

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:
June 30, 2001

Commission File Number: 0-19871

STEMCELLS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of
incorporation or organization)

94-3078125

(I.R.S. Employer
identification No)

3155 PORTER DRIVE
PALO ALTO, CA 94304

(Address of principal executive offices including zip code)

525 Del Rey Avenue, Suite C, Sunnyvale, CA 94086
(Former address of principal executive offices) (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 /X/ No / /

At July 31, 2001 there were 23,112,139 shares of Common Stock, \$.01 par value, issued and outstanding.

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STEMCELLS, INC.

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PART I - ITEM 1 - FINANCIAL STATEMENTS

STEMCELLS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

June 30, 2001
December 31,
2000
(unaudited) -

Assets
Current
assets: Cash
and cash
equivalents \$
9,439,252 \$
6,068,947
Short-term

restricted
investments -
16,356,334
Accrued
interest
receivable
14,519 16,725
Prepaid rent
376,688 -
Other current
assets
561,395
524,509 -----

Total current
assets

10,391,854
22,966,515
Property held
for sale
3,203,491
3,203,491
Property,
plant and
equipment,
net 1,375,607
1,451,061
Other assets,
net 2,462,992
2,173,912 ---

Total assets
\$17,433,944
\$29,794,979
=====

Liabilities
and
Stockholders'
Equity
Current
liabilities:

Accounts
payable \$
537,142 \$
526,191
Accrued
expenses
1,068,203
837,358
Accrued wind-
down costs
886,161
1,780,579
Current
maturities of
capitalized
lease
obligations
334,583
332,083 -----

Total current
liabilities

2,826,089
3,476,211
Capitalized
lease
obligations,
less current
maturities
2,437,500
2,605,000
Deposits
95,772 26,000
Deferred rent
815,270
705,746

Stockholders' equity	
Convertible preferred stock, \$.01 par value; 1,000,000 shares authorized, 2,626 designated as 6% Cumulative Convertible Preferred Stock 1,500 shares issued and outstanding at June 30, 2001, and December 31, 2000	1,500,000
	1,500,000
Common stock, \$.01 par value; 45,000,000 shares authorized; 21,935,192 and 20,956,887 shares issued and outstanding at June 30, 2001 and December 31, 2000, respectively	219,352
	209,569
Additional paid in capital	141,800,045
	138,150,067
Stock subscription receivable	(518,556)
- Accumulated deficit	(128,635,110)
	(130,498,187)
- Accumulated other comprehensive income -	16,356,334
Deferred compensation	(3,106,418)
	(2,735,761)
- - - - -	
- - - - -	
Total stockholders' equity	11,259,313
	22,982,022
- - - - -	
- - - - -	
Total liabilities and stockholders' equity	\$17,433,944
	\$29,794,979

=====
=====
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 Six	Months Ended
June 30, 2001	June 30, 2001	June 30, 2000
2001	2000	2000
---	---	---
-----	-----	-----
-----	-----	-----
Revenue:		
Revenue from grants	\$ -	\$ -
- Revenue - assignment of technology rights	300,000	300,000
	---	---
	-----	-----
	-----	-----
Total revenue	300,000	400,000
Operating expenses:		
Research and development	2,859,141	1,115,207
	4,503,398	2,021,839
General and administrative	1,100,300	770,019
	2,097,162	1,427,733
Wind-down expenses	54,260	---
	288,646	-----
	-----	-----
	-----	-----
	3,959,441	1,939,486
	6,600,560	3,738,218
	---	---
	-----	-----
	-----	-----
Loss from operations	(3,659,441)	(1,939,486)
	(6,200,560)	(3,738,218)
Other income (expense):		
Investment		

income 46,290
 64,900
 125,333
 138,232
 Interest
 expense -
 (73,708) -
 (142,566)
 Gain on sale
 of
 investments
 5,232,168
 1,427,686
 7,782,399
 1,427,686
 Loss on
 disposal of
 fixed assets
 (24,484)
 (11,098)
 (24,484)
 (11,098)
 Other income
 - - 180,389 -

 Total other
 income, net
 5,253,976
 1,407,780
 8,063,637
 1,412,254 ---

 ----- Net
 income (loss)
 \$ 1,594,535
 (\$ 531,706)
 \$1,863,077 (\$
 2,325,964) --

 Income (loss)
 per share:
 Net Income
 (loss)
 1,594,535
 (531,706)
 1,863,077
 (2,325,964)
 Deemed
 dividend -
 (265,000) -
 (265,000) ---

 ----- Net
 Income (loss)
 attributable
 to common
 shareholders
 1,594,535
 (796,706)
 1,863,077
 (2,590,964)
 Basic
 earnings per
 share: Net
 income (loss)
 per share
 \$0.07 (\$
 0.04) \$0.09
 (\$ 0.13)
 Weighted
 average

shares -
 21,511,171
 19,329,517
 21,251,591
 19,419,236
 Diluted
 earnings per
 share: Net
 income (loss)
 per share
 \$0.07 (\$
 0.04) \$0.08
 (\$ 0.13)
 Weighted
 average
 shares
 23,264,606
 19,329,517
 23,005,026
 19,419,236

See accompanying notes to condensed consolidated financial statements.

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PART I - ITEM 1 - FINANCIAL STATEMENTS

STEMCELLS, INC.

CONDENSED STATEMENTS OF CASH FLOWS

(unaudited)
 Six Months
 Ended June
 30, 2001

2000 -----

Cash flows
 from

operating
 activities:
 Net income
 (loss)

\$1,863,077
 (\$2,325,964)

Adjustments
 to

reconcile
 net income
 (loss) to
 net cash

used for
 operating
 activities:
 Depreciation
 and

amortization

291,453
 407,634

Gain on
 sale of
 investments
 (7,782,399)

(1,427,686)

Loss on
 disposal of
 fixed

assets
 24,484 -

Gain on
 sale of
 rights to
 technology
 (300,000) -

Compensation
 expense
 relating to

the grant
of stock
options
1,327,236
87,500 Net
changes in
operating
assets and
liabilities
(1,159,695)
(1,890,508)

--- Net
cash used
in
operating
activities
(5,735,844)
(5,149,024)

--- Cash
flows from
investing
activities:
Proceeds
from sale
of
investments
7,782,398
1,427,686
Purchase of
property,
plant and
equipment
(204,217)
8,005
Acquisition
of other
assets
(50,345)
(20,380)
Proceeds
from
assignment
of
technology
300,000
2,800,000 -

- Net cash
provided by
investing
activities
7,827,836
4,215,311 -

- Cash
flows from
financing
activities:
Proceeds
from the
exercise of
stock
options
26,613
368,913
Proceeds
from the
issuance of
equity
1,500,000 -
Cost of
equity line
(83,300) -
Proceeds
from

issuance of
 preferred
 stock -
 1,500,000
 Principal
 payments
 under
 capitalized
 lease
 obligations
 and
 mortgage
 payable
 (165,000)
 (160,000) -

 - Net cash
 provided by
 financing
 activities
 1,278,313
 1,708,913 -

 - Net
 increase in
 cash and
 cash
 equivalents
 3,370,305
 775,200
 Cash and
 cash
 equivalents,
 beginning
 of period
 6,068,947
 4,760,064 -

 - Cash and
 cash
 equivalents,
 end of
 period
 \$9,439,252
 \$5,535,264
 =====
 =====
 Supplemental
 disclosure
 of cash
 flow
 information:
 Interest
 paid
 \$129,626
 \$142,566

See accompanying notes to condensed financial statements.

PART I - ITEM 1. - FINANCIAL STATEMENTS

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
 June 30, 2001 and 2000

NOTE 1. BASIS OF PRESENTATION

On May 23, 2000, we changed our name to Stem Cells, Inc. from CytoTherapeutics, Inc. by vote of the shareholders at the Annual Meeting. The accompanying, unaudited, condensed consolidated financial statements have been prepared by us 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 six months ended June 30, 2001 are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 31, 2001.

The balance sheet at December 31, 2000 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. For the complete financial statements, refer to the audited financial statements and footnotes thereto as of December 31, 2000, included on Form 10-K as amended.

NOTE 2. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed using the weighted average of common and diluted equivalent stock options and warrants outstanding during the period. Stock options and warrants that are antidilutive are excluded from the calculation of diluted income per common share for the three and six-months period ended June 30, 2001. We excluded all stock options and warrants from the calculation of diluted loss per common share for the three and six-months period ended June 30, 2000, as these securities are antidilutive for that period.

NOTE 3. COMPREHENSIVE INCOME

The only component of other comprehensive loss is unrealized gains and losses on available for sale securities. For the three months ended June 30, 2001 and 2000, total comprehensive income was \$1,594,535 and \$ 18,688,459 respectively. For the six months ended June 30, 2001 and 2000, total comprehensive income was \$1,338,492 and \$16,894,201 respectively.

NOTE 4. WIND-DOWN OF ENCAPSULATED CELL TECHNOLOGY RESEARCH AND DEVELOPMENT PROGRAM

As previously reported, in 1999 we restructured our operations to abandon all further encapsulated cell technology research and concentrate our resources on the research and development of our proprietary platform of stem cell technologies. We relocated our remaining research and development activities and our corporate headquarters to California, and have been seeking to dispose of our former science and administrative and pilot manufacturing facilities in Rhode Island. In December 2000, we had a reserve of \$1,780,579 related to the carrying costs for the Rhode Island facilities through 2001. On February 2001, we subleased portions of the facilities and are actively seeking to sublease, assign or sell our remaining interests in the properties. However, there can be no assurance that we will be able to dispose of these facilities in a reasonable time, if at all. At June 30, 2001 the reserve was \$886,161.

Reserve as
at
12/31/2000
Payments
Reserve as
at
06/30/01 -

In the Purchase Agreement governing the August 3, 2000 sale to the Fund, we granted the Fund an option to purchase up to an additional \$3 million of our common stock and a callable warrant and an adjustable warrant. The Fund had the right to exercise this option in whole or in part at any time prior to August 3, 2001. The price per share of common stock to be issued upon exercise of the option will be based on the average market price of the common stock for a five-day period prior to the date on which the option is exercised. On August 23, 2000, the Fund exercised \$1,000,000 of its option to purchase additional common stock. The Fund purchased our common stock at \$5.53 per share, which amount was based upon the average market price of the common stock for the five-day period prior to August 23, 2000. An adjustable warrant similar to the one issued on August 3, 2000 was issued to the Fund on August 30, 2000, but was cancelled on November 1, 2000 by agreement between StemCells and the Fund. The Fund also received a five -year warrant to purchase up to 19,900 shares of common stock at \$6.03 per share. This warrant is callable by us at any time at \$10.05 per underlying share. The calculated value of this callable warrant using the Black-Scholes method is \$139,897, which we account for as stock issuance cost that has no impact on stockholders' equity.

On June 8, 2001, the Fund exercised its option to purchase \$2,000,000 of our common stock. At the closing on June 21, 2001, the Fund purchased 457,750 shares of our common stock at \$4.3692 per share. We received \$1,500,000 of the purchase price at the closing on June 21, 2001, and we will receive the remaining \$500,000 upon effectiveness of a registration statement related to these shares. The Fund also received a warrant to purchase 50,352 shares of our common stock at a price per share of \$4.7664. This warrant is callable by us at any time at \$7.944 per underlying share. The calculated value of this callable warrant using the Black-Scholes method is \$184,288, which we account for as stock issuance cost that has no impact on stockholders' equity. In addition, the Fund received an adjustable warrant similar to the adjustable warrant issued to the Fund on August 3, 2000. The adjustable warrant contains provisions regarding the adjustment or replacement of the warrants in the event of stock splits, mergers, tender offers and other similar events. The adjustable warrant also limits the number of shares that can be beneficially owned by the Fund to 9.99% of the total number of outstanding shares of Common Stock.

NOTE 8. LEASES

As of February 1, 2001, we entered into a 5-year lease for a 40,000 square foot facility located in the Stanford Research Park in Palo Alto, California. The new facility includes animal space, laboratories, offices, and a GMP (Good Manufacturing Practices) suite. GMP facilities can be used to manufacture materials for clinical trials. The rent will average approximately \$3.2 million per year over the term of the lease. We paid \$1.2 million upfront related to this new lease. Approximately \$909,000 of this payment has been recorded as prepaid rent and is being amortized over seven months. In May 2001, we entered into a space-sharing agreement effective February 1, 2001, covering approximately 11,000 square feet of the 40,000 square foot facility. We received \$314,523 upfront and \$307,630 as payment for the months February 2001 to June 2001.

On April 27, 2001, we reached an agreement to terminate as of May 15, 2001, without cost, our lease on part of our former Sunnyvale headquarters. The lease on the remaining portion of our former Sunnyvale headquarters will terminate on August 31, 2001.

We continue to lease the facilities in Lincoln, Rhode Island obtained in connection with our former encapsulated cell technology, but have now succeeded in subleasing parts of those facilities: the 3,000 square-foot cell processing facility and approximately one-third of our former scientific and administrative facility ("SAF"). We continue to seek to sublet the remainder of the approximately 65,000 square foot SAF and the 21,000 square-foot pilot manufacturing facility, or to assign or sell our interests in these properties. There can be no assurance however, that we will be able to dispose of these properties in a reasonable time, if at all.

NOTE 9. GRANT

In February 2001, we were awarded a two-year, \$300,000 per year grant from the National Institute of Health's Small Business Innovation Research (SBIR) office. The grant, which will support joint work with

virologist Dr. Jeffrey Glenn at Stanford University, is aimed at characterizing the human cells that can be infected by human hepatitis viruses and to develop a small animal model using the cells that are most infectable by these viruses to develop screening assays and identify novel drug for the disease. The company

received and recognized as revenue \$100,000 for research from a prior SBIR grant relating to the neural program.

NOTE 10. EQUITY LINE

On May 10, 2001, we entered into a common stock purchase agreement with Sativum Investments Limited ("Sativum") for the potential future issuance and sale of up to \$30,000,000 of our common stock, subject to restrictions and other obligations. We, at our sole discretion, may draw down on this facility, sometimes termed an equity line, from time to time, and Sativum is obligated to purchase shares of our common stock at a 6% discount to a volume weighted average market price over the 20 trading days following the draw-down notice. Our volume weighted average market price is calculated by adding the total dollars traded in every transaction in a given trading day and dividing that number by the total number of shares traded during that trading day. We are limited with respect to how often we can exercise a draw down and the amount of each draw down.

In connection with our execution of a common stock purchase agreement with Sativum, we issued three three-year warrants to purchase an aggregate of 350,000 shares of our common stock at \$2.38 per share to Sativum (250,000 shares), Pacific Crest Securities Inc. (75,000 shares) and Granite Financial Group, Inc. (25,000 shares). We have valued the warrants using the Black-Scholes method. The amounts of \$522,500, \$167,750 and \$55,250 respectively, were accounted for as stock issuance cost in stockholders' equity. The exercise price and number of shares are subject to adjustment for subdivisions, combinations, stock dividends and reorganizations.

NOTE 11. SUBSEQUENT EVENTS

On May 10, 2001, we entered into a common stock purchase agreement with Sativum Investments Limited for the potential future issuance and sale of up to \$30,000,000 of our common stock, subject to restrictions and other obligations. On July 2, 2001, the Securities and Exchange Commission declared effective a registration statement with respect to up to 10,350,000 shares of our common stock, which we may issue pursuant to the common stock purchase agreement (a facility sometimes termed an equity line) and to the warrants issued in connection with it. Warrants to purchase a total of 350,000 shares of our common stock were issued: 250,000 shares to Sativum and an aggregate of 100,000 shares to placement agents, all at at \$2.38 per share. We, at our sole discretion, may draw down on the equity line, from time to time, and Sativum is obligated to purchase shares of our common stock at a 6% discount to a volume weighted average market price over the 20 trading days following the drawdown notice. We cannot sell more than 3,922,606 shares pursuant to the agreement without stockholder approval. Our placement agents have exercised their warrants in full, and we have received payment of \$238,000 for the shares issued to them. We delivered a draw down notice to Sativum Investments Limited, dated as of July 11, 2001, exercising our right to draw down up to \$5,000,000 at a market-based share price not less than \$5.00 per share beginning July 12, 2001. Sativum purchased a total of 707,947 shares of our common stock at an average purchase price of \$5.65 per share, net of Sativum's discount of six percent. Because the market based price of our common stock was less than \$ 5.00 for four trading days, the total investment amount was reduced to \$4,000,000. Our placement agents, Pacific Crest Securities, Inc. and Granite Financial Group, Inc. received \$80,000 and \$40,000, respectively, as placement fees in connection with this draw down, resulting in total net proceeds to us of \$3,878,000 after paying escrow fees.

On April 27, 2001, the adjustable warrant that Millennium Partners, LP, had received as part of its August 2000 purchase of StemCells shares became exercisable for an additional 622,469 shares of our common stock. On July 19, 2001, Millennium purchased all of those shares for \$6,225.

NOTE 12. RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Financial Instruments and for Hedging Activities" ("SFAS 133"). The Statement requires the Company to recognize all derivatives on the balance sheet at fair value. Derivatives

that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in fair value of derivatives are either offset against the change in fair value of assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. As the Company had no derivative instruments and does not currently engage in hedging

activities, the adoption of Statement No. 133 on January 1, 2001 had no impact on StemCells results, operations or financial statement.

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 141, "Business Combinations" (Statement). This Statement addresses financial accounting and reporting for business combinations. This Statement supersedes APB Opinion No. 16, BUSINESS COMBINATIONS, and amends or supersedes a number of interpretations of that Opinion. This Statement requires that (1) all business combinations be accounted for by a single method--the purchase method, (2) all intangible assets recognized as assets apart from goodwill if they meet one of two criteria--the contractual-legal criterion or the separability criterion and (3) In addition to the disclosure requirements in Opinion 16, this Statement requires disclosure of the primary reasons for a business combination and the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption. When the amounts of goodwill and intangible assets acquired are significant in relation to the purchase price paid, disclosure of other information about those assets is required, such as the amount of goodwill by reportable segment and the amount of the purchase price assigned to each major intangible asset class. The provisions of this Statement apply to all business combination initiated after June 30, 2001. This statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. The Company will adopt the provisions of the Statement for any business combinations initiated after June 30, 2001.

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

The following discussion of the financial condition and results of operations of the Company for the three months and six months ended June 30, 2001 and 2000 should be read in conjunction with the accompanying unaudited condensed consolidated financial statements and the related footnotes thereto.

This report includes forward-looking statements. You can identify these statements by forward-looking words such as "may," "will," "possibly," "expect," "anticipate," "project," "believe," "estimate" and "continue" or similar words. You should read statements that contain these words carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial condition, or state other "forward-looking" information. We believe that it is important to communicate our future expectations to our investors. However, there will be events in the future that we have not been able to accurately predict or control and that may cause our actual results to differ materially from those discussed. For example, contaminations at our facilities, changes in the pharmaceutical or biotechnology industries, competition and changes in government regulations or general economic or market conditions could all have significant effects on our results. These factors should be considered carefully and readers should not place undue reliance on our forward-looking statements. Before you invest in our common stock, you should be aware that the occurrence of the events described in the "Cautionary Factors Relevant to Forward Looking Information" and "Business" sections included in our Form 10-K/A report, as of December 31, 2000 could harm our business, operating results and financial condition. All forward looking statements attributable to us or 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. As a result of a restructuring in the second half of 1999, our sole focus is now on our stem cell technology. In 1999, by contrast, our corporate headquarters, most of our employees, and the main focus of our operations were primarily devoted to a different technology--encapsulated cell therapy, or ECT. Since that time, we terminated a clinical trial of the ECT then in progress, we wound down our other operations relating to the ECT, we terminated the employment of those who worked on the ECT, we sold the ECT and we relocated from Rhode Island to California. The year 2000 was a year of transition, in which we completed the consolidation and restructuring of our operations. Comparisons with the previous year's results are correspondingly less meaningful than they may be under other circumstances.

We have not derived any revenues from the sale of any products, 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 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, nonrecurring events, including without limitation the receipt of one-time, nonrecurring licensing payments, and the initiation or termination of research collaborations, in addition to the winding-down of terminated research and development programs referred to above.

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RESULTS OF OPERATIONS

THREE MONTHS ENDED JUNE 30, 2001 AND 2000

For the three months ended June 30, 2001 revenue from the assignment of rights related to technology totaled \$300,000. There was no such revenue for the three months ended June 30, 2000.

Research and development expenses totaled \$2,859,141 for the three months ended June 30, 2001, compared with \$1,115,207 for the same period in 2000. The increase of \$1,743,934 or 156% from 2000 to 2001 was primarily attributable to compensation costs recognized in the valuation of non-qualified stock options granted to external consultants, the related costs of an increase in personnel to facilitate the expansion of our research programs and initiate development, and the cost of leasing a larger facility.

General and administrative expenses were \$1,100,300 for the three months ended June 30, 2001, compared with \$770,019 for the same period in 2000. The increase of \$330,281 or 43%, from 2000 to 2001 was primarily attributable to the related costs of an increase in personnel, which included the hiring of senior management personnel as part of the reorganization and consolidation of our operations in California, the cost of leasing a larger facility, and the compensation cost recognized in the valuation of non-qualified stock options.

Investment income for the three months ended June 30, 2001 and 2000 was \$46,290 and \$64,900 respectively. Interest expense of \$65,166 for the three months ended June 30, 2001 was charged against the wind-down reserve, as the expense was part of the bond payments related to the Rhode Island facilities. Interest expense for the same period in 2000 was \$73,708. The decrease in 2001 was attributable to lower outstanding debt and capital lease balances in 2001 compared to 2000.

On April 30, 2001, we sold our remaining shares in Modex Therapeutics, Ltd., a Swiss biotherapeutics company, traded on the Swiss Exchange, for a net price of 87.30 Swiss Francs per share, which converts to approximately \$50.51 for total proceeds and a realized gain of 5,232,168, net of commissions and fees. We no longer hold any shares of Modex.

Net income for the three months ended June 30, 2001 was \$1,594,535 or \$0.07 per share, as compared to net loss of (\$796,706) or (\$0.04) per share, for the comparable period in 2000. The net positive change of \$2,391,241 or 300% from the same period in 2000 was primarily attributable to a realized gain of \$5,232,168 from the sale of the remaining portion of our Modex investment, offset by an increase in expenses attributable to an increase in personnel, the costs associated with our move to a larger facility, and the effect of compensation cost recognized in the valuation of non-qualified stock options.

SIX MONTHS ENDED JUNE 30, 2001 AND 2000

For the six months ended June 30, 2001, revenues from grants totaled \$100,000, and revenues from assignment of rights related to technology totaled \$300,000. There was no such revenue for the six months ended June 30, 2000.

Research and development expenses totaled \$4,503,398 for the six months ended June 30, 2001, compared with \$2,021,839 for the same period in 2000. The increase of \$2,481,559 or 123% from 2000 to 2001 was primarily attributable to the related costs of an increase in personnel to facilitate the expansion of our research programs and initiate development, the cost of leasing a larger facility, and the compensation costs recognized in the valuation of non-qualified stock options.

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General and administrative expenses were \$2,097,162 for the six months ended June 30, 2001, compared with \$1,427,733 for the same period in 2000. The increase of \$669,429 or 47%, from 2000 to 2001 was primarily attributable to the related costs of an increase in personnel, which included the hiring of senior management personnel as part of the reorganization and consolidation of our operations in California, the cost of leasing a larger facility, and the compensation cost recognized in the valuation of non-qualified stock options under the fair value based method.

In December 2000, we established a reserve of \$1,780,578 related to the carrying costs for the Rhode Island facilities through 2001. At June 30, 2001 our reserve was \$886,161. In comparison, for the first six months ended June 30, 2000 we incurred costs of \$288,646 in excess of a reserve of \$1,634,522 created in December 1999 for the first six months of 2000.

Investment income for the six months ended June 30, 2001 and 2000 was \$125,333 and \$138,232 respectively. Interest expense of \$129,626 for the six months ended June 30, 2001 was charged against the wind-down reserve, as the expense was part of the bond payments related to the Rhode Island facilities. Interest expense for the same period in 2000 was \$142,566. The decrease in 2001 was attributable to lower outstanding debt and capital lease balances in 2001 compared to 2000.

On January 9, 2001, we sold 22,616 Modex shares for a net price of 182.00 Swiss francs per share, which converts to \$112.76 per share, for total proceeds and a realized gain of \$2,550,231. On April 30, 2001, we sold our remaining shares in Modex for a net price of 87.30 Swiss Francs per share, which converts to approximately \$50.51 for total proceeds and a realized gain of \$5,232,168, net of commissions and fees. We no longer hold any shares of Modex.

Other income for the six months ended June 30, 2001 was \$180,389, which was a refund for an overpayment of property taxes in prior years. At June 30, 2001 we recorded a loss of \$24,484 relating to the disposal of some our equipment located in our former headquarters in Sunnyvale, California.

Net income for the six months ended June 30, 2001 was \$1,863,077 or \$0.09 per share, as compared to net loss of (\$2,590,964) or (\$0.13) per share, for the comparable period in 2000. The net positive change of \$4,454,041 or 172% from the same period in 2000 was primarily attributable to a realized gain of \$7,782,399 from the sale of the remaining portion of our Modex investment, offset by an increase in expenses attributable to an increase in personnel, the costs associated with our move to a larger facility, and the effect of compensation cost recognized in the valuation of non-qualified stock options.

LIQUIDITY AND CAPITAL RESOURCES

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

We had unrestricted cash and cash equivalents totaling \$9,439,252 at June 30, 2001. Cash equivalents are invested in money market funds.

Our liquidity and capital resources were, in the past, significantly affected by our relationships with corporate partners, which were related to our former encapsulated cell technology, or ECT. These relationships are now terminated, and we have not yet established corporate partnerships with respect to our stem cell technology.

We continue to have outstanding obligations in regard to our former facilities in Lincoln, Rhode Island, including lease payments and operating costs of approximately \$1,200,000 per year associated with our former research laboratory and corporate headquarters building, and debt service payments and operating costs of approximately \$1,000,000 per year with respect to our pilot manufacturing and cell processing facility. 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.

On August 3, 2000, we completed a \$4 million common stock financing transaction with Millennium Partners, LP, or the Fund, an investment fund. The Fund purchased our common stock at \$4.33 per share. The Fund is entitled, pursuant to an adjustable warrant issued on August 3, 2000 in connection with the sale of common stock to the Fund, to purchase additional shares of common stock for \$0.01 per share. The adjustments to the adjustable warrant are calculated on eight dates beginning six months from the closing and every three months thereafter. The number of additional shares the Fund may be entitled to on each date will be based on the number of shares of common stock the Fund

continues to hold on each date and the market price of our common stock over a period prior to each date. We have the right, under certain circumstances, to cap the number of additional shares by

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purchasing part of the entitlement from the Fund. On January 27, 2001, the Fund's adjustable warrant became exercisable for 463,369 shares of our common stock, and the Fund purchased all of those shares on March 30, 2001, for \$4,634. On April 27, 2001, the Fund's adjustable warrant became exercisable for an additional 622,469 shares of our common stock and the Fund purchased all of those shares on July 19, 2001, for \$6,225. The Fund also received on August 3, 2000 a warrant to purchase up to 101,587 shares of common stock at \$4.725 per share. This warrant is callable by us at \$7.875 per underlying share. In addition, the Fund was granted an option for twelve months to purchase up to \$3 million of additional common stock. On August 23, 2000 the Fund exercised \$1,000,000 of its option to purchase additional common stock at \$5.53 per share. The Fund paid \$750,000 of the purchase price in connection with the closing on August 30, 2000, and paid the remaining \$250,000 upon effectiveness of a registration statement covering the shares owned by the Fund. At the closing on August 30, 2000, we issued to the Fund an adjustable warrant similar to the one issued on August 3, 2000. This adjustable warrant was canceled by agreement between us and the Fund on November 1, 2000. The Fund also received on August 23, 2000 a warrant to purchase up to 19,900 shares of common stock at \$6.03 per share. This warrant is callable by us at any time at \$10.05 per underlying share. On June 8, 2001, the Fund exercised its remaining option to purchase \$2 million of our common stock. At the closing on June 21, 2001, the Fund purchased 457,750 shares of our common stock at \$4.3692 per share. The Fund paid \$1,500,000 of the purchase price at the closing and will pay the remainder upon effectiveness of the registration statement. In connection with the closing, the Fund received an adjustable warrant similar to the adjustable warrant issued on August 3, 2000. The Fund also received a warrant to purchase 50,352 shares of our common stock at a price per share of \$4.7664. This warrant is callable by us at any time at \$7.944 per underlying share.

We have sold all of our shares of Modex Therapeutics, Ltd. Our final sale of Modex shares occurred on April 30, 2001, when we realized a gain of \$5,232,168 net of commissions and other fees. All other sales occurred prior to June 30, 2001. In addition, on April 30, 2001, we sold Modex our rights to future payments under the agreement between us and Neurotech S.A. for \$300,000.

On May 10, 2001, we entered into a common stock purchase agreement with Sativum Investments Limited for the potential future issuance and sale of up to \$30,000,000 of our common stock, subject to restrictions and other obligations. We, at our sole discretion, may draw down on this facility, sometimes termed an equity line, from time to time, and Sativum is obligated to purchase shares of our common stock at a 6% discount to a volume weighted average market price over the 20 trading days following the drawdown notice. We are limited with respect to how often we can exercise a drawdown and the amount of each drawdown. We may, but are not required to, draw down on the equity line from time to time as necessary and possible under the terms of the facility. As of July 11, 2001, we notified Sativum of our intention to draw down up to \$5,000,000 at a market-based share price not less than \$5.00 per share beginning July 12, 2001. Sativum purchased a total of 707,947 shares of our common stock at an average purchase price of \$5.65 per share, net of Sativum's discount of six percent. Because the market based price of our common stock was less than \$ 5.00 for four trading days, the total investment amount was reduced to \$4,000,000. Our placement agents, Pacific Crest Securities, Inc. and Granite Financial Group, Inc. received \$80,000 and \$40,000, respectively, as placement fees in connection with this draw down, resulting in total net proceeds to us of \$3,878,000 after paying escrow fees.

While our cash requirements may vary, as noted above, we currently expect that our existing capital resources, including income earned on invested capital, will be sufficient to fund our operations for the next twelve months. Our cash requirements may vary, however, depending on numerous factors. If for some reason we are not able to drawdown on the equity line, 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.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

No significant changes in our quantitative and qualitative disclosures from the Form 10-K

director
18,763,552
430,870 - -

Election of
John. J.
Schwartz,
Ph.D., as
18,762,302
432,420
director -

Approval of
the 2001
Equity
Incentive
Plan
6,162,082
811,295
90,362
12,130,683
-

Ratification
of Ernst &
Young LLP
as
19,047,479
114,355
32,588
independent
accountants
for 2001 -

(a) REPORTS ON FORM 8-K

On April 30, 2001, StemCells, Inc. sold all of its remaining founder's shares in Swiss Modex Therapeutics, Ltd. (SWX New Market: MDXN) in a private placement. StemCells, Inc. sold 103,577 shares at a net price of 87.30 CHF (Swiss francs) per share, or a total sum of approximately US \$5,200,000. Report dated May 8, 2001.

On May 10, 2001, StemCells, Inc. entered into a definitive agreement with an institutional investor to provide the company with up to \$30,000,000 in equity financing from time to time. Report dated May 14, 2001.

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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)

August 10, 2001

/s/ George Koshy

Controller and Acting Chief Financial
Officer (principal financial officer and
principal accounting officer)