

## Veracyte, Inc.

### Second-Quarter Results Miss Driven by Mix; Sales Guidance Unchanged; Genzyme Amendment Should Outweigh the Lower FNA Volume

- On Wednesday, August 13, Veracyte reported headline second-quarter results that were below expectations driven by lower volumes (both FNA and GEC below our estimates); the company is seeing higher penetration within institutional accounts/academic centers (which come in as GEC only), which led to a miss on FNA volume relative to internal expectations. More importantly, management announced an amended agreement with Genzyme, which we view as positive for the long-term profitability of Veracyte. Revenue of \$8.7 million was below our estimate of \$9.6 million and Street consensus at \$9.4 million. Net loss per share was \$0.31, versus our and Street consensus of \$0.33.
- Guidance.** Management reiterated 2014 revenue guidance of \$38 million to \$43 million although it expects the mix to change. Management had assumed a 5% GEC-only rate, which is now running closer to 7%. Thus, the company expects a lower contribution from FNA samples (and lowered FNA guidance to 66,000 to 73,000 samples from 76,000 to 83,000 samples), but expects a larger contribution from higher-margin GECs. GEC as a percentage of FNAs is expected to come in at the high-end of the company's 20% to 22% range. Notably, the implied GEC volume from prior guidance and current guidance remains unchanged; the only thing that has changed is expectations from where the GEC samples are coming from (more from GEC-only model). In our opinion, this is actually encouraging, as large institution accounts are usually harder to penetrate.
- Veracyte and Genzyme renegotiated the terms of the co-promotion agreement; to 15% of Afirma revenue in the United States from 32% starting in 2015. International terms will be negotiated on a country-by-country basis. In our opinion, the amended agreement is a net positive for Veracyte, as it allows the company to add specialized reps (specifically the company will add 10 additional reps in the near term), provides a level of cost control to management, and according to our calculations brings forward profitability to the fourth quarter of 2016. Though in the near term, Veracyte will spend more on sales and marketing, the amendment is positive for longer-term growth/sustainability.
- The number of lives under coverage increased to 135 million, up from 125 million in the prior quarter and roughly 100 million a year ago. The company continues to penetrate Blue Cross Blue Shield affiliated plans with the additions of Highmark Inc. and Horizon Blue Cross Blue Shield of New Jersey. Also, Veracyte gained a positive coverage decision from its first managed Medicaid plan, AmeriHealth Caritas. The rapid coverage decisions continue to highlight the clinical utility and overall cost savings to the system from the Afirma GEC.

*Veracyte is a diagnostics company that specializes in the field of molecular cytology transforming patient care and aims to save the healthcare system unnecessary costs from overtreatment of diseases.*

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August 14, 2014

Stock Rating: **Outperform**  
Company Profile: **Aggressive Growth**

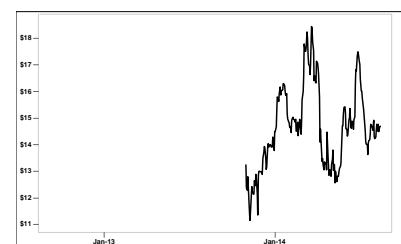
Symbol: VCYT (NASDAQ)  
Price: \$14.65 (52-Wk.: \$11-\$19)  
Market Value (mil.): \$310  
Fiscal Year End: December  
Long-Term EPS Growth Rate:  
Dividend/Yield: None

	2013A	2014E	2015E
<b>Estimates</b>			
EPS FY	\$-1.22	\$-1.35	\$-0.89
CY		\$-1.35	\$-0.89
Sales (mil.)	22	39	71
<b>Valuation</b>			
FY P/E	NM	NM	NM
CY P/E		NM	NM

<b>Trading Data (FactSet)</b>	
Shares Outstanding (mil.)	21
Float (mil.)	10
Average Daily Volume	73,825

<b>Financial Data (FactSet)</b>	
Long-Term Debt/Total Capital (MRQ)	0.1
Book Value Per Share (MRQ)	2.4
Return on Equity (TTM)	-83.4

#### Two-Year Price Performance Chart



Sources: FactSet, William Blair & Company estimates

- **Revenue Detail.** Revenue was \$8.7 million (71% growth) and consisted of roughly \$2.3 million from FNA's revenue and \$6.4 million from GECs. The company received 16,458 FNA samples (33% growth), below our 18,263 estimate (47% growth). The shortfall was a result of more GEC samples (7%) coming from the GEC-only model, compared to management's expectation of 5%. We estimate the number of GEC performed in the quarter to be 3,654 (3,361 net of the 8% no result rate and 50% growth), below our initial estimate of 4,018 (65% growth). Of the \$0.9 million shortfall compared to our forecast, 30% came from lower FNA volume and 60% from GEC volume. Volume was negatively impacted by two large conferences, the International Congress of Endocrinology (ICE/ENDO) and the American Association of Clinical Endocrinologists (AACE), in which most customers attend, and orders were noticeably light on these days.
- **Margin Detail.** Gross margin was 54.3% above our 50.0%, driven by volume mix (higher mix of GEC tests). Research-and-development expense was \$2.2 million, below our \$2.6 million estimate. Sales-and-marketing expense of \$5.1 million was above our \$4.8 million estimate, as the company has increased its salesforce from 8 reps to 14 reps. General-and-administrative expense was \$3.9 million, \$0.5 million below our estimate of \$4.4 million. The company's net loss was \$6.7 million below our \$7.1 million, driven by higher gross margin and lower R&D and G&A spend.
- **Stock Thoughts and Valuation.** The stock is trading at 3.6 times enterprise value to sales on 2015 estimates and has pulled back 23% from its 52-week high. Despite the quarter miss (which was driven more by a mix issue, at a high level, the company continues to drive meaningful commercial adoption of its tests, with GEC volume up 50% in the quarter. The company continues to gain rapid payer coverage and now has more than 135 million lives under coverage, and we expect to hear contract announcements on future earnings call (hopefully in 2014). We believe the Genzyme amended agreement not only brings forward profitability for the company, but also brings additional sales reps in house (more feet on the street) to penetrate complex accounts with a more-specialized/focused rep. We maintain our Outperform rating.
- **Model Update.** For 2014, we now model revenue of \$39.0 million down from our prior estimate of \$40.0 million as a result of a lower-than-expected second quarter. We estimate gross margin to be 54%, up from 51% previously estimated, as the percentage of GECs remains at the high end (22%). We left total operating expenses unchanged \$49.3 million. We forecast net loss per share to be \$1.35 down from \$1.36 previously estimated as a result of our higher gross margin estimate. For 2015, we model revenue of \$71.1 million and net loss per share of \$0.89 versus our prior estimate of \$71.2 million and \$1.15 respectively.

Veracyte, Inc. Second-Quarter Variance Analysis (\$ in thousands, fiscal year ends December)						
	2Q 2014 Actual	2Q 2013 Actual	Year/Year %Change	2Q 2014 Estimate	Year/Year %Change	Actual-Est.
Revenue	\$8,677	\$5,067	71.2%	\$9,599	89.4%	-\$922.2
Cost of Revenue	\$3,966	\$3,231	22.7%	\$4,800	48.5%	-\$833.6
Gross Profit	\$4,711	\$1,836	156.5%	\$4,800	161.4%	-\$88.6
Research & Development	\$2,243	\$1,902	17.9%	\$2,592	36.3%	-\$348.8
Sales & Marketing	\$5,101	\$2,615	95.1%	\$4,789	83.1%	\$312.1
General & Administrative	\$3,928	\$2,737	43.5%	\$4,416	61.4%	-\$487.6
Operating Income/Loss	-\$6,561	-\$5,418	21.1%	-\$6,997	29.1%	\$435.7
Interest	-\$113	-\$5	2107.0%	-\$121	NM	\$7.6
Other income (expense)	\$19	-\$1,068	-101.8%	\$0	-100.0%	\$19.0
Net Income/Loss	-\$6,655	-\$6,491	2.5%	-\$7,117	9.7%	\$462.3
W. Avg. Shares (Diluted)	21,237	862	2364.2%	21,360	2378.4%	-123
<b>EPS</b>	<b>-\$0.31</b>	<b>-\$7.53</b>	<b>-95.8%</b>	<b>-\$0.33</b>	<b>-95.6%</b>	<b>\$0.02</b>
<b>Margin Analysis</b>						<i>BPS</i>
Gross Margin	54.3%	36.2%	18.1%	50.0%	31.9%	429
Research & Development	25.8%	37.5%	-11.7%	27.0%	38.7%	-115
Sales & Marketing	58.8%	51.6%	7.2%	49.9%	42.7%	890
General & Administrative	45.3%	54.0%	-8.7%	46.0%	54.7%	-73
Operating Income/Loss	-75.6%	-106.9%	31.3%	-72.9%	-104.2%	-272
Net Income/Loss	-76.7%	-128.1%	51.4%	-74.1%	NM	-255
<b>Other Indicators</b>						
FNA Samples	16,458	12,424	32.5%	18,263	47.0%	-1,805
GEC Percent of FNA	22%	20%	2.6%	22%	2.4%	0%
GEC Tests	3,654	2,436	50.0%	4,018	64.9%	-364

Source: Company Reports and William Blair &amp; Company L.L.C. estimates

# Veracyte Inc. Projected Income Statement (2011 to 2016E)

	FY 2011	FY 2012	2013 Q1'13	2013 Q2'13	2013 Q3'13	2013 Q4'13	FY 2013	2014 Q1'14	2014 Q2'14	2014 Q3'14E	2014 Q4'14E	FY 2014E	FY 2015E	FY 2016E
Revenue:	\$2,645	\$11,628	\$4,385	\$5,067	\$5,594	\$6,838	\$21,884	\$7,476	\$8,677	\$9,532	\$13,349	\$39,034	\$71,107	\$115,511
Cost of Services:	\$2,925	\$7,584	\$2,773	\$3,231	\$3,132	\$3,471	\$12,607	\$3,607	\$3,966	\$4,385	\$6,140	\$18,098	\$27,013	\$38,119
Gross Profit	-\$281	\$4,044	\$1,611	\$1,836	\$2,462	\$3,367	\$9,277	\$3,869	\$4,711	\$5,147	\$7,208	\$20,936	\$44,094	\$77,393
Operating expenses:														
Research and development	\$6,680	\$6,608	\$2,010	\$1,902	\$2,028	\$1,870	\$7,810	\$2,126	\$2,243	\$2,478	\$2,803	\$9,651	\$14,933	\$18,895
Total Selling & Marketing	\$2,934	\$8,447	\$2,703	\$2,615	\$3,291	\$3,931	\$12,540	\$4,336	\$5,101	\$6,086	\$8,020	\$23,542	\$29,523	\$42,136
General & Administrative	\$5,371	\$7,918	\$2,791	\$2,737	\$3,244	\$3,328	\$12,100	\$3,982	\$3,928	\$4,099	\$4,138	\$16,147	\$18,704	\$21,120
Total Operating Expenses	\$14,985	\$22,973	\$7,504	\$7,254	\$8,563	\$9,129	\$32,450	\$10,444	\$11,272	\$12,663	\$14,961	\$49,340	\$63,160	\$82,151
Operating Income	-\$15,265	-\$18,929	-\$5,893	-\$5,418	-\$6,101	-\$5,762	-\$23,173	-\$6,575	-\$6,561	-\$7,515	-\$7,753	-\$28,404	-\$19,066	-\$4,759
Interest Income (Expense)	\$2	\$2	\$1	-\$5	-\$126	-\$97	-\$228	-\$111	-\$113	-\$114	-\$115	-\$453	-\$388	-\$196
Other Expense	\$819	\$278	-\$1,003	-\$1,068	-\$76	-\$33	-\$2,180	\$12	\$19	\$0	\$0	\$31	\$0	\$0
Pretax Income	-\$14,445	-\$18,649	-\$6,895	-\$6,491	-\$6,303	-\$5,892	-\$25,580	-\$6,674	-\$6,655	-\$7,630	-\$7,868	-\$28,827	-\$19,454	-\$4,954
Taxes														
Net Income/Loss	-\$14,445	-\$18,649	-\$6,895	-\$6,491	-\$6,303	-\$5,892	-\$25,580	-\$6,674	-\$6,655	-\$7,630	-\$7,868	-\$28,827	-\$19,454	-\$5,160
EPS basic	-\$6.23	-\$7.17	-\$0.33	-\$0.31	-\$0.30	-\$0.28	-\$1.23	-\$0.32	-\$0.31	-\$0.36	-\$0.37	-\$1.35	-\$0.89	-\$0.23
EPS fully diluted	-\$0.72	-\$0.89	-\$0.33	-\$0.31	-\$0.30	-\$0.28	-\$1.22	-\$0.32	-\$0.31	-\$0.36	-\$0.37	-\$1.35	-\$0.89	-\$0.23
W.Avg Shares Outstanding basic	2,320	2,601	20,690	20,690	20,690	20,897	20,742	21,148	21,237	21,343	21,450	21,295	21,992	22,885
W.Avg Shares Outstanding diluted	19,992	20,841	20,843	20,943	21,043	21,143	20,993	21,148	21,237	21,343	21,450	21,295	21,992	22,885
<b>Margin Analysis:</b>														
Gross Margin	-11%	35%	37%	36%	44%	49%	42%	52%	54%	54%	54%	54%	62%	67%
Total Operating Expenses	-567%	-198%	-171%	-143%	-153%	-134%	-150%	-140%	-130%	-133%	-112%	-129%	-89%	-72%
Research and development	253%	57%	46%	38%	36%	27%	37%	28%	26%	26%	21%	25%	21%	17%
Selling & Marketing	111%	73%	62%	52%	59%	57%	57%	58%	59%	64%	60%	60%	42%	37%
General & Administrative	203%	68%	64%	54%	58%	49%	56%	53%	45%	43%	31%	43%	27%	19%
EBIT	-577%	-163%	-134%	-107%	-109%	-84%	-109%	-88%	-76%	-79%	-58%	-75%	-28%	-5%
Tax Rate	NM													
Net Income/Loss	-546%	-160%	-157%	-128%	-113%	-86%	-121%	-89%	-77%	-80%	-59%	-76%	-28%	-5%
<b>Growth Metrics:</b>														
Total Revenue Growth	NM	340%	199%	104%	74%	53%	88%	71%	71%	70%	95%	78%	82%	62%
Gross Profit	NM	-1541%	653%	150%	99%	81%	129%	140%	157%	109%	114%	126%	111%	76%
Total Operating Expenses	NM	53%	68%	35%	39%	31%	41%	39%	55%	48%	64%	52%	28%	30%
Research and development	NM	NM	36%	13%	17%	9%	18%	6%	18%	22%	50%	24%	55%	27%
Selling & Marketing	NM	NM	122%	43%	40%	29%	48%	60%	95%	85%	104%	88%	25%	43%
General & Administrative	NM	NM	58%	48%	54%	52%	53%	43%	44%	26%	24%	33%	16%	13%
EBIT	NM	-24%	-39%	-17%	-24%	-13%	-22%	-12%	-21%	-23%	-35%	-23%	33%	75%
Net Income/Loss	NM	-29%	-62%	-40%	-28%	-22%	-37%	3%	-3%	-21%	-34%	-13%	33%	73%
EPS	NM	86%	81%	83%	84%	85%	-36%	5%	0%	-17%	-30%	-11%	35%	74%
Shares Outstanding	NM	4%	0%	0%	0%	0%	697%	0%	0%	1%	1%	3%	3%	4%

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William Blair intends to seek investment banking compensation in the next three months from Veracyte, Inc.

Within the past 12 months William Blair has provided or is providing investment banking services to or has an investment services relationship with Veracyte, Inc.

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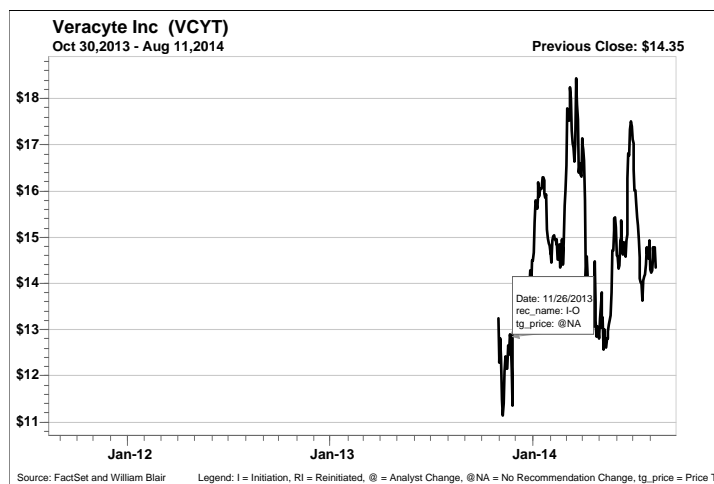
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DOW JONES: 16,651.80

S&P 500: 1,946.72

NASDAQ: 4,434.13



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Coverage Universe	Percent	Inv. Banking Relationships*	Percent
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Market Perform (Hold)	31	Market Perform (Hold)	3
Underperform (Sell)	1	Underperform (Sell)	0

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