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IMAGE NEXT PAGE: In 1997, in recognition of the importance of Genentech in establishing the biotechnology industry, South San Francisco renamed the 400 block of Point San Bruno Boulevard to "DNA Way." Reflecting their dedication to science, Genentech's employees gathered to form along DNA Way the longest human DNA strand ever assembled. Combined with inspiration and imagination, the dedication of Genentech employees continues to produce tangible improvements in patients' lives around the world.

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GENENTECH BUSINESS HIGHLIGHTS IN 1997 AND EARLY 1998

In 1997, Genentech refined its Long-Range Plan (LRP) to manage the company toward both solid earnings and a strong early- and late-stage pipeline in 1999, while providing a plan for sound and consistent growth into the next century. As part of the LRP, Genentech continues to implement its four-point strategy and has already made significant headway:

1. Maximize Sales of Marketed Products

- With partner IDEC Pharmaceuticals Corporation, received approval for Rituxan for the treatment of patients with relapsed or refractory low-grade or follicular, CD20-positive B-cell non-Hodgkin's lymphoma.
- Received approval for Nutropin and Nutropin AQ for the treatment of growth hormone deficiency in adults.
- Received approval for Nutropin AQ for the treatment of short stature associated with Turner syndrome.
- Launched a new BioOncology initiative that includes the marketed product Rituxan as well as the oncology products that Genentech has under clinical development.
- Launched a service to growth hormone patients, oncology patients and their physicians called SPOC, Single Point of Contact, to provide customer-focused reimbursement assistance.

2. Accelerate and Expand Product Development

- Based on positive preliminary Phase III results, began preparing regulatory filings seeking approval for Herceptin for the treatment of breast cancer.
- Boehringer Ingelheim International GmbH (BI) completed enrollment in its ECASS II stroke study, which is investigating using Alteplase, a tissue-plasminogen activator (t-PA), for acute ischemic stroke within the first six hours of symptom onset. (Activase currently is approved for acute ischemic stroke within the first three hours of symptom onset.)
- With partner BI, began a Phase III trial for TNK, a t-PA, for acute myocardial infarction.
- Began a Phase III trial of nerve growth factor in diabetic patients with sensory peripheral neuropathy.
- Began a Phase III Early Intervention Trial with Pulmozyme in a large group of cystic fibrosis patients with relatively preserved lung function.
- Roche began Phase III clinical trials of Xubix for acute coronary syndrome. In 1997, Roche assumed development of Xubix. Genentech will provide clinical and scientific input and may subsequently opt in and join development at any time up to the New Drug Application filing for the first indication.
- With partners Novartis AG and Tanox Biosystems, Inc., began a Phase III trial of an anti-IgE antibody for the treatment of allergic asthma.
- With partner Alkermes, Inc., began a pivotal Phase III trial of ProLease human growth hormone.
- Began planning Phase II clinical trials of the anti-CD18 antibody for the treatment of acute myocardial infarction.
- Began planning a Phase II trial of vascular endothelial growth factor (VEGF) in patients with coronary artery disease.
- Completed one and began a second of two planned Phase I safety trials of Genentech's anti-VEGF antibody in patients with cancer. Also began planning a Phase II trial with this antibody for this indication.
- Discontinued IGF-I development effort in Type I and Type II diabetes based on the scope and extended time frame of the clinical program required to address potential concerns about diabetic retinopathy.
- With partner Scios, Inc., discontinued development of Auriculin after an interim analysis of data from an ongoing Phase III study in oliguric acute renal failure suggested a low probability of a positive outcome.

3. Increase the Pace of Forming Strategic Alliances

- Agreed to provide Sumitomo Pharmaceuticals Co., Ltd. exclusive rights to develop, import and distribute in Japan Nutropin AQ and ProLease.
- Agreed with Alteon, Inc. to continue development and ultimately to market pimagedine, currently in Phase III trials to treat kidney complications associated with diabetes.
- Agreed with LeukoSite, Inc. on the development and commercialization of LeukoSite's LDP-02, a humanized monoclonal antibody for the treatment of inflammatory bowel diseases.
- Agreed to provide to Pharmacia & Upjohn (P&U) exclusive worldwide rights for thrombopoietin (TPO), which is in Phase II trials for potential use in treating patients with complications of cancer chemotherapy. P&U and Genentech will jointly develop TPO for this indication.

4. Improve Financial Returns

- 1997 earnings: $129.0 million
- 1997 revenues: $1.02 billion
- 1997 earnings as a percent of revenues: 12.7 percent.

Actimmune® (Interferon gamma-1b); Activase® (Alteplase, recombinant), a tissue-plasminogen activator (t-PA); Auriculin® (anaritide); Herceptin™ (trastuzumab) anti-HER2 antibody; Nutropin® [somatropin (rDNA origin) for injection] growth hormone; Nutropin AQ® [somatropin (rDNA origin) injection] liquid formulation growth hormone; ProLease® encapsulated sustained-release growth hormone; Protropin® (somatrem for injection) growth hormone; Pulmozyme® (dornase alfa, recombinant) Inhalation Solution; Rituxan™ (Rituximab); Xubix™ (sibrafiban) oral IIb/IIIa antagonist.

competitive

As six-year-old Derrick Hatch contends with his growth hormone deficiency, he is participating in a Phase III clinical trial of ProLease.

Healthy competition encourages some of the best scientific advances as scientists strive to be the first to discover. Genentech scientists thrive on competition, seeking to be the first to publish new discoveries, the first to develop new technologies, and the first to move potential new therapies into clinical testing. Similarly, from its first market entry, Genentech has been strongly competitive in its market areas. Competitive concerns also have helped drive product development decisions and timelines. Genentech has historically risen to competitive challenges. It has met its challenges not so much by focusing on the competition as by focusing on delivering the best medical products, information and support to patients and to the medical community. This approach has been effective in meeting competitive challenges — which Genentech intends to continue to do long into the future.

For example, in 1997, Genentech launched a new service to growth hormone patients, oncology patients and their physicians called SPOC, Single Point of Contact. SPOC provides a customer-focused reimbursement assistance program that helps facilitate patients' access to growth hormone or Rituxan therapy.

Genentech also works closely with managed care organizations. In 1997, Genentech announced a new study with Kaiser Permanente aimed at assessing the impact of improved patient management on clinical outcomes for victims of stroke. The study is designed to monitor and improve the quality, as well as reduce the costs, of stroke care.

One of the most important ways Genentech intends to continue to lead the competition is to keep developing new products and indications in existing markets. For example, in the thrombolytic therapy market, with partner Boehringer Ingelheim International GmbH, Genentech is developing TNK, a t-PA, which, with only one injection, may be easier to administer than Activase. Genentech also intends to continue to lead the increasingly crowded growth hormone market. Its efforts with partner Alkermes, Inc. to develop ProLease sustained-release human growth hormone are an important part of Genentech's competitive plan. This medicine may call for injections only once or twice a month, instead of daily, offering an important patient and market advantage.

In these and all areas, Genentech intends to continue to apply strong science and excellent medical support. This approach has served the company and its customers well in the past, and in the future it should enable Genentech to continue to lead the competition.

INSIDE EVERY WINNER IS A COMPETITIVE SPIRIT. GENENTECH'S CULTURE IS FOUNDED ON THAT CONSTRUCTIVELY COMPETITIVE PERSONALITY. WHETHER DEFENDING PATENTS OR PRODUCT MARKET SHARE, ENTERING OR CREATING NEW MARKETS, OR ACHIEVING AN ENVIABLE SCIENTIFIC PUBLICATION RECORD, GENENTECH STRIVES TO EXCEED INDUSTRY NORMS AND EXPECTATIONS.

SCIENCE IS...

cooperative

Betsy Hospodar is participating in a Phase III clinical trial of pimagedine for the potential prevention of advancement of the kidney disease that is a complication of her Type I diabetes.

Nothing is done as well without cooperation. Whether expressed as the teamwork between a patient and physician, or as a business alliance between Genentech and outside partners, teamwork creates better results and greater possibilities. Genentech works diligently to create partnerships wherever such collaborations and alliances would increase the likelihood of success. Genentech's teamwork extends from within the ranks of the company's employees to universities, government research and industry.

Scientific progress typically relies on a cooperative effort. Nobel Prize winners James Watson and Francis Crick were the first to elucidate the structure of DNA in part because they collaborated together effectively. Cooperative efforts are likewise essential to success at Genentech. Whether internal multidisciplinary project teams; global, multicompany collaborations; or cooperative efforts toward a shared goal with regulatory agencies or government health organizations, the ability of Genentech employees to cooperate effectively with a wide range of people inside and outside the company is essential to Genentech meeting its goals.

One key 1997 Genentech success stems from such an effective group effort. In developing Rituxan (Rituximab), employees of Genentech, IDEC Pharmaceuticals Corporation, Roche (who will market Rituximab as MabThera outside the United States, excluding Japan) and Zenyaku Kogyo Co., Ltd. of Japan worked together to develop Rituximab in an international development project that has led to regulatory approvals in the United States and Switzerland. Teamwork among representatives from regulatory, manufacturing, clinical and marketing, to name only a few functions, ensured that all project concerns were appropriately considered at each step. Close cooperation with the Food and Drug Administration ensured a smooth U.S. regulatory process. Genentech is now applying lessons learned from this alliance to other collaborative development projects. Examples include the joint development of the anti-IgE antibody for allergic rhinitis and allergic asthma with Novartis AG and Tanox Biosystems, Inc., and, with Alteon, Inc., the development of pimagedine for kidney complications associated with diabetes.

Genentech's majority stockholder, Roche, is also a frequent Genentech collaborator. In line with the governance agreement between Roche and Genentech, both companies collaborate as true partners. One current collaborative global development effort by Genentech and Roche is on Genentech's nerve growth factor in diabetic patients with peripheral neuropathy.

Cooperation with the FDA is fundamental to all of Genentech's product development efforts. Genentech also works with the FDA on a broader level whenever appropriate. For example, as part of a cooperative legislative process, Genentech provided input and feedback on recent FDA reform legislation. The resulting changes in the way in

which pharmaceutical products are regulated and approved enable Genentech to design and execute clinical trials more effectively and efficiently.

Genentech also works with the government to advise on legislation affecting the biotechnology and pharmaceutical industries. In January 1998, Vice President Al Gore chose Genentech as a forum for discussion on the day of an important announcement that would benefit these industries. The White House announced that its proposed budget, submitted to Congress in February 1998, included an increase in the level of research funding to the National Institutes of Health (NIH) and a one-year extension to the industry tax credit for research and experimentation expenditures. The Genentech forum, which included Genentech employees and guests from government, industry and academia, and was moderated by the Vice President, explored how investment in research and development leads to both the creation of jobs and to innovation that can positively affect people's lives.

On many levels, Genentech partners with the medical community. The company works with medical organizations to support needed public education campaigns. For example, Genentech is currently supporting the National Stroke Association in its efforts to help hospitals educate their communities about the signs and symptoms of stroke and the urgent need to seek medical treatment. It is also continuing to help medical centers establish stroke treatment protocols as recommended by the National Institute of Neurological Disorders and Stroke (NINDS), one of the National Institutes of Health.

Working with another NIH arm, Genentech partners with the National Cancer Institute (NCI) in various ways. In one effort, Genentech and the NCI seek to increase the geographic availability of the Herceptin expanded access program for eligible breast cancer patients through its Treatment Referral Center program, which works with cancer centers across the United States. Genentech and the NCI also collaborate in other areas of medical need in breast cancer and other cancers. Genentech is part of a consortium supporting the NCI's Cancer Genome Anatomy Project.

Genentech works closely with investigators at hundreds of medical centers in the United States and Europe on more than a dozen clinical trials in progress. Through a collaborative approach with managed care organizations, Genentech provides important information on the medical value of its product offerings. Aiming to help all of its customers, as it has since its first product was launched, Genentech works with medical providers to gather postmarketing clinical data on the safety and efficacy of its marketed products (see table on the next page). In line with this effort, Genentech is currently planning a new postmarketing registry in growth hormone-deficient adults. To be called the National Cooperative Somatropin Surveillance (NCSS), this registry addresses the latest indication of certain of Genentech's growth hormone products.

Genentech works closely with investigators at hundreds of medical centers in the United States and Europe on more than a dozen clinical trials in progress.

GENENTECH OBSERVATIONAL CLINICAL STUDIES

Physicians, hospitals and managed care organizations work closely with Genentech's Medical Affairs group to gather valuable information that Genentech in turn makes available to these medical providers. Such data help physicians to optimize patient care. The table below indicates the variety of observational clinical studies Genentech conducts in cooperation with clinical investigators or sponsors.

STUDY NAME	PARTICIPATING GROUPS	PATIENTS INCLUDED IN STUDY
National Cooperative Growth Study (NCGS)	>650 pediatric endocrinologists	>29,000 patients treated with growth hormone
CRI Arm of North American Pediatric Renal Transplant Cooperative Study (NAPRTCS)*	Pediatric nephrologists at >120 medical centers	>3,300 children treated with growth hormone for growth failure related to chronic renal insufficiency
National Registry of Myocardial Infarction (NRMI)	>1,500 medical centers	>1 million heart attack patients
Epidemiological Study of Cystic Fibrosis (ESCF)	>200 medical centers	>20,000 cystic fibrosis patients

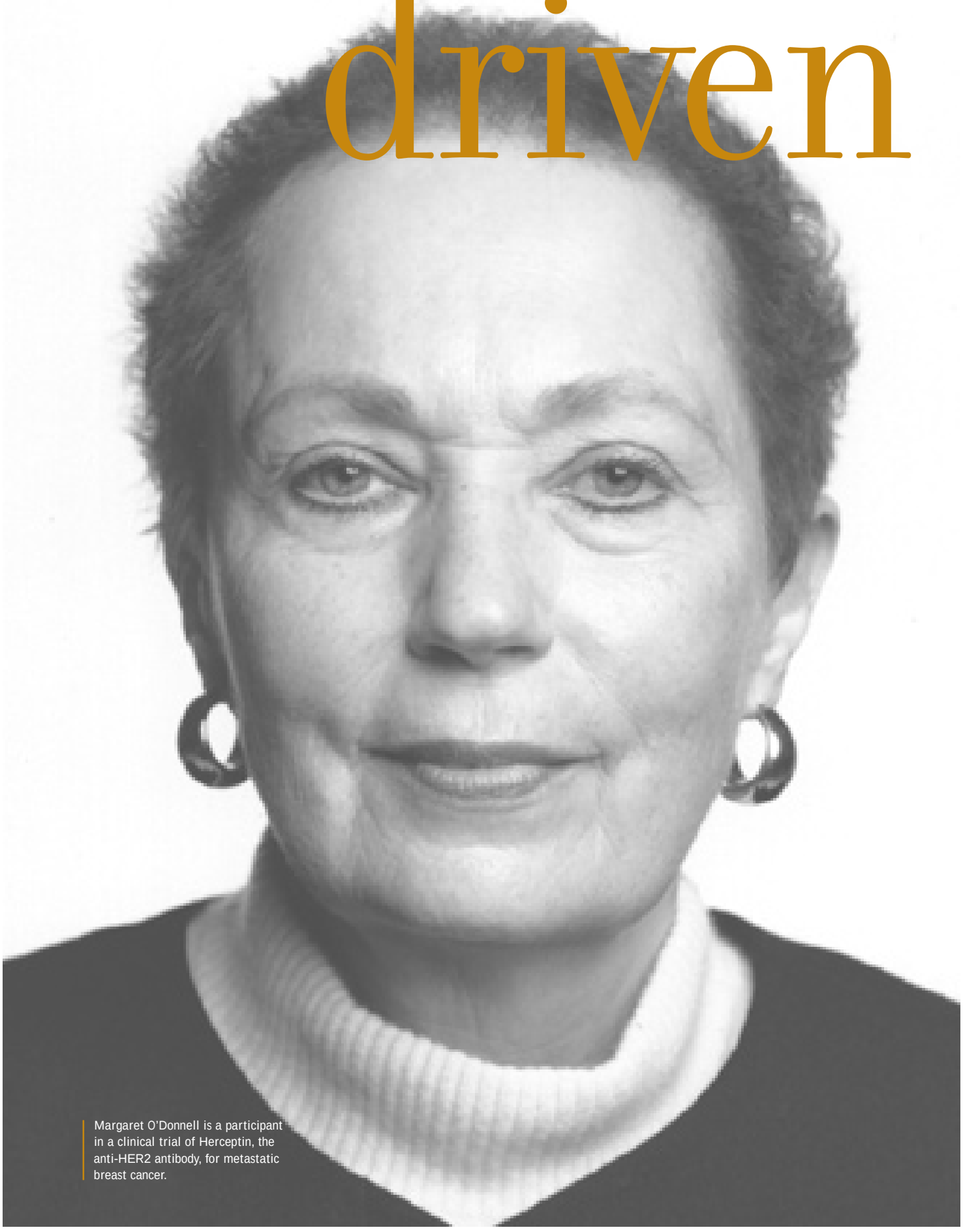
*Genentech sponsors the CRI arm of NAPRTCS, but, unlike the other studies listed here, NAPRTCS is not a Genentech study.

Genentech cooperates daily with the global scientific community. One mutually beneficial way it does so is through its Research Contracts and Reagents Program. Through this program, based on scientific merit and availability, the company makes available free of charge to researchers worldwide many of its scientific reagents for medical research projects. Genentech, which retains product rights, also benefits by gaining new leads and scientific information on potential development opportunities.

Almost every business interaction of each Genentech employee involves cooperation and collaboration on some level. For example, Genentech views its vendors as partners and teams with them to seek innovative ways to solve problems and reduce costs. Because in today's scientific, business and medical environments, the organizations that succeed best will be those that can best cooperate.

SCIENCE IS...

driven



Margaret O'Donnell is a participant in a clinical trial of Herceptin, the anti-HER2 antibody, for metastatic breast cancer.

With a resolve to succeed, Genentech is driven to achieve its many objectives. But central to the company's drive is determination to organize collective efforts into the most compelling long-term success possible. The company's Long-Range Plan, refined in 1997, provides the required focus, strategic thinking and disciplined resource deployment to help Genentech accomplish this objective.

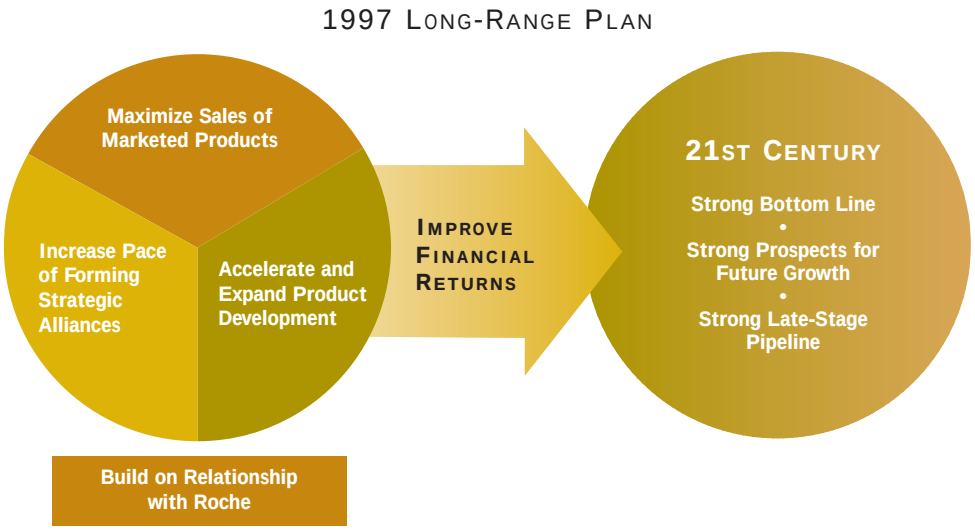
The most prolific scientists and scientific institutions are driven both by a desire for knowledge and by clear goals. While a quest for knowledge motivates Genentech scientists, all Genentech employees are driven by a shared desire to provide innovative medicines that help people and to benefit Genentech stockholders (which the majority of Genentech employees themselves are). The clear, quantitative goals of Genentech's Long-Range Plan (LRP) give everyone at Genentech a road map of disciplined business principles to achieve these objectives.

That road map lays out a desired route for Genentech as it heads into the 21st century with a destination clearly targeted. It reaffirms Genentech's commitment to implement the four-point strategy the company established in 1995: 1. maximize sales of marketed products; 2. accelerate and expand product development; 3. increase the pace of forming strategic alliances; and 4. improve financial returns. Through achieving success in these areas, the LRP looks to Genentech's achieving a strong late-stage pipeline with excellent prospects for growth and a solid bottom line.

Through its LRP, Genentech aspires for excellence. The plan sets ambitious targets for product sales. It sets development goals for major value drivers in the pipeline. And it outlines specific goals to improve efficiency in product development by optimizing activities, costs, timelines and risks. Looking toward the goals of the LRP, in 1997 Genentech successfully implemented programs throughout the company designed to increase efficiency and improve productivity at all levels.

Following the LRP, Genentech anticipates validating the intrinsic value of its product development pipeline by the year 2000. In doing so, Genentech will build on its focus areas of cardiovascular medicine, oncology and endocrinology, while continuing to be opportunistic in other areas. An important tactic of the LRP is to broaden Genentech's market platform. Success in building its BioOncology initiative and developing key opportunistic products will give Genentech four instead of two therapeutic-area legs on which to stand firmly in the healthcare marketplace.

Addressing longer-term value, Genentech will continue to nurture its industry-leading research. Combining research with strategic alliances, Genentech will build



toward an average of four new development projects annually by the year 2000. The LRP calls for Genentech to use its solid cash position to build value through product or company acquisitions or value-enhancing financial strategies. It establishes specific targets for improving Genentech's financial returns as the company's revenues increase. Following the LRP, Genentech seeks increased earnings growth in 1998. And it seeks to sustain that growth as it moves into the next century.

Genentech's LRP is a guide for the company's growth and progress toward building increased value for stockholders. Yet it provides the flexibility for Genentech to continue to assess its situation and adjust tactics as needed.

The LRP outlines research and development (R&D) and business strategies to maximize Genentech's value over both the short term and the long term – not one at the expense of the other. Its challenges are ambitious but achievable, and Genentech's employees are ready to meet them. The LRP maximizes the value of the company's strengths. And it is adaptable to changes in Genentech's business environment. Most important, it sets clear goals and priorities for Genentech's efforts to bring increasing value to all its stockholders. These clear goals can help fuel Genentech employees' already significant drive.

The LRP outlines R&D and business strategies to maximize Genentech's value over both the short term and the long term – not one at the expense of the other.

THE LRP SETS QUANTITATIVE GOALS TO GROW REVENUES AND PROFITS, INCLUDING:

- Achieve ambitious product sales targets
- Meet development goals for pipeline's major value drivers
- Improve productivity in all areas
- Validate value of pipeline by year 2000
- Build on focus areas — cardiovascular, oncology, endocrinology — and remain opportunistic
- Ensure industry-leading research, building toward four new development projects annually (including some from alliances) by the turn of the century
- Use strong cash position to build value
- Improve financial returns toward specific targets

SCIENCE IS...

exciting

Paul Weiss participated in a Phase II clinical trial of the anti-IgE antibody as a potential treatment for his allergic asthma.

Seeking scientific knowledge has the power to excite all involved in the pursuit. Ask anyone who works at Genentech. Here the excitement begins with discovery research and plays an important role at each step of the drug development process.

Excitement is a great emotion. You can feel it when you overcome or control an illness and are able to live your life fully once again. Or when winning in whatever endeavor you undertake. At Genentech, each and every advance accomplished — whether incremental or breakthrough in scope — fuels the company's excitement and work. Few things are more exciting than winning when that success brings better medical outcomes to patients.

Genentech scientists' enthusiasm for individual areas of interest contributes to the company's research direction. As it has since its founding, Genentech encourages its scientists to use their unique backgrounds and skills to develop novel areas of research. Why bridle an excited scientist? Genentech's defined corporate research focus is in the areas of cardiovascular medicine, endocrinology and oncology. Individually developed research efforts often provide opportunities for these areas, as well as for the fourth "opportunistic" area.

A fundamental mission of Genentech's research group, in direct support of the company's Long-Range Plan, is to identify and release to clinical development each year exciting new products to maintain Genentech's product pipeline. Genentech is applying innovative technologies to meet this objective. For example, through a proprietary approach combining a variety of new technologies, Genentech scientists have increased by 100-fold their pace of novel molecule discovery. Advanced screening methods help to determine quickly which of these new molecules may show therapeutic promise.

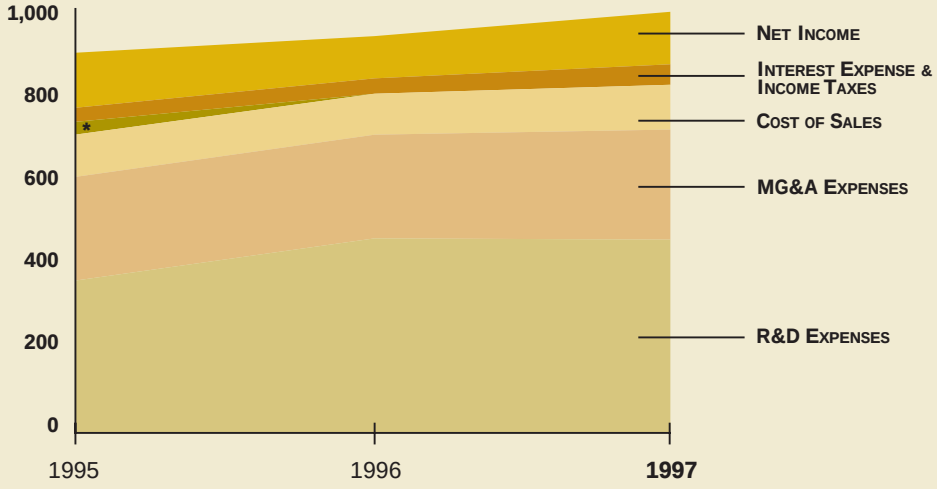
Genentech's research group also continues its fruitful efforts with humanized monoclonal antibodies. Some of these monoclonal antibodies aim for novel molecular targets. Two monoclonal antibodies being studied have the same molecular targets as Herceptin, but have properties that might provide improved clinical benefits. Herceptin is a monoclonal antibody for which Genentech is currently preparing filings to seek regulatory approval for marketing.

Genentech's successful efforts investigating apoptosis, or programmed cell death, are also proving fruitful. By determining a variety of ways to induce apoptosis of cancerous cells without affecting healthy cells, Genentech is identifying innovative potential cancer therapies. One approach Genentech is studying to kill cancer cells selectively is to cut off their blood supply by interfering with angiogenesis — the formation of new blood cells. The anti-VEGF antibody, recently moved from research into the clinic as a potential cancer therapy, is one outcome of the company's research on angiogenesis. Thus, with other molecules discussed elsewhere in this report, Genentech's BioOncology initiative has exciting components from discovery research, through various stages of clinical testing, up through the market.

Beyond discovery research, the excitement of science carries through to preclinical pharmacological and toxicology testing; to scaling-up protein production from milliliter vials for research to 100-liter tanks for development; to purifying and formulating the manufactured protein for use in humans; to clinical testing in human volunteers; and, ultimately, to product approval. At that point, Genentech employees, patients and stockholders alike can all fully share in the excitement.

Distribution of Revenue Dollars

(dollars in millions)



*SPECIAL CHARGE

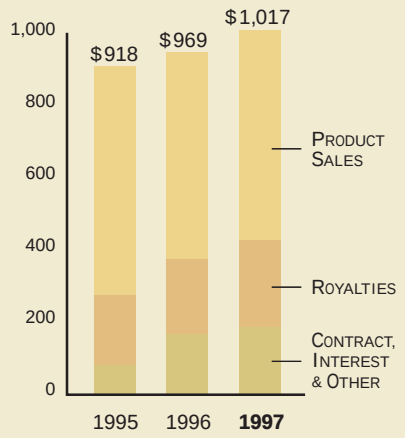
(millions, except per share, employee data and market price)

	1997	1996	1995
Income Statement			
Total revenues	$ 1,016.7	$ 968.7	$ 917.8
Product sales	584.9	582.8	635.3
Royalties	241.1	214.7	190.8
Contract and other revenues	121.6	107.0	31.2
Research and development expenses	470.9	471.1	363.0
Marketing, general and administrative expenses	269.9	240.1	251.7
Total costs and expenses	846.9	820.8	745.6
Net income	129.0	118.3	146.4
Diluted earnings per share	$ 1.02	$ 0.95	$ 1.20
Shares used to compute diluted earnings per share	126.4	124.0	121.7
Balance Sheet and Other Information			
Cash, short-term investments and long-term marketable securities	$ 1,286.5	$ 1,159.1	$ 1,096.8
Property, plant and equipment, net	683.3	586.2	503.7
Total assets	2,507.6	2,226.4	2,011.0
Long-term debt	150.0	150.0	150.0
Total stockholders' equity	2,031.2	1,801.1	1,602.0
Capital expenditures	$ 154.9	$ 141.8	$ 70.2
Employees	3,242	3,071	2,842
Market price at year-end	$ 60.63	$ 53.63	$ 53.00

The Company has paid no dividends.

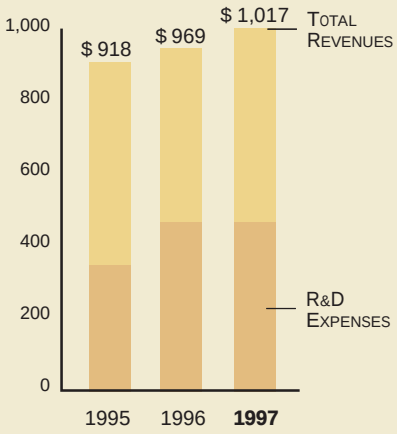
Financial Contents

Revenues (millions)



Revenues for 1997 increased 5% to over $1 billion. This growth came from all revenue areas, primarily royalties and contract and other revenues.

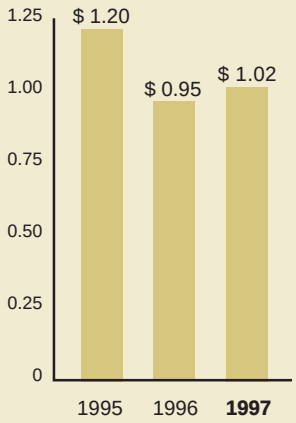
Research & Development Expenses and Total Revenues (millions)



R&D as a % of Revenues	40%	49%	46%

Substantial R&D investment is important to Genentech's future growth; however, R&D expense as a percentage of revenues decreased. This decrease is in line with continuing efforts to bring increasing revenues to the bottom line through disciplined spending in all areas of the Company.

Diluted Earnings Per Share



Net Income increased 9% in 1997, and diluted earnings per share increased 7%.

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 shares of common stock 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.

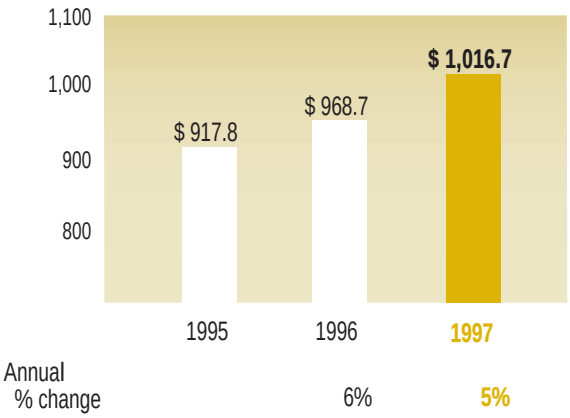
In conjunction with the Agreement, F. Hoffmann-La Roche Ltd (HLR) was granted an option for ten years for licenses to use and sell certain of the Company's products in non-United States markets (the license agreement). In the second quarter of 1997, the Company and HLR agreed in principle to changes to the license agreement. In general, these changes allow for the sharing of United States (U.S.) and European development costs regardless of location or purpose of studies. Under the license agreement, as revised, HLR may exercise its option either when the Company determines to move a product into development or at the end of Phase II clinical trials. In addition, HLR has assumed development of Xubix™ (the oral IIb/IIIa antagonist) globally on its own. See the *Relationship with Roche Holdings, Inc.* note in the *Notes to Consolidated Financial Statements* for further information.

As a result of the license agreement which transferred the Company's Canadian and European operations to Roche, in 1996 the Company's total product sales decreased compared to 1995, while contract and royalty revenue increased. Cost of sales as a percentage of product sales also increased due to the license agreement. See below for further discussion.

RESULTS OF OPERATIONS

(dollars in millions, except per share amounts)

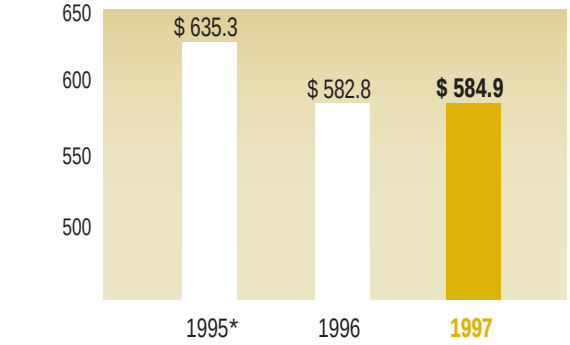
Revenues



	1995	1996	1997
Annual % change		6%	5%

Revenues for 1997 increased in all areas, but primarily from royalties and contract revenues. The increase in 1996 resulted primarily from higher contract and royalty revenue partly offset by lower product sales. Product sales to HLR in conjunction with the license agreement were $17.4 million in 1997, $13.2 million in 1996 and $1.8 million in 1995.

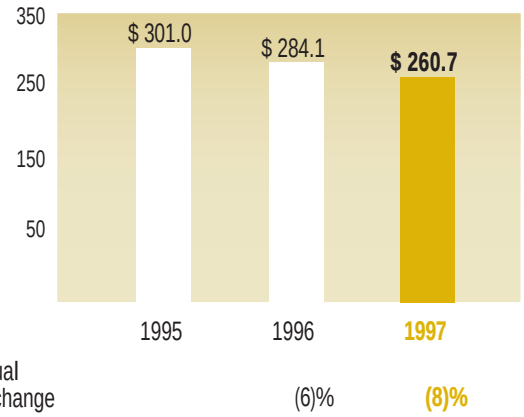
Total Product Sales



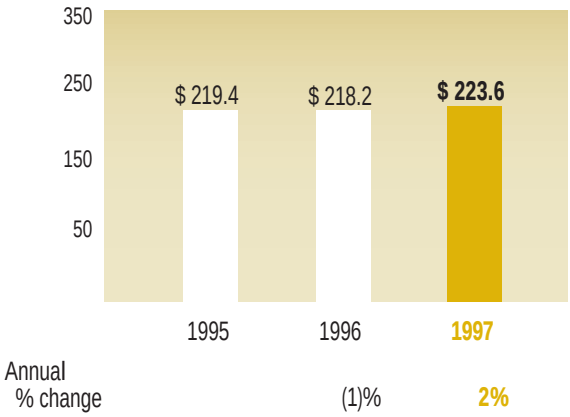
	1995*	1996	1997
Annual % change		(8)%	0%
% of revenues	69%	60%	58%

Total product sales increased slightly in 1997 over 1996 due to increases in Pulmozyme®, growth hormone sales and new sales from the introduction of Rituxan™. This increase was offset by a decrease in Activase® sales. The decrease in total product sales in 1996 compared to 1995 primarily resulted from the license 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



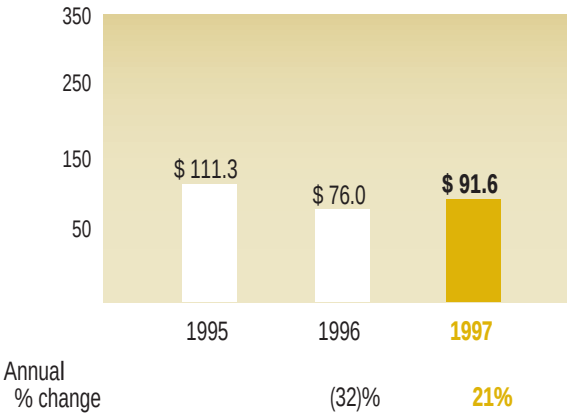
Protropin, Nutropin and Nutropin AQ



Activase: Total net sales of Activase in 1997 decreased primarily due to a new competitive thrombolytic agent, Retavase®. Activase's market share fell to approximately 71% at the end of 1997 from approximately 80% at the end of 1996 and from approximately 75% at the end of 1995. Activase sales decreased in 1996 compared to 1995 primarily due to the impact of not having Canadian customer sales in 1996 as a result of the license agreement with Roche and the decline in the overall size of the U.S. thrombolytic market. Activase sales to Canadian customers were $12.7 million in 1995. The market size decrease was approximately 6% in 1996. This 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 March 1997, results from the GUSTO III clinical trial, which involved a head-to-head comparison of Activase to Retavase, failed to demonstrate that Retavase was superior over Activase, which was the endpoint that the trial was designed to assess. 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 (blood clots in the brain). Activase is the first therapy to be indicated for the acute treatment of stroke.

Protropin, Nutropin and Nutropin AQ: Net sales of the Company's three growth hormone products—Protropin® (somatrem for injection), Nutropin® [somatropin (rDNA origin) for injection] and Nutropin AQ® [somatropin (rDNA origin) injection] liquid formulation—increased slightly in 1997 compared to 1996 and 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 for treatment of children with growth hormone inadequacy. 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 products. In the first quarter of 1997, three of those companies, Serono Laboratories, Inc., Novo Nordisk A/S (Novo) and Pharmacia & Upjohn (P&U) began selling their growth hormone products in the U.S. market. In addition, three of the Company's competitors have received approval to market their existing human growth hormone products for additional indications. In December 1997, the Company received clearance to market Nutropin and Nutropin AQ for the treatment of growth hormone inadequacy in adults. In December 1996 and January 1997, the Company received clearance from the FDA to market Nutropin and Nutropin AQ, respectively, for the treatment of growth inadequacy associated with Turner syndrome.

Pulmozyme



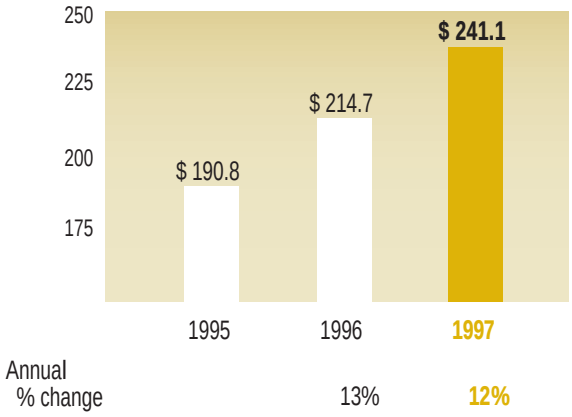
Pulmozyme: Net sales of Pulmozyme were higher in 1997 primarily due to continued penetration in the moderate and early cystic fibrosis (CF) patient populations as well as from variations in customer ordering patterns for U.S. sales. The decrease in 1996 compared to 1995 occurred primarily as a result of the license 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. In November 1996, Pulmozyme was cleared for marketing by the FDA for the management of CF patients with advanced disease, a condition that affects approximately 500 patients in the U.S.

				Annual % Change	
	1997	1996	1995	**97/96**	96/95
Rituxan	**$ 5.5**	—	—	**—**	—
Actimmune	**$ 3.5**	$ 4.5	$ 3.6	**(22)%**	25%

Rituxan: Rituxan is marketed in the U.S. for the treatment of relapsed or refractory low-grade or follicular, CD20-positive B-cell non-Hodgkin's lymphoma (B-cell NHL), a cancer of the immune system. In late November 1997, Rituxan was cleared for marketing in the U.S. by the FDA. B-cell NHL affects approximately 250,000 people in the U.S. of which one-half are follicular or low-grade lymphoma patients. A portion of these patients will have multiple relapses and may be eligible for Rituxan therapy. The Company launched Rituxan on December 16, 1997, and recorded initial sales of $5.5 million. However, not enough time has passed for these figures to be indicative of the future trend of Rituxan sales. Rituxan was co-developed by the Company and IDEC Pharmaceuticals Corporation (IDEC), from whom the Company licenses Rituxan, and is the first monoclonal antibody approved to treat cancer. IDEC and the Company are jointly promoting Rituxan in the U.S. and share responsibility for the manufacturing of the product. HLR is responsible for marketing Rituxan in the rest of the world, excluding Japan.

Actimmune: Actimmune® is approved in the U.S. for the treatment of chronic granulomatous disease, a rare, inherited disorder of the immune system which affects an estimated 250 to 400 Americans.

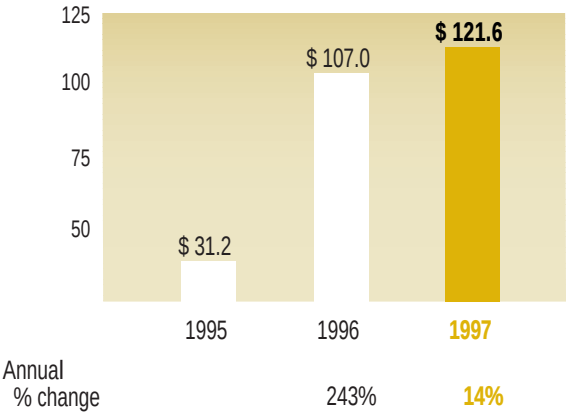
Royalties



The Company receives royalty payments from HLR from its sales of the Company's products outside of the U.S. under the license agreement, and receives royalties from other licensees and HLR from the sales of various other health care products. Total royalties in 1997 increased over 1996 primarily due to increased licensee sales from various licensees. Royalties in 1996 increased over 1995 primarily due to new royalties from HLR in conjunction with the license agreement, as well as higher income from existing licensees due to increased licensee sales. Royalty revenue under the license agreement was $17.0 million in 1996 and $1.9 million in 1995. All other royalty revenue from HLR in 1996 and 1995, totaled $9.2 million and $10.6 million, respectively. Royalties in 1995 include $30.0 million of royalty revenue related 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) to hedge these royalty cash flows. All options expire within the next three years. See below for discussion of market risks related to these financial instruments.

Contract and Other

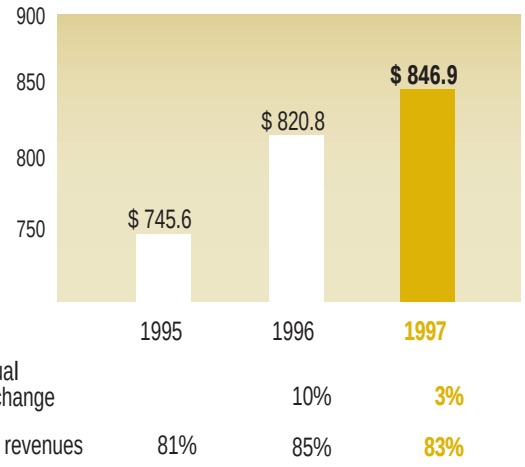


Contract and other revenues were higher in 1997 compared to 1996 primarily due to $30.9 million from Sumitomo Pharmaceuticals Co., Ltd. (Sumitomo) and P&U for strategic alliances and $11.7 million of gains from the sale of biotechnology equity securities in 1997. These increases were partly offset by higher revenues from HLR in 1996. As part of the strategic alliance with Sumitomo, the Company has agreed to provide Sumitomo exclusive rights to develop, import and distribute in Japan, Nutropin AQ and ProLease®, sustained release growth hormone. In its alliance with P&U, in exchange for development costs, fees and, upon regulatory approval, royalties, the Company agreed to provide P&U exclusive worldwide rights for thrombopoietin (TPO) which is in Phase II trials for potential use in treating patients with complications of cancer chemotherapy. P&U and the Company will jointly develop TPO for one indication; however, the Company has no marketing rights for this indication. Contract and other revenues increased in 1996 from 1995 due to contract revenue from HLR for the exercises of their options under the license agreement with respect to the development of three projects—Rituxan, insulin-like growth factor (IGF-I) and nerve growth factor (NGF). Development of IGF-I was subsequently terminated. The Company recorded non-recurring contract revenues of $44.7 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 $67.6 million in 1997, $50.6 million in 1996 and $13.4 million in 1995.

				Annual % Change	
Interest Income	**1997**	1996	1995	**97/96**	96/95
Interest income	**$ 69.1**	$ 64.2	$ 60.5	**8%**	6%

Interest income increased in 1997 from last year primarily due to an increase in the average yield on the investment portfolio and a larger investment portfolio. The increase in 1996 compared to 1995 was due to a larger investment portfolio. The Company enters into interest rate swaps (swaps) as part of its overall strategy of managing the duration of its investment portfolio. See below for discussion of market risks related to these swaps and also the *Financial Instruments* note in the *Notes to Consolidated Financial Statements*.

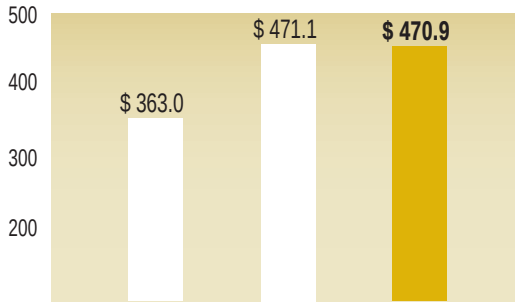
Total Costs and Expenses



				Annual % Change	
Cost of Sales	**1997**	1996	1995	**97/96**	96/95
Cost of sales	**$ 102.5**	$ 104.5	$ 97.9	**(2)%**	7%
% of product sales	**18%**	18%	15%		

Cost of sales as a percent of product sales was 18% in 1997 which was comparable to 1996, but 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 and 1995, reserves of $3.6 million and $3.7 million, respectively, included in cost of sales, were provided for expected expirations of certain inventories. In 1997, such reserves were immaterial.

Research and Development

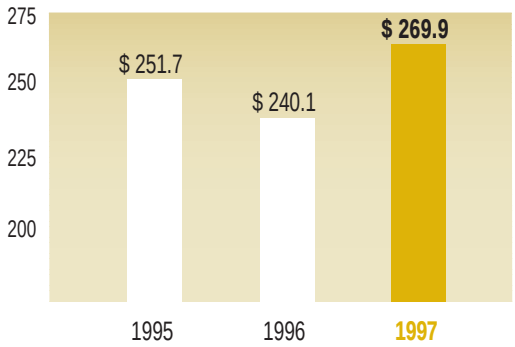


Annual % change		30%	**0%**
% of revenues	40%	49%	**46%**

Research and Development (R&D) expenses in 1997 were flat compared to 1996. R&D as a percentage of revenues decreased to 46% in 1997 from 49% in 1996. This percentage decrease from 1996 reflects increases in revenues and continuing efforts towards disciplined spending in R&D. R&D expenses increased 30% in 1996 compared to 1995 due to continued late-stage clinical testing of products and new development projects.

To gain additional access to potential new products and technologies, including acquiring the equity and convertible debt of, and to utilize other companies to help develop the Company's potential new products, the Company has established strategic alliances with 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



Annual % change		(5)%	**12%**
% of revenues	27%	25%	**27%**

Marketing, general and administrative (MG&A) expenses increased in 1997 primarily due to increased marketing and sales (M&S) expenses in the oncology area, defending Activase against new competition and launching a new indication, growth hormone deficiency in adults, for Nutropin and Nutropin AQ. In addition, there was an increase in general and administrative expenses due to higher royalty expense. MG&A expenses in 1996 decreased from 1995 primarily due to the closure of the Company's European and Canadian operations in conjunction with the license agreement.

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.

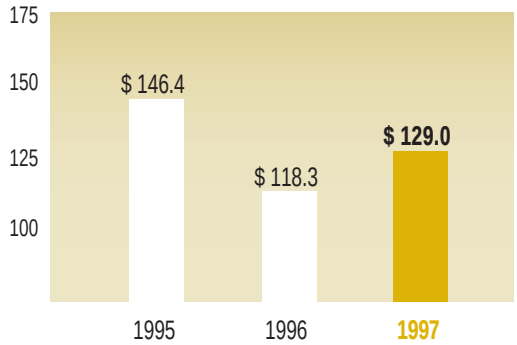
				Annual % Change	
Interest Expense	**1997**	1996	1995	**97/96**	96/95
Interest expense	**$ 3.6**	$ 5.1	$ 8.0	**(29)%**	(36)%

Interest expense declined in 1997 over 1996 due to higher capitalized interest resulting from an increase in construction projects. Interest expense in 1997, 1996 and 1995, 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	**1997**	1996	1995
Income before taxes	**$ 169.8**	$ 147.9	$ 172.2
Income tax provision	**40.8**	29.6	25.8
Effective tax rate	**24%**	20%	15%

Increases in the effective tax rate for 1997 over 1996 and 1996 over 1995 are attributable to proportionally decreased realization of previously reserved deferred tax assets. The valuation allowance for deferred tax assets was fully realized in 1996, with the exception of the portion attributable to the realization of tax benefits on stock option deductions which will be credited to additional paid-in-capital when realized.

Net Income



Annual % change		(19)%	**9%**
Earnings per share:			
Basic	$ 1.24	$ 0.98	**$ 1.05**
Diluted	$ 1.20	$ 0.95	**$ 1.02**

Net income in 1997 increased over 1996 primarily due to higher royalties and contract and other revenues partly offset by higher MG&A expenses. 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.

Liquidity and Capital Resources	**1997**	1996	1995
Cash, cash equivalents, short-term investments and long-term marketable debt and equity securities	**$ 1,286.5**	$ 1,159.1	$ 1,096.8
Working capital	**904.4**	705.1	812.0
Cash provided by (used in):			
Operating activities	**118.3**	139.7	133.9
Investing activities	**(168.4)**	(141.7)	(117.7)
Financing activities	**87.3**	72.2	54.1
Capital expenditures (included in investing activities above)	**(154.9)**	(141.8)	(70.2)
Current ratio	**4.1:1**	3.8:1	4.5:1

Cash generated from operations, income from investments and proceeds from stock issuances were used to purchase marketable securities and make capital additions in 1997.

Capital expenditures in 1997 primarily included building improvements to existing manufacturing and office facilities and production systems. In 1996, capital expenditures primarily included building and land purchases and improvements to existing manufacturing and office facilities. In 1995, the Company entered into an arrangement with a lessor, which qualifies as an operating lease, for a new manufacturing facility that 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 these and any other 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.

Product Sales: The Company's product sales may vary from period to period for several reasons including, but not limited to: the overall competitive environment for the Company's products, the amount of sales to customers in the U.S., the amount and timing of the Company's sales to HLR, the timing and volume of bulk shipments to licensees, the availability of third-party reimbursements for the cost of therapy, the effectiveness and safety of the products, the rate of adoption and use of the Company's products for approved indications and additional indications, and the potential introduction of additional new products and indications for existing products in 1998 and beyond.

Competition: The Company faces growing competition in two of its therapeutic markets. Activase lost market share and is expected to lose additional market share in the thrombolytic market to Retavase, and such adverse effect on sales could be material. Boehringer Mannheim (BM) manufactures and markets Retavase. Recently, Centocor, Inc. announced that it was purchasing the U.S. and Canadian rights to Retavase from BM and will promote and sell the product in the U.S. Retavase received FDA approval in October 1996 for the treatment of acute myocardial infarction (AMI). In addition, there is an increasing use of angioplasty in lieu of thrombolytic therapy for the treatment of AMI which is expected to continue. In the growth hormone market, the Company continues to face increased competition from five other companies with growth hormone products. Three of these competitors have also 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, Nutropin and Nutropin AQ and such effect could be material.

Other competitive factors affecting the Company's product 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 degree of patent protection afforded to particular products, the outcome of litigation involving the Company's patents and patents of competing companies for products and processes related to production and formulation of those products, the increasing use and development of alternate therapies, and the rate of market penetration by competing products.

Royalty and Contract Revenues: Royalty and contract revenues in future periods could vary significantly from 1997 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 and other licensees' sales of licensed products; the expiration of royalties from Lilly in 1998 for its sales of insulin which contribute substantially to current royalty revenues; fluctuations in foreign currency exchange rates; the initiation of other new contractual arrangements with other companies; the timing of non-U.S. approvals, if any, for products licensed to HLR; whether and when contract benchmarks are achieved; and the conclusion of existing arrangements with other companies and HLR.

R&D: The Company intends to continue to develop new products and is committed to aggressive R&D investment. 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; they may fail to receive necessary regulatory approvals; they may turn out to be uneconomical because of manufacturing costs or other factors; or they 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.

The Company currently has several products in late-stage clinical testing and anticipates that its R&D expenses will continue at a high percentage of revenues over the short-term. Over the long-term, however, as revenues increase, R&D as a percent of revenues should decrease to the 20 to 25% range. 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, in-licensing activities, including the timing and amount of related development funding or milestone payments, and future levels of revenues.

As part of the Company and HLR's agreed upon changes to the license agreement, HLR has assumed development of Xubix on its own. As a result, the Company will not be incurring future Xubix related R&D costs unless it decides to opt-in on the development of this product. Such costs, net of amounts reimbursed by HLR, were approximately $4.6 million for 1997.

In September 1997, the Company decided to discontinue development of IGF-I in Type I and Type II diabetes mellitus. As a result, the Company will not be incurring future IGF-I related R&D costs, net of amounts reimbursed by HLR, which were approximately $16.1 million for 1997.

In addition, the Company announced in early October 1997 that it opted-out of development and returned to IDEC the Company's marketing rights for IDEC-Y2B8, a radioimmunotherapy under investigation for the treatment of relapsed or refractory B-cell NHL. As a result, the Company discontinued its R&D funding to IDEC for the development of IDEC-Y2B8. Such funding for 1997 was immaterial.

Income Tax Provision: The Company expects its effective tax rate to increase from the current rate of 24% to approximately 28% in 1998 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.

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 has in the past, is currently and may in the future, be involved in 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 at a material cost 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 R&D 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.

Year 2000 Expenses: Some of the Company's older computer software programs were written using two digit fields rather than four digit fields to define the applicable year (i.e., "98" in the computer code refers to the year "1998"). As a result, time-sensitive functions of those software programs may misinterpret dates after January 1, 2000, to refer to the twentieth century rather than the twenty-first century (i.e., "02" could be interpreted as "1902" rather than "2002"). This could cause system failures or miscalculations resulting in inaccuracies in computer output or disruptions of operations, including, among other things, inaccurate processing of financial information and/or temporary inabilities to process transactions, manufacture products, or engage in similar normal business activities.

The Company has developed plans to address the potential exposures related to the impact on its computer systems for the Year 2000 and beyond. An assessment of key financial, informational and operational systems to determine if they are Year 2000 compliant has been completed. Detailed plans and timelines for implementation and testing of modifications and corrections to the computer systems have been or are in process of being developed to address computer systems problems as required by December 31, 1999. The Company believes that with these detailed plans and completed modifications, the Year 2000 issue will not pose significant operational problems for its computer systems. However, if such modifications and conversions are not made, or are not completed in a timely fashion, the Year 2000 issue could have a material impact on the operations of the Company.

The total cost of the Year 2000 systems assessments and conversions is funded through operating cash flows and the Company is expensing these costs. The financial impact of

making the required systems changes cannot be known precisely at this time, but is not expected to be material to the Company's financial position, results of operations or cash flows.

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. In addition, the Company believes it could access additional funds from the capital and debt markets. 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, in-licensing activities, including the timing and amount of related development funding or milestone payments, and capital expenditures.

Roche Holdings, Inc.: At December 31, 1997, Roche held approximately 66.9% of the Company's outstanding common equity. The Company expects to continue to have material transactions with Roche, including royalty and contract revenues, product sales and joint product development costs.

Market Risk: The Company is exposed to market risk, including changes to interest rates, foreign currency exchange rates and equity investment prices. To reduce the volatility relating to these exposures, the Company enters into various derivative transactions pursuant to the Company's investment and risk management policies and procedures in areas such as hedging and counterparty exposure practices. The Company does not use derivatives for speculative purposes.

A discussion of the Company's accounting policies for financial instruments and further disclosures relating to financial instruments is included in the *Description of Business and Significant Accounting Policies* and the *Financial Instruments* notes in the *Notes to Consolidated Financial Statements*.

The Company maintains risk management control systems to monitor the risks associated with interest rates, foreign currency exchange rates and equity investment price changes, and its derivative and financial instrument positions. The risk management control systems use analytical techniques, including sensitivity analysis, and market values. Though the Company intends for its risk management control systems to be comprehensive, there are inherent risks which may only be partially offset by the Company's hedging programs should there be unfavorable movements in interest rates, foreign currency exchange rates or equity investment prices.

The estimated exposures discussed below are intended to measure the maximum amount the Company could lose from adverse market movements in interest rates, foreign currency exchange rates and equity investment prices, given a specified confidence level, over a given period of time. Loss is defined in the value at risk estimation as fair market value loss. The exposures to interest rate, foreign currency exchange rate and equity investment price changes are calculated based on proprietary modeling techniques from a Monte Carlo simulation value at risk model (value at risk model) using a 30-day holding period and a 95% confidence level. The value at risk model assumes non-linear financial returns and generates potential paths various market prices could take and tracks the hypothetical performance of a portfolio under each scenario to approximate its financial return. The value at risk model takes into account correlations and diversification across market factors, including interest rates, foreign currencies and equity prices. Market volatilities and correlations are based on JP Morgan Riskmetrics™ dataset as of December 31, 1997.

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, convertible equity loans and long-term investments. To mitigate the impact of fluctuations in U.S. interest rates, the Company may enter into swap transactions which involve the receipt of fixed rate interest and the payment of floating rate interest without the exchange of the underlying principal. By investing the Company's cash in an amount equal to the notional amount of the swap contract, with a maturity date equal to the maturity date of the floating rate obligation, the Company hedges itself from any potential earnings impact due to changes in interest rates.

Based on the Company's overall interest rate exposure at December 31, 1997, including derivative and other interest rate sensitive instruments, a near-term change in interest rates, within a 95% confidence level based on historical

interest rate movements, would not materially affect the fair value of interest rate sensitive instruments.

Foreign Currency Exchange Rates—The Company receives royalty revenues from licensees selling products in 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 licensed products are sold. The Company is exposed to changes in exchange rates in Europe, Asia and Canada. The Company's exposure to foreign exchange rates primarily exists with the German Mark. 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. In addition, as part of its overall investment strategy, the Company has three portfolios that are managed by external money managers and these portfolios consist primarily of non-dollar denominated investments. As a result, the Company is exposed to changes in exchange rates of the countries in which these non-dollar denominated investments are made.

To mitigate this risk, the Company hedges certain of its anticipated revenues by purchasing option contracts with expiration dates and amounts of currency that are based on 40%–90% of probable future revenues so that the potential 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 duration of these options is generally one to four years. The Company may also enter into foreign currency forward contracts (forward contracts) to lock in the dollar value of a portion of these anticipated revenues. The duration of these forward contracts is generally less than one year. Also, to hedge the non-dollar denominated investments in the externally managed portfolios, the external money managers also enter into forward contracts.

Based on the Company's overall currency rate exposure at December 31, 1997, including derivative and other foreign currency sensitive instruments, a near-term change in currency rates within a 95% confidence level based on historical currency rate movements, would not materially affect the fair value of foreign currency sensitive investments.

Equity Investment Securities—As part of its strategic alliance efforts, the Company invests in equity instruments of biotechnology companies 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). In addition, as part of its strategic alliance efforts, the Company has issued interest bearing convertible equity loans.

Based on the Company's overall exposure to fluctuations from market value changes in equity prices at December 31, 1997, a near-term change in equity prices within a 95% confidence level based on historic volatilities could result in a potential loss in fair value of the equity securities portfolio of $11.3 million.

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 42 to 60, 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 61.

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. The Audit Committee of the Board of Directors is composed of four non-management directors who meet regularly with management and the independent auditors and the general auditor, jointly and separately, to review the adequacy of internal accounting controls and auditing and financial reporting matters to ascertain that each is properly discharging its responsibilities.

/s/ Arthur D. Levinson	/s/ Louis J. Lavigne, Jr.	/s/ Bradford S. Goodwin
Arthur D. Levinson, Ph.D. President and Chief Executive Officer	Louis J. Lavigne, Jr. Executive Vice President and Chief Financial Officer	Bradford S. Goodwin Vice President—Finance

CONSOLIDATED STATEMENTS OF INCOME

(thousands, except per share amounts)

YEAR ENDED DECEMBER 31	1997	1996	1995
Revenues			
Product sales (including amounts from related parties: 1997—$17,396; 1996—$13,216; 1995—$1,776)	$ 584,889	$ 582,829	$ 635,263
Royalties (including amounts from related parties: 1997—$25,362; 1996—$26,240; 1995—$12,492)	241,112	214,702	190,811
Contract and other (including amounts from related parties: 1997—$67,596; 1996—$95,299; 1995—$13,448)	121,587	107,037	31,209
Interest	69,160	64,110	60,562
Total revenues	1,016,748	968,678	917,845
Costs and expenses			
Cost of sales (including amounts from related parties: 1997—$14,348; 1996—$10,900; 1995—$6,963)	102,536	104,527	97,930
Research and development (including contract related: 1997—$67,596; 1996—$50,586; 1995—$17,124)	470,923	471,143	363,049
Marketing, general and administrative	269,852	240,063	251,653
Special charge (primarily merger related)	—	—	25,000
Interest	3,642	5,010	7,940
Total costs and expenses	846,953	820,743	745,572
Income before taxes	169,795	147,935	172,273
Income tax provision	40,751	29,587	25,841
Net income	$ 129,044	$ 118,348	$ 146,432
Earnings per share:			
Basic	$ 1.05	$ 0.98	$ 1.24
Diluted	$ 1.02	$ 0.95	$ 1.20
Weighted average shares used to compute diluted earnings per share	126,397	123,969	121,748

See Notes to Consolidated Financial Statements.

Consolidated Statements of Cash Flows

(thousands)

YEAR ENDED DECEMBER 31	1997	Increase in Cash and Cash Equivalents 1996	1995
Cash flows from operating activities:			
Net income	$ 129,044	$ 118,348	$ 146,432
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	65,533	62,124	58,421
Deferred income taxes	19,660	(34,021)	(22,655)
Gain on sales of securities available-for-sale	(13,203)	(1,010)	(7,589)
Loss on sales of securities available-for-sale	2,096	663	157
Writedown of securities available-for-sale	4,000	—	6,609
Loss on fixed asset dispositions (including merger-related in 1995)	318	5,309	1,032
Other	—	—	(234)
Changes in assets and liabilities:			
Net cash flow from trading securities	(109,132)	(8,184)	(50,014)
Receivables and other current assets	11,194	(30,416)	(28,446)
Inventories	(24,083)	1,705	9,552
Accounts payable, other current liabilities and other long-term liabilities	32,897	25,153	20,682
Net cash provided by operating activities	118,324	139,671	133,947
Cash flows from investing activities:			
Purchases of securities held-to-maturity	(304,932)	(634,124)	(682,396)
Proceeds from maturities of securities held-to-maturity	455,317	772,922	924,345
Purchases of securities available-for-sale	(512,727)	(304,806)	(353,118)
Proceeds from sales of securities available-for-sale	410,395	182,564	101,591
Purchases of nonmarketable equity securities	—	(9,323)	—
Capital expenditures	(154,902)	(141,837)	(70,166)
Change in other assets	(61,529)	(7,046)	(37,948)
Net cash used in investing activities	(168,378)	(141,650)	(117,692)
Cash flows from financing activities:			
Stock issuances	87,259	72,558	54,946
Reduction in long-term debt, including current portion	—	(358)	(871)
Net cash provided by financing activities	87,259	72,200	54,075
Increase in cash and cash equivalents	37,205	70,221	70,330
Cash and cash equivalents at beginning of year	207,264	137,043	66,713
Cash and cash equivalents at end of year	$ 244,469	$ 207,264	$ 137,043
Supplemental cash flow data:			
Cash paid during the year for:			
Interest, net of portion capitalized	$ 3,642	$ 5,010	$ 7,917
Income taxes	15,474	52,243	44,699

See Notes to Consolidated Financials Statements.

CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except par value)

DECEMBER 31	1997	1996
Assets:		
Current assets:		
Cash and cash equivalents	$ 244,469	$ 207,264
Short-term investments	588,853	415,900
Accounts receivable—trade (net of allowances of: 1997—$8,826; 1996—$4,110)	71,415	77,785
Accounts receivable—other (net of allowances of: 1997—$5,709; 1996—$3,759)	73,444	86,450
Accounts receivable—related party	44,386	33,377
Inventories	116,026	91,943
Prepaid expenses and other current assets	55,325	42,365
Total current assets	1,193,918	955,084
Long-term marketable securities	453,188	535,916
Property, plant and equipment, net	683,304	586,167
Other assets	177,202	149,205
Total assets	$ 2,507,612	$ 2,226,372
Liabilities and stockholders' equity:		
Current liabilities:		
Accounts payable	$ 48,992	$ 45,501
Income taxes payable	40,293	18,530
Accrued liabilities—related party	15,427	9,908
Other accrued liabilities	184,845	176,012
Total current liabilities	289,557	249,951
Long-term debt	150,000	150,000
Other long-term liabilities	36,830	25,362
Total liabilities	476,387	425,313
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.02 par value; authorized: 100,000,000 shares; none issued	—	—
Special common stock, $0.02 par value; authorized: 100,000,000 shares; outstanding: 1997—47,606,785; 1996—44,805,755	952	896
Common stock, $0.02 par value; authorized: 200,000,000 shares; outstanding: 1997—76,621,009; 1996—76,621,009	1,532	1,532
Additional paid-in capital	1,463,768	1,362,585
Retained earnings (since October 1, 1987 quasi-reorganization)	511,141	382,097
Net unrealized gain on securities available-for-sale	53,832	53,949
Total stockholders' equity	2,031,225	1,801,059
Total liabilities and stockholders' equity	$ 2,507,612	$ 2,226,372

See Notes to Consolidated Financials Statements.

YEAR ENDED DECEMBER 31	1997		1996		1995	
	Shares	Amount	Shares	Amount	Shares	Amount
Special common stock						
Beginning balance	44,806	$ 896	42,647	$ 853	—	—
Issuance of stock upon exercise of options and warrants	2,801	56	2,159	43	298	$ 6
Conversion of common stock to special common stock	—	—	—	—	42,349	847
Ending balance	47,607	952	44,806	896	42,647	853
Redeemable common stock						
Beginning balance	—	—	—	—	50,106	1,002
Issuance of stock upon exercise of options and warrants	—	—	—	—	679	14
Issuance of stock under employee stock plan	—	—	—	—	322	6
Conversion of redeemable common stock to common stock	—	—	—	—	(51,107)	(1,022)
Ending balance	—	—	—	—	—	—
Common stock						
Beginning balance	76,621	1,532	76,621	1,532	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	76,621	1,532
Additional paid-in capital						
Beginning balance		1,362,585		1,281,640		1,207,720
Issuance of stock upon exercise of options and warrants		68,346		55,103		37,087
Issuance of stock under employee stock plan		18,857		17,412		17,819
Income tax benefits realized from employee stock option exercises		13,980		8,430		7,204
Tax benefits arising prior to quasi-reorganization		—		—		11,810
Ending balance		1,463,768		1,362,585		1,281,640
Retained earnings						
Beginning balance		382,097		263,749		129,127
Net income		129,044		118,348		146,432
Tax benefits arising prior to quasi-reorganization		—		—		(11,810)
Ending balance		511,141		382,097		263,749
Net unrealized gain on securities						
Beginning balance		53,949		54,273		9,592
Net unrealized (loss) gain on securities available-for-sale		(117)		(324)		44,681
Ending balance		53,832		53,949		54,273
Total stockholders' equity		$ 2,031,225		$ 1,801,059		$ 1,602,047

See Notes to Consolidated Financials 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 seven 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 U.S. Of these seven products, HLR has the right to sell six in Canada and two 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. 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 interest bearing convertible debt of other biotechnology companies. Marketable equity securities are accounted for as available-for-sale investment securities as described below. Nonmarketable equity securities and convertible debt are carried at cost. At December 31, 1997 and 1996, the Company had investments of $55.2 million and $15.7 million, respectively, in convertible debt of various 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 adjustments 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, 1997, 1996 and 1995 were $32.9 million, $28.8 million and $22.1 million, respectively. Capitalized interest on construction-in-progress of $3.9 million in 1997, $2.5 million in 1996 and $1.5 million in 1995 is included in property, plant and equipment.

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

	1997	1996
At cost:		
Land	$ 69,010	$ 67,619
Buildings	339,708	297,888
Equipment	494,874	428,738
Leasehold improvements	3,270	12,314
Construction in progress	152,533	99,708
	1,059,395	906,267
Less: accumulated depreciation	376,091	320,100
Net property, plant and equipment	$ 683,304	$ 586,167

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 $39.8 million, $36.0 million, and $30.2 million in 1997, 1996, and 1995, respectively, and are classified in marketing, general and administrative expenses.

Advertising Expenses: The Company expenses the costs of advertising, which also includes promotional expenses, as incurred. Advertising expenses for the years ended December 31, 1997, 1996, and 1995, were $41.8 million, $28.0 million, and $29.2 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.

Earnings Per Share: Basic earnings per share is computed based on the weighted average number of shares of the Company's special common stock and common stock. Diluted earnings 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. See also the *New Accounting Standards* section below.

Financial Instruments: The Company uses external money managers to manage part of its investment portfolio that is held for trading purposes. This externally managed investment portfolio consists entirely of debt securities. When the money managers purchase securities denominated in a foreign currency, they enter into foreign currency forward contracts which are recorded at fair value with the related gain or loss recorded in interest income.

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. Options are generally terminated, or offsetting contracts are entered into, upon determination that purchased options no longer qualify as a hedge or are determined to exceed probable anticipated net foreign revenues. The realized gains and

losses are recorded as a component of other revenues. For early termination of options that qualify as hedges, the gain or loss on termination will be deferred through the original term of the option and then recognized as a component of the hedged revenues. Changes in the fair value of hedging instruments that qualify as a hedge are not recognized and changes in the fair value of instruments that do not qualify as a hedge would be recognized in other revenues.

The Company may also enter 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 other revenues if they occur.

Interest rate swaps (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. The accrued net settlement amounts on swaps are reflected on the balance sheet as other accounts receivable or other accrued liabilities. 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. For early termination of swaps where the underlying asset is not sold, the amount of the terminated swap is deferred and amortized over the remaining life of the original swap. For early termination of swaps with the corresponding termination or sale of the underlying asset, the amounts are recognized through interest income. Changes in the fair value of swap hedging instruments that qualify as a hedge are not recognized and changes in the fair value of swap instruments that do not qualify as a hedge would be recognized in other income.

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 short-term or long-term other assets or liabilities. Equity collar instruments that do not qualify for hedge accounting and early termination of these instruments with the sale of the underlying security would be recognized through earnings. For early termination of these instruments without the sale of the underlying security, the time value would be recognized through earnings and the intrinsic value will adjust the cost basis of the underlying security.

401(k) Plan: The Company's 401(k) Plan (Plan) covers substantially all of its 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 1997, 1996, and 1995, the Company provided $6.7 million, $6.1 million, and $5.6 million, respectively, for the Company match under the Plan.

New Accounting Standards: On December 31, 1997, the Company adopted Statement of Financial Accounting Standards (FAS) 128, *Earnings per Share*. As a result, the Company has changed the method used to compute earnings per share (EPS) and has restated all prior periods as required by FAS 128. The adoption of FAS 128 did not have a material impact on the Company's results of operations. The following is a reconciliation of the numerator and denominators of the basic and diluted EPS computations for the years ended December 31, 1997, 1996 and 1995 (in thousands).

	1997	1996	1995
Numerator:			
Net income—numerator for basic and diluted EPS:	$ 129,044	$ 118,348	$ 146,432
Denominator:			
Denominator for basic EPS—weighted-average shares	123,042	120,623	118,271
Effect of dilutive securities:			
Stock options	3,355	3,325	3,440
Warrants	—	21	37
Denominator for diluted EPS—adjusted weighted-average shares and assumed conversions	126,397	123,969	121,748

Options to purchase 103,700 shares of common stock at $59.00 per share, 5,251,665 shares of common stock at $54.25 per share and 17,500 shares of common stock at $51.63 per share were outstanding during 1997, 1996 and 1995, respectively, but were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares and therefore, the effect would be anti-dilutive. See *Capital Stock* note for information on option expiration dates.

During 1997, 1996 and 1995, the Company had convertible subordinated debentures which are convertible to 1,013,514 shares of common stock, but were not included in the computation of diluted earnings per share because they were anti-dilutive. See the *Long-Term Debt* note for additional information on the convertible subordinated debentures.

The Financial Accounting Standards Board also issued FAS 130, *Reporting Comprehensive Income*, and FAS 131, *Disclosures about Segments of an Enterprise and Related Information*, in June 1997, which requires additional disclosures to be adopted on December 31, 1998. Under FAS 130, the Company is required to display comprehensive income and its components as part of the Company's full set of financial statements. FAS 131 requires that the Company report financial and descriptive information about its reportable operating segments. The Company is evaluating the impact on its disclosures, if any.

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, 1997 and 1996 are summarized below (in thousands):

	1997	1996
Raw materials and supplies	$ 17,544	$ 17,971
Work in process	84,831	61,368
Finished goods	13,651	12,604
Total	$ 116,026	$ 91,943

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 11% of the Company's total revenues in 1997, 14% in 1996, and less than 10% in 1995. 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 in each of the last three years. Caremark, Inc., which accounted for 14%, 15% and 18% of total revenues in 1997, 1996 and 1995, respectively, distributes Protropin®, Nutropin®, Nutropin AQ®, 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% in 1997 and 1996 and 11% in 1995.

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

	1997	1996	1995
Europe	$ 139.5	$ 146.4	$ 112.0
Asia	34.2	17.8	23.6
Canada	11.7	11.1	25.0

The Company currently sells primarily to distributors and hospitals throughout the U.S., performs ongoing credit evaluations of its customers' financial condition and extends credit without collateral. In 1997, 1996 and 1995, the Company did not record any material additions to, or losses against, its provision for doubtful accounts.

RESEARCH AND DEVELOPMENT ARRRANGEMENTS

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 achieving 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 *Relationship with Roche Holdings, Inc.* note, 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 (in thousands):

	1997	1996	1995
Current:			
Federal	$ 30,617	$ 61,502	$ 43,997
State	432	2,104	4,467
Foreign	2	2	32
Total current	31,051	63,608	48,496
Deferred:			
Federal	23,799	(34,021)	(12,319)
State	(14,099)	—	(10,336)
Total deferred	9,700	(34,021)	(22,655)
Total income tax provision	$ 40,751	$ 29,587	$ 25,841

Actual current tax liabilities are lower than reflected above by $14.0 million, $8.4 million and $7.2 million in 1997, 1996 and 1995, respectively, due to employee stock option related tax benefits which were credited to stockholders' equity. The deferred provision excludes activity in the net deferred tax assets relating to appreciation in securities available-for-sale in the amount of $10.0 million.

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

	1997 Amount (thousands)	Tax Rate		
		1997	1996	1995
Tax at U.S. statutory rate	$ 59,428	35.0%	35.0%	35.0%
R&D credits realized	(19,298)	(11.4)	(3.0)	(15.9)
Tax benefit of realized gains on securities available-for-sale	(6,517)	(3.8)	—	—
Adjustment of deferred tax assets valuation allowance	—	—	(15.3)	(13.1)
Foreign losses (benefited) not benefited	—	—	(3.4)	2.8
State taxes	3,871	2.3	2.3	2.6
Other	3,267	1.9	4.4	3.6
Income tax provision	$ 40,751	24.0%	20.0%	15.0%

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

	1997	1996
Deferred tax liabilities:		
Depreciation	$ 55,137	$ 58,842
Unrealized gain on sale of securities available-for-sale	25,086	21,017
Other	2,173	10,543
Total deferred tax liabilities	82,396	90,402
Deferred tax assets:		
Capitalized R&D costs	33,950	34,280
Federal credit carryforwards	100,400	111,400
Expenses not currently deductible	35,000	38,368
State credit carryforwards	28,365	26,710
Other	4,398	6,340
Total deferred tax assets	202,113	217,098
Valuation allowance	(48,508)	(35,827)
Total net deferred tax assets	153,605	181,271
Total net deferred taxes	$ 71,209	$ 90,869

Total tax credit carryforwards of $128.8 million expire in the years 1998 through 2012, except for $43.0 million of alternative minimum tax credits which have no expiration date. The valuation allowance at December 31, 1997, 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 increased by $12.7 million in 1997, decreased by $17.0 million in 1996 and decreased by $31.6 million in 1995. 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, 1997 and 1996 are summarized below. Estimated fair value is based on quoted market prices for these or similar investments.

DECEMBER 31, 1997	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(thousands)		
Total Trading Securities (carried at estimated fair value)	$ 256,428	$ 686	$ (4,487)	$ 252,627
Securities Available-for-sale (carried at estimated fair value):				
Equity securities	$ 46,262	$ 75,796	$ (2,147)	$ 119,911
U.S. Treasury securities and obligations of other U.S. government agencies maturing:				
between 5–10 years	38,330	577	(3)	38,904
Corporate debt securities maturing:				
within 1 year	98,073	51	(8)	98,116
between 1–5 years	98,283	770	(103)	98,950
between 5–10 years	146,921	4,053	—	150,974
Other debt securities maturing:				
within 1 year	40,314	—	(578)	39,736
between 1–5 years	40,323	—	(2,008)	38,315
Total Available-for-sale	$ 508,506	$ 81,247	$ (4,847)	$ 584,906
Securities Held-to-maturity (carried at amortized cost):				
Corporate debt securities maturing:				
within 1 year	$ 193,295	$ 19	—	$ 193,314
Total Held-to-maturity	$ 193,295	$ 19	—	$ 193,314

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
between 1–5 years	103,057	1,299	(209)	104,147
between 5–10 years	113,176	1,001	(2,114)	112,063
Other debt securities maturing:				
within 1 year	46,583	27	—	46,610
between 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
between 5–10 years	30,155	—	$ (777)	29,378
Other debt securities maturing:				
within 1 year	91,664	4	(35)	91,633
between 1–5 years	141,553	576	(27)	142,102
Total Held-to-maturity	$ 340,090	$ 611	$ (839)	$ 339,862

* 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 at December 31, 1996.

The carrying value of all investment securities held at December 31, 1997 and 1996 is summarized below (in thousands):

SECURITY	1997	1996
Trading securities	$ 252,627	$ 143,495
Securities available-for-sale maturing within one year	137,852	97,718
Securities held-to-maturity maturing within one year	193,295	168,382
Accrued interest	5,079	6,305
Total short-term investments	$ 588,853	$ 415,900
Securities available-for-sale maturing between 1–10 years, including equity securities	$ 447,054	$ 357,999
Securities held-to-maturity maturing between 1–10 years	—	171,708
Accrued interest	6,134	6,209
Total long-term marketable securities	$ 453,188	$ 535,916

In 1997, proceeds from the sales of available-for-sale securities totaled $410.4 million; gross realized gains totaled $13.2 million and gross realized losses totaled $2.1 million. 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. The Company recorded charges in 1997 and 1995 of $4.0 million and $6.6 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. In 1996, there were no such write downs.

During the year ended December 31, 1997 and 1996, net unrealized holding losses on trading securities included in net income totaled $3.8 million and $1.0 million, respectively. In 1995, 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 1997, 1996 and 1995.

FINANCIAL INSTRUMENTS

Foreign Currency Instruments: Certain of the Company's revenues are earned outside of the U.S. 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, 1997, the Company had hedged approximately 75% of probable net foreign revenues anticipated within 12 months and between 40% and 75% of its probable net foreign revenues through the year 2000. At December 31, 1997 and 1996, the notional amount of the options totaled $122.9 million and $100.3 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 three years. The fair value of the options is based on exchange rates and market conditions at December 31, 1997 and 1996. At December 31, 1996, the U.S. dollar equivalent of the notional amount of the forward sell contracts was $34.3 million and the forward buy contracts totaled $0.4 million, respectively. All forward contracts were closed out at the end of December 31, 1997.

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 material 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 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 nonperformance 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, 1997 and 1996, was $3.7 million and $6.8 million, respectively. The net carrying amount of the swaps, which reflects the net interest accrued for such swaps, totaled $2.0 million and $2.1 million at December 31, 1997 and 1996, 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, 1997, 1996 and 1995, the weighted average rate received on swaps was 7.57%, 6.71% and 7.29%, respectively, and the weighted average rate paid on swaps was 5.38%, 5.68% and 6.56%, respectively. Net interest income (loss) from swaps, including amortization of net losses on terminated swaps, totaled $3.6 million in 1997, $2.5 million in 1996 and ($0.7) million in 1995.

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, 1997, the notional amount of the put and call options were $33.7 million and $50.1 million, respectively. 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, 1997 and 1996. The fair value is based on market prices of similar agreements. Dollars are in millions.

	Interest Rate Swaps			Short-term Investments		
DECEMBER 31, 1997:	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	9 days	5.65%
Other short-term investments	—			439		
Total	$ 150			$ 589		
DECEMBER 31, 1996:						
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		

* 3- and 6-month LIBOR rates are reset every 3 or 6 months. At December 31, 1997, the 3-month LIBOR rate and the 6-month LIBOR rate were 5.8%. At December 31, 1996, the 3-month LIBOR rate and the 6-month LIBOR rate were 5.6%.

** 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 three external money managers in 1997 and two external money managers in 1996 to manage part of its investment portfolio. Three portfolios in 1997, which had a combined carrying value of $145.1 million at December 31, 1997, and one portfolio in 1996, which had a carrying value of $37.2 million at December 31, 1996, consisted of primarily non-dollar denominated investments. To hedge the non-dollar denominated investments, the money managers enter into forward contracts. The notional amounts of the forward contracts at December 31, 1997 and 1996, were $209.3 million and $41.7 million, respectively. The fair value at December 31, 1997 and 1996, of the forward contracts, totaled $3.3 million and $0.8 million, respectively. The average fair value during 1997 and 1996 totaled $2.1 million and $0.3 million, respectively. Net realized and unrealized trading gains on the portfolio totaled approximately $9.1 million in 1997 and $2.4 million in 1996, respectively, 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, 1997 and 1996, 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 (in thousands):

	1997		1996	
FINANCIAL INSTRUMENT	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets:				
Investment securities (including accrued interest & traded forward contracts)	$ 1,042,041	$ 1,042,060	$ 951,816	$ 951,588
Convertible equity loans	55,248	55,248	15,668	15,668
Purchased foreign exchange put options	3,891	14,468	4,616	7,273
Outstanding interest rate swaps	5,742	165,559	6,757	226,189
Liabilities:				
Long-term debt	150,000	139,500	150,000	139,500
Equity collars	12,161	15,533	1,222	4,892
Outstanding interest rate swaps	3,732	153,732	4,635	214,634

OTHER ACCRUED LIABILITIES

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

	1997	1996
Accrued compensation	$ 44,624	$ 42,716
Accrued clinical and other studies	40,269	39,981
Accrued royalties	30,905	25,098
Accrued marketing and promotion costs	13,369	11,889
Other	55,678	56,328
Total other accrued liabilities	$ 184,845	$ 176,012

LONG-TERM DEBT

The Company's long-term debt as of December 31, 1997 and 1996 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, net of sublease income, at December 31, 1997 are as follows (in thousands):

1998	1999	2000	2001	2002	Thereafter	Total
$ 15,068	15,622	15,196	14,950	14,969	14,759	$ 90,564

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, $11.7 million and $9.5 million for the years 1997, 1996 and 1995, 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 $293.7 million. The Company also is required to maintain certain financial ratios and is limited to the amount of additional debt it can assume.

The Company and CuraGen Corporation (CuraGen) entered into a research collaborative agreement in November 1997, whereby the Company will invest $5.0 million in equity of CuraGen and provide a convertible equity loan to CuraGen of up to $26.0 million. As of December 31, 1997, no amounts have been funded to CuraGen.

In December 1997, the Company and Alteon Inc. entered into a collaborative agreement to develop and market pimagedine, an advanced glycosylation end-product formation inhibitor which Alteon currently has in Phase III clinical trials, to treat kidney disease in diabetic patients. Under the terms of the agreement, the Company licensed pimagedine from Alteon and made an initial equity investment in Alteon stock of $15.0 million and will make additional equity investments of up to $48.0 million to fund development costs for pimagedine. A $16.0 million investment is scheduled for the first quarter of 1998.

Also, in December 1997, the Company and LeukoSite Inc. entered into a collaboration agreement to develop and commercialize LeukoSite's LDP-02, a humanized monoclonal antibody for the potential treatment of inflammatory bowel diseases. Under the terms of the agreement, the Company made a $4.0 million equity investment in LeukoSite and will provide a convertible equity loan for approximately $15.0 million to fund Phase II development costs. Upon successful completion of Phase II, if LeukoSite agrees to fund 25% of Phase III development costs, the Company will provide a second loan to LeukoSite for such funding.

In addition, the Company has entered into research collaborations with companies whereby potential future payments may be due to selective collaborative partners achieving 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 limited partner in the Vector Later-Stage Equity Fund II, L.P. (Vector Fund). The General Partner is Vector Fund Management II, L.L.C., a Delaware limited liability company. The purpose of the Vector Fund is to invest in biotech equity and equity-related securities. Under the terms of the Vector Fund agreement, the Company makes contributions to the capital of the Vector Fund through installments in cash as called by the General Partner. The Company's total commitment to the Vector Fund through September 2003 is $25.0 million, of which $1.0 million was contributed as of December 31, 1997 and another $1.8 million was contributed in January 1998. The Vector Fund will terminate and be dissolved in September 2007.

The Company is a party to various legal proceedings including patent infringement cases involving human growth hormone products and Activase, product liability cases involving Protropin and other matters. In addition, in July 1997, an action was filed in the U.S. District Court for the Northern District of California alleging that the Company's manufacture, use and sale of its Nutropin human growth hormone products infringed a patent (the Goodman Patent) owned by the Regents of the University of California (UC). This action is substantially the same as a previous action filed in 1990 against the Company by UC alleging that the Company's manufacture, use and sale of its Protropin human growth hormone products infringed the Goodman Patent and it has been consolidated with that prior case. The case is expected to commence trial on June 22, 1998. In October 1997, the Company was named, along with several other pharmaceutical companies, in a lawsuit brought by Novo Nordisk A/S (Novo) in the U.S. District Court for the District of New Jersey alleging infringement of a patent held by Novo relating to the Company's manufacture, use and sale of its Nutropin human growth hormone products. Novo seeks to permanently enjoin the Company from the alleged patent infringement and also seeks compensatory and enhanced damages from the Company. In addition, in 1995 the Company received and responded to grand jury document subpoenas from the U.S. District Court for the Northern District of California for documents relating to the Company's past clinical, sales and marketing activities associated with human growth hormone. In February 1997 and February 1998, the Company received grand jury document subpoenas from the same court related to the same subject matter. The government is investigating this matter, and the Company believes that it is a subject of that investigation.

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 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, 1998, the call price is $75.00 per share and increases by $1.50 per share each quarter through the end of the option period on June 30, 1999, on which date the price will be $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 the event of the put, wherein sufficient shares of the Company's special common stock are tendered to result in Roche owning at least 85% of the total outstanding shares of the Company's stock, the Company has in place an Incentive Units Program (Program) which could result in amounts payable to eligible employees. These amounts are based on specific performance benchmarks achieved by the Company during the term of the Program. At December 31, 1997, no such amounts were payable under the Program.

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 (the license agreement). In the second quarter of 1997, the Company and HLR agreed in principle to changes to the license agreement. Key changes to the license agreement are summarized as follows: (1) For future products, HLR may choose to exercise its option either when the Company determines to move a product into development, or at the end of Phase II clinical trials (as in the 1995 agreement). U.S. and European development costs will be shared (discontinuing the distinction regarding location or purpose of studies). (2) If HLR exercises its option at the development determination point, U.S. and European development costs will be shared 50/50. (3) If HLR exercises its option at the end of Phase II clinical trials, HLR will reimburse the Company for 50 percent of any development costs incurred, and subsequent U.S. and European development costs will be shared 75/25, HLR/Genentech. (4) For nerve growth factor (NGF), which HLR has already exercised its option to develop, prospective U.S. and European development costs will be shared 60/40, HLR/Genentech. (5) HLR has assumed development of Xubix™ (the oral IIb/IIIa antagonist) globally on its own. The Company may subsequently opt-in and join development at any time up to the New Drug Application (NDA) filing for the first indication. If the Company does not opt-in, it will receive from HLR a 6.0% royalty on worldwide sales of Xubix.

In general, with respect to the Company's products, HLR pays a royalty of 12.5% until a product reaches $100.0 million in aggregate sales outside of the U.S. on a country-by-country basis, at which time the royalty rate on all sales increases to 15%. In addition, HLR has rights to, and pays the Company 20% royalties on, Canadian sales of the Company's existing products, except Rituxan™ (the C2B8 antibody), and European sales of Pulmozyme and Rituxan. Consequently, in the fourth quarter of 1995, the Company transferred to HLR the rights to sell Pulmozyme exclusively in Canada and Europe and commenced recording royalty revenue from HLR on such sales. The Company supplies its products to HLR, and has agreed to supply its 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 66.9% of the outstanding common equity of the Company as of December 31, 1997.

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 license agreement with respect to the development of three projects —Rituxan, insulin-like growth factor (IGF-I) and NGF. The Company recorded non-recurring contract revenues in 1996 of $44.7 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 $67.6 million in 1997, $50.6 million in 1996 and $13.4 million in 1995. All other revenue from Roche, HLR and their affiliates, principally royalties under previous product licensing agreements, and royalties and product sales under the license agreement, totaled $42.8 million in 1997, $39.5 million in 1996 and $14.3 million in 1995. Development of IGF-I was discontinued in September 1997 due to the amount of additional clinical effort and the greater period of time that would be required to address potential concerns about retinopathy when using IGF-I in Type I and Type II diabetes mellitus. 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 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, stock awards and stock appreciation rights to employees, non-employee directors and consultants of the Company. Incentive stock options may only be granted to employees under these plans. Generally, non-qualified options have a maximum term of 20 years, except those granted under the 1996 Plan and options granted prior to 1992 under the 1984 Plan, which have a term of 10 years. 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, 1995 and 1997. The 1991 Plan allows eligible employees to purchase special common stock at 85% of the lower of the fair market value of the special common stock on the grant date or the fair market value on the first business day of each calendar quarter. Purchases are limited to 15% of each employee's eligible compensation. All full-time employees of the Company are eligible to participate in the 1991 Plan. Of the 4,500,000 shares of special common stock reserved for issuance under the 1991 Plan, 3,316,826 shares have been issued as of December 31, 1997. During 1997, 2,624 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, *Accounting for Stock-Based Compensation*, requires the use of option valuation models that were not developed for use in valuing employee stock options. Under APB 25, *Accounting for Stock Issued to Employees*, 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 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 and the earnings per share method under FAS 128. The resulting effect on pro forma net income and earnings per share disclosed is not likely to be representative of the effects on net income and earnings per share on a pro forma basis in future years, due to subsequent years including additional grants and

years of 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 for 1997, 1996 and 1995, respectively: risk-free interest rates of 6.2%, 5.8% and 6.0%; dividend yields of 0%; volatility factors of the expected market price of the Company's common stock of 9.2%, 6.2% and 6.2%; and a weighted-average expected life of the option of five years.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. 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):

	1997	1996	1995
Net income—as reported	$ 129,044	$ 118,348	$ 146,432
Net income—pro forma	111,441	104,358	142,370
Earnings per share—as reported:			
Basic	1.05	0.98	1.24
Diluted	1.02	0.95	1.20
Earnings per share—pro forma:			
Basic	0.91	0.87	1.20
Diluted	0.88	0.84	1.17

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

	Shares	Weighted Average Price
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
Grants	**329,505**	**58.21**
Exercises	**(2,443,696)**	**30.07**
Cancellations	**(1,248,709)**	**52.35**
Options outstanding at December 31, 1997	**16,239,609**	**$ 44.41**

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	753,169	1.19	$ 17.21	753,169	$ 17.21
$ 21.375–$ 31.000	3,064,884	11.59	26.42	3,011,197	26.42
$ 32.125–$ 48.125	2,484,800	15.69	41.83	2,102,035	40.69
$ 48.250–$ 59.000	9,936,756	12.44	52.68	2,677,214	52.07
	16,239,609			8,543,615	

Using the Black-Scholes option valuation model, the weighted average fair value of options granted in 1997, 1996 and 1995, respectively, was $15.37, $13.36 and $12.27. Shares of special common stock available for future grants under all stock option plans were 5,401,056 at December 31, 1997.

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 $0.10 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 and 1997.

The Board of Directors and Stockholders of Genentech, Inc.

We have audited the accompanying consolidated balance sheets of Genentech, Inc. as of December 31, 1997 and 1996, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 1997. 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, 1997 and 1996, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles.

San Jose, California
January 20, 1998

Ernst & Young LLP

QUARTERLY FINANCIAL DATA (UNAUDITED)

(thousands, except per share amounts)

	1997 Quarter Ended			
	December 31	September 30	June 30	March 31
Total revenues	**$ 277,053**	**$ 248,917**	**$ 233,493**	**$ 257,285**
Product sales	**143,352**	**142,306**	**145,018**	**154,213**
Gross margin from product sales	**120,633**	**115,741**	**119,451**	**126,528**
Net income	**41,529**	**32,122**	**23,794**	**31,599**
Earnings per share:				
Basic	**0.34**	**0.26**	**0.19**	**0.26**
Diluted	**0.33**	**0.25**	**0.19**	**0.25**

	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
Earnings per share:				
Basic	0.06	0.42	0.18	0.32
Diluted	0.06	0.41	0.17	0.31

11-YEAR FINANCIAL SUMMARY (UNAUDITED)

(millions, except per share and employee data)

	1997	1996	1995	1994
Total revenues	$ 1,016.7	$ 968.7	$ 917.8	$ 795.4
Product sales	584.9	582.8	635.3	601.0
Royalties	241.1	214.7	190.8	126.0
Contract & other	121.6	107.0	31.2	25.6
Interest	69.1	64.2	60.5	42.8
Total costs and expenses	$ 846.9	$ 820.8	$ 745.6	$ 665.8
Cost of sales	102.5	104.5	97.9	95.8
Research & development	470.9	471.1	363.0	314.3
Marketing, general & administrative	269.9	240.1	251.7	248.6
Special charge	—	—	25.0[1]	—
Interest	3.6	5.1	8.0	7.1
Income data				
Income (loss) before taxes	$ 169.8	$ 147.9	$ 172.2	$ 129.6
Income tax provision	40.8	29.6	25.8	5.2
Net income (loss)	129.0	118.3	146.4	124.4
Earnings (loss) per share:				
Basic	1.05	0.98	1.24	1.07
Diluted	1.02	0.95	1.20	1.03
Selected balance sheet data				
Cash, short-term investments & long-term marketable securities	$ 1,286.5	$ 1,159.1	$ 1,096.8	$ 920.9
Accounts receivable	189.2	197.6	172.2	146.3
Inventories	116.0	91.9	93.6	103.2
Property, plant & equipment, net	683.3	586.2	503.7	485.3
Other long-term assets	177.2	149.2	105.5	61.0
Total assets	2,507.6	2,226.4	2,011.0	1,745.1
Total current liabilities	289.6	250.0	233.4	220.5
Long-term debt	150.0	150.0	150.0	150.4
Total liabilities	476.4	425.3	408.9	396.3
Total stockholders' equity	2,031.2	1,801.1	1,602.0	1,348.8
Other data				
Depreciation and amortization expense	$ 65.5	$ 62.1	$ 58.4	$ 53.5
Capital expenditures	154.9	141.8	70.2	82.8
Share information				
Shares used to compute EPS:				
Basic	123.0	120.6	118.3	116.0
Diluted	126.4	124.0	121.7	120.2
Actual year-end	124.2	121.4	119.3	117.2
Per share data				
Market price: High	$ 60.63	$ 55.38	$ 53.00*	$ 53.50
Low	$ 53.25	$ 51.38	$ 44.50*	$ 41.75
Book value	$ 16.35	$ 14.84	$ 13.43	$ 11.50
Number of employees	3,242	3,071	2,842	2,738

The Company has paid no dividends.

The Financial Summary above reflects adoption of FAS 128 and 129 in 1997, 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 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.

1993	1992	1991	1990	1989	1988	1987
$ 649.7	$ 544.3	$ 515.9	$ 476.1	$ 400.5	$ 334.8	$ 230.5
457.4	391.0	383.3	367.2	319.1	262.5	141.4
112.9	91.7	63.4	47.6	36.7	26.7	20.1
37.9	16.7	20.4	31.9	27.5	33.5	57.1
41.5	44.9	48.8	29.4	17.2	12.1	11.9
$ 590.8	$ 522.3	$ 469.8	$ 572.7	$ 352.9	$ 311.7	$ 186.6
70.5	66.8	68.4	68.3	60.6	46.9	23.8
299.4	278.6	221.3	173.1	156.9	132.7	96.5
214.4	172.5	175.3	158.1	127.9	101.9	59.5
—	—	—	167.7[2]	—	23.3[3]	—
6.5	4.4	4.8	5.5	7.5	6.9	6.8
$ 58.9	$ 21.9	$ 46.1	$ (96.6)	$ 47.6	$ 23.1	$ 43.9
—	1.1	1.8	1.5	3.6	2.5	1.7
58.9	20.8	44.3	(98.0)	44.0	20.6	42.2
0.52	0.19	0.40	—	—	0.25	0.54
0.50	0.18	0.39	(1.05)[4]	0.51[4]	0.24	0.50
$ 719.8	$ 646.9	$ 711.4	$ 691.3	$ 205.0	$ 152.5	$ 158.3
130.5	93.9	69.0	58.8	66.8	63.9	92.2
84.7	65.3	56.2	39.6	49.3	63.4	58.0
456.7	432.5	342.5	300.2	299.1	289.4	195.7
64.1	37.1	42.7	61.7	85.0	89.7	108.7
1,468.8	1,305.1	1,231.4	1,157.7	711.2	662.9	619.0
190.7	133.5	118.6	101.4	75.9	95.4	82.8
151.2	152.0	152.9	153.5	154.4	155.3	168.1
352.0	297.8	281.7	264.5	242.2	263.6	263.6
1,116.8	1,007.3	949.7	893.2	469.0	399.3	355.4
$ 44.0	$ 52.2	$ 46.9	$ 47.6	$ 44.6	$ 38.3	$ 23.5
87.5	126.0	71.3	36.0	37.2	110.9	65.3
113.9	111.9	111.0	—	—	82.2	78.1
118.7	115.0	113.2	93.0[4]	86.0[4]	85.0	85.1
114.8	112.9	111.3	110.6	84.3	82.9	78.7
$ 50.50	$ 39.50	$ 36.25	$ 30.88	$ 23.38	$ 47.50	$ 64.75
			$ 27.50**			
$ 31.25	$ 25.88	$ 20.75	$ 20.13	$ 16.00	$ 14.38	$ 28.00
			$ 21.75**			
$ 9.73	$ 8.92	$ 8.53	$ 8.08	$ 5.56	$ 4.82	$ 4.52
2,510	2,331	2,202	1,923	1,790	1,744	1,465

**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 shareholders 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) Reflect amounts previously reported. Information was not available to restate these amounts pursuant to FAS 128.

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 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 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, 1997, there were approximately 15,122 stockholders of record of the Company's special common stock.

STOCK PRICES

Special Common/Redeemable Common/Common Stock

	1997		1996	
	High	Low	High	Low
4th Quarter	$ 60 5/8	$ 57 1/2	$ 54 3/8	$ 52 3/4
3rd Quarter	58 15/16	56 1/2	53 1/4	51 3/8
2nd Quarter	59 1/4	56 1/2	53 3/8	51 7/8
1st Quarter	58	53 1/4	55 3/8	52 1/2

HEADQUARTERS

Genentech, Inc.
1 DNA Way
South San Francisco, California 94080-4990
(650) 225-1000

STOCK LISTINGS

Genentech, Inc. is listed on the New York Stock Exchange and Pacific Exchange 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 8040
Boston, MA 02266-8040
Telephone (781) 575-3400

ANNUAL MEETING

The annual meeting of stockholders will be held at 10:00 AM on Thursday April 30, 1998, at the San Francisco Airport Marriott Hotel, 1800 Old Bayshore Highway, Burlingame, 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 March 2, 1998.

INVESTOR RELATIONS

Genentech invites stockholders, security analysts, representatives of portfolio management firms and other interested parties to contact:

Susan Bentley
Director, Investor Relations
Genentech, Inc.
1 DNA Way
South San Francisco, California 94080-4990
Telephone: (650) 225-1260
e-mail: investor.relations@gene.com

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 (650) 225-8679 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.

INDEPENDENT AUDITORS

Ernst & Young LLP
San Jose, California

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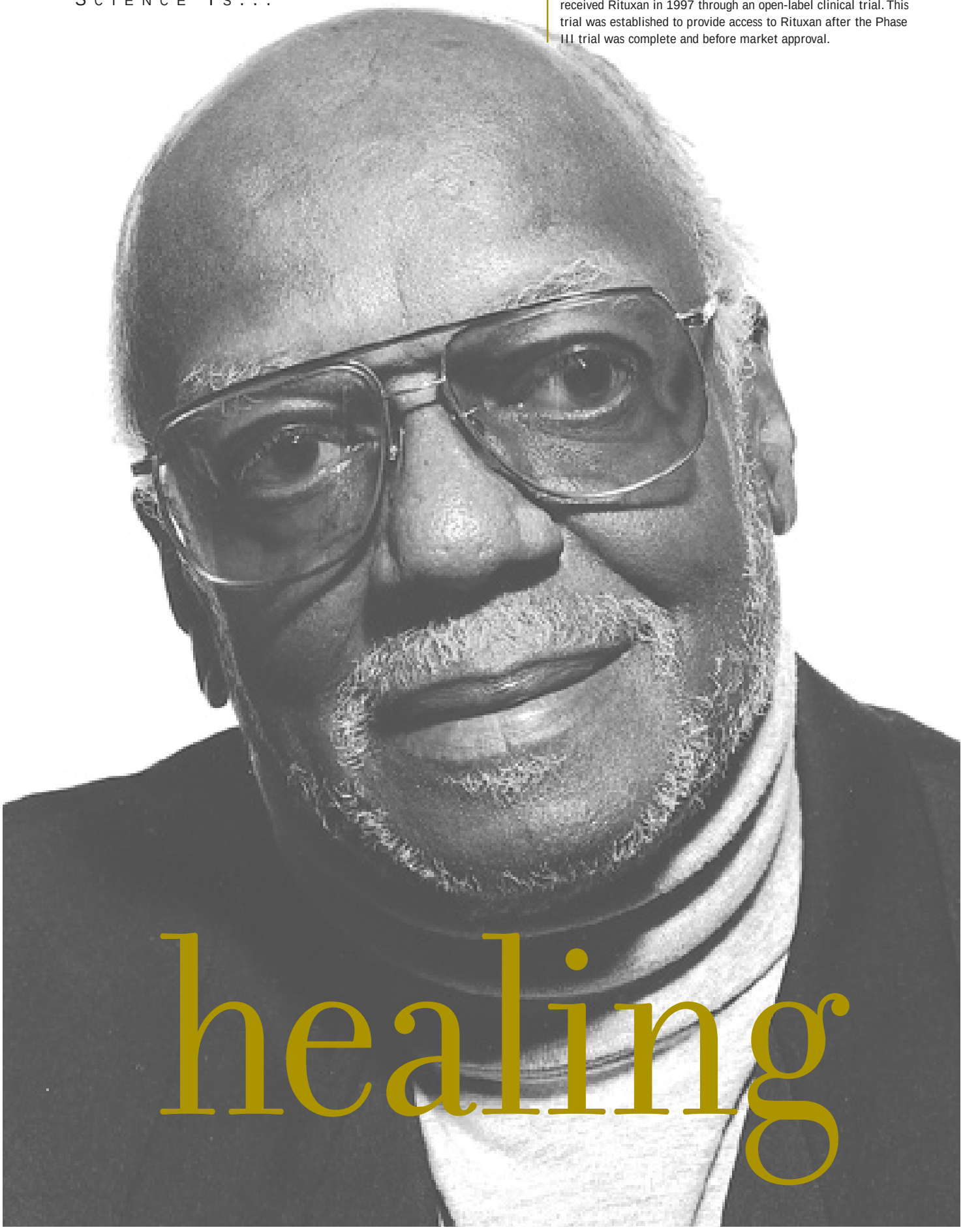


Andrew A. Henderson, who has a type of non-Hodgkin's lymphoma, received Rituxan in 1997 through an open-label clinical trial. This trial was established to provide access to Rituxan after the Phase III trial was complete and before market approval.

healing

Since Hippocrates' time, an important application of successful science has been healing, or at least ameliorating, disease. Genentech is proud to contribute to that pursuit. The company markets seven biopharmaceuticals that all target serious medical conditions. Genentech believes that all patients who need its marketed medicines should receive them. Since its first products, the company has had specific programs in place to help ensure that this happens.

Genentech today is making its latest impact in the area of oncology, or cancer medicine. To facilitate its launch into the oncology marketplace, in 1997 Genentech agreed with Roche to promote Roche's Roferon-A in the United States for the product's approved oncology indications. The company launched a new BioOncology initiative that currently includes the marketed product Rituxan. In 1997, Rituxan received approval for the treatment of relapsed or refractory low-grade or follicular, CD20-positive B-cell non-Hodgkin's lymphoma. In early 1998, Genentech agreed to return promotional rights for Roferon-A to Roche, and is now focusing its oncology marketing efforts on Rituxan. Genentech has recruited a sales force of trained professional representatives who are dedicated to oncology. In the tradition of all Genentech products, Rituxan is providing an important treatment to patients with serious medical conditions.

Genentech's earliest product areas were growth hormone (GH) therapy and thrombolytic therapy. In both cases, Genentech has expanded its initial offerings, which were Protropin for GH deficiency in children and Activase for acute myocardial infarction (heart attack). Since Genentech first launched these products in the 1980s, it has added Nutropin and a liquid formulation, Nutropin AQ, to its growth hormone offerings, and it has obtained approval for additional growth-related indications for these two newer GH products. For its thrombolytic product, Genentech has since obtained two additional indications for Activase, most recently in 1996 as the first treatment of acute ischemic stroke, transforming this serious condition into a treatable medical emergency. Genentech and the medical community have since worked together to enhance public awareness of stroke and ensure that hospitals are well poised to treat stroke. For example, Genentech has been working to provide medical centers with reference materials to establish their stroke treatment protocols as recommended by the National Institute on Neurological Disorders and Stroke (NINDS).

As it has since its inception, Genentech ultimately strives to provide medicines that heal. Today the company markets seven biotechnology products for several medical indications, while providing a variety of support programs for patients and physicians. In 1997 Genentech received regulatory approval for a new cancer medicine and for new indications for some of its growth hormone products.

Genentech Marketed Products and Approved Indications

Eleven of the approved products of biotechnology stem from Genentech science. Genentech manufactures and markets seven protein-based pharmaceuticals. These seven products are listed below. The others are licensed to other companies.

Activase® (Alteplase, recombinant)	a tissue-plasminogen activator	Acute myocardial infarction Acute ischemic stroke within the first three hours of symptom onset Acute massive pulmonary embolism
Protropin® (somatrem for injection)	growth hormone	Growth hormone deficiency (GHD) in children
Nutropin® [somatropin (rDNA origin) for injection]	growth hormone	GHD in children GHD in adults* Growth failure associated with chronic renal insufficiency(CRI) prior to kidney transplantation Short stature associated with Turner syndrome
Nutropin AQ® [somatropin (rDNA origin) injection]	liquid formulation growth hormone	GHD in children GHD in adults* Growth failure associated with CRI prior to kidney transplantation Short stature associated with Turner syndrome*
Rituxan™ (Rituximab)		Relapsed or refractory low-grade or follicular, CD20-positive B-cell non-Hodgkin's lymphoma*
Pulmozyme® (dornase alfa, recombinant)	Inhalation Solution	Cystic fibrosis
Actimmune® (Interferon gamma-1b)		Chronic granulomatous disease

*New approval

In its two initial marketing areas — growth hormone therapy and thrombolytic therapy of acute myocardial infarction — Genentech has increasingly faced significant competitive pressures, yet maintains clear market leadership. (For information on how Genentech is facing competition, see page 21.) One important reason Genentech remains a market leader is the company's fundamental commitment to excellent medicine, expressed in its support programs for physicians and patients, and in its continued clinical investigation in the areas of human growth and development and cardiovascular medicine. Besides seeking to develop new products in these areas, Genentech also continues to investigate its marketed products through observational clinical studies. As outlined on page 25, since its first product Genentech has continued to accumulate data on the safety and efficacy of its marketed products to provide physicians the information they need to offer optimal medical treatment.

One important reason Genentech remains a market leader is the company's fundamental commitment to excellent medicine.

Genentech's products have also made important medical impact on deadly genetic disorders that affect children. Early in this decade Genentech launched Actimmune for the management of chronic granulomatous disease. Though only approximately 400 U.S. children have this inherited immune disorder, Actimmune's medical impact is significant. It allows these children to lead relatively normal lives by reducing the frequency of serious infections.

Launched in 1993, Pulmozyme represented the first new therapy in 30 years for the management of cystic fibrosis. Cystic fibrosis is a progressive disease that makes breathing increasingly difficult and usually leads to death. Pulmozyme was initially approved for patients from age five with mild to moderate disease. Upon further study by Genentech, Pulmozyme subsequently received approval for patients with advanced disease in 1996, and, in 1998, the Food and Drug Administration approved an extension of the indication to include pediatric use in infants three months to two years old and in children two to four years old. Genentech is currently investigating through its Early Intervention Trial the long-term effect of the medicine on a large group of patients with relatively preserved lung function.

One thing all Genentech products have in common is that they offer patients with serious medical conditions an important therapeutic tool in their continuing struggle to heal.

Rand Coudray received vascular endothelial growth factor for the potential treatment of his coronary arterial disease in a Phase I clinical trial.

lean

Some of the best science has come out of lean and efficient environments. A lean, focused vision can be an asset to clear scientific thinking. Genentech has worked toward focusing its R&D effort for several years. Enhanced productivity and lean, effective operations in all areas of the company are key components of the company's Long-Range Plan toward improved financial results.

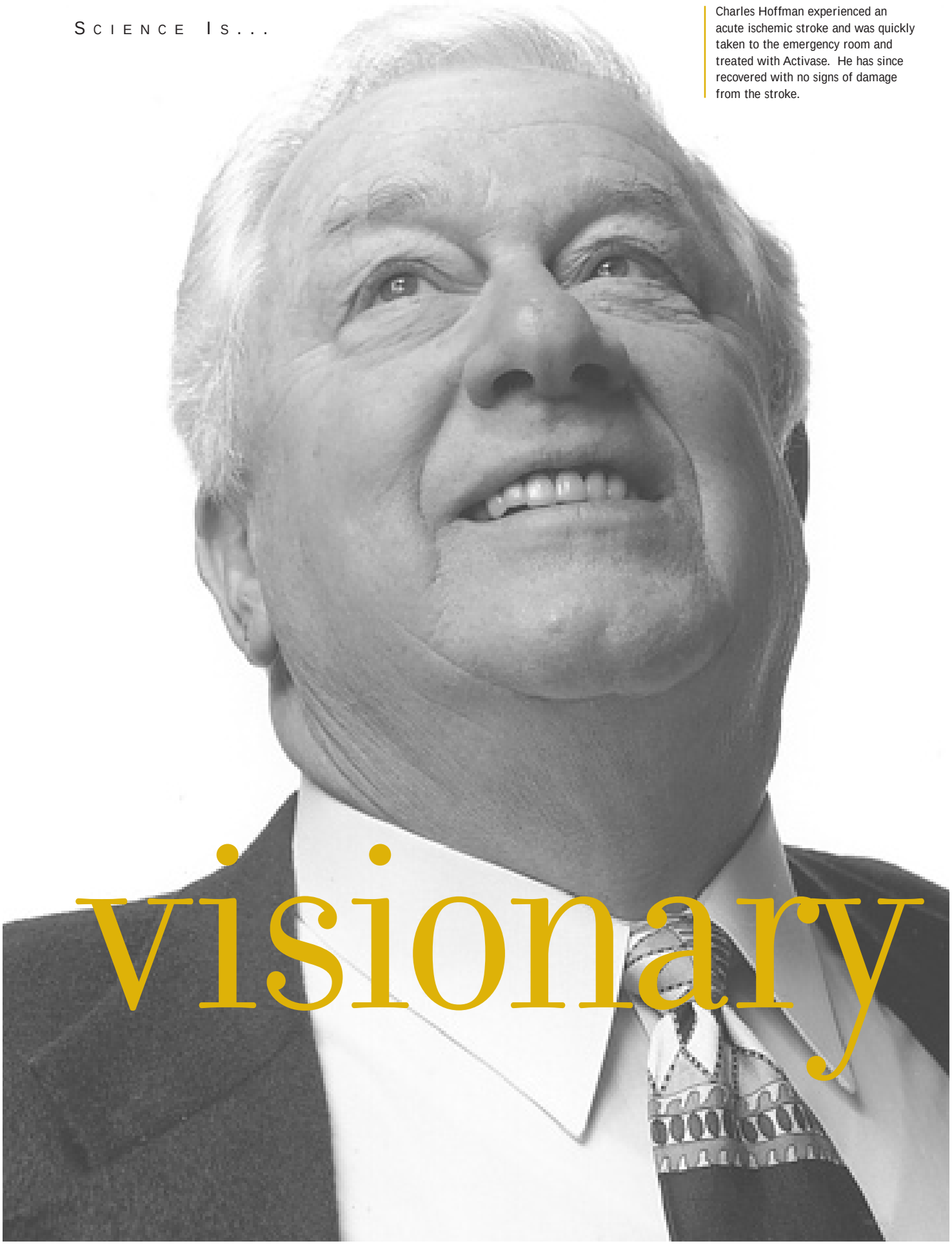
In 1996 and 1997, through a focused product development initiative, Genentech showed that a well-thought-out plan to increase efficiency can indeed bear fruit. Three project teams joined forces to minimize the time and cost required to move their preclinical products into clinical development toward a Phase II proof-of-concept point where informed decisions regarding further development could be made. If these teams had followed established procedures and timelines to move their products into the clinic, they would not have had the budget or time to do so, and would have had to drop their projects. They instead decided to join forces and question established procedures.

These project teams found several ways to cut costs and save time by taking intelligent risks — but none that would impact safety. They identified more efficient ways to manufacture product needed for preclinical and early clinical testing. They identified levels of control that were excessively duplicated and not required to meet regulatory requirements for such early clinical products. They took advantage of recently enacted Food and Drug Administration reform to reduce the number of tests needed or reported.

As a result of their efforts, three products are now in clinical testing — on an aggressive timeline and within reduced budgets — that otherwise may have been dropped: VEGF, the anti-VEGF antibody and the anti-CD18 antibody.

The most important aspect of this project is that it encouraged those involved to expand their thinking and question existing procedures. Genentech employees are used to asking: Is this effective, is it safe? They still ask these questions every day, but are now — in all departments — also increasingly asking: Is it cost and time effective, is it efficient, is it necessary? They are thinking and working lean.

As a patient or as a corporation, doing the most with what you have, seeking better ways to accomplish things, and having a tenacious spirit that doesn't allow complacency all increase the likelihood of success. Genentech strives to work smarter and more efficiently. The company's efforts to identify work project priorities, apply thoughtful expense controls and integrate cost effectiveness into both operations and products all reflect the value Genentech places on working, thinking and staying lean.



Charles Hoffman experienced an acute ischemic stroke and was quickly taken to the emergency room and treated with Activase. He has since recovered with no signs of damage from the stroke.

visionary

February 27, 1998

Arthur D. Levinson, Ph.D.
President and CEO

Dear Stockholder,

"What science is..."

At Genentech, science is at the root of everything we do. We intentionally create an environment that encourages scientific excellence. Yet we also purposefully target our science to produce therapeutic products that not only represent significant medical advances, but also could yield a strong growth rate for our company and our investors. Harnessing scientific excellence is only the beginning. Our efforts must benefit mankind and the people who invest their time, money and hope in our capability to deliver important new products.

The adjectives that head the sections of this report describe science at Genentech. These characteristics of our scientific effort create apt headings for all we do. In a short span of just over two decades at the end of the 20th century, we at Genentech changed the lives of hundreds of thousands of people. In the 21st century, we hope to benefit many more. This is our vision today. It is rooted in many of the ideals that drove Genentech's founding and that have been appropriately modified and enhanced for the coming millenium.

In 1995, we began charting our course into the next century with a four-point strategy for growth. It set a direction for our marketed products, our product development efforts, our business relationships and our financial returns. In 1997 we started to see this strategy realized, with many tangible results. In sum, 1997 was a very good year for Genentech, with much progress made toward our short- and long-term objectives.

In the area of marketed products, we retained strong positions against increased competition in our two main markets — growth hormone therapy and thrombolytic therapy (see page 21). We received three approvals for two new indications for certain of our growth hormone products: short stature associated with Turner syndrome for Nutropin AQ and growth hormone deficiency in adults for Nutropin and Nutropin AQ.

GENENTECH'S ORIGINAL VISION CONTINUES TODAY: TO COMMERCIALIZE RECOMBINANT DNA TECHNOLOGY EFFECTIVELY FOR THE BETTERMENT OF MANKIND WHILE WORKING TO PROVIDE ENVIABLE GROWTH AND RETURN TO INVESTORS. THIS VISION LAUNCHED THE COMPANY, GAVE BIRTH TO AN INDUSTRY, AND NOW OFFERS THE OPPORTUNITY TO POSITION GENENTECH AS THE PREMIER BIOTECHNOLOGY COMPANY THAT DELIVERS THE RESULTS OF ITS VISION AND HARD WORK.

We also entered an important new market: oncology. With our partner IDEC Pharmaceuticals Corporation, we received approval for and launched a new cancer product, Rituxan, for the treatment of certain non-Hodgkin's lymphomas. Rituxan is the first monoclonal antibody approved for therapeutic use in cancer in the United States. It also represents the first new medicine we marketed as part of our new BioOncology initiative. Launched in 1997, this initiative also includes the potential oncology products we have in clinical development, with which we made good progress during the year. For example, following the completion of Phase III trials, we are currently preparing regulatory filings of Herceptin seeking approval for the treatment of breast cancer. We also began clinical safety trials with an antibody to vascular endothelial growth factor (VEGF). Anti-VEGF has potential in treating a variety of solid tumors.

I believe that Herceptin and the anti-VEGF antibody — both humanized monoclonal antibodies — exemplify the vision of Genentech scientists. Several years ago, our scientists led

the effort to create monoclonal antibodies that are humanized so the human body can accept them. On their conviction, we pursued development of a number of these antibodies. Today, our scientists' vision is beginning to bear fruit as we progress in the clinical development of several of these antibodies.

Our BioOncology initiative reflects our plan to focus on specific therapeutic areas that leverage our existing strengths. Other areas of therapeutic focus are cardiovascular medicine and endocrinology, both of which build on our long-term marketing and clinical leadership in these areas. A fourth area of therapeutic focus we call opportunistic — meaning we will continue to pursue exciting opportunities that fall outside our three main areas of focus.

An example is our anti-IgE antibody, another humanized monoclonal antibody. With our partners Novartis AG and Tanox Biosystems, Inc., we have begun pivotal Phase III trials of this antibody for the treatment of allergic asthma.

As the efforts I mentioned with IDEC, Novartis and Tanox demonstrate, strategic alliances are a fundamental component of our strategy. In 1997, we initiated or enhanced several relationships that bring new potential products into our pipeline, including one with Alteon, Inc. This agreement is for the continued development and marketing of Alteon's pimagedine, which is currently in Phase III trials for the potential treatment of the kidney complications associated with diabetes. This molecule fits well in our endocrinology focus. It also complements our own potential medicine for the treatment of another complication of diabetes: nerve growth factor, which is in Phase III trials for the potential treatment of diabetic neuropathy.

Our most significant alliance is with Roche. We collaborate with Roche on several research and development projects, yet we remain operationally independent. During 1997, we agreed to changes in the 1995 ex-U.S. license agreement with Roche, to the benefit of both companies. For the Genentech development projects that Roche opts to develop outside the United States, these changes should better align shared costs and rights with each company's risk.

"Our goal is to operate as a stand-alone business apart from the put and call."

I have touched upon only a few of our accomplishments of 1997. I encourage you to visit the other sections of this report to read about our many other marketed and clinical products and the hope and opportunity they offer.

All of our key accomplishments for the year stem from the four-point strategy we implemented in 1995, which still guides us today. This strategy continues to support our goal to operate as a stand-alone business apart from the put and call. I believe that the fact that our stock price exceeded the $60 put price in December 1997, a year-and-a-half before stockholders will have the option to put at that price if Roche has not exercised its call option, suggests that our goal to remain functionally independent is realistic.

Our four-point strategy has successfully charted our direction of growth. In 1997, we furthered our vision by also charting our pace of progress into the next century. We refined our Long-Range Plan (LRP) to achieve our objectives. With our LRP we set specific quantitative goals to grow revenues and profits, as we strive for increased earnings growth in 1998 and sustained growth as we move into the next century.

"Based on our considerable progress to date, we are well on track to meeting our goals."

Another Genentech success in 1997 goes right to the heart of our LRP and could, over time, have a significant impact on our bottom line. During the year we implemented or enhanced many efforts geared toward operating every area of the company in as productive and cost-efficient a manner as possible. (For an example of such an initiative, please see page 29.) Such efforts represent a significant part of our plan to build real value in Genentech for all our stockholders.

I realize it will take discipline to accomplish the LRP's objectives. I and the rest of Genentech's management team are committed to its targets and benchmarks. Appointments and promotions during the year rounded out our management team to give it the necessary breadth and depth of experience, talent and vision to meet our objectives. Two Genentech veterans with long records of success took on new top-level executive roles: William D. Young was promoted to chief operating officer from executive vice president and Louis J. Lavigne, Jr. was promoted to executive vice president from senior vice president, and continues as chief financial officer. Our Development group gained solid leadership as Susan D. Hellmann, M.D., M.P.H., was promoted to that function's senior vice president and as John Curd, M.D., was promoted to vice president — Clinical Development. Two long-time Genentech scientists now head up key R&D functions: Joffre B. Baker, Ph.D., as vice president — Research Discovery, and Paula Jardieu, Ph.D., as vice president — Pharmacological Sciences. We promoted another long-time Genentech employee, John M. Whiting, to controller. Two other long-time employees assumed new roles: James P. Panek added Manufacturing to his existing responsibilities to become vice president – Manufacturing, Engineering and Facilities, and Robert Garnick, Ph.D., assumed responsibility for Regulatory Affairs as that function's vice president. And we hired Lars Barfod to head up our Marketing department as its vice president. I have confidence in Genentech's management team, and all members have given me their complete commitment to our LRP.

"We are realizing the value of our pipeline as we deliver more important new medicines to people who need them."

I firmly believe Genentech's employees are ready and able to rise to our objectives. Based on our considerable progress to date, we are well on track to meeting our goals. We are realizing the value of our pipeline as we deliver more important new medicines to people who need them. We have made substantial progress toward increasing value to our stockholders. We are proud of our efforts in 1997. As we continue to achieve our milestones and growth projections, we look to you for your continued support now and into the next century as you share with us the realization of our vision.

Sincerely,

/s/ Arthur D. Levinson

Arthur D. Levinson, Ph.D.

President and Chief Executive Officer