Table of Contents

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

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the quarter ended: March 31, 2006 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 executive offices including zip code)

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

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 twelve months (or for such shorter periods that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.
Yes ☑ No o

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 ☑ 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 ☑

At April 26, 2006, there were 77,733,866 shares of Common Stock, $.01 par value, issued and outstanding.

STEMCELLS, INC.

INDEX

PART I — ITEM 1 — FINANCIAL STATEMENTS

STEMCELLS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2006 (unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 30,875,874	$ 34,540,908
Receivables	350,027	201,919
Other current assets	560,107	386,966
Total current assets	31,786,008	35,129,793
Marketable securities	2,420,467	3,720,794
Property, plant and equipment, net	3,258,350	3,282,588
Other assets, net	2,679,177	2,705,513
Total assets	$ 40,144,002	$ 44,838,688
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 722,126	$ 637,122
Accrued expenses	937,524	1,483.300
Accrued wind-down expenses, current portion	1,181,962	1,118,796
Capital lease obligations, current portion	54,676	54,676
Bonds payable, current portion	256,667	254,167
Total current liabilities	3,152,955	3,548,061
Bonds payable, less current maturities	1,286,250	1,351,250
Deposits and other long-term liabilities	522,866	522,866
Accrued wind-down expenses, non-current portion	6,002,680	6,186,930
Deferred rent	965,859	853,997
Total liabilities	11,930,610	12,463,104
Stockholders' equity:		
Common stock, $.01 par value; 125,000,000 shares authorized; 65,983,046 and 65,396,022 shares issued and outstanding at March 31, 2006 and December 31, 2005, respectively	659,830	653,960
Additional paid in capital	219,244,727	217,919,336
Accumulated deficit	(190,136,691)	(185,943,565)
Accumulated other comprehensive loss	(1,554,474)	(254,147)
Total stockholders' equity	28,213,392	32,375,584
Total liabilities and stockholders' equity	$ 40,144,002	$ 44,838,688

See accompanying notes to condensed consolidated financial statements.

PART I — ITEM 1 — FINANCIAL STATEMENTS

STEMCELLS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three months ended March 31,	
	2006	2005
Revenue:		
Revenue from grants	$ 37,550	$ 26,092
Revenue from licensing agreements	4,000	9,229
Total revenue	41,550	35,321
Operating expenses:		
Research and development	2,691,881	1,618,932
General and administrative	1,677,324	1,505,203
Wind-down expenses	156,117	520,974
Total operating expenses	4,525,322	3,645,109
Loss from operations	(4,483,772)	(3,609,788)
Other income (expense):		
Interest income	339,814	227,763
Interest expense	(38,593)	(46,411)
Other income (expense)	(10,575)	(20,397)
Total other income (expense)	290,646	160,955
Net loss applicable to common stockholders	(4,193,126)	(3,448,833)
Net loss per share applicable to common stockholders; basic and diluted	($0.06)	($0.06)
Weighted average shares used to compute net loss per share applicable to common stockholders; basic and diluted	65,443,062	62,406,725

See accompanying notes to condensed consolidated financial statements.

PART I — ITEM 1 — FINANCIAL STATEMENTS

STEMCELLS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Three months ended March 31,	
	2006	2005
Cash flows from operating activities:		
Net loss	$ (4,193,126)	$ (3,448,833)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	262,106	273,155
Amortization of deferred compensation	—	(76,382)
Stock-based compensation expense	459,197	36,011
Changes in operating assets and liabilities:		
Accrued interest receivable	4,295	(11,660)
Receivables	(152,403)	19,051
Other current assets	(173,141)	(420,526)
Other assets	—	52,947
Accounts payable and accrued expenses	(460,772)	(618,672)
Accrued wind-down expenses	(121,083)	224,427
Deferred rent	111,862	(120,094)
Net cash used in operating activities	(4,263,065)	(4,090,576)
Cash flows from investing activities:		
Purchase of property, plant and equipment	(211,531)	(58,429)
Acquisition of other assets	—	(50,000)
Net cash used in investing activities	(211,531)	(108,429)
Cash flows from financing activities:		
Proceeds from the exercise of stock options	91,126	269,432
Proceeds from the exercise of warrants	994,896	347,327
Expense from issuance of common stock	(213,960)	—
Repayments of capital lease obligations	—	(12,812)
Repayment of debt obligations	(62,500)	(59,665)
Net cash provided by financing activities	809,562	544,282
Decrease in cash and cash equivalents	(3,665,034)	(3,654,723)
Cash and cash equivalents, beginning of period	34,540,908	41,059,532
Cash and cash equivalents, end of period	$30,875,874	$37,404,809
Supplemental disclosure of cash flow information:		
Interest paid	$ 38,593	$ 46,411

See accompanying notes to condensed consolidated financial statements

PART I — ITEM 1. — FINANCIAL STATEMENTS

Notes to Condensed Consolidated Financial Statements
(Unaudited) March 31, 2006 and 2005

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The terms “StemCells”, the “Company”, “our”, “we” and “us” as used in this report refer to StemCells Inc. The accompanying unaudited, condensed consolidated financial statements have been prepared by the Company in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the accompanying financial statements include all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. Results of operations for the three months ended March 31, 2006, are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 31, 2006.

The balance sheet at December 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required for complete financial statements in accordance with accounting principles generally accepted in the United States of America. For the complete financial statements, refer to the audited financial statements and footnotes thereto as of December 31, 2005, included on Form 10-K.

The Company has incurred significant operating losses and negative cash flows since inception. It has not achieved profitability and may not be able to realize sufficient revenues to achieve or sustain profitability in the future. The Company has limited capital resources and it will need to raise additional capital from time to time to sustain its product development efforts, acquisition of technologies and intellectual property rights, preclinical and clinical testing of anticipated products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, general and administrative expenses and other working capital requirements. To fund its operations, the Company relies on cash balances, proceeds from equity and debt offerings, proceeds from the transfer or sale of intellectual property rights, equipment, facilities or investments, and on government grants and collaborative arrangements. The Company cannot be certain that such funding will be available when needed. 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.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires 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 accrued wind-down expenses and the grant date fair value of share based awards recognized as compensation expense in accordance with the provisions of Statement of Financial Accounting Standards No. 123 (Revised 2004) *“Share-Based Payment”* (SFAS 123R). See “Stock-Based Compensation” below.

Marketable securities

In accordance with Statement of Financial Accounting Standards 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.

Reclassification

Certain reclassifications of prior year amounts have been made to conform to current year presentation. Patent related expenses of $205,998 for the three-month period ended March 31, 2005 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 current year presentation.

Net Loss Per Share

The Company has computed net loss per common share according to the Statement of Financial Accounting Standards (SFAS) No. 128 *"Earnings Per Share,"* which requires disclosure of basic and diluted earnings per share. Basic earnings per share excludes any dilutive effects of options, warrants and convertible securities, and is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share includes the impact of potentially dilutive securities and is computed using the weighted average of common and diluted equivalent stock options, warrants and convertible securities outstanding during the period. Stock options, warrants and convertible securities that are anti-dilutive are excluded from the calculation of diluted loss per common share.

	Three months ended March 31,	
	2006	2005
Net loss applicable to common stockholders	$ (4,193,126)	$ (3,448,833)
Weighted average shares used in computing net loss per share applicable to common stockholders, basic and diluted.	65,443,062	62,406,725
Net loss per share applicable to common stockholders, basic and diluted.	$ (0.06)	$ (0.06)

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:

	Outstanding at March 31,	
	2006	2005
Outstanding options	6,828,323	6,728,787
Outstanding warrants	1,995,000	5,165,283
Total	8,823,323	11,894,070

Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS123R. 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, pursuant to which it grants 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. The Company 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. 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 compensation expense related to qualified stock option grants for those periods. In accordance with SFAS 123R, the Company recognized stock option related compensation expense of approximately $388,000 for the three month period ended March 31, 2006. All options granted in the three-month period ended March 31, 2006 were qualified stock options and the related compensation expense was recognized on a straight line basis over the vesting period of each grant net of estimated forfeitures. The Company's estimated forfeiture rates are 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 in the first quarter of 2006:

Risk —free interest rate(1)	4.72%
Volatility (2)	119.5%
Dividend yield (3)	0%
Expected term (years until exercise) (4)	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 March 31, 2006, approximately $4,710,000 of unrecognized compensation expense related to stock options is expected to be recognized over a weighted average period of approximately 1.56 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 additional grants and subsequent periods of vesting.

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 recognized no compensation expense for qualified stock option grants. 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 compensation expense was disclosed but not recognized in periods prior to January 1, 2006, no cumulative adjustment for forfeitures was recorded in 2006. The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation in the prior three-month period ended March 31, 2005:

	Three months ended March 31, 2005
Net loss applicable to common stockholders — as reported	$ (3,448,833)
Add: Stock-based employee/director compensation expense included in reported net loss	—
Deduct: Total stock-based employee/director compensation expense under the fair value based method for all awards	(137,461)
Net loss applicable to common stockholders — pro forma	$ (3,586,294)
Basic and diluted net loss per share applicable to common stockholders as reported	$ (0.06)
Basic and diluted net loss per share applicable to common stockholders — pro forma	$ (0.06)
Shares used in basic and diluted loss per share applicable to common stockholder amounts	62,406,725

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 remeasured 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 other than options granted to non-employee members of the Board of Directors for service as Board members.

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. 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 the time of receipt.

Recent Accounting Pronouncements

Accounting for Changes and Error Corrections

In June 2005, the FASB issued Statement of Financial Accounting Standards No. 154 "*Accounting Changes and Error Corrections*" "SFAS 154). SFAS 154 replaces APB Opinion No. 20 "*Accounting Changes*" and SFAS No. 3 "*Reporting Accounting Changes in Interim Financial Statements*". SFAS 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle. SFAS 154 also requires that a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for prospectively as a change in estimate, and correction of errors in previously issued financial statements should be termed a restatement. SFAS 154 is effective for accounting changes

and correction of errors made in fiscal years beginning after December 15, 2005. The implementation of SFAS 154 is not expected to have a material impact on our consolidated financial statements.

NOTE 2. RENEURON LICENSE AND SETTLEMENT AGREEMENT

In July 2005, the Company entered into a license and settlement agreement with ReNeuron Limited, a wholly owned subsidiary of ReNeuron Group plc, a publicly listed UK corporation (collectively referred to as "ReNeuron"). As part of the agreement, the Company 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. In return for the license, StemCells 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 the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005. An amendment to the agreement was entered on April 3, 2006, a copy of which is attached as an exhibit to this Report on Form 10-Q. The fair market value of the securities (8,835,766 shares) as of December 31, 2005 and March 31, 2006 was approximately $3,721,000 and $2,420,000 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 loss" if deemed temporary, and are not recorded as "other income or loss" until the shares are disposed of and a gain or loss realized. The unrealized loss as of March 31, 2006, is approximately $1,554,000. A decline in the fair value of securities that is deemed other than temporary would be charged to earnings.

NOTE 3. LEASES

The Company 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 related to its former encapsulated cell technology. 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. Interest rates vary with the respective bonds' maturities, ranging currently from 8.1% to 9.5%. The outstanding principal at March 31, 2006 was approximately $1,543,000. The bonds contain certain restrictive covenants, which limit among other things, the payment of cash dividends and the sale of the related assets.

The Company entered into a fifteen-year lease for a laboratory facility in connection with a sale and leaseback arrangement in 1997. The lease has escalating rent payments and accordingly, the Company is recognizing rent expense on a straight-line basis. At December 31, 2005 and March 31, 2006, the Company had deferred rent liability for this facility of approximately $1,208,000 and $1,215,000 respectively; the deferred rent liability is presented as part of the wind-down accrual.

Although the Company previously discontinued activities relating to encapsulated cell technology, the Company remains obligated under the leases for the pilot manufacturing facility and the laboratory facility. The Company has succeeded in subleasing the pilot manufacturing facility and part of the laboratory facility. The aggregate income received by the Company is significantly less than the Company's aggregate obligations under the leases, and the Company's continued receipt of rental income is dependent on the financial ability of the occupants to comply with their obligations under the subleases. The Company continues to seek to sublet the vacant portions of the Rhode Island facilities, to assign or sell its interests in all of these properties, or to otherwise arrange for the termination of its obligations under the lease obligations on these facilities. There can be no assurance, however, that the Company will be able to dispose of these properties in a reasonable time, if at all, or to terminate its lease obligations without the payment of substantial consideration

As of February 1, 2001, the Company entered into a 5-year lease for 40,000 square feet of an approximately 68,000 square foot facility located in the Stanford Research Park in Palo Alto, CA. The facility includes space for animals, laboratories, offices, and a GMP (Good Manufacturing Practices) suite. GMP facilities can be used to manufacture materials for clinical trials. On December 19, 2002 the Company negotiated an amendment to the lease, which resulted in reducing the average annual rent over the remaining term of the lease from approximately $3.7 million to $2.0 million. As part of the amendment the Company issued a letter of credit on

January 2, 2003 for $503,079, which was an addition to the letter of credit in the amount of $275,000 issued at commencement of the lease, to serve as a deposit for the duration of the lease. The Company negotiated an amendment to the lease effective April 1, 2005, which extends the term of the lease through March 31, 2010, includes an immediate reduction in the rent per square foot, and provides for an expansion of the leased premises by approximately 28,000 additional square feet effective July 1, 2006. In addition, the Company has sublet some of the additional space for the period from April 1, 2005 through June 30, 2006. The average annual rent due from the Company under this lease for the period commencing April 1, 2005 to March 31, 2010 will be approximately $2 million before subtenant income. The lease has escalating rent payments, which the Company is recognizing on a straight-line basis. At March 31, 2006, the Company had deferred rent liability for this facility of approximately $966,000. At March 31, 2006 the Company has space-sharing agreements covering in total approximately 13,000 square feet of this facility. The Company receives the amount of base rent plus the proportionate share of the operating expenses that it pays for such space over the term of these agreements.

NOTE 4. RELOCATION TO CALIFORNIA FROM RHODE ISLAND

In October 1999, the Company relocated to California from Rhode Island and established a wind down reserve for the estimated lease payments and operating costs of the Rhode Island facilities through an expected disposal date of June 30, 2000. The Company did not fully sublet the Rhode Island facilities in 2000. Even though the Company intends to dispose of the facility at the earliest possible time, the Company's management cannot determine with certainty a fixed date by which such disposal will occur. In light of this uncertainty, the Company periodically re-evaluates and adjusts the reserve. The Company considers various factors such as the Company's lease payments through to the end of the lease, operating expenses, the current real estate market in Rhode Island, and estimated subtenant income based on actual and projected occupancy. At December 31, 2005 the reserve was approximately $6,098,000. The Company incurred approximately $284,000 in operating expenses for the three-month period ending March 31, 2006, which was recorded against the reserve. After evaluating the afore-mentioned factors the Company re-valued the reserve to $5,970,000 at March 31, 2006, by booking an additional $156,000 as wind-down expenses.

Wind-down reserve

	January to March 31, 2006	January to December 31, 2005
Accrued wind-down reserve at beginning of period	$ 6,098,000	$ 4,350,000
Less actual expenses recorded against estimated reserve during the period	(284,000)	(1,079,000)
Additional expense recorded to revise estimated reserve at period-end	156,000	2,827,000
Revised reserve at period-end	5,970,000	6,098,000
Add deferred rent at period end (Note 3	1,215,000	1,208,000
Total accrued wind-down expenses at period-end (current and non current portion)	$ 7,185,000	$ 7,306,000
Accrued wind-down expenses		
Current portion	$ 1,182,000	$ 1,119,000
Non current portion	6,003,000	6,187,000
Total Accrued wind-down expenses	$ 7,185,000	$ 7,306,000

NOTE 5. GRANTS

In September 2004, the National Institutes of Health (NIH) awarded the Company a Small Business Technology Transfer grant of $464,000 for studies in Alzheimer's disease, consisting of approximately $308,000 for the first year and approximately $156,000 for the remainder of the grant term, September 30, 2005 through March

31, 2006. The studies have been conducted by Dr. George A. Carlson of the McLaughlin Research Institute (MRI) in Great Falls, Montana, which will receive approximately $222,000 of the total award. The remaining $242,000 has been recognized by the Company as grant revenue as and when resources were expended for this study. For the three month period ended March 31, 2006, the Company recognized approximately $38,000; the Company has now drawn down in full its share of the grant.

NOTE 6. STOCKHOLDERS' EQUITY

In March 2006, a warrant issued as part of the June 16, 2004 financing arrangement was exercised to purchase an aggregate of 526,400 shares of the Company's common stock at $1.89 per share. The Company issued 526,400 shares of its common stock and received proceeds of approximately $995,000. For the three month period ended March 31, 2006, the Company issued 60,624 shares from activity related to its stock option plans. The following table presents the activity of the Company's stock option plans for the three month period ended March 31, 2006 and 2005.

	2006		2005	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at January 1	6,608,109	$3.02	6,682,201	$2.91
Granted	459,715	$3.69	329,838	$4.33
Exercised	(60,624)	$2.20	(173,252)	$1.76
Canceled	(178,877)	$2.02	(110,000)	$1.95
Outstanding at March 31	6,828,323	$3.10	6,728,787	$2.79
Options exercisable at March 31	4,448,369	$3.02	3,623,637	$3.00

NOTE 7. SUBSEQUENT EVENTS

On April 6, 2006, the Company sold 11,750,820 shares of its 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 placement under the Company's effective shelf registration statement previously filed with the Securities and Exchange Commission. The Company received total proceeds, net of offering expenses and placement agency fees, of approximately $33,190,000.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and the results of our operations for the three month periods ended March 31, 2006 and 2005 should be read in conjunction with the accompanying unaudited condensed consolidated 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 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) will permit us to proceed to clinical testing of proposed products despite the novel and unproven nature of our technology; the risk that, even if approved, 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; the uncertainty regarding the validity and enforceability of issued patents; the uncertainty whether any 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; 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. All forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the cautionary statements and risk factors contained or referred to herein.

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. In October 2005, we received clearance from the FDA to initiate a Phase I clinical trial of our human neural stem cells as a treatment for the infantile and late infantile forms of neuronal ceroid lipofuscinosis (NCL), a rare, fatal neurodegenerative disease often referred to as Batten disease. In March 2006, we received approval from the Institutional Review Board of Oregon Health & Science University (OHSU) to conduct the Phase I trial at Doernbecher Children's Hospital at OHSU in Portland, Oregon, and the investigators have begun screening potential patients for eligibility. Both FDA and IRB approval were required before this trial could be initiated.

We have not derived any revenues from the sale of any products apart from license revenue for the research use of our human neural stem cells and other 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 toxicology and other studies in preparation for submitting the Batten disease IND 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.

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.

Our program in neural stem and progenitor cells 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 planned clinical trial in Batten disease mentioned above. In our liver stem cell 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 AND ESTIMATES

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 management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. Actual results could differ from these estimates. The significant estimates include the accrued wind-down expenses related to our Rhode Island facilities and the grant date fair value of share based awards recognized as compensation expense in accordance with the provisions of SFAS 123R.

Stock-Based Compensation

In December 2004, FASB issued SFAS 123R*" Share-Based Payment"*. This Statement is a revision of SFAS 123 "*Accounting for Stock-Based Compensation"* and amends SFAS No. 95 "*Statement of Cash Flows"*. SFAS 123R supersedes APB Opinion No. 25 "*Accounting for Stock Issued to Employees"*, and its related implementation guidance. SFAS 123R covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The new standard is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. The Company has adopted SFAS 123R effective January 1, 2006. Adoption of the expensing requirements will reduce the Company's reported earnings. See "Stock Based Compensation" under Note 1 for its current and potential impact on net loss and net loss per share attributable to common shareholders.

Research and Development Costs

We expense all research and development costs as incurred. Research and Development costs include costs of personnel, external services, supplies, facilities and miscellaneous other costs.

Wind-down and Exit Costs

In connection with the wind-down of our former encapsulated cell technology operations, 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 "*Other Cost to Exit an Activity.*" 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 the Company's 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 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 2005 was approximately 64%, varying from 49% to 80%. As of March 31, 2006, based on current information available to management, the vacancy rate is projected to be 83% for 2006, 84% for 2007, and approximately 70% from 2008 through the end of the lease. These estimates are based on actual occupancy in 2006, expiration of subleases in 2006 and 2008, 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 at March 31, 2006,, then the reserve would have been increased by approximately $226,000; conversely, if the assumed vacancy rate for that period were five percentage points lower, then the reserve would have been decreased by approximately $226,000. Similarly, a 5% increase or decrease in the operating expenses for the facility from 2006 would have increased or decreased the reserve by approximately $135,000, and a 5% increase or decrease in the assumed average rental charge per square foot would have increased or decreased the reserve by approximately $65,000. 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 three-month period ended March 31, 2006 we recorded actual expenses of $284,000 against this reserve. Based on management's evaluation of the factors mentioned, and particularly the projected vacancy rates described above, we adjusted the reserve to $5,970,000 by recording an additional $156,000 at March 31, 2006. See Note 4 for a breakdown of these figures by quarter.

RESULTS OF OPERATIONS

Three months ended March 31, 2006 and 2005

	2006	2005	Change from previous year $	Change from previous year %
Revenue:				
Revenue from grants	$ 37,550	$ 26,092	$ 11,458	44%
Revenue from licensing agreements	4,000	9,229	(5,229)	(57)%
Total revenue	$ 41,550	$ 35,321	$ 6,229	18%

For the three months ended March 31, 2006 and March 31, 2005, revenue from grants totaled approximately $38,000 and $26,000 respectively. The revenue from grants was part of a $464,000 Small Business Technology Transfer grant for studies in Alzheimer's disease. Total revenue includes licensing revenue of $4,000 and $9,000 for the three-month periods ended March 31, 2006 and 2005, respectively.

	2006	2005	Change from previous year $	Change from previous year %
Operating expenses:				
Research and development	$ 2,691,881	$ 1,618,932	$ 1,072,949	66%
General and administrative	1,677,324	1,505,203	172,121	11%
Wind-down expenses	156,117	520,974	(364,857)	(70)%
Total operating expenses	$ 4,525,322	$ 3,645,109	$ 880,213	24%

Research and development expenses totaled approximately $2,692,000 for the three months ended March 31, 2006, compared with approximately $1,619,000 for the same period in 2005. The increase of $1,073,000 or approximately 66% from 2005 to 2006 was primarily attributable to an increase in personnel costs of approximately $543,000, increase in external services of approximately $195,000; increase in supplies of approximately $83,000; increase in the allocation of deferred rent as a result of taking on additional space and extending our lease term of approximately$168,000; increase in other operating expenses of approximately $84,000; all of the afore mentioned increases were primarily attributable to expanding our operations in cell processing and clinical development. Of the approximately $543,000 increase in personnel costs, approximately $217,000 was attributable to the expensing of stock option compensation as required by the new accounting pronouncement SFAS 123R (see “Stock Based Compensation” under Note 1 above), with the balance attributable to an increase in head count. At March 31, 2006, we had thirty three full-time employees working in research and development and laboratory support services as compared to thirty at March 31, 2005.

General and administrative expenses were approximately $1,677,000 for the three months ended March 31, 2006, compared with approximately $1,505,000 for the same period in 2005. The increase of $172,000 or approximately 11%, from 2005 to 2006 was primarily attributable to an increase in personnel costs of approximately $373,000, of which, approximately $199,000 was attributable to the expensing of stock option compensation as required by the new accounting pronouncement SFAS 123R (see “Stock Based Compensation” under Note 1 above) with the balance attributable to an increase in head count. The increase in personnel costs was partially offset by a decrease of approximately $201,000 in external services and other operating expenses mainly attributable to a decrease in recruiting fees and the cost of external services incurred in the evaluation and testing of our system of internal control over financial reporting.

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 has been re-evaluated and adjusted based on assumptions relevant to real estate market conditions and the estimated time until we could either fully sublease, assign or sell our remaining interests in the property. At December 31, 2005 the reserve was approximately $6,098,000. For the three months ended March 31, 2006, expenses of $284,000 net of subtenant income were recorded against this reserve. At March 31, 2006 we re-evaluated the estimate and adjusted the reserve to approximately $5,970,000 by recording an additional $156,000 as wind-down expenses. Wind-down expenses recorded for the same period in 2005 were $521,000. 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.

	2006	2005	Change from previous year $	Change from previous year %
Other income (expense):				
Interest income	$ 339,814	$ 227,763	$ 112,051	49%
Interest expense	(38,593)	(46,411)	7,818	17%
Other income (expense)	(10,575)	(20,397)	9,822	48%
Total other income (expense)	$ 290,646	$ 160,955	$ 129,691	81%

Interest income for the three months ended March 31, 2006 and 2005 was approximately $340,000 and $228,000 respectively. The increase in interest income in 2006 was primarily attributable to higher yield on investments. Interest expense for the three months ended March 31, 2006 and 2005 was approximately $39,000 and $46,000 respectively. The decrease in interest expense in 2006 was attributable to lower outstanding debt and capital lease balances in 2006 compared to 2005. Decrease in other expense from approximately $20,000 to $11,000 was primarily attributable to a decrease in estimated franchise tax payable.

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 and interest income.

We had cash and cash equivalents totaling $30,875,874 at March 31, 2006. Cash equivalents are invested in US Treasury debt securities with maturities of less than 90 days. The table below summarizes our cash flows for the respective three month periods.

	2006	2005	Change from previous year	
			$	%
Net cash used in operating activities	$(4,263,065)	$(4,090,576)	$(172,489)	4%
Net cash used in investing activities	(211,531)	(108,429)	(103,102)	95%
Net cash provided (used) by financing activities	809,562	544,282	265,280	49%
Decrease in cash and cash equivalents	$(3,665,034)	$(3,654,723)	$ (10,311)	0.28%

The net decrease in cash and cash equivalents was approximately $3,665,000 and $3,655,000 for the three months ended March 31, 2006 and 2005, respectively. The increase in cash used in 2006 in comparison to the same period in 2005 was primarily attributable to the increase in operating expenses and capital expenditures attributable to increases in personnel and external services for our cell processing and clinical development operations. The aforementioned increase in cash outlay was offset by an increase in cash provided by the exercise of warrants (See “Note 6 “Stockholders’ Equity).

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 placement under the Company’s effective shelf registration statement previously filed with the U.S. Securities and Exchange Commission (SEC). We received total proceeds, net of offering expenses and placement agency fees, of approximately $33,190,000. UBS Investment Bank (UBS) acted as placement agent in this offering. For acting as our placement agent, UBS received fees of approximately $2,150,000 and expense reimbursement of approximately $50,000. No warrants were issued as part of this financing transaction.

On October 26, 2004, the Company entered into an agreement with institutional investors with respect to the registered direct placement of 7,500,000 shares of its 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. The Company sold these shares under a shelf registration statement previously filed with and declared effective by the SEC. 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 a definitive 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. Unterberg served as placement agent for the transaction. For acting as our placement agent, Unterberg received fees totaling $1,200,192, 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.

On December 10, 2003 we completed a $9.5 million financing transaction with Riverview Group L.L.C. (Riverview), through the sale of 5 million shares of common stock at a price of $1.90 per share. The closing price of our common stock on that date was $2.00 per share.

Pursuant to a Stock Purchase Agreement dated May 7, 2003, we issued 4 million shares of our common stock to Riverview for $6.5 million, or $1.625 per share. On the date of the agreement, the price was above the trading price of our common stock, which closed at $1.43 per share on that date. We also agreed to issue a 2-year warrant to Riverview to purchase 1,898,000 shares of common stock at $1.50 per share. The exercise price is subject to adjustment for stock splits, dividends, distributions, reclassifications and similar events. The exercise price may be below the trading market price at the time of the exercise. In the event that certain conditions are met, including the closing sale price of the Common Stock remaining at or above $2.50 per share for 10 consecutive trading days, we may require Riverview to exercise the warrant with respect to any remaining warrant shares or relinquish the right to do so. We registered the resale of the purchased shares and the shares to be issued on exercise of the warrants. On November 7, 2003 and November 11, 2003, Riverview exercised a total of 1,098,000 of these warrants at $1.50 per share by which, we received gross proceeds of $1,647,000.

We continue to have outstanding obligations in regard to our former facilities in Lincoln, Rhode Island, and expect to pay in 2006, based on past experience and current assumptions, approximately $1,000,000 in lease payments and other operating expenses net of sub-tenant income. We have subleased a portion of these facilities and 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):

	Total	Payable April to December 2006	Payable in 2007	Payable in 2008	Payable in 2009	Payable in 2010	Payable in 2011 and beyond
Capital lease payments	$ 2,279,733	$ 358,094	$ 332,545	$ 244,531	$ 244,572	$ 242,560	$ 857,431
Operating lease payments	17,275,918	2,261,420	3,165,162	3,469,017	3,536,843	1,767,304	3,076,172
Total contractual cash obligations	$19,555,651	$2,619,514	$3,497,707	$3,713,548	$3,781,415	$2,009,864	$3,933,603

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 covering shares of our common stock up to a value of approximately $64 million that could be available for financings. 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, 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.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In July 2005, the Company entered into an agreement with ReNeuron Limited, a wholly owned subsidiary of ReNeuron Group plc, a publicly listed UK corporation (collectively referred to as "ReNeuron"). As part of the agreement, the Company 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. In return for the license, StemCells 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 the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005. The fair market value of the securities (8,835,766 shares) as of December 31, 2005 and March 31, 2006 was approximately $3,721,000 and $2,420,000 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 loss" if deemed temporary, and are not recorded as "other income or loss" until the shares are disposed and a gain or loss realized. The unrealized loss as of March 31, 2006, is approximately $1,554,000. A decline in the fair value of securities that is deemed other than temporary would be charged to earnings.

Company/Stock Symbol	Exchange	Associated Risks	No. of Shares at March 31, 2006	Share price at March 31, 2006 in GBP (£)	Exchange Rate at March 31, 2006 1 GBP = USD	Market Value in USD at March 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	8,835,766	0.1575	1.7393	$2,420,468	(1)

(1) We have not formally adopted a liquidation plan for this investment. Liquidation may be necessary in the future to meet operating cash flow requirements. Although we are not legally restricted from selling the stock, the share price is subject to change and the volume traded has 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.

Other than the above, no significant changes have occurred in our quantitative and qualitative disclosures from the Form 10-K.

ITEM 4. CONTROLS AND PROCEDURES

In response to the requirement of the Sarbanes-Oxley Act of 2002, as of the end of the period covered by this report, our chief executive officer and chief financial officer, along with other members of management, reviewed the effectiveness of the design and operation of our disclosure controls and procedures. Such controls and procedures are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the chief executive officer and the chief financial officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, the chief executive officer and chief financial officer have concluded that the Company's disclosure controls and procedures are effective.

During the most recent quarter, there were no changes in internal controls over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, these controls of the Company.

PART II — ITEM 1

LEGAL PROCEEDINGS

Geron Corporation has opposed two of our European patents that relate to neural stem cells and their uses. The oppositions were filed with the European Patent Office on December 11, 2003 (Patent No. EP-B-0594669) and February 13, 2004 (Patent No. EP-B-0669973). We filed responses to both oppositions on September 23, 2004. Geron alleged 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. The written opinions have not yet been issued; the time for appeal begins to run in each case when the Opposition Division opinion issues and there can be no assurance that the opposing party will not appeal. While we are confident that, should the decision be appealed by the opposing party, it will be upheld, there can be no guarantee of this. If we were ultimately unsuccessful in our defense of the opposed patents, all claimed rights in the opposed patents would be lost in Europe. 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, but other types of proceedings may be available to third parties to contest our U.S. patents.

PART II — ITEM 2

CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

None

PART II — ITEM 3

DEFAULTS UPON SENIOR SECURITIES

None

PART II — ITEM 4

SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

PART II — ITEM 5

OTHER INFORMATION

There were no matters required to be disclosed in a current report on Form 8-K during the fiscal quarter covered by this report that were not so disclosed.

PART II — ITEM 6

EXHIBITS

Exhibit 10.1 — April 3, 2006, Amendment to License Agreement between ReNeuron Limited and StemCells, Inc.

Exhibit 31.1 — Certification of Martin McGlynn under Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 — Certification of Rodney K. B. Young under Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 — Certification of Martin McGlynn Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2 — Certification of Rodney K. B. Young Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

STEMCELLS, INC.
(name of Registrant)

April 27, 2006

/s/ Rodney K. B. Young
Rodney K. B. Young
Chief Financial Officer

Table of Contents

EXHIBIT INDEX

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Exhibit 10.1

Execution Version

DATED 3rd of April, 2006

RENEURON LIMITED

- and -

STEMCELLS INC.

AMENDMENT 5
to
LICENSE AGREEMENT dated 1 July 2005

TABLE OF CONTENTS

THIS AMENDMENT 5 (this "**Amendment**") to the License Agreement (as defined below) is made as of 3rd of April, 2006 between the following parties:

(1) **RENEURON LIMITED** a company incorporated in England and Wales (registered number 03375897) whose registered office is at 10 Nugent Road, Surrey Research Park, Guildford, Surrey GU2 7AF, United Kingdom ("**ReN**"); and

(2) **STEMCELLS, INC.** a corporation organised and existing under the laws of the State of Delaware, whose principal place of business is at 3155 Porter Drive, Palo Alto, California 94304, United States of America ("**SCI**").

WHEREAS

(A) ReN and SCI have entered into:

(i) a license agreement dated 1 July 2005 (the "License Agreement");

(ii) an amendment to the License Agreement dated 1 August 2005 ("Amendment 1")

(iii) a subscription and share exchange agreement dated 1 July 2005 (the "Subscription and Share Exchange Agreement"), as required by the License Agreement

(iv) an amendment to the Subscription and Share Exchange Agreement pursuant to a deed dated 1 August 2005 (the "Deed of Amendment")

(v) a second amendment to the License Agreement dated 9 September 2005;

(vi) a third amendment to the License Agreement dated 28 November 2005; and

(vii) a fourth amendment to the License Agreement dated 31 January, 2006.

(B) The parties hereto wish to further amend the License Agreement in accordance with the terms of this Amendment.

IT IS AGREED as follows:

1 **INTERPRETATION**

1.1 Save as defined in this Amendment, expressions used in this Amendment shall have the meanings given thereto in the License Agreement.

1.2 In this Amendment:

1.2.1 the headings in this Amendment do not affect its construction or interpretation;

1.2.2 a reference to a document is a reference to that document as amended or modified from time to time in writing by the mutual consent of the parties; and

1.2.3 the singular includes the plural and vice versa and any gender includes any other gender.

2 **AMENDMENT**

2.1 The parties to this Amendment agree that the License Agreement shall be amended as follows:

Existing Section 1.39 of the License Agreement is hereby renumbered Section 1.40 and the following new Section 1.39 is inserted in the License Agreement:

1.39 “Supply Agreement” shall mean an agreement between the Parties so titled, of even date herewith.

Existing Sections 1.40 through 1.42 of the License Agreement are hereby renumbered Sections 1.41 through 1.43 respectively.

2.1.2 Section 2.04 of the License is deleted and the following text is substituted:

2.04 Supply of Materials

(a) **Nomination of Research Cell Lines**. From time to time during the period commencing on the Effective Date and ending upon the expiration of the Royalty Term, SCI shall have the right to nominate one or more Cell Lines from among Cell Lines already in ReN’s possession as of the Effective Date for use by SCI solely for pre-clinical research purposes (a “Research Cell Line”). Such nomination shall be rejected by ReN only if:: (i) ReN had, prior to its receipt of such nomination from SCI, directly or indirectly commenced in vivo pre-clinical testing for developmental purposes (such as initial efficacy or toxicology testing) with respect to such nominated Cell Line, or (ii) such nominated Cell Line was, as of the date of ReN’s receipt of such nomination from SCI, already created or produced by ReN for a Third Party or otherwise subject to a pre-existing contractual restriction with a Third Party. ReN shall provide written notice to SCI within thirty (30) days after ReN’s receipt of a given Cell Line nomination if any of the foregoing causes for rejection apply. A nominated Cell Line that is not timely rejected by ReN as provided in this Section 2.04(a) is referred to herein as an “Approved Research Cell Line.” The parties agree that the following three Cell Lines shall be deemed to be nominated and not rejected and therefore Approved Research Cell Lines for purposes of this Section 2.04: cortical line CTX0E10, striatal line STR0C08, and ventral mesencephalon line VME0A04. Upon nomination, SCI shall provide ReN with a written description of the research SCI will conduct with each Approved Research Cell Line (similar to the e-mail already provided to ReN by SCI with respect to the Cell Lines described in the foregoing sentence). SCI shall provide ReN with the data and results arising from its research with each Approved Research Cell Line.

(b) **Nomination of Development Cell Lines**. From time to time during the period commencing on the Effective Date and ending upon the expiration of the Royalty Term, SCI shall have the right to nominate one or more new (i.e., not previously created or pre-existing) Cell Lines for creation by ReN according to

reasonable specifications provided by SCI, for use by SCI for pre-clinical development purposes within the SCI Field (a "Development Cell Line"). Such nomination shall be rejected by ReN only if such nominated Cell Line was, as of the date of ReN's receipt of such nomination from SCI, already created or produced by ReN for itself, an Affiliate or a Third Party. ReN shall provide written notice to SCI within thirty (30) days after ReN's receipt of a given Cell Line nomination if any of the foregoing causes for rejection apply. A nominated Cell Line that is not timely rejected by ReN as provided in this Section 2.04(b) is referred to herein as an "Approved Development Cell Line."

(c) Supply ReN shall use commercially reasonable and diligent efforts to establish and thereafter produce (directly or through a sub-contractor) reasonable quantities of each Approved Research Cell Line and Approved Development Cell Line, together with methods for growth and expansion thereof. Once a Cell Line becomes an Approved Development Cell Line, ReN shall have no right to conduct research and pre-clinical development of such Approved Development Cell Line (and ReN shall not develop or commercialize such Approved Development Cell Line or Products therefrom, directly or indirectly, nor authorize or license others to do so) for so long as SCI shall continue diligently to pursue the development and commercialization of such Approved Development Cell Line or Products incorporating or derived from the use of such Approved Development Cell Line.

Following the nomination by SCI of a Cell Line that is not timely rejected by ReN and therefore becomes an Approved Cell Line, the Parties shall in good faith establish a time-line on which ReN, using reasonable diligence, shall establish the capacity (or have a sub-contractor establish such capacity) to supply such Approved Cell Line to SCI pursuant to this Section 2.04. In accordance with the agreed-upon time table, SCI shall notify ReN in advance of its projected requirements of each Approved Cell Line and shall place firm orders for such Approved Cell Line sufficiently in advance of the date agreed to for delivery.

(d) Standards

(i) Approved Research Cell Lines. Approved Research Cell Lines to be supplied by ReN under this Section 2.04 (or the tissue, or corresponding blood samples, from which such Research Cell Lines were derived) shall, at the time of delivery to SCI, have been screened by or for ReN for mycoplasma, sterility and communicable diseases (HTLV, HIV, HBV, HCV) using standard testing protocols or based on documentation on the determination of donor eligibility. Upon delivery of such Research Cell Lines, ReN shall certify in writing (including by electronic mail) that such Research Cell Lines have been successfully screened in accordance with the foregoing. For the avoidance of doubt, Approved Research Cell Lines are solely for SCI's internal research purposes and are not intended to serve as precursors for Approved Development Cell Lines.

(ii) Approved Development Cell Lines. Each Approved Development Cell Line supplied by ReN under this Section 2.04 (including, without limitation, clonal cell lots and master cell banks thereof, as described hereinbelow) shall have been manufactured, handled, stored, transported and delivered in compliance with applicable Laws and Regulations (as such term is defined in the Supply Agreement) in effect at the time of such manufacture, handling, storage, transportation and delivery (including, without limitation, with applicable Current Good Tissue Practices and Current Good Manufacturing Practices, as such terms are defined in the Supply Agreement and with applicable regulations of the Recombinant DNA Advisory Committee of the National Institutes of Health; provided, however, that clonal cell lots to be provided under (ii)(A) below will not be cGMP compliant unless and until selected for master cell banks to be provided under (ii)(B) below). Upon delivery of such Approved Development Cell Line to SCI, ReN shall warrant in writing (including by electronic mail) that such Approved Development Cell Line meet the foregoing criteria. Furthermore, with respect to compliance with the applicable regulations of the Recombinant DNA Advisory Committee of the National Institutes of Health, the parties recognize that additional testing (and corresponding time and expense) be required to establish such compliance and therefore shall meet and agree as to whether such testing and compliance for a given Approved Development Cell Line shall be done for all the clonal cell lots to be provided under (ii)(A) below or just for the master cell bank to be provided under Section (ii)(B) (and the obligation of ReN to comply with such regulations hereunder shall be adjusted (if at all) accordingly).

(A) Approved Development Cell Lines shall initially be delivered to SCI in multiple clonal cell lots derived from the same tissue source (which clonal cell lots are not required to be cGMP compliant but which have been screened by or for ReN for mycoplasma, sterility and communicable diseases including, without limitation, HTLV, HIV, HBC and HCV, using standard testing protocols or based on documentation on the determination of donor eligibility). Following receipt of such clonal cell lots SCI will conduct such in vivo and in vitro pre-clinical testing as it deems appropriate to establish whether any of such clonal cell lots meet internally established performance criteria as a pre-condition for moving forward with pre-clinical and clinical development of Approved Development Cell Lines within the SCI Field.

(B) Promptly following completion of such internal testing, SCI will notify ReN as to which — if any — of such clonal cell lots SCI wishes to continue to develop as an Approved Development Cell Line. With respect to each clonal cell lot that SCI indicates that it wishes to continue to develop, ReN shall diligently

manufacture and deliver to SCI a master cell bank ("MCB") in compliance with applicable Laws and Regulations in effect at the time of manufacture. Those clonal cell lots as to which SCI notifies ReN that SCI has no further interest shall thereafter no longer be considered "Approved Development Cell Lines" and may be exploited by ReN as it sees fit.

(C) Within 180 days following its receipt of each MCB, SCI shall test such MCB for compliance with the applicable specifications, in accordance with the procedures set forth in Section 5.1 of the Supply Agreement. In the event that an MCB fails to meet the applicable specifications or otherwise fails to comply with applicable Laws and Regulations (as determined in accordance with Section 5.1 of the Supply Agreement), the parties shall in good faith consult in an effort to ascertain the reasons for such failure and to identify mutually acceptable means to assure the production of MCBs that meet applicable specifications, Laws and Regulations. ReN shall, at SCI's request and at ReN's expense, promptly manufacture and transfer to SCI a second MCB for the relevant Approved Development Cell Line. If such second MCB fails to meet the applicable specifications or otherwise fails to comply with applicable Laws and Regulations (as determined in accordance with Section 5.1 of the Supply Agreement) SCI may, on notice to ReN, either (i) require a transfer of technology as provided in Section 5.1.5 of the Supply Agreement, whereunder ReN's right to supply Development Cell Lines pursuant to this Agreement, and SCI's obligation to purchase such Cell Lines from ReN, shall terminate, or (ii) terminate the License and the Supply Agreement.

(D) Except as expressly provided in subsection (C), above, in the event of a second MCB failure, SCI's sole and exclusive remedy, and ReN's sole obligation and liability, with respect to any Approved Development Cell Line or Approved Research Cell Line that fails to meet the standards and criteria set forth in this Section 2.04(d) shall be replacement of such Cell Line by ReN or refund by ReN of any amounts paid by SCI therefore.

(e) Payment. With respect to Approved Research Cell Lines supplied to SCI pursuant to this Agreement, SCI shall reimburse ReN for the Fully Burdened Manufacturing Costs and Cost of External Services with respect to such Cell Lines. With respect to Approved Development Cell Lines supplied to SCI pursuant to this Agreement, SCI shall reimburse ReN in the amount of one and one half (1.5) times ReN's Fully Burdened Manufacturing Costs plus one times ReN's Cost of External Services with respect to such Cell Lines. The terms "Fully Burdened Manufacturing Costs" and "Cost of External Services" are as defined in Exhibit A

to the Supply Agreement (except that references therein to "Product" shall refer to such Approved Research Cell Lines or Approved Development Cell Lines, as the case may be). SCI shall pay ReNeuron within thirty (30) days of receipt of ReNeuron's invoice for the foregoing amounts follow delivery of the applicable Cell Lines in accordance with the provisions above (except to the extent provided otherwise in the Supply Agreement).

(f) Inspections. With respect to each Approved Development Cell Line isolated, produced and supplied by ReN pursuant to this Section 2.04, SCI shall have the right, no more than once in any 12 month period, during ordinary working hours and with no fewer than 10 days' prior written notice to ReN, to conduct reasonable quality assurance audits of ReN's applicable production and testing facilities (or such facilities of ReN's applicable subcontractor for such Approved Development Cell Line). In addition, SCI shall have the right, on 15 days' prior notice to ReN, to inspect such facilities as frequently as is reasonably required in order to confirm compliance with requests or directions of regulatory authorities with respect to such facilities.

3 **FULL FORCE AND EFFECT**

Except as expressly amended by this Amendment, the License Agreement shall remain unchanged and continue in full force and effect as provided therein.

4 **GOVERNING LAW**

This Amendment shall be governed by and interpreted in accordance with the laws of the State of California, without regard to conflicts of laws principles.

5 **ENTIRE AGREEMENT**

This Amendment and the License Agreement contain the full understanding of the parties with respect to the subject matter hereof. No waiver, alteration or modification of any of the provisions hereof shall be binding unless made in writing and signed by the parties by their respective officers thereunto duly authorized.

6 **COUNTERPARTS**

This Amendment may be executed in any number of counterparts (which shall include facsimile counterparts), each of which shall be deemed an original but all of which taken together shall constitute one and the same instrument.

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be executed in their names by their properly and duly authorized officers or representatives as of the date first above written.

RENEURON LIMITED

By: _____

Title: _____

STEMCELLS, INC.

By: _____

Title: _____

Exhibit 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
UNDER SECTION 302 OF THE SARBANES-OXLEY ACT

I, Martin McGlynn, certify that:

(1) I have reviewed this quarterly report on Form 10-Q of StemCells, Inc.;

(2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

(3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

(4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

(5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 27, 2006

/s/ Martin McGlynn
Martin McGlynn
President and Chief Executive Officer

Exhibit 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER
UNDER SECTION 302 OF THE SARBANES-OXLEY ACT

I, Rodney K. B. Young, certify that:

(1) I have reviewed this quarterly report on Form 10-Q of StemCells, Inc.;

(2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

(3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

(4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

(5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 27, 2006

/s/ Rodney K. B. Young
Rodney K. B. Young
Chief Financial Officer

Exhibit 32.1

Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the StemCells, Inc. (the "Company") Quarterly on Form 10-Q for the period ending March 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Martin McGlynn, President and Chief Executive Officer of the Company, certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

(1). The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2). The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

A signed original of this written statement required by Section 906 has been provided to StemCells, Inc. and will be retained by StemCells, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

Date: April 27, 2006

/s/ Martin McGlynn
Martin McGlynn
President and Chief Executive Officer

Exhibit 32.2

Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the StemCells, Inc. (the "Company") Quarterly on Form 10-Q for the period ending March 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Rodney K. B. Young, Chief Financial Officer of the Company, certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

(1). The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2). The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

A signed original of this written statement required by Section 906 has been provided to StemCells, Inc. and will be retained by StemCells, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

Date: April 27, 2006

/s/ Rodney K.B. Young
Rodney K. B. Young
Chief Financial Officer