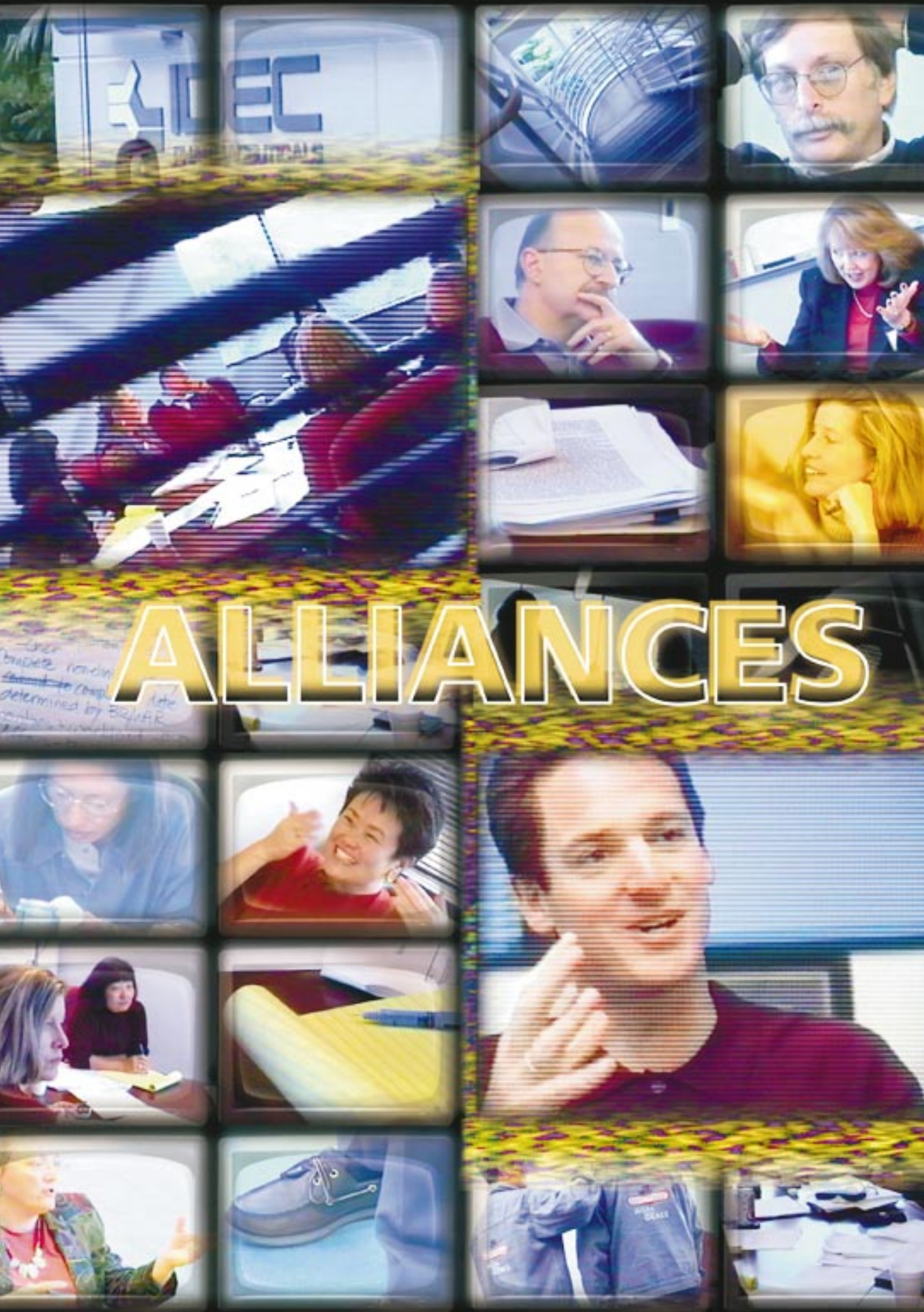
GENENTECH BUSINESS DEVELOPMENT

- A third component of Genentech's four-point strategy for growth is to continue to accelerate the pace of forming strategic alliances. Significant new alliances made in 1996 and early 1997, and key progress made within earlier alliances, show how well planned partnerships with the right fit can contribute significantly to Genentech's success.


ALLIANCES

Partnering for Success

The joint Genentech/IDEC/Roche project team for the C2B8 antibody meets to prepare to file for U.S. and European regulatory clearance to market the antibody for the treatment of non-Hodgkin's B-cell lymphoma. The filing, achieved in the first quarter of 1997, followed from successful Phase III results announced in December 1996. The collaboration with IDEC stems from Genentech's Business Development group's efforts to license late-stage products that can provide near-term market opportunities. In 1996, Roche opted to develop the C2B8 antibody outside the United States.

From new technologies, to new products, to new avenues for Genentech science, Genentech's partners in business build on the company's existing strengths

Genentech's strategy for business development is to access partners' resources that build on Genentech's strengths. Genentech has a clear, three-pronged approach:

First, the company seeks to license late-stage products that can augment its product portfolio and contribute to revenues near term. An example is Genentech's collaboration with IDEC to develop IDEC's C2B8 antibody. Another is the agreement with Roche for Genentech to promote Roferon-A in the United States for its approved cancer indications.

Second, Genentech partners with companies to access emerging technologies. Genentech's relationship with Incyte Pharmaceuticals, for example, provides access to a powerful DNA sequence and gene expression database. And a relationship with Baxter Healthcare Corporation combines Genentech's understanding of Factor VIII* with Baxter's experience in cellular therapy.

Third, Genentech seeks partnerships to realize the value of its own promising products it chooses not to develop itself. With the wealth of products from Genentech's discovery research efforts, these relationships are essential to help keep Genentech scientists motivated and ensure promising new medicines are developed. Two examples are Genentech's anti-CD11a antibody (hu1124), for which XOMA is developing the manufacturing process necessary to support development and is conducting clinical trials, and the anti-CD18 antibody, for which Roche is conducting clinical trials, each in collaboration with Genentech. Through such relationships, Genentech minimizes the impact on its clinical resources yet maintains significant product rights.

Miya Weber (photo above), 43, was diagnosed with non-Hodgkin's B-cell lymphoma in early 1995 after she found a lump in her armpit. After her cancer did not respond to chemotherapy, she enrolled in the Phase III clinical trial for the C2B8 antibody in October 1995. Miya felt better within weeks. She had a complete response and was able to return to work as a probation officer.

** Genentech conducted the initial research and development that led to the recombinant Factor VIII now on the market for treating hemophilia.*

Genentech's Partners

Genentech's collaborations include:

Alkermes — collaboration involving the development of a sustained release formulation of Genentech's human growth hormone.

Baxter — collaboration to jointly develop encapsulated cell therapy for hemophilia A.

Boehringer Ingelheim — collaboration to jointly develop TNK for treatment of acute myocardial infarction.

Cambridge Antibody Technology — collaborative research agreement based on CAT antibody engineering technology.

Connective Therapeutics — agreements for Connective to develop relaxin for the treatment of connective tissue disorders and other indications, and to develop interferon gamma to treat certain dermatological diseases.

CytoTherapeutics — collaborative agreement to develop neurotrophic factors in CytoTherapeutics' cell encapsulation technology to treat certain neurodegenerative diseases.

Genetics Institute — agreement to provide Genentech with access to the DiscoverEase™ library of secreted proteins.

Hoechst AG — collaboration to develop small molecule vitronectin receptor antagonists for treatment of chronic bone disorders.

IDEC Pharmaceuticals — collaboration to jointly develop IDEC's anti-CD20 monoclonal antibodies for the treatment of non-Hodgkin's B-cell lymphomas.

Immunex — exclusive license to Genentech for the LERK proteins for neurobiology uses.

Incyte Pharmaceuticals — agreement providing Genentech access to Incyte's LifeSeq® DNA sequence and gene expression database.

Massachusetts General Hospital — collaborative research agreement for basic developmental research conducted at the hospital's Cardiovascular Research Center through studies of zebrafish.

Novartis/Tanox — agreement to develop and commercialize anti-IgE monoclonal antibodies.

Roche — collaborations include: promoting of Roferon®-A for oncology indications, developing Genentech's anti-CD18 monoclonal antibody for treatment of hemorrhagic shock, manufacturing a TNF-receptor fusion protein being studied by Roche, and small molecule discovery collaborations focusing on antagonists to IIb/IIIa, LFA/ICAM, VLA 4/VCA M, and certain coagulation targets.

Scios — collaboration agreement for the development of Auriculin® anaritide for the treatment of oliguric acute renal failure.

Sensus — agreement for Sensus to develop growth hormone antagonists for treating certain growth disorders.

Tularik — agreement for Tularik to develop novel human therapeutics based on transcription factors.

VaxGen (formerly GenenVax) — agreement for VaxGen to develop gp120, a potential prophylactic AIDS vaccine.

Washington University — exclusive licensing agreement for neurturin, a protein which is believed to promote nerve cell growth and protect certain nerve cells against damage.

Xenova — joint discovery and development program for small molecules in the cardiovascular, growth control, inflammation and autoimmune disease areas.

XOMA — collaborative agreement to jointly develop Genentech's anti-CD11a monoclonal antibody for treatment of psoriasis and organ transplant rejection.

Business Highlights

GENENTECH BUSINESS HIGHLIGHTS IN 1996 AND EARLY 1997

Corporate

- 1996 earnings: $118.3 million, or 96 cents per share. 1996 revenues: $968.6 million.
- A Delaware Chancery Court approved the settlement of a consolidated stockholder class action lawsuit filed following the 1995 announcement of an extended buy-out option by Roche, which stockholders approved in October 1995. In the settlement, Roche agreed to an increase in the redemption prices for Genentech's stock by 50 cents each quarter, with a final redemption price of $82.50 in the quarter ending June 30, 1999, if Roche causes the redemption of the remaining Genentech stock under the extended buyout option.
- Celebrated 20th anniversary since Genentech's founding by Herbert W. Boyer, Ph.D. and Robert A. Swanson.
- Roche exercised its options, per Genentech's 1995 arrangement with Roche, to develop the following Genentech development products outside the United States: IDEC's C2B8 monoclonal antibody, insulin-like growth factor-I (IGF-I), and nerve growth factor (NGF).
- Completed a new 42,000-square-foot building to provide three floors of research labs and offices for Cell Culture/Fermentation R&D groups.
- Named J. Richard Munro as chairman of the board of directors following cofounder Robert A. Swanson's retirement as chairman and from the board.
- Filed an amended complaint alleging that Novo-Nordisk infringes five Genentech patents in the manufacture and sale of Novo's recombinant human insulin product, Novolin®, in the United States.

Marketed Products

Activase® (Alteplase, recombinant)

- 1996 Activase sales: $284.1 million.
- Reached a record thrombolytic market share of approximately 80 percent.
- Received U.S. regulatory clearance to market Activase for the treatment of eligible adult patients with acute ischemic stroke within three hours of symptom onset.
- The American Heart Association, the American Academy of Neurology and the National Institutes of Health issued guidelines or proposed standards identifying stroke as a medical emergency and recommending that eligible patients—following appropriate screening—be treated with Activase to enhance their chances of recovering with no or minimal disability.

- Filed a patent infringement suit against Boehringer Mannheim in the United States and Germany that alleges its thrombolytic agent, Reteplase, infringes several Genentech patents.
- Reached an out-of-court settlement with Sumitomo Pharmaceuticals in Japan on a seven-year patent dispute over t-PA, for which Sumitomo agreed to halt the manufacturing and marketing of the drug in exchange for Genentech foregoing demands related to damages.

Protropin® (somatrem for injection), Nutropin® [somatropin (rDNA origin) for injection] and Nutropin AQ™ [somatropin (rDNA origin) injection] growth hormones

- 1996 growth hormone sales: $218.2 million.
- Maintained a two-thirds market share in growth hormone market despite new competition.
- Received U.S. regulatory clearance to market Nutropin for the treatment of short stature associated with Turner syndrome.
- Received Canadian regulatory approval to market Nutropin for the treatment of growth hormone inadequacy in children and growth failure resulting from chronic renal insufficiency. Roche has the right to market Nutropin in Canada.
- Filed for U.S. regulatory clearance to market Nutropin for the treatment of growth hormone inadequacy in adults.

Pulmozyme® (dornase alfa) Inhalation Solution

- 1996 Pulmozyme sales: $76.0 million.
- Received U.S. regulatory clearance to market Pulmozyme for the management of cystic fibrosis patients with advanced disease.

Actimmune® (Interferon gamma-1b)

- 1996 Actimmune sales: $4.5 million.
- Discontinued pursuing Actimmune for renal cell carcinoma after analysis of Phase III clinical data showed no significant benefit of the product for this targeted indication.

Business Development

- Entered into an agreement with Roche under which Genentech will promote Roche's Roferon®-A (Interferon alfa-2a, recombinant) in the United States for its approved oncology indications.
- With Tanox Biosystems, Inc. and Novartis Pharmaceuticals Corporation, settled lawsuits related to the development of anti-IgE antibodies. Also, reached an agreement under which Genentech and Tanox/Novartis combined their existing anti-IgE antibody programs under a cross-licensing program in a cooperative development effort.

- Expanded collaborative agreement with IDEC to include the clinical development and commercialization of the Y2B8 antibody, currently in Phase I/II clinical trials, as a potential complementary treatment for non-Hodgkin's B-cell lymphoma.
- Agreed with CytoTherapeutics, Inc. to develop treatments for various neurodegenerative diseases using CytoTherapeutics' encapsulated cell technology to deliver several of Genentech's proprietary growth factors.
- Agreed with XOMA Corporation for XOMA to develop Genentech's anti-CD11a antibody (hu1124) for the treatment of psoriasis and organ transplant rejection.
- Agreed with the Biotech Group of Baxter Healthcare Corporation to jointly develop a cellular therapy for hemophilia A.
- Agreed to invest in VaxGen, Inc. (formerly Genenvax), created to expand development of gp120, Genentech's potential vaccine for the prevention of HIV-1 infection. Genentech provided VaxGen exclusive rights to gp120.
- Entered into an agreement with Genetics Institute, Inc. to gain access to its DiscoverEase™ protein development platform.
- Entered into an agreement with Incyte Pharmaceuticals, Inc. to gain access to its LifeSeq® DNA sequence and gene expression database.
- Entered a collaborative agreement with Massachusetts General Hospital for basic developmental research conducted at the hospital's Cardiovascular Research Center through studies of zebrafish.

Research and Development

- Genentech's partner, IDEC Pharmaceuticals, completed Phase III clinical trials of the C2B8 antibody for the treatment of non-Hodgkin's B-cell lymphoma and submitted regulatory filings seeking marketing clearance in the first quarter of 1997.
- Completed Phase II trials of NGF for diabetic peripheral neuropathy, which suggested initial safety and efficacy. Began planning for approval-directed Phase III clinical trials anticipated to begin in the first half of 1997.
- Completed Phase II clinical trials utilizing IGF-I as an adjunct to insulin therapy in patients with Type I and Type II diabetes.
- Completed a Phase II clinical trial with an oral IIb/IIIa antagonist, designed in collaboration with Roche, in patients with acute coronary syndrome. Preparing for pivotal Phase III trials.
- In collaboration with Alkermes, Inc., began Phase I/II clinical trials of ProLease® human growth hormone, a sustained-release growth hormone product, in children with growth hormone inadequacy.

- Began Phase I clinical trials of vascular endothelial growth factor (VEGF) for the treatment of coronary arterial disease.
- Filed an investigational new drug application (IND) and began preparations for a Phase I trial of an anti-VEGF antibody for the treatment of several types of cancer.
- Roche began a Phase I trial to investigate Genentech's anti-CD18 antibody for the treatment of hemorrhagic shock.
- XOMA began a Phase I safety trial of Genentech's anti-CD11a antibody (hu1124) in patients with psoriasis and filed an IND to test this antibody in the clinic in renal transplant patients to prevent rejection of the grafted kidney.

Corporate Responsibility

- Provided more than $23 million worth of pharmaceuticals free of charge in 1996 through various programs for un- or underinsured patients in the United States.
- Decided to continue to fund Access Excellence—a nationwide electronic forum for high school biology teachers.
- Funded the independent Genentech Foundation for Growth and Development, which supports research in the area of human growth and development.
- Donated approximately $7 million for scientific research through medical and academic research organizations and hospital groups.
- For the seventh time, Genentech was named one of the top 100 companies for working mothers by *Working Mother* magazine.

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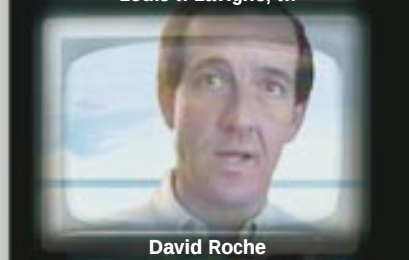
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* Member of Executive Committee

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GENENTECH FINANCIALS

- Genentech's fourth key strategy for growth is to improve financial returns. As late-stage products progress out of the pipeline, Genentech's goal is for its investment in research and development to decline in dollar terms; revenues to increase; and, as a percentage, R&D spending to approach 25 to 30 percent of revenues at the turn of the century.

This statement is a forward-looking statement and the Company's actual results may differ materially. For a discussion of the risk factors which may affect future R&D expenditures, please see page 47, "R&D Expenses," and for a discussion of the risk factors which may affect future revenues, please see page 46, "Total Product Sales" and "Activase Sales," page 47, "Growth Hormone Sales," "Pulmozyme Sales," and "Royalty and Contract Revenues," and page 48, "Successful Development of Products," "Uncertainties Surrounding Proprietary Rights," and "Market Potential/Risk."

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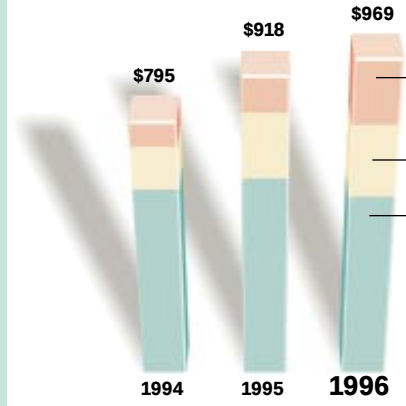
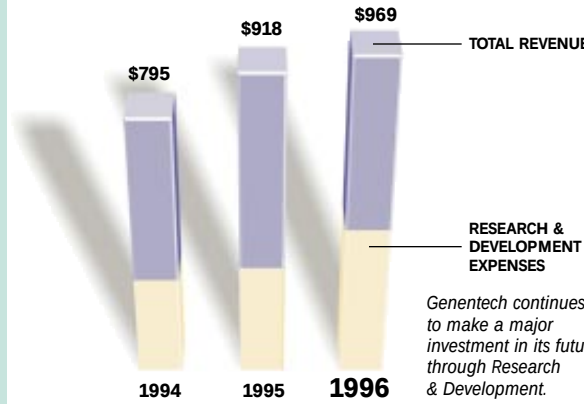


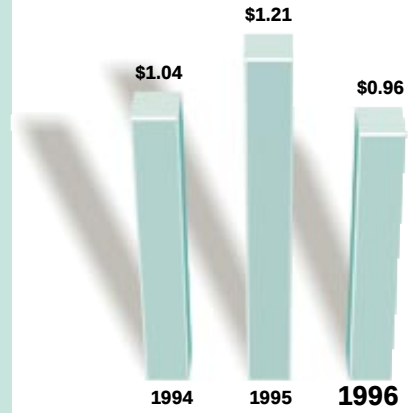
With the transfer of international product sales to HLR and HLR's exercise of development options for certain projects, Royalties and Contract Revenues continue to play an important role in Genentech's revenues.

REVENUES (millions)



Genentech continues to make a major investment in its future through Research & Development.

RESEARCH & DEVELOPMENT EXPENSES AND TOTAL REVENUES (millions)



Net Income Per Share reflects Genentech's dedication to aggressive Research & Development spending to ensure future revenue growth.

NET INCOME PER SHARE

RELATIONSHIP WITH ROCHE HOLDINGS, INC.

On October 25, 1995, Genentech, Inc. (the Company) and Roche Holdings, Inc. (Roche) entered into a new agreement (the Agreement) to extend until June 30, 1999, Roche's option to cause the Company to redeem (call) the outstanding callable putable common stock (special common stock) of the Company at predetermined prices. Should the call be exercised, Roche will concurrently purchase from the Company a like number of common shares for a price equal to the Company's cost to redeem the special common stock. If Roche does not cause the redemption as of June 30, 1999, the Company's stockholders will have the option to cause the Company to redeem none, some, or all of their shares of special common stock (and Roche will concurrently provide the necessary redemption funds to the Company by purchasing a like number of shares of common stock) within thirty business days commencing July 1, 1999. See the "Relationship with Roche Holdings, Inc." note in the "Notes to Consolidated Financial Statements" for further information.

In conjunction with the Agreement, F. Hoffmann-La Roche Ltd (HLR) was granted an option for ten years for licenses to use and sell certain of the Company's products in non-United States (U.S.) markets. As a result of the Agreement, in 1996 the Company's total product sales decreased, while contract and royalty revenue increased. Cost of sales as a percentage of product sales also increased due to the Agreement. See below for further discussion.

RESULTS OF OPERATIONS

(dollars in millions)

				Annual % Change	
Revenues	1996	1995	1994	96/95	95/94
Revenues	$ 968.6	$ 917.8	$ 795.4	6%	15%

The increase in revenues in 1996 resulted primarily from higher contract and royalty revenue partly offset by lower product sales. The 1995 increase resulted primarily from higher royalty income and product sales. Product sales to HLR in conjunction with the Agreement were $13.2 million in 1996 and $1.8 million in 1995.

				Annual % Change	
Product Sales	1996	1995	1994	96/95	95/94
Activase	$ 284.1	$ 301.0	$ 280.9	(6)%	7%
Protropin and Nutropin	218.2	219.4	225.4	(1)	(3)
Pulmozyme	76.0	111.3	88.3	(32)	26
Actimmune	4.5	3.6	6.4	25	(44)
Total product sales	$ 582.8	$ 635.3	$ 601.0	(8)%	6%
% of revenues	60%	69%	76%		

Total product sales decreased in 1996 compared to 1995 primarily as a result of the Agreement with Roche. On a pro forma basis that includes sales to HLR in 1996 and the fourth quarter of 1995, and excludes Canadian and European customer sales in 1995, sales increased to $582.8 million in 1996 from $578.7 million in 1995.

Activase: Total net sales of Activase® in 1996 decreased compared to 1995 primarily due to the impact of not having Canadian customer sales in 1996 as a result of the Agreement with Roche and the increased use of angioplasty (see below). Activase sales to Canadian customers were $12.7 million in 1995. Sales to U.S. customers decreased slightly in 1996 due to a decline in the market size. Although Activase's market share grew to approximately 80% in 1996 from approximately 75% in 1995, the overall size of the thrombolytic market at year end 1996 declined from 1995 by approximately 6%. The decline in the market size was the result of the increasing use of angioplasty rather than thrombolytic therapy, as well as from patients receiving therapy through ongoing clinical trials. On a pro forma basis, Activase sales were $284.1 million in 1996 versus $288.3 million in 1995, with the slight decrease due to lower U.S. sales and lower bulk product sales to Japan licensees. In June 1996, the Company received clearance from the U.S. Food and Drug Administration (FDA) to market Activase for the treatment of acute ischemic stroke or brain attack. Activase is the first therapy to be indicated for the management of stroke. The increase in Activase sales in 1995 over 1994 was attributable to growth in market share and an increase in the number of patients receiving thrombolytic therapy in the United States.

Protropin and Nutropin: Net sales of Protropin® and Nutropin® (together, growth hormone) were essentially flat in 1996 compared to 1995. On a pro forma basis, growth hormone sales in 1996 were $218.2 million compared to $216.7 million in 1995. The Company continues to face increased competition in the growth hormone market. Three companies in 1995, and a fourth company in 1996, received FDA approval to market their growth hormone products for treatment of growth hormone inadequacy in children, although one of those companies has been preliminarily enjoined from selling its product. Two competitors have received approval to market their existing human growth hormone products for additional indications. Growth hormone sales decreased in 1995 compared to 1994 due to a slight volume increase in sales being more than offset by the impact of pricing programs for distribution channels and for the managed care sector. In December 1996, the Company received clearance from the FDA to market Nutropin for the treatment of growth failure associated with Turner syndrome.

Pulmozyme: Net sales of Pulmozyme® in 1996 decreased compared to 1995 primarily in conjunction with the Agreement with Roche. Pulmozyme sales to customers in Europe and Canada totaled $41.3 million in 1995. In 1996, sales in these territories were made by Roche for the full year, and the Company received royalties on Roche's sales. On a pro forma basis, Pulmozyme sales were $76.0 million in 1996 compared to $70.0 million in 1995. Pulmozyme sales in 1995 increased over 1994 due to market launches in additional European countries and continued adoption of the product by physicians to treat cystic fibrosis patients. In December 1996, Pulmozyme was cleared for marketing by the FDA for the management of cystic fibrosis patients with advanced disease, a condition that affects approximately 500 patients in the United States.

Royalties, Contract and Other, and Interest Income	1996	1995	1994	Annual % Change 96/95	95/94
Royalties	$ 214.7	$ 190.8	$ 126.0	13%	51%
Contract and other	107.0	31.2	25.6	243	22
Interest income	64.1	60.5	42.8	6	42

The Company receives royalty payments from HLR from its sales of the Company's products outside of the U.S. under the Agreement, and receives royalties from other licensees and HLR from the sales of various other health care products. Total royalties in 1996 increased over 1995 primarily due to new royalties from HLR in conjunction with the Agreement, as well as higher income from existing licensees due to increased licensee sales. Royalty revenue under the Agreement was $17.0 million in 1996 and $1.9 million in 1995. All other royalty revenue from HLR in 1996, 1995 and 1994, totaled $9.2 million, $10.6 million and $7.9 million, respectively. The increase in 1995 compared to 1994 was attributable to increases in product sales by various licensees and new royalty arrangements. In 1995, the largest dollar increase was attributable to the receipt and recognition of $30.0 million of royalty revenue relating to the December 1994 settlement with Eli Lilly and Company (Lilly) regarding certain of the Company's patents. Under the December 1994 settlement agreement with Lilly, royalties of $30.0 million per year are payable, subject to possible offsets and contingent upon Humulin® continuing to be marketed in the U.S., to the Company through 1998, at which time such royalty obligations expire. Under a prior license agreement with Lilly, the Company receives royalties from Lilly's sales of its human insulin product. These royalty obligations expire in August of 1998. Cash flows from royalty income include non-dollar denominated revenues. The Company currently purchases simple foreign currency put option contracts (options) and enters into foreign currency forward exchange contracts (forward contracts) to hedge these cash flows. All options expire within the next four years. The Company has forward contracts of various durations that will expire by the end of 1997.

Contract and other revenues increased in 1996 due to contract revenue from HLR for the exercises of their options under the Agreement with respect to the development of three projects—IDEC-C2B8, insulin-like growth factor (IGF-1) and nerve growth factor (NGF). The Company recorded non-recurring contract revenues of $58.2 million relating to these option exercises in 1996. All other contract revenue from HLR, including reimbursement for ongoing development expenses after the option exercise date, totaled $37.1 million in 1996, $13.4 million in 1995 and $17.1 million in 1994. The increase in 1995 compared to 1994 was attributable to $6.4 million of gains recorded from sales of biotechnology equity securities. Contract and other revenues will continue to fluctuate due to variations in the timing of contract benchmark achievements; the initiation of new contractual arrangements, including the potential exercise of product options by HLR; and the conclusion of existing arrangements.

Interest income increased in 1996 compared to 1995 due to a larger investment portfolio. The increase in 1995 compared to 1994 was attributable to a larger investment portfolio and a higher average portfolio yield. The Company enters into interest rate swaps as part of its overall strategy of managing the duration of its investment portfolio. See the "Financial Instruments" note in the "Notes to Consolidated Financial Statements" for further information.

Costs and Expenses	1996	1995	1994	Annual % Change 96/95	95/94
Cost of sales	$ 104.5	$ 97.9	$ 95.8	7%	2%
Research and development	471.1	363.0	314.3	30	15
Marketing, general and administrative	240.1	251.7	248.6	(5)	1
Special charge	—	25.0	—	—	—
Interest expense	5.0	8.0	7.1	(38)	13
Total costs and expenses	$ 820.7	$ 745.6	$ 665.8	10%	12%
% of revenues	85%	81%	84%		
Cost of sales as % of product sales	18%	15%	16%		
R&D as % of revenues	49	40	40		
MG&A as % of revenues	25	27	31		

Cost of Sales: The cost of sales as a percentage of product sales increased in 1996 compared to 1995 primarily due to the impact of lower margin sales to HLR in 1996. The economic benefits from sales to HLR are also reflected in royalties as discussed above. In 1996, 1995 and 1994 reserves of $3.6 million, $3.7 million and $11.9 million, respectively, were provided for expected expirations of certain inventories.

Research and Development: Research and development (R&D) expense increased 30% in 1996 compared to 1995 due to continued late-stage clinical testing of products and new development projects. The increase in 1995 over 1994 resulted from a higher level of activity and associated costs of products in the later stages of clinical trials and the manufacture of products for clinical trials.

To gain additional access to potential new products and technologies and to utilize other companies to help develop the Company's potential new products, the Company has established strategic alliances with, including acquiring the equity and convertible debt of, companies developing technologies that fall outside the Company's research focus and with companies having the potential to generate new products through technology exchanges and investments. The Company has also entered into product-specific collaborations to acquire development and marketing rights for products.

Marketing, General and Administrative: Marketing, general and administrative expenses (MG&A) in 1996 decreased from 1995 primarily due to the closure of the Company's European and Canadian operations in conjunction with the Agreement. MG&A expenses in 1995 were comparable to the 1994 level of expenses.

Special Charge: The Company recorded a special charge of $25.0 million in 1995, which included $21.0 million related to the Agreement with Roche and $4.0 million associated with the resignation of the Company's former President and Chief Executive Officer. The merger expenses included investment banking fees, legal expenses, filing fees and other costs related to the Agreement, as well as charges associated with the settlement of stockholder lawsuits filed after the transaction was announced.

Interest Expense: Interest expense in 1996, 1995 and 1994, net of amounts capitalized, relates primarily to interest on the Company's 5% convertible subordinated debentures. In 1995, it also included interest on a $25.0 million borrowing arrangement which commenced in February 1995 and was paid in December of that year.

Income Before Taxes and Income Taxes	1996	1995	1994
Income before taxes	$ 147.9	$ 172.2	$ 129.6
Income tax provision	29.6	25.8	5.2
Effective tax rate	20%	15%	4%

The increase in the effective tax rate to 20% in 1996 from 15% in 1995 is due to the recognition of a greater amount of tax credit carryforwards in 1995 than in 1996. The net increase in the rate from 1994 to 1995 was primarily related to limitations on the utilization of existing carryforwards related to the U.S. alternative minimum tax.

				Annual % Change	
Net Income	1996	1995	1994	96/95	95/94
Net income	$ 118.3	$ 146.4	$ 124.4	(19)%	18%
Net income per share	$ 0.96	$ 1.21	$ 1.04		

Net income in 1996 decreased compared to 1995 primarily due to higher R&D expenses and lower product sales, partly offset by increased contract and royalty revenue. Net income in 1995 increased over 1994 due to higher revenue from all sources, partly offset by higher expenses, primarily R&D and special charges.

Liquidity and Capital Resources	1996	1995	1994
Cash, cash equivalents, short-term investments and long-term marketable debt and equity securities	$ 1,159.1	$ 1,096.8	$ 920.9
Working capital	705.1	812.0	776.6
Cash provided by (used in):			
Operating activities	139.7	133.9	200.4
Investing activities	(141.7)	(117.7)	(322.3)
Financing activities	72.2	54.1	71.2
Capital expenditures (included in investing activities above)	(141.8)	(70.2)	(82.8)
Current ratio	3.8:1	4.5:1	4.5:1

Cash generated from operations, the maturity of investments and stock issuances were used to purchase marketable securities and make capital additions in 1996.

Capital expenditures in 1996 primarily include building and land purchases and improvements to existing manufacturing and office facilities. In 1995, the Company entered into an arrangement with a lessor for a new manufacturing facility which qualifies as an operating lease and is expected to become operational in 1998.

FORWARD-LOOKING STATEMENTS

The following section contains forward-looking statements that are based on the Company's current expectations. Because the Company's actual results may differ materially from any forward-looking statements made by or on behalf of the Company, this section also includes a discussion of important factors that could affect the Company's actual future results, including its product sales, royalties, contract revenues, expenses and net income.

Total Product Sales: The Company anticipates that total reported quarterly product sales in 1997 will be comparable to 1996; however, product sales will be dependent on the overall competitive environment. Other factors affecting the Company's total product sales include, but are not limited to, the amount and timing of the Company's sales to HLR, the amount of sales to customers in the U.S., increased competition in the growth hormone and thrombolytic markets, the timing and amount of bulk shipments to licensees, and the possibility of the introduction of a new product in late 1997.

Activase Sales: The Company faces new competition in the thrombolytic market. The Company is aware that one company received FDA approval in October 1996 to market its product for the treatment of acute myocardial infarction (AMI) in the U.S. The Company has brought suit against that company for patent infringement. In addition, there is an increasing use of angioplasty in the treatment of AMI patients in lieu of the use of thrombolytic therapy. Depending on the extent and type of new competition, the Company's total Activase sales could be materially affected. Other factors affecting the Company's Activase sales include, but are not limited to, the timing of FDA approval, if any, of additional competitive products, pricing decisions made by the Company, the outcome of litigation against Boehringer Mannheim GmbH and Boehringer Mannheim Corporation involving the Company's patents for tissue plasminogen activator and processes related to its production and formulation, the

increasing use of other therapies such as angioplasty techniques for the treatment of AMI, and the impact of the FDA's recent clearance for the Company to market Activase for the treatment of acute ischemic stroke.

Growth Hormone Sales: The Company continues to face the possibility of increased competition in the growth hormone market. Three companies received FDA approval in 1995, and a fourth company received FDA approval in October 1996, to market their growth hormone products for treatment of growth hormone inadequacy in children, although one of those companies has been preliminarily enjoined from selling its product. Two of the Company's competitors have received approval to market their existing human growth hormone products for additional indications. The Company expects such competition to have an adverse effect on its sales of Protropin and Nutropin which, depending on the extent and type of competition, could be material. Other factors affecting the Company's growth hormone sales include, but are not limited to, the timing of FDA approval, if any, of other new competitive products, the outcome of litigation involving the Company's patents for human growth hormone and related processes, pricing decisions made by the Company, the availability of third-party reimbursement for the cost of growth hormone therapy, and the impact of Nutropin as a treatment for growth failure associated with Turner syndrome.

Pulmozyme Sales: Factors that may influence the future sales of Pulmozyme include, but are not limited to, physician perception of the number and kinds of patients who will benefit from such therapy, the availability of third-party reimbursement for the costs of therapy, the timing of the development of alternative therapies for the treatment and care of cystic fibrosis, whether and when additional indications are approved, and the cost of therapy.

Royalty and Contract Revenues: Royalty and contract revenues in future periods could vary significantly from 1996 levels. Major factors affecting these revenues include, but are not limited to: HLR's decisions to exercise or not to exercise its option to develop and sell the Company's future products in non-U.S. markets and the timing and amount of related development cost reimbursement, if any; variations in HLR's sales of Genentech products and other licensees' sales of licensed products; the expiration of royalties from Lilly in 1998; fluctuations in foreign currency exchange rates; the timing of non-U.S. approvals, if any, for products licensed to HLR; whether and when contract benchmarks are achieved; the initiation of other new contractual arrangements; and the conclusion of existing arrangements with other companies and HLR.

R&D Expenses: The Company intends to continue its commitment to aggressive investment in R&D. As it continues late-stage clinical testing of products, the Company anticipates that its R&D expenses will continue at a high percentage of revenues over the short-term. Over the long-term, however, R&D as a percent of revenues should decrease, although in dollar terms R&D spending is generally expected to rise as revenues rise. Factors affecting the Company's R&D expenses include, but are not limited to: the outcome of clinical trials currently being conducted; the number of products entering into development from late-stage research; future levels of the Company's product sales (including the impact of competition), royalty and contract revenues; the possibility of competition with respect to products or technologies under development; and decisions by HLR to exercise or not to exercise its option to develop and sell potential products of the Company in non-U.S. markets and the timing of such decisions.

Income Tax Provision: The Company expects that its effective tax rate will increase from the current rate of 20% to approximately 35% in 1997, and continue at or near 35% for the next several years dependent upon several factors. These factors include, but are not limited to, changes in tax laws and rates, future levels of R&D spending, the outcome of clinical trials of certain development products, the Company's success in commercializing such products, and potential competition regarding the products.

Successful Development of Products: The Company intends to continue to develop new products. Successful pharmaceutical product development is highly uncertain and is dependent on numerous factors, many of which are beyond the Company's control. Products that appear promising in the early phases of development may fail to reach the market for numerous reasons. They may be found to be ineffective or to have harmful side effects in preclinical or clinical testing, may fail to receive necessary regulatory approvals, may turn out to be uneconomical because of manufacturing costs or other factors, or may be precluded from commercialization by the proprietary rights of others or by competing products or technologies for the same indication. Success in preclinical and early clinical trials does not ensure that large-scale clinical trials will be successful. Clinical results are frequently susceptible to varying interpretations which may delay, limit or prevent regulatory approvals. The length of time necessary to complete clinical trials and to submit an application for marketing approval for a final decision by a regulatory authority varies significantly and may be difficult to predict.

Uncertainties Surrounding Proprietary Rights: The patent positions of pharmaceutical and biotechnology companies can be highly uncertain and involve complex legal and factual questions. Accordingly, the breadth of claims allowed in such companies' patents cannot be predicted. Patent disputes are frequent and can preclude commercialization of products. The Company, as in the past, may be involved in future material patent litigation. Such litigation is costly in its own right and could subject the Company to significant liabilities to third parties and, if decided adversely, the Company may need to obtain third-party licenses or cease using the technology or product in dispute. The presence of patents or other proprietary rights belonging to other parties may lead to the termination of research and development of a particular product. The Company believes it has strong patent protection or the potential for strong patent protection for a number of its products that generate sales and royalty revenue or that the Company is developing; however, the courts will determine the ultimate strength of patent protection of the Company's products and those on which the Company earns royalties.

Liquidity: The Company believes that its cash, cash equivalents, and short-term investments, together with funds provided by operations and leasing arrangements, will be sufficient to meet its foreseeable operating cash requirements. Factors affecting the Company's cash position include, but are not limited to, future levels of the Company's product sales, royalty and contract revenues, expenses and capital expenditures.

Market Potential/Risk: Over the longer term, the Company's (and its partners') ability to successfully market current products, expand their usage, and bring new products to the marketplace will depend on many factors, including, but not limited to, the effectiveness and safety of the products, FDA and foreign regulatory agencies' approvals for new products and new indications, and the degree of patent protection afforded to particular products.

Roche Holdings, Inc.: At December 31, 1996, Roche held approximately 66.0% of the Company's outstanding common equity. In January and February 1997, Roche purchased additional shares of the Company's common

equity increasing Roche's holdings to 68.0%. The Company expects to continue to have material transactions with Roche, including royalty and contract development revenues, product sales and joint product development.

Foreign Exchange: The Company receives royalty revenues from countries throughout the world. As a result, the Company's financial results could be significantly affected by factors such as changes in foreign currency exchange rates or weak economic conditions in the foreign markets in which the Company's products are sold. The Company is exposed to changes in exchange rates in Europe, Asia and Canada. When the U.S. dollar strengthens against the currencies in these countries, the U.S. dollar value of non-U.S. dollar-based revenue decreases; when the U.S. dollar weakens, the U.S. dollar value of the non-U.S. dollar-based revenues increases. Accordingly, changes in exchange rates, and in particular a strengthening of the U.S. dollar, may adversely affect the Company's royalty revenues as expressed in U.S. dollars.

To mitigate this risk, the Company hedges certain of these anticipated revenues by purchasing options with expiration dates and amounts of currency that are based on a portion of probable revenues so that the adverse impact of movements in currency exchange rates on the non-dollar denominated revenues will be at least partly offset by an associated increase in the value of the option. The Company also enters into forward contracts to lock in the dollar value of a portion of these anticipated revenues.

Interest Rates: The Company's interest income is sensitive to changes in the general level of U.S. interest rates. In this regard, changes in U.S. interest rates affect the interest earned on the Company's cash equivalents, short-term investments and long-term investments. To mitigate the impact of fluctuations in U.S. interest rates, the Company enters into interest rate swap transactions which generally involve the receipt of fixed rate interest and the payment of floating rate interest without the exchange of the underlying principal. These agreements have the effect of locking in rates for longer periods of time than the duration of short-term investments.

Equity Securities: As part of its strategic alliance efforts, the Company invests in equity instruments that are subject to fluctuations from market value changes in stock prices. To mitigate this risk, certain equity securities are hedged with costless collars. A costless collar is a purchased put option and a written call option in which the cost of the purchased put and the proceeds of the written call offset each other; therefore, there is no initial cost or cash outflow for these instruments at the time of purchase. The purchased put protects the Company from a decline in the market value of the security below a certain minimum level (the put "strike" level); while the call effectively limits the Company's potential to benefit from an increase in the market value of the security above a certain maximum level (the call "strike" level).

Credit Risk of Counterparties: The Company could be exposed to losses related to the above financial instruments should one of its counterparties default. This risk is mitigated through credit monitoring procedures.

Legal Proceedings: The Company is a party to various legal proceedings including patent infringement cases and various cases involving product liability and other matters. See the "Leases, Commitments and Contingencies" note in the "Notes to Consolidated Financial Statements" for further information.

Genentech, Inc. is responsible for the preparation, integrity and fair presentation of its published financial statements. The Company has prepared the financial statements, presented on pages 51 to 74, in accordance with generally accepted accounting principles. As such, the statements include amounts based on judgments and estimates made by management. The Company also prepared the other information included in the annual report and is responsible for its accuracy and consistency with the financial statements.

The financial statements have been audited by the independent auditing firm, Ernst & Young LLP, which was given unrestricted access to all financial records and related data, including minutes of all meetings of stockholders, the Board of Directors and committees of the Board. The Company believes that all representations made to the independent auditors during their audit were valid and appropriate. Ernst & Young LLP's audit report appears on page 75.

Systems of internal accounting controls, applied by operating and financial management, are designed to provide reasonable assurance as to the integrity and reliability of the financial statements and reasonable, but not absolute, assurance that assets are safeguarded from unauthorized use or disposition, and that transactions are recorded according to management's policies and procedures. The Company continually reviews and modifies these systems, where appropriate, to maintain such assurance. Through the Company's general audit activities, the adequacy and effectiveness of the systems and controls are reviewed and the resultant findings are communicated to management and the Audit Committee of the Board of Directors.

The selection of Ernst & Young LLP as the Company's independent auditors has been approved by the Company's Board of Directors and ratified by the stockholders. An Audit Committee of the Board of Directors, composed of four non-management directors, meets regularly with, and reviews the activities of, corporate financial management, the general audit function and the independent auditors to ascertain that each is properly discharging its responsibilities. The independent auditors and general auditor meet with the Audit Committee, with and without management present, to discuss the results of their work, the adequacy of internal accounting controls and the quality of financial reporting.

/s/ Arthur D. Levinson

ARTHUR D. LEVINSON, PH.D.
President and
Chief Executive Officer

/s/ Louis J. Lavigne, Jr.

LOUIS J. LAVIGNE, JR.
Senior Vice President and
Chief Financial Officer

/s/ Bradford S. Goodwin

BRADFORD S. GOODWIN
Vice President—Finance
and Controller

CONSOLIDATED STATEMENTS OF INCOME

(thousands, except per share amounts)

YEAR ENDED DECEMBER 31	1996	1995	1994
Revenues			
Product sales (including amounts from related parties: 1996—$13,216; 1995—$1,776; 1994—$0)	$ 582,829	$ 635,263	$ 601,064
Royalties (including amounts from related parties: 1996—$26,240; 1995—$12,492; 1994—$8,454)	214,702	190,811	126,022
Contract and other (including amounts from related parties: 1996—$95,299; 1995—$13,448; 1994—$17,106)	107,037	31,209	25,556
Interest	64,110	60,562	42,748
Total revenues	968,678	917,845	795,390
Costs and expenses			
Cost of sales (including amounts from related parties: 1996—$10,900; 1995—$6,963; 1994—$0)	104,527	97,930	95,829
Research and development (including contract related: 1996—$37,051; 1995—$17,124; 1994—$7,584)	471,143	363,049	314,322
Marketing, general and administrative	240,063	251,653	248,604
Special charge (primarily merger related)	—	25,000	—
Interest	5,010	7,940	7,058
Total costs and expenses	820,743	745,572	665,813
Income before taxes	147,935	172,273	129,577
Income tax provision	29,587	25,841	5,183
Net income	$ 118,348	$ 146,432	$ 124,394
Net income per share	$ 0.96	$ 1.21	$ 1.04
Weighted average number of shares used in computing per share amounts	123,695	121,220	119,465

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(thousands)

YEAR ENDED DECEMBER 31	Increase (Decrease) in Cash and Cash Equivalents 1996	1995	1994
Cash flows from operating activities:			
Net income	$ 118,348	$ 146,432	$ 124,394
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	62,124	58,421	53,452
Writedown of securities available-for-sale	—	6,609	12,590
Gain on sales of securities available-for-sale	(347)	(7,432)	—
Deferred income taxes	(34,021)	(22,655)	(34,193)
Loss on fixed asset dispositions (including merger-related in 1995)	5,309	1,032	5,510
Other	—	(234)	748
Changes in assets and liabilities:			
Net cash flow from trading securities	(8,184)	(50,014)	(4,634)
Receivables and other current assets	(30,416)	(28,446)	(11,937)
Inventories	1,705	9,552	(18,475)
Accounts payable, other current liabilities and other long-term liabilities	25,153	20,682	72,901
Net cash provided by operating activities	139,671	133,947	200,356
Cash flows from investing activities:			
Purchases of securities held-to-maturity	(634,124)	(682,396)	(1,088,737)
Proceeds from maturities of securities held-to-maturity	772,922	924,345	877,139
Purchases of securities available-for-sale	(304,806)	(353,118)	(22,644)
Proceeds from sales of securities available-for-sale	182,564	101,591	—
Purchases of non-marketable equity securities	(9,323)	—	(4,000)
Capital expenditures	(141,837)	(70,166)	(82,837)
Change in other assets	(7,046)	(37,948)	(1,198)
Net cash used in investing activities	(141,650)	(117,692)	(322,277)
Cash flows from financing activities:			
Stock issuances	72,558	54,946	71,955
Reduction in long-term debt, including current portion	(358)	(871)	(794)
Net cash provided by financing activities	72,200	54,075	71,161
Increase (decrease) in cash and cash equivalents	70,221	70,330	(50,760)
Cash and cash equivalents at beginning of year	137,043	66,713	117,473
Cash and cash equivalents at end of year	$ 207,264	$ 137,043	$ 66,713
Supplemental cash flow data:			
Cash paid during the year for:			
Interest, net of portion capitalized	$ 5,010	$ 7,917	$ 7,058
Income taxes	52,243	44,699	4,099

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

(dollars in thousands)

DECEMBER 31	1996	1995
Assets:		
Current assets:		
Cash and cash equivalents	$ 207,264	$ 137,043
Short-term investments	415,900	603,296
Accounts receivable—trade (net of allowances of: 1996—$4,110; 1995—$4,579)	77,785	87,694
Accounts receivable—other (net of allowances of: 1996—$3,759; 1995—$2,093)	86,450	65,185
Accounts receivable—related party	33,377	19,281
Inventories	91,943	93,648
Prepaid expenses and other current assets	42,365	39,267
Total current assets	955,084	1,045,414
Long-term marketable securities	535,916	356,475
Property, plant and equipment, net	586,167	503,654
Other assets	149,205	105,452
Total assets	$ 2,226,372	$ 2,010,995
Liabilities and stockholders' equity:		
Current liabilities:		
Accounts payable	$ 45,501	$ 37,101
Accrued liabilities—related party	9,908	8,745
Other accrued liabilities	194,542	187,598
Total current liabilities	249,951	233,444
Long-term debt	150,000	150,000
Other long-term liabilities	25,362	25,504
Total liabilities	425,313	408,948
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $.02 par value; authorized: 100,000,000 shares; none issued	—	—
Special common stock, $.02 par value; authorized: 100,000,000 shares; outstanding: 1996—44,805,755; 1995—42,646,958	896	853
Common stock, $.02 par value; authorized: 200,000,000 shares; outstanding: 1996 and 1995—76,621,009	1,532	1,532
Additional paid-in capital	1,362,585	1,281,640
Retained earnings (since October 1, 1987 quasi-reorganization)	382,097	263,749
Net unrealized gain on securities available-for-sale	53,949	54,273
Total stockholders' equity	1,801,059	1,602,047
Total liabilities and stockholders' equity	$ 2,226,372	$ 2,010,995

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(thousands)

YEAR ENDED DECEMBER 31	1996 Shares	1996 Amount	1995 Shares	1995 Amount	1994 Shares	1994 Amount
Special common stock						
Beginning balance	42,647	$ 853	—	—	—	—
Issuance of stock upon exercise of options and warrants	2,159	43	298	$ 6	—	—
Conversion of common stock to special common stock	—	—	42,349	847	—	—
Ending balance	44,806	896	42,647	853	—	—
Redeemable common stock						
Beginning balance	—	—	50,106	1,002	47,690	$ 954
Issuance of stock upon exercise of options and warrants	—	—	679	14	1,905	38
Issuance of stock under employee stock plan	—	—	322	6	511	10
Conversion of redeemable common stock to common stock	—	—	(51,107)	(1,022)	—	—
Ending balance	—	—	—	—	50,106	1,002
Common stock						
Beginning balance	76,621	1,532	67,133	1,343	67,133	1,343
Issuance of stock upon exercise of options and warrants	—	—	512	10	—	—
Issuance of stock under employee stock plan	—	—	218	4	—	—
Conversion of redeemable common stock to common stock	—	—	51,107	1,022	—	—
Conversion of common stock to special common stock	—	—	(42,349)	(847)	—	—
Ending balance	76,621	1,532	76,621	1,532	67,133	1,343
Additional paid-in capital						
Beginning balance		1,281,640		1,207,720		1,070,121
Issuance of stock upon exercise of options and warrants		55,103		37,087		56,133
Issuance of stock under employee stock plan		17,412		17,819		15,774
Income tax benefits realized from employee stock option exercises		8,430		7,204		26,038
Tax benefits arising prior to quasi-reorganization		—		11,810		39,654
Ending balance		1,362,585		1,281,640		1,207,720
Retained earnings						
Beginning balance		263,749		129,127		44,387
Net income		118,348		146,432		124,394
Tax benefits arising prior to quasi-reorganization		—		(11,810)		(39,654)
Ending balance		382,097		263,749		129,127
Net unrealized gain on securities						
Beginning balance		54,273		9,592		—
Net unrealized (loss) gain on securities available-for-sale		(324)		44,681		9,592
Ending balance		53,949		54,273		9,592
Total stockholders' equity		$ 1,801,059		$ 1,602,047		$ 1,348,784

See Notes to Consolidated Financial Statements.

DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

Description of Business: Genentech, Inc. (the Company) is a biotechnology company that discovers, develops, manufactures and markets human pharmaceuticals produced by recombinant DNA technology for significant unmet medical needs. The Company manufactures and markets six products directly in the United States (U.S.) and sells these products to F. Hoffmann-La Roche Ltd (HLR) for HLR to sell outside of the United States. Of these six products, HLR has the right to sell five in Canada and one in a number of countries. In addition, the Company receives royalties from HLR's sales of these products and receives royalties from HLR and other licensees from sales of five other products which originated from the Company's technology.

Principles of Consolidation: The consolidated financial statements include the accounts of the Company and all significant subsidiaries and collaborations. Material intercompany balances and transactions are eliminated.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents: The Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

Short-term Investments and Long-term Marketable Securities: The Company invests its excess cash balances in short-term and long-term marketable securities, primarily corporate notes, certificates of deposit and treasury notes. As part of its strategic alliance efforts, the Company also invests in equity securities and convertible debt of other biotechnology companies.

Investment securities are classified into one of three categories: held-to-maturity, available-for-sale, or trading. Securities are considered held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity. These securities are recorded as either short-term investments or long-term marketable securities on the balance sheet depending upon their contractual maturity dates. Held-to-maturity securities are stated at amortized cost, including adjustment for amortization of premiums and accretion of discounts. Securities are considered trading when bought principally for the purpose of selling in the near term. These securities are recorded as short-term investments and are carried at market value. Unrealized holding gains and losses on trading securities are included in interest income. Securities not classified as held-to-maturity or as trading are considered available-for-sale. These securities are recorded as either short-term investments or long-term marketable securities and are carried at market value with unrealized gains and losses included in stockholders' equity. If a decline in fair value below cost is considered other than temporary, such securities are written down to estimated fair value with a charge to marketing, general and administrative expenses. The cost of all securities sold is based on the specific identification method.

Property, Plant and Equipment: The costs of buildings and equipment are depreciated using the straight-line method over the following estimated useful lives of the assets: buildings—25 years; certain manufacturing equipment—15 years; other equipment—4 or 8 years; leasehold improvements—length of applicable lease. The costs of repairs and maintenance are expensed as incurred. Repairs and maintenance expenses for the years ended December 31, 1996, 1995 and 1994, were $28.8 million, $22.1 million and $19.2 million, respectively.

Interest on construction-in-progress of $2.5 million in 1996, $1.5 million in 1995 and $0.6 million in 1994 has been capitalized and is included in property, plant and equipment.

Property, plant and equipment balances at December 31 are summarized below (thousands):

	1996	1995
At cost:		
Land	$ 67,619	$ 57,313
Buildings	297,888	258,717
Equipment	428,738	383,387
Leasehold improvements	12,314	12,508
Construction in progress	99,708	60,480
	906,267	772,405
Less: Accumulated depreciation	320,100	268,751
Net property, plant and equipment	$ 586,167	$ 503,654

Patents and Other Intangible Assets: As a result of its research and development (R&D) programs, the Company owns or is in the process of applying for patents in the U.S. and other countries which relate to products and processes of significant importance to the Company. Costs of patents and patent applications are capitalized and amortized on a straight-line basis over their estimated useful lives of approximately 12 years. Intangible assets are generally amortized on a straight-line basis over their estimated useful lives.

Contract Revenue: Contract revenue for R&D is recorded as earned based on the performance requirements of the contract. In return for contract payments, contract partners may receive certain marketing and manufacturing rights, products for clinical use and testing, or R&D services.

Royalty Expenses: Royalty expenses directly related to product sales are classified in cost of sales. Other royalty expenses, relating to royalty revenue, totaled $36.0 million, $30.2 million and $26.5 million in 1996, 1995 and 1994, respectively, and are classified in marketing, general and administrative expenses.

Advertising Expenses: The Company expenses the costs of advertising as incurred. Advertising expenses for the years ended December 31, 1996, 1995 and 1994, were $28.0 million, $29.2 million and $44.2 million, respectively.

Income Taxes: The Company accounts for income taxes by the asset and liability approach for financial accounting and reporting of income taxes. The Company's method of accounting for operating loss and tax credit carryforwards arising prior to the date of the Company's quasi-reorganization in 1987 is described in the "Quasi-Reorganization" note.

Net Income Per Share: Net income per share is computed based on the weighted average number of shares of the Company's special common stock, common stock and common stock equivalents, if dilutive.

Financial Instruments: The Company purchases simple foreign currency put options (options) with expiration dates and amounts of currency that are based on a portion of probable non-dollar revenues so that the potential adverse impact of movements in currency exchange rates on the non-dollar denominated revenues will be at least partially offset by an associated increase in the value of the options. See the "Financial Instruments" note for further discussion. At the time the options are purchased they have little or no intrinsic value. Realized and unrealized gains related to the options are deferred until the designated hedged revenues are recorded. The associated costs, which are deferred and classified as other current assets, are amortized over the term of the options and recorded as a reduction of the hedged revenues. Realized gains and losses are recorded in the income statement with the related hedged revenues. The Company also enters into foreign currency forward contracts (forward contracts) as hedging instruments. Forward contracts are recorded at fair value, and any gains and losses from these forward contracts are recorded in the income statement with the related hedged revenues. Financial instruments, such as forward contracts, not qualifying as hedges under generally accepted accounting principles are marked to market with gains or losses recorded in income as they occur.

Interest rate swaps have been used and may be used in the future to adjust the duration of the investment portfolio in order to meet duration targets. Interest rate swaps are contracts in which two parties agree to swap future streams of payments over a specified period. See the "Financial Instruments" note for further discussion. Net payments made or received on swaps are included in interest income as adjustments to the interest received on invested cash. Amounts deferred on terminated swaps are classified as other assets and are amortized to interest income over the original contractual term of the swaps by a method that approximates the level-yield method.

The Company's marketable equity portfolio consists primarily of biotechnology companies whose risk of market fluctuations is greater than the stock market in general. To manage this risk, the Company enters into certain costless collar instruments to hedge certain equity securities against changes in market value. See the "Financial Instruments" note for further discussion. Gains and losses on these instruments are recorded as an adjustment to unrealized gains and losses on marketable securities with a corresponding receivable or payable recorded in long-term other assets or long-term liabilities.

401(k) Plan: The Company's 401(k) plan (Plan) covers substantially all of its U.S. employees. Under the Plan, eligible employees may contribute up to 15% of their eligible compensation, subject to certain Internal Revenue Service restrictions. The Company matches a portion of employee contributions, up to a maximum of 4% of each employee's eligible compensation. The match is effective December 31 of each year and is fully vested when made. During 1996, 1995 and 1994, the Company provided $6.1 million, $5.6 million and $5.2 million, respectively, for the Company match under the Plan.

New Accounting Standards: On January 1, 1996, the Company adopted Statement of Financial Accounting Standards (FAS) 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," which requires the Company to review for impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In certain situations, an impairment loss would be recognized. The adoption of FAS 121 did not have a material impact on the financial position, results of operations or cash flows of the Company.

In 1996, the Company also implemented the disclosure requirements of FAS 123 "Accounting for Stock-Based Compensation" (FAS 123). Under FAS 123, the Company will continue to account for stock-based employee compensation arrangements under the intrinsic value method prescribed by Accounting Principles Board Opinion 25 "Accounting for Stock Issued to Employees" (APB 25), and will provide pro forma disclosures of net income and earnings per share as if the fair value basis method prescribed by FAS 123 had been applied in measuring employee compensation expense. See the "Capital Stock" note for such disclosure.

Inventories: Inventories are stated at the lower of cost or market. Cost is determined using a weighted-average approach which approximates the first-in, first-out method. Inventories at December 31, 1996 and 1995 are summarized below (thousands):

	1996	1995
Raw materials and supplies	$ 17,971	$ 12,808
Work in process	61,368	67,239
Finished goods	12,604	13,601
Total	$ 91,943	$ 93,648

Reclassifications: Certain reclassifications of prior year amounts have been made to conform with the current year presentation.

SIGNIFICANT CUSTOMER AND GEOGRAPHIC INFORMATION

HLR contributed approximately 14% of the Company's total revenues in 1996, and contributed less than 10% in 1995 and 1994. See the "Related Party Transactions" note below for further information. Two major customers, Caremark, Inc. and Bergen Brunswig, contributed 10% or more of the Company's total revenues. Caremark, Inc., which accounted for 15%, 18% and 21% of total revenues in 1996, 1995 and 1994, respectively, distributes Protropin, Nutropin, Pulmozyme and Actimmune through its extensive branch network and is then reimbursed through a variety of sources. Bergen Brunswig, a wholesale distributor of all of the Company's products, contributed 10% of revenues in 1996 and 11% in each of the years 1995 and 1994.

Approximate foreign sources of revenues were as follows (millions):

	1996	1995	1994
Europe	$ 146.4	$ 112.0	$ 81.8
Asia	17.8	23.6	19.5
Canada	11.1	25.0	9.7

The Company currently sells primarily to distributors and hospitals throughout the U.S., performs ongoing credit evaluations of its customers' financial condition and generally requires no collateral. In 1996, 1995 and 1994, the Company did not record any material additions to, or losses against, its provision for doubtful accounts.

RESEARCH AND DEVELOPMENT ARRANGEMENTS

To gain access to potential new products and technologies and to utilize other companies to help develop the Company's potential new products, the Company has established strategic alliances with, including the acquisition of both marketable and non-marketable equity investments and convertible debt in, companies developing technologies that fall outside the Company's research focus and with companies having the potential to generate new products through technology exchanges and investments. Potential future payments may be due to certain collaborative partners if the partners achieve certain benchmarks as defined in the collaborative agreements. The Company has also entered into product-specific collaborations to acquire development and marketing rights for products.

SPECIAL CHARGE

The $25.0 million special charge in 1995 includes $21.0 million related to the merger agreement (the Agreement) with Roche Holdings, Inc. (Roche), discussed in the note "Relationship with Roche Holdings, Inc.," and $4.0 million of charges associated with the resignation of the Company's former President and Chief Executive Officer. The merger expenses include legal expenses, investment banking fees, filing fees and other costs related to the Agreement with Roche, as well as charges associated with the settlement of stockholder lawsuits filed after the transaction was announced.

INCOME TAXES

The income tax provision consists of the following amounts (thousands):

	1996	1995	1994
Current:			
Federal	$ 61,502	$ 43,997	$ 38,331
State	2,104	4,467	1,016
Foreign	2	32	29
Total current	63,608	48,496	39,376
Deferred:			
Federal	(34,021)	(12,319)	(34,193)
State	—	(10,336)	—
Total deferred	(34,021)	(22,655)	(34,193)
Total income tax provision	$ 29,587	$ 25,841	$ 5,183

Actual current tax liabilities are lower than reflected above by $8.4 million, $7.2 million and $26.0 million in 1996, 1995 and 1994, respectively, due to employee stock option related tax benefits which were credited to stockholders' equity.

A reconciliation between the Company's effective tax rate and the U.S. statutory rate follows:

	1996 Amount (thousands)	Tax Rate		
		1996	1995	1994
Tax at U.S. statutory rate	$ 51,777	35.0%	35.0%	35.0%
Operating losses utilized	—	—	—	(45.6)
Research and development credits realized	(4,500)	(3.0)	(15.9)	—
Alternative minimum tax liability	—	—	—	24.6
Adjustment of deferred tax assets valuation allowance	(22,566)	(15.3)	(13.1)	(26.4)
Foreign losses (benefited) not benefited	(5,050)	(3.4)	2.8	15.0
State taxes	3,368	2.3	2.6	0.8
Other	6,558	4.4	3.6	0.6
Income tax provision	$ 29,587	20.0%	15.0%	4.0%

The components of deferred taxes consist of the following at December 31 (thousands):

	1996	1995
Deferred tax liabilities:		
Depreciation	$ 58,842	$ 50,010
Unrealized gain on sale of securities available-for-sale	21,017	21,204
Other	10,543	3,109
Total deferred tax liabilities	90,402	74,323
Deferred tax assets:		
Capitalized research and development costs	34,280	—
Federal credit carryforwards	111,400	107,350
Expenses not currently deductible	38,368	39,433
State credit carryforwards	26,710	32,147
Other	6,340	5,058
Total deferred tax assets	217,098	183,988
Valuation allowance	(35,827)	(52,817)
Total net deferred tax assets	181,271	131,171
Total net deferred taxes	$ 90,869	$ 56,848

Total tax credit carryforwards of $138.1 million expire in the years 1997 through 2012, except for $43.0 million of alternative minimum tax credits which have no expiration date. The valuation allowance at December 31, 1996, reflected above relates to the tax benefits of stock option deductions which will be credited to additional paid-in capital when realized.

The valuation allowance decreased by $17.0 million in 1996, $31.6 million in 1995 and $38.5 million in 1994. Realization of net deferred taxes depends on future earnings from existing and new products and new indications for existing products. The timing and amount of future earnings will depend on continued success in marketing and sales of the Company's current products, as well as the scientific success, results of clinical trials and regulatory approval of products under development.

INVESTMENT SECURITIES

Securities classified as trading, available-for-sale and held-to-maturity at December 31, 1996 and 1995 are summarized below. Estimated fair value is based on quoted market prices for these or similar investments.

DECEMBER 31, 1996	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(thousands)		
Total Trading Securities (carried at estimated fair value)	$ 144,460	$ 1,932	$ (2,897)	$ 143,495
Securities Available-for-sale (carried at estimated fair value):				
Equity securities	$ 42,773	$ 56,347	$ (1,376)	$ 97,744
U.S. Treasury securities and obligations of other U.S. government agencies maturing within:				
1 year	51,179	—	(71)	51,108
1–5 years	103,057	1,299	(209)	104,147
5–10 years	113,176	1,001	(2,114)	112,063
Other debt securities maturing within:				
1 year	46,583	27	—	46,610
1–5 years	43,954	185	(94)	44,045
Total Available-for-sale	$ 400,722	$ 58,859	$ (3,864)	$ 455,717
Securities Held-to-maturity* (carried at amortized cost):				
U.S. Treasury securities and obligations of other U.S. government agencies maturing within:				
1 year	$ 76,718	$ 31	—	$ 76,749
5–10 years	30,155	—	$ (777)	29,378
Other debt securities maturing within:				
1 year	91,664	4	(35)	91,633
1–5 years	141,553	576	(27)	142,102
Total Held-to-maturity	$ 340,090	$ 611	$ (839)	$ 339,862

DECEMBER 31, 1995	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(thousands)		
Total Trading Securities (carried at estimated fair value)	$ 135,325	$ 1,314	$ (1,328)	$ 135,311
Securities Available-for-sale (carried at estimated fair value):				
Equity securities	$ 22,423	$ 45,894	$ (350)	$ 67,967
U.S. Treasury securities and obligations of other U.S. government agencies maturing within:				
1 year	7,503	17	—	7,520
1–5 years	162,322	7,103	—	169,425
5–10 years	83,188	437	—	83,625
Other debt securities maturing within:				
1–5 years	29,868	1,172	—	31,040
Total Available-for-sale	$ 305,304	$ 54,623	$ (350)	$ 359,577
Securities Held-to-maturity* (carried at amortized cost) maturing within 1 year:				
U.S. Treasury securities and obligations of other U.S. government agencies	$ 219,267	$ 318	$ (53)	$ 219,532
Other debt securities	236,870	95	(297)	236,668
Total Held-to-maturity	$ 456,137	$ 413	$ (350)	$ 456,200

* Interest rate swap arrangements are used to modify the duration of certain held-to-maturity securities. The average effective maturity of the portfolio was 2.5 years and 2.7 years at December 31, 1996 and 1995, respectively. See “Financial Instruments” note for further information.

The carrying value of all investment securities held at December 31, 1996 and 1995 is summarized below (thousands):

SECURITY	1996	1995
Trading securities	$ 143,495	$ 135,311
Securities available-for-sale maturing within one year	97,718	7,520
Securities held-to-maturity maturing within one year	168,382	456,137
Accrued interest	6,305	4,328
Total short-term investments	$ 415,900	$ 603,296
Securities available-for-sale maturing within 1–10 years, including equity securities	$ 357,999	$ 352,057
Securities held-to-maturity maturing within 1–10 years	171,708	—
Accrued interest	6,209	4,418
Total long-term marketable securities	$ 535,916	$ 356,475

In 1996, proceeds from sales of available-for-sale securities totaled $182.6 million; gross realized gains totaled $1.0 million and gross realized losses totaled $0.7 million. In 1995, proceeds from sales of available-for-sale securities totaled $101.6 million; gross realized gains totaled $7.6 million and gross realized losses totaled $0.2 million. During 1994, no available-for-sale securities were sold. The Company recorded charges in 1995 and 1994 of $6.6 million and $12.6 million, respectively, to write down certain available-for-sale biotechnology equity securities for which the decline in fair value below cost was other than temporary.

During the year ended December 31, 1996, net unrealized holding losses on trading securities included in net income totaled $1.0 million. In 1995 and 1994, such losses were not material.

Marketable debt securities held by the Company are issued by a diversified selection of corporate and financial institutions with strong credit ratings. The Company's investment policy limits the amount of credit exposure with any one institution. These debt securities are generally not collateralized. The Company has not experienced any material losses due to credit impairment on its investments in marketable debt securities in the years 1996, 1995 and 1994.

FINANCIAL INSTRUMENTS

Foreign Currency Instruments: Certain of the Company's revenues are earned outside of the United States. Moreover, the Company's foreign currency denominated revenues exceed its foreign currency denominated expenses; therefore, risk exists that net income may be impacted by changes in the exchange rates between the U.S. dollar and foreign currencies. To hedge anticipated non-dollar denominated net revenues, the Company currently purchases options and enters into forward contracts. At December 31, 1996, the Company had hedged approximately 90% of probable net foreign revenues anticipated within 12 months and between 20% and 45% of its probable net foreign revenues through 2000. At December 31, 1996 and 1995, the notional amount of the options totaled $100.3 million and $72.8 million, respectively, and consisted of the following currencies: Australian dollars, Canadian dollars, German marks, Spanish pesetas, French francs, British pounds, Italian lire, Japanese yen, and Swedish krona. All option contracts mature within the next four years. The fair value of the options, which is based on exchange rates and market conditions at December 31, 1996 and 1995, totaled $7.3 million and $6.3 million, respectively. At December 31, 1996 and 1995, the U.S. dollar equivalent of the notional amount of the forward sell contracts was $34.3 million and $6.0 million, respectively, and the forward buy contracts totaled $0.4 million and $6.2 million, respectively.

Credit exposure is limited to the unrealized gains on these contracts. All agreements are with a diversified selection of institutions with strong credit ratings which minimizes risk of loss due to nonpayment from the counterparty. The Company has not experienced any losses due to credit impairment of its foreign currency instruments.

Interest Rate Swaps: Interest income is subject to fluctuations as U.S. interest rates change. To manage this risk, the Company periodically establishes duration targets for its investment portfolio that reflect its anticipated use of cash and fluctuations in market rates of interest. The Company enters into interest rate swaps (swaps) as part of its overall strategy of managing the duration of its cash portfolio. For each swap, the Company receives interest based on fixed rates and pays interest to counterparties based on floating rates (three- or six-month London Inter-Bank Offered Rate (LIBOR)) on a notional principal amount. By designating a swap with a pool of short-term securities equal in size to the notional amount of the swap, an instrument with an effective interest rate and maturity equal to the term of the swap is created. Increases (decreases) in swap variable payments caused by rising (falling) interest rates will be essentially offset by increased (reduced) interest income on the related short-term investments, while the fixed rate payments received from the swap counterparty establish the Company's interest income. LIBOR payments received on swaps are highly correlated to interest collections on short-term investments. The use of swaps in this manner generates net interest income on the swap and the associated pool of short-term securities equivalent to interest income that would be earned from a high-grade corporate security of the same maturity as the swap, while reducing credit risk (there is no principal invested in a swap). The Company's credit exposure on swaps is limited to the value of the interest rate swaps that have become favorable to the Company and any net interest earned but not yet received. The Company's swap counterparties have strong credit ratings which minimize the risk of non-performance on the swaps. The Company has not experienced any material losses due to credit impairment. The Company's credit exposure on swaps as of December 31, 1996 and 1995, was $6.8 million and $24.1 million, respectively. The net carrying amount of the swaps, which reflects the net interest accrued for such swaps, totaled $2.1 million and $7.2 million at December 31, 1996 and 1995, respectively, and is included in accounts receivable.

The Company targets the average maturity of its investment portfolio (including cash, cash equivalents, short-term and long-term investments, swaps, and excluding equity securities) based on its anticipated use of cash and fluctuations in the market rates of interest. The maturity of the investment portfolio (including swaps) ranges from overnight funds used for near-term working capital purposes to investments maturing within the next one to ten years for future working capital, capital expenditures, strategic investments and debt repayment.

The notional amount of each swap is equal to the amount of designated high-quality short-term investments which are expected to be invested in during the life of the swap. The anticipated investments include U.S. Treasury securities, U.S. government agency securities, commercial paper and corporate debt obligations. Swaps are used to extend the maturity of the investment portfolio.

For the years ended December 31, 1996 and 1995, the weighted average rate received on swaps was 6.71% and 7.29%, respectively, and the weighted average rate paid on swaps was 5.68% and 6.56%, respectively. Net interest income (loss) from swaps, including amortization of net losses on terminated swaps, totaled $2.5 million in 1996 and ($0.7) million in 1995.

During 1995, to reduce the average effective maturity of its portfolio, the Company terminated certain swap agreements prior to maturity and is amortizing the realized gains and losses over the original contractual term of the swaps as a reduction to interest income. At December 31, 1996, net losses of $0.7 million remained unamortized; $0.5 million will be recognized in 1997 and $0.2 million will be recognized in 1998.

Equity Collar Instruments: To hedge against fluctuations in the market value of a portion of the marketable equity portfolio, the Company has entered into costless collar instruments, a form of equity collar instrument, that expire in 1998 and 1999 and will require settlement in equity securities or cash. A costless collar instrument is a purchased put option and a written call option on a specific equity security such that the cost of the purchased put and the proceeds of the written call offset each other; therefore, there is no initial cost or cash outflow for these instruments. The fair value of the purchased puts and the written calls were determined based on quoted market prices at year end. At December 31, 1996, the notional amount of the put and call options were $17.2 million and $27.5 million, respectively.

The tables below outline specific information for the swaps outstanding at December 31, 1996 and 1995. The fair value is based on market prices of similar agreements. Dollars are in millions.

	Interest Rate Swaps			Short-term Investments		
DECEMBER 31, 1996:	Notional Amounts	Fixed Rates To Be Received	Variable Rates To Be Paid*	Carrying Value	Average Maturity**	Average Effective Interest Rate
Swaps matched to investments to meet maturity target comparable to outstanding debt [Maturing on: 1/2/02]	$ 150	7.68%-7.71%	3- or 6-month LIBOR	$ 150	13 days	5.66%
Swaps matched to other investments to meet specific maturity targets [Ending dates: 10/27/97 – 9/20/99]	60	4.97%-7.20%	3- or 6-month LIBOR	60	32 days	5.47%
Other short-term investments	—			206		
Total	$ 210			$ 416		
DECEMBER 31, 1995:						
Swaps matched to investments to meet maturity target comparable to outstanding debt [Maturing on: 1/2/02]	$ 150	7.68%-7.71%	3- or 6-month LIBOR	$ 150	118 days	5.52%
Swaps matched to other investments to meet specific maturity targets [Ending dates: 8/12/97 – 9/20/99]	80	6.09%-7.20%	3- or 6-month LIBOR	80	93 days	5.85%
Other short-term investments	—			373		
Total	$ 230			$ 603		

* 3- and 6-month LIBOR rates are reset every 3 or 6 months. At December 31, 1996, the 3-month LIBOR rate and the 6-month LIBOR rate were 5.6%. At December 31, 1995, the 3-month LIBOR rate was 5.6% and the 6-month LIBOR rate was 5.5%.

** Average maturity reflects either the maturity date or, for a floating investment, the next reset date.

Financial Instruments Held for Trading Purposes: As part of its overall investment strategy, the Company has contracted with two external money managers to manage part of its investment portfolio. One portfolio, which had a carrying value of $37.2 million at December 31, 1996, and $34.9 million at December 31, 1995, consisted of primarily non-dollar denominated investments. To hedge the non-dollar denominated investments, the money manager enters into forward contracts. The fair value at December 31, 1996 and 1995, of the forward contracts totaled $0.8 million and $0.1 million, respectively. The average fair value during 1996 and 1995 totaled $0.3 million and $0.1 million, respectively. Net realized and unrealized trading gains on the portfolio totaled approximately $2.4 million in 1996 and $3.8 million in 1995, and are included in interest income. Counterparties have strong credit ratings which minimize the risk of non-performance from the counterparties.

Summary of Fair Values: The table below summarizes the carrying value and fair value at December 31, 1996 and 1995, of the Company's financial instruments. The fair value of the long-term debt was estimated based on the quoted market price at year end.

	1996		1995	
FINANCIAL INSTRUMENT	Carrying Value	Fair Value	Carrying Value	Fair Value
	(thousands)			
Assets:				
Investment securities (including accrued interest and traded forward contracts)	$ 951,816	$ 951,588	$ 959,771	$ 959,834
Purchased foreign exchange put options	4,616	7,273	2,345	6,300
Outstanding interest rate swaps (net)	2,122	11,555	7,194	23,940
Liabilities:				
Short-term and long-term debt	150,000	139,500	150,358	147,750
Equity collars	1,222	4,892	—	—
Foreign exchange forward contracts	138	138	237	237

OTHER ACCRUED LIABILITIES

Other accrued liabilities at December 31 are as follows (thousands):

	1996	1995
Accrued compensation	$ 42,716	$ 36,945
Accrued clinical and other studies	39,981	27,290
Accrued royalties	25,098	23,159
Accrued marketing and promotion costs	11,889	18,863
Income taxes payable	18,530	14,329
Other	56,328	67,012
Total other accrued liabilities	$ 194,542	$ 187,598

LONG-TERM DEBT

The Company's long-term debt as of December 31, 1996 and 1995 consisted of $150.0 million of convertible subordinated debentures, with interest payable at 5%, due in 2002. The debentures are convertible at the option of the holder into shares of the Company's special common stock. Upon conversion, the holder receives, for each $74 in principal amount of debenture converted, one-half share of the Company's special common stock and $18 in cash. The $18 in cash is reimbursed by Roche to the Company. Generally, the Company may redeem the debentures until maturity.

LEASES, COMMITMENTS AND CONTINGENCIES

Future minimum lease payments under operating leases at December 31, 1996 are as follows (thousands):

1997	1998	1999	2000	2001	Thereafter	Total
$ 7,563	3,942	5,400	5,121	4,791	9,155	$ 35,972

The Company leases various real property under operating leases that generally require the Company to pay taxes, insurance and maintenance. Rent expense was approximately $11.7 million, $9.5 million and $6.5 million for the years 1996, 1995 and 1994, respectively. Sublease income was not material in any of the three years presented.

Under three of the lease agreements, the Company has an option to purchase the properties at an amount that does not constitute a bargain. Alternatively, the Company can cause the property to be sold to a third party. The Company is contingently liable, under residual value guarantees, for approximately $166.0 million. The Company also is required to maintain certain financial ratios and is limited to the amount of additional debt it can assume.

Pursuant to its research and development collaboration agreement entered into with Scios Inc. (Scios) in 1995, the Company established a line of credit for $30 million that Scios may draw down at Scios' discretion through 2002. This commitment is supported through December 31, 1997, by a bank letter of credit under which Scios may draw up to $30 million directly from the bank, with immediate repayment of the funds due to the bank by the Company. Amounts drawn by Scios under the bank letter of credit or directly from the Company are repayable in the form of cash or Scios common stock (at the average market price over the thirty day period before the date of repayment) at Scios' option any time through December 30, 2002. Interest on amounts borrowed by Scios accrue to the Company at the prime rate of interest. At December 31, 1996 and 1995, no amounts were drawn.

In addition, the Company has entered into research collaborations with companies whereby potential future payments may be due to selective collaborative partners if the partners achieve certain benchmarks as defined in the collaborative agreements. The Company may also, from time to time, lend additional funds to these companies, subject to approval.

The Company is a party to various legal proceedings including patent infringement cases involving human growth hormone products and Activase; product liability cases involving Activase and growth hormone products;

and class action lawsuits regarding Protropin. In addition, in 1995 the Company received and responded to grand jury document subpoenas from the United States District Court for the Northern District of California for documents relating to the Company's clinical, sales and marketing activities associated with human growth hormone. In February 1997, the Company received another grand jury document subpoena from the same court related to the same subject matter. Based upon the nature of the claims made and the investigations completed to date by the Company and its counsel, the Company believes the outcome of these actions will not have a material adverse effect on the financial position, results of operations or cash flows of the Company. However, were an unfavorable ruling to occur in any quarterly period, there exists the possibility of a material impact on the net income of that period.

RELATIONSHIP WITH ROCHE HOLDINGS, INC.

On October 25, 1995, the Company and Roche entered into a new agreement (the Agreement). Each share of the Company's common stock not held by Roche or its affiliates on that date automatically converted to one share of callable putable common stock (special common stock). The Agreement extends until June 30, 1999, Roche's option to cause the Company to redeem (call) the outstanding special common stock of the Company at predetermined prices. Should the call be exercised, Roche will concurrently purchase from the Company a like number of common shares for a price equal to the Company's cost to redeem the special common stock. During the quarter beginning January 1, 1997, the call price is $69.25 per share; it increases by $1.25 in the following quarter, then increases by $1.50 per share each quarter through the end of the option period on June 30, 1999, on which date the price is $82.50 per share. If Roche does not cause the redemption as of June 30, 1999, the Company 's stockholders will have the option (the put) to cause the Company to redeem none, some, or all of their shares of special common stock at $60.00 per share (and Roche will concurrently provide the necessary redemption funds to the Company by purchasing a like number of shares of common stock at $60.00 per share) within thirty business days commencing July 1, 1999. Roche Holding Ltd, a Swiss corporation, has guaranteed Roche's obligation under the put.

In conjunction with the Agreement, HLR was granted an option for ten years for licenses to use and sell certain of the Company's products in non-U.S. markets. As a general matter, such option for a Genentech product must be exercised at, or prior to if the Company mutually agrees, the conclusion of phase II clinical trials for each product. In general, for each product for which HLR exercises its option, the Company and HLR will share equally all development expenses incurred by the Company through the option exercise date and prospectively with respect to the development of the product in the United States. HLR will pay all non-U.S. development expenses. At the Company's election, and with HLR's consent, HLR may reimburse the Company for HLR's share of development costs incurred prior to HLR's option exercise date, either by payment of such costs at the time of the option exercise or by making payments prospectively until HLR's share has been fully reimbursed to the Company.

In general, HLR pays a royalty of 12.5% until a product reaches $100 million in aggregate sales outside of the U.S., at which time the royalty rate increases to 15%. In addition, HLR has exclusive rights to, and pays the Company 20% royalties on, Canadian sales of the Company's existing products and European sales of Pulmozyme. Consequently, in the fourth quarter of 1995, the Company transferred to HLR the rights to its Canadian product sales and European sales of Pulmozyme, and commenced recording royalty revenue from HLR on such sales. The Company supplies its products to HLR, and has agreed to supply products for which HLR has exercised its option, for sales outside of the U.S. at cost plus 20%.

Under the Agreement, independent of its right to cause the Company to redeem the special common stock, Roche may increase its ownership of the Company up to 79.9% by making purchases on the open market. Roche holds approximately 66.0% of the outstanding common equity of the Company as of December 31, 1996. In January and February 1997, Roche purchased additional shares of the Company's common equity increasing Roche's holdings to 68.0%.

RELATED PARTY TRANSACTIONS

The Company has transactions with Roche, HLR (a wholly owned subsidiary of Roche, with two officers on the Company's Board of Directors), and its affiliates in the ordinary course of business. In 1996, HLR exercised its option under the Agreement with respect to the development of three projects—IDEC-C2B8, insulin-like growth factor (IGF-1) and nerve growth factor (NGF). The Company recorded non-recurring contract revenues of $58.2 million relating to the option exercises. Other contract revenue from HLR, including reimbursement for ongoing development expenses after the option exercise date for the three projects, totaled $37.1 million in 1996, $13.4 million in 1995 and $17.1 million in 1994. All other revenue from Roche, HLR and their affiliates, principally royalties under previous product licensing agreements, and royalties and product sales under the Agreement, totaled $39.5 million in 1996, $14.3 million in 1995 and $8.5 million in 1994. During the three years, the Company has collaborated with HLR on other projects.

CAPITAL STOCK

Common Stock, Special Common Stock and Redeemable Common Stock

After the close of business on June 30, 1995, each share of the Company's redeemable common stock automatically converted to one share of Genentech common stock, in accordance with the terms of the redeemable common stock put in place at the time of its issuance in 1990 and as described in Genentech's Certificate of Incorporation. On October 25, 1995, pursuant to the Agreement with Roche, each share of the Company's common stock not held by Roche or its affiliates automatically converted to one share of callable putable common stock (special common stock). See the "Relationship with Roche Holdings, Inc." note above for a discussion of these transactions.

Stock Award Plans

The Company has stock option plans adopted in 1996, 1994, 1990 and 1984, which variously allow for the granting of non-qualified stock options, incentive stock options and stock appreciation rights to employees, and the granting of non-qualified stock options to directors and consultants of the Company. Generally, non-qualified options have a maximum term of 20 years and incentive options have a maximum term of 10 years. In general, options vest in increments over four years from the date of grant, although the Company may grant options with different vesting terms from time to time. No stock appreciation rights have been granted to date.

The Company adopted the 1991 Employee Stock Plan (1991 Plan) on December 4, 1990, and amended it during 1993 and 1995. All full-time employees of the Company are eligible to participate in the 1991 Plan. Of the 3,800,000 shares of special common stock reserved for issuance under the 1991 Plan, 2,865,196 shares have been issued as of December 31, 1996. During 1996, 2,487 of the eligible employees participated in the 1991 Plan.

The Company has elected to continue to follow APB 25 for accounting for its employee stock options because the alternative fair value method of accounting prescribed by FAS 123 requires the use of option valuation models that were not developed for use in valuing employee stock options. Under APB 25, no compensation expense is recognized because the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant.

Pro forma information regarding net income and earnings per share in 1996 and 1995 has been determined as if the Company had accounted for its employee stock options and employee stock plan under the fair value method prescribed by FAS 123. The resulting effect on pro forma net income and earnings per share disclosed for 1996 and 1995 is not likely to be representative of the effects on net income and earnings per share on a pro forma basis in future years, because 1995 and 1996 pro forma results include the impact of only one and two years, respectively, of grants and related vesting, while subsequent years will include additional years of grants and vesting. The fair value of options was estimated at the date of grant using a Black-Scholes option valuation model with the following weighted average assumptions: risk-free interest rates of 5.8% for 1996 and 6.0% for 1995; dividend yields of 0%; volatility factors of the expected market price of the Company's common stock of 6.2%; and a weighted-average expected life of the option of 5.0 years. Grants under the employee stock plan terminate with each quarterly stock purchase.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

For purposes of pro forma disclosures, the estimated fair value of options is amortized to pro forma expense over the options' vesting period. Pro forma information for the years ending December 31 follows (in thousands, except per share amounts):

	1996	1995
Net income—as reported	$ 118,348	$ 146,432
Net income—pro forma	104,358	142,370
Earnings per share—as reported	0.96	1.21
Earnings per share—pro forma	0.84	1.18

A summary of the Company's stock option activity and related information were as follows:

	Shares	Weighted Average Price
Options outstanding at December 31, 1993	12,439,727	$ 27.38
Grants	5,137,055	50.19
Exercises	(1,400,223)	23.53
Cancellations	(195,752)	36.89
Options outstanding at December 31, 1994	15,980,807	34.93
Grants	1,303,800	48.52
Exercises	(1,472,759)	24.60
Cancellations	(602,774)	42.59
Options outstanding at December 31, 1995	15,209,074	36.80
Grants	6,761,545	53.99
Exercises	(1,624,541)	29.39
Cancellations	(743,569)	48.93
Options outstanding at December 31, 1996	19,602,509	42.89

The following table summarizes information concerning currently outstanding and exercisable options:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$14.080–$20.625	1,278,761	2.83	$ 17.01	1,278,361	$ 17.01
$21.375–$31.000	4,181,212	12.77	26.37	4,114,332	26.37
$32.125–$48.125	2,964,663	16.74	41.68	2,126,573	39.33
$48.250–$54.250	11,177,873	13.42	52.45	952,284	50.45
	19,602,509	13.09	42.93	8,471,550	30.91

Using the Black-Scholes option valuation model, the weighted average fair value of options granted in 1996 and 1995 was $13.36 and $12.27, respectively. Shares of special common stock available for future grants under all stock option plans were 4,469,574 at December 31, 1996.

Warrants

All previously outstanding warrants to purchase the Company's special common stock were exercised or expired as of July 31, 1996. As of December 31, 1995, 121,445 shares subject to exercisable warrants were outstanding, with a price range of $27.57 to $28.26. 113,093 shares were exercised through July 31, 1996, at a price range of $27.57 to $28.26, and 8,352 shares expired unexercised.

QUASI-REORGANIZATION

On October 1, 1987, the Company eliminated its accumulated deficit through an accounting reorganization of its stockholders' equity accounts (a quasi-reorganization) that did not involve any revaluation of assets or liabilities. An accumulated deficit of $329.5 million was eliminated by a transfer from additional paid-in capital in an amount equal to the accumulated deficit.

The Company has been recording, in income, the recognition of operating loss and tax credit carryforward items arising prior to the quasi-reorganization due to the Company's adoption of its quasi-reorganization in the context of the accounting and quasi-reorganization literature existing at the date the quasi-reorganization was effected. If the provisions of the subsequently issued Staff Accounting Bulletin 86 (SAB 86) had been applied, net income in 1995 would have been reduced by $11.8 million or $.10 per share, and 1994 net income would have been reduced by $39.7 million or $.33 per share, because SAB 86 would require that the tax benefits of prior operating loss and tax credit carryforwards be reported as a direct addition to additional paid-in capital rather than being recorded in the income statement. The Securities and Exchange Commission staff has indicated that it would not object to the Company's accounting for such tax benefits. As of June 30, 1995, the operating loss and tax credit carryforwards arising prior to the quasi-reorganization had been fully utilized, therefore there was no impact on earnings in 1996.

The Board of Directors and Stockholders of Genentech, Inc.

We have audited the accompanying consolidated balance sheets of Genentech, Inc. as of December 31, 1996 and 1995, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Genentech, Inc. at December 31, 1996 and 1995, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles.

San Jose, California
January 17, 1997

QUARTERLY FINANCIAL DATA (UNAUDITED)

(thousands, except per share amounts)

	1996 Quarter Ended			
	December 31	September 30	June 30	March 31
Total revenues	$ 230,325	$ 251,707	$ 243,762	$ 242,884
Product sales	139,724	142,463	148,305	152,337
Gross margin from product sales	113,065	117,627	121,152	126,458
Net income	7,470	50,942	21,719	38,217
Net income per share	.06	.41	.18	.31

	1995 Quarter Ended			
	December 31	September 30	June 30	March 31
Total revenues	$ 221,914	$ 223,911	$ 233,053	$ 238,967
Product sales	153,482	158,478	161,236	162,067
Gross margin from product sales	130,983	134,109	136,924	135,317
Net income	25,636	40,229	37,163	43,404
Net income per share	.21	.33	.31	.36

Total revenues were higher in the first three quarters of 1996 compared to the fourth quarter due primarily to contract revenue from HLR for the exercises of its options under the Agreement (see the "Related Party Transactions" note in the "Notes to Consolidated Financial Statements" for more information) in each of the first three quarters. Net income was lower in the fourth quarter due to lower revenues and higher expenses, primarily research and development.

11-YEAR FINANCIAL SUMMARY (UNAUDITED)

(millions, except per share and employee data)

	1996	1995	1994	1993
Total revenues	$ 968.6	$ 917.8	$ 795.4	$ 649.7
Product sales	582.8	635.3	601.0	457.4
Royalties	214.7	190.8	126.0	112.9
Contract & other	107.0	31.2	25.6	37.9
Interest	64.1	60.5	42.8	41.5
Total costs and expenses	$ 820.7	$ 745.6	$ 665.8	$ 590.8
Cost of sales	104.5	97.9	95.8	70.5
Research & development	471.1	363.0	314.3	299.4
Marketing, general & administrative	240.1	251.7	248.6	214.4
Special charge	—	25.0[1]	—	—
Interest	5.0	8.0	7.1	6.5
Income data				
Income (loss) before taxes	$ 147.9	$ 172.2	$ 129.6	$ 58.9
Income tax provision	29.6	25.8	5.2	—
Net income (loss)	118.3	146.4	124.4	58.9
Net income (loss) per share	0.96	1.21	1.04	0.50
Selected balance sheet data				
Cash, short-term investments & marketable securities	$ 1,159.1	$ 1,096.8	$ 920.9	$ 719.8
Accounts receivable	197.6	172.2	146.3	130.5
Inventories	91.9	93.6	103.2	84.7
Property, plant & equipment, net	586.2	503.7	485.3	456.7
Other long-term assets	149.2	105.5	61.0	64.1
Total assets	2,226.4	2,011.0	1,745.1	1,468.8
Total current liabilities	250.0	233.4	220.5	190.7
Long-term debt	150.0	150.0	150.4	151.2
Total liabilities	425.3	408.9	396.3	352.0
Total stockholders' equity	1,801.1	1,602.0	1,348.8	1,116.8
Other data				
Depreciation and amortization expense	$ 62.1	$ 58.4	$ 53.5	$ 44.0
Capital expenditures	141.8	70.2	82.8	87.5
Share information				
Shares used to compute EPS	123.7	121.2	119.5	117.1
Actual year-end	121.4	119.3	117.2	114.8
Per share data				
Market price: High	$ 55.38	$ 53.00*	$ 53.50	$ 50.50
Low	$ 51.38	$ 44.50*	$ 41.75	$ 31.25
Book value	$ 14.84	$ 13.43	$ 11.50	$ 9.73
Number of employees	3,071	2,842	2,738	2,510

The Company has paid no dividends.

The Financial Summary above reflects adoption of FAS 121 in 1996, FAS 115 in 1994, FAS 109 in 1992 and FAS 96 in 1988.

All share and per share amounts reflect a two-for-one split in 1986 and a two-for-one split in 1987.

*Special common stock began trading October 26, 1995. On October 25, 1995, pursuant to the new Agreement with Roche, each share of the Company's common stock not held by Roche or its affiliates automatically converted to one share of special common stock.

1992	1991	1990	1989	1988	1987	1986
$ 544.3	$ 515.9	$ 476.1	$ 400.5	$ 334.8	$ 230.5	$ 134.0
391.0	383.3	367.2	319.1	262.5	141.4	43.6
91.7	63.4	47.6	36.7	26.7	20.1	12.9
16.7	20.4	31.9	27.5	33.5	57.1	70.9
44.9	48.8	29.4	17.2	12.1	11.9	6.6
$ 522.3	$ 469.8	$ 572.7	$ 352.9	$ 311.7	$ 186.6	$ 484.6
66.8	68.4	68.3	60.6	46.9	23.8	10.8
278.6	221.3	173.1	156.9	132.7	96.5	79.8
172.5	175.3	158.1	127.9	101.9	59.5	27.3
—	—	167.7[2]	—	23.3[3]	—	366.7[4]
4.4	4.8	5.5	7.5	6.9	6.8	—
$ 21.9	$ 46.1	$ (96.6)	$ 47.6	$ 23.1	$ 43.9	$ (350.6)
1.1	1.8	1.5	3.6	2.5	1.7	2.4
20.8	44.3	(98.0)	44.0	20.6	42.2	(353.0)
0.18	0.39	(1.05)	0.51	0.24	0.50	(5.10)
$ 646.9	$ 711.4	$ 691.3	$ 205.0	$ 152.5	$ 158.3	$ 84.3
93.9	69.0	58.8	66.8	63.9	92.2	24.5
65.3	56.2	39.6	49.3	63.4	58.0	14.7
432.5	342.5	300.2	299.1	289.4	195.7	133.1
37.1	42.7	61.7	85.0	89.7	108.7	114.9
1,305.1	1,231.4	1,157.7	711.2	662.9	619.0	376.0
133.5	118.6	101.4	75.9	95.4	82.8	37.8
152.0	152.9	153.5	154.4	155.3	168.1	31.6
297.8	281.7	264.5	242.2	263.6	263.6	83.3
1,007.3	949.7	893.2	469.0	399.3	355.4	292.6
$ 52.2	$ 46.9	$ 47.6	$ 44.6	$ 38.3	$ 23.5	$ 8.1
126.0	71.3	36.0	37.2	110.9	65.3	46.3
114.0	112.5	93.0	86.0	84.5	84.4	69.3
112.9	111.3	110.6	84.3	82.9	78.7	67.0
$ 39.50	$ 36.25	$ 30.88	$ 23.38	$ 47.50	$ 64.75	$ 49.38
		$ 27.50**				
$ 25.88	$ 20.75	$ 20.13	$ 16.00	$ 14.38	$ 28.00	$ 16.44
		$ 21.75**				
$ 8.92	$ 8.53	$ 8.08	$ 5.56	$ 4.82	$ 4.52	$ 4.37
2,331	2,202	1,923	1,790	1,744	1,465	1,168

**Redeemable common stock began trading September 10, 1990; prior to that date all shares were common stock. Pursuant to the merger agreement with Roche, all stockholders as of effective date September 7, 1990, received for each common share owned, $18 in cash from Roche and one-half share of newly issued redeemable common stock from the Company.

(1) Charges related to 1995 merger and new Agreement with Roche ($21 million) and resignation of the Company's former CEO ($4 million).

(2) Charges primarily related to 1990 Roche merger.

(3) Primarily inventory-related charge.

(4) Charge for purchase of in-process R&D.

COMMON STOCK, SPECIAL COMMON STOCK AND REDEEMABLE COMMON STOCK INFORMATION

STOCK TRADING SYMBOL

GNE

STOCK EXCHANGE LISTINGS

The Company's callable putable common stock (special common stock) has traded on the New York Stock Exchange and the Pacific Stock Exchange under the symbol GNE since October 26, 1995. On October 25, 1995, the Company's non-Roche stockholders approved a new agreement (the Agreement) with Roche Holdings, Inc. (Roche). Pursuant to the Agreement, each share of the Company's common stock not held by Roche or its affiliates automatically converted to one share of special common stock. From July 3, 1995 through October 25, 1995, the Company's common stock was traded under the symbol GNE. After the close of business on June 30, 1995, each share of the Company's redeemable common stock automatically converted to one share of the Company's common stock. The conversion was in accordance with the terms of the redeemable common stock put in place at the time of its issuance on September 7, 1990, when the Company's merger with a wholly owned subsidiary of Roche was consummated. The redeemable common stock of the Company traded under the symbol GNE from September 10, 1990 to June 30, 1995. The Company's common stock was traded on the New York Stock Exchange under the symbol GNE from March 2, 1988, until September 7, 1990, and on the Pacific Stock Exchange under the symbol GNE from April 12, 1988, until September 7, 1990. The Company's common stock was previously traded in the NASDAQ National Market System under the symbol GENE. No dividends have been paid on the common stock, special common stock or redeemable common stock. The Company currently intends to retain all future income for use in the operation of its business and, therefore, does not anticipate paying any cash dividends in the foreseeable future. See the "Relationship with Roche Holdings, Inc." note in the "Notes to Consolidated Financial Statements" for a further description of the Agreement with Roche.

SPECIAL COMMON STOCKHOLDERS

As of December 31, 1996, there were approximately 16,748 stockholders of record of the Company's special common stock.

STOCK PRICES

	Special Common/Redeemable Common/Common Stock			
	1996		1995	
	High	Low	High	Low
4th Quarter	$ 54 3/8	$ 52 3/4	$ 53	$ 47 7/8
3rd Quarter	53 1/4	51 3/8	49 1/4	46 5/8
2nd Quarter	53 3/8	51 7/8	52	46 3/8
1st Quarter	55 3/8	52 1/2	51	44 1/2

HEADQUARTERS

Genentech, Inc.
460 Point San Bruno Boulevard
South San Francisco, California 94080-4990
(415) 225-1000
http://www.gene.com

STOCK LISTINGS

Genentech, Inc. is listed on the New York and Pacific Stock Exchanges under the symbol GNE.

TRANSFER AGENT

Communications concerning transfer requirements, lost certificates and change of address should be directed to Genentech's transfer agent:

Boston EquiServe
Stockholder Services Division
Post Office Box 644
M/S 45-02-09
Boston, MA 02102-0644
Telephone (617) 575-3400

ANNUAL MEETING

The annual meeting of stockholders will be held at 10:00 a.m. on Thursday April 10, 1997 at the Westin Hotel, 1 Old Bayshore Highway, Millbrae, California. Detailed information about the meeting is contained in the Notice of Annual Meeting and Proxy Statement sent with a copy of the Annual Report to each stockholder of record as of February 20, 1997.

ADDITIONAL INFORMATION

If you need additional assistance or information regarding the company, or would like to receive a free copy of Genentech's Form 10-K and 10-Q reports filed with the Securities and Exchange Commission, contact the Investor Relations Department at Genentech's corporate offices at (415) 225-1599 or send an e-mail message to investor.relations@gene.com. Or direct requests for literature to Genentech's literature request line at (800) 488-6519. You can also visit Genentech's site on the World Wide Web at http://www.gene.com.

INVESTOR RELATIONS

Genentech invites security analysts and representatives of portfolio management firms to contact:

Susan Bentley
Director, Investor Relations
Genentech, Inc.
460 Point San Bruno Boulevard
South San Francisco, California 94080-4990
Telephone: (415) 225-1034
e-mail: investor.relations@gene.com

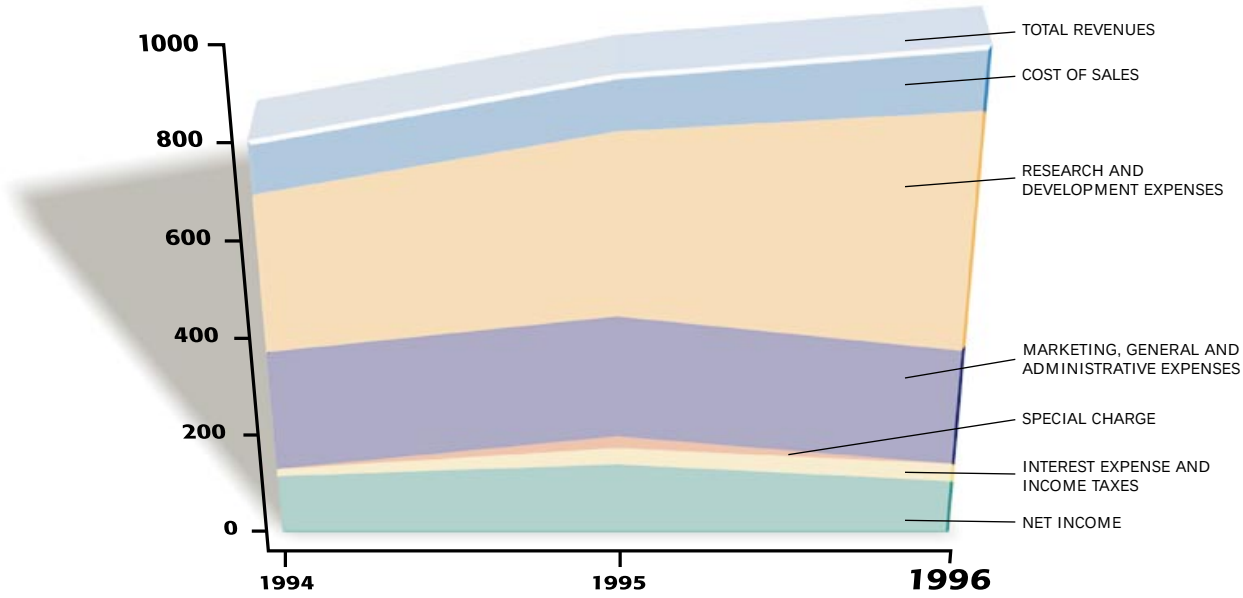
INDEPENDENT AUDITORS

Ernst & Young LLP
San Jose, California

Financial Highlights

DISTRIBUTION OF REVENUE DOLLARS

(dollars in millions)



(millions, except per share and employee data)

Income Statement	1996	1995	1994
Total revenues	$ 968.6	$ 917.8	$ 795.4
Product sales	582.8	635.3	601.0
Royalties	214.7	190.8	126.0
Contract and other revenues	107.0	31.2	25.6
Research and development expenses	471.1	363.0	314.3
Total costs and expenses	820.7	745.6	665.8
Net income	118.3	146.4	124.4
Net income per share	0.96	1.21	1.04
Weighted average number of shares	123.7	121.2	119.5
Balance Sheet			
Cash, short-term investments and marketable securities	$ 1,159.1	$ 1,096.8	$ 920.9
Property, plant and equipment, net	586.2	503.7	485.3
Total assets	2,226.4	2,011.0	1,745.1
Long-term debt	150.0	150.0	150.4
Total stockholders' equity	1,801.1	1,602.0	1,348.8
Capital expenditures	141.8	70.2	82.8
Employees	3,071	2,842	2,738
The Company has paid no dividends.			

BUILDING FOR THE FUTURE

As Genentech moves products through its development pipeline, it has to plan ahead to ensure it will have the capacity to manufacture them in quantities sufficient to supply large, late-stage clinical trials and, ultimately, the market. Significant physical expansion of the company's facilities in 1996 will help meet this need.

Manufacturing Growth

Making room for Genentech's products

Since its founding Genentech has led the industry in the manufacture of biopharmaceutical products. Genentech scientists pioneered the large-scale production of recombinant proteins. Since then Genentech has consistently manufactured enough pure, active protein to supply aggressive clinical schedules and, upon regulatory clearance, the market. Today Genentech continues to innovate biopharmaceutical manufacturing processes, and it intends to continue to adequately supply its development efforts and its markets with the highest quality products.

In anticipation of the many products moving through its development pipeline, Genentech is actively expanding its manufacturing operations. Besides continuing with a major project to develop a completely new manufacturing facility in Vacaville, California, Genentech is investing in current manufacturing operations to expand their capability to produce proteins for both clinical development and commercial purposes.

In 1996, Genentech completed the expansion of an existing building to house a $23 million cell-culture production suite. This facility adds to the company's flexibility by providing large-scale cell culture capacity to manufacture products entering late-stage clinical development.

Genentech also initiated construction on a $26 million expansion to its purification facilities, where proteins produced either by bacterial fermentation or cell culture are purified. And the company initiated construction on a $31 million expansion to its pharmaceutical manufacturing facilities, where sterile medicines are vialed. All this facilities growth will help ensure Genentech's manufacturing operations keep pace with its pipeline.

In 1996 Genentech completed a new $21 million, 42,000-square-foot building extension to provide three floors of research labs and offices for its Cell Culture/Fermentation R&D groups. Genentech engineers with experience in developing specialized facilities initiate and supervise these unique and challenging expansion projects. The Genentech groups occupying this building develop the most cost-efficient way to manufacture–at high quality–Genentech's products on the large scale needed for late-stage clinical development and marketing.

GENENTECH MARKETED PRODUCTS

Genentech manufactures and markets six pharmaceutical products in the United States for several serious medical conditions and promotes a seventh for various cancer indications. The first component of Genentech's strategy for growth is to maximize sales of its marketed products by protecting and increasing market share or market size and by leveraging new indications for the products. In 1996, Genentech received regulatory clearances for new indications for three of its products. In early 1997, through an agreement with Roche, Genentech added Roferon-A for various cancer indications to its product portfolio.

PRODUCTS AND APPROVED INDICATIONS:

Protropin (somatrem for injection) growth hormone

- Growth hormone inadequacy (GHI) in children

Nutropin [somatropin (rDNA origin) for injection] growth hormone

- GHI in children
- Growth failure from chronic renal insufficiency up to the time of renal transplantation
- Short stature from Turner syndrome*

Nutropin AQ [somatropin (rDNA origin) injection] liquid formulation growth hormone

- GHI in children
- Growth failure from chronic renal insufficiency up to the time of renal transplantation

Pulmozyme (dornase alfa) Inhalation Solution

- Cystic fibrosis patients with moderate and advanced* disease

Activase (Alteplase, recombinant), a tissue-plasminogen activator

- Acute myocardial infarction
- Acute massive pulmonary embolism
- Acute ischemic stroke*

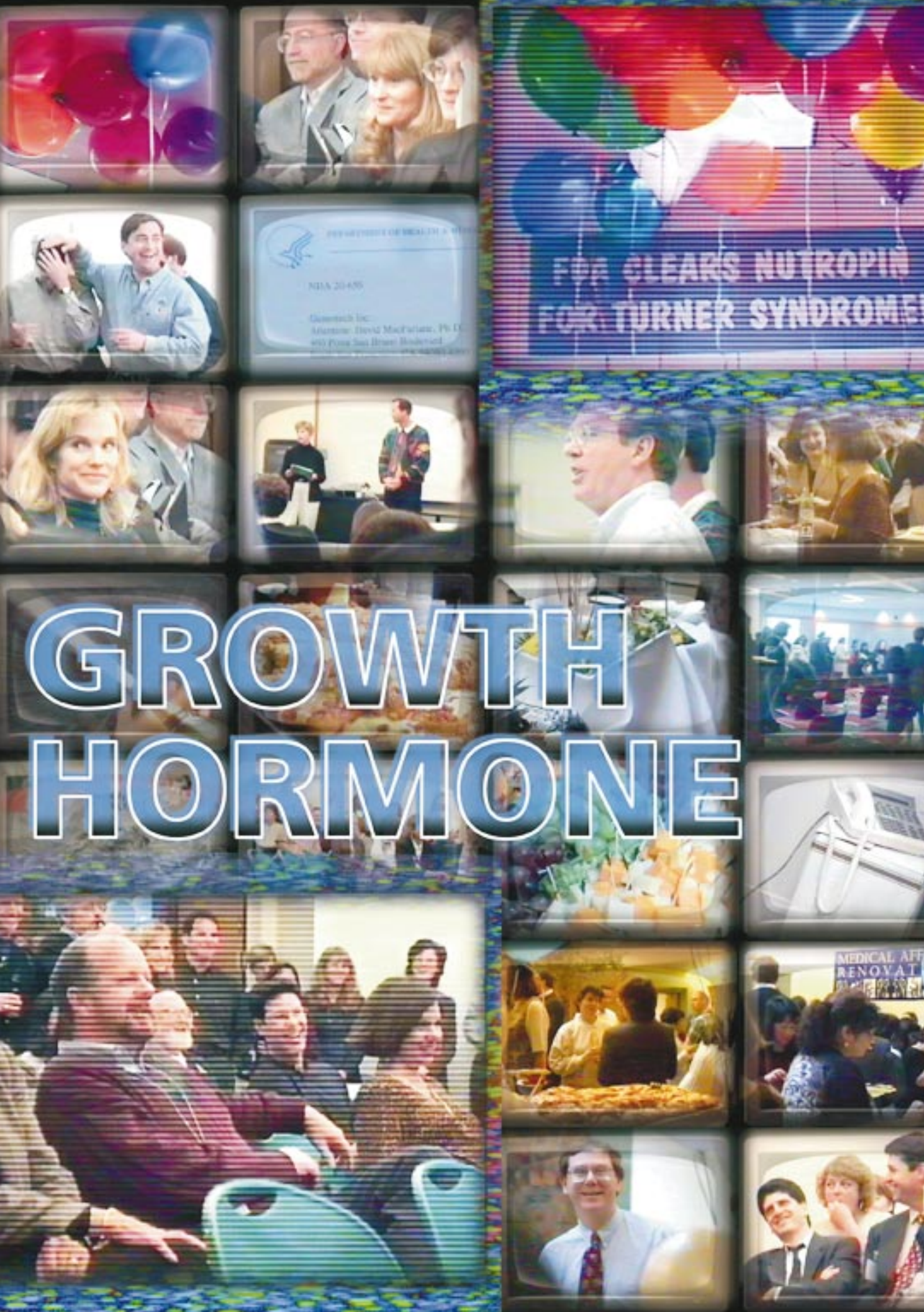
Actimmune (Interferon gamma-1b)

- Chronic granulomatous disease

Roferon-A* (Interferon alfa-2a, recombinant)

- Several types of cancer

* New indication or new to portfolio


FDA CLEARS NUTROPIN
FOR TURNER SYNDROME!
GROWTH
HORMONE

Genentech employees pause to celebrate. Years of hard work led to an announcement in December 1996 that the FDA cleared for marketing Nutropin for the long-term treatment of short stature associated with Turner syndrome. This chromosomal disorder can cause numerous problems, most notably short stature. During 1996 the team also filed for U.S. regulatory clearance to market growth hormone for growth hormone inadequacy in adults.

Leading the field through service and support

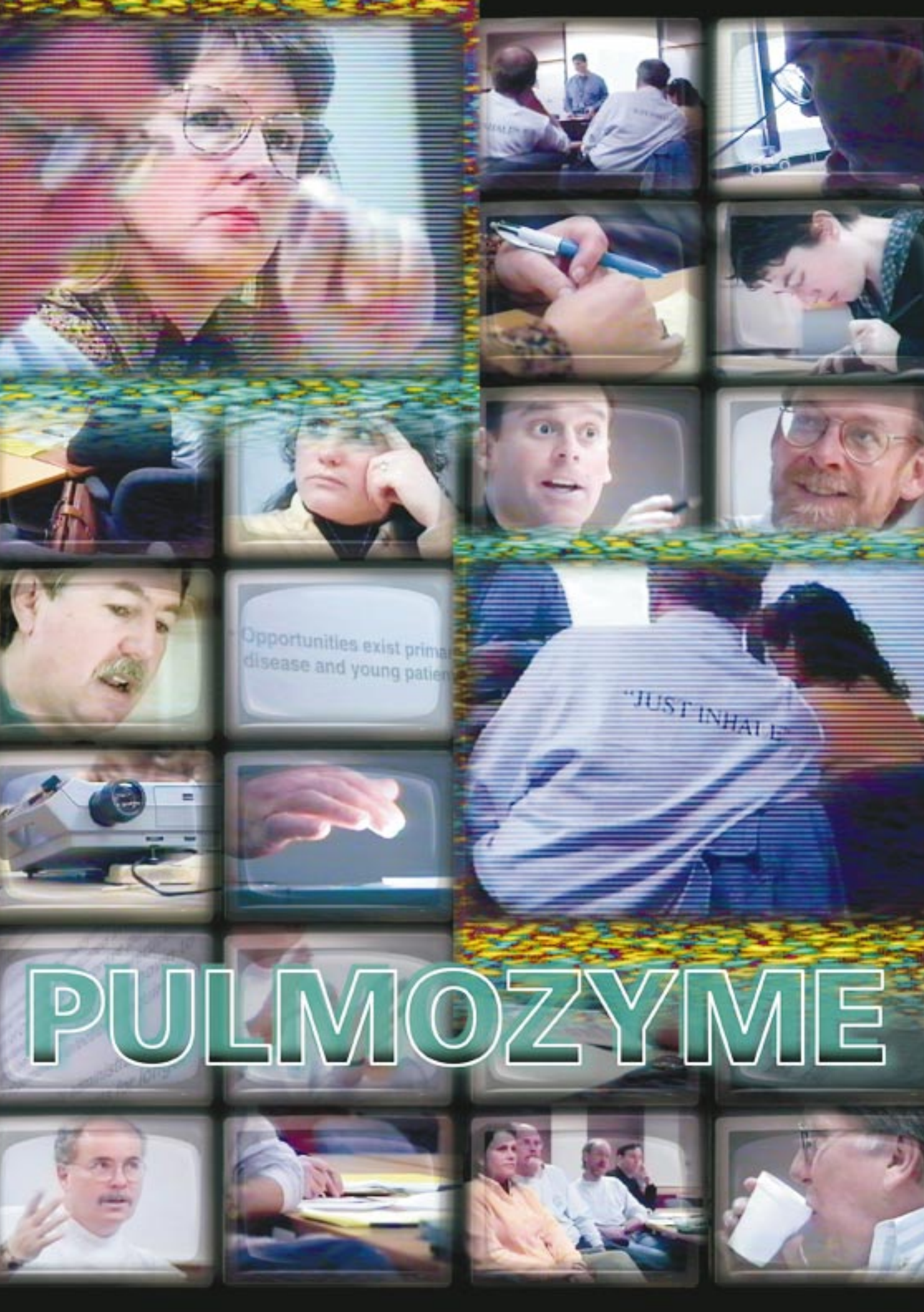
Genentech is the only company to market in the United States three different growth hormone products, one of them for three indications, and the only company to offer a convenient liquid version.

Competition against Genentech's growth hormone products increased during 1996, with four competitive products now on the U.S. market and one additional product kept off the market as a result of ongoing patent litigation. Despite this, Genentech maintains a two-thirds market share. Though some market share loss is possible, Genentech will work to maintain a majority market share by continuing to partner with the pediatric endocrinology community in helping these physicians understand and enhance their patients' growth and development. Genentech's Medical Affairs group provides valuable information to these physicians through postmarketing studies unique to the field.

Genentech also will continue to defend its patent position against one product on the market for which litigation continues, and against another product which is not marketed due to an injunction against it.

In a continuing effort to enhance ease of use, Genentech is working in collaboration with Alkermes, Inc. to develop a sustained-release growth hormone product that would reduce the need for daily injections and potentially offer a significant competitive advantage.

Eighteen-year-old Maisha Lauer (photo above) is a high school senior who had a predicted height well below five feet because of Turner syndrome. However, she was able to receive treatment with Nutropin as part of a clinical trial. Today she is 4 feet 11 and 7/8 inches tall (she calls it 5 feet) and happy to have received the therapy. Based on clinical trials of growth hormone in Turner syndrome patients such as Maisha, in 1996 Nutropin received regulatory clearance for the treatment of short stature related to Turner syndrome.


PULMOZYME

Breathing Easier

Genentech's Pulmozyme Core Team plans an Early Intervention Trial to determine the long-term two-year effectiveness of Pulmozyme in young cystic fibrosis patients with preserved lung function. The team used data accumulated through both clinical studies and Genentech's Epidemiological Study of Cystic Fibrosis to plan this trial. It is scheduled to begin in 1997.

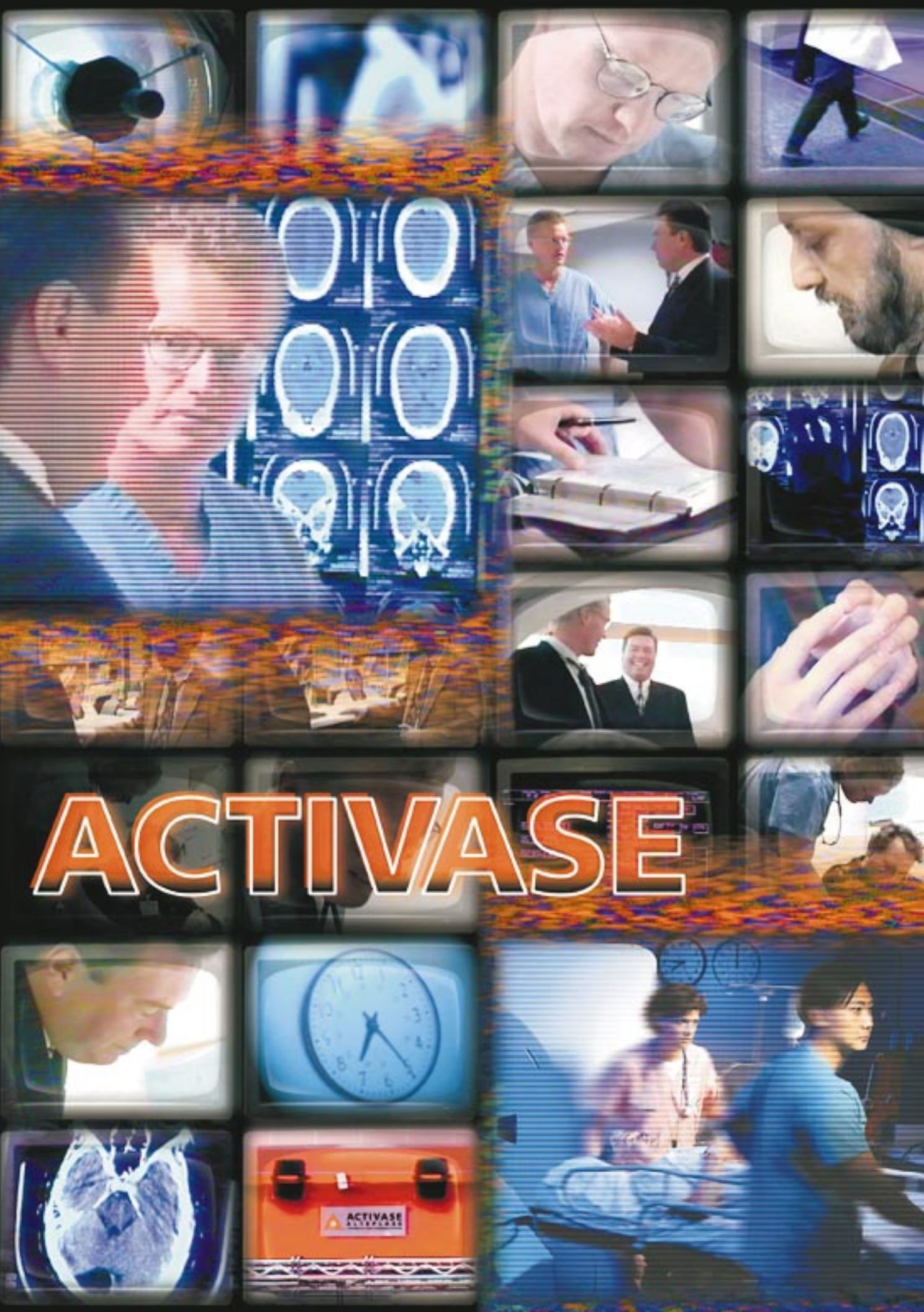
Working to help the full spectrum of cystic fibrosis patients

Cystic fibrosis is a genetically inherited, progressive disease that can begin with no or mild symptoms when the patient is very young. Over time, patients' health can deteriorate so that normal breathing becomes increasingly difficult and hospitalizations become more and more frequent. Ultimately, cystic fibrosis can progress to death, usually by age 30.

In 1994, Genentech received regulatory approval to market Pulmozyme for the management of cystic fibrosis patients from age five with mild to moderate disease. While this patient population benefited greatly from the medicine, Pulmozyme was not approved for management of very sick patients whose disease had progressed to a point where breathing is routinely compromised and infections are frequent. Genentech continued to study the medicine in these patients and in 1996 received clearance to market Pulmozyme for patients with advanced disease. This indication is especially beneficial to help keep patients healthy as they await lung transplants.

The question remained whether early intervention with Pulmozyme can benefit young patients with preserved lung function. Genentech is currently planning a clinical trial, to begin in 1997, to determine if it can. Through such continued study, Genentech's goal is to help all cystic fibrosis patients lead fuller, healthier lives.

Twenty-eight-year-old Stacy Hawes (photo above) is on "beeper status" for a lung transplant as a result of the cystic fibrosis with which she was diagnosed at age two. As the disease has progressed, Stacy has experienced increasingly frequent hospitalizations, lately about every six months. While she waits, Pulmozyme treatment helps keep her healthy enough to work full-time in the cable television industry and to qualify for a lung transplant. In 1996, Pulmozyme received regulatory clearance for the treatment of patients, like Stacy, with advanced cystic fibrosis.


ACTIVASE
ACTIVASE

The Message Is Urgency

Genentech representative Tim Yarnik has been working with Drs. Douglas Kabbes and Narinder Arora at Saint Anthony's Hospital in Effingham, Illinois, to help the hospital develop an urgent protocol for treating acute ischemic stroke with Activase, in an effort to improve outcomes of the hospital's ischemic stroke patients. The protocol involves predetermined steps: quick assessment; immediate paging of specialists needed to make a formal diagnosis if stroke is suspected; and fast administration of Activase within three hours of symptom onset if acute ischemic stroke is confirmed and the patient or patient's family agrees to the treatment. With the new protocol, these steps happen within one hour. Though still being fine-tuned at the time of her stroke, the hospital's stroke treatment protocol was essential to the successful treatment of Rosetta Bolander (opposite).

New indication for Activase gives hope to acute stroke patients

Activase received regulatory clearance for the treatment of acute ischemic stroke within three hours of symptom onset in June 1996. As a result, stroke—currently the country's leading cause of adult disability—joined heart attacks and trauma as medical conditions for which emergency treatment may reduce the risk of permanent disability. The approval was based upon data from a nationwide clinical trial, which showed that eligible patients treated with Activase within three hours were at least 33 percent more likely to recover with minimal or no disability than those treated with placebo.

Following the approval, Genentech worked closely with the National Institute of Neurological Disorders and Stroke, which, with more than 50 professional medical organizations from several health care fields, developed a blueprint for a national plan for rapid stroke treatment. The goal of this watershed effort is to help the medical community to quickly mobilize hospital teams and patients for optimal treatment of acute ischemic stroke.

Genentech is also involved with the American Academy of Neurology's national consumer and professional education campaign, the Stroke Awareness Response Treatment (StART) Initiative. Besides further educating the medical community, this program focuses on public education with this key message: Know the symptoms of stroke, and seek treatment fast.

The Symptoms of Stroke

- *Weakness/ numbness in the face, arm or leg, especially on one side of the body*
- *Sudden dimness, blurred or decreased vision, particularly in one eye*
- *Difficulty speaking or understanding speech*
- *Unexplained dizziness, loss of coordination, or sudden falls*
- *Sudden or severe headaches with no known cause*

When 67-year-old Rosetta Bolander (photo above) experienced the symptoms of a stroke in September, 1996, she and her family knew to seek treatment quickly because of reports on Activase they had seen on television. Rosetta improved within half an hour of being treated with Activase and recovered with no signs of damage, much to the delight of her six children, 17 grandchildren and two great grandchildren.

Leader for heart attack treatment

Activase currently leads the thrombolytic market in the United States. In 1996, Activase's market share climbed to approximately 80 percent from approximately 75 percent at the end of 1995.

Activase as a heart attack treatment faces challenges to its share of the thrombolytic market and to the size of that market. Genentech is vigorously facing these challenges.

In 1996, Boehringer Mannheim announced that the FDA licensed its heart attack drug, Reteplase (brand name Retavase®). Genentech believes Reteplase infringes Genentech patents and has filed a patent infringement action against Boehringer Mannheim.

Genentech also is currently developing in Phase II clinical trials a second-generation t-PA, called TNK, which is potentially more effective and faster to administer than t-PA.

Despite Activase's strong market share, the overall size of the thrombolytic therapy market during 1996 has declined by about 6.5 percent compared to 1995 as a result of some heart attack patients receiving angioplasty rather than thrombolytic therapy and others receiving therapy through ongoing large-scale clinical trials. This decreased market size has led to a 1996 decline in sales from 1995. However, a study reported in the *New England Journal of Medicine* in October 1996 demonstrated no significant mortality difference between primary angioplasty and thrombolytic therapy, but that rates of procedures and costs were lower for patients who received thrombolytic therapy. In addition, angioplasty is an invasive procedure requiring specialized equipment and facilities and is currently available at a limited number of hospitals in the United States.

The Symptoms of Heart Attack

- *Uncomfortable pressure, fullness, squeezing or pain in the center of the chest lasting for two minutes or more*
- *Pain spreading to the shoulders, neck, jaw, arms or back*
- *Dizziness, fainting, sweating, nausea and/or shortness of breath*

When what he thought was early morning indigestion persisted and worsened, 48-year-old Dalvinder Matharu (photo above) called his local hospital, who advised him to call 911. He was transported to the hospital, and was diagnosed as having an acute myocardial infarct—a heart attack. After physicians quickly treated him with Activase, he felt relief within minutes. Since his heart attack, Dalvinder has adopted a heart-healthy lifestyle, with a healthy diet and consistent exercise schedule.

Actimmune

Keeping healthy, despite CGD

Patients with chronic granulomatous disease (CGD) have a defect in their immune system that leaves them vulnerable to repeated, severe infections, which often require hospitalization and can cause death. Actimmune reduces approximately threefold the frequency of serious infections requiring hospitalizations. Of the approximately 400 patients in the United States with this very rare, inherited disease, most are children. Actimmune helps these patients stay healthy so they can lead a more normal life.

It was not until after his brother died of chronic granulomatous disease in 1994 that 8-year-old Ronald McFarland (photo at right) was diagnosed with the same inherited disease. Ronald's mom, Kim, says that before the diagnosis, Ronald was sick and hospitalized often with mold pneumonia and bladder problems. Since he started treatment with Actimmune two years ago, Ronald has not been hospitalized and rarely misses school.

Roferon-A

Roferon-A paves the way into the oncology market

Through a 1997 agreement with Roche, Genentech now promotes Roche's Roferon-A in the United States for its approved oncology indications, including hairy-cell leukemia, AIDS-related Kaposi's sarcoma and Ph-positive chronic myelogenous leukemia. As Genentech builds an oncology business, the experience it gains through promoting Roferon-A will provide significant benefit.

Programs for Marketed Products

Some of Genentech's efforts relate to all six of its marketed products. Two marketing programs are described below:

Patient assistance programs

Genentech believes all patients who need its marketed medicines should receive them, regardless of economic or insurance status. Since its first product reached the market in 1985, the company has had programs in place to help ensure this happens. Today, Genentech offers reimbursement information programs, featuring a reimbursement hotline, to provide information on and assistance with various payment resources available to patients. Genentech also has programs to ensure that even qualified patients who are not eligible for reimbursement can get the treatment they need. Over the past twelve years, Genentech has provided more than $200 million worth of pharmaceuticals free of charge through various programs for un- or underinsured patients in the United States.

Managed care

Genentech's managed care group is committed to partnering with customers to ensure it meets the needs of both patients and health care providers. The company has had a managed care staff in the field for more than a year, working to help medical providers recognize the benefits of Genentech products for their patients. As Genentech's development pipeline produces new products, the managed care group will play an essential role by preparing managed care organizations for novel therapeutics. By being well educated ahead of time, these organizations will be more readily able to integrate the products into their systems as the new medicines reach the market. In support of these efforts, Genentech's health economics group provides valuable information about the economic and quality-of-life benefits of Genentech products. This information is becoming increasingly necessary to provide the best patient care with the most efficient use of resources within a cost-conscious environment.

Genentech's Medical Affairs group also works with the company's marketed products, continuing clinical investigation efforts once a product has reached the market.

Genentech Observational Clinical Studies

Study Name	Participating Groups	Patients Included in Study
National Cooperative Growth Study (NCGS)	>650 pediatric endocrinologists	>27,000 patients treated with growth hormone
CRI Arm of North American Pediatric Renal Transplant Cooperative Study*	Pediatric nephrologists	Children treated with growth hormone for growth failure related to chronic renal insufficiency
National Registry of Myocardial Infarction (NRMI)	>1,500 participating medical centers	>750,000 heart attack patients
Epidemiological Study of Cystic Fibrosis (ESCF)	Almost 200 centers	>19,000 cystic fibrosis patients

**Genentech sponsors the CRI arm of NAPRTCS, but, unlike the other studies listed here, it is not a Genentech study.*

Observational clinical studies

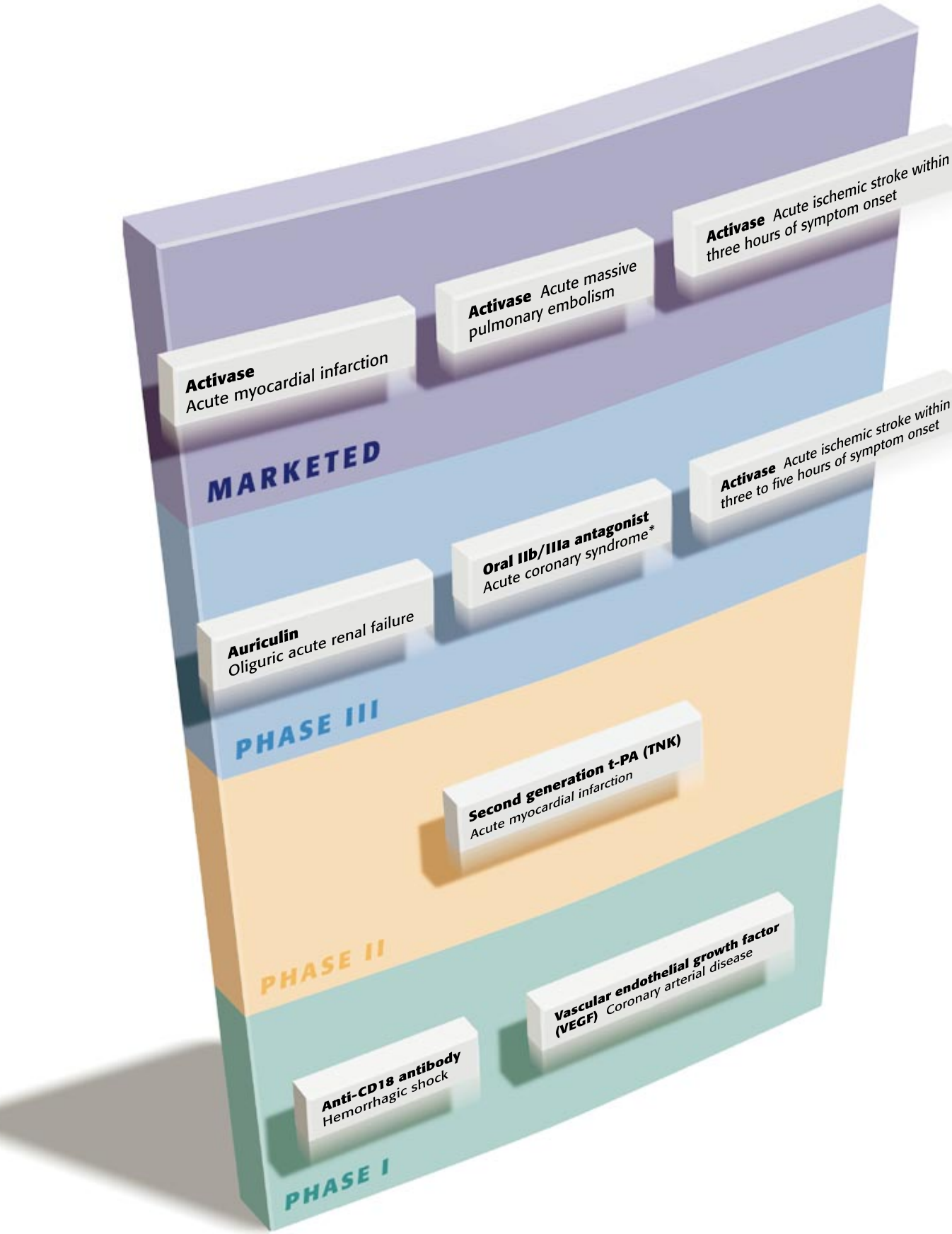
To provide physicians, hospitals and managed care organizations valuable information to help them optimize patient care, Genentech's Medical Affairs group continues clinical investigation of its marketed products after they reach the market. The table above indicates the variety of observational clinical studies Genentech conducts in cooperation with clinical investigators or sponsors.

RESEARCH AND DEVELOPMENT

From its founding, Genentech's success has been grounded in excellent science—science that has led to more than 3,000 patents worldwide with another 2,000 pending, and more than 250 published papers in peer-reviewed scientific publications each year. More tangibly, Genentech science has led to 11 of the marketed products of biotechnology, six of which Genentech markets.

Today, the company's discovery research continues to fuel its development pipeline. The third component to Genentech's strategy for growth is to accelerate and expand development of its pipeline products. The challenge is to focus on those products that will deliver the most benefit, both medically and financially.

CARDIOVASCULAR PORTFOLIO



* Genentech and Roche are currently preparing for Phase III clinical trials for this indication.

Cardiovascular Medicine

Genentech contributed to a revolution in the treatment of heart attack with the introduction of Activase in 1987. 1996 brought a similar revolution to the treatment of acute ischemic stroke. The scientific expertise and strong relationships Genentech has built over the years are of tremendous value to the company's efforts with the new potential cardiovascular products in its pipeline. Relationships with the cardiovascular medical community, with medical groups such as the American Heart Association, and with cardiovascular experts within the FDA all help ensure that Genentech is able to design and conduct clinical trials in a manner that will most quickly lead to regulatory clearance, if a drug is effective.

Genentech is working to expand and make more competitive its thrombolytic portfolio with a potentially safer and more effective second-generation t-PA—called TNK—scheduled to begin Phase III trials in 1997 if Phase II trials suggest it is effective. The company is also seeking to expand the treatment window for patients with acute ischemic stroke by studying the use of Activase in these patients between three and five hours of symptom onset.

GENENTECH IS WORKING TO EXPAND AND MAKE MORE COMPETITIVE ITS THROMBOLYTIC PORTFOLIO

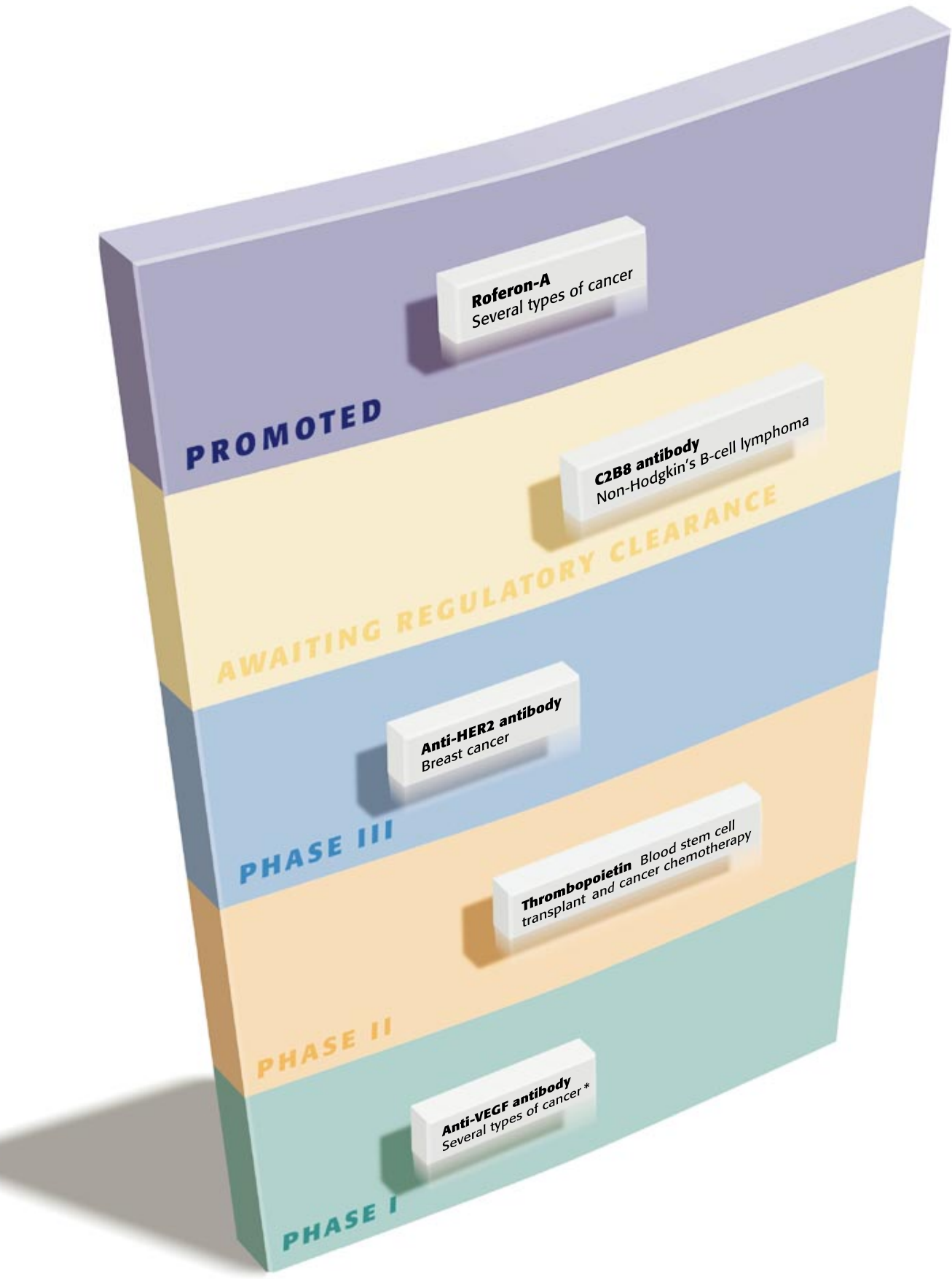
Genentech is also pursuing other avenues of cardiovascular medicine. In 1996, in collaboration with Roche, Genentech completed a Phase II clinical trial with an oral IIb/IIIa antagonist to investigate its pharmacokinetics, pharmacodynamics and safety in patients with acute coronary syndrome. This molecule was designed specifically to bind to the IIb/IIIa receptor on the surface of platelets to inhibit their ability to aggregate.

Discussed in more detail on page 24, vascular endothelial growth factor (VEGF) offers an exciting new avenue for treating coronary arterial disease.

Auriculin® anaritide, which is being developed by Scios Inc., seeks to treat the acute renal failure brought on by a sudden loss of blood flow to the kidneys, as in severe trauma. A Phase III trial suggested it is effective in a subset of these patients with low urine output, or oliguria, and a second Phase III trial is seeking to confirm efficacy in these patients.

Genentech's anti-CD18 antibody, being developed in collaboration with Roche, also seeks to address problems related to loss of blood flow, as in trauma. When patients are given blood transfusions to treat blood loss, a type of shock—hemorrhagic shock—often develops, which can result in organ failure and even death. The anti-CD18 antibody is designed to block the receptors in blood vessels that lead to this dangerous response.

ONCOLOGY PORTFOLIO



* Genentech is currently preparing for Phase I clinical trials for this indication.

Oncology

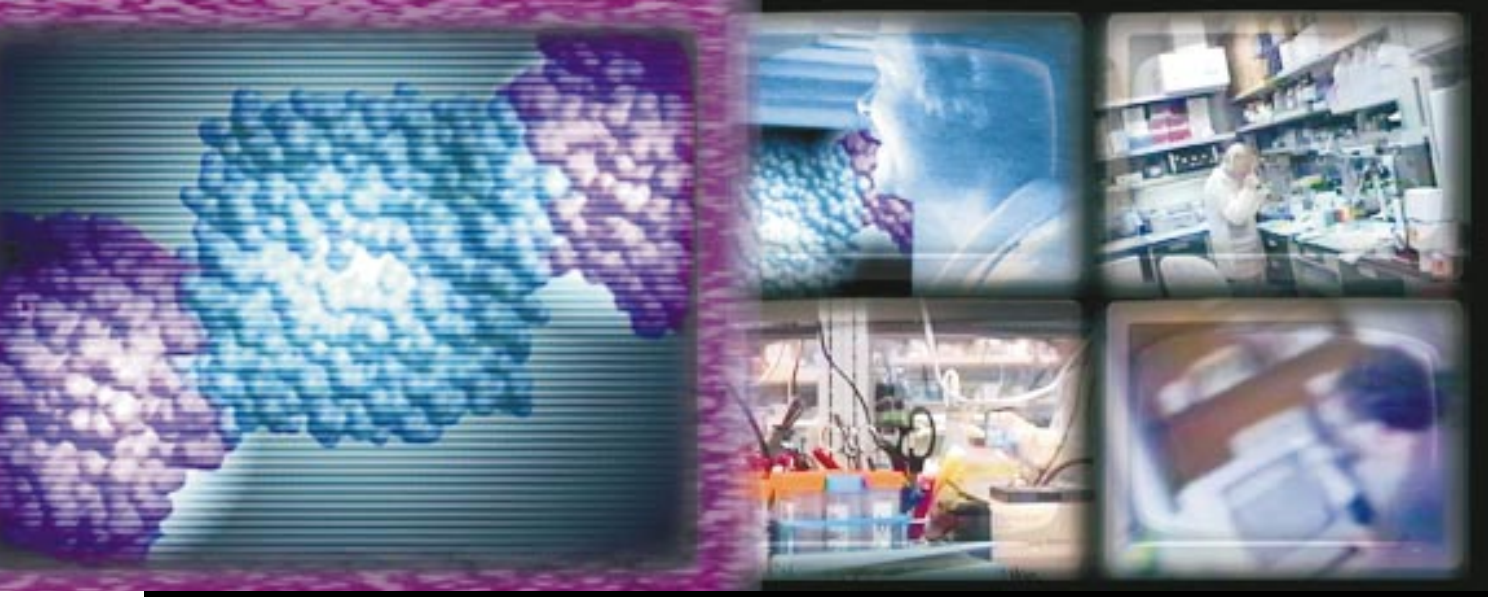
Oncology—cancer biology—represents a new area in which Genentech is building strength. Genentech has brought experts in the field in house and is collaborating with academic and clinical leaders outside the company. An Oncology Advisory Board of leading oncologists helps Genentech scientists plan the development of potential cancer therapies.

Genentech's promoted cancer product is Roche's Roferon-A, which Genentech is promoting for its approved oncology indications in the United States through a 1997 agreement with Roche. Roferon-A has come full circle: Genentech licensed patents and know-how for Roferon-A to Roche in 1980. Promoting Roferon-A will give Genentech the opportunity to enhance its knowledge of the oncology market as it moves its oncology pipeline products through development.

GENENTECH'S TWO ONCOLOGY PRODUCTS IN LATE-STAGE DEVELOPMENT HAVE THE BENEFIT OF SHOWING MINIMAL TOXICITY, ESPECIALLY COMPARED TO STANDARD CHEMOTHERAPY

Genentech's two oncology products in late-stage development have the benefit of showing minimal toxicity, especially compared to standard chemotherapy. The C2B8 antibody is being developed in collaboration with IDEC Pharmaceuticals, and IDEC has filed for regulatory clearance to market the antibody for non-Hodgkin's B-cell lymphoma. Phase III trials of the antibody as a single agent therapy for non-Hodgkin's B-cell lymphoma showed an overall response rate of 50 percent (6 percent complete response rate in evaluable patients and 44 percent partial response rate). In 1997 Genentech will complete enrollment of a pivotal Phase III clinical trial for its anti-HER2 antibody for the treatment of breast cancer. If the Phase III results confirm the positive Phase II findings, Genentech plans to file for regulatory clearance for this indication in 1998.

Genentech also has two potential oncology products in earlier clinical development. Thrombopoietin is a blood cell growth factor that promotes the production of the blood-clotting cells, platelets. Patients undergoing blood stem cell transplantation or cancer chemotherapy may suffer from thrombocytopenia, a deficiency of platelets. Genentech is studying recombinant human thrombopoietin in Phase II clinical trials to determine if this agent can ameliorate severe thrombocytopenia, which is often associated with these treatment options. And Genentech filed an IND to begin a Phase I clinical trial of the anti-VEGF antibody, discussed beginning on the next page.



Two Faces

Research into one molecule reveals two potential therapies

Vascular endothelial growth factor (VEGF) is a protein that ischemic tissues—tissues lacking in oxygen—secrete. It binds to receptors on nearby blood vessels and causes angiogenesis—the formation of new blood vessels.

Genentech's discovery research with VEGF has led to two different potential therapies. One relies on the angiogenetic effects of VEGF, and the other attempts to block those effects.

GENENTECH'S DISCOVERY RESEARCH WITH VEGF HAS LED TO TWO DIFFERENT POTENTIAL THERAPIES

VEGF as a treatment for coronary arterial disease

VEGF could potentially benefit patients who have a heart that is functioning but has a blocked blood supply due to atherosclerotic coronary artery disease. Current therapies for patients with coronary ischemia include angioplasty and coronary artery by-pass surgery. Patients with coronary arterial disease who are not optimal candidates for such procedures represent an unmet medical need for which VEGF may be useful. Any patient, however, with a functioning but underperfused heart could potentially benefit from therapeutic angiogenesis with VEGF.

With the potential formation of new blood vessels into previously ischemic areas of the heart, benefits that might result include improved blood flow to the heart, improved heart function, improved exercise ability, fewer clinical symptoms of angina, quality of life improvement, and reduced mortality due to heart attacks. Genentech is currently investigating VEGF for the treatment of coronary ischemia in Phase I clinical trials.

o f V E G F

The anti-VEGF antibody as a treatment for cancer

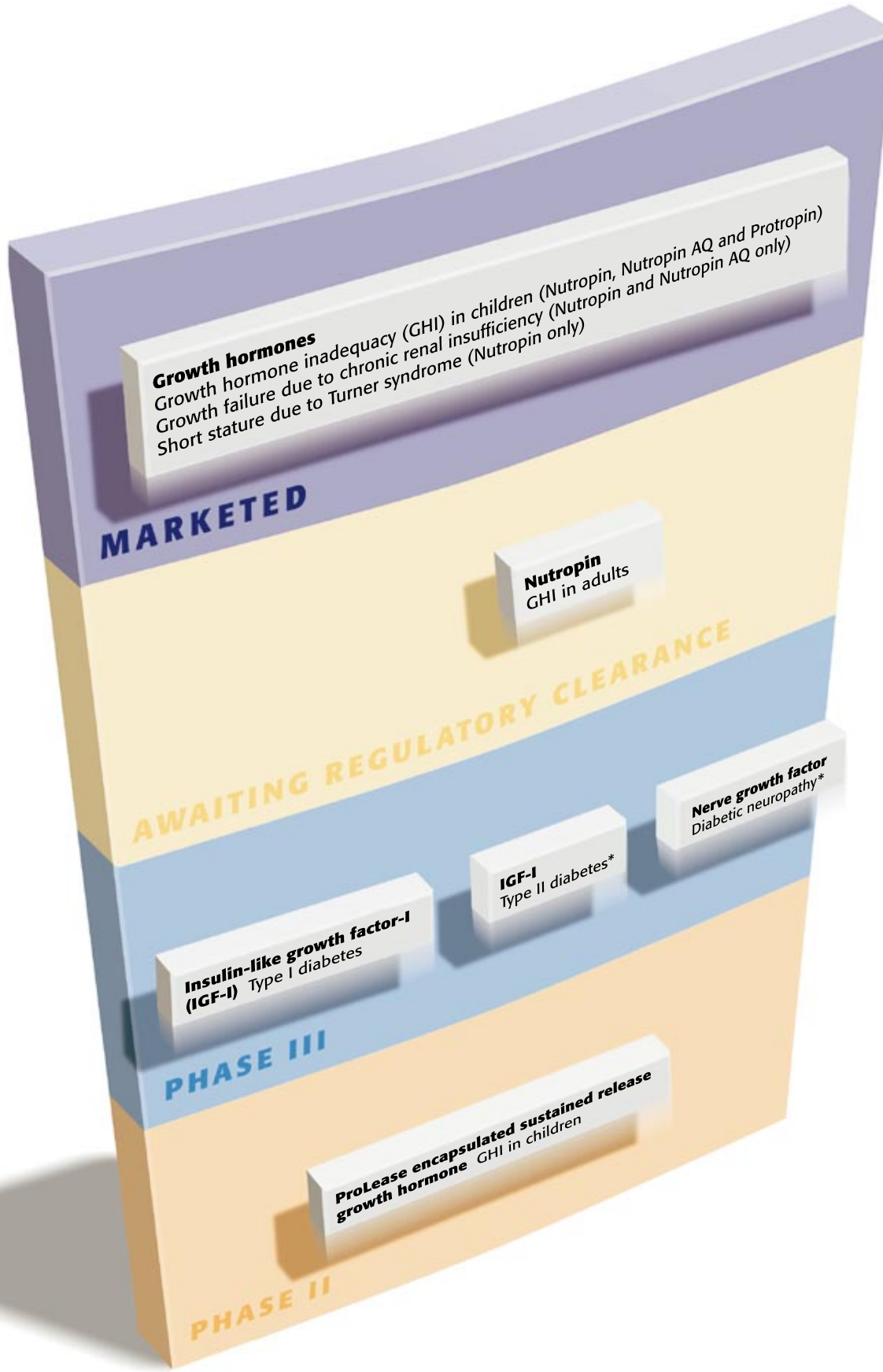
The second potential therapy resulting from Genentech's research with VEGF is the use of an anti-VEGF antibody developed by Genentech scientists to treat cancer. This approach stems from VEGF's apparent involvement in angiogenesis during tumor growth.

Despite significant advances over the past 15 years in the use of chemotherapeutic agents in the treatment of solid tumors, many of these tumors continue to be relatively unresponsive to even the most active agents. Cancerous tumors start off small with no blood supply of their own, and they cannot grow large or spread until they develop one. Angiogenesis has been shown to play an important role in both tumor growth and metastasis. In fact, the extent of tumor vascularization is considered an independent prognostic indicator, correlating strongly with relapse and survival. The greater the blood supply into the tumor, the worse the prognosis.

In preclinical studies in disease models, the anti-VEGF antibody resulted in decreased vascularization and a decline in growth and metastasis of a variety of tumors. Genentech has filed an IND to investigate its anti-VEGF antibody in a Phase I clinical trial as a potential therapy against solid tumors.

Genentech scientists (photos above) studied VEGF and identified some activities that were beneficial and some that play a role in cancer. Based on the discovery efforts of these scientists, Genentech is now seeking to harness and amplify the beneficial effects of VEGF in the treatment of coronary arterial disease and block the cancer-related effects of VEGF with an anti-VEGF antibody in the treatment of cancer.

ENDOCRINOLOGY PORTFOLIO



* Genentech is currently preparing for Phase III clinical trials for this indication.

Endocrinology

Since the development and introduction in 1985 of recombinant growth hormone, Genentech has established significant clinical and marketing expertise in the area of endocrinology. Since the launch of growth hormone, in collaboration with pediatric endocrinologists around the United States, Genentech has conducted the National Cooperative Growth Study, which has continuously helped increase the knowledge of experts, both external and internal. Genentech is the only company with three growth hormone products on the market and the only one with a liquid formulation available to simplify administration.

Genentech continues to apply its expertise in the area of human growth and development. In 1996 it received clearance for a new indication for growth hormone—Turner syndrome—and applied for regulatory clearance for another—growth hormone inadequacy in adults. In addition, Genentech is working in collaboration with Alkermes, Inc. to develop a sustained-release formulation of human growth hormone. Currently in Phase I/II clinical trials, this formulation is designed to free patients receiving growth hormone therapy from the need for daily injections. It does so by encapsulating the drug in biodegradable microspheres that slowly release the growth hormone over a period of weeks. If successful, this sustained release formulation will provide a significant competitive advantage in an increasingly competitive market.

GENENTECH CONTINUES TO APPLY ITS EXPERTISE IN THE AREA OF HUMAN GROWTH AND DEVELOPMENT

Genentech has also turned its expertise in the area of endocrinology to diabetes, with two significant products in late-stage clinical testing. These potential medicines—insulin-like growth factor and nerve growth factor—are profiled beginning on the next page. As is Genentech's characteristic approach, the company is developing a team of diabetes experts internally and building relationships with external leaders in diabetes treatment and research to ensure its clinical development plans are the best they can be.

I G F - I

Two potential new medicines for diabetes

Diabetes is a complex disease in which the normal control of blood sugar levels by insulin and other factors is disrupted. Even with close monitoring of blood sugar levels and regular insulin injections, over time it can lead to a variety of complications. One is a condition called peripheral neuropathy, marked by spontaneous pain, numbness and other abnormal sensations, such as burning or tingling, in the hands and feet.

Genentech is investigating two different medicines for diabetes in late-stage clinical studies—one targeting the underlying problem of blood sugar control and the other targeting the complication of peripheral neuropathy.

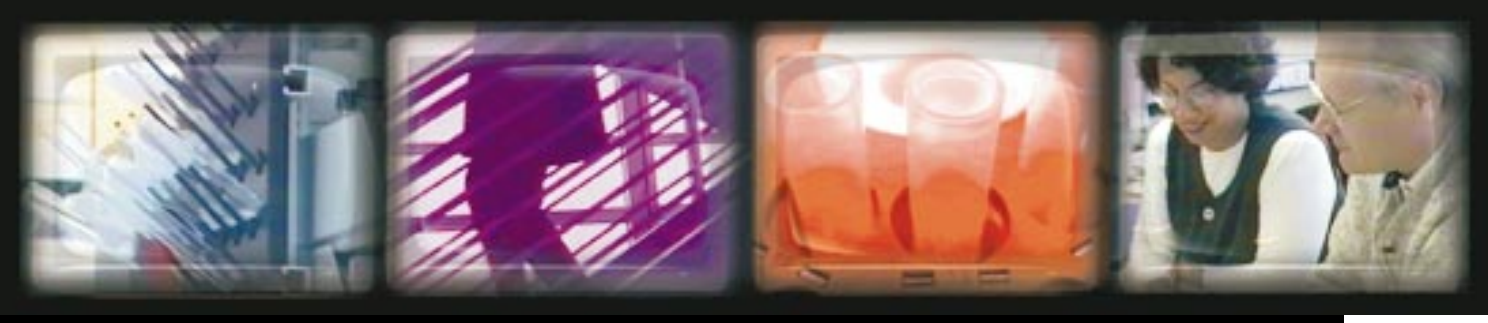
Insulin-like growth factor-I

Insulin-like growth factor-I (IGF-I) is one of three naturally occurring hormones capable of lowering blood sugar in humans (along with insulin and IGF-II). IGF-I and insulin act synergistically to regulate normal glucose levels. Both systems are disrupted in diabetes.

Genentech is investigating recombinant human IGF-I in Phase III clinical trials as a potential therapy for the management of diabetes. Specifically it is being investigated for chronic use as an adjuvant to insulin in individuals whose diabetes is not adequately controlled by insulin.

In addition to its beneficial effect on blood glucose, IGF-I may have other advantages over insulin. Insulin use has limitations including increased risk of hypoglycemia (low blood

Thirteen-year-old 8th grade honor student and professional dancer Jaclyn Litwa (photo above), diagnosed at age three with diabetes, diligently manages her disease. She receives three injections of insulin each day and monitors her blood sugar at school every day, keeping a daily log of her results. In 1996 Jaclyn enrolled in Genentech's Phase II trial of insulin-like growth factor-I (IGF-I).



sugar), worsening of insulin resistance, increased body weight, and increased body fat. By contrast, early clinical data suggest IGF-I presents lower risk of hypoglycemia, improves insulin sensitivity, and produces no change in body weight. The data also suggest it improves glucose control—a constant goal for diabetics.

Nerve growth factor

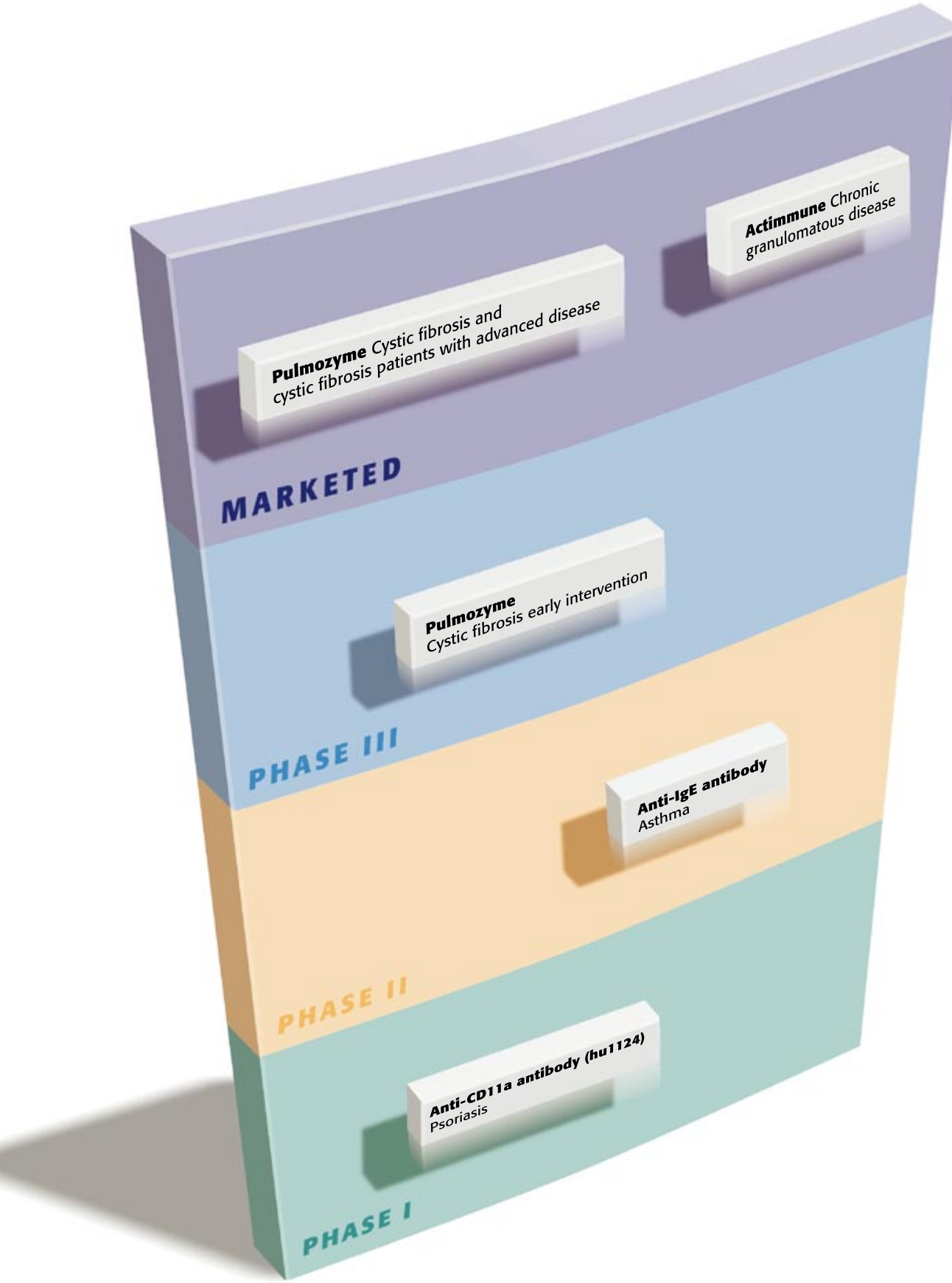
The condition peripheral neuropathy has multiple causes, including diabetes, AIDS and chemotherapy, with diabetes being the most common cause. No effective treatment exists for this degenerative condition.

Nerve growth factor (NGF) is known to stimulate the growth and survival of some neurons in the nervous system. A Phase II clinical study suggested that NGF positively affected small-fiber sensory neurons involved in diabetic neuropathy. This study showed that NGF improves patients' neurological function and the sensation of cooling detection and of heat measured as pain by well accepted neurological function tests.

In consultation with the FDA, Genentech is preparing for a pivotal Phase III trial of NGF in approximately 1,300 diabetic patients with diabetic neuropathy to begin in the first half of 1997. This trial will seek to confirm the Phase II results that NGF can improve the symptoms and neurological impairments in diabetic patients with neuropathy.

Forty-seven-year-old consulting engineer John Wilson (photo above) was diagnosed with diabetes 14 years ago and has been on insulin for 10 years. Over the last 5 years he developed peripheral neuropathy, and would experience pain in his feet whenever he was cold. In 1995 John began a six-month participation in Genentech's Phase II clinical trial for nerve growth factor (NGF). Though he did not know whether he was receiving NGF or placebo, he felt better as the trial progressed, with no pain in his feet. He has since learned that he did indeed receive NGF.

PULMONARY/ALLERGY/IMMUNOLOGY PORTFOLIO



Pulmonary/Allergy/Immunology

In 1991, after years of preclinical and clinical research, Genentech entered the field of immunology with the introduction of Actimmune to manage the rare immune disorder chronic granulomatous disease. In 1994 Genentech entered the pulmonary arena with Pulmozyme, the first new medicine for use in cystic fibrosis in 30 years.

Genentech has continued to build on its expertise in these areas. For instance, the company is working to broaden the range of cystic fibrosis patients who can benefit from Pulmozyme therapy, as described on page 13.

In addition, Genentech has combined an understanding of pulmonary medicine with an expertise in immunology and allergy to work on its anti-IgE antibody. In collaboration with Tanox and Novartis, Genentech is investigating a custom anti-IgE antibody in Phase II clinical trials as a potential treatment for asthma. The antibody is designed to interfere early in the body's complex immune cascade that leads to an allergic response that can trigger asthma. Phase I clinical trials showed that this humanized antibody is well tolerated. Genentech anticipates completing Phase II trials in the first half of 1997.

GENENTECH HAS COMBINED AN UNDERSTANDING OF PULMONARY MEDICINE WITH AN EXPERTISE IN IMMUNOLOGY AND ALLERGY TO WORK ON ITS ANTI-IgE ANTIBODY

Third, through a collaboration with XOMA Corporation, Genentech is tackling the immune disorder psoriasis, which leaves patients with itchy, scaly, red patches on their skin, often covering large areas of the body. XOMA is conducting Phase I clinical trials of Genentech's anti-CD11a antibody, called hu1124. This antibody is designed to curb the immune cells, called T-cells, that are over-active in psoriasis. Preclinical studies suggest it also may be useful to inhibit these same immune cells after an organ transplant, thus preventing rejection of the transplant. If the Phase I trials demonstrate safety, XOMA will take the anti-CD11a antibody through Phase II clinical testing, initially for psoriasis, and also for organ transplant rejection.

Letter to Stockholders

February 28, 1997

Dear Stockholder,

1996 marked Genentech's 20th anniversary. When Herb Boyer and Bob Swanson founded Genentech, they began more than a company. They formed a philosophy and a culture that has proven productive and, even as it has matured, has guided its employees to continued success—to the benefit of many, many people. Even as the individual employees may change, key employee attributes, first brought to the company by its founders, remain the same: they're bright, they're driven from within, and they pursue a higher ideal. Over the years, Genentech has developed a reputation as a casual company and a fun—but intense—place to work. This atmosphere helped drive our successes in 1996, laying the foundation for continued growth as we approach a new century.

Arthur D. Levinson, Ph.D.
President and Chief Executive Officer

In 1996 we received three regulatory clearances for new indications for our key marketed products, including a breakthrough indication for Activase for the treatment of acute ischemic stroke. The electronic regulatory submission for this indication is featured on the cover of this report. At the same time our two leading products, Activase and growth hormone, faced significant but anticipated market challenges. As described in the section beginning on page 9, we intend to maintain and ultimately hope to grow our markets. To do so, we are continuing our leadership efforts in education and post-marketing clinical research in partnership with the practicing medical community; we continue to defend our strong patent positions; we are focusing our efforts with managed care providers; and we are developing improved versions of our current products in the clinic.

These efforts support our first key strategy for growth: to maximize sales of marketed products. The three other key strategies for our growth are: to accelerate and expand product development; to increase the pace of forming strategic alliances; and to improve financial returns.

Our product development efforts in 1996 and early 1997 have been well rewarded, so that we now have five potential new products or indications in late-stage clinical development, with three additional new products or indications about to enter Phase III trials. Besides the three regulatory clearances for new indications, we filed a regulatory submission for marketing approval for another new indication for growth hormone—growth hormone inadequacy in adults. And our partner IDEC Pharmaceuticals filed a regulatory

submission for marketing clearance for a potential new treatment for non-Hodgkin's B-cell lymphoma. The Phase III trials for this C2B8 antibody, which IDEC completed in 1996, showed a 50 percent response rate in evaluable patients, with minimal toxicity—which is very promising for the very sick patient population studied. It is especially so when you consider that it lacks the considerable side effects of traditional chemotherapy (a benefit, also, of our anti-HER2 antibody for breast cancer, which is in Phase III clinical trials). We completed Phase II trials of nerve growth factor in patients with diabetic peripheral neuropathy, with good results, so that we are now preparing for pivotal Phase III trials. And we are poised to begin Phase III trials of an oral IIb/IIIa antagonist in acute coronary syndrome. We also moved four new products into clinical development.

In line with our third strategy, we formed important new strategic alliances in 1996 and early 1997, and made substantial progress on earlier alliances. Most significantly, our relationship with our majority stockholder Roche has moved in several positive directions. First, through an earlier collaborative agreement, Roche began Phase I clinical trials of our anti-CD18 antibody for the treatment of hemorrhagic shock.

"A PROMISE TO REMAIN TRUE TO OUR ENTREPRENEURIAL SPIRIT"

Second, Roche exercised its options (per our 1995 arrangement with Roche) to develop three pipeline products outside the United States: the C2B8 antibody, insulin-like growth factor-I, and nerve growth factor. This provided important contract revenue to Genentech and serves as tangible validation for the medical potential of these products on a global scale.

Third, Roche agreed to have us promote its Roferon-A in the United States for its approved oncology indications. I am excited about this arrangement for two reasons: it provides us with an initial product for our growing oncology franchise; and it allows Genentech to promote yet another product that resulted from Genentech science, as we licensed patents and know-how for this product to Roche in 1980.

To name just two alliances Genentech has formed with other companies: we agreed with XOMA Corporation for XOMA to develop Genentech's anti-CD11a antibody, called hu1124, for the treatment of psoriasis and organ transplant rejection (XOMA has begun Phase I clinical trials in the former indication and filed an investigational new drug application (IND) in the latter); and we agreed with CytoTherapeutics, Inc. to work to develop treatments for Huntington's disease, Parkinson's disease and amyotrophic lateral sclerosis (ALS) using CytoTherapeutic's encapsulated cell technology to deliver several of Genentech's proprietary growth factors.

As expected, our fourth strategy for growth, improve financial returns, had the least visible results in 1996. Our earnings declined to $118.3 million from $146.4 million in 1995 as a result of strong investment to pursue the promise of our development pipeline. However, this strategy follows from the success of the first three, and should move into place over the longer term. Over the short term, earnings are restrained as we invest aggressively in R&D, which—at $471.1 million—was at a level of almost 50 percent of revenues in 1996, compared to—at $363.0 million—40 percent of revenues in 1995. As late-stage products progress through the pipeline, our goal is for R&D expenses to decline in absolute terms. As new products reach the market, revenues should increase. With the combination of these two factors, as we approach the turn of the century, our goal is for R&D expenditures to level off at approximately 25 to 30 percent of revenues. And I anticipate we will realize our fourth strategy. I hope you agree it will have been worth our aggressive investment in R&D today. Certainly the patients who stand to benefit from our new medicines would believe so.

As Genentech reached its 20th year, one of our cofounders stepped down to pursue new interests. Bob Swanson's retirement as chairman and from the board serves to remind us how much he has contributed to Genentech, to the biotechnology industry that his and Herb Boyer's vision began, and to the many patients who have benefited from our medicines.

Though he has large shoes to fill, eight-year board veteran Dick Munro, our new chairman, will, I know, do the job admirably. He brings a tremendous wealth of experience as both a former chief executive officer of Time Warner, Inc. and as a member of the board of several of America's premier companies.

I know our success will continue, because the original philosophy for what Genentech should be continues today. This report is dedicated to those hard-working, jeans-clad employees who emphasize that philosophy, including those first two, Herb and Bob. It is also dedicated to all Genentech stockholders. To you we make a promise to remain true to our entrepreneurial spirit, as we strive to bring both important new medicines to patients and an attractive return to our investors.

Sincerely,

/s/ Arthur D. Levinson

Arthur D. Levinson, Ph.D.
President and Chief Executive Officer

This letter contains several forward-looking statements relating to future R&D expenses and revenues. The Company's actual results may differ materially. For a discussion of the risk factors which may affect future R&D expenditures, please see page 47, "R&D Expenses," and for a discussion of the risk factors which may affect future revenues, please see page 46, "Total Product Sales" and "Activase Sales," page 47, "Growth Hormone Sales," "Pulmozyme Sales," and "Royalty and Contract Revenues," and page 48, "Successful Development of Products," "Uncertainties Surrounding Proprietary Rights," and "Market Potential/Risk."