

# Complete Genomics, Inc.

## Disappointing Second-Quarter Results Point to Volatility but Also Continued Traction (Albeit Slower Than Expected)

- Complete Genomics (CGI) announced disappointing second-quarter results after the close Wednesday. Revenue of \$5.9 million fell well below our estimate of \$7.6 million and consensus estimates of \$7.7 million; in addition, Complete Genomics reported a \$0.56 loss versus our estimate of \$0.50 loss and consensus of \$0.49 loss.
- The number of genomes shipped in the quarter was in line with our expectations and guidance of 900; as of the end of June, the company had a backlog of 2,200 genomes (representing \$12 million in revenue), which implies 1,100 genomes signed in the quarter. CGI expects to ship 2,400 genomes in the back half (600 in the third quarter and 1,800 in the fourth quarter) for a total of 4,000 for 2011, which falls well below our estimate of 4,950 genomes for 2011.
- Revenue per genome of \$6,500 was below our expectation of around \$8,000, which was a surprise given our belief that the company's recent drop to \$5,000 per genome (\$4,000 for large orders) would take some time to flow through the P&L; our understanding was that prior orders would remain whole from an absolute revenue standpoint (i.e., a lower price would mean more genomes).
- Given the miss in the quarter, we are likely to reduce our expectations for shipments for the remainder the 2011 by roughly 1,000 genomes and our revenue expectation by roughly \$10 million for 2011 and at least that amount for 2012 after the call Thursday morning (at 7:30 Central time).
- It is important to note that this backlog number does not include two contracts for 2,700 genomes (representing \$14 million in revenue) signed in the third quarter with the National Cancer Institute/SAIC Frederick and the Inova Translational Medicine Institute; thus, as of the end of July, the backlog was a more impressive 4,900 genomes.
- In our view, results this quarter highlight the early stage of this market—and how results can be skewed by the timing of one or two large orders one way or the other, as well as the timing of sample receipt from customers by the company. Taking a step back, the company continues to gain traction despite the miss (albeit slower than expected) and still maintains a significant share of total human genome sequences completed worldwide. Thus, we view CGI as a way for small-cap, risk-tolerant, longer-term investors to play the sequencing space and maintain our Outperform rating.

## Healthcare | Life Sciences

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Stock Rating: **Outperform**

Company Profile: **Aggressive Growth**

Symbol: GNOM (NASDAQ)  
 Price: \$11.25 (52-Wk.: \$7-\$19)  
 Market Value (mil.): \$398  
 Fiscal Year End: December  
 Long-Term EPS Growth Rate:  
 Dividend/Yield: None

	2010A	2011E	2012E
<b>Estimates</b>			
EPS Q1	\$-3.36	A\$-0.48	\$-0.32
Q2	\$-2.96	A\$-0.56	\$-0.26
Q3	\$-4.88	\$-0.50	\$-0.19
Q4	\$-0.69	\$-0.39	\$-0.05
FY	\$-13.60	\$-1.94	\$-0.81
CY		\$-1.94	\$-0.81
Sales (mil.)	9	36	83
<b>Valuation</b>			
FY P/E	NM	NM	NM
CY P/E		NM	NM

## Trading Data (Thomson Financial)

Shares Outstanding (mil.)	26
Float (mil.)	12
Average Daily Volume	313,258

## Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	NA
Book Value Per Share (MRQ)	NA
Enterprise Value (mil.)	253.4
EBITDA (TTM)	-34.9
Enterprise Value/EBITDA (TTM)	-7.3x
Return on Equity (TTM)	-88.9

## Two-Year Price Performance Chart



Source: Thomson Financial, William Blair & Company estimates

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Complete Genomics offers whole-human-genome sequencing services using its proprietary sequencing platform. Incorporated in 2005, CGI began commercial operations in 2010 and raised more than \$50 million in an IPO in late 2010.

William Blair & Company, L.L.C. receives or seeks to receive compensation for investment banking services from Complete Genomics, Inc. Investors should consider this report as a single factor in making an investment decision.

Please consult the last page of this report for all disclosures.

### Investment Conclusions

After the markets closed Wednesday, Complete Genomics reported disappointing second-quarter results. Revenue of \$5.9 million fell well below our estimate of \$7.6 million and consensus estimates of \$7.7 million. In addition, Complete Genomics reported a \$0.56 loss versus our estimated \$0.50 loss and consensus of a \$0.49 loss. In our view, results this quarter highlight the early stage of the whole human genome outsourced sequencing market—and how results can be skewed by the timing of one or two large orders one way or the other as well as the timing of sample receipt from customers by the company.

The number of genomes shipped in the quarter was in line with our expectations at 900; however, revenue of roughly \$6,500 per genome fell below our expectations of around \$8,000 per genome. We note the following:

- As of the end of June, the company had a backlog of 2,200 genomes (representing \$12 million in revenue) versus 2,000 genomes (representing \$15 million) exiting the first quarter. This implies an incremental 1,100 genomes were signed in the second quarter. The company intends to ship 2,400 genomes in the back half (600 in the third quarter and 1,800 in the fourth quarter) for a total of 4,000 for 2011. This falls well below our estimate of 4,950 genomes for 2011 and points to the volatility driven by variability in samples provided to the company from customers. Thus, we are likely to reduce our expectations for shipments for the remainder of the year by roughly 1,000 genomes and our revenue expectation by roughly \$10 million for 2011 and at least that amount for 2012.
- We note, however, this backlog number does not include two new contracts for an additional 2,700 genomes (representing \$14 million in revenue) with the National Cancer Institute/SAIC Frederick and Inova Translational Medicine Institute that were signed in the third quarter. With these orders, the backlog would have been 4,900 genomes. While these orders appear to have been signed later than expected and thus are likely to ship in part in 2012 versus 2011, they point to continued traction of the whole human genome outsourced model.
- In May, Complete Genomics matched Illumina's (ILMN \$58.72; Outperform) price drop for whole human genome sequencing to \$5,000 a genome (\$4,000 for orders of 50 or more). We are surprised by the revenue miss in the quarter, however, since we believed that price adjustments would take some time to flow the P&L and because, according to management, previously signed contracts are based on a static revenue amount and thus a lower price per genome would dictate more genomes.
- Given the recent price drop and re-pricing of prior contracts, it is difficult to infer price per genome from first quarter to second quarter according to backlog information. Looking at the new contracts signed with the National Cancer Institute and Inova Translational Medicine Institute implies an average price per genome of just over \$5,000.
- Moreover, the company adopted an accounting change in the quarter whereby revenue for genomes in 2011 will be recognized in two parts, data delivery and post-delivery analytical support and service, which resulted in deferral of roughly \$0.2 million in revenue in the quarter.
- Expenses also exceeded expectations. Although gross margin was -4%, slightly better than our -7% target, R&D spending was \$8.0 million (versus our \$7.2 million estimate) and SG&A expense was \$6.6 million versus our \$5.9 million target. Operating margin was likely negatively affected by lower ASP relative to our target.
- Still, the company appears on track in terms of planned instrumentation improvements, has expanded capacity to 600 genomes per month, and is on track to further expand capacity to 800 to 1,200 genomes per month—in line with previous commentary. These improvements are important to the company's ability to drive down COGS per genome and so we are encouraged that CGI continues to make progress here.
- Turnaround time is now below 70 days (versus an average of 70 days in the first quarter).

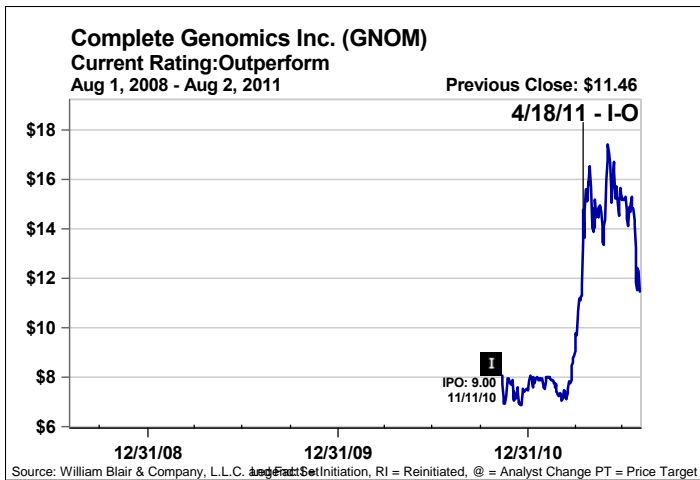
Clearly results were well below expectations; however, taking a step back and looking at the bigger picture, the company continues to gain traction, albeit slower than anticipated. Genomes expected to be shipped in the second half are up 60% relative to the first half; including the large orders signed in the third quarter to date, the backlog is 4,900 genomes, up 145% over the backlog as of the end the first quarter. The company's results point to volatility inherent in the company's early stage—where sample flow to CGI and large orders can swing results to one way or the other. The stock has been weak in recent trading along with many other life sciences stocks—down 34% from its high reached in early June. We continue to believe in the long-term viability of the business model and thus view CGI as a way for small-cap, longer-term, risk tolerant investors to participate in the sequencing space. At this point, despite the miss in the quarter, we are maintaining our Outperform rating.

## Second-Quarter Variance Analysis

August 3, 2011	<b>2Q 2011</b>	<b>2Q 2010</b>	<b>Year/Year</b>	<b>2Q 2011</b>	<b>Year/Year</b>	<b>Difference</b>
	<u>(Actual)</u>	<u>(Actual)</u>	<u>% Change</u>	<u>(Estimate)</u>	<u>% Change</u>	<u>Actual - Est.</u>
Total Revenue	\$5,865	\$1,089	438.6%	\$7,596	597.5%	-\$1,731
Cost of Revenue	\$6,122	4,908	24.7%	8,122	65.5%	-\$2,000
Gross Profit	-257	-3,819	-93.3%	-526	-86.2%	\$269
R&D	8,028	4,928	62.9%	7,216	46.4%	\$812
SG&A	6,606	3,076	114.8%	5,925	92.6%	\$681
Operating income	-14,891	-11,823	25.9%	-13,667	15.6%	-\$1,224
Interest Expense and Other (net)	1,068	808	32.2%	336	-58.4%	\$732
Earnings before tax	-15,959	-12,631	26.3%	-14,003	10.9%	-\$1,956
Income taxes	0	0	NM	0	NM	\$0
<b>Net Income (GAAP)</b>	<b>-\$15,959</b>	<b>-\$12,631</b>	<b>26.3%</b>	<b>-\$14,003</b>	<b>10.9%</b>	<b>-\$1,956</b>
Shares outstanding	28,290	4,271	562.4%	28,210	560.5%	80
<b>EPS (GAAP)</b>	<b>-\$0.56</b>	<b>-\$2.96</b>	<b>-80.9%</b>	<b>-\$0.50</b>	<b>-83.2%</b>	<b>-\$0.07</b>
% of Total Revenue:			<u>Change</u>		<u>Change</u>	
Gross Profit	-4%	-351%	346%	-7%	344%	3%
R&D	137%	453%	-316%	95%	-358%	42%
SG&A	113%	282%	-170%	78%	-204%	35%
Operating income	-254%	-1086%	832%	-180%	906%	-74%
Net income	-272%	-1160%	888%	-184%	976%	-88%
Effective tax rate	0%	0%	0%	0%	0%	0%
Genome Shipped	900	87	934%	956	999%	-56
ASP per Genome	\$6,517	\$12,500	-48%	\$7,950	-36%	-\$1,433

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Additional information is available upon request.



#### Current Rating Distribution (as of 07/31/11)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	59	Outperform (Buy)	8
Market Perform (Hold)	31	Market Perform (Hold)	1
Underperform (Sell)	1	Underperform (Sell)	0

\*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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