# SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 20-F

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2001 COMMISSION FILE NO. 005-60609

# Compugen Ltd.

(Exact name of registrant as specified in its charter and translation of registrant's name into English)

**Israel**
(Jurisdiction of incorporation or organization)

**72 Pinchas Rosen Street, Tel Aviv, 69512 Israel**
(Address of principal executive offices)

**Securities registered or to be registered pursuant to Section 12(b) of the Act:**

None

**Securities registered or to be registered pursuant to Section 12(g) of the Act:**

Ordinary Shares, par value New Israeli Shekels 0.01 per share
(Title of Class)

**Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:**

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

26,059,051 Ordinary Shares.

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

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 [ ] Item 18 [x]

This annual report on Form 20-F includes "forward-looking" statements within the meaning of Section 21E of the Securities Exchange Act of 1934. We have based these forward-looking statements on information available to us on the date hereof, our current intentions, our beliefs, and expectations or projections about future events. We assume no obligation to update any such forward-looking statements. These statements involve risks and uncertainties and actual results could differ materially from our expectations or projections. Factors that could cause our actual results to differ materially from those projected in the forward-looking statements include the risk factors set forth in this annual report at "Item 3. Risk Factors."

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We have prepared our consolidated financial statements in United States dollars and in accordance with accounting principles generally accepted in the United States. All references herein to "dollars" or "$" are to United States dollars, and all references to "Shekels" or "NIS" are to New Israeli Shekels.

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## PART I.

## ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable.

## ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

## ITEM 3. KEY INFORMATION

### Selected Financial Data

The selected financial data is incorporated by reference to Item 5 of this annual report.

### Risk Factors

This annual report includes forward-looking statements. We have based these forward-looking statements on our current intentions, beliefs, expectations or projections about the future. These forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that could cause our actual results to differ materially from those projected in the forward-looking statements.

***Risks Related to Our Business***

**Our approach to understanding life sciences through the convergence of computational technologies and molecular biology is novel and may not be accepted by our potential customers.**

Our technologies involve new and unproven approaches to understanding biological processes. Our approaches to understanding these matters may prove to be ineffective or not as effective as other methods, or they may not be accepted by our potential customer base. These approaches are based on the assumption that very complex molecular biological processes and experimental results can be successfully understood and modeled through the convergence of advanced mathematical techniques, computer science and molecular biology in ways not attainable as quickly or at all using conventional techniques. If our technologies are not accepted by customers, our business may fail or we may never become profitable. In addition, the life processes and experimental results that we are now attempting to model and understand in our research activities may turn out to be significantly more complex than those involved in our earlier efforts.

**We have a history of losses, expect to incur future losses and may never achieve or sustain profitability**.

We incurred net losses of approximately $8.1 million in 1999, $13.4 million in 2000 and $15.1 million in 2001. As of December 31, 2001, we had an accumulated deficit of approximately $43.5 million (not including approximately $24.9 million in accumulated deficit attributable to the conversion of preferred shares upon the closing of our initial public offering). We expect to continue to incur net losses and negative cash flows in the future due in part to increasing research and development expenses, including enhancements to our technologies and investments in new technologies, and increased sales, marketing and business development expenses. As a result, we will need to generate significantly higher revenues to achieve profitability. We cannot assure you that we will ever achieve profitability. Even if we do achieve profitability, we may not be able to sustain or increase profitability.

**Even if our technologies are effective as research tools, we or our customers may be unable to develop or commercialize new drugs, therapies or other products based on them.**

Even if our technologies perform their intended functions as research tools, we or our customers may be unable to use the discoveries resulting from them to produce new drugs, therapies, diagnostics or other life science products. There is still a limited understanding of the roles of genes and proteins and their involvement in diseases and other life processes. Few therapeutic products based on genomic or proteomic discoveries have been developed and commercialized. To date, no one has developed or commercialized any drug, therapeutic, diagnostic, or other life science products based on our technologies.

Development of drugs, therapies, diagnostics and other life science products based on our Novel Genomics division's or our customers' discoveries will also be subject to other risks of failure inherent in development or commercialization of products of these types. These risks include the possibility that any of these products will:

- be found to be toxic or ineffective;
- fail to receive necessary regulatory approvals;
- be difficult or impossible to manufacture on a large scale;
- be uneconomical to market;
- fail to be developed prior to the successful marketing of similar products by competitors; or
- be impossible to market because they infringe on the proprietary rights of third parties or compete with superior products marketed by third parties.

Any of these factors could materially harm our business and financial results.

**Our industry is evolving rapidly, and we may be unable to keep pace with changes in technology.**

The life science industry, and genomic technologies in particular, are characterized by rapid technological change, and the area of gene and protein research is a quickly evolving field. Our future success will depend in large part on maintaining a competitive position in the field of genomic and proteomic research. If we fail to keep pace with changes in technology, our business will be materially harmed. Rapid technological development by us or others may result in our products or technologies becoming obsolete. This may occur even before we recover the expenses we incur in connection with their development. Products or services offered by us could become obsolete due to the development of less expensive or more effective drug discovery technologies, including technologies developed by third parties that may be unrelated to genomics, functional genomics or proteomics. We may not be able to make the necessary enhancements to our technologies to compete successfully with newly emerging technologies. In addition, the federally funded Human Genome Project and others engaged in genomic research have committed to make basic human sequence data available to the public. These publications, including the publication of the human genome, may make some of our products and technologies less valuable or obsolete.

**We face intense competition, and if we are unable to compete successfully, we could experience a loss of market share and reduced gross margins for our products and services.**

We compete with companies in the United States and elsewhere that provide products and services for the analysis of genomic and proteomic information or that commercialize novel genes and proteins. These include genomics, pharmaceutical and biotechnology companies, academic and research institutions and government and other publicly-funded agencies. We may not be able to compete successfully against current and future competitors. Many of our competitors have substantially greater capital resources,

research and development staffs, facilities, manufacturing and marketing experience, distribution channels and human resources than we do. This may allow these competitors to discover, characterize or develop important discoveries, or to obtain regulatory approval for products based on these discoveries, in advance of us or our customers. Some of our competitors, especially academic and research institutions and government and other publicly-funded agencies, may provide for free services or data similar to ours that we may provide for a fee. Greater resources may also allow these competitors to develop products that are more effective than ours or those of our customers. Moreover, our competitors may obtain patent protection or other intellectual property rights that would limit our rights or our customers' ability to use our products and services to commercialize their discoveries. If we are unable to compete successfully against existing or potential competitors, our revenues and margins may decline.

**Our Novel Genomics division is a new venture with limited resources, and it may never develop or commercialize products or achieve profitability.**

Our Novel Genomics division is a new venture, with limited research personnel and limited development, manufacturing or marketing capability. Novel Genomics has generated only negligible revenues to date, has no clear source of revenues and may never achieve profitability. Although we intend to allocate additional cash resources to Novel Genomics' operations, we do not anticipate that this funding for research and sales and marketing will enable Novel Genomics to achieve profitability in the near future. As a result, its operations may require substantial additional funds in the future. If Novel Genomics is unable to obtain the required additional funding from us, from third-party collaborators or from other third parties on commercially reasonable terms, we may have to curtail or cease Novel Genomics' operations.

Currently, Novel Genomics has no products under development and lacks the infrastructure, equipment and experienced personnel it would need to develop product candidates. Once developed, product candidates must undergo extensive testing, including animal and human clinical trials, to obtain regulatory approvals needed for commercialization. Even if Novel Genomics is able to develop and commercialize its product candidates, we cannot assure you that its products, if any, would be commercially marketable or successful.

**The success of our Novel Genomics division will depend on its ability to find third party collaborators to develop and commercialize product candidates. Working with third party collaborators may expose our Novel Genomics division to several risks related to the terms of licensing agreements, dependence on our collaborators and disputes over the development and ownership of jointly developed technologies**

Our strategy for the development and commercialization of drug targets and diagnostic markers depends, in large part, upon the formation of collaborations with third parties. Potential third parties include pharmaceutical and biotechnology companies, academic institutions and other entities. These collaborations are necessary in order:

- to enable us to gain access to complimentary technologies;
- to enable the performance of research and development activities which we are not capable of performing or do not have the necessary human resources to perform;
- to enable the funding of our research and development activities;
- to enable the funding of pre-clinical development, clinical trials and manufacturing;
- to enable us to seek and obtain regulatory approvals; and
- to enable us to successfully commercialize existing and future product candidates.

To date, we have entered into only one such collaboration, which is in its initial stages. We cannot assure you that this collaboration will be successful. Although we are currently negotiating with several life science companies regarding possible additional collaborations, we cannot assure you that we will enter into collaborations with any of these companies or into any other collaborations in the future. If we fail to enter into successful collaborations, the business of our Novel Genomics Division, and our financial condition and results of operations may be materially harmed.

Our dependence on licensing and other agreements with third parties subjects us to a number of risks. These agreements may not be on terms favorable to us, and collaborators may typically be afforded significant discretion in electing whether to pursue any of the planned activities. In most cases, our collaborators will have responsibility for formulating and implementing key strategic or operational plans. Decisions by our collaborators on key development, clinical, regulatory, marketing (including pricing), inventory management and other issues may prevent successful commercialization of the product or otherwise impact our profitability. In addition, we may not be able to control the amount and timing of resources our collaborators will devote to the product candidates, and collaborators may not perform their obligations as expected. Additionally, business combinations or significant changes in a collaborator's business strategy may negatively affect a collaborator's willingness or ability to complete its obligations under arrangements with us. Furthermore, our rights in any intellectual property or products that may result from our collaborations may depend on additional investment of money that we may not be able or willing to make. If we are not able to establish successful collaborations, we may be required to undertake product development and commercialization at our own expense. Such an undertaking may:

- limit the number of product candidates that we will be able to develop and commercialize;
- reduce the likelihood of successful product introduction;
- significantly increase our capital requirements;
- place additional strain on our management's time; and
- limit the revenues we receive from each product.

Potential or future collaborators may pursue alternative technologies, including those of our competitors. Disputes may arise with respect to the ownership of rights to any technology or products developed with any future collaborator. Lengthy negotiations with potential collaborators or disagreements between us and our collaborators may lead to delays or termination in the research, development or commercialization of product candidates or result in time-consuming and expensive litigation or arbitration. If our collaborators pursue alternative technologies or fail to develop or commercialize successfully any product candidate to which they have obtained rights from us, our business, financial condition and results of operations may be significantly harmed.

**Our business of providing access to our products and data to our customers and the activities of our Novel Genomics division may conflict with each other.**

Our Novel Genomics division depends, in large part, on our computational platforms and tools and proprietary data to make inventions and establish intellectual property rights in genes and proteins. This access to our tools and proprietary information provides our Novel Genomics division with a competitive advantage over biotechnology companies that are pursuing patents that may compete with us, including patents to gene and protein sequences. The licensing or provision of access to our platforms, tools or proprietary data to our customers, primarily biotechnology companies, may diminish or eliminate our Novel Genomics division’s competitive advantage over these customers. If our customers, many of which have greater financial and other resources than our Novel Genomics division, research genes or proteins that we are researching, they may establish intellectual property rights in such genes or proteins before our Novel Genomics division. As a result, our business, financial condition and results of operations may be significantly harmed. In addition, our Novel Genomics division may pursue opportunities in fields that could conflict with those of our customers or discourage potential customers from working with us, thereby reducing our potential revenues.

**Our failure to manage our growth effectively could limit our ability to pursue business opportunities and expand our business.**

We experienced a period of rapid growth that has placed, and continues to place, a strain on our management, operations, infrastructure and financial resources. Between January 1, 1998 and December 31, 2001, the number of our employees increased from 56 to 176 and we substantially expanded our United States subsidiary. Any failure to properly manage the expansion of our business could limit our ability to operate effectively. Our success will depend on the ability of our officers and key employees to efficiently

utilize our human resources, to focus on the key issues essential for our success, continue to implement and improve our operational and financial systems and managerial controls, to manage concurrent research projects and customer relationships and to hire, train and manage our employees.

**Our revenues are derived primarily from, and are subject to risks faced by, the pharmaceutical and biotechnology industries.**

We expect that our revenues in the foreseeable future will be derived primarily from products and services provided to the pharmaceutical and biotechnology industries. Accordingly, our success will depend directly upon their demand for our products and services. Our operating results may fluctuate substantially due to reductions and delays in research and development expenditures by companies in these industries. These reductions and delays may result from factors beyond our control, including:

- changes in the regulatory environment affecting health care and health care providers;
- pricing pressures and reimbursement policies;
- market-driven pressures on companies to consolidate and reduce costs;
- business combinations within these industries;
- willingness to invest, or decisions to postpone investment of, substantial amounts in the new areas of genomics, functional genomics and proteomics; and
- other factors affecting research and development spending.

**We rely on a small number of customers for a large portion of our revenues.**

A small number of our customers account for a substantial amount of our revenues. Warner-Lambert Company, a subsidiary of Pfizer, Inc., accounted for approximately 71% of our revenues in 1999, approximately 35% of our revenues in 2000 and approximately 30% of our revenues in 2001; the U.S. Patent and Trademark Office accounted for approximately 24% of our revenues in 2000 and approximately 17% of our revenues in 2001; and Novartis Pharma A.G. accounted for approximately 17% of our revenues in 2001. We cannot be certain that these customers will continue to use our products and services for their research. Our agreement with Warner-Lambert expires in March 2002; the USPTO has not placed any orders for 2002; and Novartis may terminate our agreement with them in July 2002. A loss of our significant customers, or a reduction in orders from these customers, could harm our business and financial results.

**If we are unable to hire or retain key personnel or sufficient qualified employees, we may be unable to successfully operate our business.**

Our business is highly dependent upon the continued services of our senior management and key technical personnel in all areas of our business. While members of our senior management are parties to employment or consulting agreements and non-competition and non-disclosure agreements, we cannot assure you that these key personnel and others will not leave or compete with us, which could materially harm our financial results and our ability to compete. We do not carry key person life insurance on any member of our senior management. Furthermore, competition for highly qualified personnel in our industry and geographic locations is intense. Our business would be seriously harmed if we were unable to retain our key employees, or to attract, integrate or retain other highly qualified personnel in the future.

**If we are unable to raise additional capital in the future, we may have to curtail or cease operations.**

Based on our current projections, we anticipate that our existing cash and cash equivalents will be sufficient to support our operations for at least the next two years. We cannot assure you, however, that we will not need to raise additional capital prior to that time or that we would be able to raise sufficient

additional capital on favorable terms, if at all. If we fail to raise sufficient funds, we may have to curtail or cease operations, which would materially harm our business and financial results. To the extent we raise additional capital by issuing equity securities, our shareholders may experience substantial dilution. To the extent we raise additional funds through collaboration and licensing arrangements, we may be required to relinquish some rights to our technologies or product candidates, or grant licenses on terms that are not favorable to us.

**Our operating results are likely to fluctuate and may fail to meet the expectations of securities analysts, which may cause our share price to decline.**

Our quarterly operating results have fluctuated in the past and are likely to do so in the future. These fluctuations, or the failure of our operating results to meet the expectations of securities analysts, could cause our share price to fluctuate significantly or decline. Some of the factors that could cause our operating results to fluctuate include:

- the timing of payments under arrangements with our current and future customers;
- our rate of success and timing of new collaborations and sales of our products and services;
- changes in demand for our existing products and services and our further penetration of the life science industry;
- the level of activity and funding in the life science industry;
- a drop in the financial resources available to our customers;
- changes to our fee structure or our operating expenses;
- product quality problems;
- increased competition and the timing of the release of products and data by our competitors and academic and other non-profit organizations;
- the timing and number of our new hires;
- the timing of capital expenditures; and
- fluctuations in the sales activities of our distributors.

Based upon these and other factors, our quarterly operating results are likely to fluctuate significantly in the future, and quarterly results of operations may not be meaningful. As a result, comparisons of these results should not be relied upon as indications of future performance.

**We have a limited sales and business development organization, which may cause significant difficulties. Our ability to successfully commercialize some of our products will depend on our ability to enter into and maintain successful marketing and distribution arrangements with third parties.**

Our sales and business development organization may not be sufficiently large to successfully penetrate our target markets. Although we substantially expanded our direct sales and business development organization during 2000 and 2001, we may not be able to continue expanding our direct sales and business development organization to meet our commercial objectives.

Our ability to successfully commercialize some of our products, such as Z4000 and OligoLibraries, will depend on our ability to enter into and/or maintain successful marketing and distribution arrangements with third parties. To date, we have entered into an agreement with Sigma Genosys, Inc. for the manufacture, marketing and distribution of the co-branded OligoLibraries, with GeneLogic, Inc. for the limited

distribution of Human Gencarta and with companies in Taiwan and Japan for the limited distribution of some of our products. We cannot be certain that we will successfully identify other potential distributors for our products or that we will enter into other agreements for the marketing and distribution of our products. In addition, we may not be able to control the amount and timing of resources Sigma or any other distributor will devote to our products, and distributors may not perform their obligations as expected. If we are unable to identify and enter into distribution agreements with potential distributors for our products or Sigma or other distributors of our products do not successfully market and distribute our products, our business, financial condition and results of operations may be significantly harmed.

**We intend to acquire or make strategic investments in other businesses and technologies in the future, and these could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results.**

Although we have not made acquisitions of other companies or businesses in the past and currently have no commitments or agreements with respect to future acquisitions, our business plan includes making future acquisitions of businesses, technologies, services or products that we believe are a strategic fit with our business. We may not be able to identify suitable acquisition or investment candidates. Even if we do identify suitable candidates, we may not be able to enter into any potential acquisitions or investments on commercially acceptable terms. Moreover, even if we are successful in acquiring complementary businesses or technologies, we may be unable to successfully integrate any additional personnel, operations or acquired technologies into our business. Any difficulties could disrupt our business, distract our management and employees and increase our expenses. In addition, if we conduct acquisitions using convertible debt or equity securities, existing stockholders may be diluted, which could affect the market price of our stock.

**If our access to necessary genomic data, tissue samples or other information is restricted, or if this data is faulty, we may not be able to continue to develop our business.**

To continue to build our technologies and related products and services, we need access to scientific and other data supplied by others, as well as normal and diseased human and other tissue samples, other biological materials and related clinical and other information. We compete with many other companies for these materials and information. We may not be able to obtain or maintain access to these materials and information on acceptable terms, if at all. Some of our suppliers could become our competitors and discontinue selling supplies to us. Data from these suppliers could also contain errors or defects that could corrupt our databases or results. In addition, government regulation in the United States and other countries could result in restricted access to, or use of, human and other tissue samples. If we lose access to sufficient numbers or sources of tissue samples, or if tighter restrictions are imposed on our use of the information generated from tissue samples, our business will suffer.

**Our business and the products developed by our collaborators and licensees may be subject to government regulation.**

Any new drug, therapy or diagnostic products that may be developed by our Novel Genomics division, collaborators, or licensees of our Novel Genomics division will have to undergo a lengthy and expensive regulatory review process in the United States and other countries before it can be marketed. It may be several years, if ever, before any drugs or diagnostic products developed using our technologies will be sold or will provide us with any revenues. This may delay or prevent us from becoming profitable. Changes in policies of U.S. and other regulatory bodies can increase the delay for each new drug, product license and biological license application. We expect similar delays in the regulatory review process for any diagnostic product if similar review or other approval is required. Even if marketing clearance is obtained, a marketed product and its manufacturer are subject to continuing review. Discovery of previously unknown problems with a product may result in withdrawal of the product from the market.

No drug, therapeutic, diagnostic or other product resulting from the use of our databases or our other products or services requiring regulatory approval has been released for commercialization in the United States or elsewhere. In addition, no new drug application or application for a diagnostic product has been

submitted for any product candidate. We expect to rely on collaborators or licensees of our Novel Genomics division to file these applications and generally direct the regulatory review process. We cannot be certain whether our collaborators or licensees will be able to obtain marketing clearance for any products that may be developed on a timely basis, if at all. If our collaborators or licensees fail to obtain required governmental clearances, it will prevent them from marketing drugs or diagnostic products until clearance can be obtained, if at all. This will in turn reduce our chances of ever receiving any form of payments related to sales of marketed drugs, therapies or diagnostic products from our collaborators or licensees.

**If ethical and other concerns surrounding the use of genetic information become widespread, there may be less demand for our products and services.**

Genetic testing has raised ethical issues regarding confidentiality and the appropriate uses of the resulting information. For these reasons, governmental authorities may call for limits on or regulation of the use of genetic testing or prohibit testing for genetic predisposition to various conditions, particularly for those that have no known cure. Any of these scenarios could reduce the potential markets for our products, which could materially harm our business and financial results.

**The sales cycle for some of our products and services is lengthy. We expend substantial funds and management effort with no assurance of successfully selling our products or services.**

Our ability to obtain customers for our products and services depends in significant part upon the perception that our technologies can help accelerate their efforts in genomics, functional genomics and proteomics, as well as our ability to successfully negotiate terms and conditions for such arrangements. The sales cycle for some of our products and services is typically lengthy and could take 12 months or longer. Our sales effort may require the effective demonstration of the benefits of our products and services to, and significant training of, many different departments within a potential customer. These departments often include key management personnel. In addition, we are often required to negotiate agreements containing terms unique to each customer. Therefore, we expend and will need to continue expending substantial funds and management effort with no assurance that we will be successful in reaching agreements with potential customers.

**We may be subject to product liability claims if our products, or products derived from our products or services, injure people.**

We may be held liable if any product we develop, or any product that is made with the use, or incorporation of, any of our technologies or data causes injury or is found otherwise unsuitable. These risks are inherent in the development of genomics, functional genomics and pharmaceutical products. If we are sued for any injury caused by products derived from our services or products, our liability could exceed our total assets. In addition, such claims could cause us to incur substantial costs and subject us to negative publicity even if we prevail in our defense of such claims.

**Our business is dependent on the continuous, reliable and secure operation of our tools and functions we provide. If we are unable to safeguard the integrity, security and privacy of our data or our customers' data, our revenue will decline, our business could be disrupted, and we may be sued.**

Our computer and communications hardware and software is protected through physical and software safeguards. However, they are still vulnerable to fire, storm, flood, power loss, earthquakes, telecommunications failures, physical or software break-ins and similar events. In addition, our database products are complex and sophisticated and could contain erroneous data, design defects or software errors that could be difficult to detect and correct. Software errors and viruses may be found in current products or any future products that we develop. If we fail to maintain and further develop the necessary data to support our customers' data discovery efforts, it could result in a loss of or delay in our revenues and market acceptance and exposure.

We need to preserve and protect our data and our customers' data against loss, corruption and

misappropriation caused by system failures and unauthorized access. We also could be subject to liability claims by customers who have submitted their data to us for analysis for misuse of their data. We have taken security measures to protect our proprietary databases, including software and hardware security mechanisms and entering into confidentiality agreements with employees, customers and collaborators who are provided or have access to confidential or proprietary information. However, these measures may not be sufficient to prevent unauthorized access, use and publication of our proprietary data. A party who is able to circumvent our security measures could misappropriate or destroy proprietary information or cause interruptions in our operations. In addition, a party who obtains unauthorized access to our proprietary data or a party who breaches its confidentiality agreements with us could publish large portions or all of our proprietary data. Such publication of our proprietary data could make some of our products less valuable or obsolete, thereby seriously harming our financial condition. We may be required to make significant expenditures to protect against system failures or security breaches or to alleviate problems caused by any failures or breaches. Any failure that causes the loss or corruption of, or unauthorized access to, our or our customers' data could reduce customer satisfaction, expose us to liability and, if significant, could cause our revenue to decline.

**Any inability to adequately establish and maintain protection for our proprietary technologies or products could harm our competitive position.**

If we do not adequately protect the intellectual property underlying our products and services, competitors may be able to develop and market the same or similar products and services and erode our competitive advantage. The laws of some countries do not protect or enable the enforcement of proprietary rights to the same extent as the laws of the U.S.

We use trade secret protection for a significant portion of our confidential and proprietary information and know-how. This includes a substantial portion of the knowledge base from which we develop our proprietary products and services. We have taken security measures to protect our proprietary information. For example, we seek to protect our proprietary information by entering into confidentiality agreements with employees, collaborators and consultants. However, these measures may not provide adequate protection for our trade secrets or other proprietary information and know-how. Employees, scientific advisors, collaborators or consultants may still disclose our proprietary information in violation of their agreements with us, and we may not be able to meaningfully protect our trade secrets against this disclosure. In addition, others may independently develop substantially equivalent proprietary information or techniques or otherwise gain access to our trade secrets.

**If we are unable to obtain and preserve patent protection for our proprietary technologies or for genes or proteins that we discover, we may not be able to use or commercialize these discoveries.**

We cannot assure you that we will attempt or be able to obtain patent protection for our proprietary technologies or for any of the genes and proteins that we discover using these technologies. If we decide not to seek or are unable to obtain this protection, we may be unable to continue using or commercializing these technologies and will not be able to prevent others from using or commercializing these technologies. To date, we have applied for patents covering some aspects of some of our technologies and predicted genes and proteins we have discovered using these technologies, but we have not yet been granted any patent. We plan to continue to apply for patents covering our technologies and discoveries as we deem appropriate, but cannot assure you that we will be able to obtain any patents. The patent positions of biotechnology companies, including Compugen, are generally uncertain and involve complex legal and factual questions. Legislative changes and/or changes in the examination guidelines of government patents offices may negatively affect our ability to obtain patent protection for certain aspects of our intellectual property, especially with respect to genetic discoveries.

The success of our Novel Genomics Division depends, in large part, on our ability to obtain patents on genes and proteins we have discovered and are attempting to commercialize. Even if patent protection is generally available for genetic discoveries, we face intense competition from other biotechnology and pharmaceutical companies, including customers who use our products and technologies, that are pursuing patent protection for discoveries, which are similar or identical to our discoveries. We cannot assure you

that other parties have not previously discovered and/or sought patent protection for all or patentable portions of the genes and proteins we have discovered or may discover in the future. Our patent applications may conflict with prior applications of third parties or otherwise be challenged and may not result in issued patents. Even if issued, our patents could be invalidated or may not be sufficiently broad to provide us with any competitive advantages. Patent applications may not be in the public domain and therefore, may not be known to us at the time of filing our application. Therefore, applications which at the time of filing appear to be novel, may be determined at a later stage to be inconsistent with earlier applications. Any of these events could materially harm our business or financial results.

**Litigation or other proceedings or third party claims of intellectual property infringement could prevent us or our customers from using our discoveries or require us to spend time and money or modify our operations.**

Our commercial success depends in part on neither infringing patents or proprietary rights of third parties, nor breaching any licenses that we have entered into with regard to our technologies and products. We could incur substantial costs and diversion of management and technical personnel in defending ourselves against any claims by third parties that our technologies infringe their patents or other intellectual property rights, or in enforcing our patents or other rights against others. Furthermore, parties making claims against us may be able to obtain injunctive or other equitable relief that could effectively prevent us from being able to further develop, commercialize and sell products, and could result in the award of substantial damages against us. In the event of a successful claim of infringement against us, we may be required to pay damages and obtain one or more licenses from third parties. We may not be able to obtain these licenses at a reasonable cost, if at all. In that event, we could encounter delays in product introductions while we attempt to develop alternative methods or products. Defense of any lawsuit or failure to obtain any of these licenses could prevent us from commercializing available products. Although we are not aware of any of these situations at present, we cannot assure you that they will not occur in the future.

**We use hazardous chemicals and radioactive and biological materials in our business. Any claims relating to improper handling, storage or disposal of these materials could be time consuming and costly.**

Our research and development processes involve the controlled use of hazardous materials, including chemicals, radioactive and biological materials and the development of viruses. We cannot eliminate the risk of accidental contamination or discharge and any injury from these materials. We could be subject to civil damages in the event of an improper or unauthorized release of, or exposure of individuals to, hazardous materials. In addition, claimants may sue us for injury or contamination that results from our use or the use by third parties of these materials, and our liability may exceed our total assets. Compliance with environmental laws and regulations may be expensive, and current or future environmental regulations may impair our research, development, or production efforts. Future compliance or a failure to comply could materially harm our business and results of operations.

In addition, some of our research collaborators are working with these types of hazardous materials in connection with our research collaborations. To our knowledge, the work is performed in accordance with applicable biosafety regulations. In the event of a lawsuit or investigation, we could be held responsible for any injury caused to persons or property by exposure to, or release of, these viruses and hazardous materials.

**We have been and may continue to be negatively affected by the aftermath of September 11 events.**

On September 11, 2001, the United States was subject to terrorist attacks at the World Trade Center buildings in New York City and at the Pentagon in Washington, D.C. In response to these terrorist attacks, a United States led coalition of nations commenced a series of retaliatory military strikes in Afghanistan upon strategic installations of the Taliban regime. These events have had, and we expect will continue for the unforeseeable future to have, an adverse effect on the global economy, and could result in a disruption of our business or that of our customers.

*Risks Related to our Ordinary Shares*

**Holders of our ordinary shares who are United States residents face income tax risks.**

There is a significant risk that we will be classified as a passive foreign investment company, or PFIC. Our treatment as a PFIC could result in a reduction in the after-tax return to the holders of our ordinary shares and may cause a reduction in the value of these shares. For U.S. Federal income tax purposes, we will be classified as a PFIC for any taxable year in which either (i) 75% or more of our gross income is passive income, or (ii) at least 50% of the average value of all of our assets for the taxable year produce or are held for the production of passive income. For this purpose, passive income includes dividends, interest, royalties, rents, annuities and the excess of gains over losses from the disposition of assets that produce passive income. If we were determined to be a PFIC for U.S. federal income tax purposes, highly complex rules would apply to U.S. taxpayers owning our ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of these rules.

As a result of our substantial cash position and the decline in the value of our stock, there is a significant risk that we will be classified as a PFIC under the asset test described in the preceding paragraph. However, based on an independent third party opinion, we believe that we should not be classified as a PFIC for the year 2001. We have, however, no assurance that the U.S. Internal Revenue Service will accept this position. In addition, there can be no assurance that we will not be classified as a PFIC in the future, because the determination of whether we are a PFIC is based upon the composition of our income and assets from time to time, and such determination cannot be made with certainty until the end of a calendar year.

United States residents should carefully read "Item 10E. Additional Information – Taxation, United States Federal Income Tax Consequences" for a more complete discussion of the U.S. federal income tax risks related to owning and disposing of our ordinary shares.

**Since our IPO, our share price has been volatile and is likely to be volatile in the future.**

Since our IPO, the market price of our ordinary shares has been highly volatile and is likely to continue to be highly volatile due to risks and uncertainties described in this annual report, as well as other factors, including:

- conditions and publicity in the economy or in life science-related industries;
- actual or anticipated fluctuations in our operating results;
- changes in expectations as to our future financial performance or changes in financial estimates by securities analysts;
- technological innovations by us or our competitors;
- investors' perceptions or changes in market valuation of life science companies generally; and
- the operating and share price performance of other comparable companies.

In addition, due to the downturn in the world economy over the past few years and the world security situation, the securities markets in general have experienced increased volatility which has particularly affected the market prices of equity securities of many high-technology and biotechnology companies. The market prices of equity securities of companies that have a significant presence in Israel may also be affected by the security situation in Israel. Although the volatility of these companies' securities has often been unrelated to the operating performance of these companies, they may experience difficulties in raising additional financing required to effectively operate and grow their businesses. Such failure and the volatility of the securities market in general, and in particular in relation to our shares, may affect our

ability to raise additional financing in the future. These broad market and industry fluctuations may also adversely affect the trading price of our ordinary shares, regardless of our actual operating performance. In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against the company. We may become involved in this type of litigation in the future. Litigation of this type is often extremely expensive and diverts management attention and resources.

**Future sales of our ordinary shares may depress our share price.**

A substantial number of our ordinary shares could be sold into the public market. The occurrence of these sales, or the perception that these sales could occur, could materially and adversely affect our share price or could impair our ability to obtain capital through future offerings of equity securities. As of February 28, 2002, we had outstanding 26,048,384 ordinary shares. In addition, as of February 28, 2002, options to purchase 5,726,249 of our ordinary shares were outstanding, of which 2,252,200 were exercisable. In addition, as of February 28, 2002, there were 335,000 ordinary shares issuable upon the exercise of outstanding warrants, all of which are exercisable.

**Some of our existing shareholders can exert control over us and may not make decisions that are in the best interests of all shareholders.**

As of February 28, 2002, our officers, directors and shareholders holding more than 5% of our outstanding shares together controlled approximately 23% of our outstanding ordinary shares. As a result, these shareholders, if they act together, would be able to exert a significant degree of influence over our management and affairs and over matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. Accordingly, this concentration of ownership may harm the market price of our ordinary shares by delaying or preventing a change in control of us, even when a change may be in the best interests of our other shareholders. In addition, the interests of this concentration of ownership may not always coincide with our interests or the interests of other shareholders, and accordingly, they could cause us to enter into transactions or agreements that we would not otherwise consider.

***Risks Relating to Operations in Israel***

**Conditions in Israel may harm our ability to produce and sell our products and services.**

Our principal offices and research and development facilities and many of our suppliers are located in Israel. Political, economic and military conditions in Israel directly affect our operations. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, as well as incidents of civil unrest. A state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. There has been a significant increase in violence since September 2000 which has continued with varying levels of severity into 2001 and 2002 and negotiations between Israel and Palestinian representatives has ceased. While certain parties with whom we do business have declined to visit our facilities in Israel during periods of heightened unrest or tension, we have made alternative arrangements when required and we do not believe that the political and security situation has had any material impact on our business. The political and security situation in Israel may result in certain parties with whom we have contracts claiming that they are not obligated to perform their commitments under those agreements pursuant to force majeure provisions. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could adversely affect our operations and could make it more difficult for us to raise capital. Furthermore, many of our facilities are located in Israel, which is currently experiencing civil unrest, terrorist activity and military action. Since we do not have a detailed disaster recovery plan that would allow us to quickly resume business activity, we could experience serious disruptions if acts associated with this conflict result in any serious damage to our facilities. Our business interruption insurance may not adequately compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business. We cannot give any assurance that security and political conditions will not have such an

effect in the future. Any future armed conflicts or political instability in the region would likely negatively affect business conditions and harm our results of operations.

In addition, in the past Israel and companies doing business with Israel have been subjected to an economic boycott. Several countries still restrict business with Israel and Israeli companies. These restrictive laws and policies may have an adverse impact on our operating results, financial condition or the expansion of our business.

**Our results of operations may be negatively affected by the obligation of key personnel to perform military service.**

Many of our executive officers and employees are obligated to perform annual military reserve duty and are subject to being called to active duty for extended periods of time under emergency conditions. Recently, there has been a significant call up of military reservists. To date, these call-ups have not affected us materially. However, it is possible that there will be additional call-ups in the future which may have a more material effect on us. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of our other employees due to military service. Any disruption in our operations would harm our business.

**Because a substantial portion of our revenues are generated in U.S. dollars, while a significant portion of our expenses are incurred in New Israeli Shekels, our results of operations may be adversely affected by inflation and currency fluctuations.**

We generate a substantial portion of our revenues in U.S. dollars but incur a significant portion of our expenses, principally salaries and related personnel expenses, in New Israeli Shekels, commonly referred to as NIS. As a result, we are exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the dollar or that the timing of any devaluation may lag behind inflation in Israel. While in recent years the rate of devaluation of the NIS against the dollar has exceeded the rate of inflation, especially in recent months, which is a reversal from prior years, we cannot be sure that this reversal will continue. If the dollar cost of our operations in Israel increases, our dollar-measured results of operations will be adversely affected. Our operations also could be adversely affected if we are unable to guard against currency fluctuations in the future. Accordingly, we may enter into currency hedging transactions to decrease the risk of financial exposure from fluctuations in the exchange rate of the dollar against the NIS. These measures, however, may not adequately protect us from material adverse effects due to the impact of inflation in Israel.

**The government programs and tax benefits in which we currently participate or which we currently receive require us to meet several conditions and may be terminated or reduced in the future, which would negatively impact our revenues or increase our costs or taxes.**

We currently receive research and development grants and are entitled to certain grants and tax benefits under Israeli government programs, particularly as a result of the "approved enterprise" status of our existing facilities in Israel and research and development programs funded by Office of Chief Scientist of the Israel Ministry of Industry and Trade. To maintain our eligibility for these programs and tax benefits, we must continue to meet conditions, including making specified investments in fixed assets, 30% of which must be from paid-in capital. In addition, we must continue to file periodic reports and pay royalties with respect to some of the grants received. If we fail to meet such conditions, we will become ineligible for such grants and tax benefits and could be required to return all or part of the investment grants received. We cannot assure you that we will continue to receive grants at the same rate, if at all. In addition, some of these programs restrict our ability to manufacture particular products or transfer particular technologies outside of Israel. See "Item 5. Operating and Financial Review and Prospects—Government of Israel Support Programs." We received or accrued grants from the government of Israel of approximately $994,000 in 2001, $466,000 in 2000, and $507,000 in 1999. From time to time, we submit requests for additional research and development grants and expansions of our approved enterprise programs or for new programs. These requests might not be approved. The termination or reduction of these programs and tax benefits could have a material adverse effect on our business, financial condition and results of operations. If these programs or tax benefits are terminated or reduced, we could lose a significant source of income or be required to pay increased taxes in the future, which could decrease our profits.

**It may be difficult to enforce a U.S. judgment against us, or our officers and directors to assert U.S. securities law claims in Israel.**

Service of process upon Compugen, which is incorporated in Israel, and upon our directors and officers and our Israeli auditors, almost all of whom reside outside the United States, may be difficult to obtain within the United States. In addition, because substantially all of our assets and almost all of our directors and officers are located outside the United States, any judgment obtained in the United States against us or any of our directors and officers may not be collectible within the United States.

**Provisions of Israeli law may delay, prevent or make undesirable an acquisition of all or a significant portion of our shares or assets.**

Israeli corporate law regulates acquisitions of shares through tender offers, requires special approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. For information about these limitations, see "Item 6. Directors, Senior Management and Employees" and "Item 10. Additional Information – Anti-Takeover Provisions under Israeli Law." Furthermore, Israeli tax considerations may make potential transactions undesirable to us or to some of our shareholders.

**The Israeli Companies Law may cause uncertainties regarding corporate governance.**

The Israeli Companies Law, which became effective on February 1, 2000, has brought about significant changes to Israeli corporate law. Under this new law, there may be uncertainties regarding corporate governance in some areas. These uncertainties will persist until this new law has been adequately interpreted, and these uncertainties could inhibit takeover attempts or other transactions and inhibit other corporate decisions.

## ITEM 4. INFORMATION ON THE COMPANY

### History and Development of the Company

Our legal and commercial name is Compugen Ltd. We were established under the laws of the State of Israel in 1993. Our principal office premises are located at 72 Pinchas Rosen Street, Tel Aviv 69512, Israel, and our telephone number is 011-972-3-765-8585. The principal office premises of Compugen, Inc., our U.S. subsidiary, are located at 7 Centre Drive, Jamesburg, New Jersey 08831, and its telephone number is (609) 655-5105. Our internet addresses are www.cgen.com (U.S.-based address) and www.compugen.co.il (Israel-based address). We also maintain several other websites, including www.LabOnWeb.com. None of the information on our websites is incorporated by reference into this annual report.

We are a leader in merging computational technologies with biology to enhance drug discovery and development. Our innovative predictive biology technologies support two complimentary product development and commercialization divisions. Our BioApplications division develops and markets platforms, tools and products that enable and enhance the discovery and functional analysis of genes, proteins and cell processes. Products and services that we have commercialized to date include: LEADS, Gencarta, DNA chip design, OligoLibraries, Z3, Z4000, LabOnWeb.com and Bioccelerators. In addition, through our Novel Genomics Division, we discover and seek to commercialize genes, proteins and drug targets. We are pursuing collaborations with other organizations for the further development and commercialization of genes, proteins and drug targets we have discovered and for the discovery, development and commercialization of new genes, proteins and drug targets.

In August 2000, we sold 5,000,000 of our ordinary shares in the initial public offering of our shares on the Nasdaq National Market, and in September 2000, we sold an additional 750,000 ordinary shares upon the exercise by our underwriters of their over-allotment option. Our aggregate net proceeds from these sales was $51.1 million. Prior to our initial public offering, we financed our operations through private placements of our share capital (including a private placement in July 2000 in which we raised net proceeds of $35.5 million), revenues generated from sales of our products and services and borrowings under lines of credit. For a description of our principal capital expenditures, see “Item 5. Operating and Financial Review and Prospects.”

### Business Overview

#### Current Challenges in the Life Science Industry

The availability of large amounts of genomic data, coupled with a greater theoretical understanding of biological behavior at the molecular level, is creating a fundamental transition in the field of life science. Biology is moving from primarily a "wet" science, where progress is based largely on observations obtained during laboratory experiments, to a more "dry" science, where progress is also achieved through the quantitative analysis of vast amounts of data and the use of mathematical models to predict biological processes. This understanding has the potential to alter the way diseases are diagnosed, drugs are developed, animals are bred and crops are grown.

#### *Biological Processes*

The characteristics of all living organisms are determined by DNA, a molecule found in every living cell. DNA is comprised of pairs of four types of small chemical units, each called a nucleotide. DNA contains genes, which in general are comprised of thousands of nucleotides. Scientists estimate that the total DNA found in the form of chromosomes in each cell of a person, known as the human genome, consists of a total of approximately three billion nucleotides and contains between 40,000 and 60,000 genes.

Cells carry out most of their biological functions by means of genetic instructions encoded in DNA. These codes govern the production of proteins through a process known as gene expression. During gene

expression, the nucleotides in a gene are first copied into a related molecule called messenger RNA, or mRNA. This mRNA then instructs the cell to produce a protein. Proteins are the molecules that regulate or perform most of the physiological functions of the body. The sequence of nucleotides determines which protein out of an almost unlimited number of possible proteins is produced. Because the sequence of nucleotides in each gene is different, each gene directs the production of a different protein. Identifying these proteins is made even more difficult because of alternative splicing, a natural process by which a single gene may, under different circumstances or at the same time, produce a number of different proteins.

Genomics is the study of the genetic content of cells; functional genomics is the large-scale study of gene function; and proteomics is the study of the function of the proteins that genes encode and their interactions with other proteins. Because many human diseases are associated with the inadequate or inappropriate presence, production or performance of proteins, genomics, functional genomics and proteomics can assist pharmaceutical and biotechnology companies in developing diagnostic products, therapies and drugs that will interact with a targeted protein involved in disease in order to identify the presence or absence of the protein, or to regulate, inhibit or stimulate its biological activity. Current drug therapy addresses several hundred specific protein targets. However, we believe that as the functions of additional proteins become better understood, hundreds or thousands of additional potential drug targets will be identified. As additional progress is achieved in genomics, functional genomics and proteomics research, new drugs and therapies may be developed to actually cure disease rather than just treat the symptoms.

In recent years, public and private endeavors, including the Human Genome Project, an international research program designed to construct detailed genetic and physical maps of the human gene, have created, and are continuing to create, vast amounts of raw genomic and related data at an increasing rate. These efforts led to the publication of the initial draft of the human genome in February 2001. Although this data contains information that should be able to provide scientists with important insights and knowledge about molecular biological processes, the data is very difficult to analyze. This difficulty is due to many factors, including:

- the complexity of the underlying biology and the existence of biological processes which scientists do not fully understand;
- the limitations inherent in the laboratory devices used in the creation of the data;
- the largely random nature of the selection of the biological material from which much of the data is derived;
- the enormous quantity of raw data, with a high percentage of errors, overlaps, duplication, and missing pieces;
- the possibility that there may be biological processes that scientists are not yet aware of;
- the variability and quality of available data due to factors such as incorrect annotation and contamination.

Although new data is constantly being created at an increasing rate, we believe that a substantial amount of the useful information contained in the data that already exists has not yet been extracted.

***DNA Sequencing***

DNA sequencing is the process of identifying the order in which nucleotides are arranged in a particular section of DNA, or DNA fragment. In addition to the Human Genome Project, a number of commercial and public organizations have undertaken similar efforts with respect to DNA sequencing in humans and other organisms, including various species of bacteria, plants and animals.

A common method used by these organizations and companies to obtain expressed sequences is to extract mRNA from a specific cell and transcribe it to cDNA. This process produces a DNA copy, or cDNA, which contains only the exons, or coding regions, of the gene segment of the original DNA that expressed the mRNA. This segment of cDNA is then sequenced. Using this procedure, scientists obtain data about DNA sequences that are expressed as mRNA and are then usually translated into proteins. Each sequence is termed an expressed sequence tag, or EST, which is typically a short fragment of a gene. Many private companies and not-for-profit organizations have produced large quantities of ESTs, resulting in large public and proprietary databases.

***Current Challenges in Converting DNA Sequence Data into Useful Information***

In order to extract value from genomic EST data, molecular biologists need to first overcome some inherent difficulties associated with analyzing this data. While the Human Genome Project and other efforts have created an enormous amount of DNA sequence data, it is still only partially annotated, and unorganized. Furthermore, researchers are producing sequences far faster than scientists can analyze them. While some existing analytical tools and database systems do help in the management of genomic data, most have significant limitations in allowing scientists to effectively make use of this vast amount of data. The following are some of the most important challenges in making use of this new biological data:

*Computational Challenges: Vast Amounts of Data.* A database may contain millions of ESTs, each containing potentially valuable information. As ESTs are only short fragments of genes, researchers must generally find the full coding sequence of the gene represented by the EST in order to make use of that information. This requires an effective method of clustering the millions of ESTs into many different groups, each belonging to a different gene, and assembling, or using sequences in each of these groups to build a comprehensive picture of what can be known about this gene from the available data. This clustering and assembling poses significant mathematical challenges.

*Biological Challenges: Alternative Splicing.* Analyzing genomic data has other inherent difficulties caused by biological processes, including alternative splicing, the expression of more than one protein from the same genetic material. In the past, it was believed that each human gene produced one protein. It is now generally accepted that alternative splicing does exist. However, the extent to which this occurs is still a matter of debate. Researchers have found that alternative splicing occurs in somewhere between 40% and 60% of the human genes represented in the public databases. Although the multiple resulting proteins have large areas of identical sequences, these alternative splice variants often perform different functions or are produced in different areas of the body. Analytical methods that fail to model or that incorrectly model alternative splicing will create databases containing distorted representations of the proteins whose mRNA fragments they contain.

*Biological Challenges: Single Nucleotide Polymorphisms.* Another difficulty in analyzing genetic data is the existence of single nucleotide polymorphisms, or SNPs, in which a single nucleotide base difference exists in the same DNA region in different individuals. SNPs and other types of polymorphisms, while apparently minor and hard to detect, are believed to account for differences in individuals' susceptibility to diseases and their responses to particular drugs. We believe that a wide range of genetics disciplines stand to benefit from the study and use of SNPs. Identifying SNPs is difficult, however, because they are hard to distinguish from sequencing errors that exist in current EST databases.

*Experimental Challenges: Errors and Anomalies.* Further complicating the analysis of EST sequence data is the presence of experimental errors and anomalies, including:

- *Sequencing errors;*
- *Chimeric sequences,* which occur where a single EST represents the union of fragments from more than one mRNA molecule;
- *Intron contamination,* which results from the presence of introns, or non-coding regions of a gene, that were not spliced out in the formation of the mRNA; and

- *Vector contamination*, which results from the presence of vectors, pieces of DNA that are used in the laboratory sequencing process that are unrelated to the researched gene.

***Current Challenges in Developing and Analyzing DNA Chips***

Another challenge for scientists is in the use of experimental devices known as DNA chips. DNA chips are glass or silicon wafers onto which probes, fragments of DNA with known sequences, are attached. One application of DNA chips is to enable scientists to perform thousands of measurements of mRNA expression level in a tissue sample in a single experiment.

While important advances have been made in chip fabrication, we believe the current usefulness of the chips for expression analysis can be significantly enhanced by better probe design capabilities. Following are some of the challenges in the selection of probes for a DNA chip:

- selecting error-free probes that accurately reflect the exact genes of interest;
- selecting probes that are unique to the genes of interest;
- ensuring that the probes account for the different alternative splice variants of the genes; and
- ensuring that the probes hybridize.

In order to address all of these challenges in choosing probes for DNA chips, scientists would need a reasonably complete picture of all of the possible mRNA forms, including alternative splice variants of the tested organism. An additional problem is that the EST databases that are used today to create probes are known to contain sequencing errors. Therefore, we believe a substantial number of the resulting probes contain errors as well. Because current EST databases, on which DNA chip probes are based, contain sequencing errors, a substantial portion of DNA chip probes used today contain errors as well. As a result of these and other chip fabrication problems, current DNA chips tend to use several probes to represent a single gene on a chip, and the results of current DNA chip analysis may be inaccurate or incomplete.

***Current Challenges in Converting Proteomic Data into Useful Information***

Proteomics research aims at characterizing the hundreds or thousands of proteins expressed by organisms in the context of whole organisms, specific tissues or normal versus diseased states. Although still facing technological challenges, as any early phase science, the field of proteomics is predicted to be indispensable in understanding disease mechanisms and identifying therapeutic targets. However, there are significant computational challenges associated with assembling proteomic data. These challenges include:

*Protein Separation Using 2-D Gel Analysis.* 2-D gel analysis is a method in which two or more different samples containing protein mixtures are separated through the use of gels into individual proteins based on their molecular weight and isoelectric point. After the separation process is completed, results are compared side by side for differences. The technology to separate proteins using 2-D gel analysis has been available for over 20 years, and, although widely used, it has significant limitations. For example, often biologists performing the same experiment in seemingly the same conditions obtain results that look completely different. This has led many researchers to search for other protein separation techniques. This search is continuing, but to our knowledge no better high throughput separation technique is currently available.

*Identifying Proteins Using Mass Spectrometry.* Mass spectrometry is a term used to describe a variety of techniques to accurately measure the mass of small molecules. After a protein is separated using, for example, 2-D gel analysis, its mass can be measured using mass spectrometry. After measuring the mass of different fragments of a protein, the researcher can compare the results to profiles in a database of known protein samples. Although the introduction of mass spectrometry to proteomics has been considered a

breakthrough, its usefulness has been limited because only a small percentage of all human or mouse proteins are publicly known to the extent that their respective mass profile would identify them. Proteins that cannot be identified from a database must be re-sequenced at the protein level in order to be identified, a long and difficult process compared to sequencing at the mRNA level.

***Conclusion***

We believe that most researchers would benefit substantially from additional and more computationally precise tools to meet the challenges involved in current genomic, functional genomics and proteomic research. Because of the limitations of most available analytical tools, many molecular biologists cannot effectively use the large amounts of genomic, EST and proteomic information available in public and private databases to obtain reliable information to identify and characterize genes or proteins. Researchers are thus often required to perform months of computer searches, manual analysis and biological experimentation to obtain this information. In addition, researchers may perform months of research working on incorrect information. This situation has created a need for analytical tools that can accurately predict or analyze gene sequences, proteins and other important biological information using genomic, EST or proteomic data.

**Our Strategy**

The key elements of our business strategy are to:

*Expand the Customer Base for our Computational Genomic, Functional Genomics and Proteomic Solutions.* We plan to continue to pursue collaborations and other agreements with leading life science companies, as well as governmental, research and academic organizations. Through these arrangements, we intend to continue to commercialize our LEADS software platform and our other existing products and services, and to develop additional solutions for important current and future aspects of life science research. We also hope to expand the market for our Gencarta database, our proteomics software, our genomics research services and our functional genomics products and services.

*Expand our Technological Leadership.* Our current products and services address the immediate need of life scientists to organize and analyze the first wave of genomic, expressed sequence, functional genomics and proteomic data. We intend to continue to identify and provide solutions to the industry's future biological challenges using our multidisciplinary approach to molecular biology. For example, we are assisting users of DNA chips to design more efficient and accurate chips for analyzing gene expression in mRNA samples. We are also currently developing additional solutions for various aspects of proteomics and are applying a computational approach to designing small molecules for medicinal chemistry. In addition to our internal efforts, we plan to search for and identify new complementary technologies and products through collaborations with public and private organizations and the possible acquisition of other companies, technologies or data.

*Commercialize Discovered Genes and Proteins.* Through our Novel Genomics division, we intend to commercialize some of the predicted genes, proteins and other intellectual property that we continue to discover in our research and development efforts. We anticipate doing this through licensing arrangements with pharmaceutical and biotechnology companies. We have currently identified approximately eighty genes and proteins that we believe are targets for the potential development of therapeutic or diagnostic products and are candidates for possible further development and licensing.

*Discover New Drug Targets and Diagnostic Markers.* Through our Novel Genomics division, we intend to pursue collaborations with life science companies and research and academic organizations for the joint discovery, development and commercialization of drug targets and diagnostic markers. We believe that by combining our capabilities in merging computational technologies with experimental biology with proprietary technologies of potential collaboration partners, we can increase our and our potential collaborators' chances of successfully discovering, developing and commercializing drug targets, drugs and diagnostic markers.

*Participate in Success Resulting from use of Our Products.* In some of our collaborations in which we license our computational tools or databases or in which we provide services using our computational tools and databases, we seek warrants or other forms of equity in our collaboration partners as part of the consideration for the transaction. We believe that by obtaining equity positions in some of our collaboration partners, we can participate in the potential success resulting, among other things, from the significant contribution we make to their research and development efforts. To date, we have obtained such equity in our collaborations with Avalon Pharmaceuticals, Inc. and diaDexus, Inc.

*Jointly Develop Products and Technologies with Collaboration Partners*. We intend to pursue collaborations in which we combine our technologies and capabilities with complimentary technologies and capabilities of our collaboration partners to develop innovative products and technologies. To date, we have entered into three collaborations of this type. We collaborate with Sigma to develop and produce our OligoLibraries; we are working with Millennium Pharmaceuticals, Inc. to co-develop software tools to assist in the prediction of protein pathways for use in drug discovery and development; and we collaborate with Gene Logic, Inc. to integrate our human Gencarta database with the gene expression information in Gene Logic's GeneExpress® Suite.

**Our Technologies**

Since our inception in 1993, our multi-disciplinary team of mathematicians, computer scientists, physicists, chemists, physicians and molecular biologists has developed technologies in the areas of:

- analyzing and modeling biological behavior at the molecular level;
- accelerating the analysis of genomic, functional genomics, and proteomic data;
- creating user-friendly applications that allow life scientists to quickly obtain results from their biological queries using our modeling and analytical tools;

§ integrating annotated genomic data into reagents.

§ applying a computational approach to designing small molecules for medicinal chemistry; and

§ integrating computational biology and plant genomics with classical breeding approaches.

We initially directed our technologies towards developing computer hardware systems and software applications to accelerate similarity, or homology, searches in nucleotide and protein sequence databases.

In recent years, a significant focus of our activities has been on the development of technologies that allow molecular biologists to obtain significantly more information from genomic and expressed sequence databases through the analysis and modeling of the underlying biological and experimental processes. An important aspect of these technologies is the clustering and assembly of genomic and expressed sequence data in order to provide missing information for the discovery of new genes and proteins and the annotation of genes and proteins. This clustering and assembly technology, when applied to publicly available database information, can lead to the discovery of novel genes and splice variants. To date, we have found full or partial sequence information for over 4,000 predicted human proteins that we believe have not been discovered by others. In approximately 90% of the approximately 300 cases we have tested in our laboratories, we have verified the existence of the genes predicted by our analysis. We have also identified several thousand predicted SNPs.

We are also developing solutions for challenges in the fields of functional genomics and proteomics. In the field of functional genomics, we are focusing on improving the design of probes and DNA chips. While important advances have been made in DNA chip fabrication, we believe the current usefulness of the chips for expression analysis can be significantly enhanced by better probe design. We are applying our technologies to develop more efficient probe design and data analysis for DNA chips. A common problem for life scientists doing research in the area of proteomics is the need to separate individual proteins from

the thousands included in a test sample and then to identify the known and unknown proteins. Through the use of advanced computational techniques, including pattern recognition and image processing, our scientists are creating new solutions for these difficult problems. We have also begun a research program in computational chemistry.

***Our Core Technology***

Our clustering and assembly software technology is primarily used in analyzing DNA and EST sequence data, and also provides input for our proteomics efforts. It involves nine major steps:

- First, it examines the expressed input data – EST or mRNA sequences – and cleans it by eliminating erroneous sequence fragments and marking repetitive and low complexity sequence fragments.

- Second, it compares the cleaned expressed data to the available genomic data, and finds the best possible genomic location.

- Third, based upon the positioning of the expressed data on the genomic data, it forms genomic clusters, which are groups of EST and mRNA sequences that are positioned in the same genomic area, and have overlapping regions, along with the relevant genomic sequence.

- Fourth, it assembles sequences in most of the genomic clusters, taking into account alternative splicing, and derives a consensus sequence, putative exons and introns and one or more possible transcripts for each contig. A consensus sequence is a predicted combination of all putative exons in a cluster inferred from the data available about these segments. The consensus may or may not exist in nature. This consensus accounts for alternative splicing by re-inserting exons that are left out of each different alternative spliced sample. A putative intron is a segment located between expressed segments of a single gene. Introns are considered part of a gene, although they do not express mRNA.

- Fifth, a transcript is inferred from the combination of some or all contig segments in the order suggested by the biological data. In cases of alternative splicing, a contig has multiple transcripts, each with a different, although usually overlapping, set of segments.

- Sixth, it takes all the cleaned expressed data that cannot be located on the genomic data, and taking into account alternative splicing, forms expressed contigs.

- Seventh, it joins the expressed contigs to form clusters, which are sets of one or more expressed contigs that contain sequences originating from the same cDNA and therefore are considered to be derived from the same gene.

- Eighth, it assembles sequences in most of the clusters, in a fashion similar to the fourth step, taking into account that there is no genomic data in these clusters (and therefore not identifying putative introns). It then assembles one or more possible transcripts for each cluster, in a fashion similar to the fifth step.

- Ninth, it automatically annotates the thousands of predicted genes and presents concise analytical findings for each gene to be used for further evaluation by biologists and other life scientists. This annotation includes predicted SNP's, predicted coding regions, and homology information relating to these coding regions.

**Our BioApplications Division**

The BioApplications Division is responsible for the development and marketing of our computational technologies for genomics, functional genomics and proteomics research. Following are the products and services developed and marketed by our BioApplications Division.

***Genomics Software, Hardware and Services***

*LEADS for Genomic and Expressed Data*

Our LEADS software platform for computational biology analyzes genomic and expressed sequence data to enable rapid discovery of genes, splice variants and gene function. LEADS solves quantitative and qualitative problems inherent in the analysis of EST data and allows molecular biologists to quickly identify genes from gene fragments. LEADS customers have in-house access to this software, which gives them the capability to analyze their own databases in conjunction with public data.

LEADS improves available genomic and expressed sequence data by, among other things:

- eliminating overlapping regions of sequences belonging to the same gene, which reduces the size of the databases and reduces the amount of required analysis;
- improving gene coverage by creating a fuller picture of gene structure from EST fragments;
- detecting and correcting sequencing errors;
- detecting and accounting for instances of alternative splicing and SNPs and distinguishing these occurrences from sequencing errors;
- detecting other experimental anomalies, including chimeric sequences, intron contamination and vector contamination; and
- automatically annotating the resulting sequences.

Pfizer Inc. is using LEADS to discover novel drug targets through the analysis of expressed sequence and genomic data, and to engage in DNA chip design and analysis. In October 1998, we entered into a non-exclusive agreement with Warner-Lambert, which was subsequently acquired by Pfizer Inc. in June 2000, under which it became our first LEADS customer. Under this agreement, Pfizer obtains access to LEADS for analyzing genomic and expressed data for all of Pfizer's internal research and development activities in exchange for an annual license fee and milestone payments. This agreement accounted for approximately 71% of our revenues in 1999, approximately 35% of our revenues in 2000, and approximately 30% of our revenues in 2001. Our agreement with Warner-Lambert expired in March 2002.

Novartis Pharma A.G. is utilizing LEADS to accelerate its identification of drug targets based on the analysis of fundamental gene and protein data. In July 2001, we entered into a non-exclusive agreement with Novartis. Under this agreement, we granted Novartis a non-exclusive license to use LEADS for analyzing genomic and expressed data for Novartis and Novartis' affiliates internal research and development activities in exchange for an annual license fee. We also agreed to provide specified LEADS modification services to address Novartis' specific needs and to provide Novartis with specified DNA chip design services. This agreement accounted for approximately 17% of our revenues in 2001. Our agreement with Novartis is for a term of three years, but Novartis may terminate the agreement for any reason effective on the first or second anniversary of its execution.

*Gencarta*

Gencarta is an annotated database of the genome, transcriptome and proteome, comprised of the data obtained from the periodic application of our LEADS software platform to various public databases. Gencarta includes three components: the database, a graphical user interface, and query tools. The current version of Gencarta includes a gene index, with predicted splice variants, genomic alignments, chromosomal location, alignment of ESTs and known mRNAs to their genes, and SNP and SAGE tag prediction. Each predicted transcript is further analyzed and annotated, resulting in predicted proteins (where identified), expression profiles, detailed domain summaries and homologies to known and predicted proteins. The browser interface provides an intuitive graphic presentation of database elements and their

inter-relationships, which enables users to browse the genome efficiently. The query tools are suitable for various types of experiment approaches, and enable users to perform searches from multiple entry points. The current version of Gencarta, Version 2.3, includes human, mouse and rat data.

We commenced marketing of Gencarta in the first quarter of 2001. We offer Gencarta as a complete package including the hardware, software and database, which we install at customers' sites and update regularly. Customers of Gencarta include: Avalon Pharmaceuticals, Inc., with whom we signed a collaborative agreement that includes cash payments and equity participation in Avalon; Kyowa-Hakko Kogyo Co., Ltd., a leading Japanese pharmaceutical company; Albert Einstein College of Medicine of Yeshiva University; and the Weizmann Institute of Science.

In January 2002, we entered into a collaboration agreement with GeneLogic, Inc., pursuant to which we will integrate our human Gencarta database with the gene expression information in Gene Logic's GeneExpress® Suite. Under this agreement, we will provide Gene Logic with a customized version of Gencarta. This customized version will be integrated with the gene expression and clinical information sets in the GeneExpress® Suite. Gene Logic will market this customized human Gencarta database as an add-on component available to existing and prospective GeneExpress® Suite customers.

*Analysis of Genomic and Proteomic Information*

We also provide custom-tailored solutions that combine our analysis of the customer's proprietary data with publicly available and proprietary data using our unique computational technologies and our scientists. This analysis of genomic and proteomic information for customers is performed on a customized, per project basis.

In December, 2001, we entered into an agreement with diaDexus Inc., pursuant to which our scientists are using our LEADS technology and other tools to perform an analysis of certain public databases and diaDexus' proprietary genomic databases. diaDexus will use these results to advance its internal research and development efforts for the development of certain diagnostic products and therapeutic products. In consideration, Compugen received cash payments and a warrant to purchase equity in diaDexus.

*Bioccelerators*

Our Bioccelerator line of products consists of dedicated computers designed to accelerate similarity, or homology, searches in nucleotide and protein sequence databases. Rigorous algorithms used for these types of searches are computationally intensive, forcing researchers to use less sensitive but faster algorithms. By performing rigorous searches between 100 and 1,000 times faster than a typical high-end single-processor workstation, the Bioccelerator makes the use of more sensitive algorithms more attractive.

We have sold Bioccelerator products to over 40 customers worldwide, including many of the leading companies and research institutions in the field of genomic research.

To date, our largest customer for the Bioccelerator has been the U.S. Patent and Trademark Office. The hardware-based corporate solution that we developed for the U.S. Patent and Trademark Office accelerates their analysis of DNA and protein sequence data contained in U.S. patent applications. Revenues from this customer accounted for approximately 24% of our total revenues in 2000 and approximately 17% of our total revenues in 2001. We cannot predict whether we will continue to derive a significant portion, if at all, of our total revenues from this customer in the future.

***Functional Genomics***

*DNA Chip Design Service*

We are applying our technologies to develop more efficient probe design and data analysis for DNA chips. Our chip design service uses our LEADS software platform in order to improve the efficiency and accuracy of chip probe design and the analysis of chip experiment results. By correctly placing probes on

DNA chips, one can significantly improve chip usage efficiency and the quality of results. We believe that approximately 20% of the probes on most DNA chips using synthesized probes based on EST data contain sequencing errors. Many also contain introns that can be mistaken for expressed sequences. We believe the main challenge in effective DNA chip design is to select error- and intron-free probes that will accurately reflect the exact genes of interest and will ensure accurate differentiation between the different expressed forms, or alternative splice variants, of these genes.

Our DNA chip probe design service offers the following advantages:

- it eliminates redundant probes, allowing representation of a larger number of genes on the same size chip by using our clustering techniques to cluster large amounts of EST and genomic data;

- it identifies sequencing errors, SNPs and introns in ESTs and selects probes from the most error- and intron-free regions it identifies, making our probes high quality representatives of the desired expressed genes;

- it can choose probes in a manner designed to either maximally differentiate between different splice variants or maximize the chance that alternatively spliced variants of a gene will be measured, depending on the customer's needs;

- it can help reduce the amount of lab work required to analyze the results;

§ probes are designed to be as unique as possible to genes of interest, by comparing the probes to other transcripts in the transcriptome; and

§ it is designed to ensure that the probes have good properties for hybridization

*OligoLibraries*

OligoLibraries are oligonucleotide collections, representing genomes, or sub-sets of genomes, of various organisms. They are designed to provide scientists with a more accurate solution for the rapidly growing area of high-throughput analysis of gene function. Our OligoLibraries are based on probe selection using our LEADS technology platform and our proprietary chip design tools. These technologies enable us to address redundancy, account for alternative splicing and consider specificity and cross-homology while designing optimum oligos for gene expression, drug discovery or functional assays.

In May 2000, we entered into an agreement with Sigma Genosys, Inc., a wholly-owned subsidiary of Sigma Aldrich, Inc., pursuant to which the parties produce and market OligoLibraries as co-branded products. According to this agreement, Compugen provides the designs for the co-branded products, Sigma manufactures them and both parties market them. The first three OligoLibraries manufactured and marketed under the agreement are collections representing the human, rat and mouse genome subsets. OligoLibraries were offered on an early access basis beginning in the first quarter of 2001 and the parties commercially launched the products in October 2001.

***Proteomics***

*Z3 2d-PAGE Gel Analysis.*

Our Z3 2D-PAGE gel analysis uses advanced computational technologies and novel algorithms for image registration, spot detection and differential expression calculation, in order to automatically analyze 2D gel images. Z3's raw master gel module, designed to maximize the amount and quality of information derived from repeat runs, and the multiple gel analysis mode enable high throughput analyses in multiple gel studies. The product's color coding feature enables users to instantaneously detect differential expressions.

*Z4000*.

Z4000 is based on the Z3 and is designed to enable analyses of a large number of gels. Z4000 allows the user to organize the experiment in a hierarchical manner according to the different dimensions tested and control the study's progress. The system's workflow is designed to extract the most significant data out of the images while enabling the user, at any point, to view the entire history of a certain protein across the experiment. Z4000 also includes extensive query possibilities that allow the user to extract meaningful information from the data accumulated in the study.

*ProtoCall*

ProtoCall applies novel algorithms to extract and analyze mass spectrometry data, enabling researchers in the field of proteomics to receive meaningful information about the identity and character of proteins. ProtoCall searches against a comprehensive database of protein, EST and genomic data from public sources. We provide services using ProtoCall on *LabOnWeb.com*, but do not market the product.

***LabOnWeb.com***

*LabOnWeb.com* provides some of our research and analysis capabilities to life scientists over the Internet. *LabOnWeb.com* gives us direct access to life scientists worldwide. *LabOnWeb.com* is designed to provide life science researchers with user-friendly tools and services that significantly enhance and accelerate their discovery efforts. By increasing the exposure of scientists to *LabOnWeb.com*, we hope to provide molecular biologists and other researchers worldwide with a means of evaluating our computational capabilities and thereby interest them in our other products and services.

**Our Novel Genomics Division**

We established our Novel Genomics division in 1999 to utilize the capabilities of our pioneering tools and platforms to discover and commercialize genes, proteins, drug targets and diagnostic markers. Novel Genomics' research efforts are focused on finding novel genes, proteins and other discoveries that have potential pharmaceutical, therapeutic or diagnostic uses. The Novel Genomics division's in-house molecular biology laboratories also test our tools and platforms and verify discoveries predicted through our proprietary analysis capabilities.

Using our proprietary analysis and predictive models, our researchers have identified full or partial sequence information for thousands of predicted genes that we believe are novel and not identified in any public databases, published scientific literature or patents. In approximately 90% of the approximately 300 cases we have tested in our laboratory, we verified the existence of the genes predicted by our analysis.

We intend to commercialize the most promising discoveries through collaborations and licensing arrangements with third parties, primarily pharmaceutical and biotechnology companies. In addition, we intend to pursue collaborations with life science companies and research and academic organizations for the joint discovery, development and commercialization of drug targets and diagnostic markers. We are seeking these arrangements on a project by project basis, under which, in most cases, most of the funding would be provided by our partners, and we would receive payments in the form of fees, milestone payments and royalties on product sales. In other cases, we may share more equally with our partners in the funding of, and revenues derived from, the project. We believe that by combining our computational and experimental capabilities with proprietary technologies of potential collaboration partners, we can substantially increase our and our potential collaborators' chances of successfully discovering, developing and commercializing drug targets and diagnostic markers. In certain circumstances, we may choose to further develop products ourselves through Novel Genomics.

To date, we have entered into only one such collaboration, which is in its initial stages. We cannot assure you that this collaboration will be successful. Although we are currently negotiating with several

life science companies regarding possible additional collaborations we cannot assure you that we will enter into any arrangements in the future.

We currently expect to continue to fund all of Novel Genomics' research, development and commercialization activities, although we may elect to seek separate funding from third parties, including equity investors in Novel Genomics, in the future.

**Development-Stage Businesses**

*Plant Genomics.* In October 1999, we formed a division focusing on agricultural biotechnology and plant genomics. Effective January 1, 2002, we spun-off the business of this division into a majority owned subsidiary, Evogene Ltd., with offices and laboratories located in Rehovot, Israel. We own 82% of the outstanding shares of Evogene and the two founders of this business activity beneficially own the remaining 18%.

Evogene is working to overcome the limitations of both classical breeding and modern biotechnology in order to generate improved crops and new agricultural biotechnology products in an economically efficient way. Evogen integrates computational biology and plant genomics with classical breeding approaches into high-throughput platforms for the purpose of accelerating, directing and mimicking the natural evolution process. Evogene's high-throughput platforms utilize an extensive base of proprietary and licensed technologies, including our LEADS computational biology platform, the Weizmann Institute of Science's patent pending "tomato gene machine" for functional genomics in plants, and various high-throughput processes for molecular analysis of genomic components.

Evogene's core product focus will be the development of seeds with new and highly improved traits. In addition, an important aspect of Evogene's business strategy will be collaborative initiatives with other organizations in areas such as crop protection products, nutritionally enhanced crops, the use of plants as factories for nutraceuticals, and industrial and therapeutic products.

*Computational Chemistry and Drug Design.* We are now in the early stages of applying our multidisciplinary approach to computational chemistry. Our goal is to devise a new approach to the design of small molecules to be used for pharmaceutical purposes.

*Computational Medicine.* We are now in the early stages of applying our multidisciplinary approach to medicine. Our goal is to devise a new approach for the analysis of medical and clinical data to be used for pharmaceutical purposes.

**Sales and Marketing**

Since our founding in 1993, we have devoted most of our capital and human resources to research and development of our technologies and products and services. In 1999, we began to expand our sales and marketing capabilities. In 2000 and 2001, we continued to increase significantly our marketing and business development efforts.

In the United States, we have marketing, sales and business development offices in Sunnyvale, California, Jamesburg, New Jersey and Rockville, Maryland. We also conduct marketing, sales and business development from our Tel Aviv offices. As of December 31, 2001, our sales, marketing and business development staff consisted of 20 employees, with 9 based in the United States and 11 based in Tel Aviv. The geographic breakdown of our total sales for the year ended December 31, 2001 was approximately 68% in North America, approximately 22% in Europe, approximately 8% in the Far East and approximately 2% in other countries. The geographic breakdown of our total sales for the year ended December 31, 2000 was approximately 94% in North America, approximately 3% in Europe, approximately 2% in the Far East and approximately 1% in other countries. The increase in the percentage of our sales in Europe was due primarily to revenues from our agreement with Novartis.

We plan to continue to aggressively market our products and services to pharmaceutical and

biotechnology companies and to academic, governmental and other non-profit research organizations and institutions. To accomplish this we intend to:

- recruit additional marketing, sales and business development personnel primarily in Europe and the United States;
- increase direct marketing efforts targeted at specific companies;
- enter into marketing and distribution arrangements with third parties with respect to some of our products and services. These may be worldwide arrangements such as our agreement with Sigma Genosys relating to our OligoLibraries and our arrangement with GeneLogic relating to Gencarta or arrangements relating to specific territories;
- continue to advertise, both in general and scientific journals and on the Internet;
- exhibit at and sponsor conferences and trade shows; and
- increase awareness regarding our technologies and products through publications in scientific journals and press releases.

**Intellectual Property Rights**

We seek patent protection for certain components of our technology platform, including analysis techniques, and for certain of our discoveries relating to gene and protein sequences. We also rely heavily on confidentiality obligations to protect our trade secrets and confidential and proprietary information. We use license agreements both to access third party technologies and to license others to use our intellectual property rights. Our commercial success will be dependent in part on our ability to obtain commercially valuable patent positions, maintain the confidentiality of our trade secrets and otherwise protect our intellectual property portfolio.

Our strategy to apply for patents relates primarily to the following areas for potential coverage:

- certain aspects of our computational technologies, which includes pending patent applications for portions of our LEADS clustering and assembly technology, our chip design technology and our 2-D gel analysis method for proteomics;
- large-scale gene data, which includes transcripts for human, mouse and other DNA that we have identified using LEADS and our other analysis tools;
- individual nucleic acid sequences, which includes a total of 32 patent applications (not including international applications corresponding to an initial national application), relating to hundreds of sequences we believe to be novel
- Oligo sequences which we have designed; and
- with respect to our subsidiary, Evogene, biological methodologies for developing genetically improved plants.

The patent positions of biotechnology companies, including ours, are generally uncertain and involve complex legal and factual questions that are still evolving. Our business could be hurt by any of the following:

- government agencies in the United States or abroad may determine that our discoveries are not patentable;
- our pending patent applications may not result in issued patents;

- the claims of any patents that may issue from an application may not provide meaningful protection;

- we may not be successful in developing additional proprietary technologies that could be patentable;

- patents that we may ultimately obtain may not provide a basis for commercially viable products or provide us with any competitive advantages and may be challenged by third parties;

- others may obtain patent which have priority over ours, thus preventing the success of our applications; and

- others may have patents that relate to our technology or business.

The degree of future protection for our intellectual property is therefore uncertain. Furthermore, others may independently develop similar or alternative technologies, duplicate any of our technologies or, if patents are licensed or issued to us, design around the patented technologies licensed to or developed by us. Other technologies may also provide third parties with competitive advantages over us and may harm our business. In addition, we could incur substantial costs in litigation if we are required to initiate suits to defend our patents or to defend ourselves in patent suits brought by third parties.

These costs could significantly increase our expenses and increase our losses. Furthermore, in circumstances where claims relating to proprietary technology or information are asserted against us, we may seek licenses to this intellectual property. However, any required licenses may not be made available on commercially viable terms, if at all. Failure to obtain any required license could prevent us from using or commercializing one or more of our technologies.

We have applied, and intend to make additional applications, for patent protection for inventions relating to novel genes and gene fragments and to novel uses for known genes or gene fragments identified through our research discovery programs. We may not be able to obtain meaningful patent protection for our inventions. Even if we are issued patents, we may need to obtain additional licenses or other rights from third parties in order to offer our products and services that are covered by our patents. Failure to obtain these licenses on commercially viable terms would materially harm our business, financial condition and results of operations.

Several companies and other organizations are attempting to identify and obtain patents relating to novel genes and gene fragments and uses for known genetic sequences, the functions of which have not been characterized, as well as for fully characterized genetic sequences. To the extent any patents are issued to other parties on these partial or full-length genes, we may be prevented from commercializing these partial and full-length genes and/or products or processes which are based on these genes. Others may have filed, and in the future are likely to file, patent applications covering genes or gene products that are similar or identical to those for which we may seek patent protection. These patent applications may have priority over patent applications filed by us. Any legal action against us or our customers claiming damages and seeking to enjoin commercial activities relating to the affected products and processes could, in addition to subjecting us to potential liability for damages, require us and our customers to obtain a license in order to continue to manufacture or market the affected products and processes. We or our customers may not prevail in any action, and any license required under any patent may not be available on commercially acceptable terms, if at all. We believe that there is likely to be significant litigation in the industry regarding patent and other intellectual property rights. If we become involved in litigation, it could consume a substantial portion of our managerial and financial resources and negatively impact our financial results.

With respect to proprietary know-how that is not patentable and for processes for which patents are difficult to enforce, we rely on trade secret protection and confidentiality agreements to protect our

interests. We believe that several elements of our computational genomics, functional genomics and proteomics capabilities involve proprietary know-how, technology or data that are not covered by patents or patent applications. In addition, we have developed a proprietary database of genes, alternative splice variants and gene fragment sequences which we update on an ongoing basis. Some of this data is the subject of a patent application. We have taken security measures to protect our proprietary know-how and technologies and confidential data and continue to explore further methods of protection. While we require employees, consultants and customers to enter into confidentiality agreements, we cannot be sure that proprietary information will not be disclosed in violation of these agreements, that others will not independently develop substantially equivalent proprietary information and techniques or otherwise gain access to our trade secrets, or that we can meaningfully protect our trade secrets. In the case of arrangements with our customers that require the sharing of data, our policy is to make available to our customers only data that is relevant to our agreements with these customers, under controlled circumstances, and only during the contractual term of those agreements, and subject to a duty of confidentiality on the part of our customer. However, these measures may not adequately protect our data. Any material leak of confidential data into the public domain or to third parties may cause our business, financial condition and results of operations to be harmed.

We are a party to various license agreements that give us rights to use technologies and biological materials in our research and development processes. We may not be able to maintain these rights on commercially reasonable terms, if at all. Our failure to maintain these rights could harm our business.

**Competition**

We compete in a number of overlapping markets to provide analytical tools and data to aid institutions and individuals in their genomic and proteomic research. Our Novel Genomics division is competing to identify the makeup and function of genes and proteins that will lead to the development of therapeutic and diagnostic products and services. Our principal competitors include, among others:

- Celera Genomics Group, which provides genomic data that may compete with our LEADS software, Gencarta and our genomic services;

- Incyte Genomics, Inc., which provides genomic data that may compete with our LEADS software, Gencarta and *LabOnWeb.com*;

- Lion Bioscience AG, which provides genomic research and infrastructure tools and services that may compete with our genomic services;

§ Amersham Pharmacia Biotech, Nonlinear Dynamics Ltd., Biorad, Inc., Geneva Bioinformatics S.A. and Definiens AG, which provide 2D-gel analysis systems that compete with Z3;

§ Nonlinear Dynamics Ltd., which provides 2D-gel analysis systems that compete with Z4000; and

§ Operon Technologies, Inc. and Clonetech Laboratories, Inc., which provide products that compete with our OligoLibraries.

Competition among entities attempting to identify the genes and proteins associated with specific diseases and to develop products based on these discoveries is intense. We face, and will continue to face, competition from pharmaceutical, biotechnology and diagnostic companies, academic and research institutions, and government agencies, in the United States and elsewhere, including many of our customers. We are aware that several of our competitors are using a variety of gene expression analysis methodologies, including the use of chip-based systems, to attempt to identify disease-related genes.

In addition, our Novel Genomics division depends, in large part, on our computational platforms and tools and proprietary data to make inventions and establish intellectual property rights in genes and

proteins. This access to our tools and proprietary information provides our Novel Genomics division with a competitive advantage over biotechnology companies that are pursuing patents that may compete with us, including patents to gene and protein sequences. The licensing or provision of access to our platforms, tools or proprietary data to our customers, primarily biotechnology companies, may diminish or eliminate our Novel Genomics division's competitive advantage over these customers. If our customers, many of which have greater financial and other resources than our Novel Genomics division, research genes or proteins that we are researching, they may establish intellectual property rights in such genes or proteins before our Novel Genomics division. As a result, the business, financial condition and results of operations of our Novel Genomics division may be significantly harmed. In addition, our Novel Genomics division, may pursue opportunities in fields that could conflict with those of our customers or discourage potential customers from working with us. As a result, our business, financial condition and results of operations may be significantly harmed

Many of our competitors have substantially greater capital resources, research and development staffs, facilities, manufacturing and marketing experience, distribution channels and human resources than we do. These competitors may discover, characterize or develop important genes, drug targets, lead compounds, drug discovery technologies or drugs in advance of us or our customers or that are more effective than those developed by us or our customers, or they may obtain regulatory approvals for their drugs more rapidly than we or our customers do. Any of these events could have a material adverse effect on any of our similar programs. Moreover, our competitors may obtain patent protection or other intellectual property rights that could limit our rights or our customers' ability to use our technologies or commercialize drug, therapeutics, diagnostics or agricultural products. We also face competition from these and other entities in gaining access to cells, tissues and nucleic acid samples used in our discovery programs.

**Government Regulation**

***Environmental Regulation***

Our research and development activities in some cases involve the controlled use of biological and other hazardous materials, chemicals and various radioactive materials. We are subject to Israeli laws and regulations governing the use, storage, handling and disposal of these materials and waste products. The risk of accidental contamination or injury from these materials cannot be eliminated. In the event of an accident, we could be held liable for any damages that result, and any liability could exceed our resources. Other than laws and regulations governing the generation, use and disposal of hazardous materials and wastes, and limiting workplace exposures to these materials, we do not believe our current and proposed activities are subject to any specific government regulation other than regulations affecting the operations of companies generally.

***Regulation of Use of Human Tissue***

Our access to and use of human or other tissue samples in the expansion of our proprietary database or our product development through Novel Genomics may become subject to further government regulation, in the United States, Israel and elsewhere. U.S. and foreign government agencies may also impose restrictions on the use of data derived from human or other tissue samples. If our access to or use of human tissue samples, or our customers' use of data derived from these samples, is restricted, our business will suffer.

***Regulation of Products Developed with Government Support***

For a discussion of regulations governing products developed with research and development grants from the Government of Israel, see "Item 5. Operating and Financial Review and Prospects, Government of Israel Support Programs, Research and Development Grants."

**Organizational Structure**

Compugen is the parent of one wholly-owned subsidiary: Compugen, Inc., which is incorporated in Delaware and which has its principal place of business in New Jersey. Compugen owns 82% of the outstanding shares of Evogene Ltd., formerly Agro Leads Ltd., which was formed under the laws of the State of Israel and which has its principal place of business in Rehovot, Israel.

**Property, Plant and Equipment**

We lease an aggregate of approximately 2,863 square meters of office and laboratory facilities in Tel Aviv, Israel, and approximately 720 square meters of office and laboratory facilities in Ashqelon, Israel. The leases in Tel Aviv expire between July 2002 and March 2004 and the lease in Ashqelon expires in August, 2002.

In addition, Compugen, Inc. leases approximately 5,704 square feet of office space in Jamesburg, New Jersey, approximately 260 square feet of office space in Sunnyvale, California, and approximately 450 square feet of office space in Rockville, Maryland. The lease in New Jersey expires in December 2003, the lease in Sunnyvale expires on August 2002, and the lease in Maryland expires on December 2002.

Evogene leases approximately 289 square meters of office and laboratory facilities in Rehovot, Israel. This lease expires in March 2004.

We believe that the facilities we currently lease are sufficient for approximately the next 12 months.

## ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### Selected Financial Data

The following consolidated statement of operations data for the years ended December 31, 1998, 1999 and 2000 and consolidated balance sheet data as of December 31, 1999 and 2000 are derived from our audited consolidated financial statements presented elsewhere in this annual report. The following consolidated statement of income data for the years ended December 31, 1996 and 1997 and the consolidated balance sheet data as of December 31, 1996 and 1997 are derived from our audited consolidated financial statements not included in this annual report. The financial data set forth below should be read together with our consolidated financial statements and the notes thereto and the other financial information appearing elsewhere in this annual report.

| | Year ended December 31, | | | | |
|---|---|---|---|---|---|
| | 1997* | 1998* | 1999* | 2000* | 2001 |
| | (U.S. $ in thousands, except share and per share data) | | | | |
| **Consolidated Statements of Operations Data** | | | | | |
| Revenues: | | | | | |
| Products | 1,530 | 4,020 | 783 | 2,268 | 5,883 |
| Services | 334 | 511 | 2,454 | 4,623 | 4,483 |
| Research and development grants | 432 | 333 | 507 | 466 | 994 |
| Total revenues | 2,296 | 4,864 | 3,744 | 7,357 | 11,360 |
| Cost of revenues: | | | | | |
| Products | 767 | 1,399 | 611 | 477 | 1,853 |
| Services | 100 | 100 | 480 | 1,243 | 1,602 |
| Research and development expenses | 2,136 | 3,900 | 7,183 | 12,635 | 15,976 |
| Sales and marketing expenses | 1,121 | 924 | 1,166 | 3,781 | 6,565 |
| General and administrative Expenses | 1,473 | 1,815 | 3,152 | 5,397 | 4,383 |
| Total operating expenses ** | 5,597 | 8,138 | 12,592 | 23,533 | 30,379 |
| Operating (loss) profit | (3,301) | (3,274) | (8,848) | (16,176) | (19,019) |
| Financing income (expenses), net | 111 | 192 | 719 | 2,772 | 3,875 |
| Net loss | $ (3,190) | $ (3,082) | $ (8,129) | $ (13,404) | $ (15,144) |
| Dividends related to convertible preferred shares | 234 | 882 | 1,886 | 24,923 | — |
| Net loss available to ordinary shares | (3,424) | (3,964) | (10,015) | (38,327) | (15,144) |
| Basic and diluted net loss per ordinary share *** | $ (0.62) | $ (0.67) | $ (1.70) | $ (2.75) | $ (0.58) |
| Weighted average number of ordinary shares outstanding | 5,493,959 | 5,886,208 | 5,896,780 | 13,914,485 | 26,005,784 |
| Pro forma basic and diluted net loss Per share (unaudited) **** | $ (0.46) | $ (0.29) | $ (0.58) | $ (0.69) | $ (0.58) |
| Pro forma weighted average number of shares outstanding (unaudited) **** | 6,938,272 | 10,749,861 | 14,102,899 | 19,305,553 | 26,005,784 |

| | As of December 31, | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| | (U.S. $ in thousands) | | | | |
| **Consolidated Balance Sheet Data:** | | | | | |
| Cash and cash equivalents, short-term cash deposits and corporate bonds | $ 5,715 | $ 19,941 | $ 11,436 | $ 90,675 | $ 32,347 |
| Long-term investments in corporate bonds and cash deposits | — | — | — | — | 46,148 |
| Receivables | 1,084 | 905 | 710 | 2,682 | 2,950 |
| Inventory | 621 | 530 | 380 | 385 | 343 |
| Total assets | 8,644 | 23,279 | 15,518 | 97,872 | 87,289 |
| Accumulated deficit | (3,706) | (6,788) | (14,917) | (53,244) | (68,388) |
| Total shareholders' equity | 6,933 | 18,780 | 12,787 | 92,510 | 80,062 |

(*) Reclassified

(**) Includes deferred compensation costs – see Note 12 to the consolidated financial statements.

(***) Basic and diluted net loss and pro-forma basic and diluted net loss, for the year ended December 31, 2000 exclude the non-cash dividend recorded in the amount of $24.9 million related to the beneficial conversion feature of the issuance of 5,538,462 Series C preferred shares (at a price of $6.50 per share). As per their terms, all preferred shares were converted to ordinary shares upon the closing of Compugen's initial public offering (IPO) in August 2000.

(****) Pro-forma basic and diluted net loss per share and pro-forma weighted average number of shares outstanding for the year ended December 31, 2000 give effect to the automatic conversion of the preferred shares which occurred in August 2000 upon the closing of the IPO (using the "as-if converted" method from original date of issuance).

**Overview**

The following discussion should be read in conjunction with the selected financial data included above and our consolidated financial statements and the related notes thereto included in this annual report.

We are a leader in merging computational technologies with biology to enhance drug discovery and development. Our innovative predictive biology technologies support two complimentary product development divisions. Our BioApplications division develops and markets platforms, tools and products that enable and enhance the discovery and functional analysis of genes, proteins and cell processes. In addition, through our Novel Genomics Division, we discover and seek to commercialize genes, proteins and drug targets.

Since our inception, we have incurred significant losses and, as of December 31, 2001, we had an accumulated deficit of $43.5 million (not including approximately $24.9 million in accumulated deficit attributable to the conversion of preferred shares upon the closing of our initial public offering). Through 2002, our revenues were primarily generated by: the license of, and provision of services related to, our LEADS platform; sales of Bioccelerator systems; licenses of Gencarta; licenses of Z3; and sales of OligoLibraries.

We recorded deferred compensation of approximately $2.1 million in 1999, approximately $5.7 million in 2000 and approximately $2.6 million in 2001 in connection with the grant of share options. These amounts are being amortized over the vesting periods of the individual share options. Based on options granted through December 31, 2001, future amortization of deferred compensation is expected to amount to approximately $1.4 million in 2002, $587,000 in 2003 and $86,000 in 2004. Our current policy is to grant options at the fair market value of the underlying shares on the date of grant.

In July 2000, we raised an aggregate of approximately $35.5 million in a private placement through the issuance of 5,538,462 Series C preferred shares at a price of $6.50 per share. As a result of this transaction, we recorded a preferred share dividend for the third quarter of 2000 of approximately $24.9 million, representing the value of the beneficial conversion feature of this issuance, based on the difference between the conversion price of $6.50 per share and $11.00 per share, the range of the offering price in our initial public offering.

In August 2000, we sold 5,000,000 of our ordinary shares in the initial public offering of our shares on the Nasdaq National Market, and in September 2000, we sold an additional 750,000 ordinary shares upon the exercise by our underwriters of their over-allotment option. Our aggregate net proceeds from these sales were $51.1 million. All outstanding preferred shares were converted into Ordinary Shares upon the closing of the public offering.

Commencing January 1, 2001, we record research grants as part of revenues. Prior to January 1, 2001, research grants were accounted for as a reduction in research and development expenses. Our financial statements for previous years have been changed to conform to this change in 2001.

**Results of Operations**

***Years Ended December 31, 2001 and 2000***

*Revenues.* Total revenues increased 54% to approximately $11.4 million for 2001 from approximately $7.4 million for 2000. Product revenues increased 159% to approximately $5.9 million for 2001 from approximately $2.3 million for 2000. This increase was due to increased sales of LEADS, sales of Gencarta, which was introduced in the second quarter of 2001, sales of OligoLibraries™, which were introduced on an early access basis in the second quarter, and commercially launched in October, of 2001, and sales of Z3. Service revenues decreased 3% to approximately $4.5 million for 2001 from approximately $4.6 million for 2000. Revenues from research and development grants increased 113% to approximately $994,000 for 2001 from approximately $466,000 for 2000. This increase was due to an increase in applications for grants submitted to, and grants received from, the Office of Chief Scientist of the Ministry of Industry and Trade of State of Israel (OCS). Revenues from Pfizer, the United State Patent and Trademark Office and Novartis represented 64% of our products and services revenues in 2001.

*Cost of Revenues.* Cost of revenues increased 101% to approximately $3.5 million for 2001 from approximately $1.7 million for 2000. Cost of product revenues increased 288% to approximately $1.9 million for 2001 from approximately $477,000 in 2000. This increase was primarily due to increased costs related to the introduction of new products to the market and manufacturing costs related to our OligoLibraries, which were introduced in 2001. Cost of services revenues increased 29% to approximately $1.6 million for 2001 from approximately $1.2 million for 2000. This increase was primarily due to costs related to support services provided to Novartis and an increase in the support services provided to Pfizer.

*Research and Development Expenses.* Research and development expenses increased 26% to approximately $16.0 million for 2001 from approximately $12.6 million for 2000. The increase in research and development expenses was primarily due to an increase in the number of research and development personnel to support existing as well as new research and development projects and increased salaries. This increase was partially set off by a decrease in the amortization of deferred compensation to approximately $1.6 million for 2001 from approximately $2.4 million for 2000. Research and development expenses as a percentage of total revenues decreased from 172% in 2000 to 141% in 2001.

*Sales and Marketing Expenses.* Sales and marketing expenses increased 74% to approximately $6.6 million for 2001 from approximately $3.8 million for 2000. This increase was primarily due to an increase in the number and variety of products we market and sell, an increase in sales and marketing personnel, costs related to the launch of new products, and increased promotional costs and marketing expenses to accommodate the growth of our business. Sales and marketing expenses as a percentage of total revenues increased from 51% in 2000 to 58% in 2001.

*General and Administrative Expenses.* General and administrative expenses decreased 19% to approximately $4.4 million for 2001 from approximately $5.4 million for 2000. This decrease was primarily due to a decrease of approximately $2.2 million in amortization of deferred compensation recorded in connection with options issued to employees and consultants. Without taking into account the amortization of deferred compensation, general and administrative expenses increased 42% to approximately $3.9 million for 2001 from approximately $2.8 million for 2000. This increase was primarily due to an increase in personnel to support the growth of our business, the leasing of additional office space and human resource activities. General and administrative expenses as a percentage of total revenues decreased from 73% for 2000 to 39% for 2001. Excluding expenses related to the amortization of deferred compensation, general and administrative expenses as a percentage of total revenues decreased from 37% for 2000 to 35% for 2001.

*Financing Income, Net.* Financing income, net increased 40% to approximately $3.9 million for 2001 from approximately $2.8 million for 2000. This increase was attributable to higher levels of cash and cash equivalents available from the aggregate proceeds of approximately $35.5 million from the sale of our Series C preferred shares in July 2000, net of issuance expenses of $487,000, and approximately $51.1 million from the initial public offering of our shares on the Nasdaq National Market, net of issuance

expenses of approximately $6.4 million, in August 2000. Financing income, net as a percentage of total revenues decreased from 38% for 2000 to 34% for 2001.

***Years Ended December 31, 2000 and 1999***

*Revenues.* Total revenues increased 97% to approximately $7.4 million for 2000 from approximately $3.7 million for 1999. Product revenues increased 190% to approximately $2.3 million for 2000 from approximately $783,000 for 1999. This increase was due to an increase in Bioccelerator sales to the United States Patent and Trade Mark Office (USPTO) and from sales of Z3 which was introduced in the fourth quarter of 2000. Service revenues increased 88% to approximately $4.6 million for 2000 from approximately $2.5 million for 1999. This increase was due to an increase in revenues resulting from our agreement with Human Genome Sciences (HGS), our collaboration with Pfizer, increased maintenance fees from our installed base of Bioccelerators, and sales through LabOnWeb.com, which was launched in December 1999. Research and development grants revenues decreased 8% to approximately $466,000 for 2000 from approximately $507,000 for 1999. Revenues from Pfizer, HGS, and the USPTO represented 81% of our products and services revenues in 2000.

*Cost of Revenues.* Cost of revenues increased 58% to approximately $1.7 million for 2000 from approximately $1.1 million for 1999. Cost of product revenues decreased 22% to approximately $477,000 for 2000 from approximately $611,000 in 1999. This decrease was primarily due to the write down during 1999 of the net realizable value of inventory in the amount of $300,000, and an increase in production efficiency. Cost of services revenues increased 159% to approximately $1.2 million for 2000 from approximately $480,000 for 1999. This increase was due to costs related to support services provided under our agreement with HGS, an increase in costs related to support services provided under our agreement with Pfizer, and costs related to our LabOnWeb.com operations.

*Research and Development Expenses.* Research and development expenses increased 76% to approximately $12.6 million for 2000 from approximately $7.2 million for 1999. The increase in research and development expenses was primarily due to an increase in the number of research and development personnel to support existing as well as new research and development projects, increased salaries due to increased competition for professional employees, and an increase in the amortization of the deferred compensation to approximately $2.4 million for 2000 from approximately $882,000 for 1999. Research and development expenses as a percentage of total revenues decreased from 192% in 1999 to 172% in 2000.

*Sales and Marketing Expenses.* Sales and marketing expenses increased 224% to approximately $3.8 million for 2000 from approximately $1.2 million for 1999. This increase was primarily due to an increase in the number of sales and marketing personnel, increased travel expenses, promotional costs and marketing expenses to accommodate the growth of our business, and an increase in the amortization of deferred compensation to approximately $505,000 for 2000 from approximately $55,000 for 1999. Sales and marketing expenses as a percentage of total revenues increased from 31% in 1999 to 51% in 2000.

*General and Administrative Expenses.* General and administrative expenses increased 71% to approximately $5.4 million for 2000 from approximately $3.2 million for 1999. This increase was primarily due to an increase of approximately $1.5 million in amortization of deferred compensation recorded in connection with options issued to employees and consultants, and an increase in personnel to support the growth of our business. General and administrative expenses as a percentage of total revenues decreased from 84% for 1999 to 73% for 2000.

*Financing Income, Net.* Financing income, net increased 286% to approximately $2.8 million for 2000 from approximately $719,000 for 1999. This increase was attributable to higher levels of cash and cash equivalents available from the aggregate proceeds of approximately $35.5 million from the sale of our Series C preferred shares in July 2000, net of issuance expenses of $487,000, and approximately $51.1 million from the initial public offering of our shares on the Nasdaq National Market, net of issuance expenses of approximately $6.3 million, in August 2000. Financing income, net as a percentage of total revenues increased from 19% for 1999 to 38% for 2000.

**Liquidity and Capital Resources**

From our inception until the initial public offering of our Ordinary Shares in August 2000, we obtained financing primarily through private placements of equity securities, and, to a lesser extent, government grants and loans. Financing activities from private placements of preferred and ordinary shares, net of issuance costs, provided cash of approximately $14.8 million in 1998, approximately $19,000 in 1999 and approximately $35.5 million in 2000.

In August 2000, we sold 5,000,000 of our ordinary shares in the initial public offering of our shares on the Nasdaq National Market, and in September 2000, we sold an additional 750,000 ordinary shares upon the exercise by our underwriters of their over-allotment option. Our aggregate consideration from these sales was $57.5 million ($51.1 million net of issuance expenses). All outstanding preferred shares were converted into Ordinary Shares upon the closing of the public offering.

Net cash used in operating activities was approximately $5.8 million in 1999, approximately $6.1 million in 2000, and approximately $9.5 million in 2001. These amounts were used to fund our net losses for these periods, adjusted for non-cash expenses and changes in operating assets and liabilities.

Net cash used in investing activities consists of investments in corporate bonds, purchases of short-term and long-term deposits, and purchases of fixed assets. Net cash used in investing activities was approximately $1.8 million in 1999, $12.1 million in 2000, and $62.8 million in 2001. The increase in net cash used in 2001 resulted primarily from the investment of approximately $30.6 million in short-term deposits, and the purchase of approximately $29.4 million short-term and long-term deposits.

Our net cash provided by financing activities was approximately $87.4 million in 2000, and approximately $104,000 in 2001. Our net cash used in financing activities was approximately $939,000 in 1999. The principal sources of cash in 2000 and 2001 were derived from the private placement of our preferred shares and issuance of Ordinary Shares in our initial public offering. The cash used in financing activities in 1999 is attributable to the repayment of a short-term bank loan.

As of December 31, 2001, we had cash and cash equivalents and short-term deposits and corporate bonds of approximately $32.3 million, and long-term cash deposits and corporate bonds of approximately $46.1 million. We believe that our existing cash and cash equivalents, short-term cash deposits, corporate bonds and long-term cash deposits will be sufficient to fund our operations for at least the next two years. However, we may need additional equity or debt financing in the future to fund our operations or to finance potential acquisitions of other businesses, products or technologies.

**Corporate Tax Rate**

Israeli companies are generally subject to income tax at the corporate tax rate of 36%. However, several investment programs at our manufacturing facility in Tel Aviv and at Evogene's facilities in Rehovot have been granted approved enterprise status and we are, therefore, eligible for the reduced tax benefits under the Law for the Encouragement of Capital Investments, 1959. We have derived, and expect to continue to derive, a substantial portion of our income from the approved enterprise programs at our manufacturing facility. Subject to compliance with applicable requirements, the portion of our income derived from the approved enterprise programs will be tax-exempt for a period of two years commencing in the first year in which it generates taxable income and will be subject, for a period of five to eight years, to a reduced corporate tax of up to 25%, depending on the percentage of non-Israeli investors who acquire our ordinary shares. The period of tax benefits with respect to our approved enterprise programs has not yet commenced, because we have yet to realize taxable income. These benefits should result in income recognized by us being tax exempt or taxed at a lower rate for a specified period after we begin to report taxable income and exhaust any net operating loss carry-forwards. However, these benefits may not be applied to reduce the tax rate for any income derived by our U.S. subsidiary.

As of December 31, 2001, our net operating loss carry-forwards for Israeli tax purposes amounted to approximately $22.4 million. Under Israeli law, these net-operating losses may be carried forward indefinitely and offset against future taxable income.

As of December 31, 2001, the net operating loss carry-forwards of our U.S. subsidiary for U.S. tax purposes amounted to approximately $10.3 million. These losses are available to offset any future U.S. taxable income of our U.S. subsidiary and will expire between the years 2012 and 2021.

**Government and other Support Programs**

*Israeli Government Research and Development Grants*

We participate in programs offered by the Office of the Chief Scientist of Israel ("OCS") that support research and development activities. We received or accrued participations from the OCS of approximately $507,000 in 1999, approximately $466,000 in 2000 and approximately $994,000 in 2001.

We have received grants from the OCS for several projects. Under the terms of these grants, a royalty of 3% to 5% of the net sales of products developed from a project funded by the OCS must be paid, beginning with the commencement of sales of products developed with grant funds and ending when 100% of the dollar value of the grant is repaid (100% plus LIBOR interest for grants received from January 1, 1999 and afterwards). As of December 31, 2001, we were subject to the payment of $115,700 in royalties to the OCS out of future net sales of products developed under OCS funded projects. The terms of Israeli government participation also require that the manufacture of products developed with government grants be performed in Israel, unless a special approval has been granted by the OCS. This approval, if granted, is generally subject to an increase in the total amount to be repaid to the OCS to between 120% and 300% of the amount granted, depending on the extent of the manufacturing to be conducted outside of Israel. Separate Israeli government consent is required to transfer to third parties technologies developed through projects in which the government participates. These restrictions do not apply to exports from Israel of products developed with these technologies.

In addition to the OCS programs described above, we are a party to several consortia of Israeli research institutions and high technology companies devoted to the development of various generic technologies in the fields of biotechnology, agricultural biotechnology and pharmaceuticals. These consortia are sponsored by the OCS MAGNET program. Under the terms of the MAGNET program, the OCS contributes 66% of the approved budget of the consortium and the members of the consortium contribute the remaining 34%. No royalties are payable to the OCS with respect to this funding. Expenses in excess of the approved budget are borne by the consortium members.

In general, any member of the consortium that develops technology in the framework of the consortium retains the intellectual property rights to this technology and all other members of the consortium have the right to use and implement this technology without having to pay royalties to the developing consortium member, provided that the technology will not be transferred under any circumstances to any entity outside of the consortium. None of the other members of these consortia is currently a direct competitor of ours. The terms of the program prohibit the manufacture of products using technology developed in the context of the program outside of Israel and the transfer of technology developed under the program to any person, without the prior written consent of the OCS. These restrictions do not apply to the sale or export from Israel of products developed with this know-how.

*Canada-Israel Industrial Research and Development Foundation Grants*

The Canada-Israel Industrial Research and Development Foundation (CIIRDF) was established in 1994 in Canada as a not-for-profit corporation to promote collaborative research and development between Canadian and Israeli companies. CIIRDF has a contact office in Israel and works closely with the OCS. CIIRDF has entered into agreements with both the government of Israel and of Canada pursuant to which each contributes CDN $1 million to CIIRDF per year.

CIIRDF's mission is to promote collaborative research and development between Canadian and Israeli companies, by providing information to companies in both countries regarding research and development partnering potential, and by supporting national industrial research and development initiatives through its funding contributions.

In February 2002, CIIRDF approved a CDN $800,000 grant to assist Compugen and its research and development collaborator, DiagnoCure Inc., in the research and development of a nucleic acid probe-based diagnostic kit for the early detection of lung cancer. According to the terms of the CIIRDF's agreement, Compugen and DiangnoCure must perform the funded research and pay the fund royalties based on gross sales derived from commercialization of the results of the research until 100% of the funds are repaid.

**Impact of Inflation and Currency Fluctuations**

We generate substantially all of our revenues in U.S. dollars but incur a significant portion of our expenses, principally salaries and related personnel expenses, in New Israeli Shekels, or NIS. As a result, we are exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the U.S. dollar or that the timing of this devaluation lags behind inflation in Israel. In addition, we are exposed to the risk that the U.S. dollar will be devalued against the NIS. We try to protect ourselves against this possibility by investing a portion of our cash in NIS deposits. While in recent years the rate of devaluation of the NIS against the dollar has exceeded the rate of inflation, especially in recent months, which is a reversal from prior years, we cannot be sure that this reversal will continue. To date, we have not been materially affected by changes in the Israeli rate of inflation or the exchange rates of the NIS compared to the U.S. dollar. We do not currently use financial instruments for trading purposes and do not currently hold any derivative financial instruments that could expose us to significant market risk.

**Trend Information**

There is a trend towards consolidation in the pharmaceutical and biotechnology industries. This trend may negatively affect us in several ways. These consolidations usually involve larger companies acquiring smaller companies, which results in the remaining large companies having greater financial resources and technological capabilities, thus strengthening competition in the industry. In addition, continued consolidation within the pharmaceutical and biotechnology industries may result in fewer customers for our products and services. Also, if one of the parties to a consolidation uses the products or services of our competitors, we may lose existing customers as a result of such consolidation.

To date, most of the public efforts relating to genomics involved producing data under the Human Genome Project. Following the publication of the first draft of the human genome, there has been an increase in public efforts to develop analysis tools for understanding genomic, functional genomic and proteomic data. These efforts may result in the development of tools which are competitive to ours and available for free. Such developments could require us to lower our prices or cause some of our products to be less commercially viable or to be obsolete.

Due to the downturn in the securities markets worldwide during the past two years, including in the stock of biotechnology companies, biotechnology companies, including current and potential customers of ours, may experience difficulties in raising additional financing required to effectively operate and grow their businesses. If some of our current or potential customers are unable to raise such financing, they may be unable or less willing to expend the amounts required to purchase our products and services. As a result, we may lose potential sales or may be forced to lower our prices. This could negatively impact our business, financial condition and results of operations.

## ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

### Directors and Senior Management

The following sets forth information with respect to our directors and executive officers as of February 28, 2002.

| Name | Age | Positions |
|---|---|---|
| Martin S. Gerstel | 60 | Chairman of the Board of Directors |
| Mor Amitai, Ph.D | 36 | Chief Executive Officer, President and Director |
| Nurit Benjamini | 35 | Chief Financial Officer |
| Erez Chimovits | 37 | Executive Vice President, Marketing & Sales and President, BioApplications Division Compugen Inc. |
| Lior D. Ma'ayan | 37 | Executive Vice President, Corporate Development |
| Eli Mintz | 37 | Director and Chairman of the Board of Directors of Compugen, Inc. |
| David Haselkorn, Ph.D | 57 | Director |
| Amos Goren | 46 | Director |
| Rimon Ben Shaoul | 57 | Director |
| Philip Young | 62 | Director |
| Orna Berry, Ph.D | 52 | Director |
| David Schlachet | 56 | Director |

**Martin S. Gerstel** has served as our Chairman since August 1997. From September 1993 until August 1997, Mr. Gerstel was an independent consultant and lecturer and served on various boards of directors. From July 1987 until August 1993, he was Co-Chairman and Chief Executive Officer of Alza Corporation in Palo Alto, California. Mr. Gerstel is co-chairman of Itamar Medical Ltd. and serves on the board of directors of Symyx Corporation. He also serves on the Board of Governors and Executive committee of the Weizmann Institute of Science, and he is an advisor to the U.S.-Israel Binational Industrial Research and Development Foundation. Mr. Gerstel is obligated to devote at least 50% of his time to our affairs. Mr. Gerstel holds a B.S. in Engineering from Yale University and an M.B.A. from Stanford University.

**Mor Amitai, Ph.D.** joined Compugen in November 1994 as Chief Scientist, was promoted to Head of Research at the end of 1995, has served as our Chief Executive Officer and a director since January 1998 and received the title of President in 2000. Prior to joining us, Mr. Amitai had served as an engineer at Comverse Technologies since August 1991. Mr. Amitai holds a B.Sc. in Mathematics and Physics, and a M.Sc. and a Ph.D. in Mathematics, each from Hebrew University.

**Nurit Benjamini** joined Compugen as Vice President Finance and Investor Relations in April 2000, and was promoted to Chief Financial Officer in December 2000. Prior to joining Compugen, she served as the Chief Financial Officer of Phone-Or Ltd., from 1998 to 2000, and of Aladdin Knowledge Systems Ltd. (NASDAQ: ALDN) from 1993 and 1998. Previously, Ms. Benjamini served as Chief Financial Analyst and Economist with Cubital Ltd, and as an economist on the Tel Aviv Stock Exchange. Ms. Benjamini holds a BA in Economics and Business and an MBA in Finance from Bar Ilan University, Israel.

**Erez Chimovitz** joined Compugen as Director of Marketing & Sales in 1999, was promoted to Vice President Marketing & Sales Compugen Inc. in June 2001, and was promoted to Executive Vice President, Marketing & Sales and President, BioApplications Division in August 2001. Prior to joining Compugen, Mr. Chimovits held various positions in business development, marketing and sales at Saifan Ltd. Mr. Chimovits holds a B.Sc. in Molecular Biology, an M.Sc. in Human Genetics and an MBA, all from Tel Aviv University, Israel.

**Lior D. Ma'ayan** joined us in October 1998 as Vice President — Operations, was promoted to Vice President, Commercial Operations in 2000 and was promoted to Executive Vice President, Corporate Development in September 2001. From August 1990 until September 1998, Mr. Ma'ayan held various positions with Scitex Corporation Ltd., most recently as Managing Director of Scitex Middle East and Africa. Mr. Ma'ayan holds a B.Sc. in Physics and Mathematics from Hebrew University, an M.Sc. in behavioral sciences from Technion Institute of Technology and an M.B.A. from INSEAD.

**Eli Mintz**, a co-founder of Compugen, has served as a director since our founding in 1993 and has served as Chairman of the Board of Directors of Compugen, Inc. since November 2001. He served in various capacities at Compugen since our founding and, from January 1998 until November 2001, he served as President of Compugen, Inc. From January 1998 until March 2000, he also served as our Vice President Business Development and Commercialization. Mr. Mintz holds a B.Sc. in Physics, Mathematics and Computer Science from Hebrew University and an M.B.A. from INSEAD.

**David Haselkorn, Ph.D.** has served as a director since December 1998. Since 1998, Dr. Haselkorn has been the Chief Executive Officer of Clal Biotechnology Industries Ltd. From 1987 to 1998, Dr. Haselkorn served as a Managing Director and Chief Operating Officer of Bio-Technology General Corp. Dr. Haselkorn is also on the board of directors of several privately-held companies. Dr. Haselkorn holds a B.Sc. in Chemistry and an M.Sc. in Biochemistry from Hebrew University, and a Ph.D. in Chemical Immunology from the Weizmann Institute of Science.

**Amos Goren** has served as a director since December 1997. Since June 1997, Mr. Goren has been a Director of Apax Partners Israel, Ltd., the investment advisor to Israel Growth Fund, L.P., a venture capital fund. From May 1993 until June 1997, Mr. Goren served as the Chief Executive Officer and Chairman of AquaPharm Technologies Inc., a pharmaceutical company that he co-founded. From August 1990 until January 1993, Mr. Goren served as a Vice President of Business Development at Carmel Containers in Israel. Mr. Goren holds a B.Sc. in Biology from the Hebrew University, an M.Sc. in Biochemistry from Weizmann Institute in Israel and an M.B.A. from Harvard Business School.

**Rimon Ben Shaoul** has been Co-Chairman, President and Chief Executive Officer of Koonras Technologies Ltd., an investment company controlled by Poalim Investments Ltd. since February 2001. From June 1997 to February 2001, he was President and Chief Executive Officer of Clal Industries and Investments Ltd., one of Israel's largest holding companies. During that period, Mr Ben-Shaoul also served on the Boards of Directors of Clal (Israel) Ltd. and several of its subsidiaries. From 1985 to June 1997, Mr. Ben-Shaoul was President and Chief Executive Officer of Clal Insurance Company Ltd. and a member of its Board of Directors, and Chairman or member of the Board of Directors of various subsidiaries of Clal Insurance Company Ltd. He holds a B.A. in economics and an MBA from Tel Aviv University.

**Philip Young** has served as a director since May 1997. Since 1990, Mr. Young has been a general partner of U.S. Venture Partners, a venture capital investment firm located in Menlo Park, CA. He currently serves on the boards of directors of Zoran Corporation, and Aerogen, Inc., as well as a number of privately-held companies. He holds a B.M.E. from Cornell University, an M.S. in Applied Sciences from George Washington University and an M.B.A. from Harvard Business School.

**Orna Berry, Ph.D** joined our Board as an outside director in June 2001. She is a Venture Partner at Gemini Capital Fund Management Ltd., and the active Chairperson at Lambda Crossing, Ltd. and at WanWall Inc. From 1997 to 2000, she was the Chief Scientist of the Ministry of Industry and Trade of the Government of Israel. Dr. Berry was a co-founder of ORNET Data Communication Technologies Ltd. She served as the Chief Scientist of Fibronics and as a senior research engineer in several companies, including IBM and UNISYS. Dr. Berry received her Ph.D. in computer science from the University of Southern California and M.A. and B.A. degrees in statistics and mathematics from Tel Aviv and Haifa Universities, respectively. Dr. Berry serves as an outside director on our Board for a fixed term which expires in June 2004.

**David Schlachet** joined our Board as an outside director in June 2001. He is the Managing Partner of Biocom, a venture capital fund focused on life sciences. He also serves on the Boards of Directors of the following companies: Poalim Capital Markets & Investments Ltd., Harel Capital Markets Ltd (as Chairman), Taya Investment Company Ltd., United Studios Ltd., Pharmos Ltd., Taldor Ltd., ProSeed Venture Capital Fund Ltd and Israel Discount Bank Limited. From 1997 to July 2000, he was Chairman of the Board of Directors of Elite Industries Ltd. From 1996 to January 2000, Mr. Schlachet served as Vice President of the Strauss Group of companies. From 1990 to 1996, he was Vice President, Finance and Administration at the Weizmann Institute of Science. From 1989 to 1990, Mr. Schlachet was Chief Executive Officer of Yeda Research and Development Ltd. of the Weizmann Institute of Science. From 1974 to 1988, he was a senior manager at the Investment Company of Bank Hapoalim Ltd. Mr. Schlachet holds a B.Sc. degree in chemical engineering from the Technion, Israel Institute of Technology and an MBA degree from Tel Aviv University.

***Election of Directors and Terms of Office***

Our board of directors currently consists of nine members, including our chairman and chief executive officer. Other than our two outside directors, our directors are elected by an ordinary resolution at the annual general meeting of our shareholders. Unless they earlier resign or are removed in accordance with our Articles of Association, all of our other directors will serve as directors until our next annual general meeting of shareholders.

Dr. Orna Berry and David Schlachet serve as outside directors pursuant to the provisions of the Israel Companies Law for a three-year term ending in June 2004. Thereafter their term of service may be renewed for one additional three-year term. None of our directors or officers have any family relationships with any other director or officer.

***Alternate Directors***

Our Articles of Association provide that a director may appoint, by written notice to us, any individual to serve as an alternate director, provided that the director is not currently serving as a director or as an alternate director. Any alternate director will have all of the rights and obligations of the director appointing him or her, except the power to appoint an alternate, unless the instrument appointing him or her provides otherwise, and the right to remuneration. The alternate director may not act at any meeting at which the director appointing him or her is present. Unless the time period or scope of any appointment is limited by the appointing director, the appointment is effective for all purposes, but will expire upon the expiration of the appointing director's term.

***Outside and Independent Directors***

The Israeli Companies Law requires Israeli companies with shares that have been offered to the public in or outside of Israel to appoint at least two outside directors. No person may be appointed as an outside director if the person or the person's relative, partner, employer or any entity under the person's control, has or had, on or within the two years preceding the date of the person's appointment to serve as outside director, any affiliation with the company or any entity controlling, controlled by or under common control with the company. The term affiliation includes:

- an employment relationship;
- a business or professional relationship maintained on a regular basis;
- control; and
- service as an office holder.

No person may serve as an outside director if the person's position or other business activities create, or may create, a conflict of interest with the person's responsibilities as an outside director or may otherwise

interfere with the person's ability to serve as an outside director. If, at the time outside directors are to be appointed, all current members of the board of directors are of the same gender, then at least one outside director must be of the other gender.

Outside directors are to be elected by a majority vote at a shareholders' meeting, provided that either:

- the majority of shares voted at the meeting, including at least one-third of the shares held by non-controlling shareholders voted at the meeting, vote in favor of election of the director; or

- the total number of shares held by non-controlling shareholders voted against the election of the director does not exceed one percent of the aggregate voting rights in the company.

The initial term of an outside director is three years and may be extended for an additional three years. Outside directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the outside directors cease to meet the statutory qualifications for their appointment or if they violate their duty of loyalty to the company. Each committee of a company's board of directors must include at least one outside director.

An outside director is entitled to compensation as provided in regulations adopted under the new Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an outside director.

In addition, the Nasdaq National Market requires us to have at least two independent directors on our board of directors and to establish an audit committee, at least a majority of whose members are independent of management.

Dr. Orna Berry and David Schlachet currently serve as our outside directors under Israeli law and as our independent directors under Nasdaq requirements. They both serve on our audit committee.

***Approval of Certain Transactions***

The Companies Law codifies the fiduciary duties that office holders, including directors and executive officers, owe to a company. An office holder, as defined in the Companies Law, is a director, general manager, chief business manager, deputy general manager, vice general manager, executive vice president, vice president, other manager directly subordinate to the managing director or any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title. An office holder's fiduciary duties consist of a duty of care and a duty of loyalty. The duty of loyalty includes avoiding any conflict of interest between the office holder's position in the company and his personal affairs, avoiding any competition with the company, avoiding exploiting any business opportunity of the company in order to receive personal advantage for himself or others, and revealing to the company any information or documents relating to the company's affairs which the office holder has received due to his position as an office holder. Each person listed in the table under "Directors and Senior Management" above is an office holder. Under the Companies Law, all arrangements as to compensation of office holders who are not directors require approval of the board of directors, or a committee thereof. Arrangements regarding the compensation of directors also require audit committee and shareholder approval, with the exception of compensation to outside directors in an amount specified in the regulations discussed above.

The Companies Law requires that an office holder promptly disclose any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. The disclosure must be made to our board of directors or shareholders prior to the meeting at which the transaction is to be discussed. In addition, if the transaction is an extraordinary transaction, as defined under Israeli law, the office holder must also disclose any personal interest held by the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of the foregoing, or by any corporation in which the office holder is a five percent or greater shareholder, or holder of 5% or more of the voting power, director or general manager or in which he or she has the right to appoint at least one director or the general manager. An

extraordinary transaction is defined as a transaction not in the ordinary course of business, not on market terms, or that is likely to have a material impact on the company's profitability, assets or liabilities.

In the case of a transaction which is not an extraordinary transaction, after the office holder complies with the above disclosure requirement, only board approval is required unless the Articles of Association of the company provides otherwise. The transaction must not be adverse to the company's interest. If the transaction is an extraordinary transaction, then, in addition to any approval required by the Articles of Association, it also must be approved by the audit committee and by the board of directors, and, under specified circumstances, by a meeting of the shareholders. An office holder who has a personal interest in a matter that is considered at a meeting of the board of directors or the audit committee may not be present at this meeting or vote on this matter.

The Companies Law applies the same disclosure requirements to a controlling shareholder of a public company, which is defined as a shareholder who has the ability to direct the activities of a company, other than in circumstances where this power derives solely from the shareholder's position on the Board or any other position with the company, and includes a shareholder that holds 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the board of directors and the shareholders of the company.

The shareholder approval must either include at least one-third of the disinterested shareholders who are present, in person or by proxy, at the meeting, or, alternatively, the total shareholdings of the disinterested shareholders who vote against the transaction must not represent more than one percent of the voting rights in the company.

Under the Companies Law, a shareholder has a duty to act in good faith towards the company and other shareholders and refrain from abusing his power in the company, including, among other things, voting in the general meeting of shareholders on the following matters:

- any amendment to the Articles of Association;
- an increase of the company's authorized share capital;
- a merger; or
- approval of interested party transactions that require shareholder approval.

In addition, any controlling shareholder, any shareholder who knows it can determine the outcome of a shareholder vote and any shareholder who, under a company's Articles of Association, can appoint or prevent the appointment of an office holder, is under a duty to act with fairness towards the company. The Companies Law does not describe the substance of this duty.

For information concerning the direct and indirect personal interests of some of our office holders and principal shareholders in transactions with us, see "Item 7. Major Shareholders and Related Party Transactions."

***Compensation***

The aggregate compensation paid by us and our subsidiaries to all persons who served in the capacity of director or executive officer for the year ended December 31, 2001 (10 persons) was approximately $2,053,685. This amount includes approximately $475,652 set aside or accrued to provide pension, severance, retirement or similar benefits. This amount also includes sums paid to Shomar Corporation under the consulting agreements described under "Item 7. Major Shareholders and Related Party Transactions; Related Party Transactions and Consulting Agreement with Shomar Corporation." This amount does not include expenses, including business travel, relocation, professional and business

association dues and expenses, reimbursed to officers and other benefits commonly reimbursed or paid by companies in Israel.

During 2001, we granted a total of 900,000 options to purchase Ordinary Shares to our directors and executive officers as a group. These options are exercisable at a range of between $3.07 per share and $4.39 per share, and expire ten years after the date of grant.

All members of the board of directors and scientific advisory board members who are not employees or consultants are reimbursed for their expenses for each meeting attended and are eligible to receive share options under our share option plans. Members of our scientific advisory board receive cash compensation and may be granted share options for their services. As of December 31, 2001, options to purchase 1,825,000 ordinary shares were granted to our directors and scientific advisors.

*Employment Agreement with Mor Amitai*

Pursuant to our agreement with Mor Amitai, our President and Chief Executive Officer, we pay Mr. Amitai a gross annual salary of $220,000 plus other benefits customarily paid to employees in Israel. In addition, Mr. Amitai is entitled to a maximum year-end bonus for 2001 of $55,000 if the Board of Directors determines that he has met his objectives for 2001. Mr. Amitai's employment agreement also provides that in the event that we terminate Mr. Amitai's employment without "justifiable cause" (as defined in the employment agreement), we must provide Mr. Amitai with at least sixty (60) days prior written notice and pay Mr. Amitai a one-time severance payment equal to six months of Mr. Amitai's gross salary. In addition, if Mr. Amitai's employment is terminated without "justifiable cause" within one year following a change in control of us, Mr. Amitai will be entitled to an additional one-time payment equal to six months of Mr. Amitai's gross salary. These severance payments will be in addition to severance required by Israeli law, one month's salary for each year of employment with the company.

**Board Practices**

None of our directors is entitled to receive any severance or similar benefits upon termination of his or her service, except Mor Amitai and Eli Mintz who are entitled to severance pursuant to the terms of their employment agreements**.**

Our Articles of Association permit us to hold officers' liability insurance and to indemnify our officers for actions performed on our behalf, subject to specified limitations.

***Audit Committee***

The Companies Law requires public companies to appoint an audit committee. The responsibilities of the audit committee include identifying irregularities in the management of the company's business and approving related party transactions as required by law. An audit committee must consist of at least three directors, including all of its outside directors. The chairman of the board of directors, any director employed by or otherwise providing services to the company, and a controlling shareholder or any relative of a controlling shareholder, may not be a member of the audit committee. An audit committee may not approve an action or a transaction with a controlling shareholder, or with an office holder, unless at the time of approval two outside directors are serving as members of the audit committee and at least one of the outside directors was present at the meeting in which an approval was granted.

Our audit committee is currently comprised of Dr. Orna Berry, David Schlachet and Amos Goren.

***Internal Auditor***

Under the Companies Law, the board of directors must appoint an internal auditor, nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether the company's actions comply with the law and orderly business procedure. Under the Companies Law, the

internal auditor may be an employee of the company but not an office holder (as defined above), or an affiliate, or a relative of an office holder or affiliate, and he or she may not be the company's independent accountant or its representative.

***Scientific Advisory Board***

Our scientific advisory board meets once or twice annually, and we consult with its individual members regularly. At its meetings, we review our primary ongoing and planned projects, and the board recommends which projects to pursue and in what priority. Our scientific advisory board currently includes:

| Name | Affiliation |
|---|---|
| Richard Durbin, Ph.D. | Head of Informatics, Deputy Director of the Sanger Centre, UK |
| C. Ronald Kahn, M.D., D.Sc. | Professor of Medicine, Harvard Medical School, Cambridge, MA |
| Joseph Schlessinger, Ph.D. | William H. Prusoff Professor and Chairman of the Department of Pharmacology of the Yale University School of Medicine; Member, National Academy of Sciences, USA |
| Arthur Weiss, M.D., Ph.D. | Ephraim P. Engleman Distinguished Professor of Rheumatology; Professor of Medicine; Professor of Microbiology and Immunology, University of California, San Francisco, CA |

**Employees**

The following table sets forth for the last three fiscal years, the number of our employees engaged in the specified activities, by geographic location.

| Year Ended December 31, | 2001 | 2000 | 1999 |
|---|---|---|---|
| Research and Development and Engineering | | | |
| Israel | 108 | 105 | 69 |
| U.S. | 17 | 15 | 11 |
| Administration, Accounting and Operations | | | |
| Israel | 22 | 21 | 15 |
| U.S. | 4 | 2 | 2 |
| Sales, Marketing, Business Development and Support | | | |
| Israel | 12 | 17 | 9 |
| U.S. | 13 | 8 | 5 |
| Total | 176 | 168 | 111 |

We and our Israeli employees are subject to provisions of the collective bargaining agreements between the Histadrut, the General Federation of Labor in Israel and the Coordination Bureau of Economic Organizations, including the Industrialists Associations, by order of the Israeli Ministry of Labor and Welfare. These provisions principally concern cost of living increases, recreation pay and other conditions of employment. We provide our employees with benefits and working conditions above the required minimum. Our employees are not represented by a labor union. We have written employment contracts with most of our employees and we believe that our relations with our employees are good.

**Share Ownership**

***Share Ownership by Directors and Senior Management***

All of the persons listed above under the caption “Directors and Senior Management” own Ordinary Shares and/or options to purchase Ordinary Shares. Except as set forth below, none of the directors or

executive officers owns shares and/or options amounting to 1% or more of the outstanding Ordinary Shares.

The following table sets forth certain information as of February 28, 2002, regarding the beneficial ownership of our directors and executive officers.

| Beneficial Owner | Amount Owned | Percent of Class |
|---|---|---|
| Martin S. Gerstel(1) | 1,567,653 | 6.0% |
| Mor Amitai, Ph.D.(2) | 572,375 | 2.2% |
| Eli Mintz(3) | 1,115,821 | 4.3% |
| Simchon Faigler(4) | 743,761 | 2.9% |
| David Haselkorn, Ph.D.(5) | 3,053,339 | 11.7% |
| Philip Young(6) | 1,150,000 | 4.4% |
| Amos Goren(7) | 565,115 | 2.2% |
| Rimon Ben Shaoul(8) | 791,085 | 3.0% |
| Directors and executive officers as a group (10) | 9,769,671 | 37.5% |

(1) Includes 550,000 shares held by Shomar Corporation, an affiliate of Mr. Gerstel, and 1,017,653 shares held by Merrill Lynch IRA for Martin Gerstel, of which Martin Gerstel is the beneficiary. Based on information provided in the Form 13G filed with the Securities and Exchange Commission in February 2002.

(2) Includes options to purchase 572,375 shares that are exercisable within 60 days of March 31, 2002.

(3) Includes options to purchase 182,821 shares that are exercisable within 60 days of March 31, 2002.

(4) Includes options to purchase 142,511 shares that are exercisable within 60 days of March 31, 2002.

(5) Ownership consists of options to purchase 7,500 that are exercisable within 60 days of March 31, 2002, and 4,091 shares held by Clal Industries & Investments Ltd., and 3,041,748 shares held by Clal Biotechnology Industries, both affiliates of Dr. Haselkorn. Dr. Haselkorn's address is c/o Clal Biotechnology Industries Ltd., 3 Azrieli Center, Tel Aviv 67023, Israel.

(6) Ownership consists of options to purchase 7,500 shares that are exercisable within 60 days of March 31, 2002 and 1,028,275 shares held by U.S. Venture Partners V, L.P., 57,112 shares held by USVP V International, L.P., 31,963 shares held by 2180 Associates Fund V, L.P. and 25,150 shares held by USVP V Entrepreneur Partners, L.P. Philip Young is a managing member of Presidio Management Group V, L.L.C., the general partner of U.S. Venture Partners V, L.P., USVP V International, L.P., 2180 Associates Fund V, L.P. and USVP V Entrepreneur Partners, L.P. Mr. Young, a member of our board of directors, may be deemed beneficial owner of the reported shares but disclaims beneficial ownership in the shares held by these entities, except to the extent of any indirect pecuniary interest therein. The address of Mr. Young, Presidio Management Group V, LLC and its affiliated entities is c/o U.S. Venture Partners, 2180 Sand Hill Road, Suite 300, Menlo Park, California 94025.

(7) Ownership consists of options to purchase 7,500 shares that are exercisable within 60 days of March 31, 2002 and 173,000 shares held by Israel Growth Fund L.P., 331,707 shares held by Apax Israel II L.P., 45,403 shares held by Apax Israel II (Israel) L.P., 4,165 shares held by Apax Israel II Entrepreneur's Club L.P., and 3,340 shares held by Apax Israel Entrepreneur's Club (Israel) L.P., all affiliates of Mr. Goren. Mr. Goren's address is c/o Apax Partners Ventures (Israel), Ltd., P.O. Box 2034, Herzliya 46120, Israel.

(8) Ownership consists of options to purchase 2,500 shares that are exercisable within 60 days of March 31, 2002 and 788,585 shares held by Koonras Technologies Ltd., an affiliate of Mr. Ben Shaoul. Mr. Ben Shaoul's address is 21 Ha'arba'ah Street, Tel Aviv 64739, Israel.

***Share Option Plans***

We maintain the following share option plans for our and our subsidiaries' employees, directors and consultants. In addition to the discussion below, see Note 12 to our Consolidated Financial Statements.

*Compugen Ltd. Employee Share Option Plan (1996)*

We have granted options to purchase up to 559,750 ordinary shares to our employees and consultants under the Compugen Ltd. Employee Share Option Plan (1996). As of March 31, 2002, options to purchase 472,250 ordinary shares remained outstanding under the plan at an exercise price of $1.34. Of these options, 344,250 were held by the directors and officers listed under "Directors and Senior Management" above. These options expire ten years after the date of grant. If a grantee leaves his or her employment or other relationship with us or is terminated without cause, his or her unexercised vested options expire four weeks later. If we terminate the grantee for cause, the options expire immediately. We do not intend to grant additional options under this plan.

*Compugen Share Option Plan (1998)*

Under the Compugen Share Option Plan (1998), we may grant options for up to an aggregate of 2,500,000 ordinary shares to employees, directors and consultants of Compugen and its subsidiaries. A committee of our board of directors administers the plan and designates, subject to the approval of our board of directors, all terms of the options, including the grantees, exercise prices, grant dates, vesting schedules and expiration dates, which may be no more than ten years after the grant date. Options may not be granted with an exercise price of less than the current fair market value of our ordinary shares unless otherwise determined by our board of directors. If the fair market value of our ordinary shares drops below the exercise price of any options previously granted, the committee may lower the exercise price of those options to the then-current fair market value. As of March 31, 2001, options to purchase 1,706,017 ordinary shares were outstanding under the plan at a weighted average exercise price of approximately $2.19 per share. Options to purchase 574,972 ordinary shares under the plan have previously been exercised at an exercise price of approximately $1.38, and options to purchase 219,011 ordinary shares remain available for future grant. These options expire ten years after the date of grant. If a grantee leaves his or her employment or other relationship with us, his or her unexercised vested options expire 90 days later.

*Compugen Share Option Plan (2000)*

Under the Compugen Share Option Plan (2000), we may grant options for up to an aggregate of3,581,192 ordinary shares to our and our subsidiary's employees, directors and consultants. This total number automatically increases each January 1 by the lesser of 1,500,000 shares or 4% of the total number of our then-outstanding shares or such lower amount as shall be determined by the board of directors. A committee of our board of directors administers the plan and designates, subject to the approval of our board of directors, all terms of the options, including the grantees, exercise prices, grant dates and vesting schedules. These options expire ten years after the date of grant. Options may not be granted with an exercise price of less than the fair market value of our ordinary shares on the date of grant, unless otherwise determined by our board of directors. If the fair market value of our ordinary shares drops below the exercise price of any options previously granted, the committee may lower the exercise price of those options to the then-current fair market value. If a grantee leaves his or her employment or other relationship with us, or if his or her relationship with us is terminated without cause, his or her unexercised options will expire three months later. As of March 31, 2002, options to purchase 3,386,192 ordinary shares were outstanding under the plan at a weighted average exercise price of approximately $5.13 per share. Options to purchase 195,000 ordinary shares remain available for future grant.

*Non-Plan Options*

In 1996, we granted options to purchase a total of 249,250 ordinary shares to three of our employees. 32,797 of these options were forfeited without being exercised in November 1999. In addition, 54,663 of these options have been exercised to date. The terms of these options are the same as those granted under the Compugen Share Option Plan (1998).

*Directors' Options*

Prior to our initial public offering, we adopted a plan to grant options to our directors, effective as of the closing of out initial public offering. Pursuant to such plan, effective as of the closing of our initial public offering, we granted options to purchase 20,000 ordinary shares at an exercise price of $10.00 per share to all of our directors (on the date of the closing of our initial public offering) who were not employees or consultants. Of these options, options to purchase 1,250 ordinary shares vest at the end of every three-month period following the date of grant. Pursuant to this plan, we also grant each new non-employee director options to purchase 20,000 ordinary shares at the time he or she becomes a director. Of these options, options to purchase 5,000 ordinary shares vest on the first anniversary of the grant date, and options to purchase 1,250 ordinary shares vest at the end of every three-month period afterwards. In addition, pursuant to the plan, we grant each director options to purchase an additional 5,000 ordinary shares on each anniversary of the initial date of grant of options to such director. Of these options, options to purchase 1,250 ordinary shares vest at the end of every three-month period during the fourth year after the date of grant. All of the options described above have been and will be granted under, and subject to, the terms of share option plans of Compugen in effect on the date of the grant of the option.

## ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

### Major Shareholders

The following table sets forth certain information regarding beneficial ownership of our ordinary shares as of February 28, 2002 by each person who is known by us to own beneficially more than 5% of our outstanding ordinary shares. The voting rights of our major shareholders do not differ from the voting rights of other holders of our ordinary shares.

| Beneficial Owner | Number of Ordinary Shares Beneficially Owned | Percent of Ownership |
|---|---|---|
| Martin Gerstel(1) | 1,567,653 | 6.0% |
| David Haselkorn Ph.D.(2) | 3,053,339 | 11.7% |
| Clal Biotechnology Industries Ltd.(3) | 3,041,748 | 11.7% |
| Apax Funds Nominees Limited E4 Account | 1,384,615 | 5.3% |

(1) Includes 550,000 shares held by Shomar Corporation, an affiliate of Mr. Gerstel, and 1,017,653 shares held by Merrill Lynch IRA for Martin Gerstel, of which Martin Gerstel is the beneficiary. Based on information provided in the Form 13G filed with the Securities and Exchange Commission in February 2002.

(2) Ownership consists of options to purchase 7,500 shares that are exercisable within 60 days of March 31, 2002, 4,091 shares held by Clal Industries & Investments Ltd. and 3,041,748 shares held by Clal Biotechnology Industries, both affiliates of Dr. Haselkorn. Dr. Haselkorn's address is c/o Clal Biotechnology Industries Ltd., 3 Azrieli Center, Tel Aviv 67023, Israel.

(3) The address of Clal Biotechnology Industries Ltd. is 3 Azrieli Center, Tel Aviv 67023, Israel. David Haselkorn, Ph.D. the member of our board of directors affiliated with Clal Biotechnologies Industries Ltd., may be deemed to be the natural person with voting or investment control over the shares held by this entity.

As of March 31, 2002, there were a total of 189 holders of record of our Ordinary Shares, of which 106 were registered with addresses in the United States. Such United States holders were, as of such date, the holders of record of approximately 74.4% of the outstanding Ordinary Shares.

### Related Party Transactions

It is our policy to enter into transactions with related parties on terms that, on the whole, are no less favorable than those that would be available from unaffiliated parties. Based on our experience in the business segments in which we operate and the terms of our transactions with unaffiliated third parties, we believe that all of the transactions described below met our policy standards at the time they occurred.

#### *Private Placement of Series C Preferred Shares*

We issued 5,538,462 Series C preferred shares on July 17, 2000 at a purchase price of $6.50 per share, to Apax Partners & Co., Pequot Private Equity Fund II, L.P., Clal Biotechnology Industries Ltd., Evergreen Canada – Israel Management and certain of its affiliates, and Israel Growth Fund L.P. and certain of its affiliates. Upon the closing of the initial public offering of our Ordinary Shares, each Series C preferred share was converted into one Ordinary Share and all preferred rights granted to the Series C preferred share holders expired, except the registration rights described below.

***Registration Rights***

Under the terms of the Investor Rights Agreement, the holders of registration rights are entitled to request that we effect the registration of their Compugen ordinary shares under the Securities Act. At the request of any holder of demand registration rights, we must use our best efforts to register at least 20% of the shares held by that holder if they are not freely tradable under the Securities Act. These demand rights may be exercised at least six months following any other registration of our shares. Certain groups of shareholders may only make one demand for us to register shares. Other of our shareholders and a warrantholder will have the right to include their shares in these registrations, subject to specified limitations.

At any time when we are eligible to register securities on Form F-3, subject to specified exceptions, the holders of registration rights will have the right to request that we register their ordinary shares that are not freely tradable under the Securities Act. The minimum aggregate offering price of the securities to be registered is at least $500,000.

The holders of registration rights will also have the right to include their shares in any registration statements filed by us for purposes of a public offering, subject to specified limitations. An underwriter participating in an offering may limit the number of shares offered for marketing reasons, in which case the number of shares to be registered would be reduced pro rata among the holders requesting registration of their shares.

We will pay all expenses in connection with any registration, other than underwriting fees or discounts. These registration rights are transferable under specified circumstances and may be amended or waived only with our written consent and a specified number of the affected holders.

***Consulting Agreement with Shomar Corporation***

In October 1998, we entered into a two-year consulting agreement with Shomar Corporation, a company controlled by Martin S. Gerstel, our active Chairman of the Board of Directors. The agreement renews automatically each year unless terminated by either party. Under the agreement, as amended, Mr. Gerstel provides consulting services to us and is required to devote at least 50% of his business time to us. As compensation for his services under this agreement, we pay Shomar Corporation an annual consulting fee of $150,000, plus reimbursement of Mr. Gerstel's reasonable out-of-pocket expenses. The agreement includes nondisclosure and noncompetition obligations in favor of us. In February 1999, our shareholders ratified our board's decisions to grant Shomar options to purchase an aggregate of 500,000 of our ordinary shares at a price of $1.35 per share. All of these options have been exercised. In August 2001, our shareholders ratified our board’s decision to pay Shomar Corporation a year-end bonus of $15,000 for the year ended December 31, 2000. Mr. Gerstel does not receive any other compensation for his services to us.

***Loans and Options Among Shareholders***

In March 1999, two of our officers and one other shareholder executed promissory notes in favor of five of our other existing shareholders. In connection with the promissory notes, the borrowers entered into option agreements under which the lenders had the right to purchase a portion of the shares pledged by each borrower to secure the promissory notes. These options were exercised immediately preceding the closing of our initial public offering.

## ITEM 8. FINANCIAL INFORMATION

### Consolidated Statements and Other Financial Information

Our consolidated financial statements are incorporated herein by reference to pages F-1 through F-25.

***Legal Proceedings***

Currently, we are not a party to any material pending legal proceedings.

***Dividend Distributions***

We have never paid any cash dividends on our Ordinary Shares and we do not intend to pay cash dividends on our Ordinary Shares in the foreseeable future. Our current policy is to retain earnings for use in our business.

In the event that we decide to pay a cash dividend from income that is tax exempt under our approved enterprise status, we would be liable for corporate tax on the amount distributed at the rate of up to 25%. See Note 15 to our Consolidated Financial Statements and "Item 10. Taxation." Cash dividends may be paid by an Israeli company only out of retained earnings as calculated under Israeli law.

### Significant Changes

No significant changes have occurred since the date of the consolidated financial statements included in this annual report.

## ITEM 9. THE OFFER AND LISTING

### Price History of the Stock and Markets

The regulated markets for our Ordinary Shares are the Nasdaq National Market, where our shares have been listed and traded under the symbol "CGEN" since our initial public offering in August 2000 and the Tel Aviv Stock Exchange, since January 7, 2002. The following table sets forth, for the periods indicated, the high and low reported sales prices of the Ordinary Shares on the Nasdaq National Market and on the Tel Aviv Stock Exchange:

| **Last Six Calendar Months** | **Nasdaq** | | **TASE** | |
|---|---|---|---|---|
| | **High** | **Low** | **High** | **Low** |
| March 2002 | $4.390 | $3.130 | $4.219 | $3.212 |
| February 2002 | $4.540 | $3.210 | $4.540 | $3.339 |
| January 2002 | $5.240 | $3.970 | $6.335 | $4.135 |
| December 2001 | $4.950 | $3.010 | -- | -- |
| November 2001 | $3.470 | $2.920 | -- | -- |
| October 2001 | $3.900 | $2.600 | -- | -- |
| | | | | |
| **Financial Quarters During the Past Two Years** | | | | |
| First Quarter 2002 | $5.240 | $3.130 | $6.335 | $3.212 |
| Fourth Quarter 2001 | $4.950 | $2.600 | -- | -- |
| Third Quarter 2001 | $4.700 | $2.760 | -- | -- |
| Second Quarter 2001 | $6.050 | $3.125 | -- | -- |
| First Quarter 2001 | $8.625 | $3.125 | -- | -- |
| Fourth Quarter 2000 | $14.000 | $5.063 | -- | -- |
| Third Quarter 2000 | $19.500 | $10.063 | -- | -- |

## ITEM 10. ADDITIONAL INFORMATION

### Memorandum and Articles of Association

#### *Objects and Purposes of the Company*

We are registered under the Israel Companies Law as a public company with the name Compugen Ltd. and registration number 51-177-963-9. The objective stated in our articles of association is to engage in any lawful activity.

#### *Powers of the Directors*

Pursuant to the Israel Companies Law and our articles of association, a director is not permitted to vote on a proposal, arrangement or contract in which he or she has a personal interest. Also, the directors may not vote compensation to themselves or any members of their body without the approval of our audit committee and our shareholders at a general meeting. The requirements for approval of certain transactions are set forth above in "Item 6. Directors, Senior Management and Employees; Directors and Senior Management; Approval of Certain Transactions". The powers of our directors to enter into borrowing arrangements on our behalf is limited to the same extent as any other transaction by us.

#### *Rights Attached to Ordinary Shares*

Our authorized share capital consists of 50,000,000 Ordinary Shares, par value NIS 0.01 per share. Holders of Ordinary Shares have one vote per share, and are entitled to participate equally in the payment of dividends and share distributions and, in the event of our liquidation, in the distribution of assets after satisfaction of liabilities to creditors. No preferred shares are currently authorized. All outstanding Ordinary Shares are validly issued and fully paid.

#### *Transfer of Shares and Notices*

Fully paid ordinary shares are issued in registered form and may be freely transferred under our Articles of Association unless the transfer is restricted or prohibited by another instrument. Our Articles of Association provide that each shareholder of record is entitled to receive at least 21 days' prior notice of any shareholders' meeting.

#### *Dividend and Liquidation Rights*

We may declare a dividend to be paid to the holders of Ordinary Shares according to their rights and interests in our profits. In the event of our liquidation, after satisfaction of liabilities to creditors, our assets will be distributed to the holders of Ordinary Shares in proportion to the nominal value of their holdings. This right may be affected by the grant of preferential dividend or distribution rights to the holders of a class of shares with preferential rights that may be authorized in the future. Pursuant to Israel's securities laws, a company registering its shares for trade on the TASE may not have more than one class of shares for a period of one year following registration, after which it is permitted to issue preference shares. Under the Companies Law, the declaration of a dividend does not require the approval of the shareholders of the company, unless the company's Articles of Association require otherwise. Our Articles of Association provide that the board of directors may declare and distribute dividends without the approval of the shareholders.

***Annual and Extraordinary General Meetings***

We must hold our annual general meeting of shareholders each year no later than 15 months from the last annual meeting, at a time and place determined by the board of directors, upon at least 21 days' prior notice to our shareholders. A special meeting may be convened by request of two directors or by written request of one or more shareholders holding at least 5% of our issued share capital and 1% of the voting rights or one or more shareholders holding at least 5% of the voting rights. Shareholders requesting a special meeting must submit their proposed resolution with their request. Within 21 days of receipt of the request, the Board must convene a special meeting and send out notices setting forth the date, time and place of the meeting. Such notice must be given at least 21 days but not more than 35 days prior to the special meeting.

The quorum required for a meeting of shareholders consists of at least two shareholders present in person or by proxy who hold or represent between them at least 33.3% of the issued share capital. A meeting adjourned for lack of a quorum generally is adjourned to the same day in the following week at the same time and place or any time and place as the directors designate in a notice to the shareholders. At the reconvened meeting, the required quorum consists of any two members present in person or by proxy.

***Voting Rights***

Our Ordinary Shares do not have cumulative voting rights in the election of directors. As a result, the holders of ordinary shares that represent more than 50% of the voting power represented at a shareholders meeting have the power to elect all of our directors, except the outside directors whose election requires a special majority as described under the section entitled "Item 6. Directors, Senior Management and Employees; Board Practices; Outside and Independent Directors."

Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. Shareholders may vote in person or by proxy. These voting rights may be affected by the grant of any special voting rights to the holders of a class of shares with preferential rights that may be authorized in the future.

Under the Companies Law, unless otherwise provided in the Articles of Association or by applicable law, all resolutions of the shareholders require a simple majority and all shareholders' meetings require prior notice of at least 21 days. Our Articles of Association provide that all decisions may be made by a simple majority. See "Item 6. Directors, Senior Management and Employees; Directors and Senior Management; Approval of Certain Transactions" above for certain duties of shareholders towards the company.

***Limitations on the Rights to Own Securities***

The ownership or voting of ordinary shares by non-residents of Israel is not restricted in any way by our articles of association or the laws of the State of Israel, except that nationals of countries which are, or have been, in a state of war with Israel may not be recognized as owners of Ordinary Shares.

***Anti-Takeover Provisions under Israeli Law***

The Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become shareholder with over 25% of the voting rights in the company. This rule does not apply if there is already another shareholder of the company with 25% or more of the voting rights. Similarly, the Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser's shareholdings would entitle the purchaser to over 45% of the voting rights in the company, unless there is a shareholder with 50% or more of the voting rights in the company. These rules do not apply if the acquisition is made by way of a merger. Regulations promulgated under the Companies Law provide that these tender offer requirements do not apply to companies whose shares are listed for trading outside of Israel if, according to the law in the country in which the shares are traded, including the rules

and regulations of the stock exchange or which the shares are traded, either:

- there is a limitation on acquisition of any level of control of the company; or
- the acquisition of any level of control requires the purchaser to do so by means of a tender offer to the public.

Finally, in general, Israeli tax law treats specified acquisitions less favorably than does U.S. tax law. However, Israeli tax law has recently been amended to provide for tax deferral in specified acquisitions, including transactions where the consideration for the sale of shares is the receipt of shares of the acquiring company, making Israeli tax consequences more favorable than they had been in the past for shareholders who exchange their ordinary shares for shares in a foreign corporation under certain circumstances.

**Material Contracts**

***Series C Share Purchase Agreement***

In July 2000, we completed a private placement of 5,538,462 Series C preferred shares at a price of $6.50 per share, for aggregate consideration of approximately $36.0 million ($35.4 million net of issuance expenses). We issued the 5,538,462 Series C preferred shares to Apax Partners & Co., Pequot Private Equity Fund II, L.P., Clal Biotechnology Industries Ltd., Evergreen Canada – Israel Management and certain of its affiliates, and Israel Growth Fund L.P. and certain of its affiliates. Upon the closing of the initial public offering of our ordinary shares, each Series C preferred share was converted into one ordinary share.

***Underwriting Agreement***

In August 2000, we entered into an underwriting agreement with FleetBoston Robertson Stephens Inc., U.S. Bancorp Piper Jaffray Inc. and Invemed Associates LLC, the representatives of the several underwrites of our initial public offering, pursuant to which these underwriters purchased a total of 5,000,000 of our ordinary shares at a price of $10.00 per share, less the underwriters discount. As part of the underwriting agreement, we granted to the underwriters an option, exercisable during the 30-day period following the date of the prospectus, to purchase up to 750,000 additional ordinary shares at the same price per share. This option was exercised in September 2000.

**Exchange Controls**

Under the Israeli Currency Control Law, 1978, and the "general permit" issued pursuant thereto in May 1998, substantially all transactions in foreign currency are permitted. Non-residents of Israel who purchase Ordinary Shares with certain non-Israeli currencies (including dollars) may freely repatriate in such non-Israeli currencies all amounts received in Israeli currency in respect of the Ordinary Shares, whether as a dividend, as a liquidating distribution, or as proceeds from any sale in Israel of the Ordinary Shares, provided in each case that any applicable Israeli income tax is paid or withheld on such amounts. The conversion into the non-Israeli currency must be made at the rate of exchange prevailing at the time of conversion.

**Taxation**

The following discussion of Israeli and United Sates tax consequences material to our shareholders is not intended and should not be construed as legal or professional tax advice and does not exhaust all possible tax considerations. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, the views expressed in the discussion might not be accepted by the tax authorities in question.

**We urge shareholders and prospective purchasers of our ordinary shares to consult their own tax advisors as to the U.S., Israeli, or other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.**

***Israeli Tax Considerations***

The following discussion refers to the current tax law applicable to companies in Israel, with special reference to its effect on us. This discussion also includes specified Israeli tax consequences to holders of our ordinary shares and Israeli Government programs benefiting us. To the extent that the discussion is based on new tax legislation that has not been subject to judicial or administrative interpretation, we cannot assure you that the views expressed in the discussion will be accepted by the tax authorities in question. The following discussion of Israeli tax considerations is not intended and should not be construed as legal or professional tax advice and does not exhaust all possible tax considerations.

It should be noted that there is currently a public commission in Israel charged with recommending broad reforms to the Israeli tax system. While the committee has yet to make its recommendations, it is possible that reform legislation will become effective at some point during the year 2002.

*General Corporate Tax Structure*

Israeli companies are generally subject to company tax at the rate of 36% of taxable income. However, the effective tax rate payable by a company which derives income from an approved enterprise may be considerably less, as discussed further below.

*Tax Benefits Under the Law for the Encouragement of Capital Investments, 1959*

The Law for the Encouragement of Capital Investment, 1959, as amended, commonly referred to as the Investment Law, provides that a proposed capital investment in eligible facilities may, upon application to the Investment Center of the Ministry of Industry and Trade of the State of Israel, be designated as an approved enterprise. Each certificate of approval for an approved enterprise relates to a specific investment program delineated both by its financial scope, including its capital sources, and by its physical characteristics, for example, the equipment to be purchased and utilized under the program. The tax benefits derived from any certificate of approval relate only to taxable income attributable to the specific approved enterprise. If a company has more than one approval or only a portion of its capital investments is approved, its effective tax rate is the result of a weighted average of the applicable rates.

Taxable income of a company derived from an approved enterprise is subject to company tax at the maximum rate of 25%, rather than 36%, for the benefit period. This period is ordinarily seven years, or ten years if the company qualifies as a foreign investors' company as described below, commencing with the year in which the approved enterprise first generates taxable income. However, this period is limited to 12 years from commencement of production or 14 years from the date of approval, whichever is earlier.

A company owning an approved enterprise may elect to forego entitlement to grants otherwise available as a result of an approved enterprise in return for an alternative package of benefits. Under the alternative package of benefits, a company's undistributed income derived from an approved enterprise will be exempt from company tax for a period of between two and ten years from the first year of taxable income, depending on the geographic location of the approved enterprise within Israel, and the company will be eligible for a reduced tax rate for the remainder of the benefits period.

A company that has elected the alternative package of benefits and that subsequently pays a dividend out of income derived from the approved enterprise during the tax exemption period will be subject to tax on the amount distributed, including any Company tax on these amounts, at the rate which would have been applicable had it not elected the alternative package of benefits, generally 10%-25%, depending on the percentage of the company's shares held by foreign shareholders. The dividend recipient is taxed at the reduced rate applicable to dividends from approved enterprises, which is 15%, if the dividend is distributed during the tax exemption period or within 12 years after this period, or in the case of a foreign investors' company, without time limitation. The company must withhold this tax at source, regardless of whether the dividend is converted into or paid in foreign currency.

A company that has an approved enterprise program is eligible for further tax benefits if it qualifies as a foreign investors' company. A foreign investors' company is a company more than 25% of whose share capital and combined share and loan capital is owned by non-Israeli residents. A company which qualifies as a foreign investors' company and has an approved enterprise program is eligible for tax benefits for a ten year benefit period. The company tax rate applicable to income earned from approved enterprise programs in the benefit period by a company meeting these qualifications is as follows:

| **For a company with foreign investment of** | **Company Tax Rate** |
|---|---|
| Over 25% but less than 49% ..... | 25% |
| 49% or more but less than 74%..... | 20% |
| 74% or more but less than 90%..... | 15% |
| 90% or more..... | 10% |

Subject to applicable provisions concerning income under the alternative package of benefits, all dividends are considered to be attributable to the entire enterprise and their effective tax rate is the result of a weighted average of the various applicable tax rates. Under the Investment Law, a company that has elected the alternative package of benefits is not obliged to distribute exempt retained profits, and may generally decide from which year's profits to declare dividends. We currently intend to reinvest any income derived from our approved enterprise programs and not to distribute the income as a dividend.

The Investment Center bases its decision whether or not to approve an application on the criteria set forth in the Investment Law and regulations, the then prevailing policy of the Investment Center, and the specific objectives and financial criteria of the applicant. Therefore, we cannot assure you that any applications we may make in the future will be approved. In addition, the benefits available to an approved enterprise are conditioned upon the fulfillment of conditions stipulated in the Investment Law and its regulations and in the criteria in the specific certificate of approval, as described above. If a company does not meet these conditions, it would be required to refund the amount of tax benefits, together with consumer price index linkage adjustment and interest.

The Investment Center has granted approved enterprise status to three of our investment programs. Taxable income derived from these programs will be tax exempt for a period of two years beginning with the year in which we first generate taxable income, and thereafter will be subject to a reduced tax rate of 25% or less, if we qualify as a foreign investors' company, for a period of between five and eight years, depending on the percentage of our capital held by non-Israeli shareholders. We have derived, and expect to continue to derive, a substantial portion of our revenues from our approved enterprise programs. To date, we have not generated taxable revenues, from our approved enterprise programs or otherwise.

*Tax Benefits for Research and Development*

Israeli tax law allows, under specific conditions, a tax deduction in the year incurred for expenditures, including capital expenditures, relating to scientific research and development projects, if the expenditures are approved by the relevant Israeli government ministry, determined by the field of research, and the research and development is for the promotion of the company and is carried out by or on behalf of the company seeking the deduction. Expenditures not so approved are deductible over a three-year period.

However, expenditures made out of proceeds made available to us through government grants are not deductible.

*Tax Benefits Under the Law for the Encouragement of Industry (Taxes), 1969*

The Law for the Encouragement of Industry (Taxes), 1969, generally referred to as the Industry Encouragement Law, provides several tax benefits for industrial companies. An industrial company is defined as a company resident in Israel, at least 90% of the income of which in a given tax year exclusive of income from specified government loans, capital gains, interest and dividends, is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity.

Under the Industry Encouragement Law, industrial companies are entitled to a number of corporate tax benefits, including:

- deduction of purchase of know-how and patents over an eight-year period;
- deduction of certain share issuance expenses over a three-year period; and
- the right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies and an industrial holding company.

Under some tax laws and regulations, an industrial enterprise may be eligible for special depreciation rates for machinery, equipment and buildings. These rates differ based on various factors, including the date the operations begin and the number of work shifts. An industrial company owning an approved enterprise may choose between these special depreciation rates and the depreciation rates available to the approved enterprise.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority.

We believe that we currently qualify as an industrial company within the definition of the Industry Encouragement Law. We cannot assure you that we will qualify or, if we qualify, that we will continue to qualify as an industrial company or that the benefits described above will be available to us in the future.

*Special Provisions Relating to Taxation under Inflationary Conditions*

The Income Tax Law (Inflationary Adjustments), 1985, generally referred to as the Inflationary Adjustments Law, represents an attempt to overcome the problems presented to a traditional tax system by an economy undergoing rapid inflation. The Inflationary Adjustments Law is highly complex. Its features which are material to us can be described as follows:

- There is a special tax adjustment for the preservation of equity which classifies corporate assets into fixed assets and non-fixed assets. Where a company's equity, as defined in the law, exceeds the depreciated cost of fixed assets, a deduction from taxable income that takes into account the effect of the applicable annual rate of inflation on the excess is allowed up to a ceiling of 70% of taxable income in any single tax year, with the unused portion permitted to be carried forward on a linked basis. If the depreciated cost of fixed assets exceeds a company's equity, then the excess multiplied by the applicable annual rate of inflation is added to taxable income.
- subject to specified limitations, depreciation deductions on fixed assets and losses carried forward are adjusted for inflation based on the increase in the consumer price index.
- Gains on traded securities, which are normally exempt from tax, are taxable in specified circumstances.

*Capital Gains Tax on Sales of Our Ordinary Shares*

Israeli law imposes a capital gains tax on the sale of capital assets. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain that is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli consumer price index between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus. The inflationary surplus accumulated from and after December 31, 1993, is exempt from any capital gains tax in Israeli while the real gain is added to ordinary income, which is taxed at ordinary rates of 30% to 50% for individuals and 36% for corporations.

Under current law, sales of our ordinary shares, which were purchased pursuant to a prospectus or were quoted on a recognized exchange when they were purchased, are exempt from Israeli capital gains tax for so long as these shares are either (i) traded on the Tel Aviv Stock Exchange or (ii) traded on the Nasdaq National Market or on a stock exchange in specified countries and we qualify as an industrial company. We cannot assure you that we will remain listed on the Tel Aviv Stock Exchange or on the Nasdaq National Market, nor can we assure you that we currently are and will continue to be an industrial company. This exemption does not apply to dealers in securities in Israel and persons subject to the Adjustment Law who are taxed at regular tax rates.

Under the income tax convention between the government of the United States of America and the government of Israel with respect to taxes on income, the sale, exchange or disposition of ordinary shares by a person who qualifies as a resident of the United States within the meaning of the U.S.-Israel tax treaty and who is entitled to claim the benefits afforded to the person by the U.S.-Israel tax treaty generally will not be subject to the Israeli capital gains tax unless the U.S. resident holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding the sale, exchange or disposition, subject to specified conditions. Gain from a sale, exchange or disposition of ordinary shares by a treaty U.S. resident who holds, directly or indirectly, shares representing 10% or more of our voting power at any time during the preceding 12-month period would be subject to Israeli tax, to the extent applicable and subject to the general exemption described in the previous paragraph; however, under the U.S.-Israel tax treaty, the U.S. resident would be permitted to claim a credit for the taxes against the U.S. federal income tax imposed with respect to the sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel tax treaty does not apply to U.S. state or local taxes.

*Taxation of Non-Resident Holders of Shares*

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. These sources of income include passive income, including dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distribution of dividends other than bonus shares or stock dividends, income tax is withheld at source, at the rate of 25%, or 12.5% for dividends not generated by an approved enterprise if the non-resident is a U.S. corporation and holds at least 10% of our voting power, and 15% for dividends generated by an approved enterprise, unless in each case a different rate is provided in a treaty between Israel and shareholder's country of residence. Under the U.S.-Israel tax treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a U.S. resident will be 25%. However, under the Investment Law, dividends generated by an approved enterprise are taxed at the rate of 15%.

***United States Federal Income Tax Considerations***

The following discusses the material United States federal income tax consequences to a holder of our ordinary shares and qualifies as a U.S. Holder, which is defined as:

- a citizen or resident of the United States;
- a corporation created or organized under the laws of the United States, the District of Columbia, or any state; or
- a trust or estate, treated, for United States federal income tax purposes, as a domestic trust or estate.

This opinion is based on current provisions of the Internal Revenue Code of 1986, as amended, current and proposed Treasury regulations promulgated under the Code, and administrative and judicial decisions as of the date of this prospectus, all of which are subject to change, possibly on a retroactive basis. This opinion does not address any aspect of state, local or non-United States tax laws.

Further, this opinion does not purport to be a comprehensive description of all of the tax considerations that may be relevant to U.S. Holders entitled to special treatment under United States federal income tax laws, for example, financial institutions, insurance companies, tax-exempt organizations and broker-dealers, and it does not address all aspects of United States federal income taxation that may be relevant to any particular shareholder based on the shareholder's individual circumstances. In particular, this opinion does not address the potential application of the alternative minimum tax, nor the special United States federal income tax rules applicable in special circumstances, including to U.S. Holders who:

- have elected mark-to-market accounting;
- hold our ordinary shares as part of a straddle, hedge or conversion transaction with other investments;
- own directly, indirectly or by attribution at least 10% of our voting power; and
- have a functional currency that is not the U.S. dollar.

Additionally, this opinion does not consider the tax treatment of partnerships or persons who hold ordinary shares through a partnership or other pass-through entity or the possible application of United States federal gift or estate taxes. Material aspects of United States federal income tax relevant to a holder other than a U.S. Holder are also described below.

***Taxation of Dividends Paid On Ordinary Shares***

A U.S. Holder will be required to include in gross income as ordinary income the amount of any distribution paid on ordinary shares, including any Israeli taxes withheld from the amount paid, to the extent the distribution is paid out of our current or accumulated earnings and profits as determined for United States federal income tax purposes. Distributions in excess of these earnings and profits will be applied against and will reduce the U.S. Holder's basis in the ordinary shares and, to the extent in excess of this basis, will be treated as gain from the sale or exchange of ordinary shares.

Distributions of current or accumulated earnings and profits paid in foreign currency to a U.S. Holder will be includible in the income of a U.S. Holder in a U.S. dollar amount calculated by reference to the exchange rate on the day the distribution is received. A U.S. Holder that receives a foreign currency distribution and converts the foreign currency into U.S. dollars subsequent to receipt will have foreign exchange gain or loss based on any appreciation or depreciation in the value of the foreign currency against the U.S. dollar, which will generally be U.S. source ordinary income or loss.

As described above, we will generally be required to withhold Israeli income tax from any dividends paid to holders who are not resident in Israel. See "Israeli Tax Considerations — Taxation of Non-Resident Holders of Shares." If a U.S. Holder receives a dividend from Compugen that is subject to Israeli withholding, the following would apply:

- You must include the gross amount of the dividend, not reduced by the amount of Israeli tax withheld, in your U.S. taxable income.

- You may be able to claim the Israeli tax withheld as a foreign tax credit against your U.S. income tax liability.

- The foreign tax credit is subject to significant and complex limitations. Generally, the credit can offset only the part of your U.S. tax attributable to your net foreign source passive income. Additional special rules apply to taxpayers predominantly engaged in the active conduct of a banking, insurance, financing or similar business. Additionally, if we pay dividends at a time when 50% or more of our stock is owned by U.S. persons, you may be required to treat the part of the dividend attributable to U.S. source earnings and profits as U.S. source income, possibly reducing the allowable credit, unless you elect to calculate your foreign tax credit separately with respect to Compugen dividends.

- A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent the U.S. Holder has not held the ordinary shares for at least 16 days of the 30-day period beginning on the date which is 15 days before the ex-dividend date or to the extent the U.S. Holder is under an obligation to make related payments with respect to substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute.

- If you do not elect to claim foreign taxes as a credit, you will be entitled to deduct the Israeli income tax withheld from your Compugen dividends in determining your taxable income. Individuals who do not claim itemized deductions, but instead utilize the standard deduction, may not claim a deduction for the amount of the Israeli income taxes withheld.

- If you are a U.S. corporation holding our stock, you cannot claim the dividends-received deduction with respect to our dividends.

Special rules, described below, apply if Compugen is a passive foreign investment company.

***Taxation of the Disposition of Ordinary Shares***

Subject to the description of the passive foreign investment company rules below, upon the sale, exchange or other disposition of our ordinary shares, a U.S. Holder will recognize capital gain or loss in an amount equal to the difference between the U.S. Holder's basis in the ordinary shares, which is usually the cost of these shares, and the amount realized on the disposition. If, as anticipated, the ordinary shares are publicly traded, a disposition of shares will be considered to occur on the trade date, regardless of the holder's method of accounting. Capital gain from the sale, exchange or other disposition of ordinary shares held more than one year is long-term capital gain and is eligible for a reduced rate of taxation for noncorporate holders. Gain or loss recognized by a U.S. Holder on a sale, exchange or other disposition of ordinary shares generally will be treated as United States source income or loss for United States foreign tax credit purposes. The deductibility of capital losses is subject to limitations for both corporate and individual shareholders.

A U.S. Holder that uses the cash method of accounting calculates the U.S. dollar value of the proceeds received from a sale of ordinary shares as of the date that the sale settles, and will generally have no additional foreign currency gain or loss on the sale, while a U.S. Holder that uses the accrual method of accounting is required to calculate the value of the proceeds of the sale as of the trade date and may

therefore realize foreign currency gain or loss, unless the U.S. Holder has elected to use the settlement date to determine its proceeds of sale for purposes of calculating this foreign currency gain or loss. In addition, a U.S. Holder that receives foreign currency upon disposition of our ordinary shares and converts the foreign currency into U.S. dollars subsequent to receipt will have foreign exchange gain or loss based on any appreciation or depreciation in the value of the foreign currency against the U.S. dollar, which will generally be U.S. source ordinary income or loss.

***Tax Consequences If We Are a Passive Foreign Investment Company***

We will be a passive foreign investment company, or PFIC, if 75% or more of our gross income in a taxable year, including our pro rata share of the gross income of any company, U.S. or foreign, in which we are considered to own 25% or more of the shares by value, is passive income. Alternatively, we will be considered to be a PFIC if at least 50% of our assets in a taxable year, averaged over the year and ordinarily determined based on fair market value and including our pro rata share of the assets of any company in which we are considered to own 25% or more of the shares by value, are held for the production of, or produce, passive income. Passive income includes amounts derived by reason of the temporary investment of funds raised in our public offerings. If we were a PFIC, and a U.S. Holder did not make an election to treat us as a qualified electing fund, the following would apply:

- Excess distributions by us to a U.S. Holder would be taxed punitively. Excess distributions are amounts received by a U.S. Holder with respect to our stock in any taxable year that exceed 125% of the average distributions received by a U.S. Holder from us in the shorter of either the three previous years or the U.S. Holder's holding period for ordinary shares before the present taxable year. Excess distributions must be allocated ratably to each day that a U.S. Holder has held our shares. A U.S. Holder must include amounts allocated to the current taxable year in its gross income as ordinary income for that year. A U.S. Holder must pay tax on amounts allocated to each prior taxable year in which we were a PFIC at the highest rate in effect for that year on ordinary income, and the tax is also subject to an interest charge at the rate applicable to deficiencies for income tax.

- The entire amount of gain realized by a U.S. Holder upon the sale or other disposition of ordinary shares will also be treated as an excess distribution and will be subject to tax as described above.

- The tax basis in our shares that were acquired from a decedent who was a U.S. Holder would not receive a step-up to fair market value as of the date of the decedent's death but would instead be equal to the decedent's basis, if lower.

The special PFIC rules described above will not apply to a U.S. Holder if the U.S. Holder makes an election to treat us as a qualified electing fund, or QEF, in the first taxable year in which the U.S. Holder owns ordinary shares and if we comply with applicable reporting requirements. Instead, a shareholder of a QEF is required for each taxable year to include in income a pro rata share of the ordinary earnings of the QEF as ordinary income and a pro rata share of the net capital gain of the QEF as long-term capital gain, subject to a separate election to defer payment of taxes, which deferral is subject to an interest charge. We have agreed to supply U.S. Holders with the information needed to report income and gain pursuant to a QEF election in the event we are classified as PFIC. The QEF election is made on a shareholder-by-shareholder basis and can be revoked only with the consent of the Internal Revenue Service, or IRS. A shareholder makes a QEF election by attaching a completed IRS Form 8621, including the PFIC annual information statement supplied by the PFIC, to a timely filed United States federal income tax return and by filing this form with the IRS Service Center in Philadelphia, Pennsylvania. Even if a QEF election is not made, a shareholder in a PFIC who is a U.S. person must file a completed IRS Form 8621 every year.

A U.S. Holder of PFIC stock which is publicly traded could elect to mark the stock to market annually, recognizing as ordinary income or loss each year an amount equal to the difference as of the close of the taxable year between the fair market value of the PFIC stock and the U.S. Holder's adjusted tax basis in the PFIC stock. Losses would be allowed only to the extent of net mark-to-market gain previously included by

the U.S. Holder under the election for prior taxable years. If the mark-to-market election were made, then the rules set forth above would not apply for periods covered by the election.

We believe that we will not be a PFIC for 2001. However, the tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to this determination. We cannot assure you that we will not become a PFIC. U.S. Holders who hold ordinary shares during a period when we are a PFIC will be subject to the foregoing rules, even if we cease to be a PFIC. U.S. Holders are urged to consult their tax advisors about the PFIC rules, including QEF elections.

***United States Federal Income Tax Consequences for Non-U.S. Holders of Ordinary Shares***

Except as described in "— Information Reporting and Back-up Withholding" below, a Non-U.S. Holder of ordinary shares will not be subject to U.S. federal income or withholding tax on the payment of dividends on, and the proceeds from the disposition of, ordinary shares, unless:

- the item is effectively connected with the conduct by the Non-U.S. Holder of a trade or business in the United States and, in the case of a resident of a country which has a tax treaty with the United States, the item is attributable to a permanent establishment or, in the case of an individual, a fixed place of business, in the United States;

- the Non-U.S. Holder is an individual who holds the ordinary shares as a capital asset and is present in the United States for 183 days or more in the taxable year of the disposition and does not qualify for an exemption; or

- the Non-U.S. Holder is subject to tax under the provisions of United States tax law applicable to U.S. expatriates.

***Information Reporting and Back-up Withholding***

U.S. Holders generally are subject to information reporting requirements with respect to dividends paid in the United States on ordinary shares. Under existing regulations, these dividends are not subject to back-up withholding. U.S. Holders are subject to information reporting and back-up withholding at a rate of 30% on proceeds paid from the disposition of ordinary shares unless the U.S. Holder provides IRS Form W-9 or otherwise establishes an exemption.

Non-U.S. Holders generally are not subject to information reporting or back-up withholding with respect to dividends paid on, or upon the disposition of, ordinary shares, provided that the non-U.S. Holder provides a taxpayer identification number, certifies to its foreign status, or otherwise establishes an exemption.

Treasury regulations effective January 1, 2001 may alter the rules regarding information reporting and back-up withholding. In particular, those regulations would impose back-up withholding on dividends paid in the United States on ordinary shares unless the U.S. Holder provides IRS Form W-9 or otherwise establishes an exemption. Prospective investors should consult their tax advisors concerning the effect, if any, of these Treasury regulations on an investment in ordinary shares. The amount of any back-up withholding will be allowed as a credit against a U.S. or Non-U.S. Holder's United States federal income tax liability and may entitle the Holder to a refund, provided that specified required information is furnished to the IRS.

**Documents on Display**

We are required to file reports and other information with the SEC under the Securities Exchange Act of 1934 and the regulations thereunder applicable to foreign private issuers. You may inspect and copy reports and other information filed by us with the SEC at the SEC's public reference facilities described below. Although as a foreign private issuer we are not required to file periodic information as frequently or as

promptly as United States companies, we generally announce publicly our quarterly and year-end results promptly and file periodic information with the SEC under cover of Form 6-K. As a foreign private issuer, we are also exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements and our officers, directors and principal shareholders are exempt from the reporting and other provisions in Section 16 of the Exchange Act.

You may review a copy of our filings with the SEC, including any exhibits and schedules, at the SEC's public reference facilities in Room 1024, Judiciary Plaza, 450 Fifth Street, N.W., Washington, D.C. 20549 and at the regional office of the SEC located at the Northwestern Atrium Center, 500 West Madison Street, Suite 1400, Chicago, Illinois 60661. You may also obtain copies of such materials from the Public Reference Section of the SEC, Room 1024, Judiciary Plaza, 450 Fifth Street, N.W., Washington, D.C. 20549, at prescribed rates. You may call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. As a foreign private issuer we are not required to file through the SEC's EDGAR system and our periodic filings are therefore not available on the SEC's Web site. You may read and copy any reports, statements or other information that we file with the SEC at the SEC facilities listed above. These SEC filings are also available to the public from commercial document retrieval services.

Any statement in this annual report about any of our contracts or other documents is not necessarily complete. If the contract or document is filed as an exhibit to this annual report, the contract or document is deemed to modify the description contained in this annual report. We urge you to review the exhibits themselves for a complete description of the contract or document.

## ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

### Interest Rate Risk

At December 31, 2001, we were not exposed to any material interest rate risk.

### Foreign Currency Exchange Risk and Inflation

Since the majority of our revenues are paid in U.S. dollars, we believe that inflation and fluctuations in the NIS/U.S. dollar exchange rate have no material effect on our revenues. We incur a significant portion of our expenses, principally salaries and related personnel expenses, in New Israeli Shekels, or NIS. As a result, we are exposed to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the U.S. dollar or that the timing of this devaluation lags behind inflation in Israel. In addition, we are exposed to the risk that the U.S. dollar will be devalued against the NIS. We try to protect ourselves against this possibility by investing a portion of our cash in NIS deposits. To date, we have not been materially affected by changes in the Israeli rate of inflation or the exchange rates of the NIS compared to the U.S. dollar.

### Market Risk

We do not currently use financial instruments for trading purposes and do not currently hold any derivative financial instruments that could expose us to significant market risk.

## ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

## PART II

## ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None.

## ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

**Material Modifications to the Rights of Security Holders**

None.

**Use of Proceeds**

The effective date of the registration statement for which the information is being disclosed is August 11, 2000 (Commission file number 333-12316). The underwriters were FleetBoston Robertson Stephens Inc., U.S. Bancorp Piper Jaffray Inc. and Invemed Associates LLC.

We issued 5,750,000 Ordinary Shares (including the exercise of the over-allotment option by the underwriters), at a price of $10 per share, for an aggregate consideration of approximately $57.5 million.

In connection with the issuance and distribution of the registered securities, we incurred total expenses of approximately $6.4 million, consisting of $4.025 million in underwriting discounts and commissions, and $2.375 million for other expenses. None of such expenses were paid directly or indirectly to directors, officers, persons owning 10% or more of any class of our equity securities or to our affiliates. The net public offering proceeds to us were $51.1 million.

Between August 11, 2000 and December 31, 2001, none of the proceeds were used. Pending use of the proceeds for research and development, sales and marketing, working capital and other general corporate purposes, such proceeds were invested in short-term and long-term, interest-bearing deposits, investment grade securities and U.S. corporate bonds.

## ITEM 15. [RESERVED]

## ITEM 16. [RESERVED]

## PART III

### ITEM 17. FINANCIAL STATEMENTS

We have elected to furnish financial statements and related information specified in Item 18.

### ITEM 18. FINANCIAL STATEMENTS

See pages F-1 to F-25.

### ITEM 19. EXHIBITS

**Index to Exhibits**

| Exhibit Number | Description |
|---|---|
| *1.1 | Form of Articles of Association of Registrant (post offering) |
| 10.1 | Auditors Consent dated April 11, 2002. |

* Incorporated by reference to our registration statement on Form F-1, registration number 333-12316, as amended, filed with the Securities and Exchange Commission.

**SIGNATURES**

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all the requirements for filing on Form 20-F and has duly caused this Annual Report to be signed on its behalf by the undersigned, thereunto duly authorized on this 12th day of April 2002.

**COMPUGEN LTD.**

By: _____/s/_____
Mor Amitai, Ph.D
*President, Chief Executive Officer and Director*

# COMPUGEN LTD.

**CONSOLIDATED FINANCIAL STATEMENTS**

**As of December 31, 2001**

(In thousands of U.S. dollars)

# COMPUGEN LTD.

**CONTENTS**



# # # # # #

**REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS**

To the Shareholders of
Compugen Ltd.

We have audited the accompanying consolidated balance sheets of Compugen Ltd. (an Israeli corporation) and its subsidiaries (the Company) as of December 31, 2000 and 2001, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001. 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 generally accepted auditing standards in the United States and in Israel, including those prescribed under the Auditors' Regulations (Auditor's Mode of Performance), 1973. Those standards require that we plan and preform 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Compugen Ltd. and its subsidiaries as of December 31, 2000 and 2001, and the results of their operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

**Luboshitz Kasierer**
**Arthur Andersen**

Tel-Aviv, Israel
February 12, 2002

# COMPUGEN LTD.

**CONSOLIDATED BALANCE SHEETS**
(U.S.$ in thousands, except share data)

| | Note | December 31 2000 | December 31 2001 |
|---|---|---|---|
| **ASSETS** | | | |
| CURRENT ASSETS | | | |
| Cash and cash equivalents | (3) | 80,675 | 8,438 |
| Short-term cash deposits | (4) | 10,000 | 9,241 |
| Corporate bonds | (5) | - | 14,668 |
| Trade receivables | | 1,203 | 1,122 |
| Other receivables | (6) | 1,479 | 1,828 |
| Inventory | | 385 | 343 |
| Total current assets | | 93,742 | 35,640 |
| LONG-TERM INVESTMENTS | | | |
| Corporate bonds | (5) | - | 15,953 |
| Long-term cash deposits | (7) | - | 30,195 |
| | | - | 46,148 |
| PROPERTY AND EQUIPMENT, NET | (8) | 3,189 | 4,272 |
| OTHER ASSETS | (10) | 941 | 1,229 |
| Total assets | | 97,872 | 87,289 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | |
| CURRENT LIABILITIES | | | |
| Accounts payable and accrued expenses | (9) | 3,118 | 4,887 |
| Deferred revenue | | 1,185 | 960 |
| Total current liabilities | | 4,303 | 5,847 |
| LONG-TERM LIABILITIES | | | |
| Accrued severance pay | (10) | 1,059 | 1,380 |
| COMMITMENTS | (11) | | |
| SHAREHOLDERS' EQUITY | (12) | | |
| Share capital | | | |
| Ordinary shares of NIS 0.01 par value Authorized - as of December 31, 2000 and 2001 50,000,000 shares; Issued and outstanding as of December 31, 2000 and 2001 - 25,981,416 shares and 26,048,384 shares, respectively | | 71 | 71 |
| Additional paid-in capital | | 150,380 | 150,418 |
| Deferred compensation | | (4,697) | (2,039) |
| Accumulated deficit | | (53,244) | (68,388) |
| Total shareholders' equity | | 92,510 | 80,062 |
| Total liabilities and shareholders' equity | | 97,872 | 87,289 |

. . . . . .
**MOR AMITAI, Ph.D.**
Chief Executive Officer

. . . . . .
**NURIT BENJAMINI**
Chief Financial Officer

**The accompanying notes form an integral part of these financial statements.**

# COMPUGEN LTD.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(U.S.$ in thousands, except share and per share data)

| | Note | Year ended December 31 | | |
|---|---|---|---|---|
| | | 1999 | 2000 | 2001 |
| Revenues | (13) | | | |
| Products | | 783 | 2,268 | 5,883 |
| Services | | 2,454 | 4,623 | 4,483 |
| Research and development grants | | 507 | 466 | 994 |
| Total revenues | | 3,744 | 7,357 | 11,360 |
| Cost of revenues | | | | |
| Products | | 611 | 477 | 1,853 |
| Services | | 480 | 1,243 | 1,602 |
| Research and development expenses | | 7,183 | 12,635 | 15,976 |
| Sales and marketing expenses | | 1,166 | 3,781 | 6,565 |
| General and administrative expenses | | 3,152 | 5,397 | 4,383 |
| Total operating expenses (*) | | 12,592 | 23,533 | 30,379 |
| Operating loss | | (8,848) | (16,176) | (19,019) |
| Financing income, net | (14) | 719 | 2,772 | 3,875 |
| Net loss | | (8,129) | (13,404) | (15,144) |
| Dividends related to convertible preferred shares | | 1,886 | 24,923 | - |
| Net loss available to ordinary shares | | (10,015) | (38,327) | (15,144) |
| Basic and diluted net loss per ordinary share | (2L) | (1.70) | (2.75) | (0.58) |
| Weighted average number of ordinary shares outstanding | | 5,896,780 | 13,914,485 | 26,005,784 |

(*) Includes deferred compensation costs - see Note 12.

**The accompanying notes form an integral part of these financial statements.**

# COMPUGEN LTD.

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(U.S.$ in thousands, except share data)

| | Ordinary shares | Preferred shares | Share capital | Additional paid-in capital | Deferred compen-sation | Accumulated deficit | Total |
|---|---|---|---|---|---|---|---|
| Balance as of January 1, 1999 | 5,981,000 | 8,206,119 | 42 | 26,238 | (712) | (6,788) | 18,780 |
| Employee options exercised | - | - | - | 19 | - | - | 19 |
| Deferred compensation | - | - | - | 3,925 | (3,925) | - | - |
| Amortization of deferred compensation | - | - | - | - | 869 | - | 869 |
| Compensation relating to options and warrants issued to scientific advisory board members, consultants and others | - | - | - | 1,248 | - | - | 1,248 |
| Net loss | - | - | - | - | - | (8,129) | (8,129) |
| Balance as of December 31, 1999 | 5,981,000 | 8,206,119 | 42 | 31,430 | (3,768) | (14,917) | 12,787 |
| Employee options exercised | 505,835 | - | 1 | 784 | - | - | 785 |
| Issuance of Series C preferred shares | - | 5,538,462 | 14 | 35,499(*) | - | - | 35,513 |
| Issuance of Ordinary shares in an initial public offering | 5,750,000 | - | 14 | 51,134(**) | - | - | 51,148 |
| Conversion of Preferred shares | 13,744,581 | (13,744,581) | - | - | - | - | - |
| Dividend related to convertible preferred shares | - | - | - | 24,923 | - | (24,923) | - |
| Deferred compensation | - | - | - | 4,680 | (4,680) | - | - |
| Amortization of deferred compensation | - | - | - | - | 3,751 | - | 3,751 |
| Compensation relating to options and warrants issued to scientific advisory board members, consultants and others | - | - | - | 1,930 | - | - | 1,930 |
| Net loss | - | - | - | - | - | (13,404) | (13,404) |
| Balance as of December 31, 2000 | 25,981,416 | - | 71 | 150,380 | (4,697) | (53,244) | 92,510 |
| Employee options exercised | 66,968 | - | - | 104 | - | - | 104 |
| Amortization of deferred compensation | - | - | - | - | 2,593 | - | 2,593 |
| Compensation relating to options and warrants issued to scientific advisory board members, consultants and others | - | - | - | (1) | - | - | (1) |
| Forfeited options | - | - | - | (65) | 65 | - | - |
| Net loss | - | - | - | - | - | (15,144) | (15,144) |
| Balance as of December 31, 2001 | 26,048,384 | - | 71 | 150,418 | (2,039) | (68,388) | 80,062 |

(*) Net of issuance expenses of approximately $487.

(**) Net of issuance expenses of approximately $6,352.

**The accompanying notes form an integral part of these financial statements.**

# COMPUGEN LTD.

**CONSOLIDATED STATEMENTS OF CASH FLOWS**
(U.S.$ in thousands)

| | Year ended December 31 | | |
|---|---|---|---|
| | **1999** | **2000** | **2001** |
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net loss | (8,129) | (13,404) | (15,144) |
| Adjustments to reconcile net loss to net cash used in operating activities - | | | |
| Income and expenses not affecting operating cash flows: | | | |
| Amortization of deferred compensation | 869 | 3,751 | 2,593 |
| Compensation relating to options and warrants issued to scientific advisory board members, consultants and others | 1,248 | 1,930 | (1) |
| Depreciation | 991 | 1,242 | 1,682 |
| Severance pay, net | (85) | 120 | 55 |
| Changes in operating assets and liabilities: | | | |
| Decrease (increase) in trade receivables | 284 | (1,033) | 81 |
| Increase in other receivables | (89) | (939) | (349) |
| Decrease (increase) in inventory | 165 | (5) | 42 |
| Increase (decrease) in accounts payable and accrued expenses | (263) | 1,481 | 1,769 |
| Increase (decrease) in deferred revenue | (754) | 716 | (225) |
| Net cash used in operating activities | (5,763) | (6,141) | (9,497) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Investment in corporate bonds | - | - | (30,621) |
| Purchase of short-term and long-term deposits | - | (10,000) | (29,436) |
| Purchase of fixed assets | (1,800) | (2,034) | (2,765) |
| Increase in other assets | (3) | (32) | (22) |
| Net cash used in investing activities | (1,803) | (12,066) | (62,844) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Short-term borrowings repaid to bank | (958) | - | - |
| Proceeds from issuance of ordinary shares | 19 | 51,933 | 104 |
| Proceeds from issuance of preferred shares | - | 35,513 | - |
| Net cash provided by (used in) financing activities | (939) | 87,446 | 104 |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (8,505) | 69,239 | (72,237) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | 19,941 | 11,436 | 80,675 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | 11,436 | 80,675 | 8,438 |
| NON-CASH ACTIVITY | | | |
| Dividend related to convertible preferred shares | - | 24,923 | - |

**The accompanying notes form an integral part of these financial statements.**

# COMPUGEN LTD.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**
(U.S.$ in thousands)

**Note 1 - GENERAL**

A. Compugen Ltd. (the "Company") merges computational technologies with biology and medicine to enhance drug discovery and development. The Company's innovative predictive biology technologies support two complementary product development and commercialization divisions. Compugen's BioApplications division offers high value products and services that enable and enhance the discovery and functional analysis of genes, proteins and cell processes. Compugen's Novel Genomics division is developing human therapeutic and diagnostic products based on target genes, proteins and other intellectual property discovered through the Company's innovative research activities. Currently marketed products and services include: LEADS, Gencarta, DNA Chip design, Z3, Oligos Libraries, Bioccelerators and certain genes and proteins discovered by the Company. The Company's headquarters and research facilities are located in Israel, with U.S. operations, through a wholly owned subsidiary, in Jamesburg, New Jersey and Sunnyvale, California.

Subsequent to balance sheet date, the Company established a majority owned subsidiary that will focus on agricultural biotechnology and plant genomics.

B. The financial statements of the Company have been prepared in U.S. dollars, as the currency of the primary economic environment in which the operations of the Company are conducted is the U.S. dollar. Most of the Company's sales are made outside Israel in foreign currencies (mainly the U.S. dollar). A majority of the purchases of materials and components are denominated in or linked to the U.S. dollar. In addition, most marketing expenses are incurred outside Israel, mainly in U.S. dollars.

Transactions and balances originally denominated in U.S. dollars are presented at their original amounts. Transactions and balances in other currencies are remeasured into U.S. dollars in accordance with the principles prescribed in Statement No. 52 of the Financial Accounting Standards Board of the United States (FASB). Accordingly, items have been remeasured as follows:

(U.S.$ in thousands)

**Note 1 - GENERAL (Cont.)**

| | | |
|---|---|---|
| *Monetary items* | - | at the exchange rate in effect on the balance sheet date. |
| *Nonmonetary items* | - | at historical exchange rates. |
| *Revenues and expense items* | - | at the exchange rates in effect as of the date of recognition of those items (excluding depreciation and other items deriving from non-monetary items). |

Exchange gains and losses from the aforementioned remeasurement are reflected in the statement of operations. The representative rate of exchange of the New Israeli Shekel (NIS) at December 31, 2001, was U.S. $1 = NIS 4.42 (December 31, 2000 - NIS 4.04; December 31, 1999- NIS 4.15).

C. In August 2000, the Company issued 5,750,000 ordinary shares (including the exercise of the over-allotment option by the underwriters) in an initial public offering on the NASDAQ, at a price of $10.00 per share, for an aggregate consideration of approximately $57.5 million ($51.1 million net of issuance expenses). Upon the closing of the offering, all outstanding preferred shares were converted into an identical number of ordinary shares. Subsequent to balance sheet date, on January 7, 2002, the Company has registered its ordinary shares for trading also on the Tel Aviv Stock Exchange.

## Note 2 - SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States (U.S. GAAP). The significant accounting policies followed in the preparation of the financial statements, applied on a consistent basis, are:

A. BASIS OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Compugen Inc. All material intercompany transactions and balances have been eliminated on consolidation.

B. CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments with an original maturity of three months or less as cash equivalents.

C. CORPORATE BONDS

The corporate bonds have been categorized as held to maturity securities in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115 - Accounting for Certain Investments in Debt and Equity Securities. These investments are stated at cost (including accrued interest), as it is the intent of the Company to hold these securities until maturity. The Company's investment holdings have been classified in the consolidated balance sheet according to the maturity date.

These investments, which potentially subject the Company to credit risk, are placed in investment grade bonds and are limited in the amount of credit exposure to any one commercial issuer.

D. INVENTORY

Inventory is valued at the lower of cost or market, cost being determined mainly on the "first-in, first-out" method.

E. PROPERTY AND EQUIPMENT

Property and equipment are stated at cost. Costs of purchased software for internal use are capitalized in accordance with Statement of Position 98-1 "Accounting for the Cost of Computer Software Developed or Obtained for Internal Use." Depreciation is calculated using the straight-line method over the estimated useful lives of the assets, ranging from three to eight years.

**Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

F. RESEARCH AND DEVELOPMENT

Research and development costs incurred prior to the establishment of technological feasibility are included in research and development expenses. Software development costs incurred subsequent to the establishment of technological feasibility through the period of general market availability of the products are considered for capitalization. Technological feasibility is established when a working model has been completed and its completeness is confirmed by testing. To date, development costs that are eligible for capitalization have not been material and have been expensed.

G. REVENUE RECOGNITION

Revenues from a contract to provide platform software (not including off-the-shelf software) and software development services, are recognized by the percentage of completion method. Under this method, revenues are recognized as work progresses, in the ratio that costs incurred related to contract performance bear to estimated costs of contract performance. Milestone payments are recognized only when realization is reasonably assured.

Revenues from software product licenses are recognized upon delivery of the software, provided there is persuasive evidence of an agreement, the fee is fixed and determinable and collection of the related receivable is reasonably assured.

Revenue from sales of hardware systems (including associated software) is recognized in accordance with Statement of Position 97-2, "Software Revenue Recognition", upon delivery, or at the end of the evaluation period, if applicable, and when collection is reasonably assured. The purchase price includes a prepaid maintenance fee, generally for a period of one year from the date of the sale; accordingly, this portion of the purchase price is deferred and included as income ratably over the maintenance period.

Revenue from maintenance contracts is recognized ratably over the term of the maintenance contract. Revenues related to services are recognized as the services are rendered.

Revenues from participations by the Government of Israel through the Ministry of Industry and Trade - the Office of the Chief Scientist of Israel ("OCS"), are recognized as revenues as the related research and development expenses are incurred. Prior to January 1, 2001, the participations were presented in the statement of operations as a deduction from the research and development expenses. The prior years financial statements have been changed to conform to the 2001 presentation.

**Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

H. INCOME TAXES

The Company accounts for income taxes using the asset and liability method of accounting in accordance with the provisions of Statements of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes". Under the asset and liability method, deferred taxes are determined based on the differences between the financial statements and tax basis of assets and liabilities at enacted tax rates in effect in the year in which the differences are expected to reverse. Valuation allowances are established, when necessary, to reduce deferred tax assets to amounts expected to be realized.

I. DERIVATIVE FINANCIAL INSTRUMENTS

Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133 - "Accounting for Derivative Instruments and Hedging Activities". The adoption of SFAS No. 133 had no material impact on reported earnings for the year ended December 31, 2001. The Company's derivative financial instruments consist of foreign currency forward exchange contracts and option contracts. These contracts are utilized by the Company, from time to time, to manage risk exposure to movements in foreign exchange rates. None of these contracts have been designated as hedging instruments. These contracts are recognized as assets or liabilities on the balance sheet at their fair value, which is the estimated amount at which they could be settled based on market prices or dealer quote, where available, or based on pricing models. Changes in fair value are recognized currently in earnings.

**Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

J. FAIR VALUE OF FINANCIAL INSTRUMENTS

Unless otherwise noted, the carrying amount of financial instruments approximates fair value.

K. SHARE-BASED COMPENSATION

According to US GAAP, the Company may account for stock option grants in accordance with Accounting Principles Board Opinion ("APB") No. 25 - "Accounting for Stock Issued to Employees" or SFAS 123 - "Accounting for Stock Based Compensation". The Company chose to account for stock option grants according to APB 25 and has made all the required proforma disclosures according to SFAS 123 for the years ended December 31, 1999, 2000 and 2001 in Note 12. Options granted to non-employees in exchange for services are recorded at fair value.

L. BASIC AND DILUTED NET LOSS PER SHARE

The Company has adopted SFAS No. 128 - "Earnings per Share". In accordance with the provisions of this Statement, basic net loss per share is computed based on the weighted average number of ordinary shares outstanding. Net loss for 1999 has been increased by the amount of cumulative unpaid dividends on the Preferred shares ($1,886). Net loss for the year ended December 31, 2000 has been increased by $24.9 million for the preferred share dividend representing the value of the beneficial conversion feature. Outstanding options to purchase shares (see Note 12) are not included in the computation of diluted earnings per ordinary share as their effect would be anti-dilutive for all periods presented. The total number of shares related to the outstanding options excluded from the calculations of diluted net loss per share were 2,614,486, 3,446,916 and 4,877,416 for the years ended December 31, 1999, 2000 and 2001, respectively.

M. USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the 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.

**Note 2 - SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

N. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations ("SFAS 141") and No. 142, Goodwill and Other Intangible Assets ("SFAS 142"). SFAS 141 requires all business combinations initiated after June 30, 2001, to be accounted for using the purchase method. Under SFAS 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. All other intangible assets will continue to be amortized over their estimated useful lives. The amortization provisions of SFAS 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, the Company is required to adopt SFAS 142 effective January 1, 2002. The Company does not believe that the adoption of SFAS 142 will have a material effect on the Company's consolidated financial statements.

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets ("SFAS 144"). Although SFAS 144 supersedes FASB Statement No. 121 ("FASB 121"), it retains the requirements of FASB 121 regarding recognition of impairment loss for long-lived assets to be held and used (based on undiscounted cash flows) and resolves certain implementation issues. Also, the accounting model used in FASB 121 for long-lived assets to be disposed of by sale (lower of carrying amount or fair value less cost to sell) is broadened by SFAS 144 to include discontinued operations and supersedes APB Opinion No. 30. Therefore, discontinued operations will no longer be measured on a net realizable value basis and future operating losses will no longer be recognized before they occur. SFAS 144 also broadens the presentation of discontinued operations to include a component of an entity (rather than a segment of a business). The provisions of SFAS 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those years. The Company believes that the adoption of SFAS 144 will not have a material impact on the Company's financial statements.

(U.S.$ in thousands)

**Note 3 - CASH AND CASH EQUIVALENTS**

| | December 31 | |
|---|---|---|
| | **2000** | **2001** |
| Bank deposits in U.S. dollars (bearing annual interest rate of 1.7% (*)) | 77,765 | 1,173 |
| Bank deposits in NIS (bearing annual interest rates of 3.8% to 5.6% (*)) | 2,696 | 5,695 |
| Cash in banks (current accounts) | 214 | 1,570 |
| | 80,675 | 8,438 |

(*) Rate as of December 31, 2001

**Note 4 - SHORT-TERM CASH DEPOSITS**

| | December 31 | |
|---|---|---|
| | **2000** | **2001** |
| Bank deposits in U.S. dollars (bearing annual interest rates of 3.9% - 4.0% (*)) | 10,000 | 5,355 |
| Bank deposits in NIS (bearing annual interest rate of 3.8% (*)) | - | 3,886 |
| | 10,000 | 9,241 |

(*) Rate as of December 31, 2001

**Note 5 - CORPORATE BONDS**

| | December 31, 2001 | |
|---|---|---|
| | **Amortized cost** | **Market value** |
| Short-term corporate bonds (*) | 14,668 | 14,849 |
| Long-term corporate bonds (*) | 15,953 | 16,214 |

(*) Includes accrued interest.

(U.S.$ in thousands)

**Note 6 - OTHER RECEIVABLES**

| | December 31 | |
|---|---|---|
| | **2000** | **2001** |
| Accrued interest | 490 | 807 |
| Government participation receivables | 125 | 106 |
| Government institutes receivables | 243 | 459 |
| Employee loans | 209 | 75 |
| Other (mainly prepaid expenses) | 412 | 381 |
| | 1,479 | 1,828 |

**Note 7 - LONG-TERM CASH DEPOSITS**

| | December 31 | |
|---|---|---|
| | **2000** | **2001** |
| Bank deposits in U.S. dollars (bearing annual interest rates of 4.2% to 4.9%) | - | 30,195 |

**Note 8 - PROPERTY AND EQUIPMENT, NET**

| | **Annual rates of depreciation** | **December 31** | |
|---|---|---|---|
| | | **2000** | **2001** |
| COST | | | |
| Computers, software and related equipment | 33% | 4,572 | 6,052 |
| Laboratory equipment | 20 – 33% | 810 | 1,916 |
| Office furniture and leasehold improvements | 7 – 15% | 706 | 881 |
| | | 6,088 | 8,849 |
| ACCUMULATED DEPRECIATION | | | |
| Computers, software and related equipment | | 2,326 | 3,681 |
| Laboratory equipment | | 342 | 575 |
| Office furniture and leasehold improvements | | 231 | 321 |
| | | 2,899 | 4,577 |
| NET BOOK VALUE | | 3,189 | 4,272 |

The Company's property and equipment are primarily located in Israel. For the years ended December 31, 1999, 2000 and 2001, depreciation expense was approximately $991, $1,242 and $1,682, respectively.

(U.S.$ in thousands)

## Note 9 - ACCOUNTS PAYABLE AND ACCRUED EXPENSES

| | December 31 | |
|---|---|---|
| | **2000** | **2001** |
| Suppliers | 1,253 | 2,271 |
| Employees and related expenses | 1,492 | 2,041 |
| Other accrued expenses | 373 | 575 |
| | 3,118 | 4,887 |

## Note 10 - ACCRUED SEVERANCE PAY

Under Israeli law and labor agreements, the Company is required to make severance payments to its dismissed employees and employees leaving its employment in certain other circumstances. The Company's severance pay liability to its employees, which is calculated on the basis of the salary of each employee for the last month of the reported period multiplied by the years of such employees' employment, is reflected in the Company's balance sheet on the accrual basis, and is partially funded by purchase of insurance policies in the name of the Company. Deposits with insurance companies in respect of the severance pay accrual are included in other assets.

The severance pay expenses (income) for the years ended December 31, 1999, 2000 and 2001 were $(85), $120 and $55, respectively.

(U.S.$ in thousands)

**Note 11 - COMMITMENTS**

A. The Company's research and development efforts have been partially financed through both royalty bearing and non-royalty bearing programs sponsored by the Office of the Chief Scientist of Israel ("OCS"). In return for the OCS's participation, the Company is committed to pay royalties at a rate of 3% to 5% of sales of the products, up to 100% of the amount of such participation received (for grants received under programs approved subsequent to January 1, 1999 - 100% plus interest at LIBOR). The Company is entitled to the grants only upon incurring research and development expenditures. The Company is not obligated to repay any amounts received from the OCS if the research effort is unsuccessful. There are no repayment obligations relating to the funds received under the non-royalty bearing programs sponsored by the OCS. Grants received in advance of the corresponding expenditures incurred are recorded as a liability. There are no future performance obligations related to the participations received from the OCS and there are no other significant terms of these programs. The Company's potential maximum obligation for royalties, based on royalty-bearing Government participation received or accrued, net of royalties paid or accrued, totaled approximately $165 as of December 31, 2001. The liability for royalties to the OCS is recorded at the time the related royalty-bearing sales are recognized as revenues in the statement of operations.

B. The Company's headquarters and research facilities are located in Israel, with U.S. operations in Jamesburg, New Jersey and Sunnyvale, California. Lease agreements expire in the years 2002 to 2004. Annual minimum future rental payments due under the above agreements and operating lease agreements for vehicles, at exchange rates in effect on December 31, 2001 are approximately as follows:

| | |
|---|---|
| 2002 | 1,502 |
| 2003 | 1,369 |
| 2004 | 223 |
| | 3,094 |

Rent expense was $387, $566 and $1,020 for the years ended December 31, 1999, 2000 and 2001, respectively.

**Note 12 - SHARE CAPITAL**

A. In July 2000, the Company completed a private placement of 5,538,462 Series C convertible preferred shares at a price of $6.50 per share, for an aggregate consideration of approximately $36.0 million ($35.5 million net of issuance expenses). As a result of the initial public offering in August 2000, the Company recorded a non-cash charge for preferred share dividends of approximately $24.9 million, representing the value of the beneficial conversion feature of this issuance based on the difference between the conversion price of $6.50 per share and the assumed offering price of $11.00 in the initial public offering (see Note 1C).

B. In September 1996, the Company adopted the Compugen Ltd. Employee Share Option Plan (1996) (the "Plan"), which provides for the grant by the Company of options to purchase 559,750 ordinary shares to employees and consultants of the Company and its subsidiaries. The Company has elected to register the Plan under Section 102 of the Israeli Income Tax Ordinance. The Company does not intend to grant additional options under this plan.

In June 1998, the Company adopted the Compugen Ltd. Share Option Plan (1998) (the "1998 Plan"), which provides for the grant by the Company of options to purchase up to an aggregate of 2,500,000 ordinary shares to directors, employees and consultants of the Company and its subsidiaries. In general, options granted under these plans vest over a four year period. The options expire ten years from the date of issuance.

In March 2000, the Company adopted the Compugen Ltd. Share Option Plan (2000) (the "2000 Plan"), which provided for the grant by the Company of options to purchase 1,500,000 ordinary shares to employees and consultants of the Company and its subsidiaries. This total number will automatically increase each January 1 by the lesser of 1,500,000 or 4% of the total number of the Company's then outstanding shares or such lower amount as shall be determined by the board of directors. The terms of the 2000 Plan are substantially identical to the terms of the 1998 Plan described above. Subject to the 1998 and 2000 plans, there were 220,909 options to purchase shares available for future grants at December 31, 2001.

(U.S.$ in thousands)

**Note 12 - SHARE CAPITAL (Cont.)**

Transactions related to the grant of options to employees, directors and consultants under the above plans during the years ended December 31, 1999, 2000 and 2001 were as follows:

| | Year ended December 31 | | | | | |
|---|---|---|---|---|---|---|
| | 1999 | | 2000 | | 2001 | |
| | Shares | Weighted average exercise price $ | Shares | Weighted average exercise price $ | Shares | Weighted average exercise price $ |
| Options outstanding at beginning of year | 1,528,000 | 1.34 | 2,614,486 | 1.44 | 3,446,916 | 3.66 |
| Options granted | 1,174,750 | 1.56 | 1,504,937 | 6.60 | 1,828,500 | 4.16 |
| Options exercised | (14,354) | 1.34 | (578,981) | 1.37 | (66,968) | 1.64 |
| Options forfeited | (73,910) | 1.35 | (93,526) | 3.00 | (331,032) | 6.04 |
| Options outstanding at end of year | 2,614,486 | 1.44 | 3,446,916 | 3.66 | 4,877,416 | 3.71 |
| Exercisable at end of year | 1,035,890 | 1.35 | 1,337,580 | 1.79 | 2,095,792 | 2.53 |
| Weighted average fair value of options granted | | 3.54 | | 5.78 | | 1.68 |

The following table summarizes information about options outstanding at December 31, 2001:

| | Options outstanding | | | Options exercisable | |
|---|---|---|---|---|---|
| Range of exercise prices $ | Number outstanding at December 31 2001 | Weighted - average remaining contractual life | Weighted - average exercise price $ | Number outstanding at December 31 2001 | Weighted - average exercise price $ |
| 1.33 - 1.35 | 1,359,157 | 6.60 | 1.34 | 1,289,311 | 1.34 |
| 1.75 | 598,692 | 7.90 | 1.75 | 322,588 | 1.75 |
| 3.00-4.99 | 1,751,546 | 9.48 | 4.35 | 90,802 | 4.30 |
| 5.00 - 6.88 | 718,469 | 8.75 | 5.88 | 257,693 | 5.36 |
| 9.00 - 10.00 | 449,552 | 8.70 | 9.67 | 135,398 | 9.14 |
| | 4,877,416 | | | 2,095,792 | |

(U.S.$ in thousands)

**Note 12 - SHARE CAPITAL (Cont.)**

According to U.S. GAAP, the Company may account for stock option grants in accordance with APB 25 or SFAS No. 123, "Accounting for Stock Based Compensation" ("SFAS 123"). The Company chooses to account for stock option grants according to APB 25. The amounts of deferred compensation recognized arising from the difference between the exercise price and the fair market value on the date of the grant, for options granted in the years ended December 31, 1999, 2000 and 2001, respectively, are included in shareholders' equity and are being amortized over the vesting periods of the respective options in accordance with APB 25. The balance of unamortized deferred compensation at December 31, 2001 is $2,039. Under APB 25, the deferred compensation that has been charged to operations for the year ended December 31, 2001 amounted to $2,593 (year ended December 31, 1999 and 2000, $869 and $3,751, respectively).

If deferred compensation had been determined under the alternative fair value accounting method provided for under SFAS 123, the Company's net loss and basic and diluted net loss per share would have been increased or decreased to the following proforma amounts:

| | 1999 | 2000 | 2001 |
|---|---|---|---|
| Net loss | | | |
| As reported | (8,129) | (13,404) | (15,144) |
| Pro Forma | (7,169) | (14,184) | (17,272) |
| Basic and diluted net loss per share | | | |
| As reported | (1.70) | (2.75) | (0.58) |
| Pro Forma | (1.54) | (2.81) | (0.66) |

Under SFAS 123, the fair value of each option grant is estimated on the date of grant using the Black & Scholes pricing method (the minimum value method - 1999) with the following weighted-average assumptions: (1) expected life of 2.1 years (1999 - 2.5, 2000 - 2.1); (2) dividend yield of 0%; (3) expected volatility of 72% (1999 – 0%, 2000 – 68%) and (4) risk-free interest rate of 1.75% (1999 – 5%, 2000 – 6.5%).

(U.S.$ in thousands)

**Note 12 - SHARE CAPITAL (Cont.)**

Deferred compensation costs were included in the following expense categories:

| | For the year ended December 31 | | |
|---|---|---|---|
| | **1999** | **2000** | **2001** |
| Cost of revenues | - | 156 | (11) |
| Research and development expenses | 882 | 2,380 | 1,636 |
| Sales and marketing expenses | 55 | 505 | 510 |
| General and administrative expenses | 1,180 | 2,640 | 457 |
| | 2,117 | 5,681 | 2,592 |

On March 30, 2000, the Company issued 300,000 warrants to purchase Compugen ordinary shares to Genome Therapeutics Corp., as part of an internet collaboration agreement. The warrants have an exercise price of $8.00. The warrants are accounted for at fair value using the Black & Scholes pricing model in accordance with SFAS 123 and EITF 96-18, "Accounting for equity instruments that are issued to other than employees for acquiring, or in conjunction with selling goods or services". Changes in the fair value of these warrants prior to completion of performance will be reflected as an adjustment to the expense to be recorded in future periods over the vesting period. Subsequent to balance sheet date, the collaboration agreement was terminated and the warrants will expire in March 2002.

In May 2000, the Company issued a warrant to purchase up to 35,000 Compugen ordinary shares to Bain & Company, as part of a consulting agreement, at an exercise price of $10.00 per share. This warrant is immediately exercisable in whole or in part and will expire in May 2005. The warrants are accounted for at fair value using the Black & Scholes pricing model in accordance with SFAS 123 and EITF 96-18.

(U.S.$ in thousands)

**Note 13 - REVENUES**

The Company's revenues from services and products by geographical area are as follows:

| | For the year ended December 31 | | |
|---|---|---|---|
| | **1999** | **2000** | **2001** |
| United States | 2,904 | 6,469 | 7,061 |
| Far East | 271 | 144 | 875 |
| Europe | 38 | 178 | 2,235 |
| Other | 24 | 100 | 195 |
| | 3,237 | 6,891 | 10,366 |
| Sales to a single customer exceeding 10% | **%** | **%** | **%** |
| Customer A | 71 | 35 | 30 |
| Customer B | (*) | 24 | 17 |
| Customer C | (*) | 22 | (*) |
| Customer D | - | (*) | 17 |

(*) Less than 10%.

The Company's business is currently comprised of one operating segment, the research, development and commercialization of products and services in the field of computational genomics and proteomics. The nature of the products and services provided by the Company and the type of customers for these products and services are similar.

Compugen's U.S. subsidiary serves as a marketing arm and customer support for products developed in Israel. The operating results in the U.S. are an integral portion of the results of operations for Israel and are not viewed by Company management as a separate operating segment.

(U.S.$ in thousands)

**Note 14 - FINANCING INCOME, NET**

| | For the year ended December 31 | | |
|---|---|---|---|
| | **1999** | **2000** | **2001** |
| Income (expense): | | | |
| Interest income | 752 | 2,736 | 4,253 |
| Interest expense and bank fees | (15) | (24) | (30) |
| Other (includes exchange rate differences) | (18) | 60 | (348) |
| | 719 | 2,772 | 3,875 |

**Note 15 - TAXES ON INCOME**

A. The Company is subject to the Israeli Income Tax Law (Inflationary Adjustments), 1985, which provides for an adjustment to taxable income for the effects of inflation (based on the Israeli Consumer Price Index) on that portion of shareholders' equity not invested in inflation resistant assets.

B. In 1994, the Company's investment plan for the development and production of dedicated computers for sequence analysis ("Bioaccelerators") totaling $695 was granted "Approved Enterprise" status, through the "Alternative Benefits" program, under the Law for Encouragement of Capital Investments, 1959. In respect of this plan, the Company is entitled to a tax exemption for a period of 2 years commencing in the first year in which the Company has taxable income, and a reduced income tax rate of 25% (instead of the regular rate of 36%) on taxable income derived from the "Approved Enterprise" for an additional period of 5 to 8 years. Due to the reported losses, the benefit period has not yet commenced. In 1996 and 2000, the Company's additional investment plan totaling $1,080 and $2,050, respectively in respect of an expansion of its manufacturing facilities, was granted "Approved Enterprise" status, as well

C. In 2000, the Company's investment plan totaling $860 in respect of its molecular biology "wet lab" was granted "Approved Enterprise" status. The Company has chosen to receive its benefits in respect of this plan through the "Alternative Benefits" program. The benefits under this program are similar to those stated in Item B above.

(U.S.$ in thousands)

**Note 15 - TAXES ON INCOME (Cont.)**

D. In 2001, the Company's investment plan totaling $900 in respect of its manufacturing of seed species was granted "Approved Enterprise" status. The Company has chosen to receive its benefits in respect of this plan through the "Alternative Benefits" program. The benefits under this program are similar to those stated in Item B above.

E. The Company believes it is an "Industrial Company" under the law for the Encouragement of Industry. The principal benefit is the deductibility of expenses in connection with a public offering.

F. Compugen Ltd. has a tax loss carryforward resulting from the years up to and including 2001 amounting to approximately $22,400, which may be carried forward indefinitely. The Company's tax assessments are considered final through 1997. Compugen Inc. is subject to U.S. income taxes and has a loss carryforward resulting from the years up to and including 2001 amounting to approximately $10,300, which expires in the years 2012 to 2021. The Company has provided a valuation allowance against the full amount of the tax benefits in the amount of approximately $9,800 due to its history of operating losses and the uncertainty as to when these benefits would be utilized.

The difference between the loss carryforward for tax purposes and the accumulated deficit as of December 31, 2001 relates mainly to non-cash dividends related to convertible preferred shares of $24,923 and to temporary differences mainly in respect of reserves and allowances not currently deductible.

**Note 16 - RELATED PARTY TRANSACTIONS**

| | For the year ended December 31 | | |
|---|---|---|---|
| | **1999** | **2000** | **2001** |
| Consulting fees to director and shareholder | 75 | 150 | 165 |

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