to pay us (1) additional research funding at specified rates per FTE working on the project during the research term and (2) additional milestone payments upon the achievement of milestones. Shell has the right to reduce the number of funded FTEs, subject to certain limitations, with a required advance notice period ranging from 30 to 270 days and a subsequent period ranging from 90 to 360 days during which notices of further FTE reductions cannot be made by Shell. The length of these periods varies dependent on the number of funded FTEs reduced. Effective August 2011, Shell reduced the number of funded FTEs engaged in our research and development collaboration by 12 from 128 to 116 FTEs.

In accordance with our revenue recognition policy, the $20.0 million up-front exclusivity fee and the research funding fees to be received for FTE services are recognized in proportion to the actual research efforts incurred relative to the amount of total expected effort to be incurred by us over the five-year research period commencing November 2007. Milestones payments to be earned under this agreement have been determined to be at risk at the inception of the arrangement and substantive and are expected to be recognized upon achievement of the applicable milestone and when collectability of such payment is reasonably assured. We recorded $3.1 million and $1.5 million of milestone revenues during the three months ended September 30, 2011 and 2010, respectively. We recorded milestone revenues of $3.1 million and $2.9 million during the nine months ended September 30, 2011 and 2010, respectively.

For the three months ended September 30, 2011 and 2010, our collaborative research and development revenue from Shell was $17.3 million and $16.2 million, respectively. For the nine months September 30, 2011 and 2010, our collaborative research and development revenues from Shell was $47.0 million and $46.9 million, respectively.

Under the agreements with Shell, we have the right to license technology from third parties that will assist us in meeting objectives under the collaboration. If third-party technology to be licensed is identified and mutually agreed upon by both parties, Shell is obligated to reimburse us for the licensing costs of the technology. Payments made by us to the third-party providers were recorded as research and development expenses related to our collaborative research agreement with Shell. None of the acquired licenses are expected to be used in products that will be sold within the next year and the phase of the project has not reached technological feasibility. Shell reimbursed us for $51,000 and $1.1 million of licensing costs during the three months ended September 30, 2011 and 2010, respectively. Shell reimbursed us for licensing costs of $116,000 and $1.3 million for the nine months ended September 30, 2011 and 2010, respectively. We record these reimbursements against the costs incurred.

In June 2011, Shell completed the transfer of all of its equity interests in us, together with the associated right to appoint one member to our board of directors, to Raízen Energia Participações S.A., (Raízen) Shell s joint venture with Cosan S.A. in Brazil. At the time of transfer, Raízen became our largest stockholder by owning approximately 5.6 million shares. Notwithstanding the above, Shell did not transfer our collaborative research agreement to Raízen and we continue to collaborate with Shell. Additionally in September 2011, we entered into a joint development agreement directly with Raízen. Under the agreement, we will deploy our CodeEvolver directed evolution technology platform to develop an improved first generation ethanol process for producing ethanol made from sugar.

11

Manufacturing Collaboration

Arch

Since October 2005, we have partnered with Arch Pharmalabs, Ltd. (Arch), a company based in India engaged in the manufacturing and sale of active pharmaceutical ingredients (APIs), and intermediaries to pharmaceutical companies worldwide.

In February 2010, we consolidated certain of the contractual terms in our agreements with Arch by simultaneously terminating all of our existing agreements with Arch, other than the Master Services Agreement with Arch entered into as of August 1, 2006, and entering into new agreements with Arch. The new agreements, among other things, provide for biocatalyst supply from us to Arch and intermediate supply from Arch to us. We sell the biocatalysts to Arch at an agreed upon price, and Arch manufactures the intermediates on our behalf. Arch sells the intermediates to us at a formula-based or agreed upon price. We then directly market and sell the intermediates to a specified group of customers in the generic pharmaceutical industry. Under the new agreements, Arch may also sell intermediates directly to other customers, and a license royalty is owed by Arch to us based on the volume of product they sell to us and their other customers. Royalties earned from Arch under this arrangement were $230,000 and $124,000 for the three months ended September 30, 2011 and 2010, respectively and $550,000 and $286,000 for the nine months ended September 30, 2011 and 2010, respectively.

4. Joint Development Agreement with CO_2 Solution

On December 15, 2009, we entered into an exclusive joint development agreement with CO_2 Solution, a company based in Quebec City, Quebec, Canada, whose shares are publicly traded in Canada on the TSX Venture Exchange. Under the agreement, we obtained a research license to CO_2 Solution s intellectual property and agreed to conduct research and development activities jointly with CO_2 Solution with the goal of advancing the development of carbon capture technology. We also purchased 10,000,000 common shares (approximately 16.6% of total common shares outstanding) of CO_2 Solution in a private placement subject to a four-month statutory resale restriction, which expired on April 15, 2010. In February of 2010, our Chief Executive Officer was appointed to the board of directors of CO_2 Solution.

The original joint development agreement with CO_2 Solution expired in January 2011, and at that time, we extended our joint development agreement with CO_2 Solution on essentially the same terms as the original agreement. The extended agreement will now expire on the later of September 30, 2012 or six months after the expiration of any third party collaborations.

We concluded that through September 30, 2011, we did not have the ability to exercise significant influence over CO_2 Solution s operating and financial policies. We consider our investment in CO_2 Solution common shares as an investment in a marketable security that is available for sale, and carry it at fair value in non-current marketable securities, with changes in fair value recognized in accumulated other comprehensive income (loss). We have estimated the fair value of common shares using the fair value as of September 30, 2011, as determined by trading on the TSX Venture Exchange. Accordingly, we have classified our investment in CO_2 Solution as a level 1 investment as discussed in Note 6.

At December 31, 2010, the estimated fair value of our investment in CO_2 Solution common stock was $1.7 million and the unrealized gain was $334,000. At September 30, 2011, the estimated fair value of our investment in CO_2 Solution common stock was $2.0 million and the unrealized gain of $0.7 million with a related tax expense of $0.3 million recorded in accumulated other comprehensive income (loss). The unrealized loss for the three months ended September 30, 2011 was $0.1 million with a related tax benefit of $27,000 and was recorded in accumulated other comprehensive income (loss) on the condensed consolidated balance sheet.

5. Balance Sheets and Statements of Operations Details

Cash Equivalents and Marketable Securities At September 30, 2011, cash equivalents and marketable securities consisted of the following (in thousands):

	September 30, 2011				
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Average Contractual Maturities (in days)
Money market funds	$ 23,889	$	$	$ 23,889	n/a
Commercial paper	3,997			3,997	103

Corporate bonds	30,563	11	(74)	30,500	352
U.S. Treasury obligations	998	4		1,002	366
Government-sponsored enterprise securities	3,004	12	(1)	3,015	313
Common shares of CO_2 Solution	1,316	694		2,010	n/a
Total	$ 63,767	$ 721	$ (75)	$ 64,413	

Table of Contents

The total cash and cash equivalents balance of $30.1 million as of September 30, 2011 was comprised of money market funds of $23.9 million and $6.2 million held as cash with major financial institutions worldwide.

At December 31, 2010, cash equivalents and marketable securities consisted of the following (in thousands):

	December 31, 2010				
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Average Contractual Maturities (in days)
Money market funds	$ 64,956	$	$	$ 64,956	n/a
Common shares of CO_2 Solution	1,316	334		1,650	n/a
Total	$ 66,272	$ 334	$	$ 66,606	

Inventories

Inventories consisted of the following (in thousands):

	September 30, 2011	December 31, 2010
Raw materials	$ 3,095	$ 1,963
Work in process	149	38
Finished goods	1,996	816
Total inventories	$ 5,240	$ 2,817

Property and Equipment, net

Property and equipment consisted of the following (in thousands):

	September 30, 2011	December 31, 2010
Laboratory equipment	$ 33,354	$ 29,931
Leasehold improvements	12,859	10,961
Computer equipment and software	4,170	3,050
Office equipment and furniture	947	865
Construction in progress (1)	1,766	838
	53,096	45,645
Less: accumulated depreciation and amortization	(29,775)	(24,193)
Property and equipment, net	$ 23,321	$ 21,452

(1) Construction in progress includes equipment received but not yet placed into service pending installation.

13

Table of Contents

Due to the extension of the lease period for certain currently occupied facilities, we re-evaluated the depreciable lives of existing leasehold improvements, totaling $2.3 million in net book value at the time of reassessment in February 2011. Since leasehold improvements are typically depreciated over the lesser of the assets useful life or the remaining lease period, the extension of contracted facilities leases through 2020 necessitated a change in our estimate of depreciable lives on leasehold improvements. While some lives have been shortened under this reassessment with the vacating of a portion of our facilities, the majority of depreciable lives have been extended up to as much as 5 years from the assets in service date, in accordance with our leasehold improvements standard useful lives. The net effect of this reassessment is lower monthly depreciation being recognized on leasehold improvements over a longer period of time. These changes net effect on depreciation expense recognized is not expected to be material on a quarterly or annual basis.

Intangible Assets

Intangible assets consisted of the following (in thousands):

	September 30, 2011			December 31, 2010		
	Gross Carrying Amount	**Accumulated Amortization**	**Net Carrying Amount**	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Carrying Amount**
Customer relationships	$ 3,098	$ (3,016)	$ 82	$ 3,098	$ (2,943)	$ 155
Developed and core technology	1,534	(1,395)	139	1,534	(1,212)	322
Noncompete agreements	90	(90)		90	(90)	
Intellectual property	20,244	(3,093)	17,151	20,244	(563)	19,681
	$ 24,966	$ (7,594)	$ 17,372	$ 24,966	$ (4,808)	$ 20,158

Amortization expense for intangible assets totaled $2.8 million and $366,000 for the nine months ended September 30, 2011 and 2010, respectively. Amortization expense for intangible assets totaled $928,000 and $88,000 for the three months ended September 30, 2011 and 2010, respectively.

6. Fair Value

Assets and liabilities recorded at fair value in the condensed consolidated financial statements are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels which are directly related to the amount of subjectivity associated with the inputs to the valuation of these assets or liabilities are as follows:

Level 1 Inputs that are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.

Level 2 Inputs (other than quoted prices included in Level 1) that are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument s anticipated life.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities and which reflect management s best estimate of what market participants would use in pricing the asset or liability at the measurement date.

Table of Contents

The following table presents our financial instruments that were measured at fair value on a recurring basis at September 30, 2011 by level within the fair value hierarchy (in thousands):

	September 30, 2011			
	Level 1	Level 2	Level 3	Total
Financial Assets				
Money market funds	$ 23,889	$	$	$ 23,889
Commercial paper		3,997		3,997
Corporate bonds		30,500		30,500
U.S. Treasury obligations		1,002		1,002
Government-sponsored enterprise securities		3,015		3,015
Common shares of CO_2 Solution	2,010			2,010
Total	$ 25,899	$ 38,514	$	$ 64,413

The following table presents our financial instruments that were measured at fair value on a recurring basis at December 31, 2010 by level within the fair value hierarchy (in thousands):

	December 31, 2010			
	Level 1	Level 2	Level 3	Total
Financial Assets				
Money market funds	$ 64,956	$	$	$ 64,956
Common shares of CO_2 Solution	1,650			1,650
Total	$ 66,606	$	$	$ 66,606

7. Related Party Transactions

***Shell and* Raízen**

Prior to June, 2011 Shell was our largest shareholder and transactions between us and Shell were considered related party transactions. As discussed in Note 3, Collaborative Research and Development Agreements , Shell transferred full ownership of our common stock to Raízen, Shell s joint venture with Cosan S.A. in Brazil. Based on our analysis and effective, as of July 1, 2011, Shell is no longer considered a related party. Before June 30, 2011, related party receivables, related party deferred revenue, and related party collaboration research and development revenue were primarily comprised of transactions under our five-year collaborative research agreement and a license agreement with Shell. These agreements expire in 2012. The revenues earned from Shell are included in the collaborative research and development on our statement of operations. Collaborative research and development revenue received from Shell accounted for 52% and 61% of our revenues for the nine months ended September 30, 2011 and 2010, respectively.

At the time of the transfer, Raízen became our largest shareholder with approximately 5.6 million shares of our common stock with rights to appoint a member to our board of directors. In September 2011, we entered into a joint development agreement directly with Raízen to deploy our CodeEvolver directed evolution technology platform to develop an improved first generation ethanol process for producing ethanol made from sugar. There has been no material financial activity under this agreement thru September 30, 2011.

Exela PharmaSci, Inc.

We signed a license agreement with Exela PharmaSci, Inc. (Exela) in 2007. A member of our board of directors is also on the board of directors of Exela. Under the terms of the agreement, Exela would pay us a royalty based on their achievement of certain commercial goals.

During the three and nine months ended September 30, 2011, we recognized $120,000 and $450,000, respectively of revenue related to this arrangement, shown in our condensed consolidated statement of operations as collaborative research and development revenue. We did not recognize any revenue from Exela prior to 2011. As of September 30, 2011, we have no amounts owed from Exela.

8. Commitments and Contingencies

Operating Leases

Our headquarters are located in Redwood City, California where we occupy approximately 91,000 square feet of office and laboratory space in four buildings. On March 16, 2011, we entered into a Fifth Amendment to Lease (the Fifth Amendment) with Metropolitan Life Insurance Company (MetLife) with respect to our offices located at 200 and 220 Penobscot Drive, Redwood City, California, (the Penobscot Space), 400 Penobscot Drive, Redwood City, California (the Building 2 Space) and 640 Galveston Drive, Redwood City, California (the Galveston Space), and with respect to approximately 29,921 square feet of additional space located at 101 Saginaw Drive, Redwood City, California (the Saginaw Space). Under the Fifth Amendment, the term of the lease of the Penobscot Space, the Building 2 Space and the Saginaw Space lasts until January 31, 2020, with options to extend for two additional five year periods. The Fifth Amendment provides a number of incentives to us including forgiveness of rent payments for the initial two months of the lease term, a tenant improvement allowance (TIA) of $2.4 million and additional special allowances for certain HVAC costs. We intend to apply TIA funds toward capital improvements to the expanded facility as well as upgrades and re-configuration of existing lab and office space. A portion of the TIA may be utilized by us to pay costs for furniture, furnishings and equipment. As of September 30, 2011 we have spent $1.9 million on capital improvements related to the facilities. During October, 2011 we requested $1.8 million of reimbursements from the landlord out of the TIA for the completed construction. The TIA will be recognized when cash is received and on a straight-line basis over the term of the lease as a reduction in rent expense. Additionally, the Fifth Amendment waived our existing asset retirement obligations for the impacted buildings, resulting in a $0.3 million decrease in our obligation and a $0.1 million gain on extinguishment of asset retirement obligations recorded in our condensed consolidated statement of operation as sales, general and administrative expenses.

The lease of the Galveston Space on this property was not extended with the Fifth Amendment and will expire as per the original agreement in January 2013, with an option for an additional term of up to two years.

Rent payments under the Fifth Amendment will increase at an annual rate of approximately 3%, with rent expense recognized on a straight-line basis over the term of the lease. In accordance with the terms of the lease, we exercised our right to deliver a letter of credit in lieu of a security deposit. This letter of credit increased from $562,000 as of December 31, 2010 to $707,000 as of September 30, 2011 and is recorded as restricted cash on the consolidated balance sheets.

We also rent facilities in Singapore and Hungary. Rent expense is being recognized on a straight-line basis over the respective terms of these leases.

Future minimum payments under non-cancellable operating leases at September 30, 2011 are as follows (in thousands):

	Operating leases
Three months ending December 31, 2011:	$ 783
Years ending December 31, 2012:	3,268
2013	2,909
2014	2,731
2015	2,808
2016 and beyond	11,259
Total minimum payments	$ 23,758

Litigation

We have been subject to various legal proceedings related to matters that have arisen during the ordinary course of business. Although there can be no assurance as to the ultimate disposition of these matters, we have determined, based upon the information available, that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Indemnifications

We are required to recognize a liability for the fair value of any obligations we assume upon the issuance of a guarantee. We have certain agreements with licensors, licensees and collaborators that contain indemnification provisions. In such provisions, we typically agree to

Table of Contents

_indemnify the licensor, licensee and collaborator against certain types of third party claims. The maximum amount of the indemnifications is not limited. We accrue for known indemnification issues when a loss is probable and can be reasonably estimated. There were no accruals for expenses related to indemnification issues for any periods presented.

Other contingencies

In November 2009, one of our foreign subsidiaries sold intellectual property to us. Under the local laws of the subsidiary, the sale of intellectual property to a nonresident legal entity is deemed an export and is not subject to value added tax. However, there is uncertainty regarding whether the items sold represented intellectual property or research and development services, which would subject the sale to value added tax. We believe that the uncertainty results in an exposure to pay value added tax that is more than remote but less than likely to occur and, accordingly, have not recorded an accrual for this exposure. Should the sale be deemed a sale of research and development services, we could be obligated to pay an estimated amount of $0.6 million.

9. Warrants

No warrants were exercised during the nine months ended September 30, 2011. At September 30, 2011, the following common stock warrants were issued and outstanding:

	September 30, 2011			
Issue Date	Shares Subject to Warrants		Exercise Price per Share	Expiration
October 25, 2005	6,066	$	1.05	October 25, 2012
May 25, 2006	184,895	$	5.96	May 25, 2013
July 17, 2007	2,384	$	12.45	February 9, 2016
September 28, 2007	72,727	$	8.25	September 28, 2017

10. Stockholders Deficit

In 2002, we adopted the 2002 Stock Plan (the 2002 Plan), under which our board of directors may issue incentive stock options, non-statutory stock options (options that do not qualify as incentive stock options) and restricted stock to our employees, officers, directors or consultants. In March, 2010, our board of directors and stockholders approved the 2010 Equity Incentive Award Plan (the 2010 Plan), which became effective upon the completion of our IPO in April 2010. A total of 1,100,000 shares of common stock were initially reserved for future issuance under the 2010 Plan and any shares of common stock reserved for future grant or issuance under our 2002 Plan that remained unissued at the time of completion of the IPO became available for future grant or issuance under the 2010 Plan. In addition, the shares reserved for issuance pursuant to the exercise of any outstanding awards under the 2002 Plan that expire unexercised will also become available for future issuance under the 2010 Plan. The 2010 Plan also provides for automatic annual increases in the number of shares reserved for future issuance, and during the nine months ended September 30, 2011 an additional 1,393,142 shares were reserved under the 2010 plan as a result of this provision. As of September 30, 2011, we had a total of 9,961,440 shares of common stock reserved for issuance under our 2010 Plan and no shares available for issuance under the 2002 Plan.

We granted 18,468 and 578,267 restricted stock units (RSU) during the three and nine months ended September 30, 2011. The RSUs vest over four years with 25% of the RSUs vesting on each annual anniversary. The fair value of the RSUs was calculated based on the NASDAQ quoted stock price on the date of the grant with the expense recognized over the vesting period. For the three and nine months ended September 30, 2011, we recorded $321,000 and $818,000, respectively of stock compensation expense related to the RSUs.

During the three and nine months ended September 30, 2011, we issued 76,902 and 1,119,487 common shares for stock options exercised, respectively.

Stock-Based Compensation Expense

We estimate the fair value of stock-based awards granted to employees and directors using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model requires the use of highly subjective and complex assumptions to determine the fair value of stock-based awards, including the expected life of the option and expected volatility of the underlying stock over the expected life of the related grants. Since we were not a publically traded entity prior to April 2010, company-specific historical volatility data is not available. As a result, we estimate the expected volatility based on the historical volatility of a group of unrelated public companies within our industry. We will continue to consistently apply this process until a sufficient amount of historical information regarding the volatility of our own stock price becomes available. Due to our limited history of grant activity, the expected life of options granted to employees is calculated using the simplified method permitted by the SEC as the average of the total contractual term of the option and its vesting period. The risk-free rate assumption was based on U.S. Treasury instruments whose terms were consistent with the terms of our stock options. The expected dividend assumption was based on our history and expectation of dividend payouts.

Table of Contents

The following table presents total stock-based compensation expense included in the condensed consolidated statements of operations (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Research and development	955	984	2,756	2,555
Sales, general and administrative	1,581	1,531	4,637	3,911
	$ 2,536	$ 2,515	$ 7,393	$ 6,466

11. Segment Reporting

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision makers are our Chief Executive Officer and our board of directors. The Chief Executive Officer and our board of directors review financial information presented on a consolidated basis, accompanied by information about revenues by geographic region, for purposes of allocating resources and evaluating financial performance. We have one business activity and there are no segment managers who are held accountable for operations, operating results beyond revenue goals or gross margins, or plans for levels or components below the consolidated unit level. Accordingly, we have a single reporting segment.

Operations outside of the United States consist principally of research and development and sales activities. Geographic revenues are identified by the location of the customer and consist of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues				
Americas (1)	$ 19,680	$ 19,038	$ 54,816	$ 52,571
Europe	3,889	1,400	9,245	5,994
Asia	9,713	6,675	26,311	18,728
	$ 33,282	$ 27,113	$ 90,372	$ 77,293

(1) Primarily United States

Geographic presentation of identifiable long-lived assets below shows those assets that can be directly associated with a particular geographic area and consist of the following (in thousands):

	September 30, 2011	December 31, 2010
Long-lived assets		
Americas (1)	$ 34,769	$ 37,023
Europe	4,526	3,980
Asia	2,517	3,398
	$ 41,812	$ 44,401

(1) Primarily United States

Table of Contents

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the unaudited condensed consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q and the audited consolidated financial statements and notes thereto and management s discussion and analysis of financial condition and results of operations for the year ended December 31, 2010 included in our Annual Report on Form 10-K filed with the SEC on February 10, 2011. This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended,(the Exchange Act). These statements are often identified by the use of words such as may, will, expect, believe, anticipate, intend, could, should, estimate, or continue, and similar expressions or variations. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled Risk Factors, set forth in Part II, Item 1A of this Quarterly Report on Form 10-Q and elsewhere in this Report. The forward-looking statements in this Quarterly Report on Form 10-Q represent our views as of the date of this Quarterly Report on Form 10-Q. We anticipate that subsequent events and developments will cause our views to change. However, while we may elect to update these forward-looking statements at some point in the future, we have no current intention of doing so except to the extent required by applicable law. You should, therefore, not rely on these forward-looking statements as representing our views as of any date subsequent to the date of this Quarterly Report on Form 10-Q.

Overview

Our proprietary technology platform enables the creation of optimized biocatalysts that make existing industrial processes faster, cleaner and more efficient than current methods and has the potential to make new industrial processes possible on a commercial scale. We have focused our biocatalyst development efforts on large and rapidly growing markets, including pharmaceuticals, advanced biofuels and bio-based chemicals. We have commercialized our biocatalysts in the pharmaceutical industry and are developing biocatalysts for use in producing advanced biofuels under a multi-year research and development collaboration with Shell, for use in sustainable detergent alcohols under collaboration with M&G and to develop improved processes for the production of first generation ethanol in collaboration with Raízen. We have enabled biocatalyst-based drug manufacturing processes at commercial scale and have delivered biocatalysts and drug products to some of the world s leading pharmaceutical companies. In our research and development collaboration with Shell, we are developing biocatalysts for use in producing advanced biofuels from renewable sources of non-food plant materials, known as cellulosic biomass. In our collaboration with Raízen, we are deploying our CodeEvolver directed evolution technology platform to develop an improved first generation ethanol process for producing ethanol made from sugar. We are also pursuing opportunities in the bio-based chemicals market, including developing sustainable detergent alcohols for use in the household products market in collaboration with M&G. Additionally, we are using our technology platform to pursue biocatalyst-enabled solutions in other bioindustrial markets, including carbon management and water treatment.

Biocatalysts are enzymes or microbes that initiate or accelerate chemical reactions. Manufacturers have historically used naturally occurring biocatalysts to produce many goods used in everyday life. However, inherent limitations in naturally occurring biocatalysts have restricted their commercial use. Our proprietary technology platform is able to overcome many of these limitations, allowing us to evolve and optimize biocatalysts to perform specific and desired chemical reactions at commercial scale.

To date, we have generated revenues primarily from collaborative research and development funding, pharmaceutical product sales and government grants. Our revenues have increased in each of the last three fiscal years, growing from $50.5 million in 2008, to $82.9 million in 2009 to $107.1 million in 2010. Our revenues increased from $77.3 million for the nine months ended September 30, 2010 to $90.4 million for the nine months ended September 30, 2011. As of September 30, 2011, we had an accumulated deficit of $179.4 million. We incurred net losses of $45.1 million, $20.3 million and $8.5 million in the years ended December 31, 2008, 2009 and 2010, respectively and a net loss of $11.3 million for the nine months ended September 30, 2011.

Most of our revenues since inception have been derived from collaborative research and development arrangements, which accounted for 66%, 78% and 66% of our revenues in 2010, 2009 and 2008, respectively. Collaborative research and development arrangements accounted for 60% and 64% of our revenues for the nine months ended September 30, 2011 and 2010, respectively. Collaborative research and development revenue received from Shell accounted for 62%, 76% and 60% of our revenues in 2010, 2009 and 2008, respectively. Collaborative research and development revenue received from Shell accounted for 52% and 61% of our revenues for the nine months ended September 30, 2011 and 2010, respectively.

Our product sales accounted for 31%, 22% and 33% of our revenues in 2010, 2009 and 2008, respectively. Product sales accounted for 37% and 31% of our revenues for the nine months ended September 30, 2011 and 2010, respectively. Our product sales on a dollar basis have increased in each of the last three fiscal years, from $16.9 million in 2008 to $18.6 million in 2009 and to $32.8 million in 2010. Our product sales increased from $24.3 million for the nine months ended September 30, 2010 to $33.5 million for the nine months ended September 30, 2011.

19

Table of Contents

Notwithstanding our revenue growth, we continue to experience significant losses as we have invested heavily in research and development and administrative infrastructure in connection with the growth of our business. In light of the growth in market acceptance of our products and services to date, we currently intend to increase our investment in research and development.

Our revenue stream is diversified across various industries, which should mitigate our exposure to cyclical downturns or fluctuations in any one market. Revenues during 2008, 2009 and 2010 were derived from the pharmaceuticals and biofuels markets, and consisted of collaborative research and development revenues, product sales and government grants, which are separately identified in our consolidated statements of operations.

Revenues and Operating Expenses

Revenues

Our revenues are comprised of collaborative research and development revenues, product revenues and government grants.

- Collaborative research and development revenues include license, technology access and exclusivity fees, FTE payments, milestones, royalties, and optimization and screening fees.

- Product revenues consist of sales of biocatalysts, intermediates, APIs and Codex Biocatalyst Panels and Kits.

- Government grants consist of payments from government entities. The terms of these grants generally provide us with cost reimbursement for certain types of expenditures in return for research and development activities over a contractually defined period. Historically, we have received government grants from Germany, Singapore and the United States. We expect to receive additional grants from the United States and other governments in the future.

Cost of Product Revenues

Cost of product revenues includes both internal and third-party fixed and variable costs including amortization of purchased technology, materials and supplies, labor, facilities and other overhead costs associated with our product revenues.

Research and Development Expenses

Research and development expenses consist of costs incurred for internal projects as well as partner-funded collaborative research and development activities. These costs include our direct and research-related overhead expenses, which include salaries and other personnel-related expenses, facility costs, supplies, depreciation of facilities, and laboratory equipment and amortization of acquired technologies, as well as research consultants and the cost of funding research at universities and other research institutions, and are expensed as incurred. As a result of our purchase of the directed evolution intellectual property assets from Maxygen, Inc. (Maxygen) (Maxygen IP) in 2010, our obligation to pay biofuels royalties to Maxygen terminated. License and royalty fees paid to Maxygen prior to our acquisition of the Maxygen IP fluctuated depending on the timing and type of consideration received in connection with our biofuels research and development collaboration with Shell. Costs to acquire technologies that are utilized in research and development and that have no alternative future use are expensed when incurred.

Selling, General and Administrative Expenses

Selling, general and administrative expenses consist of compensation expenses (including stock-based compensation), hiring and training costs, consulting and service provider expenses (including patent counsel related costs), marketing costs, occupancy-related costs, depreciation and amortization expenses and travel and relocation expenses.

Critical Accounting Policies and Estimates

The interim condensed consolidated financial statements have been prepared in conformity with GAAP and include our accounts and the accounts of our wholly-owned subsidiaries. The preparation of our condensed consolidated financial statements requires our management to make estimates, assumptions, and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the applicable periods. Management bases its estimates, assumptions and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. Different assumptions and judgments would change the estimates used in the preparation of our condensed consolidated financial statements, which, in turn, could change the results from those reported. Our management evaluates its estimates, assumptions and judgments on an ongoing basis.

Table of Contents

Financial Operations Overview

The following table shows the amounts from our condensed consolidated statements of operations for the periods presented (in thousands).

	Three Months Ended September 30,		% of Total Revenues		Nine Months Ended September 30,		% of Total Revenues	
	2011	2010	2011	2010	2011	2010	2011	2010
Revenues:								
Product	$ 12,199	$ 9,491	36%	35%	$ 33,528	$ 24,250	37%	31%
Collaborative R&D	19,201	17,243	58%	64%	54,073	49,450	60%	64%
Government grants	1,882	379	6%	1%	2,771	3,593	3%	5%
Total Revenues	33,282	27,113	100%	100%	90,372	77,293	100%	100%
Costs and operating expenses:								
Cost of product revenues	9,958	8,563	30%	32%	28,713	19,856	32%	26%
Research and development	16,786	13,070	50%	48%	45,502	39,056	50%	51%
Selling, general and administrative	8,871	7,940	27%	29%	27,160	25,192	30%	33%
Total costs and operating expenses	35,615	29,573	107%	109%	101,375	84,104	112%	109%
Loss from operations	(2,333)	(2,460)	nm	nm	(11,003)	(6,811)	nm	nm
Interest income	76	61	0%	0%	195	135	0%	0%
Interest expense and other, net	(411)	(35)	-1%	0%	(378)	(1,047)	0%	1%
Loss before provision for income taxes	(2,668)	(2,434)	nm	nm	(11,186)	(7,723)	nm	nm
Provision (benefit) for income taxes	74	298	0%	1%	68	324	0%	0%
Net loss	$ (2,742)	$ (2,732)	nm	nm	$ (11,254)	$ (8,047)	nm	nm

Three months ended September 30, 2011 compared to three months ended September 30, 2010.

Revenues

	Three Months Ended September 30,		Change	
(In Thousands)	**2011**	**2010**	**$**	**%**
Product	$ 12,199	$ 9,491	$ 2,708	29%
Collaborative R&D	19,201	17,243	1,958	11%
Government grants	1,882	379	1,503	397%
Total revenues	$ 33,282	$ 27,113	$ 6,169	23%

Revenues increased during the three months ended September 30, 2011 compared to the three months ended September 30, 2010 due to increased revenues from product sales, collaborative research and development and government grants.

Product revenues increased $2.7 million during the three months ended September 30, 2011 compared to the three months ended September 30, 2010 primarily due to an increase in product sales to both generic and innovator pharmaceutical customers.

Collaborative research and development revenues increased $2.0 million during the three months ended September 30, 2011 compared to the three months ended September 30, 2010 primarily due to milestones earned in our Shell collaboration and our expanded activities in our collaborations in carbon management and collaborations with pharmaceuticals customers.

Collaborative research and development revenues derived from Shell increased $1.1 million to $17.3 million during the three months ended September 30, 2011 compared to $16.2 million during the three months ended September 30, 2010. This includes milestone payments of $3.1 million and $1.5 million earned in the three months ended September 30, 2011 and 2010 respectively. Effective August 2011, Shell reduced the number of funded FTEs engaged in our research and development collaboration with Shell by 12, from 128 to 116 FTEs. We had an average of 122 and 128 FTEs in this collaboration during the three months ended September 30, 2011 and September 30, 2010, respectively. The decrease in the number of Shell funded FTEs in our collaborative research and development revenues during the three months ended September 30, 2011 was partially offset by contractual increases in the billing rates for the FTEs engaged in our research and development collaboration with Shell.

Table of Contents

Government grant revenues increased $1.5 million during the three months ended September 30, 2011 compared to the three months ended September 30, 2010 primarily due to a grant we recognized from the Singapore Economic Development Board (EDB) for $1.3 million. Our grant revenues from the U.S. Department of Energy under the ARPA-E Recovery Act program increased $0.2 million to $0.6 million during the three months ended September 30, 2011 compared to $0.4 million during the three months ended September 30, 2010.

Our top five customers accounted for 81% and 88% of our total revenues for the three months ended September 30, 2011 and 2010, respectively. Shell accounted for 52% and 60% of our total revenues for the three months ended September 30, 2011 and 2010, respectively.

Cost of Product Revenues

	Three Months Ended September 30,		Change	
(In Thousands)	**2011**	**2010**	**$**	**%**
Cost of revenues:				
Product	$ 9,958	$ 8,563	$ 1,395	16%
Gross profit:				
Product	$ 2,241	$ 928	$ 1,313	141%
Product gross margin %	18%	10%		

Our cost of product revenues increased $1.4 million during the three months ended September 30, 2011 compared to the three months ended September 30, 2010 primarily due to the $2.7 million increase in our product sales. Gross margins increased to 18% from 10% in the three months ended September 30, 2011 and 2010, respectively. This shift was primarily due to a change in the weighting of the sales mix towards higher margin innovator products in the third quarter of 2011 compared to the lower margin generic product sales in the third quarter of 2010.

Operating Expenses

	Three Months Ended September 30,		Change	
(In Thousands)	**2011**	**2010**	**$**	**%**
Research and development	$ 16,786	$ 13,070	$ 3,716	28%
Selling, general and administrative	8,871	7,940	931	12%
Total operating expenses	$ 25,657	$ 21,010	$ 4,647	22%

Research and Development. Research and development expenses increased $3.7 million during the three months ended September 30, 2011 compared to the three months ended September 30, 2010 primarily due to the $1.3 million increase in amortization expense related to our acquisition of the Maxygen IP, a $1.3 million increase in compensation costs related to an increase in headcount and stock-based compensation, a $0.7 million increase in expenses related to outside services and consultants supporting our research, a $0.4 million increase in costs for lab supplies related to our lab expansion, a $0.3 million increase in facility costs related to our expanded facilities in Redwood City, California, a $0.2 million increase in costs for software and system support and a $0.1 million increase in travel costs. This was partially offset by a $0.5 million decrease in royalty fees paid to Maxygen as a consequence of our acquisition of the Maxygen IP and related termination of the IP license agreement. Research and development expenses included stock-based compensation expense of $1.0 million during each of the three month periods ended September 30, 2011 and 2010.

Selling, General and Administrative. Selling, general and administrative expenses increased $0.9 million during the three months ended September 30, 2011 compared to the three months ended September 30, 2010 primarily due to a $0.4 million increase in compensation costs related to increased headcount and stock-based compensation, a $0.3 million increase in outside services and consultants and a $0.2 million increase in recruiting costs. Selling, general and administrative expenses included stock-based compensation expense of $1.6 million and $1.5 million during the three months ended September 30, 2011 and 2010, respectively.

Other Income (Expense), net

(In Thousands)	Three Months Ended September 30, 2011	2010	Change $	%
Interest income	$ 76	$ 61	$ 15	25%
Interest expense and other, net	(411)	(35)	(376)	1,074%
Total other income (expense), net	$ (335)	$ 26	$ 361	nm

Interest Income. Interest income increased due to higher average returns on our of cash, cash equivalents and marketable securities on hand during the three months ended September 30, 2011 compared to the three months ended September 30, 2010.

Interest Expense and Other, Net. Interest expense and other, net, increased $0.4 million during the three months ended September 30, 2011 compared to the three months ended September 30, 2010 primarily related to increased foreign exchange losses of $0.5 million partially offset by decreased interest expense of $0.1 million due to the payoff of our debt obligation on a loan from the General Electric Capital Corporation and the Oxford Finance Corporation (GE Capital Loan).

Provision for Income Taxes. The tax provision of $0.1 million and $0.3 million for the three months ended September 30, 2011 and 2010, respectively, primarily consisted of income taxes attributable to foreign operations.

Restructuring Charges. There was no change in our restructuring accruals of $63,000 during the three months ended September 30, 2011.

Nine months ended September 30, 2011 compared to nine months ended September 30, 2010.

Revenues

(In Thousands)	Nine Months Ended September 30, 2011	2010	Change $	%
Product	$ 33,528	$ 24,250	$ 9,278	38%
Collaborative R&D	54,073	49,450	4,623	9%
Government grants	2,771	3,593	(822)	-23%
Total revenues	$ 90,372	$ 77,293	$ 13,079	17%

Revenues increased during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 primarily due to increased revenues from product sales and collaborative research and development projects which was partially offset by declines in revenues from government grants.

Product revenues increased $9.3 million or 38% for the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010, primarily due to an increase in product sales to both generic and innovator pharmaceutical customers.

Collaborative research and development revenues increased $4.6 million during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 primarily due to increased revenues of $4.1 million in our collaborations in carbon management and increased collaboration revenues of $0.5 million with new and existing pharmaceuticals customers.

Collaborative research and development revenues derived from Shell increased $0.1 million to $47.0 million during the nine months ended September 30, 2011 compared to $46.9 million during the nine months ended September 30, 2010. This includes milestone payments $3.1 million and $2.9 million received in the nine months ended September 30, 2011 and 2010 respectively. Effective August 2011, Shell reduced the number of funded FTEs engaged in our research and development collaboration with them by 12, from 128 to 116 FTEs. We had an average of 126 and 128 FTEs in this collaboration during the nine months ended September 30, 2011 and September 30, 2010.The decrease in the number of funded FTEs in collaborative research and development revenues in 2011 was partially offset by contractual increases in the billing rates for the FTEs in that same period.

Table of Contents

Government grant revenues decreased $0.8 million during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 primarily due to the recognition of a grant from the EDB for $1.3 million in the nine months ended September 30, 2011 compared with $2.7 million in the same period of 2010. This decrease in government grant revenues was partially offset by a $1.5 million grant we received from the U.S. Department of Energy during the nine months ended September 30, 2011 under the ARPA-E Recovery Act program compared to $0.4 million in revenue we received under the ARPA-E Recovery Act program for the nine months ended September 30, 2010.

Our top five customers on a year to date basis accounted for 78% and 85% of our total revenues for the nine months ended September, 30, 2011 and 2010, respectively. Shell accounted for 52% and 61% of our total revenues for the nine months ended September 30, 2011 and 2010, respectively.

Cost of Product Revenues

(In Thousands)	Nine Months Ended September 30, 2011	2010	Change $	%
Cost of revenues:				
Product	$ 28,713	$ 19,856	$ 8,857	45%
Gross profit:				
Product	$ 4,815	$ 4,394	$ 421	10%
Product gross margin %	14%	18%		

Our cost of product revenues increased $8.9 million during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 primarily due to the $9.3 million increase in our product sales. Gross margins decreased to 14% from 18% in the nine months ended September 30, 2011 and 2010, respectively, due to a change in sales mix towards lower margin product sales in the first half of 2011, partially offset by a change in sales mix towards higher margin innovator products in the three months ended September 30, 2011.

Operating Expenses

(In Thousands)	Nine Months Ended September 30, 2011	2010	Change $	%
Research and development	$ 45,502	$ 39,056	$ 6,446	17%
Selling, general and administrative	27,160	25,192	1,968	8%
Total operating expenses	$ 72,662	$ 64,248	$ 8,414	13%

Research and Development. Research and development expenses increased $6.4 million during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 primarily due to a $2.5 million increase in amortization expense related to our acquisition of the Maxygen IP, a $1.8 million increase in compensation costs related to an increase in headcount and stock-based compensation, a $0.7 million increase in expenses related to outside services and consultants supporting our research, a $0.6 million increase in rent and utilities related to expanded facilities, a $0.6 million increase in costs for software and system support, a $0.5 million increase in travel costs, a $0.4 million increase in lab supplies, and a $0.2 million increase in depreciation and amortization expense due to leasehold improvements and capital equipment acquisitions. This was partially offset by a $1.2 million decrease in royalty fees paid to Maxygen as a consequence of our acquisition of the Maxygen IP and related termination of the IP license agreement. Research and development expenses included stock-based compensation expense of $2.8 million and $2.6 million during the nine months ended September 30, 2011 and 2010, respectively.

Selling, General and Administrative. Selling, general and administrative expenses increased $2.0 million during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 primarily due to a $1.8 million increase in compensation costs related to headcount increases and stock-based compensation, a $0.5 million increase in expenses related to outside services and consultants, a $0.3 million increase in travel costs, a $0.3 million increase in employee recruiting costs and a $0.2 million increase in depreciation and amortization expense. These costs were partially offset by $0.9 million decrease in legal costs in the nine months ended September 30, 2011 as we decreased our dependence on outside legal firms. Selling, general and administrative expenses included stock-based compensation expense of $4.6 million and $3.9 million during the nine months ended September 30, 2011 and 2010, respectively.

Table of Contents

Other Income (Expense), net

(In Thousands)	Nine Months Ended September 30, 2011	2010	Change $	%
Interest income	$ 195	$ 135	$ 60	44%
Interest expense and other, net	(378)	(1,047)	669	-64%
Total other income (expense), net	$ (183)	$ (912)	$ 729	-80%

Interest Income. Interest income increased due to higher average returns on our cash, cash equivalents and marketable securities on hand during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010.

Interest Expense and Other, Net. Interest expense and other, net, decreased $0.7 million during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 primarily related the recognition of an increase in the fair value of our redeemable convertible preferred stock warrant liability in 2010 of $0.7 million, and decreased interest expense of $0.5 million due to the payoff of our debt obligation on the GE Capital Loan, partially offset by decreased other income of $0.4 million due to contractual arrangements with Arch and increased foreign exchange losses of $0.1 million compared to the nine months ended September 30, 2010. The preferred stock warrants converted to common stock warrants upon our IPO and subsequently no longer impact other expenses.

Provision for Income Taxes. The tax provision of $0.1 million and $0.3 million for the nine months ended September 30, 2011 and 2010, respectively, primarily consisted of income taxes attributable to foreign operations.

Restructuring Charges. There was no change in our restructuring accruals of $63,000 during the nine months ended September 30, 2011.

Table of Contents

Liquidity and Capital Resources

(In Thousands)	Nine Months Ended September 30, 2011	2010
Net cash used in operating activities	$ 2,406	$ (16,052)
Net cash used in investing activities	(47,251)	18,575
Net cash provided by financing activities	2,476	64,981
Effect of foreign exchange rates on cash and cash equivalents	105	(15)
Net increase in cash and cash equivalents	$ (42,264)	$ 67,489

(In Thousands)	September 30, 2011	December 31, 2010
Cash and cash equivalents	$ 30,132	$ 72,396
Marketable securities (1)	19,503	
Accounts receivable, net	19,325	15,333
Accounts payable, accrued compensation and other accrued liabilities	25,774	22,945
Working capital (2)	42,631	64,708

(1) Includes only the current portion of our marketable securities.
(2) Working capital consists of total current assets less total current liabilities.

Cash Flows from Operating Activities

Operating activities provided $2.4 million of net cash during the nine months ended September 30, 2011. We incurred a net loss of $11.3 million in the nine months ended September 30, 2011, which included non-cash depreciation and amortization of $8.5 million and share-based compensation expense of $7.4 million. Changes in operating asset and liability accounts used $2.6 million of net cash during the nine months ended September 30, 2011.

Operating activities used $16.1 million of net cash during the nine months ended September 30, 2010. We incurred a net loss of $8.0 million in the nine months ended September 30, 2010, which included non-cash share-based compensation expense of $6.5 million and depreciation and amortization of $5.7 million. Changes in operating asset and liability accounts used $21.4 million of net cash during the nine months ended September 30, 2010.

Cash Flows from Investing Activities

Cash flows from investing activities primarily relate to capital expenditures to support our growth and our investments in marketable securities.

Cash used by investing activities totaled $47.3 million during the nine months ended September 30, 2011 and consisted of and purchases of marketable securities of $50.9 million offset by $11.5 million of cash received from maturities and sales of marketable securities and capital expenditures of $7.8 million primarily due to the purchase of lab equipment and improvements to our facilities in Redwood City, California

Cash provided by investing activities totaled $18.6 million during the nine months ended September 30, 2010 and consisted of cash received from maturities and sales of marketable securities of $23.3 million, partially offset by capital expenditures of $4.7 million primarily related to the purchase of manufacturing and lab equipment.

Cash Flows from Financing Activities

Cash provided by financing activities totaled $2.5 million during the nine months ended September 30, 2011 and consisted of proceeds from the exercise of stock options.

Cash provided by financing activities totaled $65.0 million during the nine months ended September 30, 2010 and consisted of gross proceeds received related to our IPO of $72.6 million and $0.3 million from exercises of stock options, partially offset by payments in preparation for our IPO of $3.9 million and payments on financing obligations of $4.0 million.

Table of Contents

Contractual Obligations and Commitments

Our contractual obligations relate primarily to operating leases. Our commitments for operating leases primarily relate to our leased facilities in Redwood City, California. As a result of our amended lease we increased our restricted cash balance by $145,000 in March 2011. The following table summarizes the future commitments arising from our contractual obligations at September 30, 2011 (in thousands):

	Operating leases
Three months ending December 31, 2011:	$ 783
Years ending December 31, 2012:	3,268
2013	2,909
2014	2,731
2015	2,808
2016 and beyond	11,259
Total minimum payments	$ 23,758

Off-Balance Sheet Arrangements

As of September 30, 2011, we had no off-balance sheet arrangements as defined in Item 303(a)(4) of Regulation S-K as promulgated by the SEC.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk Management

Our cash flow and earnings are subject to fluctuations due to changes in foreign currency exchange rates, interest rates and other factors. There were no significant changes in our market risk exposures during the nine months ended September 30, 2011. This is discussed in further detail in our Annual Report on Form 10-K filed with the SEC on February 10, 2011.

Equity Price Risk

As described in Note 4 to the condensed consolidated financial statements, we have an investment in common shares of CO_2 Solution, whose shares are publicly traded in Canada on the TSX Venture Exchange. This investment is exposed to fluctuations in both the market price of CO_2 Solution s common shares and changes in the exchange rates between the U.S. dollar and the Canadian dollar. The effect of a 10% adverse change in the market price of CO_2 Solution s common shares as of September 30, 2011 would have been an unrealized loss of approximately $201,000, recognized as a component of other comprehensive income (loss) in stockholders deficit on the condensed consolidated balance sheets. The effect of a 10% adverse change in the exchange rates between the U.S. dollar and the Canadian dollar as of September 30, 2011 would have been an unrealized loss of approximately $201,000, recognized as a component of interest expense and other, net on the condensed consolidated statements of operations.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. We maintain disclosure controls and procedures and internal controls that are designed to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC s 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 the disclosure controls and procedures and internal controls, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable, and not absolute, assurance of achieving the desired control objectives. In reaching a reasonable level of assurance, management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures and internal controls.

Management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as required by Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended. Based on this review, our Chief Executive Officer and Chief Financial Officer concluded that these disclosure controls and procedures were effective as of September 30, 2011 at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There has been no significant change in our internal control over financial reporting during the three months ended September 30, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. Internal control over financial reporting means a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are not currently a party to any material litigation or other material legal proceedings.

ITEM 1A. RISK FACTORS

You should carefully consider the risks described below together with the other information set forth in this Quarterly Report on Form 10-Q, which could materially affect our business, financial condition or future results. The risks described below are not the only risks facing our company. Risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Risks Relating to Our Business and Strategy

We have a limited operating history, which may make it difficult to evaluate our current business and predict our future performance.

Our company has been in existence since early 2002. From 2002 until 2005, our operations focused on organizing and staffing our company and developing our technology platform. In 2005, we recognized our first revenues from product sales. Since 2005, we have continued to generate revenues, but because our revenue growth has occurred in recent periods, our limited operating history may make it difficult to evaluate our current business and predict our future performance. Any assessments of our current business and predictions you make about our future success or viability may not be as accurate as they could be if we had a longer operating history. We have encountered and will continue to encounter risks and difficulties frequently experienced by growing companies in rapidly changing industries. If we do not address these risks successfully, our business will be harmed.

Our quarterly operating results may fluctuate in the future. As a result, we may fail to meet or exceed the expectations of research analysts or investors, which could cause our stock price to decline.

Our financial condition and operating results have varied significantly in the past and may continue to fluctuate from quarter to quarter and year to year in the future due to a variety of factors, many of which are beyond our control. Factors relating to our business that may contribute to these fluctuations include the following factors, as well as other factors described elsewhere in this report and in our annual report on Form 10-K:

- our ability to achieve or maintain profitability;
- our relationships with and dependence on collaborators in our principal markets;
- our dependence on Shell for the development and commercialization of advanced biofuels;
- the feasibility of producing and commercializing biofuels derived from cellulose;
- our dependence on a limited number of customers;

our dependence on a limited number of contract manufacturers of our biocatalysts and suppliers for our pharmaceutical intermediates and APIs;

our dependence on a limited number of products in our pharmaceutical business;

our ability to manage our growth;

our ability to develop and successfully commercialize new products for the pharmaceuticals market;

our ability to commercialize our technology in other bioindustrial markets;

our ability to maintain license rights for commercial scale expression systems for cellulases;

fluctuations in the price of and demand for petroleum-based fuels;

the availability of renewable biomass sources;

reductions or changes to existing fuel regulations and policies;

our potential bio-based chemical products might not be approved or accepted by our customers;

the existence of government subsidies or regulation with respect to carbon dioxide emissions;

our ability to obtain and maintain governmental grants;

Table of Contents

- risks associated with the international aspects of our business;
- our ability to integrate any businesses we may acquire with our business;
- potential issues related to our ability to accurately report our financial results in a timely manner;
- our dependence on, and the need to attract and retain, key management and other personnel;
- our ability to obtain, protect and enforce our intellectual property rights;
- our ability to prevent the theft or misappropriation of our biocatalysts, the genes that code for our biocatalysts, know-how or technologies;
- potential advantages that our competitors and potential competitors may have in securing funding or developing products;
- our ability to obtain additional capital that may be necessary to expand our business;
- business interruptions such as earthquakes and other natural disasters;
- public concerns about the ethical, legal and social ramifications of genetically engineered products and processes;
- our ability to comply with laws and regulations;
- our ability to properly handle and dispose of hazardous materials used in our business;
- potential product liability claims; and
- our ability to use our net operating loss carryforwards to offset future taxable income.

Due to the various factors mentioned above, and others, the results of any prior quarterly or annual periods should not be relied upon as indications of our future operating performance.

We have a history of net losses, and we may not achieve or maintain profitability.

We have incurred net losses since our inception, including losses of $45.1 million, $20.3 million and $8.5 million in 2008, 2009 and 2010, respectively, and a net loss of $11.3 million for the nine months ended September 30, 2011. As of September 30, 2011, we had an accumulated deficit of $179.4 million. To date, we have derived a substantial portion of our revenues from research and development agreements with our collaborators and expect to derive a substantial portion of our revenues from these sources for the foreseeable future. If we are unable to extend our existing agreements or enter into new agreements upon the expiration or termination of our existing agreements, our revenues could be adversely affected. In addition, some of our collaboration agreements provide for milestone payments and future royalty payments, the payment of which are uncertain as they are dependent on our and our collaborators abilities and willingness to successfully develop and commercialize products. We expect to spend significant amounts to fund the development of additional pharmaceutical and potential bioindustrial products, including biofuels and bio-based chemicals. There can be no assurance that we will ever achieve profitability on a quarterly or annual basis. If we fail to achieve profitability, or if the time required to achieve profitability is longer than we anticipate, we may not be able to continue our business. Even if we do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis.

We are dependent on our collaborators, and our failure to successfully manage these relationships could prevent us from developing and commercializing many of our products and achieving or sustaining profitability.

Our ability to maintain and manage collaborations in our markets is fundamental to the success of our business. We currently have license agreements, research and development agreements, supply agreements and/or distribution agreements with various collaborators. We may have limited or no control over the amount or timing of resources that any collaborator is able or willing to devote to our partnered products or collaborative efforts. Any of our collaborators may fail to perform their obligations. These collaborators may breach or terminate their agreements with us or otherwise fail to conduct their collaborative activities successfully and in a timely manner. Further, our collaborators may not develop products arising out of our collaborative arrangements or devote sufficient resources to the development, manufacture, marketing, or sale of these products. Moreover, disagreements with a collaborator could develop and any conflict with a collaborator could reduce our ability to enter into future collaboration agreements and negatively impact our relationships with one or more existing collaborators. If any of these events occur, or if we fail to maintain our agreements with our collaborators, we may not be able to commercialize our existing and potential products, grow our business, or generate sufficient revenues to support our operations. Our collaboration opportunities could be harmed if:

- we do not achieve our research and development objectives under our collaboration agreements in a timely manner or at all;

- we develop products and processes or enter into additional collaborations that conflict with the business objectives of our other collaborators;

- we disagree with our collaborators as to rights to intellectual property that are developed during the collaboration, or their research programs or commercialization activities;

- we are unable to manage multiple simultaneous collaborations;
- our collaborators become competitors of ours or enter into agreements with our competitors; or
- our collaborators become unable or less willing to expend their resources on research and development or commercialization efforts due to general market conditions, their financial condition or other circumstances beyond our control.

Additionally, our business could be negatively impacted if any of our collaborators or suppliers undergoes a change of control or were to otherwise assign the rights or obligations under any of our agreements. For example, under our license agreement with Shell, Shell may assign the agreement without our consent to controlled affiliates or in connection with a change of control. If Shell or any of our other collaborators were to assign these agreements to a competitor of ours or to a third party who is not willing to work with us on the same terms or commit the same resources as the current collaborator, our business and prospects could be harmed.

Our future success in advanced biofuels is heavily dependent on our collaborative research agreement with Shell.

Our current business plan for advanced biofuels is heavily dependent on our collaborative research agreement with Shell, which will continue to be critical to researching and developing successful biocatalysts for producing advanced biofuel products. Shell s efforts in commercializing those products profitably will be critical to the success of our business plan for advanced biofuels. If we are unable to successfully execute on the development of products for Shell, our ability to expand into other bioindustrial areas may be significantly impaired, which will materially and adversely affect our ability to grow our business.

We cannot control the financial resources Shell devotes to our programs under the collaborative research agreement. Currently, we receive bi-monthly payments from Shell that are based on the number of full-time employee equivalents, or FTEs, that work on our research collaboration with Shell. The number of FTEs that work on the program, and the payments from Shell for these FTEs, are specified in our collaborative research agreement. Shell has the right to reduce the number of funded FTEs, with any one reduction not to exceed 98 funded FTEs, following advance written notice. The required notice period ranges from 30 to 270 days. Following any such reduction, Shell is subject to a standstill period of between 90 and 360 days during which period Shell cannot provide notice of any further FTE reductions. The notice and standstill periods are dependent on the number of funded FTEs reduced, with the length of notice and standstill periods increasing commensurate with the number of FTEs reduced. Effective August 2011, Shell reduced the number of funded FTEs engaged in our joint research and development collaboration from 128 to 116. Any further reduction could have a material adverse impact on our revenues and business plan for advanced biofuels. Moreover, disputes may arise between us and Shell, which could delay the programs on which we are working or could prevent the commercialization of products developed under our research and development collaboration. If that were to occur, we may have to use funds, personnel, equipment, facilities and other resources that we have not budgeted to undertake certain activities on our own. Disagreements with Shell could also result in expensive arbitration or litigation, which may not be resolved in our favor. Performance issues, program delay or termination or unbudgeted use of our resources may have a material adverse effect on our business and financial condition. Even if we successfully develop commercially viable technologies, our ability to derive revenues from those technologies will be dependent upon Shell s willingness and ability to commercialize them. Shell has the right, but not the obligation, to commercialize these technologies. If Shell decides to commercialize our technology, we would need to rely on Shell, or other parties selected by Shell, to design, finance and construct commercial scale advanced biofuel facilities, and operate commercial scale facilities at costs that are competitive with traditional petroleum-based fuels and other alternative fuel technologies that may be developed. Shell could merge with or be acquired by another company or experience financial or other setbacks unrelated to our research collaboration agreement that could adversely affect us.

We have agreed to work exclusively with Shell until November 2012 in the field of converting cellulosic biomass into fermentable sugars that are used in the production of fuels and related products as well as the conversion of these sugars into fuels and related products. However, Shell is not required to work exclusively with us, and could develop or pursue alternative technologies that it decides to use for commercialization purposes instead of the technology developed under our collaborative research agreement with Shell. For example, Shell is currently working with Virent Energy Systems to develop a thermo-chemical approach to developing biogasoline and biodiesel. Even if Shell decides to commercialize products based on our technologies, they have no obligation to purchase their biocatalyst supply from us. Our license agreement with Shell prohibits us from licensing any technology developed under the collaboration for the patent life of such technology, which could place us at a significant competitive disadvantage in the advanced biofuels market.

We cannot guarantee that our relationship with Shell will continue. Our collaborative research agreement with Shell expires in November 2012 unless extend by the parties.Shell can terminate its collaborative research agreement with us for any or no reason by providing us with nine months notice. Each party also has the right to terminate the license agreement and the collaborative research agreement in the case of an uncured breach by the other party, and to terminate the collaborative research agreement if that party believes the other party has assigned the collaborative research agreement to a direct competitor of the terminating party. Furthermore, in June 2011 Shell transferred all of its equity interests in us, together with its right to appoint one member to our board of directors, to Raízen Energia Participações S.A., or Raízen, a Brazil-based biofuels joint venture between Shell and Cosan S.A., and it is unknown at this time what impact, if any, this transfer will have on our collaboration with Shell. If our collaboration with Shell were to end, we would likely need to find other collaborators to provide the financial assistance and infrastructure necessary for us to develop and commercialize our products and execute our strategy with respect to advanced biofuels. Failure to maintain this relationship would have a material adverse effect on our business, financial condition and prospects.

Table of Contents

The success of our cellulosic ethanol program may be dependent on the performance of other parties.

In connection with our research and development collaboration with Shell, we entered into a multiparty collaborative research and license agreement with Shell and Iogen in July 2009, which is focused on developing technology to convert cellulosic biomass to ethanol for commercial scale production. Either Shell or Iogen may fail to perform their obligations under this collaboration, may breach or terminate the collaboration agreement or otherwise fail to conduct their collaborative activities successfully and in a timely manner. Further, they may not devote sufficient resources to the development of technology to convert cellulosic biomass to ethanol or may fail to develop the technology altogether. Moreover, disagreements or conflicts amongst the parties could develop and could negatively impact our development efforts or our relationships with Shell and Iogen. Disagreements with Shell or Iogen could also result in expensive arbitration or litigation, which may not be resolved in our favor. If any of these events occur, or if we fail to maintain this collaboration with Shell and Iogen, we may be unable to develop technology for use in the production of cellulosic ethanol at commercial scale, which would have an adverse impact on our ability to grow our business. In addition, the collaborative research and license agreement with Shell and Iogen terminates in the event (i) our separate license agreements with Shell terminate or (ii) Iogen s separate technology license agreement with Shell terminates. In addition, Shell can terminate the collaborative research and license agreement for any or no reason by providing us and Iogen with 30 days notice. Any unilateral action by Shell to terminate either its separate license agreements with us or Iogen will prevent any further research and development activities under the multi-party collaboration. As a result, our ability to pursue research and development activities relating to the conversion of cellulosic biomass and our biofuels programs may be adversely impacted.

We do not yet know what impact, if any, our relationship with Raízen will have on our business.

In June 2011, Shell completed the transfer of all of its equity interests in us, together with the associated right to appoint one member to our board of directors, to Raízen. Following the transfer, Raízen became our largest stockholder. Raízen s primary business is the production of ethanol, sugar and power, and the supply, distribution and retail of transportation fuels. In September 2011, we entered into a joint development agreement with Raízen to develop an improved first generation ethanol process with enhanced performance economics. Our collaborative relationship with Raízen is in its early stages and neither we nor Raízen knows yet which of our joint projects may produce commercially viable technologies.

Production and commercialization of biofuels and bio-based chemicals derived from cellulose may not be feasible.

We are developing biocatalysts for use in producing advanced biofuels and bio-based chemicals. However, production and commercialization of cellulosic biofuels and bio-based chemicals may not be feasible for a variety of reasons. For example, the development of technology for converting sugar derived from non-food renewable biomass sources into a commercially viable biofuel or bio-based chemical is still unproven, and we do not know whether this can be done commercially or at all. To date, there has been limited private and government funding for research and development in advanced biofuels relative to the scope of the challenges presented by this development effort. Furthermore, there have been only a few well-directed public policies emphasizing investment in the research and development of, and providing incentives for the commercialization of and transition to, biofuels.

As of the date of this report, we believe that there are no commercial scale cellulosic biofuel or cellulosic bio-based chemicals production plants in operation. There can be no assurance that anyone will be able or willing to develop and operate these production plants at commercial scale or that any of these facilities can be profitable. Additionally, different biocatalysts may need to be developed for use in different geographic locations to convert the cellulosic biomass available in each locale into sugars that can be used in the production of these biofuels or bio-based chemicals. This will make the development of biofuels or bio-based chemicals derived from cellulose more challenging and expensive. Moreover, substantial development of infrastructure will be required for the ethanol market to grow. Areas requiring expansion include, but are not limited to, additional rail capacity, additional storage facilities for ethanol, increases in truck fleets capable of transporting ethanol within localized markets, expansion of refining and blending facilities to handle ethanol, logistics for the collection and storage of biomass and growth in the fleet of end user vehicles capable of using ethanol blends. Substantial investments required for infrastructure changes and expansions may not be made on a timely basis or at all. Any delay or failure in making the changes to or expansion of infrastructure could harm demand or prices for ethanol and impose additional costs that would hinder its commercialization. Finally, if existing tax credits, subsidies and other incentives in the United States and foreign markets are phased out or reduced, the overall cost of commercialization of cellulosic biofuels will increase.

We are dependent on a limited number of customers.

Our current revenues are derived from a limited number of key customers. For the year ended December 31, 2009, our top five customers accounted for 90% of our total revenues, with Shell accounting for 76% of our total revenues. For the year ended December 31, 2010, our top five customers accounted for 85% of our total revenues, with Shell accounting for 62% of our total revenues. For the nine months ended September 30, 2011, our top five customers accounted for 78% of our total revenues, with Shell accounting for 52% of our total revenues. We expect a limited number of customers to continue to account for a significant portion of

Table of Contents

our revenues for the foreseeable future. This customer concentration increases the risk of quarterly fluctuations in our revenues and operating results. The loss or reduction of business from one or a combination of our significant customers could materially adversely affect our revenues, financial condition and results of operations.

We are dependent on a limited number of products in our pharmaceutical business.

Our current product revenues are derived from a limited number of pharmaceutical products. For the year ended December 31, 2010, we derived 87% of our product revenue from three pharmaceutical product families: statins, hepatitis C therapies and anti-diabetics. We expect a limited number of pharmaceutical products to continue to account for a significant portion of our pharmaceutical product revenues for the foreseeable future. This product concentration increases the risk of quarterly fluctuations in our revenues and operating results. The loss or reduction of business of one or a combination of our significant pharmaceutical products could materially adversely affect our revenues, financial condition and results of operations.

We are dependent on contract manufacturers for commercial scale production of our biocatalysts.

We have limited internal capacity to manufacture biocatalysts and are unable to manufacture for all of our commercial scale production needs. As a result, we are dependent upon the performance and capacity of third party manufacturers for the commercial scale manufacturing of our biocatalysts.

We rely on several contract manufacturers, including Lactosan GmbH & Co. KG, or Lactosan, to manufacture substantially all of the biocatalysts used in our pharmaceutical business. Our pharmaceutical business, therefore, faces risks of difficulties with, and interruptions in, performance by these contract manufacturers, the occurrence of which could adversely impact the availability, launch and/or sales of our enzymes in the future. The failure of any manufacturers that we may use to supply manufactured product on a timely basis or at all, or to manufacture our biocatalysts in compliance with our specifications or applicable quality requirements or in volumes sufficient to meet demand would adversely affect our ability to sell pharmaceutical products, could harm our relationships with our collaborators or customers and could negatively affect our revenues and operating results. For example, in 2008, we were required to secure an alternative source of certain biocatalysts when viruses infected one of our contract manufacturer s facilities. If this or any similar event disrupts the operations of any of our suppliers in the future, we may be forced to secure alternative sources of supply, which may be unavailable on commercially acceptable terms, cause delays in our ability to deliver products to our customers, increase our costs and decrease our profit margins.

We have a supply agreement with Lactosan, but we do not currently have a supply contract with any other contract manufacturers. Other than Lactosan, our contract manufacturers are under no obligation to manufacture our biocatalysts and could elect to discontinue their manufacture at any time. If we require additional manufacturing capacity and are unable to obtain it in sufficient quantity, we may not be able to increase our pharmaceutical sales, or we may be required to make substantial capital investments to build that capacity or to contract with other manufacturers on terms that may be less favorable than the terms we currently have with our suppliers. If we choose to build our own additional manufacturing capacity, it could take two years or longer before our facility is able to produce commercial volumes of our biocatalysts. Any resources we expend on acquiring or building internal manufacturing capabilities could be at the expense of other potentially more profitable opportunities. In addition, if we contract with other manufacturers, we may experience delays of several months in qualifying them, which could harm our relationships with our collaborators or customers and could negatively affect our revenues or operating results.

We rely on Arch to market our products in certain regions, and Arch may not be able to effectively market our products.

Using our biocatalysts, Arch manufactures certain specified APIs, and intermediates used in the manufacture of APIs, that we then purchase and have the right to sell to innovator pharmaceutical companies worldwide, generic pharmaceutical companies in the United States, Canada, Europe and Israel, and certain pharmaceutical companies in India. Arch has the exclusive right to manufacture market and sell such APIs and intermediaries to generic pharmaceutical companies in countries other than the United States, Canada, Europe and Israel, and certain other pharmaceutical companies in India. We must therefore rely on Arch for their financial resources and their marketing expertise for the commercialization of such APIs and intermediates in these regions. We cannot control Arch s level of activity or expenditures relating to the marketing of such products relative to the rest of their products or marketing efforts. Arch may fail to effectively market our products in these regions. Conflicting priorities, competing demands or other factors that we cannot control, and of which we may not be aware, may cause Arch to deemphasize such products. If we are unable to effectively leverage Arch s marketing capabilities or Arch does not successfully promote such products in the designated territories as our sole marketing partner, this could harm our business, our revenues and operating results, and our ability to bring such products to the marketplace.

33

Table of Contents

The accuracy and timeliness of our financial reporting may be adversely affected if we are unable to implement and maintain effective internal control over financial reporting in the future.

Under Section 404 of the Sarbanes-Oxley Act, we are required to perform an evaluation of our internal control over financial reporting by no later than December 31, 2011, and we have not yet performed such evaluation. Based on the procedures performed as of December 31, 2010, we noted no control deficiencies in our internal control over financial reporting. Our independent registered public accounting firm is currently performing preliminary testing over such internal control and we expect them to perform an audit of our internal control over financial reporting as of December 31, 2011. As a result of this audit of our internal control over financial reporting, our independent registered public accounting firm may determine that control deficiencies, including material weaknesses and significant deficiencies exist.

We have taken numerous steps to enhance our internal control over financial reporting, including the development and implementation of policies, improved processes and documented procedures, the retention of third-party experts and contractors, and the hiring of additional accounting and finance personnel with technical accounting, inventory accounting and financial reporting experience. We cannot make assurances that in the future material weaknesses or significant deficiencies will not exist or otherwise be discovered, a risk that is significantly increased in light of the complexity of our business and multinational operations. If deficiencies are discovered in the future, our ability to accurately and timely report our financial position, results of operations or cash flows could be impaired, which could result in late filings of our annual and quarterly reports under the Securities Exchange Act of 1934, as amended, restatements of our consolidated financial statements, a decline in our stock price, suspension or delisting of our common stock by The NASDAQ Global Market, or other material adverse effects on our business, reputation, results of operations, financial condition or liquidity.

We may encounter difficulties managing our growth, which could adversely affect our business.

Our business has grown rapidly and this growth may continue in the future. Overall, we have grown from approximately 40 employees at the end of 2002 to approximately 339 employees as of September 30, 2011. Currently, we are working simultaneously on multiple projects targeting several markets. Furthermore, we are conducting our business across several countries, including countries in North America, South America, Europe and Asia. These diversified, global operations place increased demands on our limited resources and may require us to expand the capabilities of our administrative and operational resources and to attract, train, manage and retain qualified management, technicians, scientists and other personnel which we may be unable to do effectively. As our operations expand domestically and internationally, we will need to continue to manage multiple locations and additional relationships with various customers, collaborators, suppliers and other third parties. Our ability to manage our operations, growth, and various projects effectively may require us to make additional investments in our infrastructure to continue to improve our operational, financial and management controls and our reporting systems and procedures. In addition, we may not be able to successfully improve our management information and control systems, including our internal control over financial reporting, to a level necessary to manage our growth and we may discover deficiencies in existing systems and controls that we may not be able to remediate in an efficient or timely manner.

Our business could be adversely affected if our customers pharmaceutical products, or the processes used by our customers to manufacture their final pharmaceutical products, fail to be approved, or if our customers discontinue their drug development activities for any reason.

Our biocatalysts are used in the manufacture of intermediates and APIs which are then used in the manufacture of final pharmaceutical products by our existing and potential branded drug customers. These pharmaceutical products must be approved by the FDA in the United States and similar regulatory bodies in other markets prior to commercialization. If our customers who sell branded-drugs, which we refer to as innovators, fail to receive regulatory approval for the drugs, fail to receive regulatory approval for new manufacturing processes for previously approved drugs, or decide for business or other reasons to discontinue their drug development activities, our revenues and prospects will be negatively impacted. The process of producing these drugs, and their generic equivalents, is also subject to regulation by the FDA in the United States and equivalent regulatory bodies in other markets. If any pharmaceutical process that uses our biocatalysts does not receive approval by the appropriate regulatory body or if customers decide not to pursue approval, our business could be adversely affected.

Our pharmaceutical product gross margins are variable and may decline from quarter to quarter.

Our pharmaceutical product gross margins have varied significantly in the past and may continue to fluctuate from quarter to quarter and year to year in the future due to a variety of factors, including product mix, pricing pressure from our pharmaceutical customers and competition from other products or technologies. We do not expect product gross margins for our current generic products to improve in the near or long term, which may have a material adverse impact on our operating results and financial condition and cause our stock price to decline.

34

If we are unable to develop and commercialize new products for the pharmaceutical market, our business and prospects will be harmed.

We plan to launch new products for the pharmaceutical market. These efforts are subject to numerous risks, including the following:

- pharmaceutical companies may be reluctant to adopt new manufacturing processes that use our biocatalysts;
- we may be unable to successfully develop the biocatalysts or manufacturing processes for our products in a timely and cost-effective manner, if at all;
- we may face difficulties in transferring the developed technologies to the contract manufacturers that we may use for commercial scale production;
- the contract manufacturers that we may use may be unable to scale their manufacturing operations to meet the demand for these products and we may be unable to secure additional manufacturing capacity;
- customers may not be willing to purchase these products for the pharmaceutical market from us on favorable terms, if at all;
- we may face product liability litigation, unexpected safety or efficacy concerns and pharmaceutical product recalls or withdrawals;
- changes in laws or regulations relating to the pharmaceutical industry could cause us to incur increased costs of compliance or otherwise harm our business;
- our customers pharmaceutical products may experience adverse events or face competition from new products, which would reduce demand for our products;
- we may face pressure from existing or new competitive products; and
- we may face pricing pressures from existing or new competitors, some of which may benefit from government subsidies or other incentives.

If we are unable to successfully commercialize our technology in biofuels or bio-based chemicals, we may be unable to grow our business.

We expect to invest a significant amount of our future research and development efforts in the bio-based chemicals market and, potentially, the biofuels market. We have limited financial and managerial resources, we will be required to prioritize our application of resources to particular development and commercialization efforts. Any resources we expend on one or more of these efforts could be at the expense of other potentially profitable opportunities. If we focus our efforts and resources on one or more of these areas and they do not lead to commercially viable products, our revenues, financial condition and results of operations could be adversely affected.

If we are unable to maintain license rights to a commercial scale expression system for enzymes that convert cellulosic biomass to sugars, our business may be materially adversely affected.

We entered into a license agreement with Dyadic International, Inc. and its affiliate, or Dyadic, in November 2008 to obtain access to an expression system that is capable of producing the necessary biocatalysts for the commercialization of products derived from cellulose, including biofuels and bio-based chemicals. Under the license agreement with Dyadic, we obtained a non-exclusive license under intellectual property rights of Dyadic relating to Dyadic s proprietary fungal expression technology for the production of enzymes. We also obtained access to specified materials of Dyadic relating to such Dyadic technology. Our license is sublicenseable to Shell in the field of biofuels. Dyadic has the right to terminate our licenses under the license agreement if we challenge the validity of any of the patents licensed under the license agreement and for various other reasons. Our licenses and access to such materials of Dyadic under the license agreement will terminate as a result of any termination of the license agreement other than due to Dyadic s material breach. If we are unable to maintain these rights on commercially reasonable terms or if the license agreement is terminated for any reason, we will need to buy or license this type of expression system from another party or develop this type of expression system ourselves, which may be difficult, costly and time consuming, in part because of the broad, existing intellectual property rights owned by Novozymes, Danisco A/S, which was recently acquired by E.I. Du Pont De Nemours and Company, or DuPont, and others. If any of these events occur, our business may be materially adversely affected.

Fluctuations in the price of and demand for fossil fuel-based products may reduce demand for biofuels and bio-based chemicals.

Biofuels and some bio-based chemicals are anticipated to be marketed as an alternative to petroleum-based products. Therefore, if the price of natural gas or oil falls, any revenues that we generate from biofuel or bio-based chemical products could decline, and we may be unable to produce products that are a commercially viable alternative to fossil fuel-based products. Additionally, demand for liquid transportation fuels, including biofuels, may decrease due to economic conditions or otherwise. Demand for bio-based chemicals may also fluctuate if the price of natural gas or oil is variable.

Table of Contents

The royalties that we may earn under our agreements with Shell are indexed to the price of oil and generally increase as the price of oil increases. However, the index is set based on average prices between November 2007 and the date of first commercial sale. Therefore, if prices fall, our revenues would be negatively impacted.

Our biofuel and bio-based chemical business opportunities may be limited by the availability or cost of renewable feedstocks.

Our business opportunities in the biofuel and bio-based chemical markets may be dependent on the availability and price of feedstocks, including sugar, starch and cellulosic biomass. If the availability of these feedstocks decreases or their price increases, this may reduce the desirability of our biofuel and bio-based chemical products, as well as the biofuels royalties that we collect from Shell, and have a material adverse effect on our financial condition and operating results. At certain levels, prices may make these products uneconomical to use and produce.

The price and availability of feedstocks may be influenced by general economic, market and regulatory factors. These factors include the availability of arable land to supply feedstock, weather conditions, farming decisions, logistics for collection and storage of biomass, government policies and subsidies with respect to agriculture and international trade, and global demand and supply. The significance and relative impact of these factors on the price of feedstocks is difficult to predict, especially without knowing what types of feedstocks we may need to use.

Reductions or changes to existing biofuel regulations and policies may present technical, regulatory and economic barriers, all of which may significantly reduce demand for biofuels.

The market for biofuels is heavily influenced by foreign, federal, state and local government regulations and policies concerning the petroleum industry. In 2007, the U.S. Congress passed an alternative fuels mandate that currently calls for approximately 36 billion gallons of liquid transportation fuels sold in 2022 to come from alternative sources, including biofuels. Of this amount, a minimum of 21 billion gallons must be advanced biofuels, with 16 billion gallons of that to be cellulosic derived. In the U.S. and a number of other countries, these regulations and policies have been modified in the past and may be modified again in the future. For example, EPA has the authority to adjust or reduce the gallon milestones of the alternative fuels mandate to reflect the marketplace supply availability. Any reduction in mandated requirements for fuel alternatives and additives to gasoline may cause demand for biofuels to decline and deter investment in the research and development of biofuels. Congressional and market uncertainty regarding future policies will affect our ability to develop new biofuels products or to license our technologies to third parties. Any inability to address these requirements and any regulatory or policy changes could have a material adverse effect on our biofuels business, financial condition and operating results. Our other potential bioindustrial products may be subject to additional regulations.

We cannot assure you that our potential bio-based chemical products will be approved or accepted by customers.

We have only recently entered the market for chemical products used by large consumer products or chemical companies through our collaboration with M&G, and we intend to explore other opportunities in these markets. In entering these markets, we intend to sell our products as alternatives to chemicals currently in use, and in some cases the chemicals that we seek to replace have been used for many years. The potential customers for our molecules generally have well developed manufacturing processes and arrangements with suppliers of the chemical components of their products and may resist changing these processes and components. These potential customers frequently impose lengthy and complex product qualification procedures on their suppliers. Factors that these potential customers consider during the product qualification process include consumer preference, manufacturing considerations such as process changes and capital and other costs associated with transitioning to alternative components, supplier operating history, regulatory issues, product liability and other factors, many of which are unknown to, or not well understood by, us. Satisfying these processes may take many months or years. If we are unable to convince these potential customers that our products are comparable to the chemicals that they currently use or that the use of our products produces other benefits to them, we will not be successful in these markets and our business will be adversely affected.

Our government grants are subject to uncertainty, which could harm our business and results of operations.

We have received various government grants to complement and enhance our own resources. We may seek to obtain government grants and subsidies in the future to offset all or a portion of the costs of building additional manufacturing facilities and research and development activities. We cannot be certain that we will be able to secure any such government grants or subsidies. Any of our existing grants or new grants that we may obtain may be terminated, modified or recovered by the granting governmental body under certain conditions.

Table of Contents

We are subject to routine audits by government agencies or other third parties as part of our government grants contracts. The auditor may review our performance, cost structures and compliance with applicable laws, regulations and standards. Funds available under grants must be applied by us toward the research and development programs specified by the granting agencies, rather than for all of our programs generally. If any of our costs are found to be allocated improperly, the costs may not be reimbursed and any costs already reimbursed may have to be refunded. Accordingly, an audit could result in an adjustment to our revenues and results of operations.

We face risks associated with our international business.

Significant portions of our operations are conducted outside of the United States and we expect to continue to have significant foreign operations in the foreseeable future. International business operations are subject to a variety of risks, including:

- changes in or interpretations of foreign regulations that may adversely affect our ability to sell our products, repatriate profits to the United States or operate our foreign-located facilities;
- the imposition of tariffs;
- the imposition of limitations on, or increase of, withholding and other taxes on remittances and other payments by foreign subsidiaries or joint ventures;
- the imposition of limitations on genetically-engineered products or processes and the production or sale of those products or processes in foreign countries;
- currency exchange rate fluctuations;
- uncertainties relating to foreign laws and legal proceedings including tax, anti-corruption and exchange control laws;
- the availability of government subsidies or other incentives that benefit competitors in their local markets that are not available to us;

economic or politires, which are disclosed in Note 4 to the Consolidated Financial Statements.

Our leasing strategy is generally to secure creditworthy tenants that meet our underwriting guidelines. Furthermore, following the initiation of a lease, we continue to actively monitor the tenant s creditworthiness to ensure that all tenant related assets are recorded at their realizable value. When assessing tenant credit quality, we:

- review relevant financial information, including:
  - financial ratios;
  - net worth;

- revenue;
- cash flows;
- leverage; and
- liquidity;

- evaluate the depth and experience of the tenant s management team; and
- assess the strength/growth of the tenant s industry.

As a result of the underwriting process, tenants are then categorized into one of three categories:

(1) acceptable-risk tenants;

(2) the tenant s credit is such that we may require collateral, in which case we:

- may require a security deposit; and/or
- may reduce upfront tenant improvement investments; or

(3) the tenant s credit is below our acceptable parameters.

We consistently monitor the credit quality of our tenant base. We provide an allowance for doubtful accounts arising from estimated losses that could result from the tenant s inability to make required current rent payments and an allowance against accrued rental income for future potential losses that we deem to be unrecoverable over the term of the lease.

Tenant receivables are assigned a credit rating of 1 through 4. A rating of 1 represents the highest possible rating and no allowance is recorded. A rating of 4 represents the lowest credit rating, in which case we record a full reserve against the receivable balance. Among the factors considered in determining the credit rating include:

- payment history;
- credit status and change in status (credit ratings for public companies are used as a primary metric);

change in tenant space needs (i.e., expansion/downsize);

tenant financial performance;

economic conditions in a specific geographic region; and

industry specific credit considerations.

If our estimates of collectability differ from the cash received, the timing and amount of our reported revenue could be impacted. The average remaining term of our in-place tenant leases, including unconsolidated joint ventures, was approximately 6.6 years as of March 31, 2014. The credit risk is mitigated by the high quality of our existing tenant base, reviews of prospective tenants risk profiles prior to lease execution and consistent monitoring of our portfolio to identify potential problem tenants.

Recoveries from tenants, consisting of amounts due from tenants for common area maintenance, real estate taxes and other recoverable costs, are recognized as revenue in the period during which the expenses are incurred. Tenant reimbursements are recognized and presented in accordance with guidance in ASC 605-45 Principal Agent Considerations (ASC 605-45). ASC 605-45 requires that these reimbursements be recorded on a gross basis, as we are generally the primary obligor with respect to purchasing goods and services from third-party suppliers, have discretion in selecting the supplier and have credit risk. We also receive reimbursement of payroll and payroll related costs from third parties which we reflect on a net basis.

Our parking revenues are derived from leases, monthly parking and transient parking. We recognize parking revenue as earned.

Our hotel revenues are derived from room rentals and other sources such as charges to guests for telephone service, movie and vending commissions, meeting and banquet room revenue and laundry services. Hotel revenues are recognized as earned.

We receive management and development fees from third parties. Property management fees are recorded and earned based on a percentage of collected rents at the properties under management, and not on a straight-line basis, because such fees are contingent upon the collection of rents. We review each development agreement and record development fees as earned depending on the risk associated with each project. Profit on development fees earned from joint venture projects is recognized as revenue to the extent of the third-party partners ownership interest.

Gains on sales of real estate are recognized pursuant to the provisions included in ASC 360-20 Real Estate Sales (ASC 360-20). The specific timing of the sale is measured against various criteria in ASC 360-20 related to the terms of the transaction and any continuing involvement in the form of management or financial assistance associated with the properties. If the sales criteria for the full accrual method are not met, we defer some or all of the gain recognition and account for the continued operations of the property by applying the finance, leasing, profit sharing, deposit, installment or cost recovery methods, as appropriate, until the sales criteria are met.

Depreciation and Amortization

We compute depreciation and amortization on our properties using the straight-line method based on estimated useful asset lives. We allocate the acquisition cost of real estate to its components and depreciate or amortize these assets over their useful lives. The amortization of acquired above- and below-market leases and acquired in-place leases is recorded as an adjustment to revenue and depreciation and amortization, respectively, in the Consolidated Statements of Operations.

Table of Contents

Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, marketable securities, escrows, receivables, accounts payable, accrued expenses and other assets and liabilities are reasonable estimates of their fair values because of the short maturities of these instruments.

We follow the authoritative guidance for fair value measurements when valuing our financial instruments for disclosure purposes. We determine the fair value of our unsecured senior notes and unsecured exchangeable senior notes using market prices. The inputs used in determining the fair value of our unsecured senior notes and unsecured exchangeable senior notes is categorized at a level 1 basis (as defined in the accounting standards for Fair Value Measurements and Disclosures) due to the fact that we use quoted market rates to value these instruments. However, the inputs used in determining the fair value could be categorized at a level 2 basis if trading volumes are low. We determine the fair value of our mortgage notes payable using discounted cash flow analyses by discounting the spread between the future contractual interest payments and hypothetical future interest payments on mortgage debt based on current market rates for similar securities. In determining the current market rates, we add our estimates of market spreads to the quoted yields on federal government treasury securities with similar maturity dates to our debt. The inputs used in determining the fair value of our mortgage notes payable and mezzanine notes payable are categorized at a level 3 basis (as defined in the accounting standards for Fair Value Measurements and Disclosures) due to the fact that we consider the rates used in the valuation techniques to be unobservable inputs.

Derivative Instruments and Hedging Activities

Derivative instruments and hedging activities require management to make judgments on the nature of its derivatives and their effectiveness as hedges. These judgments determine if the changes in fair value of the derivative instruments are reported in the Consolidated Statements of Operations as a component of net income or as a component of comprehensive income and as a component of equity on the Consolidated Balance Sheets. While management believes its judgments are reasonable, a change in a derivative s effectiveness as a hedge could materially affect expenses, net income and equity. We account for the effective portion of changes in the fair value of a derivative in other comprehensive income (loss) and subsequently reclassify the effective portion to earnings over the term that the hedged transaction affects earnings. We account for the ineffective portion of changes in the fair value of a derivative directly in earnings.

Results of Operations

The following discussion is based on our Consolidated Statements of Operations for the three months ended March 31, 2014 and 2013.

At March 31, 2014 and March 31, 2013, we owned or had interests in a portfolio of 175 and 157 properties, respectively (in each case, the Total Property Portfolio). As a result of changes within our Total Property Portfolio, the financial data presented below shows significant changes in revenue and expenses from period-to-period. Accordingly, we do not believe that our period-to-period financial data with respect to the Total Property Portfolio is necessarily meaningful. Therefore, the comparison of operating results for the three months ended March 31, 2014 and 2013 show separately the changes attributable to the properties that were owned by us and in service throughout each period compared (the Same Property Portfolio) and the changes attributable to the properties included in the Placed In-Service, Acquired or Consolidated or Development or Redevelopment Portfolios.

In our analysis of operating results, particularly to make comparisons of net operating income between periods meaningful, it is important to provide information for properties that were in-service and owned by us throughout each period presented. We refer to properties acquired or consolidated or placed in-service prior to the beginning of the earliest period presented and owned by us and in service through the end of the latest period

Table of Contents

presented as our Same Property Portfolio. The Same Property Portfolio therefore excludes properties placed in-service, acquired or consolidated or in development or redevelopment after the beginning of the earliest period presented or disposed of prior to the end of the latest period presented.

Net operating income, or NOI, is a non-GAAP financial measure equal to net income attributable to Boston Properties, Inc., the most directly comparable GAAP financial measure, plus income attributable to noncontrolling interests, depreciation and amortization, interest expense, impairment loss, transaction costs, general and administrative expense, less discontinued operations, gains from investments in securities, income from unconsolidated joint ventures, interest and other income and development and management services revenue. We use NOI internally as a performance measure and believe NOI provides useful information to investors regarding our financial condition and results of operations because it reflects only those income and expense items that are incurred at the property level. Therefore, we believe NOI is a useful measure for evaluating the operating performance of our real estate assets.

Our management also uses NOI to evaluate regional property level performance and to make decisions about resource allocations. Further, we believe NOI is useful to investors as a performance measure because, when compared across periods, NOI reflects the impact on operations from trends in occupancy rates, rental rates, operating costs and acquisition and development activity on an unleveraged basis, providing perspectives not immediately apparent from net income attributable to Boston Properties, Inc. NOI excludes certain components from net income attributable to Boston Properties, Inc. in order to provide results that are more closely related to a property s results of operations. For example, interest expense is not necessarily linked to the operating performance of a real estate asset and is often incurred at the corporate level as opposed to the property level. In addition, depreciation and amortization, because of historical cost accounting and useful life estimates, may distort operating performance at the property level. NOI presented by us may not be comparable to NOI reported by other REITs that define NOI differently. We believe that in order to facilitate a clear understanding of our operating results, NOI should be examined in conjunction with net income attributable to Boston Properties, Inc. as presented in our Consolidated Financial Statements. NOI should not be considered as an alternative to net income attributable to Boston Properties, Inc. as an indication of our performance or to cash flows as a measure of liquidity or ability to make distributions. For a reconciliation of NOI to net income attributable to Boston Properties, Inc., see Note 11 to the Consolidated Financial Statements.

Comparison of the three months ended March 31, 2014 to the three months ended March 31, 2013.

The table below shows selected operating information for the Same Property Portfolio and the Total Property Portfolio. The Same Property Portfolio consists of 132 properties totaling approximately 35.9 million net rentable square feet of space, excluding unconsolidated joint ventures. The Same Property Portfolio includes properties acquired or consolidated or placed in-service on or prior to January 1, 2013 and owned and in service through March 31, 2014. The Total Property Portfolio includes the effects of the other properties either placed in-service, acquired or consolidated or in development or redevelopment after January 1, 2013 or disposed of on or prior to March 31, 2014. This table includes a reconciliation from the Same Property Portfolio to the Total Property Portfolio by also providing information for the three months ended March 31, 2014 and 2013 with respect to the properties that were placed in-service, acquired or consolidated or in development or redevelopment.

Table of Contents

dollars in thousands)	Same Property Portfolio 2014	2013	Increase/ (Decrease)	% Change	Properties Acquired or Consolidated Portfolio 2014	2013	Properties Placed In-Service Portfolio 2014	2013	Properties in Development or Redevelopment Portfolio 2014	2013	Total Property Portfolio 2014	2013	Increase/ (Decrease)	% Change
Rental Revenue:														
Rental Revenue	$ 467,544	$ 450,629	$ 16,915	3.75%	$ 79,402	$	$ 7,778	$ 2,319	$	$ 1,800	$ 554,724	$ 454,748	$ 99,976	21.98
Termination Income	1,110	476	634	133.19%							1,110	476	634	133.19
Total Rental Revenue	468,654	451,105	17,549	3.89%	79,402		7,778	2,319		1,800	555,834	455,224	100,610	22.10
Real Estate Operating Expenses	175,608	165,232	10,376	6.28%	23,901		3,899	787		310	203,408	166,329	37,079	22.29
Net Operating Income, excluding residential and hotel	293,046	285,873	7,173	2.51%	55,501		3,879	1,532		1,490	352,426	288,895	63,531	21.99
Residential Net Operating Income(1)	2,471	2,845	(374)	(13.15)%							2,471	2,845	(374)	(13.15
Hotel Net Operating Income(1)	1,396	1,247	149	11.95%							1,396	1,247	149	11.95
Consolidated Net Operating Income(1)	296,913	289,965	6,948	2.40%	55,501		3,879	1,532		1,490	356,293	292,987	63,306	21.61
Other Revenue:														
Development and management services											5,216	8,733	(3,517)	(40.27
Other Expenses:														
General and administrative expense											29,905	45,516	(15,611)	(34.30
Transaction costs											437	443	(6)	(1.35
Impairment loss												8,306	(8,306)	(100.00
Depreciation and amortization	116,861	115,339	1,522	1.32%	34,724		2,685	680		3,434	154,270	119,453	34,817	29.15
Total Other Expenses	116,861	115,339	1,522	1.32%	34,724		2,685	680		3,434	184,612	173,718	10,894	6.27
Operating Income	180,052	174,626	5,426	3.11%	20,777		1,194	852		(1,944)	176,897	128,002	48,895	38.20
Other Income:														
Income from unconsolidated joint ventures											2,816	8,721	(5,905)	(67.71
Interest and other income											1,311	1,471	(160)	(10.88
Gains from investments in securities											286	735	(449)	(61.09
Other Expenses:														
Interest expense											113,554	100,433	13,121	13.06
Income From Continuing Operations											67,756	38,496	29,260	76.01
Discontinued Operations:														
Income from discontinued operations												2,494	(2,494)	(100.00

Gain on forgiveness of debt from discontinued operations		20,182	(20,182)	(100.00
Impairment loss from discontinued operations		(3,241)	3,241	100.00
Net Income	$ 67,756	$ 57,931	$ 9,825	16.96
Net Income Attributable to Noncontrolling Interests:				
Noncontrolling interests in property partnerships	(4,354)	(2,574)	(1,780)	(69.15
Noncontrolling interest redeemable preferred units of the Operating Partnership	(619)	(1,180)	561	47.54
Noncontrolling interest common units of the Operating Partnership	(6,160)	(4,111)	(2,049)	(49.84
Noncontrolling interest in discontinued operations common units of the Operating Partnership		(2,066)	2,066	100.00
Net Income Attributable to Boston Properties, Inc.	$ 56,623	$ 48,000	$ 8,623	17.96
Preferred dividends	(2,589)	(146)	(2,443)	(1,673.29
Net Income Attributable to Boston Properties, Inc. Common shareholders	$ 54,034	$ 47,854	$ 6,180	12.91

(1) For a detailed discussion of NOI, including the reasons management believes NOI is useful to investors, see page 37. Residential Net Operating Income for the three months ended March 31, 2014 and 2013 are comprised of Residential Revenue of $5,451 and $5,578 less Residential Expenses of $2,980 and $2,733, respectively. Hotel Net Operating Income for the three months ended March 31, 2014 and 2013 are comprised of Hotel Revenue of $8,193 and $8,291 less Hotel Expenses of $6,797 and $7,044, respectively, per the Consolidated Statements of Operations.

Table of Contents

Same Property Portfolio

Rental Revenue

Rental revenue from the Same Property Portfolio increased approximately $16.9 million for the three months ended March 31, 2014 compared to 2013. The increase was primarily the result of an increase of approximately $16.9 million in revenue from our leases due to an increase in tenant recoveries related to higher operating expenses and increases in rental rates and occupancy. Rental revenue from our leases increased approximately $16.9 million as a result of our average revenue per square foot increasing by approximately $0.96, contributing approximately $7.9 million, and an approximately $9.0 million increase due to an increase in average occupancy from 91.4% to 93.2%.

For fiscal 2014, we expect an increase in Same Property Portfolio net operating income of approximately 1.75% to 2.5% compared to 2013.

Termination Income

Termination income increased by approximately $0.6 million for the three months ended March 31, 2014 compared to 2013.

Termination income for the three months ended March 31, 2014 related to eleven tenants across the Same Property Portfolio and totaled approximately $1.1 million, of which approximately $0.5 million was related to a negotiated settlement with a former tenant at Cambridge Center.

Termination income for the three months ended March 31, 2013 related to six tenants across the Same Property Portfolio and totaled approximately $0.5 million.

Real Estate Operating Expenses

Operating expenses from the Same Property Portfolio increased approximately $10.4 million for the three months ended March 31, 2014 compared to 2013 due primarily to (1) an increase of approximately $3.0 million, or 4.1%, in real estate taxes, which increases primarily occurred in our Washington, DC and New York regions, (2) an increase of approximately $3.0 million, or 12.2%, in repairs and maintenance expense, which was primarily in the Boston and New York CBD buildings, (3) an approximately $1.6 million, or 5.5%, increase in utilities expense, which was primarily due to an increase in the delivery rate for steam in the Boston region, (4) an approximately $1.5 million, or 16.1%, increase in roads and grounds expense, which was primarily related to snow removal in the Washington, DC region and (5) an increase of approximately $1.3 million, or 4.4%, in other operating expenses.

Beginning in the third quarter of 2013, we modified the presentation of expenses to operate our San Francisco and Princeton regional offices to reflect the growing activity in our San Francisco region and to have a consistent presentation across our company. These expenses, which totaled approximately $1.9 million for the three months ended March 31, 2013, were previously included in Rental Operating Expenses and are now included in General and Administrative Expenses for all periods presented.

Depreciation and Amortization Expense

Depreciation and amortization expense for the Same Property Portfolio increased approximately $1.5 million, or 1.3%, for the three months ended March 31, 2014 compared to 2013.

Properties Acquired or Consolidated Portfolio

On April 10, 2013, we acquired the Mountain View Research Park and Mountain View Technology Park properties from the Value-Added Fund for an aggregate net purchase price of approximately $233.1 million.

Table of Contents

Prior to the acquisition, our ownership interest in the properties was approximately 39.5%. As a result of the acquisition, we own 100% of the properties and account for them on a consolidated basis. Mountain View Research Park is an approximately 604,000 net rentable square foot, sixteen building Office/Technical complex. Mountain View Technology Park is an approximately 135,000 net rentable square foot, seven building Office/Technical complex.

On May 31, 2013, our two joint venture partners in 767 Venture, LLC (the entity that owns 767 Fifth Avenue (the General Motors Building) in New York City) transferred all of their interests in the joint venture to third parties. In connection with the transfer, we and our new joint venture partners modified our relative decision making authority and consent rights with respect to the joint venture s assets and operations. These changes resulted in us having sufficient financial and operating control over 767 Venture, LLC such that we now account for the assets, liabilities and operations of 767 Venture, LLC on a consolidated basis in our financial statements instead of under the equity method of accounting. Our ownership interest in 767 Venture, LLC remained unchanged at 60%. 767 Fifth Avenue (the General Motors Building) is an approximately 1.8 million net rentable square foot, 59-story Class A office tower.

Rental Revenue

Rental revenue from our Properties Acquired or Consolidated Portfolio increased approximately $79.4 million for the three months ended March 31, 2014 compared to 2013, as detailed below:

Property	Date Acquired or Consolidated	Rental Revenue for the three months ended March 31, 2014	2013 (in thousands)	Change
Mountain View Research Park	April 10, 2013	$ 4,952	$	$ 4,952
Mountain View Technology Park	April 10, 2013	1,118		1,118
767 Fifth Avenue (the General Motors Building)	May 31, 2013	73,332		73,332
Total		$ 79,402	$	$ 79,402

Real Estate Operating Expenses

Real estate operating expenses from our Properties Acquired or Consolidated Portfolio increased approximately $23.9 million for the three months ended March 31, 2014 compared to 2013, as detailed below:

Property	Date Acquired or Consolidated	Real Estate Operating Expenses for the three months ended March 31, 2014	2013 (in thousands)	Change
Mountain View Research Park	April 10, 2013	$ 999	$	$ 999
Mountain View Technology Park	April 10, 2013	176		176
767 Fifth Avenue (the General Motors Building)	May 31, 2013	22,726		22,726
Total		$ 23,901	$	$ 23,901

Depreciation and Amortization Expense

Depreciation and amortization expense for our Properties Acquired or Consolidated Portfolio increased by approximately $34.7 million for the three months ended March 31, 2014 compared to 2013 as a result of the acquisition or consolidation of properties after March 31, 2013.

Table of Contents

For a discussion of the operating results for 767 Fifth Avenue (the General Motors Building), Mountain View Research Park and Mountain View Technology Park for the period prior to consolidation / acquisition refer to *Results of Operations Other Income and Expense Items Income from Unconsolidated Joint Ventures* within *Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations.*

Properties Placed In-Service Portfolio

We placed in-service or partially placed in-service seven properties between January 1, 2013 and March 31, 2014. The square footage amount for the four properties that are fully placed in-service is approximately 1.1 million square feet. One and Two Patriots Park is a two-phase redevelopment project for a single tenant.

Rental Revenue

Rental revenue from our Properties Placed In-Service Portfolio increased approximately $5.5 million for the three months ended March 31, 2014 compared to 2013, as detailed below:

Property	**Quarter Initially Placed In-Service**	**Quarter Fully Placed In-Service**	**Rental Revenue for the three months ended March 31, 2014**	**2013**	**Change**
				(in thousands)	
One and Two Patriots Park	Second Quarter, 2012 (Phase I) and First Quarter, 2013 (Phase II)	Second Quarter, 2012 (Phase I) and First Quarter, 2013 (Phase II)	$ 4,278	$ 2,319	$ 1,959
Seventeen Cambridge Center	Second Quarter, 2013	Second Quarter, 2013	2,660		2,660
250 West 55th Street	Third Quarter, 2013	N/A	601		601
The Avant at Reston Town Center (Residential)	Fourth Quarter, 2013	First Quarter, 2014	231		231
680 Folsom Street	Fourth Quarter, 2013	N/A	8		8
Total			$ 7,778	$ 2,319	$ 5,459

Real Estate Operating Expenses

Real estate operating expenses from our Properties Placed In-Service Portfolio increased approximately $3.1 million for the three months ended March 31, 2014 compared to 2013, as detailed below:

Property	**Quarter Initially Placed In-Service**	**Quarter Fully Placed In-Service**	**Real Estate Operating Expenses for the three months ended March 31, 2014**	**2013**	**Change**
				(in thousands)	
One and Two Patriots Park	Second Quarter, 2012 (Phase I) and First Quarter, 2013 (Phase II)	Second Quarter, 2012 (Phase I) and First Quarter, 2013 (Phase II)	$ 1,514	$ 787	$ 727
Seventeen Cambridge Center	Second Quarter, 2013	Second Quarter, 2013	195		195
250 West 55th Street	Third Quarter, 2013	N/A	1,367		1,367
The Avant at Reston Town Center (Residential)	Fourth Quarter, 2013	First Quarter, 2014	782		782
680 Folsom Street	Fourth Quarter, 2013	N/A	41		41
Total			$ 3,899	$ 787	$ 3,112

Table of Contents

Depreciation and Amortization Expense

Depreciation and amortization expense for our Properties Placed In-Service Portfolio increased by approximately $2.0 million for the three months ended March 31, 2014 compared to 2013.

Properties in Development or Redevelopment Portfolio

At March 31, 2013, the Properties in Development or Redevelopment Portfolio consisted primarily of our 601 Massachusetts Avenue property located in Washington, DC.

On April 25, 2013, we commenced development of our 601 Massachusetts Avenue property, which is expected to be completed during the fourth quarter of 2015. Prior to the commencement of development, this building was operational and during the three months ended March 31, 2013, had approximately $1.8 million of revenue and approximately $0.3 million of operating expenses. In addition, during the three months ended March 31, 2013, the building had approximately $3.4 million of depreciation and amortization expense.

Other Operating Income and Expense Items

Residential Net Operating Income

Net operating income for our residential properties decreased by approximately $0.4 million for the three months ended March 31, 2014 compared to 2013.

The following reflects our occupancy and rate information for The Lofts at Atlantic Wharf and the Residences on The Avenue for the three months ended March 31, 2014 and 2013.

	The Lofts at Atlantic Wharf			Residences on The Avenue		
	2014	2013	Percentage Change	2014	2013	Percentage Change
Average Physical Occupancy(1)	96.9%	99.6%	(2.7)%	92.5%	92.7%	(0.2)%
Average Economic Occupancy(2)	97.7%	99.8%	(2.1)%	91.8%	92.5%	(0.8)%
Average Monthly Rental Rate(3)	$ 3,927	$ 3,781	3.9%	$ 3,182	$ 3,360	(5.3)%
Average Rental Rate Per Occupied Square Foot	$ 4.37	$ 4.19	4.3%	$ 3.90	$ 4.12	(5.3)%

(1) Average Physical Occupancy is defined as the average number of occupied units divided by the total number of units, expressed as a percentage.

(2) Average Economic Occupancy is defined as total possible revenue less vacancy loss as a percentage of total possible revenue. Total possible revenue is determined by valuing average occupied units at contract rates and average vacant units at Market Rents. Vacancy loss is determined by valuing vacant units at current Market Rents. By measuring vacant units at their Market Rents, Average Economic Occupancy takes into account the fact that units of different sizes and locations within a residential property have different economic impacts on a residential property s total possible gross revenue. Market Rents used by us in calculating Economic Occupancy are based on the current market rates set by the managers of our residential properties based on their experience in renting their residential property s units and publicly available market data. Trends in market rents for a region as reported by others could vary. Market Rents for a period are based on the average Market Rents during that period and do not reflect any impact for cash concessions.

(3) Average Monthly Rental Rates are calculated by us as rental revenue in accordance with GAAP, divided by the weighted monthly average number of occupied units.

Hotel Net Operating Income

Net operating income for the Cambridge Center Marriott hotel property increased by approximately $0.1 million for the three months ended March 31, 2014 compared to 2013. We expect our hotel net operating income for fiscal 2014 to be between $13 million and $14 million.

42

The following reflects our occupancy and rate information for the Cambridge Center Marriott hotel for the three months ended March 31, 2014 and 2013.

	2014	2013	Percentage Change
Occupancy	77.7%	73.5%	5.7%
Average daily rate	$ 199.88	$ 194.79	2.6%
Revenue per available room, REVPAR	$ 155.78	$ 143.17	8.8%

Development and Management Services

Development and management services income decreased approximately $3.5 million for the three months ended March 31, 2014 compared to 2013. The decrease was due to decreases in development fee and management fee income of approximately $1.8 million and $1.7 million, respectively. The decrease in development fees is primarily due to a decrease in fees associated with tenant improvement project management. The decrease in management fees is due primarily to a decrease in management fees earned from our joint ventures primarily due to the consolidation of 767 Fifth Avenue (the General Motors Building), the acquisition of the Mountain View assets and the sale of 125 West 55th Street in New York City. We expect fee income for fiscal 2014 to be between $19 million and $22 million. Our 2014 estimates are less than 2013 due to the conclusion of several fee development projects in Washington, DC and Boston, as well as the consolidation of 767 Fifth Avenue (the General Motors Building). As a result of the consolidation of 767 Fifth Avenue (the General Motors Building), the management fees for the building that were approximately $5 million per year will no longer be recognized as fee income. Instead our partners 40% share will be reflected as an adjustment to noncontrolling interest in property partnerships.

General and Administrative

General and administrative expenses decreased approximately $15.6 million for the three months ended March 31, 2014 compared to 2013 due primarily to the Transition Benefits Agreement that we entered into with Mortimer B. Zuckerman in 2013. On March 11, 2013, we announced that Owen D. Thomas would succeed Mr. Zuckerman as our Chief Executive Officer, effective April 2, 2013. Mr. Zuckerman will continue to serve as Executive Chairman for a transition period and thereafter is expected to continue to serve as the Non-Executive Chairman of the Board. In connection with succession planning, Mr. Zuckerman entered into the Transition Benefits Agreement with us. If Mr. Zuckerman remains employed by us through July 1, 2014, he will be entitled to receive, on January 1, 2015, a lump sum cash payment of $6.7 million and an equity award with a targeted value of approximately $11.1 million. The cash payment and equity award vest one-third on each of March 10, 2013, October 1, 2013 and July 1, 2014, subject to acceleration in certain circumstances. As a result, we recognized approximately $6.6 million of compensation expense during the three months ended March 31, 2013 and approximately $2.0 million of compensation expense during the three months ended March 31, 2014. We expect to recognize the remaining compensation expense over the remaining vesting period and, accordingly, expect to expense approximately $2.0 million in the second quarter of 2014. Due to the Transition Benefits Agreement, during the three months ended March 31, 2013, we accelerated the remaining approximately $12.9 million of stock-based compensation expense associated with Mr. Zuckerman s unvested long-term equity awards. In addition, the value of our deferred compensation plan and other general and administrative expenses, which includes compensation expense decreased by approximately $0.5 million and $0.5 million, respectively. These decreases were partially offset by the following increases: (1) approximately $0.9 million related to the issuance of the 2014 MYLTIP Units, (2) approximately $1.2 million related to the termination of the 2011 OPP Awards (refer to Note 10 to the Consolidated Financial Statements), (3) approximately $0.5 million in taxes and (4) approximately $0.3 million in health care costs.

Beginning in the third quarter of 2013, we modified the presentation of expenses to operate our San Francisco and Princeton regional offices to reflect the growing activity in our San Francisco region and to have a

Table of Contents

consistent presentation across our company. These expenses, which totaled approximately $1.9 million for the three months ended March 31, 2013, were previously included in Rental Operating Expenses and are now included in General and Administrative Expenses for all periods presented. We expect our fiscal 2014 general and administrative expenses to be between $100 million and $104 million.

Wages directly related to the development of rental properties are not included in our operating results. These costs are capitalized and included in real estate assets on our Consolidated Balance Sheets and amortized over the useful lives of the real estate. Capitalized wages for the three months ended March 31, 2014 and 2013 were approximately $3.5 million and $2.8 million, respectively. These costs are not included in the general and administrative expenses discussed above.

Transaction Costs

During the three months ended March 31, 2014, we incurred approximately $0.4 million of transaction costs, which related to several properties that we are marketing for potential sale and legal fees associated with the formation of joint ventures. During the three months ended March 31, 2013, we incurred approximately $0.4 million of transaction costs related to Salesforce Tower (formerly Transbay Tower) in San Francisco, California,

Impairment Loss

On March 28, 2013, we executed a binding contract for the sale of our 303 Almaden Boulevard property located in San Jose, California for a sale price of $40.0 million. The pending sale of this asset caused us to evaluate our strategy for development of the adjacent Almaden land parcel which can accommodate approximately 840,000 square feet of office development. Based on a shorter than expected hold period, we reduced the carrying value of the land parcel to its estimated fair market value and we recognized an impairment loss of approximately $8.3 million during the three months ended March 31, 2013. We did not recognize any impairment losses during the three months ended March 31, 2014.

Other Income and Expense Items

Income from Unconsolidated Joint Ventures

For the three months ended March 31, 2014 compared to 2013, income from unconsolidated joint ventures decreased by approximately $5.9 million due primarily to (1) an approximately $4.8 million decrease in our share of net income from 767 Fifth Avenue (the General Motors Building) related to its consolidation on June 1, 2013, (2) an approximately $0.4 million decrease in our share of net income from the Value-Added Fund due to our acquisition of the Mountain View assets on April 10, 2013 and (3) an approximately $1.3 million decrease in our share of net income from 125 West 55th Avenue due to its sale on May 30, 2013. These decreases were partially offset by an approximately $0.6 million increase in our share of net income from our other unconsolidated joint ventures, which was primarily related to increased leasing and occupancy at 540 Madison Avenue in New York City.

For the consolidated operating results for 767 Fifth Avenue (the General Motors Building), Mountain View Research Park and Mountain View Technology Park refer to *Results of Operations Properties Acquired or Consolidated Portfolio* within *Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations.*

Gains from Investments in Securities

Gains from investments in securities for the three months ended March 31, 2014 and 2013 related to investments that we have made to reduce our market risk relating to a deferred compensation plan that we maintain for our officers. Under this deferred compensation plan, each officer who is eligible to participate is permitted to defer a portion of the officer s current income on a pre-tax basis and receive a tax-deferred return on

Table of Contents

these deferrals based on the performance of specific investments selected by the officer. In order to reduce our market risk relating to this plan, we typically acquire, in a separate account that is not restricted as to its use, similar or identical investments as those selected by each officer. This enables us to generally match our liabilities to our officers under the deferred compensation plan with equivalent assets and thereby limit our market risk. The performance of these investments is recorded as gains from investments in securities. During the three months ended March 31, 2014 and 2013, we recognized gains of approximately $0.3 million and $0.7 million, respectively, on these investments. By comparison, our general and administrative expense increased by approximately $0.3 million and $0.8 million during the three months ended March 31, 2014 and 2013, respectively, as a result of increases in our liability under our deferred compensation plan that were associated with the performance of the specific investments selected by our officers participating in the plan.

Interest Expense

Interest expense increased approximately $13.1 million for the three months ended March 31, 2014 compared to 2013 as detailed below:

Component		**Change in interest expense for the three months ended March 31, 2014 compared to March 31, 2013 (in thousands)**
Increases to interest expense due to:		
Interest associated with the consolidation of the $1.6 billion of debt outstanding for 767 Fifth Avenue (the General Motors Building)	$	12,811
Partner s share of the interest for the outstanding Outside Members Notes Payable for 767 Fifth Avenue (the General Motors Building)		6,940
Issuance of $700 million in aggregate principal of our Operating Partnership s 3.800% senior notes due 2024 on June 27, 2013		6,692
Issuance of $500 million in aggregate principal of our Operating Partnership s 3.125% senior notes due 2023 on April 11, 2013		3,971
Total increases to interest expense	$	30,414
Decreases to interest expense due to:		
Interest expense associated with the adjustment for the equity component allocation of our unsecured exchangeable debt	$	(4,719)
Repurchases/redemption/exchange of $450.0 million in aggregate principal of our Operating Partnership s 3.75% exchangeable senior notes due 2036		(4,219)
Repayment of $747.5 million in aggregate principal of our Operating Partnership s 3.625% exchangeable senior notes due 2014		(3,854)
Increase in capitalized interest		(3,290)
Repayment of mortgage financings		(774)
Other interest expense (excluding senior notes)		(437)
Total decreases to interest expense	$	(17,293)
Total change in interest expense	$	13,121

The following properties are included in the repayment of mortgage financings line item: Kingstowne One and 140 Kendrick Street. As properties are placed in-service, we cease capitalizing interest and interest is then expensed.

Interest expense directly related to the development of rental properties is not included in our operating results. These costs are capitalized and included in real estate assets on our Consolidated Balance Sheets and amortized over the useful lives of the real estate. Interest capitalized for the three months ended March 31, 2014 and 2013 was approximately $17.7 million and $14.4 million, respectively. These costs are not included in the interest expense referenced above.

We anticipate net interest expense for 2014 will be approximately $446 million to $450 million. This estimate assumes approximately $52 million to $56 million of capitalized interest and the repayment of a $63.0 million mortgage secured by New Dominion Tech. Park Building Two that matures in October 2014. These estimates also assume that we will not incur any additional indebtedness, make additional prepayments or repurchases of existing indebtedness and that there will not be any fluctuations in interest rates or any changes in our development activity.

At March 31, 2014, our variable rate debt consisted of our Operating Partnership s $1.0 billion Unsecured Line of Credit. For a summary of our consolidated debt as of March 31, 2014 and March 31, 2013 refer to the heading *Liquidity and Capital Resources Capitalization Debt Financing* within *Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations*.

Discontinued Operations

On April 10, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity (ASU No. 2014-08). ASU No. 2014-08 clarifies that discontinued operations presentation applies only to disposals representing a strategic shift that has (or will have) a major effect on an entity s operations and financial results (e.g., a disposal of a major geographical area, a major line of business, a major equity method investment or other major parts of an entity). ASU No. 2014-08 is effective prospectively for reporting periods beginning after December 15, 2014. Early adoption is permitted, and we early adopted ASU No. 2014-08 during the first quarter of 2014. Our adoption of ASU No. 2014-08 did not have a material impact on our consolidated financial statements.

Prior to the adoption of ASU No. 2014-08, we had the following properties that were considered discontinued operations for the three months ended March 31, 2013: 10 & 20 Burlington Mall Road, One Preserve Parkway, 1301 New York Avenue, 303 Almaden Boulevard and Montvale Center. Each of these dispositions is discussed below.

On December 20, 2013, we completed the sale of our 10 & 20 Burlington Mall Road property located in Burlington, Massachusetts for a sale price of approximately $30.0 million. 10 & 20 Burlington Mall Road consists of two Class A office properties aggregating approximately 152,000 net rentable square feet. The operating results of the property through the date of sale have been classified as discontinued operations on a historical basis for all periods presented.

On December 20, 2013, we completed the sale of our One Preserve Parkway property located in Rockville, Maryland for a sale price of approximately $61.3 million. One Preserve Parkway is a Class A office property totaling approximately 184,000 net rentable square feet. The operating results of the property through the date of sale have been classified as discontinued operations on a historical basis for all periods presented.

On August 22, 2013, we completed the sale of our 1301 New York Avenue property located in Washington, DC for a net contract sale price of approximately $121.7 million. After adjusting for outstanding lease and other transaction costs assumed by the buyer, the gross sale price was approximately $135.0 million. 1301 New York Avenue is a Class A office property totaling approximately 201,000 net rentable square feet. The operating results of the property through the date of sale have been classified as discontinued operations on a historical basis for all periods presented.

On June 28, 2013, we completed the sale of our 303 Almaden Boulevard property located in San Jose, California for a sale price of $40.0 million. Net cash proceeds totaled approximately $39.3 million. 303 Almaden Boulevard is a Class A office property totaling approximately 158,000 net rentable square feet. Because we entered into the related purchase and sale agreement on March 28, 2013 and the carrying value of the property exceeded its net sale price, we recognized an impairment loss totaling approximately $3.2 million during the

Table of Contents

three months ended March 31, 2013. As a result, there was no loss on sale of real estate recognized. The impairment loss and operating results of this property have been classified as discontinued operations on a historical basis for all periods presented.

On February 20, 2013, the foreclosure sale of our Montvale Center property was ratified by the court. As a result of the ratification, the mortgage loan totaling $25.0 million was extinguished and the related obligations were satisfied with the transfer of the real estate resulting in the recognition of a gain on forgiveness of debt totaling approximately $20.2 million during the first quarter of 2013. The operating results of the property through the date of ratification have been classified as discontinued operations on a historical basis for all periods presented.

Noncontrolling interests in property partnerships

Noncontrolling interests in property partnerships increased by approximately $1.8 million for the three months ended March 31, 2014 compared to 2013 as detailed below.

Property	Date of Consolidation	Partners noncontrolling interest for the three months ended March 31, 2014	2013	Change
			(in thousands)	
505 9th Street	October 1, 2007	$ 575	$ 566	$ 9
Fountain Square	October 4, 2012	1,768	2,008	(240)
767 Fifth Avenue (the General Motors Building)	May 31, 2013	(4,644)		(4,644)
Times Square Tower	October 9, 2013	6,655		6,655
		$ 4,354	$ 2,574	$ 1,780

The decrease at 767 Fifth Avenue (the General Motors Building) was primarily due to the partners share of the interest expense for the outside members notes payable.

Noncontrolling interest Common Units of the Operating Partnership

Noncontrolling interest-common units of the Operating Partnership increased by approximately $2.0 million for the three months ended March 31, 2014 compared to 2013 due to an increase in allocable income partially offset by a decrease in the noncontrolling interest s ownership percentage.

Liquidity and Capital Resources

General

Our principal liquidity needs for the next twelve months and beyond are to:

fund normal recurring expenses;

meet debt service and principal repayment obligations, including balloon payments on maturing debt;

fund capital expenditures, including major renovations, tenant improvements and leasing costs;

fund development costs;

redeem our Operating Partnership s Series Four Preferred Units;

fund possible property acquisitions; and

make the minimum distribution required to maintain our REIT qualification under the Internal Revenue Code of 1986, as amended.

47

Table of Contents

We expect to satisfy these needs using one or more of the following:

- cash flow from operations;
- distribution of cash flows from joint ventures;
- cash and cash equivalent balances;
- issuances of our equity securities and/or additional preferred or common units of partnership interest in our Operating Partnership;
- our Operating Partnership s Unsecured Line of Credit or other short-term bridge facilities;
- construction loans;
- long-term secured and unsecured indebtedness (including unsecured exchangeable indebtedness); and
- sales of real estate or ownership interests in our assets.

We draw on multiple financing sources to fund our long-term capital needs. Our Operating Partnership s Unsecured Line of Credit is utilized primarily as a bridge facility to fund acquisition opportunities, refinance outstanding indebtedness and meet short-term development and working capital needs. Although we may seek to fund our development projects with construction loans, which may be guaranteed by our Operating Partnership, the financing for each particular project ultimately depends on several factors, including, among others, the project s size and duration, the extent of pre-leasing and our available cash and access to cost effective capital at the given time.

The following table presents information on properties under construction as of March 31, 2014 (dollars in thousands):

Construction Properties	Estimated Stabilization Date	Location	# of Buildings	Estimated Square Feet	Investment to Date(1)	Estimated Total Investment(1)	Percentage Leased(2)
Office							
680 Folsom Street(3)	Fourth Quarter, 2014	San Francisco, CA	2	524,509	$ 305,313	$ 340,000	96%
Annapolis Junction Building Seven (50% ownership)(4)	First Quarter, 2015	Annapolis, MD	1	125,000	11,796	17,500	100%
250 West 55th Street(5)	Fourth Quarter, 2015	New York, NY	1	989,000	868,268	1,050,000	73%
804 Carnegie Center	First Quarter, 2016	Princeton, NJ	1	130,000	2,234	40,410	100%
535 Mission Street	Third Quarter, 2016	San Francisco, CA	1	307,000	135,348	215,000	26%
601 Massachusetts Avenue	Fourth Quarter, 2017	Washington, DC	1	478,000	171,232	360,760	80%
Salesforce Tower (95% Ownership)(6)	First Quarter, 2019	San Francisco, CA	1	1,400,000	264,788	1,130,000	51%
Total Properties under Construction			8	3,953,509	$ 1,758,979	$ 3,153,670	67%

(1) Represents our share. Includes net revenue during lease up period, acquisition expenses and approximately $60.9 million of construction cost and leasing commission accruals.
(2) Represents percentage leased as of May 5, 2014, includes leases with future commencement dates.
(3) As of March 31, 2014, this project was 1% placed in-service.
(4) This development project has a construction loan.
(5) Investment to Date excludes approximately $24.8 million of costs that were expensed in prior periods in connection with the suspension of development activities. Estimated Total Investment includes approximately $230 million of interest capitalization. As of March 31, 2014, this property was 6% placed in-service.
(6) On April 11, 2014, the joint venture executed a lease for 714,000 square feet of this 61-story, 1.4 million square foot Class A office tower. This project was (formerly Transbay Tower). The Estimated Total investment has been updated to represent the total cost to complete the project.

Contractual rental revenue, recoveries from tenants, other income from operations, available cash balances and draws on our Operating Partnership s Unsecured Line of Credit are our principal sources of capital used to pay operating expenses, debt service, recurring capital expenditures and the minimum distribution required to enable us to maintain our REIT qualification. We seek to maximize income from our existing properties by maintaining quality standards for our properties that promote high occupancy rates and permit increases in rental rates while reducing tenant turnover and controlling operating expenses. Our sources of revenue also include third-party fees generated by our property management, leasing, and development and construction businesses, as well as the sale of assets from time to time. We believe our revenue, together with our cash balances and proceeds from financing activities, will continue to provide the necessary funds for our short-term liquidity needs.

Material adverse changes in one or more sources of capital may adversely affect our net cash flows. Such changes, in turn, could adversely affect our ability to fund dividends and distributions, debt service payments and tenant improvements. In addition, a material adverse change in the cash provided by our operations may affect our ability to comply with the financial covenants under our Operating Partnership s Unsecured Line of Credit and unsecured senior notes.

The completion of our ongoing developments, through 2018, have remaining costs to fund of approximately $1.4 billion. We have approximately $77 million of secured debt (of which our share is approximately $70 million) expiring through the end of 2014. In addition, our Operating Partnership anticipates that it will redeem the remaining 360,126 Series Four Preferred Units at a redemption price of $50.00 per unit plus accrued and unpaid distributions. We believe that our strong liquidity, including available cash as of May 5, 2014 of approximately $0.9 billion, the approximately $990 million available under our Operating Partnership s Unsecured Line of Credit and proceeds from potential asset sales provide sufficient capacity to meet our debt obligations and fund our remaining capital requirements on existing development projects, our foreseeable potential development activity and pursue additional attractive investment opportunities. We expect to establish a new at-the-market equity offering program upon the expiration of our existing program in June 2014. Given the relatively low interest rates currently available to us in the debt markets, we may seek to enhance our liquidity in the future, which may result in us carrying additional cash and cash equivalents pending our Operating Partnership s use of the proceeds. In order to reduce future cash interest payments, as well as future amounts due at maturity or upon redemption, we may, from time to time, purchase unsecured senior notes for cash in open market purchases or privately negotiated transactions, or both. We will evaluate any such potential transactions in light of then-existing market conditions, taking into account the trading prices of the notes, our current liquidity and prospects for future access to capital.

REIT Tax Distribution Considerations

Dividend

As a REIT we are subject to a number of organizational and operational requirements, including a requirement that we currently distribute at least 90% of our annual taxable income. Our policy is to distribute at least 100% of our taxable income to avoid paying federal tax. On December 2, 2013, we announced that our Board of Directors declared a special cash dividend of $2.25 per common share payable on January 29, 2014 to shareholders of record as of the close of business on December 31, 2013. The decision to declare a special dividend was primarily a result of the sale of a 45% interest in our Times Square Tower property in October 2013. The Board of Directors did not make any change in our policy with respect to regular quarterly dividends. Holders of common units of limited partnership interest in Boston Properties Limited Partnership, our Operating Partnership, as of the close of business on December 31, 2013 received the same distribution on January 29, 2014. Our Board of Directors will continue to evaluate our dividend rate in light of our actual and projected taxable income, liquidity requirements and other circumstances, and there can be no assurance that the future dividends declared by our Board of Directors will not differ materially.

Sales

To the extent that we sell assets at a taxable gain and cannot efficiently use the proceeds in a tax deferred manner for either our development activities or attractive acquisitions, we would, at the appropriate time, decide whether it is better to declare a special dividend, adopt a stock repurchase program, reduce our indebtedness or retain the cash for future investment opportunities. Such a decision will depend on many factors including, among others, the timing, availability and terms of development and acquisition opportunities, our then-current and anticipated leverage, the cost and availability of capital from other sources, the price of our common stock and REIT distribution requirements. At a minimum, we expect that we would distribute at least that amount of proceeds necessary for us to avoid paying corporate level tax on the applicable gains realized from any asset sales.

Cash Flow Summary

The following summary discussion of our cash flows is based on the Consolidated Statements of Cash Flows and is not meant to be an all-inclusive discussion of the changes in our cash flows for the periods presented below.

Cash and cash equivalents were approximately $1.2 billion and $0.9 billion at March 31, 2014 and 2013, respectively, representing a increase of approximately $0.3 billion. The following table sets forth changes in cash flows:

	Three months ended March 31,		
	2014	2013	Increase (Decrease)
		(in thousands)	
Net cash provided by operating activities	$ 124,209	$ 237,429	$ (113,220)
Net cash used in investing activities	(147,072)	(432,991)	285,919
Net cash provided by (used in) financing activities	(1,162,701)	62,960	(1,225,661)

Our principal source of cash flow is related to the operation of our office properties. The average term of our in-place tenant leases, including our unconsolidated joint ventures, is approximately 6.6 years with occupancy rates historically in the range of 91% to 94%. Our properties generate a relatively consistent stream of cash flow that provides us with resources to pay operating expenses, debt service and fund quarterly dividend and distribution payment requirements. In addition, over the past several years, we have raised capital through the sale of some of our properties, secured and unsecured borrowings and equity offerings.

For the three months ended March 31, 2014, our total dividends payments exceeded our cash flow from operating activities due to the special dividend which was declared in December 2013 and paid to common stockholders and common unitholders of our Operating Partnership in January 2014. The cash flows distributed were primarily a result of the sale of a 45% interest in our Times Square Tower property in October 2013 which was included as part of cash flows provided by financing activities. Dividends will generally exceed cash flows from operating activities during periods in which we sell significant real estate assets and distribute gains on sale that would otherwise be taxable. In addition, the payment of a special dividend may not occur in the same period as the asset sale.

Our cash flows provided by operating activities for the three months ended March 31, 2014, were lower than 2013 due to the settlement of approximately $93.0 million of accreted debt discount on our Operating Partnership s repurchase of $747.5 million of exchangeable senior notes.

Table of Contents

Cash is used in investing activities to fund acquisitions, development, net investments in unconsolidated joint ventures and recurring and nonrecurring capital expenditures. We selectively invest in new projects that enable us to take advantage of our development, leasing, financing and property management skills and invest in existing buildings to enhance or maintain their market position. Cash used in investing activities for the three months ended March 31, 2014 and 2013 consisted primarily of funding our development projects and the acquisitions of 535 Mission Street and the Salesforce Tower (formerly Transbay Tower) and Reston, Virginia land parcels, as detailed below:

	Three months ended March 31,	
	2014	2013
	(in thousands)	
Acquisitions of real estate	$	$ (289,816)
Construction in progress	(97,025)	(103,178)
Building and other capital improvements	(17,510)	(14,162)
Tenant improvements	(31,551)	(24,988)
Repayments of notes receivable, net		184
Capital contributions to unconsolidated joint ventures		(113)
Capital distributions from unconsolidated joint ventures	113	
Investments in securities, net	(1,099)	(918)
Net cash used in investing activities	$ (147,072)	$ (432,991)

Cash used in investing activities changed primarily due to the following:

On February 6, 2013, we completed the acquisition of 535 Mission Street, a development site, in San Francisco, California for an aggregate purchase price of approximately $71.0 million in cash, including work completed and materials purchased to date.

On March 26, 2013, the consolidated joint venture in which we have a 95% interest completed the acquisition of a land parcel in San Francisco, California which will support a 61-story, 1.4 million square foot Class A office tower known as Salesforce Tower (formerly Transbay Tower). The purchase price for the land was approximately $192.0 million.

On March 29, 2013, we completed the acquisition of a parcel of land located in Reston, Virginia for a purchase price of approximately $27.0 million. The land parcel is commercially zoned for 250,000 square feet of office space.

Construction in progress for the three months ended March 31, 2013 includes expenditures associated with our continued development and redevelopment of Seventeen Cambridge Center, The Avant at Reston Town Center, the Cambridge Center Connector, 250 West 55th Street, 680 Folsom Street, 535 Mission Street and expenditures associated with Two Patriots Park, which was fully placed in-service on March 22, 2013. Construction in progress for the three months ended March 31, 2014 includes ongoing expenditures associated with The Avant at Reston Town Center, 250 West 55th Street and 680 Folsom Street which were fully or partially placed in-service during the three months ended March 31, 2014. In addition, we incurred costs associated with our continued development of 535 Mission Street, 601 Massachusetts Avenue, 804 Carnegie Center and Salesforce Tower (formerly Transbay Tower).

Our capital expenditures for the three months ended March 31, 2014 and 2013 were approximately $12.6 million and $7.8 million, respectively. Included in our 2014 amount is approximately $2.9 million of non-recurring capital expenditures related to the repositioning of Bay Colony Corporate Center in Waltham, Massachusetts and expenditures at our Boston CBD buildings.

Tenant improvement costs increased by approximately $6.6 million due to the commencement of tenant projects in 2014.

Table of Contents

Cash used in financing activities for the three months ended March 31, 2014 totaled approximately $1.2 billion. This consisted primarily of the repayment at maturity of $747.5 million of 3.625% exchangeable senior notes due 2014 and the payments of regular and special dividends and distributions to our shareholders and the unitholders. Future debt payments are discussed below under the heading Capitalization-Debt Financing.

Capitalization

At March 31, 2014, our total consolidated debt was approximately $10.6 billion. The GAAP weighted-average annual interest rate on our consolidated indebtedness was 4.46% (with a coupon/stated rate of 5.01%) and the weighted-average maturity was approximately 5.5 years.

Consolidated debt to total consolidated market capitalization ratio, defined as total consolidated debt as a percentage of the value of our outstanding equity securities plus our total consolidated debt, is a measure of leverage commonly used by analysts in the REIT sector. Our total consolidated market capitalization was approximately $30.4 billion at March 31, 2014. Our total consolidated market capitalization was calculated using the March 31, 2014 closing stock price of $114.53 per common share and the following: (1) 153,017,311 shares of our common stock, (2) 15,583,853 outstanding common units of partnership interest in our Operating Partnership (excluding common units held by us), (3) an aggregate of 874,168 common units issuable upon conversion of all outstanding Series Two Preferred Units of partnership interest in our Operating Partnership, (4) an aggregate of 1,554,353 common units issuable upon conversion of all outstanding LTIP Units, assuming all conditions have been met for the conversion of the LTIP Units, (5) 360,126 Series Four Preferred Units of partnership interest in our Operating Partnership multiplied by the fixed liquidation preference of $50 per unit, (6) 80,000 shares (8,000,000 depositary shares, each representing 1/100th of a share), of our 5.25% Series B Cumulative Redeemable Preferred Stock, at a price of $2,500 per share ($25 per depositary share) and (7) our consolidated debt totaling approximately $10.6 billion. At March 31, 2014, our total consolidated debt, which excludes debt collateralized by our unconsolidated joint ventures represented approximately 34.81% of our total consolidated market capitalization.

Following the consolidation of 767 Venture, LLC (the entity that owns 767 Fifth Avenue (the General Motors Building)), effective June 1, 2013, our consolidated debt increased significantly compared to prior periods even though our economic interest in 767 Venture, LLC remained substantially unchanged. As a result, we believe the presentation of total adjusted debt may provide investors with a more complete picture of our share of consolidated and unconsolidated debt. Total adjusted debt is defined as our total consolidated debt, plus our share of unconsolidated joint venture debt, minus our joint venture partners share of consolidated debt, and was approximately $10.0 billion at March 31, 2014. In addition, in light of the difference between our total consolidated debt and our total adjusted debt, we believe that also presenting our total adjusted debt to total adjusted market capitalization ratio may provide investors with a more complete picture of our leverage in relation to the overall size of our company. The calculation of the total adjusted debt to total adjusted market capitalization ratio is the same as consolidated debt to total consolidated market capitalization ratio except that the total adjusted debt balance is used in lieu of the total consolidated debt balance. At March 31, 2014 our total adjusted debt represented approximately 33.61% of our total adjusted market capitalization.

The calculation of total consolidated and adjusted market capitalization does not include 394,590 2012 OPP Units, 314,974 2013 MYLTIP Units and 483,555 2014 MYLTIP Units because, unlike other LTIP Units, they are not earned until certain return thresholds are achieved. These percentages will fluctuate with changes in the market value of our common stock and does not necessarily reflect our capacity to incur additional debt to finance our activities or our ability to manage our existing debt obligations. However, for a company like ours, whose assets are primarily income-producing real estate, the consolidated debt to total consolidated market capitalization ratio and the adjusted debt to total adjusted market capitalization ratio may provide investors with an alternate indication of leverage, so long as it is evaluated along with other financial ratios and the various components of our outstanding indebtedness.

Table of Contents

For a discussion of our unconsolidated joint venture indebtedness, see *Liquidity and Capital Resources Capitalization Off-Balance Sheet Arrangements Joint Venture Indebtedness* within *Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations.*

Debt Financing

As of March 31, 2014, we had approximately $10.6 billion of outstanding consolidated indebtedness, representing approximately 34.81% of our total consolidated market capitalization as calculated above consisting of approximately (1) $5.836 billion (net of discount) in publicly traded unsecured senior notes having a weighted-average interest rate of 4.44% per annum and maturities in 2015, 2018, 2019, 2020, 2021, 2023 and 2024; (2) $4.4 billion of property-specific mortgage debt having a GAAP weighted-average interest rate of 4.31% per annum and weighted-average term of 3.9 years and (3) $0.3 billion of mezzanine notes payable, associated with 767 Fifth Avenue (the General Motors Building), having a GAAP interest rate of 5.53% per annum and maturing in 2017. The table below summarizes our mortgage and mezzanine notes payable, our unsecured senior notes and our Operating Partnership s Unsecured Line of Credit at March 31, 2014 and March 31, 2013:

	March 31,	
	2014	2013
	(Dollars in Thousands)	
Debt Summary:		
Balance		
Fixed rate mortgage notes payable	$ 4,430,110	$ 3,053,798
Unsecured senior notes, net of discount	5,836,290	4,639,843
Unsecured exchangeable senior notes, net of discount and adjustment for the equity component allocation		1,177,877
Unsecured Line of Credit		
Mezzanine notes payable	310,735	
Total	$ 10,577,135	$ 8,871,518
Percent of total debt:		
Fixed rate	100.00%	100.00%
Variable rate	%	%
Total	100.00%	100.00%
GAAP Weighted-average interest rate at end of period:		
Fixed rate	4.46%	5.12%
Variable rate	%	%
Total	4.46%	5.12%
Coupon/Stated Weighted-average interest rate at end of period:		
Fixed rate	5.01%	4.87%
Variable rate	%	%
Total	5.01%	4.87%

Unsecured Line of Credit

On July 26, 2013, our Operating Partnership amended and restated the revolving credit agreement governing its Unsecured Line of Credit, which, among other things, (1) increased the total commitment from $750.0 million to $1.0 billion, (2) extended the maturity date from June 24, 2014 to July 26, 2018 and (3) reduced the per annum variable interest rates and other fees. Our Operating Partnership may increase the total commitment to $1.5 billion, subject to syndication of the increase and other conditions. At our Operating Partnership s option, loans

53

Table of Contents

outstanding under the Unsecured Line of Credit will bear interest at a rate per annum equal to (1) in the case of loans denominated in Dollars, Euro or Sterling, LIBOR or, in the case of loans denominated in Canadian Dollars, CDOR, in each case, plus a margin ranging from 0.925% to 1.70% based on our Operating Partnership s credit rating or (2) an alternate base rate equal to the greatest of (a) the Administrative Agent s prime rate, (b) the Federal Funds rate plus 0.5% or (c) LIBOR for a one month period plus 1.00%, in each case, plus a margin ranging from 0.0% to 0.70% based on our Operating Partnership s credit rating. The Unsecured Line of Credit also contains a competitive bid option that allows banks that are part of the lender consortium to bid to make loan advances to our Operating Partnership at a reduced interest rate. In addition, our Operating Partnership is obligated to pay (1) in quarterly installments a facility fee on the total commitment at a rate per annum ranging from 0.125% to 0.35% based on our Operating Partnership s credit rating and (2) an annual fee on the undrawn amount of each letter of credit equal to the LIBOR margin. Based on our Operating Partnership s current credit rating, the LIBOR and CDOR margin is 1.00%, the alternate base rate margin is 0.0% and the facility fee is 0.15%. Our ability to borrow under our Operating Partnership s Unsecured Line of Credit is subject to our compliance with a number of customary financial and other covenants on an ongoing basis, including:

- a leverage ratio not to exceed 60%, however the leverage ratio may increase to no greater than 65% provided that it is reduced back to 60% within one year;
- a secured debt leverage ratio not to exceed 55%;
- a fixed charge coverage ratio of at least 1.40;
- an unsecured leverage ratio not to exceed 60%, however the leverage ratio may increase to no greater than 65% provided that it is reduced back to 60% within one year;
- an unsecured debt interest coverage ratio of at least 1.75; and
- limitations on permitted investments.

We believe we are in compliance with the financial and other covenants listed above.

As of March 31, 2014, we had no borrowings and outstanding letters of credit totaling approximately $9.9 million outstanding under the Unsecured Line of Credit, with the ability to borrow approximately $990.1 million. As of May 5, 2014, we had no borrowings and outstanding letters of credit totaling approximately $9.9 million outstanding under the Unsecured Line of Credit, with the ability to borrow approximately $990.1 million.

Unsecured Senior Notes

The following summarizes the unsecured senior notes outstanding as of March 31, 2014 (dollars in thousands):

	Coupon/ Stated Rate	**Effective Rate(1)**	**Principal Amount**	**Maturity Date(2)**
12 Year Unsecured Senior Notes	5.625%	5.693%	$ 300,000	April 15, 2015
12 Year Unsecured Senior Notes	5.000%	5.194%	250,000	June 1, 2015
10 Year Unsecured Senior Notes	5.875%	5.967%	700,000	October 15, 2019
10 Year Unsecured Senior Notes	5.625%	5.708%	700,000	November 15, 2020
10 Year Unsecured Senior Notes	4.125%	4.289%	850,000	May 15, 2021
7 Year Unsecured Senior Notes	3.700%	3.853%	850,000	November 15, 2018
11 Year Unsecured Senior Notes	3.850%	3.954%	1,000,000	February 1, 2023

10.5 Year Unsecured Senior Notes	3.125%	3.279%	500,000	September 1, 2023
10.5 Year Unsecured Senior Notes	3.800%	3.916%	700,000	February 1, 2024
Total principal			5,850,000	
Net unamortized discount			(13,710)	
Total			$ 5,836,290	

(1) Yield on issuance date including the effects of discounts on the notes and the amortization of financing costs.
(2) No principal amounts are due prior to maturity.

Our unsecured senior notes are redeemable at our option, in whole or in part, at a redemption price equal to the greater of (i) 100% of their principal amount or (ii) the sum of the present value of the remaining scheduled payments of principal and interest discounted at a rate equal to the yield on U.S. Treasury securities with a comparable maturity plus 35 basis points (or 20 basis points in the case of the $500 million of notes that mature on September 1, 2023, 25 basis points in the case of the $250 million and $700 million of notes that mature on June 1, 2015 and February 1, 2024, respectively, 40 basis points in the case of the $700 million of notes that mature on October 15, 2019 and 30 basis points in the case of the $700 million and $850 million of notes that mature on November 15, 2020 and May 15, 2021, respectively), in each case plus accrued and unpaid interest to the redemption date. The indenture under which our unsecured senior notes were issued contains restrictions on incurring debt and using our assets as security in other financing transactions and other customary financial and other covenants, including (1) a leverage ratio not to exceed 60%, (2) a secured debt leverage ratio not to exceed 50%, (3) an interest coverage ratio of greater than 1.50, and (4) unencumbered asset value to be no less than 150% of our unsecured debt. As of March 31, 2014, we believe we were in compliance with each of these financial restrictions and requirements.

Mortgage Notes Payable

The following represents the outstanding principal balances due under the mortgage notes payable at March 31, 2014:

Properties	Stated Interest Rate	GAAP Interest Rate(1)	Stated Principal Amount	Historical Fair Value Adjustment	Carrying Amount	Maturity Date
			(Dollars in thousands)			
767 Fifth Avenue (the General Motors Building)	5.95%	2.44%	$ 1,300,000	$ 152,724	$ 1,452,724(2)(3)(4)	October 7, 2017
599 Lexington Avenue	5.57%	5.41%	750,000		750,000(4)(5)	March 1, 2017
601 Lexington Avenue	4.75%	4.79%	719,473		719,473	April 10, 2022
John Hancock Tower	5.68%	5.05%	640,500	11,495	651,995(4)(6)	January 6, 2017
Embarcadero Center Four	6.10%	7.02%	358,800		358,800(7)	December 1, 2016
Fountain Square	5.71%	2.56%	211,250	13,752	225,002(4)(8)	October 11, 2016
505 9th Street	5.73%	5.87%	120,762		120,762(8)	November 1, 2017
New Dominion Tech Park, Bldg. Two	5.55%	5.58%	63,000		63,000(4)	October 1, 2014
New Dominion Tech Park, Bldg. One	7.69%	7.84%	42,147		42,147	January 15, 2021
Kingstowne Two and Retail	5.99%	5.61%	32,618	239	32,857	January 1, 2016
University Place	6.94%	6.99%	13,350		13,350	August 1, 2021
Total			$ 4,251,900	$ 178,210	$ 4,430,110	

(1) GAAP interest rate differs from the stated interest rate due to the inclusion of the amortization of financing charges, effects of hedging transactions and adjustments required to reflect loans at their fair values upon acquisition. All adjustments to reflect loans at their fair value upon acquisition are noted above.
(2) This property is owned by a consolidated joint venture in which we have a 60% interest.
(3) In connection with the assumption of the loan, we guaranteed the joint venture s obligation to fund various escrows, including tenant improvements, taxes and insurance in lieu of cash deposits. As of March 31, 2014, the maximum funding obligation under the guarantee was approximately $11.7 million. We earn a fee from the joint venture for providing the guarantee and have an agreement with our partners to reimburse the joint venture for their share of any payments made under the guarantee.

Table of Contents

(4) The mortgage loan requires interest only payments with a balloon payment due at maturity.
(5) On December 19, 2006, we terminated the forward-starting interest rate swap contracts related to this financing and received approximately $10.9 million, which amount is reducing our GAAP interest expense for this mortgage over the term of the financing, resulting in an effective interest rate of 5.41% per annum for the financing. The stated interest rate is 5.57% per annum.
(6) In connection with the mortgage financing we have agreed to guarantee approximately $21.4 million related to our obligation to provide funds for certain tenant re-leasing costs.
(7) Under our interest rate hedging program, we are reclassifying into earnings over the eight-year term of the loan as an increase in interest expense approximately $26.4 million (approximately $3.3 million per year) of the amounts recorded on our Consolidated Balance Sheets within Accumulated Other Comprehensive Loss resulting in an effective interest rate of 7.02% per annum.
(8) This property is owned by a consolidated joint venture in which we have a 50% interest.

Mezzanine Notes Payable

The following represents the outstanding principal balances due under the mezzanine notes payable at March 31, 2014:

Property Debt is Associated With	Stated Interest Rate	GAAP Interest Rate(1)	Stated Principal Amount	Historical Fair Value Adjustment	Carrying Amount	Maturity Date
			(Dollars in thousands)			
767 Fifth Avenue (the General Motors Building)	6.02%	5.53%	$ 306,000	$ 4,735	$ 310,735(2)(3)	October 7, 2017

(1) GAAP interest rate differs from the stated interest rate due to adjustments required to reflect loans at their fair values upon acquisition or consolidation. All adjustments to reflect loans at their fair value upon acquisition are noted above.
(2) This property is owned by a consolidated joint venture in which we have a 60% interest.
(3) The mortgage loan requires interest only payments with a balloon payment due at maturity.

Outside Members Notes Payable

In conjunction with the consolidation of 767 Fifth Avenue (the General Motors Building), we recorded loans payable to the joint venture s partners totaling $450.0 million and related accrued interest payable totaling approximately $175.8 million. The partner loans bear interest at a fixed rate of 11.0% per annum and mature on June 9, 2017. We have eliminated in consolidation our partner loan totaling $270.0 million and our share of the related accrued interest payable of approximately $116.0 million at March 31, 2014. The remaining notes payable to the outside joint venture partners and related accrued interest payable totaling $180.0 million and approximately $77.3 million as of March 31, 2014 have been reflected as Outside Members Notes Payable and within Accrued Interest Payable, respectively, on our Consolidated Balance Sheets. The related interest expense from the Outside Members Notes Payable totaling approximately $6.9 million for the three months ended March 31, 2014 is fully allocated to the outside joint venture partners as an adjustment to Noncontrolling Interests in Property Partnerships in our Consolidated Statements of Operations.

Off-Balance Sheet Arrangements Joint Venture Indebtedness

We have investments in unconsolidated joint ventures with our effective ownership interests ranging from 25% to 60%. Six of these ventures have mortgage indebtedness. We exercise significant influence over, but do not control, these entities and therefore they are presently accounted for using the equity method of accounting. See also Note 4 to the Consolidated Financial Statements. At March 31, 2014, the aggregate carrying amount of debt, including both our and our partners share, incurred by these ventures was approximately $748.7 million (of which our proportionate share is approximately $328.9 million). The table below summarizes the outstanding debt of these joint venture properties at March 31, 2014. In addition to other guarantees specifically noted in the table, we have agreed to customary environmental indemnifications and nonrecourse carve-outs (e.g., guarantees against fraud, misrepresentation and bankruptcy) on certain of the loans.

Properties	Venture Ownership %	Stated Interest Rate	GAAP Interest Rate(1)	Carrying Amount	Maturity Date
			(Dollars in thousands)		
540 Madison Avenue	60%	1.66%	1.83%	$ 120,000(2)(3)	June 5, 2018
Metropolitan Square	51%	5.75%	5.81%	173,133	May 5, 2020
Market Square North	50%	4.85%	4.91%	129,191	October 1, 2020
Annapolis Junction Building One	50%	1.91%	2.07%	41,133(4)	March 31, 2018
Annapolis Junction Building Six	50%	1.81%	2.00%	13,982(2)(5)	November 17, 2014
Annapolis Junction Building Seven	50%	1.82%	2.38%	13,415(2)(6)	April 4, 2016
500 North Capitol Street	30%	4.15%	4.19%	105,000(2)	June 6, 2023
901 New York Avenue	25%	5.19%	5.27%	152,846	January 1, 2015
Total				$ 748,700	

(1) GAAP interest rate differs from the stated interest rate due to the inclusion of the amortization of financing charges.
(2) The loan requires interest only payments with a balloon payment due at maturity.
(3) Mortgage loan bears interest at a variable rate equal to LIBOR plus 1.50% per annum.
(4) Mortgage loan bears interest at a variable rate equal to LIBOR plus 1.75% per annum and matures on March 31, 2018 with one, three-year extension option, subject to certain conditions.
(5) The construction financing bears interest at a variable rate equal to LIBOR plus 1.65% per annum and matures on November 17, 2014 with one, one-year extension options, subject to certain conditions.
(6) The construction financing bears interest at a variable rate equal to LIBOR plus 1.65% per annum and matures on April 4, 2016 with two, one-year extension options, subject to certain conditions.

State and Local Tax Matters

Because we are organized and qualify as a REIT, we are generally not subject to federal income taxes, but subject to certain state and local taxes. In the normal course of business, certain entities through which we own real estate either have undergone, or are currently undergoing, tax audits or other inquiries. Although we believe that we have substantial arguments in favor of our positions in the ongoing audits, in some instances there is no controlling precedent or interpretive guidance on the specific point at issue. Collectively, tax deficiency notices received to date from the jurisdictions conducting the ongoing audits have not been material. However, there can be no assurance that future audits will not occur with increased frequency or that the ultimate result of such audits will not have a material adverse effect on our results of operations.

Insurance

We carry insurance coverage on our properties of types and in amounts and with deductibles that we believe are in line with coverage customarily obtained by owners of similar properties. In response to the uncertainty in the insurance market following the terrorist attacks of September 11, 2001, the Federal Terrorism Risk Insurance Act (as amended, TRIA) was enacted in November 2002 to require regulated insurers to make available coverage for certified acts of terrorism (as defined by the statute). The expiration date of TRIA was extended to December 31, 2014 by the Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA) and we can provide no assurance that it will be extended further. Currently, the per occurrence limits of our portfolio property insurance program are $1.0 billion, including coverage for acts of terrorism other than nuclear, biological, chemical or radiological terrorism (Terrorism Coverage). We also carry $250 million of Terrorism Coverage for 601 Lexington Avenue, New York, New York (601 Lexington Avenue) in excess of the

$1.0 billion of Terrorism Coverage in our property insurance program. Certain properties, including the General Motors Building located at 767 Fifth Avenue in New York, New York (767 Fifth Avenue), are currently insured in separate insurance programs. The property insurance program per occurrence limits for 767 Fifth Avenue are $1.625 billion, including Terrorism Coverage, with $1.375 billion of Terrorism Coverage in excess of $250 million being provided by NYXP, LLC, (NYXP) as a direct insurer. We also currently carry nuclear, biological, chemical and radiological terrorism insurance coverage for acts of terrorism certified under TRIA (NBCR Coverage), which is provided by IXP, as a direct insurer, for the properties in our portfolio, including 767 Fifth Avenue, but excluding certain other properties owned in joint ventures with third parties or which we manage. The per occurrence limit for NBCR Coverage is $1 billion. Under TRIA, after the payment of the required deductible and coinsurance, the NBCR Coverage provided by IXP and the Terrorism Coverage provided by NYXP are backstopped by the Federal Government if the aggregate industry insured losses resulting from a certified act of terrorism exceed a program trigger. The program trigger is $100 million and the coinsurance is 15%. Under TRIPRA, if the Federal Government pays out for a loss under TRIA, it is mandatory that the Federal Government recoup the full amount of the loss from insurers offering TRIA coverage after the payment of the loss pursuant to a formula in TRIPRA. We may elect to terminate the NBCR Coverage if the Federal Government seeks recoupment for losses paid under TRIA, if there is a change in our portfolio or for any other reason. In the event TRIPRA is not extended beyond December 31, 2014, (i) our $1.0 billion portfolio property insurance program and the $250 million of additional Terrorism Coverage for 601 Lexington Avenue will continue to provide Terrorism Coverage through the expiration of the program on March 1, 2015, (ii) we will evaluate alternative approaches to secure coverage for acts of terrorism thereby potentially increasing our overall cost of insurance, (iii) if such insurance is not available at commercially reasonable rates with limits equal to our current coverage or at all, we may not continue to have full occurrence limit coverage for acts of terrorism, (iv) we may not satisfy the insurance requirements under existing or future debt financings secured by individual properties, (v) we may not be able to obtain future debt financings secured by individual properties and (vi) we may cancel the insurance policies issued by IXP for the NBCR Coverage and by NYXP for the Terrorism Coverage for 767 Fifth Avenue. We intend to continue to monitor the scope, nature and cost of available terrorism insurance and maintain terrorism insurance in amounts and on terms that are commercially reasonable.

We also currently carry earthquake insurance on our properties located in areas known to be subject to earthquakes in an amount and subject to self-insurance that we believe are commercially reasonable. In addition, this insurance is subject to a deductible in the amount of 5% of the value of the affected property. Specifically, we currently carry earthquake insurance which covers our San Francisco region (excluding 535 Mission Street and Salesforce Tower (formerly Transbay Tower)) with a $120 million per occurrence limit and a $120 million annual aggregate limit, $20 million of which is provided by IXP, as a direct insurer. The builders risk policy maintained for the development of 535 Mission Street in San Francisco includes a $15 million per occurrence and annual aggregate limit of earthquake coverage. In addition, the builders risk policy maintained for the development of the below grade improvements of the Salesforce Tower (formerly Transbay Tower) in San Francisco includes a $15 million per occurrence and annual aggregate limit of earthquake coverage. We are evaluating purchasing additional earthquake insurance limits upon the commencement of the vertical construction of Salesforce Tower (formerly Transbay Tower). The amount of our earthquake insurance coverage may not be sufficient to cover losses from earthquakes. In addition, the amount of earthquake coverage could impact our ability to finance properties subject to earthquake risk. We may discontinue earthquake insurance or change the structure of our earthquake insurance program on some or all of our properties in the future if the premiums exceed our estimation of the value of the coverage.

IXP, a captive insurance company which is a wholly-owned subsidiary, acts as a direct insurer with respect to a portion of our earthquake insurance coverage for our Greater San Francisco properties and our NBCR Coverage. NYXP, a captive insurance company which is a wholly-owned subsidiary, acts as a direct insurer with respect to a portion of our Terrorism Coverage for 767 Fifth Avenue. Currently, NYXP only insures losses which exceed the program trigger under TRIA and NYXP reinsures with a third-party insurance company any coinsurance payable under TRIA. Insofar as we own IXP and NYXP, we are responsible for their liquidity and capital resources, and the accounts of IXP and NYXP are part of our consolidated financial statements. In particular, if a loss occurs which is covered by our NBCR Coverage but is less than the applicable program trigger under TRIA, IXP would be responsible for the full amount of the loss without any backstop by the Federal Government. IXP and NYXP would also be responsible for any recoupment charges by the Federal Government in the event losses are paid out and their insurance policies are maintained after the payout by the Federal Government. If we experience a loss and IXP or NYXP are required to pay under their insurance policies, we would ultimately record the loss to the extent of the required payment. Therefore, insurance coverage provided by IXP and NYXP should not be considered as the equivalent of third-party insurance, but rather as a modified form of self-insurance. In addition, our Operating Partnership has issued a guarantee to cover liabilities of IXP in the amount of $20.0 million.

The mortgages on our properties typically contain requirements concerning the financial ratings of the insurers who provide policies covering the property. We provide the lenders on a regular basis with the identity of the insurance companies in our insurance programs. The ratings of some of our insurers are below the rating requirements in some of our loan agreements and the lenders for these loans could attempt to claim an event of default has occurred under the loan. We believe we could obtain insurance with insurers which satisfy the rating requirements. Additionally, in the future our ability to obtain debt financing secured by individual properties, or the terms of such financing, may be adversely affected if lenders generally insist on ratings for insurers or amounts of insurance which are difficult to obtain or which result in a commercially unreasonable premium. There can be no assurance that a deficiency in the financial ratings of one or more of our insurers will not have a material adverse effect on us.

We continue to monitor the state of the insurance market in general, and the scope and costs of coverage for acts of terrorism and California earthquake risk in particular, but we cannot anticipate what coverage will be available on commercially reasonable terms in future policy years. There are other types of losses, such as from wars, for which we cannot obtain insurance at all or at a reasonable cost. With respect to such losses and losses from acts of terrorism, earthquakes or other catastrophic events, if we experience a loss that is uninsured or that exceeds policy limits, we could lose the capital invested in the damaged properties, as well as the anticipated future revenues from those properties. Depending on the specific circumstances of each affected property, it is possible that we could be liable for mortgage indebtedness or other obligations related to the property. Any such loss could materially and adversely affect our business and financial condition and results of operations.

Funds from Operations

Pursuant to the revised definition of Funds from Operations adopted by the Board of Governors of NAREIT, we calculate Funds from Operations, or FFO, by adjusting net income (loss) attributable to Boston Properties, Inc. common shareholders (computed in accordance with GAAP, including non-recurring items) for gains (or losses) from sales of properties, impairment losses on depreciable real estate of consolidated real estate, impairment losses on investments in unconsolidated joint ventures driven by a measurable decrease in the fair value of depreciable real estate held by the unconsolidated joint ventures, real estate related depreciation and amortization, and after adjustment for unconsolidated partnerships, joint ventures and preferred distributions. FFO is a non-GAAP financial measure. The use of FFO, combined with the required primary GAAP presentations, has been fundamentally beneficial in improving the understanding of operating results of REITs among the investing public and making comparisons of REIT operating results more meaningful. Management generally considers FFO to be a useful measure for reviewing our comparative operating and financial performance because, by excluding gains and losses related to sales of previously depreciated operating real estate assets, impairment losses on depreciable real estate of consolidated real estate, impairment losses on investments in unconsolidated joint ventures driven by a measurable decrease in the fair value of depreciable real estate held by the unconsolidated joint ventures and excluding real estate asset depreciation and amortization (which can vary among owners of identical assets in similar condition based on historical cost accounting and useful life estimates), FFO can help one compare the operating performance of a company s real estate between periods or as compared to different companies. Our computation of FFO may not be comparable to FFO reported by other REITs or real estate companies that do not define the term in accordance with the current NAREIT definition or that interpret the current NAREIT definition differently.

Table of Contents

FFO should not be considered as an alternative to net income attributable to Boston Properties, Inc. common shareholders (determined in accordance with GAAP) as an indication of our performance. FFO does not represent cash generated from operating activities determined in accordance with GAAP and is not a measure of liquidity or an indicator of our ability to make cash distributions. We believe that to further understand our performance, FFO should be compared with our reported net income attributable to Boston Properties, Inc. and considered in addition to cash flows in accordance with GAAP, as presented in our Consolidated Financial Statements.

The following table presents a reconciliation of net income attributable to Boston Properties, Inc. common shareholders to FFO for the three months ended March 31, 2014 and 2013:

	Three months ended March 31,	
	2014	2013
	(in thousands)	
Net income attributable to Boston Properties, Inc. common shareholders	$ 54,034	$ 47,854
Add:		
Preferred dividends	2,589	146
Noncontrolling interest in discontinued operations common units of the Operating Partnership		2,066
Noncontrolling interest common units of the Operating Partnership	6,160	4,111
Noncontrolling interest redeemable preferred units of the Operating Partnership	619	1,180
Noncontrolling interests in property partnerships	4,354	2,574
Impairment loss from discontinued operations		3,241
Less:		
Income from discontinued operations		2,494
Gain on forgiveness of debt from discontinued operations		20,182
Income from continuing operations	67,756	38,496
Add:		
Real estate depreciation and amortization(1)	158,514	142,555
Income from discontinued operations		2,494
Less:		
Noncontrolling interests in property partnerships share of funds from operations	19,023	3,038
Noncontrolling interest redeemable preferred units of the Operating Partnership	619	1,180
Preferred distributions	2,589	146
Funds from operations attributable to the Operating Partnership	$ 204,039	$ 179,181
Less:		
Noncontrolling interest common units of the Operating Partnership s share of funds from operations	20,195	18,557
Funds from Operations attributable to Boston Properties, Inc.	$ 183,844	$ 160,624
Boston Properties, Inc. s percentage share of Funds from Operations basic	90.10%	89.86%
Weighted-average shares outstanding basic	153,030	151,646

(1) Real estate depreciation and amortization consists of depreciation and amortization from the Consolidated Statements of Operations of $154,270 and $119,453, our share of unconsolidated joint venture real estate depreciation and amortization of $4,584 and $21,657 and depreciation and amortization from discontinued operations of $0 and $1,738, less corporate related depreciation and amortization of $340 and $293 for the three months ended March 31, 2014 and 2013, respectively.

Table of Contents

Reconciliation to Diluted Funds from Operations:

	Three Months Ended March 31, 2014		Three Months Ended March 31, 2013	
	Income (Numerator)	**Shares (Denominator)**	**Income (Numerator)**	**Shares (Denominator)**
		(in thousands)		
Basic FFO	$ 204,039	169,841	$ 179,181	168,750
Effect of Dilutive Securities				
Convertible Preferred Units	530	874	879	1,307
Stock Based Compensation and Exchangeable Senior Notes		139		306
Diluted FFO	$ 204,569	170,854	$ 180,060	170,363
Less:				
Noncontrolling interest common units of the Operating Partnership s share of diluted FFO	20,128	16,811	18,077	17,104
Boston Properties, Inc. s share of Diluted FFO(1)	$ 184,441	154,043	$ 161,983	153,259

(1) Our share of diluted Funds from Operations was 90.16% and 89.96% for the quarter ended March 31, 2014 and 2013, respectively.

Contractual Obligations

We have various standing or renewable service contracts with vendors related to our property management. In addition, we have certain other contracts we enter into in the ordinary course of business that may extend beyond one year. These contracts include terms that provide for cancellation with insignificant or no cancellation penalties. Contract terms are generally between three and five years.

During the first quarter of 2014, we paid approximately $48.1 million to fund tenant-related obligations, including tenant improvements and leasing commissions, and incurred approximately $48.3 million of new tenant-related obligations associated with approximately 1.4 million square feet of second generation leases, or approximately $34 per square foot. In addition, we signed leases for approximately 160,000 square feet at our development properties. The tenant-related obligations for the development properties are included within the projects Estimated Total Investment referred to in *Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.* In the aggregate, during the first quarter of 2014, we signed leases for approximately 1.6 million square feet of space and incurred aggregate tenant-related obligations of approximately $65.3 million, or approximately $42 per square foot.

ITEM 3 Quantitative and Qualitative Disclosures about Market Risk.

As of March 31, 2014, approximately $10.6 billion of our consolidated borrowings bore interest at fixed rates and none of our consolidated borrowings bore interest at variable rates. The fair value of these instruments is affected by changes in market interest rates. The table below does not include our unconsolidated joint venture debt. For a discussion concerning our unconsolidated joint venture debt, refer to Note 4 to the Consolidated Financial Statements and *Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations Capitalization Off-Balance Sheet Arrangements Joint Venture Indebtedness.*

	2014	2015	2016	2017	2018	2019+	Total	Estimated Fair Value
				(dollars in thousands)				
				Mortgage debt				
Fixed Rate	$ 120,627	$ 80,070	$ 659,511	$ 2,855,942	$ 18,633	$ 695,327	$ 4,430,110	$ 4,577,435
Average Interest Rate	5.63%	5.48%	5.29%	3.90%	3.89%	4.59%	4.31%	
Variable Rate								
				Mezzanine debt				
Fixed Rate	$ 939	$ 1,314	$ 1,389	$ 307,093	$	$	$ 310,735	$ 310,764
Average Interest Rate				5.53%			5.53%	
Variable Rate								
				Unsecured debt				
Fixed Rate	$ (1,372)	$ 548,314	$ (1,681)	$ (1,749)	$ 848,226	$ 4,444,552	$ 5,836,290	$ 6,145,060
Average Interest Rate		5.47%			3.85%	4.53%	4.52%	
Variable Rate								
Total Debt	$ 120,194	$ 629,698	$ 659,219	$ 3,161,286	$ 866,859	$ 5,139,879	$ 10,577,135	$ 11,033,259

At March 31, 2014, the weighted-average coupon/stated rates on our fixed rate debt was 5.01% per annum. The weighted-average coupon/stated rates for our unsecured debt was 4.44% per annum.

At March 31, 2014, we had no outstanding variable rate debt.

The fair value amounts were determined solely by considering the impact of hypothetical interest rates on our financial instruments. Due to the uncertainty of specific actions we may undertake to minimize possible effects of market interest rate increases, this analysis assumes no changes in our financial structure.

ITEM 4 Controls and Procedures.

(a) Evaluation of Disclosure Controls and Procedures. As of the end of the period covered by this report, our management, with the participation of our Chief Executive Officer (Principal Executive Officer) and Chief Financial Officer (Principal Financial Officer), evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that these disclosure controls and procedures were effective as of the end of the period covered by this report.

(b) Changes in Internal Control Over Financial Reporting. No change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred during the first quarter of our fiscal year ending December 31, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1 Legal Proceedings.

We are subject to legal proceedings and claims that arise in the ordinary course of business. These matters are generally covered by insurance. Management believes that the final outcome of such matters will not have a material adverse effect on our financial position, results of operations or liquidity.

ITEM 1A Risk Factors.

Except to the extent updated below or previously updated or to the extent additional factual information disclosed elsewhere in this Quarterly Report on Form 10-Q relates to such risk factors (including, without limitation, the matters discussed in Part I, *Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations*), there were no material changes to the risk factors disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2013.

ITEM 2 Unregistered Sales of Equity Securities and Use of Proceeds

(a) During the three months ended March 31, 2014, we issued an aggregate of 18,528 common shares in exchange for 18,528 common units of limited partnership held by certain limited partners of BPLP. Of these shares, 1,219 shares were issued in reliance on an exemption from registration under Section 4(2) of the Securities Act of 1933, as amended. We relied on the exemption under Section 4(2) based upon factual representations received from the limited partner who received the common shares.

(b) Not applicable.

(c) Issuer Purchases of Equity Securities.

Period	(a) Total Number of Shares of Common Stock Purchased	(b) Average Price Paid per Common Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet be Purchased
January 1, 2014 January 31, 2014	8,896(1)	$ 105.38	N/A	N/A
February 1, 2014 February 28, 2014			N/A	N/A
March 1, 2014 March 31, 2014	439(2)	$ 0.01	N/A	N/A
Total	9,335	$ 105.12	N/A	N/A

(1) Represents shares of Common Stock surrendered by employees to the Company to satisfy such employees tax withholding obligations in connection with the vesting of restricted common stock.

(2) Represents shares of restricted common stock repurchased in connection with the termination of an employee s employment with the Company. Under the terms of the applicable restricted stock award agreement, such shares were repurchased by us at a price of and $0.01 per share, which was the amount originally paid by such employee for such shares.

ITEM 3 Defaults Upon Senior Securities.

None.

ITEM 4 Mine Safety Disclosures.

None.

63

Table of Contents

PART II. OTHER INFORMATION

ITEM 5 Other Information.

(a) None.

(b) None.

ITEM 6 Exhibits.

(a) Exhibits

12.1	Calculation of Ratios of Earnings to Fixed Charges and Calculation of Ratios of Earnings to Combined Fixed Charges and Preferred Dividends.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.
101	The following materials from Boston Properties, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2014 formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Stockholders Equity, (v) the Consolidated Statements of Cash Flows, and (vi) related notes to these financial statements.

Table of Contents

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.

BOSTON PROPERTIES, INC.

May 9, 2014

/s/ MICHAEL E. LABELLE
Michael E. LaBelle
Chief Financial Officer
(duly authorized officer and
principal financial officer)