

Equity Research

October 10, 2014

Price: \$8.66 (10/9/2014)

Price Target: \$12.00

OUTPERFORM (1)

Doug Schenkel

617.946.3918

doug.schenkel@cowen.com

Shaun Rodriguez, Ph.D.

617.946.3929

shaun.rodriguez@cowen.com

Chris Lin

617.946.3825

chris.lin@cowen.com

Key Data

Symbol [NASDAQ: VCYT](#)

Market Cap (MM) [\\$186.1](#)

Company Quick Take

Investor Day Provides Refresher On VCYT's Solid Science & Market Opps

The Cowen Insight

We attended Veracyte's Investor Day yesterday in NYC; we believe it is clear that progress is being made with driving Afirma GEC penetration and obtaining reimbursement (two private payor contracts were announced yesterday) and developing and commercializing new tests (Allegro's lung cancer diagnostic test and internally developed lung disease test). We remain positive on the outlook for Veracyte.

Two Commercial Payor Contracts For Afirma GEC Announced

Veracyte has recently obtained two commercial payor contracts from UnitedHealthcare (coverage obtained March 2013; ~27MM covered lives) and Cigna (coverage obtained December 2013; ~13MM covered lives) for its Afirma GEC test, both of which will become effective by the end of 2014. We believe these contracts should greatly help reduce the reimbursement barrier to adoption of Afirma GEC. Within a few quarters, Veracyte should be able to start accruing revenue from United and Cigna subsequent to establishing a history of expected collections from patient deductibles and co-pays. These developments and additional contracts will go a long way to addressing one source of investor concern - the timing of better and broader reimbursement contracts with a broader group of major payors.

Commercialization of Allegro Diagnostics' Lung Cancer Test On Track

Much like it has successfully done with the Afirma GEC test, management positioned its lung cancer detection test (obtained via the acquisition of Allegro Diagnostics) as addressing a significant unmet clinical need. A physician from a leading academic medical center discussed the clinical challenges of diagnosing early stage lung cancer (screening) with current methods and was enthused about the potential of Veracyte's lung cancer test improving diagnostic yield (currently, up to 40% of bronchoscopies are non-diagnostic) and preventing unnecessary invasive lung biopsies. Currently, there are two clinical studies for Allegro's test: AEGIS I and II; along with Veracyte's management team, the doctor was clear that the AEGIS I study demonstrates Allegro's test improves lung cancer diagnostics while reducing invasiveness. While no incremental results from the AEGIS 2 study were provided, management asserted that the results are just as convincing as the AEGIS I study and the company will soon submit the AEGIS clinical validation studies for publication. Allegro's test remains on track for a US launch in H2:2015.

Progress With Interstitial Lung Diseases Test (Idiopathic Pulmonary Fibrosis)

A doctor from a leading academic medical center outlined the difficulties of diagnosing interstitial lung diseases (ILD) and focused on idiopathic pulmonary fibrosis (IPF); he was clear that the correct diagnosis of IPF even among experts remains poor, and there is a clear need for a better diagnostic test, particularly as a few new drugs are expected to launch that will improve the survival rate for IPF. He was enthused about the potential of Veracyte's idiopathic pulmonary fibrosis (IPF) test to change the paradigm and the accuracy of IPF diagnosis. Veracyte's IPF test remains

earlier in the product development cycle than its lung cancer test; clinical validation studies and further assay and algorithm development are currently underway. IPF remains on track for a 2016 launch.

Thoughts On Valuation And Outlook From Here

Veracyte is making progress addressing some key investor concerns including: (1) increasing its target market opportunity size (with the two lung tests, Veracyte estimates it is addressing a nearly ~\$2B market opportunity, about double that it addresses with just thyroid); (2) obtaining contracted reimbursement rates for Afirma GEC (announced two private payor contracts yesterday); and (3) driving adoption of Afirma GEC (intends to hire 10 additional Sales & Marketing personnel in H2:2014). While we do not believe anything presented at the Investor Day will catalyze the stock upwards in the near term, we believe details provided at the event represent multiple affirmations of the investment thesis which is pillared very much on strong management and robust science; accordingly, we believe relative downside from current stock levels should be limited. Veracyte currently trades at a material discount (~40-50%) to small cap Tools and Diagnostics peers on a 2015-2016 EV/sales basis – at these levels, we think it would be hard to argue the current valuation is expensive. We remain positive on the outlook for Veracyte and believe the bias should be to the upside. Please see our recent note ([link](#)) for a more in depth analysis on Veracyte.

Valuation Methodology And Risks

Valuation Methodology

Life Science & Diagnostic Tools:

Price targets are based on several methodologies which may include: analysis of market risk, growth rate, revenue stream, discounted cash flows (DCF), EBITDA, EPS, cash flow (CF), free cash flow (FCF), EV/EBITDA, P/E, PE/growth, P/CF, P/FCF, premium (discount) / average group EV/EBITDA, premium (discount) / average group P/E, sum of the parts, net asset value, dividend returns, and return on equity (ROE) over the next 12 months.

Investment Risks

Life Science & Diagnostic Tools:

Risks to the Medical and Life Science Tools sector may include: reduction or delay in research and development budgets and government funding, reduced or delayed purchasing from health care / hospital customers, increased or extended regulatory hurdles or processes for regulated products, increased dependence on volatile emerging markets for revenues and profitability, and general macroeconomic challenges.

We make investment recommendations on early stage and pre-commercial LS&DT companies based upon an assessment of their technology, the probability of market success (competitive, regulatory, reimbursement, etc), and the potential market opportunity in the event of success. However, because these companies lack traditional and/or more mature financial metrics, we do not believe there are good methodologies for assigning a specific target price to such stocks.

Risks To The Price Target

Risks include but are not limited to: difficulty in expanding payer coverage and entering into payer contracts; reimbursement prices lower than expected; delays or weaker than expected clinical data in support of new products; competition from other potential molecular diagnostic players; weaker than expected uptake in international markets; Genzyme partnership could become "relatively" expensive; and delivering on margin / profitability targets.

Addendum

Stocks Mentioned in Important Disclosures

Ticker	Company Name
VCYT	Veracyte

Analyst Certification

Each author of this research report hereby certifies that (i) the views expressed in the research report accurately reflect his or her personal views about any and all of the subject securities or issuers, and (ii) no part of his or her compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed in this report.

Important Disclosures

Cowen and Company, LLC and/or its affiliates make a market in the stock of Veracyte securities.

Veracyte has been client(s) of Cowen and Company, LLC in the past 12 months.

Veracyte is or was in the past 12 months a client of Cowen and Company, LLC; during the past 12 months, Cowen and Company, LLC provided IB services.

Cowen and Company, LLC and/or its affiliates received in the past 12 months compensation for investment banking services from Veracyte.

Cowen and Company, LLC and/or its affiliates managed or co-managed a public offering of Veracyte within the past twelve months.

Cowen and Company, LLC compensates research analysts for activities and services intended to benefit the firm's investor clients. Individual compensation determinations for research analysts, including the author(s) of this report, are based on a variety of factors, including the overall profitability of the firm and the total revenue derived from all sources, including revenues from investment banking. Cowen and Company, LLC does not compensate research analysts based on specific investment banking transactions.

Disclaimer

This research is for our clients only. Our research is disseminated primarily electronically and, in some cases, in printed form. Research distributed electronically is available simultaneously to all Cowen and Company, LLC clients. All published research can be obtained on the Firm's client website, <https://cowenlibrary.bluematrix.com/client/library.jsp>.

Further information on any of the above securities may be obtained from our offices. This report is published solely for information purposes, and is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Other than disclosures relating to Cowen and Company, LLC, the information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete statement or summary of the available data. Any opinions expressed herein are statements of our judgment on this date and are subject to change without notice.

For important disclosures regarding the companies that are the subject of this research report, please contact Compliance Department, Cowen and Company, LLC, 599 Lexington Avenue, 20th Floor, New York, NY 10022. In addition, the same important disclosures, with the exception of the valuation methods and risks, are available on the Firm's disclosure website at <https://cowen.bluematrix.com/sellside/Disclosures.action>.

Price Targets: Cowen and Company, LLC assigns price targets on all covered companies unless noted otherwise. The price target for an issuer's stock represents the value that the analyst reasonably expects the stock to reach over a performance period of twelve months. The price targets in this report should be considered in the context of all prior published Cowen and Company, LLC research reports (including the disclosures in any such report or on the Firm's disclosure website), which may or may not include price targets, as well as developments relating to the issuer, its industry and the financial markets. For price target valuation methodology and risks associated with the achievement of any given price target, please see the analyst's research report publishing such targets.

Notice to UK Investors: This publication is produced by Cowen and Company, LLC which is regulated in the United States by FINRA. It is to be communicated only to persons of a kind described in Articles 19 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005. It must not be further transmitted to any other person without our consent.

Copyright, User Agreement and other general information related to this report

© 2014 Cowen and Company, LLC. Member NYSE, FINRA and SIPC. All rights reserved. This research report is prepared for the exclusive use of Cowen clients and may not be reproduced, displayed, modified, distributed, transmitted or disclosed, in whole or in part, or in any form or manner, to others outside your organization without the express prior written consent of Cowen. Cowen research reports are distributed simultaneously to all clients eligible to receive such research reports. Any unauthorized use or disclosure is prohibited. Receipt and/or review of this research constitutes your agreement not to reproduce, display, modify, distribute, transmit, or disclose to others outside your organization the contents, opinions, conclusion, or information contained in this report (including any investment recommendations, estimates or price targets). All Cowen trademarks displayed in this report are owned by Cowen and may not be used without its prior written consent.

Cowen and Company, LLC. New York (646) 562-1000 **Boston** (617) 946-3700 **San Francisco** (415) 646-7200 **Chicago** (312) 577-2240 **Cleveland** (440) 331-3531 **Atlanta** (866) 544-7009 **London** (affiliate) 44-207-071-7500

COWEN AND COMPANY RATING DEFINITIONS

Cowen and Company Rating System effective May 25, 2013

Outperform (1): The stock is expected to achieve a total positive return of at least 15% over the next 12 months

Market Perform (2): The stock is expected to have a total return that falls between the parameters of an Outperform and Underperform over the next 12 months

Underperform (3): Stock is expected to achieve a total negative return of at least 10% over the next 12 months

Assumption: The expected total return calculation includes anticipated dividend yield

Cowen and Company Rating System until May 25, 2013

Outperform (1): Stock expected to outperform the S&P 500

Neutral (2): Stock expected to perform in line with the S&P 500

Underperform (3): Stock expected to underperform the S&P 500

Assumptions: Time horizon is 12 months; S&P 500 is flat over forecast period

Cowen Securities, formerly known as Dahlgren Rose & Company, Rating System until May 25, 2013

Buy – The fundamentals/valuations of the subject company are improving and the investment return is expected to be 5 to 15 percentage points higher than the general market return

Sell – The fundamentals/valuations of the subject company are deteriorating and the investment return is expected to be 5 to 15 percentage points lower than the general market return

Hold – The fundamentals/valuations of the subject company are neither improving nor deteriorating and the investment return is expected to be in line with the general market return

Cowen And Company Rating Definitions

Distribution of Ratings/Investment Banking Services (IB) as of 09/30/14

Rating	Count	Ratings Distribution	Count	IB Services/Past 12 Months
Buy (a)	440	59.95%	105	23.86%
Hold (b)	278	37.87%	10	3.60%
Sell (c)	16	2.18%	0	0.00%

(a) Corresponds to "Outperform" rated stocks as defined in Cowen and Company, LLC's rating definitions. (b) Corresponds to "Market Perform" as defined in Cowen and Company, LLC's ratings definitions. (c) Corresponds to "Underperform" as defined in Cowen and Company, LLC's ratings definitions.

Note: "Buy", "Hold" and "Sell" are not terms that Cowen and Company, LLC uses in its ratings system and should not be construed as investment options. Rather, these ratings terms are used illustratively to comply with FINRA and NYSE regulations.

Veracyte Rating History as of 10/09/2014

powered by: BlueMatrix



Legend for Price Chart:

I = Initiation | 1 = Outperform | 2 = Market Perform | 3 = Underperform | UR = Price Target Under Review | T = Terminated Coverage | \$xx = Price Target | NA = Not Available | S=Suspended

Points Of Contact

Reaching Cowen

Main U.S. Locations

New York

599 Lexington Avenue
New York, NY 10022
646.562.1000
800.221.5616

Boston

Two International Place
Boston, MA 02110
617.946.3700
800.343.7068

Cleveland

20006 Detroit Road
Suite 100
Rocky River, OH 44116
440.331.3531

San Francisco

555 California Street, 5th Floor
San Francisco, CA 94104
415.646.7200
800.858.9316

Atlanta

3399 Peachtree Road NE
Suite 417
Atlanta, GA 30326
866.544.7009

Chicago

181 West Madison Street
Suite 1925
Chicago, IL 60602
312.577.2240

International Locations

**Cowen International
Limited****London**

1 Snowden Street - 11th Floor
London EC2A 2DQ
United Kingdom
44.20.7071.7500

**Cowen and Company (Asia)
Limited****Hong Kong**

Suite 1401 Henley Building
No. 5 Queens Road Central
Central, Hong Kong
852 3752 2333



@CowenResearch



Cowen and Company