

COMPLETE GENOMICS INC
Form 10-Q
November 09, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

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: 001-34939

Complete Genomics, Inc.

(Exact Name of Registrant as Specified in its Charter)

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Delaware (State or Other Jurisdiction of Incorporation or Organization)	20-3226545 (I.R.S. Employer Identification No.)
2071 Stierlin Court Mountain View, California (Address of Principal Executive Offices)	94043 (Zip Code)
(650) 943-2800 (Registrant's Telephone Number, Including Area Code)	

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

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

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

As of October 31, 2012, the number of outstanding shares of the registrant's common stock, par value \$0.001 per share, was 34,488,711.

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COMPLETE GENOMICS, INC.

FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2012

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Table of Contents**PART I FINANCIAL INFORMATION****COMPLETE GENOMICS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

	September 30, 2012	December 31, 2011
	(in thousands, except par value and share data)	
Assets		
Current assets		
Cash and cash equivalents	\$ 34,715	\$ 77,074
Short-term investments		6,000
Accounts receivable	5,388	6,488
Inventory	6,764	4,121
Prepaid expenses	1,333	1,141
Other current assets	95	341
Total current assets	48,295	95,165
Property and equipment, net	31,393	33,592
Other assets	1,132	1,446
Total assets	\$ 80,820	\$ 130,203
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$ 4,974	\$ 5,363
Accrued liabilities	5,980	5,400
Notes payable, current	19,436	7,099
Convertible notes payable	6,000	
Deferred revenue	9,089	10,026
Total current liabilities	45,479	27,888
Notes payable, net of current		16,162
Deferred rent, net of current	2,899	3,539
Total liabilities	48,378	47,589
Commitments and contingencies (Note 8)		
Stockholders' equity		
Preferred stock, par value \$0.001 5,000,000 shares authorized and no shares outstanding at September 30, 2012 and December 31, 2011		
Common stock, \$0.001 par value 300,000,000 shares authorized and 34,457,289 shares issued and outstanding at September 30, 2012; 300,000,000 shares authorized and 33,409,638 shares issued and outstanding at December 31, 2011	34	33
Additional paid-in capital	300,652	293,777
Accumulated deficit	(268,244)	(211,196)
Total stockholders' equity	32,442	82,614
Total liabilities and stockholders' equity	\$ 80,820	\$ 130,203

See accompanying notes to condensed consolidated financial statements.

Table of Contents**COMPLETE GENOMICS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS****(UNAUDITED)**

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands, except share and per share data)			
Revenue	\$ 7,276	\$ 4,177	\$ 19,877	\$ 16,875
Cost and expenses:				
Cost of revenue	7,228	8,182	20,648	20,886
Research and development	8,867	9,546	26,506	24,382
Sales and marketing	3,678	3,455	13,573	9,293
General and administrative	4,675	3,810	12,392	10,058
Restructuring charges	144		1,640	
Total cost and expenses	24,592	24,993	74,759	64,619
Loss from operations	(17,316)	(20,816)	(54,882)	(47,744)
Interest expense	(674)	(799)	(2,173)	(1,949)
Interest and other income (expense), net	1	9	7	(333)
Net loss	\$ (17,989)	\$ (21,606)	\$ (57,048)	\$ (50,026)
Net loss per share basic and diluted	\$ (0.52)	\$ (0.65)	\$ (1.68)	\$ (1.72)
Weighted-average shares of common stock outstanding used in computing net loss per share basic and diluted	34,334,730	33,076,940	33,966,760	29,135,162
Comprehensive loss	\$ (17,989)	\$ (21,606)	\$ (57,048)	\$ (50,026)

See accompanying notes to condensed consolidated financial statements.

Table of Contents**COMPLETE GENOMICS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

	Nine months ended September 30, 2012 2011 (in thousands)	
Cash flows from operating activities		
Net loss	\$ (57,048)	\$ (50,026)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	10,142	8,368
Increase in inventory reserves	269	480
Change in fair value of warrant liability		361
Stock-based compensation	4,725	2,905
Noncash interest expense related to notes payable	621	350
Other	194	25
Changes in assets and liabilities		
Accounts receivable	1,100	2
Inventory	(2,912)	232
Prepaid expenses	(192)	291
Other current assets	246	(281)
Other assets	276	(368)
Accounts payable	456	1,357
Accrued liabilities	441	2,317
Deferred revenue	(937)	1,190
Deferred rent	(640)	(580)
Net cash used in operating activities	(43,259)	(33,377)
Cash flows from investing activities		
Purchase of available-for-sale securities	(15,998)	(52,653)
Proceeds from maturities of available-for-sale securities	21,998	12,451
Purchase of property and equipment	(8,944)	(15,563)
Purchase of patent		(250)
Net cash used in investing activities	(2,944)	(56,015)
Cash flows from financing activities		
Proceeds from notes payable		20,000
Proceeds from convertible notes payable	6,000	
Repayment of notes payable	(4,307)	(9,096)
Proceeds from issuance of common stock, net of costs	1,091	73,932
Proceeds from issuance of common stock under equity incentive plans	1,060	549
Net cash provided by financing activities	3,844	85,385
Net decrease in cash and cash equivalents	(42,359)	(4,007)
Cash and cash equivalents at beginning of period	77,074	68,918
Cash and cash equivalents at end of period	\$ 34,715	\$ 64,911

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Supplemental disclosure of cash flow information

Cash paid for interest	\$ 1,683	\$ 1,578
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Supplemental disclosure of noncash investing and financing activities

Issuance of warrants for common stock in connection with term debt	\$	\$ 987
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Acquisition of property and equipment under accounts payable	\$ (845)	\$ 777
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Reclassification of warrant liability to additional-paid-in capital upon exercise of warrant	\$	\$ 643
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See accompanying notes to condensed consolidated financial statements.

Table of Contents**Complete Genomics, Inc.****Notes to Condensed Consolidated Financial Statements (unaudited)****1. THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES***Nature of Operations*

Complete Genomics, Inc., (the Company) is a life sciences company that has developed and commercialized a DNA sequencing platform for whole human genome sequencing and analysis. In the DNA sequencing industry, whole human genome sequencing is generally deemed to be coverage of at least 90% of the nucleotides in the genome. The Company's Complete Genomics Analysis Platform (CGA Platform) combines its proprietary human sequencing technology with its advanced informatics and data management software and its end-to-end outsourced service model to provide customers with data that is immediately ready to be used for genome-based research. The Company's solution provides academic, biopharmaceutical and translational medicine researchers with whole human genome data and analysis without requiring them to invest in in-house sequencing instruments, high-performance computing resources and specialized personnel. The Company was incorporated in Delaware on June 14, 2005 and began operations in March 2006.

On September 15, 2012, the Company, BGI-Shenzhen, a company organized under the laws of the People's Republic of China (BGI), and Beta Acquisition Corporation, a Delaware corporation and a wholly owned subsidiary of BGI (the Purchaser), entered into a definitive Agreement and Plan of Merger (the Merger Agreement), pursuant to which BGI, through the Purchaser, has commenced an offer (the Offer) to acquire all of the outstanding shares of the Company's common stock, par value \$0.001 per share (the Shares), for \$3.15 per share (the Offer Price) net to the selling stockholders in cash, without interest. Following successful consummation of the Offer and satisfaction of certain conditions, the Purchaser will merge with and into the Company (the Merger), with the Company surviving as a wholly owned subsidiary of BGI (see Note 2). In connection with the Merger Agreement, the Company, BGI and BGI-HONGKONG Co., Limited, a limited company incorporated in Hong Kong and wholly owned subsidiary of BGI (the Lender) entered into a Convertible Subordinated Promissory Note (the Note). As of September 30, 2012, pursuant to the terms of the Note, the Company has drawn \$6 million and may draw up to an aggregate principal amount of \$30 million (see Note 8).

The Company has incurred net operating losses and significant negative cash flow from operations during every year since inception. At September 30, 2012, the Company had an accumulated deficit of \$268.2 million. Management believes that without continued funding from BGI under the Note, based on the current level of operations, cash and cash equivalents balances, including interest income the Company will earn on these balances will not be sufficient to meet the anticipated cash requirements beyond January 31, 2013. If the Merger does not occur, the Company may be required to significantly reduce, restructure or cease operations. The Company's recurring operating losses and negative cash flow from operations and its requirement for additional funding to execute its business objectives beyond this period gives rise to substantial doubt as to the Company's ability to continue as a going concern if the Merger were not to occur. These financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Basis of Presentation

The interim condensed consolidated financial statements have been prepared and presented by the Company in accordance with accounting principles generally accepted in the United States (GAAP) and the rules and regulations of the Securities and Exchange Commission, without audit, and reflect all adjustments, consisting of adjustments of a normal, recurring nature, necessary to state fairly the Company's interim financial information. The accounting principles and methods of computation adopted in these financial statements are the same as those of the audited financial statements for the year ended December 31, 2011.

The preparation of the Company's unaudited condensed consolidated financial statements in conformity with GAAP 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 unaudited condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period.

Certain information and footnote disclosures normally included in the Company's annual financial statements prepared in accordance with GAAP have been condensed or omitted. The accompanying unaudited financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2011 included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 9, 2012. The financial results for any interim period are not necessarily indicative of financial results for the full year or any other interim period.

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The Company operates as one segment, providing whole human genome sequencing and analysis.

The condensed consolidated financial statements include the accounts of Complete Genomics, Inc. and those of its wholly-owned subsidiaries. All inter-company accounts and transactions have been eliminated.

Management determined that the decision to defer capital expenditures as part of the restructuring plan announced on June 5, 2012 (see Note 12) was a change in circumstances that required an evaluation of the recoverability of the Company's property and equipment and patent (intellectual property). Therefore, in the second quarter of 2012, management performed an evaluation of the recoverability of the Company's property and equipment and patent (intellectual property) by comparing the carrying value of these assets to the projected, undiscounted cash flows generated by these assets over the estimated remaining useful life of these assets. Management determined that the Company's property and equipment and patent (intellectual property) were not impaired at June 30, 2012, as the projected undiscounted cash flows exceed the carrying value.

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Summary of Significant Accounting Policies

The following accounting policy was adopted by the Company during the three months ended June 30, 2012 in addition to the significant accounting policies described in its audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011:

Restructuring Charges The Company measures and accrues the liabilities associated with restructuring charges at fair value as of the date the restructuring plan is announced. The fair value measurement of restructuring related liabilities requires certain assumptions and estimates be made by the Company. It is the Company's policy to use the best estimates based on facts and circumstances available at the time of measurement, review the assumptions and estimates periodically, and adjust the liabilities when necessary.

Recent Adopted Accounting Standards

In May 2011, the FASB issued further guidance that generally aligns the principles of fair value measurements with International Financial Reporting Standards. The guidance clarifies the application of existing fair value measurement requirements and expands the disclosure requirements for fair value measurements, and was effective January 1, 2012. The adoption of the guidance had no effect on the Company's financial position or results of operations.

In June 2011, the FASB issued guidance concerning the presentation of comprehensive income. The guidance gives companies the option to present total comprehensive income, components of net income, and components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance was effective January 1, 2012 and was applied retrospectively. The adoption of the guidance had no effect on the Company's financial position or results of operations.

2. MERGER

On September 15, 2012, the Company, BGI and the Purchaser entered into the Merger Agreement, pursuant to which BGI, through the Purchaser, commenced the Offer to acquire all of the outstanding Shares, for the Offer Price net to the selling stockholders in cash, without interest. The Offer commenced on September 25, 2012, was extended on October 22, 2012 and is currently scheduled to expire at midnight, New York City time, on November 21, 2012, subject to further extension in certain circumstances as required or permitted by the Merger Agreement, the Securities and Exchange Commission (the "SEC") or applicable law.

Completion of the Offer is subject to several conditions, including (i) that a majority of the Shares outstanding (determined on a fully diluted basis) be validly tendered and not validly withdrawn prior to the expiration of the Offer; (ii) the expiration or termination of any applicable waiting period relating to the Offer, the Merger or the other transactions contemplated by the Merger Agreement under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSR Act"); (iii) the approval of each of the Ministry of Commerce of the People's Republic of China (the "PRC"), the National Development and Reform Commission of the PRC and the State Administration of Foreign Exchange of the PRC; (iv) the Committee on Foreign Investment in the United States ("CFIUS") shall have notified BGI and the Company in writing that it has determined not to investigate the transactions contemplated by the Merger Agreement (including the Offer and the Merger) pursuant to the powers vested in it by the Exon-Florio Amendment to the Defense Production Act of 1950 or, in the event that CFIUS has undertaken such an investigation, CFIUS has terminated such investigation or the President of the United States has determined not to take any action to suspend or prohibit the transactions contemplated by the Merger Agreement; (v) the absence of a material adverse effect on the Company; and (vi) certain other customary conditions.

The Merger Agreement also provides that following consummation of the Offer and satisfaction of certain conditions, the Merger will occur, with the Company surviving as a wholly owned subsidiary of BGI. Upon completion of the Merger, each Share outstanding immediately prior to the effective time of the Merger (excluding those Shares that are held by (i) BGI, the Purchaser, the Company or their respective subsidiaries or (ii) stockholders of the Company who properly exercised their appraisal rights under the Delaware General Corporation Law) will be converted into the right to receive the Offer Price.

If the Purchaser holds 90% or more of the outstanding Shares following the completion of the Offer, the parties will effect the Merger as a short-form merger without the need for approval by the Company's stockholders. Otherwise, the Company may hold a special stockholders meeting to obtain stockholder approval of the Merger. Subject to the terms of the Merger Agreement, applicable law and the number of authorized and unissued Shares available under the Company's certificate of incorporation, the Company has granted the Purchaser an irrevocable option (the "Top-Up Option"), exercisable after completion of the Offer, to purchase additional Shares (the "Top-Up Shares") from the Company as necessary so that BGI and the Purchaser own one Share more than 90% of the total Shares outstanding immediately after the issuance of the Top-Up Shares on a fully diluted basis. The Purchaser will pay the Offer Price for each Share acquired through exercise of the

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Top-Up Option, with the Purchaser paying the Company the aggregate par value of the Top-Up Shares in cash and the balance of the aggregate price by delivery of a promissory note.

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BGI and the Company have made customary representations, warranties and covenants in the Merger Agreement. In addition, the Company has agreed to conduct its business in all material respects in the ordinary course consistent with past practice, including not taking certain specified actions, prior to consummation of the Merger. The Merger Agreement, which has been unanimously adopted by the Company's board of directors, can be terminated by BGI or the Company under certain circumstances, and the Company will be required to pay BGI a termination fee of \$4.0 million plus 4% of any amounts drawn under the Note in connection with certain terminations.

In connection with the Merger Agreement, the Company, BGI and the Lender entered into the Note. Pursuant to the terms of the Note, the Company has drawn \$6 million and may draw up to an aggregate principal amount of \$30 million (see Note 8).

The foregoing description of the Offer, Merger, Merger Agreement and Note is only a summary, does not purport to be complete and is qualified in its entirety by reference to (i) the Merger Agreement and Note, copies of which are filed as Exhibits 2.1 and 10.2, respectively, to the Company's Current Report on Form 8-K filed with the SEC on September 17, 2012 and incorporated herein by reference, and are included to provide investors with information regarding their terms, and (ii) the information contained in the Tender Offer Statement on Schedule TO-T filed by BGI and the Purchaser with the SEC on September 25, 2012, as amended thereafter and as may be further amended from time to time, and the Solicitation/Recommendation Statement on Schedule 14D-9C filed by the Company with the SEC on September 25, 2012, as amended thereafter and as may be further amended from time to time.

3. CONCENTRATION OF CREDIT RISKS AND OTHER RISKS AND UNCERTAINTIES

The Company is subject to all of the risks and uncertainties inherent in an early-stage company developing and promoting a new approach to DNA sequencing with limited cash and financing capabilities. These risks and uncertainties include, but are not limited to, significant capital requirements, limited management resources, intense competition, development of new technologies, capabilities and services, demand for DNA sequencing services, the need to develop new applications for DNA sequencing services and the changing nature of the DNA sequencing industry. The Company's operating results may be materially affected by the foregoing factors.

The announcement of the Merger Agreement with BGI (see Note 2) has adversely affected the Company's business, due to customers' and employees' uncertainty and other disruptions as well as intensified competition from competitors as they attempt to take advantage of the uncertainties. In addition, the Company has incurred legal and other expenses in connection with the pending Merger (see Note 8). All of these factors are likely to continue to adversely affect the Company's business and have an adverse effect on its financial condition or results of operations.

The Company depends on a limited number of suppliers, including sole- and single-source suppliers, of various critical components in the sequencing process. The loss of these suppliers, or their failure to supply the Company with the necessary components in sufficient quantities on a timely basis and without defect, could cause delays in the sequencing process and adversely affect the Company.

The Company primarily derives accounts receivable from direct sales and amounts contractually due, but not received, under contracts. The Company reviews its exposure to accounts receivable and generally requires no collateral for any of its accounts receivable. The allowance for doubtful accounts is the Company's best estimate of the amount of expected credit losses existing in accounts receivable and is based upon specific customer issues that have been identified. As of both September 30, 2012 and December 31, 2011, the Company has \$44,000 recorded as an allowance for doubtful accounts.

The Company allocates its revenues to individual countries based on the primary locations of its customers.

As of September 30, 2012 and December 31, 2011, customers representing greater than 10% of accounts receivable were as follows:

Customer	September 30, 2012	December 31, 2011
Customer A	20%	13%
Customer B	20%	16%

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For the three and nine months ended September 30, 2012 and 2011, customers representing greater than 10% of revenue were as follows:

Customer	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Customer A	23%	30%	21%	*
Customer B	14%	*	18%	*
Customer C	*	*	*	17%
Customer D	*	*	*	12%

* *Less than 10%*

For the three and nine months ended September 30, 2012 and 2011, countries representing greater than 10% of revenue were as follows:

Countries	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
United States	84%	79%	84%	72%
United Kingdom	*	11%	*	*
The Netherlands	*	*	*	13%

* *Less than 10%*

4. NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding during the period. The Company's potential dilutive shares, which include shares issuable upon conversion of the Note, outstanding common stock options, restricted stock units, shares issuable under the employee stock purchase plan, and warrants, have not been included in the computation of diluted net loss per share for all periods as the result would be anti-dilutive. Such potentially dilutive shares are excluded when the effect would be to reduce the net loss per share.

The following outstanding shares of potentially dilutive securities were excluded from the computation of diluted net loss per share for the periods presented because including them would have had an anti-dilutive effect:

	September 30,	
	2012	2011
Common stock issuable upon conversion of the Note	1,904,761	
Options to purchase common stock	4,124,736	4,176,872
Employee Stock Purchase Plan purchase rights	286,927	83,562
Restricted stock units for common stock	1,079,335	27,500
Warrants to purchase common stock	1,533,823	1,533,823
Total	8,929,582	5,821,757

5. SHORT-TERM INVESTMENTS*Summary of Available-for-Sale Securities*

The following table summarizes the Company's available-for-sale securities (in thousands):

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2011				
Fixed income securities:				
U.S. government securities	\$ 6,000	\$	\$	\$ 6,000
Total fixed income securities	\$ 6,000	\$	\$	\$ 6,000

The Company had no available-for-sale securities outstanding at September 30, 2012.

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Assets and liabilities recorded at fair value in the financial statements are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels that 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: Observable inputs, such as quoted prices in active markets for identical assets or liabilities.

Level 2: Observable inputs, other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

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.

The following tables set forth the Company's financial instruments that are measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011 and by level within the fair value hierarchy. Assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires management to make judgments and consider factors specific to the asset or liability.

As of September 30, 2012, the Company's fair value hierarchy for its financial assets and financial liabilities that are carried at fair value was as follows:

	Level 1	Level 2	Level 3	Total
	(in thousands)			
Assets				
Money market funds (included in cash and cash equivalents)	\$ 25,333	\$	\$	\$ 25,333

As of December 31, 2011, the Company's fair value hierarchy for its financial assets and financial liabilities that are carried at fair value was as follows:

	Level 1	Level 2	Level 3	Total
	(in thousands)			
Assets				
Money market funds (included in cash and cash equivalents)	\$ 74,376	\$	\$	\$ 74,376
U.S. government securities (included in short-term investments)	\$	\$ 6,000	\$	\$ 6,000

Level 2 U.S. government securities are priced using non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models, such as discounted cash flow techniques. The Company did not have any transfers between Level 1 and Level 2 fair value measurements during the nine months ended September 30, 2012.

The Company has determined that its notes payable would be classified as a Level 3 item in the fair value hierarchy. At September 30, 2012, the fair value of the notes payable under the Oxford and Atel Loan Agreements (see Note 8) was approximately \$18.6 million compared to the carrying amount of \$19.4 million. At September 30, 2012, the Company had borrowings of \$6.0 million under the Note (see Note 8), which approximates the fair value of the Note based on available market data. The Company estimated the fair value of the notes payable based on the cost of capital for comparable public companies that have similar default and credit risks, using a conventional discounted cash flow methodology. Considerable judgment is required in interpreting market data to develop estimates of fair value. The use of different assumptions and/or estimation methodologies may have a material effect on the estimated fair value. For certain financial instruments, including accounts receivable, accounts payable and accrued liabilities, the carrying amounts approximate fair value due to the relatively short maturity of the items.

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Inventory consists of the following:

	September 30, 2012	December 31, 2011
	(in thousands)	
Raw materials	\$ 2,505	\$ 1,617
Work-in-progress	2,826	1,923
Finished goods	1,433	581
	\$ 6,764	\$ 4,121

Property and equipment, net

Property and equipment, net, consist of the following:

	September 30, 2012	December 31, 2011
	(in thousands)	
Computer equipment	\$ 10,612	\$ 10,442
Computer software	2,631	2,398
Furniture and fixtures	575	586
Machinery and equipment	32,811	30,017
Leasehold improvements	11,095	10,800
Equipment under construction	7,725	3,301
	65,449	57,544
Less: Accumulated depreciation and amortization	(34,056)	(23,952)
	\$ 31,393	\$ 33,592

Depreciation and amortization expense for the three months ended September 30, 2012 and 2011 was \$2.6 million and \$3.1 million, respectively. Depreciation and amortization expense for the nine months ended September 30, 2012 and 2011 was \$10.1 million and \$8.4 million, respectively.

In June 2012, the Company accelerated the amortization of certain leasehold improvements and depreciation of certain furniture and fixtures associated with a leased facility the Company vacated in July 2012 (see Note 8) as part of its restructuring plan announced on June 5, 2012 (see Note 12). The impact of the accelerated depreciation and amortization related to the vacated facility for the three and nine months ended September 30, 2012 was \$0.3 million and \$0.6 million, respectively.

Accrued liabilities

Accrued liabilities consist of the following:

September 30, 2012	December 31, 2011
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	(in thousands)	
Accrued paid time off	\$ 2,317	\$ 1,840
Accrued compensation and benefits other	2,036	1,909
Accrued restructuring charges	43	
Deferred rent, current	855	793
Other	729	858
	\$ 5,980	\$ 5,400

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In October 2007, the Company entered into an agreement for office facilities consisting of approximately 10,560 square feet under an operating lease, which began on January 1, 2008. This agreement, as amended, expires in August 2016.

In October 2008, the Company entered into an agreement for office facilities consisting of approximately 66,096 square feet under an operating lease, which began on March 1, 2009 and expires in August 2016.

In April 2011, the Company entered into an agreement for office facilities consisting of approximately 19,334 square feet under an operating lease, which began on July 15, 2011 and expires in March 2013. In connection with the restructuring plan (see Note 12), the Company vacated these facilities in July 2012. In October 2012, the Company negotiated with the landlord to terminate the agreement effective October 31, 2012.

The Company recognizes rent expense on a straight-line basis over the non-cancellable lease term and records the difference between cash rent payments and the recognition of rent expense as a deferred rent liability. Where leases contain escalation clauses, rent abatements and/or concessions, such as rent holidays and landlord or tenant incentives or allowances, the Company applies them in the determination of straight-line rent expense over the lease term. Rent expense for both the three months ended September 30, 2012 and 2011 was \$0.6 million. For the nine months ended September 30, 2012 and 2011 rent expense was \$1.9 million and \$1.6 million, respectively.

Future minimum lease payments under these non-cancellable operating leases as of September 30, 2012 are as follows:

	(in thousands)
Years ending December 31,	
2012 (three months remaining)	\$ 699
2013	2,861
2014	2,940
2015	3,020
2016	2,065
Total future minimum lease payments	\$ 11,585

Convertible Subordinated Promissory Note

On September 15, 2012, in connection with the Merger Agreement (see Note 2), the Company, BGI and the Lender entered into the Note.

Pursuant to the terms of the Note, the Company may draw up to an aggregate principal amount of \$30 million. The first draw in the amount of \$6 million was funded by the Lender as of September 30, 2012. The Company may make one additional draw per calendar month beginning in November 2012 subject to certain conditions, including the Merger Agreement being in full force and the absence of certain events of default. All amounts drawn under the Note shall bear interest at six percent (6%) per annum and the Note will mature on the earlier of September 30, 2014, the occurrence of a change in control or an event of default. The Company may voluntarily prepay all or any part of the interest and/or principal borrowings without premium or penalty. The Note is unsecured, and the Lender has entered into subordination agreements with Oxford Finance LLC (Oxford) and ATEL Ventures, Inc. (ATEL and together with Oxford, the Senior Lenders) whereby the Lender has agreed to subordinate its indebtedness under the Note to the indebtedness owed by the Company to the Senior Lenders. The loan proceeds from the Note will be used to fund the Company's operating losses, working capital and capital expenditure requirements.

All amounts outstanding under the Note may be convertible at any time after the termination of the Merger Agreement into common stock of the Company at the Offer Price per the Merger Agreement of \$3.15 per share. If a change of control occurs, the Lender may elect to have such conversion occur upon such change of control. Upon a conversion of all amounts outstanding under the Note, the Company is required to prepare, within 30 days from such conversion, a registration statement on Form S-3 with respect to all of the converted shares, and use commercially reasonable efforts to cause such registration statement to be declared effective. In addition to the foregoing registration right, subject to certain exceptions, if the Company registers any shares of its common stock, the Lender will have the right to include any converted shares in such registration.

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The Note also contains covenants that restrict the Company's ability to, among other things, incur or assume certain debt, merge or consolidate, materially change the nature of its business, make certain investments, acquire or dispose of assets, make guaranties or grant liens on its assets, make certain loans, advances or investments, declare dividends or make distributions or enter into transactions with affiliates. The Company may incur indebtedness that is subordinated to the indebtedness under the Note.

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The events of default under the Note include payment defaults, material breaches of covenants, bankruptcy events and the occurrence of an event of default that continues under that certain Loan and Security Agreement between the Company and Oxford dated as of March 25, 2011, as amended (the Oxford Loan Agreement). In the case of a continuing event of default, the Lender may, declare due all unpaid principal amounts outstanding and exercise other customary remedies, subject in each case to the Subordination Agreements.

At September 30, 2012, the Company had borrowings of \$6.0 million under the Note, which approximates the fair value of the Note based on available market data, were classified as a current liability. The Company reviewed various terms under the Note for potential embedded derivatives and determined that no terms required separate bifurcation and valuation.

Term Loans

On December 17, 2010, the Company entered into a loan and security agreement with ATEL. On March 25, 2011, the Company entered into the Oxford Loan Agreement.

Atel Loan Agreement

The loan and security agreement with ATEL (the Atel Loan Agreement) consists of a \$6.0 million term loan for equipment purchases. Under the terms of the Atel Loan Agreement, the term loan balance is repaid in 36 equal monthly payments of principal and interest. Interest accrues on the term loan at a rate of 11.26% per annum. The outstanding borrowings under the term loan are collateralized by a senior priority interest in certain of our current property and equipment, and all property and equipment that was purchased during the term of the Atel Loan Agreement. In connection with entering into the loan and security agreement with Oxford, the Company and ATEL made certain administrative and technical amendments to the Atel Loan Agreement.

In connection with the Atel Loan Agreement, the Company issued to ATEL a warrant to purchase 49,834 shares of common stock at an exercise price of \$7.224 per share. The warrant was exercised in full on June 17, 2011.

The Atel Loan Agreement contains customary representations and warranties, covenants, including closing and advancing conditions, events of defaults and termination provisions. The affirmative covenants include, among other things, that the Company maintains certain cash account balances, and liability and other insurance, and that the Company pledges security interests in any ownership interest of a future subsidiary. The negative covenants preclude the Company from, among other things, disposing of certain assets, engaging in any merger or acquisition, incurring additional indebtedness, encumbering any collateral, paying dividends or making prohibited investments, in each case without the prior consent of ATEL, or defaulting under the term loan with Oxford (described below). In February 2012, the Company determined that it violated a covenant in the Atel Loan Agreement because its audited 2011 consolidated financial statements contained an explanatory paragraph regarding substantial doubt about the Company's ability to continue as a going concern in the opinion on the financial statements from the Company's independent registered public accounting firm. The Atel Loan Agreement was amended to include, among other things, a waiver for this covenant violation.

Oxford Loan Agreement

The Oxford Loan Agreement provides for a term loan of \$20.0 million. The outstanding balance of the term loan must be repaid in full by October 1, 2014 (the Maturity Date). Under the terms of the Oxford Loan Agreement, the outstanding balance accrues interest at a rate of 9.80% per annum. Until May 1, 2012 (the Amortization Date), the Company made monthly payments equal to the accrued interest on the outstanding loan balance. After the Amortization Date and through the Maturity Date the outstanding loan balance will be repaid in thirty (30) equal monthly payments of principal and interest.

As a condition to the Oxford Loan Agreement, a portion of the term loan was used to repay the remaining balance of \$7.4 million on the existing term loan agreement with Comerica Bank. Following repayment of the outstanding indebtedness, the Comerica Loan Agreement was terminated. The Oxford Loan Agreement is secured by a senior priority on all of the Company's assets, excluding its intellectual property and those assets securing borrowings under the Atel Loan Agreement. In addition, the Company agreed not to pledge its intellectual property to another entity without Oxford's approval or consent.

In connection with the entry into the Oxford Loan Agreement, the Company issued to Oxford warrants to purchase an aggregate of 160,128 shares of its common stock (the Warrant Shares) at an exercise price of \$7.495 per share. The warrants expire on the seventh anniversary of the issuance date. The Company also agreed to use best efforts to provide Oxford certain registration rights covering the Warrant Shares.

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The Oxford Loan Agreement contains customary representations and warranties, covenants, closing and advancing conditions, events of defaults and termination provisions. The affirmative covenants include, among other things, that the Company timely files taxes, maintain certain operating accounts subject to control agreements in favor of Oxford, maintain liability and other insurance, and pledge security interests in any ownership interest of a future subsidiary. The negative covenants preclude, among other things,

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disposing of certain assets, engaging in any merger or acquisition, incurring additional indebtedness, encumbering any collateral, paying dividends or making prohibited investments, in each case, without the prior consent of Oxford. The Oxford Loan Agreement provides that an event of default will occur if (1) there is a material adverse change in the Company's business, operations or condition (financial or otherwise), (2) there is a material impairment in the prospects of the Company repaying any portion of its obligations under the term loan, (3) there is a material impairment in the value of the collateral pledged to secure its obligations under the agreement or in Oxford's perfection or priority over the collateral, (4) the Company defaults in the payment of any amount payable under the agreement when due, or (5) the Company breaches any negative covenant or certain affirmative covenants in the agreement (subject to a grace period in some cases). The repayment of the term loan is accelerated following the occurrence of an event of default or otherwise, which would require the Company to immediately pay an amount equal to the sum of: (i) all outstanding principal plus accrued but unpaid interest, (ii) the prepayment fee, (iii) the final payment, plus (iv) all other sums, that have become due and payable but have not been paid, including interest at the default rate with respect to any past due amounts. In February 2012, the Company determined that it violated a covenant in the Oxford Loan Agreement because its audited 2011 consolidated financial statements contained an explanatory paragraph regarding substantial doubt about the Company's ability to continue as a going concern in the opinion on the financial statements from the Company's independent registered public accounting firm. The Oxford Loan Agreement was amended to include, among other things, a waiver for this covenant violation.

Amendment to Oxford Loan Agreement

On September 15, 2012, in connection with the Note entered into between the Company, BGI and the Lender as a result of the Merger Agreement (see Note 2), Oxford and the Company agreed to amend the Oxford Loan Agreement, whereby the Company agreed to maintain a minimum liquidity ratio covenant. The ratio requires the Company to maintain a cash and cash equivalents balance equal to at least 90% of the outstanding indebtedness owed to Oxford and ATEL. Failure to comply with the minimum liquidity covenant will be an event of default under the Oxford Loan Agreement and if uncured will result in an event of default under the Atel Loan Agreement.

Management believes that, without continued funding from BGI under the Note, based on the current level of operations and anticipated growth, cash and cash equivalents balances, including interest income the Company will earn on these balances, will not be sufficient to meet the anticipated cash requirements beyond January 31, 2013. Accordingly, amounts due under the Atel Loan Agreement and the Oxford Loan Agreement, as well as, the borrowings under the Note with BGI, have been classified as current liabilities.

Future contractual loan payments under the Oxford and Atel loan agreements as of September 30, 2012 are as follows:

	(in thousands)
Years ending December 31,	
2012 (three months remaining)	\$ 3,045
2013	11,202
2014	8,295
Total payments	22,542
Less:	
Cash interest payment and balloon payment accretion	2,477
Unamortized portion of value of warrants issued in connection with Atel and Oxford loans	629
Total principal payments - notes payable	\$ 19,436

Contingencies

The Company is subject to claims and assessments from time to time in the ordinary course of business. The Company's management does not believe that any such matters, individually or in the aggregate, will have a material adverse effect on the Company's business, financial condition, results of operations or cash flows.

Indemnification

In the normal course of business, the Company enters into contracts and agreements that contain a variety of representations and warranties and provide for general indemnifications. The Company's exposure under these agreements is unknown because it involves claims that may be made

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against the Company in the future, but that have not yet been made. To date, the Company has not paid any claims or been required to defend any action related to its indemnification obligations. However, the Company may record charges in the future as a result of these indemnification obligations.

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In accordance with its Certificate of Incorporation and Bylaws, as well as Indemnification Agreements, the Company has indemnification obligations to its officers and directors for certain events or occurrences, subject to certain limits, while they are serving at the Company's request in such capacity. There have been no claims to date, and the Company has director and officer insurance that enables it to recover a portion of certain amounts paid for future potential claims.

Legal Proceedings

On August 3, 2010, a patent infringement lawsuit was filed by Illumina, Inc. and Solexa, Inc. (an entity acquired by Illumina), or the plaintiffs, against the Company, in the U.S. District Court for Delaware. The U.S. District Court in Delaware subsequently granted the Company's motion to transfer the case to the U.S. District Court for the Northern District of California. The case caption is *Illumina, Inc. and Solexa, Inc. v. Complete Genomics, Inc.*, Civil Action No. 3:10-cv-05542. The complaint alleges that Complete Genomics' Analysis Platform, and in particular the combinatorial probe anchor ligation technology, infringes upon three patents held by Illumina and Solexa. The plaintiffs seek unspecified monetary damages and injunctive relief. On September 23, 2010, the Company filed an answer to the complaint as well as its counterclaims against the plaintiffs. On May 5, 2011, the Court entered a stipulated order to dismiss two patents from the lawsuit. The dismissal is without prejudice but includes conditions on the plaintiffs' ability to file lawsuits on these patents, including a limitation that the plaintiffs may not re-file such lawsuits against the Company until the later of (1) August 1, 2012, or (2) the exhaustion of all appeal rights in both (a) the pending reexaminations in the U.S. Patent and Trademark Office and (b) the pending civil litigation in which these patents are also asserted, *Life Technologies Corp. v. Illumina*, Case No. 3:11-cv-00703 (S.D. Cal.). On October 18, 2012, the Court granted partial summary judgment in favor of the Company, declaring certain claims in the remaining patent to be invalid. The Company believes that it has substantial and meritorious defenses to the plaintiffs' remaining claims and intends to vigorously defend its position. However, if the Company is found to infringe one or more valid claims of a patent-in-suit and if the Court grants an injunction, the Company may be forced to redesign portions of its sequencing process, seek a license, cease the infringing activity and/or pay monetary damages. A negative outcome in this matter could therefore have a material adverse effect on the Company's financial position, results of operations, cash flows and business. In addition, the Company has incurred and anticipates that it will continue to incur significant expense and invest substantial time in defending against these claims. The Company is not currently able to estimate the potential loss, if any, that may result from this litigation.

On June 15, 2012, a second patent infringement lawsuit was filed by Illumina, Inc. and Illumina Cambridge Ltd. (a subsidiary of Illumina), or the plaintiffs, against the Company, in the U.S. District Court for the Southern District of California. The case caption is *Illumina, Inc. and Illumina Cambridge Ltd. v. Complete Genomics, Inc.*, Civil Action No. 12CV1465 AJB BGS. The complaint alleges that Complete Genomics' Analysis Platform infringes upon one patent held by Illumina. The plaintiffs seek unspecified monetary damages (including treble damages) and injunctive relief. On July 9, 2012, the Company filed an answer to the complaint as well as its counterclaims against the plaintiffs. The Company believes that it has substantial and meritorious defenses to the plaintiffs' claims and intends to vigorously defend its position. However, if the Company is found to infringe one or more valid claims of the patent-in-suit and if the Court grants an injunction, the Company may be forced to redesign portions of its sequencing process, seek a license, cease the infringing activity and/or pay monetary damages. A negative outcome in this matter could therefore have a material adverse effect on the Company's financial position, results of operations, cash flows and business. In addition, the Company anticipates that it will incur significant expense and invest substantial time in defending against these claims. The Company is not currently able to estimate the potential loss, if any, that may result from this litigation.

On September 15, 2012, the Company entered into the Merger Agreement with BGI and the Purchaser, pursuant to which the Purchaser commenced the Offer (see Note 2). Beginning on September 20, 2012 and through October 1, 2012, eight separate alleged class action lawsuits were filed against the Company, each of its directors, BGI, and the Purchaser, by purported stockholders of the Company. Four of those lawsuits were filed in the Court of Chancery of the State of Delaware, and the other four were filed in the Superior Court for the State of California, County of Santa Clara. Each of those lawsuits purports to be brought individually and on behalf of the public stockholders of the Company and alleges claims for breaches of fiduciary duties against the Company's directors in connection with the Offer and that the Company and BGI aided and abetted the purported breaches of fiduciary duties. Each lawsuit seeks, among other things, preliminary and permanent injunctive relief prohibiting consummation of the Offer, rescission of the Merger Agreement and an award of attorneys' fees and costs. The Company believes that it has substantial and meritorious defenses to the plaintiffs' claims and intends to vigorously defend its position. However, a negative outcome in any of these lawsuits could therefore have a material adverse effect on the Company's financial position, results of operations, cash flows and business if it results in preliminary or permanent injunctive relief or rescission of the Merger Agreement. In addition, although the Company has directors and officers liability insurance, the Company has incurred and anticipates that it will continue to incur significant expense within its self-insured retention under that insurance. The Company is not currently able to estimate the potential outcome of any of these lawsuits.

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From time to time, the Company may become involved in other legal proceedings and claims arising in the ordinary course of its business. Other than as described above, the Company is not currently a party to any legal proceedings the outcome of which, if determined adversely to the Company, would individually or in the aggregate has a material adverse effect on its financial position, results of operations, cash flows or business.

9. COMMON STOCK

On March 8, 2012, the Company entered into an At Market Issuance Sales Agreement (the "ATM Agreement") with MLV & Co. LLC ("MLV"), which provides that, upon the terms and subject to the conditions and limitations set forth therein, the Company may

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sell from time to time, at its option, shares of its common stock through MLV, as its sales agent. On March 12, 2012, the Company filed a prospectus supplement with the Securities and Exchange Commission to its currently effective Registration Statement on Form S-3 (File No. 333- 178728) with respect to the sale of up to an aggregate of \$30.0 million of the Company's common stock through MLV pursuant to the ATM Agreement. The Company is required to pay MLV a commission of up to 3% of the gross proceeds from the sale of shares of its common stock pursuant to the ATM Agreement and provide MLV with customary indemnification rights. As of September 30, 2012, the Company had received proceeds of \$1.2 million from the sale of an aggregate of 398,047 shares of common stock through MLV and had \$28.8 million of its common stock remaining available to issue and sell under its current prospectus supplement relating to the ATM Agreement. As a result of certain covenants in the Merger Agreement entered into between the Company and BGI (see Note 2), the Company ceased the sale of shares of its common stock under the ATM Agreement.

10. WARRANTS FOR COMMON STOCK

In March 2011, the Company issued a warrant to purchase 160,128 shares of common stock at an exercise price of \$7.495 per share in connection with the Oxford Loan Agreement. The warrant expires on the seventh anniversary of its issuance date. The initial fair value of the warrant was calculated using the Black-Scholes option pricing model with the following assumptions: seven year contractual term; 75.01% volatility; 0% dividend rate; and a risk-free interest rate of 2.87%. The fair value of the warrant was determined to be \$1.0 million and was recorded as equity in additional paid-in capital and a discount to the carrying value of the loan. All of the warrants remain outstanding at September 30, 2012. The discount is being amortized to interest expense using the effective interest rate method over the 42-month term of the loan.

In December 2010, the Company issued a warrant to purchase 49,834 shares of common stock at an exercise price of \$7.224 per share in connection with the Atel Loan Agreement. The warrant expires on the tenth anniversary of its issuance date. The initial fair value of the warrant was calculated using the Black-Scholes option pricing model with the following assumptions: 10 year contractual term; 76.2% volatility; 0% dividend rate; and a risk-free interest rate of 3.33%. The fair value of the warrant was determined to be \$0.3 million and was recorded as a liability and a discount to the carrying value of the loan. The fair value of the warrant was recorded as a liability due to certain mandatory redemption features at the option of the holder. The discount was being amortized to interest expense using the effective interest rate method over the three-year term of the loan. These warrants were marked to market each reporting period until they were exercised. The final mark to market revaluation of the warrants occurred on June 17, 2011, the date the warrants were exercised.

11. STOCK-BASED COMPENSATION*Stock-based Compensation Plans*

The number of shares reserved for issuance under the 2010 Equity Incentive Award Plan (the "2010 Plan") and the Employee Stock Purchase Plan (the "ESPP") increased by 1,300,000 shares and 668,192 shares, respectively, effective January 1, 2012. As of September 30, 2012, there were 2,256,501 and 1,397,308 shares available to be granted under the 2010 Plan and the ESPP, respectively.

Compensation Expense

During the three and nine months ended September 30, 2012 and 2011, the Company granted stock options to purchase common stock and restricted stock units as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands, except share and per share amounts)			
Number of options granted to non-employees	4,000		8,000	
Number of options granted to employees	3,000	204,950	1,507,078	1,751,950
Weighted-average grant date fair value per share of options granted to employees	\$ 1.72	\$ 6.98	\$ 2.04	\$ 7.39
Total fair value of options granted to employees that vested	\$ 653	\$ 970	\$ 3,579	\$ 1,963
Number of restricted stock units granted to employees	30,000		1,250,000	
Weighted-average grant date fair value per share of restricted stock units	\$ 2.53	\$	\$ 2.11	\$

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The following table summarizes stock-based compensation expense from stock option and restricted stock unit awards to employees, directors and nonemployees as well as from employee purchase rights under the ESPP for the three and nine months ended September 30, 2012 and 2011:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(in thousands)			
Employee awards	\$ 1,717	\$ 1,327	\$ 4,712	\$ 2,844
Nonemployee awards	8	11	13	61
Total stock-based compensation expense	\$ 1,725	\$ 1,338	\$ 4,725	\$ 2,905

As of September 30, 2012, the Company had unrecognized stock-based compensation expense related to unvested stock options and restricted stock units of \$9.2 million, which is expected to be recognized over the remaining weighted-average vesting period of 2.4 years.

12. RESTRUCTURING CHARGES

On June 5, 2012, the Company announced a restructuring plan (the Q2 2012 Plan) to reduce headcount, vacate one of its leased buildings and defer capital expenditures in an effort to reduce cash consumption. In June 2012, the Company notified approximately 55 employees of their involuntary termination. As a result of the reduction in headcount, the Company recorded a restructuring charge in the second quarter of 2012 of \$1.5 million, consisting of \$1.4 million in employee severance benefits and \$0.1 million related to contract cancellation charges and cancelled marketing program costs. In July 2012, the Company vacated one of its leased buildings (the lease for which terminated effective October 31, 2012 (see Note 8)) and recorded \$0.2 million of lease termination costs as a restructuring charge in the third quarter of 2012. The Company measured the employee termination and lease termination costs at fair value.

The Company recorded a restructuring charge of \$0.1 million and \$1.6 million for the three and nine months ended September 30, 2012, respectively associated with the Q2 2012 Plan. The restructuring charge for the three months ended September 30, 2012 was comprised of \$0.2 million in lease termination costs and a reduction in employee severance benefits of \$0.1 million. The restructuring charge for the nine months ended September 30, 2012 was comprised of \$1.3 million in employee severance benefits, \$0.2 million in lease termination costs, and \$0.1 million in contract cancellation charges and cancelled marketing program costs.

As a result of the Q2 2012 Plan to defer capital expenditures, the Company reassessed the estimated useful lives of its sequencing equipment and determined that the equipment would be used until December 2017. This change in estimate was applied prospectively from the date of the assessment. Depreciation expense for the three and nine months ended September 30, 2012 was reduced by \$1.0 million and \$1.4 million, respectively, consisting of a \$0.6 million and \$0.7 million decrease in cost of revenues for the three and nine months ended September 30, 2012, respectively.

As of September 30, 2012, the activity and liability balances related to the restructuring charge are as follows:

	Severance- related charges	Lease Termination Costs	Other	Total
Q2 2012 Plan	\$ 1,391	\$ 216	\$ 105	\$ 1,712
Cash payments	(1,276)	(216)	(35)	(1,527)
Non-cash charges			(70)	(70)
Adjustments	(72)			(72)
Balance as of September 30, 2012	\$ 43	\$	\$	\$ 43

At September 30, 2012, the restructuring liability outstanding was included in accrued liabilities in the Condensed Consolidated Balance Sheet. The Company expects the restructuring liability outstanding at September 30, 2012 to be substantially paid by the end of 2012.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This Quarterly Report on Form 10-Q contains 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 (the Exchange Act), which are subject to the safe harbor created by those sections. Forward-looking statements are based on our management's beliefs and assumptions and on information currently available to our management. All statements other than statements of historical factors are forward-looking statements for purposes of these provisions. In some cases you can identify forward-looking statements by terms such as may, will, should, could, would, expect, plan, anticipate, believe, estimate, project, predict, and potential, and similar expressions intended to identify forward-looking statements. Such forward-looking statements are subject to risks, uncertainties and other important 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 identified below, and those discussed in the section titled Risk Factors in this report. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Overview

We are a life sciences company that has developed and commercialized a DNA sequencing platform for whole human genome sequencing and analysis. In the DNA sequencing industry, whole human genome sequencing is generally deemed to be coverage of at least 90% of the nucleotides in the genome. Our goal is to become the preferred solution for whole human genome sequencing and analysis. Our Complete Genomics Analysis Platform, or CGA Platform, combines our proprietary human genome sequencing technology with our advanced informatics and data management software and our innovative, end-to-end, outsourced service model to provide our customers with data that is immediately ready to be used for genome-based research. We believe that our solution can provide academic, biopharmaceutical, and translational medicine researchers with whole human genome data and analysis at an unprecedented combination of quality, cost and scale without requiring them to invest in in-house sequencing instruments, high-performance computing resources and specialized personnel. By removing these constraints and broadly enabling researchers to conduct large-scale complete human genome studies, we believe that our solution has the potential to advance medical research and expand understanding of the basis, treatment and prevention of complex diseases.

We have targeted our complete human genome sequencing service at academic, governmental and other research institutions, as well as biopharmaceutical and healthcare organizations. We perform our sequencing service at our Mountain View, California headquarters facility, which began commercial operation in May 2010. In the near term, we expect to use our available capital to fund our research and development initiatives, obtain and maintain CLIA certification to supply sequenced genomes to clinical customers, and eventually grow our sales and marketing and general and administrative organization and expand our sequencing capacity to support our commercial operations and anticipated growth.

Our ability to generate revenue, and the timing of our revenue, will depend on generating new orders and contracts, receiving qualified DNA samples from customers and the rate at which we can convert our backlog of sequencing orders into completed and delivered data and the price per genome contracted with the customer. We define backlog as the number of genomes for which customers have placed orders or entered into contracts with volume estimates that we believe are firm and for which no revenue has yet been recorded. As of September 30, 2012, we had a backlog of orders for sequencing approximately 3,800 genomes, which we believe could contribute approximately \$18.0 million toward revenue over the next 12 months. The speed with which we can convert orders into revenue depends principally on:

the speed with which our customers provide us with qualified samples after submitting an order;

the rate at which our system can sequence a genome; and

the rate at which all significant contractual obligations are fulfilled.

Changes in these variables (or orders cancellations or reductions) will cause our results of operations to fluctuate, perhaps significantly. We also have a very limited history to guide us in predicting variables like equipment and/or operating failure, throughput yield, customer delivery of qualified genomic samples and other factors that could affect revenue.

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Although we do not anticipate any material seasonal effects, given our limited operating history as a revenue generating company, our sales cycle is uncertain. A limited number of customers accounted for all of the revenue we recognized for the nine months ended September 30, 2012, with National Cancer Institute and Inova Translational Medicine Institute accounting for approximately 21% and 18% of this revenue, respectively. The loss of one or more of the customers named above could have a material adverse effect on our future results of operations.

We have not been profitable in any period since we were formed. We incurred net losses of \$18.0 million and \$21.6 million for the three months ended September 30, 2012 and 2011, respectively. Also, we incurred net losses of \$57.0 million and \$50.0 million for the nine months ended September 30, 2012 and 2011, respectively. As of September 30, 2012, our accumulated deficit was \$268.2 million. We believe that without continued funding from BGI under the Note, based on our current level of operations and anticipated growth, our

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cash and cash equivalents balances, including interest income we earn on these balances, will not be sufficient to meet our anticipated cash requirements beyond January 31, 2013. Our recurring operating losses and negative cash flow from operations and our requirement for additional funding to execute our business objectives beyond this period gives rise to substantial doubt as to our ability to continue as a going concern.

On June 5, 2012, we announced a restructuring plan to reduce headcount, vacate one of our leased buildings and defer capital expenditures in an effort to reduce cash consumption. In June 2012, we notified approximately 55 employees of their involuntary termination. In July 2012, we vacated one of our leased buildings (the lease for which expires in November 2012). We measured the restructuring charges at fair value. As a result of the restructuring plan, we recorded a restructuring charge of \$0.1 million and \$1.6 million for the three and nine months ended September 30, 2012, respectively. The restructuring charge for the three months ended September 30, 2012 was comprised of \$0.2 million in lease termination costs and a reduction in employee termination costs of \$0.1 million. The restructuring charge for the nine months ended September 30, 2012 was comprised of \$1.3 million in employee severance benefits, \$0.2 million in lease termination costs and \$0.1 million in contract cancellation charges and cancelled marketing program costs. These amounts are being funded by our available working capital. As a result of the reductions in headcount and the termination of the building lease, we expect to realize approximately \$8.0 million of annualized savings.

We also announced in connection with this restructuring plan that we would focus on development of clinical applications for our whole human genome sequencing service, while continuing to provide high-quality genomes to research customers. We will maintain our current monthly manufacturing capacity of approximately 1,000 genomes at 40x coverage or 500 genomes at 80x coverage and delay capacity expansion until demand for clinical-grade genomes supports expansion. The delay in expanding capacity will defer capital expenditures. As a result of the plan to defer capital expenditures, we reassessed the estimated useful lives of our sequencing equipment and determined that the equipment would be used until December 2017. This change in estimate was applied prospectively from the date of the assessment. Depreciation expense for the three and nine months ended September 30, 2012 was reduced by \$1.0 million and \$1.4 million, respectively, consisting of a \$0.6 million and \$0.7 million decrease in cost of revenues for the three and nine months ended September 30, 2012, respectively.

Merger

On September 15, 2012, the Company, BGI and the Purchaser entered into the Merger Agreement, pursuant to which BGI, through the Purchaser, commenced the Offer to acquire all of the outstanding Shares for the Offer Price net to the selling stockholders in cash, without interest. Following successful consummation of the Offer and satisfaction of certain conditions, the Merger will occur, with the Company surviving as a wholly owned subsidiary of BGI. The Offer commenced on September 25, 2012, was extended on October 22, 2012 and is currently scheduled to expire at midnight, New York City time, on November 21, 2012, subject to extension in certain circumstances as required or permitted by the Merger Agreement, the SEC or applicable law.

Completion of the Offer is subject to several conditions, including (i) that a majority of the Shares outstanding (determined on a fully diluted basis) be validly tendered and not validly withdrawn prior to the expiration of the Offer; (ii) the expiration or termination of any applicable waiting period relating to the Offer, the Merger or the other transactions contemplated by the Merger Agreement under the HSR Act; (iii) the approval of each of the Ministry of Commerce of the PRC, the National Development and Reform Commission of the PRC and the State Administration of Foreign Exchange of the PRC; (iv) CFIUS shall have notified BGI and the Company in writing that it has determined not to investigate the transactions contemplated by the Merger Agreement (including the Offer and the Merger) pursuant to the powers vested in it by the Exon-Florio Amendment to the Defense Production Act of 1950 or, in the event that CFIUS has undertaken such an investigation, CFIUS has terminated such investigation or the President of the United States has determined not to take any action to suspend or prohibit the transactions contemplated by the Merger Agreement; (v) the absence of a material adverse effect on the Company; and (vi) certain other customary conditions.

Upon completion of the Merger, each Share outstanding immediately prior to the effective time of the Merger (excluding those Shares that are held by (i) BGI, the Purchaser, the Company or their respective subsidiaries or (ii) stockholders of the Company who properly exercised their appraisal rights under the Delaware General Corporation Law) will be converted into the right to receive the Offer Price.

If the Purchaser holds 90% or more of the outstanding Shares following the completion of the Offer, the parties will effect the Merger as a short-form merger without the need for approval by the Company's stockholders. Otherwise, the Company may hold a special stockholders meeting to obtain stockholder approval of the Merger. Subject to the terms of the Merger Agreement, applicable law and the number of authorized and unissued Shares available under the Company's certificate of incorporation, the Company has granted the Purchaser the Top-Up Option, exercisable after completion of the Offer, to purchase the Top-Up Shares from the Company as necessary so that BGI and the Purchaser own one Share more than 90% of the total Shares outstanding immediately after the issuance of the Top-Up Shares on a fully diluted basis. The Purchaser will pay the Offer Price for each Share acquired through exercise of the Top-Up Option, with the Purchaser paying the Company the aggregate par value of the Top-Up Shares in cash and the balance of the aggregate price by delivery of a promissory note.

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The Company and BGI have made customary representations, warranties and covenants in the Merger Agreement, including covenants (i) to promptly as practicable effect all registrations, filings and submissions required pursuant to the HSR Act and any other required governmental approvals, the Securities Exchange Act of 1934, as amended, and other applicable laws with respect to the Offer and the Merger; and (ii) to use reasonable best efforts to take all appropriate action to consummate and effectuate the transactions contemplated by the Merger Agreement.

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The Company has agreed to conduct its business in all material respects in the ordinary course consistent with past practice, including not taking certain specified actions, prior to consummation of the Merger.

The Company has agreed not to solicit, initiate, seek, or knowingly encourage or facilitate any alternative proposals for the acquisition of the Company, or take any action to solicit, initiate, seek or knowingly encourage or facilitate any inquiry, expression of interest, proposal or offer that constitutes or could reasonably be expected to lead to any alternative proposal for the acquisition of the Company. However, subject to the satisfaction of certain conditions, the Company and its board of directors, as applicable, would be permitted to take certain actions which may, as more fully described in the Merger Agreement, include changing the board of directors' recommendation following receipt of an unsolicited proposal, if the board of directors of the Company has concluded in good faith after consultation with its outside legal counsel that failure to do so would reasonably be expected to breach the fiduciary duties owed by the board of directors to the Company's stockholders under Delaware law. In addition, the board of directors would be permitted to change its recommendation, for reasons not related to the receipt of an unsolicited proposal, in response to an unforeseen event that occurred after signing the Merger Agreement if the board of directors has concluded in good faith after consultation with the Company's outside legal counsel and its independent financial advisor that in light of the unforeseen event the failure to make such change in recommendation would reasonably be expected to breach the fiduciary duties owed by the board of directors to the Company's stockholders under Delaware law.

The Merger Agreement, which has been unanimously adopted by the Company's board of directors, can be terminated by BGI or the Company under certain circumstances, and the Company will be required to pay BGI a termination fee of \$4.0 million plus 4% of any amounts drawn under the Note in connection with certain terminations.

In connection with the Merger Agreement, the Company, BGI and the Lender entered into the Note. Pursuant to the terms of the Note, the Company has drawn \$6.0 million as of September 30, 2012, and may draw up to an aggregate principal amount of \$30.0 million (see *Liquidity and Capital Resources*).

The foregoing description of the Offer, Merger, Merger Agreement and Note is only a summary, does not purport to be complete and is qualified in its entirety by reference to (i) the Merger Agreement and Note, copies of which are filed as Exhibits 2.1 and 10.2, respectively, to the Company's Current Report on Form 8-K filed with the SEC on September 17, 2012 and incorporated herein by reference, and are included to provide investors with information regarding their terms, and (ii) the information contained in the Tender Offer Statement on Schedule TO-T filed by BGI and the Purchaser with the SEC on September 25, 2012, as amended thereafter and as may be further amended from time to time, and the Solicitation/Recommendation Statement on Schedule 14D-9C filed by us with the SEC on September 25, 2012, as amended thereafter and as may be further amended from time to time.

Critical Accounting Policies and Estimates

Our management's discussion and analysis of our financial condition and results of operations are based on our unaudited condensed consolidated financial statements that have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of our 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 it believes to be reasonable under the circumstances. Different assumptions and judgments would change the estimates used in the preparation of our financial statements, which, in turn, could materially change the results from those reported. Our management evaluates its estimates, assumptions and judgments on an ongoing basis. Historically, our critical accounting estimates have not differed materially from actual results. However, if our assumptions change, we may need to revise our estimates, or take other corrective actions, either of which may also have a material adverse effect on our statements of operations, liquidity and financial condition.

Management determined that the decision to defer capital expenditures as part of the restructuring plan announced on June 5, 2012 was a change in circumstances that required an evaluation of the recoverability of the Company's property and equipment and patent (intellectual property). Therefore, management performed an evaluation of the recoverability of the Company's property and equipment and patent (intellectual property) by comparing the carrying value of these assets to the projected, undiscounted cash flows generated by these assets over the estimated remaining useful life of these assets. Management determined that the Company's property and equipment and patent (intellectual property) were not impaired at June 30, 2012, as the projected undiscounted cash flows exceed the carrying value. However, management cannot assure that the property and equipment and patent (intellectual property) will remain recoverable in the future.

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The following accounting policy was adopted during the three months ended June 30, 2012, in addition to the critical accounting policies described in *Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates* in our Annual Report on Form 10-K for the year ended December 31, 2011:

Restructuring Charges We measure and accrue liabilities associated with restructuring charges at fair value as of the date the restructuring plan is announced. The fair value measurement of restructuring related liabilities requires certain assumptions and estimates to be made by us. It is our policy to use the best estimates based on facts and circumstances available at the time of measurement, review the assumptions and estimates periodically, and adjust the liabilities when necessary.

Recent Adopted Accounting Standards

In May 2011, the FASB issued further guidance that generally aligns the principles of fair value measurements with International Financial Reporting Standards. The guidance clarifies the application of existing fair value measurement requirements and expands the disclosure requirements for fair value measurements, and was effective January 1, 2012. The adoption of the guidance had no effect on our financial position or results of operations.

In June 2011, the FASB issued guidance concerning the presentation of comprehensive income. The guidance gives companies the option to present total comprehensive income, components of net income, and components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance was effective January 1, 2012 and was applied retrospectively. The adoption of the guidance had no effect on our financial position or results of operations.

Results of Operations**Comparison of Three Months Ended September 30, 2012 and 2011**

The following table shows the amounts of the listed items from our statements of operations for the periods presented, showing period-over-period changes (in thousands, except for percentages).

	Three months ended September 30,		\$ Change	% Change
	2012	2011		
Revenue	\$ 7,276	\$ 4,177	\$ 3,099	74%
Cost and expenses:				
Cost of revenue	7,228	8,182	(954)	(12)%
Research and development	8,867	9,546	(679)	(7)%
Sales and marketing	3,678	3,455	223	6%
General and administrative	4,675	3,810	865	23%
Restructuring charges	144		144	*
Total costs and expenses	24,592	24,993	(401)	(2)%
Loss from operations	(17,316)	(20,816)	3,500	(17)%
Interest expense	(674)	(799)	125	(16)%
Interest and other income (expense), net	1	9	(8)	(89)%
Net loss	\$ (17,989)	\$ (21,606)	\$ 3,617	(17)%

* Increase meaningless
Revenue

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During the three months ended September 30, 2012, revenue was \$7.3 million, compared to \$4.2 million during the same period in 2011, an increase of 74%. We recognized revenue for approximately 1,900 genomes in the three months ended September 30, 2012, compared to approximately 700 genomes during the same period in 2011, a 171% increase. The increase in our revenue resulted from the significant increase in the number of genomes for which revenue was recognized, offset by the decrease in the average selling price per genome.

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During the third quarter of 2012, the average selling price per genome for revenue recognized was approximately \$3,900, compared to approximately \$5,700 during the third quarter of 2011. This decrease in price per genome was driven both by competitive pricing pressures from alternatives to whole genome sequencing, such as exome sequencing, as well as price competition from other suppliers of whole human genome sequencing services. We expect this price pressure to continue for the foreseeable future.

Cost of Revenue

During the three months ended September 30, 2012, cost of revenue was \$7.2 million, compared to \$8.2 million during the same period in 2011, a 12% decrease. The decrease in cost of revenue was achieved while recognizing revenue for approximately 171% more genomes than the same period last year. The decrease in cost of revenue was primarily a result of efficiencies gained in our sequencing processes, increases in our laboratory capacity utilization while maintaining similar fixed costs, and the change in the depreciable life of our sequencers.

Cost of revenue as a percent of revenue was 99% in the third quarter of 2012, compared to 196% in the third quarter of 2011. This decrease in cost of revenue as a percent of revenue was due to improvements in our manufacturing process and higher sequencing volume, offset by the decline in average selling price. We anticipate that these costs as a percentage of revenue will fluctuate as our capacity utilization changes, as we continue to improve and automate our sequencing process, and as the sequencing prices we charge to our customers change.

Research and Development

Research and development expenses were \$8.9 million during the three months ended September 30, 2012, compared to \$9.5 million during the three months ended September 30, 2011, representing a decrease of \$0.6 million, or 7%. The decrease in research and development expenses was primarily due to a \$0.9 million decrease in development material expenses, a \$0.6 million decrease in non-revenue genomic services, a \$0.2 million decrease in non-recurring engineering charges and a \$0.2 million decrease in facilities expenses. The overall decrease in research and development expenses was offset primarily by a \$0.4 million increase in manufacturing expenses related to research and development initiatives, a \$0.3 million increase in consulting expenses, a \$0.2 million increase in depreciation expense, a \$0.2 million write-off of fixed assets and a \$0.2 million increase in stock-based compensation expense.

We expect to continue to invest in research and development activities as we seek to enhance our sequencing processes, components and systems to improve the yield and throughput, to reduce the cost of our sequencing service and to commercialize new technologies that will lower costs and increase accuracy of our sequencing services.

Sales and Marketing

Sales and marketing expenses were \$3.7 million during the three months ended September 30, 2012, compared to \$3.5 million during the three months ended September 30, 2011, representing an increase of \$0.2 million, or 6%. The increase in sales and marketing expenses was due primarily to expenses incurred of \$0.7 million for genome sequencing services performed for marketing purposes during the third quarter of 2012 and a \$0.2 million increase in employee salaries and benefits expense. The overall increase in sales and marketing expenses was partially offset by a \$0.2 million decrease in marketing promotion expenses, a \$0.2 million decrease in consulting expenses, a \$0.1 million decrease in travel and entertainment expenses and a \$0.1 million decrease in recruiting fees.

General and Administrative

General and administrative expenses were \$4.7 million for the three months ended September 30, 2012, compared to \$3.8 million for the three months ended September 30, 2011, representing an increase of \$0.9 million, or 23%. The increase in general and administrative expenses was primarily due to a \$0.9 million increase in outside service expenses related principally to investment banking fees incurred in connection with our review of strategic alternatives during the third quarter of 2012 and a \$0.1 million increase in facility expenses, partially offset by a \$0.2 million decrease in legal expenses.

Restructuring Charges

On June 5, 2012, we announced a restructuring plan (the Q2 2012 Plan) to reduce headcount, vacate one of our leased buildings and defer capital expenditures in an effort to reduce cash consumption. In July 2012, we vacated one of our leased buildings (the lease for which terminated effective October 31, 2012). As a result of the Q2 2012 Plan, we recorded a \$0.1 million restructuring charge for the three months ended September 30, 2012 which consisted of \$0.2 million of lease termination costs and a \$0.1 million reduction in employee severance benefits costs. We expect the remaining restructuring charges of approximately \$43,000 to be substantially paid by the end of 2012.

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During the three months ended September 30, 2012, we incurred interest expense of \$0.7 million compared to \$0.8 million during the three months ended September 30, 2011. The decrease in interest expense between the two periods was primarily due to lower debt balances related to our loans.

Interest and Other Income (Expense), Net

Interest and other income (expense), net, for the three months ended September 30, 2012 was income of \$1,000 compared to \$9,000 for the three months ended September 30, 2011. The change between the two periods was primarily due to the lower cash and cash equivalents and marketable securities balances.

Comparison of Nine Months Ended September 30, 2012 and 2011

The following table shows the amounts of the listed items from our statements of operations for the periods presented, showing period-over-period changes (in thousands, except for percentages).

	Nine months ended September 30,		\$ Change	% Change
	2012	2011		
Revenue	\$ 19,877	\$ 16,875	\$ 3,002	18%
Cost and expenses:				
Cost of revenue	20,648	20,886	(238)	(1)%
Research and development	26,506	24,382	2,124	9%
Sales and marketing	13,573	9,293	4,280	46%
General and administrative	12,392	10,058	2,334	23%
Restructuring charges	1,640		1,640	*
Total costs and expenses	74,759	64,619	10,140	16%
Loss from operations	(54,882)	(47,744)	(7,138)	15%
Interest expense	(2,173)	(1,949)	(224)	11%
Interest and other income (expense), net	7	(333)	340	(102)%
Net loss	\$ (57,048)	\$ (50,026)	\$ (7,022)	14%

* Increase meaningless

Revenue

During the nine months ended September 30, 2012, revenue was \$19.9 million, compared to \$16.9 million during the same period in 2011, an 18% increase. We recognized revenue for approximately 4,900 genomes during the nine months ended September 30, 2012, compared to approximately 2,400 genomes during the same period in 2011, an increase of 104%. The significant increase in the number of genomes for which revenue was recognized during the nine months ended September 30, 2012 was partially offset by the decrease in the average selling price per genome.

During the first nine months of 2012, the average selling price per genome for revenue recognized was approximately \$4,000, compared to approximately \$7,100 during the first nine months of 2011, a 44% decrease. This decrease in price per genome was driven both by competitive pricing pressures from alternatives to whole genome sequencing, such as exome sequencing, as well as price competition from other suppliers of whole human genome sequencing services. We expect this price pressure to continue for the foreseeable future.

Cost of Revenue

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During the nine months ended September 30, 2012, cost of revenue was \$20.6 million compared to \$20.9 million during the same period in 2011, a 1% decrease. The slight decrease in cost of revenue was achieved while shipping genomic data for approximately 104% more genomes than in the same period last year. This decrease in cost of revenue was primarily a result of the efficiencies gained in our sequencing processes, increases in our laboratory capacity utilization while maintaining similar fixed costs and the change in depreciable life of our sequencers.

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Cost of revenue as a percent of revenue decreased to 104% in the first nine months of 2012, compared to 124% in the first nine months of 2011. The decrease in cost of revenue as a percent of revenue was due to the decline in our average unit costs outpacing the decline in our average selling price. We anticipate that these costs as a percentage of revenue will fluctuate as our capacity utilization changes, as we continue to improve and automate our sequencing processes, and as the sequencing prices we charge to our customers change.

Research and Development

Research and development expenses were \$26.5 million during the nine months ended September 30, 2012 compared to \$24.4 million during the nine months ended September 30, 2011, representing an increase of \$2.1 million, or 9%. The increase in research and development expenses was primarily due to a \$1.6 million increase in salaries and benefits expense resulting from increased headcount during the first six months of 2012, a \$0.7 million increase in stock-based compensation expense, a \$0.5 million increase in depreciation expense, a \$0.5 million increase in manufacturing costs in support of research and development initiatives, a \$0.4 million increase in consulting expenses and a \$0.3 million increase in facilities expenses. The increase in research and development expenses was partially offset by a \$1.2 million decrease in non-revenue genomic services, a \$0.5 million decrease in development materials and a \$0.3 million decrease in non-recurring engineering service charges.

We expect to continue to invest in research and development activities as we seek to enhance our sequencing processes, components and systems to improve the yield and throughput and to reduce the cost of our sequencing service.

Sales and Marketing

Sales and marketing expenses were \$13.6 million during the nine months ended September 30, 2012 compared to \$9.3 million during the nine months ended September 30, 2011, representing an increase of \$4.3 million, or 46%. The increase in sales and marketing expenses was due primarily to a \$2.2 million increase in employee salaries and benefits expense due to increased headcount during the first six months of 2012, \$1.8 million in genome sequencing service expenses performed for marketing purposes, a \$0.4 million increase in stock-based compensation expense and a \$0.3 million increase in facilities expenses. The overall increase in sales and marketing expenses was partially offset by a \$0.2 million decrease in marketing promotion expenses, a \$0.1 million decrease in consulting expenses and a \$0.1 million decrease in recruiting fees.

General and Administrative

General and administrative expenses were \$12.4 million for the nine months ended September 30, 2012 compared to \$10.1 million for the nine months ended September 30, 2011, representing an increase of \$2.3 million, or 23%. The increase in general and administrative expenses was primarily due to a \$0.9 million increase in outside service expenses related principally to investment banking fees incurred in connection with our review of strategic alternatives during the third quarter of 2012, a \$0.4 million increase in facilities expenses, a \$0.3 million increase in employee salaries and benefits due to increased headcount during the first six months of 2012, a \$0.2 million increase in stock-based compensation, a \$0.2 million increase in legal expenses and a \$0.2 million increase in business insurance, taxes and fees.

Restructuring Charges

On June 5, 2012, we announced a restructuring plan (Q2 2012 Plan) to reduce headcount, vacate one of our leased buildings and defer capital expenditures in an effort to reduce cash consumption. In June 2012, we notified approximately 55 employees of their involuntary termination. In July 2012, we vacated one of our leased buildings (the lease for which expires on October 31, 2012). As a result of the Q2 2012 Plan, we recorded a \$1.6 million restructuring charge for the nine months ended September 30, 2012 consisting of \$1.3 million in employee severance benefits, \$0.2 million associated with the vacated leased building and \$0.1 million related to contract cancellation charges and cancelled marketing program costs. We expect the remaining restructuring charges of approximately \$43,000 to be substantially paid by the end of 2012.

Interest Expense

During the nine months ended September 30, 2012, we incurred interest expense of \$2.2 million compared to \$1.9 million during the nine months ended September 30, 2011. The increase in interest expense was primarily due to higher debt balances outstanding during the first nine months of 2012 when compared to the same period in 2011.

Interest and Other Income (Expense), Net

Interest and other income (expense), net, for the nine months ended September 30, 2012 was an income of \$7,000 compared to expense of \$333,000 for the nine months ended September 30, 2011. The change between the two periods was primarily due to the change in the valuation of our warrant liability during the first nine months of 2011. The final mark to market revaluation of the warrants occurred on June 17, 2011,

the date the warrants were exercised.

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Liquidity and Capital Resources

Since our inception, we have generated operating losses in every quarter, resulting in an accumulated deficit of \$268.2 million as of September 30, 2012. We have financed our operations to date primarily through private placements of preferred stock and promissory notes, borrowings under our credit facilities, proceeds from our initial public offering, follow-on public offerings, term debt and convertible notes. As of September 30, 2012, we had working capital of \$2.8 million, consisting of \$48.3 million in current assets and \$45.4 million in current liabilities. As of December 31, 2011, we had working capital of \$67.3 million, consisting of \$95.2 million in current assets and \$27.9 million in current liabilities. Cash in excess of immediate operating requirements is invested primarily in money market funds in accordance with our investment policy, primarily with the goals of capital preservation and liquidity maintenance.

On September 15, 2012, in connection with the Merger Agreement, the Company, BGI and the Lender entered into the Note. Pursuant to the terms of the Note, the Company may draw up to an aggregate principal amount of \$30 million, with the first draw in the amount of \$6 million funded by the Lender as of September 30, 2012. The Company may make one additional draw per calendar month beginning in November 2012 subject to certain conditions, including the Merger Agreement being in full force and the absence of certain events of default. All amounts drawn under the Note shall bear interest at six percent (6%) per annum and the Note will mature on the earlier of September 30, 2014, the occurrence of a change in control or an event of default occurring. The Company may voluntarily prepay all or any part of the interest and/or principal borrowings without premium or penalty. The Note is unsecured and the Lender has entered into subordination agreements with the Senior Lenders whereby the Lender has agreed to subordinate its indebtedness under the Note to the indebtedness owed by the Company to the Senior Lenders. The loan proceeds from the Note will be used to fund the Company's working capital and capital expenditure requirements.

All amounts outstanding under the Note may be convertible at any time after a termination of the Merger Agreement into common stock of the Company at the Offer Price per the Merger Agreement of \$3.15 per share. If a change of control occurs, the Lender may elect to have such conversion occur upon such change of control. Upon a conversion of all amounts outstanding under the Note, the Company is required to prepare, within 30 days from such conversion, a registration statement on Form S-3 with respect to all of the converted shares, and use commercially reasonable efforts to cause such registration statement to be declared effective. In addition to the foregoing registration right, subject to certain exceptions, if the Company registers any shares of its common stock, the Lender will have the right to include any converted shares in such registration.

The Note also contains covenants that restrict the Company's ability to, among other things, incur or assume certain debt, merge or consolidate, materially change the nature of its business, make certain investments, acquire or dispose of assets, make guaranties or grant liens on its assets, make certain loans, advances or investments, declare dividends or make distributions or enter into transactions with affiliates. The Company may incur indebtedness that is subordinated to the indebtedness under the Note.

The events of default under the Note include payment defaults, material breaches of covenants, bankruptcy events and the occurrence of an event of default that continues under the Oxford Loan Agreement. In the case of a continuing event of default, the Lender may, declare due all unpaid principal amounts outstanding and exercise other customary remedies, subject in each case to the Subordination Agreements.

At September 30, 2012, the Company had borrowings outstanding of \$6.0 million under the Note that were classified as a current liability.

We believe that without continued funding from BGI under the Note, based on our current level of operations and anticipated growth, our cash and cash equivalents balances, including interest income we earn on those balances, will not be sufficient to meet our anticipated cash requirements beyond January 31, 2013. If the Merger does not occur, we may be required to significantly reduce, restructure or cease operations. The report of our independent registered public accounting firm on our consolidated financial statements for the year ended December 31, 2011 includes an explanatory paragraph stating that our recurring losses from operations and significant negative cash flow from operations raise substantial doubt on our ability to continue as a going concern.

Table of Contents***Cash Flows for the Nine Months Ended September 30, 2012 and 2011***

The following table summarizes our cash flows for the nine months ended September 30, 2012 and 2011.

	Nine months ended September 30,	
	2012	2011
	(in thousands)	
Net cash used in operating activities	\$ (43,259)	\$ (33,377)
Net cash used in investing activities	(2,944)	(56,015)
Net cash provided by financing activities	3,844	85,385
Net decrease in cash and cash equivalents	\$ (42,359)	\$ (4,007)

Operating Activities

Net cash used in operating activities was \$43.3 million during the nine months ended September 30, 2012 and consisted of a net loss of \$57.0 million and a net increase in operating assets and liabilities of \$2.1 million, offset by noncash items of \$16.0 million. Noncash items for the nine months ended September 30, 2012 consisted primarily of depreciation and amortization expense of \$10.1 million, stock-based compensation expense of \$4.7 million, noncash interest expense related to notes payable of \$0.6 million, and an increase in inventory reserves of \$0.3 million. The significant items impacting the net increase in operating assets and liabilities include increases in inventory and prepaid expenses of \$2.9 million and \$0.2 million, respectively, and decreases in deferred revenue and deferred rent of \$0.9 million and \$0.6 million, respectively. The net increase in operating assets and liabilities was partially offset by a decrease in accounts receivable of \$1.1 million and increases in accounts payable and accrued liabilities of \$0.5 million and \$0.4 million, respectively. The decrease in accounts receivable was due to improved cash collections, while the decrease in deferred revenue was due to increased revenue recognized during the third quarter of 2012. The increase in inventory was due to increased purchases of inventory to support orders in backlog and the increase in accounts payable was primarily due to the timing of receipts and payments for inventory and expenses at the end of the quarter.

Net cash used in operating activities was \$33.4 million during the nine months ended September 30, 2011 and consisted of a net loss of \$50.0 million, offset by noncash items of \$12.0 million and a net change in operating assets and liabilities of \$4.6 million. Noncash items for the nine months ended September 30, 2011 consisted primarily of the change in the fair value of our warrant liability of \$0.4 million, depreciation expense of \$8.4 million and stock-based compensation expense of \$2.9 million. The significant items in the change in operating assets and liabilities include an increase in accrued liabilities of \$2.3 million and an increase in deferred revenue of \$1.2 million, partially offset by a decrease in deferred rent of \$0.6 million. The increase in deferred revenue was due to increased advance billing arrangements during the first nine months of 2011. The increase in accrued liabilities was primarily due to employee deposits for our employee stock purchase program that began in May 2011.

Investing Activities

Net cash used in investing activities was \$2.9 million and \$56.0 million for the nine months ended September 30, 2012 and 2011, respectively. Net cash used for the nine months ended September 30, 2012 represents proceeds from the maturities of short-term investment of \$22.0 million, offset by net purchases of investments of \$16.0 million and purchases of property and equipment of \$8.9 million. Net cash used in investing activities during the nine months ended September 30, 2011 was due to the purchase of \$52.7 million in available-for-sale investments, purchases of property and equipment of \$15.6 million and the purchase of a patent for \$0.3 million. Net cash used in investing activities was offset by \$12.5 million in proceeds from maturities of available-for-sale securities. The purchases of property and equipment during the first nine months of 2012 and 2011 were primarily for sequencing and related equipment used in production.

Financing Activities

Net cash provided by financing activities during the nine months ended September 30, 2012 of \$3.8 million consisted of proceeds from the issuance of convertible notes payable of \$6.0 million, net proceeds from the issuance of common stock of \$1.1 million and proceeds from the issuance of common stock under equity incentive plans of \$1.1 million, partially offset by repayments of notes payable of \$4.3 million

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Net cash provided by financing activities during the nine months ended September 30, 2011 of \$85.4 million consisted primarily of \$73.9 million in net proceeds from our common stock offering in the second quarter of 2011 and \$20.0 million in proceeds from our term loan with Oxford. These proceeds were partially offset by repayments on term loans of \$9.1 million.

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Operating and Capital Expenditure Requirements

To date, we have not achieved profitability on a quarterly or annual basis, and we expect this trend to continue as our cash expenditures will remain significant in the short-term. We plan to fund our short-term liquidity requirements using cash and cash equivalents and short-term investments, including interest income earned on those balances. At October 1, 2012, our principal short-term liquidity needs are:

to fund our operating losses;

to fund our working capital for commercial operations, including personnel costs and other operating expenses;

to fund our activities relating to becoming a CLIA-certified and staffed laboratory for providing clinical-quality genome sequencing;

to finance the further research and development of our sequencing technology and services;

to finance sales and marketing and general and administrative activities; and

to service our debt obligations.

Based on our current operating plans, we forecast up to \$3 million in additional capital expenditures during the remainder of 2012. We anticipate that we will continue to incur net losses for the foreseeable future.

In addition to our eventually resuming expenditures for the expansion of our Mountain View sequencing capacity, further development of our sequencing technology and services, and expansion of our sales and marketing activities, our principal long-term liquidity needs are:

to fund our working capital for commercial operations, including any growth in working capital required by growth in our business;

to finance the possible development of additional sequencing centers; and

to service our debt obligations.

The timing and amount of our future capital requirements will depend on many factors, including, but not limited to, the following:

the financial success of our genome sequencing business;

our ability to increase the sample preparation, sequencing and computing capacities in our Mountain View and Santa Clara leased facilities;

the average selling price per genome at which we are able to sell our whole genome sequencing services;

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whether repayment of our loan(s) is accelerated if an event of default is triggered;

the rate at which we eventually establish satellite genome sequencing centers, if any, and whether we can find suitable partners to establish such centers, if at all;

whether we are successful in obtaining payments from customers;

whether we can enter into collaborations or establish a recurring customer base;

the progress and scope of our research and development projects;

our ability to obtain CLIA certification, staff our laboratory to deliver clinical-grade genome sequencing and capture clinical customers;

the effect of any joint ventures or acquisitions of other businesses or technologies that we may enter into or make in the future;

the filing, prosecution and enforcement of patent claims; and

the costs associated with our current litigation with Illumina, Inc. and any other litigation.

Our forecast of the period of time through which our financial resources will be adequate to support our operations and the costs to support our general and administrative, sales and marketing and research and development activities are forward-looking statements and involve risks and uncertainties. Actual results could vary materially and negatively as a result of a number of factors, including the factors discussed under the caption Risk Factors. We have based these estimates on assumptions that may prove to be wrong, and we could use our available capital resources faster than we currently expect.

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Convertible Subordinated Promissory Note

On September 15, 2012, in connection with the Merger Agreement (see *Merger*), the Company, BGI and the Lender entered into the Note.

Pursuant to the terms of the Note, the Company may draw up to an aggregate principal amount of \$30.0 million. The first draw in the amount of \$6 million was funded by the Lender as of September 30, 2012. The Company may draw up to an additional \$6 million once per calendar month beginning in November 2012 subject to certain conditions, including the Merger Agreement being in full force and the absence of certain events of default. All amounts drawn under the Note shall bear interest at six percent (6%) per annum and the Note will mature on the earlier of September 30, 2014, the occurrence of a change in control or an event of default. The Company may voluntarily prepay all or any part of the interest and/or principal borrowings without premium or penalty. The Note is unsecured and the Lender has entered into subordination agreements with the Senior Lenders whereby the Lender has agreed to subordinate its indebtedness under the Note to the indebtedness owed by the Company to the Senior Lenders. The loan proceeds from the Note will be used to fund the Company's working capital and capital expenditure requirements.

All amounts outstanding under the Note may be convertible at any time after the termination of the Merger Agreement into common stock of the Company at the Offer Price per the Merger Agreement of \$3.15 per share. If a change of control occurs, the Lender may elect to have such conversion occur upon such change of control. Upon a conversion of all amounts outstanding under the Note, the Company is required to prepare, within 30 days from such conversion, a registration statement on Form S-3 with respect to all of the converted shares, and use commercially reasonable efforts to cause such registration statement to be declared effective. In addition to the foregoing registration right, subject to certain exceptions, if the Company registers any shares of its common stock, the Lender will have the right to include any converted shares in such registration.

The Note also contains covenants that restrict the Company's ability to, among other things, incur or assume certain debt, merge or consolidate, materially change the nature of its business, make certain investments, acquire or dispose of assets, make guaranties or grant liens on its assets, make certain loans, advances or investments, declare dividends or make distributions or enter into transactions with affiliates. The Company may incur indebtedness that is subordinated to the indebtedness under the Note.

The events of default under the Note include payment defaults, material breaches of covenants, bankruptcy events and the occurrence of an event of default that continues under the Oxford Loan Agreement. In the case of a continuing event of default, the Lender may, declare due all unpaid principal amounts outstanding and exercise other customary remedies, subject in each case to the Subordination Agreements.

At September 30, 2012, the Company had borrowings of \$6.0 million under the Note that were classified as a current liability.

Term Loans

On December 17, 2010, we entered into the Atel Loan Agreement. On March 25, 2011, we entered into the Oxford Loan Agreement.

Atel Loan Agreement

The Atel Loan Agreement consists of a \$6.0 million term loan for equipment purchases. Under the terms of the Atel Loan Agreement, the term loan balance is being repaid in 36 equal monthly payments of principal and interest. Interest accrues on the term loan at a rate of 11.26% per annum. The outstanding borrowings under the term loan are collateralized by a senior priority interest in certain of our current property and equipment, and all property and equipment that was purchased during the term of the Atel Loan Agreement. In connection with entering into the loan and security agreement with Oxford, we and ATEL made certain administrative and technical amendments to the Atel Loan Agreement.

In connection with the Atel Loan Agreement, we issued to ATEL a warrant to purchase 49,834 shares of our common stock at an exercise price of \$7.224 per share. The warrant was exercised in full on June 17, 2011.

The Atel Loan Agreement contains customary representations and warranties, covenants, including closing and advancing conditions, events of defaults and termination provisions. The affirmative covenants include, among other things, that we maintain certain cash account balances, and liability and other insurance, and that we pledge security interests in any ownership interest of a future subsidiary. The negative covenants preclude us from, among other things, disposing of certain assets, engaging in any merger or acquisition, incurring additional indebtedness, encumbering any collateral, paying dividends or making prohibited investments, in each case without the prior consent of ATEL, or defaulting under the term loan with Oxford (described below). In February 2012, we would breached a covenant in the Atel Loan Agreement because our audited 2011 consolidated financial statements contained an explanatory paragraph regarding substantial doubt about our ability to continue as a going concern in the opinion on the financial statements from our independent registered public accounting firm. The Atel Loan Agreement was

amended to include, among other things, a waiver for this covenant violation.

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Oxford Loan Agreement

The Oxford Loan Agreement provides for a term loan of \$20.0 million. The outstanding balance of the term loan must be repaid in full by the Maturity Date. Under the terms of the Oxford Loan Agreement, the outstanding balance accrues interest at a rate of 9.80% per annum. Until the Amortization Date, we made monthly payments equal to the accrued interest on the outstanding loan balance. After the Amortization Date and through the Maturity Date the outstanding loan balance will be repaid in thirty (30) equal monthly payments of principal and interest.

As a condition to the Oxford Loan Agreement, a portion of the term loan was used to repay the remaining balance of \$7.4 million on our existing term loan agreement with Comerica Bank. Following repayment of the outstanding indebtedness, the Comerica Loan Agreement was terminated. The Oxford Loan Agreement is secured by a senior priority on all of our assets, excluding our intellectual property and those assets securing borrowings under the Atel loan agreement. In addition, we have agreed not to pledge our intellectual property to another entity without Oxford's approval or consent.

In connection with the entry into the Oxford Loan Agreement, we issued to Oxford warrants to purchase an aggregate of 160,128 shares of our common stock (the Warrant Shares) at an exercise price of \$7.495 per share. The warrants expire on the seventh anniversary of the issuance date. We also agreed to use best efforts to provide Oxford certain registration rights covering the Warrant Shares.

The Oxford Loan Agreement contains customary representations and warranties, covenants, closing and advancing conditions, events of default and termination provisions. The affirmative covenants include, among other things, that we timely file taxes, maintain certain operating accounts subject to control agreements in favor of Oxford, maintain liability and other insurance, and pledge security interests in any ownership interest of a future subsidiary. The negative covenants preclude, among other things, disposing of certain assets, engaging in any merger or acquisition, incurring additional indebtedness, encumbering any collateral, paying dividends or making prohibited investments, in each case, without the prior consent of Oxford. The Oxford Loan Agreement provides that an event of default will occur if (1) there is a material adverse change in our business, operations or condition (financial or otherwise), (2) there is a material impairment in the prospects of us repaying any portion of our obligations under the term loan, (3) there is a material impairment in the value of the collateral pledged to secure our obligations under the agreement or in Oxford's perfection or priority over the collateral, (4) we default in the payment of any amount payable under the agreement when due, or (5) we breach any negative covenant or certain affirmative covenants in the agreement (subject to a grace period in some cases). The repayment of the term loan is accelerated following the occurrence of an event of default or otherwise, which would require us to immediately pay an amount equal to the sum of: (i) all outstanding principal plus accrued but unpaid interest, (ii) the prepayment fee, (iii) the final payment, plus (iv) all other sums, that have become due and payable but have not been paid, including interest at the default rate with respect to any past due amounts. In February 2012, we breached a covenant in the Oxford Loan Agreement because our audited 2011 consolidated financial statements contained an explanatory paragraph regarding substantial doubt about our ability to continue as a going concern in the opinion on the financial statements from our independent registered public accounting firm. The Oxford Loan Agreement was amended to include, among other things, a waiver for this covenant violation.

Management believes that, without continued funding from BGI under the Note, based on the current level of operations and anticipated growth, cash and cash equivalents balances, including interest income we will earn on these balances, will not be sufficient to meet the anticipated cash requirements beyond January 31, 2013. Accordingly, amounts due under the Atel Loan Agreement and the Oxford Loan Agreement, as well as, the borrowings under the Note with BGI, have been classified as current liabilities

Amendment to Oxford Loan Agreement

On September 15, 2012, in connection with the Note entered into as a result of the Merger Agreement, Oxford and the Company agreed to amend the Oxford Loan Agreement, whereby the Company agreed to, after the Company borrows under the Note, maintain a minimum liquidity ratio covenant. The ratio requires the Company to maintain a cash and cash equivalents balance equal to at least 90% of the outstanding indebtedness owed to Oxford and ATEL. Failure to comply with the minimum liquidity covenant will be an event of default under the Oxford Loan Agreement and if uncured will result in an event of default under the Atel Loan Agreement.

Table of Contents**Contractual Obligations and Commitments**

The following summarizes the future commitments arising from our contractual obligations at September 30, 2012 (in thousands):

Contractual obligations	Total	Payment due by period			More than 5 years
		Less than 1 year	1-3 years	3-5 years	
Debt obligations ⁽¹⁾	\$ 25,718	\$ 10,064	\$ 15,654	\$	\$
Interest ⁽²⁾	3,557	1,504	2,053		
Operating lease obligations ⁽³⁾	11,585	2,841	5,920	2,824	
Purchase obligations ⁽⁴⁾	8,466	7,777	689		
Total	\$ 49,326	\$ 22,186	\$ 24,316	\$ 2,824	\$

(1) Represents our outstanding debt under our term loans and convertible note as of September 30, 2012.

(2) Represents interest payments on our outstanding debt under our term loans as of September 30, 2012.

(3) Consists of contractual obligations under non-cancellable office space operating leases.

(4) Consists primarily of purchase obligations related to our data center, inventory purchases and non-cancellable orders for sequencing components. The table above also includes agreements to purchase goods or services that have cancellation provisions requiring little or no payment. The amounts under such contracts are included in the table above because management believes that cancellation of these contracts is unlikely and the Company expects to make future cash payments according to the contract terms or in similar amounts for similar materials.

Off-Balance Sheet Arrangements

We do not currently have, nor have we ever had, any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

As of September 30, 2012, our investment portfolio consists of money market funds. The primary objectives of our investment are to preserve capital and maintain liquidity. Our primary exposures to market risk are interest rate income sensitivity, which is affected by changes in the general level of U.S. interest rates, and conditions in the credit markets, including default risk. However, since all of our investments are in money market funds, we do not believe we are subject to any material market interest rate risk exposure. We do not have any foreign currency or any other derivative financial instruments.

ITEM 4: CONTROLS AND PROCEDURES**Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our chief executive and financial officers, evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of September 30, 2012. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its chief executive and financial officers, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management

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necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2012, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at a reasonable assurance level.

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Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting during the quarter ended September 30, 2012 identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION**ITEM 1: LEGAL PROCEEDINGS**

On August 3, 2010, a patent infringement lawsuit was filed by Illumina, Inc. and Solexa, Inc. (an entity acquired by Illumina), or the plaintiffs, against the Company, in the U.S. District Court for Delaware. The U.S. District Court in Delaware subsequently granted the Company's motion to transfer the case to the U.S. District Court for the Northern District of California. The case caption is *Illumina, Inc. and Solexa, Inc. v. Complete Genomics, Inc.*, Civil Action No. 3:10-cv-05542. The complaint alleges that Complete Genomics' Analysis Platform, and in particular the combinatorial probe anchor ligation technology, infringes upon three patents held by Illumina and Solexa. The plaintiffs seek unspecified monetary damages and injunctive relief. On September 23, 2010, the Company filed an answer to the complaint as well as its counterclaims against the plaintiffs. On May 5, 2011, the Court entered a stipulated order to dismiss two patents from the lawsuit. The dismissal is without prejudice but includes conditions on the plaintiffs' ability to file lawsuits on these patents, including a limitation that the plaintiffs may not re-file such lawsuits against the Company until the later of (1) August 1, 2012, or (2) the exhaustion of all appeal rights in both (a) the pending reexaminations in the U.S. Patent and Trademark Office and (b) the pending civil litigation in which these patents are also asserted, *Life Technologies Corp. v. Illumina*, Case No. 3:11-cv-00703 (S.D. Cal.). On October 18, 2012, the Court granted partial summary judgment in favor of the Company, declaring certain claims in the remaining patent to be invalid. The Company believes that it has substantial and meritorious defenses to the plaintiffs' remaining claims and intends to vigorously defend its position. However, if the Company is found to infringe one or more valid claims of a patent-in-suit and if the Court grants an injunction, the Company may be forced to redesign portions of its sequencing process, seek a license, cease the infringing activity and/or pay monetary damages. A negative outcome in this matter could therefore have a material adverse effect on our financial position, results of operations, cash flows and business. In addition, the Company has incurred and we anticipate that it will continue to incur significant expense and invest substantial time in defending against these claims. We are not currently able to estimate the potential loss, if any, that may result from this litigation.

On June 15, 2012, a second patent infringement lawsuit was filed by Illumina, Inc. and Illumina Cambridge Ltd. (a subsidiary of Illumina), or the plaintiffs, against the Company, in the U.S. District Court for the Southern District of California. The case caption is *Illumina, Inc. and Illumina Cambridge Ltd. v. Complete Genomics, Inc.*, Civil Action No. 12CV1465 AJB BGS. The complaint alleges that Complete Genomics' Analysis Platform infringes upon one patent held by Illumina. The plaintiffs seek unspecified monetary damages (including treble damages) and injunctive relief. On July 9, 2012, the Company filed an answer to the complaint as well as its counterclaims against the plaintiffs. The Company believes that it has substantial and meritorious defenses to the plaintiffs' claims and intends to vigorously defend its position. However, if the Company is found to infringe one or more valid claims of the patent-in-suit and if the Court grants an injunction, the Company may be forced to redesign portions of its sequencing process, seek a license, cease the infringing activity and/or pay monetary damages. A negative outcome in this matter could therefore have a material adverse effect on our financial position, results of operations, cash flows and business. In addition, we anticipate that the Company will incur significant expense and invest substantial time in defending against these claims. We are not currently able to estimate the potential loss, if any, that may result from this litigation.

On September 15, 2012, the Company entered into the Merger Agreement with BGI and the Purchaser, pursuant to which the Purchaser commenced the Offer. Beginning on September 20, 2012 and through October 1, 2012, eight separate alleged class action lawsuits were filed against the Company, each of its directors, BGI and the Purchaser, by purported stockholders of the Company. Four of those lawsuits were filed in the Court of Chancery of the State of Delaware, and the other four were filed in the Superior Court for the State of California, County of Santa Clara. Each of those lawsuits purports to be brought individually and on behalf of the public stockholders of the Company and alleges claims for breaches of fiduciary duties against the Company's directors in connection with the Offer and that the Company and BGI aided and abetted the purported breaches of fiduciary duties. Each lawsuit seeks, among other things, preliminary and permanent injunctive relief prohibiting consummation of the Offer, rescission of the Merger Agreement and an award of attorneys' fees and costs. The Company believes that it has substantial and meritorious defenses to the plaintiffs' claims and intends to vigorously defend its position. However, a negative outcome in any of these lawsuits could therefore have a material adverse effect on the Company's financial position, results of operations, cash flows and business if it results in preliminary or permanent injunctive relief or rescission of the Merger Agreement. In addition, although the Company has directors and officers liability insurance, the Company has incurred and anticipates that it will continue to incur significant expense within its self-insured retention under that insurance. The Company is not currently able to estimate the potential outcome of any of these lawsuits.

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For more information regarding the risk of this litigation and future litigation, please see Risk Factors We currently are, and could in the future be, subject to litigation regarding patent and other proprietary rights that could harm our business and We may incur substantial costs as a result of our current, or future, litigation or other proceedings relating to patent and other proprietary rights.

From time to time, we may become involved in other legal proceedings and claims arising in the ordinary course of our business. Other than as described above, we are not currently a party to any legal proceedings the outcome of which, if determined adversely to us, we believe would individually or in the aggregate have a material adverse effect on our financial position, results of operations, cash flows or business.

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ITEM 1A. RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below and the other information in this Quarterly Report on Form 10-Q. If any of such risks actually occur, our business, operating results or financial condition could be adversely affected. In those cases, the trading price of our common stock could decline and you may lose all or part of your investment.

Risks Related to the Announcement and Pendency of Agreement to be Acquired

On September 15, 2012, the Company, BGI, and the Purchaser entered into the Merger Agreement, pursuant to which BGI, through the Purchaser, has commenced the Offer to acquire all of the outstanding Shares for the Offer Price net to the selling stockholders in cash, without interest. Following successful consummation of the Offer and satisfaction of certain conditions, the Merger will occur with the Company surviving as a wholly owned subsidiary of BGI.

In connection with the Merger Agreement, the Company, BGI and the Lender entered into the Note. As of September 30, 2012, pursuant to the terms of the Note, the Company has drawn \$6.0 million and may draw up to an aggregate principal amount of \$30 million.

The announcement and pendency of the Merger has adversely affected our business, due to customers' and employees' uncertainty and other disruptions as well as intensified competition from our competitors as they attempt to take advantage of the uncertainties. Some employees have resigned, and it may be difficult to hire new employees due to the pendency of the Merger. In addition, we have incurred legal and other expenses in connection with the pending Merger. All of these factors are likely to continue to adversely affect our business and have an adverse effect on our financial condition or results of operations.

Under the terms of the Merger Agreement, we have agreed to operate our business in the ordinary course consistent with past practice, as well as to refrain from taking certain actions in the conduct of our business without BGI's prior written consent until the consummation of the Merger. Actions that may require BGI's consent include, but are not limited to, new indebtedness, capital expenditures, loans and investments, certain agreements and issuance of securities. These restrictions could adversely affect our business and could have an adverse effect on our financial condition or results of operations.

There is no assurance that the Offer will be successful or the Merger will occur. If the Merger is not completed, the share price of our common stock could be negatively impacted to the extent that the current market price of our common stock reflects an assumption that the Merger will be completed. In addition, any disruptions to our business resulting from the announcement and pendency of the Merger could continue in the event the Merger is not completed. Moreover, under certain circumstances BGI is not required to continue funding the Company under the Note and we will continue to be obligated to repay amounts drawn under the Note pursuant to the terms of the Note. Since restrictions in the Merger Agreement prevent the Company from securing other financing (equity- or debt-based) during the pendency of the Merger, if the Merger is not completed it will be very difficult for the Company to secure other financing in a timely manner.

Risks Related to Our Limited Operating History, Financial Condition and Capital Requirements

Without continued funding from BGI, we would not have sufficient cash to fund our operations to January 31, 2013.

Without continued funding from BGI under the Note, as described above, based on the current level of our operations, cash and cash equivalents balances, including interest income the Company will earn on these balances, would not be sufficient to meet the Company's anticipated cash requirements beyond January 31, 2013. If the Merger does not occur, we may be required to significantly reduce, restructure or cease operations. The Company's recurring operating losses and negative cash flow from operations and its requirement for additional funding to execute its business objectives beyond this period gives rise to substantial doubt as to the Company's ability to continue as a going concern absent the funding from BGI under the Note.

We are an early, commercial-stage company and have a limited operating history, which may make it difficult to evaluate our current business and predict our future performance.

We are an early, commercial-stage company and have a limited operating history. We were incorporated in Delaware in June 2005 and began operations in March 2006. From March 2006 until mid-2009, our operations focused on research and development of our DNA sequencing technology platform. Our revenue for the nine months ended September 30, 2012 and 2011 was \$19.9 million and \$16.9 million, respectively. Our limited operating history, particularly in light of our novel, service-based business model in the rapidly evolving genome sequencing industry, make it difficult to evaluate our current business and predict our future performance. Our lack of a long operating history, and especially our very short history as a revenue-generating company, make any assessment of our profitability or prediction about our future success or viability subject to significant uncertainty. We have encountered and will continue to encounter risks and difficulties frequently

experienced by early, commercial-stage companies in rapidly evolving industries. If we do not address these risks successfully, our business will suffer.

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On June 5, 2012, we announced a restructuring plan under which we are delaying sequencing capacity expansion, deferring certain capital expenditures, eliminated approximately 55 employee positions, terminated one of our building leases and shifting our focus from sequencing for research customers to sequencing for clinical customers. Among other risks, this restructuring as well as the announced Merger Agreement could impact our ability to retain employees and secure new customers or maintain current or obtain anticipated orders for sequencing services from existing customers.

We will require substantial additional funding and may be unable to raise capital when needed, which could force us to delay, reduce or cancel certain business objectives or we may be unable to continue as a going concern.

Our capital requirements are substantial, particularly as we further develop our business, eventually resume expansion of sample preparation, sequencing and computing capacities in our Mountain View and Santa Clara, California facilities. Our business model requires us to make significant research and development investments in many areas including sample preparation, sequencing, and bioinformatics. Historically, we have financed our operations through private placements of preferred stock, convertible debt, borrowings under our credit facility, secured debt and through public offerings of our common stock.

The amount of additional capital and timing at which we require the additional capital necessary to fund our operations and expand our business depends on many factors, including:

the financial success of our genome sequencing business;

the average selling price per genome at which we are able to sell our whole genome sequencing services;

whether repayment of our term loan(s) is accelerated if an event of default occurs;

whether we are successful in obtaining payments from customers;

whether we can establish a recurring customer base, in particular with clinical customers;

the progress and scope of our research and development projects;

our progress in obtaining a federal CLIA license to operate a clinical laboratory;

the filing, prosecution and enforcement of patent claims; and

the costs associated with our current litigation with Illumina, Inc. and any other litigation.

Our term loans contain restrictions that limit our flexibility in operating our business and provisions that enable the lenders to accelerate repayment of the outstanding amounts in the event of default.

Our term loans with Oxford and ATEL contain various covenants that limit our ability to engage in specified types of transactions. These covenants limit our ability to, among other things:

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sell, transfer, lease or dispose of our assets;

create, incur or assume additional indebtedness;

encumber or permit liens on certain of our assets;

make restricted payments, including paying dividends on, repurchasing or making distributions with respect to our common stock;

make specified investments (including loans and advances);

consolidate, merge, sell or otherwise dispose of all or substantially all of our assets; and

enter into certain transactions with our affiliates.

A breach of any of these covenants or a material adverse change to our business could result in a default under either or both of our term loans. In addition, our term loan with Oxford provides that an event of default will occur, among other instances, if there is a material adverse change in our business, operations or condition (financial or otherwise) or if there is a material impairment in the prospects of us repaying any portion of our obligations under the term loan. These provisions are inherently subjective in nature. If we fail to raise additional capital in a timely manner, an event of default could occur under our term loan with Oxford. Upon the occurrence of an event of default under either of our term loans, both Oxford and ATEL could elect to declare all amounts outstanding to be immediately due and payable and terminate all commitments to extend further credit. If we were unable to repay those amounts, the lenders could proceed against the collateral granted to them to secure such indebtedness. We have pledged substantially all of our assets, other than our intellectual property, as collateral under the term loans.

In addition, in connection with the Note entered into in connection with the Merger Agreement, Oxford and the Company agreed to amend the Oxford Loan Agreement, whereby the Company agreed to, after the Company borrows under the Note, maintain a minimum liquidity ratio covenant. The ratio requires the Company to maintain a cash and cash equivalents balance equal to at least 90% of the outstanding indebtedness owed to Oxford and ATEL. Failure to comply with the minimum liquidity covenant will be an event of default under the Oxford Loan Agreement and if uncured will result in an event of default under the Atel Loan Agreement.

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We have a history of losses, and we may not achieve or sustain profitability in the future, on a quarterly or annual basis.

We have not been profitable in any annual or quarterly period since we were formed. We incurred net losses of \$57.0 million and \$50.0 million for the nine months ended September 30, 2012 and 2011, respectively. As of September 30, 2012, our accumulated deficit was \$268.2 million. Based on our current operating plans and assumptions, we do not expect to achieve profitability in the near future. In addition, we expect our cash expenditures to remain significant in the near term, including expenditures for the shift and acceleration toward serving clinical customers, and eventually the expansion of our sample preparation, sequencing and computing capabilities, research and development, sales and marketing and general and administrative expenses relating to that strategic shift. We may encounter unforeseen difficulties, complications and delays in our existing sequencing facility and other unforeseen factors that require additional expenditures. These costs, among other factors, have had and will continue to have an adverse effect on our working capital and stockholders' equity. We will have to generate and sustain substantially increased revenue to achieve and maintain profitability, which we may never do. If we are unable to achieve and then maintain profitability, the market value of our common stock will decline.

Our 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 may 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, as well as other factors described elsewhere in this Quarterly Report:

our ability to achieve profitability;

our need for and ability to obtain the capital necessary to operate and shift and expand our business for clinical applications;

the timing of our receipt of customer samples;

the size and frequency of customer orders;

our ability to lower the average cost per genome that we sequence;

the average selling price we charge our customers for sequencing genomes;

the presence or absence in a specific quarter of one or more new large orders;

our ability to expand our sample preparation, sequencing and computing operations, in particular if we see growth in demand from clinical customers;

our ability to obtain and maintain our license to operate as a CLIA laboratory;

the demand for the sequencing of complete human genomes, from both research customers and clinical customers;

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the existence and extent of government funding for research and development relating to genome sequencing;

the emergence of alternative genome sequencing technologies;

the emergence and rate of growth in demand for genome sequencing for clinical applications;

risks associated with expanding our business into international markets;

our dependence on sole- or single-source suppliers;

our ability to manage our growth;

our ability to successfully partner with other businesses in joint ventures or collaborations;

our dependence on, and our need to attract and retain, key management and qualified sales personnel;

our ability to obtain, protect and enforce our intellectual property rights and avoid infringing the intellectual property rights of others;

our ability to prevent the theft or misappropriation of our know-how or technologies;

lawsuits brought against us by third parties;

business interruptions, such as earthquakes and other natural disasters;

public concerns about the ethical, legal and social concerns related to the use of genetic information;

our ability to comply with current laws and regulations and new or expanded regulatory schemes;

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our ability to properly handle and dispose of hazardous materials used in our business and biological waste; 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 are not necessarily indicative of our future operating performance.

Our independent registered public accounting firm has included an explanatory paragraph relating to our ability to continue as a going concern in its report on our audited financial statements included in our last Annual Report.

The report from our independent registered public accounting firm dated March 8, 2012 for the year ended December 31, 2011 includes an explanatory paragraph stating that our recurring losses from operations and significant negative cash flow from operations raise substantial doubt about our ability to continue as a going concern. If we are unable to obtain sufficient funding, our business, financial condition and results of operations will be materially and adversely affected and we may be unable to continue as a going concern. If we are unable to continue as a going concern, we may have to liquidate our assets and may receive less than the value at which those assets are carried on our consolidated financial statements, and it is likely that investors will lose all or a part of their investment.

Risks Related to Our Business

We may experience delays or incur significant expenses in obtaining and maintaining certification under the Clinical Laboratory Improvement Amendments of 1988.

We are seeking CLIA certification. CLIA, which extends federal oversight over clinical laboratories by requiring that they be certified by the federal government or by a federally approved accreditation agency, is designed to ensure the quality and reliability of clinical laboratories by mandating specific standards in the areas of personnel qualifications, administration and participation in proficiency testing, patient test management, quality control, quality assurance and inspections. In order to obtain and maintain CLIA certification, we have expended, and will be required to continue to expend, time, money and effort to ensure that we meet the applicable quality and safety requirements. In addition, it may take us longer and/or require us to spend considerably more than planned resources to obtain and maintain CLIA certification.

CLIA certification will be based on our own laboratory developed test (LDT) as currently defined by the FDA. The FDA could change its regulations on LDTs, which could impact our ability to operate a CLIA-certified laboratory.

There is no guarantee that we will obtain CLIA certification, within the timeframe we expect or at all. Without CLIA certification, we will not be able to provide sequencing services to customers that require genomic data from a CLIA-certified laboratory for clinical applications. Obtaining CLIA certification and providing genomic data for clinical uses is key to our business strategy.

Our only source of revenue is our human genome sequencing service, which is a new business model in an emerging industry, and failure to achieve market acceptance will harm our business.

Since our inception, all of our efforts have been focused on the creation of a technology platform for our human genome sequencing service, which we commercialized in May 2010. We expect to generate all of our revenue from our human genome sequencing service for the foreseeable future. As a result, market acceptance of our human genome sequencing service is critical to our future success.

Providing genome sequencing as a service is a new and unproven business model in a relatively new and rapidly evolving industry. We are using proprietary technology, involving multiple scientific and engineering disciplines, and a novel service model to bring complete human genome sequencing to an unproven market. We incur considerable research and development and general and administrative expenses in providing our services to our customers and, hence, our revenues will have to grow many fold before we can achieve profitability.

Historically, companies in this industry have sold sequencing instruments directly to customers, and the customer performs the sequencing itself. We do not know if the purchasers and users of sequencing instruments will adopt our service model. For example, many potential customers want to sequence human genomes for proprietary studies that may lead to discoveries that they would seek to exploit, either commercially or through the publication of scientific literature. Accordingly, these potential customers may have significant reservations about allowing a third party to control the sequencing processes for their proprietary studies. Alternatively, other potential customers may want to sequence only portions of human genomes, such as exomes, rather than complete human genomes. There are many reasons why our services might not become widely adopted, ranging from logistical or quality problems to a failure by our sales force to engage potential customers, and including the other reasons stated in this Risk Factors section. As a result, our genome sequencing service may not achieve sufficient market acceptance to allow us

to become profitable.

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Our success depends on the growth in demand for analysis of genetic variation and biological function, and the shift and growth in demand to whole human genome sequencing.

We are currently serving customers for our genome sequencing service in academic centers, medical research centers, government research institutions, biopharmaceutical companies and health care organizations. These customers are using our service for small- and large-scale human genome studies for a wide variety of diagnostic and discovery applications. We are seeking to shift our focus to clinical customers who would use genome sequencing to diagnose and to determine treatments for diseases.

These customers and applications are new and emerging, and they may not develop as quickly as we anticipate, or reach their full potential. Our success depends on the demand of whole human genome sequencing increasing substantially from its current levels. The development of demand for whole human genome sequencing and the success of our service depend in part on the following factors:

demand from researchers for whole human genome sequencing;

demand from clinicians for whole human genome sequencing;

the usefulness and cost effectiveness of genomic data in preventing, identifying or treating disease;

the willingness of third-party payers (such as insurance companies and Medicare) to reimburse for whole human genome sequencing in clinical applications;

the ability of our customers to successfully analyze the genomic data we provide;

the ability of researchers and clinicians to convert genomic data into medically valuable information;

the capacity and scalability of the hardware storage components necessary to store, manage, backup, retain and safeguard genomic data;

the development of software tools, such as bioinformatics systems, to efficiently search, correlate and manage genomic data to assist our customers in effectively analyzing the genomic data we provide; and

competitive product offerings.

For instance, demand for our genome sequencing service may develop slowly or decrease if researchers and clinicians are unable to effectively use and ultimately analyze the large amounts of genomic data from a whole human genome or if they fail to find meaningful correlations between genetic variation and disease susceptibility through whole human genome studies. In February 2012, our Genomic Discovery Partners Program was launched to facilitate the analysis of large amounts of genomic data. This program is a partnership with other analysis software providers whose analysis tools are compatible with our analysis tools. We cannot be certain this program will be successful. In addition, factors affecting research and development spending generally, such as changes in the regulatory environment affecting biopharmaceutical and other healthcare organizations and changes in government programs that provide funding to companies and research institutions, could harm our business. If our target markets do not develop in a timely manner, demand for our service may grow at a slower rate than we expect, or may fall, and we may not achieve profitability.

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To date, relatively few whole human genomes have been sequenced, in large part due to the high cost of large-scale sequencing. Our business plan assumes that the demand for sequencing whole human genomes will increase significantly as the cost of whole human genome sequencing decreases. This assumption may prove to be incorrect, or the increase in demand may take significantly more time than we anticipate. For example, potential customers may not think our cost reductions are sufficient to permit or justify large-scale sequencing. Moreover, some companies and institutions have focused on sequencing targeted areas of the genome that are believed to be primarily associated with disorders and diseases, as opposed to the entire genome. Demand for sequencing whole human genomes may not increase if these targeted sequencing strategies, such as exome sequencing, where selected regions containing key portions of genes are sequenced, prove to be more cost effective or are viewed as a more efficient method of genetic analysis than whole human genome sequencing. Since exome sequencing is significantly less expensive than the sequencing of an entire human genome, customers, including those with limited budgets, may choose to sequence exomes instead of whole human genomes.

In addition, to date, reimbursement by third-party payers (such as insurance companies and Medicare) for whole genome sequencing for clinical purposes is rare. The cost-effectiveness of genome sequencing for the diagnosis and treatment planning for diseases is still being questioned. This is currently limiting demand for genome sequencing for clinical purposes.

In addition, customers of whole genome sequencing services have a number of service options available to them. For us to succeed, our customers will need to find our service alternative superior to services offered by our competitors.

We must eventually significantly increase our production capabilities in order to achieve profitability.

We have limited experience in running a commercial-scale production facility. We have only one sequencing facility, which at present has the capacity to sequence approximately 1,000 complete human genomes per month. This capacity is significantly less than what would be required to achieve profitability. Our long-term business plan assumes that we will be able to increase our capacity multiple fold.

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We plan to eventually increase the capacity of our sequencing facility by increasing our sample preparation capacity, upgrading our existing sequencers, installing additional sequencers, improving our software and designing and installing newer generations of sequencing instruments that are currently under research and development. We may also eventually construct satellite genome sequencing centers in the United States and elsewhere in the future. We may encounter difficulties in expanding our sequencing infrastructure, and we may not be able to build and improve this infrastructure in time to meet the volume, quality or timing requirements necessary to be successful. Manufacturing and supply quality issues may arise, including issues due to third parties who provide the components of our technology platform. We are designing our next generation of sequencers that are targeted to be faster than our current sequencers. We may experience technical difficulties that may cause substantial delays and as a result hamper our efforts to achieve a significant increase in our capacity. As our sequencing capacity and demand for our sequencing services increases, we will be required to scale up our sample and library preparation capacity. We encountered delays and difficulties in scaling up our sample and library preparation capacity in the second half of 2011. We may also encounter delays or difficulties in our future sample and library expansion efforts. Generally, implementing improvements to our sequencing technology may involve significant changes that may result in delays, or may not achieve expected results. For example, we are experimenting with improved library construction processes and with advanced fluidics for our sequencing platform. These experiments may be unsuccessful and may not lead to feasible technological improvements that increase the capacity or reduce the costs of our sequencing services. If capacity or cost limitations prevent us from meeting our customers' expectations, we will lose revenue and our potential customers may take their business to our competitors.

Our need to increase capacity will eventually require us to upgrade our machines to enhance our current production process. This may render our current machines obsolete sooner than anticipated. If this occurs, the value of these machines could be impaired and we may need to write down the value of this equipment, which could have a material impact on our financial statements.

We also plan to continue our efforts to reduce our turn-around time. We have a number of projects underway to do so. However, there can be no assurance that we will be successful in these efforts. In addition, from time to time, our turn-around time may increase if we encounter any operator or process failures, if we have to resequence genomes, or if our capacity does not keep up with our backlog. Failure to improve our turn-around time may cause us to lose existing or prospective orders.

Reduction or delay in research and development budgets and government funding may adversely impact our sales.

We expect that for the immediate future, our revenue will be derived primarily from selling our genome sequencing service to a relatively small number of academic, governmental and other research institutions, as well as biopharmaceutical and healthcare organizations. Our revenue may decline substantially due to reductions and delays in research and development expenditures by these customers, which depend, in part, on their budgets and the availability of government funding. Factors that could affect the spending levels of our customers include:

weakness in the global economy and changing market conditions that affect our customers;

changes in the extent to which the pharmaceutical and life science industry may use genetic information and genetic testing as a methodology for drug discovery and development;

changes in government programs that provide funding to companies and research institutions;

changes in the regulatory environment affecting biopharmaceutical and life science companies and research and medical institutions;

impact of consolidation within the biopharmaceutical and life science industry; and

cost-reduction initiatives of customers.

Also, government funding of research and development is subject to the political process, which is inherently unpredictable. Any reduction in the funding of life science research and development or delay surrounding the approval of government budget proposals may cause our customers to delay or forgo purchases of our services. For example, uncertainty regarding the size of the U.S. government's 2012-2013 budget for the National Institute of Health, or NIH, and related agencies may cause our customers to slow or delay purchases of our services. In

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addition, it is unclear what will happen to demand for our services after the stimulus funds provided pursuant to the American Recovery and Reinvestment Act of 2009 have been allocated and fully spent, or due to the impact of sequestration under the Budget Control Act of 2011. A reduction or delay in demand for our service, due to a reduction in government funding, will adversely affect our ability to achieve profitability.

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The presence or absence in a specific quarter of one or more new large orders, our ability to process orders or the cancellation of previous orders, may cause our results of operations and backlog to fluctuate significantly on a quarterly basis.

Since beginning commercial operations, we have received purchase orders or contracts from a growing but limited number of customers each quarter. Historically, the size of each purchase order has fluctuated between a few genomes and multiple hundreds of genomes. As a result, the presence or absence in a specific quarter of one or more new large orders, delays in our ability to process large orders or the cancellation of previous orders, combined with our uncertain sales cycle and changes in the variables that influence conversion of orders into revenue, may cause our results of operations and our backlog to fluctuate on a quarterly basis. These fluctuations may be significant from one quarter to the next. In addition, our limited commercial history and the characteristic of our quarterly orders make it very difficult to predict or forecast our future operating results and backlog.

If we are not successful in reducing the average cost of our sequencing service, demand for our services, as well as our ability to achieve profitability, will suffer.

Our ability to expand our customer base depends largely on our ability to reduce the average cost of sequencing a human genome. For example, certain academic or government-sponsored research organizations may forgo or delay whole genome-wide studies based on the cost required to sequence complete human genomes, in favor of other less expensive studies, including targeted sequencing strategies such as exome sequencing. Additionally, certain of our target customers may decide it is more cost-effective to purchase sequencing instruments from a competitor than contract for our sequencing service or may choose to outsource their sequencing projects to another service provider. To compete effectively with competitors who sell and market sequencing instruments or provide sequencing services, our service must provide cost advantages, superior quality and time savings.

In addition, we have significantly reduced the price of our complete human genome sequencing services over the past year. This reduction in price has been driven in part by competitive pricing pressure. As our competitors reduce the price of their sequencing services, or as new competitors enter the market or expand their business model to include sequencing services, we expect increased pricing pressure, which may force us to further decrease the price of our genome sequencing service. Our gross profit and operating results will suffer if we are unable to offset any reductions in our prices by reductions in our costs through developing new or enhanced technologies or methods, or increasing our sales volumes.

We face significant competition. Our failure to compete effectively could adversely affect our sales and results of operations.

We currently compete with companies that develop, manufacture and market genome sequencing instruments or provide genome sequencing services. We expect competition to increase as our competitors develop new, improved or cheaper instruments or expand their businesses to include sequencing services, and as new companies enter the market with innovative technologies.

The genome sequencing industry is highly competitive and is served by several large companies with significant competitive positions. For example, established companies such as Illumina, Inc., Life Technologies Corporation and Roche Diagnostics Corporation are marketing instruments for genetic sequencing that impact demand for our services, and these companies have significantly greater financial, technical, marketing and other resources than we do to invest in new technologies and have substantial intellectual property portfolios and substantial experience in product development and regulatory expertise. Also, many other companies, such as NABsys, Inc., Oxford Nanopore Technologies, Ltd., Pacific Biosciences, Inc. and Perkin Elmer Corporation, have developed or are developing sequencing technologies or services that would compete with ours. Moreover, large established companies may acquire smaller companies with emerging technologies and use their extensive resources to develop and commercialize such technologies or incorporate such technologies into their instruments and services. For example, in 2010, Life Technologies acquired Ion Torrent Systems, Inc., a chip-based sequencing technology company, and in September 2012, announced that the sequencing platform acquired from Ion Torrent may be able to sequence a genome for \$1,000, in less than one day, in 2013

In addition, many research, academic and other non-profit institutions are pursuing new sequencing technologies. These institutions often have access to significant government and other funding. For example, BGI (formerly known as Beijing Genomics Institute) in the People's Republic of China offers a service similar to ours and may receive funding from the government of China. In the United States, agencies such as the National Human Genome Research Institute provide funding to institutions to discover new sequencing technology and to optimize use of sequencing technology developed and sold by competing sequencing instrument suppliers. We may compete directly with these institutions, or these institutions may license their technologies to third parties with whom we would compete.

While many of our existing competitors primarily sell sequencing instruments, they may also provide sequencing services like us. Since these competitors have already developed their own sequencing technology, they will not experience significant technological barriers to entry and

can likely enter the sequencing services market fairly quickly and with little additional cost. For example, Illumina began providing whole genome sequencing services in-house and through its Illumina Genome Network. Furthermore, many of these instrumentation companies have already established a significant market presence, have large cash balances and/or positive balances from their current businesses, and are trusted by customers in the industry. As established instrumentation companies offer sequencing services, many potential customers may purchase sequencing services from these companies instead of us, even if we offer superior technology and services.

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In addition to commercial companies, there are large, government-funded or research-sponsored organizations, such as the Broad Institute of MIT and Harvard, the Genome Center at Washington University, the Baylor College of Medicine Human Genome Sequencing Center, the Wellcome Trust Sanger Institute and BGI, that purchase commercial DNA sequencing instruments and offer DNA sequencing services to academic and commercial customers.

Our order backlog may never be completed, and we may never earn revenue on backlogged contracts to sequence genomes. In addition, the timing of the conversion of our order backlog into revenue is dependent on the timing of receipt of samples from our customers.

As of September 30, 2012, we had a backlog of orders for sequencing approximately 3,800 genomes, which we believe could contribute approximately \$18.0 million toward revenue over the next 12 months. This figure represents the number of genomes for which customers have placed orders or entered into contracts with volume estimates that we believe are firm and for which we have not yet recognized revenue. We may not be able to convert order backlog into revenue at the rate or times we anticipate, or at all. Consequently, the order backlog we report in this Form 10-Q and elsewhere from time to time may not be indicative of future revenue.

We may fail to complete backlog orders as we expect for many reasons. We may experience sequencing delays or customers may delay providing samples for sequencing or might reduce or cancel orders. We have in the past experienced growing backlog due to our inability to keep pace with new orders, operational challenges in implementing new equipment and procedures, delays in processing orders and in some cases due to lack of timely arrival of samples. Delays in sequencing for lack of capacity, lack of samples, or for any other reason could cause backlog orders to be delayed or even cancelled by customers, which has happened on occasion. Even with sufficient throughput capacity, we are not always in control of the rate at which we complete orders and therefore convert backlog to revenue. For example, customers often place orders with us before providing us with genomic samples, delaying our start of the sequencing process by weeks or months. A delay in receiving samples, particularly from a large order, may cause our results of operations to fluctuate significantly from one quarter to the next. Additionally, once we receive a customer's samples, we test them to assure that they are of sufficient quality and quantity for sequencing. If a sample fails this test, we contact the customer and request additional samples, resulting in further delay. Also, customers may negotiate a period of time, measured in weeks or in some cases months, to accept or reject our sequencing reports once delivered. Customer acceptance in these instances is a prerequisite for recording revenue for those orders. For these reasons, you should use caution in adopting changes in, or the absolute amount of, our backlog as a measure for market acceptance of our sequencing services or as an indicator of future revenue.

The emergence of competitive genome sequencing technologies may harm our business.

The success of our genome sequencing services will depend, in part, on our ability to continue to enhance the performance and decrease the cost of our genome sequencing technology. A number of genome sequencing technologies exist, and new methods and improvement to existing methods are currently being developed, including technology platforms developed by companies that we expect will directly compete with us as providers of sequencing services or instruments. These new technologies may result in faster, more cost-effective and more accurate sequencing methods than ours. For example, our sequencing technology does not currently cover all of the nucleotides in the genome. If competitive technologies emerge that sequence portions of the genome that our technology does not, our business could suffer if those portions contain important genomic information. We face competition from a number of companies, including NABsys, Oxford Nanopore Technologies and Pacific Biosciences, as well as from established companies such as Illumina, Inc., Life Technologies Corporation and Roche Diagnostics Corporation. As a result of the emergence of these competitive sequencing technologies, demand for our service may decline or never develop sufficiently to sustain our operations.

Our industry is rapidly changing, with emerging and continually evolving technologies that increase the efficiency and reduce the cost of sequencing genomes. As new technologies emerge, we believe that the cost and error rates of, and the time required to, sequence human genomes will eventually decrease to a level where competition in the industry will shift to other factors, such as providing related services and analytical technologies. We may not be able to maintain any technological advantage over these new sequencing technologies, and if we fail to compete effectively on other factors relevant to our customers, our business will suffer.

Our genome sequencing technology platform was developed for human DNA and is not currently optimized to sequence non-human DNA.

Our technology platform was developed and has been optimized for sequencing human DNA, and we do not intend to sequence non-human DNA. We face significant competition from established companies that sell genome sequencing instruments that can sequence both human and non-human DNA. Many of the academic and research institutions that are our target customers conduct studies on both human and non-human DNA. Prospective customers may choose to purchase sequencing instruments rather than services from us because of their broader sequencing application. Our competitors may also choose to provide sequencing services for non-human DNA. As a result, there may not be sufficient demand for our human genome sequencing service, which will harm our business.

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We depend on a limited number of suppliers, including single-source suppliers, of various critical components for our sequencing process. The loss of these suppliers, or their failure to supply us with the necessary components on a timely basis, could cause delays in the current and future capacity of our sequencing center and adversely affect our business.

We depend on a limited number of suppliers, including some sole- and single-source suppliers, of various critical components for our sequencing process. We do not have long-term contracts with our suppliers or service providers. Because we do not have long-term contracts, our suppliers generally are not required to provide us with any guaranteed minimum production levels. As a result, we may not be able to obtain sufficient quantities of critical components in the future.

Although alternative suppliers exist for each of the critical components of our sequencing process, that process has been designed around the functions, limitations, features and specifications of the components that we currently utilize. If we are required to integrate new components into future sequencers, we would experience a delay in the deployment of these sequencers, and, as a result, our efforts to expand our sequencing capacity would be delayed.

A delay or interruption by our suppliers may also harm our business. For example, the wafers that comprise the base of our sample slide are fabricated by SVTC Technologies, L.L.C. SVTC Technologies recently closed operations. We have not yet qualified an alternative source for the supply of these wafers, which are critical to our sequencing process, and the custom manner in which these wafers are made may make it difficult to qualify other semiconductor suppliers to manufacture them for us. We believe we have built sufficient inventory of these wafers to take us through the period before we qualify a new supplier. However, if the stock that we have built is faulty or it takes it longer than anticipated to qualify a new supplier our business can be adversely impacted. Similarly, an interruption of services by Amazon Web Services, on whom we rely to deliver finished genomic data to our customers, could result in our customers not receiving their data on time.

In addition, the lead time needed to establish a relationship with a new supplier can be lengthy, and we may experience delays in meeting demand in the event we must switch to a new supplier. The time and effort to qualify a new supplier could result in additional costs, diversion of resources or reduced manufacturing yields, any of which would negatively impact our operating results. Our dependence on single-source suppliers exposes us to numerous risks, including the following:

our suppliers may cease or reduce production or deliveries, raise prices or renegotiate terms;

delays by our suppliers could significantly limit our ability to sequence customer data and delay our efforts to increase our sequencing capacity;

quality issues that may not be immediately detected by our quality assurance team may arise causing disruption or delay in our operations;

we may be unable to locate a suitable replacement on acceptable terms or on a timely basis, if at all; and

delays caused by supply issues may harm our reputation, frustrate our customers and cause them to turn to our competitors for future projects.

If our Mountain View genome sequencing facility becomes inoperable, we will be unable to perform our genome sequencing services and our business will be harmed.

We currently do not have redundant sequencing facilities on a scale that could support our business. We perform all of our commercial genome sequencing in our facility located in Mountain View, California. Mountain View is situated on or near earthquake fault lines. Our facility, the equipment we use to perform our sequencing services and our other business process systems are costly to replace and could require substantial time to repair or replace. The facility may be harmed or rendered inoperable by natural or man-made disasters, including earthquakes, wildfires, floods, acts of terrorism or other criminal activities, infectious disease outbreaks and power outages, which may render it difficult or impossible for us to sequence genomes for some period of time. In addition, these events may temporarily interrupt our ability to receive samples from our customers or materials from our suppliers and our access to our various systems necessary to operate our business. The inability to perform our

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sequencing service would result in the loss of customers and harm our reputation. We do not currently have insurance coverage for damage arising from an earthquake. Our insurance covering damage to our property may not be sufficient to cover all of our potential losses and will not cover us in the event of an earthquake, and may not continue to be available to us on acceptable terms, or at all.

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Failure to achieve expected sequencing process yields, or variability in our sequencing process yields, could harm our operating results and damage our reputation.

Our sequencing process, like any other commercial-scale production process, is not flawless. For example, our DNBs may not adhere to all of the sticky spots on the surface of the silicon wafers we use to sequence DNA, or parts of the wafers may be unreadable. We refer to the efficiency of our sequencing process as its yield. The sequencing process yields we achieve depend on the design and operation of our sequencing process, which uses a number of complex and sophisticated biochemical, informatics, optical and mechanical processes, many of which are highly sensitive to external factors. An operational or technology failure in one of these complex processes or fluctuations in external variables may result in sequencing processing yields that are lower than we anticipate or that vary between sequencing runs. In addition, we are regularly evaluating and refining our sequencing process. These refinements may initially result in unanticipated issues that further reduce our sequencing process yields or increase the variability of our sequencing yields. Low sequencing yields, or higher than anticipated variability, increases total sequencing costs and reduces the number of genomes we can sequence in a given time period, which can cause variability in our operating results and damage our reputation.

We may have to resequence genomes due to contamination of DNA samples or other failures in the sequencing process.

In the past, we have had to resequence various genome samples as a result of DNA samples that are degraded, improperly prepared or contaminated when we receive them, or as a result of contamination or other failures in the sample preparation and library construction process. The sequencing process is highly sensitive, and the presence of any foreign substances or variances in external factors, such as heat or moisture, during the preparation of the slide samples can corrupt the results of the sequencing process. The quality of our sequencing runs may also vary for other reasons. As we continue to refine the efficiency of our sequencing process, we may modify the protocols in various stages of the sequencing process, which may have unintended consequences requiring us to further modify the protocols and/or resequence genomes samples. Resequencing requires additional expense, time and capacity and delays the delivery of data and the recognition of revenue from the service. Samples may be contaminated in the future or the quality of our sequencing results may vary, which may damage our reputation and decrease the demand for our service.

Mishandling or switching of DNA samples or genomic data may harm our reputation and result in litigation against us.

We may unintentionally mishandle DNA samples. For example, if customer samples or sequencing results are switched, our customers would receive the wrong sequencing data, which could have significant consequences, particularly if that data is used to diagnose or treat disease. Mishandling customer samples or data could lead to loss of current or future business, harm our reputation and result in litigation against us.

Ethical, legal and social concerns related to the use of genetic information could reduce demand for our genome sequencing services.

Our genome sequencing services are intended to facilitate large-scale human genome studies for a wide variety of diagnostic and discovery applications. However, genetic testing has raised ethical, legal and social issues regarding privacy and the appropriate uses of the resulting information. Governmental authorities could, for social or other purposes, limit or regulate the use of genetic testing or prohibit testing for genetic predisposition to certain conditions, particularly for those that have no known cure. Similarly, these concerns may lead individuals to refuse to use genetics tests even if permissible.

In addition, we do not control how our customers use the genomic data we provide. In most cases, we do not know the identity of the individuals whose DNA we sequence, the reason why their DNA is being sequenced or the intended use of the genomic data we provide. If our customers use our services or the resulting genomic data irresponsibly or in violation of legal restrictions, our reputation could be harmed and litigation could be brought against us.

Ethical and social concerns may also influence U.S. and foreign patent offices and courts with regard to patent protection for technology relevant to our business. These and other ethical, legal and social concerns may limit market acceptance of our technology for certain applications or reduce the potential demand for our technology, either of which could have an adverse effect on our business, financial condition or results of operations.

We use biological and hazardous materials that require considerable expertise and expense for handling, storage and disposal and may result in claims against us.

We work with materials, including chemicals, biological agents and compounds and DNA samples that could be hazardous to human health and safety or the environment. Our operations also produce hazardous and biological waste products. Federal, state and local laws and regulations govern the use, generation, manufacture, storage, handling and disposal of these materials and wastes. Compliance with applicable

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environmental laws and regulations is expensive, and current or future environmental laws and regulations may restrict our operations. If we do not comply with applicable regulations, we may be subject to fines and penalties.

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In addition, we cannot eliminate the risk of accidental injury or contamination from these materials or wastes. While our property insurance policy provides limited coverage in the event of contamination from hazardous and biological products and the resulting cleanup costs, we do not currently have any additional insurance coverage for legal liability for claims arising from the handling, storage or disposal of hazardous materials. Further, our general liability insurance and workers' compensation insurance policies do not cover damages and fines arising from biological or hazardous waste exposure or contamination. Accordingly, in the event of contamination or injury, we could be liable for damages or penalized with fines in an amount exceeding our resources and our operations could be suspended or otherwise adversely affected.

We have limited selling and marketing resources and may be unable to successfully commercialize our human genome sequencing service.

To grow our business as planned, we must eventually expand our sales, marketing and customer support capabilities. We may be unable to attract, retain and manage the specialized workforce necessary to gain market acceptance and successfully commercialize our services. In addition, developing these functions is time consuming and expensive.

We have recently reduced some of these capabilities, as part of the restructuring plan that we announced on June 5, 2012. The employee headcount reductions impacted our sales, marketing and customer support capabilities, which may make it even more difficult to retain remaining employees and to eventually hire new employees when growth in our business supports new hiring.

The sale of genome sequencing services involves extensive knowledge about genomic research and sequencing technology, including the sequencing technology of our competitors. To be successful, our sales force and related personnel must be technically proficient in a variety of disciplines. For example, many of our existing salespersons have a Ph.D. or other advanced degree in relevant scientific fields. There are relatively few people that have the necessary knowledge and qualifications to be successful salespersons or support personnel in our industry.

In certain regions or for certain customers, we may seek to partner with others to assist us with sales, marketing and customer support functions. However, we may be unable to find appropriate third parties with whom to enter into these arrangements. Furthermore, if we do enter into these arrangements, these third parties may not perform as expected.

Our software may incorrectly analyze the raw genomic data produced by our sequencing equipment.

Our sequencing instruments generate raw genomic data from various segments of the genome being sequenced. This data must be arranged into the correct order to reconstruct the original genomic structure of the sample. We have developed software algorithms that facilitate this reconstruction. However, these algorithms rely on statistical models that provide only relative assurance, and not absolute assurance, that the original genomic structure has been reconstructed.

In addition, the genomic data we provide our customers includes a comparison of the sequenced genome against a reference genome to help identify possible mutations or variations. This reference genome is designed to approximate a standard human genome. However, this approximation may not be accurate. If the algorithms we use to reconstruct genomic data incorrectly reconstruct the sequenced genome, or if our reference genome is significantly flawed, the genomic data we deliver could be inaccurate and of little or no use to our customers.

An inability to manage our planned growth or expansion of our operations could adversely affect our business, financial condition or results of operations.

To effectively manage our operations and growth, we must continue to expend funds to enhance our operational, financial and management controls, reporting systems and procedures and to attract and retain sufficient numbers of talented employees. If we are unable to eventually expand our genome sequencing capacity and implement improvements to our control systems efficiently and quickly, or if we encounter deficiencies in existing systems and controls, then we will not be able to successfully expand the commercialization of our services. In addition to enhancing our sequencing capacity, our future operating results will depend on our management's ability to:

implement and improve our sales, marketing and customer support programs and our research and development efforts;

enhance our operational and financial control systems;

expand, train and manage our employee base;

manage the operating expenses of our business as we expand;

integrate acquired businesses, if applicable; and

effectively address new issues related to our growth as they arise.

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We may not manage our expansion successfully, which could adversely affect our business, financial condition or results of operations.

If we expand our operations outside of the United States, we will face risks that may increase our operating costs.

Our long-term plan is to expand our operations to include satellite genome sequencing centers outside of the United States. Because the laws of certain countries currently prohibit the export of DNA, we will have to establish local facilities to access customers in those countries and establish a presence there. To date, we have not expanded our sequencing operations outside the United States. Operating in international markets requires significant resources and management attention and will subject us to regulatory, economic and political risks that are different from those in the United States. Because of our limited experience with international operations, our international expansion efforts may be unsuccessful. In addition, we will face risks in doing business internationally that could increase our operating costs, including the following:

economic conditions in various parts of the world;

unexpected and more restrictive laws and regulations, including those laws governing ownership of intellectual property, collection and use of personal information and other privacy considerations, hazardous materials and other activities important to our business;

new and different sources of competition;

multiple, conflicting and changing tax laws and regulations that may affect both our international and domestic tax liabilities and result in increased complexity and costs;

the difficulty of managing and staffing satellite genome sequencing centers and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;

difficulties in enforcing contracts and collecting accounts receivable, especially in developing countries;

fluctuations in exchange rates; and

tariffs and trade barriers, import/export controls and other regulatory or contractual limitations on our ability to sell or develop our services in certain foreign markets.

The success of the expansion of our business internationally will depend, in part, on our ability to anticipate and effectively manage these and other risks associated with international operations. Our failure to manage any of these risks successfully could increase our operating costs.

Because demand and applications for genome sequencing is relatively new and rapidly evolving, we may become subject to additional future governmental regulation, which may place additional cost and time burdens on our operations.

We are subject, both directly and indirectly, to the potential adverse impact of existing and potential future government regulation of our business and services. The life sciences, pharmaceutical and medical services industries, which are important target industries for our services, have historically been heavily regulated. There are comprehensive federal and state laws regarding matters such as the privacy of patient information, quality of laboratory services and research in genetic engineering. For example, if we inadvertently disclose private personal information in the course of providing our sequencing services, we could face liability for violations of federal law.

Legislative bodies or regulatory authorities may adopt additional regulation that adversely affects our growth opportunities. They could also extend existing regulations to cover our services. For example, medical diagnostic services may, depending on their intended use, be regulated as medical devices by the Food and Drug Administration, or FDA

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Medical devices generally cannot be marketed without first receiving clearance or approval (depending on the regulatory pathway) from the FDA. We do not believe that our sequencing services are currently subject to the FDA's medical device requirements. However, we cannot control how the genomic information we provide will be used by our customers.

In addition, the FDA is focusing on genomic and diagnostic-related services, which has created uncertainty regarding the regulatory landscape. The FDA has recently taken actions suggesting that it interprets the applicable regulations expansively to cover certain genomic devices and services, particularly those sold directly to consumers. Since June 2010, the FDA has sent numerous letters to certain companies in DNA sequencing, including 23andMe, Inc., deCODE Genetics, Knome, Inc., Navigenics, Inc. and Pathway Genomics. In these letters, the FDA noted that it considers genetic tests marketed by these companies to be subject to FDA regulation and, accordingly, unapproved medical devices. Additionally, in March 2011, the FDA held a public two-day meeting discussing the appropriate regulation of the direct-to-consumer genetic tests. The FDA may extend this position to services such as ours. In addition, the FDA may implement new regulations that may be broad enough to cover our operations. Changes to the current regulatory framework, including the imposition of new regulations, could arise anytime, and we may be unable to obtain or maintain FDA or comparable regulatory approval or clearance for our services, if required. For example, the FDA may impose restrictions on the types

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of customers to which we can market and sell our services and the types of persons whose DNA we may sequence. Also, future legislation may require that research subjects or patients provide specific consent to have their DNA sequenced. This could require our customers to obtain new consents before they can submit DNA samples to us for sequencing.

As we look to expand our business to include sequencing services for the diagnosis of disease, we will become subject to further regulation by the FDA or other comparable agencies of other countries, which may require us to obtain regulatory approval or clearance before we can offer those services.

These regulatory approval processes may be expensive, time-consuming and uncertain, and our failure to obtain or comply with these approvals or clearances could harm our business, financial condition or operating results.

Disruption to or failure of our data center or other technical systems may disrupt our business and harm our operating results.

We rely on our network infrastructure, data centers, enterprise applications and technology systems for the development and support of our sequencing service, including the preparation, analysis and transmission of data from our sequencing center, as well as for the internal operation of our business. These systems are susceptible to disruption or failure in the event of natural disasters such as a major earthquake, fire, flood, cyber-attack, terrorist attack, telecommunications failure, power outage or other catastrophic event. Further, our data center and our sequencing facility, which houses certain of our technology systems, are located near major earthquake faults. Disruptions to or the failure of our data center or any of these technology systems, including the network connection between our Mountain View facility and our data center, and the resulting loss of critical data, could cause delays in the transmission and analysis of the sequencing data, prevent us from fulfilling our customers' orders and severely affect our ability to conduct normal business operations.

If we fail to retain the services of our key executives or if we are unable to attract and retain skilled personnel, our ability to grow our business and our competitive position would be impaired.

We believe our future success will depend in large part upon our ability to attract, retain and motivate highly skilled personnel. In particular, we depend highly on the contributions of Clifford A. Reid, Ph.D., our President and Chief Executive Officer, and Radoje T. Drmanac, Ph.D., our Chief Scientific Officer. The loss of either of these executives could make it more difficult to manage our operations and research and development activities, reduce our employee retention and revenue and impair our ability to compete. If either of these key executives were to leave us unexpectedly, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity, both during the search for, and integration of, any such successor.

Our research and development, operations and sales and marketing personnel represent a significant asset and serve as the source of our business strategy, scientific and technological innovations and sales and marketing initiatives. As a result, our success substantially depends on our ability to retain and attract personnel for all areas of our organization. Competition for qualified personnel is intense, and we may not be successful in attracting and retaining qualified personnel on a timely basis or on competitive terms, if at all. In addition, many qualified personnel are located outside of Northern California, where we are located, and some qualified personnel that we may recruit may not be interested in relocating. If we are unable to attract and retain the necessary personnel on a cost-effective basis, our ability to grow our business and our competitive position would be impaired.

We may engage in joint ventures or acquisitions that could disrupt our business, cause dilution to our stockholders, reduce our financial resources and result in increased expenses.

In the future, we may enter into joint ventures or acquire other businesses, products or technologies. Because we have not entered into any joint ventures or made any acquisitions to date, our ability to do so successfully is unproven. We may not be able to find suitable partners or acquisition candidates, and we may not be able to complete such transactions on favorable terms, if at all, or successfully integrate any acquired business, products or technologies into our operations. If we do enter into any joint ventures or complete acquisitions, we may not strengthen our competitive position or achieve our goals; alternatively these transactions may be viewed negatively by customers or investors. In addition, we may have difficulty integrating personnel, technologies and operations from acquired businesses and retaining and motivating key personnel from those businesses. Joint ventures and acquisitions may disrupt our ongoing operations, divert management from day-to-day responsibilities and increase our expenses. Future acquisitions may reduce our cash available for operations and other uses, and could result in an increase in amortization expense related to identifiable intangible assets acquired, potentially dilutive issuances of equity securities or the incurrence of debt. We cannot predict the number, timing or size of future joint ventures or acquisitions, or the effect that any such transactions might have on our operating results.

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We incur significant costs as a result of operating as a public company, and our management devotes substantial time to new compliance initiatives. We may fail to comply with the rules that apply to public companies, including section 404 of the Sarbanes-Oxley Act of 2002.

We have incurred and will continue to incur significant legal, accounting and other expenses as a public company, including costs resulting from public company reporting obligations under the Securities Exchange Act of 1934, as amended, and regulations regarding corporate governance practices. The listing requirements of The NASDAQ Global Market require that we satisfy certain corporate governance requirements relating to director independence, distributing annual and interim reports, stockholder meetings, approvals and voting, soliciting proxies, conflicts of interest and a code of conduct. Our management and other personnel devote a substantial amount of time to all of these requirements. Moreover, the reporting requirements, rules and regulations increase our legal and financial compliance costs and make some activities more time-consuming and costly. These reporting requirements, rules and regulations, coupled with the increase in potential litigation exposure associated with being a public company, could make it more difficult for us to attract and retain qualified persons to serve on our board of directors or board committees or to serve as executive officers. In addition, the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley Act, and the related rules of the Securities and Exchange Commission require that we maintain effective internal control over financial reporting and disclosure controls and procedures. In particular, our management and independent registered public accounting firm are required to provide a report on the effectiveness of our internal control over financial reporting with our annual report, as required by Section 404 of the Sarbanes-Oxley Act. During the course of our review and testing, we may identify deficiencies and be unable to remediate them before we must provide the required reports. We or our independent registered public accounting firm may not be able to conclude on an ongoing basis that we have effective internal control over financial reporting, which could harm our operating results, cause investors to lose confidence in our reported financial information and cause the trading price of our stock to fall.

Our compliance with Section 404 may require that we incur substantial expense and expend significant management time on compliance-related issues. Moreover, if we are unable to comply with the requirements of Section 404 in a timely manner, or if we or our independent registered public accounting firm is unable to conclude that our internal control over financial reporting is effective or otherwise identifies material weaknesses in our internal control, the market price of our stock would likely decline and we could be subject to sanctions or investigations by NASDAQ, the Securities and Exchange Commission or other regulatory authorities, which would require additional financial and management resources.

Our ability to use our net operating loss carryforwards to offset future taxable income may be subject to certain limitations.

In general, under Section 382 of the Internal Revenue Code of 1986, as amended, or the Code, a corporation that undergoes an ownership change is subject to limitations on its ability to use its pre-change net operating loss carryforwards, or NOLs, to offset future taxable income. If the Internal Revenue Service challenges our analysis that our existing NOLs will not expire before utilization due to previous ownership changes, our ability to use our NOLs could be limited by Section 382 of the Code. Future changes in our stock ownership, some of which are outside of our control, could result in an ownership change under Section 382 of the Code. Furthermore, our ability to use NOLs of companies that we may acquire in the future may be subject to limitations. For these reasons, we may not be able to use a material portion of the NOLs reflected on our balance sheet, even if we attain profitability.

Unfavorable global economic conditions could adversely affect our business, financial condition or results of operations.

Our results of operations could be adversely affected by general conditions in the global economy and in the global financial markets. The recent global financial crisis caused extreme volatility and disruptions in the capital and credit markets. A severe or prolonged economic downturn, such as the recent global financial crisis, could result in a variety of risks to our business, including, reductions or delays in planned research and development and other expenditures by our customers or decreased funding of genomic research by governmental entities. A weak or declining economy could also put strain on our suppliers, possibly resulting in supply disruption, or cause our customers to delay making payments for our services. Any of the foregoing could harm our business.

Risks Related to Intellectual Property

We currently are, and could in the future be, subject to litigation regarding patent and other proprietary rights that could harm our business.

Our commercial success depends in part on not infringing patents and proprietary rights of third parties. Illumina, Inc. and affiliated entities have filed two lawsuits against the Company alleging patent infringement by us. See Part II, Item 1. Legal Proceedings

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As we enter our markets, it is possible other competitors will claim that our services infringe their intellectual property rights as part of a business strategy to impede our successful entry into those markets. Such competitors and other third parties may have obtained and may in the future obtain patents covering products or processes that are similar to or may include steps or processes used in our sequencing technology, allowing them to claim that the use of our technologies infringes these patents. In particular, we are aware of issued U.S. patents owned by competitors and other third parties, including Illumina, to which we do not have licenses that may relate to our sequencing technology and which pertain to, among other things:

sample preparation techniques;

processes for making nucleic acid templates, or library construction;

processes for making DNBs from nucleic acid templates;

nucleic acid arrays;

methods of making arrays of DNBs;

sequencing methods, including those involving ligation;

identifying genomic sequences on nucleic acid arrays;

devices and apparatus used in nucleic acid detection systems, including optical systems; and

information processing systems including software for base calling, sequence mapping and assembly.

Some of the third parties that own these patents, including Illumina, have strong economic incentives, and substantial financial resources, to claim that we are infringing their patent rights. In a patent infringement claim against us, we may assert, as a defense, that we do not infringe the relevant patent claims, that the patent is invalid or both. The strength of our defenses will depend on the patents asserted, the breadth and scope of the construction of the claims of these patents, our ability to identify prior art in order to invalidate the asserted patent and on other factors.

However, we could be unsuccessful in advancing non-infringement and/or invalidity arguments in our defense. In the United States, issued patents enjoy a presumption of validity, and the party challenging the validity of a patent claim must present clear and convincing evidence of invalidity, which is a high burden of proof. Conversely, the patent owner need only prove infringement by a preponderance of the evidence, which is a lower burden of proof.

If we were found by a court to have infringed a valid patent claim, we could be prevented from using the patented technology or be required to pay the owner of the patent rights for the rights to use that technology and/or pay monetary damages, including, for example, treble damages if we are found to have willfully infringed. If we decide to pursue a license to one or more of these patents, we may not be able to obtain such a license on commercially reasonable terms, if at all, or the license we obtain may require us to pay substantial royalties or grant cross licenses to our patent rights. For example, if the relevant patent is owned by a competitor, that competitor may choose not to license patent rights to us, as it would be under no obligation to do so. If we decide to develop alternative technology, we may not be able to do so on a timely or cost-effective manner, if at all.

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In addition, because patent applications can take years to issue and are often afforded confidentiality for some period of time, there may currently be pending applications, unknown to us, which later result in issued patents that processes in our sequencing technology infringe. Processes in our sequencing technology may also infringe existing issued patents of which we are currently unaware. Even though we own or have other rights to patents, these patents do not provide us with the freedom to offer our sequencing services unimpeded by the patent rights of others. For example, we may be required to pursue or defend a patent infringement action in order to protect our intellectual property rights or practice our sequencing technology. If we expand our business to include sequencing services intended to be used for the diagnosis of disease, it may be necessary to license patents related to such services.

It is possible that, in addition to our current litigation, we may in the future receive communications from competitors and others alleging that we may be infringing their patents, trade secrets or other intellectual property rights or offering licenses to such intellectual property or threatening litigation. For example, an educational institution has invited us to engage in negotiations for the license of certain of that institution's patent rights. We have not yet determined whether we will seek such a license. In addition to patent infringement claims, third parties may assert copyright, trademark or other proprietary rights against us. We may not be able to successfully defend against the claims asserted by Illumina, or future claims, and our business may suffer if we are found to have infringed upon the patents held by Illumina, or if future claims are brought against us.

We may not be able to protect our patent rights or other intellectual property which could impair our ability to compete effectively.

We depend on proprietary technology for our success and ability to compete. If others are able to reproduce our technology, our business will suffer significantly unless we can prevent them from competing with us. To protect our proprietary technology, we rely on patents and other intellectual property laws, as well as nondisclosure agreements, licensing arrangements and confidentiality provisions. U.S. patent, copyright and trade secret laws afford us only limited protection, and the laws of some foreign countries do not protect proprietary rights to the same extent.

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We have licensed, from Callida Genomics, Inc., U.S. and international patents and patent applications relating to our business. Because the issuance of a patent is not conclusive of its validity or enforceability, our existing patent rights, and rights we may obtain in the future, may not provide us with meaningful protection. The patent rights on which we rely may be challenged and invalidated or may be interpreted not to be broad enough to cover the critical components of our technology. Our pending patent applications may have their claims limited or may not result in issued patents. Moreover, our patent rights become more limited as owned or licensed patents begin to expire in 2014. We will be able to protect our technologies from unauthorized use by third parties only to the extent that valid and enforceable patents or other proprietary rights cover them. Even if we have valid and enforceable patents or other proprietary rights, competitors may be able to design alternative methods or devices that avoid infringement of those patents or rights. Our key patent rights are licensed from Callida, which is owned by our Chief Scientific Officer and his spouse. If we materially breach the terms of this license, Callida may seek to terminate the license. If we lose our rights to use these patents, we may be forced to re-design our sequencing technology, which would be expensive and may not be possible.

The patent positions of biotechnology companies, including us, can be highly uncertain and involve complex and evolving legal and factual questions. No consistent policy regarding the breadth of claims allowed in biotechnology patents has emerged to date in the United States. Legal developments may preclude or limit the patent protection available for our sequencing technology.

Despite our efforts to protect our proprietary rights, attempts may be made to copy or reverse engineer aspects of our sequencing technology or to obtain and use information that we regard as proprietary. Accordingly, we may be unable to protect our proprietary rights against unauthorized third-party copying or use. Furthermore, policing the unauthorized use of our intellectual property is difficult. Litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Litigation could result in substantial costs and diversion of resources and could harm our business.

We may incur substantial costs as a result of our current, or future, litigation or other proceedings relating to patent and other proprietary rights.

The genomic sequencing industry includes several large companies that have rights to many broad issued patents and pending patent applications. Competitors in this industry have fiercely litigated their patent positions and alleged infringements by others. For example, Illumina and Affymetrix were involved in long and expensive patent litigation relating to DNA sequencing technology. This litigation resulted in a settlement involving the payment of \$90 million by one party to the other.

Our current litigation with Illumina or our involvement in any other future intellectual property litigation, including, or administrative proceedings could result in significant expense. Some of our competitors, including Illumina, Life Technologies and Roche, have considerable resources available to them. We, on the other hand, are an early-stage commercial company with comparatively few resources available to us to engage in costly and protracted litigation. Intellectual property infringement claims asserted against us, whether with or without merit, could be costly to defend and could limit our ability to use some technologies in the future. They will be time consuming, will divert our management's and scientific personnel's attention and may result in liability for substantial damages. For example, we have incurred and anticipate that we will continue to incur significant expense and substantial time in defending against our current intellectual property infringement dispute with Illumina. In addition, our standard customer contract requires us to indemnify our customers for claims alleging that any of our products misappropriate or violate any third party patent, copyright, trade secret or other intellectual property or proprietary rights.

If third parties file patent applications or are issued patents claiming technology also claimed by us in pending applications, we may be required to participate in interference or other proceedings with the U.S. Patent Office or U.S. courts or in other proceedings outside the United States, including oppositions, to determine priority of invention or patentability. Even if we are successful in these proceedings, we may incur substantial costs, and the time and attention of our management and scientific personnel will be diverted in pursuit of these proceedings.

We may not be able to enforce our intellectual property rights throughout the world.

The laws of some foreign countries do not protect intellectual property rights to the same extent as the laws of the United States. Many companies have encountered significant problems in protecting and defending intellectual property rights in certain foreign jurisdictions. The legal systems of some countries, particularly developing countries, do not favor the enforcement of patents and other intellectual property protection, especially those relating to biotechnology. This could make it difficult for us to stop the infringement of our patents or the misappropriation of our other intellectual property rights. For example, many foreign countries have compulsory licensing laws under which a patent owner must grant licenses to third parties. In addition, many countries limit the enforceability of patents against third parties, including government agencies or government contractors. In these countries, patents may provide limited or no benefit.

Proceedings to enforce our patent rights in foreign jurisdictions could result in substantial costs and divert our efforts and attention from other aspects of our business. Accordingly, our efforts to protect our intellectual property rights in such countries may be inadequate. In addition,

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changes in the law and legal decisions by courts in the U.S. and foreign countries may affect our ability to obtain adequate protection for our technology and the enforcement of intellectual property.

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Confidentiality agreements with employees and others may not adequately prevent disclosures of our trade secrets and other proprietary information.

We rely in part on trade secret protection to protect our confidential and proprietary information and processes. However, trade secrets are difficult to protect. We have taken measures to protect our trade secrets and proprietary information, but these measures may not be effective. We require new employees and consultants to execute confidentiality agreements upon the commencement of an employment or consulting arrangement with us. These agreements generally require that all confidential information developed by the individual or made known to the individual by us during the course of the individual's relationship with us be kept confidential and not disclosed to third parties. These agreements also generally provide that inventions conceived by the individual in the course of rendering services to us will be our exclusive property. Despite these measures, our proprietary information may be disclosed, third parties could reverse engineer our sequencing technologies and others may independently develop substantially equivalent proprietary information and techniques or otherwise gain access to our trade secrets. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our proprietary rights, and failure to obtain or maintain trade secret protection could adversely affect our competitive business position.

Risks Related to Ownership of Our Common Stock

Our stock price is volatile and purchasers of our common stock could incur substantial losses.

Our stock price is volatile, and from December 31, 2010 to September 30, 2012, the trading prices of our stock have ranged from \$18.55 to \$1.57 per share. The market price of our common stock may fluctuate significantly in response to a number of factors. These factors include those discussed in this Risk Factors section of this Quarterly Report and others such as:

our ability to raise capital to continue our operations as a going concern;

quarterly variations in our results of operations or those of our competitors;

changes in financial estimates or guidance, including our ability to meet our future revenue and operating profit or loss estimates or guidance;

changes in earnings estimates or recommendations by securities analysts;

announcements by us or our competitors of new products or services, significant contracts, commercial relationships, acquisitions, capital commitments or changes in the outlook of the market for genomic sequencing products and services;

developments with respect to intellectual property rights;

whether repayment of our term loan(s) is accelerated if an event of default occurs;

our commencement of, or involvement in, litigation;

announcements regarding equity or debt financing transactions;

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any major changes in our board of directors or management;

changes in governmental regulations; and

a decrease in government funding of research and development or a slowdown in the general economy; and

speculation in our stock due our announced Merger Agreement with BGI.

In recent years, the stock market in general, and the market for technology and life sciences companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Broad market and industry factors may seriously affect the market price of our common stock, regardless of our actual operating performance. In addition, in the past, following periods of volatility in the overall market and the market price of a particular company's securities, securities class action litigation has often been instituted against these companies. This litigation, if inst