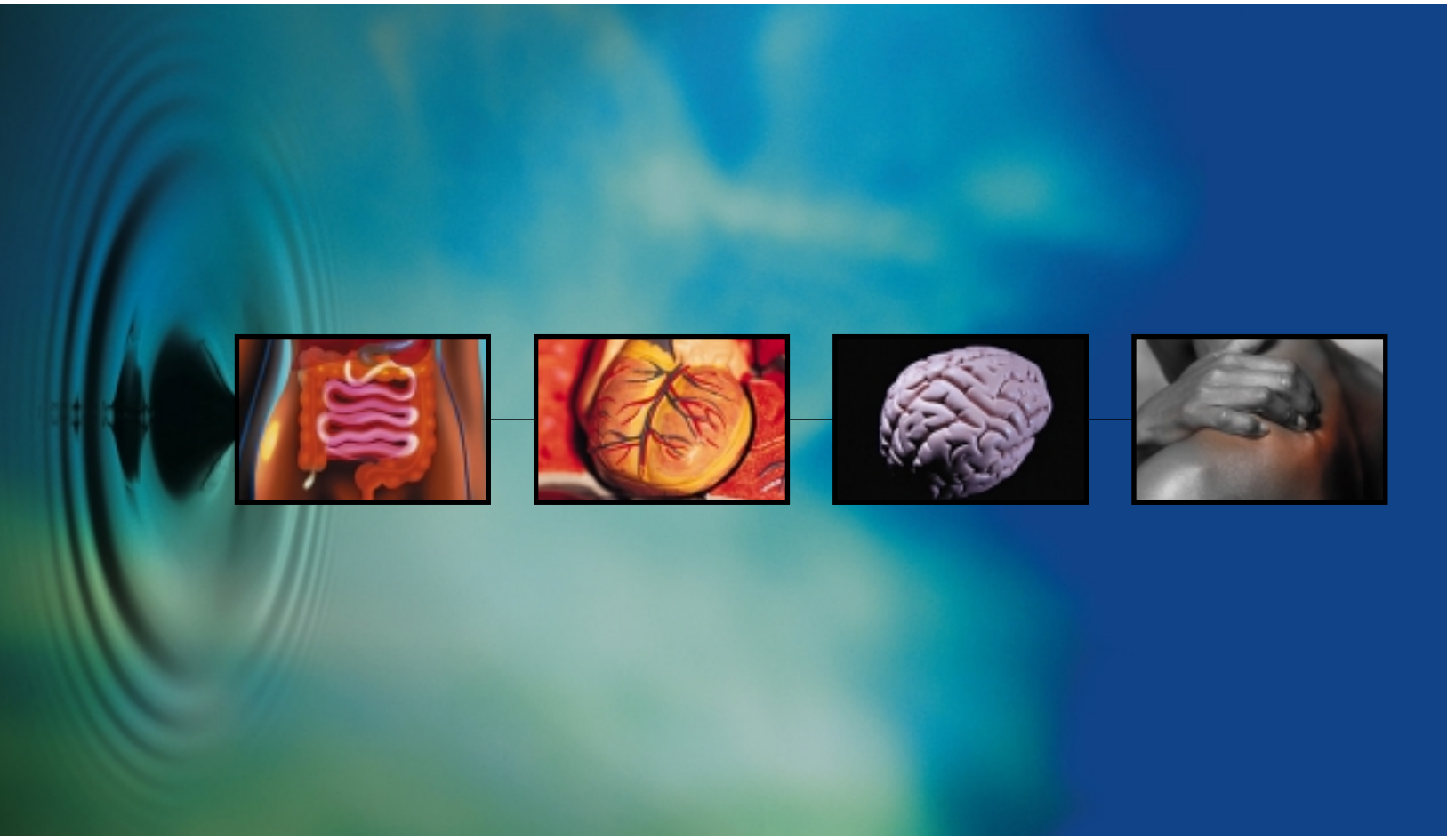
Arena Pharmaceuticals, Inc. | Annual Report 2002



Focus on the Future

2002 Highlights

- Collaborations initiated with Merck & Co. and Ferring Pharmaceuticals
- Successful completion of collaboration with Eli Lilly
- Progress in four areas of internal therapeutic focus
- Identified novel class of potential anti-diabetic and anti-obesity agents
- Project Genesis continued at a strong pace
- Enhanced infrastructure to meet future expansion needs
- Arena employment level exceeded 300

2002 in Review

In 2002, we generated significant new information on important therapeutic targets and advanced our Project Genesis, including making substantial progress in our search to identify essentially all relevant G protein-coupled receptor ("GPCR") targets. We developed our second generation GPCR microarray chip and began further new analysis of GPCR expression and localization. We screened over 60 receptors and extended the capacity of our screening group. Additionally, our medicinal chemistry and pharmaceutical development groups made continuing advances in small molecule development.

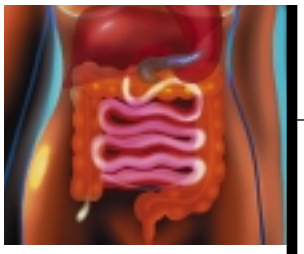
We continued the progress of our lead programs toward filings of INDs for clinical trials, and were pleased that the quality of our scientific work attracted two significant new collaborators to Arena.

Moving Forward with Arena

Our mission continues to be to create and commercialize new therapeutics by integrating genomic information, biologic discoveries and proprietary technologies. To this end, we will continue to focus on the important target class of GPCRs. We have proprietary technologies that aid us in the rapid identification of potential drug candidates. We have assembled an outstanding group of scientists and researchers to lead our programs and projects, and have focused our efforts and expertise on four areas of therapeutic interest where GPCRs play important biological roles. We will continue to dedicate substantial resources in pursuit of the successful completion of our mission.

We expect that our research and development efforts will result in a significant pipeline of pre-clinical and, eventually, clinical programs. We also look forward to developing new collaborations in the future.

Four Focused Areas of Therapeutic Interest at Arena



Metabolism

It is well established that GPCR signaling provides critical contributions to the control of both insulin secretion and insulin action. We are focusing discovery efforts on GPCR targets that have been determined to play a role in beta cell function and insulin regulation, using both *in vitro* and *in vivo* approaches.

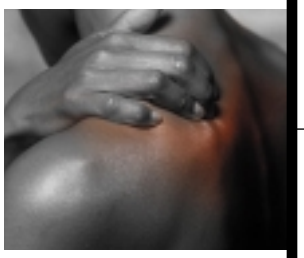
Our researchers have made discoveries in the area of obesity research with respect to identifying novel GPCRs that regulate energy homeostasis. Drug discovery efforts are currently underway to identify novel drug candidates targeting GPCRs in the CNS and peripheral tissues, which we believe may act to reduce fat mass in patients.

Cardiovascular

Our cardiovascular group has built internal research programs in two therapeutic areas: atherosclerosis and heart failure. The decision to focus on these two areas is based on significant unmet medical need, growing target populations and a mechanistic understanding of the role of GPCRs in the disease process. We believe that our expertise in GPCRs provides a significant competitive advantage in the development of novel drugs for these important therapeutic targets.

Central Nervous System

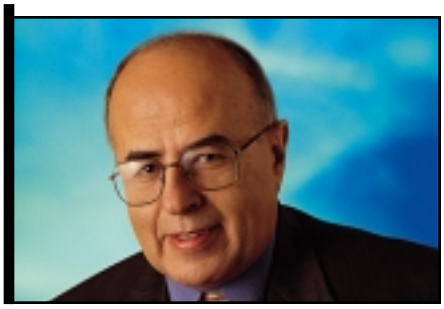
We have several programs in the area of neuropsychopharmacology and neurodegeneration. These are mainly directed at identifying known and novel GPCR targets for the treatment of psychosis, depression, anxiety and neurodegenerative diseases such as peripheral neuropathy and Parkinson's disease.



Inflammation

We are developing small molecule therapeutics that target GPCRs involved in the inflammatory process. Diseases such as asthma and inflammatory bowel disease (including Crohn's disease and ulcerative colitis) are initiated and exacerbated by an aberrant inflammatory response. We have identified GPCRs that are restricted in cell type expression and that may mediate the inflammatory process. Small molecule therapeutics targeted to these receptors are being evaluated for efficacy in models of these inflammatory diseases. We currently have a portfolio of GPCR targets that may represent novel mechanisms of intervention in a broad range of inflammatory mediated diseases.

Jack Lief



To the Stockholders of Arena Pharmaceuticals, Inc.:

This past year was marked by many accomplishments as Arena matured into a world leader in G protein-coupled receptor ("GPCR") medicinal discovery. Our bioinformatics and gene discovery groups made substantial progress in our GPCR acquisition program and created the second-generation GPCR micro-array chip. This has enhanced our understanding of GPCR gene regulation and function. Our screening group completed a preliminary evaluation of a majority of therapeutically interesting receptor targets and our biology and chemistry groups are developing potential drug candidates at 12 GPCR targets.

I am optimistic about the future because of Arena's outstanding scientific capability to discover small molecule modulators to the rich array of drugable GPCR targets. My optimism is also based on our deep understanding of this important class of genes and our solid financial position. We focus on GPCRs because this single class of receptor is responsible for about 80% of cellular communication and represents the single largest family of receptors present in the human body. We have gained a deeper understanding of small molecule-GPCR interactions through Project Genesis, our ambitious effort to complete the screening of substantially all therapeutically relevant GPCRs at the Arena GPCR small molecule library in order to identify chemical structures associated with GPCR sub-families. Financially, we finished the year on a strong note with over $185 million in unrestricted cash and cash equivalents, along with two new research collaborations.

Let me now focus on selected 2002 highlights:

- We completed the screening of over 300 potentially therapeutically interesting GPCRs at selected subsets of our chemical library and discovered many previously unknown receptor activities. For example, we have now identified GPCRs that may be modulated by certain steroids, GPCRs that may modulate insulin release in the pancreas, GPCRs that may modulate plasma free fatty acids and cholesterol levels, GPCRs that may modulate heart function and GPCRs that may modulate immune cell targets for inflammatory bowel disease and asthma. We are now actively engaged in identifying high potency molecules targeting subsets of these prioritized GPCRs. Indeed, this effort has already yielded a novel class of orally active insulin releasing molecules with *in vivo* activity in animal models of diabetes. Needless to say, this may open up an exciting, novel approach for this widespread and debilitating disease. Drug discovery is ongoing, including at a dozen internally prioritized GPCR targets.

- In spite of a difficult partnering environment, we reported an increase in our revenues for 2002 because we achieved significant progress in our partnering activities. In October, Arena initiated a significant collaboration with Merck, which included payment to Arena of over $5 million and resulted in 4th quarter revenues in excess of $1.6 million. We expect our Merck collaboration to generate over $10 million in revenues during 2003, based on continued success and achievement of additional milestones.

- During 2002, we achieved 32 milestones in our collaboration with Eli Lilly, and they rated us among their best research collaborators. Arena's productivity in this collaboration has provided Eli Lilly with many new GPCR targets that could generate future additional developmental milestones. Our Eli Lilly collaboration generated over $14 million in revenues in 2002.

- In June, Arena entered into a collaboration with Ferring Pharmaceuticals, focused on reproductive health. This collaboration contributed over a million dollars to our revenues during 2002 and we expect increased revenues in 2003, based on milestone success.

- Our collaboration with Taisho has achieved important progress and we hope to achieve our goal of identifying an IND candidate to treat depression or obesity by early 2004.

As I look to the future, I hope to report the filing of an IND either late this year or early in 2004, along with news of expected additional filings. I also hope to report on additional GPCR collaborations in areas such as diabetes. Finally, I am committed to carefully weighing our need to make substantial expenditures for drug discovery against my desire to maintain our solid financial position through collaborative efforts and cost containment initiatives.

Arena was founded in 1997 and began research operations in January 1998. I believe we have accomplished a great deal, and am confident that we are just beginning to achieve our potential.

Jack Lief
President & Chief Executive Officer

Financial Highlights

Year ended December 31,	2002	2001	2000	1999
Total revenues	$ 19,421,765	$ 18,059,999	$ 7,683,396	$ —
Research and development	44,399,136	22,864,250	12,080,204	8,336,483
General and administrative	7,499,011	5,390,446	2,678,980	1,814,023
Amortization of deferred compensation	2,264,934	4,239,740	4,342,896	378,109
Amortization of acquired technology and other purchased intangibles	1,586,127	1,280,830	—	—
Total operating expenses	55,749,208	33,775,266	19,102,080	10,528,615
Interest and other, net	3,497,505	8,832,543	5,056,714	290,665
Net loss	(32,829,938)	(6,882,724)	(6,361,970)	(10,237,950)

As of December 31,	2002	2001	2000	1999
Balance Sheet Data:				
Cash, cash equivalents and short-term investments	$185,142,885	$226,924,293	$144,413,176	$ 5,401,508
Total assets	254,890,047	276,973,710	152,711,929	8,525,840
Long-term debt, net of current portion	45,737	402,092	960,517	2,158,784
Total stockholders' equity (deficit)	242,051,701	269,473,678	148,784,325	(13,899,549)

Selected Financial Data

The following Selected Financial Data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Audited Financial Statements" included elsewhere in this Annual Report.

Year Ended December 31,	2002	2001	2000	1999	1998
Revenues					
Collaborative agreements	$ 18,005,765	$ 16,643,999	$ 7,683,396	$ —	$ —
Collaborative agreements with affiliates	1,416,000	1,416,000	—	—	—
Total revenues	19,421,765	18,059,999	7,683,396	—	—
Expenses					
Research and development	44,399,136	22,864,250	12,080,204	8,336,483	2,615,526
General and administrative	7,499,011	5,390,446	2,678,980	1,814,023	728,806
Amortization of deferred compensation	2,264,934	4,239,740	4,342,896	378,109	—
Amortization of acquired technology and other purchased intangibles	1,586,127	1,280,830	—	—	—
Total operating expenses	55,749,208	33,775,266	19,102,080	10,528,615	3,344,332
Interest and other, net	5,284,302	8,832,543	5,056,714	290,665	(51,986)
Investment write-down	(1,786,797)	—	—	—	—
Net loss	(32,829,938)	(6,882,724)	(6,361,970)	(10,237,950)	(3,396,318)
Non-cash preferred stock charge	—	—	(22,391,068)	—	—
Net loss applicable to common stockholders	$(32,829,938)	$ (6,882,724)	$ (28,753,038)	$(10,237,950)	$(3,396,318)
Net loss per share, basic and diluted	$ (1.19)	$ (0.28)	$ (2.84)	$ (10.05)	$ (3.51)
Shares used in calculating net loss per share, basic and diluted	27,487,537	24,989,067	10,139,755	1,018,359	966,799
Balance Sheet Data:					
Cash and cash equivalents	$ 61,871,305	$176,676,669	$144,413,176	$ 5,401,508	$ 194,243
Short-term investments	123,271,580	50,247,624	—	—	—
Total assets	254,890,047	276,973,710	152,711,929	8,525,840	1,653,090
Long-term obligations, net of current portion	45,737	402,092	960,517	2,158,784	970,785
Redeemable convertible preferred stock	—	—	—	18,251,949	2,598,643
Deferred compensation	(1,060,689)	(3,611,933)	(7,899,970)	(625,955)	—
Accumulated deficit	(60,403,665)	(27,573,727)	(20,691,003)	(14,329,033)	(4,091,083)
Total stockholders' equity (deficit)	242,051,701	269,473,678	148,784,325	(13,899,549)	(4,068,283)

You should read the following discussion and analysis in conjunction with "Audited Financial Statements" included below in this Annual Report. Operating results are not necessarily indicative of results that may occur in future periods. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. The actual results may differ materially from those anticipated in these forward-looking statements as a result of many factors, including those listed in "Information Relating to Forward-Looking Statements" below.

Arena Pharmaceuticals®, Arena®, Aressa Pharmaceuticals® and our corporate logo are registered service marks of Arena. CART™ and BRL Screening™ are unregistered service marks of Arena.

In this Annual Report, "Arena Pharmaceuticals," "Arena," "we," "us" and "our" refer to Arena Pharmaceuticals, Inc. and/or our wholly owned subsidiary, BRL Screening, Inc., unless the context otherwise provides.

Overview

We incorporated on April 14, 1997, in the state of Delaware and commenced operations in July 1997. We are a biopharmaceutical company focused principally on discovering and developing drugs that act on an important class of drug targets called G protein-coupled receptors, or GPCRs. We use our Constitutively Activated Receptor Technology, or CART™, Melanophore technology and other proprietary technologies to better understand GPCRs and to more efficiently and effectively identify compounds that may lead to new drugs.

We focus our efforts in four major therapeutic areas: metabolic diseases, cardiovascular diseases, central nervous system disorders and inflammatory diseases. In addition, we are pursuing an internal drug discovery program that we call Project Genesis. Project Genesis is comprised of the following steps: Identifying therapeutically relevant GPCRs; determining expression levels and localization of these GPCRs; using our proprietary technologies for high-throughput screening of these GPCRs against our chemical compound library; and optimizing small molecule leads identified from our chemical library screens into drug candidates. With the completion of the sequencing of the human genome, we view Project Genesis as a strategic extension of our scientific and business capabilities that will allow us to discover new drug leads at therapeutically relevant GPCRs.

We may enter into collaborative arrangements with respect to our CART and Melanophore technologies, CART-activated receptors, drug leads or drug candidates that we discover. Alternatively, we may choose to internally develop the drug candidates.

In 2002, we recorded revenues of over $19.4 million from research and development collaborations with pharmaceutical companies. Our current collaborators include Eli Lilly and Company ("Eli Lilly"), Merck & Co., Inc. ("Merck"), Ferring Pharmaceuticals, Inc. ("Ferring"), TaiGen Biotechnology Co., Ltd. ("TaiGen"), Taisho Pharmaceutical Co., Ltd. ("Taisho") and others. We expect that our research collaboration with Eli Lilly, which accounted for $14.2 million, or 73%, of our revenues in 2002, will be completed on April 14, 2003. As a result, we expect revenues from Eli Lilly in 2003 to be significantly less than in 2002. However, we expect that our revenues in 2003 will exceed revenues in 2002 because of our other collaborations. In 2003, our revenues are expected to be derived to a significant extent from Merck. Our revenues have historically fluctuated and may fluctuate significantly from quarter to quarter in the future, depending on a variety of factors, including the timing of and receipt by us of milestone payments as evidenced by acknowledgment from our collaborators.

Following is a summary of our significant collaborations in 2002:

Eli Lilly and Company

In April 2000, we entered into a research and licensing agreement with Eli Lilly to focus on GPCRs in the central nervous system and, to a lesser extent, GPCRs of potential interest in the cardiovascular and oncology fields. We receive research funding from Eli Lilly for our internal resources committed to our collaboration, which have been augmented by substantial resources at Eli Lilly. We are also eligible to

receive preclinical and clinical milestones and royalties on sales of products discovered using our CART technology, if any.

Our research activities under this collaboration are scheduled to be completed on April 14, 2003. Accordingly, we will no longer receive research funding from Eli Lilly under this collaboration after such date. We will, however, be eligible to receive preclinical, clinical and marketing milestone payments and royalties on sales of products discovered by Eli Lilly as a result of this collaboration, if any. We will continue to look for opportunities to collaborate with Eli Lilly.

For the year ended December 31, 2002, we recognized revenues under the Eli Lilly collaboration of approximately $14.2 million, consisting of research funding of $6.0 million, milestone achievements of $8.0 million, and approximately $200,000 from amortization of the upfront payment. For the year ended December 31, 2001, we recognized revenues under the Eli Lilly collaboration of approximately $8.5 million, consisting of research funding of approximately $4.9 million, milestone achievements of approximately $3.5 million, and $100,000 from amortization of the upfront payment. For the year ended December 31, 2000, we recognized revenues under the Eli Lilly collaboration of approximately $5.2 million, consisting of research funding of approximately $2.9 million, milestone achievements of approximately $2.2 million, and $75,000 from amortization of the upfront payment.

Merck & Co., Inc.

In October 2002, we entered into a research and licensing agreement with Merck to collaborate on validating and developing therapeutics on three GPCRs. During this collaboration, we will pursue an agreed upon research plan relating to such GPCRs and possibly other GPCRs that are discovered under the collaboration.

We received approximately $7.2 million in cash proceeds from Merck through December 31, 2002, comprised of a one-time upfront payment of $4.0 million and research funding of approximately $3.2 million, of which $1.8 million is research funding for research to be conducted from January 1, 2003, to March 31, 2003. We will receive research funding from Merck for our internal resources committed to the collaboration. In the future, we may receive up to $8.0 million in preclinical milestone payments. We may also receive additional milestones for Merck's clinical and marketing achievements, if any, and royalty payments associated with Merck's commercialization of drugs discovered under the agreement, if any.

The term of the collaborative research program under this agreement is three years from October 21, 2002. Merck can terminate this program for any of the following reasons: (i) without cause, at any time on or after the second anniversary of October 21, 2002, by giving notice at least 90 days prior to such termination date, if certain milestones have been achieved and paid; (ii) without cause, at any time after the second anniversary of October 21, 2002, by giving notice on or after such anniversary, and at least 180 days prior to such termination date; (iii) for certain technical grounds, at any time by giving 30 days prior notice; and (iv) in the event of a change in control of Arena, by giving 30 days prior notice. Merck can terminate the agreement at any time after the third anniversary of October 21, 2002. Either party can terminate the agreement at any time for cause if the other party breaches its material obligations under the agreement by causes and reasons within its control, has not cured such breach and there is no dispute as to whether such breach has occurred. Additionally, in lieu of terminating the agreement, Merck can terminate certain aspects of the agreement by giving 90 days prior notice if we materially breach our obligations at any time during the period from October 21, 2002, to the third anniversary of such date (or such earlier date of termination) and fail to cure such breach, if such default can be cured but not within a certain period, or if we do not commence and diligently continue good faith efforts to cure such default during such period.

For the year ended December 31, 2002, we recognized revenues under the Merck agreement of approximately $1.6 million, which included research funding of approximately $1.4 million and approximately $200,000 from the amortization of the upfront payment.

Ferring Pharmaceuticals, Inc.

In May 2002, we entered into a research and licensing agreement with Ferring. This collaboration will principally focus on a validated GPCR target in the field of reproductive biology. The objective of the

collaboration is to discover novel small molecule compounds of therapeutic potential. We will utilize our technologies to develop a CART-activated version of the GPCR target, develop a drug-screening assay, and screen focused small molecule compound libraries based on structures provided by Ferring and us.

We will receive research funding from Ferring for our internal resources committed to the collaboration, which we expect will be augmented by Ferring. Through December 31, 2002, we have recognized one preclinical screening milestone in the amount of $500,000. In the future, we may receive up to approximately $1.3 million in additional preclinical milestone payments if we identify a small molecule that has certain activity at the GPCR target and Ferring selects this compound for development, plus additional preclinical milestones if Ferring selects multiple small molecules to develop. We may also receive additional milestones for clinical and marketing achievements, if any. We may also receive royalty payments associated with the commercialization of drugs discovered under the agreement, if any.

Unless terminated earlier by one party for the other party's breach, insolvency or bankruptcy, this agreement is effective until the earlier of the following events: (i) no compound is being optimized, developed, commercialized and/or sold by Ferring under this agreement, or (ii) the expiration of Ferring's obligation to pay royalty payments to us for each drug product.

For the year ended December 31, 2002, we recognized revenues under the Ferring agreement of approximately $1.3 million, which included research funding of approximately $800,000 and a milestone achievement of $500,000.

TaiGen Biotechnology Co., Ltd.

In July 2001, we entered into a licensing agreement with TaiGen, a start-up biopharmaceutical organization focused on the discovery and development of innovative therapeutics primarily in the areas of oncology and inflammation. This agreement was later amended in December 2002. In exchange for a license to our technologies, including the right to select and obtain several GPCRs from us, we received $3.3 million in equity in TaiGen's Series A preferred financing, but did not receive any cash payment. We are eligible to receive preclinical and clinical milestones and royalty payments based on licensing revenues and drug sales, if any. We account for our ownership interest in TaiGen using the equity method of accounting because we own approximately 17% of TaiGen's outstanding shares and our President and CEO, Jack Lief, is a member of TaiGen's board of directors. This is a method of accounting for an investment that requires increasing or decreasing the value of our investment on our balance sheet based on our proportionate share of TaiGen's earnings or losses. We shared in TaiGen's losses and thereby increased our net loss for the year ended December 31, 2002, and 2001 by approximately $1.0 million and $204,000, respectively. Our investment in TaiGen was valued at $2.1 million and $3.1 million at December 31, 2002, and 2001, respectively. We also recognize non-cash revenues at the time we transfer to TaiGen a GPCR assay under our collaboration.

This agreement is effective until the expiration of TaiGen's obligation to make royalty payments under the agreement, if any. Additionally, either party may terminate this agreement if the other party fails to cure a material breach of the agreement within two months of receiving notice of such breach, becomes insolvent or commences bankruptcy proceedings, or dissolves or liquidates.

For each of the years ended December 31, 2002, and 2001, we recognized non-cash related party revenues under the TaiGen agreement of $1.4 million for the transfer of GPCR assays to TaiGen.

Taisho Pharmaceutical Co., Ltd.

In May 2000, we entered into a research and licensing collaboration with Taisho (the "2000 Taisho Agreement") focused on a few GPCRs. Under the terms of the 2000 Taisho Agreement, we were eligible to receive up to a total of $2.3 million in revenues per receptor associated with research, development and screening fees.

In January 2001, we amended the 2000 Taisho Agreement to grant Taisho worldwide rights to our 18F program, which includes the 18F receptor and small molecule modulators discovered using this receptor.

In October 2002, we further amended the 2000 Taisho Agreement and Taisho returned worldwide rights to the 18F program in exchange for royalties on drug sales, if any.

In January 2003, we further amended the 2000 Taisho Agreement to focus on one GPCR (in addition to 18F) and to identify and develop small molecule GPCR ligands for the treatment of obesity and/or certain CNS-related disorders. Under the terms of the amended agreement, we cross-licensed our technologies relating to such GPCR, and will share research and development costs and marketing rights with Taisho. In addition, each party will pay the other party royalties on drug sales, if any.

The 2000 Taisho Agreement is effective until the expiration of Taisho's obligation to make royalty payments under the agreement, if any. Additionally, either party may terminate this agreement if the other party fails to cure a material breach of the agreement within two months of receiving notice of such breach, becomes insolvent or commences bankruptcy proceedings, or dissolves or liquidates.

In addition to the 2000 Taisho Agreement, in March 2001, we entered into a receptor discovery agreement with Taisho (the "2001 Taisho Agreement"). In connection with the 2001 Taisho Agreement, Taisho paid us a one-time, non-refundable research and development fee, which was recognized as revenues in 2001 as services were performed. We do not expect any further work to be performed, or to receive any additional revenues, under the 2001 Taisho Agreement.

For the year ended December 31, 2002, we recognized revenues under the Taisho collaborations of approximately $283,000, consisting of research funding of approximately $163,000 and $120,000 from amortization of the upfront payment. For the year ended December 31, 2001, we recognized revenues under the Taisho collaborations of approximately $6.2 million, consisting of milestone achievements and research and development fees of approximately $4.8 million, research funding of $1.3 million and $120,000 from amortization of the upfront payment. For the year ended December 31, 2000, we recognized revenues under the Taisho collaborations of approximately $2.4 million, consisting of milestone achievements of approximately $2.3 million and $80,000 from amortization of the upfront payment.

Looking Forward

We plan to pursue several specific objectives during 2003 and 2004, including establishing additional collaborations with pharmaceutical and biotechnology companies, pursuing the objectives of Project Genesis, filing an investigational new drug application (an "IND"), and continuing our internally funded drug discovery and development efforts, including expansion of our capabilities.

We expect our number of employees to increase from 322 at the end of 2002 to approximately 340 employees at the end of 2003, and also expect non-executive personnel wages and related expenses to increase in order to retain our current employees and to remain competitive. We expect research and development and general and administrative expenses to be greater in 2003 than in 2002. We believe that continued investment in research and development is important to attaining our strategic objectives, and expect that the success of our internal projects will significantly increase our research and development expenses in the long term, particularly if we begin clinical testing. In an effort to mitigate these expected increases, we have implemented certain initiatives intended to more strictly monitor and control our expenditures, including those related to laboratory supplies which constituted a substantial portion of our total operating expenses in 2002.

Our ability to achieve our identified objectives depends on many factors, some of which are out of our control. Our operating results will depend on many factors, including the status of current and future collaborations. As a consequence, our revenues in future periods are likely to fluctuate significantly.

Our ability to meet our objectives may also be impacted by our largest stockholder, Biotechnology Value Fund, L.P., Biotechnology Value Fund II, L.P., BVF Investments, L.L.C., BVF Partners L.P., and BVF Inc. (collectively, "BVF"), which owns or controls approximately 27% of our outstanding shares. To allow us to pursue our strategic objectives, retain key management and scientific personnel, and to protect the interests of stockholders, since October 2002, our Board of Directors has (i) adopted a stockholders' rights plan, also known as a "poison pill," (ii) adopted an amendment to our by-laws requiring advance

notice of stockholder proposals to be submitted at an annual meeting of stockholders, (iii) approved certain termination protection agreements and a change in control severance plan, and (iv) issued an aggregate of 737,500 shares of restricted common stock to key employees which vest over a two or four-year period. Of the granted restricted stock, 347,000 shares will vest on January 20, 2004, subject to forfeiture in individual cases should an employee leave the company, acceleration in the case of a change of control at the company and certain other restrictions and conditions. Executive officers received this restricted stock in lieu of being considered to receive annual grants of stock options in 2003. In addition, during 2002 and the first quarter of 2003 executive officers and other scientific and management employees that received restricted stock grants agreed to forfeit an aggregate of 813,250 stock options that had a weighted-average exercise price of $21.44.

On January 17, 2003, we entered into a Stockholders Agreement with BVF and Investment 10, L.L.C. (the "Stockholders Agreement"). Pursuant to the Stockholders Agreement, we appointed Mark Lampert, the President of each of the BVF entities, to serve on our Board of Directors. The Stockholders Agreement also provides BVF and Investment 10, L.L.C. (collectively with BVF, the "BVF Stockholders") the right to call a Special Meeting of Arena stockholders in limited circumstances. The Stockholders Agreement further provides that from July 1, 2003, through October 15, 2003, we will have the right to offer to purchase from the BVF Stockholders at least three million (3,000,000) shares (representing approximately 11% of our outstanding stock at December 31, 2002) of our stock on terms described in the Stockholders Agreement. The Stockholders Agreement does not require the BVF Stockholders to accept or reject such offer. Pursuant to the terms of the Stockholders Agreement, the BVF Stockholders agreed to certain time-limited standstill provisions, including a prohibition on any acquisitions of the stock or assets of Arena, a prohibition on the solicitation of proxies or the submission of stockholder proposals except as provided in the Stockholders Agreement, and a prohibition on engaging in any of the actions set forth in paragraphs (a) through (j) of Item 4 of Schedule 13D. The Stockholders Agreement also provides that the stock owned by the BVF Stockholders shall be voted in accordance with the recommendations of our Board of Directors with respect to nominees for election to our Board of Directors and certain stockholder proposals while the standstill provisions are in effect.

Additional information regarding our stockholders' rights plan and the Stockholders Agreement can be found in our recent reports filed with the SEC on Forms 8-K and 8-A.

Critical Accounting Policies and Management Estimates

The SEC defines critical accounting policies as those that are, in management's view, important to the portrayal of our financial condition and results of operations and demanding of management's judgment. Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting standards generally accepted in the United States ("GAAP"). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We base our estimates on historical experience and on various assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Under different assumptions, actual results may differ from these estimates.

Our significant accounting policies include:

Revenue recognition. Our revenue recognition policies are in accordance with the SEC Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements," which provides guidance on revenue recognition in financial statements, and is based on the interpretations and practices developed by the SEC. Many of our agreements contain multiple elements, including technology access fees, research funding, milestones and royalty obligations.

Revenue from a milestone is recognized when earned, as evidenced by acknowledgment from our collaborator, provided that: (i) the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, (ii) the milestone represents the culmination of an earnings

process, and (iii) our performance obligations after the milestone achievement will continue to be funded by our collaborator at a comparable level to the level before the milestone achievement. If all of these criteria are not met, the milestone payment is recognized over the remaining minimum period of our performance obligations under the agreement. Upfront fees under our collaborations are deferred and recognized over the period the related services are provided. Amounts received for research funding for a specified number of full-time researchers are recognized as revenue as the services are performed, as long as the amounts received are not refundable based on the results of the research project.

In November 2002, the Emerging Issues Task Force ("EITF") finalized its tentative consensus on EITF Issue 00-21, "Revenue Arrangements with Multiple Deliverables," which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. We are currently evaluating the impact of the adoption of this consensus on our revenue recognition policies and our financial statements.

Goodwill and intangibles. Purchase accounting requires estimates and judgments to allocate the purchase price to the fair market value of the assets received and liabilities assumed. In February 2001, we acquired Bunsen Rush, Inc. for $15.0 million in cash and assumed $400,000 in liabilities. We allocated $15.4 million to the patented Melanophore technology acquired in such transaction. The Melanophore technology is being amortized over its estimated useful life of 10 years, which was determined based on an analysis, as of the acquisition date, of conditions in, and the economic outlook for, the pharmaceutical and biotechnology industries and the patent life of the technology. As with any intangible asset, we will continue to evaluate the value of the Melanophore technology, and we will have a future write-down of the carrying value of the technology if we determine that the technology has become impaired or we will accelerate the amortization if we determine that the technology life has been shortened.

Investment valuations. We periodically review the valuation and recoverability of our investments. SAB No. 59, "Accounting for Non-Current Marketable Equity Securities," sets forth examples of the factors, that, individually or in combination, indicate that a decline is other than temporary and that a write-down of the carrying value is required. These factors are as follows: (i) the length of the time and the extent to which the market value has been less than cost; (ii) the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or (iii) the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value. Any realized gains and losses and impairments in value judged to be other than temporary will be included in the statement of operations.

Income taxes. We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. While we have considered future taxable income and prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that we would be able to realize our deferred tax assets in the future in excess of their net recorded amount, an adjustment to the deferred tax assets would increase income in the period such determination was made. Likewise, should we determine that we would not be able to realize all or part of our net deferred tax assets in the future, an adjustment to the deferred tax assets would be charged to income in the period such determination was made.

Stock-based compensation. As permitted by the Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," we account for stock options granted to employees using the intrinsic value method in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and the Financial Accounting Standards Board ("FASB") Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation—An Interpretation of APB 25." Pursuant to these guidelines, we measure the intrinsic value of the option on its grant date as the difference between the exercise price of the option and the fair market value of our stock and expense the difference, if any, over the vesting period of the option, on an accelerated basis,

in accordance with FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans."

SFAS No. 123 requires stock-based compensation to be accounted for under the fair value method. If we adopted SFAS No. 123 to account for options granted to employees under our stock-based compensation plans, our earnings would have been materially impacted. The impact of this method is disclosed in the audited consolidated financial statements and notes thereto included elsewhere in this Annual Report.

Options issued to non-employees are accounted for under the fair value based method in accordance with SFAS No. 123 and EITF Issue No. 96-18, "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services." Under the fair value based method, compensation cost is measured at the grant date of the option based on the value of the award using the Black-Scholes method. Compensation cost is periodically re-measured as the underlying options vest in accordance with EITF Issue No. 98-18 and is recognized over the service period, which is usually the vesting period.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. See our audited consolidated financial statements and notes thereto included elsewhere in this Annual Report which contains accounting policies and other disclosures required by GAAP.

Year Ended December 31, 2002 Compared to the Year Ended December 31, 2001

Revenues. We recorded revenues of $19.4 million during the year ended December 31, 2002, compared to $18.1 million in revenues during the year ended December 31, 2001. Seventy-three percent and 47% of our revenues during the years ended December 31, 2002, and 2001, respectively, were from our collaboration with Eli Lilly, a significant customer, which included research funding, milestone payments, and technology access and development fees. TaiGen, a related party, accounted for $1.4 million in non-cash revenues in each of the years ended December 31, 2002, and 2001. Our collaborators often pay us before we recognize the revenues and these payments are deferred until earned. As of December 31, 2002, we had deferred revenues totaling approximately $6.6 million.

Research and development expenses. Research and development expenses increased $21.5 million to $44.4 million for the year ended December 31, 2002, from $22.9 million for the year ended December 31, 2001. The increase was due primarily to the following: (i) personnel and consulting expenses increased by $9.4 million, (ii) lab supplies and depreciation and maintenance of laboratory and computer equipment increased by $9.3 million, (iii) preclinical study fees increased by $1.2 million, and (iv) rent and utilities expense increased by $511,000. As of December 31, 2002, all research and development costs have been expensed as incurred. Our research and development employees increased from 168 at December 31, 2001, to 276 at December 31, 2002. We believe that continued investment in research and development is critical to attaining our strategic objectives and we expect these expenses to continue.

General and administrative expenses. General and administrative expenses increased $2.1 million to $7.5 million for the year ended December 31, 2002, from $5.4 million for the year ended December 31, 2001. The increase was a result of increased personnel during the year from 34 to 46 general and administrative employees to support a growing company as well as supporting the needs of a public company. General and administrative expenses consist primarily of salaries and related personnel expenses for executive, legal, business development, finance and administrative personnel, professional fees, and other general corporate expenses.

Amortization of deferred compensation. Deferred compensation for options granted to employees has been determined as the difference between the exercise price and the fair value of our common stock, as estimated by us for financial reporting purposes, or quoted market value after July 28, 2000, on the date options were granted. Compensation expense for options granted to consultants was determined in accordance with SFAS No. 123 and EITF Issue No. 96-18 and is based on the fair value of the options issued using the Black-Scholes method. Compensation expense is periodically re-measured as the underlying

options vest in accordance with EITF Issue No. 96-18. For the year ended December 31, 2002, we recorded amortization of deferred compensation of $2.3 million, compared to $4.2 million for the year ended December 31, 2001. Subsequent to BVF increasing their ownership in our stock in January and March of 2003, we issued an aggregate of 737,500 shares of restricted common stock to key employees which vest over a two or four-year period. We expect charges to be recognized in future periods from amortization of deferred compensation related to the shares of restricted common stock and stock option grants will be $3.2 million, $1.7 million, $519,000, $429,000, and $36,000 for the years ending December 31, 2003, 2004, 2005, 2006 and 2007, respectively.

Interest income and other, net. Interest income and other (net) decreased $3.5 million to $5.3 million for the year ended December 31, 2002, from $8.8 million for the year ended December 31, 2001. The decrease was primarily due to: (i) $2.2 million less interest income as a result of declining interest rates, (ii) $767,000 less in investment gains, and (iii) $829,000 more in expenses attributable to our share of the net loss of TaiGen, which we have accounted for by the equity method of accounting.

Investment write-down. We recorded a $1.8 million write-down of our investment in Axiom Biotechnologies, Inc, ("Axiom"). On September 3, 2002, our investment was converted into restricted shares of Sequenom, Inc. ("Sequenom") upon the closing of the acquisition of Axiom by Sequenom. At December 31, 2002, we valued our investment in Sequenom at its fair value as quoted on the NASDAQ National Market, less a discount for restrictions on the sale of Sequenom stock.

Year Ended December 31, 2001 Compared to the Year Ended December 31, 2000

Revenues. We recorded revenues of $18.1 million during the year ended December 31, 2001, compared to $7.7 million in revenues during the year ended December 31, 2000. Eighty-one percent and 99% of our revenues during the years ended December 31, 2001, and 2000, respectively, were from our collaborations with Eli Lilly and Taisho, both significant customers, which included research funding, milestone payments, and technology access and development fees. TaiGen, a related party, accounted for $1.4 million in non-cash revenues in the year ended December 31, 2001. Our collaborators often pay us before we recognize the revenues and these payments are deferred until earned. As of December 31, 2001, we had deferred revenues totaling approximately $2.8 million.

Research and development expenses. Research and development expenses increased $10.8 million to $22.9 million for the year ended December 31, 2001, from $12.1 million for the year ended December 31, 2000. The increase was due primarily to increases in personnel expenses of $5.1 million, lab supplies, laboratory equipment rental and depreciation of laboratory equipment totaling $4.0 million, and subscription fees of $750,000 for our subscription to the web-based Celera Discovery System, which we entered into in 2001.

General and administrative expenses. General and administrative expenses increased $2.7 million to $5.4 million for the year ended December 31, 2001, from $2.7 million for the year ended December 31, 2000. The increase was a result of increased personnel added to support a growing company as well as supporting the needs of a public company. General and administrative expenses consist primarily of salaries and related personnel expenses for executive, legal, business development, finance and administrative personnel, professional fees, and other general corporate expenses.

Amortization of deferred compensation. Deferred compensation for options granted to employees has been determined as the difference between the exercise price and the fair value of our common stock, as estimated by us for financial reporting purposes, or quoted market value after July 28, 2000, on the date options were granted. Compensation expense for options granted to consultants was determined in accordance with SFAS No. 123 and EITF Issue No. 96-18 and is based on the fair value of the options issued using the Black-Scholes method. Compensation expense is periodically re-measured as the underlying

options vest in accordance with EITF Issue No. 96-18. For the year ended December 31, 2001, we recorded amortization of deferred compensation of $4.2 million, compared to $4.3 million for the year ended December 31, 2000.

Interest income and other, net. Interest income and other increased $3.7 million to $8.8 million for the year ended December 31, 2001, from $5.1 million for the year ended December 31, 2000. The increase was primarily due to $3.0 million more interest income due to higher average cash and investment balances primarily due to our public offering in June 2001 through which we raised net cash proceeds of $123.0 million, offset by declining interest rates in 2001, as well as $608,000 more in investment gains.

Non-cash preferred stock charge. We recorded a non-cash preferred stock charge of $22.4 million for the year ended December 31, 2000. This non-cash preferred stock charge relates to the issuance of our Series E preferred stock in January 2000, our Series F preferred stock in March 2000 and our Series G preferred stock in April 2000, which were converted into shares of our common stock upon the closing of our initial public offering. We recorded the non-cash preferred stock charge at the dates of issuance by increasing the net loss applicable to common stockholders, without any effect on total stockholders' equity. The amount increased our basic net loss per share for the year ended December 31, 2000.

Related Party Transactions

We believe that all of the transactions described below were made and are on terms no less favorable to us than those that could be obtained from independent third parties in arms-length negotiations.

ChemNavigator

In January 1999, we began development of an Internet-based search engine that allows scientists to search for compounds based primarily on the similarity of chemical structures. In May 1999, ChemNavigator was incorporated and in June 1999, we licensed to ChemNavigator a Web site, the trademark "ChemNavigator" and goodwill associated with the trademark, intellectual property related to the search engine, as well as technology needed to perform chemical similarity searches. In return, we received 2,625,000 shares of preferred stock in ChemNavigator valued at approximately $2.6 million based on independent investors' participation in ChemNavigator's Series A preferred round of financing. However, our historical cost basis in the licensed technology was zero and we, therefore, recorded our investment in ChemNavigator at zero. As of both December 31, 2002, and 2001, our equity ownership represented approximately 35% of the outstanding voting equity securities of ChemNavigator. Although ChemNavigator has an accumulated deficit, we are not under an obligation to reimburse other ChemNavigator stockholders for our share of ChemNavigator's losses, and, therefore, have not included any of ChemNavigator's losses in our Consolidated Statements of Operations. In March 2002, we entered into an additional license agreement with ChemNavigator for the use of their cheminformatic software program. We paid ChemNavigator $165,000 in 2002 under this agreement, and have an option to renew our license in subsequent years for $50,000 per year. We expect to renew our license in 2003.

We sublease office space to ChemNavigator at current market rates. Lease payments are subject to a 2% increase in April 2003 and annually thereafter. In 2002, we received approximately $88,000 for this sublease.

Jack Lief, our President and Chief Executive Officer, is also the Chairman of the Board of ChemNavigator. As compensation for his services he has received 200,000 shares of common stock of ChemNavigator, which vest over a period of four years, subject to Mr. Lief remaining in our employ. Robert E. Hoffman, our Vice President, Finance, is also the Chief Financial Officer of ChemNavigator. Mr. Hoffman entered into a four-year service agreement with ChemNavigator in May of 1999, in which he agreed to provide up to 200 hours of service per year. As compensation for his services he has received 100,000 shares of Common Stock of ChemNavigator, which vest over a period of four years, subject to Mr. Hoffman remaining in our employ. Steven W. Spector, our Vice President and General Counsel, is also a director of ChemNavigator. Mr. Spector does not receive any compensation from ChemNavigator for the services he provides to ChemNavigator. Dr. Nigel Beeley, our Vice President, Chief Chemical Officer has provided consulting services to ChemNavigator and has received 3,200 options to purchase shares of common

stock of ChemNavigator as compensation for services rendered. The options vest over a period of four years, provided he continues to provide services to ChemNavigator.

Michael R. Lerner, M.D., Ph.D.

On February 15, 2001, we acquired, through our wholly owned subsidiary BRL Screening, Inc., all of the outstanding capital stock of Bunsen Rush Laboratories, a then privately held research-based company, for $15.0 million in cash. In April 2001, Michael R. Lerner, M.D., Ph.D., a founder and former stockholder of Bunsen Rush Laboratories, joined us as our Director of Screening. Subsequently, he served as our Vice President, Screening, and currently serves as a Research Fellow in our screening group. Pursuant to terms of the acquisition, we paid Dr. Lerner approximately $6.8 million. Additionally, we paid Ethan A. Lerner, M.D., a founder and former stockholder of BRL Screening and brother of Dr. Lerner, approximately $6.8 million. We also granted Ethan A. Lerner, M.D. 15,000 options to purchase shares of common stock at an exercise price of $16.00 as compensation for providing consulting services to us subsequent to the acquisition. We also paid Peter Lerner, a former stockholder of Bunsen Rush Laboratories and brother of Dr. Lerner, $400,000.

TaiGen

In July 2001, we entered into a licensing agreement with TaiGen and received 11,500,000 shares of TaiGen's Series A Preferred Stock. Under the terms of our agreement, TaiGen has the right to select and obtain several GPCRs from us, together with a license to certain of our technologies. We recognized non-cash revenues of $1.4 million for each of the years ended December 31, 2002, and 2001, in connection with the transfer of selected receptor screens to TaiGen. Jack Lief, our President and CEO, is a member of the board of directors of TaiGen. Mr. Lief does not receive any compensation for his services to TaiGen.

Liquidity and Capital Resources

Liquidity refers to our ability to generate adequate amounts of cash to meet our needs.

During 2003, we anticipate expenses for research and development and general and administration activities will be approximately $61.0 million, which is equal to those expenses for the fourth quarter of 2002 on an annualized basis. We expect capital expenditures, including completion of our chemical development facility, will be significantly less than our expenditures for 2002, which were $24.3 million. We believe we have sufficient cash to meet our near-term objectives, including filing at least one IND, continuing multiple internal drug discovery programs and building and improving our infrastructure.

Our potential immediate sources of liquidity include cash balances and short-term investments. As of December 31, 2002, we had $185.1 million in cash and cash equivalents and short-term investments compared to $226.9 million in cash and cash equivalents and short-term investments as of December 31, 2001. The decrease of $41.8 million in our cash and cash equivalents for the year ended December 31, 2002, was primarily attributable to cash used in operations of $17.2 million and the purchases of property and equipment totaling $24.3 million. Other potential sources of liquidity are the sale of real estate that we own, unused borrowing capacity, if any, and, if the financing markets improve, the sale of additional shares of our stock. In March 2003, we entered into an agreement to sell one of our occupied facilities and to lease it back from the purchaser. The sale is subject to a number of conditions, including the purchaser's due diligence and us agreeing on a form of lease. Accordingly, the proposed sale may not occur. The agreement contemplates a sale price of approximately $13.0 million, and an initial annual lease payment of approximately $1.3 million, which payment will be increased by 2.5% each year.

We have been, however, generating only a portion of the cash necessary to fund our operations from revenues. We have incurred a loss in each year since our inception, and we expect to incur substantial losses for at least the next several years. Such losses may fluctuate, and the fluctuations may be substantial. At December 31, 2002, we had an accumulated deficit of $60.4 million. We have funded our operations primarily through public and private equity financings, and to a lesser extent from cash we have received from our collaborators, together with interest income and gains from our investments. For the near-term, we expect our expenses will significantly exceed the cash received from our collaborators, interest income and gains from our investments.

Net cash used in operating activities was approximately $17.2 million during the year ended December 31, 2002. The primary use of cash for the year ended December 31, 2002, was to fund our net loss in the period, adjusted for non-cash expenses, including $2.3 million in amortization of deferred compensation, $1.6 million in amortization of acquired technology and other purchased intangibles, and changes in operating assets and liabilities. Net cash used in operating activities was approximately $1.6 million during the year ended December 31, 2001, and $4.1 million during the year ended December 31, 2000. The primary use of cash was to fund our net losses for these periods, adjusted for non-cash expenses, including $4.2 million and $4.3 million in non-cash amortization of deferred compensation during the years ended December 31, 2001, and 2000, respectively, and changes in operating assets and liabilities.

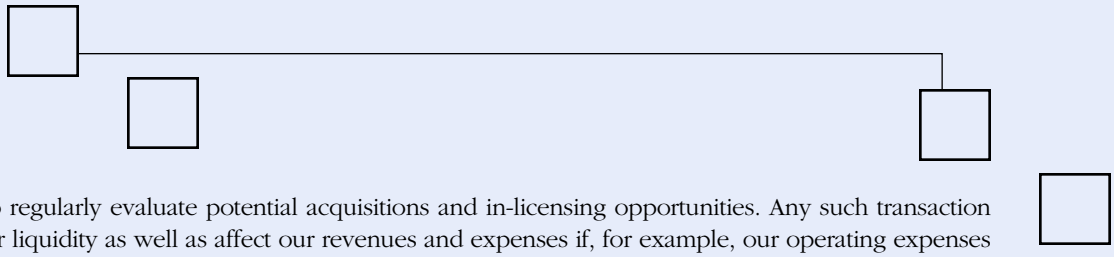
Net cash used in investing activities was approximately $97.6 million during the year ended December 31, 2002, and was primarily the result of purchases of short-term investments, offset by the proceeds and maturities of short-term investments, as well as the purchase of equipment, leasehold improvements to the facilities we lease and capital improvements to the facilities we own. Net cash used in investing activities was approximately $88.9 million during the year ended December 31, 2001, and was primarily the result of purchases of short-term investments, the acquisition of Bunsen Rush Laboratories, our purchase of three facilities and the acquisition of laboratory and computer equipment, and furniture and fixtures. Net cash used in investing activities was approximately $2.2 million during the year ended December 31, 2000, and was used primarily to purchase laboratory and computer equipment and furniture and fixtures.

Net cash provided by financing activities was approximately $32,000 during the year ended December 31, 2002, and was attributable to the net proceeds from the issuance of common stock upon exercise of options offset by principal payments on our capital leases. Net cash provided by financing activities was approximately $122.8 million during the year ended December 31, 2001, and was primarily attributable to the net proceeds from our public offering of common stock in June 2001 where we raised $123.0 million offset by $540,000 in principal payments on our capital leases. Net cash proceeds from financing activities were approximately $145.3 million during the year ended December 31, 2000, and were primarily from net proceeds of $113.9 million from our initial public offering in July 2000 as well as $30.1 million from the issuance of preferred stock.

In March 2002, we signed a lease for an additional 31,000 square feet of laboratory and office space at 6124-6126 Nancy Ridge Drive in San Diego, California. Expiring in March 2012, the lease provides us with an option to buy the entire building, comprised of approximately 58,000 square feet, at the end of the lease. We started occupying this building in the third quarter of 2002.

Aggregate annual future minimum lease obligations on our 6124-6126 Nancy Ridge Drive facility, our 6166 Nancy Ridge Drive facility and other operating leases we have on equipment totaled approximately $11.1 million at December 31, 2002. We have also entered into capital lease agreements for various lab and office equipment. The terms of these capital lease agreements range from 48 to 60 months. At December 31, 2002, current total minimum annual payments under these capital leases are $382,000 in 2003 and $49,000 in 2004.

In the short term, certain known events or possibilities could occur which could affect our liquidity. Under the Stockholders Agreement, from July 1, 2003, through October 15, 2003, we have the right to offer to purchase from the BVF Stockholders at least three million (3,000,000) shares of our stock at a 10% discount to the market value (as defined in the Stockholders Agreement). We also have the right to offer to purchase those shares at a price that is $8.00 or more per share. The BVF Stockholders have the right to accept or reject any offer by us. If our offer is for $8.00 or more per share, then the terms of the standstill described in the Stockholders Agreement are extended from December 31, 2003, to December 31, 2004. The standstill includes a prohibition on any acquisitions of the stock or assets of Arena, a prohibition on the solicitation of proxies or the submission of stockholder proposals except as provided in the Stockholders Agreement, and a prohibition on engaging in any of the actions set forth in paragraphs (a) through (j) of Item 4 of Schedule 13D. The BVF Stockholders also have the right to a board seat and have agreed to vote in favor of our Board of Directors' nominees during the term of the Stockholders Agreement. If we exercise our right to offer to purchase the BVF Stockholders' shares, and the BVF Stockholders accept, we will need to immediately pay them for the purchase price.



We continue to regularly evaluate potential acquisitions and in-licensing opportunities. Any such transaction may impact our liquidity as well as affect our revenues and expenses if, for example, our operating expenses increase as a result of such license or acquisition or we use our cash to finance the license or acquisition.

Also, our revenues for 2003 are expected to be largely dependent on one collaborator, Merck. The loss of this collaborator would significantly increase our expected operating losses and could have a significant effect on our plans. The research portion of our collaboration with Eli Lilly, a collaborator that has accounted for a significant portion of our revenues since our inception, is scheduled to conclude on April 14, 2003.

Looking beyond 2003, we will need to raise or generate significant amounts of cash to execute our objective of internally developing pharmaceuticals. It takes many years and potentially hundreds of millions of dollars to develop a drug. We do not currently have adequate internal liquidity to meet this long-term goal. In order to do so, we will need to substantially increase our out-licensing activities and look to external sources of liquidity, including the public or private financial markets and strategic partners, if available.

The length of time that our current cash and cash equivalents, short-term investments and available borrowings will sustain our operations will be based on the scientific progress in our research and development programs, our research and development costs (including personnel costs), progress in preclinical and clinical testing, the time and cost related to proposed clinical studies and regulatory approvals, if any, cost associated with securing in-licensing opportunities, if any, and the costs of filing and prosecuting patent applications and enforcing patent claims. We cannot assure you that adequate funding will be available to us or, if available, that such funding will be available on acceptable terms. Any shortfall in funding could result in the partial or full curtailment of our research and development efforts.

Recently issued accounting standards

In June 2001, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations," or SFAS No. 143, which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. We do not expect the adoption of this statement to have a material effect on our financial statements.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," or SFAS No. 146. SFAS No. 146 addresses accounting and reporting for costs associated with exit or disposal activities. SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value when the liability is incurred. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. We do not expect the adoption of this statement to have a material effect on our financial statements.

In November 2002, the EITF finalized its tentative consensus on EITF Issue 00-21, "Revenue Arrangements with Multiple Deliverables," which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. We are currently evaluating the impact of the adoption of this consensus on our financial statements.

In November 2002, the FASB issued FASB Interpretation No. 45, or FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statement Nos. 5, 57, and 107 and Rescission of FASB Interpretation No. 34." FIN 45 clarifies the requirements of FASB Statement No. 5, "Accounting for Contingencies," relating to the guarantor's accounting for, and disclosure of, the issuance of certain types of guarantees. FIN 45 requires that upon issuance of a guarantee, the guarantor must recognize a liability for the fair value of the obligation it assumes under that guarantee. The disclosure provisions of FIN 45 are effective for financial

statements of interim or annual periods that end after December 15, 2002. FIN 45's provisions for initial recognition and measurement should be applied on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The guarantor's previous accounting for guarantees that were issued before the date of FIN 45's initial application may not be revised or restated to reflect the effect of the recognition and measurement provisions of FIN 45. The adoption of this statement did not have a material effect on our financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure—an Amendment of FASB Statement No. 123." This Statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The interim disclosure requirements are effective for the first quarter of 2003. The adoption of SFAS did not have a material effect on our results of operations or financial condition.

Income Taxes

As of December 31, 2002, we had approximately $39.0 million of net operating loss carryforwards and $5.1 million of research and development tax credit carryforwards for federal income tax purposes. These carryforwards expire on various dates beginning in 2012. These amounts reflect different treatment of expenses for tax reporting than is used for financial reporting. United States tax law contains provisions that may limit our ability to use net operating loss and tax credit carryforwards in any year, including if there has been a significant ownership change.

Quantitative and Qualitative Disclosures About Market Risk

Our management establishes and oversees the implementation of board-approved policies covering our investments. We manage our market risk in accordance with our investment guidelines, which: (i) emphasize preservation of principal over other portfolio considerations, (ii) require investments to be placed with high credit quality institutions, (iii) establish guidelines for the diversification of our investment portfolio, and (iv) require investments to be placed with maturities that maintain safety and liquidity. We target our portfolio to have an average duration of approximately three years with no one instrument having a duration exceeding five years. We do not invest in derivative instruments, or any financial instruments for trading purposes. Our primary market risk exposure as it affects our cash equivalents, short-term investments, and securities held for sale is interest rate risk. We monitor our interest rate risk on a periodic basis and we ensure that our cash equivalents, short-term investments, and securities held for sale are invested in accordance with our investments guidelines. Managing credit ratings and the duration of our financial investments enhances the preservation of our capital.

We model interest rate exposure by a sensitivity analysis that assumes a hypothetical parallel shift downwards in the U.S. Treasury yield curve of 100 basis points. Under these assumptions, if the yield curve were to shift lower by 100 basis points from the level existing at December 31, 2002, we would expect future interest income from our portfolio to decline by less than $1.9 million over the next 12 months.

As of December 31, 2001, our estimate for the effect of this same hypothetical reduction in interest rates was a decline in interest income of less than $2.3 million. The difference in these two estimates is due to the difference in the gross amount of our cash and cash equivalents, short-term investments, and securities held for sale between the two periods.

The model we use is not intended to forecast actual losses in interest income, but is used as a risk estimation and investment management tool. The hypothetical changes and assumptions are likely to be different from what actually occurs in the future. Furthermore, the computations do not incorporate actions our management could take if the hypothetical interest rate changes actually occur. As a result, actual earnings consequences will likely differ from those quantified herein.

Report of Ernst & Young LLP, Independent Auditors

The Board of Directors and Stockholders
Arena Pharmaceuticals, Inc.

We have audited the accompanying consolidated balance sheets of Arena Pharmaceuticals, Inc. as of December 31, 2002 and 2001, and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Arena Pharmaceuticals, Inc. at December 31, 2002 and 2001 and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

San Diego, California
January 16, 2003

Consolidated Balance Sheets

December 31,	2002	2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 61,871,305	$176,676,669
Short-term investments, available-for-sale	123,271,580	50,247,624
Accounts receivable	3,519,209	3,481,250
Prepaid expenses and other current assets	4,647,558	2,903,281
Total current assets	193,309,652	233,308,824
Land, property and equipment, net	44,073,365	23,268,567
Acquired technology, net	12,560,208	14,097,204
Other non-current assets	4,946,822	6,299,115
Total assets	$254,890,047	$276,973,710
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 4,010,513	$ 2,329,426
Accrued compensation	912,906	620,404
Current portion of deferred revenues	4,148,492	2,386,029
Current portion of obligations under capital leases	363,311	499,387
Total current liabilities	9,435,222	5,835,246
Obligations under capital leases, less current portion	45,737	402,092
Deferred rent	912,941	871,867
Deferred revenues, less current portion	2,444,446	390,827
Commitments		
Stockholders' equity:		
Redeemable convertible preferred stock, $.0001 par value: 7,500,000 shares authorized at December 31, 2002, and 2001; no shares issued and outstanding at December 31, 2002, and 2001	—	—
Common stock, $.0001 par value: 67,500,000 shares authorized at December 31, 2002, and 2001; 27,746,536 and 27,585,048 shares issued and outstanding at December 31, 2002, and December 31, 2001, respectively	2,775	2,759
Additional paid-in capital	300,887,917	300,649,789
Accumulated other comprehensive income	2,625,363	6,790
Deferred compensation	(1,060,689)	(3,611,933)
Accumulated deficit	(60,403,665)	(27,573,727)
Total stockholders' equity	242,051,701	269,473,678
Total liabilities and stockholders' equity	$254,890,047	$276,973,710

See accompanying notes.

Consolidated Statements of Operations

Year Ended December 31,	2002	2001	2000
Revenues			
Collaborative agreements	$ 18,005,765	$16,643,999	$ 7,683,396
Collaborative agreements with affiliates	1,416,000	1,416,000	—
Total revenues	19,421,765	18,059,999	7,683,396
Operating expenses			
Research and development	44,399,136	22,864,250	12,080,204
General and administrative	7,499,011	5,390,446	2,678,980
Amortization of deferred compensation ($1,576,661, $2,710,464 and $3,018,623 related to research and development expenses and $688,273, $1,529,276 and $1,324,273 related to general and administrative expenses for 2002, 2001 and 2000, respectively)	2,264,934	4,239,740	4,342,896
Amortization of acquired intangibles	1,586,127	1,280,830	—
Total operating expenses	55,749,208	33,775,266	19,102,080
Interest income	5,423,742	7,609,893	4,644,471
Investment write-down	(1,786,797)	—	—
Interest expense	(76,536)	(112,188)	(220,483)
Gain on sale of investments	416,910	1,183,977	575,855
Other income	552,849	354,463	56,871
Equity in losses of TaiGen	(1,032,663)	(203,602)	—
Net loss	(32,829,938)	(6,882,724)	(6,361,970)
Non-cash preferred stock charge	—	—	(22,391,068)
Net loss applicable to common stockholders	$(32,829,938)	$(6,882,724)	$(28,753,038)
Net loss per share, basic and diluted	$ (1.19)	$ (0.28)	$ (2.84)
Shares used in calculating net loss per share, basic and diluted	27,487,537	24,989,067	10,139,755

See accompanying notes.

Consolidated Statements of Stockholders' Equity (Deficit)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income	Deferred Compensation	Accumulated Deficit	Total Stockholders' Equity (Deficit)
	Shares	Amount					
Balance at December 31, 1999	1,116,375	$ 111	$ 1,055,328	$ —	$ (625,955)	$(14,329,033)	$ (13,899,549)
Issuance of common stock upon exercise of options, net of repurchases	808,300	81	360,044	—	—	—	360,125
Issuance of common stock upon exercise of warrants	410,060	41	1,123,925	—	—	—	1,123,966
Conversion of convertible note into common stock	755,000	75	975,499	—	—	—	975,574
Issuance of common stock in initial public offering, net of offering costs of $10,274,000	6,900,000	690	113,925,310	—	—	—	113,926,000
Conversion of preferred stock to common stock upon closing of initial public offering	12,698,578	1,270	48,316,013	—	—	—	48,317,283
Deferred compensation related to stock options	—	—	11,616,911	—	(11,616,911)	—	—
Amortization of deferred compensation	—	—	—	—	4,342,896	—	4,342,896
Net loss	—	—	—	—	—	(6,361,970)	(6,361,970)
Balance at December 31, 2000	22,688,313	$2,268	$177,373,030	$ —	$ (7,899,970)	$(20,691,003)	$148,784,325
Issuance of common stock upon exercise of options, net of repurchases	123,100	13	81,357	—	—	—	81,370
Issuance of common stock under the employee stock purchase plan	23,635	3	219,144	—	—	—	219,147
Issuance of common stock in public offering, net of offering costs of $7,599,970	4,750,000	475	123,024,555	—	—	—	123,025,030
Deferred compensation related to stock options	—	—	(516,371)	—	516,371	—	—
Amortization of deferred compensation	—	—	468,074	—	3,771,666	—	4,239,740
Net loss	—	—	—	—	—	(6,882,724)	(6,882,724)
Net unrealized gain on available-for-sale securities	—	—	—	6,790	—	—	6,790
Net comprehensive loss							(6,875,934)
Balance at December 31, 2001	27,585,048	$2,759	$300,649,789	$ 6,790	$ (3,611,933)	$(27,573,727)	$269,473,678
Issuance of common stock upon exercise of options, net of repurchases	83,975	8	50,391	—	—	—	50,399
Issuance of common stock under the employee stock purchase plan	77,513	8	474,047	—	—	—	474,055
Deferred compensation related to stock options	—	—	(286,310)	—	286,310	—	—
Amortization of deferred compensation	—	—	—	—	2,264,934	—	2,264,934
Net loss	—	—	—	—	—	(32,829,938)	(32,829,938)
Net unrealized gain on available-for-sale securities and investments	—	—	—	2,618,573	—	—	2,618,573
Net comprehensive loss							(30,211,365)
Balance at December 31, 2002	27,746,536	$2,775	$300,887,917	$2,625,363	$ (1,060,689)	$(60,403,665)	$242,051,701

See accompanying notes.

Consolidated Statements of Cash Flows

Year Ended December 31,	2002	2001	2000
OPERATING ACTIVITIES			
Net loss	$ (32,829,938)	$ (6,882,724)	$ (6,361,970)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	3,507,470	1,628,575	787,829
Equity in losses of TaiGen	1,032,663	203,602	—
Amortization of acquired technology	1,586,127	1,280,830	—
Amortization of deferred compensation	2,264,934	4,239,740	4,342,896
Amortization/accretion of short-term investment premium/discount	1,423,181	53,374	—
Interest accrued on notes payable to related party	—	—	41,262
Deferred rent	41,074	5,858	72,886
Loss on disposal of equipment	7,066	—	—
Investment write-down	1,786,797	—	—
Change in operating assets and liabilities:			
Accounts receivable	(37,959)	(1,365,104)	(2,116,146)
Prepaid expenses and other assets	(1,793,408)	(1,218,159)	(1,657,279)
Deferred revenues	3,816,082	(1,616,582)	705,000
Accounts payable and accrued expenses	1,973,589	2,034,290	49,126
Net cash used in operating activities	(17,222,322)	(1,636,300)	(4,136,396)
INVESTING ACTIVITIES			
Acquisition of Bunsen Rush	—	(15,000,000)	—
Purchases of short-term investments available-for-sale	(207,336,208)	(51,292,856)	—
Proceeds from sales/maturities of short-term investments	135,543,996	998,648	—
Purchases of land, property and equipment	(24,325,234)	(20,631,882)	(2,279,707)
Proceeds from sale of equipment	5,900	—	—
Deposits, restricted cash and other assets	(1,503,519)	(2,960,088)	90,882
Net cash used in investing activities	(97,615,065)	(88,886,178)	(2,188,825)
FINANCING ACTIVITIES			
Advances under capital lease obligations	—	—	377,015
Principal payments on capital leases	(492,431)	(539,576)	(515,551)
Proceeds from issuance of redeemable preferred stock	—	—	30,065,334
Proceeds from issuance of common stock	524,454	123,325,547	115,410,091
Net cash provided by financing activities	32,023	122,785,971	145,336,889
Net increase (decrease) in cash and cash equivalents	(114,805,364)	32,263,493	139,011,668
Cash and cash equivalents at beginning of period	176,676,669	144,413,176	5,401,508
Cash and cash equivalents at end of period	$ 61,871,305	$176,676,669	$144,413,176
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Interest paid	$ 70,120	$ 112,189	$ 179,221
Conversion of convertible note to related party into common stock			$ 975,574
Equity investment in TaiGen		$ 3,310,404	

See accompanying notes.

1. The Company and Summary of Significant Accounting Policies

The Company

Arena Pharmaceuticals, Inc. (the "Company") was incorporated on April 14, 1997, and commenced operations in July 1997. The Company operates in one business segment and is focused principally on discovering and developing drugs that act on an important class of drug targets called G protein-coupled receptors ("GPCRs"). The Company uses CART™, which is its constitutively activated receptor technology, Melanophore technology and other proprietary technologies to better understand GPCRs and to more efficiently identify compounds that may lead to new drugs.

Principles of Consolidation

The Company's financial statements include the activity of its wholly owned subsidiary, BRL Screening, Inc. ("BRL") since its formation in February 2001. The financial statements do not include the accounts of its majority-owned subsidiary, Aressa Pharmaceuticals, Inc. ("Aressa") that was formed in August 1999. The Company's carrying value for its investment in Aressa is zero because it made no financial contribution to Aressa in exchange for its ownership interest. In addition, the Company is not required to reimburse the outside investor for any losses Aressa incurs, which have been immaterial to the Company.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States ("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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash and highly liquid investments with original maturities of three months or less when purchased.

Available-for-sale Securities

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Debt and Equity Securities," short-term investments are classified as available-for-sale. These securities are carried at fair value, with unrealized gains and losses reported as accumulated other comprehensive income. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included in interest income. Realized gains and losses and declines judged to be other than temporary, are included in interest income. The cost of securities sold is based on the specific identification method. Interest and dividends on available-for-sale securities are included in interest income. Investments held as of December 31, 2002, consist primarily of U.S. Treasury and Federal Agency obligations, U.S. corporate debt securities and mortgage-backed securities.

Fair Value of Financial Instruments

Cash and cash equivalents, accounts payable and accrued liabilities, are carried at cost, which management believes approximates fair value due to the short-term maturity of these instruments. Short-term investments, available-for-sale are carried at fair value.

Concentration of Credit Risk and Major Customers

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist primarily of cash, cash equivalents and short-term investments. The Company limits its exposure to credit loss by placing its cash with high credit quality financial institutions and, in accordance with the Company's investment policy, debt that is rated investment grade.

Eli Lilly and Company ("Eli Lilly") accounted for 73.2% of total revenues during the year ended December 31, 2002, and Eli Lilly and Taisho Pharmaceutical Co., Ltd. ("Taisho") together accounted for 81.5% of total revenues during the year ended December 31, 2001. Eli Lilly accounted for 99.5%

of accounts receivable as of December 31, 2002, and Eli Lilly and Taisho together accounted for 97.1% of accounts receivable as of December 31, 2001.

Property and Equipment

Property and equipment are stated at cost and depreciated over the estimated useful lives of the assets (three to seven years) using the straight-line method. Buildings and building improvements are stated at cost and depreciated over the estimated useful life estimated to be approximately 20 years using the straight-line method. Amortization of leasehold improvements and assets under capital leases are stated at cost and amortized over the shorter of the estimated useful lives of the assets or the lease term.

Intangible Assets

Acquired technology and other purchased intangibles from the Company's acquisition of Bunsen Rush Laboratories, Inc. ("Bunsen Rush") are being amortized over the estimated useful life of 10 years. Acquired technology from an inlicensing arrangement of patented technology is being amortized over its estimated useful life of five years. Accumulated amortization from acquired technology and other purchased intangibles totaled approximately $2.9 million and $1.3 million at December 31, 2002, and 2001, respectively. As of December 31, 2002, the Company anticipates that total charges to be recognized in future periods from the amortization of acquired technology and other purchased intangibles will be approximately $1.6 million for each of the next five years.

Long-lived Assets

The Company reviews the recoverability of long-lived and finite-lived intangible assets when circumstances indicate that the carrying amount of assets may not be recoverable. This evaluation is based on various analyses including undiscounted cash flow projections. In the event undiscounted cash flow projections indicate an impairment, the Company would record an impairment loss, if any, based on the fair value of the assets. Effective January 1, 2002, the Company accounts for impairments under SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Prior to the adoption of this standard, impairments were accounted for using SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" which was superceded by SFAS No. 144. No impairments of long-lived assets were recorded in 2002, 2001 or 2000.

Deferred Rent

Rent expense is recorded on a straight-line basis over the term of the lease. The difference between rent expense and amounts paid under the lease agreements is recorded as deferred rent in the accompanying balance sheets.

Stock-based Compensation

The Company accounts for stock-based compensation based on the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") and its related Interpretations, which states that, for fixed plans, no compensation expense is recorded for stock options or other stock-based awards to employees that are granted with an exercise price equal to or above the estimated fair value per share of the Company's common stock on the grant date. In the event that stock options are granted with an exercise price below the estimated fair value of the Company's common stock at the grant date, the difference between the fair value of the Company's common stock and the exercise price of the stock option is recorded as deferred compensation. Deferred compensation is amortized to compensation expense over the vesting period of the stock option. The Company has adopted the disclosure requirements of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" and Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure—an Amendment of FASB Statement No. 123," which requires compensation expense to be disclosed based on the fair value of the options granted at the date of the grant (See Note 9).

Had compensation cost for the Company's stock option plan been determined based on the fair value at the grant dates for awards under the plan consistent with the method required by SFAS No. 123, the Company's net loss and basic and diluted net loss per common share would have been the pro forma amounts indicated below.

Years Ended December 31,	2002	2001	2000
Net loss, as reported	$(32,829,938)	$ (6,882,724)	$(28,753,038)
Fair value of stock-based employee compensation	(6,561,000)	(4,924,000)	(1,137,000)
Pro forma net loss	$(39,390,938)	$(11,806,724)	$(29,890,038)
Earnings per share:			
Basic and diluted—as reported	$ (1.19)	$ (0.28)	$ (2.84)
Basic and diluted—pro forma	$ (1.43)	$ (0.47)	$ (2.95)

Pro forma information regarding net income is required by SFAS No. 123 and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. For options granted through July 27, 2000, the fair value of options granted were estimated at the date of grant using the minimum value pricing model with the following weighted-average assumptions: risk-free interest rate of 6.5%, dividend yield of 0%, and weighted-average expected life of the option of five years. For options granted from July 28, 2000, to December 31, 2000, the fair value of the options was estimated at the date of grant using the Black-Scholes method for option-pricing with the following weighted-average assumptions: risk-free interest rate of 6.5%, dividend yield of 0%, expected volatility of 90% and weighted-average expected life of the option of five years. For options granted from January 1, 2001, to December 31, 2001, the fair value of the options was estimated at the date of grant using the Black-Scholes method for option-pricing with the following weighted-average assumptions: risk-free interest rate of 2.8%, dividend yield of 0%, expected volatility of 113% and weighted-average expected life of the option of five years. For options granted from January 1, 2002, to December 31, 2002, the fair value of the options was estimated at the date of grant using the Black-Scholes method for option-pricing with the following weighted-average assumptions: risk-free interest rate of 2.0%, dividend yield of 0%, expected volatility of 93% and weighted-average expected life of the option of five years.

The effects of applying SFAS No. 123 for providing pro forma disclosures are not likely to be representative of the effect on reported net income (loss) for future years.

Revenue Recognition

The Company's revenue recognition policies are in accordance with the Securities and Exchange Commission Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements," which provides guidance on revenue recognition in financial statements, and is based on the interpretations and practices developed by the Securities and Exchange Commission (the "SEC"). Many of the Company's agreements contain multiple elements, including technology access fees, research funding, milestones and royalty obligations.

Revenues from a milestone are recognized when earned, as evidenced by acknowledgment from the Company's collaborator, provided that: (i) the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, (ii) the milestone represents the culmination of an earnings process, and (iii) the Company's performance obligations after the milestone achievement will continue to be funded by the Company's collaborator at a comparable level to the level before the milestone achievement. If all of these criteria are not met, the milestone payment is recognized over the remaining minimum period of the Company's performance obligations under the agreement. Upfront fees under the Company's collaborations are deferred and recognized over the period the related services are provided. Amounts received for research funding for a specified number of full-time researchers are recognized as revenue as the services are performed, as long as the amounts received are not refundable based on the results of the research project.

In November 2002, the EITF finalized its tentative consensus on EITF Issue 00-21, "Revenue Arrangements with Multiple Deliverables," which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. The Company is currently evaluating the impact of the adoption of this consensus on its revenue recognition policies and its financial statements.

Research and Development Costs

All research and development expenses are expensed in the year incurred and consist primarily of personnel related expenses and laboratory expenses.

Patent Costs

Costs related to filing and pursuing patent applications are expensed as incurred as recoverability of such expenditures is uncertain.

Income Taxes

In accordance with SFAS No. 109, "Accounting for Income Taxes," a deferred tax asset or liability is determined based on the difference between the financial statement and tax basis of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. The Company provides a valuation allowance against net deferred tax assets unless, based upon the available evidence, it is more likely than not that the deferred tax assets will be realized.

Comprehensive Loss

In accordance with SFAS No. 130, "Reporting Comprehensive Loss," all components of comprehensive loss, including net loss, are reported in the financial statements in the period in which they are recognized. Comprehensive loss is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. The Company's accumulated other comprehensive income consists of the following:

Year Ended December 31, 2002	
Unrealized gain on available-for-sale securities	$2,661,715
Unrealized loss on investment	(36,352)
Accumulated other comprehensive income	$2,625,363

Net Loss Per Share

Basic and diluted loss per common share are presented in conformity with SFAS No. 128, "Earnings per Share," for all periods presented.

In accordance with SFAS No. 128, basic and diluted loss per share has been computed using the weighted-average number of shares of common stock outstanding during the period, less shares subject to repurchase.

The following table presents the calculation of net loss per share:

Year Ended December 31,	2002	2001	2000
Net loss applicable to common stockholders	$(32,829,938)	$(6,882,724)	$(28,753,038)
Basic and diluted net loss per share	$ (1.19)	$ (0.28)	$ (2.84)
Weighted-average shares used in computing net loss per share, basic and diluted	27,487,537	24,989,067	10,139,755

The Company has excluded all outstanding stock options and warrants, and shares subject to repurchase from the calculation of diluted loss per common share because all such securities are antidilutive for all years presented. The total number of shares excluded from the calculation of diluted net loss per share, prior to application of the treasury stock method for stock options, was 184,123, 291,499 and 509,850 for the years ended December 31, 2002, 2001, and 2000, respectively. Such securities, had they been dilutive, would have been included in the computation of diluted net loss per share.

Acquisition

On February 15, 2001, the Company completed its acquisition of Bunsen Rush pursuant to an Agreement and Plan of Merger dated February 15, 2001. Bunsen Rush was a research-based company that provided receptor screening for the pharmaceutical and biotechnology industries using its proprietary and patented Melanophore technology. The purchase price was $15.0 million in cash.

The acquisition was accounted for as a purchase. Costs related to performing the acquisition, which were immaterial, have been expensed. The purchase price was allocated as follows:

Existing technology	$15,378,000
Non-current assets	52,000
Current liabilities	(430,000)
Total	$15,000,000

The acquired technology is being amortized over its estimated useful life of ten years. The estimated useful life of ten years was determined based on an analysis, as of the acquisition date, of conditions in, and the economic outlook for the pharmaceutical and biotechnology industries, the patent life of the technology and the history, current state and planned future operations of Bunsen Rush.

The acquisition was effected in the form of a merger of Bunsen Rush into BRL, a newly formed wholly owned subsidiary of the Company. BRL's results from operations have been included in the Company's results from operations since February 15, 2001. If the acquisition would have occurred on January 1, 2001, or January 1, 2000, pro forma financial information would not have differed materially from actual results.

Effect of New Accounting Standards

In July 2002, the FASB issued SFAS 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS 146 requires that a liability for a cost associated with an exit or disposal activity be recognized at its fair market value when the liability is incurred, rather than at the date of an entity's commitment to an exit plan. The provisions of SFAS 146 are effective for exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS 146 is not expected to have a material effect on the Company's financial statements.

In November 2002, the EITF finalized its tentative consensus on EITF Issue 00-21, "Revenue Arrangements with Multiple Deliverables," which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. The Company is currently evaluating the impact of the adoption of this consensus on its revenue recognition policies and its financial statements.

In November 2002, the FASB issued Financial Accounting Standards Board Interpretation No. 45, or FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statement Nos. 5, 57, and 107 and Rescission of FASB Interpretation No. 34." FIN 45 clarifies the requirements of FASB Statement No. 5, "Accounting for Contingencies," relating to the guarantor's accounting for, and disclosure of, the issuance of certain types of guarantees. FIN 45 requires that upon issuance of a guarantee, the guarantor must recognize a liability for the fair value of the obligation it assumes under that guarantee. The disclosure provisions of FIN 45 are effective for financial statements of interim or annual periods that end after December 15, 2002. FIN 45's provisions for initial recognition and measurement should be applied on a prospective basis to

guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The guarantor's previous accounting for guarantees that were issued before the date of FIN 45's initial application may not be revised or restated to reflect the effect of the recognition and measurement provisions of FIN 45. The Company does not expect the adoption of this statement to have a material effect on its financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure—an Amendment of FASB Statement No. 123." This Statement amends SFAS No. 123, "Accounting for Stock-Based Compensation" to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. This statement requires that companies having a year-end after December 15, 2002, follow the prescribed format and provide the additional disclosures in their annual reports. The Company has elected to continue to follow the intrinsic value method of accounting as prescribed by Accounting Principles Board Opinion No. 25 ("APB25"), "Accounting for Stock Issued to Employees," to account for employee stock and stock options. The Company has followed the prescribed format.

2. Investment in ChemNavigator

In January 1999, the Company began development of an Internet-based search engine that allows scientists to search for compounds based primarily on the similarity of chemical structures. In May 1999, ChemNavigator was incorporated and in June 1999, the Company licensed to ChemNavigator a website, the trademark "ChemNavigator" and goodwill associated with the trademark, intellectual property related to the search engine, as well as technology needed to perform chemical similarity searches. In return, the Company received 2,625,000 shares of preferred stock in ChemNavigator valued at approximately $2.6 million based on independent investors' participation in ChemNavigator's Series A preferred round of financing. However, the Company's historical cost basis in the licensed technology was zero and the Company, therefore, recorded its investment in ChemNavigator at zero. As of both December 31, 2002, and 2001, the Company's equity ownership represented approximately 35% of the outstanding voting equity securities of ChemNavigator. ChemNavigator has an accumulated deficit and since the Company is under no obligation to reimburse the other ChemNavigator stockholders for its share of ChemNavigator's losses, the Company has not included any of ChemNavigator's loss in the Company's Consolidated Statements of Operations. In March 2002, the Company entered into an additional license agreement with ChemNavigator for the use of their cheminformatic software program. The Company paid ChemNavigator $165,000 in 2002 under the agreement, and have an option to renew its license in subsequent years for $50,000 per year. The Company expects to renew its license in 2003.

The Company subleases office space to ChemNavigator at current market rates. Lease payments are subject to a 2% increase in April 2003 and annually thereafter. In 2002, the Company received approximately $88,000 for the sublease. At December 31, 2002, ChemNavigator owed the Company approximately $18,000.

Jack Lief, the Company's President and Chief Executive Officer, is also the Chairman of the Board of ChemNavigator. As compensation for his services he has received 200,000 shares of common stock of ChemNavigator, which vest over a period of four years, subject to Mr. Lief remaining in the Company's employ. Robert E. Hoffman, the Company's Vice President, Finance, is also the Chief Financial Officer of ChemNavigator. Mr. Hoffman entered into a four-year service agreement with ChemNavigator in May of 1999, in which he agreed to provide up to 200 hours of service per year. As compensation for his services he has received 100,000 shares of common stock of ChemNavigator, which vest over a period of four years, subject to Mr. Hoffman remaining in the Company's employ. Steven W. Spector, the Company's Vice President and General Counsel, is also a director of ChemNavigator. Mr. Spector does not receive any compensation from ChemNavigator for the services he provides to ChemNavigator. Dr. Nigel Beeley, the Company's Vice President, Chief Chemical Officer has provided consulting services to

ChemNavigator and has received 3,200 options to purchase shares of common stock of ChemNavigator as compensation for services rendered. The options vest over a period of four years, provided he continues to provide services to ChemNavigator.

3. Investment in Aressa Pharmaceuticals, Inc.

In October 2000, the Company received shares of stock in Aressa that constitute approximately 83% of the presently outstanding voting equity securities of Aressa, valued at $5.0 million based on the participation of an independent investor in Aressa's Series A preferred round of financing raising gross proceeds of $1.0 million. The Company's carrying value for its investment in Aressa is zero because it made no financial contribution to Aressa in exchange for its ownership interest. In addition, the Company is not required to reimburse the outside investor for any losses Aressa incurs. Through December 31, 2002, Aressa has had limited activity and the amounts of its assets and liabilities are currently immaterial to the Company's consolidated financial statements. Therefore, the Company has not included the accounts of Aressa in its consolidated financial statements.

Jack Lief, the Company's President and Chief Executive Officer, is also the President and Chief Executive Officer and a Director of Aressa. Joyce Williams, the Company's Vice President, Drug Development is also the Vice President, Regulatory and Clinical Affairs of Aressa. Mr. Lief and Ms. Williams receive no compensation for their services to Aressa.

4. Investment in Axiom Biotechnologies, Inc. and Subsequent Acquisition by Sequenom, Inc.

In April 2001, the Company signed a binding letter of intent with Axiom Biotechnologies, Inc. ("Axiom") for a collaborative research program involving Axiom's proprietary RHACE™ Technology and Human Cell Bank, and purchased $2.0 million of Axiom's preferred stock. The Company accounts for this investment using the cost method of accounting. The Company periodically reviews the valuation and recoverability of its investments. Realized gains and losses and impairments in value judged to be other than temporary are included in the statement of operations. The Company determined that its investment in Axiom was impaired and accordingly recorded a $1.7 million write-down during the quarter ended June 30, 2002. On September 3, 2002, Axiom was acquired by Sequenom, Inc. ("Sequenom"), and the Company further wrote down its investment by $87,000 to its fair value, less a discount for restrictions on the sale of Sequenom stock, on the date of acquisition of Axiom by Sequenom. At December 31, 2002, the Company valued its investment in Sequenom at its fair value as quoted on the NASDAQ national market, less a 10% discount for restrictions on the sale of Sequenom stock.

5. Available-for-Sale Securities

The following table summarizes the various investment categories for available-for-sale securities at December 31, 2002, and 2001:

December 31, 2002	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	$ 29,694,790	$ 361,537	$(15,382)	$ 30,040,945
Corporate debt securities	34,571,564	1,180,984	(2,409)	35,750,139
Federal agency notes	56,343,511	1,136,985	—	57,480,496
Total available-for-sale securities	$120,609,865	$2,679,506	$(17,791)	$123,271,580

December 31, 2001	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	$ 11,394,981	$ 32,249	$ (3,750)	$ 11,423,480
Corporate debt securities	19,870,831	19,346	(72,037)	19,818,140
Federal agency notes	18,974,798	31,206	—	19,006,004
Total available-for-sale securities	$ 50,240,610	$ 82,801	$(75,787)	$ 50,247,624

The amortized cost and estimated fair value of available-for-sale securities by contractual maturity at December 31, 2002, are shown below:

	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 10,325,395	$ 10,385,879
Due after one year through four years	81,231,345	83,023,866
Due after four years through five years	29,053,124	29,861,836
	$120,609,865	$123,271,580

6. Property and Equipment

Property and equipment consisted of the following:

December 31,	2002	2001
Laboratory and computer equipment	$15,946,633	$ 7,600,627
Furniture, fixtures and office equipment	1,207,219	428,048
Land, building and capital improvements	28,842,156	16,697,774
Leasehold improvements	4,586,276	1,547,528
	50,582,284	26,273,977
Less accumulated depreciation and amortization	(6,508,920)	(3,005,410)
Net property and equipment	$44,073,364	$23,268,567

Depreciation expense was approximately $3.5 million, $1.6 million and $788,000 for the years ended December 31, 2002, 2001 and 2000, respectively.

Cost and accumulated amortization of furniture and equipment under capital leases totaled approximately $2.2 million and $1.7 million, and approximately $2.2 million and $1.2 million, at December 31, 2002, and 2001, respectively.

7. Other Non-Current Assets

Other non-current assets consisted of the following:

December 31,	2002	2001
Investment in TaiGen Biotechnology Co., Ltd., net (See Note 8)	$ 2,074,139	$ 3,106,802
Investment in Sequenom, Inc. (See Note 4)	176,851	2,000,000
Other non-current assets	2,695,832	1,192,313
Net property and equipment	$ 4,946,822	$ 6,299,115

8. Commitments

Leases

In 1997, the Company leased its facility located at 6166 Nancy Ridge Drive in San Diego, California under an operating lease that had an expiration date in 2004. The Company had an option to buy the facility during the first 12 months of the lease term for approximately $2.1 million. In 1998, the Company assigned the option to a publicly traded Real Estate Investment Trust ("REIT") in exchange for approximately $733,000 in cash. The $733,000 is being recognized on a straight-line basis as a reduction in the rent expense on the underlying lease. In addition, the Company signed a new lease with the REIT, which expires in 2013. The lease provides the Company with an option to extend the lease term via two five-year options. Under the terms of the new lease, effective April 1998, monthly rental payments will be increased in April 2000 and annually thereafter by 2.75%. In accordance with the terms of the new lease, the Company is required to maintain restricted cash balances totaling approximately $80,000 on behalf of the landlord as rent deposits throughout the term of the lease.

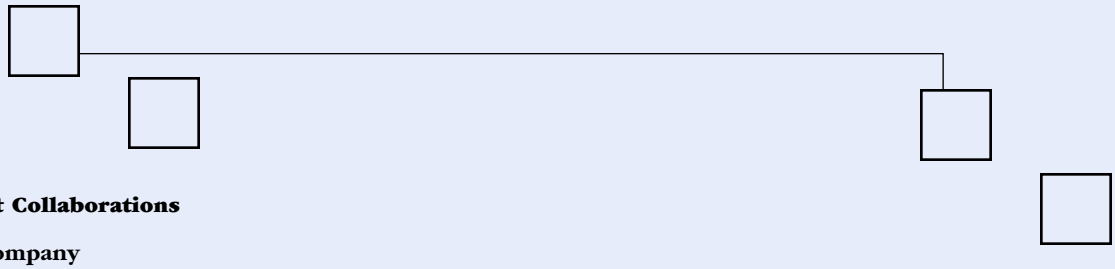
In 2000, the Company leased an additional facility located at 6150 Nancy Ridge Drive in San Diego, California under an operating lease which would have expired in 2013. In January 2001, the Company purchased this facility, along with the adjacent facility at 6138 Nancy Ridge Drive, for approximately $5.4 million in cash.

In March 2002, the Company leased an additional facility located at 6124-6126 Nancy Ridge Drive in San Diego, California, consisting of approximately 31,000 square feet of office and laboratory space. Under the terms of the lease, effective April 2002, monthly rental payments will be increased in April 2003 and annually thereafter by 2%. At the end of the lease in March 2012, the lease provides the Company with an option to buy the entire building, comprised of approximately 58,000 square feet, for $7.9 million. The Company subleases approximately 6,000 square feet, primarily office space, of the 6126 facility to ChemNavigator, a related party, at current market rates. Sublease payments from ChemNavigator are subject to a 2% increase in April 2003 and annually thereafter. In 2002, the Company received approximately $88,000 for the sublease.

Rent expense was $869,000, $585,000 and $728,000 for the years ended December 31, 2002, 2001 and 2000, respectively.

Annual future minimum lease obligations as of December 31, 2002, are as follows:

Year Ending December 31,	Operating Leases	Capital Leases
2003	$ 1,521,643	$ 382,442
2004	1,114,079	49,097
2005	993,796	—
2006	1,001,142	—
2007	1,026,005	—
Thereafter	5,479,906	—
Total minimum lease payments	$11,136,571	431,539
Less amount representing interest		(22,491)
Present value of minimum lease obligations		409,048
Less current portion		(363,311)
Long-term portion of capital lease obligations		$ 45,737



9. Significant Collaborations

Eli Lilly and Company

In April 2000, the Company entered into a research and licensing agreement with Eli Lilly to focus on GPCRs in the central nervous system and, to a lesser extent, GPCRs of potential interest in the cardiovascular and oncology fields. The Company receives research funding from Eli Lilly for its internal resources committed to the collaboration, which have been augmented by substantial resources at Eli Lilly. The Company is also eligible to receive preclinical and clinical milestones and royalties on sales of products discovered using the Company's CART technology, if any.

The Company's research activities under the collaboration are scheduled to be completed on April 14, 2003. Accordingly, the Company will no longer receive research funding from Eli Lilly under this collaboration after such date. The Company will, however, be eligible to receive preclinical, clinical and marketing milestone payments and royalties on sales of products discovered by Eli Lilly as a result of the collaboration, if any.

For the year ended December 31, 2002, the Company recognized revenues under the Eli Lilly collaboration of approximately $14.2 million, consisting of research funding of $6.0 million, milestone achievements of $8.0 million, and approximately $200,000 from amortization of the upfront payment. For the year ended December 31, 2001, the Company recognized revenues under the Eli Lilly collaboration of approximately $8.5 million, consisting of research funding of approximately $4.9 million, milestone achievements of approximately $3.5 million, and $100,000 from amortization of the upfront payment. For the year ended December 31, 2000, the Company recognized revenues under the Eli Lilly collaboration of approximately $5.2 million, consisting of research funding of approximately $2.9 million, milestone achievements of approximately $2.2 million, and $75,000 from amortization of the upfront payment.

Merck & Co., Inc.

In October 2002, the Company entered into a research and licensing agreement with Merck & Co., Inc. ("Merck") to collaborate on validating and developing therapeutics on three GPCRs. During the collaboration, the Company and Merck will pursue an agreed upon research plan relating to such GPCRs and possibly other GPCRs that are discovered under the collaboration.

The Company received approximately $7.2 million in cash proceeds from Merck through December 31, 2002, comprised of a one-time upfront payment of $4.0 million and research funding of approximately $3.2 million, of which $1.8 million is research funding for research to be conducted from January 1, 2003, to March 31, 2003. The Company will receive research funding from Merck for its internal resources committed to the collaboration. In the future, the Company may receive up to $8.0 million in preclinical milestone payments. The Company may also receive additional milestones for Merck's clinical and marketing achievements, if any, and royalty payments associated with Merck's commercialization of drugs discovered under the agreement, if any.

The term of the collaborative research program under the agreement is three years from October 21, 2002. Merck can terminate this program for any of the following reasons: (i) without cause, at any time on or after the second anniversary of October 21, 2002, by giving notice at least 90 days prior to such termination date, if certain milestones have been achieved and paid; (ii) without cause, at any time after the second anniversary of October 21, 2002, by giving notice on or after such anniversary, and at least 180 days prior to such termination date; (iii) for certain technical grounds, at any time by giving 30 days prior notice; and (iv) in the event of a change in control of Arena, by giving 30 days prior notice. Merck can terminate the agreement at any time after the third anniversary of October 21, 2002. Either party can terminate the agreement at any time for cause if the other party breaches its material obligations under the agreement by causes and reasons within its control, has not cured such breach and there is no dispute as to whether such breach has occurred. Additionally, in lieu of terminating the agreement, Merck can terminate certain aspects of the agreement by giving 90 days prior notice if the Company materially

breaches its obligations at any time during the period from October 21, 2002, to the third anniversary of such date (or such earlier date of termination) and fails to cure such breach, if such default can be cured but not within a certain period, or if the Company does not commence and diligently continue good faith efforts to cure such default during such period.

For the year ended December 31, 2002, the Company recognized revenues under the Merck agreement of approximately $1.6 million, which included research funding of approximately $1.4 million and approximately $200,000 from the amortization of the upfront payment.

Ferring Pharmaceuticals, Inc.

In May 2002, the Company entered into a research and licensing agreement with Ferring Pharmaceuticals, Inc. ("Ferring"). The collaboration will principally focus on a validated GPCR target in the field of reproductive biology. The objective of the collaboration is to discover novel small molecule compounds of therapeutic potential. The Company will utilize its technologies to develop a CART-activated version of the GPCR target, develop a drug-screening assay, and screen focused small molecule compound libraries based on structures provided by Ferring and the Company.

The Company will receive research funding from Ferring for its internal resources committed to the collaboration, which the Company expects will be augmented by Ferring. Through December 31, 2002, the Company has recognized one preclinical screening milestone in the amount of $500,000. In the future, we may receive up to $1.25 million in additional preclinical milestone payments if the Company identifies a small molecule that has certain activity at the GPCR target and Ferring selects this compound for development, plus additional preclinical milestones if Ferring selects multiple small molecules to develop. The Company may also receive additional milestones for clinical and marketing achievements, if any. The Company may also receive royalty payments associated with the commercialization of drugs discovered under the agreement, if any.

Unless terminated earlier by one party for the other party's breach, insolvency or bankruptcy, this agreement is effective until the earlier of the following events: (i) no compound is being optimized, developed, commercialized and/or sold by Ferring under this agreement, or (ii) the expiration of Ferring's obligation to pay royalty payments to the Company for each drug product.

For the year ended December 31, 2002, the Company recognized revenues under the Ferring agreement of approximately $1.3 million, which included research funding of approximately $800,000 and a milestone achievement of $500,000.

TaiGen Biotechnology Co., Ltd.

In July 2001, the Company entered into a licensing agreement with TaiGen Biotechnology Co., Ltd. ("TaiGen"), a start-up biopharmaceutical organization focused on the discovery and development of innovative therapeutics primarily in the areas of oncology and inflammation. This agreement was later amended in December 2002. In exchange for a license to the Company's technologies, including the right to select and obtain several GPCRs, the Company received $3.3 million in equity in TaiGen's Series A preferred financing, but did not receive any cash payment. The Company is eligible to receive preclinical and clinical milestones and royalty payments based on licensing revenues and drug sales, if any. The Company accounts for its ownership interest in TaiGen using the equity method of accounting because the Company owns approximately 17% of TaiGen's outstanding shares and the Company's President and CEO, Jack Lief, is a member of TaiGen's board of directors. This is a method of accounting for an investment that requires increasing or decreasing the value of the Company's investment on its balance sheet based on its proportionate share of TaiGen's earnings or losses. The Company shared in TaiGen's losses and thereby increased its net loss for the year ended December 31, 2002, and 2001 by approximately $1.0 million and $204,000, respectively. The Company's investment in TaiGen was valued at $2.1 million and $3.1 million at December 31, 2002, and 2001, respectively. The Company also recognizes non-cash revenues at the time the Company transfers to TaiGen a GPCR assay under the collaboration.

This agreement is effective until the expiration of TaiGen's obligation to make royalty payments under the agreement, if any. Additionally, either party may terminate this agreement if the other party fails to cure a material breach of the agreement within two months of receiving notice of such breach, becomes insolvent or commences bankruptcy proceedings, or dissolves or liquidates.

For each of the years ended December 31, 2002, and 2001, the Company recognized non-cash related party revenues of $1.4 million for the transfer of GPCR assays to TaiGen.

Taisho Pharmaceutical Co., Ltd.
In May 2000, the Company entered into a research and licensing collaboration with Taisho (the "2000 Taisho Agreement") focused on a few GPCRs. Under the terms of the 2000 Taisho Agreement, the Company was eligible to receive up to a total of $2.3 million in revenues per receptor associated with research, development and screening milestones.

In January 2001, the Company amended the 2000 Taisho Agreement to grant Taisho worldwide rights to the Company's 18F program, which includes the 18F receptor and small molecule modulators discovered using this receptor. In October 2002, the Company further amended the 2000 Taisho Agreement and Taisho returned worldwide rights to the 18F program in exchange for royalties on drug sales, if any.

The 2000 Taisho Agreement is effective until the expiration of Taisho's obligation to make royalty payments under the agreement, if any. Additionally, either party may terminate this agreement if the other party fails to cure a material breach of the agreement within two months of receiving notice of such breach, becomes insolvent or commences bankruptcy proceedings, or dissolves or liquidates.

In addition to the 2000 Taisho Agreement, in March 2001, the Company entered into a receptor discovery agreement with Taisho (the "2001 Taisho Agreement"). In connection with the 2001 Taisho Agreement, Taisho paid the Company a one-time non-refundable research and development fee, which was recognized as revenues in 2001 as services were performed. The Company does not expect any further work to be performed, or to receive any additional revenues, under the 2001 Taisho Agreement.

For the year ended December 31, 2002, the Company recognized revenues under the Taisho collaborations of approximately $283,000, consisting of research funding of approximately $163,000 and $120,000 from amortization of the upfront payment. For the year ended December 31, 2001, the Company recognized revenues under the Taisho collaborations of approximately $6.2 million, consisting of milestone achievements and research and development fees of approximately $4.8 million, research funding of $1.3 million and $120,000 from amortization of the upfront payment. For the year ended December 31, 2000, the Company recognized revenues under the Taisho collaborations of approximately $2.4 million, consisting of milestone achievements of approximately $2.3 million and $80,000 from amortization of the upfront payment.

10. Stockholders' Equity

Preferred Stock
In 2000, the Company sold shares of convertible redeemable preferred stock. In connection with its initial public offering process and in accordance with EITF 98-5 "Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," the Company recorded a non-cash preferred stock charge of $22.4 million for the year ended December 31, 2000. The non-cash preferred stock charge increases the loss applicable to common stockholders in the calculation of basic net loss per share for the year ended December 31, 2000.

In October 2002, and in conjunction with the stockholders rights plan (see "stockholders' rights plan" below in this note), the Company's Board of Directors created a series of preferred stock, consisting of 350,000 shares, par value $.0001 per share, designated as Series A Junior Participating Preferred Stock (the "Series A Preferred Stock"). Such number of shares may be increased or decreased by the Board of Directors, provided that no decrease shall reduce the number of shares of Series A Preferred Stock to a number less than the number of shares then outstanding, plus the number of shares reserved for

issuance upon the exercise of outstanding options, rights or warrants or upon the conversion of any outstanding securities issued by the Company convertible into Series A Preferred Stock. As of December 31, 2002, no shares of Series A Preferred Stock were issued or outstanding.

Equity Compensation Plans

Since inception through December 31, 2002, the Company has authorized an aggregate of 6.25 million shares of common stock for issuance under the Amended and Restated 1998 Equity Compensation Plan, the Amended and Restated 2000 Equity Compensation Plan and the 2002 Equity Compensation Plan (collectively, the "Option Plans"). The Option Plans provide designated employees of the Company, certain consultants and advisors who perform services for the Company, and non-employee members of the Company's Board of Directors with the opportunity to receive grants of incentive stock options, non-qualified stock options and restricted stock. The options generally vest 25% a year for four years and are immediately exercisable up to ten years from the date of grant. The restricted stock generally vest over a two or four-year period and the recipient, at the date of grant, has all rights of a stockholder, subject to certain restrictions on transferability and a risk of forfeiture.

Unvested shares issued to the Company's employees, consultants, advisors and non-employee members of the Company's Board of Directors pursuant to the exercise of options are subject to repurchase, at the original purchase price, in the event of termination of employment or engagement. In the event the Company elects not to buy back any such unvested shares, the unvested options will be expensed at their fair value at that point in time. At December 31, 2002, 184,123 shares of common stock, issued pursuant to the exercise of options, were subject to repurchase by the Company. In accordance with SFAS No. 128, the Company has excluded unvested common stock arising from exercised options in its basic loss per share calculations.

The following tables summarize the Company's stock option activity and related information for the years ended December 31:

	2002		2001		2000	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at January 1,	1,730,200	$16.21	1,064,475	$12.44	684,600	$ 0.40
Granted	1,136,075	10.91	895,700	18.89	1,215,175	11.07
Exercised	(89,375)	0.60	(129,850)	0.59	(809,425)	0.46
Cancelled	(271,125)	20.07	(100,125)	19.82	(25,875)	1.66
Outstanding at December 31,	2,505,775	$13.95	1,730,200	$16.21	1,064,475	$12.44

Pursuant to stock option agreements between the Company and its employees, each of its employees are entitled to exercise their options prior to vesting. All of the exercisable options shown in the table below are vested, but have not yet been exercised. The following table summarizes information concerning outstanding and exercisable options as of December 31, 2002:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	Number Outstanding at December 31, 2002	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable at December 31, 2002	Weighted-Average Exercise Price
$ 0.20–$ 6.77	438,750	7.7 Years	$ 2.57	154,750	$ 0.64
$ 9.05–$11.37	582,200	9.4 Years	10.33	38,626	9.86
$12.25–$15.40	590,000	8.9 Years	12.61	21,875	14.89
$16.00–$24.23	659,575	7.9 Years	21.40	263,052	22.09
$25.58–$31.34	235,250	8.5 Years	26.57	69,750	27.26
$ 0.20–$31.34	2,505,775	8.5 Years	$13.95	548,053	$16.51

At December 31, 2002, 2001, and 2000, 184,123, 291,499 and 509,850 shares of common stock issued upon the exercise of options were subject to repurchase at the original purchase price at a weighted-average price of $.60, $.58 and $.51, respectively. At December 31, 2002, 2001, and 2000, 2,594,975, 704,525 and 1,492,233 shares, respectively, were available for future grant. The 2,505,775 options not exercised at December 31, 2002, can be exercised at any time; however, unvested shares are subject to repurchase at the original purchase price if a grantee terminates prior to vesting.

In 2001, the Company granted 87,000 stock options to employees at less than the market price of the stock on the date of grant. These options had a weighted-average exercise price of $14.72 and a weighted-average grant date fair value of $17.32. For options granted at the market value in 2001, the weighted-average exercise price and weighted-average grant date fair value were $19.34. In 2000, the Company granted 516,250 stock options to employees at less than the market price of the stock on the date of grant. These options had a weighted-average exercise price of $24.95 and a weighted-average grant date fair value of $29.36. For options granted at the market value in 2000, the weighted-average exercise price and weighted-average grant date fair value were $0.72.

In connection with the grant of stock options to employees, the Company recorded deferred stock compensation totaling $0, $226,000 and $11.6 million during the years ended December 31, 2002, 2001, and 2000, respectively. The deferred stock compensation represents the difference on the date such stock options were granted between the exercise price and the estimated market value of the Company's common stock as determined by the Company's management, or after July 28, 2000, the quoted market value. Deferred compensation is included as a reduction of stockholders' equity and is amortized to expense over the vesting period of the options in accordance with FASB Interpretation No. 28, which permits an accelerated amortization methodology. The Company recorded amortization of deferred compensation expense of approximately $2.3 million during the year ended December 31, 2002, $4.2 million during the year ended December 31, 2001, and $4.3 million during the year ended December 31, 2000. As of December 31, 2002, the Company anticipates that total charges to be recognized in future periods from amortization of deferred stock compensation will be $1.0 million for the year ending December 31, 2003, and $106,000 for the year ending December 31, 2004.

Employee Stock Purchase Plan

The 2001 Arena Employee Stock Purchase Plan (the "Purchase Plan") was adopted by the Company's Board of Directors in March 2001. The Purchase Plan qualifies under Section 423 of the Internal Revenue Service and permits substantially all employees to purchase shares of common stock of the Company. Under the Purchase Plan, employees can choose to have up to 15 percent of their annual compensation withheld to purchase shares of common stock. The purchase price of the common stock is at 85 percent of the lower of the fair market value of the common stock at the enrollment date or the purchase date. The aggregate number of shares of the Company's common stock that may be issued pursuant to the Purchase Plan is 1,000,000. As of December 31, 2002, 101,148 shares have been issued pursuant to the Purchase Plan.

Common Shares Reserved for Future Issuance

The following shares of common stock are reserved for future issuance at December 31, 2002:

Stock option plans	5,100,750
Employee stock purchase plan	898,852
Total	5,999,602

Stockholders' Rights Plan

In October 2002, subsequent to Biotechnology Value Fund, L.P., Biotechnology Value Fund II, L.P., BVF Investments, L.L.C., BVF Partners L.P., and BVF Inc. (collectively, "BVF") increasing their share ownership in the Company, the Company's Board of Directors adopted a stockholders' rights plan (the "Rights Agreement") under which all stockholders of record as of November 13, 2002, received rights to purchase shares of the Series A Preferred Stock (the "Rights"). Each Right entitles the registered holder to purchase from the Company one one-hundredth of a share of the Series A Preferred Stock at an initial exercise price of $36, subject to adjustment. The Rights are not exercisable until the tenth day after such time as a person or group acquires beneficial ownership of 10% or more, or announces a tender offer for 10% or more, of the Company's common stock. At such time, all holders of the Rights, other than the acquiror, will be entitled to purchase shares of the Company's common stock at a 50% discount from the then current market price.

BVF, which beneficially owned more than 10% of the Company's common stock on the effective date of the Rights Agreement, was excluded to the extent of BVF's then current position, and, thus, did not trigger the exerciseability of the Rights on the effective date of the agreement.

The Rights will trade with the Company's common stock, unless and until they are separated due to a person or group acquiring beneficial ownership of 10% or more, or announcing a tender offer for 10% or more, of the Company's common stock. The Company's Board of Directors may terminate the Rights Agreement at any time or redeem the Rights prior to the time a person acquires 10% or more of the common stock.

The Rights are more fully described in the Rights Agreement, which the Company filed with the Securities and Exchange Commission on November 1, 2002.

11. Employee Benefit Plan

The Company has a defined contribution retirement plan that complies with Section 401(k) of the Internal Revenue Code. All employees of the Company are eligible to participate in the plan. The Company matches 100% of each participant's voluntary contributions, subject to a maximum Company contribution of 6% of the participant's compensation. The Company's matching portion, which totaled $795,878, $496,859 and $281,595 for the years ended December 31, 2002, 2001, and 2000 respectively, vests over a five-year period.

12. Income Taxes

Significant components of the Company's deferred tax assets at December 31, 2002, and 2001 are shown below. A valuation allowance of $25.0 million and $13.1 million has been recognized to offset the deferred tax assets as of December 31, 2002, and 2001, respectively, as realization of such assets is uncertain.

December 31,	2002	2001
Deferred tax assets:		
Net operating loss carryforwards	$ 14,925,000	$ 5,440,000
Research and development credits	7,338,000	3,176,000
Other, net	3,107,000	4,869,000
Net deferred tax assets	25,370,000	13,485,000
Valuation allowance for deferred tax assets	(25,040,000)	(13,131,000)
Total deferred tax assets	330,000	354,000
Deferred tax liabilities:		
Depreciation	(330,000)	(354,000)
Net deferred tax assets	$ —	$ —

At December 31, 2002, the Company had federal and state tax net operating loss carryforwards of approximately $39.0 million and $28.6 million, respectively. The federal and California tax net operating loss carryforwards will begin to expire in 2012 and 2005, respectively, unless previously utilized. The Company also has federal and California research tax credit carryforwards of approximately $5.1 million and $3.4 million respectively, which will begin to expire in 2012 unless previously utilized.

Pursuant to Sections 382 and 383 of the Internal Revenue Code, annual use of the Company's net operating loss and credit carryforwards could be limited in the event of cumulative changes in ownership of more than 50%. Such a change occurred in prior years. However, the Company does not believe such limitation will have a material effect upon the Company's ability to utilize the carryforwards.

13. Quarterly Financial Data (Unaudited)

2002 for quarter ended	Dec. 31	Sept. 30	June 30	March 31	Year
Revenues	$ 6,364,224	$ 2,987,741	$ 5,829,496	$ 4,240,304	$ 19,421,765
Net loss	(8,778,543)	(10,268,023)	(7,313,638)	(6,469,734)	(32,829,938)
Basic and diluted loss per share	$ (0.32)	$ (0.37)	$ (0.27)	$ (0.24)	$ (1.19)

2001 for quarter ended	Dec. 31	Sept. 30	June 30	March 31	Year
Revenues	$ 5,865,071	$ 3,472,338	$ 3,330,255	$ 5,392,335	$ 18,059,999
Net income (loss)	(2,802,484)	(2,019,554)	(3,145,680)	1,084,994	(6,882,724)
Basic and diluted earnings (loss) per share	$ (0.10)	$ (0.07)	$ (0.14)	$ 0.05	$ (0.28)

Market for the Registrant's Common Equity and Related Stockholder Matters

Our common stock has traded on the NASDAQ National Market under the symbol "ARNA" since our initial public offering on July 28, 2000. The following table sets forth, for the period indicated, the high and low sale prices for the common stock as reported by the NASDAQ National Market.

Year Ended December 31, 2001	High	Low
First Quarter	$27.13	$11.56
Second Quarter	$33.10	$17.13
Third Quarter	$35.49	$ 8.65
Fourth Quarter	$13.02	$ 8.77

Year Ended December 31, 2002	High	Low
First Quarter	$12.79	$ 9.46
Second Quarter	$ 9.98	$ 5.95
Third Quarter	$ 8.37	$ 5.45
Fourth Quarter	$ 7.49	$ 5.20

On March 3, 2003, the last reported sale price on the NASDAQ National Market for our common stock was $6.28 per share.

As of March 3, 2003, there were approximately 3,700 stockholders of record of our common stock.

Dividends

We have never declared or paid any cash dividends on our capital stock and do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain future earnings, if any, to fund the expansion and growth of our business. Payments of future dividends, if any, will be at the discretion of our Board of Directors after taking into account various factors, including our financial condition, operating results, current and anticipated cash needs, plans for expansion and other factors that our Board of Directors deem relevant.

Information Relating to Forward-Looking Statements

This Annual Report includes forward-looking statements. These forward-looking statements involve a number of risks and uncertainties. Such forward-looking statements include statements about our strategies, our discoveries, our collaborations, our internal programs, and other statements that are not historical facts, including statements which are preceded by the words "intend," "will," "plan," "expect," "anticipate," "estimate," "aim," and "believe" or similar words. For such statements, we claim the protection of the Private Securities Litigation Reform Act of 1995. Readers of this Annual Report are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of our most recent annual report on Form 10-K. We undertake no obligation to update publicly or revise any forward-looking statements. Actual events or results may differ materially from our expectations. Important factors that could cause actual results to differ materially from those stated or implied by our forward-looking statements include, but are not limited to, the following: the actions of our largest stockholders; the timing, success and cost of preclinical research, out-licensing endeavors and clinical studies; and the timing and receipt of additional milestone or other payments, if any, from new or existing collaborators. Additional risk factors that could cause actual results to differ materially from those in these forward-looking statements are disclosed in our SEC reports, including, but not limited to, our most recent annual report on Form 10-K.

Corporate Information

Board of Directors

Jack Lief
President & Chief Executive Officer
Arena Pharmaceuticals, Inc.

Dominic P. Behan, Ph.D.
Vice President, Research
Arena Pharmaceuticals, Inc.

Duke K. Bristow, Ph.D.
Economist
Anderson Graduate School of Management at UCLA

Derek T. Chalmers, Ph.D.
Vice President, Research
Arena Pharmaceuticals, Inc.

J. Clayburn La Force, Jr., Ph.D.
Dean Emeritus
Anderson Graduate School of Management at UCLA

Mark N. Lampert
Founder & President
BVF Inc.

Executive Officers

Jack Lief
President & Chief Executive Officer

Nigel R.A. Beeley, Ph.D.
Vice President, Chief Chemical Officer

Dominic P. Behan, Ph.D.
Vice President, Research

Derek T. Chalmers, Ph.D.
Vice President, Research

Robert E. Hoffman, C.P.A.
Vice President, Finance

Paul W. Maffuid, Ph.D.
Vice President, Pharmaceutical Development

Joseph F. Mooney
Chief Financial Officer

Louis J. Scotti
Vice President, Marketing & Business Development

Steven W. Spector
Vice President, General Counsel & Secretary

Joyce H. Williams, R.A.C.
Vice President, Drug Development

Wholly Owned Subsidiary

BRL Screening, Inc.

Designed by Curran & Connors, Inc. / www.curran-connors.com

Corporate Headquarters

Arena Pharmaceuticals, Inc.
6166 Nancy Ridge Drive
San Diego, California 92121
Telephone: 858.453.7200 Facsimile: 858.453.7210

Annual Meeting

The Annual Meeting of Stockholders will be held on Wednesday, June 11, 2003, at 10:00 a.m., local time, at 6150 Nancy Ridge Drive, San Diego, California 92121. For further information, call 858.453.7200, ext. 253.

Investor Relations

Stockholders' inquiries should be directed to:
Investor Relations
Arena Pharmaceuticals, Inc.
6166 Nancy Ridge Drive
San Diego, California 92121
Telephone: 858.453.7200, ext. 253 Facsimile: 858.453.7210

Information Available

A copy of the Company's annual report on Form 10-K for the year ended December 31, 2002, as filed with the Securities and Exchange Commission, is available without charge by writing Investor Relations at the Company's corporate headquarters or calling 858.453.7200, ext. 253.

In addition, the Company's annual report on Form 10-K, other filings with the Securities and Exchange Commission, and press releases, along with general information on the Company's business and technology, are available through the Company's home page on the Internet at the following address: www.arenapharm.com.

Transfer Agent and Registrar

Computershare Investor Services
350 Indiana Street, Suite 800
Golden, Colorado 80401
Telephone: 303.262.0600 Facsimile: 303.262.0604

Stock Listing

The Company's common stock trades on The NASDAQ Stock Market® under the symbol ARNA.

Independent Auditors

Ernst & Young LLP
501 West Broadway, Suite 1100
San Diego, California 92101
Telephone: 619.235.5000 Facsimile: 619.235.5151

Trademarks and Service Marks

The following trademarks and service marks in this report are the property of the Company or its subsidiary: Arena Pharmaceuticals®, Arena®, Aressa Pharmaceuticals®, CART™, and BRL Screening™. The corporate logo is a registered trademark.

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