

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS**

**THIRD QUARTER 2007**

**INFORMATION REGARDING FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. Forward-looking statements include, but are not limited to, statements about:

- the marketing and sales of our products and services;
- the declaration and distribution of any future dividends;
- our ability to sustain licensing and other contract-based revenues;
- the impact of our contracts with the NIH and The Wellcome Trust on future business;
- the value of, and expenses associated with, our intellectual property;
- the requirements of pharmaceutical and biotechnology companies;
- the benefits of knockout mice programs and, in particular, our technologies and products, to the pharmaceutical industry;
- the increasing competition we face in the field of knockout mice from both commercial and government organizations;
- failures in the drug discovery, development and approval processes by our partners and collaborators;
- our ability to successfully execute our business plan and to meet contractual obligations, in view of the Company's limited staff; and
- liquidity and capital resources.

In some cases, you can identify forward-looking statements by terms such as "may," "will," "should," "could," "would," "expects," "plans," "anticipates," "believes," "estimates," "projects," "predicts," "potential" and similar expressions intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. Given these uncertainties, you should not place undue reliance on these forward-looking statements. These forward-looking statements represent our estimates and assumptions only as of the date of this report.

You should read this report completely and with the understanding that our actual future results may be materially different from what we expect. We qualify all of our forward-looking statements by these cautionary statements.

**YOU SHOULD READ THE FOLLOWING DISCUSSION AND ANALYSIS IN CONJUNCTION WITH OUR FINANCIAL STATEMENTS AND THE NOTES ACCOMPANYING THE FINANCIAL STATEMENTS.**

## 1. Overview

Deltagen (or the “Company” or “We”) is a provider of research tools to the biopharmaceutical industry and to the academic research community. Deltagen has generated an inventory of “knockout mice” in which a single gene has been deleted (“knocked out”). The knockout mice have been analyzed to determine the phenotypic changes associated with that gene deletion. This phenotypic data has been organized in an integrated database known as DeltaBase. DeltaBase contains phenotypic data on 750 different knockout mouse lines. In addition to those 750 knockout mouse lines, Deltagen has approximately 150 additional knockout mouse lines that have not been characterized phenotypically. Deltagen also has approximately 450 knockout lines at the embryonic stem (ES) cell stage.

Our customers and partners/collaborators have included some of the world’s largest pharmaceutical companies, including GlaxoSmithKline plc, Merck & Co., Inc., Pfizer Inc., Eli Lilly and Company and Schering-Plough Research Institute.

We have historically generated revenue from our DeltaBase and DeltaOne products and programs.

DeltaBase is our proprietary database that provides information, based on knockout mouse studies, on gene function and validated gene targets for drug discovery. Each knockout mouse underwent a standardized, detailed and extensive analysis in order to determine the function and role that a particular gene plays in the mouse and that gene’s suitability as a drug target.

DeltaOne offers access to our portfolio of knockout mice and/or accompanying phenotypic data, as well as any corresponding intellectual property, on a gene-by-gene basis.

We derive substantially all of our revenues from a narrow and limited range of sources. Substantially all of our revenues are currently derived from the licensing of knockout mouse lines and related phenotypic data to the biopharmaceutical industry and academic institutions under our DeltaOne program. Because of continuing consolidation in the biopharmaceutical industry and the finite number of knockout lines in the Company’s inventory, significant uncertainty exists with respect to the Company’s future revenues.

Our operating results have fluctuated in the past and are likely to do so in the future, and we do not believe that period-to-period comparisons of our operating results are a good indication of our future performance.

## 2. Critical Accounting Policies and Estimates

The consolidated financial statements of Deltagen for the three months ended September 30, 2007 are unaudited, but have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for annual financial information. These consolidated financial statements have been prepared so that they present fairly, in the opinion of management, the Company’s financial position and its results of operations and its cash flows for the period presented.

Under our revenue recognition policy, revenues are recognized when a definitive agreement with a determinable price exists, product delivery and/or invoicing (in each case where there is reasonable assurance of meeting customer-specified criteria) have occurred, and collectibility is reasonably assured. A change in our revenue recognition policy or changes in the terms of contracts under which we recognize revenues could have an impact on the amount and timing of our recognition of revenues.

The preparation of consolidated financial statements in conformity with GAAP requires the Company to make estimates and assumptions that affect the amounts that are reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on the Company’s best knowledge of current events and actions that the Company may undertake in the future, actual results may differ materially from the estimates.

### **3. Results of Operations**

The Company's consolidated revenues for the three months ended September 30, 2007 totaled \$0.410 million. The revenues were attributable primarily to license fees associated with the provision of knockout mice and related phenotypic data to The Wellcome Trust (the "Trust") pursuant to a May 29, 2007 order placed by the Trust (\$0.213 million) and under the Company's DeltaOne™ program.

The Company had interest income of \$0.027 million for the three months ended September 30, 2007.

Total consolidated expenses for the three months ended September 30, 2007 were \$0.359 million, compared to \$0.849 million for the previous quarter. The decrease in operating expenses was attributable primarily to the restructuring changes implemented by the Company in July 2007 in an effort to reduce the fixed operating expenses of the Company. The operating expenses for the third quarter were attributable primarily to third-party royalties and commissions (\$0.115 million) and labor costs and other general and administrative expenses (\$0.244 million).

Net income before provision for income taxes for the three months ended September 30, 2007 was \$0.079 million.

As of September 30, 2007, the Company had \$2.851 million in consolidated cash and cash equivalents and \$1.553 million in accounts receivable. This accounts receivable amount includes approximately \$1.2 million relating to tax credits expected to be received from the French government by the Company's wholly-owned subsidiary, Deltagen Europe, S.A. The Company is uncertain as to the timing of the payment of these tax credits.

### **4. Major Events**

#### **The Wellcome Trust:**

The Company received on September 13, 2007 an order from the Trust, a United Kingdom-based, independent charitable organization that funds research to improve human and animal health, for twenty of the Company's knockout mouse lines and related phenotypic data. This order was the second to be received by the Company from the Trust and is worth \$1.000 million. The Company had earlier received on May 29, 2007 its first order from the Trust for seventeen of the Company's knockout mouse lines and related phenotypic data, worth \$0.850 million. The Company received during the third quarter \$0.213 million pursuant to the first order and expects to receive the balance of the license fees relating to the first order in installment payments between the fourth quarter of 2007 and the end of the second quarter of 2008, contingent upon satisfactory completion of specified delivery and acceptance milestones. The Company expects to receive the license fees associated with the second order in installment payments between the fourth quarter of 2007 and the end of the third quarter of 2008, contingent upon satisfactory completion of specified delivery and acceptance milestones.

The knockout mouse lines obtained by the Trust will be archived at and distributed by the European Mutant Mouse Archive (EMMA). The knockout mouse lines will be made available through EMMA to the academic research community. The Company will retain exclusive rights to make these ordered knockout lines available to commercial organizations. The Company may receive future orders for knockout mouse lines from the Trust, but the Trust has no obligations to place any such additional orders and the Trust does not currently intend to issue a third call for proposals.

## 5. Subsequent Events

### **Xenopharm Earnout Shares:**

In an Agreement and Plan of Merger and Reorganization dated February 15, 2002 by and among the Company, XP Acquisition Corporation and Xenopharm, Inc. (the “Merger Agreement”), entered into in connection with the Company’s acquisition of Xenopharm, Inc. (“Xenopharm”), the Company agreed to issue shares of the Company’s common stock to the former Xenopharm shareholders (the “XP Holders”) upon the occurrence of certain events.

On March 14, 2004, pursuant to and in satisfaction of a certain condition of the Merger Agreement, the XP Holders had rights to receive an aggregate of 131,572 shares of the Company’s common stock (the “XP Earnout Shares”). These XP Earnout Shares were not issued to the XP Holders at such time, notwithstanding the requirement to do so. In addition to receipt of the XP Earnout Shares, the XP Holders were entitled to receive the cash dividend of \$0.20 per share distributed by the Company on December 28, 2006 (the “2006 Dividend”) with respect to the XP Earnout Shares. In February 2007, the Board approved the issuance and delivery of the XP Earnout Shares to the XP Holders in accordance with the provisions of the Merger Agreement, and upon such issuance, payment of the 2006 Dividend and any future dividends of the Company to the XP Holders with respect to the XP Earnout Shares.

In August 2007, the Company received a letter from certain XP Holders asserting the XP Holders’ right to receive certain other earnout shares (the “Additional XP Earnout Shares”) under the Merger Agreement. In October 2007, the Company entered into a settlement agreement (the “Settlement Agreement”) with the stockholder representative of the XP Holders. Under the Settlement Agreement, Deltagen agreed to issue to the XP Holders, in accordance with the Merger Agreement, the Additional XP Earnout Shares, totaling 1,054,021 shares of the Company’s common stock, and to pay to the XP Holders all prior and future dividends of the Company with respect to the Additional XP Earnout Shares, subject to the Company having received a release of liability (“Release”) with respect to the Merger Agreement from at least 75% of the XP Holders, on a ratable basis (the “Threshold”).

The Threshold was met on October 24, 2007. Deltagen shall issue the Additional XP Earnout Shares and distribute a dividend payment of \$0.25 per share with respect to the Additional XP Earnout Shares (“XP Dividends”) to those XP Holders that execute a Release before January 23, 2008. The XP Dividends relate to the Company’s 2006 Dividend (\$0.20 per share) and the \$0.05 per share dividend distributed in May 2007. Accordingly, the Company will issue up to 1,054,021 and distribute up to \$263,505.25 in XP Dividends to the XP Holders.

## **RISK FACTORS AFFECTING FUTURE OPERATING RESULTS**

There are numerous risks and uncertainties related to both our business and our industry that could cause actual results or events to differ materially from those indicated by forward-looking statements.

For a list of additional risk factors that may affect our future operating results, refer to the “Risk Factors” section of “Management’s Discussion and Analysis of Financial Conditions and Results of Operations” for the year ended December 31, 2005, as posted on the Company’s website ([www.deltagen.com](http://www.deltagen.com)). The risk factors listed there are not the only ones we face and additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair or otherwise affect our business operations.