

Reason for report:

PROPRIETARY INSIGHTS

VERACYTE, INC.

Plenty of Catalysts on Deck; Reiterate Outperform

• **Bottom Line:** Following recent due diligence, we continue to believe our forecasts for VCYT are attainable and the company has a number of near-term catalysts which could improve stock sentiment, including a product line extension in thyroid and proof-of-concept data in lung, both anticipated before May-end. We continue to rate VCYT Outperform with a \$23 price target, and consider the stock our top small cap idea for investors not bothered by liquidity.

• **2014 forecasts attainable, in our view; several levers to drive 2H volume acceleration.** We're looking for an aggressive ramp in Afirma volume in 2H14 but believe that several drivers support this outlook: (1) expansion of sales infrastructure, including fast progress on plans to add reps; (2) incremental society guidelines; and (3) the launch of the Afirma Malignant Classifier in May.

• **Afirma Malignant Classifier to offer incremental value to base Afirma brand, in addition to modest revenue opportunity.** Beginning in May, VCYT's test will also report if an indeterminate nodule deemed suspicious by the test is specifically suspicious for medullary thyroid cancer, renal cell carcinoma metastasis, and other malignancies, which could enable physicians to better manage surgical strategy. We believe the indication expansion offers VCYT's expanded sales force an opportunity to reintroduce the product to physicians.

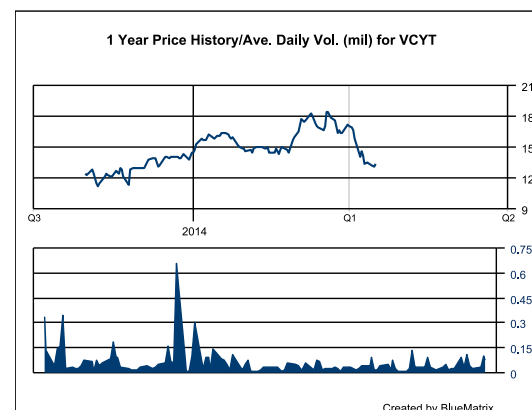
• **More visibility on lung pipeline on deck.** We expect VCYT will offer proof of concept data on its test for idiopathic pulmonary fibrosis (IPF) at the American Thoracic Society (ATS)'s annual meeting in San Diego which begins on May 16th. The IPF market could be as large or larger than thyroid, and motivate more investor interest due to overlap with therapeutic diligence efforts.

• **Blues the high priority on the payer front.** VCYT has yet to receive positive coverage decisions from any of the Blues for its Afirma product, but we are hopeful that we could see some positive coverage decisions in 2014.

Key Stats:

(NASDAQ:VCYT)

S&P 600 Health Care Index:	1,228.69
Price:	\$13.36
Price Target:	\$23.00
Methodology:	~7.0x EV/2015E revenues
52 Week High:	\$19.00
52 Week Low:	\$10.88
Shares Outstanding (mil):	21.2
Market Capitalization (mil):	\$283.2
Book Value/Share:	\$2.66
Cash Per Share:	\$5.11
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	\$7.2	\$9.5	\$9.9	\$12.9	\$39.5	(\$0.35)	(\$0.34)	(\$0.34)	(\$0.27)	(\$1.31)	NM
2015E	--	--	--	--	\$75.2	--	--	--	--	(\$0.93)	NM
2016E	--	--	--	--	\$110.3	--	--	--	--	(\$0.12)	NM

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

2013 quarterly EPS do not sum to annual total due to change in shares outstanding. IPO: 10/30/13.

INVESTMENT THESIS

We rate San Francisco, California-based Veracyte (VCYT) Outperform with a \$23 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.

2014 forecasts attainable, in our view; several levers to drive 2H volume acceleration. We're looking for an aggressive ramp in Afirma volume in 2H14; we expect 4Q specifically to comprise >30% of the volume for the entire year (vs 4Q13, which comprised 28% of full-year volume). Several assumptions underpin this outlook, which we believe reasonable:

- (1) The company has gotten off to an aggressive start in its efforts to double its sales force in the U.S. VCYT had targeted expanding its sales team in the U.S. from 8 reps to 16 reps by the end of 2014, and we believe it had hired well more than half of these reps by the end of 1Q. Thus, it should reap the benefits of these additions during the entirety of 2H14, if not sooner.
- (2) The company has further bulked up its sales and marketing channel by adding more senior managers and also a channel manager who is specifically focused on driving test adoption in integrated delivery networks.
- (3) While timing of inclusion in society guidelines is difficult to predict, we think it reasonable to assume that VCYT's Afirma test could be recognized in guidelines issued by the American Thyroid Association (ATA) as well as American Association of Clinical Endocrinologists (AACE) in 2014. In fact, we noticed that a satellite symposium to discuss ATA guidelines on thyroid nodules and differentiated thyroid cancer (DTC) is on the docket for the ICE/ENDO meeting in Chicago on June 20th, and the preliminary agenda suggests a guideline update.
- (4) VCYT plans to launch its Afirma Malignant Classifier at the AACE annual meeting which begins on May 14th. While the Afirma-M product standalone is not a large market opportunity, the addition of this information to VCYT's Afirma test could catalyze additional interest in the core product.

Afirma Malignant Classifier to offer incremental value to base Afirma brand, in addition to modest revenue opportunity. The VCYT existing Afirma test report classifies thyroid nodules deemed indeterminate by conventional cytology as either benign or suspicious for malignancy based on a gene expression signature. Beginning in May, VCYT's test will also report if an indeterminate nodule deemed suspicious by the test is specifically suspicious for medullary thyroid

cancer, renal cell carcinoma metastasis, and other malignancies, which could enable physicians to better manage surgical strategy. While the company won't charge separately for this information, the added value is incorporated in its recent increase in list price from \$4,275 to \$4,875. Most importantly, we believe the indication expansion offers VCYT's expanded sales force an opportunity to reintroduce the product to physicians. VCYT does plan to charge separately for the information in cases where physicians order the test from samples deemed suspicious or malignant by cytology, or in any case when the physician orders a test for BRAF mutational status.

More visibility on lung pipeline on deck. We expect VCYT will offer proof of concept data on its test for idiopathic pulmonary fibrosis (IPF) at the American Thoracic Society (ATS)'s annual meeting in San Diego which begins on May 16th. While we don't expect the company will launch this test commercially until 2016, we think more visibility on this opportunity will boost investor interest in the stock for a couple of reasons: (1) the market for an IPF test could be as large if not larger than the market in thyroid; (2) IPF is a very active area in therapeutics development (e.g., ITMN [MP]), and we think investors will be more likely to do incremental work on VCYT if they can leverage diligence efforts in therapeutics. The opportunity to leverage diligence in thyroid is limited, as the market is not an active area for therapeutics development and the only public diagnostics company with ambitions to compete here that we're aware of is ROSG (~\$40M cap).

Blues the high priority on the payer front. VCYT has announced positive coverage decisions from meaningful payers every quarter since its test was included in National Comprehensive Cancer Network (NCCN) guidelines in December 2012. The company has yet to receive positive coverage decisions from any of the Blues, which collectively might comprise ~30% of VCYT's case load. We expect the Blues are a high priority for VCYT in 2014 and are hopeful that we could see some positive coverage decisions during the year.

VALUATION

Our \$23 price target reflects an enterprise value (using projected levels of debt and cash) that is ~7x our 2015 revenue estimate. 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)

Dan Leonard, 212-277-6116

dan.leonard@leerink.com

Income statement												dan.leonard@leerink.com		
Period Ended (\$ thousands)	2011	2012	Mar-13	Jun-13	Sep-13	Dec-13	2013	Mar-14e	Jun-14e	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	\$7,249	\$9,536	\$9,873	\$12,879	\$39,538	\$75,183	\$110,328
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	7,249	9,536	9,873	12,879	39,538	75,183	110,328
Cost of service	2,925	7,584	2,773	3,231	3,132	3,471	12,607	4,132	5,245	5,233	6,311	20,920	33,081	44,131
Gross profit	(281)	4,044	1,611	1,836	2,462	3,367	9,277	3,117	4,291	4,640	6,568	18,617	42,103	66,197
SG&A	8,305	16,365	5,494	5,352	6,535	7,259	24,640	8,336	9,059	9,379	9,659	36,435	48,869	50,751
R&D	6,680	6,608	2,010	1,902	2,028	1,870	7,810	2,102	2,479	2,567	2,705	9,853	13,533	17,652
Operating income (loss)	(15,265)	(18,929)	(5,893)	(5,418)	(6,101)	(5,762)	(23,173)	(7,322)	(7,247)	(7,306)	(5,796)	(27,671)	(20,299)	(2,207)
Interest expense (income) and other, net	(820)	(280)	1,002	1,073	202	130	2,407	124	125	126	128	503	522	532
Pretax income	(14,445)	(18,649)	(6,895)	(6,491)	(6,303)	(5,892)	(25,580)	(7,445)	(7,372)	(7,433)	(5,924)	(28,174)	(20,822)	(2,739)
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)	(\$7,445)	(\$7,372)	(\$7,433)	(\$5,924)	(\$28,174)	(\$20,822)	(\$2,739)
Basic shares outstanding	580	650	813	813	956	13,944	4,131	21,235	21,435	21,635	21,835	21,535	22,335	23,135
Diluted shares outstanding	580	650	813	813	956	13,944	4,131	21,235	21,435	21,635	21,835	21,535	22,335	23,135
EPS diluted	(\$24.90)	(\$28.68)	(\$8.48)	(\$7.99)	(\$6.59)	(\$0.42)	(\$6.19)	(\$0.35)	(\$0.34)	(\$0.34)	(\$0.27)	(\$1.31)	(\$0.93)	(\$0.12)
EPS growth														
Testing service revenue growth		339.7%	198.8%	104.4%	73.5%	53.4%	88.2%	65.3%	88.2%	76.5%	88.3%	80.7%	90.2%	46.7%
FNA volume	6,402	25,890	10,757	12,424	12,417	14,059	49,657	15,383	19,009	18,998	24,181	77,571	108,599	141,179
Gross margin	(10.6%)	34.8%	36.7%	36.2%	44.0%	49.2%	42.4%	43.0%	45.0%	47.0%	51.0%	47.1%	56.0%	60.0%
SG&A % of revenue	314.0%	140.7%	125.3%	105.6%	116.8%	106.2%	112.6%	115.0%	95.0%	95.0%	75.0%	92.2%	65.0%	46.0%
R&D % of revenue	252.6%	56.8%	45.8%	37.5%	36.3%	27.3%	35.7%	29.0%	26.0%	26.0%	21.0%	24.9%	18.0%	16.0%
Operating margin	(577.2%)	(162.8%)	(134.4%)	(106.9%)	(109.1%)	(84.3%)	(105.9%)	(101.0%)	(76.0%)	(74.0%)	(45.0%)	(70.0%)	(27.0%)	(2.0%)
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%
												31.2%		
D&A expense	\$611	\$706	\$197	\$231	\$289	\$282	\$999	\$217	\$286	\$296	\$386	\$1,186	\$2,255	\$3,310
EBITDA	(\$14,654)	(\$18,222)	(\$5,696)	(\$5,187)	(\$5,812)	(\$5,480)	(\$22,174)	(\$7,104)	(\$6,961)	(\$7,010)	(\$5,409)	(\$26,485)	(\$18,044)	\$1,103
Free cash flow														
Operating cash flow	(\$13,524)	(\$7,167)	(\$6,649)	(\$3,974)	(\$5,238)	(\$3,298)	(\$19,159)					(\$34,244)	(\$11,327)	\$3,123
CapX	(276)	(1,462)	(577)	(364)	(120)	(271)	(1,332)					(3,386)	(6,337)	(7,543)
Free cash flow	(\$13,800)	(\$8,629)	(\$7,226)	(\$4,338)	(\$5,358)	(\$3,569)	(\$20,491)					(\$37,630)	(\$17,664)	(\$4,419)

Guidance
FNAs
Revenue

76k - 83k
\$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-14e	Jun-14e	Sep-14e	Dec-14e
Assets								
Cash, equivalents, ST investments, restricted cash	\$7,072	\$20,683	\$15,426	\$71,220	\$56,428	\$48,641	\$41,719	\$35,830
Accounts receivable	464	991	714	1,143	1,192	1,568	1,623	2,117
Inventory	737	770	1,392	2,567	1,132	1,437	1,434	1,729
Prepaid expenses and other current assets	<u>854</u>	<u>1,398</u>	<u>2,938</u>	<u>1,477</u>	<u>1,595</u>	<u>2,098</u>	<u>2,172</u>	<u>2,833</u>
Total current assets	9,127	23,841	20,470	76,407	60,346	53,744	46,948	42,510
Property and equipment, net	2,826	3,025	2,826	2,952	2,900	3,814	3,949	5,152
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>153</u>	<u>153</u>	<u>153</u>	<u>153</u>
Total assets	\$12,179	\$27,159	\$23,571	\$79,630	\$63,517	\$57,829	\$51,168	\$47,933
Liabilities and shareholders' equity								
Notes payable - current portion	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Accounts payable	1,651	1,906	5,604	5,294	2,355	2,989	2,982	3,596
Accruals	3,168	5,387	4,416	7,594	870	1,144	1,185	1,546
Other liabilities	<u>4,085</u>	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	<u>3,162</u>	<u>3,478</u>	<u>3,738</u>	<u>4,808</u>
Total current liabilities	8,903	9,793	12,520	15,388	6,387	7,612	7,905	9,950
Notes payable - long-term portion	0	4,826	4,863	4,899	4,899	4,899	4,899	4,899
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>286</u>	<u>286</u>	<u>286</u>	<u>286</u>
Total liabilities	\$13,463	\$18,922	\$21,124	\$23,187	\$13,561	\$14,161	\$13,829	\$15,249
Convertible preferred stock	\$63,372	\$79,025	\$79,022	\$0	\$0	\$0	\$0	\$0
Shareholders' equity	(\$64,656)	(\$70,789)	(\$76,575)	\$56,443	\$49,956	\$43,669	\$37,339	\$32,684
Total liabilities and shareholders' equity	\$12,179	\$27,159	\$23,571	\$79,630	\$63,517	\$57,829	\$51,168	\$47,933

Source: Company reports and Leerink Partners estimates

Disclosures Appendix

Analyst Certification

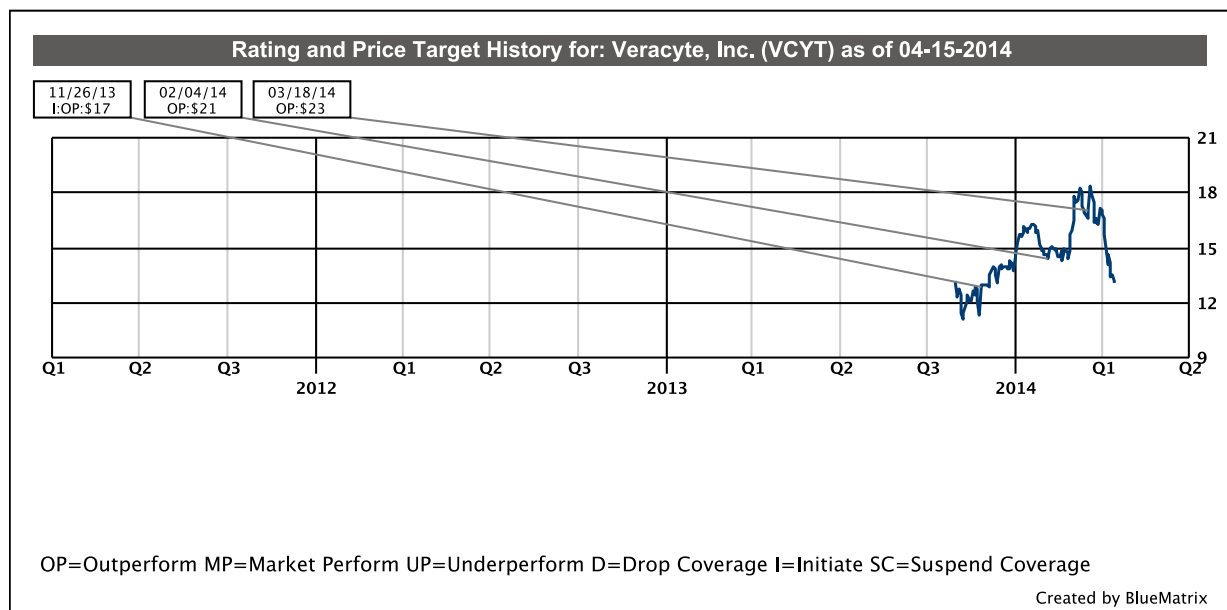
I, Dan Leonard, certify that the views expressed in this report accurately reflect my views and that no part of my compensation was, is, or will be directly related to the specific recommendation or views contained in this report.

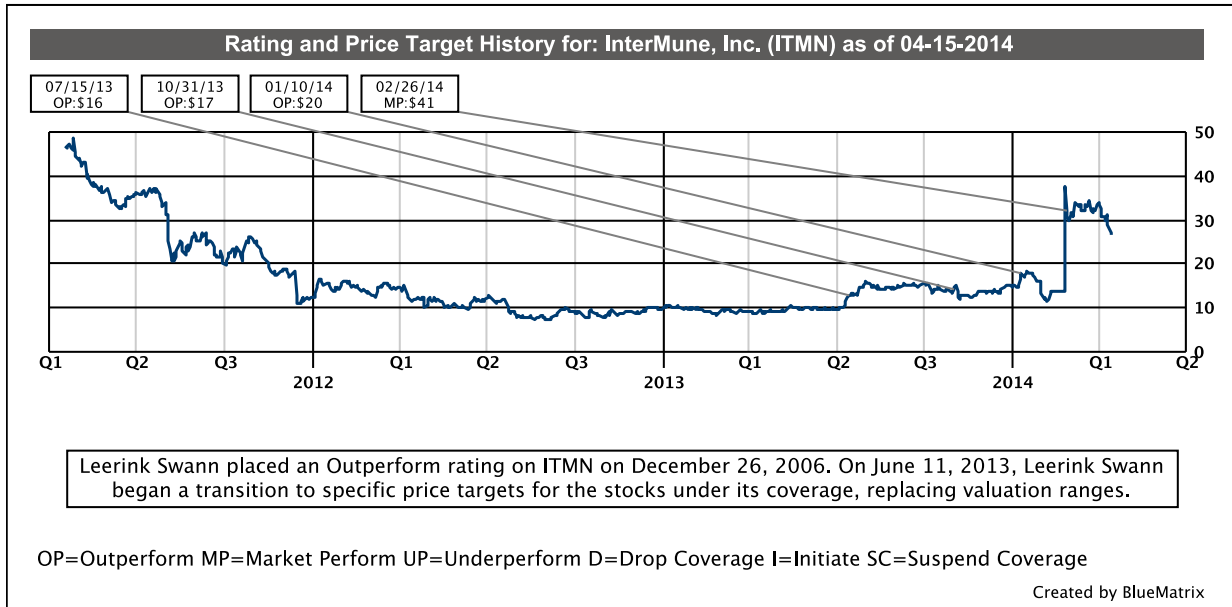
Valuation

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Risks to Valuation

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.





Distribution of Ratings/Investment Banking Services (IB) as of 03/31/14				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OP]	131	68.23	46	35.11
HOLD [MP]	61	31.77	3	4.92
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.

Important Disclosures

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

Leerink Partners LLC makes a market in Veracyte, Inc. and InterMune, Inc.

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

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

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Leerink Partners LLC Equity Research			
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Director of Equity Research	John L. Sullivan, CFA	(617) 918-4875	john.sullivan@leerink.com
Associate Director of Research	Alice C. Avanian, CFA	(617) 918-4544	alice.avanian@leerink.com
Healthcare Strategy	John L. Sullivan, CFA	(617) 918-4875	john.sullivan@leerink.com
	Alice C. Avanian, CFA	(617) 918-4544	alice.avanian@leerink.com
Biotechnology	Howard Liang, Ph.D.	(617) 918-4857	howard.liang@leerink.com
	Joseph P. Schwartz	(617) 918-4575	joseph.schwartz@leerink.com
	Marko Kozul, M.D.	(415) 905-7221	marko.kozul@leerink.com
	Michael Schmidt, Ph.D.	(617) 918-4588	michael.schmidt@leerink.com
	Jonathan Chang, Ph.D.	(617) 918-4015	jonathan.chang@leerink.com
	Irene Lau	(415) 905-7256	irene.lau@leerink.com
	Paul Matteis	(617) 918-4585	paul.matteis@leerink.com
	Gena Wang, Ph.D., CFA	(212) 277-6073	gena.wang@leerink.com
	Richard Goss	(617) 918-4059	richard.goss@leerink.com
Life Science Tools and Diagnostics	Dan Leonard	(212) 277-6116	dan.leonard@leerink.com
	Justin Bowers, CFA	(212) 277-6066	justin.bowers@leerink.com
Pharmaceuticals/Major	Seamus Fernandez	(617) 918-4011	seamus.fernandez@leerink.com
	Ario Arabi	(617) 918-4568	ario.arabi@leerink.com
Specialty Pharmaceuticals, Generics	Jason M. Gerberry, JD	(617) 918-4549	jason.gerberry@leerink.com
	Christopher W. Kuehnle, JD	(617) 918-4851	chris.kuehnle@leerink.com
Medical Devices, Cardiology & Orthopedics	Danielle Antalffy	(212) 277-6044	danielle.antalffy@leerink.com
	Richard Newitter	(212) 277-6088	richard.newitter@leerink.com
	Ravi Misra	(212) 277-6049	ravi.misra@leerink.com
Healthcare Services	Ana Gupte, Ph.D.	(212) 277-6040	ana.gupte@leerink.com
Healthcare Technology & Distribution	David Larsen, CFA	(617) 918-4502	david.larsen@leerink.com
	Christopher Abbott	(617) 918-4010	chris.abbott@leerink.com
Sr. Editor/Supervisory Analyst	Mary Ellen Eagan, CFA	(617) 918-4837	maryellen.eagan@leerink.com
Supervisory Analysts	Robert Egan		bob.egan@leerink.com
	Amy N. Sonne		amy.sonne@leerink.com

New York
299 Park Avenue, 21st floor
New York, NY 10171
(888) 778-1653

Boston
One Federal Street, 37th Floor
Boston, MA 02110
(800) 808-7525

San Francisco
201 Spear Street, 16th Floor
San Francisco, CA 94105
(800) 778-1164