STEMCELLS INC
Form 10-K
March 15, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)**
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2006

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)**
OF THE SECURITIES EXCHANGE ACT OF 1934

COMMISSION FILE NUMBER 0-19871

STEMCELLS, INC.
(Exact name of Registrant as specified in its charter)

DELAWARE	**94-3078125**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

3155 PORTER DRIVE, PALO ALTO, CA 94304
(Address of principal offices) (zip code)

Registrant s telephone number, including area code:
(650) 475-3100

Securities registered pursuant to Section 12(b) of the Act:
NONE

Securities registered pursuant to Section 12(g) of the Act:

COMMON STOCK, $.01 PAR VALUE
JUNIOR PREFERRED STOCK PURCHASE RIGHTS

Title of class

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated Filer þ Non-accelerated filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

Aggregate market value of Common Stock held by non-affiliates at June 30, 2006: $157,013,768. Inclusion of shares held beneficially by any person should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of management policies of the registrant, or that such person is controlled by or under common control with the Registrant.

Common stock outstanding at February 23, 2007: 78,625,667 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement relating to the registrant s 2007 Annual Meeting of Stockholders to be filed with the Commission pursuant to Regulation 14A are incorporated by reference in Part III of this report.

FORWARD LOOKING STATEMENTS

THIS REPORT CONTAINS FORWARD-LOOKING STATEMENTS AS DEFINED UNDER THE FEDERAL SECURITIES LAWS. ACTUAL RESULTS COULD VARY MATERIALLY. FACTORS THAT COULD CAUSE ACTUAL RESULTS TO VARY MATERIALLY ARE DESCRIBED HEREIN AND IN OTHER DOCUMENTS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION. READERS SHOULD PAY PARTICULAR ATTENTION TO THE CONSIDERATIONS DESCRIBED IN THE SECTION OF THIS REPORT ENTITLED MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS AS WELL AS ITEM 1A UNDER THE HEADING RISK FACTORS.

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PART I

Item 1. *Business*

Overview

StemCells, Inc. is focused on the discovery and development of cell-based therapeutics to treat damage to or degeneration of major organ systems such as the Central Nervous System, Liver and Pancreas. Many degenerative diseases are caused by the loss of normal cellular function in the particular organ. Our aim is to restore organ function, improve patients lives, and reduce the substantial health care costs associated with these diseases and disorders. We seek to identify and purify rare stem and progenitor cells, develop methods and processes to expand and bank them as transplantable cells, and then demonstrate their safety and efficacy as therapeutic agents. We are currently conducting a Phase I clinical trial to evaluate the safety and preliminary efficacy of our lead product, the human neural stem cell (HuCNS-SC[tm]), as a treatment for infantile and late infantile neuronal ceroid lipofuscinosis (NCL), two forms of a group of disorders often referred to as Batten disease. As of February 2007, two patients out of a total of six planned in this trial have been enrolled and transplanted with HuCNS-SC.

Stem cells are cells that can produce all the functional mature cell types found in normal organs of healthy individuals. Progenitor cells are cells that have already developed from the stem cells, but can still produce one or more types of mature cells within an organ. We use cells derived from donated fetal or adult tissue sources, which are supplied to us in compliance with all applicable state and federal regulations. At this time, we are not developing embryonic stem cells for therapeutic use nor are we involved in any activity directed toward human cloning. Our programs are all directed toward the use of tissue-derived cells for treating or curing diseases and injuries.

We have successfully identified, purified, and characterized the human neural stem cell. Our neural stem cell product, HuCNS-SC, is in a Phase I clinical trial for its first indication and we are conducting additional preclinical and IND-enabling work for additional indications. We have also identified a population of cells derived from liver tissue, the human liver engrafting cells (hLEC), which when transplanted into a mouse model of liver degeneration, show long-term engraftment, differentiate into human hepatocytes, secrete human hepatic proteins and form structural elements of the liver. Based on this data, we are developing the hLEC for potential therapeutic applications to liver diseases. Our goal is to initiate a clinical test of these cells in patients within the next twelve months. We have also identified a candidate stem cell of the pancreas and this program is at the research stage.

We believe that, if successfully developed, our cell technologies will create the basis for therapies that would address a number of conditions with significant unmet medical needs. Many neurodegenerative diseases involve the failure of an organ that cannot be transplanted, i.e., the brain or central nervous system. Other diseases, such as hepatitis and diabetes, involve organs, such as the liver or pancreas, that can be transplanted, but of which there is a very limited supply available for transplant. We estimate that these neural, liver and pancreatic conditions affect more than 57 million people in the United States and account for more than $325 billion annually in health care costs.(1)

StemCells California, Inc., a California corporation, is our wholly-owned subsidiary, and the owner or licensee of most of our intellectual property. References in this annual report to the Company, we, us, and similar words include this subsidiary.

Stem Cell Therapy Background

Cells maintain normal physiological function in healthy individuals by secreting or metabolizing substances, such as sugars, amino acids, neurotransmitters and hormones, which are essential to life. When cells are damaged or

(1) This estimate is based on information from the Alzheimer s Association, the Alzheimer s Disease Education & Referral Center (National Institute on Aging), the National Parkinson Foundation, the National Institutes of Health s National Institute on Neurological Disorders and Stroke, the Foundation for Spinal Cord Injury Prevention, Care & Cure, the Travis Roy Foundation, the Centers for Disease Control and Prevention, the Wisconsin Chapter of the Huntington s Disease Society of America, the American Liver Foundation, the Cincinnati Children s Hospital Medical Center, and JAIDs.

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destroyed, they no longer produce, metabolize or accurately regulate those substances. Cell loss and impaired cellular function are leading causes of degenerative diseases, and some of the specific substances or proteins that are deficient in some of these diseases have been identified. Although administering these substances or proteins has some advantages over traditional pharmaceuticals, such as specificity, there is no existing technology that can deliver them precisely to the sites of action, under the appropriate physiological regulation, in the appropriate quantity, nor for the duration required to cure the degenerative condition. Cells, however, can do all this naturally. Thus, where failing cells are no longer producing needed substances or proteins or where there has been irreversible tissue damage or organ failure, transplantation of stem or progenitor cells may slow or prevent the loss of functional cells or enable the generation of new functional cells, thus potentially maintaining or restoring organ function and the patient s health.

Stem cells have two defining characteristics: (i) they produce all the kinds of mature cells making up the particular organ; and (ii) they self renew that is, some of the cells developed from stem cells are themselves new stem cells, thus permitting the process to occur again and again. Stem cells are known to exist for a number of systems of the human body, including the blood and immune system, the central and peripheral nervous systems (including the brain), the skin, bone, and even hair. They are thought to exist for many others, including the liver and pancreas endocrine systems, gut, muscle, and heart. Stem cells are responsible for organ regeneration during normal cell replacement and, to a greater or lesser extent, after injury.

Stem cells are rare and only available in limited supply, whether from the patients themselves or from donors. Cells obtained from the same person who will receive them may be abnormal if the patient is ill or the tissue is contaminated with disease-causing cells. Also, such cells can often be obtained only through significant surgical procedures. Therefore, in order to develop cell-based therapeutics, three key challenges must be overcome: (i) identifying the stem or progenitor cells of a particular organ and testing them for therapeutic potential; (ii) creating processes to enable use of these rare cells in clinical applications, such as expanding and banking them in sufficient quantities to transplant into multiple patients, or purifying them for use in direct transplantation; and (iii) demonstrating the safety and efficacy of these potential therapeutics in human clinical trials.

The Potential of Our Tissue-Derived Cell-Based Therapeutics

We believe that, if successfully developed, stem and progenitor cell-based therapeutics have the potential to provide a broad therapeutic approach comparable in importance to traditional pharmaceuticals and genetically engineered biologics. Stem cells can self-renew and specialize into the different kinds of cells that are commonly lost in various diseases, and our preclinical research suggests that transplanted stem cells may also be able to migrate some distance to the proper location within the body, expand, specialize and protect or replace damaged or defective cells. Because of this, we believe that cell-based therapeutics may facilitate the return to proper function, potentially for the life of the patient.

To our knowledge, no one has developed an FDA-approved method for replacing lost or damaged tissues from the human nervous system. Replacement of tissues in other areas of the human body is mainly limited to those few cases, such as bone marrow or peripheral blood cell transplants, where transplantation of the patient s own cells is now feasible. In a few additional areas, including the liver, transplantation of donor organs is now used, but is limited by the scarcity of organs available through donation. More recently, investigators have isolated subpopulations of cells from a specific organ, such as hepatocytes from the liver or islet cells from the pancreas, which have been transplanted into patients with a measure of success. However, these types of cell transplants are also limited by the availability of suitable organs.

StemCells has focused on identifying and purifying tissue-derived stem and progenitor cells for use in homologous therapy, that is, use of brain derived neural stem cells for treatment of brain disorders; pancreas derived cells for treatment of pancreas disorders; or liver derived cells for treatment of liver disorders. Tissue-derived stem cells are

developmentally pre-programmed to become the specialized cells of the organ from which they are derived by responding directly to cues of the host environment. We believe the homologous use of purified, unmodified tissue-derived cells is the most direct way to provide for engraftment of the cells and differentiation into the mature specialized cells of the organ, and should minimize the risk of transplantation of unwanted cell types.

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We have developed techniques for discovering novel monoclonal antibodies that can be used to label markers on cell surfaces to identify and isolate specific cell types, and particularly stem and progenitor cells. This methodology allows us to purify the stem cell population and eliminate other unwanted cell types. For example, we have discovered and patented the use of monoclonal antibodies to identify the human neural stem cell, as well as human liver engrafting cells and a candidate pancreatic stem/progenitor cell.

With respect to the human neural stem cell, our lead product candidate, we believe we have overcome the first two key challenges to developing a cell-based therapeutic. We have developed proprietary and reproducible processes to identify, purify, expand and bank human neural stem cells from brain tissue. Because the product is a purified composition of normal human neural stem cells, it should be better suited for transplantation and should provide a safer and more effective alternative to therapies that are based on cells derived from cancer cells, animal-derived cells or are an unpurified mix of many different cell types. Furthermore, we have shown that these purified and expanded stem cells, when transplanted into immunodeficient mice, engraft, migrate, differentiate into neurons and glial cells and survive for as long as one year with *no sign* of tumor formation or adverse effects on the animals; moreover, the cells were still dividing at the end of the test period. These findings show that our neural stem cells, when transplanted, adopt the characteristics of the host brain and act like normal stem cells, suggesting the possibility of a continual replenishment of normal human brain cells.

Business Strategy

We are seeking to develop and commercialize cell-based therapeutics to treat, and possibly cure, a range of human diseases. Our strategy is to be the first to identify, isolate and patent multiple types of human stem and progenitor cells with therapeutic and commercial importance; to develop techniques and processes either to reproducibly purify the cells for direct transplant or to enable the expansion and banking of those cells; and then to take them into clinical development as transplantable therapeutics. To date, we have identified three rare cell types: the human neural stem cell, human liver engrafting cells, and a candidate pancreas stem cell. We have developed the methods and processes to expand and bank the neural stem cell and are now engaged in the first clinical trial of our neural stem cell product, HuCNS-SC.

We believe that patent protection will be available to the first to identify and isolate any of the finite number of different types of human stem cells, and the first to define methods to culture such cells, making the commercial development of cell-based treatments for currently intractable diseases financially feasible. Thus, a central element of our business strategy is to obtain patent protection for the compositions, processes and uses of these multiple types of cells. We have obtained rights to certain inventions relating to stem cells and progenitor cells from academic institutions. We expect to continue to expand our search for, and to seek to acquire rights from third parties relating to, new stem and progenitor cells, and to further develop our intellectual property positions with respect to these cells in-house and through research at scholarly institutions. Our portfolio of issued patents includes a method of culturing normal human central nervous system stem and progenitor cells in our proprietary chemically-defined media, and our published studies show that these cultured and expanded cells give rise to all three major cell types of the central nervous system. We also have patent applications pending in connection with our work on liver and pancreas stem and progenitor cells.

Research and Development Programs

Overview

We have devoted substantial resources to our research programs to isolate and develop stem and progenitor cells that we believe can serve as a basis for protecting or replacing diseased or injured cells. Our efforts to date have been

directed at methods to identify, isolate and culture large quantities of stem and progenitor cells of the human nervous system, liver and pancreas and to develop therapeutics utilizing these cells.

The following table shows the current status of, and the potential initial indications for, our primary research and product development programs and projects. The table is qualified in its entirety by reference to the more detailed descriptions of such programs and projects appearing elsewhere in this report. We continually evaluate our research and product development efforts and reallocate resources among existing programs or to new programs in light of experimental results, commercial potential, availability of third party funding, likelihood of near-term

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efficacy, collaboration success or significant technology enhancement, as well as other factors. Our research and product development programs are at relatively early stages of development and will require substantial resources to commercialize.

Program Description and Objective	Stage/Status(1)
Neural Program	*Clinical*
Cellular therapy to restore or preserve function to central nervous system tissue by protecting, repairing or replacing dysfunctional or damaged cells. Initial indications are lysosomal storage diseases that affect the CNS, e.g., NCL, and disorders in which demyelination plays a central role, e.g. certain spinal cord injuries, cerebral palsy	*Neuronal Ceroid Lipofuscinosis (also known as Batten disease)* Demonstrated *in vivo* proof of principle showing in a mouse model for Infantile NCL that HuCNS-SC can continuously produce the enzyme that is deficient in Infantile NCL protect host neurons from death extend the lifespan of the HuCNS-SC transplanted mice *Phase 1 clinical trial ongoing at Oregon Health & Science University. As of February 2007, two patients out of a total of six planned have been enrolled and transplanted with HuCNS-SC* *Preclinical* *Spinal Cord Indications:* Demonstrated *in vivo* proof of principle in a mouse model for spinal cord injury that transplanted HuCNS-SC restores motor function in injured animals directly contributes to the functional recovery; when human cells are ablated restored function is lost become specialized oligodendrocytes and neurons demonstrated in preclinical studies that transplanted HuCNS-SC does not contribute to scar formation does not induce abnormal pain *Myelin Disorders:* Demonstrated *in vivo* proof of principle in the myelin deficient shiverer mouse and spinal cord injured mouse that transplanted HuCNS-SC shows integration of myelin producing oligodendrocytes into the mouse brain and spinal cord

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Program Description and Objective	Stage/Status(1)
	tight wrapping of the mouse nerve axons to form myelin sheath
	Research
	Demonstrated the ability to reproducibly purify human neural stem cells and expand these cells to create cell banks Expanded and banked human neural stem cells engraft in the brain and spinal cords of rodents to give rise to the 3 specialized cell types of the CNS with no evidence of tumor formation
Liver Program	*Preclinical*
Cellular therapy to restore function to liver tissue by replacing dysfunctional or damaged cells. Initial indications may include liver-based metabolic disorders	Demonstrated the engraftment and survival of the hLECs in an in vivo mouse liver degeneration model. Detected human serum albumin and alpha-1-antitrypsin in serum of transplanted animals. Detected bile canaliculi for liver protein export
	Research
	Identified cell surface markers and methods for purification of human liver engrafting cells (hLECs) from livers, of a broad age range, deemed not suitable for liver transplantation. Identified in vitro culture assay for growth of human liver engrafting cells, containing cells that co-express markers for both bile duct cells and hepatocytes
Pancreas Program	*Research*
Cellular therapy to restore function to pancreas tissue by replacing dysfunctional or damaged cells	Identified cell surface markers and methods for purification of candidate human pancreatic stem/progenitor cells (hPSCs) Developed *in vitro* screening assay for testing

biological activity of hPSCs

(1) Research refers to early stage research and product development activities *in vitro*, including the selection and characterization of product candidates for preclinical testing. Preclinical refers to further testing of a defined product candidate *in vitro* and in animals prior to clinical studies. Clinical refers to the testing of a defined product candidate in humans.

Neural Program

Many neurodegenerative diseases involve the failure of brain or other central nervous system tissue due to the loss of functional cells. We believe the transplantation of neural stem or progenitor cells may slow or prevent the

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loss of functional cells or enable the generation of new functional cells, thus potentially maintaining or restoring organ function. Our Neural Program is initially focusing on developing clinical applications to prevent the loss of, or restore function to, neural cells affected by genetic disorders such as neuronal ceroid lipofuscinosis, Type III Gaucher s Disease, and certain other lysosomal storage diseases; diseases in which deficient myelination plays a central role, such as certain spinal cord injuries or brain disorders such as cerebral palsy; and traumatic or ischemic insults to the brain or spinal cord, such as stroke or traumatic brain injuries. These disorders affect a significant number of people in the United States and there currently are no effective long-term therapies for them. We believe that therapeutics based on our process for identifying, purifying and culturing neural stem and progenitor cells may be useful in treating such diseases.

StemCells Inc holds a substantial portfolio of issued and allowed patents in the neural field. See **Patents, Proprietary Rights and Licenses.**

Neuronal Ceroid Lipofuscinosis (NCL; also known as Batten disease).

Neuronal ceroid lipofuscinosis (NCL), which is often referred to as Batten disease, is a neurodegenerative disease that affects infants and young children. All three forms of NCL infantile, late infantile and juvenile are caused by the lack of a lysosomal enzyme, but all are genetically different. Infantile and late infantile NCL are brought on by inherited genetic mutations in the *CLN1* gene, which codes for palmitoyl-protein thioesterase 1 (PPT1) and in the *CLN2* gene, which codes for tripeptidyl peptidase I (TPP-I), respectively. As a result of these mutations, the relevant enzyme is either defective or missing, leading to the accumulation of non-degraded lysosomal substrates in various cell types. This accumulation eventually interferes with normal cellular and tissue function, and leads to seizures and progressive loss of motor skills, sight and mental capacity. Today, NCL is always fatal. To correct the major defect in NCL patients, the missing enzyme has to be provided to the brain where it can be taken up by the enzyme-deficient cells.

We are currently conducting a Phase I clinical trial at Oregon Health & Science University Doernbecher Children s Hospital to evaluate the safety and preliminary efficacy of HuCNS-SC as a treatment for infantile and late infantile NCL. This trial is an open label study with two dose levels and is planned to enroll six patients. HuCNS-SC will be transplanted into these patients, who will then receive immunosuppression for one year following transplantation. In addition to measuring the safety of HuCNS-SC, the trial will also evaluate the ability of HuCNS-SC to affect the progression of the disease. We believe this clinical trial is the first FDA-approved trial to use purified human neural stem cells as a potential therapeutic agent. As of February 2007, two patients have been enrolled and transplanted with HuCNS-SC.

Our preclinical data demonstrate that HuCNS-SC, when transplanted in a mouse model of infantile NCL, engraft, migrate throughout the brain, produce the missing PPT1 enzyme, measurably reduce the toxic storage material in the brain, and protect host neurons so that more of them survive; in addition, we have shown that the lifetime of the HuCNS-SC transplanted mice is extended compared to the control group. We have also demonstrated *in vitro* that HuCNS-SC produce TPP-I, the enzyme that is deficient in late infantile NCL.

Other Lysosomal Storage Diseases.

NCL, or Batten disease, is one of a group of approximately 46 lysosomal storage diseases (LSDs). Some of these LSDs, which are all caused by defective or missing enzymes, can be treated by enzyme replacement therapies. Examples of enzyme replacement products used in these therapies are Cerezyme[tm] for Gaucher disease, Fabryzyme[tm] for Fabry disease, Myozyme for Pompe disease, Aldurazyme[tm] for MPS I and Naglazyme[tm] for MPS VI. About half of the lysosomal storage diseases, however, affect the central nervous system; consequently, enzyme replacement therapy is not currently a practical treatment option for this subset of LSDs because enzymes are typically too large to cross the blood-brain barrier. We believe that HuCNS-SC may have the potential to treat some LSDs that affect the

CNS by acting as cellular mini-pumps for the secretion and supply of missing enzymes to the brain. To date, we have found that HuCNS-SC can produce the relevant enzyme in several LSDs that affect the CNS, including infantile and late infantile NCL.

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Spinal Cord Indications.

Stem cells may have the potential to treat various spinal cord indications. Using a mouse model of spinal cord injury, our collaborators, Drs. Aileen Anderson and Brian Cummings of the Reeve-Irvine Center at the University of California, have shown that HuCNS-SC have the potential to protect and regenerate damaged nerves and nerve fibers, and that injured mice transplanted with our human neural stem cells showed improved motor function compared to control animals. Inspection of the spinal cords from these mice showed significant levels of human neural cells derived from the transplanted stem cells. Moreover, the human cells that are found in the spinal cord of the transplanted mice matured into oligodendrocytes, the specialized neural cell that forms the myelin sheath around axons, insulating them and enabling them to conduct signals to other axons. Drs. Anderson and Cummings then selectively ablated the human cells, and found that the functional improvement was lost, thus demonstrating that the human cells had played a direct role in the functional recovery of the transplanted mice. We are currently conducting preclinical development on HuCNS-SC as a potential therapeutic for various spinal cord indications.

Other Remyelination Indications.

In addition to certain spinal cord indications, loss of myelin characterizes conditions such as multiple sclerosis, cerebral palsy and certain genetic disorders (for example, Krabbe s disease and metachormatic leukodystrophy). We have shown that HuCNS-SC differentiate into oligodendrocytes, the myelin producing cells, and produce myelin. We have transplanted HuCNS-SC into the brain of the mutant shiverer mouse, which is deficient in myelin, and shown widespread engraftment of human cells that matured into oligodendrocytes. Furthermore, analysis of the brain tissue of these mice shows the myelin produced by the human cells ensheathes the mouse nerve, providing the proper layers of insulation. Further studies are in progress to demonstrate proper function of the newly produced myelin. Pilot studies for understanding myelin production and repair were conducted in collaboration with researchers at the Oregon Health & Science University and the Yale University School of Medicine. We are currently conducting preclinical development on HuCNS-SC as a potential therapeutic for a brain indication characterized by myelin deficiency.

Other Neural Collaborations.

We have established a number of research collaborations in the neural field to assess both the in vitro potential of the HuCNS-SC and the effects of transplanting HuCNS-SC into preclinical animal models, including a collaboration with researchers at the Stanford University School of Medicine to evaluate our human neural stem cells in animal models of stroke. Collaborative studies regarding the formation of specific populations of neurons have also been done with researchers at The University of Texas Medical Branch and the University of California, San Diego. In addition, we concluded an NIH-funded collaboration with Dr. George A. Carlson of the McLaughlin Research Institute to understand the role of Alzheimer s plaques in neuronal cell death in Alzheimer s disease. Under the collaboration, Dr. Carson transplanted HuCNS-SC into mouse models of Alzheimer s disease and the cells showed robust engraftment in an environment riddled with Alzheimer s plaques. We plan to analyze the engrafted human cells in the brains of the transplanted mice.

Liver Program

Approximately 1 in 10 Americans suffers from diseases and disorders of the liver for many of which there currently are no effective, long-term treatments. Liver stem cells may be useful in the treatment of some of these diseases, such as hepatitis, liver failure, blood-clotting disorder, cirrhosis of the liver and liver cancer. A source of defined human cells capable of engraftment and substantial liver regeneration could provide a cell-based therapeutic product available to a wider patient base than whole liver (or organ) transplants.

We have identified and isolated a cell population that we call human Liver Engrafting Cells (hLEC) which shows promise as a potential therapeutic. The hLEC can be derived from all types of human livers, including those that would not otherwise be used for orthotopic liver transplantation. When tested in our *in vitro* culture assay, these antibody-enriched cells produce enzymes needed for normal liver function, such as human serum albumin. When transplanted into immunodeficient mice, the hLEC demonstrate robust engraftment and produce human proteins including albumin and alpha-1-antitrypsin and form structural elements of the liver, suggesting that once

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transplanted, hLEC become functional cells. Based on these data, our Liver Program has a goal of initiating a clinical trial to test the hLEC in patients within the next twelve months, with the initial indication likely to be a liver-based metabolic disorder characterized by an enzyme deficiency.

Pancreas Program

We have used our monoclonal antibody-based search methodology to identify a rare subset of human pancreatic cells that may be candidate pancreatic stem/progenitor cells. If those cells can be differentiated into islet cells, the pancreas cells that produce insulin, they may be useful in the treatment of Type 1 diabetes and those cases of Type 2 diabetes where insulin secretion is defective. We have filed a patent application on the monoclonal antibodies used and have developed what we believe to be an appropriate animal model to test the biological activity of the purified candidate pancreatic stem cells.

Note on State and Federal Grants

In November 2004, California State Proposition 71 (Prop. 71), the California Stem Cell Research and Cures Initiative, was adopted by the electorate. It is intended to encourage stem cell research in the State of California, and to finance such research with State funds of approximately $295 million annually for 10 years beginning with 2005. It is our understanding that the California Institute for Regenerative Medicine to be created under the Initiative will provide grants, primarily but not exclusively to academic institutions, to advance both embryonic stem cell research and adult stem cell research; the latter is the current and exclusive focus at StemCells. StemCells, Inc. is eligible to receive Prop. 71 generated funds and we do intend to apply for such funding. We also remain eligible for federal government support from the National Institute of Health (NIH) due to our focus on adult stem cells, although Prop. 71 funds will not go to any project that receives NIH funding.

Manufacturing

We have made considerable investments in our manufacturing operations. We believe we have the ability to process cells suitable for use in our ongoing and planned research and development activities and clinical trials.

Marketing

Because of the early stage of our stem and progenitor cell programs, we have not yet addressed questions of channels of distribution and marketing of potential future products.

Patents, Proprietary Rights and Licenses

We believe that proprietary protection of our inventions will be critical to our future business. We vigorously seek out intellectual property that we believe might be useful in connection with our products, and have an aggressive program of protecting our intellectual property. We believe that our know-how will also provide a significant competitive advantage, and we intend to continue to develop and protect our proprietary know-how. We may also from time to time seek to acquire licenses to important externally developed technologies.

We have exclusive or non-exclusive rights to a portfolio of patents and patent applications related to various stem and progenitor cells and methods of deriving and using them. These patents and patent applications relate to compositions of matter, methods of obtaining such cells, and methods for preparing, transplanting and utilizing such cells. As of December 31, 2006, our U.S. patent portfolio included forty-eight issued U.S. patents, seven of which issued in 2006. Approximately 20 additional patent applications were pending, four of which had been allowed. In addition, we have foreign counterparts to many of the U.S. applications and patents; counterparts to thirteen of our U.S. patents or

applications have issued in various countries, making a total of over 130 individual non-U.S. patents from those thirteen cases. In 2003, one party filed an opposition to two of our issued European patent cases. Both oppositions were heard in 2005, and the patents were maintained in somewhat altered form by the Opposition Division of the European Patent Office. The time for appeal has run in each case. U.S. counterparts to these patents are part of our issued patent portfolio; they are not subject to opposition, since that procedure does not exist under U.S. patent law, although other types of proceedings may be available to third parties to contest our U.S. patents.

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Among our significant patents are:

U.S. Patent No. 5,851,832, covering our methods for the human CNS cell cultures containing central nervous system stem cells, for compositions of human CNS cells expanded by these methods, and for use of these cultures in human transplantation. These human CNS stem and progenitor cells expanded in culture may be useful for repairing or replacing damaged central nervous system tissue, including the brain and the spinal cord;

U.S. Patent No. 5,968,829, entitled Human CNS Neural Stem Cells, which covers our composition of matter for human CNS stem cells;

U.S. Patent No. 6,103,530, covering our media for culturing human CNS stem cells;

U.S. Patent Number 6,468,794, entitled Enriched central nervous system stem cell and progenitor cell populations, and methods for identifying, isolating and enriching for such populations, which covers the identification and purification of the human CNS stem cell;

U.S. Patent Nos. 6,238,922 and 7,049,141 (Use of collagenase in the preparation of neural stem cell cultures), which describe methods to advance the in vivo culture and passage of human CNS stem cells that result in a 100-fold increase in CNS stem and progenitor cell production after 6 passages. We believe the methodologies of these patents and the one mentioned immediately above together augment our leadership position in the stem cell field by providing a reproducible proprietary method for obtaining and expanding stem cells for therapeutic uses;

U.S. Patent Number 6,294,346 (Use of multipotent neural stem cells and their progeny for the screening of drugs and other biological agents); and

U.S. Patent Number 6,497,872, entitled Neural transplantation using proliferated multipotent neural stem cells and their progeny, covers transplanting any neural stem cells or their differentiated progeny, whether the cells have been cultured in suspension or as adherent cells, for the treatment of any disease. We are the exclusive licensees of the patent, which gives us the right to exclude others from practicing the claimed invention.

Among the recent patents issued or exclusively licensed to us are patents covering a method of drug screening using enriched populations of neural stem cells (U.S. Patent No. 7,105,150); methods for producing enriched populations of neural stem cells (U.S. Patent No. 7,037,719); in vitro cell culture compositions of enriched populations of neural stem cells (U.S. Patent No. 7,153,686); methods for the in vitro proliferation of neural stem cells (U.S. Patent No. 7,115,418); cDNA libraries obtained from neurospheres (U.S. Patent No. 7,105,342); and methods of screening for biological agents that affect proliferation, differentiation, survival, phenotype, or function of neural stem cells (U.S. Patent No. 7,101,709). In addition, we expect several other neural stem cell cases to issue shortly; we have also received indications that another application, covering methods of selecting for human liver engrafting cells, should be allowed soon.

These new patents have further strengthened our already extensive patent portfolio and, we believe, give StemCells the dominant intellectual property position in the field, covering methods for identification, isolation, expansion, and transplantation of neural stem cells as well as drug discovery and testing.

The following table lists our issued U.S. patents:

U.S. Patent Number Owned by StemCells	Subject	Date of Expiration
5,968,829	Human CNS neural stem cells	9/05/17
6,103,530	Human CNS neural stem cells culture media	9/05/17
6,238,922	Use of collagenase in the preparation of neural stem cell cultures	2/26/19
6,468,794	Enriched neural stem cell populations, and methods for identifying, isolating and enriching for neural stem cells	10/21/19
6,498,018	Human CNS neural stem cells	9/05/17
6,777,233	Cultures of human CNS neural stem cells	9/05/17
7,037,719	Enriched neural stem cell populations, and methods for identifying, isolating and enriching for neural stem cells	10/21/19

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U.S. Patent Number Owned by StemCells	Subject	Date of Expiration
7,049,141	Use of collagenase in the preparation of neural stem cell cultures	2/26/19
7,105,150	Drug screening & discovery using enriched neural stem cell populations	10/21/19
7,153,686	Enriched neural stem cell populations, and methods for identifying, isolating and enriching for neural stem cells	10/21/19
Licensed from NeuroSpheres		
5,750,376	In vitro genetic modification	5/12/15
5,851,832	In vitro proliferation	12/22/15
5,980,885	Methods for inducing in vivo proliferation of precursor cells	11/09/16
5,981,165	In vitro induction of dopaminergic cells from mammalian central nervous system multipotent stem cell compositions	11/09/16
6,071,889	Methods for in vivo transfer of a nucleic acid sequence to proliferating neural cells	6/06/17
6,093,531	Generation of hematopoietic cells from multipotent neural stem cells	6/19/18
6,165,783	Methods of inducing differentiation of multipotent neural stem cells	10/20/18
6,294,346	Methods for screening biological agents	9/25/18
6,368,854	Hypoxia-mediated neurogenesis	10/20/18
6,399,369	cDNA libraries derived from populations of non-primary neural cells	6/04/19
6,497,872	Neural transplantation using proliferated multipotent neural stem cells and their progeny	12/24/19
6,638,501	Use of multipotent neural stem cell progeny to augment non-neural tissues	6/19/18
6,897,060 B1	Generation of hematopoietic cells	6/19/18
6,924,142 B2	Hypoxia-mediated neurogenesis assay	10/20/18
7,101,709	Methods of making cDNA libraries, cell screening with cultures of neural stem cells	9/22/12
7,105,342	cDNA libraries derived from populations of non-primary neural cells	12/5/12
7,115,418	Methods of Proliferating Undifferentiated Neural Cells	11/30/12
U.S. Licensed from NeuroSpheres		
7,166,277	Remyelination	1/23/24
Licensed from the California Institute of Technology		
5,589,376	Mammalian neural crest stem cells	12/31/13
5,629,159	Immortalization and disimmortalization of cells	5/13/14
5,654,183	Genetically engineered mammalian neural crest stem cells	8/05/14
5,672,499	Methods for immortalizing multipotent neural crest stem cells	9/30/14

5,693,482	In vitro neural crest stem cell assay	12/02/14
5,824,489	Methods for isolating mammalian multipotent neural crest stem cells	10/20/15

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Licensed from the California Institute of Technology	Subject	
5,849,553	Immortalizing and disimmortalizing multipotent neural crest stem cells	12/15/15
5,928,947	Mammalian multipotent neural crest stem cells	7/27/16
5,935,811	Neuron restrictive silencer factor proteins	8/10/16
6,001,654	Methods for differentiating neural stem cells to neurons or smooth muscle cells (TGFb)	7/27/12
6,033,906	Differentiating mammalian neural stem cells to glial cells using neuregulins	3/07/17
6,270,990	Neuron restrictive silencer factor proteins	3/03/15
6,555,337	Neurogenin	9/27/16
6,566,496	Neurogenin	9/27/16
6,824,774	Antibodies that bind neuron-restrictive silencer factor proteins	10/25/16
6,890,724 B2	Methods and Compositions for Neural Progenitor Cells (cRET)	9/06/16
Licensed from the Scripps Research Institute		
6,242,666	An animal model for identifying a common stem/ progenitor to liver cells and pancreatic cells	12/16/18
6,541,251	Pancreatic progenitor 1 gene and its uses	4/26/21
6,753,153	Markers for identification and isolation of pancreatic islet alpha and beta progenitors	12/13/20
6,911,533	Pancreatic progenitor I gene and its uses	4/26/21
Licensed from Oregon Health & Science University		
6,132,708	Liver regeneration using pancreas cells	10/10/17

We also rely upon trade-secret protection for our confidential and proprietary information and take active measures to control access to that information.

Our policy is to require our employees, consultants and significant scientific collaborators and sponsored researchers to execute confidentiality agreements upon the commencement of an employment or consulting relationship with us. These agreements generally provide that all confidential information developed or made known to the individual by us during the course of the individual s relationship with us is to be kept confidential and not disclosed to third parties except in specific circumstances. In the case of employees and consultants, the agreements generally provide that all inventions conceived by the individual in the course of rendering services to us shall be our exclusive property.

We have obtained rights from universities and research institutions to technologies, processes and compounds that we believe may be important to the development of our products. These agreements typically require us to pay license fees, meet certain diligence obligations and, upon commercial introduction of certain products, pay royalties. These include exclusive license agreements with The Scripps Institute, the California Institute of Technology and the Oregon Health & Science University, to certain patents and know-how regarding present and certain future developments in CNS, liver and pancreas stem cells. Our licenses may be canceled or converted to non-exclusive licenses if we fail to use the relevant technology or if we breach our agreements. Loss of such licenses could expose us to the risks of third

party patents and/or technology. There can be no assurance that any of these licenses will provide effective protection against our competitors. We have also obtained patent rights from cross-licensing certain of our patents to NeuroSpheres and to StemCell Therapeutics. See **Patents, Proprietary Rights and Licenses**

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The patent positions of pharmaceutical and biotechnology companies, including ours, are uncertain and involve complex and evolving legal and factual questions. The coverage sought in a patent application can be denied or significantly reduced before or after the patent is issued. Consequently, we do not know whether any of our pending applications will result in the issuance of patents, or if any existing or future patents will provide significant protection or commercial advantage or will be circumvented by others. Because patent applications are secret until the applications are published (usually eighteen months after the earliest effective filing date), and since publication of discoveries in the scientific or patent literature often lags behind actual discoveries, we cannot be certain that we were the first to make the inventions covered by each of our pending patent applications or that we were the first to file patent applications for such inventions. There can be no assurance that patents will issue from our pending or future patent applications or, if issued, that such patents will be of commercial benefit to us, afford us adequate protection from competing products, or not be challenged or declared invalid.

In the event that a third party has also filed a patent application relating to inventions claimed in our patent applications, we may have to participate in interference proceedings declared by the United States Patent and Trademark Office to determine priority of invention, which could result in substantial uncertainties and cost for us, even if the eventual outcome is favorable to us. There can be no assurance that our patents, if issued, would be held valid by a court of competent jurisdiction.

A number of pharmaceutical, biotechnology and other companies, universities and research institutions have filed patent applications or have been issued patents relating to cell therapy, stem cells and other technologies potentially relevant to or required by our expected products. We cannot predict which, if any, of such applications will issue as patents or the claims that might be allowed.

If third party patents or patent applications contain claims infringed by our technology and such claims or claims in issued patents are ultimately determined to be valid, there can be no assurance that we would be able to obtain licenses to these patents at a reasonable cost, if at all, or be able to develop or obtain alternative technology. If we are unable to obtain such licenses at a reasonable cost, we may not be able to develop certain products commercially. There can be no assurance that we will not be obliged to defend ourselves in court against allegations of infringement of third party patents. Patent litigation is very expensive and could consume substantial resources and create significant uncertainties. An adverse outcome in such a suit could subject us to significant liabilities to third parties, require disputed rights to be licensed from third parties, or require us to cease using such technology.

License Agreements

We have entered into a number of research-plus-license agreements with academic organizations including The Scripps Research Institute (Scripps), the California Institute of Technology (Cal Tech), the Oregon Health & Science University (OHSU), and the University of Texas Medical Branch. The research components of these agreements have been concluded and have resulted in a number of licenses for resultant technology. Under the license agreements, we are typically subject to obligations of due diligence and the requirement to pay royalties on products that use patented technology licensed under such agreements. The license agreements with these institutions relate largely to stem or progenitor cells and or to processes and methods for the isolation, identification, expansion or culturing of stem or progenitor cells. Generally speaking, these license agreements will terminate upon expiration, revocation or invalidation of the patents licensed to us, unless governmental regulations require a shorter term. They also will terminate earlier if we breach our obligations under the agreement and do not cure the breach, or if we declare bankruptcy, and we can terminate the license agreements at any time upon notice.

In the case of Scripps, we must pay $50,000 upon the initiation of the Phase II trial for our first product using Scripps licensed technology, and upon completion of that Phase II trial we must pay Scripps an additional $125,000. Upon approval of the first product for sale in the market, we must pay Scripps $250,000.

Pursuant to the terms of our license agreement with Cal Tech, we must pay $10,000 upon the issuance of the first patent in each family licensed to us under the relevant agreement and $5,000 on the first anniversary of the issuance of each such patent, payable in cash or stock at our option. We have paid $40,000 on account of these patents through December 31, 2006; the $10,000 due in 2006 was paid in stock (3,848 shares). These amounts are creditable against royalties we must pay under the license agreements. The maximum royalties that we will have to pay to the California Institute of Technology will be $2 million per year, with an overall maximum of $15 million.

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Once we pay the $15 million maximum royalty, the licenses will become fully paid and irrevocable. In August 2002 we acquired an additional license from Cal Tech to different technology, pursuant to which we issued 27,535 shares of our common stock with a market value of approximately $35,000; we have also issued 9,535 shares of our common stock with a market value of approximately $15,000 to Cal Tech on the issuance of two patents covered under this additional license.

In 2002, we issued a license to BioWhittaker, Inc., for the exclusive right to make, sell and distribute one of our proprietary cells for the research market only. BioWhittaker was acquired by Cambrex, and the cognizant Cambrex division has now been acquired by Lonza. In 2003 and 2004 respectively, we issued non-exclusive licenses to StemCell Technologies, Inc. to make, use and sell certain proprietary mouse and rat neural stem cells and culture media for all mammalian neural stem cells, and to R&D Systems to make, use and sell certain stem cell expansion kits, also for the research market. These licenses are not expected to generate material revenues.

In July 2005, we entered into an agreement with ReNeuron Limited, a wholly owned subsidiary of ReNeuron Group plc, a listed UK corporation (collectively referred to as ReNeuron). As part of the agreement, we granted ReNeuron a license that allows ReNeuron to exploit their c-mycER conditionally immortalized adult human neural stem cell technology for therapy and other purposes. We received a 7.5% fully-diluted equity interest in ReNeuron, subject to certain anti-dilution provisions, as well as a cross-license to the exclusive use of ReNeuron s technology for certain diseases and conditions, including lysosomal storage diseases, spinal cord injury, cerebral palsy and multiple sclerosis. The agreement also provides for full settlement of any potential claims that either we or ReNeuron might have had against the other in connection with any putative infringement of certain of each party s patent rights prior to the effective date of the agreement. The agreement is Exhibit 10.71 to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005. See Note 2 and Item 7a. Quantitative and Qualitative Disclosures about Market Risk for more details on this transaction. In August 2006, we entered an agreement with Stem Cell Therapeutics (SCT), a Canadian corporation listed on the Toronto Stock Exchange, granting it a non-exclusive, royalty-bearing license to use several of our patents for treating specified diseases of the central nervous system; the grant does not include any rights to cell transplantation. SCT granted StemCells a royalty-free non-exclusive license to certain of its patents for research and development and a royalty-bearing non-exclusive for certain commercial purposes. SCT paid an up-front license fee; the license also provides for other payments including annual maintenance, milestones, and royalties.

NeuroSpheres, Ltd.

In March 1994, we entered into a Contract Research and License Agreement with NeuroSpheres, Ltd., which was clarified in a License Agreement dated as of April 1, 1997. Under the agreement as clarified, we obtained an exclusive patent license from NeuroSpheres in the field of transplantation, subject to a limited right of NeuroSpheres to purchase a nonexclusive license from us, which right was not exercised and has expired. We have developed additional intellectual property relating to the subject matter of the license. We entered into an additional license agreement with NeuroSpheres as of October 30, 2000, under which we obtained an exclusive license in the field of non-transplant uses, such as drug discovery and drug testing and clarified our rights under NeuroSpheres patents for generating cells of the blood and immune system from neural stem cells. Together, our rights under the licenses are exclusive for all uses of the technology. We made up-front payments to NeuroSpheres of 65,000 shares of our common stock in October 2000 and $50,000 in January 2001, and we will make additional cash payments when milestones are achieved under the terms of the October 2000 agreement. In addition, in October 2000 we reimbursed Neurospheres for patent costs amounting to $341,000. Milestone payments, payable at various stages in the development of potential products, would total $500,000 for each product that is approved for market. In addition, beginning in 2004, annual payments of $50,000 became due, payable by the last day of the year and fully creditable against royalties due to NeuroSpheres under the October 2000 Agreement. Our agreements with NeuroSpheres will terminate at the expiration of all patents licensed to us, but can terminate earlier if we breach our obligations under the agreement and do not cure the breach, or if we declare bankruptcy. We have a security interest in the licensed

technology.

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Signal Pharmaceuticals, Inc.

In December 1997, we entered into two sublicense agreements with Signal Pharmaceuticals (Signal), Inc. under which each party sublicensed to the other certain patent rights and biological materials for use in defined fields. Signal has now been acquired by Celgene, which in 2004 relinquished its license to the University of California, which then terminated the sublicense to StemCells for lack of diligence. Effective September 11, 2005, StemCells terminated the remaining sublicense.

Competition

The targeted disease states for our initial products in some instances currently have no effective long-term therapies. However, we do expect that our initial products will have to compete with a variety of therapeutic products and procedures. Major pharmaceutical companies currently offer a number of pharmaceutical products to treat lysosomal storage disorders, neurodegenerative and liver diseases, diabetes and other diseases for which our technologies may be applicable. Many pharmaceutical and biotechnology companies are investigating new drugs and therapeutic approaches for the same purposes, which may achieve new efficacy profiles, extend the therapeutic window for such products, alter the prognosis of these diseases, or prevent their onset. We believe that our products, when and if successfully developed, will compete with these products principally on the basis of improved and extended efficacy and safety and their overall economic benefit to the health care system. The market for therapeutic products that address degenerative diseases is large, and competition is intense. We expect competition to increase. We believe that our most significant competitors will be fully integrated pharmaceutical companies and more established biotechnology companies. Smaller companies may also be significant competitors, particularly through collaborative arrangements with large pharmaceutical or biotechnology companies. Many of these competitors have significant products approved or in development that could be competitive with our potential products.

Competition for any stem and progenitor cell products that we may develop may be in the form of existing and new drugs, other forms of cell transplantation, ablative and simulative procedures, and gene therapy. We believe that some of our competitors are also trying to develop stem and progenitor cell-based technologies. We expect that all of these products will compete with our potential stem and progenitor cell products based on efficacy, safety, cost and intellectual property positions.

We may also face competition from companies that have filed patent applications relating to the use of genetically modified cells to treat disease, disorder or injury. In the event our therapies should require the use of such genetically modified cells, we may be required to seek licenses from these competitors in order to commercialize certain of our proposed products, and such licenses may not be granted.

If we develop products that receive regulatory approval, they would then have to compete for market acceptance and market share. For certain of our potential products, an important success factor will be the timing of market introduction of competitive products. This is a function of the relative speed with which we and our competitors can develop products, complete the clinical testing and approval processes, and supply commercial quantities of a product to market. These competitive products may also impact the timing of clinical testing and approval processes by limiting the number of clinical investigators and patients available to test our potential products.

While we believe that the primary competitive factors will be product efficacy, safety, and the timing and scope of regulatory approvals, other factors include, in certain instances, obtaining marketing exclusivity under the Orphan Drug Act, availability of supply, marketing and sales capability, reimbursement coverage, price, and patent and technology position.

Government Regulation

Our research and development activities and the future manufacturing and marketing of our potential products are, and will continue to be, subject to regulation for safety and efficacy by numerous governmental authorities in the United States and other countries.

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In the United States, pharmaceuticals, biologicals and medical devices are subject to rigorous Food and Drug Administration, or FDA, regulation. The Federal Food, Drug and Cosmetic Act, as amended, and the Public Health Service Act, as amended, the regulations promulgated thereunder, and other Federal and state statutes and regulations govern, among other things, the testing, manufacture, safety, efficacy, labeling, storage, export, record keeping, approval, marketing, advertising and promotion of our potential products. Product development and approval within this regulatory framework takes a number of years and involves significant uncertainty combined with the expenditure of substantial resources. In addition, the federal, state, and other jurisdictions have restrictions on the use of fetal tissue.

FDA Approval

The steps required before our potential products may be marketed in the United States include:

Steps	Considerations
1. Preclinical laboratory and animal tests	Preclinical tests include laboratory evaluation of the cells and the formulation intended for use in humans for quality and consistency. *In vivo* studies are performed in normal animals and specific disease models to assess the potential safety and efficacy of the cell therapy product.
2. Submission to the FDA of an Investigational New Drug application (IND), which must become effective before U.S. human clinical trials may commence	The IND is submitted to the FDA with the preclinical and manufacturing data, a proposed development plan and a proposed protocol for a study in humans. The IND becomes effective 30 days following receipt by the FDA, provided there are no questions, requests for delay or objections from the FDA. If the FDA has questions or concerns, it notifies the sponsor, and the IND will then be on clinical hold until the sponsor responds satisfactorily.
3. Adequate and well-controlled human clinical trials to establish the safety and efficacy of the product	Clinical trials involve the evaluation of a potential product under the supervision of a qualified physician, in accordance with a protocol that details the objectives of the study, the parameters to be used to monitor safety and the efficacy criteria to be evaluated. Each protocol is submitted to the FDA as part of the IND. The protocol for each clinical study must be approved by an independent Institutional Review Board (IRB) of the institution at which the study is conducted and the informed consent of all participants must be obtained. The IRB reviews the existing information on the product, considers ethical factors, the safety of human subjects, the potential benefits of the therapy and the possible liability of the institution. The IRB is responsible for ongoing safety assessment of the subjects during the Clinical Investigation.

Clinical development is traditionally conducted in three sequential phases, Phase 1, 2 and 3.

Phase 1 studies for a cell therapy product are designed to evaluate safety in a small number subjects in a selected patient population by assessing adverse effects, and may

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Steps	Considerations
	include multiple dose levels. This study may also gather preliminary evidence of a beneficial effect on the disease. Phase 2 may involve studies in a limited patient population to determine biological and clinical effects of the product and to identify possible adverse effects and safety risks of the product in the selected patient population. Phase 3 trials would be undertaken to conclusively demonstrate clinical benefit or effect and to test further for safety within a broader patient population, generally at multiple study sites. The FDA continually reviews the clinical trial plans and results and may suggest changes or may require discontinuance of the trials at any time if significant safety issues arise.
4. Submission to the FDA of marketing authorization applications	The results of the preclinical studies and clinical studies are submitted to the FDA in the form of marketing approval authorization applications.
5. FDA approval of the application(s) prior to any commercial sale or shipment of the drug. Biologic product manufacturing establishments located in certain states also may be subject to separate regulatory and licensing requirement	The testing and approval process will require substantial time, effort and expense. The time for approval is affected by a number of factors, including relative risks and benefits demonstrated in clinical trials, the availability of alternative treatments and the severity of the disease. Additional animal studies or clinical trials may be requested during the FDA review period, which might add to that time.

After FDA approval for the product, the manufacturing and the initial indications, further clinical trials may be required to gain approval for the use of the product for additional indications. The FDA may also require unusual or restrictive post-marketing testing and surveillance to monitor for adverse effects, which could involve significant expense, or may elect to grant only conditional approvals.

FDA Manufacturing Requirements

Among the conditions for product licensure is the requirement that the prospective manufacturer s quality control and manufacturing procedures conform to the FDA s current good manufacturing practice (cGMP) requirements. Even after product licensure approval, the manufacturer must comply with cGMP on a continuing basis, and what constitutes cGMP may change as the state of the art of manufacturing changes. Domestic manufacturing facilities are subject to regular FDA inspections for cGMP compliance, which are normally held at least every two years. Foreign

manufacturing facilities are subject to periodic FDA inspections or inspections by the foreign regulatory authorities. Domestic manufacturing facilities may also be subject to inspection by foreign authorities.

Orphan Drug Act

The Orphan Drug Act provides incentives to drug manufacturers to develop and manufacture drugs for the treatment of diseases or conditions that affect fewer than 200,000 individuals in the United States. Orphan drug status can also be sought for treatments for diseases or conditions that affect more than 200,000 individuals in the United States if the sponsor does not realistically anticipate its product becoming profitable from sales in the United

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States. We may apply for orphan drug status for certain of our therapies. Under the Orphan Drug Act, a manufacturer of a designated orphan product can seek tax benefits, and the holder of the first FDA approval of a designated orphan product will be granted a seven-year period of marketing exclusivity in the United States for that product for the orphan indication. While the marketing exclusivity of an orphan drug would prevent other sponsors from obtaining approval of the same compound for the same indication, it would not prevent other compounds or products from being approved for the same use including, in some cases, slight variations on the originally designated orphan product.

FDA Human Cell and Tissue Regulations

Our research and development is based on the use of human stem and progenitor cells. The FDA has initiated a risk-based approach to regulating Human Cell, Tissue and Cellular and Tissue-based (HCT/P) products and has published current Good Tissue Practice (cGTP) regulations. As part of this approach, the FDA has published final rules for registration of establishments that recover, process, store, label, package or distribute HCT/P products or that screen or test the donor of HCT/P products, and for the listing of such products. In addition, the FDA has published rules for determining the suitability of donors of cells and tissue, the eligibility of the cells and tissues for clinical use and for current good tissue practice for manufacturers using them, which came into effect in May 2005. We cannot yet determine the full effects of this regulatory initiative, including precisely how it may affect the extent of regulatory obligations associated with multipotent stem cell research, and the manufacture and marketing of stem cell products.

Other Regulations

In addition to safety regulations enforced by the FDA, we are also subject to regulations under the Occupational Safety and Health Act, the Environmental Protection Act, the Toxic Substances Control Act and other present and potential future foreign, Federal, state and local regulations.

Outside the United States, we will be subject to regulations that govern the import of drug products from the United States or other manufacturing sites and foreign regulatory requirements governing human clinical trials and marketing approval for our products. The requirements governing the conduct of clinical trials, product licensing, pricing and reimbursements vary widely from country to country. In particular, the European Union, or EU, is revising its regulatory approach to biotechnology products, and representatives from the United States, Japan and the EU are in the process of harmonizing and making more uniform the regulations for the registration of pharmaceutical products in these three markets. Furthermore, human stem and progenitor cells may be regulated in the EU and other countries as transplant material or as a somatic cell therapy medicinal product, depending on the processing, indication and country.

Reimbursement and Health Care Cost Control

Reimbursement for the costs of treatments and products such as ours from government health administration authorities, private health insurers and others both in the United States and abroad is a key element in the success of new health care products. Significant uncertainty often exists as to the reimbursement status of newly approved health care products.

The revenues and profitability of some health care-related companies have been affected by the continuing efforts of governmental and third party payers to contain or reduce the cost of health care through various means. Payers are increasingly attempting to limit both coverage and the levels of reimbursement for new therapeutic products approved for marketing by the FDA, and are refusing, in some cases, to provide any coverage for uses of approved products for disease indications for which the FDA has not granted marketing approval. In certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. In the United States, there have been a number of Federal and state proposals to implement government control over health care costs.

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Employees

As of December 31, 2006, we had forty-six full-time employees, of whom thirteen have Ph.D. or M.D. degrees. Thirty-five full-time employees work in research and development and laboratory support services. No employees are covered by collective bargaining agreements.

Scientific Advisory Board

Members of our Scientific Advisory Board (SAB) provide us with strategic guidance in regard to our research and product development programs, as well as assistance in recruiting employees and collaborators. Each SAB member has entered into a consulting agreement with us. These consulting agreements specify the compensation to be paid to the consultant and require that all information about our products and technology be kept confidential. All of the SAB members are employed by employers other than us and may have commitments to or consulting or advising agreements with other entities that limit their availability to us. The SAB members have generally agreed, however, for so long as they serve as consultants to us, not to provide any services to any other entities that would conflict with the services the member provides to us. We are entitled to terminate the arrangements if we determine that there is such a conflict. Members of the SAB offer consultation on specific issues encountered by us as well as general advice on the directions of appropriate scientific inquiry for us. In addition, SAB members assist us in assessing the appropriateness of moving our projects to more advanced stages. The following persons are members of our SAB:

Irving L. Weissman, M.D., is the Virginia and Daniel K. Ludwig Professor of Cancer Research, Professor of Pathology and Professor of Developmental Biology at Stanford University, Stanford California, and Director of the Stanford University Institute for Stem Cell Biology and Regenerative Medicine, as well as Director of the Stanford Comprehensive Cancer Center. Dr. Weissman s lab was responsible for the discovery and isolation of the first ever mammalian tissue stem cell, the hematopoietic (blood-forming) stem cell. Dr. Weissman was responsible for the formation of three stem cell companies, SyStemix, Inc., StemCells, Inc., and Cellerant, Inc. He is a member of the Board of Directors and Chairman of the Scientific Advisory Boards of StemCells and Cellerant. Dr. Weissman co-discovered the mammalian and human hematopoietic stem cells and the human neural stem cell. He has extended these stem cell discoveries to cancer and leukemia, discovering the leukemic stem cells in human and mouse acute or blast crisis myeloid leukemias, and has enriched the cancer stem cells in several human brain cancers as well as human head and neck squamous cell carcinoma. Past achievements of Dr. Weissman s laboratory include identification of the states of development between stem cells and mature blood cells, the discovery and molecular isolation and characterization of lymphocyte and stem cell homing receptors, and identification of the states of thymic lymphocyte development. His laboratory at Stanford has developed accurate mouse models of human leukemias, and has shown the central role of inhibition of programmed cell death in that process. He has also established the evolutionary origins of pre-vertebrate stem cells, and identified and cloned the transplantation genes that prevent their passage from one organism to another. Dr. Weissman has been elected to the National Academy of Science, the Institute of Medicine of the National Academies, the American Association of the Arts and Sciences, the American Society of Microbiology, and several other societies.. He has received the Kaiser Award for Excellence in Preclinical Teaching, the Pasarow Foundation Award for Cancer Research, the California Scientist of the Year (2002), the Kovalenko Medal of the National Academy of Sciences, the Elliott Joslin Medal for Diabetes Research, the de Villiers Award for Leukemia Research, the Irvington Award for Immunologist of the Year, the Bass Award of the Society of Neurosurgeons, the New York Academy of Medicine Award for Medical Research, the Alan Cranston Award for Aging Research, the Linus Pauling Award for Biomedical Research, the E. Donnall Thomas Award for Hematology Research, the van Bekkum Award for Stem Cell Research, the Outstanding Investigator Award from the National Institutes of Health, and many other awards.

David J. Anderson, Ph.D., is Roger W. Sperry Professor of Biology, California Institute of Technology, Pasadena, California and Investigator, Howard Hughes Medical Institute. His laboratory was the first to isolate a multipotent, self-renewing, stem cell for the peripheral nervous system, the first to identify instructive signals that promote the differentiation of these stem cells along various lineages, and the first to accomplish a direct purification of peripheral neural stem cells from uncultured tissue. Dr. Anderson s

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laboratory also was the first to isolate transcription factors that act as master regulators of neuronal fate. More recently, he has identified signals that tell a neural stem cell to differentiate to oligodendrocytes, the myelinating glia of the central nervous system, as well as factors for astrocyte differentiation. Dr. Anderson is a co-founder of StemCells and a member of its SAB, and was a founding SAB member of the International Society for Stem Cell Research. Dr. Anderson also serves on the SAB of Allen Institute for Brain Science. He has held a presidential Young Investigator Award from the National Science Foundation, a Sloan foundation Fellowship in Neuroscience, and has been Donald D. Matson lecturer at Harvard Medical School. He has received the Charles Judson Herrick Award from the American Association of Anatomy, the 1999 W. Alden Spencer Award in Neurobiology from Columbia University, and the Alexander von Humboldt Foundation Award. Dr. Anderson is a member of the American Academy of Arts and Sciences.

Fred H. Gage, Ph.D., is Professor, Laboratory of Genetics, The Salk Institute for Biological Studies, La Jolla, California and Adjunct Professor, Department of Neurosciences, University of California, San Diego, California. Dr. Gage s lab was the first to discover Neurogenesis in the adult human brain. His research focus is on the development of strategies to induce recovery of function following central nervous system (CNS) damage. Dr. Gage is a co-founder of StemCells and of BrainCells, Inc., and a member of the SAB of each. Dr. Gage also serves on the Scientific Advisory Board of Ceregene, Inc. Dr. Gage has been the recipient of numerous awards, including the 1993 Charles A. Dana Award for Pioneering Achievements in Health and Education, the Christopher Reeves Medal, the Decade of the Brain Medal, the Max-Planck research Prize, and the Pasarow Foundation Award. Professor Gage is a member of the Institute of Medicine, a member of the National Academy of Science, and a Fellow of the American Academy of Arts and Science.

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AVAILABLE INFORMATION

Our principal executive offices are located at 3155 Porter Drive, Palo Alto, CA 94304, and our main telephone number is (650) 475-3100. Investors can obtain access to this annual report on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K and all amendments to these reports, free of charge, on our website at http://www.stemcellsinc.com as soon as reasonably practicable after such filings are electronically filed with the SEC. The public may read and copy any material we file with the SEC at the SEC s Public Reference Room at 450 Fifth Street, N.W., Washington D.C., 20549. The public may obtain information on the operations of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site, http://www.sec.gov, which contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC.

Item 1A. *Risk Factors*

Risks Related to our Business

Any adverse development in the initial clinical trial for our stem cell technology could substantially depress our stock price and prevent us from raising the capital we will need to further develop our stem cell technology.

To an unusual extent, our ability to progress as a company is significantly dependent on a single early stage clinical trial. Any clinical, regulatory or other development that prevents or delays us from conducting our initial clinical trial for NCL (Batten disease), or any safety issue or adverse side effect to any patient that occurs during the trial, or the failure of this initial trial to enroll patients and proceed to completion as anticipated or to show the results expected by investors, would likely significantly depress our stock price and could prevent us from raising the substantial additional capital we will require to further develop our stem cell technologies.

Our financial situation is precarious and, based on currently estimated operating expenses, our existing capital resources may not be sufficient to fund our operations beyond the next eighteen months.

We have incurred significant operating losses and negative cash flows since inception. We have not achieved profitability and may not be able to realize sufficient revenues to achieve or sustain profitability in the future. We do not expect to be profitable in the next several years, but rather expect to incur additional and increasing operating losses. We have limited liquidity and capital resources and must obtain significant additional capital resources in order to sustain our product development efforts and for acquisition of technologies and intellectual property rights, preclinical and clinical testing of our anticipated products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, maintaining and enforcing our intellectual property portfolio, general and administrative expenses and other working capital requirements. We rely on cash reserves and proceeds from equity and debt offerings, proceeds from the transfer or sale of our intellectual property rights, equipment, facilities or investments, and government grants and funding from collaborative arrangements, if obtainable, to fund our operations. If we exhaust our cash reserves and are unable to realize adequate financing, we may be unable to meet operating obligations and be required to initiate bankruptcy proceedings. Our existing capital resources may not be sufficient to fund our operations beyond the next eighteen months. We intend to pursue opportunities to obtain additional financing in the future through equity and debt financings, corporate alliances, grants and collaborative research arrangements. The source, timing and availability of any future financing will depend principally upon market conditions, interest rates and, more specifically, on our progress in our exploratory, preclinical and future clinical development programs. Funding may not be available when needed at all or on terms acceptable to us. Lack of necessary funds may require us to delay, scale back or eliminate some or all of our research and product development programs and/or our capital expenditures or to license our potential products or technologies to third parties.

Our product development programs are based on novel technologies and are inherently risky.

We are subject to the risks of failure inherent in the development of products based on new technologies. The novel nature of the therapies creates significant challenges in regards to product development and optimization, manufacturing, government regulation, third party reimbursement and market acceptance. For example, the FDA

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has relatively little experience with stem cell-based therapeutics, and the pathway to regulatory approval for our product candidates may accordingly be more complex and lengthy than the pathway for new conventional drugs. These challenges may prevent us from developing and commercializing products on a timely or profitable basis or at all.

Our technology is at an early stage of discovery and development, and we may fail to develop any commercially acceptable or profitable products.

We have yet to develop any products that have been approved for marketing. Before we may market any product, we must obtain regulatory approval from the FDA and equivalent foreign agencies after conducting extensive preclinical studies and clinical trials that demonstrate that our product candidates are safe and effective for each disease for which we seek approval. We have no experience in conducting clinical trials prior to the current NCL trial being conducted at the Oregon Health & Science University (OHSU). We expect that none of our cell-based therapeutic product candidates will be commercially available for several years, if at all.

Our programs are still at the preclinical phase for our human liver engrafting cell, and at the discovery phase for our candidate human pancreas stem cell. While the U.S. Food and Drug Administration (FDA) has permitted us to go forward with our Phase I clinical trial of our proprietary neural stem cell therapy product HuCNS SC in NCL, and the Institutional Review Board of OHSU has approved the protocol, there can be no assurance that the clinical investigators will be able to identify suitable candidates for completion of the trial (which is intended to enroll six subject, only of whom two have received transplants so far), or of a successful outcome of the trial if candidates are enrolled. We may fail to discover the stem cells we are seeking, to develop any products, to obtain regulatory approvals, to enter clinical trials, or to commercialize any products. We may elect to delay or discontinue preclinical studies or clinical trials based on unfavorable results. Any product using stem cell technology may fail to:

survive and persist in the desired location;

provide the intended therapeutic benefits;

properly integrate into existing tissue in the desired manner; or

achieve therapeutic benefits equal to or better than the standard of treatment at the time of testing.

In addition, our products may cause undesirable side effects. Results of preclinical research may not be indicative of the results that will be obtained in later stages of preclinical or clinical research. If regulatory authorities do not approve our products or if we fail to maintain regulatory compliance, we would be unable to commercialize our products, and our business and results of operations would be harmed. Furthermore, because transplantation of stem cells is a new form of therapy, the marketplace may not accept any products we may develop. If we do succeed in developing products, we will face many potential obstacles such as the need to obtain regulatory approvals and to develop or obtain manufacturing, marketing and distribution capabilities. In addition, we will face substantial additional risks such as product liability claims.

Moreover, because our cell-based therapeutic products will be derived from tissue of individuals other than the patient (that is, they will be non-self or allogeneic transplant products), patients will require the use of immunosuppressive drugs such as cyclosporine, FK506, or others to prevent rejection of the cells. While immunosuppression is now standard in connection with allogeneic transplants of various kinds, long-term maintenance on immunosuppressive drugs can produce complications that include infection, cancer, cardiovascular disease, renal dysfunction and other side effects depending upon which immunosuppressive regimen is employed. Immunosuppression is currently being tested with our therapeutic product candidate in our Phase I clinical trial for NCL (Batten disease).

Our success will depend in large part on our ability to develop and commercialize products that treat diseases other than Batten disease.

Although we have initially focused on evaluating our neural stem cell product for the treatment of infantile and late infantile NCL (Batten disease), this disease is rare, and the market for treating this disease is small.

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Accordingly, even if we obtain marketing approval for HuCNS-SC for infantile and late infantile NCL, in order to achieve profitability, if at all, we will need to obtain approval for HuCNS-SC and other potential products to treat additional diseases that present more significant market opportunities.

We have payment obligations resulting from real property owned or leased by us in Rhode Island, which diverts funding from our stem cell research and development.

Prior to our reorganization in 1999 and the consolidation of our business in California, we carried out our former encapsulated cell therapy programs in Lincoln, Rhode Island, where we also had our administrative offices. Although we have vacated the Rhode Island facilities, we remain obligated to make lease payments and payments for operating costs for our former science and administrative facility, which we have leased through June 30, 2013. These costs, before sub-tenant rental income, amounted to approximately $1,550,000 in 2006; our rent payments will increase over the term of the lease, and our operating costs may increase as well. In addition to these costs of our former science and administrative facility, we are obligated to make debt service payments and payments for operating costs of approximately $450,000 per year for our former encapsulated cell therapy pilot manufacturing facility, which we own. We have currently subleased a portion of the science and administrative facility, and are seeking to sublease the remaining portion, but we cannot be sure that we will be able to keep any part of the facility subleased for the duration of our obligation. We have currently subleased the entire pilot manufacturing facility to a privately-held biotechnology company, but may not be able to sublease or sell the facility in the future once the current sublease agreements expire. These continuing costs significantly reduce our cash resources and adversely affect our ability to fund further development of our stem cell technology. In addition, changes in real estate market conditions and assumptions regarding the length of time it may take us to either fully sublease, assign or sell our remaining interest in the our former research facility in Rhode Island may have a significant impact on and cause large variations in our quarter to quarter results of operations. In 1999, in connection with exiting our former research facility in Rhode Island, we created a reserve for the estimated lease payments and operating expenses related to it. The reserve is periodically re-evaluated and adjusted based on assumptions relevant to real estate market conditions and the estimated time until we can either fully sublease, assign or sell our remaining interests in the property. At December 31, 2006, the reserve was $6,750,000. In 2006 and 2005, we incurred $1,295,000 and $1,079,000 in operating expenses net of sub-tenant income for this facility. Expenses for this facility will fluctuate based on changes in tenant occupancy rates and other operating expenses related to the lease. Even though it is our intent to sublease, assign, sell or otherwise divest ourselves of our interests in the facility at the earliest possible time, we cannot determine with certainty a fixed date by which such events will occur. In light of this uncertainty, based on estimates, we will periodically re-evaluate and adjust the reserve, as necessary, and we may make significant adverse adjustments to the reserve in the future.

We may need but fail to obtain partners to support our stem cell development efforts and to commercialize our technology.

Equity and debt financings alone may not be sufficient to fund the cost of developing our stem cell technologies, and we may need to rely on partnering arrangements to provide financial support for our stem cell discovery and development efforts. In addition, in order to successfully develop and commercialize our technology, we may need to enter into a wide variety of arrangements with corporate sponsors, pharmaceutical companies, universities, research groups and others. While we have engaged, and expect to continue to engage, in discussions regarding such arrangements, we have not reached any agreement, and we may fail to obtain any such agreement on terms acceptable to us. Even if we enter into such arrangements, we may not be able to satisfy our obligations under them or renew or replace them after their original terms expire. Furthermore, these arrangements may require us to grant rights to third parties, such as exclusive marketing rights to one or more products, may require us to issue securities to our collaborators and may contain other terms that are burdensome to us. If we enter collaboration agreements and any of our collaborators terminates its relationship with us or fails to perform its obligations in a timely manner, the

development or commercialization of our technology and potential products may be adversely affected.

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Because the patient population for NCL, or Batten disease, is very small, we may encounter difficulties in enrolling subjects in our first clinical trial.

The first clinical application we are pursuing NCL (also known as Batten disease) has a very small patient population. From this small population, we must locate and enroll patients that satisfy the specific enrollment criteria for our Phase I clinical trial for this indication. This clinical trial may be delayed significantly or terminated if we are unable to enroll a sufficient number of qualified patients.

We have a history of operating losses, and we may fail to obtain revenues or become profitable.

We expect to continue to incur substantial operating losses in the future in order to conduct our research and development activities, and, if those activities are successful, to fund clinical trials and other expenses. These expenses include the cost of acquiring technology, product testing, acquiring regulatory approvals, establishing production, marketing, sales and distribution programs and administrative expenses. We have not earned any revenues from sales of any product. All of our past revenues have been derived from, and any revenues we may obtain for the foreseeable future are expected to be derived from, license agreements, cooperative agreements, research grants, investments and interest on invested capital. We currently have no cooperative agreements or research grants and we may not obtain any such agreements or additional grants in the future or receive any revenues from them.

If we are unable to protect our patents and proprietary rights, our business, financial condition and results of operations will be harmed.

We own or license a number of patents and pending patent applications related to various stem and progenitor cells and methods of deriving and using them, including human neural stem cell cultures. Patent protection for products such as those we propose to develop is highly uncertain and involves complex and continually evolving factual and legal questions. The governmental authorities that consider patent applications can deny or significantly reduce the patent coverage requested in an application before or after issuing the patent. Consequently, we do not know whether any of our pending applications will result in the issuance of patents, if any existing or future patents will provide sufficient protection or significant commercial advantage or if others will circumvent these patents. We cannot be certain that we were the first to discover the inventions covered by each of our pending patent applications or that we were the first to file patent applications for such inventions because patent applications are secret until they are published, and because publication of discoveries in the scientific or patent literature often lags behind actual discoveries. Patents may not issue from our pending or future patent applications or, if issued, may not be of commercial benefit to us. In addition, our patents may not afford us adequate protection from competing products. Third parties may challenge our patents or governmental authorities may declare them invalid or reduce their scope. In the event that a third party has also filed a patent application relating to inventions claimed in our patent applications, we may have to participate in proceedings to determine priority of invention. Even if a patent issues, a court could decide that the patent was issued invalidly. Because patents issue for a limited term, our patents may expire before we utilize them profitably. Our most important patents begin to expire in 2015. Under the procedures of the European Patent Office, third parties may oppose our issued European patents during the relevant opposition period. These proceedings and oppositions could result in substantial uncertainties and cost for us, even if the eventual outcome is favorable to us, and the outcome might not be favorable to us. One party has opposed two of our granted European patents. Both oppositions were heard in 2005, and the patents were maintained in somewhat altered form. Although the time for appeal has now run, and the .U.S. counterparts to these patents are not subject to opposition, since that procedure does not exist under U.S. patent law, other types of proceedings may be available to third parties to contest our U.S. patents. See Item 1. Business Patents, Proprietary Rights and Licenses and Item 3. Legal proceedings.

If we learn of third parties who infringe our patent rights, we may need to initiate legal proceedings to enforce our patent rights. These proceedings may entail significant costs, and these third parties may have significantly greater financial resources than us. We may not prevail in these proceedings. See Item 1. Business Patents, Proprietary Rights and Licenses and Item 3. Legal proceedings.

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Proprietary trade secrets and unpatented know-how are also important to our research and development activities. We cannot be certain that others will not independently develop the same or similar technologies on their own or gain access to our trade secrets or disclose such technology or that we will be able to meaningfully protect our trade secrets and unpatented know-how. We require our employees, consultants, and significant scientific collaborators and sponsored researchers to execute confidentiality agreements upon the commencement of an employment or consulting relationship with us. These agreements may, however, fail to provide meaningful protection or adequate remedies for us in the event of unauthorized use, transfer or disclosure of such information or technology.

If others are first to discover and patent the stem cells we are seeking to discover, we could be blocked from further work on those stem cells.

Because the first person or entity to discover and obtain a valid patent to a particular stem or progenitor cell may effectively block all others, it will be important for us or our collaborators to be the first to discover any stem cell that we are seeking to discover. Failure to be the first could prevent us from commercializing all of our research and development affected by that patent.

If we are unable to obtain necessary licenses to third-party patents and other rights, we may not be able to commercially develop our expected products.

A number of pharmaceutical, biotechnology and other companies, universities and research institutions have filed patent applications or have received patents relating to cell therapy, stem cells and other technologies potentially relevant to or necessary for our expected products. We cannot predict which, if any, of the applications will issue as patents, and there may be existing patents of which we are currently unaware which the commercialization of our product candidates would infringe. If third party patents or patent applications contain valid claims that our technology infringes upon their technology, we may be prevented from commercializing that technology unless the third party is willing to grant a license to us. We may be unable to obtain licenses to the relevant patents at a reasonable cost, if at all, and may also be unable to develop or obtain alternative non-infringing technology. If we are unable to obtain such licenses or develop non-infringing technology at a reasonable cost, our business could be significantly harmed. Also, any infringement lawsuits commenced against us may result in significant costs, divert our management s attention and result in an award against us for substantial damages.

We are aware of intellectual property rights held by third parties that relate to products or technologies we are developing. For example, some aspects of our stem cell product candidates involve the use of growth factors, antibodies and other reagents that may, in certain cases, be the subject of third party rights. Before we commercialize any product using these growth factors, antibodies or reagents, we may need to obtain license rights from third parties or use alternative growth factors, antibodies and reagents that are not then the subject of third party patent rights. We currently believe that the commercialization of our products as currently planned will not infringe these third party rights, or, alternatively, that we will be able to obtain necessary licenses or otherwise use alternate non-infringing technology. However, third parties may nonetheless bring suit against us claiming infringement. If we are unable to prove that our technology does not infringe their patents, or if we are unable to obtain necessary licenses or otherwise use alternative non-infringing technology, we may not be able to commercialize any products. Also, if we use alternative non-infringing technology, we may need to demonstrate comparability in subsequent clinical trials.

We have obtained rights from universities and research institutions to technologies, processes and compounds that we believe may be important to the development of our products. These licensors, however, may cancel our licenses or convert them to non-exclusive licenses if we fail to use the relevant technology or otherwise breach these agreements. Loss of these licenses could expose us to the risk that our technology infringes the rights of third parties. We can give no assurance that any of these licenses will provide effective protection against our competitors.

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We compete with companies that have significant advantages over us.

The market for therapeutic products to treat diseases of, or injuries to, the central nervous system (CNS) is large, and competition is intense. The majority of the products currently on the market or in development are small molecule pharmaceutical compounds. Many of the world s large pharmaceutical companies, including Merck, Pfizer, Abbott, Bristol-Myers Squibb, Novartis and GlaxoSmithKline, have made significant commitments to the CNS field. Any cell-based therapy to treat diseases of, or injuries to, the CNS is likely to face intense competition from the small molecule sector. In addition, a number of biotechnology companies with resources far greater than ours may also emerge as competitors. These include Genzyme, Amgen, Cephalon, Shire Pharmaceuticals, BioMarin, Celgene, Biogen Idec, and Titan Pharmaceuticals/Schering AG. Finally, we also expect to compete with smaller biotechnology companies, such as NeuralStem, Geron, NeuroNova, ReNeuron, and ES Cell International, some of which are privately owned.

We believe that our human neural stem cells may have application to many or most of the Lysosomal Storage Diseases (LSDs) with CNS involvement. We are currently conducting a Phase I clinical trial at Doernbecher Children s Hospital at Oregon Health & Safety University to treat infantile and late infantile NCL (also known as Batten disease), which are among the LSDs that affect the CNS. There can be no assurance that the trial will demonstrate either safety or efficacy of our HuCNS-SC. There are, so far as we know, no approved therapies for NCL or any of the other CNS-specific LSDs, but other companies, including Genzyme, BioMarin, and Shire, have products approved to treat peripheral aspects of some of the other LSDs, and other products are in clinical trials.

In the liver field, there are no broad-based therapies for the treatment of liver disease at present. The primary therapy is liver transplantation, which is limited by the availability of matched donor organs. Liver-assist devices, when and if they become available, could also be used to help patients while they await suitably matched organs for transplantation. In addition, new therapies may become available before we successfully develop a cell-based therapy for liver disease.

In the field of diabetes, a number of major companies currently market products for the treatment of diabetes and are also engaged in the research and development of new therapies. Such companies include Eli Lilly, Novo Nordisk, J&J, Amylin, ViaCell, and Serono. Consequently, should we successfully develop a cell-based therapy for diabetes, we would expect to face severe competition from these and similar companies.

Development of our technology is subject to and restricted by extensive government regulation, which could impede our business.

Our research and development efforts, as well as any future clinical trials, and the manufacturing and marketing of any products we may develop, will be subject to and restricted by extensive regulation by governmental authorities in the United States and other countries. The process of obtaining U.S. Food and Drug Administration and other necessary regulatory approvals is lengthy, expensive and uncertain. We or our collaborators may fail to obtain the necessary approvals to commence or continue clinical testing or to manufacture or market our potential products in reasonable time frames, if at all. In addition, the U.S. Congress and other legislative bodies may enact regulatory reforms or restrictions on the development of new therapies that could adversely affect the regulatory environment in which we operate or the development of any products we may develop.

We base our research and development on the use of human stem and progenitor cells obtained from fetal tissue. The federal and state governments and other jurisdictions impose restrictions on the use of fetal tissue, including those incorporated in the recent federal current Good Tissue Practice, or cGTP, regulations. These regulatory and other constraints could prevent us from obtaining cells and other components of our products in the quantity or quality

needed for their development or commercialization. These restrictions change from time to time and may become more onerous. Additionally, we may not be able to identify or develop reliable sources for the cells necessary for our potential products that is, sources that follow all state and federal guidelines for cell procurement. Certain components used to manufacture our stem cell product candidates will need to be manufactured in compliance with the FDA s Good Manufacturing Practices, or cGMP. Accordingly, we will need to enter into supply agreements with companies that manufacture these components to cGMP standards.

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Although we do not use embryonic stem cells, government regulation and threatened regulation of embryonic tissue may lead top researchers to leave the field of stem cell research, or the country, in order to assure that their careers will not be impeded by restrictions on their work. Similarly, these factors may induce the best graduate students to choose other fields less vulnerable to changes in regulatory oversight, thus exacerbating the risk, discussed below, that we may not be able to attract and retain the scientific personnel we need in face of the competition among pharmaceutical, biotechnology and health care companies, universities and research institutions for what may become a shrinking class of qualified individuals. In addition, we cannot be certain that constraints on the use of embryonic stem cells will not be extended to use of fetal stem cells. Moreover, it is possible that concerns regarding research using embryonic stem cells will negatively impact our stock price and our ability to attract collaborators and investors.

We may apply for status under the Orphan Drug Act for some of our therapies to gain a seven-year period of marketing exclusivity for those therapies. The U.S. Congress in the past has considered, and in the future again may consider, legislation that would restrict the extent and duration of the market exclusivity of an orphan drug. If enacted, such legislation could prevent us from obtaining some or all of the benefits of the existing statute even if we were to apply for and obtain orphan drug status with respect to a potential product.

We are dependent on the services of key personnel.

We are highly dependent on the principal members of our management and scientific staff and some of our outside consultants, including the members of our scientific advisory board, our chief executive officer, our chief operating officer, our vice presidents and the heads of key departments or functions within the company. Although we have entered into employment agreements with some of these individuals, they may terminate their agreements at any time. In addition, our operations are dependent upon our ability to attract and retain additional qualified scientific and management personnel. We may not be able to attract and retain the personnel we need on acceptable terms given the competition for experienced personnel among pharmaceutical, biotechnology and health care companies, universities and research institutions.

Our activities involve hazardous materials and experimental animal testing; improper handling of these animals and materials by our employees or agents could expose us to significant legal and financial penalties.

Our research and development activities involve the controlled use of hazardous chemicals and potentially hazardous biological materials such as human tissue and animals. Their use subjects us to environmental and safety laws and regulations such as those governing laboratory procedures, exposure to blood-borne pathogens, use of animals and the handling of biohazardous materials. Compliance with current or future laws and regulations may be expensive and the cost of compliance could adversely affect us.

Although we believe that our safety procedures for using, handling, storing and disposing of hazardous and potentially hazardous materials comply with the standards prescribed by California and federal regulations, the risk of accidental contamination or injury from these materials cannot be eliminated. In the event of such an accident or of any violation of these or future laws and regulations, state or federal authorities could curtail our use of these materials; we could be liable for any civil damages that result, the cost of which could be substantial; and we could be subjected to substantial fines or penalties. In addition, any failure by us to control the use, disposal, removal or storage, or to adequately restrict the discharge, or to assist in the cleanup, of hazardous chemicals or hazardous, infectious or toxic substances could subject us to significant liability. Any such liability could exceed our resources and could have a material adverse effect on our business, financial condition and results of operations. Moreover, an accident could damage our research and manufacturing facilities and operations and result in serious adverse effects on our business.

The manufacture, development and commercialization of stem cell products expose us to product liability claims, which could lead to substantial liability.

By developing and, ultimately, commercializing medical products, we are exposed to the risk of product liability claims. Product liability claims against us could entail substantial litigation costs and damage awards

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against us. We have obtained liability insurance that covers our clinical trials, and we will need to increase our insurance coverage if and when we begin commercializing products. We may not be able to obtain insurance on acceptable terms, if at all, and the policy limits on our insurance policies may be insufficient to cover our liability.

Since health care insurers and other organizations may not pay for our products or may impose limits on reimbursements, our ability to become profitable could be reduced.

In both domestic and foreign markets, sales of potential products are likely to depend in part upon the availability and amounts of reimbursement from third-party health care payor organizations, including government agencies, private health care insurers and other health care payors, such as health maintenance organizations and self-insured employee plans. There is considerable pressure to reduce the cost of therapeutic products, and government and other third party payors are increasingly attempting to contain health care costs by limiting both coverage and the level of reimbursement for new therapeutic products and by refusing, in some cases, to provide any coverage for uses of approved products for disease indications for which the U.S. Food and Drug Administration has not granted marketing approval. Significant uncertainty exists as to the reimbursement status of newly approved health care products or novel therapies such as ours. Even if we obtain regulatory approval to market our products, we can give no assurance that reimbursement will be provided by such payors at all or without substantial delay or, if such reimbursement is provided, that the approved reimbursement amounts will be sufficient to enable us to sell products we develop on a profitable basis. Changes in reimbursement policies could also adversely affect the willingness of pharmaceutical companies to collaborate with us on the development of our stem cell technology. In certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. We also expect that there will continue to be a number of federal and state proposals to implement government control over health care costs. Efforts at health care reform are likely to continue in future legislative sessions. We do not know what legislative proposals federal or state governments will adopt or what actions federal, state or private payers for health care goods and services may take in response to health care reform proposals or legislation. We cannot predict the effect government control and other health care reforms may have on our business.

We have limited liquidity and capital resources and may not obtain the significant capital resources we will need to sustain our research and development efforts.

We have limited liquidity and capital resources and must obtain substantial additional capital to support our research and development programs, for acquisition of technology and intellectual property rights and, to the extent we decide to undertake these activities ourselves, for preclinical and clinical testing of our anticipated products, pursuit of regulatory approvals, establishment of production capabilities, maintaining and enforcing our intellectually property portfolio, establishment of marketing and sales capabilities and distribution channels, and general administrative expenses. If we do not obtain the necessary capital resources, we may have to delay, reduce or eliminate some or all of our research and development programs or license our technology or any potential products to third parties rather than commercialize them ourselves. We intend to pursue our needed capital resources through equity and debt financings, corporate alliances, grants and collaborative research arrangements. We may fail to obtain the necessary capital resources from any such sources when needed or on terms acceptable to us. Our ability to complete successfully any such arrangements will depend upon market conditions and, more specifically, on continued progress in our research and development efforts.

Ethical and other concerns surrounding the use of stem cell therapy may negatively affect regulatory approval or public perception of our product candidates, which could reduce demand for our products.

The use of stem cells for research and therapy has been the subject of debate regarding related ethical, legal and social issues. Although these concerns have mainly been directed to the use of embryonic stem cells, which we do not use, the distinction between embryonic and non-embryonic stem cells is frequently overlooked; moreover, our use of

human stem cells from fetal sources might raise these or similar concerns. Negative public attitudes toward stem cell therapy could result in greater governmental regulation of stem cell therapies, which could harm our business. For example, concerns regarding such possible regulation could impact our ability to attract collaborators and investors. Also, existing regulatory constraints on the use of embryonic stem cells may in the future be extended to use of fetal stem cells, and these constraints might prohibit or restrict us from conducting research or

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commercializing products. Government regulation and threatened regulation of embryonic tissue could also harm our ability to attract and retain qualified scientific personnel by causing top researchers to leave the country or the field of stem cell research altogether; and by encouraging the best graduate students to choose other fields that are less vulnerable to changes in regulatory oversight.

Our corporate documents and Delaware law contain provisions that may make it difficult for us to be acquired in a transaction that would be beneficial to our shareholders.

Our board of directors has the authority to issue shares of preferred stock and to fix the rights, preferences, privileges and restrictions of these shares without shareholder approval. In addition, we have adopted a rights plan that generally permits our existing shareholders to acquire additional shares at a substantial discount to the market price in the event of certain attempts by third parties to acquire us. These rights, along with certain provisions in our corporate documents and Delaware law, may make it more difficult for a third party to acquire us or discourage a third party from attempting to acquire us, even if the acquisition might be beneficial to our shareholders.

Risks Related to the Securities Market

Our stock price has been, and will likely continue to be, highly volatile, which may negatively affect our ability to obtain additional financing in the future.

The market price of our stock has been and is likely to continue to be highly volatile due to the risks and uncertainties described in this section of the Form 10-K, as well as other factors, including:

- our ability to develop and test our technology;
- our ability to patent or obtain licenses to necessary technology;
- conditions and publicity regarding the industry in which we operate, as well as the specific areas our product candidates seek to address;
- competition in our industry;
- price and volume fluctuations in the stock market at large that are unrelated to our operating performance; and
- comments by securities analysts, or our failure to meet market expectations.

Over the two-year period ended December 31, 2006, the trading price of our common stock as reported on the Nasdaq Markets ranged from a high of $6.77 to a low of $1.77. As a result of this volatility, your investment in our stock is subject to substantial risk. Furthermore, the volatility of our stock price could negatively impact our ability to raise capital in the future.

We are contractually obligated to issue shares in the future, diluting the interest of current shareholders.

As of December 31, 2006, there were outstanding warrants to purchase 1,930,658 shares of our common stock, at a weighted average exercise price of $1.86 per share. As of December 31, 2006, there were also outstanding options to purchase 8,501,503 shares of our common stock, at a weighted average exercise price of $2.88 per share. Moreover, we expect to issue additional options to purchase shares of our common stock to compensate employees, consultants and directors, and may issue additional shares to raise capital, to acquire other companies or technologies, to pay for services, or for other corporate purposes. Any such issuances will have the effect of diluting the interest of current

shareholders.

Item 1B. ***Unresolved Staff Comments***

None.

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Item 2. ***Properties***

We entered into a 5-year lease, as of February 1, 2001, for a 40,000 square foot facility, located in the Stanford Research Park in Palo Alto, California. This facility includes space for animals as well as laboratories, offices, and a suite designed to be used to manufacture materials for clinical trials. Effective July 1, 2006, under an agreement that extends the lease through March 31, 2010, we leased the remainder of the building, adding approximately 27,500 square feet to our leased premises. The facility will better enable us to achieve our goal of utilizing human stem and progenitor cells for the treatment of disorders of the nervous system, liver, and pancreas. We have a space-sharing agreement with Stanford University for part of the animal facility not needed for our own use.

We continue to lease the following facilities in Lincoln, Rhode Island obtained in connection with our former encapsulated cell technology: our former research laboratory and corporate headquarters building which contains 62,500 square feet of wet labs, specialty research areas and administrative offices held on a lease agreement that goes through June 2013, as well as a 21,000 square-foot pilot manufacturing facility and a 3,000 square-foot cell processing facility financed by bonds issued by the Rhode Island Industrial Facilities Corporation. We have subleased the 21,000 square-foot and the 3,000 square foot facilities. We have also subleased small portions of the 62,500 square foot facility, amounting to approximately ten percent for most of 2006. We are actively seeking to sublease, assign or sell our remaining interests in these properties.

Item 3. ***Legal Proceedings***

In December 2003, Geron Corporation filed oppositions to two of our European patents that relate to neural stem cells and their uses, alleging that each patent should be revoked on multiple grounds. Both oppositions were heard in 2005, and the patents were maintained in somewhat altered form by the Opposition Division of the European Patent Office, and the time for appeal has run. U.S. counterparts to both of these patents are part of our issued patent portfolio; they are not subject to opposition, since that procedure does not exist under U.S. patent law, but other types of proceedings may be available to third parties to contest our U.S. patents.

In July, 2006, we filed suit against Neuralstem, Inc., in the Federal District Court for the District of Maryland, alleging that its activities violate claims in four of our patents. Neuralstem has filed a motion for dismissal or summary judgment, citing Title 35, Section 271(e)(1) of the United States Code, which says that it is not an act of patent infringement to make, use or sell a patented invention solely for uses reasonably related to the development and submission of information to the FDA. Neuralstem argues that since it does not have any therapeutic products on the market yet, the activities complained of fall within the protection of Section 271(e)(1) that is, basically, that the suit is premature. This issue will be decided after discovery is complete.

Item 4. ***Submission Of Matters To A Vote Of Security Holders***

None.

PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

(a) Market Price and dividend information

In September 2005 the Nasdaq Stock Market approved our application to move the listing of our common stock from the Nasdaq Capital Market (previously known as the Nasdaq SmallCap Market) to the Nasdaq National Market (now known as the Nasdaq Global Market). The stock began trading on the Nasdaq National Market on

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September 30, 2005 under the same symbol, STEM. The quarterly ranges of high and low bid prices for the last two fiscal years as reported by NASDAQ are shown below:

2006	**High**	**Low**
First Quarter	$ 4.06	$ 3.45
Second Quarter	$ 3.58	$ 1.77
Third Quarter	$ 2.55	$ 1.90
Fourth Quarter	$ 3.49	$ 2.05
2005		
First Quarter	$ 6.76	$ 3.00
Second Quarter	$ 4.60	$ 2.58
Third Quarter	$ 6.57	$ 4.19
Fourth Quarter	$ 5.53	$ 3.40

No cash dividends have been declared on the Company s common stock since the Company s inception.

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PERFORMANCE GRAPH

The following graph compares the cumulative 5-year total return to shareholders of StemCells, Inc. s common stock relative to the cumulative total returns of the S & P 500 Index and the Amex Biotechnology Stock Index. The graph assumes that the value of the investment in the company s common stock and in each of the indexes (including reinvestment of dividends) was $100 on December 31, 2001 and tracks it through December 31, 2006.

The stock price performance shown on the graph below is not necessarily indicative of future stock price performance.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN
Among StemCells, Inc., S & P 500 Index and the Amex Biotechnology Stock Index
for the period from December 31, 2001 until December 31, 2006[(1)]

	December 31, 2001	December 31, 2002	December 31, 2003	December 31, 2004	December 31, 2005	December 31, 2006
StemCells, Inc.	$ 100.00	$ 31.23	$ 56.73	$ 121.20	$ 98.85	$ 75.93
S&P 500 Index	$ 100.00	$ 76.63	$ 96.85	$ 105.56	$ 108.73	$ 123.54
AMEX BIOTECH STOCK INDEX	$ 100.00	$ 58.26	$ 84.42	$ 93.74	$ 117.28	$ 129.91

(1) Based on the closing price of the company s common stock on the first day of trading on the NASDAQ Global Market. Cumulative total returns assume reinvestment of all dividends and a hypothetical investment of $100 on December 31, 2001.

(b) Approximate Number of Holders of Common Stock

As of February 28, 2007, there were approximately 592 holders of record of the common stock, and as of the same date the closing price per share of the common stock on the NASDAQ Global Market was $2.83.

(c) Recent Sale of Unregistered Securities (last three years ending December 31, 2006)

The Company issued the following unregistered securities in 2004:

In August 2004, StemCells issued 9,535 shares of common stock to the California Institute of Technology (Cal Tech) as payment for fees of $10,000 and $5,000 that were due on the issuance of two patents to which StemCells holds a license from Cal Tech that were payable in cash or stock at the Company s option. The shares were issued in a transaction not involving any public offering pursuant to Section 4(2) of the Securities Act of 1933, as amended.

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In December 2004, StemCells issued 1,816 shares of common stock to inventors of a technology as part payment for approximately $2,800 of the total option fee of $25,000 to acquire an exclusive license to the technology from the Board of Trustees of The Leland Stanford Junior University. The shares were issued in a transaction not involving any public offering pursuant to Section 4(2) of the Securities Act of 1933, as amended.

No unregistered securities were issued in 2005.

The Company issued the following unregistered securities in 2006:

In August 2006, StemCells issued 3,848 shares of common stock to the California Institute of Technology (Cal Tech) as payment of annual fees of $5,000 on each for two patents to which StemCells holds a license from Cal Tech, payable in cash or stock at the Company s choice. The Company elected to pay the fees in stock. The shares were issued in a transaction not involving any public offering pursuant to Section 4(2) of the Securities Act of 1933, as amended.

Equity Compensation Plan Information

The following table provides certain information with respect to all of the Company s equity compensation plans in effect as of December 31, 2006.

	Equity Compensation Plan Information		
Plan category	**Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)**	**Weighted-average Exercise Price of Outstanding Options, Warrants and rights (b)**	**Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column(a)) (c)**
Equity compensation plans approved by security holders	8,501,503(1)	$ 2.88	5,320,935
Equity compensation arrangements not approved by security holders	100,000(2)	$ 1.20	N/a
Totals	8,601,503	$ 2.86	5,320,935

(1) Consists of options issued to employees and options issued as compensation to consultants for consultation services. These options were issued under the Company s 1992 Equity Incentive Plan, its Directors Stock Option Plan, its StemCells, Inc. Stock Option Plan, or its 2001, 2004 and 2006 Equity Incentive Plans.

(2) Represents the portion outstanding of a fully vested warrant issued in January 2003, to purchase 200,000 shares with an exercise price of $1.20 per share and exercisable, in whole or in part, for five years from the date of issuance. The warrant which constitutes an equity compensation arrangement not approved by security holders was issued in exchange for advisory services by non-employees.

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Item 6. ***Selected Financial Data***

The following selected financial and operating data are derived from our audited consolidated financial statements. The selected financial and operating data should be read in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation and the consolidated financial statements and notes thereto contained elsewhere in this Form 10-K.

	Year ended December 31,				
	2006	2005	2004	2003	2002
	(In thousands, except per share amounts)				
Consolidated Statement of Operations					
Revenue from collaborative and licensing agreements	$ 55	$ 20	$ 22	$ 18	$ 40
Revenue from grants	38	186	119	255	375
Total revenue	93	206	141	273	415
Research and development expenses	13,600	8,226	7,844	5,479	6,732
General and administrative expenses	7,154	5,540	4,870	4,056	4,009
Wind-down expense(1)	709	2,827	2,827	2,885	1,164
License & settlement agreement income, net(2)	103	3,736			
Loss before deemed dividends and cumulative effect of change in accounting principle	(18,948)	(11,738)	(15,330)	(12,291)	(11,644)
Net loss	(18,948)	(11,738)	(15,330)	(14,425)	(13,276)
Basic and diluted loss per share	$ (0.25)	$ (0.18)	$ (0.31)	$ (0.45)	$ (0.53)
Shares used in computing basic and Diluted loss per share amounts	74,611	63,643	49,606	32,080	25,096

	December 31,				
	2006	2005	2004	2003	2002
	(In thousands)				
Consolidated Balance Sheet					
Cash and cash equivalents	$ 51,795	$ 34,541	$ 41,060	$ 13,082	$ 4,236
Marketable securities	7,266	3,721			
Total assets	66,857	44,839	47,627	19,786	11,329
Accrued wind-down expenses and deferred rent(1)	6,750	7,306	5,528	3,823	1,931
Long-term debt, including capital leases	1,145	1,351	1,646	1,850	2,087
Redeemable preferred stock(3)					2,660
Stockholders equity	54,376	32,376	36,950	10,964	1,933

(1)

Relates to wind-down expenses in respect of the Company s Rhode Island facility. See Note 8 in the consolidated financial statements.

(2) Relates to an agreement with ReNeuron Limited. See Note 2 in the consolidated financial statements.

(3) See Note 10 in the consolidated financial statements.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion of our financial condition and results of operations should be read in conjunction with the accompanying financial statements and the related footnotes thereto.

This report contains forward looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act that involve substantial risks and uncertainties. Such statements include, without limitation, all statements as to expectation or belief and statements as to our future results of

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operations, the progress of our research, product development and clinical programs, the need for, and timing of, additional capital and capital expenditures, partnering prospects, costs of manufacture of products, the protection of and the need for additional intellectual property rights, effects of regulations, the need for additional facilities and potential market opportunities. Our actual results may vary materially from those contained in such forward-looking statements because of risks to which we are subject, including uncertainty as to whether the U.S. Food and Drug Administration (FDA) or other applicable regulators or review boards will permit clinical testing of proposed products despite the novel and unproven nature of our technology; the risk that, although it has been allowed to go forward by the FDA and is now in progress, our initial clinical trial could be substantially delayed beyond its expected dates or cause us to incur substantial unanticipated costs; uncertainties regarding our ability to obtain the capital resources needed to continue our current research and development operations and to conduct the research, preclinical development and clinical trials necessary for regulatory approvals; failure to obtain a corporate partner or partners to support the development of our stem cell programs; the uncertainty regarding the outcome of the Phase I clinical trial and any other trials we may conduct in the future; including uncertainty as to whether results obtained in the animal models of infantile neuronal ceroid lipofuscinosis (NCL), spinal cord injury, or other diseases and conditions will be able to be translated into treatment for humans; the uncertainty regarding the validity and enforceability of issued patents; the uncertainty whether HuCNS-SC and any other products that may be generated in our stem cell programs will prove clinically effective and not cause tumors or other side effects; the uncertainty whether we will achieve revenues from product sales or become profitable; our likely increase in the use of cash as compared to our historical use of cash; uncertainties regarding our obligations in regard to our former encapsulated cell therapy facilities in Rhode Island; obsolescence of our technology; competition from third parties; intellectual property rights of third parties; litigation and other risks to which we are subject. See Risk Factors under Item 1A above.

Overview

Since our inception in 1988, we have been primarily engaged in research and development of human therapeutic products. Since the second half of 1999, our sole focus has been on our stem cell technology. We are currently conducting a Phase I clinical trial of our human neural stem cells as a treatment for infantile and late infantile neuronal ceroid lipofuscinosis (NCL), a fatal neurodegenerative disease often referred to as Batten disease. The trial is being conducted at Oregon Health & Science University s Doernbecher Children s Hospital in Portland, Oregon.

We have not derived any revenues from the sale of any products apart from license revenue for the research use of certain of our patented cells and media, and we do not expect to receive revenues from product sales for at least several years. We have not commercialized any product and in order to do so we must, among other things, substantially increase our research and development expenditures as research and product development efforts accelerate and clinical trials are initiated. We had expenditures for screening and enrolling patients and for preparing HuCNS-SC doses for our Phase I clinical trial and will incur more such expenditures for any future clinical trials. We previously had expenditures for toxicology and other studies in preparation for submitting the Investigational New Drug application (IND) for our Phase I trial for NCL to the FDA and getting it cleared by the FDA, and will incur more such expenditures for any future INDs. We have incurred annual operating losses since inception and expect to incur substantial operating losses in the future. As a result, we are dependent upon external financing from equity and debt offerings and revenues from collaborative research arrangements with corporate sponsors to finance our operations. There are no such collaborative research arrangements at this time and there can be no assurance that such financing or partnering revenues will be available when needed or on terms acceptable to us.

Significant events of the past year include these:

In November, 2006, the first patient in our Phase I clinical trial was transplanted with our proprietary human neural stem cell product HuCNS-SC™ at Oregon Health & Science University s (OHSU) Doernbecher Children s Hospital. Since then, a second patient has also been transplanted with HuCNS-SC at OHSU. This study is designed to evaluate

the safety and preliminary efficacy of HuCNS-SC as a treatment for infantile and late infantile NCL (also known as Batten Disease), and a total of six patients are planned to be enrolled.

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In April, 2006, we sold 11,750,820 shares of common stock to a limited number of institutional investors at a price of $3.05 per share, for gross proceeds of $35.8 million. We received total proceeds, net of offering expenses and placement agency fees, of approximately $33.4 million.

In June 2006 and February 2007, we received a combined total of approximately 1.3 million additional shares of ReNeuron Group plc, pursuant to the anti-dilution provisions of the license agreement entered into with ReNeuron in July 2005 as they applied to two ReNeuron financings. In February 2007, we sold approximately 5,275,000 shares of ReNeuron for net proceeds of approximately $3.1 million. As of February 26, 2007, we owned approximately 4.8 million shares of ReNeuron. See Note 2 and Item 7a. Quantitative and Qualitative Disclosures about Market Risk.

In 2006, the U.S. Patent and Trademark Office issued seven new patents that are owned by or exclusively licensed to StemCells, Inc., further strengthening what the Company believes is the dominant intellectual property position in the neural stem cell field, with claims covering methods for identification, isolation, expansion, and transplantation of neural stem cells as well as methods for drug discovery and testing. See Patents, Proprietary Rights and Licenses.

In August, 2006, we licensed certain rights to our intellectual property to Stem Cell Therapeutics Corp., a Canadian biotechnology company engaged in treating certain central nervous system disorders by stimulating endogenous neural stem cells. Under the agreement, we received an up-front fee and will receive license maintenance fees, as well as milestone and royalty payments. See *License Agreements* under Patents, Proprietary Rights and Licenses**.**

Our results of operations have varied significantly from year to year and quarter to quarter and may vary significantly in the future due to the occurrence of material recurring and nonrecurring events, including without limitation the receipt and payment of recurring and nonrecurring licensing payments, the initiation or termination of research collaborations, the on-going expenses to lease and maintain our facilities in Rhode Island and the increasing costs associated with our facility in California. To expand and provide high quality systems and support to our Research and Development programs, as well as to enhance our internal controls over financial reporting, we will need to hire more personnel, which will lead to higher operating expenses. Throughout 2006 and early 2007, we made a number of additions to our management team: In January, Maria Millan, M.D., FACS, joined us as Director, Liver Cell Transplant Program; in December, she was promoted to Vice President and Head of the Liver Program. In April, Elizabeth Leininger, Ph.D. was appointed Vice President, Regulatory Affairs and Quality Assurance. In December, Ann Tsukamoto, Ph.D., formerly Vice President, Research and Development, was promoted to the newly created position of Chief Operating Officer, and Rodney Young was promoted to Chief Financial Officer and Vice President, Finance and Administration. In January, 2007, Stephen Huhn, M.D., F.A.C.S., F.A.A.P., joined us as Vice President and Head of the Neural Program.

Our Neural Program ranges from the preclinical stage, in which we test human neural stem cells in small animal models of human diseases, both in-house and through external academic collaborators, through the development phase, in which we evaluate improvements to expansion methods and the toxicology of the cells, through the clinical development phase, with respect to the Phase I clinical trial in NCL mentioned above. In our Liver Program, we are engaged in evaluating our proprietary liver engrafting cell in various *in vivo* assays, and are planning to advance our liver stem cell program into product development as rapidly as we can. Our pancreas program is still in the discovery stage and further evaluation of the therapeutic potential of the candidate human pancreatic stem/progenitor cell will be required.

Critical Accounting Policies

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

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires our management to make estimates and assumptions that affect

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the amounts reported in the consolidated financial statements. Actual results could differ from these estimates. Significant estimates include the following:

Accrued wind-down expenses (See Note 8).

The grant date fair value of share-based awards recognized as compensation expense in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004) *Share Based Payment* (SFAS 123R). See Stock-based Compensation below.

Valuation allowance against net deferred tax assets (See Note 12).

Marketable securities

In accordance with SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities,* the Company has classified the Company s short-term investments as available-for-sale marketable securities in the accompanying consolidated financial statements. The marketable securities are stated at fair market value, with unrealized gains and losses reported in other comprehensive income. Management reviews securities with unrealized losses for other than temporary impairment. A decline in the fair value of securities that is deemed other than temporary is charged to earnings when so deemed. See Note 2.

Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123R. SFAS 123R requires all share-based payments to employees, or to non-employee directors as compensation for service on the Board of Directors, to be recognized as compensation expense in the consolidated financial statements based on the fair values of such payments. We maintain shareholder approved stock-based compensation plans, pursuant to which we granted stock-based compensation to our employees, and to non-employee directors for Board service. These grants are primarily in the form of options that allow a grantee to purchase a fixed number of shares of our common stock at a fixed exercise price equal to the market price of the shares at the date of the grant (qualified stock option grants). The options may vest on a single date or in tranches over a period of time, but normally they do not vest unless the grantee is still employed by or a director of the Company on the vesting date. The compensation expense for these grants will be recognized over the requisite service period which is typically the period over which the stock-based compensation awards vest. We made no modifications to outstanding options with respect to vesting periods or exercise prices prior to adopting SFAS 123R. In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107 (SAB 107), which provides guidance on the implementation of SFAS 123R. We applied the principles of SAB 107 in conjunction with its adoption of SFAS 123R.

We adopted SFAS 123R effective January 1, 2006, using the modified-prospective transition method. Under this transition method, compensation expense will be recognized based on the grant date fair value estimated in accordance with the provisions of SFAS 123R for all new grants effective January 1, 2006, and for options granted prior to but not vested as of December 31, 2005. Prior periods were not restated to reflect the impact of adopting the new standard and therefore do not include fair value compensation expense related to stock option grants for those periods. In accordance with SFAS 123R, we recognized stock option related compensation expense of approximately $2,285,000 for the year ended December 31, 2006. Stock option related compensation expense was recognized on a straight line basis over the vesting period of each grant net of estimated forfeitures. We estimated forfeiture rates based on our historical experience within separate groups of employees. The estimated fair value of the options granted during 2006 and prior years was calculated using a Black Scholes Merton option pricing model

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(Black Scholes model). The following summarizes the assumptions used in the Black Scholes model as applied by quarter for the year ended December 31, 2006:

	First Quarter 2006	Second Quarter 2006	Third Quarter 2006	Fourth Quarter 2006
Risk free interest rate (1)	4.72%	5.08%	4.68%	4.54%
Volatility (2)	119.5%	110.8%	106.6%	103.3%
Dividend yield (3)	0%	0%	0%	0%
Expected term (years until exercise) (4)	6.25	6.25	6.25	6.25

(1) The risk-free interest rate is based on US Treasury debt securities with maturities close to the expected term of the option.

(2) Expected volatility is based on historical volatility of the Company s stock factoring in daily share price observations. In computing expected volatility, the length of the historical period used is equal to the length of the expected term of the option.

(3) No cash dividends have been declared on the Company s common stock since the Company s inception, and the Company currently does not anticipate paying cash dividends over the expected term of the option.

(4) The expected term is equal to the average of the contractual life of the stock option and its vesting period.

At December 31, 2006, approximately $5,775,000 of unrecognized compensation expense related to stock options is expected to be recognized over a weighted average period of approximately 1.6 years. The resulting effect on net loss and net loss per share attributable to common stockholders may not be representative of the effects in future periods, due to changes in forfeiture rates, additional grants and subsequent periods of vesting.

Prior to January 1, 2006, we accounted for our stock-based compensation plans under Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees.* In accordance with APB 25, we generally recognized no compensation expense for qualified stock option grants, as the options were usually granted at fair market price of the underlying shares on the date of the grant. For options issued with an exercise price less than the fair market value of the shares at the date of grant, we recognized the difference between the exercise price and fair market value as compensation expense in accordance with APB 25. Prior to January 1, 2006, we provided pro forma disclosure amounts in accordance with Statement of Financial Accounting Standards No. 123 *Accounting for Stock-Based Compensation,* (SFAS 123) as amended by Statement of Financial Accounting Standards No. 148 *Accounting for Stock-Based Compensation Transition and Disclosure,* (SFAS 148). As fair value compensation expense was disclosed but not recognized in periods prior to January 1, 2006, no cumulative adjustment for forfeitures was recorded in 2006. See table in Stock-Based Compensation under Note 1 below for an illustration of the effect on net loss and net loss per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation in the prior years ended December 31, 2005 and 2004.

We account for stock options granted to non-employees in accordance with SFAS 123 and Emerging Issues Task Force (EITF) 96-18 *Accounting For Equity Instruments That Are Issued To Other Than Employees For Acquiring, Or In Conjunction With Selling, Goods Or Services,* and accordingly, recognize as expense the estimated fair value of such options as calculated using the Black Scholes model. The fair value is re-measured at each reporting date during

the service period and is amortized over the vesting period of each option or the recipient s contractual arrangement, if shorter. No stock options were issued to non-employees during the year ended December 31, 2006, other than options granted to non-employee members of the Board of Directors for service as Board members.

In July 2006, pursuant to the 2006 Equity Incentive Plan, we granted cash-settled Stock Appreciation Rights (SARs) to certain employees. The SARs give the holder the right, upon exercise, to the difference between the price per share of our common stock at the time of exercise and the exercise price of the SAR. The exercise price of the SARs is equal to the market price of our common shares at the date of grant. The SARs will vest on the same schedule as our qualified options issued to employees, i.e., 25% on the first anniversary of the grant date and then 1/48th every month thereafter. We will recognize compensation expense for the SARs over the requisite service period which is typically the period over which the awards vest. Since the vesting schedule of the SARs is identical

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to the vesting schedule of options granted this period, our fair value calculation of the SARs issued using the Black Scholes model were based on the same assumptions used in calculating compensation expense for stock options granted this period. The fair value of the share-based compensation liability for the cost of the requisite service that has been rendered at the reporting date is re-measured at each reporting date through the date of settlement. The following table presents the activity of the Company s SARs awards for the year ended December 31, 2006 and 2005.

	2006		2005	
	SARs	Weighted Average Exercise Price	SARs	Weighted Average Exercise Price
Outstanding at January 1				
Granted	1,564,599	$ 2.00		
Exercised				
Canceled				
Outstanding at September 30	1,564,599	$ 2.00		
SARs exercisable at December 31				

For the year ended December 31, 2006, we recorded approximately $293,000 as compensation expense related to SARs granted. At December 31, 2006, approximately $2,336,000 of unrecognized compensation expense related to SARs is expected to be recognized over a weighted average period of approximately 1.9 years. The resulting effect on net loss and net loss per share attributable to common stockholders is not likely to be representative of the effects in future periods, due to changes in the fair value calculation which is dependent on the stock price, volatility, interest and forfeiture rates, additional grants and subsequent periods of vesting.

Long-Lived Assets

We routinely evaluate the carrying value of our long-lived assets. We record impairment losses on long-lived assets used in operations when events and circumstances indicate that assets may be impaired and the undiscounted cash flows estimated to be generated by the assets are less than the carrying amount of those assets. If an impairment exists, the charge to operations is measured as the excess of the carrying amount over the fair value of the assets.

Wind-down and Exit Costs

In connection with our wind-down of our research and manufacturing operations in Lincoln, Rhode Island, and the relocation of our remaining research and development activities and corporate headquarters, to California, in October 1999, we have provided our estimate of the exit cost obligation in accordance with EITF 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring) . On an ongoing basis we re-evaluate such estimate. For further discussion, see Wind-down expenses under Results of Operations and Note 8 to the consolidated financial statements.

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RESULTS OF OPERATIONS

Years Ended December 31, 2006, 2005 and 2004

Revenues

Revenues totaled approximately $93,000, $206,000, and $141,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

	2006	2005	2004	Change from previous year: 2006 versus 2005 $	Change from previous year: 2006 versus 2005 %	Change from previous year: 2005 versus 2004 $	Change from previous year: 2005 versus 2004 %
Revenue:							
Revenue from licensing revenue	$ 55,299	$ 19,526	$ 22,206	$ 35,773	183%	$ (2,680)	(12)%
Revenue from grants	37,551	186,388	118,828	(148,837)	(80)%	67,560	57%
Total revenue	$ 92,850	$ 205,914	$ 141,034	$ 113,064	(55)%	$ 64,880	46%

Revenues for 2006 include $38,000 that is part of a Small Business Technology Transfer (STTR) grant received in 2004 for approximately $464,000 over one and one half years for studies in Alzheimer s disease. The STTR grant will support joint work with the McLaughlin Research Institute (MRI) in Great Falls, Montana. We retained $243,000 and the remaining $221,000 was disbursed to MRI. Revenues for 2006 also include licensing revenue of approximately $55,000 received from various licensees. Revenues for 2005 include $186,000 that was part of the STTR grant and approximately $20,000 in licensing revenue. Revenues for 2004 include $93,000 that completes the draw down of a one-year Small Business Innovation Research grant of $342,000 from the National Institute of Neurological Disease and Stroke (NINDS) received at the end of 2003, and $26,000 which is part of the STTR grant received in 2004. Total revenue for 2004 includes licensing revenue of $22,000.

Operating Expenses

Operating expenses totaled approximately $21,464,000, $16,594,000, and $15,541,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

	2006	2005	2004	Change from previous year: 2006 versus 2005 $	Change from previous year: 2006 versus 2005 %	Change from previous year: 2005 versus 2004 $	Change from previous year: 2005 versus 2004 %
Operating Expenses							
Research & development	$ 13,600,433	$ 8,226,734	$ 7,843,981	$ 5,373,699	65%	$ 382,753	5%
General & administrative	7,154,042	5,539,845	4,870,014	1,614,197	29%	669,831	14%

Wind-down expenses	709,209	2,827,403	2,826,879	(2,118,194)	(75)%	524	0%
Total expense	$ 21,463,684	$ 16,593,982	$ 15,540,874	$ 4,869,702	29%	$ 1,053,108	7%

Research & development expenses

Research and development expenses totaled approximately $13,600,000 in 2006, as compared to $8,227,000 in 2005 and $7,844,000 in 2004.

2006 versus 2005. The increase of approximately $5,374,000 or 65% from 2005 to 2006 was primarily attributable to expansion of our operations in cell processing and clinical development, which consisted of an increase in personnel costs of approximately $2,669,000, an increase in external services of approximately $1,464,000, an increase in supplies and other expenses of $771,000 and the cost of additional space leased in 2006 allocated to research and development. Of the approximately $2,669,000 increase in personnel costs, approximately $1,344,000 was attributable to the expensing of stock-based compensation (which includes the grant of stock options, stock appreciation rights and share awards) as required by the new accounting

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pronouncement SFAS 123R (see Stock-Based Compensation under Note 1), with the balance attributable to an increased head count which includes the hiring of key personnel necessary to facilitate the expansion of our cell processing and clinical operations. At December 31, 2006, we had thirty-five full-time employees working in research and development and laboratory support services as compared to thirty-three at December 31, 2005.

2005 versus 2004. The increase of $383,000 or 5% from 2004 to 2005 was primarily attributable to increased head count and related costs of $848,000 in 2005 as compared to 2004. At December 31, 2005, we had thirty-three full-time employees working in research and development and laboratory support services as compared to twenty-eight at December 31, 2004. This increase in 2005 was partially offset by a net decrease in expenses of $465,000 primarily related to external services. We required a high level of external services in 2004 for preclinical pharmacology and toxicology studies and other external services in preparation for submitting our first IND to the FDA. The decrease in expenses related to external services was also attributable to a decrease in valuation in 2005 of stock options granted as compensation to non-employees as compared to the valuation in 2004. The valuation computed by the Black Scholes Method is dependant on variable factors at the time of such valuation such as stock price, stock price volatility, interest rate and remaining life of the option. Our stock price at December 31, 2005 was $3.45 as compared to $4.23 at December 31, 2004.

General & administrative expenses

General and administrative expenses were approximately $7,154,000 in 2006, compared with $5,540,000 in 2005 and $4,870,000 in 2004.

2006 versus 2005. The increase of $1,614,000 or 29% from 2005 to 2006 was primarily attributable to the increase in personnel costs of approximately $1,826,000, of which approximately $1,423,000 was attributable to the expensing of stock-based compensation (which includes the grant of stock options and stock appreciation rights) as required by the new accounting pronouncement SFAS 123R (see Stock-Based Compensation under Note 1). The increase in personnel costs was partially offset by a net decrease in other costs primarily attributable to the expensing of the fair value of options granted to a consultant in 2005. No such options were granted in 2006.

2005 versus 2004. The increase of $670,000 or 14% from 2004 to 2005 was primarily attributable to expensing the fair value of stock options granted to our previous chief financial officer, which was approximately $457,000. The vesting of the options was accelerated as part of an agreement that retained our previous chief financial officer as a consultant for approximately six months following her employment termination date. The increase was also attributable to the increase in head count and related costs of approximately $394,000; increase in recruiting fees of approximately $145,000; and the increase in listing fees of approximately $114,000 incurred in 2005 for moving the listing of our shares from the Nasdaq Capital Market to the Nasdaq Global Market. The aforementioned increases were partially offset by a decrease in 2005 of approximately $186,000 for external services to evaluate and test our internal financial control systems so as to meet the requirements of and be in compliance with the Securities and Exchange Commission rules issued under Section 404 of the Sarbanes-Oxley Act, and a net decrease of approximately $254,000 in other expenses.

Wind-down expenses

In connection with our wind-down of our research and manufacturing operations in Lincoln, Rhode Island, and the relocation of our remaining research and development activities and corporate headquarters, to California in October 1999, we provided a reserve for our estimate of the exit cost obligation in accordance with EITF 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring*. The reserve reflects estimates of the ongoing costs of our former research and administrative facility in Lincoln, which we hold on a lease that terminates on June 30, 2013. We are seeking to

sublease, assign, sell or otherwise divest ourselves of our interest in the facility at the earliest possible time, but we cannot determine with certainty a fixed date by which such events will occur, if at all.

In determining the facility exit cost reserve amount, we are required to consider our lease payments through to the end of the lease term and estimate other relevant factors such as facility operating expenses, real estate market conditions in Rhode Island for similar facilities, occupancy rates and sublease rental rates projected over the course of the leasehold. We re-evaluate the estimate each quarter, taking account of changes, if any, in each underlying

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factor. The process is inherently subjective because it involves projections over time from the date of the estimate through the end of the lease and it is not possible to determine any of the factors except the lease payments with certainty over that period.

Management forms its best estimate on a quarterly basis, after considering actual sublease activity, reports from our broker/realtor about current and predicted real estate market conditions in Rhode Island, the likelihood of new subleases in the foreseeable future for the specific facility and significant changes in the actual or projected operating expenses of the property. We discount the projected net outflow over the term of the leasehold to arrive at the present value, and adjust the reserve to that figure. The estimated vacancy rate for the facility is an important assumption in determining the reserve because changes in this assumption have the greatest effect on estimated sublease income. In addition, the vacancy rate estimate is the variable most subject to change, while at the same time it involves the greatest judgment and uncertainty due to the absence of highly predictive information concerning the future of the local economy and future demand for specialized laboratory and office space in that area. The average vacancy rate of the facility for years 2001 through 2006 was approximately 67%, varying from 49% to 84%. As of December 31, 2006, based on current information available to management, the vacancy rate is projected to be 91% for 2007, and approximately 70% from 2008 through the end of the lease. These estimates are based on actual occupancy as of December 31, 2006, predicted lead time for acquiring new subtenants, historical vacancy rates for the area and assessments by our broker/realtor of future real estate market conditions. If the assumed vacancy rate for 2008 to the end of the Lease had been five percentage points higher or lower at December 31, 2006, then the reserve would have increased or decreased by approximately $239,000. Similarly, a 5% increase or decrease in the operating expenses for the facility from 2006 would have increased or decreased the reserve by approximately $124,000, and a 5% increase or decrease in the assumed average rental charge per square foot would have increased or decreased the reserve by approximately $66,000. Management does not wait for specific events to change its estimate, but instead uses its best efforts to anticipate them on a quarterly basis.

The wind-down reserve at the end of December 31, 2005 was $6,098,000. For the year ended December 31, 2006, we recorded actual expenses against this reserve of approximately $1,295,000. Based on management s evaluation of the factors mentioned, and particularly the projected vacancy rates described above, we adjusted the reserve to $5,512,000 by recording an additional $709,000 for the year ended December 31, 2006. See Note 8 for a breakdown of these figures by quarter.

Other income (expense)

				Change from previous year: 2006 versus 2005		Change from previous year: 2005 versus 2004	
	2006	2005	2004	$	%	$	%
Other income (expense):							
License and settlement agreement	$ 103,359	$ 3,735,556		$ (3,632,197)	(97)%	$ 3,735,556	* N/M
Interest income	2,479,740	1,122,963	$ 322,227	1,356,777	(121)%	800,736	249%
Interest expense	(143,001)	(171,909)	(191,006)	28,908	(17)%	19,097	(10)%
Other income (expense), net	(17,644)	(36,892)	(61,680)	19,248	(52)%	24,788	(40)%

Total other income (expense)	$ 2,422,454	$ 4,649,718	$ (69,541)	$ (2,227,264)	(48)%	$ 4,580,177	* N/M

* Non meaningful

License and settlement agreement

In July 2005, we entered into an agreement with ReNeuron Limited, a wholly owned subsidiary of ReNeuron Group plc, a listed UK corporation (collectively referred to as ReNeuron). As part of the agreement, we granted ReNeuron a license that allows ReNeuron to exploit their c-mycER conditionally immortalized adult human neural stem cell technology for therapy and other purposes. StemCells received a 7.5% fully-diluted equity interest

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in ReNeuron, subject to certain anti-dilution provisions, and a cross-license to the exclusive use of ReNeuron s technology for certain diseases and conditions, including lysosomal storage diseases, spinal cord injury, cerebral palsy and multiple sclerosis. The agreement also provides for full settlement of any potential claims that either we or ReNeuron might have had against the other in connection with any putative infringement of certain of each party s patent rights prior to the effective date of the agreement. The agreement is Exhibit 10.71 to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.

We recorded approximately $103,000 and $3,736,000 as other income in 2006 and 2005 respectively, which was the fair value of the ReNeuron shares net of legal fees and the value shares that was transferred to NeuroSpheres Ltd., an Alberta corporation from which we have licensed some of the patent rights that are the subject of the agreement with ReNeuron. See Note 2 for more details on this transaction.

Interest income

Interest income for the years ended December 31, 2006, 2005 and 2004 totaled approximately $2,480,000, $1,123,000 and $322,000, respectively. The increase in interest income from 2004 to 2006 was primarily attributable to a higher average bank balance as a result of our financing transactions. (See Liquidity and Capital Resources below for further detail on these transactions) and a higher yield on overnight and money market funds.

Interest expense

In 2006, interest expense was approximately $143,000, compared to approximately $172,000 in 2005 and approximately $191,000 in 2004. The decrease from 2004 to 2006 was attributable to lower outstanding debt and capital lease balances.

Other income/expense, net

Other expenses for 2006 were approximately $18,000, which include approximately $20,000 for state franchise taxes paid, partially offset by a gain of approximately $2,000 from the disposal of old equipment. Other expenses for 2005 were approximately $37,000, which include approximately $36,000 for state franchise taxes and approximately $1,000 from a write-off of obsolete equipment. Other expenses for 2004 were approximately $62,000, which include a loss of approximately $56,000 resulting from a write-off of obsolete lab equipment and approximately $6,000 for state franchise taxes.

Liquidity and Capital Resources

Since our inception, we have financed our operations through the sale of common and preferred stock, the issuance of long-term debt and capitalized lease obligations, revenues from collaborative agreements, research grants, license fees and interest income.

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We had cash and cash equivalents totaling approximately $51,796,000 at December 31, 2006. Cash equivalents are generally invested in U.S. Treasuries with maturities of less than 90 days. The table below summarizes our cash flows for the respective fiscal years.

	2006	2005	2004	Change from previous year: 2006 versus 2005 $	Change from previous year: 2006 versus 2005 %	Change from previous year: 2005 versus 2004 $	Change from previous year: 2005 versus 2004 %
Net cash used in operating activities	$ (16,104,120)	$ (11,870,568)	$ (11,273,908)	$ (4,233,552)	36%	$ (596,660)	5%
Net cash used in investing activities	(1,297,124)	(847,505)	(748,305)	(449,619)	53%	(99,200)	13%
Net cash provided by financing activities	34,655,865	6,199,449	40,000,042	28,456,416	459%	(33,800,592)	(85)%
Increase (decrease) in cash and cash equivalents	$ 17,254,621	$ (6,518,624)	$ 27,977,829	$ 23,773,245	365%	$ (34,496,452)	(123)%

We used approximately $16,104,000, $11,871,000, and $11,274,000 of cash, in 2006, 2005 and 2004 respectively, in our operating activities. The increase in cash used in operating activities in 2006 as compared to 2005 was primarily attributable to the expansion of our operations in cell processing and clinical development in 2006. The increase in cash used in operating activities in 2005 as compared to 2004 was primarily attributable to an increase in head count to strengthen our scientific and management team.

The increase from 2005 to 2006 of approximately $28,456,000 for net cash provided by financing activities was primarily attributable to the sale on April 6, 2006, of 11,750,820 shares of our common stock to a limited number of institutional investors at a price of $3.05 per share. The Company received total proceeds, net of offering expenses and placement agency fees, of approximately $33,422,000.

Listed below are key financing transactions entered into by us in the last three years:

On April 6, 2006, we sold 11,750,820 shares of our common stock to a limited number of institutional investors at a price of $3.05 per share, for gross proceeds of approximately $35,840,000. The shares were offered as a registered direct offering under an effective shelf registration statement previously filed with and declared effective by the Securities and Exchange Commission. We received total proceeds, net of offering expenses and placement agency fees, of approximately $33,422,000. No warrants were issued as part of this

financing transaction.

In 2005, an aggregate of 2,958,348 warrants were exercised. For the exercise of these warrants, we issued 2,842,625 shares of our common stock and received proceeds of approximately $5,939,000.

On October 26, 2004, we entered into an agreement with institutional investors with respect to the registered direct placement of 7,500,000 shares of our common stock at a purchase price of $3.00 per share, for gross proceeds of $22,500,000. C.E. Unterberg, Towbin LLC (Unterberg) and Shoreline Pacific, LLC (Shoreline) served as placement agents for the transaction. We sold these shares under a shelf registration statement previously filed with and declared effective by the U.S. Securities and Exchange Commission. For acting as our placement agent Unterberg and Shoreline received fees of approximately $1,350,000 and expense reimbursement of approximately $40,000. No warrants were issued as part of this financing transaction.

On June 16, 2004, we entered into an agreement with institutional and other accredited investors with respect to the private placement of approximately 13,160,000 shares of our common stock at a purchase price of $1.52 per share, for gross proceeds of approximately $20,000,000. Investors also received warrants exercisable for five years to purchase approximately 3,290,000 shares of common stock at an exercise price of $1.90 per share. During the period October 2004 to December 2005, part of these warrants were

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exercised to purchase an aggregate of 1,459,342 shares of our common stock at $1.90 per share. We received proceeds of $2,772,750 on issuance of the shares. Unterberg served as placement agent for the private placement. For acting as our placement agent, Unterberg received fees of approximately $1,200,000, expense reimbursement of approximately $25,000 and a five year warrant to purchase 526,400 shares of our common stock at an exercise price of $1.89 per share.

We continue to have outstanding obligations in regard to our former facilities in Lincoln, Rhode Island. In 1997, we had entered into a fifteen-year lease for a scientific and administrative facility (the SAF) in a sale and leaseback arrangement. The lease includes escalating rent payments. For the year 2007, we expect to pay approximately $938,000 in operating lease payments and estimated operating expenses of approximately $490,000, before receipt of sub-tenant income. In 1992 and 1994 we had undertaken direct financing transactions with the State of Rhode Island and received proceeds from the issuance of industrial revenue bonds totaling $5,000,000 to finance the construction of a pilot manufacturing facility and a related cell processing facility. The related leases are structured such that lease payments will fully fund all semiannual interest payments and annual principal payments through maturity in August 2014. For these related facilities we expect to pay approximately $365,000 in principal, interest and related expenses in 2007, before receipt of sub-tenant income. We have subleased the pilot manufacturing facility and the cell processing facility, as well as approximately one-fourth of the SAF. For the year 2007, we expect to receive, in aggregate, approximately $573,000 in sub-tenant rent for all of the Rhode Island facilities. As a result of the above transactions, our estimated cash outlay net of sub-tenant rent for the Rhode Island facilities will be approximately $1,220,000 for 2007. We are actively seeking to sublease, assign or sell our remaining interests in these facilities. Failure to do so within a reasonable period of time will have a material adverse effect on our liquidity and capital resources.

The following table summarizes our future contractual cash obligations (including both Rhode Island and California leases, but excluding interest income and sub-lease income with respect to the Rhode Island properties):

	Total Obligations at 12/31/06	Payable in 2007	Payable in 2008	Payable in 2009	Payable in 2010	Payable in 2011	Payable in 2012 and Beyond
Bonds Payable (principal & interest)	$ 1,921,639	$ 332,545	$ 244,531	$ 244,572	$ 242,560	$ 242,321	$ 615,110
Operating lease payments	15,014,498	3,165,162	3,469,017	3,536,843	1,767,304	1,171,875	1,904,297
Total contractual cash obligations	$ 16,936,137	$ 3,497,707	$ 3,713,548	$ 3,781,415	$ 2,009,864	1,414,196	$ 2,519,407

We have incurred significant operating losses and negative cash flows since inception. We have not achieved profitability and may not be able to realize sufficient revenues to achieve or sustain profitability in the future. We do not expect to be profitable in the next several years, but rather expect to incur additional operating losses. We have

limited liquidity and capital resources and must obtain significant additional capital resources in order to sustain our product development efforts, for acquisition of technologies and intellectual property rights, for preclinical and clinical testing of our anticipated products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, for general and administrative expenses and other working capital requirements. We rely on cash balances and proceeds from equity and debt offerings, proceeds from the transfer or sale of our intellectual property rights, equipment, facilities or investments, and government grants and funding from collaborative arrangements, if obtainable, to fund our operations.

We intend to pursue opportunities to obtain additional financing in the future through equity and debt financings, grants and collaborative research arrangements. We have a shelf registration statement which, as of December 31, 2006, covered shares of our common stock up to a value of $64 million that could be available for financings. On December 29, 2006, we filed a Prospectus Supplement announcing the entry of a sales agreement with Cantor Fitzgerald & Co. under which up to 10,000,000 shares may be sold from time to time under the shelf registration statement. The source, timing and availability of any future financing will depend principally upon market conditions, interest rates and, more specifically, on our progress in our exploratory, preclinical and future clinical development programs. Funding may not be available when needed at all, or on terms acceptable to us. Lack of necessary funds may require us to delay, scale back or eliminate some or all of our research and product

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development programs, planned clinical trials, and/or our capital expenditures or to license our potential products or technologies to third parties.

With the exception of operating leases for facilities, we have not entered into any off balance sheet financial arrangements and have not established any special purpose entities. We have not guaranteed any debts or commitments of other entities or entered into any options on non-financial assets.

Recent Accounting Pronouncements

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Interpretation is effective for fiscal years beginning after December 15, 2006. While our analysis of the impact of this Interpretation is not yet complete, we do not anticipate that it will have a material impact on its consolidated financial statements at the time of adoption.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The adoption of FAS 157 is not expected to have a material impact on our consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108), to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that we quantify misstatements based on their impact on each of our financial statements and related disclosures. SAB 108 is effective for fiscal years ending after November 15, 2006. Our adoption of this bulletin did not have a material impact on our consolidated financial statements.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk***

In July 2005, we entered into an agreement with ReNeuron. As part of the agreement, we granted ReNeuron a license that allows ReNeuron to exploit its c-mycER conditionally immortalized adult human neural stem cell technology for therapy and other purposes. In return for the license, we received a 7.5% fully-diluted equity interest in ReNeuron, subject to certain anti-dilution provisions, and a cross-license to the exclusive use of ReNeuron s technology for certain diseases and conditions, including lysosomal storage diseases, spinal cord injury, cerebral palsy and multiple sclerosis. The agreement also provides for full settlement of any potential claims that either StemCells or ReNeuron might have had against the other in connection with any putative infringement of certain of each party s patent rights prior to the effective date of the agreement. The agreement is Exhibit 10.71 to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005. On July 1, 2005, we were entitled to approximately 3,775,000 shares of ReNeuron, representing 7.5% of its fully-diluted share capital. On August 12, 2005 ReNeuron listed its shares on the London Stock Exchange s Alternative Investment Market (AIM), a market for smaller, growing companies. In accordance with the anti-dilution provisions of the agreement, the placement and listing of additional shares by ReNeuron resulted in StemCells receiving an additional 5,165,000 shares. Of the total of approximately 8.9 million shares of ReNeuron received by StemCells on account of these events, 104,000 was transferred to NeuroSpheres LTD., an Alberta corporation from

which StemCells has licensed some of the patent rights that are the subject of the agreement with ReNeuron. On June 29, 2006, ReNeuron issued additional shares of common stock, of which StemCells was entitled to approximately 439,000 shares under the anti-dilution provisions of the agreement and net of approximately 5,600 shares due to Neurospheres Ltd. The Company recorded approximately $103,000 as other income for the additional shares due in 2006. The fair market value of the Company s holdings in ReNeuron common stock as of December 31, 2005 (8,835,766 shares) and December 31,

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2006 (9,274,837 shares) was approximately $3,721,000 and $7,266,000 respectively. Changes in market value as a result of changes in market price per share or the exchange rate between the US dollar and the British pound are accounted for under other comprehensive income (loss) if deemed temporary, as in this case, and are not recorded as other income or loss until the shares are disposed of and a gain or loss realized. The unrealized gain as of December 31, 2006, was approximately $3,188,000. A decline in the fair value of securities that is deemed other than temporary would be charged to earnings. In February 2007, ReNeuron issued additional shares of common stock; as a consequence of the anti-dilution provisions, StemCells was entitled to approximately 823,000 shares net of approximately 10,000 shares to be transferred to NeuroSpheres. These shares satisfy ReNeuron s obligations under the anti-dilution provision of the agreement. As of February 26, 2007, StemCells had sold approximately 5,275,000 shares of ReNeuron, realizing net proceeds of approximately $3.1 million, and still held approximately 4.8 million shares.

Company/ Stock Symbol	Exchange	Associated Risks	No. of Shares at December 31, 2006	Share price at December 31, 2006 in GBP (£)	Exchange Rate at December 31, 2006 1 GBP = USD	Market Value in USD at December 31, 2006	Expected Future Cash Flows
ReNeuron Group plc/RENE	AIM (AIM is the London Stock Exchange s Alternative Investment Market)	- Lower share price - Foreign currency translation - Liquidity - Bankruptcy	9,274,837	0.40	1.9586	$ 7,266,278	(1)

(1) It is our intention to liquidate this investment when we can do so at prices acceptable to us. Although we are not legally restricted from selling the stock, the share price is subject to change and the volume traded has often been very small since the stock was listed on the AIM on August 12, 2005. The performance of ReNeuron Group plc stock since its listing does not predict its future value.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Board of Directors and Stockholders of
StemCells, Inc.

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting as of December 31, 2006, that StemCells, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). StemCells, Inc. s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment, and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

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

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

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

In our opinion, management s assessment that StemCells, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on Internal Control Integrated Framework issued by COSO. Furthermore, in our opinion, StemCells, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on Internal Control Integrated Framework issued by COSO.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of StemCells, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in stockholders equity, and cash flows for each of the three years in the period ended December 31, 2006 and our report dated March 1, 2007 expressed an unqualified opinion on those financial statements.

/s/ GRANT THORNTON LLP

San Jose, CA
March 1, 2007

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Item 8. ***Financial Statements and Supplementary Data***

STEMCELLS, INC.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
StemCells, Inc.

We have audited the accompanying consolidated balance sheets of StemCells, Inc. and subsidiary as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in stockholders equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of StemCells, Inc. as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2006 the Company adopted the provisions of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, applying the modified-prospective method.

We also have audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the effectiveness of StemCells, Inc. s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 1, 2007 expressed an unqualified opinion on management s assessment of, and an unqualified opinion on the effective operation of, internal control over financial reporting.

/s/ GRANT THORNTON LLP

San Jose, California
March 1, 2007

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StemCells, Inc.

Consolidated Balance Sheets

	December 31, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 51,795,529	$ 34,540,908
Other receivables	482,850	201,919
Other current assets	1,119,467	386,966
Marketable securities	4,132,646	
Total current assets	57,530,492	35,129,793
Marketable securities	3,133,632	3,720,794
Property, plant and equipment, net	3,596,150	3,282,588
Other assets, net	2,596,543	2,705,513
Total assets	66,856,817	$ 44,838,688
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 620,765	$ 637,122
Accrued expenses and other	2,053,902	1,483,300
Accrued wind-down expenses	1,252,483	1,118,796
Deferred revenue	16,826	
Capital lease obligations, current portion		54,676
Bonds payable, current portion	205,833	254,167
Total current liabilities	4,149,809	3,548,061
Bonds payable, less current maturities	1,145,416	1,351,250
Deposits and other long-term liabilities	547,392	522,866
Accrued wind-down expenses non current	5,497,774	6,186,930
Deferred rent	959,732	853,997
Deferred revenue, less current portion	180,691	
Total liabilities	12,480,814	12,463,104
Commitments (Note 6)		
Stockholders equity:		
Common stock, $.01 par value; 125,000,000 shares authorized; 78,046,304 and 65,396,022 shares issued and outstanding at December 31, 2006 and 2005, respectively	780,462	653,960
Additional paid-in capital	255,299,508	217,919,335
Accumulated deficit	(204,891,945)	(185,943,564)
Accumulated other comprehensive gain (loss)	3,187,978	(254,147)

Total stockholders equity	54,376,003	32,375,584
Total liabilities and stockholders equity	$ 66,856,817	$ 44,838,688

See accompanying notes to consolidated financial statements.

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StemCells, Inc.

Consolidated Statements of Operations

	Year Ended December 31,		
	2006	**2005**	**2004**
Revenue from collaborative and licensing agreements	$ 55,299	$ 19,526	$ 22,206
Revenue from grants	37,551	186,388	118,828
Total Revenues	92,850	205,914	141,034
Operating Expenses			
Research and development	13,600,433	8,226,734	7,843,981
General and administrative	7,154,042	5,539,845	4,870,014
Wind-down expenses	709,209	2,827,403	2,826,879
	21,463,684	16,593,982	15,540,874
Loss from operations	(21,370,834)	(16,388,068)	(15,399,840)
Other Income (expense):			
License and settlement agreement, net	103,359	3,735,556	
Interest income	2,479,740	1,122,963	322,227
Interest expense	(143,001)	(171,909)	(191,006)
Other income (expense)	(17,644)	(36,892)	(61,680)
	2,422,454	4,649,718	69,541
Net loss	(18,948,380)	(11,738,350)	(15,330,299)
Basic and diluted net loss per share	$ (0.25)	$ (0.18)	$ (0.31)
Weighted average shares used in basic and diluted loss per share calculations	74,611,196	63,643,176	49,606,277

See accompanying notes to consolidated financial statements.

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STEMCELLS, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

	Common Stock		Additional Paid-in	Accumulated	Accumulated Other Comprehensive Income	Deferred	Total Stockholder
	Shares	Amount	Capital	Deficit	(Loss)	Compensation	Equity
ances, December 31, 3	40,998,858	$ 409,989	$ 170,406,393	$ (158,874,916)	$	$ (977,908)	$ 10,963,5
uance of common k related to equity ncing net of ance cost of 863,021	20,660,000	206,600	39,433,578				39,640,1
mmon stock issued licensing agreements	11,351	114	17,719				17,8
mmon stock issued external services	41,050	410	72,640				73,0
mmon stock issued suant to employee efit plan	48,707	487	93,526				94,0
rcise of employee consultant stock ions	62,916	629	44,750				45,3
rcise of warrants	306,525	3,065	579,333				582,3
mpensation expense m grant of options			33,868				33,8
ferred compensation			737,493			(737,493)	
ortization of erred compensation						829,569	829,5
loss				(15,330,299)			(15,330,2
ances, December 31, 4	62,129,407	621,294	211,419,300	(174,205,215)		(885,832)	36,949,5
penses related to ity financing			(193,946)				(193,9
mmon stock issued external services	2,022	20	8,310				8,3
mmon stock issued suant to employee efit plan	28,459	285	110,772				111,0
mpensation expense m grant of options			461,675				461,6

stock (fair value)							
rcise of employee consultant stock ions	393,509	3,935	733,753				737,68
rcise of warrants	2,842,625	28,426	5,910,680				5,939,10
ferred compensation			(531,208)			531,208	
ortization of erred compensation						354,624	354,62
ealized loss on rketable securities					(254,147)		(254,14
loss				(11,738,350)			(11,738,35
mprehensive loss							(11,992,49
ances, December 31, 5	65,396,022	653,960	217,919,336	(185,943,565)	(254,147)		32,375,58
uance of common k related to equity ncing net of ance cost of 418,467	11,750,820	117,508	33,304,026				33,421,53
mmon stock issued licensing agreements	3,848	38	9,962				10,00
mmon stock issued suant to employee efit plan	50,120	501	121,955				122,45
mpensation expense m grant of options stock (fair value)			2,409,509				2,409,50
rcise of employee consultant stock ions	319,094	3,191	545,088				548,27
rcise of warrants	526,400	5,264	989,632				994,89
ealized gain on rketable securities					3,442,125		3,442,12
loss				(18,948,380)			(18,948,38
mprehensive loss							(15,506,25
ances, December 31, 6	78,046,304	$ 780,462	$ 255,299,508	$ (204,891,945)	$ 3,187,978		$ 54,376,00

See accompanying notes to consolidated financial statements.

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StemCells, Inc.

Consolidated Statements of Cash Flows

	Year ended December 31,		
	2006	**2005**	**2004**
Cash flows from operating activities:			
Net loss	$ (18,948,380)	$ (11,738,350)	$ (15,330,299)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	1,044,688	1,082,793	1,037,719
Amortization of deferred compensation		354,624	829,569
Issue of shares and options in exchange for services	2,531,966	581,062	200,931
Loss on disposal of fixed assets	1,573	1,377	54,644
Non-cash income from license and settlement agreement, net	(103,359)	(3,974,941)	
Changes in operating assets and liabilities:			
Accrued interest receivable	(112,542)	(47,928)	(61,660)
Other receivables	(168,389)	26,972	26,160
Other current assets	(732,501)	(177,892)	(29,026)
Other assets, net	56,270	(47,053)	
Accounts payable and accrued expenses	554,245	48,135	665,409
Accrued wind-down expenses	(555,469)	1,777,697	1,705,045
Deferred revenue	197,517		
Deferred rent	105,735	330,196	(372,400)
Deposits and other long-term liabilities	24,526	(87,260)	
Net cash used in operating activities	(16,104,120)	(11,870,568)	(11,273,908)
Cash flows from investing activities:			
Purchases of property, plant and equipment	(1,258,749)	(817,505)	(676,138)
Acquisition of other assets	(38,375)	(30,000)	(72,167)
Net cash used in investing activities	(1,297,124)	(847,505)	(748,305)
Cash flows from financing activities:			
Proceeds (expense) from issuance of common stock, net	33,421,534	(193,946)	39,640,178
Proceeds from the exercise of stock options	548,279	737,688	45,379
Proceeds from the exercise of warrants	994,896	5,939,106	582,398
Repayments of capital lease obligations	(54,676)	(39,232)	(30,830)
Repayments of debt obligations	(254,168)	(244,167)	(237,083)
Net cash provided by financing activities	34,655,865	6,199,449	40,000,042
Increase (decrease) in cash and cash equivalents	17,254,621	(6,518,624)	27,977,829
Cash and cash equivalents at beginning of year	34,540,908	41,059,532	13,081,703
Cash and cash equivalents at end of the year	$ 51,795,529	$ 34,540,908	$ 41,059,532

Supplemental disclosure of cash flow information:			
Interest paid	$ 143,001	$ 171,909	$ 191,006
Supplemental schedule of non-cash investing and financing activities:			
Stock issued for licensing agreements	$ 10,000(1)		$ 17,833(2)

(1) Under terms of a license agreement with the California Institute of Technology (Cal Tech), annual fees of $5,000 were due on each of two patents to which StemCells holds a license from Cal Tech, payable in cash or stock at the Company s choice. The Company elected to pay the fees in stock and issued 3,848 shares to Cal Tech.

(2) Under the terms of a license agreement with Cal Tech, fees of $10,000 and $5,000 were due on the issuance of two patents to which StemCells holds a license from Cal Tech, payable in cash or stock at the Company s choice. The Company elected to pay the fees in stock and issued 9,535 unregistered shares to Cal Tech. The Company also paid $2,833 in stock (1,816 shares) as part of an option agreement with the Board of Trustees of the Leland Stanford Junior University to acquire an exclusive license to an invention.

See accompanying notes to consolidated financial statements.

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StemCells, Inc.

Notes to Consolidated Financial Statements
December 31, 2006

StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Note 1. Summary of Significant Accounting Policies

Nature of Business

StemCells, Inc., a Delaware corporation, (the Company) is a biopharmaceutical company that operates in one segment, the development of novel cell-based therapeutics designed to treat human diseases and disorders.

The accompanying consolidated financial statements have been prepared on the basis that the Company will continue as a going concern. Since inception, the Company has incurred annual losses and negative cash flows from operations and has an accumulated deficit of approximately $204.9 million at December 31, 2006. The Company has not derived revenues from the sale of products, and does not expect to receive revenues from product sales for at least several years. It may not be able to realize sufficient revenues to achieve or sustain profitability in the future.

StemCells expects to incur additional operating losses over the next several years. The Company has very limited liquidity and capital resources and must obtain significant additional capital resources in order to sustain its product development efforts, for acquisition of technologies and intellectual property rights, for preclinical and clinical testing of our anticipated products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, for general and administrative expenses and other working capital requirements. StemCells relies on cash reserves and proceeds from equity and debt offerings, proceeds from the transfer or sale of intellectual property rights, equipment, facilities or investments, and government grants and funding from collaborative arrangements, if obtainable, to fund its operations. If the Company exhausts its cash reserves and is unable to realize adequate financing, it may be unable to meet operating obligations and be required to initiate bankruptcy proceedings. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Principles of Consolidation

The consolidated financial statements include accounts of the Company and StemCells California, Inc., a wholly owned subsidiary. All significant inter-company balances and transactions have been eliminated on consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires our management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. Actual results could differ from these estimates. Significant estimates include the following:

Accrued wind-down expenses (See Note 8).

The grant date fair value of share-based awards recognized as compensation expense in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004) *Share Based Payment* (SFAS 123R). (See Note 10).

Valuation allowance against net deferred tax assets (See Note 12).

Marketable securities

In accordance with SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities,* the Company has classified its investments as available-for-sale marketable securities in the accompanying consolidated financial statements. The marketable securities are stated at fair market value, with unrealized gains and losses reported in other comprehensive income. Management reviews securities with unrealized losses for other

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

than temporary impairment. A decline in the fair value of securities that is deemed other than temporary is charged to earnings when so deemed (See Note 2).

Reclassification

Certain reclassifications of prior year amounts have been made to conform to current year presentation. Patent related expenses of approximately $703,000 and $916,000 for prior years ended December 31, 2005 and 2004 respectively have been reclassified from research and development expense to general and administrative expense on the consolidated statements of operations for that period to conform with the current year presentation. The reclassifications had no effect on total assets, liabilities, equity, or net loss previously reported.

Cash and Cash Equivalents

The Company considers cash equivalents to be only those investments that are highly liquid, readily convertible to cash and which mature within three months from the date of purchase.

Estimated Fair Value of Financial Instruments

The carrying value of cash and cash equivalents, other receivables, accounts payable and the current portion of the bonds payable approximates their estimated fair values due to the short maturities of these instruments. The carrying value of long-term debt approximates its fair value based on current rates available to the Company for similar debt.

Property, Plant and Equipment

Property, plant and equipment, including that held under capital lease obligations, is stated at cost and depreciated using the straight-line method over the estimated life of the respective asset, or the lease term if shorter, as follows:

Building and improvements	3 - 20 years
Machinery and equipment	3 - 10 years
Furniture and fixtures	3 - 10 years

Leasehold improvements are amortized on a straight-line basis over the shorter of their estimated useful lives or lease terms.

Patent and License Costs

Prior to fiscal year 2001, the Company capitalized certain patent costs related to patent applications. Accumulated costs were amortized over the estimated economic life of the patents, not to exceed 17 years, using the straight-line method, commencing at the time the patent was issued. Costs related to patent applications are charged to expense at the time such patents are deemed to have no continuing value. Since 2001, the Company s policy has been to expense all patent costs as incurred. At December 31, 2006 and 2005, total costs capitalized amounted to approximately $980,000 and the related accumulated amortization was approximately $404,000 and $348,000, respectively. Patent related expenses totaled approximately $852,000, $703,000, and $753,000 in 2006, 2005 and 2004, respectively.

License costs are capitalized and amortized over the period of the license agreement.

Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123R. SFAS 123R requires all share-based payments to employees, or to non-employee directors as compensation for service on the Board of Directors, to be recognized as compensation expense in the consolidated financial statements based on the fair values of such payments. The Company maintains shareholder approved stock-based compensation plans,

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

pursuant to which it granted stock-based compensation to its employees, and to non-employee directors for Board service. These grants are primarily in the form of options that allow a grantee to purchase a fixed number of shares of the Company s common stock at a fixed exercise price equal to the market price of the shares at the date of the grant (qualified stock option grants). The options may vest on a single date or in tranches over a period of time, but normally they do not vest unless the grantee is still employed by or a director of the Company on the vesting date. The compensation expense for these grants will be recognized over the requisite service period which is typically the period over which the stock-based compensation awards vest. In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107 (SAB 107), which provides guidance on the implementation of SFAS 123R. The Company applied the principles of SAB 107 in conjunction with its adoption of SFAS 123R.

The Company adopted SFAS 123R effective January 1, 2006, using the modified-prospective transition method. Under this transition method, compensation expense will be recognized based on the grant date fair value estimated in accordance with the provisions of SFAS 123R for all new grants effective January 1, 2006, and for options granted prior to but not vested as of December 31, 2005. Prior periods were not restated to reflect the impact of adopting the new standard and therefore do not include fair value compensation expense related to stock option grants for those periods. In accordance with SFAS 123R, the Company recognized stock option related compensation expense of approximately $2,285,000 for the year ended December 31, 2006. Stock option related compensation expense was recognized on a straight line basis over the vesting period of each grant net of estimated forfeitures. The Company estimated forfeiture rates based on its historical experience within separate groups of employees. The estimated fair value of the options granted during 2006 and prior years was calculated using a Black Scholes Merton option pricing model (Black Scholes model). The following summarizes the assumptions used in the Black Scholes model as applied by quarter for the year ended December 31, 2006:

	First Quarter 2006	Second Quarter 2006	Third Quarter 2006	Fourth Quarter 2006
Risk free interest rate(1)	4.72%	5.08%	4.68%	4.54%
Volatility(2)	119.5%	110.8%	106.6%	103.3%
Dividend yield(3)	0%	0%	0%	0%
Expected term (years until exercise)(4)	6.25	6.25	6.25	6.25

(1) The risk-free interest rate is based on US Treasury debt securities with maturities close to the expected term of the option.

(2) Expected volatility is based on historical volatility of the Company s stock factoring in daily share price observations. In computing expected volatility, the length of the historical period used is equal to the length of the expected term of the option.

(3)

No cash dividends have been declared on the Company s common stock since the Company s inception, and the Company currently does not anticipate paying cash dividends over the expected term of the option.

(4) The expected term is equal to the average of the contractual life of the stock option and its vesting period.

The adoption of SFAS 123R had the following impact on our consolidated statement of operations for the year ended December 31, 2006:

Increase in net loss	$ 2,285,000
Increase in basic and diluted net loss per share	$ 0.03

At December 31, 2006, approximately $5,775,000 of unrecognized compensation expense related to stock options is expected to be recognized over a weighted average period of approximately 1.6 years. The resulting effect on net loss and net loss per share attributable to common stockholders may not be representative of the effects in future periods, due to changes in forfeiture rates, additional grants and subsequent periods of vesting.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Prior to January 1, 2006, the Company accounted for its stock-based compensation plans under Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees.* In accordance with APB 25, the Company generally recognized no compensation expense for qualified stock option grants, as the options were usually granted at fair market price of the underlying shares on the date of the grant. For options issued with an exercise price less than the fair market value of the shares at the date of grant, the Company recognized the difference between the exercise price and fair market value as compensation expense in accordance with APB 25. Prior to January 1, 2006, the Company provided pro forma disclosure amounts in accordance with Statement of Financial Accounting Standards No. 123 *Accounting for Stock-Based Compensation,* (SFAS 123) as amended by Statement of Financial Accounting Standards No. 148 *Accounting for Stock-Based Compensation Transition and Disclosure,* (SFAS 148). As fair value compensation expense was disclosed but not recognized in periods prior to January 1, 2006, no cumulative adjustment for forfeitures was recorded in 2006. See table below for an illustration of the effect on net loss and net loss per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation in the prior years ended December 31, 2005 and 2004.

	2005	2004
Net loss applicable to common stockholders as reported	$ (11,738,350)	$ (15,330,299)
Add: Stock-based employee/ director compensation expense included in reported net loss under the intrinsic value method		33,868
Deduct: Total stock-based employee/director compensation expense under the fair value based method for all awards	(1,019,120)	(819,317)
Net loss pro forma	$ (12,757,470)	$ (16,115,748)
Basic and diluted net loss per share as reported	$ (0.18)	$ (0.31)
Basic and diluted net loss per share pro forma	$ (0.20)	$ (0.32)
Shares used in computing basic and diluted loss per share amounts	63,643,176	49,606,277

The Company accounts for stock options granted to non-employees in accordance with SFAS 123 and Emerging Issues Task Force (EITF) 96-18 *Accounting For Equity Instruments That Are Issued To Other Than Employees For Acquiring, Or In Conjunction With Selling, Goods Or Services,* and accordingly, recognizes as expense the estimated fair value of such options as calculated using the Black Scholes model. The fair value is re-measured at each reporting date during the service period and is amortized over the vesting period of each option or the recipient s contractual arrangement, if shorter. No stock options were issued to non-employees during the year ended December 31, 2006 other than options granted to non-employee members of the Board of Directors for service as Board members.

In July 2006, pursuant to the 2006 Equity Incentive Plan, the Company granted cash-settled Stock Appreciation Rights (SARs) to certain employees. The SARs give the holder the right, upon exercise, to the difference between the price per share of our common stock at the time of exercise and the exercise price of the SAR. The exercise price of the SARs is equal to the market price of our common shares at the date of grant. The SARs will vest on the same schedule as our qualified options issued to employees, i.e., 25% on the first anniversary of the grant date and then 1/48th every month thereafter. The maximum contractual term for the SARs granted is ten years. We will recognize

compensation expense for the SARs over the requisite service period which is typically the period over which the awards vest. Since the vesting schedule of the SARs is identical to the vesting schedule of options granted this period, our fair value calculation of the SARs issued using the Black Scholes model were based on the same assumptions used in calculating compensation expense for stock options granted this period. The fair value of the share-based compensation liability for the cost of the requisite service that has been rendered at the reporting date is

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

re-measured at each reporting date through the date of settlement. The following table presents the activity of the Company s SARs awards for the year ended December 31, 2006 and 2005.

	2006		2005	
	SARs	Weighted Average Exercise Price	SARs	Weighted Average Exercise Price
Outstanding at January 1				
Granted	1,564,599	$ 2.00		
Exercised				
Canceled				
Outstanding at September 30	1,564,599	$ 2.00		
SARs exercisable at December 31				

For the year ended December 31, 2006, the Company recorded approximately $294,000 as compensation expense related to SARs granted. At December 31, 2006, approximately $2,336,000 of unrecognized compensation expense related to SARs is expected to be recognized over a weighted average period of approximately 1.9 years. The resulting effect on net loss and net loss per share attributable to common stockholders is not likely to be representative of the effects in future periods, due to changes in the fair value calculation which is dependent on the stock price, volatility, interest and forfeiture rates, additional grants and subsequent periods of vesting.

Long-Lived Assets

The Company routinely evaluates the carrying value of its long-lived assets. The Company records impairment losses on long-lived assets used in operations when events and circumstances indicate that assets may be impaired and the undiscounted cash flows estimated to be generated by the assets are less than the carrying amount of those assets. If an impairment exists, the charge to operations is measured as the excess of the carrying amount over the fair value of the assets. No such impairment was recognized during the years ended December 31, 2006, 2005 and 2004.

Income Taxes

The liability method is used to account for income taxes. Deferred tax assets and liabilities are determined based on differences between financial reporting and income tax bases of assets and liabilities as well as net operating loss carry forwards and tax credits carryforwards and are measured using the enacted tax rates and laws that are expected to be in effect when the differences reverse. Deferred tax assets may be reduced by a valuation allowance to reflect the uncertainty associated with their ultimate realization.

Revenue Recognition

Revenues from collaborative agreements and grants are recognized as earned upon either the incurring of reimbursable expenses directly related to the particular research plan or the completion of certain development milestones as defined within the terms of the collaborative agreement. Payments received in advance of research performed are designated as deferred revenue. The Company recognizes non-refundable upfront license fees and certain other related fees on a straight-line basis over the development period. Fees associated with substantive at risk, performance based milestones are recognized as revenue upon their completion, as defined in the respective agreements. Incidental assignment of technology rights is recognized as revenue at time of receipt.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

Research and Development Costs

The Company expenses all research and development costs as incurred. Research and development costs include costs of personnel, external services, supplies, facilities and miscellaneous other costs.

Net Loss per Share

Basic and diluted net loss per share have been computed using the weighted-average number of shares of common stock outstanding during the period. Basic earnings per share excludes any dilutive effects of options, shares subject to repurchase, warrants and convertible securities. Diluted earnings per share includes the impact of potentially dilutive securities if dilutive.

	Years Ended December 31,		
	2006	2005	2004
Net loss	$ (18,948,380)	$ (11,738,350)	$ (15,330,299)
Weighted average shares used in computing basic and diluted net loss per share amounts	74,611,196	63,643,176	49,606,277
Basic and diluted net loss per share	$ (0.25)	$ (0.18)	$ (0.31)

The Company has excluded outstanding stock options and warrants from the calculation of diluted loss per common share because all such securities are anti-dilutive for all applicable periods presented. These outstanding securities consist of the following potential common shares:

	Years Ended December 31,		
	2006	2005	2004
Outstanding options	8,501,503	6,608,109	6,682,201
Outstanding warrants	1,930,658	2,521,400	5,490,285

Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net income (loss) and other comprehensive income (loss). The only component of other comprehensive income (loss) is an unrealized gain of $3,187,978 related to our marketable securities.

Recent Accounting Pronouncements

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109. This Interpretation

prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Interpretation is effective for fiscal years beginning after December 15, 2006. While the Company s analysis of the impact of this Interpretation is not yet complete, it does not anticipate that it will have a material impact on its consolidated financial statements at the time of adoption.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). This Standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The adoption of FAS 157 is not expected to have a material impact on the Company s consolidated financial statements.

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StemCells, Inc.

Notes to Consolidated Financial Statements (Continued)

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108), to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that the Company quantify misstatements based on their impact on each of its financial statements and related disclosures. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company s adoption of this bulletin did not have a material impact on its consolidated financial statements.

Note 2. ReNeuron License Agreement