

Reason for report:

EARNINGS

VERACYTE, INC.

Reducing Revenue Estimates on Lower FNAs; GEC Robust

• **Bottom Line:** We are reducing our revenue forecasts for VCYT following the company's 2Q14 report. We maintain our Outperform rating but reduce our price target to \$20 (from \$23).

• **FNA volume lower than expected, but GEC robust.** VCYT reported 2Q14 revenue of \$8.7M, which was below our \$9.1M est. and Street's \$9.4M. The shortfall versus our model was driven by lower thyroid nodule fine needle aspirate (FNA) samples (16.5k vs. our 18.0k estimate). Afirma Gene Expression Classifier (GEC) growth was robust, up ~50% y/y. Both gross margin and opex were favorable compared to our model. VCYT lowered its full year FNA guidance to 66k – 73k from 76k – 83k. Our new revenue forecast reflects lower FNA volume offset somewhat by a higher GEC penetration rate.

• **Wins at IDNs could offset lower doc office volume.** VCYT's earlier-than-anticipated success winning business from integrated delivery networks (IDNs), which order GEC tests à la carte (i.e., without cytology), could enable it to achieve our ~\$39M revenue outlook for 2014 despite a reduced FNA forecast. Thus, we've left our 2014 revenue estimate little changed. Because VCYT has limited sales resources, the opportunity cost of pursuing IDN business was likely absorbed at the expense of pursuing orders for the entire Afirma offering (cytology + GEC reflex) from physician offices, hence the shortfall in FNAs.

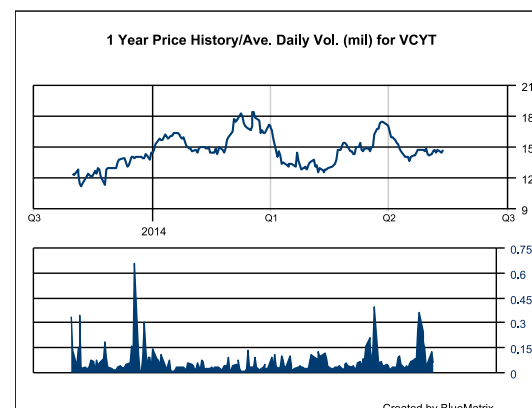
• **Amendment to Genzyme agreement boosts long-term profitability profile.** VCYT amended its co-promotion agreement with Genzyme (SNY [MP]); the new agreement reduces the U.S. royalty rate VCYT pays Genzyme to 15% from 32% beginning January 1, 2015, and requires VCYT to enhance its direct involvement in the sales process (VCYT adding 10 more reps in the U.S. in 2014 as a result). Both companies will continue to market the product in the U.S., and international arrangements will be determined on a country-by-country basis.

• **Revenue estimates reduced to reflect lower FNA forecast.** Despite VCYT's 2Q revenue miss and reduction in FNA volume guidance (-12.5% at the midpoint), we believe it reasonable to assume the company's GEC volume comprises a higher proportion of its total FNA volume (we now forecast 22% vs 21% previously), and thus leave our 2014 revenue forecast little changed. That said, we think it reasonable to moderate our FNA volume growth assumptions in 2015 and 2016, which reduces our revenue forecasts as shown.

Key Stats:

(NASDAQ:VCYT)

S&P 600 Health Care Index:	1,298.82
Price:	\$14.65
Price Target:	\$20.00 from \$23.00
Methodology:	~5.5x EV/TTM June 2016E revenues
52 Week High:	\$19.00
52 Week Low:	\$10.88
Shares Outstanding (mil):	21.2
Market Capitalization (mil):	\$310.6
Book Value/Share:	\$2.12
Cash Per Share:	\$2.73
Dividend (ann):	\$0.00
Dividend Yield:	0.0%



Dec Yr	1Q	2Q	3Q	4Q	FY Rev	1Q	2Q	3Q	4Q	FY EPS	P/E
2013A	\$4.4	\$5.1	\$5.6	\$6.8	\$21.9	(\$8.48)	(\$7.99)	(\$6.59)	(\$0.42)	(\$6.19)	NM
2014E - New	\$7.5A	\$8.7A	\$10.8	\$12.4	\$39.4	(\$0.32)A	(\$0.31)A	(\$0.34)	(\$0.39)	(\$1.36)	NM
2014E - Old	\$7.5A	\$9.1	\$10.2	\$13.0	\$39.7	(\$0.32)A	(\$0.38)	(\$0.38)	(\$0.33)	(\$1.41)	NM
2015E - New	--	--	--	--	\$70.4	--	--	--	--	(\$0.91)	NM
2015E - Old	--	--	--	--	\$75.7	--	--	--	--	(\$0.94)	NM
2016E - New	--	--	--	--	\$104.2	--	--	--	--	(\$0.16)	NM
2016E - Old	--	--	--	--	\$111.6	--	--	--	--	(\$0.12)	NM

Source: Company Information and Leerink Partners LLC Research
Revenues in \$ millions.

INVESTMENT THESIS

We rate San Francisco, California-based Veracyte (VCYT) Outperform with a \$20 price target. VCYT markets a proprietary 142-gene expression test that identifies which thyroid nodules deemed indeterminate by traditional cytology are truly benign, thus enabling physicians and patients to confidently forgo unnecessary thyroid surgery. Additionally, the company has multiple products in development that can improve diagnosis for a range of conditions using a cytology sample. We believe adoption of VCYT's gene expression test for thyroid nodules should increase, and that forthcoming data on its pipeline offer additional catalysts. Thus, we rate VCYT's stock Outperform.

VALUATION

Our \$20 price target reflects an enterprise value (using projected levels of debt and cash) that is ~5.5x our revenue estimate for the 12-months ended June 2016. This multiple is a premium to the median life science tools and diagnostic company multiple of ~4x forward-twelve month revenue. We believe this premium is warranted in light of VCYT's growth prospects.

RISKS TO VALUATION

The primary risks to our price target for VCYT include, but are not limited to: the trajectory of the Afirma Gene Expression Classifier (GEC) revenue ramp, ability to obtain positive coverage decisions and contract terms with third-party payers, competitive pressures from incumbent cytology labs, and ability to change traditional practice patterns among the physician community.

Veracyte (VCYT)

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Income statement												dan.leonard@leerink.com		
Period Ended (\$ thousands)	2011	2012	Mar-13	Jun-13	Sep-13	Dec-13	2013	Mar-14	Jun-14	Sep-14e	Dec-14e	2014e	2015e	2016e
Revenues														
Testing service revenue	\$2,645	\$11,628	\$4,385	\$5,067	\$5,594	\$6,838	\$21,884	\$7,476	\$8,677	\$10,791	\$12,429	\$39,374	\$70,399	\$104,238
Other	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total revenues	2,645	11,628	4,385	5,067	5,594	6,838	21,884	7,476	8,677	10,791	12,429	39,374	70,399	104,238
Cost of service	2,925	7,584	2,773	3,231	3,132	3,471	12,607	3,607	3,966	4,856	5,593	18,022	28,160	39,610
Gross profit	(281)	4,044	1,611	1,836	2,462	3,367	9,277	3,869	4,711	5,935	6,836	21,351	42,239	64,628
SG&A	8,305	16,365	5,494	5,352	6,535	7,259	24,640	8,318	9,029	10,359	12,429	40,136	49,279	52,119
R&D	6,680	6,608	2,010	1,902	2,028	1,870	7,810	2,126	2,243	2,698	2,734	9,801	12,672	15,636
Operating income (loss)	(15,265)	(18,929)	(5,893)	(5,418)	(6,101)	(5,762)	(23,173)	(6,575)	(6,561)	(7,122)	(8,328)	(28,586)	(19,712)	(3,127)
Interest expense (income) and other, net	(820)	(280)	1,002	1,073	202	130	2,407	99	94	130	130	453	536	546
Pretax income	(14,445)	(18,649)	(6,895)	(6,491)	(6,303)	(5,892)	(25,580)	(6,674)	(6,655)	(7,252)	(8,458)	(29,039)	(20,248)	(3,673)
Taxes	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net income	(\$14,445)	(\$18,649)	(\$6,895)	(\$6,491)	(\$6,303)	(\$5,892)	(\$25,580)	(\$6,674)	(\$6,655)	(\$7,252)	(\$8,458)	(\$29,039)	(\$20,248)	(\$3,673)
Basic shares outstanding	580	650	813	813	956	13,944	4,131	21,148	21,237	21,437	21,637	21,365	22,137	22,937
Diluted shares outstanding	580	650	813	813	956	13,944	4,131	21,148	21,237	21,437	21,637	21,365	22,137	22,937
EPS diluted	(\$24.90)	(\$28.68)	(\$8.48)	(\$7.99)	(\$6.59)	(\$0.42)	(\$6.19)	(\$0.32)	(\$0.31)	(\$0.34)	(\$0.39)	(\$1.36)	(\$0.91)	(\$0.16)
EPS growth														
Testing service revenue growth		339.7%	198.8%	104.4%	73.5%	53.4%	88.2%	70.5%	71.2%	92.9%	81.8%	79.9%	78.8%	48.1%
FNA volume	6,402	25,890	10,757	12,424	12,417	14,059	49,657	14,373	16,458	17,632	20,386	68,849	96,388	125,305
Gross margin	(10.6%)	34.8%	36.7%	36.2%	44.0%	49.2%	42.4%	51.8%	54.3%	55.0%	55.0%	54.2%	60.0%	62.0%
SG&A % of revenue	314.0%	140.7%	125.3%	105.6%	116.8%	106.2%	112.6%	111.3%	104.1%	96.0%	100.0%	101.9%	70.0%	50.0%
R&D % of revenue	252.6%	56.8%	45.8%	37.5%	36.3%	27.3%	35.7%	28.4%	25.8%	25.0%	22.0%	24.9%	18.0%	15.0%
Operating margin	(577.2%)	(162.8%)	(134.4%)	(106.9%)	(109.1%)	(84.3%)	(105.9%)	(87.9%)	(75.6%)	(66.0%)	(67.0%)	(72.6%)	(28.0%)	(3.0%)
Tax rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
D&A expense	\$611	\$706	\$197	\$231	\$289	\$282	\$999	\$264	\$260	\$324	\$373	\$1,221	\$2,112	\$3,127
EBITDA	(\$14,654)	(\$18,222)	(\$5,696)	(\$5,187)	(\$5,812)	(\$5,480)	(\$22,174)	(\$6,311)	(\$6,301)	(\$6,798)	(\$7,955)	(\$27,365)	(\$17,600)	\$0
Free cash flow														
Operating cash flow	(\$13,524)	(\$7,167)	(\$6,649)	(\$3,974)	(\$5,238)	(\$3,298)	(\$19,159)	(\$6,757)				(\$38,683)	(\$18,470)	\$5,879
CapX	(276)	(1,462)	(577)	(364)	(120)	(271)	(1,332)	(124)				(3,183)	(5,399)	(7,023)
Free cash flow	(\$13,800)	(\$8,629)	(\$7,226)	(\$4,338)	(\$5,358)	(\$3,569)	(\$20,491)	(\$6,881)				(\$41,866)	(\$23,869)	(\$1,144)

Guidance

FNAs

Revenue

66k - 73k

\$38M - \$43M

Notes:

Source: Company reports and Leerink Partners estimates

Veracyte (VCYT)**Balance sheet**

Period Ended (\$ thousands)	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14e	Dec-14e
Assets								
Cash, equivalents, ST investments, restricted cash	\$7,072	\$20,683	\$15,426	\$71,220	\$64,237	\$57,998	\$40,708	\$34,436
Accounts receivable	464	991	714	1,143	1,191	1,430	1,774	2,043
Inventory	737	770	1,392	2,567	2,721	3,300	1,330	1,532
Prepaid expenses and other current assets	<u>854</u>	<u>1,398</u>	<u>2,938</u>	<u>1,477</u>	<u>1,014</u>	<u>1,450</u>	<u>2,374</u>	<u>2,734</u>
Total current assets	9,127	23,841	20,470	76,407	69,163	64,178	46,186	40,746
Property and equipment, net	2,826	3,025	2,826	2,952	3,028	3,312	4,316	4,972
Restricted cash / LT investments	118	118	118	118	118	118	118	118
Other assets	<u>108</u>	<u>175</u>	<u>157</u>	<u>153</u>	<u>145</u>	<u>142</u>	<u>142</u>	<u>142</u>
Total assets	\$12,179	\$27,159	\$23,571	\$79,630	\$72,454	\$67,750	\$50,762	\$45,978
Liabilities and shareholders' equity								
Notes payable - current portion	\$0	\$0	\$0	\$0	\$467	\$940	\$0	\$0
Accounts payable	1,651	1,906	5,604	5,294	7,214	8,539	1,645	3,302
Accruals	3,168	5,387	4,416	7,594	5,267	5,128	1,295	1,492
Other liabilities	<u>4,085</u>	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	<u>2,963</u>	<u>4,164</u>
Total current liabilities	8,903	9,793	12,520	15,388	15,448	17,107	5,903	8,958
Notes payable - long-term portion	0	4,826	4,863	4,899	4,467	4,031	4,971	4,971
Deferred revenues - long-term portion	0	0	0	0	0	0	0	0
Deferred Genzyme co-promotion fee	4,489	3,864	3,239	2,614	1,989	1,364	739	114
Other liabilities	<u>71</u>	<u>439</u>	<u>502</u>	<u>286</u>	<u>260</u>	<u>223</u>	<u>223</u>	<u>223</u>
Total liabilities	\$13,463	\$18,922	\$21,124	\$23,187	\$22,164	\$22,725	\$11,836	\$14,266
Convertible preferred stock	\$63,372	\$79,025	\$79,022	\$0	\$0	\$0	\$0	\$0
Shareholders' equity	(\$64,656)	(\$70,789)	(\$76,575)	\$56,443	\$50,290	\$45,025	\$38,927	\$31,712
Total liabilities and shareholders' equity	\$12,179	\$27,159	\$23,571	\$79,630	\$72,454	\$67,750	\$50,762	\$45,978

Source: Company reports and Leerink Partners estimates

Disclosures Appendix

Analyst Certification

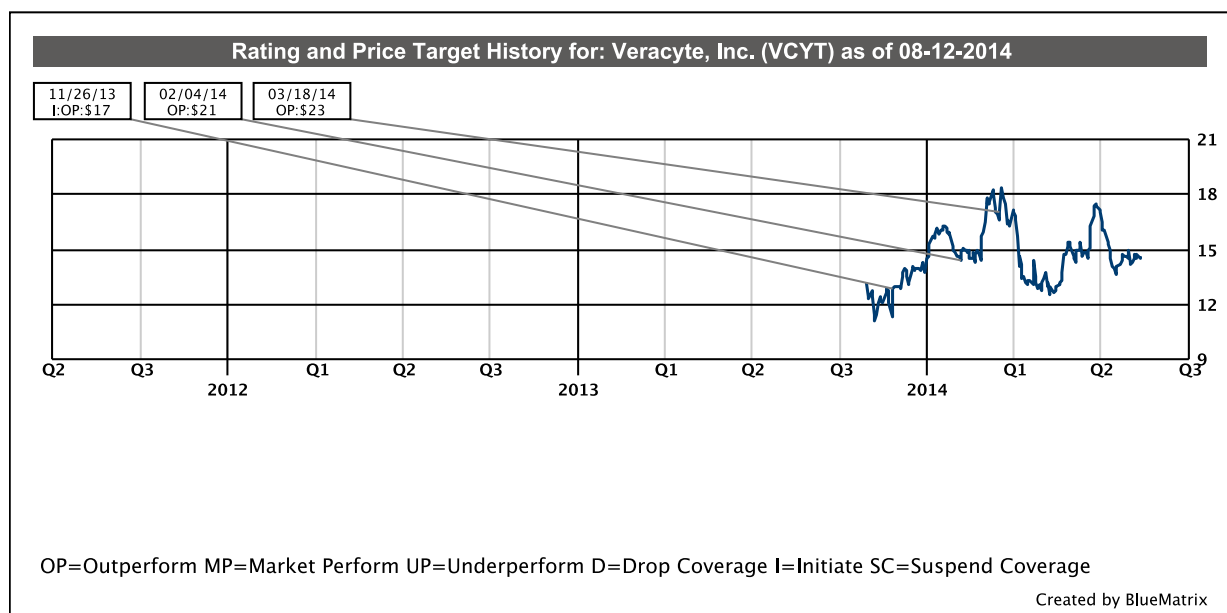
I, Dan Leonard, certify that the views expressed in this report accurately reflect my views and that no part of my compensation was, is, or will be directly related to the specific recommendation or views contained in this report.

Valuation

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Risks to Valuation

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Rating and Price Target History for: Sanofi (SAN FP) as of 08-12-2014



Leerink Swann initiated coverage of SAN FP with an Outperform rating on February 26, 2010. On June 11, 2013, Leerink Swann began a transition to specific price targets for the stocks under its coverage, replacing valuation ranges.

OP=Outperform MP=Market Perform UP=Underperform D=Drop Coverage I=Initiate SC=Suspend Coverage

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Distribution of Ratings/Investment Banking Services (IB) as of 06/30/14				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OP]	138	69.00	50	36.20
HOLD [MP]	62	31.00	2	3.20
SELL [UP]	0	0.00	0	0.00

Explanation of Ratings

Outperform (Buy): We expect this stock to outperform its benchmark over the next 12 months.

Market Perform (Hold/Neutral): We expect this stock to perform in line with its benchmark over the next 12 months.

Underperform (Sell): We expect this stock to underperform its benchmark over the next 12 months. The degree of outperformance or underperformance required to warrant an Outperform or an Underperform rating should be commensurate with the risk profile of the company.

For the purposes of these definitions the relevant benchmark will be the S&P 600® Health Care Index for issuers with a market capitalization of less than \$2 billion and the S&P 500® Health Care Index for issuers with a market capitalization over \$2 billion.

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In the past 12 months, the Firm has received compensation for providing investment banking services to Veracyte, Inc. .

Leerink Partners LLC makes a market in Veracyte, Inc.

Leerink Partners LLC is willing to sell to, or buy from, clients the common stock of Sanofi on a principal basis.

Leerink Partners LLC has acted as the manager for a public offering of Veracyte, Inc. in the past 12 months.

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