

Complete Genomics, Inc.

Reevaluating Estimates After Disappointing Results; GNOM Gaining Traction But Slower Than Expected

- Complete Genomics (CGI) announced disappointing second-quarter results after the markets closed Wednesday. Revenue of \$5.9 million missed our target of \$7.6 million and the consensus of \$7.7 million; in addition, expenses exceeded expectations, fueling a \$0.56 loss, versus our estimate of a \$0.50 loss and consensus of a \$0.49 loss.
- Given the miss in the quarter, dramatically declining ASP, and expectations for the remainder of the year below our target (4,000 genomes for the year versus our 5,900), we reevaluated our estimates much lower; we now expect revenue of \$24 million for 2011 and \$40 million for 2012, down from \$33 million and \$68 million, respectively; a per-share of loss of \$2.11 for 2011 and loss of \$1.87 for 2012, compared to our previous loss of \$1.87 and loss of \$1.13, respectively.
- The company is admittedly difficult to model, given the lack of visibility into ASP and an uncertain demand curve; we believe expectations will be reset post this quarter to more-achievable results; the company signed two large orders in the third quarter for 2,700 genomes and as of the end of July has a backlog of 4,900 genomes (up from 2,000 as of the end of March); thus, the company continues to gain traction. However, the company is early stage and large orders/sample flow can dramatically swing estimates.
- The stock is trading at 3.3 times our revised 2012 revenue estimate of \$40 million on an enterprise-value-to-sales basis. Despite trading down 32% on Thursday, Complete Genomics continues to hold a significant share of total whole human genome sequenced worldwide, a market we believe should become larger over time. Thus, we view Complete Genomics as a way for small-cap, risk-tolerant, longer-term investors to play the fast-growing sequencing space. We maintain our Outperform rating, despite the difficult quarter.

Healthcare | Life Sciences

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Stock Rating: **Outperform**

Company Profile: **Aggressive Growth**

Symbol: GNOM (NASDAQ)

Price: \$7.71 (52-Wk.: \$7-\$19)

Market Value (mil.): \$364

Fiscal Year End: December

Long-Term EPS Growth Rate:

Dividend/Yield: None

	2010A	2011E	2012E
Estimates			
EPS Q1	\$-3.36	A\$-0.48	\$-0.56
Q2	\$-2.96	A\$-0.56	\$-0.48
Q3	\$-4.88	\$-0.54	\$-0.46
Q4	\$-0.69	\$-0.53	\$-0.38
FY	\$-13.60	\$-2.11	\$-1.87
CY		\$-2.11	\$-1.87
Sales (mil.)	9	24	40
Valuation			
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	330,912

Financial Data (Thomson Financial)

Long-Term Debt/Total Capital (MRQ)	NA
Book Value Per Share (MRQ)	NA
Enterprise Value (mil.)	155.9
EBITDA (TTM)	-34.9
Enterprise Value/EBITDA (TTM)	-4.5x
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 close on Wednesday, Complete Genomics (CGI) reported a disappointing quarter, with reported revenue of \$5.9 million compared to our target of \$7.6 million and the consensus estimate of \$7.7 million. In addition, CGI reported a \$0.56 loss versus our estimated \$0.50 loss and consensus of a \$0.49 loss. The lower-than-expected revenue was driven in part by re-pricing of previously signed contracts after the company dropped price in May and perhaps a mismatch between genomes contracted and the ability for customers to deliver sample flow to CGI.

Moreover, guidance for 600 genomes in the third quarter was below our previous 1,380 target, which appears to be driven by a delay in sample shipments from the Institute of Systems Biology (ISB) contract specifically; the ISB has an order in place for 615 genomes. The company expects acceleration in genome shipments to 1,800 genomes in the fourth quarter, as the ISB sample issue is resolved and the company begins to realize genomes from two large orders placed in the third quarter by Inova and the National Cancer Institute (for 2,700 genomes).

Based on the results this quarter and the discussion on the call Thursday morning, we reevaluated our estimates. We now expect the company to ship roughly 4,000 genomes this year (versus our previous estimate of roughly 4,900 genomes), and roughly 10,500 genomes for 2012 (versus our previous estimate of roughly 19,300 genomes). The change implies revised revenue estimates of \$24 million for 2011 and \$40 million for 2012. Our revised assumptions are summarized below.

Estimate Revisions	Calendar 2011 Estimates			Calendar 2012 Estimates		
	New Estimate	Old Estimate	Change New vs. Old	New Estimate	Old Estimate	Change New vs. Old
Revenue	\$24	\$33	-\$9	\$40.1	\$68.5	-\$28
Adjusted EPS	(\$2.11)	(\$1.89)	NM	(\$1.87)	(\$1.13)	NM
Average ASP	\$5,950	\$6,620	-10.1%	\$3,810	\$3,550	7.3%
Genomes Shipped	4,013	4,949	-18.9%	10,530	19,277	-45.4%

Source: William Blair & Company, L.L.C. estimates

Given the recent price drop and re-pricing of prior contracts, it is difficult to infer price per genome from the first to second quarter according to backlog information. However, the two large contracts the company announced last night (National Cancer Institute/SAIC-Frederick and Inova Translational Medicine Institute for a total of \$14 million revenue and 2,700 genomes) suggest the latest ASP priced at around \$5,200. We estimate a continued decline in ASP to \$3,000 by the end of 2012 and moderating to \$2,800 through 2014.

Again, as mentioned in our first-look note, the results point to volatility inherent in the company's early stage of commercial operation, where sample flow and large orders can swing results one way or the other. We acknowledge the recent downward bias to estimates and the difficulty in modeling revenue given declining pricing dynamics and an uncertain demand curve. Yet the company appears to still be gaining traction, albeit slower than expected, with 4,900 genomes in the backlog as of the end of July (up from 2,000 as of the end of March). According to management, CGI had gone through a competitive bidding process for the National Cancer Institute/SAIC Frederick contract (and this is the third contract from this customer), which supports the validity of the CGI model, in our view. CGI has shown increased diversity of its customer base—the company now has over 80 customers compared to more than 50 customers in the first quarter). Moreover, management suggested customer re-order rate is roughly at 50%, which also shows confidence in the model, given the relative youth of the company.

Turning to our model, we now project a steeper ASP decline until the first half 2012, and slower penetration than we had modeled previously. To be specific, we model ASP of \$4,500 exiting 2011, versus our previous estimate of \$5,000, and a decline gradually to \$3,500 by the third quarter of 2012; we model roughly 4,000 genomes shipped in 2011 (which is in line with guidance) and 10,500 genomes for 2012 (versus our previous of around 19,300 genomes). Given the company's cash burn rate (roughly \$21 million in the second quarter and we project around \$83 million in operating expenses in 2011 and close to \$100 million in 2012), we expect an additional capital injection in 2013.

The stock was down 32% in trading Thursday morning, and is trading at 3.3 times our revised 2012 revenue estimate of \$40 million on an enterprise-value-to-sales basis. While the stock has been volatile and we reduced our expectations, we believe the company is experiencing growing pains as would be expected from an early-stage company. Looking at the bigger picture, we believe in the long-term viability of the business model, and view the stock as appropriate for small-cap, long-term, risk-tolerant investors looking to participate in the rapidly growing sequencing space. Thus, we maintain our Outperform rating.

Complete Genomics, Inc.
Projected Income Statement (2008 to 2013E)

	2008	2009	2010	Q1'11	Q2'11	Q3'11E	Q4'11E	2011E	Q1'12E	Q2'12E	Q3'12E	Q4'12E	2012E	2013E
Revenue:														
Total Revenue	-	\$623	\$9,389	\$6,833	\$5,865	\$3,016	\$8,144	\$23,858	\$9,365	\$9,574	\$9,633	\$11,560	\$40,133	\$61,316
Cost of Revenue	-	5,033	19,895	6,582	6,122	4,826	8,687	26,217	8,741	6,702	5,780	4,954	26,177	23,402
Gross Profit	-	(\$4,410)	(\$10,506)	\$251	(\$257)	(\$1,810)	(\$543)	(\$2,359)	\$624	\$2,872	\$3,853	\$6,606	\$13,956	\$37,915
R&D	23,633	22,424	21,691	6,808	8,028	8,144	8,144	31,124	8,897	9,095	9,248	9,479	36,719	40,673
SG&A	4,224	6,751	15,456	5,480	6,606	6,033	7,329	25,448	8,897	8,808	9,152	9,364	36,220	37,685
Total Operating Expenses	27,857	29,175	37,147	12,288	14,634	14,176	15,473	56,572	17,794	17,903	18,400	18,843	72,940	78,358
Operating Income	(27,857)	(33,585)	(47,653)	(12,037)	(14,891)	(15,986)	(16,016)	(58,930)	(17,170)	(15,031)	(14,546)	(12,237)	(58,984)	(40,443)
Interest Expense (Income) and Other, net	537	2,364	10,034	424	1,068	370	378	2,240	386	375	380	386	1,526	1,673
Pretax Income	(\$28,394)	(\$35,949)	(\$57,687)	(\$12,461)	(\$15,959)	(\$16,356)	(\$16,394)	(\$61,170)	(\$17,556)	(\$15,405)	(\$14,927)	(\$12,623)	(\$60,511)	(\$42,116)
Income Tax Expense (Benefit)	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Income (excl. non-recurr items)	(\$28,394)	(\$35,949)	(\$57,687)	(\$12,461)	(\$15,959)	(\$16,356)	(\$16,394)	(\$61,170)	(\$17,556)	(\$15,405)	(\$14,927)	(\$12,623)	(\$60,511)	(\$42,116)
Stock-Based Comp	336	1,410	1,751	494	587	754	977	2,812	1,030	957	867	948	3,802	4,061
Tax Adjustments	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Stock-Based Comp (net of tax)	336	1,410	1,751	494	587	754	977	2,812	1,030	957	867	948	3,802	4,061
Adjusted Net Income (excl. stock-based comp)	(28,058)	(34,539)	(55,936)	(11,967)	(15,373)	(15,602)	(15,417)	(58,359)	(16,525)	(14,448)	(14,060)	(11,675)	(56,708)	(38,055)
Non Recurring Items	-	-	(405)	-	-	-	-	-	-	-	-	-	-	-
Tax Adjustments	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Non Recurring Items (net of tax)	-	-	(405)	-	-	-	-	-	-	-	-	-	-	-
Net Income (GAAP)	(\$28,394)	(\$35,949)	(\$58,092)	(\$12,461)	(\$15,959)	(\$16,356)	(\$16,394)	(\$61,170)	(\$17,556)	(\$15,405)	(\$14,927)	(\$12,623)	(\$60,511)	(\$42,116)
EPS (excl. non-recurr. items)	(\$305.32)	(\$386.56)	(\$13.51)	(\$0.48)	(\$0.56)	(\$0.54)	(\$0.53)	(\$2.11)	(\$0.56)	(\$0.48)	(\$0.46)	(\$0.38)	(\$1.87)	(\$1.24)
Adjusted EPS (excl. stock-based comp)	(\$301.71)	(\$371.40)	(\$13.10)	(\$0.46)	(\$0.54)	(\$0.51)	(\$0.50)	(\$2.02)	(\$0.52)	(\$0.45)	(\$0.43)	(\$0.35)	(\$1.75)	(\$1.12)
EPS (GAAP)	(\$305.32)	(\$386.56)	(\$13.60)	(\$0.48)	(\$0.56)	(\$0.54)	(\$0.53)	(\$2.11)	(\$0.56)	(\$0.48)	(\$0.46)	(\$0.38)	(\$1.87)	(\$1.24)
W. Avg. Shares Outstanding (Diluted)	93	93	4,271	25,960	28,290	30,540	31,040	28,958	31,590	32,140	32,690	33,240	32,415	33,990

MARGIN ANALYSIS:

Total Gross Profit	NM	(707.9%)	(111.9%)	3.7%	(4.4%)	(60.0%)	(6.7%)	(9.9%)	6.7%	30.0%	40.0%	57.1%	34.8%	61.8%
R&D	NM	3599.4%	231.0%	99.6%	136.9%	270.0%	100.0%	130.5%	95.0%	95.0%	96.0%	82.0%	91.5%	66.3%
SG&A	NM	1083.6%	164.6%	80.2%	112.6%	200.0%	90.0%	106.7%	95.0%	92.0%	95.0%	81.0%	90.3%	61.5%
EBIT	NM	NM	(507.5%)	(176.2%)	(253.9%)	(530.0%)	(196.7%)	(247.0%)	(183.3%)	(157.0%)	(151.0%)	(105.9%)	(147.0%)	(66.0%)
Tax Rate	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Stock-Based Comp	NM	226.3%	18.6%	7.2%	10.0%	25.0%	12.0%	11.8%	11.0%	10.0%	9.0%	8.2%	9.5%	6.6%
Net Income (GAAP)	NM	NM	(614.4%)	(182.4%)	(272.1%)	(542.3%)	(201.3%)	(256.4%)	(187.4%)	(160.9%)	(154.9%)	(109.2%)	(150.8%)	(68.7%)

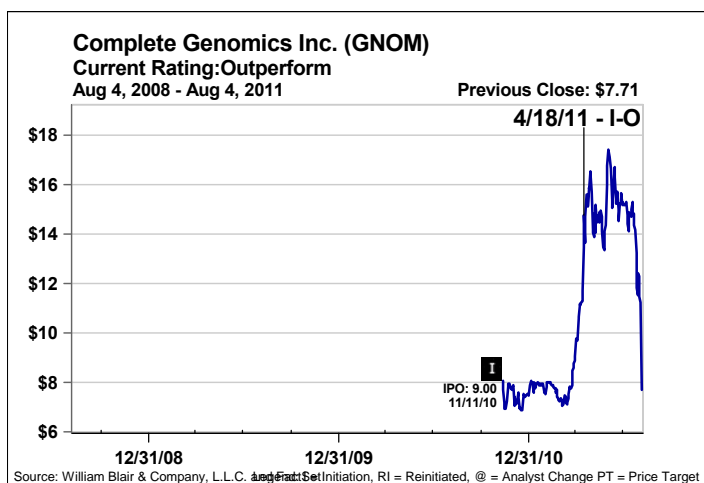
GROWTH METRICS:

Total Revenue Growth	NA	NM	1407%	1934%	439%	(28%)	114%	154%	37%	63%	219%	42%	68%	53%
COGS	NA	NM	295.3%	61%	25%	(20%)	77%	31.8%	33%	9%	20%	(43%)	(0%)	(11%)
Gross Profit	NA	NM	NM	NM	NM	NM	NM	NM	NM	NM	(313%)	(1317%)	NM	172%
R&D	NA	(5%)	(3%)	10%	63%	64%	44%	43%	31%	13%	14%	16%	18%	11%
SG&A	NA	60%	129%	27%	115%	54%	77%	65%	62%	33%	52%	28%	42%	4%
Operating Income	NA	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
Net Income (excl. nonrecurr.)	NA	NA	NM	NM	NM	NM	NM	61%	NM	NM	NM	NM	NM	NM
Stock Based Comp	NA	320%	24%	NM	68%	79%	122%	61%	109%	63%	15%	(3%)	35%	7%
EPS (GAAP)	NA	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
EPS (excl. stock-based comp)	NA	NA	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
Diluted Shares Outstanding	NA	-	4493%	508%	562%	615%	109%	578%	22%	14%	7%	7%	12%	5%

E=William Blair & Company, L.L.C. estimate

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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

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