SANGAMO BIOSCIENCES INC
Form 10-Q
May 10, 2006

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FORM 10-Q
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

(Mark One)

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

For the quarterly period ended March 31, 2006

OR

o **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 000-30171

SANGAMO BIOSCIENCES, INC.

(exact name of small business issuer as specified in its charter)

Delaware	**68-0359556**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

501 Canal Blvd, Suite A100
Richmond, California 94804
(Address of principal executive offices)

(510) 970-6000
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by section 13 or 15(d) of the Securities 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 þ No o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

As of May 5, 2006, 30,738,861 shares of the issuer s common stock, par value $0.01 per share, were outstanding.

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SANGAMO BIOSCIENCES, INC.

Some statements contained in this report are forward-looking with respect to our operations, research and development activities, operating results and financial condition. Statements that are forward-looking in nature should be read with caution because they involve risks and uncertainties, which are included, for example, in specific and general discussions about:

our strategy;

product development and commercialization of our products;

clinical trials;

revenues from existing and new collaborations;

sufficiency of our cash resources;

our research and development and other expenses;

our operational and legal risks; and

our plans, objectives, expectations and intentions and any other statements that are not historical facts.

Various terms and expressions similar to them are intended to identify these cautionary statements. These terms include: anticipates, believes, continues, could, estimates, expects, intends, may, plans, seeks, sh results may differ materially from those expressed or implied in those statements. Factors that could cause these differences include, but are not limited to, those discussed under Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations. Sangamo undertakes no obligation to publicly release any revisions to forward-looking statements to reflect events or circumstances arising after the date of this report. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Quarterly Report.

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PART 1. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

SANGAMO BIOSCIENCES, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share amounts)

	March 31, 2006 (unaudited)	December 31, 2005 (1)
Assets		
Current assets:		
Cash and cash equivalents	$ 13,398	$ 18,507
Marketable securities	29,140	28,449
Interest receivable	200	218
Accounts receivable	292	971
Prepaid expenses	334	317
Total current assets	43,364	48,462
Property and equipment, net	637	472
Other assets	49	49
Total assets	$ 44,050	$ 48,983
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 794	$ 1,534
Accrued compensation and employee benefits	496	933
Deferred revenue	3,435	4,327
Total current liabilities	4,725	6,794
Deferred revenue, non-current portion	3,750	4,375
Total liabilities	8,475	11,169
Stockholders equity:		
Common stock, $0.01 par value; 80,000,000 shares authorized, 30,700,165 and 30,570,912 shares issued and outstanding at March 31, 2006 and December 31, 2005, respectively	31	31
Additional paid-in capital	148,647	148,131
Accumulated deficit	(113,152)	(110,408)
Accumulated other comprehensive income	49	60
Total stockholders equity	35,575	37,814
Total liabilities and stockholders equity	$ 44,050	$ 48,983

(1)

Amounts derived from Audited Consolidated Statements dated December 31, 2005 filed as a part of Form 10-K.

See accompanying notes.

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SANGAMO BIOSCIENCES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three months ended March 31,	
	2006	**2005**
Revenues:		
Collaboration agreements	$ 1,873	$ 180
Federal government research grants	263	76
Total revenues	2,136	256
Operating expenses:		
Research and development	3,589	2,597
General and administrative	1,755	1,239
Total operating expenses	5,344	3,836
Loss from operations	(3,208)	(3,580)
Interest and other income, net	464	27
Net loss	$ (2,744)	$ (3,553)
Basic and diluted net loss per share	$ (0.09)	$ (0.14)
Shares used in computing basic and diluted net loss per share	30,600	25,337

See accompanying notes.

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SANGAMO BIOSCIENCES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three months ended March 31,	
	2006	**2005**
Operating Activities:		
Net loss	$ (2,744)	$ (3,553)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	49	78
Amortization of premium / discount on investments	(25)	114
Realized (gain) / loss on investments	(5)	68
Stock-based compensation	451	101
Changes in operating assets and liabilities:		
Interest receivable	18	53
Accounts receivable	679	343
Prepaid expenses and other assets	(17)	
Accounts payable and accrued liabilities	(740)	(278)
Accrued compensation and employee benefits	(437)	(245)
Deferred revenue	(1,517)	(61)
Net cash used in operating activities	(4,288)	(3,380)
Investing Activities:		
Purchases of investments	(6,186)	(6,124)
Maturities of investments	5,514	8,455
Purchases of property and equipment	(214)	(28)
Net cash provided by / (used in) investing activities	(886)	2,303
Financing Activities:		
Proceeds from issuance of common stock	65	71
Net cash provided by financing activities	64	71
Net decrease in cash and cash equivalents	(5,109)	(1,006)
Cash and cash equivalents, beginning of period	18,507	8,626
Cash and cash equivalents, end of period	$ 13,398	$ 7,620

See accompanying notes.

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SANGAMO BIOSCIENCES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
March 31, 2006

NOTE 1-BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Sangamo Biosciences, Inc. (Sangamo or the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The condensed consolidated financial statements include the accounts of Sangamo and its wholly-owned subsidiary, Gendaq Limited, after elimination of all material intercompany balances and transactions. Operating results for the three-months ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. These financial statements should be read in conjunction with the financial statements and footnotes thereto for the year ended December 31, 2005, included in Sangamo s Form 10-K as filed with the SEC.

USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates.

Certain reclassifications of prior period amounts have been made to the Condensed Consolidated Financial Statements to conform to the current period presentation, including the reclassification of patent prosecution expenses to general and administrative from research and development expense. The reclassifications were immaterial and had no impact on the Company s net loss or accumulated deficit.

FOREIGN CURRENCY TRANSLATION

The Company records foreign currency transactions at the exchange rate prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currency are translated into U.S. dollars at the exchange rates in effect at the balance sheet date. All currency translation adjustments arising from foreign currency transactions are recorded through profit and loss.

REVENUE RECOGNITION

In accordance with Staff Accounting Bulletin No. 104, Revenue Recognition, revenue from research activities made under strategic partnering agreements is recognized as the services are provided when there is persuasive evidence that an arrangement exists, delivery has occurred, the price is fixed or determinable, and collectibility is reasonably assured. Amounts received in advance under such agreements are deferred until the above criteria are met and the research services are performed. Sangamo s federal government research grants are typically multi-year agreements and provide for the reimbursement of qualified expenses for research and development as defined under the terms of the grant agreement. Revenue under grant agreements is recognized when the related qualified research expenses are incurred. Grant reimbursements are received on a quarterly or monthly basis and are subject to the issuing agency s right of audit.

Sangamo recognizes revenue from its Enabling Technology collaborations when ZFP-based products are delivered to the collaborators, persuasive evidence of an agreement exists, there are no unfulfilled obligations, the price is fixed and determinable, and collectibility is reasonably assured. Generally, Sangamo receives partial payments from these collaborations prior to the delivery of ZFP-based products and the recognition of these revenues is deferred until the ZFP-based products are delivered, the risk of ownership has passed to the collaborator and all performance obligations have been satisfied. Upfront or signature payments received upon the signing of an Enabling Technology agreement are generally recognized ratably over the applicable period of the agreement or as ZFP-based products are delivered.

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Milestone payments under research, partnering, or licensing agreements are recognized as revenue upon the achievement of mutually agreed upon milestones, provided that (i) the milestone event is substantive and its achievement is not reasonably assured at the inception of the agreement, and (ii) there are no performance obligations associated with the milestone payment.

In accordance with Emerging Issues Task Force Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, revenue arrangements entered into after June 15, 2003, that include multiple deliverables, are divided into separate units of accounting if the deliverables meet certain criteria, including whether the fair value of the delivered items can be determined and whether there is evidence of fair value of the undelivered items. In addition, the consideration is allocated among the separate units of accounting based on their fair values, and the applicable revenue recognition criteria are considered separately for each of the separate units of accounting.

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses consist of costs incurred for Company-sponsored as well as collaborative research and development activities. These costs include direct and research-related overhead expenses, which include salaries and other personnel-related expenses, stock-based compensation, facility costs, supplies and depreciation of facilities and laboratory equipment, as well as the cost of funding research at universities and other research institutions, and are expensed as incurred. Costs to acquire technologies that are utilized in research and development and that have no alternative future use are expensed as incurred.

STOCK-BASED COMPENSATION

Prior to January 1, 2006, we accounted for our stock-based employee compensation arrangements under the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), as allowed by SFAS No. 123, *Accounting for Stock-based Compensation* (SFAS No. 123), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS No. 148). As a result, no expense was recognized for options to purchase our common stock that were granted with an exercise price equal to fair market value at the date of grant and no expense was recognized in connection with purchases under our employee stock purchase plan for the years ended December 31, 2005 or 2004. In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004) *Share-Based Payment* (SFAS No. 123R), which replaces SFAS No. 123 and supersedes APB No. 25. SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first interim or annual period after June 15, 2005. Subsequent to the effective date, the pro forma disclosures previously permitted under SFAS No. 123 are no longer an alternative to financial statement recognition. Effective January 1, 2006, we have adopted SFAS No. 123R using the modified prospective method. Under this method, compensation cost recognized during the three-month period ended March 31, 2006, includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 amortized on an accelerated basis over the options vesting period, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R amortized on a straight-line basis over the options vesting period. Results for prior periods have not been restated. As a result of adopting SFAS No. 123R on January 1, 2006, our net loss is greater by $430,000 for the three-month period ended March 31, 2006 than had we continued to account for stock-based employee compensation under APB No. 25. Basic and diluted net loss per share for the three-month period ended March 31, 2006 would have been $0.08 had we not adopted SFAS No. 123R, compared to reported basic and diluted net loss per share of $0.09. The adoption of SFAS No. 123R had no impact on cash flows from operations or financing.

Stock Option Plan

Sangamo s 2004 Stock Option Plan (the 2004 Option Plan), which supersedes the 2000 Stock Option Plan, provides for the issuance of common stock and grants of options for common stock to employees, officers, directors and consultants. The exercise price per share will be no less than 85 percent of the fair value per share of common stock on the option grant date, and the option term will not exceed ten years. If the person to whom the option is granted is a 10 percent stockholder, and the option granted qualifies as an Incentive Stock Option Grant, then the exercise price

per share will not be less than 110 percent of the fair value per share of common stock on the option grant date, and the option term will not exceed five years. Options granted under the 2004 Option Plan generally vest over four years at a rate of 25 percent one year from the grant date and one thirty-sixth per month thereafter and expire ten years

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after the grant, or earlier upon employment termination. Options granted pursuant to the 2004 Option Plan may be exercised prior to vesting, with the related shares subject to Sangamo s right to repurchase the shares that have not vested at the issue price if the option holder terminates employment. The right of repurchase lapses over the original option vesting period, as described above. A total of 6.5 million shares are reserved for issuance pursuant to the 2004 Option Plan. The number of shares authorized for issuance automatically increases on the first trading day of the fiscal year by an amount equal to 3.0 percent of the total number of shares of our common stock outstanding on the last trading day of the preceding fiscal year.

Employee Stock Purchase Plan

The Board of Directors adopted the 2000 Employee Stock Purchase Plan in February 2000, effective upon the completion of Sangamo s initial public offering of its common stock. Sangamo reserved a total of 400,000 shares of common stock for issuance under the plan. Eligible employees may purchase common stock at 85 percent of the lesser of the fair market value of Sangamo s common stock on the first day of the applicable two-year offering period or the last day of the applicable six-month purchase period. The reserve for shares available under the plan will automatically increase on the first trading day of the second fiscal quarter each year, beginning in 2001, by an amount equal to 1 percent of the total number of outstanding shares of our common stock on the last trading day of the immediately preceding first fiscal quarter.

As of March 31, 2006, total shares reserved for future awards under all plans were 8,296,385.

Adoption of FAS 123R

Employee stock-based compensation expense recognized in the first quarter of 2006 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. FAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. A forfeiture rate of 10% is applied to the stock-based compensation expense, determined through historical experience of employee stock option exercises. The following table shows total stock-based employee compensation expense (see above for types of stock-based employee arrangements) included in the condensed consolidated statement of operations for the three-month period ended March 31, 2006 (in thousands):

	Three months ended March 31, 2006
Costs and expenses:	
Research and development	$ 317
General and administrative	113
Total stock-based compensation expense	$ 430

There was no capitalized stock-based employee compensation cost as of March 31, 2006. There were no recognized tax benefits during the quarter ended March 31, 2006.

As of March 31, 2006, total compensation cost related nonvested stock options not yet recognized was $3.3 million, which is expected to be allocated to expense over a weighted average period of 48 months.

Pro Forma Information for Period Prior to Adoption of FAS 123R

The following table illustrates the effect on net loss and net loss per share had we applied the fair value recognition provisions of SFAS No. 123 to account for our employee stock option and employee stock purchase plans for the three-month period ended March 31, 2005 because stock-based employee compensation was not accounted for using the fair value recognition method during that period. For purposes of pro forma disclosure, the estimated fair value of the stock awards, as prescribed by SFAS No. 123, is amortized to expense over the vesting period of such awards (in thousands, except per share data).

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	Three months ended March 31, 2005 (1)
Net loss, as reported	$ (3,553)
Deduct: Total stock-based employee compensation expense determined under fair value method	(547)
Pro forma net loss	$ (4,100)
Basic and diluted net loss per share:	
As reported	$ (0.14)
Pro forma	$ (0.16)

(1) During the preparation of footnotes to the condensed consolidated financial statements for our quarterly filings during fiscal year 2006, we determined that the calculation of our net loss pro forma reported under SFAS No. 123 for fiscal year 2005, as reported in that year, did not appropriately reflect the effect of SFAS No. 123 for certain options granted prior to January 1, 2006. Accordingly, the amount of net loss pro

forma reported under SFAS No. 123 for the first quarter of fiscal 2005 presented in the table above has been revised, resulting in an increase in the previously reported amount of pro forma net loss of $338,000 or $0.01 per basic and diluted share. This revision had no effect on our previously reported condensed consolidated results of operations or financial condition.

The historical pro forma impact of applying the fair value method prescribed by SFAS No. 123 is not representative of the impact that may be expected in the future due to changes resulting from additional grants in future years and changes in assumptions such as volatility, interest rates and expected life used to estimate fair value of the grants in future years.

Valuation Assumptions

The employee stock-based compensation expense recognized under FAS123R and presented in the pro forma disclosure required under FAS123 was determined using the Black Scholes option valuation model. Option valuation models require the input of subjective assumptions and these assumptions can vary over time.

We primarily base our determination of expected volatility through our assessment of the historical volatility of our Common Stock. We do not believe that we are able to rely on our historical exercise and post-vested termination activity to provide accurate data for estimating our expected term for use in determining the fair value of these options. Therefore, as allowed by Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment* , we have opted to use the simplified method for estimating our expected term equal to the midpoint between the vesting period and the contractual term.

The weighted average assumptions used for estimating the fair value of the employee stock options are as follows:

	Three Months Ended March 31,	
	2006	**2005**
Risk-free interest rate	4.95%	4.24%
Expected life of option	6.25 yrs	5.00 yrs
Expected dividend yield of stock	0%	0%
Expected volatility	.82	1.0

The weighted average assumptions used for estimating the fair value of the employees purchase rights are as follows:

	Three Months Ended March 31,	
	2006	**2005**
Risk-free interest rate	3.17 - 4.26%	2.71 %
Expected life of option	0.5 - 1 yr	0.5 - 2 yrs
Expected dividend yield of stock	0%	0%
Expected volatility	0.413 - 0.636	.70

Stock Option Activity

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A summary of Sangamo s stock option activity follows:

	Options Outstanding		
	Shares Available for Grant of Options	Number of Shares	Weighted-Average Exercise per Share Price
Outstanding at January 1, 2006	3,256,505	3,874,097	$ 4.27
Options granted	(34,500)	34,500	$ 5.11
Options exercised		(142,836)	$ 5.99
Options canceled	40,578	(40,578)	$ 6.41
Balance at March 31, 2006	3,262,583	3,725,183	$ 5.48

There were no shares subject to Sangamo s right of repurchase as of March 31, 2006. The intrinsic value of options exercised during the first quarter of 2006 and 2005 were $790,000 and $392,000, respectively.

The weighted-average estimated fair value per share of options granted during the three months ended March 31, 2006 and 2005 were $3.76 and $3.41, respectively, based upon the assumptions in the Black-Scholes valuation model described above. The weighted-average estimated fair value per share of employee purchase rights during the three months ended March 31, 2006 and 2005 were $1.70 and $1.72, respectively, based upon the assumptions in the Black-Scholes valuation model described above.

The following table summarizes information with respect to stock options outstanding at March 31, 2006:

	Options Outstanding	
Range of Exercise Price	Number of Shares	Weighted Average Remaining Contractual Life (In Years)
$0.05 - $0.17	461,583	2.07
$0.23 - $3.61	470,153	6.70
$3.78 - $5.19	1,494,497	8.63
$5.36 - $7.49	705,750	6.83
$7.57 - $11.13	361,700	4.88
$14.50 - $17.65	231,500	5.12
	3,725,183	6.59

At March 31, 2006, the aggregate intrinsic value of the outstanding options was $6.2 million.

Sangamo did not grant any nonqualified common stock options to consultants during the three months ended March 31, 2006 and 2005. The Company granted 15,000 and 10,000 nonqualified common stock options to consultants at exercise prices that range from $3.00 to $3.80 per share for services rendered in 2005 and 2004, respectively. Such options are included in the option tables disclosed above. The options generally vest over four years at a rate of 25 percent one year from grant date and one-thirty-sixth per month thereafter and expire ten years after the grant date. Total nonqualified stock-based compensation expense was $21,000 and $100,000 in the three months ended March 31, 2006 and 2005, respectively. The fair value of these options was determined using the Black-Scholes model.

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NOTE 2-BASIC AND DILUTED NET LOSS PER SHARE

Basic and diluted net loss per share have been computed using the weighted-average number of shares of common stock outstanding during the period. Weighted-average shares outstanding used to calculate the reported net loss per common share were equal to shares used to compute basic and diluted net loss per common share.

NOTE 3-COMPREHENSIVE LOSS

Comprehensive loss is comprised of net loss and other comprehensive income (loss). Other comprehensive loss includes certain changes in stockholders equity that are excluded from net loss, which includes unrealized gains and losses on our available-for-sale securities. Comprehensive loss and its components are as follows (in thousands):

	Three months ended March 31,	
	2006	**2005**
Net loss	$ (2,744)	$ (3,553)
Changes in unrealized (losses)/gains on securities available-for-sale	(11)	58
Comprehensive loss	$ (2,755)	$ (3,495)

NOTE 4-MAJOR CUSTOMERS, PARTNERSHIPS AND STRATEGIC ALLIANCES

Strategic Partnership with Edwards Lifesciences Corporation

In January 2000, we announced a therapeutic product development collaboration with Edwards Lifesciences Corporation (Edwards). Under the agreement, we have licensed to Edwards, on a worldwide, exclusive basis, ZFP Therapeutics for use in the activation of VEGFs and VEGF receptors in ischemic cardiovascular and vascular diseases. Edwards purchased a $5.0 million note that converted, together with accrued interest, into 333,333 shares of common stock at the time of our initial public offering (IPO) at the IPO price. In March 2000, Edwards purchased a $7.5 million convertible note in exchange for a right of first refusal for three years to negotiate a license for additional ZFP Therapeutics in cardiovascular and peripheral vascular diseases. That right of first refusal was not exercised and terminated in March 2003. Together with accrued interest, this note converted into common stock at the time of our initial public offering at the IPO price. Through 2001, we received $2 million in research funding from Edwards and a $1.4 million milestone payment for delivery of a lead ZFP Therapeutic product candidate. In November 2002, Edwards signed an amendment to the original agreement and agreed to provide up to $3.5 million in research and development funding, including $2.95 million for research and development activities performed in 2002 and 2003. The filing of the IND for PAD in 2004, and the achievement of other research-related milestones in 2003, triggered a total of $1.0 million in milestone payments from Edwards in the first quarter of 2004. There were no revenues attributable to milestone achievement and collaborative research and development performed under the Edwards agreements for both the three-month periods ended March 31, 2006 and 2005.

Our license agreement with Edwards Lifesciences provides Edwards with worldwide, exclusive rights for ZFP Therapeutics for the activation of VEGF and VEGF receptors for the treatment and prevention of ischemic cardiovascular and vascular disease in humans. We have retained all rights to use our technology for all therapeutic applications of VEGF activation outside of the treatment and prevention of ischemic cardiovascular and vascular disease in humans. During the first quarter of 2005, Sangamo commenced a Phase I clinical trial for the treatment of diabetic neuropathy using a ZFP Therapeutic for the activation of VEGF. Edwards has stated that its rights include diabetic neuropathy and consequently our activities relating to diabetic neuropathy constitute a breach of the agreement. We strongly disagree with the Edwards assertion because diabetic neuropathy is a neurological disease and not an ischemic vascular disease and therefore is outside the scope of the Edwards license. Sangamo and Edwards are in discussions regarding this issue.

In the future, Sangamo may receive milestone payments and royalties under this agreement. We have received $2.5 million in milestone payments to date and we could receive $27.0 million in additional milestone payments under the agreement if all future milestones are met for the first product developed under the agreement. Any subsequent products developed under the agreement may generate up to $15.0 million in milestone payments each. We would

also receive royalties on any sales of products generated under the agreement and these royalty obligations would continue until the expiration of the last-to-expire patent covering products developed under the agreement on a country-by-country basis. Based on currently issued patents, these royalty obligations would last through January 12, 2019. The development of any products is subject to numerous risks and no assurance can be given that any

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products will successfully be developed under this agreement. See Risk Factors Our gene regulation technology is relatively new, and if we are unable to use this technology in all our intended applications, it would limit our revenue opportunities.

Under the Sangamo-Edwards agreement, we were responsible for advancing product candidates into preclinical animal testing. Edwards had responsibility for preclinical development, regulatory affairs, clinical development, and the sales and marketing of ZFP Therapeutic products developed under the agreement. Sangamo may receive milestone payments in connection with the development and commercialization of the first product under this agreement and may also receive royalties on product sales. As part of the November 2002 amendment to our original agreement, Edwards also entered into a joint collaboration with us to evaluate ZFP TFs for the regulation of a second therapeutic gene target, phospholamban (PLN), for the treatment of congestive heart failure. Under the amended agreement, Sangamo granted Edwards a right of first refusal to Sangamo s ZFP TFs for the regulation of PLN. This right of first refusal terminated on June 30, 2004. On August 14, 2003 Edwards and Sangamo entered into a Third Amendment to the original license agreement. Under this amendment, Sangamo received payment for research and development milestones associated with the VEGF and PLN programs.

There is no assurance that the companies will achieve the development and commercialization milestones anticipated in these agreements. Edwards has the right to terminate the agreement at any time upon 90 days written notice. In the event of termination, we retain all payments previously received as well as the right to develop and commercialize all related products.

Agreement with LifeScan for Regenerative Medicine

In September 2004, we announced that we had entered into a research agreement with LifeScan, Inc., a Johnson & Johnson company. The agreement provides LifeScan with our ZFP TFs for use in a program to develop therapeutic cell lines as a potential treatment for diabetes. In December 2004, and again in September 2005, this agreement was expanded to include additional targets important in diabetes. The agreements represented our first collaboration in the field of regenerative medicine. During the three months ended March 31, 2006 and 2005, revenues attributable to collaborative research and development performed under the LifeScan agreements were $150,000 and $55,000, respectively. Related research and development costs and expenses performed under the LifeScan agreements were $8,000 and $18,000 during the three months ended March 31, 2006 and 2005, respectively.

Enabling Technology Collaborations for Pharmaceutical Protein Production

We have established several research collaborations in this area. In December 2004, we announced a research collaboration agreement with Pfizer Inc to use our ZFP technology to develop enhanced cell lines for protein pharmaceutical production. The scope of this agreement was expanded in January 2006 and provided further research funding from Pfizer to develop additional cell lines for enhanced protein production. Under the terms of the agreement, Pfizer is funding research at Sangamo and Sangamo will provide our proprietary ZFP technology for Pfizer to assess its feasibility for use in mammalian cell-based protein production. We are generating novel cell lines and vector systems for enhanced protein production as well as novel technology for rapid creation of new production cell lines. During the first quarter of 2006 and first quarter of 2005, we received $775,000 and $500,000 in research-related funding under our agreements with Pfizer. Revenues attributable to collaborative research and development performed under the Pfizer agreement were $150,000 and $125,000 during the three months ended March 31, 2006 and 2005, respectively. Related research and development costs and expenses performed under the Pfizer agreement were $57,000 and $22,000 during the three months ended March 31, 2006 and 2005, respectively.

Plant Agriculture Agreements

Sangamo scientists and collaborators have shown that ZFP TFs and ZFNs can be used to regulate and modify genes in plants with similar efficacy to that shown in various mammalian cells and organisms. The ability to regulate gene expression with engineered ZFP TFs may lead to the creation of new plants that increase crop yields, lower production costs, are more resistant to herbicides, pesticides, and plant pathogens; and permit the development of branded agricultural products with unique nutritional and processing characteristics. In addition, ZFNs may be used to facilitate the efficient and reproducible generation of transgenic plants. Effective as of October 1, 2005, we entered into a Research License and Commercial Option Agreement with Dow AgroSciences LLC (DAS), a wholly owned indirect subsidiary of Dow Chemical Corporation. Under this agreement, we will provide DAS with access to our

proprietary ZFP technology and the exclusive right to use our ZFP technology to modify the genomes or alter the nucleic acid or protein expression of plant cells, plants, or plant cell cultures. We will retain rights to use plants or plant-derived products to deliver ZFP TFs or ZPF nucleases (ZFNs) into human or animals for diagnostic, therapeutic, or prophylactic purposes.

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Our agreement with DAS provides for an initial three-year research term during which time we will work together to validate and optimize the application of our ZFP technology to plants, plant cells and plant cell cultures. A joint committee having equal representation from both companies will oversee this research. During the initial three-year research term, DAS will have the option to obtain a commercial license to sell products incorporating or derived from plant cells generated using our ZFP technology, including agricultural crops, industrial products and plant-derived biopharmaceuticals. This commercial license will be exclusive for all such products other than animal and human health products. In the event that DAS exercises this option, DAS may elect to extend the research program beyond the initial three-year term on a year-to-year basis.

Pursuant to the Research License and Commercial Option Agreement, DAS made an initial cash payment to us of $7.5 million and agreed to purchase up to $4.0 million of our common stock in the next financing transaction meeting certain criteria. In November 2005, the Company sold approximately 1.0 million shares of common stock to DAS at a price of $3.85 per share, resulting in gross proceeds of $3.9 million. In addition, DAS will provide between $4.0 and $6.0 million in research funding over the initial three-year research term and may make an additional payment of up to $4.0 million in research milestone payments to us during this same period, depending on the success of the research program. In the event that DAS elects to extend the research program beyond the initial three-year term, DAS will provide additional research funding. If DAS exercises its option to obtain a commercial license, we will be entitled to full payment of the $4.0 million in research milestones, a one-time exercise fee of $6.0 million, minimum annual payments of up to $25.25 million, development and commercialization milestone payments for each product, and royalties on sales of products. Furthermore, DAS will have the right to sublicense our ZFP technology to third parties for use in plant cells, plants, or plant cell cultures, and we will be entitled to 25% of any cash consideration received by DAS under such sublicenses.

We have agreed to supply DAS and its sublicensees with ZFP TFs and/or ZFNs for both research and commercial use. If DAS exercises its option to obtain a commercial license, DAS may request that we transfer, at DAS s expense, the ZFP manufacturing technology to DAS or to a mutually agreed-upon contract manufacturer.

The Research License and Commercial Option Agreement will terminate automatically if DAS fails to exercise its option for a commercial license by the end of the initial three-year research term. DAS may also terminate the agreement at the end of the second year of the initial research term if the joint committee overseeing the research determines that disappointing research results have made it unlikely that DAS will exercise the option; we are guaranteed to receive $4.0 million in research funding from DAS prior to such a termination. Following DAS s exercise of the option and payment of the exercise fee, DAS may terminate the agreement at any time. In addition, each party may terminate the agreement upon an uncured material breach of the other party. In the event of any termination of the agreement, all rights to use our ZFP technology will revert to us, and DAS will no longer be permitted to practice our ZFP technology or to develop or, except in limited circumstances, commercialize any products derived from our ZFP technology. Revenues related to the research license under the DAS agreement are being recognized ratably over the initial three-year research term of the agreement and were $625,000 during the three months ended March 31, 2006. Revenues attributable to collaborative research and development performed under the DAS agreement were $948,070 during the three months ended March 31, 2006. Related costs and expenses incurred under the DAS agreement were $862,500 during the three months ended March 31, 2006.

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

The discussion in Management s Discussion and Analysis of Financial Condition and Results of Operations contains trend analysis, estimates and other forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements include, without limitation, statements containing the words believes, anticipates, expects, continue, and other words of similar import or the negative of those terms or expressions. Such forward-looking statements are subject to known and unknown risks, uncertainties, estimates and other factors that may cause the actual results, performance or achievements of the Company, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Actual results could differ materially from those set forth in such forward-looking statements as a result of, but not limited to, the Risk Factors described below. You should read the following discussion and analysis along with the financial statements and notes attached to those statements included elsewhere in this report and in our annual report on Form 10-K for the year ended December 31, 2005 as filed with the Securities and Exchange Commission on March 13, 2006.

Overview

We were incorporated in June 1995. From our inception through March 31, 2006, our activities related primarily to establishing and operating a biotechnology research and development organization and developing relationships with our corporate collaborators. Our scientific and business development endeavors currently focus on the engineering of novel zinc finger DNA binding proteins (ZFPs) for the regulation and modification of genes. We have incurred net losses since inception and expect to incur losses in the future as we continue our research and development activities. To date, we have funded our operations primarily through the issuance of equity securities, borrowings, payments from federal government research grants and from corporate collaborators and strategic partners. As of March 31, 2006, we had an accumulated deficit of $113.2 million.

Our revenues have consisted primarily of revenues from our corporate partners for ZFP TFs and ZFNs, contractual payments from strategic partners for research programs and research milestones, and Federal government research grant funding. We expect revenues will continue to fluctuate from period to period and there can be no assurance that new collaborations or partner fundings will continue beyond their initial terms.

Commencing in 2005, we have placed more emphasis on higher-value therapeutic product development and related strategic partnerships and less emphasis on our Enabling Technology collaborations. We believe this shift in emphasis has the potential to increase the return on investment to our stockholders by allocating capital resources to higher value, therapeutic product development activities. At the same time, it may reduce our revenues over the next several years and it increases our financial risk by increasing expenses associated with product development. We have filed an Investigational New Drug (IND) application with the U.S. Food and Drug Administration (FDA) and have initiated a Phase 1 clinical trial of a ZFP Therapeutic in patients with diabetic neuropathy during the first quarter of 2005. Development of novel therapeutic products is costly and is subject to a lengthy and uncertain regulatory process by the FDA. Our future products are gene-based therapeutics. Adverse events in both our own clinical program and other programs in gene therapy may have a negative impact on regulatory approval, the willingness of potential commercial partners to enter into agreements and the perception of the public.

Research and development expenses consist primarily of salaries and related personnel expenses, including stock-based compensation, laboratory supplies, allocated facilities costs, subcontracted research expenses, trademark registration and technology licenses. Research and development costs incurred in connection with collaborator-funded activities are expensed as incurred. We believe that continued investment in research and development is critical to attaining our strategic objectives. We expect these expenses will increase significantly as we increase our focus on development of ZFP Therapeutics. The Company is also developing zinc finger nucleases (ZFNs) for therapeutic gene correction and therapeutic gene modification as a treatment for certain monogenic and infectious diseases. Additionally, in order to develop ZFP TFs and ZFNs as commercially relevant therapeutics, we expect to expend additional resources for expertise in the manufacturing, regulatory affairs and clinical research aspects of biotherapeutic development.

General and administrative expenses consist primarily of salaries and related personnel expenses for executive, finance and administrative personnel, stock-based compensation, professional fees, patent prosecution expenses, allocated facilities costs and other general corporate expenses. As we pursue commercial development of our therapeutic leads we expect the business aspects of the

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Company to become more complex. We may be required in the future to add personnel and incur additional costs related to the maturity of our business.

Critical Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Sangamo believes the following critical accounting policies have significant effect in the preparation of our consolidated financial statements.

Revenue Recognition

In accordance with Staff Accounting Bulletin No. 104, Revenue Recognition, revenue from research activities made under strategic partnering agreements is recognized as the services are provided when there is persuasive evidence that an arrangement exists, delivery has occurred, the price is fixed or determinable, and collectibility is reasonably assured. Amounts received under such agreements are deferred until the above criteria are met and the research services are performed. Sangamo s federal government research grants are typically multi-year agreements and provide for the reimbursement of qualified expenses for research and development as defined under the terms of the grant agreement. Revenue under grant agreements is recognized when the related research expenses are incurred. Grant reimbursements are typically received on a quarterly basis and are subject to the issuing agency s right of audit.

Sangamo recognizes revenue from its Enabling Technology collaborations when ZFP-based products are delivered to the collaborators, persuasive evidence of an agreement exists, there are no unfulfilled obligations, the price is fixed and determinable, and collectibility is reasonably assured. Generally, Sangamo receives partial payments from these collaborations prior to the delivery of ZFP-based products and the recognition of these revenues is deferred until the ZFP-based products are delivered, the risk of ownership has passed to the collaborator and all performance obligations have been satisfied. Upfront or signature payments received upon the signing of an Enabling Technology agreement are generally recognized ratably over the applicable period of the agreement or as ZFP-based products are delivered.

Milestone payments under research, partnering, or licensing agreements are recognized as revenue upon the achievement of mutually agreed upon milestones, provided that (i) the milestone event is substantive and its achievement is not reasonably assured at the inception of the agreement, and (ii) there are no further significant performance obligations associated with the milestone payment.

In accordance with Emerging Issues Task Force Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, revenue arrangements entered into after June 15, 2003, that include multiple deliverables, are divided into separate units of accounting if the deliverables meet certain criteria, including whether the fair value of the delivered items can be determined and whether there is evidence of fair value of the undelivered items. In addition, the consideration is allocated among the separate units of accounting based on their fair values, and the applicable revenue recognition criterion is considered separately for each of the separate units of accounting.

Stock-Based Compensation

Prior to January 1, 2006, we accounted for our stock-based employee compensation arrangements under the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), as allowed by SFAS No. 123, *Accounting for Stock-based Compensation* (SFAS No. 123), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS No. 148). As a result, no expense was recognized for options to purchase our common stock that were granted with an exercise price equal to fair market value at the date of grant and no expense was recognized in connection with purchases under our employee stock purchase plan for the years ended December 31, 2005 or 2004. In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004) *Share-Based Payment* (SFAS No. 123R), which replaces SFAS No. 123 and supersedes APB No. 25. SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first interim or annual period after June 15, 2005. Subsequent to the effective date, the pro forma disclosures previously permitted under SFAS No. 123 are no longer an alternative to financial statement recognition. Effective January 1, 2006,

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we have adopted SFAS No. 123R using the modified prospective method. Under this method, compensation cost recognized during the three-month period ended March 31, 2006, includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 amortized on an accelerated basis over the options vesting period, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R amortized on a straight-line basis over the options vesting period. Results for prior periods have not been restated. As a result of adopting SFAS No. 123R on January 1, 2006, our net loss is greater by $430,000 for the three-month period ended March 31, 2006 than had we continued to account for stock-based employee compensation