protected by emergent biosolutions™

PROTECTING

About Emergent BioSolutions Emergent BioSolutions is a profitable, multinational biopharmaceutical company dedicated to one simple mission — to protect life. We develop, manufacture and commercialize immunobiotics, consisting of vaccines and therapeutics that assist the body's immune system to prevent or treat disease and other medical conditions that have resulted in significant unmet or underserved medical needs. Our marketed product, BioThrax® (Anthrax Vaccine Adsorbed), is the only vaccine approved by the U.S. Food and Drug Administration for the prevention of anthrax infection. More information on the company is available at www.emergentbiosolutions.com.

EBS
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NYSE®


## A global footprint

We are expanding our presence around the globe. Along with our manufacturing facilities in the United States, product development operations in the United States and Europe, and marketing and sales offices in the United States, Singapore and Germany, we recently established a joint venture with the government of Malaysia. We also work with third-party marketing representatives in countries that represent potential strategic growth markets.

**While our business can seem complex, our mission remains stunningly simple:**

**Protecting life.** We pursue innovative ways of directing the immune system to prevent and treat life-threatening diseases. Whether it is developing vaccines and therapeutics that hold the promise of a better life for millions of adults and children or providing the world's only FDA-approved anthrax vaccine to protect against the threat of bioterrorism, we are passionate in our mission.

# 2007 accomplishments position us well for future growth

Dear Stockholders:

In 2007, our first full year as a public company, we achieved financial and operational success as well as progress in our multiple product development initiatives. Operationally, we sold more of our licensed product, BioThrax®(Anthrax Vaccine Adsorbed), and accomplished key product development milestones. We also advanced our manufacturing expansion program and completed key business development objectives.

## Achieving a track record of financial success

In 2007, we reported another year of record revenues of $183 million and net income of $23 million, our sixth consecutive year of profitable operations. As a result of this financial performance, in 2007 we continued to self-fund a majority of the development of our product pipeline in pursuit of vaccines and therapeutics that address significant unmet or underserved medical needs. With over $100 million in cash at year-end and visibility into anticipated 2008 revenues, we believe we are well positioned to pursue the acquisition of one or more late-stage product candidates, which would complement the advancement of our product portfolio. This is one of our primary goals in 2008.

## Securing global demand for BioThrax

We succeeded in capturing a greater portion of the U.S. Department of Health and Human Services (HHS) requirements for the stockpiling of anthrax vaccines. In 2007, we signed a contract valued at $448 million with HHS that includes the delivery of 18.75 million doses of BioThrax over three years, the largest contract in the history of our company. Internationally, we closed meaningful sales of BioThrax to allied foreign governments while pursuing growing interest from a number of other countries.

## Advancing our product pipeline

In 2007, we achieved progress in our advanced pipeline candidates.

- **Anthrax IG Therapeutic** — Our anthrax immune globulin (IG) therapeutic candidate was granted Fast Track status by the U.S. Food and Drug Administration (FDA) and received additional funding of $9.5 million in the form of a development contract with Biomedical Advanced Research and Development Authority (BARDA) and the National Institute of Allergy and Infectious Diseases (NIAID).
- **Typhoid Vaccine** — Our single-dose, oral typhoid vaccine candidate completed a Phase II clinical trial in Vietnam achieving all endpoints for safety and immunogenicity; if successful, it would be the world's first single-dose drinkable typhoid vaccine.
- **Hepatitis B Therapeutic** — Our hepatitis B candidate advanced in its Phase II clinical program following a positive Safety Monitoring Committee review.

## Strengthening our infrastructure

We completed the construction and equipment installation of our new state-of-the-art, large-scale manufacturing facility located in Lansing, Michigan. I am pleased to report that this manufacturing expansion program is coming in on time and within budget. We initiated engineering runs for BioThrax in preparation for the upcoming submission of a supplement to our Biological Licensing Agreement (BLA) to the FDA to allow us to manufacture BioThrax in this new facility. This facility is campaignable, which would support manufacture of different types of fermentation-based vaccines. We also recently commissioned a pilot plant in support of manufacturing clinical material for our advancing product candidates.

## Expanding our global footprint

We continued to pursue licensure of BioThrax in various foreign markets. We also continued to develop partnerships with government and non-government entities in strategic growth markets. Specifically, we formed a joint venture in Malaysia with Ninebio Sdn. Bhd. (9Bio) to supply BioThrax and other medical and biodefense products and related services to the Government of Malaysia, as well as potentially other countries within Asia.

## Pursuing our mission

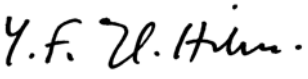
Protecting life is a pursuit that demands relentless devotion and an unwavering commitment. We follow five essential principles that guide our decision-making process and are the basis for our past and future success.

- We are **focused** — We focus on product development from proof-of-concept to commercialization. We continually evaluate and prioritize our development programs to ensure that we focus on product candidates that hold the greatest promise.
- We are **balanced** — We develop both vaccines and therapeutics serving multiple markets. Our current focus is on infectious diseases. We are also exploring other disease areas that have resulted in significant unmet or underserved public health needs.
- We are **collaborative** — We aim to establish non-dilutive partnerships with governmental and non-governmental organizations in the United States and abroad to leverage our investment in the development of our own product candidates.
- We are **acquisitive** — We pursue the licensure and acquisition of products and product candidates that leverage our existing capabilities and expand our pipeline.
- We are **profitable** — We manage our business in a fiscally responsible manner. This has helped us achieve a track record of financial success that has enabled us to fund our pipeline development.

These guiding principles, along with our 2007 achievements, have laid the groundwork and provided momentum for success in 2008. In March 2008, we announced the acquisition of a monoclonal antibody product candidate against anthrax. This acquisition is designed to round-out our anthrax countermeasure program in that it enables us to develop an additional therapeutic candidate in parallel to our polyclonal anthrax IG therapeutic. HHS has indicated its interest in acquiring both anthrax monoclonal and polyclonal (immunoglobulin) therapeutics for the Strategic National Stockpile (SNS) for the treatment of post-symptomatic anthrax infection.

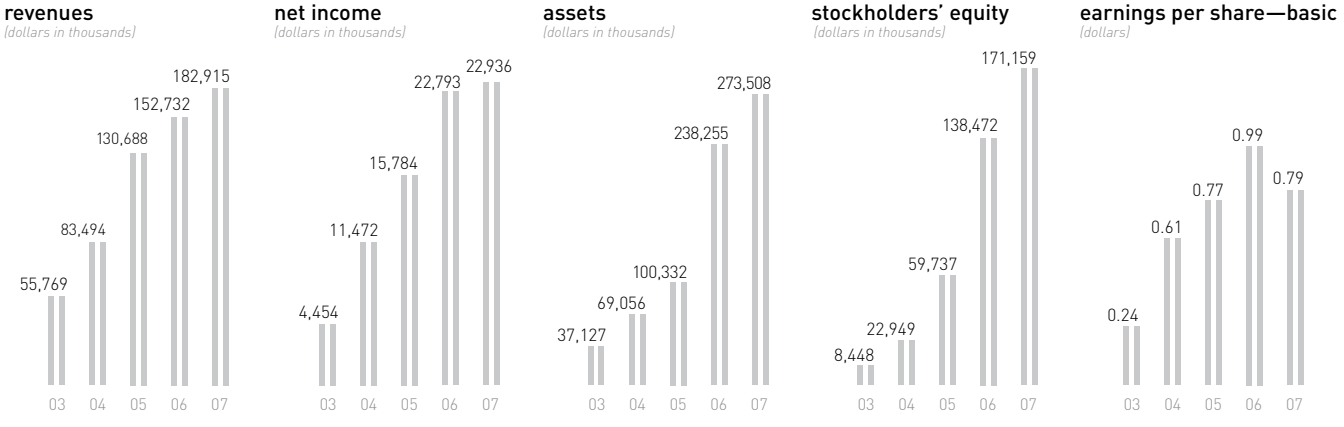
In closing, I would like to thank all of our employees worldwide who are working every day to build our company into a leading biopharmaceutical company. I am grateful for the continued guidance provided by our Board of Directors. I would like to acknowledge the support of our key customers, collaborators and vendors. Finally, I would like to pay particular thanks to our stockholders for your confidence in our company and the mission we are pursuing.

Sincerely yours,



Fuad El-Hibri
Chairman and Chief Executive Officer

## Financial highlights



# A biopharmaceutical company

## Protecting life

## Focused

We focus on product development, from proof-of-concept to commercialization. Our approach is to continuously evaluate and prioritize our development programs to advance those product candidates that hold the greatest promise.

## Balanced

We take a balanced approach in developing products that serve multiple markets. Our product portfolio comprises vaccines and therapeutics that address underserved or unmet medical needs. We employ multiple platforms in product development to reduce risk. Our products target markets that provide significant opportunities for growth, whether vaccines and therapeutics for biodefense application or targeting infectious diseases worldwide.

# Collaborative

We aim to establish collaborative non-dilutive arrangements with governmental and non-governmental agencies in the United States and abroad to advance the development of our product candidates.

# Acquisitive

We seek to strategically expand our product portfolio by pursuing opportunities to acquire promising advanced product candidates. This approach enables us to reduce product development risk, accelerate timelines and avoid costs associated with exploratory research.


# Proven

We manage our business in a fiscally responsible manner. This has helped us achieve a track record of financial success that has enabled us to fund the development of a majority of our pipeline development.

# A balanced product portfolio

Our approach is to achieve balance in the products that we develop through a portfolio comprised of innovative vaccines and therapeutics that target infectious diseases worldwide. For the development of certain product candidates we use multiple proprietary technologies: our *spi*-VEC™ bacterial platform suitable for oral delivery, and MVAtor™, a viral vector for injectable vaccines.

## Delivering the difference

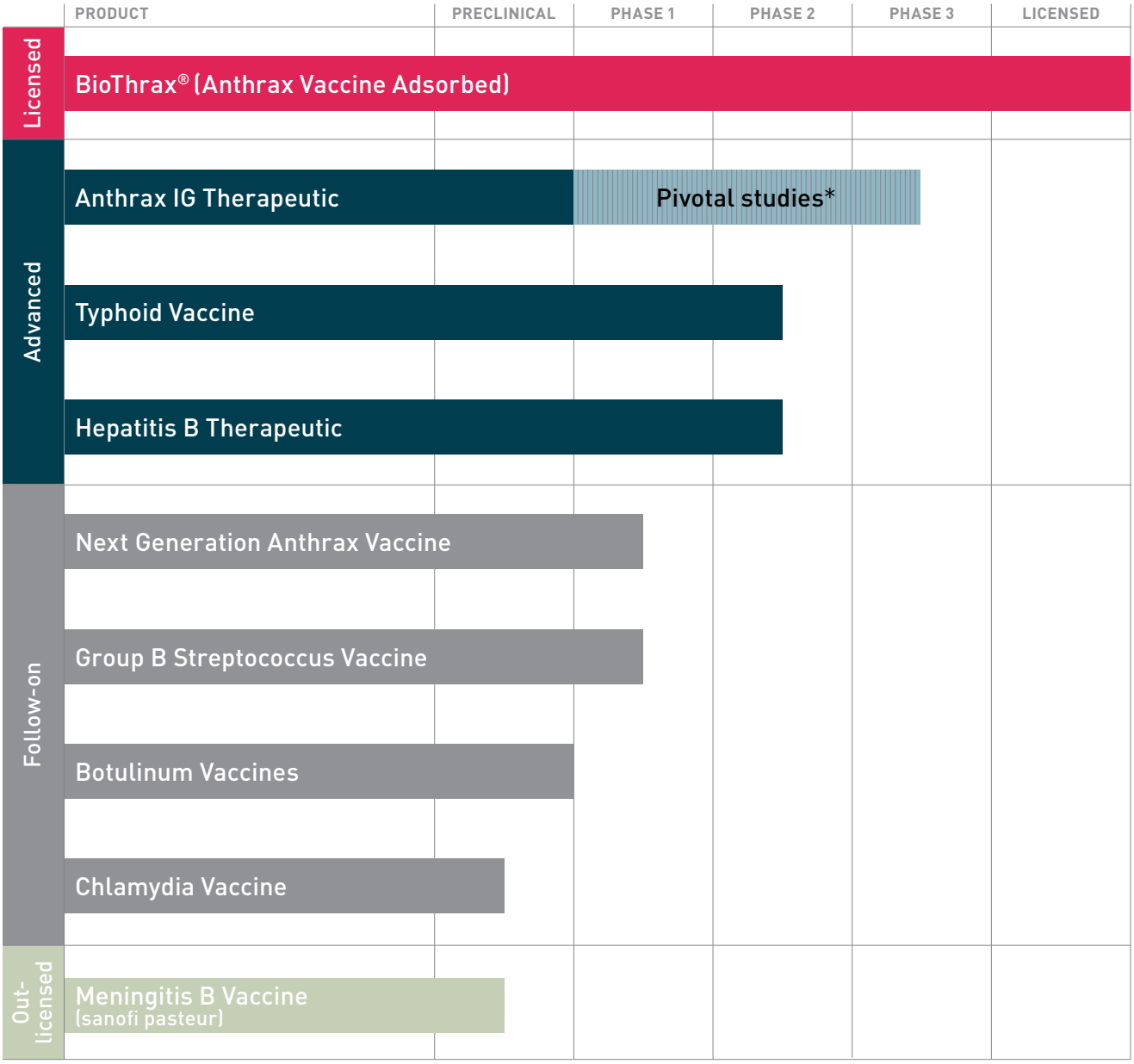
*spi*-VEC, our proprietary oral delivery platform, is designed to enable the effective delivery of vaccines and therapeutics. Based on the *Salmonella typhi* bacterium, the *spi*-VEC vector has demonstrated a promising safety profile in clinical trials in both adults and children. *spi*-VEC technology is versatile and is designed to deliver a wide range of antigens to prevent or treat numerous diseases, including bacterial and viral infections and cancer. Our *spi*-VEC technology is our oral typhoid product candidate and is the basis by which we are developing our hepatitis B candidate, an immunotherapy for chronic carriers of the hepatitis B virus.

MVAtor is a viral vector based on the Modified *Vaccinia Ankara* (MVA) virus, an attenuated virus that can be used to deliver a foreign antigen, which stimulates an immune response. MVA has been used in people and shows promising results for safety and immunogenicity. In animal models, recombinant MVA vaccines have been shown to be highly immunogenic and capable of eliciting a protective immune response against various infectious diseases. Clinical trials that have been performed with recombinant MVA underscore the safety of MVA for potential use as a viral vector.

## Understanding vaccine vectors

Vaccine vectors are the means by which antigens can be delivered to patients to effect a prophylactic or therapeutic immune response. Attenuated vaccine vectors are live bacteria or viruses that have been weakened so that they are no longer capable of causing disease, yet they can still efficiently express foreign antigens in a manner that will lead to a protective immune response. These attenuated vectors can be used as vaccines themselves, or as a general delivery system for vaccines and therapeutics for use against a variety of diseases.

We are developing a balanced portfolio of vaccines and therapeutics from proof-of-concept to commercialization.




*Pivotal studies in animals and humans expected to proceed in parallel under the FDA animal rule.

Shielding life

# Protecting those most at risk for anthrax exposure through vaccination

"...anthrax is a top threat. I know my colleagues have heard me say before that the top three threats, in fact, are anthrax, anthrax, anthrax."

Gerald W. Parker
Assistant Secretary, HHS


According to the Centers for Disease Control and Prevention (CDC), weaponized anthrax is one of the greatest possible bioterrorist threats to the public. To combat this Category A threat, we have developed a franchise of prophylaxis and post-exposure treatments to shield against anthrax disease.

Our licensed anthrax vaccine, BioThrax® (Anthrax Vaccine Adsorbed), is the only FDA-approved product for pre-exposure prophylaxis of anthrax disease. Marketed as a biodefense countermeasure, our principal customers include governments which actively immunize military personnel and which stockpile for protection in the event of an anthrax attack on civilians. To date, more than 7 million doses have been administered to almost 2 million individuals. The U.S. government has contracted with us to supply the CDC's Strategic National Stockpile (SNS) with BioThrax. Since 1998, we have delivered over 25 million doses of BioThrax under our contracts with the Department of Defense and the Department of Health and Human Services (HHS). Last year, we secured a three-year contract with HHS to continue providing BioThrax for supply into the SNS.

We continue to advance the utility of BioThrax through several product enhancement programs. We are seeking FDA approval to use BioThrax as a post-exposure prophylaxis in conjunction with antibiotics, to extend the label's expiry dating to four years, to reduce the number of doses required for immunization and to add a new route of administration.

## Expanding markets worldwide

To further expand our international market opportunities, we are pursuing regulatory approval in a number of foreign jurisdictions and remain encouraged by the current level of interest from several governments around the world. We continued to develop partnerships with government and non-government entities in strategic growth markets. Specifically, we formed a joint venture in Malaysia with 9Bio that focuses on creating critical biologics infrastructure and supplying biodefense countermeasures, including BioThrax and other medical and complementary products and services to the Government of Malaysia, as well as potentially other countries within the region. In addition, the Government of Malaysia, through 9Bio, selected Emergent BioSolutions as one of its principal partners to assist, as a contract service provider, in building a vaccine development and manufacturing infrastructure.

Target Indication
Pre- and post-exposure prophylaxis for anthrax disease

Intended Market
Civilian stockpile, military

Target Product Characteristics
Recombinant protective antigens or *Bacillus anthracis* toxoid technology

## Next generation anthrax vaccine

We have established a program to develop additional anthrax vaccine product candidates that would incorporate advanced characteristics, including one or more of the following: reduced number of doses, room temperature storage, enhanced immune response, longer expiry dating or novel delivery method. We are evaluating candidates based on recombinant protective antigens, or rPA, as well as a candidate based on native protective antigens of *Bacillus anthracis*.

BioThrax® (Anthrax Vaccine Adsorbed) is the only FDA-approved product for pre-exposure prophylaxis of anthrax disease.

# Protecting those exposed to anthrax through therapeutics

## Anthrax Therapeutics (IG & Monoclonal)

**Target Indication**
Treatment of patients with manifest symptoms of anthrax disease

**Intended Market**
Civilian stockpile, military

**Target Product Characteristics**
Intravenous


For investigational use only.

In August 2004, HHS issued a request for proposal seeking 200,000 doses of an anthrax therapeutic to be administered following exposure to anthrax. Anthrax therapies are being purchased by HHS as means of expanding its arsenal of effective countermeasures in the event of future anthrax attacks. We are developing a polyclonal anthrax immune globulin and a monoclonal anthrax antibody product candidate.

### Anthrax IG Therapeutic

Our Anthrax Immune Globulin (IG) Therapeutic for use against symptomatic anthrax infection is in advanced development. We are developing our anthrax IG therapeutic using plasma produced by healthy donors who have been immunized with our anthrax vaccine, BioThrax. Our FDA-approved manufacturing partner, Talecris Biotherapeutics Inc., has completed two full-scale commercial lots of our product candidate for use in clinical studies. Last year, the FDA granted our anthrax IG therapeutic candidate Fast Track status. We subsequently filed an Investigational New Drug application with the FDA for a Phase I clinical trial to evaluate the safety and pharmacokinetics of our product candidate. We have signed development contracts with NIAID totaling $13.4 million for the continued studies designed to assess tolerability of our anthrax IG therapeutic. Pivotal animal studies and clinical trial planning are underway.

Currently, there are no FDA-approved products for the treatment of anthrax disease that can neutralize the anthrax toxin.

### Monoclonal anthrax therapeutic

We are also developing AVP-21D9, a monoclonal anthrax therapeutic for use against symptomatic anthrax infection. This product is a human monoclonal antibody, and has demonstrated efficacy in animal studies. Development of this product is funded in part with a grant from NIAID. The addition of an anthrax monoclonal therapeutic to our portfolio broadens our anthrax countermeasures program and reflects our ongoing commitment to develop a full portfolio of countermeasures to strengthen national preparedness in the event of future anthrax attacks.

Our anthrax therapeutic product candidates are being designed for use against symptomatic anthrax infection.

Transforming life

# Seeking to protect millions against typhoid fever through innovation

"The trial will advance the development of a sorely needed vaccine for typhoid fever. The ease of administration of the product is one of its chief attractions from a public health perspective."

Dr. Ted Bianco, Director of Technology Transfer at the Wellcome Trust, which funded the study

wellcome trust

Typhoid fever is a global public health burden with an estimated 22 million cases and 200,000 deaths occurring worldwide each year. Typhoid fever continues to be a public health problem in many developing countries, with young children being disproportionately affected. The World Health Organization (WHO) recommends vaccinating pre-school-aged children living in typhoid endemic regions against the disease. With antibiotic resistant strains of typhoid fever being increasingly seen in endemic populations, there is an even greater need to control the disease through targeted vaccination programs.

We are excited about developing the world's first single-dose oral vaccine to protect children and adults at risk of typhoid fever. The patient-friendly administration of our vaccine candidate holds the promise of expanding the global vaccine market and increasing the likelihood of immunization.

In 2007, we completed a randomized, placebo-controlled Phase II clinical trial of our vaccine candidate in Vietnam, with new trials planned for 2008. In this Phase II trial, the vaccine candidate achieved all clinical endpoints for safety and immunogenicity. The Wellcome Trust has provided important funding for Phase I and II clinical trials of our oral typhoid vaccine candidate.


## Traveling with peace of mind

Typhoid fever is a concern for the millions of travelers who visit typhoid endemic areas. The CDC recommends vaccinating children and adults traveling to regions with endemic typhoid fever. Approximately 60 million U.S. and European citizens traveled overseas in 2006, with travelers to typhoid endemic regions most at risk of contracting the disease. With global travel increasing annually, typhoid fever can affect families worldwide regardless of economic status.

Typhoid fever remains a major public health problem in many developing countries.

# Protecting hepatitis B patients through targeted treatment

"As a serious global health issue afflicting the lives of millions of people, advancing the clinical study of Emergent's hepatitis B immunotherapy is an important step toward alleviating patients' suffering from this chronic disease."

Professor Graham Foster, Clinical Investigator, Professor of Hepatology, Barts and The London School of Medicine

Hepatitis B is one of the most widespread viral infections in the world. Globally, approximately 350 to 400 million people are chronically infected with hepatitis B, with over 100 million of those individuals living in China alone. Chronic hepatitis B infection can lead to cirrhosis, liver cancer and liver failure, making it the tenth leading cause of death worldwide. Despite improvements in hepatitis B therapy, current therapies are only partially effective at controlling the disease and rarely cure infection in chronic carriers; most patients require lifelong therapy.

Our approach uses our proprietary *spi*-VEC oral delivery platform to develop a hepatitis B immunotherapy designed to direct the immune system against virus-infected cells in the liver. Potentially promoting the rate of viral clearance would also enable patients to benefit from shorter durations of therapy, fewer side effects and less risk of developing resistance to antiviral therapy. We believe that our product has the potential to improve the standard of care for hepatitis B patients.

## Addressing a scourge in the developing world

The WHO calls hepatitis B one of the major diseases of mankind and a serious global public health problem. High rates of chronic hepatitis B infection are found in much of the developing world where prevention and treatment are rare. While vaccines are available that can prevent hepatitis B infection, existing therapies have limitations in treating people with chronic hepatitis B infection. As a result, a large number of chronically infected people require lifelong treatment to prevent the development of liver disease and to reduce the risk of transmitting the infection to others.

Our approach uses our proprietary *spi*-VEC oral delivery platform.

# Protecting against a broad spectrum of infectious diseases

## Group B streptococcus

We are developing a vaccine that would be administered to women of child-bearing age to protect newborns against group B streptococcus, or group B strep. Group B strep is a bacterium that causes life-threatening infections such as sepsis, meningitis and pneumonia in newborns. There is no vaccine currently available to protect against group B strep. NIAID/NIH has agreed to fund, manage and conduct a Phase I clinical trial of our bivalent group B streptococcus vaccine product candidate.

**Target Indication**
Prevention of neonatal group B streptococcus infections

**Intended Market**
Women of childbearing age

**Target Product Characteristics**
Recombinant protein subunit vaccine

**Target Indication**
Prevention of botulinum serotypes A, B and E

**Intended Market**
Civilian stockpile, military

**Target Product Characteristics**
Injectable recombinant protein subunit vaccine or toxoid vaccine

## Botulinum vaccines

We are developing two vaccine candidates to protect against botulinum illness caused by botulinum serotypes A, B and E. The first, in collaboration with the United Kingdom's Health Protection Agency (HPA), is a recombinant protein subunit trivalent vaccine based on a fragment of the botulinum toxin that we have selected as an antigen because we believe it to be non-toxic and immunogenic.

Our second vaccine candidate is a botulinum toxoid vaccine that includes a combination of up to three botulinum serotypes A, B and E. We are developing this product using our proprietary botulinum serotypes B and E and serotype A from HPA.

Target Indication
Prevention of
*Chlamydia trachomatis*

Intended Market
Adolescents and
young adults

Target Product
Characteristics
Recombinant protein
subunit vaccine

## Chlamydia

Our vaccine candidate intended for adolescents is designed to protect against chlamydia infection, the most prevalent bacterial sexually transmitted disease in the world. *Chlamydia trachomatis* infections occur in both men and women. In women, repeat reinfections may result in pelvic inflammatory disease, which is a major cause of infertility, ectopic pregnancy and chronic pelvic pain. Pregnant women infected with chlamydia can pass the infection to their infants during delivery, potentially resulting in neonatal ophthalmia and pneumonia. There is no vaccine currently available to protect against chlamydia.

## Meningitis B

We are collaborating with sanofi pasteur, to whom we have out-licensed our technology, to develop a vaccine for infants, children and adolescents to protect against meningitis B, an infection of the fluid surrounding the spinal cord and brain. The rapid progression of the infection means that antibiotics can be ineffective in preventing serious morbidity and mortality. Children from six months to two years of age are at the highest risk of infection, with teenagers also at enhanced risk. There is currently no licensed vaccine in the United States or Europe that protects against group B meningococcal infection.

Target Indication
Prevention of type B
meningitis caused by
*Neisseria meningitis*

Intended Market
Infants, children,
adolescents

Target Product
Characteristics
Recombinant protein
subunit vaccine

| Partner | Product/Focus |
|---|---|
| **HHS** (BARDA) | Anthrax IG Therapeutic<br>BioThrax (Post-exposure) |
| **CDC** | BioThrax (Dose Reduction, IM) |
| **NIH/NIAID** | Anthrax IG Therapeutic<br>Group B Streptococcus Vaccine |
| **Wellcome Trust** (UK) | Typhoid Vaccine |
| **9Bio** (Malaysian Government) | BioThrax Sales and Distribution,<br>Product Development and<br>Contract Manufacturing |
| **Health Protection Agency** (UK) | Botulinum Vaccines |
| **sanofi pasteur** | Meningitis B Vaccine |

## Making progress together

No company can combat serious diseases alone. We know that developing vaccines and therapeutics requires significant investment and that such a pursuit must be a collaborative effort. We are actively working to bring together the best scientific, business and public policy minds in pursuit of our product development goals. We are grateful for the support we enjoy from our government and non-government partners.

# Leading the way

## Guiding Emergent BioSolutions with strong leadership

### Board of directors

**Fuad El-Hibri**
Chairman and
Chief Executive Officer,
Emergent BioSolutions Inc.

**Joseph M. Allbaugh**[2,3]
President and Chief Executive Officer,
The Allbaugh Company, LLC;
Former Director, Federal Emergency
Management Agency

**Sue Bailey, M.D.**[3]
Former news analyst for NBC
and Assistant Secretary of
Defense (Health Affairs)

**Zsolt Harsanyi, Ph.D.**[1*,2,4]
Chairman and
Chief Executive Officer,
Exponential Biotherapies, Inc.

**Jerome M. Hauer**
Chief Executive Officer,
The Hauer Group, LLC;
Former Director,
City of New York Office of
Emergency Management

**Ronald B. Richard**[1,2*]
President and
Chief Executive Officer,
The Cleveland Foundation

**Louis W. Sullivan, M.D.**[1,3*]
President Emeritus,
Morehouse School of Medicine;
Former Secretary, Department
of Health and Human Services

1 Audit Committee
2 Compensation Committee
3 Nominating & Corporate
Governance Committee
4 Lead Independent Director
* Chairman of Committee

### Corporate officers

**Fuad El-Hibri***
Chief Executive Officer and
Chairman of the Board of Directors

**Daniel J. Abdun-Nabi***
President and Chief Operating Officer

**R. Don Elsey***
Senior Vice President Finance and
Administration and Chief Financial Officer

**Denise Esposito***
Senior Vice President Legal Affairs,
General Counsel and Secretary

**Mauro Gibellini**
Senior Vice President Corporate Affairs

**W. James Jackson, Ph.D.**
Senior Vice President and
Chief Scientific Officer

**Kyle W. Keese***
Senior Vice President Manufacturing Operations

**Denise Landry**
Senior Vice President Quality and
Regulatory Affairs

**Allen Shofe**
Senior Vice President Public Affairs

*Executive Officer

### Heads of operating subsidiaries

**Robert G. Kramer, Sr.**
President and Chief Executive Officer,
Emergent Biodefense Operations
Lansing Inc.

**Stephen Lockhart, MA, BM, BCh, DM, MRCP, FFPM**
President, Emergent Product
Development UK Limited

**Michael J. Langford, DVM, Ph.D.**
President, Emergent Product
Development Gaithersburg Inc.

**Andreas Hartmann, Ph.D.**
Managing Director, Emergent
Product Development
Germany GmbH

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# 2007 FINANCIAL REPORT

# SELECTED CONSOLIDATED FINANCIAL DATA

You should read the following selected consolidated financial data together with our consolidated financial statements and the related notes included in this annual report and the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of this annual report.

We have derived the consolidated statement of operations data for the years ended December 31, 2007, 2006 and 2005 and the consolidated balance sheet data as of December 31, 2007 and 2006 from our audited consolidated financial statements, which are included in this annual report. We have derived the consolidated statements of operations data for the years ended December 31, 2004 and 2003 and the consolidated balance sheet data as of December 31, 2005, 2004 and 2003 from our audited consolidated financial statements, which are not included in this annual report. Our historical results for any prior period are not necessarily indicative of results to be expected in any future period.

| (in thousands, except share and per share data) | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2005 | 2004 | 2003 |
| **Statements of Operations Data:** | | | | | |
| Revenues: | | | | | |
| Product sales | $ 169,799 | $ 147,995 | $ 127,271 | $ 81,014 | $ 55,536 |
| Contracts and grants | 13,116 | 4,737 | 3,417 | 2,480 | 233 |
| Total revenues | 182,915 | 152,732 | 130,688 | 83,494 | 55,769 |
| Operating expenses (income): | | | | | |
| Cost of product sales | 40,309 | 24,125 | 31,603 | 30,102 | 22,342 |
| Research and development | 53,958 | 45,501 | 18,381 | 10,117 | 6,327 |
| Selling, general & administrative | 55,555 | 44,601 | 42,793 | 30,323 | 19,547 |
| Purchased in-process research and development | — | 477 | 26,575 | — | 1,824 |
| Settlement of State of Michigan Obligation | — | — | — | (3,819) | — |
| Litigation settlement | — | — | (10,000) | — | — |
| Total operating expenses | 149,822 | 114,704 | 109,352 | 66,723 | 50,040 |
| Income from operations | 33,093 | 38,028 | 21,336 | 16,771 | 5,729 |
| Other income (expense): | | | | | |
| Interest income | 2,809 | 846 | 485 | 65 | 100 |
| Interest expense | (71) | (1,152) | (767) | (241) | (293) |
| Other income (expense), net | 156 | 293 | 55 | 6 | 168 |
| Total other income (expense) | 2,894 | (13) | (227) | (170) | (25) |
| Income before provision for income taxes | 35,987 | 38,015 | 21,109 | 16,601 | 5,704 |
| Provision for income taxes | 13,051 | 15,222 | 5,325 | 5,129 | 1,250 |
| Net income | $ 22,936 | $ 22,793 | $ 15,784 | $ 11,472 | $ 4,454 |
| Earnings per share—basic | $ 0.79 | $ 0.99 | $ 0.77 | $ 0.61 | $ 0.24 |
| Earnings per share—diluted | $ 0.77 | $ 0.93 | $ 0.69 | $ 0.56 | $ 0.22 |
| Weighted average number of shares—basic | 28,995,667 | 23,039,794 | 20,533,471 | 18,919,850 | 18,904,992 |
| Weighted average number of shares—diluted | 29,663,127 | 24,567,302 | 22,751,733 | 20,439,252 | 20,316,752 |

| (in thousands) | As of December 31, 2007 | 2006 | 2005 | 2004 | 2003 |
|---|---|---|---|---|---|
| **Balance Sheet Data:** | | | | | |
| Cash and cash equivalents | $105,730 | $ 76,418 | $ 36,294 | $ 6,821 | $ 7,119 |
| Working capital | 88,649 | 82,990 | 29,023 | 7,509 | (3,147) |
| Total assets | 273,508 | 238,255 | 100,332 | 69,056 | 37,127 |
| Total long-term liabilities | 46,688 | 35,436 | 10,502 | 11,921 | 1,228 |
| Total stockholders' equity | 171,159 | 138,472 | 59,737 | 22,949 | 8,448 |

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*You should read the following discussion and analysis of our financial condition and results of operations together with our financial statements and the related notes and other financial information included elsewhere in this annual report. Some of the information contained in this discussion and analysis or set forth elsewhere in this annual report, including information with respect to our plans and strategy for our business and related financing, includes forward-looking statements that involve risks and uncertainties. You should review the "Special Note Regarding Forward Looking Statements" section of this annual report for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in the following discussion and analysis.*

## OVERVIEW

We are a profitable multinational biopharmaceutical company focused on the development, manufacture and commercialization of immunobiotics, consisting of vaccines and therapeutics that assist the body's immune system to prevent or treat disease. We manufacture and market BioThrax®, the only vaccine approved by the U.S. Food and Drug Administration, for the prevention of anthrax infection. We use internally generated cash flows from the sale of BioThrax to fund the development of a product pipeline that addresses a variety of infectious diseases and other medical conditions. We develop immunobiotics for use against infectious diseases that have resulted in significant unmet or underserved public health needs and against biological agents that are potential weapons of bioterrorism and biowarfare. We operate in two business segments, biodefense and commercial.

Our biodefense business focuses on immunobiotics for use against biological agents that are potential weapons of bioterrorism and biowarfare. Our product candidates targeted to the biodefense market are anthrax immune globulin therapeutic, next generation anthrax vaccine and botulinum vaccines and botulinum immune globulin therapeutic. Our commercial business focuses on immunobiotics for use against infectious diseases and other medical conditions that have resulted in significant unmet or underserved public health needs. Our product candidates targeted to the commercial market are typhoid vaccine, hepatitis B therapeutic, group B streptococcus and chlamydia vaccines. We expect to continue to seek to obtain marketed products and development stage product candidates through acquisitions and licensing arrangements with third parties.

Our biodefense business has generated net income for each of the last three fiscal years. Our commercial business has generated revenue through development grant funding and an upfront license fee and additional payments for development work under a collaboration agreement with Sanofi Pasteur. None of our commercial product candidates have received marketing approval and therefore, have not generated any product sales revenues. As a result, our commercial business has incurred a net loss for each of the last three fiscal years.

### Product Sales

We have derived substantially all of our revenues from BioThrax sales to the DoD and HHS, and expect for the foreseeable future to continue to derive substantially all of our revenues from the sales of BioThrax to HHS. Our total revenues from BioThrax sales were $169.8 million in 2007, $148.0 million in 2006 and $127.3 million in 2005. We are focused on increasing sales of BioThrax to U.S. government customers, expanding the market for BioThrax to other customers and pursuing label expansions and improvements for BioThrax.

In addition to BioThrax, our advanced product portfolio includes an anthrax immune globulin therapeutic candidate for biodefense indications and a typhoid vaccine and hepatitis B therapeutic vaccine for commercial infectious disease indications. We are developing our anthrax immune globulin therapeutic in part with funding from NIAID. The Wellcome Trust provided funding for the Phase I and Phase II clinical trials of our typhoid vaccine candidate. We typically advance development of our biodefense product candidates only with external funding, and may slow down or put development programs on hold during periods that are not covered by funding.

Our early stage product portfolio includes a next generation anthrax vaccine and botulinum vaccine and immune globulin therapeutic candidates for biodefense indications and group B streptococcus and chlamydia vaccine candidates for commercial infectious disease indications. We have entered into collaboration agreements with the HPA for the development of a recombinant botulinum vaccine candidate and a botulinum

immune globulin candidate. The NIAID is conducting and funding the Phase I clinical trial of our group B streptococcus vaccine candidate.

We are actively pursuing additional government sponsored development grants as well as encouraging both governmental and non-governmental agencies and philanthropic organizations to provide development funding, or to conduct clinical studies of these products. For example, the Wellcome Trust provided funding for the Phase I and Phase II clinical trials of our typhoid vaccine candidate. In addition, the NIAID is conducting and funding one of the Phase I clinical trials of our group B streptococcus vaccine candidate.

### Manufacturing Infrastructure

We conduct our primary vaccine manufacturing operations at a multi-building campus on approximately 12.5 acres in Lansing, Michigan. To augment our existing manufacturing capabilities, we have constructed a new 50,000 square foot manufacturing facility on our Lansing campus. We expect the facility to cost approximately $75 million when complete, including approximately $55 million for the building and associated capital equipment, with the balance related to validation and qualification activities required for regulatory approval and initiation of manufacturing. We have incurred costs of approximately $63 million for these purposes through December 2007. We substantially completed construction of this facility in 2006, and are conducting validation and qualification activities required for regulatory approval. This new facility is a large scale manufacturing plant that we can use to produce multiple fermentation based vaccine products, subject to complying with appropriate change-over procedures.

We also own two buildings in Frederick, Maryland that are available to support our future manufacturing requirements. We have incurred costs of approximately $4 million through December 2007 related to initial engineering design and preliminary utility build out of one of these buildings. Because we are in the preliminary planning stages of our Frederick build out, we cannot reasonably estimate the timing and costs that would be necessary to complete this project. If we proceed with this project, we expect the costs to be substantial and to likely require external sources of funds to finance the project. We may elect to lease all or a substantial portion of, or sell, one of these facilities to third parties.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities and expenses.

On an ongoing basis, we evaluate our estimates and judgments, including those related to accrued expenses, fair value of stock-based compensation and income taxes. We based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the reported amounts of revenues and expenses that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

### Revenue Recognition

We recognize revenues from product sales in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition,* or SAB 104. SAB 104 requires recognition of revenues from product sales that require no continuing performance on our part if four basic criteria have been met:

- there is persuasive evidence of an arrangement;
- delivery has occurred or title has passed to our customer based on contract terms;
- the fee is fixed and determinable and no further obligation exists; and
- collectibility is reasonably assured.

We have generated BioThrax sales revenues under U.S. government contracts with the DoD and HHS. Under previous DoD contracts, we invoiced the DoD for progress payments upon reaching contractually specified stages in the manufacture of BioThrax. We recorded as deferred revenue the full amount of each progress payment invoice that we submitted to the DoD. Title to the product passed to the DoD upon submission of

the first invoice. The earnings process was considered complete upon FDA release of the product for sale and distribution. Following FDA release of the product, we segregated the product for later shipment and recognized as period revenue all deferred revenue related to the released product in accordance with the "bill and hold" sale requirements under SAB 104. At that time, we also invoiced the DoD for the final progress payment and recognized the amount of that invoice as period revenue.

Under previous contracts with HHS, we invoiced HHS and recognized the related revenues upon delivery of the product to the government carrier, at which time title to the product passed to HHS. Under our current contract with HHS, we invoice HHS and recognize the related revenues upon acceptance by the government at the delivery site, at which time title to the product passes to HHS.

Under the collaboration agreement that we entered into with Sanofi Pasteur in May 2006 for our meningitis B vaccine candidate, we received an upfront license fee and are entitled to additional payments for development work under the collaboration and upon achieving contractually defined development and commercialization milestones. We evaluated the various components of the collaboration in accordance with Emerging Issues Task Force, or EITF, Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables,* or EITF No. 00-21, which addresses whether, for revenue recognition purposes, there is one or several units of accounting in an arrangement. We concluded that under EITF No. 00-21, the upfront license fee, the development work and the milestone payments under our agreement with Sanofi Pasteur should be accounted for as a single unit of accounting. We recognize amounts received under this agreement over the estimated development period as we perform services. We recorded the amount of the upfront license fee as deferred revenue. We are recognizing this revenue over the estimated development period under the contract, currently estimated at seven years, as adjusted from time to time for any delays or acceleration in the development of the product candidate. Under the collaboration agreement, we are entitled to payments up to specified levels for development work we perform on behalf of Sanofi Pasteur. We generally invoice Sanofi Pasteur in advance of each quarter for the estimated work to occur in the upcoming quarter. We record the invoice amount as deferred revenue and, as services are completed, recognize the amount of the related deferred revenue as period revenues. Under the collaboration agreement, we also will be entitled to royalty payments on any future net sales of this product candidate.

From time to time, we are awarded reimbursement contracts for services and development grant contracts with government entities and non-government and philanthropic organizations. Under these contracts, we typically are reimbursed for our costs in connection with specific development activities and may also be entitled to additional fees. We record the reimbursement of our costs and any associated fees as contract and grant revenues and the associated costs as research and development expense. We issue invoices under these contracts after we incur the reimbursable costs. We recognize revenue upon invoicing the sponsoring organization.

**Accounts Receivable**

Accounts receivable are stated at invoice amounts and consist primarily of amounts due from the DoD and HHS as well as amounts due under reimbursement contracts with other government entities and non-government and philanthropic organizations. Because the collection history for receivables from these entities indicate that collection is likely, we do not currently record an allowance for doubtful accounts.

**Inventories**

Inventories are stated at the lower of cost or market, with cost being determined using a standard cost method, which approximates average cost. Average cost consists primarily of material, labor and manufacturing overhead expenses and includes the services and products of third party suppliers.

We analyze our inventory levels quarterly and write down in the applicable period inventory that has become obsolete, inventory that has a cost basis in excess of its expected net realizable value and inventory in excess of expected customer demand. We also write off in the applicable period the costs related to expired inventory. We capitalize the costs associated with the manufacture of BioThrax as inventory from the initiation of the manufacturing process through the completion of manufacturing, labeling and packaging.

### Accrued Expenses

As part of the process of preparing financial statements, we are required to estimate accrued expenses. This process involves identifying services that have been performed on our behalf and estimating the level of service performed and the associated cost incurred for such service where we have not yet been invoiced or otherwise notified of actual cost. We make these estimates as of each balance sheet date in our financial statements. Examples of estimated accrued expenses include:

- fees payable to contract research organizations in conjunction with clinical trials;
- fees payable to third party manufacturers in conjunction with the production of clinical trial materials; and
- professional service fees.

In accruing service fees, we estimate the time period over which services were provided and the level of effort in each period. If the actual timing of the provision of services or the level of effort varies from the estimate, we will adjust the accrual accordingly. The majority of our service providers invoice us monthly in arrears for services performed. In the event that we do not identify costs that have begun to be incurred or we underestimate or overestimate the level of services performed or the costs of such services, our actual expenses could differ from such estimates. The date on which some services commence, the level of services performed on or before a given date and the cost of such services are often subjective determinations. We make judgments based upon the facts and circumstances known to us.

### Purchased In-process Research and Development

We account for purchased in-process research and development in accordance with Statement of Financial Accounting Standards, or SFAS, No. 2, *Accounting for Research and Development Costs,* along with Financial Accounting Standards Board, or FASB, Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.*

Under these standards, we are required to determine whether the technology relating to a particular research and development project we acquire has an alternative future use. If we determine that the technology has no alternative future use, we expense the value of the research and development project not directly attributed to tangible assets. Otherwise, we capitalize the value of the research and development project not attributable to tangible assets as an intangible asset and conduct an impairment analysis at least annually. In connection with our acquisitions of ViVacs GmbH, in July 2006, and Microscience Limited, or Microscience, in June 2005, we allocated the value of the purchase consideration to current assets, current liabilities, fixed assets and development programs. Because we determined that the development programs at ViVacs and Microscience had no future alternative use, we charged the value attributable to the development programs as in-process research and development. The ViVacs acquisition was a cash transaction, and therefore no fair value determination was necessary. For the Microscience acquisition, which was a share exchange, our board of directors determined the fair value of our shares issued in the exchange for financial statement purposes.

### Stock-based Compensation

We adopted SFAS No. 123 (revised 2004), *Share-Based Payment,* or SFAS No. 123(R), on January 1, 2006 using the modified prospective method. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their estimated grant date fair values.

We value our share-based payment transactions using the Black-Scholes valuation model. Under the modified prospective method, we recognize compensation cost in our financial statements for all awards granted after January 1, 2006 and for all awards outstanding as of January 1, 2006 for which the requisite service had not been rendered as of the date of adoption. We measure the amount of compensation cost based on the fair value of the underlying equity award on the date of grant. We recognize compensation cost over the period that an employee provides service in exchange for the award. As of December 31, 2007, total compensation expense not yet recognized related to unvested options is approximately $2.9 million after tax. This expense is expected to be recognized over a weighted-average period of 3.0 years.

The effect of adopting SFAS No. 123(R) on net income (loss) and net income (loss) per share is not necessarily representative of the effects in future years due to, among other things, the vesting period of the stock options and the fair value of additional stock option grants in future years.

### Income Taxes

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes,* or SFAS No. 109. Under the asset and liability method of SFAS No. 109, deferred tax assets and liabilities are determined based on the differences between the financial reporting and the tax bases of assets and liabilities and are measured using the tax rates and laws that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A net deferred tax asset or liability is reported in the balance sheet. Our deferred tax assets include the unamortized portion of in-process research and development expenses, the anticipated future benefit of the net operating losses that we have incurred and other timing differences between the financial reporting basis of assets and liabilities.

We have historically incurred net operating losses for income tax purposes in some states, primarily Maryland, and in some foreign jurisdictions, primarily the United Kingdom. The amount of the deferred tax assets on our balance sheet reflects our expectations regarding our ability to use our net operating losses to offset future taxable income. The applicable tax rules in particular jurisdictions limit our ability to use net operating losses as a result of ownership changes. In particular, we believe that these rules will significantly limit our ability to use net operating losses generated by Microscience and Antex Biologics, Inc., or Antex, prior to our acquisition of Microscience in June 2005 and our acquisition of substantially all of the assets of Antex in May 2003.

We review our deferred tax assets on a quarterly basis to assess our ability to realize the benefit from these deferred tax as sets. If we determine that it is more likely than not that the amount of our expected future taxable income will not be sufficient to allow us to fully utilize our deferred tax assets, we increase our valuation allowance against deferred tax assets by recording a provision for income taxes on our income statement, which reduces net income, or increases net loss, for that period and reduces our deferred tax assets on our balance sheet. If we determine that the amount of our expected future taxable income will allow us to utilize net operating losses in excess of our net deferred tax assets, we reduce our valuation allowance by recording a benefit from income taxes on our income statement, which increases net income, or reduces net loss, for that period and increases our deferred tax assets on our balance sheet.

We account for uncertainty in income taxes in accordance with FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109, Accounting for Income Taxes,* or FIN 48. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Under FIN 48, we recognize in our financial statements the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure.

## FINANCIAL OPERATIONS OVERVIEW

### Revenues

Between May 2005 and February 2007, we supplied 10.0 million doses of BioThrax to HHS for inclusion in the SNS under a base contract for 5.0 million doses for a fixed price of $123 million and a contract modification for an additional 5.0 million doses for a fixed price of $120 million. We completed delivery of all doses to HHS under this contract in February 2007.

On September 25, 2007, we entered into an agreement with HHS to supply 18.75 million doses of BioThrax to HHS for placement into the SNS. The term of the agreement is from September 25, 2007 through September 24, 2010. The first 5.5 million doses delivered under this contract were sold to HHS at a discounted price, as specified in the contract, due to the limited remaining shelf-life for these specific doses. This discounted price does not apply to the remaining 13.25 million doses that will be sold to HHS under the contract. The firm fixed price for the 18.75 million doses, including the discount, is $400 million in the aggregate. If we receive FDA approval of our pending application to extend the expiry dating of BioThrax from three years to four years, HHS has agreed to increase the price per dose under the agreement for the remaining 13.25 million doses. In that event, HHS would make a lump sum payment to us reflecting an increase in the price per dose for specified doses delivered prior to approval and pay an increased price per dose for doses delivered following the date of such approval. The aggregate value of such

price adjustment is $34 million. If we do not receive FDA approval of four-year expiry dating during the term of the agreement there will be no adjustment in the price per dose under the agreement. We delivered over 6 million doses of BioThrax to HHS under this agreement in 2007. Under this agreement, we have also agreed to provide all shipping services related to delivery of doses into the SNS over the term of the agreement, for which HHS has agreed to pay approximately $2.2 million. We invoice HHS for each delivery upon acceptance of BioThrax doses delivered into the SNS. The agreement also provides for HHS to pay up to $11.5 million in milestone payments in connection with us advancing a program to obtain a post-exposure prophylaxis indication for BioThrax. These funds are payable upon achievement of specific program milestones. In October 2007, we achieved the initial milestone and invoiced HHS for $8.8 million. We received this payment from HHS and revenue was recognized in November 2007.

Since 1998, we have been a party to two supply agreements for BioThrax with the DoD. Pursuant to these contracts, we have supplied approximately 10 million doses of BioThrax for immunization of military personnel. Our most recent contract with the DoD, as amended in October 2006, provided for the supply of a minimum of approximately 1.5 million doses of BioThrax to the DoD through September 2007. As a result of a further amendment of the DoD contract in June 2007, we completed delivery of all doses to the DoD under this contract prior to June 30, 2007. We are not currently party to a procurement contract with the DoD.

We believe that the DoD has a continued commitment to procure BioThrax for its active immunization program. We believe that, as a result of the October 2007 Presidential Directive, in the future the DoD will likely procure additional doses of BioThrax to satisfy ongoing requirements for its active immunization program directly from HHS and not from us. We believe that these purchases by DoD from HHS may result in additional purchases by HHS from us.

In May 2006, we entered into a collaboration agreement with Sanofi Pasteur relating to the development and commercialization of our meningitis B vaccine candidate under which we granted Sanofi Pasteur an exclusive, worldwide license under our proprietary technology to develop and commercialize our meningitis B vaccine candidate and received a $3.8 million upfront license fee. This agreement also provides for a series of milestone payments upon the achievement of specified development and commercialization objectives, payments for development work under the collaboration and royalties on net sales of this product. We defer the upfront license fee, milestone payments and development reimbursement payments under this agreement, and record revenue in accordance with our revenue recognition policies. We are currently in negotiations with Sanofi Pasteur to amend this agreement.

In September 2007, we received a development contract from NIAID, valued at up to $9.5 million, in support of non-clinical and clinical studies of our anthrax immune globulin therapeutic candidate. Under terms of the development contract, we will use the funds to conduct various studies on this product candidate, including animal efficacy studies and clinical trials. Through December 31, 2007, we have invoiced $61,000 under this contract.

Our revenue, operating results and profitability have varied, and we expect that they will continue to vary on a quarterly basis, primarily because of the timing of our fulfilling orders for BioThrax and work done under new and existing contracts and grants.

### Cost of Product Sales

The primary expense that we incur to deliver BioThrax to our customers is manufacturing costs, which are primarily fixed costs. These fixed manufacturing costs consist of attributable facilities, utilities and salaries and personnel-related expenses for indirect manufacturing support staff. Variable manufacturing costs for BioThrax consist primarily of costs for materials, direct labor and contract filling operations.

We determine the cost of product sales for doses sold during a reporting period based on the average manufacturing cost per dose for the specific earlier period in which the doses sold were manufactured. We calculate the average manufacturing cost per dose in the period of manufacture by dividing the actual costs of manufacturing in such period by the number of units produced in that period. In addition to the fixed and variable manufacturing costs described above, the average manufacturing cost per dose depends on the efficiency of the manufacturing process, utilization of available manufacturing capacity and the production yield for the period of production.

### Research and Development Expenses

We expense research and development costs as incurred. Our research and development expenses consist primarily of:

- salaries and related expenses for personnel;
- fees to professional service providers for, among other things, preclinical and analytical testing, independently monitoring our clinical trials and acquiring and evaluating data from our clinical trials;
- costs of contract manufacturing services;
- costs of materials used in clinical trials and research and development;
- depreciation of capital assets used to develop our products; and
- operating costs, such as the operating cost of facilities and the legal costs of pursuing patent protection of our intellectual property.

We believe that significant investment in product development is a competitive necessity and plan to continue these investments in order to be in a position to realize the potential of our product candidates. We expect that development spending for both our advanced stage products and earlier stage products will increase as our product development activities continue and we prepare for regulatory submissions and other regulatory activities. We expect that the magnitude of any increase in our research and development spending will be dependent upon such factors as the results from our ongoing preclinical studies and clinical trials, the size, structure and duration of any follow on clinical program that we may initiate, costs associated with manufacturing our product candidates on a large scale basis for later stage clinical trials, our ability to use data generated by government agencies, such as the ongoing studies with BioThrax being conducted by the Centers for Disease Control and Prevention, or CDC, and our ability to rely upon and utilize clinical and non-clinical data, such as the data generated by CDC from use of the pentavalent botulinum toxoid vaccine previously manufactured by the State of Michigan.

### Selling, General and Administrative Expenses

Selling, general and administrative expenses consist primarily of salaries and other related costs for personnel serving the executive, sales and marketing, business development, finance, accounting, information technology, legal and human resource functions. Other costs include facility costs not otherwise included in cost of product sales or research and development expense and professional fees for legal and accounting services. We currently market and sell BioThrax directly to the HHS with a small, targeted marketing and sales group. As we seek to broaden the market for BioThrax and if we receive marketing approval for additional products we expect that we will increase our spending for marketing and sales activities.

### Total Other Income (Expense)

Total other income (expense) consists principally of interest income and interest expense. We earn interest on our cash, cash equivalents and short-term investments, and we incur interest expense on our indebtedness. We capitalize interest expense in accordance with SFAS No. 34, *Capitalization of Interest Cost,* based on the cost of major ongoing projects which have not yet been placed in service, such as our new manufacturing facility. Our total interest cost will increase in future periods as compared to prior periods as a result of the term loan that we entered into in June 2007, as well as any borrowings under our revolving line of credit. In addition, some of our existing debt arrangements provide for increasing amortization of principal payments in future periods. See "Liquidity and Capital Resources—Debt Financing" for additional information.

## RESULTS OF OPERATIONS

## YEAR ENDED DECEMBER 31, 2007 COMPARED TO YEAR ENDED DECEMBER 31, 2006

### Revenues

Product sales revenues increased by $21.8 million, or 15%, to $169.8 million for 2007 from $148.0 million for 2006. This increase in product sales revenues was primarily due to a 41% increase in the number of doses of BioThrax delivered, offset by a 19% decrease in the average sales price per dose attributable to a discounted price provided to HHS due to the limited remaining shelf life for those certain doses delivered in the third quarter and first part of the fourth quarter of 2007. Product sales revenues in 2007 consisted of BioThrax sales to HHS of $141.6 million, sales to the DoD of $26.2 million and aggregate international and other sales of $2.0 million. Product sales revenues in 2006 consisted of BioThrax sales to HHS of $109.8 million, sales to the DoD of $37.4 million and aggregate international and other sales of $763,000.

Contracts and grant revenues increased by $8.4 million, or 177%, to $13.1 million in 2007 from $4.7 million in 2006. Contracts and grants revenues for 2007 consisted of a milestone payment of $8.8 million from HHS in connection with the Company advancing a program to obtain a post-exposure prophylaxis indication for BioThrax, $3.1 million from the Sanofi Pasteur collaboration, related to recognition of deferred revenue associated with the upfront payment received in 2006 as well as development service revenue, and $1.2 million in grant revenue from the National Institutes of Health, or NIH, and the Wellcome Trust. Contracts and grant revenues for 2006 consisted of $3.2 million in upfront and development program revenue from the Sanofi Pasteur collaboration and $1.5 million in grant revenue from the Wellcome Trust.

**Cost of Product Sales**

Cost of product sales increased by $16.2 million, or 67%, to $40.3 million for 2007 from $24.1 million for 2006. This increase was attributable to a 41% increase in the number of doses of BioThrax delivered, coupled with increased costs associated with our annual production shut-down, the related impact on production yield, and the write-off of waste during the period.

**Research and Development Expenses**

Research and development expenses increased by $8.5 million, or 19%, to $54.0 million for 2007 from $45.5 million for 2006. This increase reflects additional personnel and contract service costs, and includes increased expenses of $2.5 million on product candidates that are categorized in the biodefense segment, $3.7 million on product candidates categorized in the commercial segment, and $2.2 million in other research and development expenses, which are in support of technology platforms and central research and development activities.

The increase in spending on candidates in the biodefense and commercial segments, detailed in the table below, was attributable to increased efforts on various programs as we completed various studies and began subsequent studies and trials. The spending for BioThrax enhancements is related to preparing for and conducting animal efficacy studies to support applications for marketing approval of these enhancements, which we expect to submit to the FDA in late 2008 or 2009. The spending for our immune globulin therapeutic candidate development programs related primarily to costs associated with the plasma collection and fractionation program for our anthrax immune globulin therapeutic. The spending for the recombinant botulinum vaccine program resulted from advancing this program to the process development stage and the manufacture of clinical trial material. The spending for the next generation anthrax vaccine program resulted from feasibility studies and formulation development of product candidates. We continue to assess, and may alter, our future development plans for our products based on the interest of the U.S. government or other non-governmental organizations in providing funding for further development or procurement.

The spending in 2007 for our typhoid vaccine candidate resulted from the ongoing Phase II study in Vietnam, which commenced in the first quarter of 2007. The spending in 2006 for our typhoid vaccine candidate resulted from ongoing work for the Phase I clinical trial in Vietnam, which we completed in the second quarter of 2006. The spending in 2007 for our hepatitis B therapeutic vaccine candidate resulted from preparing for and initiating our Phase II clinical trial, which commenced in the first quarter 2007. The spending in 2007 for our group B streptococcus vaccine candidate resulted from preparing for Phase I clinical trials for two of the protein components of the vaccine candidate, which the NIAID is conducting and funding. Both our chlamydia and meningitis B vaccine candidates are in preclinical development.

The increase in other research and development expenses was primarily attributable to spending associated with product development programs that we acquired in the acquisition of ViVacs in July 2006.

Our principal research and development expenses for 2007 and 2006 are shown in the following table:

| (in thousands) | Year Ended December 31, 2007 | 2006 |
|---|---|---|
| **Biodefense:** | | |
| BioThrax enhancements | $ 5,175 | $ 7,232 |
| Immune globulin therapeutic development | 13,619 | 11,289 |
| Recombinant bivalent botulinum vaccine | 3,231 | 2,610 |
| Next generation anthrax vaccine | 2,719 | 1,088 |
| Total biodefense | 24,744 | 22,219 |
| **Commercial:** | | |
| Typhoid vaccine | 9,641 | 9,642 |
| Hepatitis B therapeutic vaccine | 5,370 | 4,058 |
| Group B streptococcus vaccine | 6,790 | 3,759 |
| Chlamydia vaccine | 3,146 | 1,991 |
| Meningitis B vaccine | 1,212 | 2,975 |
| Total commercial | 26,159 | 22,425 |
| Other | 3,055 | 857 |
| Total | $53,958 | $45,501 |

### Selling, General and Administrative Expenses

Selling, general and administrative expenses increased by $11.0 million, or 25%, to $55.6 million for 2007 from $44.6 million for 2006. The increase in selling, general and administrative expenses was driven by an increase in our headquarters and staff organization to support our operations as a public company and to support the overall growth of our business, and is primarily attributable to an increase of approximately $9.0 million resulting from the addition of personnel and increased legal and other professional services for our headquarters organization and an increase of $2.1 million in sales and marketing expenses related to the growth of our staff and an increase in our selling and marketing activities. The majority of the expense is attributed to the biodefense segment, in which selling, general and administrative expenses increased by $7.4 million, or 21%, to $43.0 million for 2007 from $35.6 million for 2006. Selling, general and administrative expenses related to our commercial segment increased by $3.6 million, or 40%, to $12.5 million for 2007 from $9.0 million for 2006.

### Purchased In-process Research and Development

In July 2006, we recorded a non-cash charge for purchased in-process research and development of $477,000 associated with our acquisition of ViVacs. We paid total purchase consideration of $250,000 and assumed a net deficit of liabilities in excess of assets of $47,000. We valued the acquisition at $430,000 after the inclusion of acquisition costs. Of this amount, we identified $153,000 as current assets, $97,000 as fixed assets, $297,000 as current liabilities and $477,000 as the value attributable to development programs and technology. Because we determined that the development programs and technology had no future alternative use, we charged the value attributable to the development programs and technology as purchased in-process research and development.

### Total Other Income (Expense)

Total other income (expense) increased by $2.9 million to income of $2.9 million for 2007 from expense of $13,000 for 2006. This increase resulted primarily from an increase in interest income of $2.0 million as a result of higher investment return on increased average cash balances, including the net proceeds of our initial public offering, and a decrease in interest expense of $1.1 million due to the capitalization of interest costs related to the construction of our new building in Lansing.

### Income Taxes

Provision for income taxes decreased by $2.2 million, or 14%, to $13.1 million for 2007 from $15.2 million for 2006. The provision for income taxes for 2007 resulted primarily from our income before provision for income taxes of $36.0 million and an effective annual tax rate of 36%. The provision for income taxes for 2006 resulted primarily from our income before provision for income taxes of $38.0 million and an effective annual tax rate of 40%. The decrease in the effective annual tax rate is due primarily to a reduction in state valuation allowances related to the expected utilization of net operating losses. The provision for income taxes also reflects research and development tax credits of $880,000 for 2007 and $759,000 for 2006.

## YEAR ENDED DECEMBER 31, 2006 COMPARED TO YEAR ENDED DECEMBER 31, 2005

### Revenues

Product sales revenues increased by $20.7 million, or 16%, to $148.0 million for 2006 from $127.3 million for 2005. This increase in product sales revenues was primarily due to a 18% increase in the number of doses of BioThrax delivered. Product sales revenues in 2006

consisted of BioThrax sales to HHS of $109.8 million, sales to the DoD of $37.4 million and aggregate international and other sales of $763,000. Product sales revenues in 2005 consisted of BioThrax sales to HHS of $111.2 million, sales to the DoD of $14.5 million and aggregate international and other sales of $1.6 million.

Contracts and grants revenues increased by $1.3 million, or 39%, to $4.7 million in 2006 from $3.4 million in 2005. Contracts and grants revenues for 2006 consisted of $3.2 million from the Sanofi Pasteur collaboration, related to recognition of deferred revenue associated with the upfront payment received in 2006 as well as development service revenue, and $1.5 million in grant revenue from the Wellcome Trust. Contracts and grants revenues for 2005 resulted from reimbursement from the DoD for expenses related to production development and supply chain management improvements for BioThrax incurred in prior periods, and for additional work that we performed on a project basis for the DoD's Defense Advanced Research Projects Agency, or DARPA, to evaluate a new vaccine adjuvant for BioThrax.

**Cost of Product Sales**

Cost of product sales decreased by $7.5 million, or 24%, to $24.1 million for 2006 from $31.6 million for 2005. This decrease was attributable to improved utilization of our manufacturing capacity for BioThrax, partially offset by an increase of approximately 900,000 BioThrax doses delivered. Manufacturing efficiencies resulted in a cost savings of $13.1 million. The increase in the number of doses delivered resulted in an increase of costs of approximately $5.6 million.

**Research and Development Expenses**

Research and development expenses increased by $27.1 million, or 148%, to $45.5 million for 2006 from $18.4 million for 2005. This increase reflects additional personnel and contract service costs, and includes increased expenses of $11.9 million on product candidates that are categorized in the biodefense segment and $15.9 million on product candidates that are categorized in the commercial segment, offset by a reduction of $633,000 in other research and development expenses.

The increase in spending on candidates in the biodefense segment was attributable to increased efforts on all our programs as we completed various studies and began subsequent studies and trials. The increase in spending for BioThrax enhancements is related to preparing for animal efficacy studies to support applications for marketing approval of these enhancements, which we expect to submit to the FDA in late 2008 or 2009. The increase in spending for immune globulin therapeutic development related primarily to costs associated with our plasma collection program for our anthrax immune globulin therapeutic candidate. The increase in spending for the recombinant botulinum vaccine program, which is in preclinical development, resulted from advancing this program to the process development stage and the manufacture of clinical trial material. The increase in spending for the next generation anthrax vaccine program, which has product candidates in preclinical and Phase I clinical development, resulted from feasibility studies and formulation development of product candidates.

The increase in commercial spending was mainly attributable to spending on the commercial products listed in the table below following our acquisition of Microscience in June 2005. Research and development spending by Microscience prior to our acquisition of Microscience in June 2005 is not included in our results for 2005. The spending for our typhoid vaccine candidate resulted from ongoing work for the Phase I clinical trial in Vietnam that we completed in 2006 and preparing for our Phase II clinical trial in Vietnam that we initiated in the first quarter of 2007. The spending in 2006 for our hepatitis B therapeutic vaccine candidate resulted from preparing for our Phase II clinical trial, which we received regulatory clearance to commence in the fourth quarter of 2006. The spending in 2006 for our group B streptococcus vaccine candidate resulted from costs associated with our analysis of results from the Phase I clinical trial for one of the protein components of the vaccine candidate and preparation for Phase I clinical trials for two of the protein components of the vaccine candidate. In December 2006, we signed an agreement with the NIAID under which the NIAID has agreed to sponsor a Phase I clinical trial of each of the two components separately and the two proteins in combination in healthy human volunteers. Both our chlamydia and meningitis B vaccine candidates are in preclinical development.

The decrease in spending on other research and development expenses was attributable to our discontinuation of preclinical programs that we acquired from Antex and determined not to pursue at that time.

Our principal research and development expenses for 2006 and 2005 are shown in the following table:

| (in thousands) | Year Ended December 31, 2006 | 2005 |
|---|---|---|
| **Biodefense:** | | |
| BioThrax enhancements | $ 7,232 | $ 2,883 |
| Immune globulin therapeutic development | 11,289 | 5,309 |
| Recombinant bivalent botulinum vaccine | 2,610 | 1,708 |
| Next generation anthrax vaccine | 1,088 | 427 |
| Total biodefense | 22,219 | 10,327 |
| **Commercial:** | | |
| Typhoid vaccine | 9,642 | 1,477 |
| Hepatitis B therapeutic vaccine | 4,058 | 1,884 |
| Group B streptococcus vaccine | 3,759 | 1,032 |
| Chlamydia vaccine | 1,991 | 837 |
| Meningitis B vaccine | 2,975 | 1,334 |
| Total commercial | 22,425 | 6,564 |
| Other | 857 | 1,490 |
| Total | $45,501 | $18,381 |

### Selling, General and Administrative Expenses

Selling, general and administrative expenses increased by $1.8 million, or 4%, to $44.6 million for 2006 from $42.8 million for 2005. The increase in selling, general and administrative expenses was primarily attributable to an increase in general and administrative expenses of $1.0 million resulting from the addition of personnel and increased legal and other professional services for our headquarters organization, and an increase of $937,000 related to the addition of personnel for Emergent Product Development UK. Selling, general and administrative expenses related to our biodefense segment decreased by $397,000, or 1%, to $35.6 million for 2006 from $36.0 million for 2005. Selling, general and administrative expenses related to our commercial segment increased by $2.2 million, or 33%, to $9.0 million for 2006 from $6.8 million for 2005.

### Purchased In-process Research and Development

In July 2006, we recorded a non-cash charge for purchased in-process research and development of $477,000 associated with our acquisition of ViVacs. We paid total purchase consideration of $250,000 and assumed a net deficit of liabilities in excess of assets of $47,000. We valued the acquisition at $430,000 after the inclusion of acquisition costs. Of this amount, we identified $153,000 as current assets, $97,000 as fixed assets, $297,000 as current liabilities and $477,000 as the value attributable to development programs and technology. Because we determined that the development programs and technology had no future alternative use, we charged the value attributable to the development programs and technology as purchased in-process research and development.

In June 2005, we recorded a non-cash charge for purchased in-process research and development of $26.6 million associated with our acquisition of Microscience. We valued the 3,636,801 shares of class A common stock that we issued in the acquisition at $28.2 million after the inclusion of acquisition costs. Of this amount, we identified $1.4 million as current assets, $863,000 as fixed assets, $684,000 as current liabilities and $26.6 million as the value attributable to development programs. Because we determined that the development programs had no future alternative use, we charged the value attributable to the development programs as purchased in-process research and development.

### Litigation Settlement

In 2005, we recorded a gain of $10.0 million relating to a settlement of a litigation matter that we initiated to resolve a contract and intellectual property dispute.

### Total Other Income (Expense)

Total other expense decreased by $214,000, or 94%, to $13,000 for 2006 from $227,000 for 2005. This decrease resulted primarily from an increase in interest income of $361,000 as a result of higher investment return on increased average cash balances, including the net proceeds of our initial public offering, and an increase in other income of $238,000, offset by an increase in interest expense of $385,000 related primarily to the mortgage loan we entered into in April 2006 and the term loan we entered into in August 2006.

### Income Taxes

Provision for income taxes increased by $9.9 million, or 186%, to $15.2 million for 2006 from $5.3 million for 2005. The provision for income taxes for 2006 resulted primarily from our income before provision for income taxes of $38.0 million and an effective annual tax rate of 40%. The provision for income taxes for 2005 resulted primarily from our income before provision for income

taxes of $21.1 million and an effective annual tax rate of 25%. The increase in the effective annual tax rate is due primarily to the impact of foreign and state net operating losses and an increase in permanent differences, including incentive stock options. The provision for income taxes also reflects research and development tax credits of $759,000 for 2006 and $474,000 for 2005.

## LIQUIDITY AND CAPITAL RESOURCES

### Sources of Liquidity

We require cash to meet our operating expenses and for capital expenditures, acquisitions and principal and interest payments on our debt. We have funded our cash requirements from inception through December 31, 2007 principally with a combination of revenues from BioThrax product sales, debt financings and facilities and equipment leases, revenues under our collaboration agreement with Sanofi Pasteur, development funding from government entities and non-government and philanthropic organizations, the net proceeds from our initial public offering and, to a lesser extent, from the sale of our common stock upon exercise of stock options. We have operated profitably for each of the years in the three year period ended December 31, 2007.

As of December 31, 2007, we had cash and cash equivalents of $105.7 million. On November 20, 2006, we completed our initial public offering, in which we raised $54.2 million, net of issuance costs.

### Cash Flows

The following table provides information regarding our cash flows for the years ended December 31, 2007, 2006 and 2005.

| | Year Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2007 | 2006 | 2005 |
| Net cash provided by (used in): | | | |
| Operating activities[1] | $ 54,790 | $ (4,258) | $41,974 |
| Investing activities | (43,969) | (41,446) | (7,091) |
| Financing activities | 18,491 | 85,828 | (5,410) |
| Total net cash provided | $ 29,312 | $ 40,124 | $29,473 |

(1) Includes the effect of exchange rate changes on cash and cash equivalents.

Net cash provided by operating activities of $54.8 million in 2007 resulted principally from our net income of $22.9 million, a decrease in accounts receivable of $24.5 million due to amounts billed primarily to HHS in December 2006 that were collected in 2007, partially offset by amounts billed in December 2007 and outstanding at year end, a decrease in inventory of $7.8 million related to increased product sales in 2007, and $4.8 million from the impact of non-cash depreciation and amortization, partially offset by a decrease in income taxes payable of $5.2 million due to the timing of payment of the 2006 income tax liability offset by the pending payable for 2007 income taxes.

Net cash used in operating activities of $4.3 million in 2006 resulted principally from our net income of $22.8 million, an increase in income taxes payable of $11.5 million due to the timing of payment of the 2006 income tax liability, an increase in accounts payable of $5.8 million related to increased research and development and selling, general and administrative expenses, and the impact of non-cash depreciation and amortization expense of $4.7 million, offset by an increase in accounts receivable of $40.8 million due from the DoD and HHS reflecting amounts billed in December 2006 that were still outstanding at year end, and a increase in inventory of $8.3 million reflecting the value of work in process for BioThrax lots being manufactured or awaiting delivery.

Net cash provided by operating activities of $42.0 million in 2005 resulted principally from our net income of $15.8 million, a non-cash charge for purchased in-process research and development related to the Microscience acquisition, which reduced net income by $26.6 million, and a reduction of accounts receivable of $16.1 million as a result of the collection of amounts due from the DoD during 2005 for invoices outstanding at the end of 2004 for progress in the manufacture of BioThrax lots, offset by a reduction of deferred revenue of $10.9 million, reflecting the delivery to the DoD in the first quarter of 2005 of BioThrax lots for which we had previously invoiced the DoD for progress payments and been paid, and an increase in deferred tax assets of $11.0 million, reflecting a deferred tax asset recorded to reflect the timing differences between the book charge and the tax deferral of expense related to the purchased in-process research and development expense related to the Microscience acquisition.

Net cash used in investing activities for the years ended December 31, 2007, 2006 and 2005 resulted principally from the purchase of property, plant and equipment.

Capital expenditures in 2007 include $30.3 million in construction and related costs for our new manufacturing facility in Lansing and approximately $13.7 million in infrastructure investments and other equipment. Capital expenditures in 2006 relate primarily to $25.7 million for construction of our new building in Lansing, Michigan, $10.2 million related to the acquisition of our second facility in Frederick, Maryland, and approximately $5.3 million in infrastructure investments and other equipment. Capital expenditures in 2005 were primarily attributable to investments in information technology upgrades and miscellaneous facility enhancements.

Net cash provided by financing activities of $18.5 million in 2007 resulted primarily from $15.3 million in additional proceeds from a term loan with HSBC related to financing a portion of the costs related to the construction of our new building in Lansing, $17.9 million in proceeds from borrowings under our revolving line of credit with Fifth Third Bank, $6.0 million related to excess tax benefits from the exercise of stock options, and $2.5 million in proceeds from stock option exercises, partially offset by $18.0 million in principal payments on long-term indebtedness, including $15.0 million in payments on our revolving line of credit with Fifth Third Bank and restricted cash deposits in 2007 consist of $5.0 million in restricted cash deposits in conjunction with our June 2007 HSBC term loan.

Net cash provided by financing activities of $85.8 million in 2006 resulted primarily from $54.2 million in proceeds from our initial public offering, $15.0 million in proceeds related to financing a portion of the costs related to the construction of our new building in Lansing, $8.5 million in proceeds from notes payable related to the financing of the purchase of our Frederick facility in April 2006, and $8.9 million in proceeds from our revolving line of credit with Fifth Third Bank.

Net cash used in financing activities of $5.4 million in 2005 resulted principally from the payment of a special dividend of $5.4 million from a portion of the proceeds of a litigation settlement and the repayment of notes payable to employees.

## Contractual Obligations

The following table summarizes our contractual obligations at December 31, 2007:

| | Payments Due by Period | | | | | | |
|---|---|---|---|---|---|---|---|
| (in thousands) | **Total** | **2008** | **2009** | **2010** | **2011** | **2012** | **After 2012** |
| **Contractual obligations:** | | | | | | | |
| Short and long-term debt[1] | $46,102 | $3,514 | $6,049 | $3,585 | $16,203 | $16,751 | $ — |
| Operating lease obligations | 13,983 | 2,048 | 1,436 | 1,453 | 1,471 | 1,489 | 6,086 |
| Contractual settlement liabilities | 50 | 50 | — | — | — | — | — |
| Total contractual obligations | $60,135 | $5,612 | $7,485 | $5,038 | $17,674 | $18,240 | $6,086 |

(1) Includes scheduled interest payments.

The preceding table excludes contingent contractual payments that we may become obligated to make upon achievement of specified research, development and commercialization milestones and contingent contractual royalty payments. The amount of contingent contractual milestone payments that we may become obligated to make is variable based on the actual achievement and timing of the applicable milestones and the characteristics of any products or product candidates that are developed, including factors such as number of products or product candidates developed, type and number of components of each product or product candidate, ownership of the various components and the specific markets affected. We are not obligated to pay any minimum royalties under our existing contracts.

**Debt Financing**

As of December 31, 2007, we had $57.9 million principal amount of debt outstanding, comprised primarily of the following:

- $2.5 million outstanding under a forgivable loan from the Department of Business and Economic Development of the State of Maryland used to finance eligible costs incurred to purchase the first facility in Frederick, Maryland;
- $6.6 million outstanding under a mortgage loan from PNC Bank (formerly Mercantile Potomac Bank) used to finance the remaining portion of the purchase price for the first Frederick facility;
- $8.2 million outstanding under a mortgage loan from HSBC Realty Credit Corporation used to finance the purchase price for the second facility on the Frederick site;
- $28.8 million outstanding under a term loan from HSBC Realty Credit Corporation used to finance a portion of the costs of our facility expansion in Lansing, Michigan; and
- $11.8 million outstanding under a $15.0 million revolving line of credit with Fifth Third Bank. This balance was repaid in January 2008.

We can borrow under the line of credit with Fifth Third Bank through May 2008.

Some of our debt instruments contain financial and operating covenants. In particular:

- Under our forgivable loan from the State of Maryland, we are not required to repay the principal amount of the loan if beginning December 31, 2009 and through 2012 we maintain a specified number of employees at the Frederick site, by December 31, 2009 we have invested at least $42.9 million in total funds toward financing the purchase of the buildings on the site and for related improvements and operation of the facility, and we occupy the facility through 2012.
- Under our mortgage loan from PNC Bank for our Frederick facility, we are required to maintain at all times a minimum tangible net worth of not less than $5.0 million. In addition, we are required to maintain at all times a ratio of earnings before interest, taxes, depreciation and amortization to the sum of current obligations under capital leases and principal obligations and interest expenses for borrowed money, in each case due and payable within the following 12 months, of not less than 1.1 to 1.0.
- Under our term loan with HSBC Realty Credit Corporation, we are required to maintain on an annual basis a book leverage ratio of less than 1.25. This ratio is calculated by dividing total liabilities, excluding deferred revenues specific to contracts with the U.S. government, by total net worth. In addition, we are required to maintain on a quarterly basis a debt coverage ratio of not less than 1.25 to 1.00 or maintain $5.0 million in a cash collateral account. This ratio is calculated by dividing earnings before interest, taxes, depreciation and amortization for the most recent four quarters by the sum of current obligations under capital leases and principal obligations and interest expenses for borrowed money, in each case due and payable for the following four quarters.
- Under our revolving line of credit with Fifth Third Bank, our wholly owned subsidiary, Emergent BioDefense Operations, is required to maintain at all times a ratio of total liabilities to tangible net worth of not more than 2.5 to 1.0.

Our debt instruments also contain negative covenants restricting our activities. Our term loan with HSBC Realty Credit Corporation limits the ability of Emergent BioDefense Operations to incur indebtedness and liens, sell assets, make loans, advances or guarantees, enter into mergers or similar transactions and enter into transactions with affiliates. Our line of credit with Fifth Third Bank limits the ability of Emergent BioDefense Operations to incur indebtedness and liens, sell assets, make loans, advances or guarantees, enter into mergers or similar transactions, enter into transactions with affiliates and amend the terms of any government contract.

The facilities, software and other equipment that we purchased with the proceeds of our loans from PNC Bank, the State of Maryland and HSBC Realty Credit Corporation serve as collateral for these loans. Our line of credit with Fifth Third Bank is secured by accounts receivable under our DoD and HHS contracts. Our term loan with HSBC Realty Credit Corporation is secured by substantially all of Emergent BioDefense Operations' assets, other than accounts receivable under our DoD and HHS contracts. The covenants under our existing debt instruments and the pledge of our existing assets as collateral limit our ability to obtain additional debt financing.

Under our mortgage loan from PNC Bank, we began to make monthly principal payments beginning in November 2006. A residual principal repayment of approximately $5.0 million is due upon maturity in October 2011. Interest is payable monthly and accrues at an annual rate of 6.625% through October 2009. In October 2009, the interest rate is scheduled to be adjusted to a fixed annual rate equal to 3.20% over the yield on U.S. government securities adjusted to a constant maturity of two years.

Under our mortgage loan from HSBC Realty Credit Corporation, we are required to make monthly principal payments. A residual principal repayment of approximately $7.5 million is due upon maturity in April 2011. Interest is payable monthly and accrues at an annual rate equal to LIBOR plus 3.00%.

Under our term loan with HSBC Realty Credit Corporation, we are required to make monthly payments in the amount of $250,000 in principal plus accrued interest beginning August 2007, with a residual principal payment due upon maturity in June 2012. Interest on the loan accrues at an annual rate equal to LIBOR plus 2.75%.

Under our revolving line of credit with Fifth Third Bank, any outstanding principal is due upon maturity in May 2008. The principal amount outstanding at any time under the line of credit may not exceed 75% of total eligible accounts receivable under the DoD and HHS contracts. Consistent with the terms of this agreement, we repaid $11.8 million of outstanding principal under the line of credit in January 2008. Interest is payable monthly and accrues at an annual rate equal to 0.375% less than the prime rate of interest established from time to time by Fifth Third Bank.

**Tax Benefits**

In connection with our facility expansion in Lansing, the State of Michigan and the City of Lansing have provided us a variety of tax credits and abatements. We estimate that the total value of these tax benefits may be up to $18.5 million over a period of up to 15 years, beginning in 2006. These tax benefits are primarily based on our $75 million planned investment in our Lansing facility. In addition, we must maintain a specified number of employees in Lansing to continue to qualify for these tax benefits.

**Funding Requirements**

We expect to continue to fund our anticipated operating expenses, capital expenditures and debt service requirements from existing cash and cash equivalents, revenues from BioThrax product sales and other committed sources of funding. There are numerous risks and uncertainties associated with BioThrax product sales and with the development and commercialization of our product candidates.

We may seek to raise additional external debt financing to provide additional financial flexibility. Our committed external sources of funds consist of the remaining borrowing availability under our revolving line of credit with Fifth Third Bank, development funding under our collaboration agreement with Sanofi Pasteur and funding from the NIAID, including for studies related to our anthrax immune globulin therapeutic product candidate. Our ability to borrow additional amounts under our loan agreements is subject to our satisfaction of specified conditions.

Our future capital requirements will depend on many factors, including:

- the level and timing of BioThrax product sales and cost of product sales;
- the timing of, and the costs involved in validation and qualification activities related to our new manufacturing facility in Lansing, Michigan and the build out of our manufacturing facility in Frederick, Maryland;
- the scope, progress, results and costs of our preclinical and clinical development activities;
- the costs, timing and outcome of regulatory review of our product candidates;
- the number of, and development requirements for, other product candidates that we may pursue;
- the costs of commercialization activities, including product marketing, sales and distribution;
- the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims and other patent-related costs, including litigation costs and the results of such litigation;
- the extent to which we acquire or invest in businesses, products and technologies;
- our ability to obtain development funding from government entities and non-government and philanthropic organizations; and
- our ability to establish and maintain collaborations, such as our collaboration with Sanofi Pasteur.

We may require additional sources of funds for future acquisitions that we may make or, depending on the size of the obligation, to meet balloon payments upon maturity of our current borrowings. To the extent our capital resources are insufficient to meet our future capital requirements, we will need to finance our cash needs through public or private equity offerings, debt financings or corporate collaboration and licensing arrangements.

Additional equity or debt financing, grants, or corporate collaboration and licensing arrangements may not be available on acceptable terms, if at all. If adequate funds are not available, we may be required to delay, reduce the scope of or eliminate our research and development programs or reduce our planned commercialization efforts. If we raise additional funds by issuing equity securities, our stockholders may experience dilution. Debt financing, if available, may involve agreements that include covenants limiting or restricting our ability to take specific actions, such as incurring additional debt, making capital expenditures or declaring dividends. Any debt financing or additional equity that we raise may contain terms, such as liquidation and other preferences that are not favorable to us or our stockholders. If we raise additional funds through collaboration and licensing arrangements with third parties, it may be necessary to relinquish valuable rights to our technologies or product candidates or grant licenses on terms that may not be favorable to us.

### Effects of Inflation

Our most liquid assets are cash, cash equivalents and short-term investments. Because of their liquidity, these assets are not directly affected by inflation. We also believe that we have intangible assets in the value of our intellectual property. In accordance with generally accepted accounting principles, we have not capitalized the value of this intellectual property on our balance sheet. Due to the nature of this intellectual property, we believe that these intangible assets are not affected by inflation. Because we intend to retain and continue to use our equipment, furniture and fixtures and leasehold improvements, we believe that the incremental inflation related to replacement costs of such items will not materially affect our operations. However, the rate of inflation affects our expenses, such as those for employee compensation and contract services, which could increase our level of expenses and the rate at which we use our resources.

## RECENT ACCOUNTING PRONOUNCEMENTS

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an Amendment of ARB No. 51,* or SFAS No. 160. SFAS No. 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements, requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest, establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation, and requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. The provisions of SFAS No. 160 are effective for fiscal years beginning on or after December 15, 2008. We are currently evaluating the impact of the adoption of this statement on our financial statements.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations,* or SFAS No. 141R. SFAS No. 141R requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values, changes the recognition of assets acquired and liabilities assumed arising from contingencies, changes the recognition and measurement of contingent consideration, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, and it may not applied before that date. The provisions of SFAS No. 141R will impact our financial statements to the extent that we are party to a business combination after the pronouncement has been adopted.

In June 2007, the FASB issued EITF No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities,* or EITF No. 07-3. EITF No. 07-3 states that nonrefundable advance payments for goods or services that will be used or rendered for

future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. The provisions of EITF No. 07-3 are effective for fiscal years beginning after December 15, 2007. We anticipate that the adoption of the provisions of EITF No. 07-3 will not have a material impact on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement* No. 115, or SFAS No. 159. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The provisions of SFAS No. 159 are effective for fiscal years beginning after November 15, 2007. We anticipate that the adoption of this statement will not have a material impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, or SFAS No. 157. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We anticipate that the adoption of this statement will not have a material impact on our financial statements.

## QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk is currently confined to our cash and cash equivalents and restricted cash that have maturities of less than three months. We currently do not hedge interest rate exposure or foreign currency exchange exposure. We have not used derivative financial instruments for speculation or trading purposes. Because of the short-term maturities of our cash and cash equivalents, we do not believe that an increase in market rates would have a significant impact on the realized value of our investments, but would likely increase the interest expense associated with our debt.

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

**Board of Directors and Stockholders of Emergent BioSolutions Inc. and Subsidiaries**

We have audited the accompanying consolidated balance sheets of Emergent BioSolutions Inc. and Subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Emergent BioSolutions Inc. and Subsidiaries at December 31, 2007 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 11 to the consolidated financial statements, in 2007 the Company changed its method of accounting for uncertain tax provisions. As discussed in Note 2 to the consolidated financial statements, in 2006 the Company changed its method of accounting for share-based payments.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Emergent BioSolutions Inc. and Subsidiaries' internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 6, 2008 expressed an unqualified opinion thereon.

Ernst & Young LLP

McLean, Virginia
March 6, 2008

Emergent BioSolutions Inc. and Subsidiaries

# CONSOLIDATED BALANCE SHEETS

| (in thousands, except share and per share data) | December 31, 2007 | 2006 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $105,730 | $ 76,418 |
| Accounts receivable | 18,817 | 43,331 |
| Inventories | 16,897 | 24,721 |
| Income taxes receivable | — | 869 |
| Deferred tax assets | — | 295 |
| Prepaid expenses and other current assets | 2,866 | 1,703 |
| Total current assets | 144,310 | 147,337 |
| Property, plant and equipment, net | 110,218 | 78,174 |
| Deferred tax assets, net of current | 12,397 | 11,477 |
| Restricted cash | 5,200 | 192 |
| Other assets | 1,383 | 1,075 |
| Total assets | $273,508 | $238,255 |
| **Liabilities and Stockholders' Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 17,979 | $ 27,366 |
| Accrued expenses and other current liabilities | 4,056 | 3,270 |
| Accrued compensation | 9,502 | 7,190 |
| Indebtedness under lines of credit | 11,832 | 8,930 |
| Long-term indebtedness, current portion | 3,514 | 2,456 |
| Income taxes payable | 7,665 | 13,703 |
| Deferred tax liabilities | 211 | — |
| Deferred revenue, current portion | 902 | 1,432 |
| Total current liabilities | 55,661 | 64,347 |
| Long-term indebtedness, net of current portion | 42,588 | 31,368 |
| Deferred revenue, net of current portion | 2,473 | 2,997 |
| Other liabilities | 1,627 | 1,071 |
| Total liabilities | 102,349 | 99,783 |
| Commitments and contingencies | — | — |
| Stockholders' equity: | | |
| Preferred Stock $0.001 par value; 15,000,000 shares authorized, 0 shares issued and outstanding at December 31, 2007 and 2006, respectively | — | — |
| Common Stock, $0.001 par value; 100,000,000 shares authorized, 29,750,237 and 27,596,249 shares issued and outstanding at December 31, 2007 and 2006, respectively | 30 | 28 |
| Additional paid-in capital | 101,933 | 90,920 |
| Accumulated other comprehensive loss | (1,130) | (473) |
| Retained earnings | 70,326 | 47,997 |
| Total stockholders' equity | 171,159 | 138,472 |
| Total liabilities and stockholders' equity | $273,508 | $238,255 |

The accompanying notes are an integral part of the consolidated financial statements.

Emergent BioSolutions Inc. and Subsidiaries

# CONSOLIDATED STATEMENTS OF OPERATIONS

| (in thousands, except share and per share data) | Year Ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| **Revenues:** | | | |
| Product sales | $ 169,799 | $ 147,995 | $ 127,271 |
| Contracts and grants | 13,116 | 4,737 | 3,417 |
| **Total revenues** | 182,915 | 152,732 | 130,688 |
| **Operating expense (income):** | | | |
| Cost of product sales | 40,309 | 24,125 | 31,603 |
| Research and development | 53,958 | 45,501 | 18,381 |
| Selling, general and administrative | 55,555 | 44,601 | 42,793 |
| Purchased in-process research and development | — | 477 | 26,575 |
| Litigation settlement | — | — | (10,000) |
| **Income from operations** | 33,093 | 38,028 | 21,336 |
| **Other income (expense):** | | | |
| Interest income | 2,809 | 846 | 485 |
| Interest expense | (71) | (1,152) | (767) |
| Other income (expense), net | 156 | 293 | 55 |
| **Total other income (expense)** | 2,894 | (13) | (227) |
| **Income before provision for income taxes** | 35,987 | 38,015 | 21,109 |
| **Provision for income taxes** | 13,051 | 15,222 | 5,325 |
| **Net income** | $ 22,936 | $ 22,793 | $ 15,784 |
| **Earnings per share—basic** | $ 0.79 | $ 0.99 | $ 0.77 |
| **Earnings per share—diluted** | $ 0.77 | $ 0.93 | $ 0.69 |
| **Weighted-average number of shares—basic** | 28,995,667 | 23,039,794 | 20,533,471 |
| **Weighted-average number of shares—diluted** | 29,663,127 | 24,567,302 | 22,751,733 |
| **Cash dividends per share—basic** | $ — | $ — | $ 0.26 |

The accompanying notes are an integral part of the consolidated financial statements.

Emergent BioSolutions Inc. and Subsidiaries

# CONSOLIDATED STATEMENTS OF CASH FLOWS

| (in thousands) | Year Ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| **Cash flows from operating activities:** | | | |
| Net income | $ 22,936 | $ 22,793 | $ 15,784 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities (net of effects of acquisitions): | | | |
| Stock-based compensation expense (credit) | 2,541 | 723 | (17) |
| Depreciation and amortization | 4,817 | 4,715 | 3,549 |
| Deferred income taxes | 5,589 | 987 | (10,968) |
| Loss on disposal of property and equipment | 24 | 27 | 32 |
| Purchased in-process research and development | — | 477 | 26,575 |
| Excess tax benefits from stock-based compensation | (6,003) | (789) | — |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | 24,514 | (40,801) | 16,107 |
| Inventories | 7,825 | (8,280) | (3,189) |
| Income taxes | (5,169) | 11,463 | (2,390) |
| Prepaid expenses and other assets | (1,316) | (792) | (865) |
| Accounts payable | (2,303) | 5,801 | 5,463 |
| Accrued compensation | 2,312 | 1,013 | 2,466 |
| Accrued expenses and other liabilities | 734 | 1,513 | 619 |
| Deferred revenue | (1,054) | (2,911) | (10,916) |
| Net cash provided by (used in) operating activities | 55,447 | (4,061) | 42,250 |
| **Cash flows from investing activities:** | | | |
| Purchases of property, plant and equipment | (43,969) | (41,228) | (6,532) |
| Acquisitions, net of cash received | — | (218) | (559) |
| Net cash used in investing activities | (43,969) | (41,446) | (7,091) |
| **Cash flows from financing activities:** | | | |
| Restricted cash deposits | (5,008) | (192) | 1,250 |
| Proceeds from borrowings on long term indebtedness and lines of credit | 33,195 | 32,430 | 31 |
| Proceeds from notes payable to employees | — | — | 123 |
| Issuance of common stock in initial public offering (net of issuance cost) | — | 54,229 | — |
| Issuance of common stock subject to exercise of stock options | 2,471 | 590 | 33 |
| Redemption of Class B common stock | — | (192) | (337) |
| Principal payments on long term indebtedness, notes payable to employees, and lines of credits | (18,015) | (1,569) | (1,110) |
| Excess tax benefits from stock-based compensation | 6,003 | 789 | — |
| Debt issuance costs | (155) | (257) | — |
| Payment of dividend | — | — | (5,400) |
| Net cash provided by (used in) financing activities | 18,491 | 85,828 | (5,410) |
| Effect of exchange rate changes on cash and cash equivalents | (657) | (197) | (276) |
| Net increase (decrease) in cash and cash equivalents | 29,312 | 40,124 | 29,473 |
| Cash and cash equivalents at beginning of year | 76,418 | 36,294 | 6,821 |
| Cash and cash equivalents at end of year | 105,730 | 76,418 | 36,294 |
| **Supplemental disclosure of cash flow information:** | | | |
| Cash paid during the year for interest | $ 3,094 | $ 1,681 | $ 696 |
| Cash paid during the year for income taxes | $ 14,329 | $ 2,788 | $ 17,985 |
| **Supplemental information on non-cash investing and financing activities:** | | | |
| Issuance of common stock to acquire Microscience Limited | $ — | $ — | $ 27,001 |
| Purchases of property, plant and equipment unpaid at year end | $ 7,084 | $ 11,140 | $ — |

The accompanying notes are an integral part of the consolidated financial statements.

Emergent BioSolutions Inc. and Subsidiaries

# CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

| (in thousands, except share and per share data) | Class A $0.001 Par Value Common Stock | | Class B $0.01 Par Value Common Stock | |
|---|---|---|---|---|
| | Shares | Amount | Shares | Amount |
| Balance at December 31, 2004 | 18,666,479 | $ 19 | — | $— |
| Issuance of common stock to acquire Microscience Limited | 3,636,801 | 3 | — | — |
| Exercise of stock options | — | — | 133,451 | 1 |
| Redemption of common stock | — | — | (112,168) | (1) |
| Forfeiture of stock options | — | — | — | — |
| Payment of dividend | — | — | — | — |
| Net income | — | — | — | — |
| Foreign currency translation | — | — | — | — |
| Comprehensive income | — | — | — | — |
| Balance at December 31, 2005 | 22,303,280 | $ 22 | 21,283 | $— |
| Exercise of stock options | — | — | 95,858 | 1 |
| Redemption of common stock | — | — | — | — |
| Conversion of class A $0.001 and class B par value $0.001 to common stock $.001 par value common stock | (22,303,280) | (22) | (117,141) | (1) |
| Issuance of common stock in initial public offering (net of issuance cost) | — | — | — | — |
| Stock-based compensation expense | — | — | — | — |
| Excess tax benefits from exercises of non-qualified stock options | — | — | — | — |
| Net income | — | — | — | — |
| Foreign currency translation | — | — | — | — |
| Comprehensive income | — | — | — | — |
| Balance at December 31, 2006 | — | $ — | — | $— |
| Exercise of stock options | — | — | — | — |
| Stock-based compensation expense | — | — | — | — |
| Cumulative effect of change in accounting principle (FIN 48) | — | — | — | — |
| Excess tax benefits from exercises of non-qualified stock options | — | — | — | — |
| Net income | — | — | — | — |
| Foreign currency translation | — | — | — | — |
| Comprehensive income | — | — | — | — |
| Balance at December 31, 2007 | — | $ — | — | $— |

The accompanying notes are an integral part of the consolidated financial statements.

| $0.001 Par Value Common Stock | | Additional Paid-In Capital | Accumulated Other Comprehensive Loss | Retained Earnings | Total Stock-holders' Equity |
|---|---|---|---|---|---|
| Shares | Amount | | | | |
| — | $ — | $ 7,610 | $ — | $15,320 | $ 22,949 |
| — | — | 26,998 | — | — | 27,001 |
| — | — | 32 | — | — | 33 |
| — | — | (28) | — | (308) | (337) |
| — | — | (17) | — | — | (17) |
| — | — | — | — | (5,400) | (5,400) |
| — | — | — | — | 15,784 | 15,784 |
| — | — | — | (276) | — | (276) |
| — | — | — | — | — | 15,508 |
| — | $ — | $ 34,595 | $ (276) | $25,396 | $ 59,737 |
| 175,828 | — | 589 | — | — | 590 |
| — | — | — | — | (192) | (192) |
| 22,420,421 | 23 | — | — | — | — |
| 5,000,000 | 5 | 54,224 | — | — | 54,229 |
| — | — | 723 | — | — | 723 |
| — | — | 789 | — | — | 789 |
| — | — | — | — | 22,793 | 22,793 |
| — | — | — | (197) | — | (197) |
| — | — | — | — | — | 22,596 |
| 27,596,249 | $ 28 | $ 90,920 | $ (473) | $47,997 | $138,472 |
| 2,153,988 | 2 | 2,469 | — | — | 2,471 |
| — | — | 2,541 | — | — | 2,541 |
| — | — | — | — | (607) | (607) |
| — | — | 6,003 | — | — | 6,003 |
| — | — | — | — | 22,936 | 22,936 |
| — | — | — | (657) | — | (657) |
| — | — | — | — | — | 22,279 |
| 29,750,237 | $ 30 | $101,933 | $(1,130) | $70,326 | $171,159 |

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. NATURE OF THE BUSINESS AND ORGANIZATION

Emergent BioSolutions Inc. (the "Company" or "Emergent") is a biopharmaceutical company focused on the development, manufacture and commercialization of immunobiotics. The Company is developing products to be offered both to the biodefense and commercial markets. The Company commenced operations as BioPort Corporation ("BioPort") in September 1998 through an acquisition from the Michigan Biologic Products Institute of rights to the marketed product, BioThrax, vaccine manufacturing facilities at a multi-building campus on approximately 12.5 acres in Lansing, Michigan and vaccine development and production know-how. In December 2001, the U.S. Food and Drug Administration ("FDA") approved a supplement to the Company's manufacturing facility license for the manufacture of BioThrax at the renovated facilities. In June 2004, the Company completed a corporate reorganization ("Reorganization").

As a result of the Reorganization, BioPort became a wholly owned subsidiary of Emergent. The Company has renamed BioPort as Emergent BioDefense Operations Lansing Inc. ("Emergent BioDefense Operations"). The Company acquired its portfolio of commercial vaccine candidates through an acquisition of Microscience Limited ("Microscience") in a share exchange in June 2005 and an acquisition of substantially all of the assets, for cash, of Antex Biologics Inc. ("Antex") in May 2003 and ViVacs GmbH, Germany ("ViVacs") in July 2006. The Company has renamed Microscience as Emergent Product Development UK Limited, Antex as Emergent Product Development Gaithersburg Inc. and ViVacs as Emergent Product Development Germany GmbH.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation and Consolidation

The accompanying consolidated financial statements include the accounts of Emergent and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

### 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 the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### Cash and Cash Equivalents

Cash equivalents are highly liquid investments with a maturity of 90 days or less at the date of purchase and consist of time deposits and investments in money market funds with commercial banks and financial institutions. Also, the Company maintains cash balances with financial institutions in excess of insured limits. The Company does not anticipate any losses with such cash balances. At December 31, 2007 and 2006 the Company maintained all of its cash and cash equivalents in four financial institutions.

### Fair Value of Financial Instruments

The carrying amounts of the Company's short-term financial instruments, which include cash and cash equivalents, accounts receivable and accounts payable, approximate their fair values due to their short maturities. The fair value of the Company's long-term indebtedness is estimated based on the quoted prices for the same or similar issues or on the current rates offered to the Company for debt of the same remaining maturities. The carrying value and fair value of long-term indebtedness were $46.1 million and $45.6 million, respectively, at December 31, 2007 and $33.8 million and $33.2 million, respectively, at December 31, 2006.

### Restricted Cash

Restricted cash at December 31, 2007 and 2006 includes a certificate of deposit held by a bank as collateral for a letter of credit acting as a security deposit on a loan. Restricted cash at December 31, 2007 also includes $5.0 million in a pledged bank deposit account as collateral for a term loan. As of December 31, 2007 and 2006 the Company had restricted cash of $5.2 million and $192,000, respectively.

### Significant Customers and Accounts Receivable

The Company's primary customers are the U.S. Department of Defense (the "DoD") and U.S. Department of Health and Human Services ("HHS"). For the years ended December 31, 2007, 2006 and 2005, sales of BioThrax to the DoD and HHS comprised 97%, 97% and 96%, of total revenues, respectively. As of December 31,

2007 and 2006, the Company's receivable balances were comprised of 84% and 100%, respectively, from these customers. Unbilled accounts receivable, included in accounts receivable, totaling $1.1 million and $26,000 as of December 31, 2007 and 2006, respectively, relate to various service contracts for which product has been delivered or work has been performed, though invoicing has not yet occurred. Accounts receivable are stated at invoice amounts and consist primarily of amounts due from the DoD and HHS as well as amounts due under reimbursement contracts with other government entities and non-government and philanthropic organizations. If necessary, the Company records a provision for doubtful receivables to allow for any amounts which may be unrecoverable. This provision is based upon an analysis of the Company's prior collection experience, customer creditworthiness and current economic trends. As of December 31, 2007 and 2006, an allowance for doubtful accounts was not recorded, as the collection history from these customers indicates collection is probable.

**Concentrations of Credit Risk**

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. The Company places its cash and cash equivalents with high quality financial institutions. Management believes that the financial risks associated with its cash and cash equivalents are minimal. Because accounts receivable consist of amounts due from the U.S. federal government for product sales and from government agencies under government grants, management deems there to be minimal credit risk.

**Inventories**

Inventories are stated at the lower of cost or market, with cost being determined using a standard cost method, which approximates average cost. Average cost consists primarily of material, labor and manufacturing overhead expenses and includes the services and products of third party suppliers. The Company analyzes its inventory levels quarterly and writes down, in the applicable period, inventory that has become obsolete, inventory that has a cost basis in excess of its expected net realizable value and inventory in excess of expected customer demand. The Company also writes off in the applicable period the costs related to expired inventory.

**Property, Plant and Equipment**

Property, plant and equipment are stated at cost. Depreciation is computed using the straight-line method over the following estimated useful lives:

| | |
|---|---|
| Buildings | 39 years |
| Furniture and equipment | 3–7 years |
| Software | Lesser of 3 years or product life |
| Leasehold improvements | Lesser of the asset life or lease term |

Upon retirement or sale, the cost of assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is credited or charged to operations. Repairs and maintenance costs are expensed as incurred.

**Income Taxes**

Income taxes are accounted for using the liability method. Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the year in which those temporary differences are expected to be recovered or settled.

The Company records valuation allowances to reduce deferred tax assets to the amounts that more likely than not will be realized. The Company considers future taxable income and ongoing tax planning strategies in assessing the need for valuation allowances. In general, if the Company determines that it is able to realize more than the recorded amounts of net deferred tax assets in the future, net income will increase in the period in which the determination is made. Likewise, if the Company determines that it is not able to realize all or part of the net deferred tax asset in the future, net income will decrease in the period in which the determination is made. The Company applies any reversals of valuation allowance related to an acquired deferred tax asset against other intangibles before impacting net income.

Under sections 382 and 383 of the Internal Revenue Code, if an ownership change occurs with respect to a "loss corporation", as defined, there are annual limitations on the amount of net operating losses and deductions that are available. Due to the acquisition of

Microscience in 2005 and the Company's initial public offering, the Company believes the use of the operating losses will be significantly limited.

The Company's ability to realize deferred tax assets depends upon future taxable income as well as the limitations discussed above. For financial reporting purposes, a deferred tax asset must be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized prior to expiration.

**Revenue Recognition**

The Company recognizes revenues from product sales in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition* ("SAB No. 104"). SAB No. 104 requires recognition of revenues from product sales that require no continuing performance by the Company if four basic criteria have been met:

- there is persuasive evidence of an arrangement;
- delivery has occurred and title has passed to the Company's customer;
- the fee is fixed and determinable and no further obligation exists; and
- collectibility is reasonably assured.

All revenues from product sales are recorded net of applicable allowances for sales returns, rebates, special promotional programs, and discounts. For arrangements where the risk of loss has not passed to the customer, the Company defers the recognition of revenue until such time that risk of loss has passed. Also, the cost of revenue associated with amounts recorded as deferred revenue is recorded in inventory until such time as risk of loss has passed.

Under the Company's previous contracts with the DoD, title to the product passed to the DoD upon submission of the first invoice. The earnings process was considered complete upon FDA release of the product for sale and distribution. Following FDA release of the product, the product is segregated for later shipment, and all deferred revenue related to the released product is recognized in accordance with the "bill and hold" requirements under SAB 104.

In December 2005, the Securities and Exchange Commission released an interpretation with respect to the accounting for sales of vaccines and bioterror countermeasures to the federal government for placement into the Strategic National Stockpile ("SNS"). This interpretation provides for revenue recognition for specifically identified products purchased for the SNS in the event that all requirements for revenue recognition, as specified in Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* are not met. While the Company's contracts with HHS are for qualifying sales of vaccine for placement into the SNS, the Company meets all requirements for revenue recognition upon delivery of product to HHS, and therefore has not applied this guidance.

Collaborative research and development agreements can provide for one or more of up-front license fees, research payments, and milestone payments. Agreements with multiple components ("deliverables" or "items") are evaluated in accordance with Emerging Issues Task Force ("EITF") Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables* ("EITF No. 00-2 1"), to determine if the deliverables can be divided into more than one unit of accounting. An item can generally be considered a separate unit of accounting if all of the following criteria are met: (1) the delivered item(s) has value to the customer on a stand-alone basis; (2) there is objective and reliable evidence of the fair value of the undelivered items(s); and (3) if the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in control of the Company. Items that cannot be divided into separate units are combined with other units of accounting, as appropriate. Consideration received is allocated among the separate units based on their respective fair values or based on the residual value method and is recognized in full when the criteria in the discussion of SAB No. 104 above are met. The Company deems service to have been rendered if no continuing obligation exists on the part of the Company.

Revenue associated with non-refundable up-front license fees under arrangements where the license fees and research and development activities cannot be accounted for as separate units of accounting is deferred and recognized as revenue on a straight-line basis over the expected term of the Company's continued involvement in the research and development process. Revenues from the achievement of research

and development milestones, if deemed substantive, are recognized as revenue when the milestones are achieved, and the milestone payments are due and collectible. If not deemed substantive, the Company would recognize such milestone as revenue on a straight-line basis over the remaining expected term of continued involvement in the research and development process.

Milestones are considered substantive if all of the following conditions are met: (1) the milestone is non-refundable; (2) achievement of the milestone was not reasonably assured at the inception of the arrangement; (3) substantive effort is involved to achieve the milestone; and (4) the amount of the milestone appears reasonable in relation to the effort expended, the other milestones in the arrangement and the related risk associated with the achievement of the milestone and any ongoing research and development or other services are priced at fair value. Payments received in advance of work performed are recorded as deferred revenue.

Payments received by the Company for the reimbursement of expenses for research and development activities are recorded in accordance with EITF Issue No. 99-19, *Reporting Revenue Gross as Principal Versus Net as an Agent* ("EITF No. 99-19"). Pursuant to EITF No. 99-19, for transactions in which the Company acts as principal, with discretion to choose suppliers, bears credit risk and performs a substantive part of the services, revenue is recorded at the gross amount of the reimbursement. Costs associated with these reimbursements are reflected as a component of research and development expenses.

**Impairment of Long-lived Assets**

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ("SFAS No. 144"), the Company assesses the recoverability of its long-lived assets for which an indicator of impairment exists by determining whether the carrying value of such assets can be recovered through undiscounted future operating cash flows. If the Company concludes that the carrying value will not be recovered, the Company measures the amount of such impairment by comparing the fair value to the carrying value. The Company has recorded no impairment losses for the years ended December 31, 2007, 2006 and 2005.

**Research and Development**

Research and development costs are expensed as incurred. Research and development costs primarily consist of salaries, materials and related expenses for personnel and facility expenses. Other research and development expenses include fees paid to consultants and outside service providers and the costs of materials used in clinical trials and research and development.

**Purchased In-process Research and Development**

The Company accounts for purchased in-process research and development in accordance with the SFAS No. 2, *Accounting for Research and Development Costs* ("SFAS No. 2") along with Financial Accounting Standards Board ("FASB") Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method—an interpretation of FASB Statement No. 2* ("FIN 4"). Under these standards, the Company is required to determine whether the technology relating to a particular research and development project acquired through an acquisition has an alternative future use. If the determination is that the technology has no alternative future use, the acquisition amount assigned to assets to be used in the particular research and development project is expensed. Otherwise, the Company capitalizes and amortizes the costs incurred over the estimated useful lives of the technology acquired.

**Comprehensive Income**

SFAS No. 130, *Reporting Comprehensive Income,* requires the presentation of the comprehensive income and its components as part of the financial statements. Comprehensive income is comprised of net income and other changes in equity that are excluded from net income. The Company includes gains and losses on intercompany transactions with foreign subsidiaries that are considered to be long-term investments and translation gains and losses incurred when converting its subsidiaries' financial statements from their functional currency to the U.S. dollar in accumulated other comprehensive income (loss).

**Foreign Currencies**

The local currency is the functional currency for the Company's foreign subsidiaries and, as such, assets and liabilities are translated into U.S. dollars at year-end exchange rates. Income and expense items are translated at average exchange rates during the year. Translation adjustments resulting from this process are charged or credited to other comprehensive income (loss).

### Capitalized Interest

The Company capitalizes interest in accordance with SFAS No. 34, *Capitalization of Interest Cost,* based on the cost of major ongoing capital projects which have not yet been placed in service. For the years ended December 31, 2007, 2006 and 2005, the Company incurred interest expense of $3.2 million, $1.9 million and $767,000, respectively. Of these amounts, the Company capitalized $3.1 million, $759,000 and $0, respectively.

### Certain Risks and Uncertainties

The Company has derived substantially all of its revenue from sales of BioThrax under contracts with the DoD and HHS. The Company's ongoing U.S. government contract does not necessarily increase the likelihood that it will secure future comparable contracts with the U.S. government. The Company expects that a significant portion of the business that it will seek in the near future, in particular for BioThrax, will be under government contracts that present a number of risks that are not typically present in the commercial contracting process. U.S. government contracts for BioThrax are subject to unilateral termination or modification by the government. The Company may fail to achieve significant sales of BioThrax to customers in addition to the U.S. government, which would harm its growth opportunities. The Company may not be able to sustain or increase profitability. The Company is spending significant amounts for the expansion of its manufacturing facilities. The Company may not be able to manufacture BioThrax consistently in accordance with FDA specifications. Other than BioThrax, all of the Company's product candidates are undergoing clinical trials or are in early stages of development, and failure is common and can occur at any stage of development. None of the Company's product candidates other than BioThrax has received regulatory approval.

### Earnings per Share

Basic net income per share of common stock excludes dilution for potential common stock issuances and is computed by dividing net income by the weighted average number of shares outstanding for the period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

The following table presents the calculation of basic and diluted net income per share:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in thousands, except share and per share data) | 2007 | 2006 | 2005 |
| Numerator: | | | |
| Net Income | $ 22,936 | $ 22,793 | $ 15,784 |
| Denominator: | | | |
| Weighted-average number of shares—basic | 28,995,667 | 23,039,794 | 20,533,471 |
| Dilutive securities—stock options | 667,460 | 1,527,508 | 2,218,262 |
| Weighted-average number of shares—diluted | 29,663,127 | 24,567,302 | 22,751,733 |
| Earnings per share—basic | $ 0.79 | $ 0.99 | $ 0.77 |
| Earnings per share—diluted | $ 0.77 | $ 0.93 | $ 0.69 |

For the years ending December 31, 2007, 2006 and 2005, outstanding stock options to purchase approximately 463,000, 160,000 and 21,000 shares, respectively, of common stock are not considered in the diluted earnings per share calculation because the exercise price of these options is greater than the average per share closing price during the year.

### Accounting for Stock-based Compensation

As of December 31, 2007, the Company has two stock-based employee compensation plans, the Emergent BioSolutions Inc. 2006 Stock Incentive Plan (the "2006 Plan") and the Emergent BioSolutions Employee Stock Option Plan (the "2004 Plan"), described more fully in Note 10—Stockholders' Equity. Through December 31, 2005, the Company accounted for grants under the 2004 Plan using the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB No. 25") and provided the pro forma disclosures of net income and net income per share in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS No. 123") as amended by SFAS

No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosures* using the fair value method. Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant between the fair value of the Company's stock and the exercise price of the option and is recognized ratably over the vesting period of the option.

Effective January 1, 2006, the Company adopted the fair value provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* ("SFAS No. 123(R)"), using the modified prospective method. Under the fair value recognition provisions of SFAS No. 123(R), the Company recognizes stock-based compensation net of an estimated forfeiture rate. The Company accounts for equity instruments issued to non-employees in accordance with SFAS No. 123 and EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services.*

Under the modified prospective method, compensation cost recognized in 2007 and 2006 includes: (1) compensation cost for all share-based payments granted prior to but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (2) compensation cost for all share-based payments granted and vested subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Stock based compensation is recognized on a straight-line basis over the vesting period.

Results for prior periods have not been restated. Based on options granted to employees as of December 31, 2007, total compensation expense not yet recognized related to unvested options is approximately $2.9 million, after tax. The Company expects to recognize that expense over a weighted average period of 3.0 years.

The Company has utilized the Black-Scholes valuation model for estimating the fair value of all stock options granted. The fair value of each option is estimated on the date of grant. Set forth below are the weighted-average assumptions used in valuing the stock options granted and a discussion of the Company's methodology for developing each of the assumptions used:

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2007** | **2006** | **2005** |
| Expected dividend yield | 0% | 0% | 0% |
| Expected volatility | 50% | 50% | 50% |
| Risk-free interest rate | 2.99–5.09% | 4.58–5.21% | 3.33–4.32% |
| Expected average life of options | 3.0 years | 3.0 years | 2.9 years |

- Expected dividend yield—The Company does not pay regular dividends on its common stock and does not anticipate paying any dividends in the foreseeable future.
- Expected volatility—Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company analyzed the expected historical volatility used by similar companies at a similar stage of development to estimate expected volatility. The volatility used by these similar companies ranged from 33% to 79%, with an average estimated volatility of 53%.
- Risk-free interest rate—This is the range of U.S. Treasury rates with a term that most closely resembles the expected life of the option as of the date in which the option was granted.
- Expected average life of options—This is the period of time that the options granted are expected to remain outstanding. This estimate is based primarily on the employee position profile of option holders and the trading lock out periods that result from the employee's access to stock price sensitive information.

Prior to the adoption of SFAS No. 123(R), the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the statement of cash flows. SFAS No. 123(R) requires the cash flows resulting from the tax benefits of deductions in excess of the compensation cost recognized for those options (excess tax benefits from stock-based compensation) to be classified as financing cash flows.

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for the year ended December 31, 2005.

| (in thousands, except per share data) | Year Ended December 31, 2005 |
|---|---|
| Net income, as reported | $15,784 |
| Add: Stock-based compensation in reported net income, net of taxes | — |
| Deduct: Total stock-based compensation expense determined under the fair value based method for all awards, net of taxes | (258) |
| Pro forma net income | $15,526 |
| Net income per common share—basic | $ 0.77 |
| Net income per common share—diluted | $ 0.69 |
| Pro forma net income per common share—basic | $ 0.76 |
| Pro forma net income per common share—diluted | $ 0.68 |

## Reclassifications

Restricted cash deposits in the consolidated statements of cash flows for the years ended December 31, 2006 and 2005 have been reclassified from investing cash flows to financing cash flows, to conform to current period presentation.

## Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an Amendment of ARB No. 51* ("SFAS No. 160"). SFAS 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements, requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest, establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation, and requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. The provisions of SFAS No. 160 are effective for fiscal years beginning on or after December 15, 2008. The Company is currently evaluating the impact of the adoption of this statement on its financial statements.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* ("SFAS No. 141R"). SFAS No. 141R requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values, changes the recognition of assets acquired and liabilities assumed arising from contingencies, changes the recognition and measurement of contingent consideration, and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, and it may not be applied before that date. The provisions of SFAS No. 141R will impact the Company's financial statements to the extent that the Company is party to a business combination after the pronouncement has been adopted.

In June 2007, the FASB issued EITF No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities* ("EITF No. 07-3"). EITF No. 07-3 states that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. The provisions of EITF No. 07-3 are effective for fiscal years beginning after December 15, 2007. The Company anticipates that the adoption of the provisions of EITF No. 07-3 will not have a material impact on its financial statements.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115* ("SFAS No. 159"). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The provisions of SFAS No. 159 are effective for fiscal years beginning after November 15, 2007. The Company anticipates that the adoption of this statement will not have a material impact on its financial statements.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company anticipates that the adoption of this statement will not have a material impact on its financial statements.

## 3. ACQUISITIONS

### ViVacs GmbH

On July 13, 2006, Emergent International, Inc., a wholly owned subsidiary of the Company, incorporated in Delaware ("EII"), completed the acquisition of ViVacs GmbH, a German limited liability company, to expand the Company's commercial vaccine portfolio, pursuant to the terms and conditions of the Share Purchase and Assignment Agreement dated July 13, 2006 by and between EII and ViVacs. EII paid $150,000 in cash on the closing date of the agreement and agreed to pay $50,000 on each of the first and second anniversaries of the closing date. The acquisition agreement also provides for a potential variable earn-out purchase price of up to $220,000, based on future payments from third party licensees of the technology. As of December 31, 2007, the Company has not received any such payments from third party licensees. Because ViVacs was a development stage company and had not commenced its planned principal operations, the transaction was accounted for as an acquisition of assets rather than as a business combination and, therefore, goodwill was not recorded.

Total purchase consideration consisted of:

| (in thousands) | |
|---|---|
| Cash (including future guaranteed cash payments of $100) | $250 |
| Direct acquisition costs | 180 |
| Total purchase consideration | $430 |

The assets acquired were accounted for in accordance with the provisions of SFAS No. 141, *Business Combinations* ("SFAS No. 141"). All of the tangible and intangible assets acquired and liabilities assumed of ViVacs were recorded at their estimated fair market values on the acquisition date.

The purchase price was allocated as follows:

| (in thousands) | |
|---|---|
| Current assets | $ 153 |
| Property and equipment | 97 |
| Current liabilities | (297) |
| Net liabilities acquired | (47) |
| In-process research and development | 477 |
| Total purchase consideration | $ 430 |

In connection with the transaction, the Company recorded a charge of $477,000 for acquired research projects associated with product candidates in development for which, at the acquisition date, technological feasibility had not been established and, for accounting purposes, no alternative future use existed.

### Microscience Limited

On June 23, 2005, Emergent Europe, Inc., a wholly owned subsidiary of the Company incorporated in Delaware ("EEI"), completed the acquisition of Microscience pursuant to the terms and conditions of the Share Exchange Agreement dated June 23, 2005 by and between EEI and Microscience Holdings PLC, a public limited liability company incorporated in England. At the closing date, the Company, through EEI, issued Microscience shareholders 3,636,801 shares of the Company's Class A Common Stock in exchange for all of the outstanding stock of Microscience. Shares of Class A Common Stock of the Company were valued for financial statement purposes at $7.42 per share based on a determination of the estimated fair value by the Company's board of directors. Because Microscience was a development stage company and had not commenced its planned principal operations, the transaction was accounted for as an acquisition of assets rather than as a business combination and, therefore, goodwill was not recorded.

Total purchase consideration consisted of:

| (in thousands) | |
|---|---|
| Fair value of common stock | $27,001 |
| Direct acquisition costs | 1,194 |
| Total purchase consideration | $28,195 |

The assets acquired were accounted for in accordance with the provisions of SFAS No. 141. All of the tangible and intangible assets acquired and liabilities assumed of Microscience were recorded at their estimated fair market values on the acquisition date. The purchase price was allocated as follows:

| (in thousands) | |
|---|---|
| Current assets | $ 1,441 |
| Property and equipment | 863 |
| Current liabilities | (684) |
| Net assets acquired | 1,620 |
| In-process research and development | 26,575 |
| Total purchase consideration | $28,195 |

In connection with the transaction, the Company recorded a charge of $26.6 million for acquired research projects associated with products in development for which, at the acquisition date, technological feasibility had not been established and, for accounting purposes, no alternative future use existed.

## 4. ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

| | December 31, | |
|---|---|---|
| (in thousands) | 2007 | 2006 |
| Billed | $17,741 | $43,305 |
| Unbilled | 1,076 | 26 |
| Total | $18,817 | $43,331 |

## 5. INVENTORIES

Inventories consist of the following:

| | December 31, | |
|---|---|---|
| (in thousands) | 2007 | 2006 |
| Raw materials and supplies | $ 2,463 | $ 2,133 |
| Work-in-process | 11,483 | 22,239 |
| Finished goods | 2,951 | 349 |
| Total inventories | $16,897 | $24,721 |

## 6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

| | December 31, | |
|---|---|---|
| (in thousands) | 2007 | 2006 |
| Land and improvements | $ 4,974 | $ 5,173 |
| Buildings and leasehold improvements | 26,410 | 25,074 |
| Furniture and equipment | 19,626 | 15,963 |
| Software | 5,866 | 3,937 |
| Construction-in-progress | 71,129 | 41,563 |
| | 128,005 | 91,710 |
| Less: Accumulated depreciation and amortization | (17,787) | (13,536) |
| Total Property, plant and equipment, net | $110,218 | $ 78,174 |

Depreciation and amortization expense was $4.8 million, $4.7 million and $3.5 million for the years ended December 31, 2007, 2006 and 2005, respectively. For the years ended December 31, 2007, 2006 and 2005, depreciation and amortization expense included approximately $1.0 million, $1.3 million and $1.3 million, respectively, related to the amortization of internal-use software. As of December 31, 2007 and 2006, unamortized software cost was $0 and $1.2 million, respectively.

## 7. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities consist of the following:

| | December 31, | |
|---|---|---|
| (in thousands) | 2007 | 2006 |
| Contract costs | $1,962 | $1,218 |
| Professional fees | 723 | 1,115 |
| Interest payable | 259 | 222 |
| Property taxes and other | 1,112 | 715 |
| Total | $4,056 | $3,270 |

## 8. LONG-TERM DEBT

The components of long term-debt are as follows:

| (in thousands) | December 31, 2007 | 2006 |
|---|---|---|
| Term Loan dated June 2007; Libor plus 2.75%, due June 2012 | $28,750 | $ — |
| Term Loan dated August 2006; Libor plus 3.75%, due August 2011 | — | 10,000 |
| Revolving credit loan; Libor plus 3.75% | — | 5,000 |
| Term Loan dated April 2006; Libor plus 3.0%, due April 2011 | 8,167 | 8,383 |
| Forgivable Loan dated October 2004; 3.0%, due March 2013 | 2,500 | 2,500 |
| Term Loan dated October 2004; 6.625%, due October 2011 | 6,671 | 6,955 |
| ERP Term Loan; Prime less 0.375%, due September 2007 | — | 960 |
| Other | 14 | 26 |
| Total long-term indebtedness | 46,102 | 33,824 |
| Less current portion of long-term indebtedness | (3,514) | (2,456) |
| Noncurrent portion of long-term indebtedness | $42,588 | $31,368 |

In June 2007, the Company entered into a loan agreement with HSBC Realty Credit Corporation (USA) ("HSBC"), under which HSBC provided the Company with a term loan of $30 million. This loan replaced a prior loan arrangement with HSBC under which HSBC agreed to loan the Company $15 million, consisting of a $10 million term loan and a $5 million revolving line of credit. Under the new loan agreement, the Company is required to maintain a minimum balance of $5 million in a deposit account pledged to HSBC and to make monthly payments in the amount of $250,000 in principal plus accrued interest beginning in August 2007, with a residual principal payment due upon maturity in June 2012. Payment of the loan is secured by substantially all of the assets of Emergent BioDefense Operations, other than accounts receivable under BioThrax supply contracts with the DoD and HHS that are pledged as collateral to secure the $15 million revolving line of credit with Fifth Third Bank. Interest on the loan accrues at an annual rate of LIBOR plus 2.75% (7.73% as of December 31, 2007).

Under this term loan, the Company is required to maintain a book leverage ratio of less than 1.25. This ratio is calculated by dividing total liabilities, excluding deferred revenues specific to contracts with the U.S. government, by total net worth. In addition, the Company is required to maintain a debt coverage ratio of not less than 1.25 to 1.00. This ratio is calculated by dividing earnings before interest, taxes, depreciation and amortization for the most recent four quarters by the sum of current obligations under capital leases and principal obligations and interest expenses for borrowed money, in each case due and payable for the following four quarters. The Company is in compliance with these covenants as of December 31, 2007.

In August 2006, the Company entered into a term loan for $10 million and a revolving credit loan that provided for borrowings up to $5 million. Under the term loan, the Company was required to make monthly principal payments beginning in April 2007 and a residual principal payment of approximately $5.6 million upon maturity in August 2011. Interest was payable monthly and accrued at an annual rate equal to LIBOR plus 3.75%. Under the revolving credit loan, the Company was not required to repay outstanding principal until October 2007. In October 2007, the outstanding principal under the revolving credit loan was to convert to a term loan with required monthly principal payments through maturity in August 2011. Interest was payable monthly and accrued at an annual rate equal to LIBOR plus 3.75%. Both the term loan and the revolving credit loan were replaced by the $30 million term loan discussed above.

In April 2006, the Company completed the acquisition of a 145,000 square foot facility in Frederick, Maryland for $9.8 million. This facility was previously under a lease which contained an option to purchase the facility. The Company paid $1.3 million in cash and financed the remaining balance with a bank loan in the amount of $8.5 million. This loan requires monthly principal and interest payments from May 2006 through April 2011 of $72,000 with a balloon payment for the remaining unpaid principal and interest due in April 2011. The

interest rate is a floating rate based on the three month LIBOR plus 3.0% (7.9 8% as of December 31, 2007). The loan is collateralized by the facility. The loan requires the Company to comply with certain non-financial covenants. The Company is in compliance with these covenants as of December 31, 2007.

In October 2004, the Company entered into a Secured Conditional Loan with the Maryland Economic Development Assistance Fund for $2.5 million. The proceeds of the loan were used to reimburse the Company for eligible costs it incurred to purchase a building in Frederick, Maryland. The loan is secured by a $1.3 million letter of credit and a security interest in the building. The Company is required to pay an annual fee of 1.0% to maintain the letter of credit. The borrowing bears interest at 3.0% per annum, and the term of the loan ends March 31, 2013. The principal and related accrued interest may be forgiven if specified employment levels are achieved and maintained through December 2012, at least $42.9 million in project costs are expended prior to December 2009, and the Company occupies the building through December 2012. For the loan to be forgiven, the Company must employ at least 280 full-time employees at the Company's facilities in Frederick, Maryland as of December 31, 2009 and maintain at least 280 full-time employees through December 31, 2012. If as of December 31, 2009, 2010, 2011 or 2012 the Company employs fewer than 280 and more than 225 full-time employees at the Company's facilities in Frederick, Maryland, then the Company will be required to repay $9,000 of principal plus accrued interest for each position not filled below the target level of 280 employees. If as of December 31, 2009, 2010, 2011 or 2012 the Company employs fewer than 225 full-time employees at the Company's facilities in Frederick, Maryland, then the Company will be required to repay the entire outstanding principal amount of the loan plus accrued interest. This loan is guaranteed by all of the subsidiaries of the Company.

In connection with the 2004 purchase of the building in Frederick, Maryland discussed above, the Company entered into a loan agreement for $7 million with a bank to finance the remaining portion of the purchase price. The borrowing accrued interest at 6.625% per annum through October 2006. The Company was required to make interest only payments through that date. Beginning in November 2006, the Company began to make monthly payments of $62,000, based upon a 15 year amortization schedule. In November 2009, the monthly payments will be adjusted based upon a 12 year amortization schedule. Beginning in November 2009, the loan will bear interest at a fixed rate equal to 3.2% over the yield on actively traded U.S. Government securities issues adjusted to a constant maturity of two years, rounded up to the nearest one-eighth of one percent (1/8 of 1%). All unpaid principal and interest is due in full in October 2011. The Company is required to maintain certain financial and non-financial covenants including a minimum tangible net worth of not less than $5.0 million and a debt coverage ratio of not less than 1.1 to 1. The Company is in compliance with these covenants as of December 31, 2007. This loan is guaranteed by all of the subsidiaries of the Company.

During 2004, the Company implemented an Enterprise Resource Planning (ERP) system. The Company financed $2.3 million of the costs through the issuance of a term loan. The loan bore interest at prime less 0.375%, and was fully repaid in September 2007.

Scheduled principal repayments and maturities on long-term debt as of December 31, 2007 are as follows:

| (in thousands) | |
|---|---|
| 2008 | $ 3,514 |
| 2009 | 6,049 |
| 2010 | 3,585 |
| 2011 | 16,203 |
| 2012 | 16,751 |
| | $46,102 |

## 9. LINE OF CREDIT

In June 2007, the Company entered into a loan agreement with Fifth Third Bank, whereby Fifth Third Bank agreed to extend to the Company a revolving line of credit up to $15 million. Collateral for this line of credit consists of accounts receivable under supply contracts with the DoD and HHS. The Company can borrow under this line of credit through May 2008, at which time the agreement expires. The line of credit is secured by accounts receivable under the Company's DOD and HHS contracts and bears interest at the prime rate less 0.375% (7.68% as of December 31, 2007). The Company is subject to certain covenants, including maintenance of specified equity levels on a quarterly basis, and is currently in compliance with those covenants. At

December 31, 2007 and 2006, $11.8 million and $8.9 million, respectively, were outstanding under the line of credit. These amounts were repaid in January 2008 and 2007, respectively.

## 10. STOCKHOLDERS' EQUITY

### Preferred Stock

The Company is authorized to issue up to 15,000,000 shares of preferred stock, $0.001 par value per share ("Preferred Stock"). Any preferred stock issued may have dividend rates, voting rights, conversion privileges, redemption characteristics, and sinking fund requirements as approved by the Company's board of directors. As of December 31, 2007 and 2006, no preferred stock has been issued.

### Common Stock

The Company currently has one class of $0.001 par value per share common stock ("Common Stock") authorized and outstanding. The Company is authorized to issue up to 100,000,000 shares of the Common Stock. Holders of Common Stock are entitled to one vote for each share of Common Stock held on all matters as may be provided by law.

On November 14, 2006, the Company completed its initial public offering ("IPO"), which resulted in the issuance of 5,000,000 shares of common stock at a price of $12.50 per share for gross proceeds of $62.5 million. Issuance costs related to the offering were $8.3 million, resulting in net proceeds from the offering of $54.2 million. In conjunction with the completion of the IPO, all outstanding shares of Class A and Class B common stock were converted into 22,420,421 shares of Common Stock at a conversion rate of one share of common stock for one share of Class A and Class B common stock.

On September 20, 2006, the Company's board of directors recommended to the stockholders of the Company an amendment of the Company's amended and restated certificate of incorporation, which the stockholders approved on October 27, 2006, that, among other things, reclassified the Class A Common Stock as $0.001 par value per share Common Stock, increased the number of authorized shares of Common Stock to 100,000,000 shares and adjusted the par value of the Preferred Stock from $0.01 par value per share to $0.001 par value per share. The amendment became effective on October 27, 2006. On September 20, 2006, the Company's board of directors also authorized the pricing committee of the board of directors to effect a stock split of both the Common Stock, in the form of a dividend of shares of Common Stock, and the Class B Common Stock, in the form of a dividend of shares of Class B Common Stock. The pricing committee subsequently declared a 2.8771-for-one stock split of the Common Stock and the Class B Common Stock effective as of October 27, 2006. The par values, the number of authorized shares and all share and per share amounts in the consolidated financial statements have been retroactively adjusted to give effect to the filing of the certificate of amendment of the Company's amended and restated certificate of incorporation and the stock split. The consolidated financial statements do not reflect the reclassification of the Class A Common Stock as Common Stock, other than the related adjustment to par value and the increase in the number of authorized shares.

Holders of Common Stock are entitled to receive dividends as and when declared by the Company's board of directors. On June 15, 2005, the Company's board of directors declared a special cash dividend to the holders of outstanding shares of Class A Common Stock and Class B Common Stock in an aggregate amount of $5.4 million. The Company's board of directors declared this special dividend in order to distribute the net proceeds of a payment received as a result of the settlement of litigation initiated in 2002 by the Company against Elan Pharmaceuticals, Inc., Athena Neurosciences, Inc. and Solstice Neurosciences, Inc. in an effort to clarify intellectual property rights, including the recovery of royalties and other costs and fees, to which the Company believed it was entitled under a series of agreements regarding the development of botulinum toxin products. The Company paid the special cash dividend on July 13, 2005 to stockholders of record as of June 15, 2005. No regular dividends have been declared or paid.

### Stock Options

As of December 31, 2007, the Company has two stock-based employee compensation plans, the 2006 Plan and the 2004 Plan (together, the "Emergent Plans"), under which the Company has granted options to purchase shares of Common Stock. The Emergent Plans have both incentive and non-qualified stock option features.

The 2006 Plan, established in connection with the Company's initial public offering in November 2006, initially authorized the issuance of up to 1,089,461 shares of Common Stock. In addition, the 2006 Plan contains an "evergreen provision" that allows for increases in the number of shares authorized for issuance under the 2006 Plan in the first and third quarter of each year from 2007 through 2009. Each semi-annual increase in the number of shares will be equal to the lowest of: (1) a specified number of shares stipulated in the 2006 Plan; (2) a specified percentage of the aggregate number of shares outstanding; and (3) an amount determined by the Company's Board of Directors. The maximum specified number of shares per semi-annual increase ranges from 428,700 to 937,900. The maximum specified percentage of outstanding shares for each semi-annual increase ranges from 1.5% to 3.0%. Accordingly, an aggregate of 1,949,362 shares of Common Stock are authorized for issuance under the 2006 Plan as of December 31, 2007. The Company has granted options to purchase a total of 1,380,111 shares of Common Stock under the 2006 Plan as of December 31, 2007. The maximum number of options that may be granted per year under the 2006 Plan to a single participant is 287,700. The exercise price of each incentive option must be not less than 100% of the fair market value of the shares on the date of grant. Options granted under the 2006 Plan have a vesting period of no more than 5 years and a contractual life of no more than 10 years. The terms and conditions of stock options (including price, vesting schedule, term and number of shares) under the Emergent Plans are determined by the Company's compensation committee, which administers the Emergent Plans. Following the closing of the Company's initial public offering, the Company no longer granted options pursuant to the 2004 Plan.

Each option granted under the Emergent Plans becomes exercisable as specified in the relevant option agreement, and no option can be exercised after ten years from the date of grant. The following is a summary of stock option plan activity:

| | 2006 Plan | | 2004 Plan | | |
|---|---|---|---|---|---|
| | Number of Shares | Weighted-Average Exercise Price | Number of Shares | Weighted-Average Exercise Price | Aggregate Intrinsic Value |
| Outstanding at December 31, 2006 | 1,030,500 | $10.13 | 2,936,389 | $2.53 | 26,375,147 |
| Exercisable at December 31, 2006 | — | $ — | 2,395,693 | $1.43 | 23,310,093 |
| Granted | 620,811 | 9.44 | — | — | |
| Exercised | — | — | (2,153,988) | 1.15 | |
| Forfeited | (271,200) | 10.41 | (110,668) | 8.31 | |
| Cancelled | — | — | (5,214) | 1.49 | |
| Outstanding at December 31, 2007 | 1,380,111 | $ 9.77 | 666,519 | $6.04 | 743,995 |
| Exercisable at December 31, 2007 | 289,900 | $10.27 | 507,802 | $4.94 | 682,439 |

The weighted average remaining contractual term of options outstanding as of December 31, 2007 and 2006 was 5.5 and 3.2 years, respectively. The weighted average remaining contractual term of options exercisable as of December 31, 2007 and 2006 was 4.6 and 1.1 years, respectively.

The weighted average grant date fair value of options granted during the years ended December 31, 2007, 2006 and 2005 was $3.58, $3.94 and $1.37, respectively. The total intrinsic value of options exercised during the years ended December 31, 2007, 2006 and 2005 was $20.5 million, $2.3 million and $563,000, respectively. The total fair value of shares vested during 2007 was $1.9 million.

Stock-based compensation expense was recorded in the following financial statement line items:

| | Years Ended December 31, | |
|---|---|---|
| (in thousands) | 2007 | 2006 |
| Cost of sales | $ 82 | $ 3 |
| Research and development | 377 | 97 |
| General and administrative | 2,082 | 623 |
| Total stock-based compensation expense | $2,541 | $723 |

A summary of the status of the Company's nonvested stock options at December 31, 2007 is presented below:

| | 2006 Plan | | 2004 Plan | |
|---|---|---|---|---|
| | Number of Shares | Weighted-Average Grant Date Fair Value | Number of Shares | Weighted-Average Grant Date Fair Value |
| Nonvested at December 31, 2006 | 1,030,500 | $3.09 | 537,532 | $5.30 |
| Granted | 620,811 | 3.58 | — | — |
| Exercised | — | — | — | — |
| Vested | (289,900) | 3.91 | (278,598) | 2.84 |
| Forfeited | (271,200) | 3.85 | (100,217) | 3.00 |
| Nonvested at December 31, 2007 | 1,090,211 | $3.66 | 158,717 | $3.53 |

During the year ended December 31, 2007, the Company received a tax benefit from stock options exercised of approximately $6.0 million and $789,000 respectively.

## 11. INCOME TAXES

Significant components of the provision for income taxes attributable to operations consist of the following:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2007 | 2006 | 2005 |
| Current | | | |
| Federal | $11,189 | $14,212 | $ 16,093 |
| State | 2,275 | 812 | 200 |
| Total Current | 13,464 | 15,024 | 16,293 |
| Deferred | | | |
| Federal | 2,832 | 100 | (9,769) |
| State | (3,245) | 98 | (1,199) |
| Total Deferred | (413) | 198 | (10,968) |
| Total Provision for Income Taxes | $13,051 | $15,222 | $ 5,325 |

The Company's net deferred tax asset consists of the following:

| | December 31, | |
|---|---|---|
| (in thousands) | 2007 | 2006 |
| Net operating loss carryforward | $ 6,361 | $ 4,160 |
| Research and development credit carryforward | 511 | 549 |
| Stock compensation | 523 | 1,452 |
| Foreign deferrals | 39,044 | 32,534 |
| Other | 1,508 | 1,681 |
| Deferred tax asset | 47,971 | 40,376 |
| Fixed assets | (756) | (888) |
| Other | (1,303) | (433) |
| Deferred tax liability | (2,059) | (1,321) |
| Valuation allowance | (33,702) | (27,283) |
| Net deferred tax asset | $ 12,186 | $ 11,772 |

Net operating loss carryforwards consist of approximately $118 million for state jurisdictions and $100 million for foreign jurisdictions. The state net operating loss carryforwards will begin to expire in 2018. The foreign net operating loss carryforwards will have an indefinite life unless the foreign entities have a change in the nature or conduct of the business in the three years following a change in ownership. The use of the Company's net operating loss carryforwards may be restricted due to changes in Company ownership.

The provision for income taxes differs from the amount of taxes determined by applying the U.S. federal statutory rate to loss before provision for income taxes as a result of the following:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2007 | 2006 | 2005 |
| US | $ 62,016 | $ 56,698 | $ 54,259 |
| International | (26,029) | (18,683) | (33,150) |
| Earnings before taxes on income | 35,987 | 38,015 | 21,109 |
| Federal tax at statutory rates | $ 12,595 | $ 13,305 | $ 7,388 |
| State taxes, net of federal benefit | 701 | (395) | (2,329) |
| Impact of foreign operations | (7,106) | (6,050) | (17,982) |
| Change in valuation allowance | 6,419 | 6,605 | 18,995 |
| Effect of change in rates | 493 | — | — |
| Effect of foreign rates | 154 | 752 | 264 |
| Tax credits | (880) | (759) | (474) |
| Other differences | (617) | 1,044 | (212) |
| Permanent differences | 1,292 | 720 | (325) |
| Provision for income taxes | $ 13,051 | $ 15,222 | $ 5,325 |

The effective annual tax rate for the years ended December 31, 2007, 2006 and 2005 was 36%, 40% and 25%, respectively. The decrease in the effective rate from 2006 to 2007 was due primarily to a reduction in state valuation allowances related to the expected utilization of net operating losses.

In September 2006, the FASB issued FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109, Accounting for Income Taxes* ("FIN 48"). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 requires that the Company recognize in its financial statements the impact of a tax position if that position is more likely than not to be sustained on audit based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure.

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized, as a cumulative effect of change in accounting principle, a $607,000 increase in tax-related liabilities for unrecognized tax benefits and a $607,000 reduction to beginning retained earnings. The Company recognizes interest in interest expense and recognizes potential penalties related to unrecognized tax benefits in selling, general and administrative expense. The Company accrued approximately $27,000 for the payment of interest and penalties as of December 31, 2007. Of the total unrecognized tax benefits recorded at December 31, 2007, $33,000 is classified as a current liability and $244,000 is classified as a non-current liability on the balance sheet. As of December 31, 2007, $33,000 of unrecognized tax benefits will reverse within the next twelve months.

A reconciliation of the beginning and ending balances of the total amounts of gross unrecognized tax benefits is as follows:

| (in thousands) | |
|---|---|
| Gross unrecognized tax benefits at January 1, 2007 | $ 607 |
| Increases for tax positions for prior years | 262 |
| Decreases for tax positions for prior years | (65) |
| Increases for tax positions for current year | 100 |
| Settlements | (201) |
| Lapse of statue of limitations | (426) |
| Gross unrecognized tax benefits at December 31, 2007 | $ 277 |

Substantially all of these reserves would impact the effective tax rate if released into income.

The Company's federal and state income tax returns for the tax years 2006-2004 remain open to examination. The Company's tax returns in the United Kingdom remain open to examination for the tax years 2006–2001, and tax returns in Germany remain open indefinitely. A federal income tax audit of the Company's tax return for the 2004 tax year was completed in March 2007. As a result of this audit, the Company paid an assessment of $722,000, including $96,000 of interest. The Company is the subject of an ongoing federal income tax audit for the tax year ended December 31, 2005. The financial statement impact of the audit has been estimated at approximately $451,000, including $56,000 of interest. This amount has been accrued as of December 31, 2007.

## 12. 401(K) SAVINGS PLAN

The Company has established a defined contribution savings plan under Section 401(k) of the Internal Revenue Code. The 401(k) Plan covers substantially

all employees. Under the 401(k) Plan, employees may make elective salary deferrals. The Company provides for matching of qualified deferrals up to 50% of the first 6% of the employee's salary. During the years ended December 31, 2007, 2006 and 2005, the Company made matching contributions of approximately $682,000, $573,000 and $520,000, respectively.

## 13. COMMITMENTS AND SETTLEMENT GAINS

### Leases

The Company leases laboratory and office facilities, office equipment and vehicles under various operating lease agreements. The Company leases office and laboratory space in Gaithersburg, Maryland under a non-cancelable operating lease that contains a 3% annual escalation and expires in November 2008. The Company leases office and laboratory space in Wokingham, England under two coterminous non-cancelable operating leases that expire in November 2016. The Company leases office space in Rockville, Maryland under a non-cancelable operating lease that contains a 3% annual escalation clause over the ten year term of the lease, which expires in December 2016 and the Company has a five year renewal option at the end of the initial term. For the years ended December 31, 2007, 2006 and 2005, total rent expense was $3.4 million, $2.4 million and $2.5 million, respectively.

Future minimum lease payments under operating lease obligations as of December 31, 2007 are as follows:

| (in thousands) | |
|---|---|
| 2008 | $ 2,048 |
| 2009 | 1,436 |
| 2010 | 1,453 |
| 2011 | 1,471 |
| 2012 | 1,489 |
| 2013 and beyond | 6,086 |
| Total minimum lease payments | $13,983 |

### Litigation

In June 2002, the Company initiated a lawsuit against Élan Pharmaceuticals and related entities in an effort to clarify intellectual property rights, including the recovery of royalties and other costs and fees, to which the Company believed it was entitled under a series of agreements and to clarify intellectual property rights associated with those agreements. The Company sought damages, injunctive relief and declaratory relief. On June 27, 2005, the Company obtained a settlement pursuant to which Élan and related entities agreed to pay the Company $10.0 million. Payment of such settlement was received by the Company in July 2005. The agreement also clarified the parties' intellectual property rights. Upon receipt of the settlement from Élan Pharmaceuticals and related entities, the Company distributed a net settlement amount (total proceeds from the settlement less reserves for applicable federal and state income taxes, legal expenses related to the suit and other miscellaneous expenses) of $5.4 million to all Company stockholders of record as of June 15, 2005.

From time to time, the Company is involved in product liability claims and other litigation considered normal in the nature of its business. The Company does not believe that any such proceedings would have a material, adverse effect on the results of its operations. For claims filed against the Company for use of BioThrax by the DoD, the Company expects to rely on contractual indemnification provisions with the DoD and statutory protections to limit our potential liability resulting from the pending lawsuits.

## 14. RELATED PARTY TRANSACTIONS

The Company has engaged Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale") to provide certain legal services to the Company. The Company's Senior Vice President Legal Affairs and General Counsel is married to a partner at WilmerHale, who has not participated in providing legal services to the Company. The Company has incurred fees for legal services rendered by WilmerHale of approximately $1.0 million for the year ended December 31, 2007. Of this amount, approximately $131,000 was in accounts payable at December 31, 2007.

The Company has entered into marketing and sales contracts with entities controlled by family members of the Chief Executive Officer to market and sell BioThrax in certain international territories if certain conditions are met. A consulting arrangement with the Chief Executive Officer's sister required a payment of 4% of net sales, not to exceed $2.00 per dose, under the agreement. This arrangement terminated in 2006. A marketing arrangement with an entity affiliated with the family of Chief Executive Officer required a payment of 40% of gross sales in countries in the Middle East and North Africa, except Israel. This arrangement terminated in 2007. A similar marketing arrangement with the same entity was entered into in 2008 that requires a payment of 17.5% of net sales and reimbursement of certain expenses, for certain countries in the Middle East and

North Africa, excluding countries to which export is prohibited by the U.S. government. No royalty payments under these agreements have been triggered for the years ended December 31, 2007, 2006 and 2005.

The Company has entered into consulting, lease and transportation arrangements with various persons or entities affiliated with the Chief Executive Officer and two members of the board of directors. At December 31, 2007 and 2006, there was $18,000 and $17,000, respectively, in accounts payable for these services. For the years ended December 31, 2007, 2006 and 2005, the Company paid approximately $200,000, $387,000 and, $625,000, respectively, to various persons or entities affiliated with two members of our board of directors. For the years ended December 31, 2007, 2006 and 2005, the Company paid approximately $33,000, $33,000 and $169,000, respectively, to entitles owned by or affiliated with the Chief Executive Officer. The Company currently has an agreement with a director to perform corporate strategic issues consultation and directed project support to the marketing and communications group and an agreement with a company owned by the Chief Executive Officer to provide transportation and logistical support.

Simba LLC, a Maryland based limited liability company 100% owned by the Company's Chief Executive Officer and his wife, provides chartered air transportation. Simba offers its services to the Company on a discount from Simba's normal commercial rate. For the years ended December 31, 2006 and 2005, the Company paid approximately $13,000 and $34,000, respectively, for transportation on an as needed basis for business purposes. In May 2006, this arrangement was terminated.

## 15. SEGMENT INFORMATION

The Company reports financial information for two business segments: biodefense and commercial. In the biodefense business, the Company develops, manufactures and commercializes products for use against biological agents that are potential weapons of bioterrorism. Revenues in this segment relate to the Company's FDA-approved product, BioThrax. In the commercial business, the Company develops products for use against infectious diseases that have resulted in significant unmet or underserved medical needs. Revenues in this segment consist predominantly of milestone payments and development and grant revenues received under collaboration and grant arrangements. The "All Other" segment relates to the general operating costs of the Company and includes costs of the centralized services departments, which are not allocated to the other segments, as well as spending on product candidates or activities that are not classified as biodefense or commercial. The assets in this segment consist of cash and fixed assets.

| | Reportable Segments | | | |
|---|---|---|---|---|
| (in thousands) | **Biodefense** | **Commercial** | **All Other** | **Total** |
| **Year Ended December 31, 2007** | | | | |
| External revenue | $179,738 | $ 3,177 | $ — | $182,915 |
| Intersegment revenue (expense) | — | — | — | — |
| Research and development | 24,744 | 26,159 | 3,055 | 53,958 |
| Interest revenue | — | — | 2,809 | 2,809 |
| Interest expense | — | — | (71) | (71) |
| Depreciation and amortization | 3,445 | 947 | 425 | 4,817 |
| Net Income (loss) | 76,397 | (38,213) | (15,248) | 22,936 |
| Assets | 133,692 | 21,672 | 118,144 | 273,508 |
| Expenditures for long-lived assets | 38,880 | 1,991 | 3,098 | 43,969 |
| **Year Ended December 31, 2006** | | | | |
| External revenue | $147,707 | $ 5,025 | $ — | $152,732 |
| Intersegment revenue (expense) | — | — | — | — |
| Research and development | 22,219 | 22,425 | 857 | 45,501 |
| Interest revenue | — | — | 846 | 846 |
| Interest expense | — | — | (1,152) | (1,152) |
| Depreciation and amortization | 3,586 | 830 | 299 | 4,715 |
| Net income (loss) | 55,074 | (24,538) | (7,743) | 22,793 |
| Assets | 125,562 | 13,732 | 98,961 | 238,255 |
| Expenditures for long-lived assets | 29,273 | 1,455 | 10,500 | 41,228 |

The accounting policies of the segments are the same as those described in Note 2—Summary of significant accounting policies. There are no inter-segment transactions.

## 16. QUARTERLY FINANCIAL DATA (UNAUDITED)

Quarterly financial information for the years ended December 31, 2007 and 2006 is presented in the following tables:

| | Three Months Ended | | | |
|---|---|---|---|---|
| (in thousands) | March 31 | June 30 | September 30 | December 31 |
| Fiscal year 2007 | | | | |
| Revenue | $26,448 | $23,186 | $43,644 | $89,637 |
| Income (loss) from operations | (5,831) | (8,657) | 4,422 | 43,159 |
| Net income (loss) | (2,690) | (4,961) | 2,845 | 27,742 |
| Net income (loss) per share, basic | (0.10) | (0.17) | 0.10 | 0.93 |
| Net income (loss) per share, diluted | (0.10) | (0.17) | 0.10 | 0.93 |
| Fiscal year 2006 | | | | |
| Revenue | $12,223 | $11,446 | $42,174 | $86,889 |
| Income (loss) from operations | (9,398) | (6,194) | 9,720 | 43,900 |
| Net income (loss) | (4,636) | (3,054) | 4,354 | 26,129 |
| Net income (loss) per share, basic | (0.21) | (0.14) | 0.19 | 1.04 |
| Net income (loss) per share, diluted | (0.21) | (0.14) | 0.18 | 0.99 |

## COMMON STOCK INFORMATION

### Market Information and Holders

Our common stock has traded on the New York Stock Exchange under the symbol "EBS" since November 15, 2006. Prior to that time, there was no public market for our common stock. The following table sets forth the high and low sales prices per share of our common stock during each quarter of the year ended December 31, 2007 and for the period from November 15, 2006 to December 31, 2006:

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| **Year Ended December 31, 2007** | | | | |
| High | $17.75 | $14.85 | $12.67 | $10.70 |
| Low | $10.50 | $ 8.33 | $ 7.67 | $ 4.40 |
| **Year Ended December 31, 2006** | | | | |
| High | n/a | n/a | n/a | $12.72 |
| Low | n/a | n/a | n/a | $ 9.75 |

As of February 29, 2008, the closing price per share of our common stock on the New York Stock Exchange was $7.47 and we had 48 holders of record of our common stock. This number does not include beneficial owners whose shares are held by nominees in street name.

### Dividend Policy

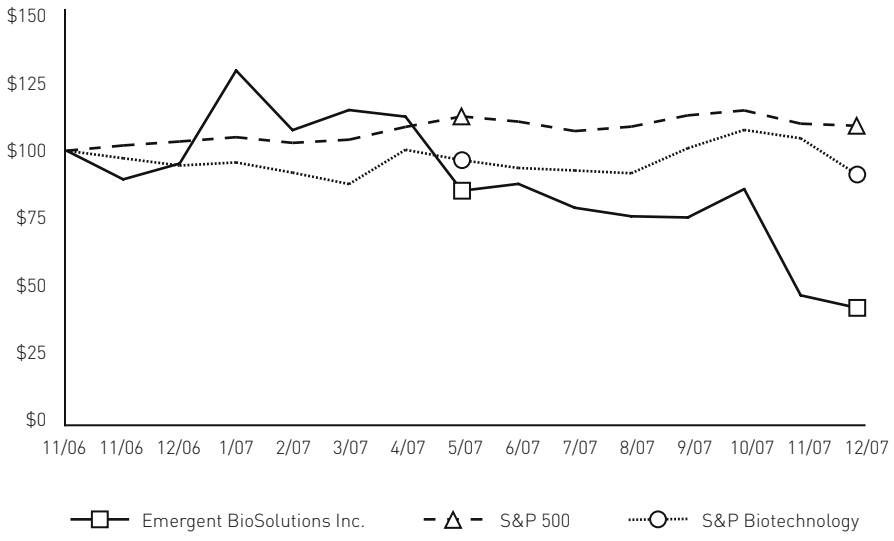
We currently intend to retain all of our future earnings to finance the growth and development of our business. We do not intend to pay cash dividends to our stockholders in the foreseeable future.

On June 15, 2005, our board of directors declared a special cash dividend to the holders of our outstanding shares of common stock in an aggregate amount of approximately $5.4 million. Our board of directors declared this special dividend in order to distribute the net proceeds of a payment that we received as a result of the settlement of litigation that we initiated against Elan Pharmaceuticals, Inc., Athena Neurosciences, Inc. and Solstice Neurosciences, Inc. We paid the special cash dividend on July 13, 2005 to stockholders of record as of June 15, 2005. Prior to this special cash dividend, we had never declared or paid any cash dividends on our common stock.

## STOCK PERFORMANCE GRAPH

The stock performance graph below compares the cumulative total stockholder return for our common stock between November 15, 2006, the date our common stock was first publicly traded, and December 31, 2007 with the cumulative total return of the S&P 500 Index and the S&P Biotechnology Index. The comparison assumes the investment of $100.00 on November 15, 2006 in our common stock, the investment of $100.00 on October 31, 2006 in each of the S&P 500 Index and the S&P Biotechnology Index, and the reinvestment of dividends. The graph below assumes that the initial value of our common stock on November 15, 2006 was the closing sales price of $11.70 per share.

**COMPARISON OF CUMULATIVE TOTAL RETURN**
**Among Emergent BioSolutions Inc., the S&P 500 Index* and the S&P Biotechnology Index***






| | Base Period | Month End 11/06 | 12/06 | 1/07 | 2/07 | 3/07 | 4/07 |
|---|---|---|---|---|---|---|---|
| Emergent BioSolutions, Inc. | 100.00 | 89.66 | 95.38 | 128.97 | 107.44 | 114.70 | 112.31 |
| S&P 500 | 100.00 | 101.90 | 103.33 | 104.89 | 102.84 | 103.99 | 108.60 |
| S&P Biotechnology | 100.00 | 97.29 | 94.65 | 95.77 | 92.08 | 87.96 | 100.34 |

| Month End 5/07 | 6/07 | 7/07 | 8/07 | 9/07 | 10/07 | 11/07 | 12/07 |
|---|---|---|---|---|---|---|---|
| 85.56 | 88.03 | 79.40 | 76.32 | 75.90 | 86.15 | 47.78 | 43.25 |
| 112.39 | 110.52 | 107.10 | 108.70 | 112.77 | 114.56 | 109.77 | 109.01 |
| 96.60 | 93.77 | 92.87 | 91.87 | 100.91 | 107.51 | 104.49 | 91.41 |

# Corporate information

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**Annual Report on Form 10-K**
The information in this annual report is a summary and should be considered along with the company's Annual Report on Form 10-K for the year ended December 31, 2007.

**A copy of the company's Form 10-K for the year ended December 31, 2007, filed with the Securities and Exchange Commission, is available without charge upon written request to Investor Relations, Emergent BioSolutions, 2273 Research Blvd, Suite 400, Rockville, MD 20850, by calling (301) 795-1800 or by accessing the company's website at www.emergentbiosolutions.com.**

**Independent Registered Public Accounting Firm**
Ernst & Young LLP
McLean, VA
United States

**Stock Transfer Agent and Registrar**
Investors with questions concerning account information, new certificate issuances, lost or stolen certificate replacement, securities transfers, or the processing of a change of address should contact:

American Stock Transfer &
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59 Maiden Lane, 1st Floor
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**Market Information**
Emergent BioSolutions Inc. common stock has traded on the New York Stock Exchange under the trading symbol **EBS** since November 15, 2006.

## Corporate Governance

Our Chief Executive Officer and Chief Financial Officer have provided the certifications required by Rule 13a-14(a) under the Securities Exchange Act of 1934, copies of which are filed as exhibits to our Annual Report on Form 10-K. In addition, our Chief Executive Officer intends to submit his annual chief executive officer certification to the New York Stock Exchange within 30 days of the date of our Annual Meeting of Stockholders in accordance with the New York Stock Exchange listing requirements.

Emergent BioSolutions Inc. is strongly committed to the highest standards of ethical conduct and corporate governance. Our Board of Directors has adopted Corporate Governance Guidelines, along with the charters of the Board Committees and a Code of Conduct and Business Ethics for directors, officers and employees, all of which are available on the company's website at www.emergentbiosolutions.com.

**Special Note About Forward-Looking Statements**
This annual report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and Section 21E of the Securities Exchange Act of 1934, as amended, that involve substantial risks and uncertainties. All statements, other than statements of historical fact, including statements regarding our strategy, future operations, future financial position, future revenues, projected costs, prospects, plans and objectives of management, are forward-looking statements. The words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "predict," "project," "will," "would" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words.

There are a number of important factors that could cause the company's actual results to differ materially from those indicated by such forward-looking statements, including our performance under existing BioThrax sales contracts with the U.S. government, including the timing of deliveries under these contracts; our ability to obtain new BioThrax sales contracts with the U.S. government; our plans for future sales of BioThrax; our plans to pursue label expansions and improvements for BioThrax; our plans to expand our manufacturing facilities and capabilities; the rate and degree of market acceptance and clinical utility of our products; our ongoing and planned development programs, preclinical studies and clinical trials; our ability to identify and acquire or in license products and product candidates that satisfy our selection criteria; the potential benefits of our existing collaboration agreements and our ability to enter into selective additional collaboration arrangements; the timing of and our ability to obtain and maintain regulatory approvals for our product candidates; our commercialization, marketing and manufacturing capabilities and strategy; our intellectual property portfolio; our estimates regarding expenses, future revenue, capital requirements and needs for additional financing; and other factors identified in the company's Annual Report on Form 10-K for the year ended December 31, 2007 and subsequent reports filed with the SEC. The company disclaims any intention or obligation to update any forward-looking statements as a result of developments occurring after the date of this annual report. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make.

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