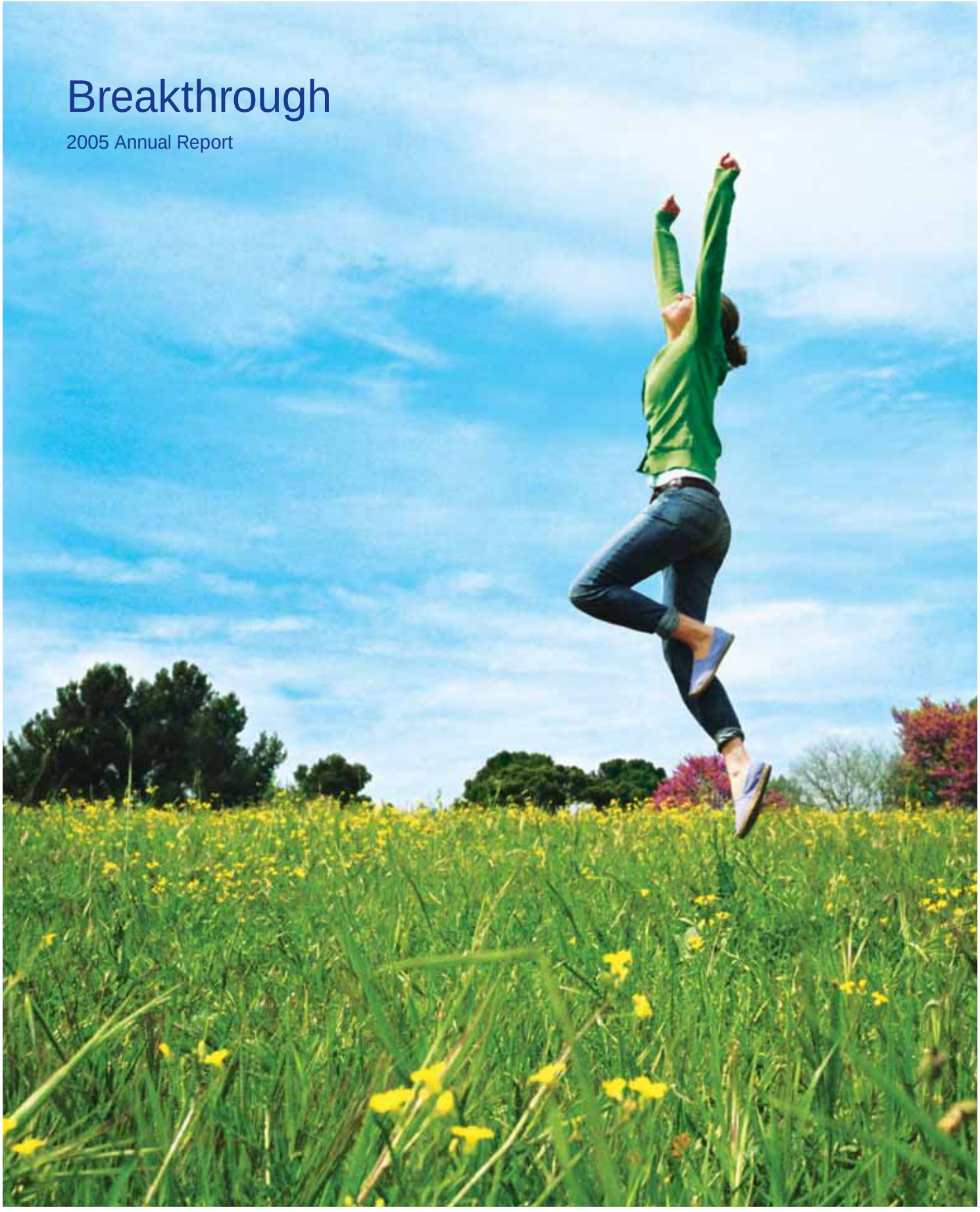
NEKTAR®

Breakthrough

2005 Annual Report



At Nektar, our mission is to develop breakthrough therapeutics that make a difference in patients' lives.

Exubera,® the world's first approved inhaled insulin product, is a medical breakthrough for diabetes patients. It was pioneered by Nektar and developed in partnership with Pfizer Inc.

The world's leading pharmaceutical and biotechnology companies have turned to Nektar for over 10 years to tap into our drug delivery expertise. Our technology and know-how have enabled nine approved products for our partners, several reaching blockbuster status for them.

Now we are using that technology and know-how for ourselves. We are in the early stages of developing our own portfolio of proprietary products that have the potential to be medical breakthroughs in their own right — for life-threatening conditions such as serious lung infections.

We believe the elements we have in place today will give Nektar the ability to break through to the next phase of our growth as a biopharmaceutical company.

We're addressing critical unmet medical needs using our strengths in drug delivery.

15 million
newly diagnosed diabetes patients in the U.S. in 2005 (above 20 years old)[1]

300 million
people worldwide expected to have diabetes by the year 2025 according to WHO[2]

$2.5 billion
in U.S. hospital costs are caused by ventilator-associated pneumonia[3]

Over 50%
Mortality rate in severely immunosuppressed patients with documented fungal lung infections[4]

Sources (from left to right): (1) American Diabetes Association, National Diabetes Fact Sheet, 2005 (2) World Health Organization, 2000
(3) Rello et al. Chest 2002; 122 (6): 215-21; AMR 2004 (4) Lin et al., Aspergillosis Case-Fatality Rate: Systematic Review of the Literature. Clinical Infectious Disease, 32: 358-366

We are at a unique juncture with the key elements in place to grow Nektar into a sustainable and profitable company.

To Our Fellow Stockholders:

This is truly an exciting time for our company. In January 2006, Exubera® (insulin human [rDNA origin]) Inhalation Powder, a medical breakthrough for diabetes patients, was approved in both the U.S. and the European Union in a two-day period. Exubera® is a result of a successful 10-year partnership between Nektar and Pfizer, the world's largest pharmaceutical company. With Exubera®, there are now nine products approved that leverage Nektar's leading drug delivery technologies.

I am proud of our achievements in the past year, but what excites me most is what lies ahead for Nektar. We are at a unique juncture with the key elements in place to grow Nektar into a sustainable, profitable company:

- Exubera® is soon to be launched by our partner Pfizer, and it has the potential to provide us with a substantial revenue stream;
- We have proven technologies that have enabled approved products, several of which reached blockbuster status for our partners;
- We're in the early stages of developing our own proprietary products that have the potential to unlock the value of our technologies and human capital for ourselves; and
- Our financial position is strong, and we believe that we can achieve profitability without additional financing.

We intend to capitalize on this unique position to break through to the next stage of our evolution as a biopharmaceutical company.

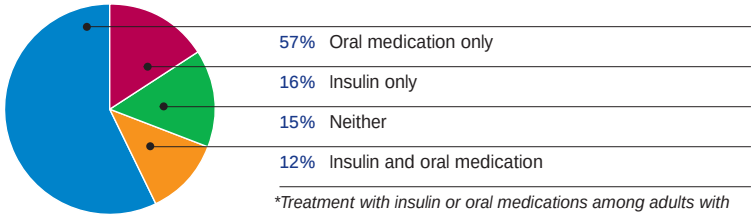
The Exubera® opportunity As the world's first approved inhaled insulin, Exubera® is an important advancement in the treatment of diabetes that could help adult patients manage their disease. Pfizer has announced its intent to launch Exubera® by mid-2006. We will receive revenues from commercialization of Exubera® from two sources – first, on manufacturing of Inhalers and processing of insulin powder and second, with royalties on Exubera® sales by Pfizer. Exubera® will be the key driver of our revenue growth and our ability to achieve profitability.

To support our manufacturing role in the commercialization of Exubera,® we have built a state-of-the-art powder processing facility at our headquarters in San Carlos, California, and we have two leading contract manufacturers in place to produce the Inhalers.

Diabetes is a growing worldwide epidemic. The World Health Organization predicts that over 300 million people are expected to have diabetes by the year 2025. This number is staggering. A sad fact is that even though there are many therapies available, millions of patients don't achieve or maintain acceptable blood sugar levels, which can lead to fatal complications from the disease. The human and economic cost of the disease is enormous. Exubera® is an innovative therapy that provides an alternative for the control of high blood sugar levels and can help to improve management of the disease.

14.6 million

diagnosed diabetes patients in the U.S., 2001-2003*



Treatment with insulin or oral medications among adults with diagnosed diabetes — (ADA National Diabetes Fact Sheet, 2005)

Developing our own portfolio of proprietary products Our strategy to develop our own portfolio of proprietary products will allow us the opportunity to capture increased value from our technologies. Partnering and licensing technologies is an excellent way to build strong technology platforms. This strategy has also provided Nektar with considerable revenue opportunities while creating successful products for our partners. However, we believe we can capture even more economic value from our technologies by advancing our own products through clinical development. Combining established medicines with our technologies to create innovative therapies gives us the opportunity to develop products less expensively and with a potentially higher success rate than is typical for new chemical entities.

Our first two proprietary programs are focused on treating and preventing lung infections and leverage our pulmonary technologies and expertise. These two products represent future potential breakthroughs in their own right to meet medical needs. They are also both hospital-based products that could be commercialized with a small specialty sales force. This gives us the option to evaluate whether the economics are right for Nektar to potentially commercialize these products ourselves or seek co-development or promotion partners for the products.

Our first product under development, amphotericin B inhalation powder, is designed to address a serious fungal lung infection that can occur in patients who are severely immunosuppressed during treatment for acute leukemias and organ or bone marrow transplants. This infection, known as aspergillosis, typically begins in the lungs but it can spread quickly causing organ failure and potentially death. Amphotericin B is the gold standard for treatment today, but in its current form as an intravenous therapy it has dose-limiting systemic toxicities, which may limit its effectiveness. The need for more effective and well-tolerated therapies gives us an opportunity to address a major medical need using Nektar pulmonary delivery. By delivering targeted doses of medicine to the lung directly, we could potentially prevent these fatal infections and not expose patients to typical systemic toxicities seen with intravenous therapies.

Inhaled amphotericin B has demonstrated promising early results in Phase I trials. The product has U.S. orphan drug designation which has the potential of providing us a seven-year period of exclusive marketing for the designated indication.

Inhaled antibiotics, our second proprietary program, is under development for treatment of serious hospital pneumonias in ventilated patients. Hospital-acquired pneumonias caused by multi-drug resistant bacteria have a high mortality rate of 25-50 percent. They are also a major cause of higher treatment costs and longer hospital stays for patients in intensive care units. Current IV treatments are often ineffective because of the inability of the drug to pass from the bloodstream to the lung in sufficient concentrations to treat the infection. They can also have dose-limiting systemic side effects. With our proprietary liquid aerosol delivery system, our goal is to deliver an effective dose of antibiotics to the infection directly without systemic side effects. The Inhaled antibiotics program is in Phase II trials.

In addition to our two anti-infective programs, we also have additional proprietary programs that are in preclinical stages. One is in the pain-related area and the other is in oncology; both use our PEGylation technology. Our objective in 2006 is to advance at least one of these programs into the clinic.

Our partner pipeline continues to advance We believe the rest of our partner pipeline beyond Exubera® could provide us, collectively, with a considerable revenue stream in the future. We have two late-stage partner products expected to be filed for FDA approval within the next 18 months – Roche's CERA for renal anemia and Chiron's Tobramycin inhalation powder for lung infections in cystic fibrosis patients. Cimzia™, a product that uses our PEGylation technology, was recently filed for marketing approval with the FDA by our partner UCB for the treatment of Crohn's Disease. If approved, Cimzia would be the first-ever biologic utilizing subcutaneous injection to treat Crohn's. This molecule is also in UCB clinical trials to evaluate it as a treatment for rheumatoid arthritis and psoriasis.

In the future, even as we advance development of our own proprietary programs, partnering will continue to be important for us. However, the nature of new collaborations will change for Nektar – we will still seek to partner our technologies when we can generate significant future economic value for the company, and we also could enter into strategic partnerships to co-develop or promote products in our proprietary pipeline.

In Summary Nektar is in an extremely attractive position today – a potential blockbuster product we pioneered is approved and near launch; we have a broad pipeline of proprietary and partner products enabled by our leading edge technology platforms; we ended the year with $566 million in cash; and we have a strong team in place and are continuing to strengthen our organization in the areas of clinical development and regulatory.

In short, we are in a good position to grow Nektar into a sustainable, profitable company and deliver increased stockholder value. Our challenge as we grow will be to balance our revenue stream with investment in clinical development of our own products while reaching sustainable profitability.

In March, I expanded my Executive Chairman role and took over as President and CEO when Ajit Gill retired. I am privileged to lead the company during this exciting time in our history. I would like to thank Ajit for his 14 years of contributions to Nektar and for the leadership he provided in broadening the technology base of Nektar, moving us into proprietary products, and gaining approval of Exubera.® As part of my Acting CEO role, one of my key objectives is to identify a new CEO for Nektar who has the experience, leadership skills and vision to advance us to the next stage as a biopharmaceutical company. I am confident that we are in a great position to attract an outstanding person to lead us forward.

I would like to thank the many employees of Nektar who demonstrate their commitment every day to delivering on our mission to develop breakthrough products that improve the quality of patients' lives. It is their hard work and perseverance that created the strong company we have in place today. Their contributions will continue to make an enormous difference for people around the world.

Thank you also to our partners and our stockholders for continued commitment to Nektar and its future.

Robert B. Chess
Acting President and Chief Executive Officer,
Chairman of the Board
April 14, 2006

Key events of 2005 and early 2006

2005	January	Nektar and Bayer sign collaboration to develop inhaled Ciprofloxacin for infections in cystic fibrosis patients
		Macugen® (pegaptanib sodium), a product to treat age-related macular degeneration enabled by Nektar PEGylation technology, launches in the U.S.
		Nektar and Zelos sign collaboration to develop inhaled parathyroid hormone therapy for osteoporosis
	March	New Drug Application (NDA) for Exubera® (insulin human [rDNA origin]) Inhalation Powder is accepted for filing by the Food and Drug Administration (FDA)
	June	Results from three two-year studies presented by Pfizer at 65th Annual Scientific Sessions of the American Diabetes Association (ADA) show that Exubera® provided effective, sustained glycemic control and was well tolerated over a two-year period in adults with type 2 diabetes
	August	Nektar announces agreement to acquire Aerogen (closes in October 2005)
	September	FDA Advisory Committee recommends approval of Exubera®
		Nektar sells $315 million aggregate principal amount of 3.25% convertible subordinated notes due 2012
		Baxter and Nektar sign collaboration to develop PEGylated therapeutic forms of blood clotting proteins for patients with hemophilia
		Nektar announces two inhaled proprietary products under development that target lung infections
	October	Chiron and Nektar announce the start of a Phase III clinical program to evaluate Tobramycin inhalation powder (TIP) for lung infections in cystic fibrosis patients
		Exubera® receives positive opinion from Committee for Medicinal Products for Human Use (CHMP) in European Union for treatment of adults with type 1 and type 2 diabetes
	December	Nektar presents pre-clinical data demonstrating improved survival of immunosuppressed animals protected against pulmonary fungal infections by amphotericin B inhalation powder at the 45th Annual Interscience Conference on Antimicrobial Agents and Chemotherapy (ICAAC) in Washington, D.C.; Nektar begins enrolling final multi-dose pre-pivotal clinical study of amphotericin B inhalation powder
2006	January	Pfizer announces intent to acquire sanofi-aventis worldwide rights to Exubera® (closes March 2006)
		New SVP, Finance & CFO, Louis Drapeau, joins Nektar
		European Commission approves Exubera® for treatment of adult type 1 and type 2 diabetes
		FDA approves Exubera,® the first inhalable form of insulin, for adult type 1 and type 2 diabetes
	February	Nektar CEO retires; Rob Chess, Executive Chairman, named Acting President and CEO
		Nektar announces that FDA grants U.S. orphan drug designation to amphotericin B inhalation powder, a Nektar proprietary product under development to prevent life-threatening pulmonary fungal infections
		Phase II trials under way for Nektar inhaled antibiotics product for the treatment of pneumonia in mechanically-ventilated patients
		Nektar presents results from Phase I clinical study of amphotericin B inhalation powder at the *2nd Advances Against Aspergillosis* conference in Athens, Greece

$132 billion

Annual healthcare costs in the U.S. associated with diabetes and its complications[1]

(1) American Diabetes Association

"Exubera® is a major, first-of-its-kind, medical breakthrough that marks another critical step forward in the treatment of diabetes, a disease that has taken an enormous human and economic toll worldwide."

— Hank McKinnell, Chairman and Chief Executive Officer, Pfizer Inc

A new era in diabetes treatment

Exubera® (insulin human [rDNA origin]) Inhalation Powder is approved in the U.S. and the EU for adults with type 1 and type 2 diabetes.(1)

Nektar developed the inhaler and the powder insulin formulation for Exubera.® Our partner, Pfizer, will be responsible for marketing and promoting Exubera® worldwide.

Exubera® is a rapid-acting, dry powder human insulin that is inhaled through the mouth into the lungs prior to eating, using the handheld Exubera® Inhaler. The Exubera® Inhaler weighs four ounces and, when closed, is about the size of an eyeglass case. The unique Exubera® Inhaler produces a cloud of insulin powder in a clear chamber visible to the patient. This insulin powder is designed to pass rapidly into the bloodstream to regulate the body's blood sugar levels.

Exubera® is a result of an innovative partnership between Nektar Therapeutics and Pfizer Inc. We pioneered the product and developed the core technologies used for Exubera,® including the formulation and particle engineering for the insulin powder, the filling and packaging techniques for the insulin blister, and the Exubera® Inhaler with its components. Pfizer manufactures and sells Exubera.® Nektar supports manufacturing including powder processing for Exubera® insulin, and manufactures the Exubera® Inhalers.

As part of our agreement with Pfizer, Nektar receives royalties on sales of Exubera® by Pfizer and revenue for the manufacture of the insulin powder and the Exubera® Inhalers.

In Pfizer studies, patients preferred Exubera® to insulin injections or diabetes pills The efficacy and safety profile of Exubera® was studied by Pfizer Inc in more than 2,500 adults with type 1 or type 2 diabetes for an average duration of 20 months. Exubera® was found in clinical trials to be as effective as short-acting insulin injections, and to significantly improve blood sugar control when added to diabetes pills. In clinical trials, many patients using Exubera® reported greater treatment satisfaction than patients taking insulin by injection. Significantly more patients who used both Exubera® and insulin injections or diabetes pills reported an overall preference for Exubera.®

The burden of diabetes in the U.S. and Europe Nearly 21 million Americans and 48 million Europeans have diabetes.(2) Despite existing therapies for diabetes, millions of patients don't achieve or maintain acceptable blood sugar levels. Complications from uncontrolled or poorly controlled blood sugar levels in diabetes patients can include heart disease, amputation, blindness and kidney failure.

In type 2 diabetes, which represents 95 percent of patients, the body does not make or use insulin well enough to manage blood sugar levels. Type 2 diabetes progresses over time, and eventually most patients will need to administer insulin to achieve blood sugar control. In type 1 diabetes, the body does not make insulin at all. These patients must take insulin to survive.

(1) Exubera® is a registered trademark of Pfizer Inc
(2) American Diabetes Association, World Health Organization

Focusing on life-threatening lung infections

We are working on innovative inhaled medicines designed to target disease directly at the site of infection to save lives.

Nektar has built expertise in the area of inhaled anti-infectives with our partnered programs. For example, we are currently partnered with Chiron to develop a new inhaled antibiotic therapy, tobramycin inhalation powder (TIP), for lung infections in cystic fibrosis (CF) patients (pictured at right). The investigational drug-device combination may significantly reduce the treatment burden for CF patients by offering full portability and a short drug administration time. TIP entered Phase III trials in October 2005.

We are in the early stages of development of two proprietary inhaled anti-infective products designed to prevent and treat fatal lung infections by overcoming the challenge of effective and safe delivery of established anti-infectives. One of the biggest limitations to current standards of care for lung infections is the inability to get a sufficient concentration of medicine to the lungs when administering it intravenously or orally. Since the systemic side effects of these medicines are considered toxic, the method of delivery itself is dose-limiting; this can reduce the effectiveness of these medicines.

Focusing on fatal fungal infections in immunosuppressed patients Immunosuppressed patients that receive organ or stem cell transplants or chemotherapy or radiation therapy for hematologic malignancies often develop a fatal fungal infection that begins in the lungs and then spreads throughout the body. This infection, known as aspergillosis, is caused by the inhalation of fungal spores found in the air. We estimate that more than 150,000 patients in the U.S. and Europe are at risk annually of developing these fungal infections, which have high mortality rates and costs of treatment. For cancer or leukemia patients, a secondary diagnosis of aspergillosis resulted, on average, in a 26-day longer hospital stay, $115,262 more in total costs (in 1996 health care dollars) and more than four times the mortality rate.[1]

Nektar's amphotericin B inhalation powder uses our small proprietary inhaler to deliver our dry powder formulation of the broad spectrum, "gold-standard" antifungal drug, amphotericin B. Nektar's unique delivery mode was designed to encourage long-term compliance and to deliver a cost-effective product to prevent fungal lung infections in immunosuppressed patients. Our approach delivers amphotericin B directly to the potentially vulnerable organ, the lungs, through inhalation, in the same manner that the fungal spores are deposited, and so it could represent a potential breakthrough in prevention of deadly aspergillosis infections. In February 2006, we announced the therapy was granted U.S. orphan drug designation. The Orphan Drug Act provides a seven-year period of exclusive marketing to the first sponsor who obtains marketing approval for a product in a designated indication. The program has completed preclinical and Phase I safety trials in humans. One trial is ongoing to prepare the product for pivotal trials.

Targeting hospital pneumonias in patients on ventilators Patients with hospital-acquired pneumonia (HAP) that need mechanical ventilation or patients on ventilators who contract ventilator-associated pneumonia (VAP) have high morbidity and mortality rates, in spite of available broad spectrum intravenous antibiotics to treat these infections. It is estimated that 3.5 million patients in U.S. hospitals each year are diagnosed with pneumonia; of these cases, up to 250,000 are on mechanical ventilators.[2] Our Inhaled antibiotics program is designed to treat pneumonias in this difficult-to-treat ventilated patient population.

Initially, our first antibiotic product will focus on adjunctive treatment of gram negative pneumonias in patients on and off mechanical ventilation. Gram negative bacilli account for greater than 60 percent of all hospital-acquired pneumonias and can have a mortality rate of 25-50 percent.[3] Our new proprietary delivery system from the acquisition of Aerogen in late 2005, is designed to deliver a highly-efficient dose of aerosolized antibiotics into a ventilator system. A Phase II trial for the Inhaled antibiotics program is in progress.

Our proprietary products strategy leverages Nektar technologies and know-how to develop products that offer better efficacy, safety and/or ease-of-use. We are also working on two additional products that are in preclinical testing using Nektar PEGylation technology in the disease settings of pain and oncology.

(1) Dasbach et al. 2000, Clin. Infect. Dis. 31:1524-8
(2) Arlington Medical Resources, Inc., The Hospital Antibiotic Market Guide, 2004
(3) Gaynes et al. 2005, Health Care Epidemiology and Merck.com

A proprietary pipeline focused on serious and life-threatening medical needs

	Product	Indications
Phase II	Inhaled Antibiotics	Treatment of pneumonia in ventilated patients
Phase I	Amphotericin B inhalation powder	Prevention of pulmonary aspergillosis
Pre-clinical	Undisclosed (PEG)	Pain-related
	Undisclosed (PEG)	Oncology

20+

pharmaceutical and biotechnology companies have turned to us to collaborate on new products

"Our collaboration with Nektar, the clear leader in PEGylation technology…reflects our strategic approach to gaining access to leading technologies through targeted partnerships that can expedite and enhance product development."

— Joy Amundson, President of Baxter BioScience

Partnering to deliver innovative therapeutics

Nektar is collaborating with top-tier pharmaceutical companies to bring category-leading products to market.

In 2005, we entered into three collaborations with new partners. In our new partnership with Bayer HealthCare, we are working to develop an inhalable powder formulation of a novel form of Ciprofloxacin to treat chronic lung infections caused by *Pseudomonas aeruginosa* in cystic fibrosis patients. With Baxter BioScience, we are collaborating to develop PEGylated therapeutic forms of blood clotting proteins for patients with hemophilia. Finally, in 2005, we also entered into an agreement with Zelos Therapeutics to work on an inhaled parathyroid hormone therapy for osteoporosis patients.

These new partnerships add to the deep partner pipeline that Nektar has built with pharmaceutical and biotechnology companies to provide our pulmonary or PEGylation technologies for the development of new products. Many of our partner programs advanced through late-stage clinical milestones in 2005 and early 2006: Chiron's TIP entered Phase III trials, UCB filed a U.S. Biologics Licensing Application for Cimzia,™ a unique PEGylated antibody fragment and Macugen® was approved in the European Union for the treatment of age-related macular degeneration.

Select Nektar Partnered Programs

Product	Partner	Indications
Approved or Filed in the U.S. and/or EU		
Exubera® (insulin human [rDNA origin]) Inhalation Powder	Pfizer Inc	Adult type 1 and type 2 diabetes
Neulasta® (pegfilgrastim)	Amgen Inc.	Neutropenia
PEGASYS® (peginterferon alfa-2a)	Hoffmann-La Roche Ltd.	Hepatitis-C
Somavert® (pegvisomant)	Pfizer Inc	Acromegaly
PEG-INTRON® (peginterferon alfa-2b)	Schering-Plough Corporation	Hepatitis-C
Definity® (PEG)	Bristol-Myers Squibb Company	Cardiac imaging
Macugen® (pegaptanib sodium injection)	OSI Pharmaceuticals (Eyetech)	Age-related macular degeneration
Cimzia™ (certolizumab pegol, CDP870)	UCB Pharma	Crohn's disease (filed in U.S.); rheumatoid arthritis (Phase III)
Phase III		
CERA (Continuous Erythropoiesis Receptor Activator)	Hoffmann-La Roche Ltd.	Renal anemia
Tobramycin inhalation powder (TIP)	Chiron Corporation	Lung infections in cystic fibrosis patients
Phase II		
Macugen® (pegaptanib sodium injection)	OSI Pharmaceuticals (Eyetech)	Diabetic macular edema
Pulmonary dronabinol (dronabinol metered dose inhaler)	Solvay Pharmaceuticals, Inc.	Migraine (with and without aura)
CDP 791 (PEG-antibody fragment angiogenesis inhibitor)	UCB Pharma	Cancer

This pipeline does not include PEG-hydrogel product collaborations.
Status definitions are as follows:
Approved — *regulatory approval to market and sell product obtained in the U.S. or EU*
Phase III or Pivotal — *product in large-scale clinical trials conducted to obtain regulatory approval to market and sell a drug Typically, these trials are initiated following encouraging Phase II trial results.*
Phase II — *product in clinical trials to establish dosing and efficacy in patients*

2005 Financial Review

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Selected Consolidated Financial Information

The selected consolidated financial data set forth below should be read together with the consolidated financial statements and related notes, "Management's Discussion and Analysis of Financial Condition and Results of Operations," and the other information contained herein. (In thousands, except per share information)

Years ended December 31,	2005	2004	2003	2002	2001
Statement of Operations Data:					
Revenue:					
Contract research revenue	$ 81,602	$ 89,185	$ 78,962	$ 76,380	$ 68,899
Product sales	29,366	25,085	27,295	18,465	8,569
Exubera commercialization readiness	15,311	—	—	—	—
Total revenue	126,279	114,270	106,257	94,845	77,468
Total operating costs and expenses	308,912	188,212	171,012	193,658	333,213
Loss from operations[2]	(182,633)	(73,942)	(64,755)	(98,813)	(255,745)
Gain (Loss) on debt extinguishment	(303)	(9,258)	12,018	—	—
Interest and other income (expense), net	(2,312)	(18,849)	(12,984)	(8,655)	5,737
Benefit (provision) for income taxes	137	163	(169)	—	—
Net loss	$ (185,111)	$ (101,886)	$ (65,890)	$ (107,468)	$ (250,008)
Basic and diluted net loss per share[1]	$ (2.15)	$ (1.30)	$ (1.18)	$ (1.94)	$ (4.71)
Shares used in computation of basic and diluted net loss per share[2]	85,915	78,461	55,821	55,282	53,136

Years ended December 31,	2005	2004	2003	2002	2001
Balance Sheet Data:					
Cash, cash equivalents and investments	$ 566,423	$ 418,740	$ 298,409	$ 293,969	$ 345,077
Working capital	450,248	223,880	223,971	136,424	180,547
Total assets	858,554	744,921	616,788	606,638	667,241
Long-term debt (excluding current portion)	42,086	45,860	43,642	35,021	37,130
Convertible subordinated notes and debentures	417,653	173,949	359,988	299,149	299,149
Accumulated deficit	(902,232)	(717,121)	(615,235)	(549,345)	(441,877)
Total stockholders' equity	326,811	467,342	164,191	206,770	270,313

(1) Basic and diluted net loss per share is based upon the weighted average number of common shares outstanding. The shares shown above retroactively reflect a two-for-one split, effective August 22, 2000.

(2) We changed our method of accounting for goodwill and other intangible assets on January 1, 2002 in connection with the adoption of SFAS No. 142, *Goodwill and Other Intangible Assets.*

The following discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this section as well as in Item 1A of Part I of the Annual Report on Form 10-K filed with the Securities and Exchange Commission under the heading "Risk Factors."

OVERVIEW

We are a biopharmaceutical company developing breakthrough products that make a difference in patients' lives. We create differentiated, innovative products by applying our drug delivery technologies to established or novel medicines. Our leading technologies are Nektar Pulmonary Technology and Nektar Advanced PEGylation Technology. To date, there have been nine products which have received regulatory approval in the U.S. or EU.

We create or enable breakthrough products in two ways. First, we develop products in collaboration with pharmaceutical and biotechnology companies that seek to improve and differentiate their products. Second, we apply our technologies to established medicines to create and develop our own differentiated, proprietary products. Our proprietary products are designed to target serious diseases in novel ways. We believe our proprietary products have the potential to raise the standards of current patient care by improving efficacy, safety, and/or ease-of-use.

The commercial success of Exubera® will be the key driver of our business in the next several years. We expect our future revenues to come increasingly from the manufacture and sale of Exubera® Inhalers and powdered insulin, and royalties from end product sales by Pfizer Inc. The commercial success of Exubera® will be a significant factor in achieving our profitability objective and our ability to fund the key elements of our business strategy. In addition, we expect to receive substantially less contract research and commercialization readiness revenue from Pfizer Inc as Exubera® transitions to the commercialization phase and therefore revenues from commercialization sales of Exubera® will be required to replace those revenue sources. Like any product in the pre-launch phase, there are a number of uncertainties that remain, including the timing and success of the commercial launch of Exubera® by Pfizer Inc, physician and patient education and experiences, third party payor reimbursement, country specific pricing approvals, manufacturing and supply execution, and other risks and uncertainties identified in the annual report on Form 10-K filed with the Securities and Exchange Commission.

In addition, we plan to make significant investments in our proprietary product programs which will comprise a substantial portion of our research and development spending. Historically we have partnered with pharmaceutical and biotechnology companies in the early development phase which has helped fund the investment of our product programs. Our strategy is to develop a portfolio of proprietary products that are intended to address critical unmet medical needs by exploiting our know-how and technology in combination with established medicines. Our objective is to advance these products into clinical development and potentially through regulatory marketing approval thereby capturing significantly more economic value from these products. This strategy requires us to make significant investments in early stage products where there is still substantial uncertainty regarding product efficacy, product safety, clinical results, regulatory approvals, competitive landscape, and market acceptance. Our decision as to when or whether to seek partners for our proprietary products will be made on a product-by-product basis and such decisions will have an important impact on our revenues, research and development spending, and financial position. While we believe this strategy may result in improved economics for any products ultimately developed and approved, it will require us to invest significant funds in developing these products without reimbursement from a collaborative partner.

We will continue to seek collaborative arrangements with pharmaceutical and biotechnology companies. Our partnering strategy enables us to develop a large and diversified pipeline of drug products using our technologies. As we continue to shift our focus towards our proprietary products programs, we expect to engage in a fewer number of higher value partnerships in order to optimize revenue potential, probability of success, and overall return on investment. To date the revenues we have received from the sales of our partner products have been insufficient to meet our operating and other expenses. Other than revenues we expect to generate from Exubera®, we do not anticipate receiving sufficient amounts of revenue from other partner product sales or royalties in the near future to meet our operating expenses.

To fund the expense related to our research and development activities, we have raised significant amounts of capital through the sale of our equity and convertible debt securities. As of December 31, 2005, we had approximately $417.7 million in long-term convertible subordinated notes, $20.3 million in non-current capital lease obligations, and $21.8 million in other long-term liabilities. Our ability to meet the repayment obligations of this debt is dependent upon our and our partners' ability to develop, obtain regulatory approvals, and successfully commercialize products. Even if we are successful in this regard, we will likely require additional capital to repay our debt obligations.

RECENT DEVELOPMENTS

In July 2005, a complaint was filed by The Board of Trustees of the University of Alabama UAH against Nektar Therapeutics AL, Corporation, and Nektar Therapeutics in the United States District Court for the Northern District of Alabama. The complaint alleges patent infringement, breach of a contract royalty obligation, violation of the Alabama Trade Secrets Act, and unjust enrichment. In August 2005, UAH amended its complaint to add J. Milton Harris, a Nektar employee, as a party to the litigation, add certain additional claims, seek declaratory judgment on patents assigned to the Company, and seek compensatory, treble and punitive damages, all in unspecified amounts. In December 2005, UAH filed its second amended complaint expanding its previously asserted claims that the Company and Harris had infringed patents of UAH, misappropriated and taken intellectual property rightfully belonging to UAH, concealed intellectual property from UAH that was rightfully the property of UAH, and converted these discoveries for their own profit notwithstanding that the Company and Harris were fully aware that the inventions rightfully belonged to UAH.

UAH further claimed fraudulent concealment, conversion, detinue, misrepresentation, conspiracy, and, as against Harris, breach of express and implied contract and breach of an assignment of application. UAH is seeking equitable relief including declaratory judgment, the imposition of a constructive trust, specific performance, injunction, accounting and other relief on the theory that UAH should be the record holder of certain patent's assigned to the Company. We have filed and continue to assert a counterclaim against UAH seeking full refund of all royalty payments erroneously paid to UAH under the patent at issue in the original complaint. The litigation is at too early a stage to make an assessment about the probability of the outcome in the case. We intend to vigorously defend ourselves in this litigation, however, there can be no assurances that we will be successful in such defense.

In September 2005 we announced an agreement with subsidiaries of Baxter International Inc. to develop PEGylated therapeutic forms of blood clotting proteins for hemophilia A patients, in order to reduce the frequency of injections required to treat blood clotting disorders in such as hemophilia A. Baxter will be responsible for the development and commercialization of products and we will be responsible for the technology development used in the products including the provision of clinical and commercial PEG reagents. Under the terms of the agreement, we will receive milestone payments, funding of R&D, and manufacturing revenues during research, clinical development, and commercialization. In addition, we will receive royalties on end product sales.

In September 2005, we announced that we are developing an inhaled Amphotericin B product for preventing fatal pulmonary fungal infections in immunosuppressed patients to reduce the incidence, morbidity, mortality and high cost of treating these infections. We have conducted two Phase I trials for ABIP and have long-term toxicity studies underway to support pivotal trials that we plan to initiate in 2007.

In September 2005, we also announced that we are developing inhaled ICU antibiotics for the prevention of ventilator-associated pneumonia in the intensive care unit. Following the acquisition of Aerogen in October 2005, we combined our Inhaled ICU antibiotics program, which was in proof-of-concept for prevention of ventilator-associated pneumonia, with Aerogen's ongoing Phase II program that uses aerosolized amikacin to treat hospital pneumonias. The new combined program will focus on adjunctive treatment of gram-negative pneumonias in patients on mechanical ventilation. A Phase II trial for our Inhaled antibiotics program is underway.

In October 2005, we announced the initiation of clinical testing in the Phase III program evaluating TIP, an investigational inhaled antibiotic being developed in collaboration with Chiron. The TIP Phase III program includes two clinical trials and will evaluate the efficacy and safety of TIP in the treatment of lung infections caused by Pseudomonas aeruginosa in patients living with cystic fibrosis (CF). The first trial, called ASPIRE I, is currently underway.

In October 2005, we completed the acquisition of Aerogen pursuant to a definitive agreement and plan of merger dated August 12, 2005. The total purchase price for the transaction was approximately $34.5 million, including $32.1 million in cash consideration, plus expenses associated with the transaction and liabilities incurred by us resulting from the transaction. We expensed approximately $7.9 million of in process research and development expenses which were allocated from the purchase price in the year ended December 31, 2005. We believe that the acquisition of Aerogen will broaden the Nektar Pulmonary Technology portfolio and strengthen capabilities for treatment in the acute care setting.

On January 19, 2006, we announced that Louis Drapeau was appointed as our Senior Vice President, Finance and Chief Financial Officer and concurrently therewith Ajay Bansal resigned as Chief Financial Officer, and Vice President, Finance and Administration.

On January 26, 2006, Pfizer Inc announced that the European Commission approved Exubera® (inhaled human insulin) for the treatment of adults with Type 1 and Type 2 diabetes.

On January 27, 2006, Pfizer Inc and the FDA announced that Exubera (insulin human [rDNA origin]) Inhalation Powder had been approved by the FDA for the treatment of adults with Type 1 and Type 2 diabetes.

On February 7, 2006, we announced that Ajit S. Gill will be retiring and resigning as CEO, President, and Director, effective as of March 17, 2006. On February 24, 2006, Robert B. Chess, our current Executive Chairman and former CEO, was appointed as interim President and CEO, effective as of March 17, 2006.

On February 14, 2006, we announced the FDA had granted orphan drug designation for our proprietary product ABIP. Orphan products are developed to treat diseases or conditions that affect fewer than 200,000 people in the U.S. The Orphan Drug Act provides a seven-year period of exclusive marketing to the first sponsor who obtains marketing approval for a designated indication for the orphan drug.

On March 2, 2006, UCB announced that it had submitted a Biologics Licensing Application to the FDA for the approval of Cimzia™ (certolizumab pegol, CDP870) for the treatment of patients with Crohn's disease.

During 2005, we announced new collaborative agreements separately with Bayer HealthCare LLC, Baxter International Inc, and Zelos Therapeutics Inc. These collaborations are for various products that use our technologies and intellectual property and are in early stages of development.

RECENT ACCOUNTING PRONOUNCEMENTS

In November 2005, the FASB released FASB Staff Position ("FSP") No. FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." This FSP, effective January 1, 2006, provides accounting guidance regarding the determination of when an impairment of debt and equity securities should be considered other-than-temporary, as well as the subsequent accounting for these investments. The adoption of this FSP is not expected to have a material impact on our financial position or results of operations.

In May 2005, the Financial Accounting Standards Board ("FASB") released Statement of Financial Accounting Standard ("SFAS") No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3,* ("FAS 154"). FAS 154 requires retrospective application to prior periods' financial statements for any change in accounting principle, unless it is impracticable to determine either the period-specific

effects or the cumulative effect of the change. The statement defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. The statement also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate affected by a change in accounting principle. The statement carries forward without change the guidance contained in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. We will be required to adopt FAS 154 for any accounting changes or corrections of errors on or after January 1, 2006. We do not expect the adoption of FAS 154 to have a material impact on our consolidated financial position, results of operations, or cash flows.

In March 2005, the SEC released Staff Accounting Bulletin (SAB) 107, "Share Based Payment" which provides the SEC staff position regarding the application of SFAS No. 123R. SAB 107 contains interpretative guidance related to the interaction between SFAS No. 123R and certain SEC rules and regulations, as well as provides the Staff's views regarding the valuation of share-based payment arrangements for public companies. SAB 107 also highlights the importance of disclosures made related to the accounting for share-based payment transactions. We are currently reviewing the effect of SAB 107 on our condensed consolidated financial statements as we prepare to adopt SFAS 123R.

In December 2004, the Financial Accounting Standards Board ("FASB") released a revision to Statement of Financial Accounting Standard ("SFAS") No. 123, *Accounting for Stock-Based Compensation* ("FAS 123R"). FAS 123R addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, Accounting for Stock Issued to Employees, and generally would require instead that such transactions be accounted for using a fair-value-based method. We have adopted FAS 123R commencing on January 1, 2006, and we expect that the adoption will have a material impact on our consolidated results of operations and loss per share in 2006. We have elected to use the Black-Scholes Model for valuing our share-based payments. We have also elected to follow the prospective adoption method when adopting SFAS 123R. We believe that the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004.* Also in December 2004, the FASB issued FASB Staff Position No. FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs* Creations Act of 2004. We do not expect the adoption of these new tax accounting standards to have a material impact on our consolidated financial position, results of operations, or cash flows.

In November 2004, the FASB released SFAS No. 151, *Inventory Costs—An Amendment to ARB No. 43.* This Statement amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" as defined by ARB No. 43, Chapter 4, *Inventory Pricing*. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. We will be required to adopt SFAS No. 151 for the reporting period ending March 31, 2006. We are currently in the process of evaluating the effect of adopting SFAS No. 151.

CRITICAL ACCOUNTING ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the U.S. It 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. Management has discussed the development, selection, and disclosure of each of the following critical accounting estimates with the audit committee.

Stock Based Compensation

In December 2004, the Financial Accounting Standards Board released a revision to SFAS No. 123, *Accounting for Stock-Based Compensation* ("FAS 123R"). FAS 123R addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, Accounting for Stock Issued to Employees, and instead would generally require that such transactions be accounted for using a fair-value-based method. We have adopted FAS 123R for all periods ending on or after January 1, 2006. As a result of our adoption of FAS 123R, we will have to recognize substantially more compensation expense. This will have a material adverse impact on our financial position and results of operations.

For periods ending on or prior to December 31, 2005, we applied the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations in accounting for those plans. Under this opinion, no stock-based employee compensation expense was charged for options that were granted at an exercise price that

was equal to the market value of the underlying common stock on the date of grant. Stock compensation costs were immediately recognized to the extent the exercise price is below the fair value on the date of grant and no future vesting criteria exist.

For stock awards issued below our market price on the date of grant, we recorded deferred compensation representing the difference between the price per share of stock award issued and the fair value of the Company's common stock at the time of issuance or grant, and we amortized this amount over the related vesting periods on a straight-line basis.

Pro forma information regarding net income and earnings per share required by SFAS 123, as amended by SFAS 148, regarding the fair value for employee options and employee stock purchase plan shares was estimated at the date of grant using a Black-Scholes option valuation model with the following weighted-average assumptions:

	2005	2004	2003
Risk-free interest rate	4.0%	3.3%	2.8%
Dividend yield	0.0%	0.0%	0.0%
Volatility factor	0.710	0.707	0.744
Weighted average expected life	4.5 years	5 years	5 years

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. We have presented the pro forma net loss and pro forma basic and diluted net loss per common share using the assumptions noted above.

The following table illustrates the effect on net loss and net loss per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation (in thousands, except per share information):

Years ended December 31,	2005	Revised 2004	Revised 2003
Net loss, as reported	$(185,111)	$(101,886)	$(65,890)
Add: stock-based employee compensation included in reported net loss	1,854	1,423	878
Deduct: total stock-based employee compensation expense determined under fair value methods for all awards	(21,986)	(25,183)	(27,468)
Net loss, pro forma	$(205,243)	$(125,646)	$(92,480)
Net loss per share			
Basic and diluted, as reported	$ (2.15)	$ (1.30)	$ (1.18)
Basic and diluted, pro forma	$ (2.39)	$ (1.60)	$ (1.66)

The revised reported pro forma net loss for the years ended December 31, 2004 and 2003 has been decreased by $6.0 million and $6.8 million, respectively, for options exchanged under stock option exchange programs and adjustments from computational corrections.

Cash, Cash Equivalents and Investments

We consider all highly liquid investments with a maturity at the date of purchase of three months or less to be cash equivalents. Cash and cash equivalents include demand deposits held in banks, interest bearing money market funds, commercial paper, federal and municipal government securities, and repurchase agreements.

Investments consist of: 1) auction rate securities with varying maturities, and 2) federal and municipal government securities, corporate bonds, and commercial paper with A1, F1, or P1 short-term ratings and A or better long-term ratings with remaining maturities at date of purchase of greater than 90 days. Investments with maturities greater than one year are classified as long-term and represent investments of cash that are reasonably expected to be realized in cash and are available for use, if needed, in current operations.

At December 31, 2005, all investments are designated as available-for-sale and are carried at fair value, with unrealized gains and losses reported in stockholders' equity as accumulated other comprehensive income (loss). Investments are adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included in interest income. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities, if any, are included in other income (expense). The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest income.

At December 31, 2005 and 2004, we had letter of credit arrangements with certain vendors including our landlord totaling $2.6 million and $2.2 million, respectively, which are secured by investments in similar amounts.

Impairment of Goodwill, Intangible Assets, and Other Long-Lived Assets

Goodwill is tested for impairment at least annually or on an interim basis if an event occurs or circumstances change that would more-likely-than-not reduce the fair value below our carrying value.

Goodwill is tested for impairment using a two-step approach. The first step is to compare our fair value to our net asset value, including goodwill. If the fair value of net assets is greater than our book value of net assets, goodwill is not considered impaired and the second step is not required. If the fair value is less than our net asset value, the second step of the impairment test measures the amount of the impairment loss, if any. The second step of the impairment test is to compare the implied fair value of goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, an impairment loss is recognized equal to that excess. The implied fair value of goodwill is calculated in the same manner that goodwill is calculated in a business combination, whereby the fair value is allocated to all of the assets and liabilities (including any unrecognized intangible assets) as if they had been acquired in a business combination and the fair value was the purchase price. The excess "purchase price" over the amounts assigned to assets and liabilities would be the implied fair value of goodwill.

The impairment tests for goodwill are performed at the business unit level, which we have identified as our pulmonary and proprietary business unit, our advanced pegylation technology business unit and our super critical fluids business unit.

We performed our annual impairment test for goodwill in October 2005 and determined at that time that the undiscounted cash flow from our long-range forecast for each respective business unit exceeded the carrying amount of the respective goodwill. In mid-December 2005 we were apprised of unfavorable results of clinical data related to programs from our super critical fluids business unit located in Bradford, England, (Nektar UK), which provided an indication that the fair value of the respective business units goodwill was below the carrying value. Therefore, in connection with our year end close process, we re-performed the impairment analysis of goodwill and other long lived assets for Nektar UK. We determined the fair value of the intangibles and other assets of Nektar UK based on a discounted cash flow model to be less than the carrying amount of goodwill and certain long lived assets. Based on management's assessment of the results of clinical data that became available in December 2005, and results of the discounted cash flow valuation as of December 31, 2005, we recorded an impairment charge to goodwill and long lived assets in the year ended December 31, 2005 in the amount of $59.6 million and $5.7 million, respectively. The remaining carrying value of goodwill, on a consolidated basis, at December 31, 2005 and 2004, is $78.4 million and $130.1 million, respectively.

In accordance with SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets,* we perform a test for recoverability of our intangible and other long-lived assets whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. An impairment loss would be recognized only if the carrying amount of an intangible or long-lived asset exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposal of the asset. Other than those long lived assets identified at Nektar UK, to date, there have been no events or changes in circumstances that would indicate that the carrying value of such assets in our other business units may not be recoverable, and therefore we have determined that there are no other impairments on our intangible and other long-lived assets, including capitalized assets related to Exubera®.

In assessing the recoverability of our intangibles and long-lived assets, we have concluded that there are no impairments in the carrying value of the remaining assets as of December 31, 2005. If this assessment changes in the future, we may be required to record impairment charges for these assets. The carrying value of our purchased intangibles as of December 31, 2005 and 2004 is $13.5 million and $6.5 million, respectively. These assets are scheduled to be fully amortized by December 2012. The carrying value of our other long-lived assets as of December 31, 2005 and 2004 is $156.6 million and $153.8 million, respectively.

Judgments Impacting Fixed Asset Capitalization for Exubera®

In accordance with SFAS 2, *Accounting for Research and Development Costs,* we have expensed certain amounts paid for plant design, engineering, and validation costs for the automated assembly line equipment that will be used in connection with the manufacture of the inhaler device for Exubera® because such costs have no alternative future use. The net credit of $0.2 million recorded in the year ended December 31, 2005 was the result of $0.5 million of expenses incurred, offset by a $0.7 million credit received from our contract manufacturer. The total amount expensed was $1.7 million, and $6.6 million, for the years ended December 31, 2004, and 2003, respectively. As of December 31, 2005, the capitalized net book value of the automated assembly line equipment located at our contract manufactures' sites totals $22.8 million. These assets are intended to be used in connection with the manufacture of the inhaler device for Exubera®. The total amount capitalized was nil, $0.2 million, and $1.4 million for the years ended December 31, 2005, 2004, and 2003, respectively. These amounts have been capitalized based upon our determination that the related assets have alternative future use and therefore have separate economic or realizable value. The depreciation expense related to these assets was $1.0 million for the year ended December 31, 2005.

Inventory Reserves

We perform quality control reviews of our raw materials and finished goods. We record inventory reserves based upon specific identification of potentially defective raw material and finished goods batches. In addition, we record an inspection reserve based on a historical estimate of finished goods that ultimately fail quality control. We generally do not maintain inventory reserves based on obsolescence or risk of competition because the shelf life of our products is long. However, if our current assumptions about demand or obsolescence were to change, additional inventory reserves may be needed, which could negatively impact our product gross margins. Our inventory reserves were $3.1 million and $3.2 million as of December 31, 2005 and 2004, respectively. This represented approximately 14% and 23% of gross inventory as of December 31, 2005 and 2004, respectively.

Revenue Recognition

We recognize revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements" ("SAB 104"). Effective July 1, 2003, we adopted the provisions of Emerging Issues Task Force, Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables" on a prospective basis.

Revenue is recognized when there is persuasive evidence that an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectability is reasonably assured. Allowances are established for uncollectible amounts.

We enter into collaborative research and development arrangements with pharmaceutical and biotechnology partners that may involve multiple deliverables. For multiple-deliverable arrangements entered into after July 1, 2003 judgment is required in the areas of separability of units of accounting and the fair value of individual elements. The principles and guidance outlined in EITF No. 00-21 provide a framework to (a) determine whether an arrangement involving multiple deliverables contains more than one unit of accounting, and (b) determine how the arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. Our arrangements may contain the following elements: collaborative research, milestones, manufacturing and supply, royalties and license fees. For each separate unit of accounting we have objective and reliable evidence of fair value using available internal evidence for the undelivered item(s) and our arrangements generally do not contain a general right of return relative to the delivered item. In accordance with the guidance in EITF No. 00-21, the Company uses the residual method to allocate the arrangement consideration when it does not have fair value of a delivered item(s). Under the residual method, the amount of consideration allocated to the delivered item equals the total arrangement consideration less the aggregate fair value of the undelivered items.

Contract revenue from collaborative research and feasibility agreements is recorded when earned based on the performance requirements of the contract. Advance payments for research and development revenue received in excess of amounts earned are classified as deferred revenue until earned. Revenue from collaborative research and feasibility arrangements are recognized as the related costs are incurred. Amounts received under these arrangements are generally non-refundable if the research effort is unsuccessful.

Payments received for milestones achieved are deferred and recorded as revenue ratably over the next period of continued development. Management makes its best estimate of the period of time until the next milestone is reached. This estimate affects the recognition of revenue for completion of the previous milestone. The original estimate is periodically evaluated to determine if circumstances have caused the estimate to change and if so, amortization of revenue is adjusted prospectively.

Product sales are derived primarily from cost-plus manufacturing and supply contracts for our PEG Reagents with individual customers in our industry. Sales terms for specific PEG Reagents are negotiated in advance. Revenues related to our product sales are recorded in accordance with the terms of the contracts. No provisions for potential product returns have been made to date because we have not experienced any significant returns from our customers.

RECLASSIFICATION

Subsequent to the filing of our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, additional clarification was provided regarding the financial statement classification of auction rate securities held as investments. Pursuant to this guidance, auction rate securities are not to be classified as cash and cash equivalents. We invest in auction rate securities as part of our cash management strategy. These investments, which we have historically classified as cash and cash equivalents because of the short time frame between auction periods, have been reclassified as short-term investments. We have reclassified $72.4 million and $19.6 million of auction rate securities from cash equivalents to short-term investments as of December 31, 2004 and 2003, respectively. There was no impact on the Consolidated Statements of Operations or total current assets as a result of the reclassification for the years ended December 31, 2004 or 2003. The impact on the Consolidated Statements of Cash Flows was an increase of $52.7 million and $9.7 million in cash used in investing activities for the years ended December 31, 2004 and 2003, respectively. This reclassification did not result in any change to our revenue, total current assets, or net loss for the years ended December 31, 2004 or 2003, or for any quarterly period during the years ended December 31, 2004 or 2003.

RESULTS OF OPERATIONS

Years Ended December 31, 2005, 2004 and 2003

Revenue (in thousands, except percentages)

Years ended December 31,	2005	2004	2003	Increase/ (Decrease) 2005 vs 2004	Increase/ (Decrease) 2004 vs 2003	Percentage Increase/ (Decrease) 2005 vs 2004	Percentage Increase/ (Decrease) 2004 vs 2003
Contract Research Revenue	$81,602	$89,185	$78,962	$(7,583)	$10,223	(9)%	13%
Product Sales and Royalty Revenue	29,366	25,085	27,295	4,281	(2,210)	17%	(8)%
Exubera Commercialization Readiness Revenue	15,311	—	—	15,311	—	N/A	N/A
Total Revenue	$126,279	$114,270	$106,257	$12,009	$8,013	11%	8%

Total revenue was $126.3 million for the year ended December 31, 2005, compared to $114.3 million and $106.3 million for the years ended December 31, 2004 and 2003, respectively. Total revenue increased 11% in 2005 compared to 2004 and increased 8% in 2004 compared to 2003.

Contract research revenue included reimbursed research and development expenses as well as the amortization of deferred up-front signing and milestone payments received from our collaborative partners. Contract revenues are expected to fluctuate from year to year, and future contract revenue cannot be predicted accurately. The level of contract revenues depends in part upon the continuation of existing collaborations, signing of new collaborations, and achievement of milestones under current and future agreements.

Contract research revenue was $81.6 million for the year ended December 31, 2005, compared to $89.2 million and $79.0 million for the years ended December 31, 2004 and 2003, respectively. The decrease in contract research revenue of $7.6 million, or 9%, for the year ended December 31, 2005, as compared to the year ended December 31, 2004, was primarily due to approximately $7.4 million decrease in revenue from Pfizer Inc related to the transition of the Exubera® program from contract research and development to commercialization readiness. The decrease in revenue from Pfizer Inc was partially offset by $4.4 million increase of launch delay revenues recorded in 2005. In addition, during the year ended December 30, 2004, we recognized $2.0 million in revenue from a one-time payment related to Aventis' termination of a collaborative program with us. Other decreases were primarily due to the expected fluctuations in contract research revenue and the timing of milestone payments.

The increase of $10.2 million or 13% in contract research revenue for the year ended December 31, 2004, as compared to the year ended December 31, 2003, was due primarily to an $8.9 million increase in contract research revenue from Pfizer Inc related to the Exubera® collaboration and a $2.0 million payment received from Aventis-Behring related to the termination of their collaboration with us.

Product and royalty revenue was $29.4 million for the year ended December 31, 2005, compared to $25.1 million and $27.3 million for the years ended December 31, 2004 and 2003, respectively. Product and royalty revenue accounted for 23% of revenues for the year ended December 31, 2005, as compared to 22% and 26% of revenues for the years ended December 31, 2004 and 2003, respectively. The increase in product revenue for the year ended December 31, 2005 as compared to the year ended December 31, 2004, was due primarily to $5.0 million of royalty revenue received from Eyetech, $1.5 million of Exubera® product sales to Pfizer Inc, and $1.4 million of product sales from Aerogen. These product and royalty revenue increases were partially offset by decreases of $3.6 million of product sales from Nektar Advanced PEGylation technology customers.

Exubera® commercialization readiness revenue represents reimbursement, by Pfizer Inc, of certain agreed upon operating costs relating to our Exubera® drug powder manufacturing facilities in preparation for commercial production, plus a markup on such costs. Such reimbursable revenue will not necessarily equal actual costs incurred and expensed as Exubera® commercialization readiness costs. We do not anticipate receiving these revenues subsequent to the launch of Exubera®.

In the early phase of the Exubera® commercial launch in 2006, we expect to receive a substantial amount of revenue from the manufacture and sale of the Exubera® Inhalers and bulk powder insulin, both of which have lower gross margins than when combined with end product royalty revenue. We do not expect to receive significant amounts of Exubera® royalty revenue until the latter half of fiscal year 2006.

The decrease in product revenue for the year ended December 31, 2004, as compared to the year ended December 31, 2003, was primarily due to lower demand, which resulted in lower sales of commercially approved products such as Neulasta®, Somavert®, and PEGASYS®.

Future product sales are dependent upon regulatory approval of new products for sale and adoption of current products in the market.

Pfizer Inc represented 64% of our revenue for the year ended December 31, 2005, 61% for the year ended December 31, 2004, and 61% for the year ended December 31, 2003. No other single customer represented 10% or more of our total revenues for any of the three years ended December 31, 2005, 2004 or 2003.

Cost of goods sold (in thousands except percentages)

Years ended December 31,	2005	2004	2003	Increase/ (Decrease) 2005 vs 2004	Increase/ (Decrease) 2004 vs 2003	Percentage Increase/ (Decrease) 2005 vs 2004	Percentage Increase/ (Decrease) 2004 vs 2003
Cost of Goods Sold	$23,728	$19,798	$14,678	$ 3,930	$5,120	20%	35%
Exubera Commercialization Readiness Cost	12,268	—	—	12,268	—	N/A	N/A
Combined Cost of Goods Sold	$35,996	$19,798	$14,678	$16,198	$5,120	82%	35%

Combined cost of goods sold for the year ended December 31, 2005, was approximately $36.0 million resulting in a gross margin from product sales and Exubera® commercialization readiness revenue of 19%. Cost of goods sold for the year ended December 31, 2004, was $19.8 million resulting in a gross margin of 21%. Cost of goods sold for the year ended December 31, 2003, was $14.7 million resulting in a gross margin from product sales of 46%.

Gross margin from product sales were approximately 19% in the year ended December 31, 2005, compared to gross margin from product sales of approximately 21% in the year ended December 31, 2004, representing a decrease of approximately 2%. The decrease in product gross margin for the year ended December 31, 2005, compared to December 31, 2004, was primarily due to $1.5 million of Exubera® sales to Pfizer Inc at zero margin and a decreased gross margin related to sales of Nektar Advanced PEGylation products primarily due to decreased sales which resulted in lower overhead absorption.

In the early phase of the Exubera® commercial launch in 2006, we expect to receive a substantial amount of revenue from the manufacture and sale of the Exubera® Inhalers and bulk powder insulin, both of which have lower gross margins than when combined with end product royalty revenue. We do not expect to receive significant amounts of Exubera® royalty revenue until the latter half of fiscal year 2006.

Exubera® commercialization readiness costs are start-up manufacturing costs we have incurred in our Exubera® drug powder manufacturing facility in preparation for commercial production for the year ended December 31, 2005. We do not anticipate incurring these costs subsequent to the launch of Exubera.®

The decrease in product gross margin for the year ended December 31, 2004, compared to December 31, 2003, was primarily due to a temporary shut down of part of the Nektar Advanced PEGylation manufacturing operations in the year ended December 31, 2004, and an increase in our inventory reserves.

Research and development (in thousands except percentages)

Years ended December 31,	2005	2004	2003	Increase/ (Decrease) 2005 vs 2004	Increase/ (Decrease) 2004 vs 2003	Percentage Increase/ (Decrease) 2005 vs 2004	Percentage Increase/ (Decrease) 2004 vs 2003
Research & development	$151,659	$133,523	$122,149	$18,136	$11,374	14%	9%
In process research and development	$ 7,859	$ —	$ —	$ 7,859	$ —	N/A	N/A

We expense all research and development costs as they are incurred. Research and development expenses were $151.7 million for the year ended December 31, 2005, as compared to $133.5 million and $122.1 million for the years ended December 31, 2004 and 2003, respectively. The 14% increase in research and development expense for the year ended December 31, 2005, as compared to the year ended December 31, 2004, was primarily attributable to increased spending relating to Exubera® as well as increased development spending for our proprietary product programs.

In the year ended December 31, 2005, we recorded a charge of $7.9 million for in-process research and development costs in connection with our acquisition of Aerogen. The in-process research and development primarily represents two programs in clinical development, amikacin and surfactant. We expect to continue investing in both of these programs over the next several years as part of our ongoing proprietary product development programs. The amount of $7.9 million was expensed on the acquisition date because the acquired technology had not yet reached technological feasibility and had no future alternative use.

The value of purchased in-process research and development was determined by estimating the related future net cash flows between 2006 and 2020 using a present value risk adjusted discount rate of 24%. This discount rate is a significant assumption and is based on our estimated weighted average cost of capital adjusted upwards for the risks associated with the project acquired. The projected cash flows from the acquired projects were based on estimates of revenues and operating profits related to the projects considering the stage of development of each potential product acquired, the time and resources needed to complete the development and approval of each product, the life of each potential commercialized product and associated risks including the inherent difficulties and uncertainties in developing a drug compound including obtaining FDA and other regulatory approvals, and risks related to the viability of and potential alternative treatments in any future target markets.

We expect research and development spending to increase over the next few years as we continue to fund development of our technologies including our proprietary product development program. While we believe our proprietary products strategy may

result in improved economics for any products ultimately developed and approved, it will require us to invest significant funds in developing these products without reimbursement from a collaborative partner.

The 9% increase in research and development expense for the year ended December 31, 2004, as compared to the year ended December 31, 2003, was primarily due to annual salary increases, a one time expense of $1.4 million associated with the buy-out of our potential future royalty and milestone obligations with a partner, increased expenses related to validation testing of our Exubera® drug delivery device and outside services related to our proprietary programs.

The following table summarizes our partner development programs for products approved for use and those in clinical trials. The table includes the primary indication for the particular drug or product, the identity of a respective corporate partner if it has been disclosed, and the present stage of clinical development or approval in the United States, unless otherwise noted.

Molecule	**Primary Indication**	**Partner**	**Status**(1)
Exubera® (insulin human [rDNA origin]) Inhalation Powder	Adult Type 1 and Type 2 Diabetes	Pfizer Inc.	Approved in the EU and U.S.
Proprietary Products			
Amphotericin B inhalation powder	Prevention of pulmonary aspergillosis	Nektar Product	Phase I
Inhaled Antibiotics	Treatment of pneumonia in ventilated patients	Nektar Product	Phase II
Partnered Products (other than Exubera®)			
Neulasta® (pegfilgrastim)	Neutropenia	Amgen Inc.	Approved
PEGASYS® (peginterferon alfa-2a)	Hepatitis-C	Hoffmann-La Roche Ltd.	Approved
Somavert® (pegvisomant)	Acromegaly	Pfizer Inc.	Approved
PEG-INTRON® (peginterferon alfa-2b)	Hepatitis-C	Schering-Plough Corporation	Approved
Definity® (PEG)	Cardiac imaging	Bristol-Myers Squibb Company	Approved
Macugen® (pegaptanib sodium injection)	Age-related macular degeneration	OSI Pharmaceuticals (Eyetech)	Approved in the U.S. EU & Canada
Macugen® (pegaptanib sodium injection)	Diabetic macular edema	OSI Pharmaceuticals (Eyetech)	Phase II
SprayGel™ adhesion barrier system (PEG-hydrogel)	Prevention of post-surgical adhesions	Confluent Surgical Inc.	Pivotal trials in U.S. Approved in Europe
Cimzia™ (certolizumab pegol, CDP870)	Crohn's disease Rheumatoid arthritis	UCB Pharma	Filed in the U.S. Phase III
CERA (Continuous Erythropoiesis Receptor Activator)	Renal anemia	Hoffmann-La Roche Ltd.	Phase III
Tobramycin inhalation powder (TIP)	Lung infection	Chiron Corporation	Phase III
Undisclosed (PEG)	Undisclosed	Undisclosed	Phase II
Pulmonary dronabinol (Dronabinol metered dose inhaler)	Migraine (with and without aura)	Solvay Pharmaceuticals, Inc.	Phase II
Undisclosed (PEG)	Undisclosed	Pfizer Inc.	Phase II
CDP 791 (PEG-antibody fragment angiogenesis inhibitor)	Cancer	UCB Pharma	Phase II

(1) Status definitions are as follows:

Approved — regulatory approval to market and sell product obtained in the U.S. or EU

Phase III or Pivotal — product in large-scale clinical trials conducted to obtain regulatory approval to market and sell a drug. Typically, these trials are initiated following encouraging Phase II trial results.

Phase II — product in clinical trials to establish dosing and efficacy in patients

Phase I — product in clinical trials typically in healthy subjects to test safety

Our product pipeline includes both partnered and proprietary products. We have ongoing collaborations with more than 20 biotechnology and pharmaceutical companies to provide our drug delivery technologies. Our partner product pipeline includes: seven products (Exubera,® Neulasta,® PEGASYS,® Somavert,® PEG-INTRON,® Definity,® and Macugen®) approved by the FDA; three products (SprayGel,™ Ex, Macugen® and Exubera®)) approved in Europe; three additional products (TIP, CimziaTM and CERA) in Phase III or pivotal trials; and at least ten products in either preclinical, Phase I or Phase II trials. In addition to our partnered product programs, we have four proprietary products in the early stages of development. One of these products involves an inhaled small molecule that has entered Phase I and another product is in proof-of-concept human studies. The remaining two products are in preclinical testing.

The length of time that a project is in a given phase varies substantially according to factors relating to the trial, such as the type and intended use of the end product, the trial design, the ability to enroll suitable patients. Generally, for partnered projects, advancement from one phase to the next and the related costs to do so is dependent upon factors that are primarily controlled by our partners.

Our research and development activities can be divided into research and preclinical programs, clinical development programs and commercial readiness. We estimate the costs associated with research and preclinical programs, clinical development programs, and commercial readiness over the past three years to be the following (in millions):

Years ended December 31,	2005	2004	2003
Research and preclinical programs	$ 53.6	$ 37.4	$ 29.0
Clinical development programs	76.1	59.4	58.0
Commercial readiness	22.0	36.7	35.1
Total	$151.7	$133.5	$122.1

Our portfolio of projects can be broken down into two categories: 1) partnered projects and 2) proprietary products and technology development. We estimate the costs associated with partnered projects and proprietary products and technology development to be the following (in millions):

Years ended December 31,	2005	2004	2003
Partnered projects	$ 83.3	$ 93.2	$ 92.7
Proprietary products and technology development	68.4	40.3	29.4
Total	$151.7	$133.5	$122.1

Our total research and development expenditures can be disaggregated into the following significant types of expenses (in millions):

Years ended December 31,	2005	2004	2003
Salaries and employee benefits	$ 68.3	$ 59.0	$ 57.2
Outside services	32.7	28.7	21.0
Supplies	22.5	18.9	16.7
Facility and equipment	26.9	19.7	16.7
Travel and entertainment	1.8	1.9	1.5
Allocated overhead, net	(3.3)	4.9	7.1
Other	2.8	0.4	1.9
Total	$151.7	$133.5	$122.1

General and Administrative (in thousands except percentages)

Years ended December 31,			Increase/ (Decrease)	Increase/ (Decrease)	Percentage Increase/ (Decrease)	Percentage Increase/ (Decrease)
2005	2004	2003	2005 vs 2004	2004 vs 2003	2005 vs 2004	2004 vs 2003
$43,852	$30,967	$29,966	$12,885	$1,001	42%	3%

General and administrative expenses were $43.9 million for the year ended December 31, 2005, as compared to $31.0 million and $30.0 million for the years ended December 31, 2004 and 2005, respectively.

General and administrative expenses increased $12.9 million or 42% in the year ended December 31, 2005, as compared to the year ended December 31, 2004. The increase in general and administrative expenses was primarily due to the following:

- Increased accounting fees and expenses of approximately $2.0 million, primarily due to Sarbanes Oxley compliance requirements, and increased headcount to support our commercial operations and manufacturing activity.
- Increased legal fees and expenses of approximately $3.0 million, primarily due to increased patent fees related to our proprietary development programs, increased headcount to support general administration, operations, and business development efforts, and increased litigation expenses related to patent defense and derivative shareholder claims.
- Incremental headcount and related expenses of $5.0 million to support our product planning and marketing efforts for our proprietary and partnered programs.
- Addition of approximately $1.0 million from Aerogen operations from the date of acquisition through December 31, 2005.

General and administrative spending during the year ended December 31, 2004, was comparable to spending during the year ended December 31, 2003.

We expect general and administrative spending to increase over the next few years to support increased activities in most areas of our operations.

Impairment of long lived assets (in thousands except percentages)

Years ended December 31,			Increase/ (Decrease)	Increase/ (Decrease)	Percentage Increase/ (Decrease)	Percentage Increase/ (Decrease)
2005	2004	2003	2005 vs 2004	2004 vs 2003	2005 vs 2004	2004 vs 2003
$65,340	$ —	$ —	$65,340	$ —	NA	NA

We performed our annual impairment test for goodwill in October 2005 and determined at that time that the undiscounted cash flow from our long-range forecast for each respective business unit exceeded the carrying amount of the respective goodwill. In December 2005 we were apprised of unfavorable results of clinical data related to programs from our super critical fluids business unit located in Bradford, England, (Nektar UK), which provided an indication that the fair value of the respective business units goodwill was below the carrying value. Therefore, in connection with our year end close process, we re-performed the impairment analysis of goodwill and other long lived assets for Nektar UK. We determined the fair value of the intangibles and other assets of Nektar UK based on a discounted cash flow model to be less than the carrying amount of goodwill and certain long lived assets. Based on management's assessment of the results of clinical data that became available in December 2005, and results of the discounted cash flow valuation as of December 31, 2005, we recorded an impairment charge to goodwill and long lived assets in the year ended December 31, 2005 in the amount of $59.6 million and $5.7 million, respectively.

Amortization of other intangible assets (in thousands except percentages)

Years ended December 31,			Increase/ (Decrease)	Increase/ (Decrease)	Percentage Increase/ (Decrease)	Percentage Increase/ (Decrease)
2005	2004	2003	2005 vs 2004	2004 vs 2003	2005 vs 2004	2004 vs 2003
$4,206	$3,924	$4,219	$282	$(295)	7%	(7)%

Acquired technology and other intangible assets include proprietary technology, intellectual property, and supplier and customer relationships acquired from third parties or in business combinations, and specifically excludes goodwill and other long lived assets. We periodically evaluate whether changes have occurred that would require revision of the remaining estimated useful lives of these assets or otherwise render the assets unrecoverable. If such an event occurred, we would determine whether the other intangibles are impaired. To date, no such impairment losses have been recorded.

The components of our other intangible assets as of December 31, 2005, are as follows (in thousands except useful life):

	Useful Life in Years	Gross Carrying Amount	Accumulated Amortization	Net
Core technology	5	$ 15,270	$ (7,529)	$ 7,741
Developed product technology	5	2,900	(2,610)	290
Intellectual property	5-7	7,301	(6,779)	522
Supplier and customer relations	5	9,870	(4,971)	4,899
Total		$ 35,341	$(21,889)	$13,452

Amortization expense related to other intangible assets totaled $4.9 million for the year ended December 31, 2005, and $4.5 million for each year ended December 31, 2004 and 2003, respectively, ($0.7 million, $0.6 million, and $0.3 million was recorded to cost of sales for the years ended December 31, 2005, 2004 and 2003, respectively). The following table shows expected future amortization expense for other intangible assets until they are fully amortized (in thousands):

Years Ending December 31,	
2006	$ 4,329
2007	2,380
2008	2,380
2009	2,380
2010	1,983
Total	$ 13,452

Gain (Loss) on debt extinguishment (in thousands except percentages)

Years ended December 31,			Increase/ (Decrease)	Increase/ (Decrease)	Percentage Increase/ (Decrease)	Percentage Increase/ (Decrease)
2005	2004	2003	2005 vs 2004	2004 vs 2003	2005 vs 2004	2004 vs 2003
$ (303)	$ (9,258)	$ 12,018	$ 8,955	$(21,276)	97%	(177)%

During the year ended December 31, 2005, we recognized a loss on debt extinguishment of approximately $0.3 million in connection with the retirement of $25.4 million and $45.9 million aggregate principle amount of our outstanding 5% and 3.5% convertible subordinate notes due February 2007 and October 2007, for cash payments of $71.0 million in the aggregate, in privately negotiated transactions. As a result of the debt retirement we wrote off approximately $0.1 million and $0.5 million of capitalized debt issuance costs related to the 5% and 3.5% convertible subordinated notes, respectively. Prior to the retirement we had outstanding principle balances of $61.4 million and $112.5 million of our 5% and 3.5% convertible subordinated notes, respectively. Our outstanding obligation at December 31, 2005, was $36.1 million for the 5% notes, and $66.6 million for 3.5% notes.

During the year ended December 31, 2004, we recognized a loss on debt extinguishment in connection with two privately negotiated transactions to convert our outstanding convertible subordinated notes into shares of our common stock. In January 2004, certain holders of our outstanding 3.5% convertible subordinated notes due October 2007 completed an exchange and cancellation of $9.0 million in aggregate principal amount of the notes for the issuance of 0.6 million shares of our common stock in a privately negotiated transaction. In February 2004, certain holders of our outstanding 3% convertible subordinated notes due June 2010 converted approximately $36.0 million in aggregate principal amount of such notes for approximately 3.2 million shares of our common stock and a cash payment of approximately $3.1 million in the aggregate in privately negotiated transactions. As a result of these transactions, we recognized losses on debt extinguishment of approximately $7.8 million and $1.5 million, respectively, in accordance with SFAS No. 84, *Induced Conversions of Convertible Debt.*

For the year ended December 31, 2003, gain on debt extinguishment totaled $12.0 million. Gain on debt extinguishment included a $4.3 million gain from the repurchase of $20.5 million of 3.5% convertible subordinated notes due October 2007 for $16.2 million during the second quarter of 2003. Gain on debt extinguishment also included a $7.7 million gain from the exchange of $87.9 million of 3.5% convertible subordinated notes due October 2007 for the issuance of $59.3 million of newly issued 3% convertible subordinated notes due June 2010.

Other income (expense) (in thousands except percentages)

Years ended December 31,			Increase/ (Decrease)	Increase/ (Decrease)	Percentage Increase/ (Decrease)	Percentage Increase/ (Decrease)
2005	2004	2003	2005 vs 2004	2004 vs 2003	2005 vs 2004	2004 vs 2003
$ (1,249)	$ 296	$ 983	$(1,545)	$ (687)	(522)%	(70)%

Other expense, net, was $1.2 million for the year ended December 31, 2005, as compared to other income of $0.3 million, net, for the year ended December 31, 2004. The additional expense incurred in the year ended December 31, 2005, is primarily related to termination of our lease obligation related to 45,574 square feet of space located at our headquarters. In connection with the termination agreement, we have recorded other expense of approximately $1.1 million during the year ended December 31, 2005, representing the write-off the capital asset partially offset by a reduction in the present value of our future rent liability. In addition, other income for the year ended December 31, 2004, included $0.7 million of income related to our real estate partnership which was dissolved in September 2004.

Other income (expense), net, was $0.3 million income for the year ended December 31, 2004, as compared to $1.0 million income for the year ended December 31, 2003.

Interest income (in thousands except percentages)

Years ended December 31,			Increase/ (Decrease)	Increase/ (Decrease)	Percentage Increase/ (Decrease)	Percentage Increase/ (Decrease)
2005	2004	2003	2005 vs 2004	2004 vs 2003	2005 vs 2004	2004 vs 2003
$13,022	$ 6,602	$ 5,360	$ 6,420	$ 1,242	97%	23%

Interest income was approximately $13.0 million for the year ended December 31, 2005, as compared to approximately $6.6 million and $5.4 million for years ended December 31, 2004 and 2003, respectively. The increase of approximately 97% for the year ended December 31, 2005, as compared to the year ended December 31, 2004, was primarily due to increases in average daily cash balances as a result of net proceeds of approximately $305.6 million in convertible subordinated notes in September 2005, and higher prevailing interest rates during 2005 compared to 2004.

The $1.2 million increase in interest income for the year ended December 31, 2004, as compared to December 31, 2003, was primarily due to higher average cash, cash equivalents, and short-term investment balances in 2004 compared to 2003.

Interest expense (in thousands except percentages)

Years ended December 31,			Increase/ (Decrease)	Increase/ (Decrease)	Percentage Increase/ (Decrease)	Percentage Increase/ (Decrease)
2005	2004	2003	2005 vs 2004	2004 vs 2003	2005 vs 2004	2004 vs 2003
$ 14,085	$ 25,747	$ 19,327	$(11,662)	$ 6,420	(45)%	33%

Interest expense was approximately $14.1 million and approximately $25.7 million for the years ended December 31, 2005 and 2004, respectively, a decrease of 45%. For the year ended December 31, 2004, interest expense included a payment of approximately $12.7 million in interest made to certain holders of our outstanding 3.0% convertible subordinated notes due June 2010 which completed an exchange of $169.3 million in aggregate principal amount of the notes held by such holders for the issuance of approximately 14.9 million shares of our common stock. The net increase of $1.0 million was primarily due to the interest expense related to the issuance of $315.0 million of 3.25% Convertible Subordinated notes in September 2005 less the decrease in interest expense related to the retirement of $25.4 million and $45.9 million aggregate principle amount of our outstanding 5% and 3.5% convertible subordinate notes in September 2005.

Interest expense was $25.7 million for the year ended December 31, 2004, as compared to $19.3 million for the year ended December 31, 2003. The $6.4 million increase in interest expense for the year ended December 31, 2004, as compared to December 31, 2003, primarily relates to approximately $12.7 million in "make-whole" payments made to certain holders of our outstanding 3.0% convertible subordinated notes due June 2010 in connection with the conversion of $169.3 million in aggregate principal amount of the notes held by such holders for the issuance of approximately 14.9 million shares of our common stock following our call for the redemption of such notes during the three-month period ended March 31, 2004. This was partially offset by a decrease in interest expense due to the lower average balance of convertible subordinated notes outstanding during the year ended December 31, 2004, as compared to the year ended December 31, 2003.

We expect interest expense to increase in future periods as a result of our $315.0 million convertible subordinated notes issued in September 2005.

Benefit (Provision) for income taxes (in thousands except percentages)

Years ended December 31,			Increase/ (Decrease)	Increase/ (Decrease)	Percentage Increase/ (Decrease)	Percentage Increase/ (Decrease)
2005	2004	2003	2005 vs 2004	2004 vs 2003	2005 vs 2004	2004 vs 2003
$ 137	$ 163	$ (169)	$ (26)	$ 332	(16)%	196%

We recorded a benefit for income taxes of $0.1 million and $0.2 million for the years ended December 31, 2005 and 2004, respectively; and a provision of $0.2 million for the year ended December 31, 2003. The benefit (provision) relate entirely to state taxes on our Alabama subsidiary.

We have also recorded a deferred tax asset related to our operations outside of Alabama of $259.9 million, which has been fully reserved due to the lack of earnings history for these operations.

We account for federal income taxes under SFAS No. 109, *Accounting for Income Taxes.* Under SFAS No. 109, the liability method is used in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax reporting bases of assets and liabilities and are measured using enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Because of our lack of earnings history, the net deferred tax assets for our operations outside of Alabama have been fully offset by a valuation allowance.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations primarily through public and private placements of our debt and equity securities, revenue from development contracts, product sales and short-term research and feasibility agreements, financing of equipment acquisitions and tenant improvements, and interest income earned on our investments of cash. We do not utilize off-balance sheet financing arrangements as a source of liquidity or financing. At December 31, 2005, we had cash, cash equivalents and investments of approximately $566.4 million.

At December 31, 2005 and 2004, we had letter of credit arrangements with certain vendors including our landlord totaling $2.6 million and $2.2 million, respectively, which are secured by investments or assets in like amounts.

	Years ended December 31,			Increase/ (Decrease) 2005 vs 2004	Increase/ (Decrease) 2004 vs 2003	Percentage Increase/ (Decrease) 2005 vs 2004	Percentage Increase/ (Decrease) 2004 vs 2003
	2005	2004	2003				
Cash, cash equivalents and investments	$ 566.4	$ 418.7	$ 298.4	$ 147.7	$ 120.3	35%	40%
Cash provided by/(used in)							
Operating activities	$ (78.0)	$ (78.1)	$ (76.2)	$ 0.1	$ (1.9)	—	(2%)
Investing activities	$ 32.4	$ (141.7)	$ (5.6)	$ 174.1	$ (136.1)	123%	(2430%)
Financing activities	$ 274.8	$ 207.4	$ 101.3	$ 67.4	$ 106.1	32%	105%
Capital expenditures (included in investing activities above)	$ (18.0)	$ (24.2)	$ (18.7)	$ 6.2	$ (5.5)	26%	(29%)

Our operations used cash of $78.0 million for the year ended December 31, 2005, as compared to $78.1 million and $76.2 million for the years ended December 31, 2004 and 2003, respectively. For the year ended December 31, 2005, the $78.0 million cash used in operations primarily reflected the loss of $185.1 million partially offset by a non-cash charge for impairment of long lived assets of $65.3 million, depreciation and amortization of $25.3 million, in-process research and development costs of $7.9 million, other non-cash items of $4.0 million, and net changes in assets and liabilities of $4.5 million. The write off of in-process R&D in the amount of $7.9 million in the year ended December 31, 2005, resulted from the purchase of Aerogen, Inc. The in-process R&D represents two programs in clinical development, amikacin and surfactant. We expect to continue investing in both of these programs over the next several years as part of our clinical development programs. For the year ended December 31, 2004, the $78.1 million of cash used in operations primarily reflects the net loss of $101.9 million, partially offset by a loss on debt extinguishment of $9.3 million and depreciation and amortization of $18.0 million. For the year ended December 31, 2003, the $76.2 million cash used in operations primarily reflected the net loss of $65.9 million, the non-cash gain on debt extinguishment of $12.0 million and depreciation and amortization expense of $18.2 million.

Cash flows provided by investing activities were $32.4 million for the year ended December 31, 2005, as compared to cash used in investing activities of $141.7 million and $5.6 million for the years ended December 31, 2004 and 2003, respectively. Cash flows used for investing activities for the year ended December 31, 2005, were primarily related to the acquisition of Aerogen, Inc in the amount of $30.7 million. Offsetting cash flows used in or provided by investing activities for the years ended December 31, 2005, 2004, and 2003 were driven primarily by the purchase, sale, and maturity of investment securities. These cash proceeds were either reinvested or used in operations. We purchased property and equipment of approximately $18.0 million, $24.2 million, and $18.7 million, during the years ended December 31, 2005, 2004 and 2003, respectively. The increase in purchased property and equipment in 2004 as compared to 2005 and 2003 primarily reflects the cost of improvements made to our Huntsville, AL facility as well as capital expenditures made in preparation for the commercial launch of Exubera®.

Cash flows provided by financing activities were $274.8 million for the year ended December 31, 2005, compared to $207.4 million and $101.3 million of the years ended December 31, 2004 and 2003, respectively. Cash flow provided by financing activity in the year ended December 31, 2005, was primarily due to the sale of approximately 1.9 million shares of our common stock in August and September 2005 at an average price of $16.93 per common share for proceeds of approximately $31.6 million, net of issuance costs, net proceeds of $305.6 million from the sale of our 3.25% convertible subordinated notes in September 2005, and cash received from employee exercises of stock options of approximately $9.6 million. During the year ended December 31, 2005, we used approximately $25.5 million and $45.5 million to retire a portion of our outstanding 5% and 3.25% convertible subordinated notes, respectively. Cash flow provided by financing activities in the year ended December 31, 2004, was primarily due to the sale of 9.5 million shares of our common stock in March 2004 at a price of $20.71 per common share for proceeds of approximately $196.4 million, net of issuance costs; cash received from employee exercises of stock options of approximately $13.7 million; a loan received from Pfizer Inc of approximately $4.4 million; partially offset by repayment of bank loans and capital lease obligations of $8.0 million. Cash flows provided by financing activities in the year ended December 31, 2003 was primarily due to the issuance of $106.1 million of 3% convertible subordinated notes due 2010.

In August 2005, we entered into a Common Stock Purchase Agreement with an institutional investor in which we sold approximately 1.9 million shares of our common stock at an average price of $16.93 per common share for proceeds of approximately $31.6 million, net of issuance costs. The proceeds were used to acquire Aerogen.

In September 2005, we completed the sale of $315.0 million aggregate principle amount of our 3.25% convertible subordinated notes due 2012. The associated costs of the financing were approximately $9.4 million. The notes bear interest at a rate of 3.25% per annum and will be converted into shares of our common stock at an initial conversion rate of 46.4727 per $1,000 principle amount of notes which is equivalent to an initial conversion price of approximately $21.52 per share.

In September 2005, the Company used cash of $71.0 million to retire $25.4 million and $45.9 million aggregate principle amount of our outstanding 5% and 3.5% convertible subordinated notes due February 2007 and October 2007, in privately negotiated transactions. We recorded a loss on the early extinguishment of debt in the nine month period ended September 30, 2005, of approximately $0.3 million.

As a result of the transactions related to convertible subordinated debt during the year ended December 31, 2005, our total contractual obligation with regard to convertible subordinated debt has increased from $173.9 million at December 31, 2004, to $417.7 million at December 31, 2005. Aggregate principal amount of $102.7 million and $315.0 million of our outstanding convertible subordinated debt as of December 31, 2005, will mature in 2007 and 2012, respectively.

The following summarizes our outstanding convertible subordinated debt as of December 31, 2005:

Class	Maturity	Amount Outstanding	Conversion Price
5%	February 2007	$ 36.1 million	$ 38.36
3.5%	October 2007	$ 66.6 million	$ 50.46
3.25%	September 2012	$315.0 million	$ 21.52

Given our current cash requirements, we forecast that we will have sufficient cash to meet our net operating expense requirements through at least the end of 2007. We plan to continue to invest in our growth and the need for cash will be dependent upon the timing of these investments. Our capital needs will depend on many factors, including continued progress in our research and development arrangements, progress with preclinical and clinical trials of our proprietary and partnered products, the time and costs involved in obtaining regulatory approvals, the costs of developing and scaling up manufacturing operations of our technologies, the timing and cost of our clinical and commercial production facilities, the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims, the need to acquire licenses to new technologies, and the status of competitive products. To date we have been primarily dependent upon equity and convertible debt financings for capital and have incurred substantial debt as a result of our issuances of subordinated notes and debentures that are convertible into our common stock. Our substantial debt, the market price of our securities, and the general economic climate, among other factors, could have material consequences for our financial position and could affect our sources of short-term and long-term funding. There can be no assurance that additional funds, if and when required, will be available to us on favorable terms, if at all.

The following is a summary of our contractual obligations as of December 31, 2005 (in thousands):

	Payments due by period				
	Total	<=1 yr 2006	2-3 yrs 2007-2008	3-5 yrs 2009-2010	2011+
Obligations					
Long-term debt, including interest	$497,773	$118,142	$23,681	$20,475	$335,475
Capital leases, including interest	45,750	3,916	8,063	8,276	25,495
Operating leases	19,743	3,787	7,254	5,058	3,644
Purchase commitments[1]	59,798	59,798	—	—	—
Other	2,739	1,494	1,245	—	—
	$625,803	$187,137	$40,243	$33,809	$364,614

Note: The above table does not include certain commitments and contingencies which are discussed in detail in footnote 9 to the audited financial statements for the year ended December 31, 2005. The above table also does not include $9.2 million non-interest bearing loan from Pfizer Inc, which is contingently payable upon commercial launch of Exubera® (see note 8).

(1) Substantially all of this amount had been ordered on definitive purchase orders as of December 31, 2005, but could be canceled by us at any time. If canceled, we could be charged restocking and/or cancellation fees up to 25%.

QUANTITATIVE AND QUALITATIVE DISCLOSURES OF MARKET RISK

Interest Rate Risk

The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we invest in highly liquid and high quality debt securities. Our investments in debt securities are subject to interest rate risk. To minimize the exposure due to an adverse shift in interest rates, we invest in short term securities and maintain a weighted average maturity of one year or less.

A hypothetical 50 basis point increase in interest rates would result in an approximate $1.1 million decrease, less than 1%, in the fair value of our available-for-sale securities at December 31, 2005. This potential change is based on sensitivity analyses performed on our investment securities at December 31, 2004. Actual results may differ materially. The same hypothetical 50 basis point increase in interest rates would have resulted in an approximate $1.2 million decrease, less than 1%, in the fair value of our available-for-sale securities at December 31, 2004.

Foreign Currency Risk

Our operations include research and development, manufacturing, and sales activities in the U.S. and Europe. As a result, our financial results could be significantly affected by factors such as changes in foreign currency exchange rates or economic conditions in the foreign markets in which we have exposure. Our results of operations are exposed to changes in exchange rates between the U.S. dollar and various foreign currencies, most significantly the British Pound.

To limit our economic exposure to foreign currency exchange rate fluctuations with respect to British Pounds, we periodically purchase British Pounds on the spot market and hold in a U.S. bank account. At December 31, 2005 and 2004, we held British Pounds valued at approximately $1.3 million and $8.4 million, respectively, in a U.S. bank account, using the exchange rate as of period end. This amount is included in cash on our balance sheet. During the year ended December 31, 2005, an immaterial amount of losses resulting from revaluing British Pounds at the current exchange rate were included in other income (expense). As part of our risk management strategy, we may decide to use derivative instruments, including forwards, foreign currency swaps and options to hedge certain foreign currency and interest rate exposures, however, to date we have not entered into any such derivative instruments. We do not use derivative contracts for speculative purposes.

A hypothetical 10% increase in the U.S. dollar relative to the British Pound as of December 31, 2005 and 2004, respectively, would have resulted in an additional $0.1 million and $0.7 million of foreign exchange loss on the British Pounds held in our account in the U.S. for the years ended December 31, 2005 and 2004, respectively.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Nektar Therapeutics

We have audited the accompanying consolidated balance sheets of Nektar Therapeutics as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. Our audits also included the financial statement schedule listed in the index at 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Nektar Therapeutics at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with U. S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Nektar Therapeutics' internal control over financial reporting as of December 31, 2005, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 13, 2006, expressed an unqualified opinion thereon.

Ernst & Young LLP

Palo Alto, California
March 13, 2006

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Nektar Therapeutics

We have audited management's assessment, included in the accompanying "Management Report on Internal Control Over Financial Reporting," that Nektar Therapeutics (the "Company") maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Nektar Therapeutics maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Nektar Therapeutics maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Nektar Therapeutics as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005, of Nektar Therapeutics and our report dated March 13, 2006, expressed an unqualified opinion thereon.

Palo Alto, California
March 13, 2006

Management's Report on Internal Control Over Financial Reporting

As Nektar's Chief Executive Officer and Chief Financial Officer, we are responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-l5(f) under the Securities Exchange Act of 1934). Our internal control system is designed to provide reasonable assurance to management, users of our financial statements and our board of directors regarding the reliability of financial reporting and preparation of published financial statements in accordance with generally accepted accounting principles ("GAAP").

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is a more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Our management has assessed our internal control over financial reporting using the criteria issued in the report Internal Control—Integrated Framework by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, our management has concluded that our internal control over financial reporting was effective as of December 31, 2005.

Our independent registered public accounting firm has issued an attestation report on management's assessment of our internal control over financial reporting which is included elsewhere herein.

Condensed Consolidated Balance Sheets

(In thousands, except per share information)

December 31,	2005	2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 261,273	$ 32,064
Short-term investments	214,928	211,670
Accounts receivable, net of allowance for doubtful accounts and sales returns of $70 and $43 at December 31, 2005 and 2004, respectively.	8,205	12,842
Inventory	18,627	10,691
Other current assets	16,810	12,266
Total current assets	519,843	279,533
Long-term investments	90,222	175,006
Property and equipment, net	142,127	151,247
Goodwill	78,431	130,120
Other intangible assets, net	13,452	6,456
Other assets	14,479	2,559
Total assets	$ 858,554	$ 744,921
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 18,895	$ 7,141
Accrued expenses	20,988	15,065
Other liabilities	9,952	15
Interest payable	3,791	2,010
Capital lease obligations	482	1,532
Deferred revenue	15,487	29,890
Total current liabilities	69,595	55,653
Convertible subordinated notes and debentures	417,653	173,949
Capital lease obligations — noncurrent	20,276	23,568
Other long-term liabilities	21,810	22,292
Accrued rent	2,409	2,117
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, 10,000 shares authorized		
Series A, $0.0001 par value: 3,100 shares designated; no shares issued or outstanding at December 31, 2005 and December 31, 2004.	—	—
Convertible Series B, $0.0001 par value: 40 shares designated; 20 shares issued and outstanding at December 31, 2005 and December 31, 2004; Liquidation preference of $19,945 at December 31, 2005 and December 31, 2004.	—	—
Common stock, $0.0001 par value; 300,000 authorized; 87,707 shares and 84,572 shares issued and outstanding at December 31, 2005 and December 31, 2004, respectively.	9	8
Capital in excess of par value	1,233,690	1,187,575
Deferred compensation	(2,949)	(2,764)
Accumulated other comprehensive loss	(1,707)	(356)
Accumulated deficit	(902,232)	(717,121)
Total stockholders' equity	326,811	467,342
Total liabilities and stockholders' equity	$ 858,554	$ 744,921

See accompanying notes.

Condensed Consolidated Statements of Operations

(in thousands, except per share information)

Years ended December 31,	2005	2004	2003
Revenue:			
Contract research revenue	$ 81,602	$ 89,185	$ 78,962
Product sales and royalty revenue	29,366	25,085	27,295
Exubera® commercialization readiness revenue	15,311	—	—
Total revenue	126,279	114,270	106,257
Operating costs and expenses:			
Cost of goods sold	23,728	19,798	14,678
Exubera® commercialization readiness costs	12,268	—	—
Research and development	151,659	133,523	122,149
General and administrative	43,852	30,967	29,966
In process research and development — Aerogen	7,859	—	—
Amortization of other intangible assets	4,206	3,924	4,219
Impairment of long lived assets	65,340	—	—
Total operating costs and expenses	308,912	188,212	171,012
Loss from operations	(182,633)	(73,942)	(64,755)
Loss on extinguishment of debt	(303)	(9,258)	12,018
Other income (expense), net	(1,249)	296	983
Interest income	13,022	6,602	5,360
Interest expense	(14,085)	(25,747)	(19,327)
Loss before provision for income taxes	(185,248)	(102,049)	(65,721)
Provision for income taxes	137	163	(169)
Net loss	$ (185,111)	$ (101,886)	$ (65,890)
Basic and diluted net loss per share	$ (2.15)	$ (1.30)	$ (1.18)
Shares used in computing basic and diluted net loss per share	85,915	78,461	55,821

See accompanying notes.

Consolidated Statement of Stockholders' Equity

(in thousands)	Preferred Shares		Common Shares		Capital In Excess of Par Value	Deferred Compensation	Accumulated Other Comprehensive Income/(Loss)	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount Paid In	Shares	Par Value					
Balance at December 31, 2002	40	—	55,553	$6	$ 754,680	$ (239)	$ 1,668	$(549,345)	$ 206,770
Common stock issued upon exercise of stock options	—	—	362	—	1,959	—	—	—	1,959
Premium associated with newly issued convertible subordinated notes (as restated)					19,208				19,208
Compensation in connection with stock options granted to consultants	—	—	—	—	178	—	—	—	178
Compensation in connection with severance					677				677
Shares issued for ESPP	—	—	140	—	595	—	—	—	595
Shares issued for retirement plans	—	—	142	—	1,203	—	—	—	1,203
Amortization of deferred compensation	—	—	—	—	—	201	—	—	201
Other comprehensive income/(loss)	—	—	—	—		—	(710)	—	(710)
Net loss	—	—	—	—	—	—	—	(65,890)	(65,890)
Comprehensive loss	—	—	—	—	—	—	—	—	(66,600)
Balance at December 31, 2003	40	—	56,197	6	778,500	(38)	958	(615,235)	164,191
Common stock issued upon exercise of stock options	—	—	1,817	—	13,665	—	—	—	13,665
Common stock issued in secondary offering net of issuance costs of $3,088	—	—	9,500	1	196,411	—	—	—	196,412
Conversion of convertible subordinated debentures net of issuance costs of $2,315	—	—	15,974	1	191,281	—	—	—	191,282
Preferred stock purchased by Enzon, Inc	(20)	—	880	—	—	—	—	—	—
Compensation in connection with stock options granted to consultants	—	—	—	—	678	—	—	—	678
Compensation in connection with severance	—	—	—	—	247	—	—	—	247
Amortization of deferred compensation	—	—	—	—	3,902	(2,726)	—	—	1,176
Shares issued for ESPP	—	—	126	—	1,285	—	—	—	1,285
Shares issued for retirement plans	—	—	66	—	1,158	—	—	—	1,158
Exercise of warrants	—	—	12	—	—	—	—	—	—
Tax benefit related to employee stock option exercises	—	—	—	—	448	—	—	—	448
Other comprehensive income/(loss)	—	—	—	—	—	—	(1,314)	—	(1,314)
Net loss	—	—	—	—	—	—	—	(101,886)	(101,886)
Comprehensive loss									(103,200)
Balance at December 31, 2004	20	—	84,572	8	1,187,575	(2,764)	(356)	(717,121)	467,342
Common stock issued upon exercise of stock options	—	—	1,015	—	9,621	—	—	—	9,621
Common stock issued in secondary offering net of issuance costs of $427	—	—	1,891	1	31,563	—	—	—	31,564
Compensation in connection with stock options granted to consultants	—	—	—	—	208	—	—	—	208
Amortization of deferred compensation	—	—	34	—	2,039	(185)	—	—	1,854
Shares issued for ESPP	—	—	108	—	1,239	—	—	—	1,239
Shares issued for retirement plans	—	—	87	—	1,445	—	—	—	1,445
Other comprehensive income/(loss)	—	—	—	—	—	—	(1,351)	—	(1,351)
Net loss	—	—	—	—	—	—	—	(185,111)	(185,111)
Comprehensive loss									(186,462)
Balance at December 31, 2005	20	—	87,707	$9	$1,233,690	$(2,949)	$(1,707)	$(902,232)	$ 326,811

See accompanying notes.

Consolidated Statements of Cash Flows

(in thousands)

Years ended December 31,	2005	2004	2003
Cash flows used in operating activities:			
Net loss	$(185,111)	$(101,886)	$ (65,890)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation	19,190	12,557	12,279
Amortization of other intangible assets	4,904	4,507	4,507
Amortization of debt issuance costs	1,217	947	1,430
Amortization of deferred compensation	1,854	1,176	201
Amortization of gain related to sale of building	(934)	—	—
Loss on termination of capital lease	1,136	—	—
Non-cash compensation for employee retirement plans	1,445	1,158	1,203
Non-cash compensation for employee severance	—	247	677
Stock-based compensation for services rendered	208	678	178
Gain (loss) on sale or disposal of assets	—	(462)	(92)
Loss(Gain) on early extinguishment of debt	303	9,258	(12,018)
Increase in provision for doubtful accounts and sales returns reserve	27	(659)	69
Tax benefit related to employee stock option exercises	—	448	—
In process research and development	7,859	—	—
Impairment of long lived assets	65,340	—	—
Changes in assets and liabilities:			
Decrease (increase) in trade accounts receivable	6,017	(6,032)	(1,852)
Increase in inventories	(7,420)	(2,132)	(2,250)
Decrease (increase) in prepaids and other assets	(7,118)	(4,399)	1,708
Increase (decrease) in accounts payable	10,329	(683)	(581)
Increase (decrease) in accrued expenses	5,259	(2,520)	(11,361)
Increase (decrease) in interest payable	1,781	(426)	(1,326)
Increase (decrease) in deferred revenue	(7,174)	11,341	(3,367)
Increase (decrease) in other liabilities	2,890	(1,260)	284
Net cash used in operating activities	(77,998)	(78,142)	(76,201)
Cash flows from investing activities:			
Purchases of short-term investments	(234,991)	(534,689)	(283,451)
Sales of short-term investments	88,950	165,077	118,616
Maturities of investments	227,113	220,260	190,351
Purchase of long-term investments	—	(28)	(14,492)
Business acquisition, net of cash acquired	(30,714)	—	—
Sales of long-term investments	—	12,470	2,050
Purchases of property and equipment	(17,955)	(24,241)	(18,746)
Disposal of property and equipment	—	—	92
Purchase of building, net	—	(2,953)	—
Proceeds from interest in partnership	—	22,450	—
Net cash provided by (used in) investing activities	32,403	(141,654)	(5,580)
Cash flows from financing activities:			
Proceeds from debt and capital lease financing	261	4,399	12,363
Payments of loan and capital lease obligations	(2,517)	(7,971)	(3,537)
Proceeds from convertible subordinated notes	305,645	—	106,100
Repurchase of convertible subordinated notes	(70,964)	(376)	(16,180)
Issuance of common stock, net of issuance costs	31,564	196,412	—
Issuance of common stock related to employee stock purchase plan	1,239	1,285	595
Issuance of common stock related to employee stock option exercises	9,621	13,665	1,959
Net cash provided by financing activities	274,849	207,414	101,300
Effect of exchange rates on cash and cash equivalents	(45)	—	—
Net increase (decrease) in cash and cash equivalents	229,209	(12,382)	19,519
Cash and cash equivalents at beginning of year	32,064	44,446	24,927
Cash and cash equivalents at end of year	$ 261,273	$ 32,064	$ 44,446

See accompanying notes.

NOTE 1 — ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Basis of Presentation

We are a biopharmaceutical company developing breakthrough products that make a difference in patients' lives. We create differentiated, innovative products by applying our drug delivery technologies to established or novel medicines. Our leading technologies are Nektar Pulmonary Technology and Nektar Advanced PEGylation Technology. Nine products using these technologies have received regulatory approval in the U.S. or the EU. Our two technology platforms are the basis of nearly all of the partnered and proprietary products we currently have in preclinical and clinical development. We are also engaged in exploratory development with other early stage technologies.

We create or enable breakthrough products in two ways. First, we develop products in collaboration with pharmaceutical and biotechnology companies that seek to improve and differentiate their products. Second, we apply our technologies to established medicines to create and develop our own differentiated, proprietary products. Our proprietary products are designed to target serious diseases in novel ways. We believe our proprietary products have the potential to raise the standards of current patient care by improving efficacy, safety, and/or ease-of-use.

Reclassification

Subsequent to the filing of our 2004 Annual Report on Form 10-K, additional clarification was provided regarding the financial statement classification of auction rate securities held as investments. Pursuant to this guidance, auction rate securities are not to be classified as cash and cash equivalents. We invest in auction rate securities as part of our cash management strategy. These investments, which we have historically classified as cash and cash equivalents because of the short time frame between auction periods, have been reclassified as short-term investments. We have reclassified $72.4 million and $19.6 million of auction rate securities from cash equivalents to short-term investments as of December 31, 2004 and 2003. There was no impact on the Consolidated Statements of Operations or total current assets as a result of the reclassification for the years ended December 31, 2004 or 2003. The impact on the Consolidated Statements of Cash Flows was an increase of $52.7 million and $9.7 million in cash used in investing activities for the years ended December 31, 2004 and 2003, respectively. This reclassification did not result in any change to our revenue, total current assets, or net loss for the years ended December 31, 2004 and 2003 or for any quarterly period during the years ended December 31, 2004 and 2003.

Use of Estimates

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

Principles of Consolidation

Our consolidated financial statements include the financial position and results of operations and cash flows of our wholly-owned subsidiaries: Nektar Therapeutics AL, Corporation ("Nektar AL"), formerly Shearwater Corporation; Nektar Therapeutics UK, Ltd. ("Nektar UK"), formerly Bradford Particle Design Ltd, Nektar Mountain View (formerly Aerogen, Inc), Nektar Therapeutics (India) Private Limited, and Inhale Therapeutic Systems Deutschland GmbH ("Inhale Germany"). As of December 31, 2003 our consolidated financial statements also included the financial statements of Inhale 201 Industrial Road, L.P., a real estate partnership in San Carlos, California and Shearwater Polymers, LLC, a real estate partnership in Alabama. As of September 30, 2004, these real estate partnerships were dissolved and are no longer included in our consolidated financial statements (see note 13). All intercompany accounts and transactions have been eliminated in consolidation.

Our consolidated financial statements are denominated in U.S. dollars. Accordingly, changes in exchange rates between the applicable foreign currency and the U.S. dollar will affect the translation of each foreign subsidiary's financial results into U.S. dollars for purposes of reporting our consolidated financial results. The process by which each foreign subsidiary's financial results are translated into U.S. dollars is as follows: income statement accounts are translated at average exchange rates for the period; balance sheet asset and liability accounts are translated at end of period exchange rates; and equity accounts are translated at historical exchange rates. Translation of the balance sheet in this manner results in an accumulated other comprehensive gain (loss) in the stockholders' equity section. To date, such cumulative translation adjustments have not been material to our consolidated financial position.

Significant Concentrations

Cash equivalents and short-term investments are financial instruments that potentially subject us to concentration of risk to the extent of the amounts recorded in the consolidated balance sheet. We limit our concentration of risk by diversifying our investment amount among a variety of industries and issuers and by limiting the average maturity to approximately one year or less. Our professional portfolio managers adhere to this investment policy as approved by our Board of Directors.

Our customers are primarily pharmaceutical and biotechnology companies that are located in the U.S. and Europe. Our account receivable balance contains trade receivables from product sales and collaborative research agreements. At December 31, 2005, two customers represented 49% and 10% of our accounts receivable, respectively, and at December 31, 2004, four different customers represented 25%, 23%, 16%, and 10% of our accounts

receivable, respectively. We provide for a general allowance for doubtful accounts by reserving for specifically identified doubtful accounts plus a percentage of past due amounts. We have not experienced significant credit losses from our accounts receivable or collaborative research agreements, and none is currently expected. We perform a regular review of our customer's payment history and associate credit risks and do not require collateral from our customers.

In addition, we are dependent on our partners, vendors and contract manufacturers to provide raw materials, drugs, and devices of appropriate quality and reliability and to meet applicable regulatory requirements. Consequently, in the event that supplies are delayed or interrupted for any reason, our ability to develop our products could be impaired, which could have a material adverse effect on our business, financial condition and results of operation.

We are dependent on Pfizer Inc as the source of a significant proportion of our revenue. Contract research revenue from Pfizer Inc represented 64%, 61% and 61% of our revenue for the years ended December 31, 2005, 2004 and 2003, respectively. Deferred revenue from Pfizer Inc represented 42% and 76% of deferred revenue as of December 31, 2005 and 2004, respectively. The termination of this collaboration arrangement could have a material adverse effect on our financial position and results of operations. No other single customer represented 10% or more of our total revenues for any of the three years ended December 31, 2005, 2004, or 2003.

Should the Pfizer Inc collaboration be discontinued during the launch of Exubera,® we will need to find alternative funding sources to replace the collaboration revenue and will need to reassess the realizability of assets capitalized. Additionally, we may have contingent payments to our contract manufacturers to reimburse them for their capital outlay to the extent that they cannot re-deploy their assets and may incur additional liabilities. At the present time, it is not possible to estimate the loss that will occur as a result of these obligations should there be a delay in the launch of Exubera.®

Recent Accounting Pronouncements

In November 2005, the FASB released FASB Staff Position ("FSP") No. FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." This FSP, effective January 1, 2006, provides accounting guidance regarding the determination of when an impairment of debt and equity securities should be considered other-than-temporary, as well as the subsequent accounting for these investments. The adoption of this FSP is not expected to have a material impact on our financial position or results of operations.

In May 2005, the Financial Accounting Standards Board ("FASB") released Statement of Financial Accounting Standard ("SFAS") No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3,* ("FAS 154"). FAS 154 requires retrospective application to prior periods' financial statements for any change in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The statement defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. The statement also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate affected by a change in accounting principle. The statement carries forward without change the guidance contained in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. We will be required to adopt FAS 154 for any accounting changes or corrections of errors on or after January 1, 2006. We do not expect the adoption of FAS 154 to have a material impact on our consolidated financial position, results of operations, or cash flows.

In March 2005, the SEC released Staff Accounting Bulletin (SAB) 107, "Share Based Payment" which provides the SEC staff position regarding the application of SFAS No. 123R. SAB 107 contains interpretative guidance related to the interaction between SFAS No. 123R and certain SEC rules and regulations, as well as provides the Staff's views regarding the valuation of share-based payment arrangements for public companies. SAB 107 also highlights the importance of disclosures made related to the accounting for share-based payment transactions. The Company is currently reviewing the effect of SAB 107 on its condensed consolidated financial statements as it prepares to adopt SFAS 123R.

In December 2004, the Financial Accounting Standards Board ("FASB") released a revision to Statement of Financial Accounting Standard ("SFAS") No. 123, *Accounting for Stock-Based Compensation* ("FAS 123R"). FAS 123R addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25, Accounting for Stock Issued to Employees, and generally would require instead that such transactions be accounted for using a fair-value-based method. We have adopted FAS 123R commencing on January 1, 2006. As a result of our application of FAS 123R, we will have to recognize substantially more compensation expense. This will have a material adverse impact on our financial position and results of operations.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004.* Also in December 2004, the FASB issued FASB Staff Position No. FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creations Act of 2004.* We do not expect the adoption of these new tax accounting standards to have a material impact on our consolidated financial position, results of operations, or cash flows.

In November 2004, the FASB released SFAS No. 151, *Inventory Costs—An Amendment to ARB No. 43.* This Statement amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal" as defined by ARB No. 43, Chapter 4, *Inventory Pricing.* In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. We have adopted SFAS No. 151 commencing on January 1, 2006. As a result of our application of FASB No. 151 we will expense more of our overhead costs as period expenses.

Cash, Cash Equivalents and Investments

We consider all highly liquid investments with a maturity at the date of purchase of three months or less to be cash equivalents. Cash and cash equivalents include demand deposits held in banks, interest bearing money market funds, commercial paper, federal and municipal government securities, and repurchase agreements.

Investments consist of: 1) auction rate securities with varying maturities, and 2) federal and municipal government securities, corporate bonds, and commercial paper with A1, F1, or P1 short-term ratings and A or better long-term ratings with remaining maturities at date of purchase of greater than 90 days. Investments with maturities greater than one year are classified as long-term and represent investments of cash that are reasonably expected to be realized in cash and are available for use, if needed, in current operations.

At December 31, 2005, all investments are designated as available-for-sale and are carried at fair value, with unrealized gains and losses, net of tax, reported in stockholders' equity as accumulated other comprehensive income (loss). Investments are adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included in interest income. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities, if any, are included in other income (expense). The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest income.

At December 31, 2005 and 2004, we had letter of credit arrangements with certain financial institutions and vendors including our landlord totaling $2.6 million and $2.2 million, respectively. These letters of credit are secured by investments in similar amounts.

Fair Value of Financial Instruments

The carrying amounts of certain of the Company's financial instruments, including cash and cash equivalents, accounts receivable, accounts payable, accrued compensation and other accrued liabilities, approximate fair value because of their short term maturities. Fair value for investments in public companies is determined using quoted market prices for those securities.

Inventories

Inventories consist primarily of raw materials, work-in-process and finished goods of Nektar San Carlos, Nektar Al, Nektar Mountain View, and Nektar Ireland. Inventories are stated at the lower of cost (first-in, first-out method) or market. Cost is computed using standard cost, which approximates actual costs on a first-in, first-out basis. Inventories are reflected net of a reserve of $3.1 million and $3.2 million as of December 31, 2005 and 2004, respectively. Reserves are determined using specific identification plus an estimated reserve against finished goods for potential defective or excess inventory based on historical experience. The following is a breakdown of net inventory (in thousands):

December 31,	2005	2004
Raw material	$ 8,050	$ 4,848
Work-in-process	2,740	4,552
Finished goods	7,837	1,291
Total	$18,627	$10,691

Property and Equipment

Property and equipment are stated at cost. Major improvements are capitalized, while maintenance and repairs are expensed when incurred. Laboratory and other equipment are depreciated using the straight-line method generally over estimated useful lives of three to seven years. Leasehold improvements and buildings are depreciated using the straight-line method over the shorter of the estimated useful life or the remaining term of the lease. Buildings are depreciated using the straight-line method over the estimated useful life of twenty years.

Certain amounts have been expensed for plant design, engineering and validation costs based on our evaluation that it is unclear whether such costs are ultimately recoverable. These amounts will become recoverable when Exubera® commercial production commences (see note 3).

Goodwill

Goodwill is tested for impairment at least annually or on an interim basis if an event occurs or circumstances change that would more-likely-than-not reduce the fair value below our carrying value. The impairment tests for goodwill are performed at the business unit level, which we have identified as our pulmonary and proprietary business unit, our advanced pegylation technology business unit and our super critical fluids business unit. We performed our annual impairment test for the respective business unit and determined that the undiscounted cash flow from the long-range forecast for the pulmonary business unit and advanced pegylation business unit exceeds the carrying amount of our goodwill. The goodwill and certain long lived assets associated with the supercritical fluids business unit was deemed to be impaired as of December 31, 2005 (see note 5).

Goodwill is tested for impairment using a two-step approach. The first step is to compare our fair value to our net asset value, including goodwill. If the fair value of our net assets is greater than our net book value, goodwill is not considered impaired and the second step is not required. If the fair value is less than our net asset value, the second step of the impairment test measures the amount of the impairment loss, if any. The second step of the impair-

ment test is to compare the implied fair value of goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, an impairment loss is recognized equal to that excess.

The implied fair value of goodwill is calculated in the same manner that goodwill is calculated in a business combination, whereby the fair value is allocated to all of the assets and liabilities (including any unrecognized intangible assets) as if they had been acquired in a business combination and the fair value was the purchase price. The excess "purchase price" over the amounts assigned to assets and liabilities would be the implied fair value of goodwill.

Other Intangible Assets

Acquired technology and other intangible assets with definite useful lives are amortized on a straight-line basis over their estimated useful lives, which we currently estimate to be a period of five to seven years. Acquired technology and other intangible assets are tested for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable from future undiscounted cash flows. If impaired, asset values are adjusted to fair value. Acquired technology and other intangible assets include proprietary technology, intellectual property, and supplier and customer relationships acquired from third parties or in business combinations.

We periodically evaluate whether changes have occurred that would require revision of the remaining estimated useful lives of these assets or otherwise render the assets unrecoverable. If such an event occurred, we would determine whether the other intangibles are impaired. To date, no such impairment losses have been recorded.

Derivative Instruments

We are exposed to foreign currency exchange rate fluctuations and interest rate changes in the normal course of our business. As part of our risk management strategy, we may use derivative instruments, including forwards, swaps and options to hedge certain foreign currency and interest rate exposures. We do not use derivative contracts for speculative purposes. To date, we have not entered into any such derivative instruments other than the interest rate swap discussed below which was accounted for in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities.*

During part of 2004, we had a bank loan which had been secured by one of our Nektar AL facilities in Alabama. This loan originally had a variable rate of interest tied to the LIBOR index. We entered into an interest rate swap agreement to limit our exposure to fluctuations in U.S. interest rates. The interest rate swap agreement effectively converts a portion of our debt to a fixed rate basis, thus reducing the impact of interest rate changes on future interest expense. The swap is designated a cash flow hedge. Under the terms of our swap arrangement, we paid an initial effective interest rate of 5.17%. This rate was variable on a monthly basis based on changes in the LIBOR index, but only to a maximum of 7.05%.

In September 2004, we retired the bank loan after paying the remaining principal balance of $5.6 million. We also retired the interest rate swap agreement by paying $0.3 million to the lender, representing the fair value of this instrument on that date which was equal to the swap liability recorded on our books. This amount was charged to interest expense.

To limit our exposure to foreign currency exchange rate fluctuations with respect to British Pounds, we have periodically purchased British Pounds on the spot market and hold in a U.S. bank account. At December 31, 2005, we held British Pounds valued at approximately $1.3 million in a U.S. bank account, using the exchange rate as of period end. Such amount is included in cash on our balance sheet. During the year ended December 31, 2005, an immaterial amount of losses resulting from revaluing British Pounds at the current exchange rate were included in other income/(expense).

Comprehensive Loss

Comprehensive loss is comprised of net loss and other comprehensive loss. Other comprehensive gain included unrealized gains (losses) on available-for-sale securities, translation adjustments, and unrealized gains (losses) on available-for-sale securities using the specific identification method. The comprehensive loss consists of the following components net of related tax effects (in thousands):

Years ended December 31,	2005	2004	2003
Net loss, as reported	$(185,111)	$(101,886)	$(65,890)
Change in net unrealized gains/(losses) on available-for-sale securities	(101)	(2,129)	(975)
Net unrealized (gains)/losses reclassified into earnings	—	23	(48)
Translation adjustment	(1,250)	792	313
Total comprehensive loss	$(186,462)	$(103,200)	$(66,600)

The components of accumulated other comprehensive loss are as follows (in thousands):

December 31,	2005	2004
Unrealized gains/(losses) on available-for-sale securities	$(1,957)	$(1,856)
Translation adjustment	250	1,500
Total accumulated other comprehensive income	$(1,707)	$ (356)

Stock-Based Compensation

For the period ended December 31, 2005, we applied the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations in accounting for those plans. Under this opinion, no stock-based employee compensation expense is charged for options that were granted at an exercise price that was equal to the market value of the underlying common stock on the date of grant. Stock compensation costs are immediately recognized to the extent the exercise price is below the fair value on the date of grant and no future vesting criteria exist.

For stock awards issued below our market price on the grant date, we record deferred compensation representing the difference between the price per share of stock award issued and the fair value of the Company's common stock at the time of issuance or grant, and we amortize this amount over the related vesting periods on a straight-line basis.

Pro forma information regarding net loss and net loss per share required by SFAS 123, as amended by SFAS 148, regarding the fair value for employee options and employee stock purchase plan shares was estimated at the date of grant using a Black-Scholes option valuation model with the following weighted-average assumptions:

December 31,	2005	2004	2003
Risk-free interest rate	4.0%	3.3%	2.8%
Dividend yield	0.0%	0.0%	0.0%
Volatility factor	0.710	0.707	0.744
Weighted average expected life	4.5 years	5.0 years	5.0 years

The Black-Scholes options valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. We have presented the pro forma net loss and pro forma basic and diluted net loss per common share using the assumptions noted above.

The following table illustrates the effect on net loss and net loss per share as if we had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation,* to stock-based employee compensation (in thousands, except per share information):

Years ended December 31,	2005	Revised 2004	Revised 2003
Net loss, as reported	$ (185,111)	$ (101,886)	$ (65,890)
Add: stock-based employee compensation included in reported net loss	1,854	1,423	878
Deduct: total stock-based employee compensation expense determined under fair value methods for all awards	(21,986)	(25,183)	(27,468)
Net loss, pro forma	$ (205,243)	$ (125,646)	$ (92,480)
Net loss per share			
Basic and diluted, as reported	$ (2.15)	$ (1.30)	$ (1.18)
Basic and diluted, pro forma	$ (2.39)	$ (1.60)	$ (1.66)

The revised reported pro forma net loss for the years ended December 31, 2004 and 2003, has been decreased by $6.0 million and $6.8 million, respectively, for options exchanged under stock option exchange programs and adjustments from computational corrections.

Stock compensation expense for options granted to non-employees has been determined in accordance with SFAS 123 and EITF No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in conjunction with Selling, Goods or Services,* as the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured. The fair value of options granted to non-employees is re-measured as the underlying options vest.

Revenue Recognition

We recognize revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, "Revenue Recognition in Financial Statements" ("SAB 104"). Effective July 1, 2003, we adopted the provisions of Emerging Issues Task Force, Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables."

Revenue is recognized when there is persuasive evidence that an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectability is reasonably assured. Allowances are established for uncollectible amounts.

We enter into collaborative research and development arrangements with pharmaceutical and biotechnology partners that may involve multiple deliverables. For multiple-deliverable arrangements entered into after July 1, 2003 judgment is required in the areas of separability of units of accounting and the fair value of individual elements. The principles and guidance outlined in EITF No. 00-21 provide a framework to (a) determine whether an arrangement involving multiple deliverables contains more than one unit of accounting, and (b) determine how the arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. Our arrangements may contain the following elements: collaborative research, milestones, manufacturing and supply, royalties and license fees. For each separate unit of accounting we have objective and reliable evidence of fair value using available internal evidence for the undelivered item(s) and our arrangements generally do not contain a general right of return relative to the delivered item. In accordance with the guidance in EITF No. 00-21, the Company uses the residual method to allocate the arrangement consideration when it does not have fair value of a delivered item(s). Under the residual method, the amount of consideration allocated to the delivered item equals the total arrangement consideration less the aggregate fair value of the undelivered items.

Contract revenue from collaborative research and feasibility agreements is recorded when earned based on the performance requirements of the contract. Advance payments for research and development revenue received in excess of amounts earned are classified as deferred revenue until earned. Revenue from collaborative research and feasibility arrangements are recognized as the related costs are incurred. Amounts received under these arrangements are generally non-refundable if the research effort is unsuccessful.

Payments received for milestones achieved are deferred and recorded as revenue ratably over the next period of continued development. Management makes its best estimate of the period of time until the next milestone is reached. This estimate affects the recognition of revenue for completion of the previous milestone. The original estimate is periodically evaluated to determine

if circumstances have caused the estimate to change and if so, amortization of revenue is adjusted prospectively. Because there is no future period of development beyond the final milestone, the final milestone payment is recognized upon achievement.

Product sales are derived primarily from cost-plus manufacturing and supply contracts for our PEG Reagents with individual customers in our industry. Sales terms for specific PEG Reagents are negotiated in advance. Revenues related to our product sales are recorded in accordance with the terms of the contracts. Provisions for potential product returns have been made on a historical trends basis. To date we have not experienced any significant returns from our customers.

Clinical Trial Accruals

We record accruals for estimated clinical study costs. Most of our clinical studies are performed by third party contract research organizations (CROs). We accrue costs for clinical studies performed by CROs on a straight-line basis over the service periods specified in the contracts and adjust our estimates, if required, based upon our on-going review of the level of effort and costs actually incurred by the CRO. We validate our accruals quarterly with our vendors and perform detailed reviews of the activities related to our significant contracts. Based upon the results of these validation processes, we assess the appropriateness of our accruals and make any adjustments we deem necessary to ensure that our expenses reflect the actual effort incurred by the CROs.

In general, our CRO contracts are terminable by us upon written notice and we are generally only liable for actual effort expended by the CRO at any point in time during the contract, regardless of payment status. Through December 31, 2005, differences between actual and estimated activity levels for any particular study were not significant enough to require a material adjustment. However, if management does not receive complete and accurate information from our vendors or has underestimated activity levels associated with a study at a given point in time, we would have to record additional and potentially significant R&D expenses in future periods.

Shipping and Handling Costs

We record costs related to shipping and handling of product to customers in cost of goods sold for all periods presented.

Research and Development

Research and development costs are expensed as incurred and include salaries, benefits, and other operating costs such as outside services, supplies, and allocated overhead costs. We perform research and development for our proprietary products and technology development and for others pursuant to feasibility agreements and development and license agreements. For our proprietary products we may invest our own funds without reimbursement from a collaborative partner. Under our feasibility agreements, we are generally reimbursed for the cost of work performed. Feasibility agreements are designed to evaluate the applicability of our technologies to a particular molecule and therefore are generally completed in less than one year. Under our development and license agreements, products developed using our technologies may be commercialized with a collaborative partner. Under these development and license agreements, we may be reimbursed for development costs, may also be entitled to milestone payments when and if certain development and/or regulatory milestones are achieved, and may be compensated for the manufacture and supply of clinical and commercial product. We may also receive royalties on sales of commercial product. All of our research and development agreements are generally cancelable by the partner without significant financial penalty.

From time to time we acquire in-process research and development programs as part of strategic business acquisitions. Generally, in-process research and development purchased in a business combination is expensed on the acquisition date primarily because the acquired technology had not yet reached technological feasibility and had no future alternative use. In the year ended December 31, 2005, we recorded a charge of $7.9 million for in-process research and development costs in connection with our acquisition of Aerogen.

Segment Reporting

We report segment information in accordance with SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information.* The Company is managed as one business segment. The entire business is comprehensively managed by our Executive Committee that reports to the Chief Executive Officer. The Executive Committee is our chief operating decision maker. We have multiple technologies, all of which are marketed to a common customer base (pharmaceutical and biotechnology companies which are typically located in the U.S. and Europe). We have three drug technology platforms that are designed to improve the performance of molecules and drug delivery. These platforms represent our business units and are comprised of Nektar Advanced PEGylation Technology, Nektar Pulmonary Technology and Nektar Supercritical Fluid Technology, respectively.

Our research revenue is derived primarily from clients in the pharmaceutical and biotechnology industries. Revenue from Pfizer Inc represented 64%, 61% and 61% of our revenue for the years ended December 31, 2005, 2004, and 2003, respectively. Deferred revenue from Pfizer Inc represented 42%, 76%, and 89% of deferred revenue as of December 31, 2005, 2004, and 2003, respectively. Product sales relate to sale of our manufactured Nektar Advanced PEGylation Technology products by Nektar AL and approximately $1.6 million of commercial product sold to Pfizer Inc.

Our accounts receivable balance contains trade receivables from product sales and collaborative research agreements. At December 31, 2005, two customers represented 48% and 10% of our accounts receivable, respectively, and at December 31, 2004, four different customers represented 25%, 23%, 16%, and 10% of our accounts receivable, respectively.

We primarily receive contract research revenue from, and provide product sales to, customers located within the United States. Revenues are derived from customers in the following geographic areas (in thousands):

Years ended December 31,	2005	2004	2003
Contract research revenue			
United States	$74,728	$87,962	$77,496
All other countries	6,874	1,223	1,466
Total contract research revenue	$81,602	$89,185	$78,962
Product sales and royalty revenues			
United States	$19,449	$12,893	$15,837
European countries	8,101	10,387	10,260
All other countries	1,816	1,805	1,198
Total product sales	$29,366	$25,085	$27,295
Exubera® commercialization readiness revenue			
United States	$15,311	$ —	$ —
Total Exubera® commercialization readiness revenue	$15,311	$ —	$ —

The net book value of our other long-lived assets are located in the following geographic areas (in thousands):

Years ended December 31,	2005	2004
United States	$243,568	$220,714
United Kingdom	1,582	69,509
Other European Countries	3,339	159
Total	$248,489	$290,382

Net Loss Per Share

Basic net loss per share is calculated based on the weighted-average number of common shares outstanding during the periods presented, less the weighted-average shares outstanding which are subject to the Company's right of repurchase.

The following table sets forth the computation of basic and diluted net loss per share (in thousands, except per share data):

Years ended December 31,	2005	2004	2003
Numerator:			
Net loss	$(185,111)	$(101,886)	$(65,890)
Denominator:			
Weighted average number of common shares outstanding	85,915	78,461	55,821
Net loss per share — basic and diluted	$ (2.15)	$ (1.30)	$ (1.18)

Diluted earnings per share would give effect to the dilutive impact of common stock equivalents which consists of convertible preferred stock and convertible subordinated debt (using the as-if converted method), and stock options and warrants (using the treasury stock method). Potentially dilutive securities have been excluded from the diluted earnings per share computations in all years presented as such securities have an anti-dilutive effect on loss per share due to the Company's net loss. Potentially dilutive securities included the following (in thousands):

December 31,	2005	2004	2003
Warrants	36	36	56
Options and restricted stock units	16,721	13,976	14,953
Convertible preferred stock	1,023	875	1,755
Convertible debentures and notes	16,896	3,831	19,106
Total	34,676	18,718	35,870

Income Taxes

We account for income taxes under SFAS No. 109, *Accounting for Income Taxes.* Under SFAS No. 109, the liability method is used in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax reporting bases of assets and liabilities and are measured using enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Because of our lack of earnings history, the net deferred tax assets for our operations outside of Alabama have been fully offset by a valuation allowance.

NOTE 2 — FINANCIAL INSTRUMENTS

As of December 31, 2005 and 2004, we held a portfolio exclusively of debt securities. Certain of these securities have a fair value less than their amortized cost. In accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* and EITF 03-01, we have recorded the difference between the amortized cost and fair value as a component of accumulated other comprehensive income. Management has concluded that no impairment should be recognized related to these investments because the unrealized losses incurred to date are not considered other than temporary. Management has reached this conclusion based upon its intention to generally hold all debt investments with an unrealized loss until maturity at which point they are redeemed at full par value, a history of actually holding the majority of our investments to maturity, and our strategy of aligning of the maturity of our debt investments to meet our cash flow needs. Therefore, we have the ability and intent to hold all of our debt investments to maturity.

We determine the fair value amounts by using available market information. At December 31, 2005 and 2004, the average portfolio duration was approximately one year, and the contractual maturity of any single investment did not exceed twenty-four months, with the exception of auction rate securities. Investments with maturities greater than one year are classified as long-term investments even though they are reasonably expected to be realized in cash and are available for use in current operations. The gross unrealized gains on available for sale securities at December 31, 2005 and 2004, amounted to approximately nil, respectively. The gross unrealized losses on available for sale securities at December 31, 2005 and 2004, amounted to approximately $2.0 million and approximately $1.9 million, respectively. As of December 31, 2005, there were 58 securities that had been in a loss position for approximately twelve months or more and which had a fair value $103.9 million and an unrealized loss of $0.5 million. As of December 31, 2004, there were 21 securities that had been in a loss position for approximately twelve months or more and which had a fair value $31.4 million and an unrealized loss of approximately $0.1 million.

The following is a summary of operating cash and available-for-sale securities as of December 31, 2005 (in thousands):

	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and Available-for-Sale Securities				
Obligations of U.S. government agencies	$123,679	$—	$ (631)	$123,048
U.S. corporate commercial paper	179,790	9	(202)	179,597
Obligations of U.S. corporations	180,253	—	(1,125)	179,128
Obligations of non U.S. corporations	2,983	—	(8)	2,975
Repurchase agreements	64,199	—	—	64,199
Cash and other debt securities	17,476	—	—	17,476
Total Cash and Available-for-Sale Securities	$568,380	$ 9	$(1,966)	$566,423
Amounts included in cash and cash equivalents	$261,466	$ 9	$ (202)	$261,273
Amounts included in short-term investments (less than one year to maturity)	215,942	—	(1,014)	214,928
Amounts included in long-term investments (one to two years to maturity)	90,972	—	(750)	90,222
Total Cash and Available-for-Sale Securities	$568,380	$ 9	$(1,966)	$566,423

The following is a summary of operating cash and available-for-sale securities as of December 31, 2004 (in thousands):

	Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash and Available-for-Sale Securities				
Obligations of U.S. government agencies	$164,883	$ 1	$ (923)	$163,961
Obligations of U.S. state and local government agencies	1,150	—	—	1,150
U.S. corporate obligations	147,114	—	(918)	146,196
Non U.S. corporate obligations	4,033	—	(16)	4,017
Repurchase agreements	14,200	—	—	14,200
Auction rate securities	72,350	—	—	72,350
Cash	16,866	—	—	16,866
Total Cash and Available-for-Sale Securities	$420,596	$ 1	$(1,857)	$418,740
Amounts included in cash and cash equivalents	$ 32,064	$—	$ —	$ 32,064
Amounts included in short-term investments (less than one year to maturity)	212,586	—	(916)	211,670
Amounts included in long-term investments (one to two years to maturity)	103,596	1	(941)	102,656
Amounts included in long-term investments (more than 2 years to maturity)	72,350	—	—	72,350
Total Cash and Available-for-Sale Securities	$420,596	$ 1	$(1,857)	$418,740

In March 2004, we converted $133.3 million of 3% convertible subordinated notes due June 2010 into 11.7 million shares of common stock. In connection with the conversion, we agreed to pay $75.00 per $1,000 of the notes to be converted, for an aggregate payment of approximately $10.0 million. This amount was paid through the sale of these held-to-maturity pledged treasury securities. As a result there were no held-to-maturity securities as of December 31, 2004. The realized gain on these held-to-maturity securities of the date of sale was less than $0.1 million.

NOTE 3 — PROPERTY AND EQUIPMENT

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

December 31	2005	2004
Laboratory and other equipment	$ 98,771	$ 66,503
Building and leasehold improvements	114,902	86,887
Construction-in-progress	15,198	61,525
Property and equipment at cost	228,871	214,915
Less: accumulated amortization and depreciation	(86,744)	(63,668)
Property and equipment, net	$142,127	$151,247

During the year ended December 31, 2004, we entered into a redemption agreement with respect to our interest in a real estate partnership (see note 13). We simultaneously entered into a sale-leaseback agreement and, in accordance with FAS 98, *Accounting for Leases,* we capitalized the building by recording a capital lease asset and obligation equal to the fair market value of the leased asset of $25.5 million. Accumulated amortization of the building under lease was approximately $2.3 million and $1.1 million for the years ended December 31, 2005 and 2004, respectively. Amortization of capital leases is included in depreciation expense.

Construction-in-progress includes assets associated with the scale-up of our commercial manufacturing operations and capitalized interest.

Depreciation expense for the years ended December 31, 2005, 2004 and 2003 was $19.2 million, $12.6 million and $12.3 million, respectively.

In accordance with SFAS 2, *Accounting for Research and Development Costs,* we have expensed certain amounts paid for plant design, engineering, and validation costs for the automated assembly line equipment that will be used in connection with the manufacture of the inhaler device for Exubera® because such costs have no alternative future use. The net credit of $0.2 million recorded in the year ended December 31, 2005 was the result of $0.5 million of expenses incurred, offset by a $0.7 million credit received from our contract manufacturer. The total amount expensed was $1.7 million, and $6.6 million, for the years ended December 31, 2004, and 2003, respectively. As of December 31, 2005, the capitalized net book value of the automated assembly line equipment located at our contract manufactures' sites totals $22.8 million. These assets are intended to be used in connection with the manufacture of the inhaler device for Exubera.® The total amount capitalized amounted to nil, $0.2 million, and $1.4 million for the years ended December 31, 2005, 2004, and 2003, respectively. These amounts have been capitalized based upon our determination that the related assets have alternative future use and therefore have separate economic or realizable value. The depreciation expense related to these assets was $1.0 million for the year ended December 31, 2005.

NOTE 4 — SIGNIFICANT COLLABORATIVE RESEARCH AND DEVELOPMENT AND PRODUCT AGREEMENTS

We perform research and development for others pursuant to feasibility agreements and collaborative development and license agreements. Under the feasibility agreements, we are generally reimbursed for the cost of work performed. Under our development and license agreements, we may be reimbursed for a portion of our development costs and may also be entitled to milestone payments when and if certain development and/or regulatory milestones are achieved. We may also receive royalties on sales of commercial product. All of our research and development agreements are generally cancelable by our partners without significant financial penalty to the partner. Cost associated with product agreements are recorded as costs of goods sold.

In January 1995, we entered into a collaborative development and license agreement with Pfizer Inc to develop Exubera® based on our Pulmonary Technology. Under the terms of the agreement, we receive funding consisting of initial fees, contract research and development funding and progress payments. Upon execution of the agreement Pfizer Inc purchased $5.0 million of our Common Stock. In addition, in October 1996, Pfizer Inc purchased an additional $5.0 million of our Common Stock. Pfizer Inc has global commercialization rights for Exubera® while we receive royalties on sales of commercialized products. We will manufacture a portion of insulin powder and supply the inhaler devices to Pfizer Inc. Under this agreement we recognized revenue of approximately $78.2 million, $64.4 million, and $55.4 million in 2005, 2004, and 2003, respectively.

In February 2006, we entered into a collaboration with Bayer HealthCare AG to develop an inhaleable powder formulation of a novel form of Ciprofloxacin (Cipro) to treat chronic lung infections caused by Pseudomonas aeruginosa in cystic fibrosis patients. Under the terms of the collaboration, Nektar will be responsible for formulation of the dry powder and development of the inhalation system, as well as clinical and commercial manufacturing of the drug formulation and device combination. Bayer will be responsible for the clinical development and worldwide commercialization of the system. Nektar will receive funding for preclinical development, milestone payments, and royalty payments when and if the product is commercialized. Under this agreement we recognized revenue of approximately $4.1 million in 2005.

In January 2005, we entered into a collaboration to develop an inhaleable powder form of Zelos Pharmaceuticals Internationals' parathyroid hormone (PTH) analogue, called Ostabolin-C.™ Under the terms of the agreement, Nektar will be responsible for development of the formulated dry powder drug and inhalation system, as well as clinical and commercial manufacturing. Zelos will be responsible for supply of the active pharmaceutical ingredient or API, clinical development and commercialization. Nektar will receive research and development funding, milestone payments, and royalty payments when the product is commercialized. Under this agreement we recognized revenue of approximately $3.5 million in 2005.

We entered into an agreement with Eyetech Pharmaceuticals, Inc. in February 2002 to supply our Advanced PEGylation Technology in the development and commercial manufacturing of Macugen® (pegaptanib sodium injection), a PEGylated anti-Vascular Endothelial Growth Factor aptamer currently approved for marketing approval in the U.S. and filed for approval in the EU by Eyetech and its partner, Pfizer Inc. Macugen® is indicated for the treatment of age-related macular degeneration ("AMD"), which is the leading cause of blindness among Americans over the age of 55. Nektar received development milestone payments and will receive royalties on sales of commercialized products, as well as revenues from exclusive manufacturing of the PEG derivative. We will share a portion of the profits on this product with Enzon Pharmaceuticals, Inc. Macugen® is also in Phase II testing for the treatment of diabetic macular edema ("DME"). Under this agreement we recognized revenue of approximately $6.1 million, $1.5 million and $0.7 million in 2005, 2004 and 2003, respectively.

In February 2002, we entered into a collaboration with Unimed Pharmaceuticals, Inc., a wholly owned subsidiary of Solvay Pharmaceuticals, Inc., to develop a formulation of dronabinol (synthetic delta-9-tetrahydrocannabinol) to be delivered using a metered dose inhaler. The product is under development for multiple indications. Dronabinol is the active ingredient in Unimed's MARINOL® capsules, which are approved in the U.S. for multiple indications. Solvay initiated Phase II trials for pulmonary dronabinol in 2005 for the treatment of migraines with and without aura. We will receive research and development funding, milestone payments as the program progresses through further clinical testing, and royalty payments on product sales and manufacturing revenues if the product is commercialized. Under this agreement we recognized revenue of approximately $2.8 million, $5.5 million, and $5.3 million in 2005, 2004, and 2003, respectively.

In November 2001, we entered into a collaboration with Chiron to develop a next-generation dry powder inhaled formulation of tobramycin for the treatment of *Pseudomonas aeruginosa* in cystic fibrosis patients and to explore the development of other inhaled antibiotics using our Pulmonary Technology. We recognized $4.8 million, $7.3 million, $5.8 million in revenue for the years ended December 31, 2005, 2004, and 2003 respectively, related to this collaboration.

We entered into a license, manufacturing and supply agreement for Cimzia™ (certolizumab pegol, CDP870) with Celltech Group plc in 2000, which was subsequently assigned to Pharmacia. In October 2002, Pharmacia initiated Phase III clinical trials with CDP 870. In April 2003, Pfizer Inc acquired Pharmacia and in February 2004, Pfizer Inc reassigned rights to CDP870 back to Celltech. In 2004, Celltech was acquired by UCB Pharma. Under the agreement, we receive milestone payments, royalties on product sales and PEG manufacturing revenues if the product is commercialized, which are partially shared with Enzon. UCB has filed a biologics licensing application with the FDA for Cimzia™ for the treatment for Crohn's disease. Under this agreement, we recognized product revenue of approximately $3.2 million, $8.5 million and $5.0 million for the years ended December 31, 2005, 2004 and 2003, respectively.

We entered into a license, manufacturing and supply agreement with Sensus Drug Development Corporation (which was subsequently acquired by Pfizer Inc) in January 2000, for the PEGylation of Somavert® (pegvisomant), a human growth hormone receptor antagonist. The agreement provides us with milestone payments, rights to manufacture the PEG reagent and a share of revenues. Somavert® has been approved for marketing in the U.S. and Europe for the treatment of certain patients with acromegaly. In 2005, 2004, and 2003, Somavert® accounted for approximately $0.9 million, $1.2 million, and $4.8 million, respectively, of our product sales.

We entered into a license, supply and manufacturing agreement with Confluent Surgical, Inc. in August 1999, for use of our PEG-hydrogel in Confluent's SprayGel™ adhesion barrier systems. Under the terms of this arrangement, we manufacture and supply PEG components used in the SprayGel™ system and receive manufacturing and supply revenues from Confluent. We may also receive royalty payments on sales of commercialized products. SprayGel™ was approved for commercial distribution in Europe, receiving product certification by European regulatory authorities in November 2001. In June 2002, Confluent initiated Phase II/III pivotal trials in the U.S. of SprayGel.™ Under this agreement we recognized revenue of approximately $1.7 million, $0.3 million and $0.3 million in 2005, 2004 and 2003, respectively.

We entered into a license, manufacturing and supply agreement in February 1997 with F. Hoffmann-La Roche Ltd. whereby we license to Roche the PEG reagent used in Roche's PEGASYS® (peginterferon alfa-2b) product for the treatment of chronic hepatitis C. This agreement provides us with milestone payments, rights to manufacture the PEG reagent and a share of revenues related to the PEGASYS® product. A subsequent agreement with Roche related to further collaborative work on PEGASYS® was entered into in April 1999 to develop the PEGylated interferon alfa-2a product. In 2005, 2004, and 2003, Roche accounted for approximately $2.5 million, $3.2 million, and $4.7 million, respectively, of our product sales.

We entered into a license, manufacturing and supply agreement with Amgen Inc., in July 1995, to supply one of our PEG reagents, which is utilized in the manufacture of Amgen's Neulasta.® This product is indicated for reducing the incidence of infection, as manifested by febrile neutropenia in patients with non-myeloid malignancies receiving myelosuppressive anti-cancer drugs. The FDA approved Neulasta® for marketing in the United States in late January 2002. Under this agreement, we recognized product sales revenue of approximately $5.8 million, $5.2 million, and $6.2 million, in 2005, 2004, and 2003, respectively.

NOTE 5 — GOODWILL AND OTHER INTANGIBLE ASSETS

Between 2001 and 2005 we acquired three businesses. The cost to acquire these businesses has been allocated to the assets acquired (including intangibles) and liabilities assumed according to their respective fair values, with the excess purchase price being allocated to goodwill.

Goodwill is tested for impairment at least annually or on an interim basis if an event occurs or circumstances change that would more-likely-than-not reduce the fair value below our carrying value. The impairment tests for goodwill are performed at the business unit level, which we have identified as our pulmonary and proprietary business unit, our advanced pegylation technology business unit and our super critical fluids business unit.

We performed our annual impairment test for goodwill in October 2005 and determined at that time that the undiscounted cash flow from our long-range forecast for each respective business unit exceeded the carrying amount of the respective goodwill. In December 2005 we were apprised of unfavorable results of clinical data related to programs from our super critical fluids business unit located in Bradford, England, Nektar UK, which provided an indication that the fair value of the respective business units goodwill was below the carrying value. Therefore, in connection with our year end close process, we re-performed the impairment analysis of goodwill and other long lived assets for Nektar UK. We determined the fair value of the intangibles and other assets of Nektar UK based on a discounted cash flow model to

be less than the carrying amount of goodwill and certain long lived assets. Based on management's assessment of the results of clinical data that became available in December 2005, and results of the discounted cash flow valuation as of December 31, 2005, we recorded an impairment charge to goodwill and long lived assets in the year ended December 31, 2005, in the amount of $59.6 million and $5.7 million, respectively. The remaining carrying value of goodwill, on a consolidated basis, at December 31, 2005 and 2004, was $78.4 million and $130.1 million, respectively.

In accordance with SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets,* we perform a test for recoverability of our intangible and other long-lived assets whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. An impairment loss would be recognized only if the carrying amount of an intangible or long-lived asset exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposal of the asset. Other than those long lived assets identified at Nektar UK, to date, there have been no events or changes in circumstances that would indicate that the carrying value of such assets in our other business units may not be recoverable, and therefore we have determined that there are no other impairments on our intangible and other long-lived assets, including capitalized assets related to Exubera®.

In assessing the recoverability of our intangibles and long-lived assets, other than those of Nektar UK, we have concluded that there are no impairments in the carrying value of the remaining assets as of December 31, 2005. If this assessment changes in the future, we may be required to record impairment charges for these assets. The carrying value of our purchased intangibles as of December 31, 2005 and 2004, is $13.5 million and $6.5 million, respectively. These assets are scheduled to be fully amortized by December 2012. The carrying value of our other long-lived assets as of December 31, 2005 and 2004, is $156.6 million and $153.8, respectively.

We periodically evaluate whether changes have occurred that would require revision of the remaining estimated useful lives of our other intangible assets or otherwise render the assets unrecoverable. If such an event occurred, we would determine whether the other intangibles are impaired. To date, there have been no events or changes in circumstances that would indicate that the carrying value of such assets may not be recoverable, and therefore we have determined that there has been no impairment on our intangible and other long-lived assets, including capitalized assets related to Exubera®. The components of our other intangible assets as December 31, 2005, are as follows (in thousands except useful life):

	Useful Life in Years	Gross Carrying Amount	Accumulated Amortization	Net
Core technology	5	$15,270	$ (7,529)	$ 7,741
Developed product technology	5	2,900	(2,610)	290
Intellectual property	5-7	7,301	(6,779)	522
Supplier and customer relations	5	9,870	(4,971)	4,899
Total		$35,341	$(21,889)	$13,452

Amortization expense related to other intangible assets totaled $4.9 million, $4.5 million and $4.5 for the years ended December 31, 2005, 2004, and 2003, respectively ($0.7 million, $0.6 million and $0.3 million was recorded to cost of sales for the years ended December 31, 2005, 2004 and 2003, respectively). The following table shows expected future amortization expense for other intangible assets until they are fully amortized (in thousands):

Years ending December 31,	
2006	$ 4,329
2007	2,380
2008	2,380
2009	2,380
2010	1,983
Total	$13,452

NOTE 6 — OTHER ASSETS, OTHER ACCRUED EXPENSES AND OTHER LONG-TERM LIABILITIES

Deposits and other assets consist of the following (in thousands):

December 31,	2005	2004
Debt issuance costs, net	$ 9,676	$2,173
Prepaid commercial costs	3,473	—
Other assets	1,330	386
Total deposits and other assets	$14,479	$2,559

Debt issuance costs are associated with our outstanding series of convertible subordinated debentures and notes (see note 7) and are amortized to interest expense ratably over the term of the related debt.

Prepaid commercial costs represent contract manufacturing fees and expenses to be amortized to cost of goods sold over the remaining twenty-two month period.

Other accrued expenses consist of the following (in thousands):

December 31,	2005	2004
Accrued research and development expenses (other than compensation)	$ 6,598	$ 2,789
Accrued general and administrative expenses (other than compensation)	2,465	2,054
Accrued compensation	10,385	8,629
Accrued clinical trials	666	—
Deferred gain on sale of interest in partnership	874	1,593
Total other accrued expenses	$20,988	$15,065

Deferred gain on sale of interest in partnership is associated with our sale-leaseback transaction of one of our facilities and is being amortized over the term of the lease (see note 13).

Other long-term liabilities consist of the following (in thousands):

December 31,	2005	2004
Tenant improvement loan and equipment leases	$ 1,372	$ 1,398
Deferred gain on sale of interest in partnership	8,523	10,596
Loan from Pfizer	—	9,165
Deferred revenue	8,374	1,131
Accrued operating costs — long term	2,933	—
Other	608	2
Total other long-term liabilities	$21,810	$22,292

The tenant improvement loan and equipment leases represent the long-term portion of the present value of a tenant improvement loan and certain equipment leases (see note 8). The loan from Pfizer Inc relates to a non-interest bearing loan from Pfizer Inc which is contingently payable upon a commercial launch of Exubera® (see note 8).

NOTE 7 — CONVERTIBLE SUBORDINATED NOTES AND DEBENTURES

Issuance of 3.25% convertible subordinated notes

In September 2005, we issued $315.0 million in aggregate principal amount of our 3.25% Convertible Subordinated Notes (the 3.25% Notes) due September 2012. Interest on the 3.25% notes is payable semiannually in arrears on March 28 and September 28 of each year. The 3.25% Notes are unsecured and subordinate in right to all our existing and future indebtedness. The notes are convertible at the option of the holder, at any time on or prior to maturity into shares of our common stock at a conversion rate of 46.4727 shares per $1,000 principal amount of the 3.25% notes, which is equal to an initial conversion price of approximately $21.52. Beginning on September 28, 2008, we may redeem the 3.25% notes in whole or in part for cash at a redemption price equal to 100% of the principal amount of the 3.25% notes plus any accrued but unpaid interest if the closing price of the common stock has exceeded 150% of the conversion price of the 3.25% notes for at least 20 days in any consecutive 30 day trading period.

At any time prior to maturity, if a fundamental change as defined in the 3.25% subordinated debt indenture occurs, we may be required to pay a make-whole premium on notes converted in connection therewith by increasing the conversion rate applicable to the notes. The amount of the make-whole premium will be determined in accordance with a table showing the make-whole premium that would apply at various common stock prices and fundamental change effective dates.

Costs relating to the issuances of these notes and debentures are recorded as long-term assets and are amortized to interest expense over the term of the debt.

Retirement of certain 3.5% and 5% convertible subordinated notes

In September 2005, we retired $25.4 million and $45.9 million aggregate principle amount of our outstanding 5% and 3.5% convertible subordinate notes due February 2007 and October 2007, respectively, in cash, in privately negotiated transactions. As a result of the transactions we recognized losses related to the early extinguishment of the 5% and 3.5% of approximately $0.3 million and nil, for the years ended December 31, 2005 and 2004, respectively.

As a result of the transactions related to convertible subordinated debt during the quarter ended September 30, 2005 our total contractual obligation with regard to convertible subordinated debt has increased from $173.9 million at December 31, 2004, to $417.7 million at December 31, 2005.

The following summarizes our outstanding convertible subordinated debt as of December 31, 2005:

Class	Maturity	Amount Outstanding	Conversion Price
5%	February 2007	$ 36.1 million	$38.36
3.5%	October 2007	$ 66.6 million	$50.46
3.25%	September 2012	$315.0 million	$21.52

The 5% convertible subordinated notes were issued in February 2000 to certain qualified institutional buyers pursuant to an exemption under Rule 144A of the 1933 Act. Interest on the notes accrues at a rate of 5.0% per year, subject to adjustment in certain circumstances. The notes will mature in February 2007 and are convertible, at the discretion of the holder, into shares of our Common Stock at a conversion price of $38.355 per share, subject to adjustment in certain circumstances. The notes were redeemable in part or in total at any time before February 8, 2003, at an exchange premium of $137.93 per $1,000 principal amount, less any interest actually paid on the notes before the call for redemption, if the closing price of our Common Stock has exceeded 150% of the conversion price then in effect for at least 20 trading days within a period of 30 consecutive trading days. We can redeem some or all of the notes at any time, with redemption prices dependent upon the date of the redemption. Interest is payable semi-annually on August 8 and February 8. The notes are unsecured subordinated obligations, which rank junior in right of payment to all of our existing and future Senior Debt. At December 31, 2005, $36.1 million of these 5.0% convertible subordinated notes remain outstanding.

The 3.5% convertible subordinated notes were issued in October 2000 to certain qualified institutional buyers pursuant to an exemption under Rule 144A of the 1933 Act. Interest on the notes accrues at a rate of 3.5% per year, subject to adjustment in certain circumstances. The notes will mature in October 2007 and are convertible, at the discretion of the holder, into shares of our Common Stock at a conversion price of $50.46 per share, subject to adjustment under certain circumstances. The notes were redeemable in part or in total at any time before October 17, 2003, at $1,000 per $1,000 principal amount plus a provisional redemption exchange premium, payable in cash or shares of Common Stock, of $105.00 per $1,000 principal amount, plus accrued and unpaid interest, if any, to the redemption date, if the closing price of our Common Stock has exceeded 150% of the conversion price then in effect for at least 20 trading days within a period of 30 consecutive trading days. The notes are also redeemable in part or in total at any time, at certain redemption prices dependent upon the date of redemption if the closing price of our Common Stock has exceeded 120% of the conversion price then in effect for at least 20 trading days within a period of 30 consecutive trading days. Interest is payable semi-annually on April 17 and October 17. The notes are unsecured obligations, which rank junior in right of payment to all of our existing and future senior debt. At December 31, 2005, $66.6 million of these 3.5% convertible subordinated notes remain outstanding.

As of December 31, 2005 and 2004, we had approximately $417.7 million and $173.9 million in outstanding convertible subordinated notes and debentures with a fair market value of approximately $422.4 million and $171.3 million, respectively. The fair market was obtained through average quoted market prices.

For the year ended December 31, 2004, we recognized a loss on debt extinguishment in connection with two privately negotiated transactions to convert our outstanding convertible subordinated notes into shares of our common stock. In January 2004, certain holders of our outstanding 3.5% convertible subordinated notes due October 2007 completed an exchange and cancellation of $9.0 million in aggregate principal amount of the notes for the issuance of 0.6 million shares of our common stock in a privately negotiated transaction. In February 2004, certain holders of our outstanding 3% convertible subordinated notes due June 2010 converted approximately $36.0 million in aggregate principal amount of such notes for approximately 3.2 million shares of our common stock and a cash payment of approximately $3.1 million in the aggregate in privately negotiated transactions. As a result of these transactions, we recognized losses on debt extinguishment of approximately $7.8 million and $1.5 million, respectively, in accordance with SFAS No. 84, Induced Conversions of Convertible Debt.

For the year ended December 31, 2003, gain on debt extinguishment totaled $12.0 million. Gain on debt extinguishment included a $4.3 million gain from the repurchase of $20.5 million of 3.5% convertible subordinated notes due October 2007 for $16.2 million during the second quarter of 2003. Gain on debt extinguishment also included a $7.7 million gain recorded in the fourth quarter of 2003 from the exchange of $87.9 million of 3.5% convertible subordinated notes due October 2007 for the issuance of $59.3 million of newly issued 3% convertible subordinated notes due June 2010.

NOTE 8 — DEBT

Tenant Improvement Loans

In November 1997, we received from the landlord of our facility in San Carlos, California, a loan of $5.0 million to fund a portion of the cost of improvements made to the facility. The loan bears interest at 9.46% per annum, and principal and interest payments are payable monthly over the ten-year loan term with a balloon payment of $4.5 million due in November 2007. In October 2002, we renegotiated the terms of this loan. As a result, we made a $1.5 million principal payment and reduced the interest rate by 1.5%. In October 2003, we made an additional $1.9 million principal payment. The loan now bears an interest rate of 7.96% per annum, and principal and interest payments are payable monthly over the original ten-year loan term with a balloon payment of $1.4 million due in November 2007.

Future non-cancelable principal payments under this tenant improvement loan as of December 31, 2005 are as follows (in thousands):

Years ending December 31,	
2006	$ 121
2007	1,464
Total minimum payments required	1,585
Less amount representing interest	201
Present value of future payments	1,384
Less current portion	12
Non-current portion	$1,372

Real Estate Capital Leases

As of January 1, 2005, we occupy a facility in San Carlos under a capital lease for which a portion expires in August 2007, while the remainder expires in September 2016.

Effective January 11, 2005, Nektar and BMR-201 Industrial Road LLC (landlord), entered into an agreement to terminate our obligation in the Amended and Restated Built-To-Suit Lease dated August 17, 2004, related to a portion of our office space located at our San Carlos location. In connection with the termination agreement, we have recorded other expense of approximately $1.1 million. This amount represents the write-off of the capital asset related to this space partially offset by a reduction in the present value of our liability related to this space.

Under the terms of the lease our rent will increase by 2% in October of each year. The total committed future minimum lease payments under the terms of these capital lease agreements are as follows (in thousands):

Years ending December 31,	
2006	$ 3,831
2007	3,907
2008	3,986
2009	4,065
2010	4,147
2011 and thereafter	25,495
Total minimum payments required	45,431
Less amount representing interest	24,673
Present value of future payments	20,758
Less current portion	482
Non-current portion	$20,276

We have recorded a total liability of $20.8 million and $25.1 million relating to this lease as of December 31, 2005 and 2004, respectively, which represents the present value of future minimum payments on the lease. During the year ended December 31, 2004, we entered into a redemption agreement with respect to our interest in the partnership (see note 13). We simultaneously entered into a sale-leaseback agreement and, in accordance with FAS 98, *Accounting for Leases,* we capitalized the building by recording a capital lease asset and obligation equal to the fair market value of the leased asset of approximately $25.5 million. The interest rate on the lease is 18.0%.

Other Debt

We have recorded a current liability of $9.2 million as of December 31, 2005 and 2004, respectively, in connection with a non-interest bearing loan from Pfizer Inc. This loan is contingently payable only upon commercial launch of Exubera® in the United States.

NOTE 9 — COMMITMENTS AND CONTINGENCIES

Operating Leases

We lease certain facilities under arrangements expiring through June 2012. Rent expense was approximately $3.1 million, $3.0 million, and $3.2 million for the years ended December 31, 2005, 2004, and 2003, respectively.

Future non-cancelable commitments under operating leases as of December 31, 2005, are as follows (in thousands):

Years ending December 31,	
2006	$ 3,787
2007	3,658
2008	3,596
2009	2,629
2010	2,429
2011 and thereafter	3,644
Total minimum payments required	$19,743

Legal Matters

In July 2005, a complaint was filed by UAH against Nektar Therapeutics AL, Corporation, and Nektar Therapeutics in the United States District Court for the Northern District of Alabama. The complaint alleges patent infringement, breach of a contract royalty obligation, violation of the Alabama Trade Secrets Act, and unjust enrichment. In August 2005, UAH amended its complaint to add J. Milton Harris, a Nektar employee, as a party to the litigation, add certain additional claims, seek declaratory judgment on patents assigned to the Company, and seek compensatory, treble and punitive damages, all in unspecified amounts. In December 2005, UAH filed its second amended complaint expanding its previously asserted claims that the Company and Harris had infringed patents of UAH, misappropriated and taken intellectual property rightfully belonging to UAH, concealed intellectual property from UAH that was rightfully the property of UAH, and converted these discoveries for their own profit notwithstanding that the Company and Harris were fully aware that the inventions rightfully belonged to UAH. UAH further claimed fraudulent concealment, conversion, detinue, misrepresentation, conspiracy, and, as against Harris, breach of express and implied contract and breach of an assignment of application. UAH is seeking equitable relief including declaratory judgment, the imposition of a constructive trust, specific performance, injunction, accounting and other relief on the theory that UAH should be the record holder of certain patent's assigned to the Company. We have filed and continue to assert a counterclaim against UAH seeking full refund of all royalty payments erroneously paid to UAH under the patent at issue in the original complaint. The litigation is at too early a stage to make an assessment about the probability of the outcome in the case. We intend to vigorously defend ourselves in this litigation, however, there can be no assurances that we will be successful in such defense.

From time to time, we may be involved in other lawsuits, claims, investigations and proceedings, consisting of intellectual property, commercial, employment and other matters, which arise in the ordinary course of business. In accordance with the SFAS No. 5, Accounting for Contingencies, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impact of negotiations, settlements, ruling, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. If any unfavorable ruling were to occur in any specific period, there exists the possibility of a material adverse impact on the results of operations of that period or on our cash and/or liquidity.

Workers Compensation

Pursuant to the terms of our worker's compensation insurance policy, we are subject to self-fund all claims up to $250,000 per occurrence subject to a maximum of $739,250 for the term of the insurance policy, November 1, 2005—October 31, 2006. Historically, we have not been obligated to make significant payments for these obligations, and no significant liabilities have been recorded for these obligations on our balance sheet as of December 31, 2005 or 2004.

Royalties

We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense was approximately $3.5 million, $2.0 million, and $3.1 million for the years ended December 31, 2005, 2004, and 2003, respectively. The overall maximum amount of the obligations is based upon sales of the applicable product and cannot be reasonably estimated.

Director and Officer Indemnifications

As permitted under Delaware law, and as set forth in our Certificate of Incorporation and our Bylaws, we indemnify our directors, executive officers, other officers, employees, and other agents for certain events or occurrences that arose while in such capacity. The maximum potential amount of future payments we could be required to make under this indemnification is unlimited; however, we have insurance policies that may limit our exposure and may enable us to recover a portion of any future amounts paid. Assuming the applicability of coverage, the willingness of the insurer to assume coverage, and subject to certain retention, loss limits and other policy provisions, we believe any obligations under this indemnification are not material, other than an initial $500,000 per incident retention deductible per our insurance policy. However, no assurances can be given that the covering insurers will not attempt to dispute the validity, applicability, or amount of coverage without expensive litigation against these insurers, in which case we may incur substantial liabilities as a result of these

indemnification obligations. Because the obligated amount of this agreement is not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations on our balance sheet as of December 31, 2005 or 2004.

Indemnification Underwriters and Initial purchasers of our Securities

In connection with our sale of equity and convertible debt securities from, we have agreed to defend, indemnify and hold harmless our underwriters or initial purchasers, as applicable, as well as certain related parties from and against certain liabilities, including liabilities under the Securities Act of 1933, as amended. The term of these indemnification obligations is generally perpetual. There is no limitation on the potential amount of future payments we could be required to make under these indemnification obligations. We have never incurred costs to defend lawsuits or settle claims related to these indemnification obligations. If any of our indemnification obligations are triggered, however, we may incur substantial liabilities. Because the obligated amount of this agreement is not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations on our balance sheet as of December 31, 2005 or 2004.

Manufacturing and Supply Agreement with Contract Manufacturers

In August 2000, we entered into a Manufacturing and Supply Agreement with our contract manufacturers to provide for the manufacturing of our pulmonary inhaler device for Exubera®. Under the terms of the Agreement, we may be obligated to reimburse the contract manufacturers for the actual unamortized and unrecovered portion of any equipment procured or facilities established and the interest accrued for their capital overlay in the event that Exubera® commercial launch is delayed to the extent that the contract manufacturers cannot re-deploy the assets. While such payments may be significant, at the present time, it is not possible to estimate the loss that will occur should the Exubera® launch become delayed indefinitely. We have also agreed to defend, indemnify and hold harmless the contract manufacturers from and against third party liability arising out of the agreement, including product liability and infringement of intellectual property. There is no limitation on the potential amount of future payments we could be required to make under these indemnification obligations. We have never incurred costs to defend lawsuits or settle claims related to these indemnification obligations. If any of our indemnification obligations is triggered, we may incur substantial liabilities. Because the obligated amount of this agreement is not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations on our balance sheet as of December 31, 2005 or 2004.

Security Agreement with Pfizer Inc

In connection with the Collaboration, Development and License Agreement ("CDLA") dated January 18, 1995, that we entered into with Pfizer Inc for the development of the Exubera® product, we entered into a Security Agreement pursuant to which our obligations under the CDLA and certain Manufacturing and Supply Agreements related to the manufacture and supply of powdered insulin and pulmonary inhaler devices for the delivery of powdered insulin, are secured. Our default under any of these agreements triggers Pfizer Inc's rights with respect to property relating solely to, or used or which will be used solely in connection with, the development, manufacture, use and sale of Exubera® including proceeds from the sale or other disposition of the property. Because the obligated amount of this agreement is not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations on our balance sheet as of December 31, 2005 or 2004.

Collaboration Agreements for Pulmonary Products

As part of our collaboration agreements with our partners for the development, manufacture and supply of products based on our Pulmonary Technology, we generally agree to defend, indemnify and hold harmless our partners from and against third party liabilities arising out of the agreement, including product liability and infringement of intellectual property. The term of these indemnification obligations is generally perpetual any time after execution of the agreement. There is no limitation on the potential amount of future payments we could be required to make under these indemnification obligations. We have never incurred costs to defend lawsuits or settle claims related to these indemnification obligations. If any of our indemnification obligations is triggered, we may incur substantial liabilities. Because the obligated amount of this agreement is not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations on our balance sheet as of December 31, 2005 or 2004.

License, Manufacturing and Supply Agreements for Products Based on our Advanced PEGylation Technology

As part of our license, manufacturing and supply agreements with our partners for the development and/or manufacture and supply of PEG reagents based on our Advanced PEGylation Technology, we generally agree to defend, indemnify and hold harmless our partners from and against third party liabilities arising out of the agreement, including product liability and infringement of intellectual property. The term of these indemnification obligations is generally perpetual any time after execution of the agreement. There is no limitation on the potential amount of future payments we could be required to make under these indemnification obligations. We have never incurred costs to defend lawsuits or settle claims related to these indemnification obligations. If any

of our indemnification obligations is triggered, we may incur substantial liabilities. Because the obligated amount of this agreement is not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations on our balance sheet as of December 31, 2005 or 2004.

Lease Restoration

We have several leases for our facilities in multiple locations. In the event that we do not exercise our option to extend the term of the lease, we guarantee certain costs to restore the property to certain conditions in place at the time of lease. If we were required to vacate our dry powder manufacturing facility located in San Carlos, Ca, we could incur significant costs to remove the plant equipment and restore the facility to its pre-leased condition. Because the obligated amount of this agreement is not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations on our balance sheet as of December 31, 2005 or 2004.

NOTE 10 — STOCKHOLDERS' EQUITY

Preferred Stock

We have authorized 10,000,000 shares of Preferred Stock, each share having a par value of $0.0001. Three million one hundred thousand (3,100,000) shares of Preferred Stock are designated Series A Junior Participating Preferred Stock (the "Series A Preferred Stock") and forty thousand (40,000) shares of Preferred Stock are designated as Series B Convertible Preferred Stock (the "Series B Preferred Stock").

Series A Preferred Stock

On June 1, 2001, the Board of Directors approved the adoption of a Share Purchase Rights Plan (the "Plan"). Terms of the Plan provide for a dividend distribution of one preferred share purchase right (a "Right") for each outstanding share of our Common Stock (the "Common Shares"). The Rights have certain anti-takeover effects and will cause substantial dilution to a person or group that attempts to acquire the Company on terms not approved by our Board of Directors. The dividend distribution was payable on June 22, 2001 (the "Record Date"), to the stockholders of record on that date. Each Right entitles the registered holder to purchase from us one one-hundredth of a share of Series A Preferred Stock at a price of $225.00 per one one-hundredth of a share of Series A Preferred Stock (the "Purchase Price"), subject to adjustment. Each one one-hundredth of a share of Series A Preferred Stock has designations and powers, preferences and rights, and the qualifications, limitations and restrictions which make its value approximately equal to the value of a Common Share.

The Rights are not exercisable until the Distribution Date (as defined in the Certificate of Designation for the Series A Preferred Stock). The Rights will expire on June 1, 2011, unless the Rights are earlier redeemed or exchanged by us. Each share of Series A Preferred Stock will be entitled to a minimum preferential quarterly dividend payment of $1.00 but will be entitled to an aggregate dividend of 100 times the dividend declared per Common Share. In the event of liquidation, the holders of the Series A Preferred Stock would be entitled to a minimum preferential liquidation payment of $100 per share, but would be entitled to receive an aggregate payment equal to 100 times the payment made per Common Share. Each share of Series A Preferred Stock will have 100 votes, voting together with the Common Shares. Finally, in the event of any merger, consolidation or other transaction in which Common Shares are exchanged, each share of Series A Preferred Stock will be entitled to receive 100 times the amount of consideration received per Common Share. Because of the nature of the Series A Preferred Stock dividend and liquidation rights, the value of one one-hundredth of a share of Series A Preferred Stock should approximate the value of one Common Share. The Series A Preferred Stock ranks junior to the Series B Preferred Stock and would rank junior to any other series of preferred stock. Until a Right is exercised, the holder thereof, as such, will have no rights as a stockholder, including, without limitation, the right to vote or to receive dividends.

Series B Convertible Preferred Stock

In connection with a strategic alliance with Enzon Pharmaceuticals, Inc., we entered into a Preferred Stock Purchase Agreement pursuant to which we sold to Enzon and Enzon purchased from us 40,000 shares of non-voting Series B Preferred Stock at a purchase price of one thousand dollars ($1,000) per share for an aggregate purchase price of $40.0 million. A Certificate of Designation filed with the Secretary of State of Delaware sets forth the rights, privileges and preferences of the Series B Preferred Stock. Pursuant to the Certificate of Designation, the Series B Preferred Stock does not have voting rights. The Series B Preferred Stock is convertible, in whole or in part, into that number of shares of our Common Stock (the "Conversion Shares") equal to the quotient of $1,000 per share divided by the Conversion Price. The "Conversion Price" was initially $22.79 per share or 125% of the Closing Price and at no time can the Preferred Stock convert into shares of Common Stock at a discount to the Closing Price. The "Closing Price" equals $18.23 per share and was based upon the average of our closing bid prices as listed on the Nasdaq National Market for the twenty (20) trading days preceding the date of the closing of the transaction.

The Series B Preferred Stock is convertible at the option of the holder. In accordance with the rights, privileges, and preferences of the Series B Preferred Stock pursuant to the certificate of designation, on January 7, 2005 the Conversion Price was adjusted to be equal to $19.49 per share based on the average of the closing bid prices of our common stock as quoted on the Nasdaq National Market for the 20 trading days preceding January 7, 2005.

To the extent not previously converted, the Series B Preferred Stock will automatically convert into shares of our Common Stock, based on the then effective Conversion Price, upon the earliest of (i) the fourth anniversary of the Original Issue Date (January 7, 2006); (ii) immediately prior to an Asset Transfer or Acquisition (as defined in the Certificate of Designation); or (iii) with the consent of the holders of a majority of the then outstanding Series B Preferred Stock immediately prior to a liquidation, dissolution or winding up of Nektar. In accordance with the terms and conditions of the Preferred Stock Purchase Agreement, on January 7, 2006, all remaining and outstanding shares of Series B preferred stock were converted into 1,023,292 shares of our common stock.

Issuance of Common Stock

On August 15, 2005, we entered into a Common Stock Purchase Agreement with Mainfield Enterprises Inc. pursuant to which we sold approximately 1.9 million shares of our common stock at an average price of $16.93 per common share for proceeds of approximately $31.6 million, net of issuance costs.

In March 2004, we entered into an underwriting agreement with Lehman Brothers Inc. pursuant to which we sold 9.5 million shares of our common stock at a price of $20.71 per common share for proceeds of approximately $196.4 million, net of issuance costs.

Employee Stock Purchase Plan

In February 1994, our Board of Directors adopted the Employee Stock Purchase Plan (the "Purchase Plan"). Under the Purchase Plan, 300,000 shares of Common Stock have been reserved for purchase by our employees pursuant to section 423(b) of the Internal Revenue Code of 1986. In May 2002, we amended and restated the Purchase Plan to increase the number of shares of Common Stock authorized for issuance under the Purchase Plan from a total of 300,000 shares to a total of 800,000 shares. Our stockholders approved this amendment in June 2002. As of December 31, 2005, 374,408 of Common Stock have been issued under the Purchase Plan.

The terms of the Employee Stock Purchase Plan provide eligible employees with the opportunity to acquire an ownership interest in Nektar through participation in a program of periodic payroll deductions for the purchase of our common stock. Employees must make an election to enroll or re-enroll in the plan on a semi-annual basis. Stock is purchased at 85% of the lower of the closing price on the first day of the enrollment period or the last day of the enrollment period.

Stock Option Plans

The following table summarizes information, as of December 31, 2005, with respect to shares of our Common Stock that may be issued under our existing equity compensation plans:

Plan Category	Number of securities to be issued upon exercise of outstanding options (a)[1]	Weighted-average exercise price of outstanding options (b)	Number of securities remaining available for issuance under equity compensation plans (excluding securities reflected in column(a)) (c)
Equity compensation plans approved by security holders	4,697,617	$17.48	1,513,427[2]
Equity compensation plans not approved by security holders	8,414,615	$18.31	1,988,320
Total	13,112,232	$17.84	3,501,747

(1) Does not include options to purchase 32,478 shares assumed in connection with the acquisition of Bradford Particle Design Ltd (with a weighted-average exercise price of $7.74 per share) and options to purchase 104,097 shares we assumed in connection with the acquisition of Shearwater Corporation (with a weighted-average exercise price of $0.03 per share).

(2) Includes 425,592 shares of common stock available for future issuance under our Employee Stock Purchase Plan as of December 31, 2004. Eligible participants purchased an aggregate amount of 108,648 shares and 125,617 shares under the Employee Stock Purchase Plan in fiscal year 2005 and 2004, respectively.

2000 Equity Incentive Plan

Our 1994 Equity Incentive Plan was adopted by the Board of Directors on February 10, 1994, and was amended and restated in its entirety and renamed the "2000 Equity Incentive Plan" on April 19, 2000. The purpose of the 2000 Equity Incentive Plan is to attract and retain qualified personnel, to provide additional incentives to our employees, officers, consultants and employee directors and to promote the success of our business. Pursuant to the 2000 Equity Incentive Plan, we may grant or issue incentive stock options to employees and officers and non-qualified stock options, rights to acquire restricted stock and stock bonuses to consultants, employees, officers and employee directors. Options granted to non-employees are recorded at fair value based on the fair value measurement criteria of FAS 123.

The maximum term of a stock option under the 2000 Equity Incentive Plan is ten years, but if the optionee at the time of grant has voting power of more than 10% of our outstanding capital stock, the maximum term of an incentive stock option is five years. The exercise price of incentive stock options granted under the 2000 Equity Incentive Plan must be at least equal to 100% (or 110% with respect to holders of more than 10% of the voting power of our outstanding capital stock) of the fair market value of the stock subject to the option on the date of the grant. The exercise price of non-qualified stock options, and the purchase price of rights to acquire restricted stock, granted under the 2000 Equity Incentive Plan are determined by the Board of Directors.

The Board may amend the 2000 Equity Incentive Plan at any time, although certain amendments would require stockholder approval. The 2000 Equity Incentive Plan will terminate on

February 9, 2010, unless earlier terminated by the Board. In 2004, we amended and restated the 2000 Equity Incentive Plan to increase the number of shares of Common Stock authorized for issuance under the Purchase Plan from a total of 10,350,000 shares to a total of 11,250,000 shares. Our stockholders approved this amendment on June 17, 2004.

Non-Employee Directors' Stock Option Plan

On February 10, 1994, our Board of Directors adopted the Non-Employee Directors' Stock Option Plan under which options to purchase up to 400,000 shares of our Common Stock at the then fair market value may be granted to our non-employee directors. There are no remaining options available for grant under this plan as of December 31, 2005.

2000 Non-Officer Equity Incentive Plan

Our 1998 Non-Officer Equity Incentive Plan was adopted by the Board of Directors on August 18, 1998, and was amended and restated in its entirety and renamed the "2000 Non-officer Equity Incentive Plan" on June 6, 2000 (the "2000 Plan"). The purpose of the 2000 Plan is to attract and retain qualified personnel, to provide additional incentives to employees and consultants and to promote the success of our business. Pursuant to the 2000 plan, we may grant or issue non-qualified stock options, rights to acquire restricted stock and stock bonuses to employees and consultants who are neither Officers nor Directors of Nektar.

The maximum term of a stock option under the 2000 Plan is ten years. The exercise price of stock options and the purchase price of restricted stock granted under the 2000 Plan are determined by the Board of Directors.

On January 25, 2002, we offered to certain employees (officers and directors were excluded) the ability to exchange certain options ("Eligible Options") to purchase shares of our Common Stock granted prior to July 24, 2001, with exercise prices greater than or equal to $25.00 per share for replacement options to purchase shares of our Common Stock to be granted under the 2000 Plan. We conducted the exchange with respect to the Eligible Options on a one-for-two (1:2) basis. If an employee accepted this offer with respect to any Eligible Option, such employee also was obligated to exchange all options to acquire our Common Stock granted to such employee on or after July 24, 2001 (the "Mandatory Exchange Options"). We conducted the exchange with respect to Mandatory Exchange Options on a one-for-one (1:1) basis. A total of 90 employees participated in the exchange offer, exchanging 1,217,500 Eligible Options and 78,170 Mandatory Exchange Options to purchase shares of our Common Stock. We issued Replacement Options to purchase 686,920 shares of Common Stock on August 26, 2002, at an exercise price equal to the closing price of our Common Stock as reported on the NASDAQ National Market on the last market trading day prior to the date of grant ($7.31).

A summary of stock option activity under the 2000 Equity Incentive Plan, the Non-Employee Directors' Stock Option Plan and the 2000 Non-Officer Equity Incentive Plan is as follows (in thousands, except for per share information):

	Options Outstanding		Weighted-Average
	Number of Shares	Exercise Price Per Share	Exercise Price Per Share
Balance at December 31, 2002	14,742	$ 0.01-61.63	$17.20
Options granted	1,631	4.46-14.63	8.75
Options exercised	(362)	0.01-14.63	5.42
Options expired and canceled	(1,058)	0.11-57.03	16.74
Balance at December 31, 2003	14,953	$ 0.01-61.63	$16.57
Options granted	1,393	10.10-22.49	17.33
Options exercised	(1,817)	0.01-19.25	7.52
Options expired and canceled	(760)	0.01-56.38	20.86
Balance at December 31, 2004, as reported	13,769	$ 0.01-61.63	$17.71
Less: restricted stock units*	(206)	0.01-0.01	0.01
Balance at December 31, 2004	13,563	0.01-61.63	17.57
Options granted	1,791	13.46-19.76	17.44
Options exercised	(1,014)	0.01-18.47	9.47
Options expired and canceled	(1,091)	3.88-56.38	21.33
Balance at December 31, 2005	13,249	$ 0.01-61.63	$17.85

*See disclosure of restricted stock units below

At December 31, 2005, 2004, and 2003, options were exercisable to purchase 9.4 million, 9.2 million, and 9.2 million shares at weighted-average exercise prices of $19.11, $18.49, and $16.52 per share, respectively.

Weighted average fair value of options granted during the years ended December 31, 2005, 2004 and 2003, was $17.44, $10.45, and $5.44 respectively. The following table provides information regarding our stock option plans as of December 31, 2005 (in thousands, except per share information and remaining life):

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life (in years)	Number	Weighted-Average Exercise Price Per Share
$ 0.01 - 7.15	1,351	$ 5.13	5.67	834	$ 4.54
7.19 - 9.31	1,407	8.12	5.62	961	8.14
9.38 - 13.54	1,334	12.18	5.57	923	12.24
13.63 - 14.50	1,470	14.09	4.00	1,289	14.09
14.53 - 16.82	1,370	15.43	5.02	798	15.26
16.85 - 18.54	1,420	18.15	7.26	412	18.14
18.55 - 23.00	1,384	20.73	6.35	798	21.65
23.05 - 27.88	2,180	27.01	4.55	2,051	26.96
27.90 - 54.09	1,326	34.93	4.87	1,295	34.98
54.13 - 61.63	7	54.70	4.81	7	54.70
$ 0.01 - 61.63	13,249	$17.85	5.38	9,368	$19.11

Restricted Stock Units

During the years ended December 31, 2005 and 2004, we issued Restricted Stock Units (RSU) to certain officers, employees and consultants. RSU's are similar to restricted stock in that they are issued for no consideration; however, the holder generally is not entitled to the underlying shares of common stock until the RSU vests. The RSU's were issued under both the 2000 Equity Incentive Plan and the 2000 Non-Officer Equity Incentive Plan. The RSU's are settled by delivery of shares of our common stock on or shortly after the date the awards vest and become fully vested over a period of 36 to 48 months.

Beginning with shares granted in the year ended December 31, 2005, each RSU depletes the pool of options available for grant in a ratio of 1:1.5.

A summary of RSU activity under the 2000 Equity Incentive Plan and the 2000 Non-Officer Equity Incentive Plan is as follows (in thousands):

	Plans/Units		
	2000 Equity Incentive Plan	2000 Non-Officer Equity Incentive Plan	Total
Balance at January 1, 2004	—	—	—
Granted	91	115	206
Balance at December 31, 2004	91	115	206
Granted	72	40	112
Exercised	—	—	—
Canceled and released	(15)	(19)	(34)
Balance at December 31, 2005	148	136	284

In connection with the RSUs, we recorded deferred compensation of $2.0 million and $3.9 million for the years ended December 31, 2005 and 2004, respectively. This deferred compensation represents the fair value of the RSUs. We are ratably amortizing the deferred compensation on a monthly basis over the vesting periods of 36 - 48 months.

For the years ended December 31, 2005 and 2004, we recognized expense related to the RSUs of $1.9 million and $1.2 million, respectively.

Warrants

In November 2000, we issued warrants to certain consultants to purchase an additional 6,000 shares of common stock. These warrants bear an exercise price of $45.88 per share and expire after six years.

In September 2000, we issued warrants to purchase 10,000 shares of common stock to the landlord of one of our facilities in connection with the signing of a capital lease on that facility. These warrants bear an exercise price of $45.88 per share and expire after six years. These warrants were accounted for as equity in accordance with EITF 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.*

The warrants issued in 2000 were valued using a Black-Scholes option valuation model with the following weighted-average assumptions: a risk free interest rate of 6.4%; a dividend yield of 0.0%; a volatility factor of 0.688; and a weighted average expected life of ten years.

In November 1996, we issued warrants to purchase a total of 40,000 shares of common stock in connection with a tenant improvement loan for one of our facilities. These warrants bear an exercise price of $6.56 per share and expire after ten years. These warrants were accounted for as equity in accordance with EITF 96-18. These warrants allow for net share settlement at the option of the warrant holder. In November 2004, one of the warrants representing 20,000 shares of common stock was exercised in the form of a net share settlement for 11,775 shares of common stock.

The warrants issued in 1996 were valued using a Black-Scholes option valuation model with the following weighted-average assumptions: a risk free interest rate of 6.4%; a dividend yield of 0.0%; a volatility factor of 0.620; and a weighted average expected life of ten years.

We recognized approximately $0.1 million of expense related to warrants for the year ended December 31, 2005 and 2004, respectively.

At December 31, 2005, we had warrants outstanding to purchase a total of 36,000 shares of our common stock. No warrants were issued during the years ended December 31, 2005 and 2004.

Stock options issued to non-employees

Options granted to consultants are recorded according to the fair value method over the vesting period. For the years ended December 31, 2005, 2004, and 2003, we have recorded compensation costs of $0.2 million, $0.7 million, and $0.2 million, respectively.

These options were valued using a Black-Scholes option valuation model with the following weighted-average assumptions:

	2005	2004	2003
Risk-free interest rate	4.07%-4.35%	1.1%-4.7%	3.2%-4.6%
Dividend yield	0.0%	0.0%	0.0%
Volatility factor	0.723	0.707	0.688
Weighted average expected life	7.2 years	4.2 years	8.4 years

Time Accelerated Restricted Stock Award Plan ("TARSAP")

During the year ended December 31, 2004, we issued options for 111,000 shares of stock out of our 2000 Non-Officer Equity Incentive Plan to certain employees. The options have an exercise price equal to fair market value on the date of grant. These options become 100% vested upon the earlier of: 1) approval of Exubera® by the FDA or 2) five years from the date of grant.

401(k) Plan

We sponsor a 401(k) retirement plan whereby eligible employees may elect to contribute up to the lesser of 60% of their annual compensation or the statutorily prescribed annual limit allowable under Internal Revenue Service regulations. The 401(k) plan permits us to make matching contributions on behalf of all participants. Currently, we match the lesser of 75% of year to date participant contributions or 3% of eligible wages. The match vests ratably over the first three years of employment, such that after three years of employment, all matching is fully vested. The matching contribution is in the form of shares of our common stock.

We issued approximately 87,000 shares, 66,000 shares, and 142,000 shares of our common stock valued at approximately $1.4 million, $1.2 million, and $1.2 million in connection with the match in 2005, 2004, and 2003, respectively. During part of 2004, shares reserved for issuance related to matching contributions that had been previously been approved by our Board of Directors became fully depleted. During this time, we purchased approximately 14,000 shares on the open market on behalf of employees for a total cost of $0.2 million. This amount was recorded as compensation expense. During the year ended December 31, 2004, our Board of Directors approved an additional 300,000 shares to be reserved for issuance related to matching contributions. A total of 184,501 shares were reserved for issuance related to matching contributions as of December 31, 2005.

Reserved Shares

At December 31, 2005, we have reserved shares of Common Stock for issuance as follows (in thousands):

Convertible subordinated notes and debentures	16,896
Stock options	16,381
Convertible preferred stock	1,023
Employee purchase plan	426
Restricted Stock Units	340
Shares reserved for retirement plans	185
Warrants to purchase Common Stock	36
Total	35,287

NOTE 11 — INCOME TAXES

For financial reporting purposes, "Loss before provision for income taxes," includes the following components (in thousands):

	2005	2004	2003
Domestic	$(172,232)	$ (95,999)	$(58,983)
Foreign	(13,016)	(6,050)	(6,738)
Total	$(185,248)	$(102,049)	$(65,721)

As of December 31, 2005, we had a net operating loss carryforward for federal income tax purposes of approximately $532.6 million, which expire beginning in the year 2006. We had a California state net operating loss carryforward of approximately $259.2 million, which expires beginning in 2005. We had a foreign net operating loss carryforward of approximately $12.3 million, which has an unlimited carryforward period. The company has a net operating loss for Alabama state tax purposes which would reduce the amount of tax to be paid to Alabama in the future.

Utilization of the federal and state net operating loss and credit carryforwards may be subject to a substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses and credits before utilization.

The benefit (provision) for income taxes consists of the following (in thousands):

	2005	2004	2003
Current:			
Federal	$ —	$ —	$ —
State	137	(665)	(169)
Foreign	—	—	—
Total Current	137	(665)	(169)
Deferred:			
Federal	—	—	—
State	—	828	—
Foreign	—	—	—
Total Deferred		828	—
Benefit/(provision) for income taxes	$137	$163	$(169)

Income tax expense benefit (provision) related to continuing operations differ from the amounts computed by applying the statutory income tax rate of 34% to pretax loss as follows (in thousands):

	2005	2004	2003
U.S. federal benefit/(taxes)			
At statutory rate	$ 62,984	$ 34,697	$ 22,345
State taxes	137	163	(169)
Net operating losses not benefited	(50,221)	(33,000)	(20,674)
Investment impairment and non-deductible amortization	(4,904)	(1,532)	(1,434)
Non-deductible in process research charge	(7,859)		
Other	—	(165)	(237)
Total	$ 137	$ 163	$ (169)

Deferred income taxes reflect the net tax effects of loss and credit carryforwards and temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of our deferred tax assets for federal and state income taxes are as follows (in thousands):

December 31,	2005	2004
Deferred tax assets:		
Net operating loss carryforwards	$ 196,716	$ 154,200
Research and other credits	20,301	16,900
Capitalized research expenses	7,529	9,200
Deferred revenue	7,177	11,900
Depreciation	13,184	5,400
Other	28,311	22,700
Total deferred tax assets	273,218	220,300
Valuation allowance for deferred tax assets	(267,941)	(219,472)
Acquisition related intangibles	(4,455)	—
Net deferred tax assets	$ 822	$ 828

Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Because of our lack of earnings history, the net deferred tax assets related to our non-Alabama operations have been fully offset by a valuation allowance. The valuation allowance increased by $48.5 million and $37.7 million during the years ended December 31, 2005 and 2004, respectively. The valuation allowance includes approximately $34.6 million of benefit related to employee stock option exercises which will be credited to additional paid in capital when realized. Also, at the end of December 31, 2005, approximately $14.0 million of the valuation allowance relates to acquisition related items, if and to the extent realized in future periods, will first reduce the carrying value of goodwill, then other long-lived intangible assets of our acquired subsidiary and then income tax expense.

We have recorded a deferred tax asset related to our Alabama subsidiary of $0.8 million.

We also have federal research credits of approximately $13.7 million, which expire beginning in the year 2006 and state tax research credits of approximately $12.3 million which have no expiration date.

NOTE 12 — STATEMENT OF CASH FLOWS DATA

Years ended December 31,	2005	2004	2003
Supplemental disclosure of cash flows information (in thousands):			
Cash paid for interest	$12,468	$ 25,226	$19,223
Cash paid for income taxes	$ 27	$ 238	$ —
Supplemental schedule of non-cash investing and financing activities (in thousands):			
Net reduction in convertible subordinated notes due to exchange of 3.5% notes for 3% notes	$ —	$ —	$28,700
Conversion of debt into common stock	$ —	$186,029	$ —
Deferred compensation related to the issuance of stock options	$ 2,039	$ 3,902	$ —
Non-cash disclosure related to consolidation of Shearwater Polymers, LLC (in thousands):			
Tangible assets primarily property and equipment	$ —	$ —	$ 2,362
Capital lease obligation	$ —	$ —	$ 2,402

NOTE 13 — RELATED PARTY TRANSACTIONS

Redemption of Interest in Inhale 201 Partnership

In connection with a Contribution Agreement dated September 14, 2000, by and between Nektar and Bernardo Property Advisors, Inc., we had contributed certain property located at 201 Industrial Road, San Carlos, CA to the Partnership in exchange for a limited partnership interest in the Partnership. In addition, we entered into a Build-to-Suit Lease with the Partnership (the "Lease") with respect to the property contributed to the Partnership and the building subsequently built on such property, now occupied by us as its headquarters (the "Building").

Effective June 23, 2004, Nektar, SciMed Prop III, Inc. (the "General Partner"), Bernardo Property Advisors, Inc., and Inhale 201 Industrial Road Partnership (the "Partnership") entered into a Redemption Agreement (the "Redemption Agreement") with respect to our limited partnership interest in the Partnership. The Redemption Agreement provides for the redemption of our limited partnership interest in the Partnership in exchange for a cash payment of $19.5 million from Bernardo Property Advisors, Inc. to Nektar, the repayment from Bernardo Property Advisors, Inc., to Nektar of a $3.0 million outstanding loan from Nektar to the Partnership, and a modification of the Lease. The redemption contemplated by the Redemption Agreement and related transactions were subject to certain closing conditions which were met on August 18, 2004, resulting in the dissolution of the Partnership on that date. As of September 30, 2004, we are no longer consolidating the Partnership as part of our consolidated financial statements.

Pursuant to the Redemption Agreement, Nektar and Bernardo Property Advisors, Inc., entered into an Amended and Restated Build-to-Suit Lease (the "Amended Lease"). The Amended Lease provides for, among other things, a decrease in the term of our obligations with respect to a portion of the Building not currently occupied by Nektar from 12 years to 3 years and the elimination of our rights to occupy certain other space in the Building.

In accordance with FAS 98, *Accounting for Leases,* we recorded a capital lease asset and obligation equal to the fair market value of the leased asset of $25.5 million. We also recorded a deferred gain on the sale-leaseback transaction of $12.7 million. In accordance with FAS 66, *Accounting for Sales of Real Estate,* this deferred gain was recorded as a liability and is being amortized over the term of the lease as a reduction to depreciation expense. During the years ended December 31, 2005 and 2004, we amortized a gain of $0.9 million and $0.5 million, respectively.

Purchase of Nektar, AL Facility

On September 30, 2004, we purchased our Church Street facility in Alabama from Shearwater Polymers, LLC ("the LLC") for $2.9 million. The land and building were recorded as fixed assets at their fair market value as of the purchase date of $0.7 million and $2.2 million, respectively.

Prior to this purchase, Nektar, AL paid $0.2 million, $0.3 million, and $0.3 million in 2004, 2003, and 2002, respectively, as rent to the LLC. The LLC was 4% owned by Nektar AL with the remaining 96% owned by Dr. J. Milton Harris. Dr. Harris is an employee of Nektar, AL and prior to March 4, 2004, he was one of our executive officers. Both Nektar AL and Dr. Harris had jointly guaranteed a bank loan on the Nektar AL facility, and the lease income from Nektar AL was the sole source of revenue for the LLC. We had fully consolidated this entity in our consolidated financial statements since December 31, 2003, in accordance with FIN 46R, *Consolidation of Variable Interest Entities.* On September 30, 2004, the LLC paid the principal balance owed on the bank loan of $1.7 million, and we were relieved of the guarantee. As of September 30, 2004, the LLC was dissolved and we are no longer consolidating the LLC as part of our consolidated financial statements.

Other

In 2004 and 2003 we paid $0.2 million and $0.5 million, respectively, for legal services rendered by Alston & Bird LLP of which Paul F. Pedigo, Esq. is a Partner. Mr. Pedigo is a relative by marriage of J. Milton Harris. Prior to March 4, 2004, Dr. Harris was one of our executive officers.

NOTE 14 — AEROGEN ACQUISITION

On October 20, 2005, the Company completed its acquisition of Aerogen, Inc. (Aerogen) pursuant to a definitive agreement and plan of merger dated August 12, 2005 ("Acquisition Agreement").

Pursuant to the Acquisition Agreement, Aerogen merged into the Company and ceased to exist as a separate entity as of October 20, 2005. The results of Aerogens' operations were included in the consolidated financial statements after that date. The Aerogen acquisition was accounted for under the purchase method of accounting.

The total purchase price of $34.5 million for the Aerogen acquisition consisted of: $32.1 million in cash (including $3.8 of cash on hand), plus expenses associated with the transaction and liabilities incurred by the Company resulting from the transaction totaling approximately $2.4 million. The allocation of the purchase price resulted in $8.0 million of goodwill. The purchase price under the plan of merger was fixed and there was no contingent consideration. The Company assessed that the purchase price allocation period had closed at December 31, 2005.

The total original purchase price was allocated as follows: $6.7 million to net tangible assets; $19.8 million to the fair value of identifiable intangible assets, including $7.9 million of in-process technology that was written off during the year ended December 31, 2005; and $8.0 million to goodwill. No amount of the goodwill is tax deductible. The fair value of amortizable intangible assets and their useful lives were as follows (in thousands):

	Useful Life in Years	Gross Carrying Amount	Accumulated Amortization	Net
Product and Core technology	5	$ 7,170	$(239)	$ 6,931
Supplier and customer relations	5	4,730	(158)	4,572
Total		$11,900	$(397)	$11,503

NOTE 15 — SELECTED QUARTERLY FINANCIAL DATA

We reclassified approximately $0.2 million, $0.2 million, and $0.3 million for the three month periods ended September 30, 2004, June 30, 2004, and March 31, 2004, respectively, from general and administrative expenses to interest expense. For the three month periods ended December 31, 2003, September 30, 2003, June 30, 2003, and March 31, 2003, the reclassification adjustment was approximately $0.4 million, $0.4 million, $0.3 million, and $0.3 million, respectively. This reclassification was made to record the amortization of debt issuance costs to interest expense as required under Accounting Principles Board No. 21, Int*erest on Receivables and Payables* and EITF 86-15 Increasing-Rate Debt.

These reclassifications did not result in any change to our cash position, revenue, or net loss for any quarterly period during the years ended December 31, 2004 or 2003.

We have experienced fluctuations in our quarterly results. Our results have included costs associated with acquisitions of various technologies, increases in research and development expenditures, and expansion of late stage clinical and early stage commercial manufacturing facilities. We expect these fluctuations to continue in the future. Due to these and other factors, we believe that quarter-to-quarter comparisons of our operating results will not be meaningful, and you should not rely on our results for one quarter as any indication of our future performance. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of our critical accounting policies.

The following table sets forth certain unaudited quarterly financial data, as adjusted to correct for the misapplications of our accounting policies under U.S. GAAP discussed above, for each of the eight quarters ended December 31, 2005. In our opinion, the unaudited information set forth below has been prepared on the same basis as the audited information and includes all adjustments necessary to present fairly the information set forth herein. The operating results for any quarter are not indicative of results for any future period. All data is in thousands except per share information.

	Fiscal Year 2005				Fiscal Year 2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Contract research revenue	$ 19,529	$ 19,552	$ 23,657	$ 18,864	$ 21,509	$ 22,102	$ 23,556	$ 22,018
Product sales	$ 6,392	$ 5,470	$ 8,450	$ 9,054	$ 4,322	$ 6,425	$ 4,990	$ 9,348
Exubera® commercialization readiness revenue	$ 2,573	$ 3,528	$ 4,247	$ 4,963	—	—	—	—
Gross margin on product sales	$ 1,137	$ 37	$ 2,325	$ 2,139	$ 1,786	$ (308)	$ 513	$ 3,296
Research and development expenses*	$ 34,945	$ 35,785	$ 38,591	$ 42,338	$ 31,292	$ 33,650	$ 34,534	$ 34,047
General and administrative expenses*	$ 9,110	$ 10,135	$ 10,948	$ 13,659	$ 6,828	$ 8,072	$ 7,382	$ 8,685
Operating loss*	$(24,092)	$(26,450)	$(23,367)	$ (108,724)	$(15,806)	$(20,909)	$(18,828)	$(18,399)
Interest expense*	$ 3,060	$ 2,856	$ 2,992	$ 5,177	$ 16,357	$ 2,987	$ 3,259	$ 3,144
Net loss	$(26,165)	$(26,912)	$(23,795)	$(108,239)	$(40,000)	$(22,164)	$(20,452)	$(19,270)
Basic and fully diluted net loss per share	$ (0.31)	$ (0.32)	$ (0.28)	$ (1.23)	$ (0.64)	$ (0.27)	$ (0.24)	$ (0.23)

* These amounts have been restated for all quarters of 2003 and for the first three quarters of 2004 as discussed above.

Nektar Corporate Information

Corporate Headquarters
Nektar Therapeutics
150 Industrial Road
San Carlos, CA 94070-6256
Telephone (650) 631-3100
Facsimile (650) 631-3150

Annual Report on Form 10-K
Copies of Nektar's Annual Report on Form 10-K, exclusive of exhibits, are available without charge upon written request to:

Investor Relations
Nektar Therapeutics
150 Industrial Road
San Carlos, CA 94070-6256

Or via email to investors@nektar.com; Online copies can also be obtained at www.nektar.com under "investor relations."

Annual Meeting
The Annual Meeting of Stockholders will be held at 10:00 a.m. Pacific Daylight Time on Thursday, June 1, 2006 at Nektar's corporate headquarters located at 150 Industrial Road, San Carlos, CA 94070-6256.

Corporate Counsel
Cooley Godward LLP
Palo Alto, CA

Independent Auditors
Ernst & Young LLP
Palo Alto, CA

Transfer Agent and Stockholder Services
Mellon Investor Services, LLC
525 Market Street, Suite 3500
San Francisco, CA 94105
1-800-522-6645

Securities
Our Common Stock trades on the NASDAQ National Market under the symbol NKTR. The table below sets forth the high and low closing sales prices for our Common Stock (as reported on the NASDAQ National Market) during the periods indicated.

Year Ended December 31, 2005		
1st Quarter	$ 19.80	$ 13.41
2nd Quarter	$ 19.02	$ 13.72
3rd Quarter	$ 19.59	$ 16.24
4th Quarter	$ 17.49	$ 14.66

Year Ended December 31, 2004		
1st Quarter	$ 23.24	$ 14.30
2nd Quarter	$ 22.83	$ 16.33
3rd Quarter	$ 19.81	$ 9.89
4th Quarter	$ 20.46	$ 13.95

The preceding discussion contains forward-looking statements that involve risks and uncertainties. Nektar's actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in Part I of the Form 10-K filed with the Securities Exchange Commission for the fiscal year ended December 31, 2005 under the heading "Risk Factors."

Nektar Board of Directors

Robert B. Chess
Acting President &
Chief Executive Officer,
Chairman of the Board
Nektar Therapeutics

John S. Patton, Ph.D.
Director, Co-Founder &
Chief Scientific Officer
Nektar Therapeutics

Michael A. Brown
Director, Quantum Corp.
Former Chairman,
Quantum Corp.

Joseph J. Krivulka
Founder and President,
Triax Pharmaceuticals

Christopher A. Kuebler,
Chairman,
Covance Inc.

Irwin Lerner
Former Chairman,
F. Hoffmann-LaRoche Inc.

Susan Wang
Former Chief Financial Officer,
Solectron Corporation

Roy A. Whitfield
Former Chairman & CEO,
Incyte Corporation

Nektar Management Team

Robert B. Chess
Acting President &
Chief Executive Officer,
Chairman of the Board

Louis Drapeau
Senior Vice President,
Finance & Chief Financial Officer

Nevan Elam
Senior Vice President,
Corporate Operations,
General Counsel & Secretary

Elizabeth Frisby
Vice President,
Human Resources

Hoyoung Huh, M.D., Ph.D.
Senior Vice President,
Business Development &
Marketing

David Johnston, Ph.D.
Senior Vice President,
Research & Development

Truc Le
Senior Vice President,
Operations & Corporate Quality

John S. Patton, Ph.D.
Director, Founder &
Chief Scientific Officer

Christopher J. Searcy, Pharm.D.
Vice President,
Corporate Development

David Tolley
Vice President, Operations
and Site Manager,
Nektar Alabama

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