

## Veracyte, Inc. (VCYT)

Overweight

### Veracyte Scopes Out Larger Lung Opportunity, Targets Allegro

#### CONCLUSION

Veracyte announced it intends to acquire lung-cancer diagnostic company, Allegro, in a stock and cash deal totaling \$21M. Veracyte plans to launch their test in 2H15, with meaningful revenue expected in 2017. Preliminary gene expression data on lung bronchoscopy-indeterminate samples (N=298) suggests sensitivity of 86% with 47% specificity (NPV = 93%). With ~100,000 annual indeterminate bronchoscopies management estimates a ~\$350M domestic market opportunity. We believe this deal makes strategic sense for a number of reasons and reiterate our OW rating and \$22 price target.

- **Dolce Musica; Veracyte to Acquire Allegro:** Veracyte announced they will buy privately-held Allegro Diagnostics for approximately \$21M consisting of ~\$7.8M in cash and \$13.2M in VCYT stock. Veracyte will launch their lung cancer classifier test in 2H15 (BronchoGen) with significant revenue expected by 2017 (i.e., with reimbursement). The deal is expected to close in the coming weeks.
- **Lung Cancer Market Size:** Management sizes the market at ~\$350M, similar to the current GEC market. Assuming up to 40% of the annual 250,000 bronchoscopies are indeterminate, this suggests potential pricing of approximately \$3,500/test.
- **The Right Tempo:** Data presented at the American Thoracic Society meeting in May suggests sensitivity for lung cancer in bronchoscopy-negative samples of 86% (CI: 74%-93%) 47% specificity (37%-58%), or roughly a false positive for every two true positives (assuming disease incidence is 50%). Accordingly, the NPV in the Aegis 1 study was 93%. Said another way, it appears Veracyte can rule roughly 25% of at-risk patients into lower-risk watchful waiting (we would note, management believe this can incrementally improve).
- **Tuning The Orchestra:** Veracyte plans to take the Allegro test in house, which will require certain CLIA certification (internal paperwork as well as CLIA approval in various states, notably NY and CA), taking the launch timeline to 2H15. Veracyte will leverage its reimbursement framework (i.e., considerable data push) to capture reimbursement and expects to ramp up the associated sales teams through 2017. Importantly, Veracyte should be able to leverage the same sales team for their IPF test (scheduled launch 2016) and we estimate the pulmonary sales team may eventually reach 35-50 reps. We will update our model upon deal close.

#### RISKS TO ACHIEVEMENT OF PRICE TARGET

Veracyte risks include GEC adoption, private payer coverage and competition.

#### COMPANY DESCRIPTION

Veracyte develops molecular cytology tests; initially focusing on the thyroid FNA market.

PRICE: US\$12.42

TARGET: US\$22.00

4.6x F2016 EV/Rev (net cash/share: \$1.94, s/o: 25.7M)

**William R. Quirk, CFA**

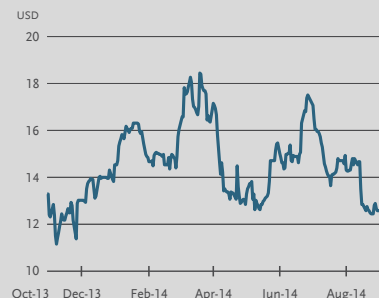
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Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$22.00
FY15E Rev (mil)	—	US\$75.0
FY16E Rev (mil)	—	US\$114.5
FY15E EPS	—	US\$(0.79)
FY16E EPS	—	US\$(0.24)
52-Week High / Low	US\$19.00 / US\$10.88	
Shares Out (mil)	21.2	
Market Cap. (mil)	US\$263.3	
Avg Daily Vol (ooo)	101	
Book Value/Share	US\$2.12	
Net Cash Per Share	US\$2.50	
Debt to Total Capital	10%	
Div (ann)	US\$0.00	
Fiscal Year End	Dec	

#### Price Performance - 1 Year



Source: Bloomberg

YEAR	REVENUE (US\$ m)						EARNINGS PER SHARE (US\$)					
	Mar	Jun	Sep	Dec	FY	FY RM	Mar	Jun	Sep	Dec	FY	FY P/E
2014E	7.5A	8.7A	10.5	13.6	40.2	6.5x	(0.32)A	(0.31)A	(0.35)	(0.37)	(1.35)	NM
2015E	15.7	17.8	19.4	22.0	75.0	3.5x	(0.26)	(0.22)	(0.17)	(0.15)	(0.79)	NM
2016E	—	—	—	—	114.5	2.3x	—	—	—	—	(0.24)	NM

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**Veracyte**  
Income Statement

Fiscal Year End: December 31  
(\$ in Thousands)

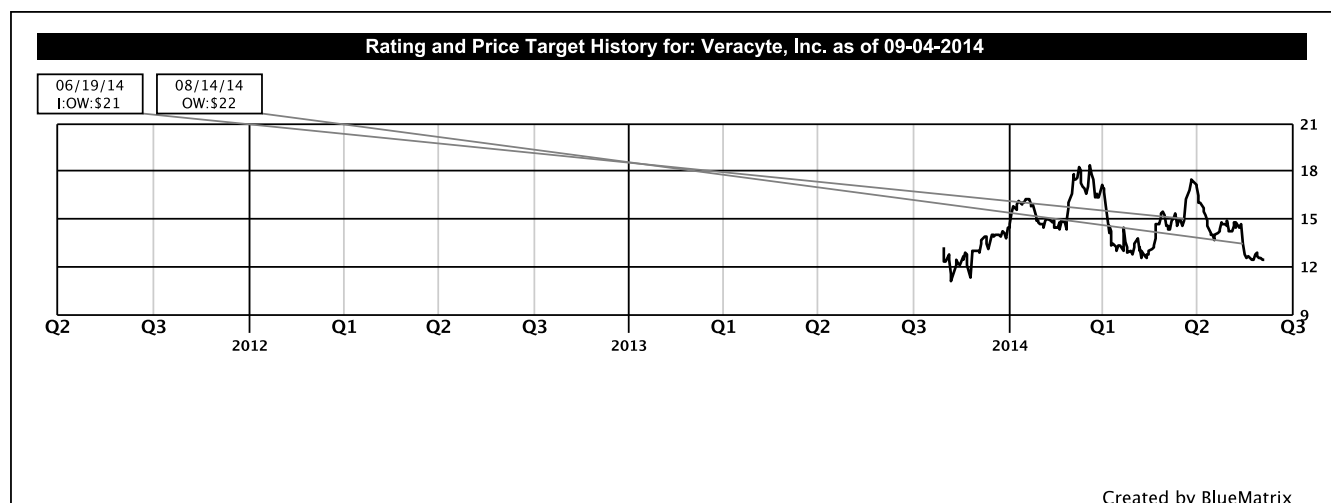
Updated as of 8/13/2014

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	2013A				2014E				2015E				Annual				
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	2012A	2013A	2014E	2015E	2016E
	Qtr 1 A	Qtr 2 A	Qtr 3 A	Qtr 4 A	Qtr 1 A	Qtr 2 A	Qtr 3 E	Qtr 4 E	Qtr 1 E	Qtr 2 E	Qtr 3 E	Qtr 4 E					
Product Revenue	4,384	5,068	5,594	6,838	7,476	8,677	10,458	13,555	15,699	17,825	19,424	22,025	11,628	21,884	40,165	74,973	114,531
<b>Total Revenue</b>	<b>4,384</b>	<b>5,068</b>	<b>5,594</b>	<b>6,838</b>	<b>7,476</b>	<b>8,677</b>	<b>10,458</b>	<b>13,555</b>	<b>15,699</b>	<b>17,825</b>	<b>19,424</b>	<b>22,025</b>	<b>11,628</b>	<b>21,884</b>	<b>40,165</b>	<b>74,973</b>	<b>114,531</b>
Cost of Goods Sold	2,773	3,231	3,132	3,471	3,607	3,966	4,760	6,016	7,259	8,212	9,029	10,311	7,584	12,607	18,349	34,811	50,975
<b>Gross Profit</b>	<b>1,611</b>	<b>1,837</b>	<b>2,462</b>	<b>3,367</b>	<b>3,869</b>	<b>4,711</b>	<b>5,698</b>	<b>7,539</b>	<b>8,441</b>	<b>9,613</b>	<b>10,395</b>	<b>11,714</b>	<b>4,044</b>	<b>9,277</b>	<b>21,816</b>	<b>40,162</b>	<b>63,556</b>
Operating Expenses:																	
Research & Development	2,010	1,902	2,028	1,870	2,126	2,243	2,510	2,711	2,826	3,030	3,108	3,194	6,608	7,810	9,590	12,157	15,590
Sales & Marketing	2,703	2,615	3,291	3,931	4,336	5,101	6,797	8,878	7,065	7,130	7,187	7,929	8,447	12,540	25,113	29,310	34,521
General & Administrative	2,791	2,737	3,244	3,328	3,982	3,928	3,974	4,066	4,239	4,278	4,351	4,361	7,918	12,100	15,950	17,229	19,717
Total Operating Expense	7,504	7,254	8,563	9,129	10,444	11,272	13,281	15,656	14,129	14,438	14,646	15,483	22,973	32,450	50,653	58,696	69,828
<b>Operating Income (Loss)</b>	<b>(5,893)</b>	<b>(5,417)</b>	<b>(6,101)</b>	<b>(5,762)</b>	<b>(6,575)</b>	<b>(6,561)</b>	<b>(7,583)</b>	<b>(8,117)</b>	<b>(5,689)</b>	<b>(4,825)</b>	<b>(4,251)</b>	<b>(3,770)</b>	<b>(18,929)</b>	<b>(23,173)</b>	<b>(28,837)</b>	<b>(18,535)</b>	<b>(6,272)</b>
Interest Income (Expense)	0	(5)	(126)	(97)	(111)	(113)	32	14	(7)	(20)	(33)	49	2	(228)	(178)	(10)	112
Other Income (Expense)	(1,002)	(1,068)	(76)	(33)	12	19	0	0	0	0	0	0	278	(2,179)	31	0	0
<b>Pretax Income (Loss)</b>	<b>(6,895)</b>	<b>(6,490)</b>	<b>(6,303)</b>	<b>(5,892)</b>	<b>(6,674)</b>	<b>(6,655)</b>	<b>(7,551)</b>	<b>(8,103)</b>	<b>(5,696)</b>	<b>(4,845)</b>	<b>(4,284)</b>	<b>(3,720)</b>	<b>(18,649)</b>	<b>(25,580)</b>	<b>(28,984)</b>	<b>(18,545)</b>	<b>(6,160)</b>
Provision for Income Taxes	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>Net Income (Loss) - Reported</b>	<b>(6,895)</b>	<b>(6,490)</b>	<b>(6,303)</b>	<b>(5,892)</b>	<b>(6,674)</b>	<b>(6,655)</b>	<b>(7,551)</b>	<b>(8,103)</b>	<b>(5,696)</b>	<b>(4,845)</b>	<b>(4,284)</b>	<b>(3,720)</b>	<b>(18,649)</b>	<b>(25,580)</b>	<b>(28,984)</b>	<b>(18,545)</b>	<b>(6,160)</b>
Non-Recurring Items	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>Net Income (Loss) - Ongoing</b>	<b>(6,895)</b>	<b>(6,490)</b>	<b>(6,303)</b>	<b>(5,892)</b>	<b>(6,674)</b>	<b>(6,655)</b>	<b>(7,551)</b>	<b>(8,103)</b>	<b>(5,696)</b>	<b>(4,845)</b>	<b>(4,284)</b>	<b>(3,720)</b>	<b>(18,649)</b>	<b>(25,580)</b>	<b>(28,984)</b>	<b>(18,545)</b>	<b>(6,160)</b>
<b>Diluted EPS (Reported)</b>	<b>(\$9.04)</b>	<b>(\$7.53)</b>	<b>(\$6.59)</b>	<b>(\$0.42)</b>	<b>(\$0.32)</b>	<b>(\$0.31)</b>	<b>(\$0.35)</b>	<b>(\$0.37)</b>	<b>(\$0.26)</b>	<b>(\$0.22)</b>	<b>(\$0.17)</b>	<b>(\$0.15)</b>	<b>(\$28.66)</b>	<b>(\$6.19)</b>	<b>(\$1.35)</b>	<b>(\$0.79)</b>	<b>(\$0.24)</b>
<b>Diluted EPS (Ongoing, Inc. SBC)</b>	<b>(\$9.04)</b>	<b>(\$7.53)</b>	<b>(\$6.59)</b>	<b>(\$0.42)</b>	<b>(\$0.32)</b>	<b>(\$0.31)</b>	<b>(\$0.35)</b>	<b>(\$0.37)</b>	<b>(\$0.26)</b>	<b>(\$0.22)</b>	<b>(\$0.17)</b>	<b>(\$0.15)</b>	<b>(\$28.66)</b>	<b>(\$6.19)</b>	<b>(\$1.35)</b>	<b>(\$0.79)</b>	<b>(\$0.24)</b>
Avg. Share Outstanding, Diluted	763	862	956	13,944	21,148	21,237	21,537	21,837	22,137	22,437	24,625	24,925	650	4,131	21,440	23,531	25,675
<b>Expense Variables:</b>																	
Cost of Goods Sold (Product)	63.3%	63.7%	56.0%	50.8%	48.3%	45.7%	45.5%	44.4%	46.2%	46.1%	46.5%	46.8%	65.2%	57.6%	45.7%	46.4%	44.5%
Cost of Goods Sold (Royalties/License)	NM	NM	NM	NM	NM	NM	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	NM	NM	NM	NM	NM
Research & Development	45.8%	37.5%	36.3%	27.3%	28.4%	25.9%	24.0%	20.0%	18.0%	17.0%	16.0%	14.5%	56.8%	35.7%	23.9%	16.2%	13.6%
Sales & Marketing	61.7%	51.6%	58.8%	57.5%	58.0%	58.8%	65.0%	65.5%	45.0%	40.0%	37.0%	36.0%	NM	35.7%	23.9%	16.2%	13.6%
General & Administrative	63.7%	54.0%	58.0%	48.7%	53.3%	45.3%	38.0%	30.0%	27.0%	24.0%	22.4%	19.8%	68.1%	55.3%	39.7%	23.0%	17.2%
Total Operating Expenses	171.2%	143.1%	153.1%	133.5%	139.7%	129.9%	127.0%	115.5%	90.0%	81.0%	75.4%	70.3%	197.6%	148.3%	126.1%	78.3%	61.0%
Effective Interest Rate, Debt	0.0%	0.0%	0.0%	0.0%	2.2%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	0.0%	0.3%	0.4%	0.0%	-0.2%
Ongoing 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%	0.0%	0.0%	0.0%
<b>Margin Analysis:</b>																	
Gross Margin (Product Sales)	36.7%	36.3%	44.0%	49.2%	51.7%	54.3%	54.5%	55.6%	53.8%	53.9%	53.5%	53.2%	34.8%	42.4%	54.3%	53.6%	55.5%
Operating Margin	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
Pretax Margin	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
Net Income Margin	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
<b>YoY Growth Rates:</b>																	
Product Revenue	298.6%	204.5%	173.5%	153.4%	170.5%	171.2%	186.9%	198.2%	210.0%	205.4%	185.7%	162.5%	NM	88.2%	83.5%	86.7%	52.8%
Net Income (Ongoing)	62.3%	40.3%	27.6%	21.8%	-3.2%	2.6%	19.8%	37.5%	-14.7%	-27.2%	-43.3%	-54.1%	NM	37.2%	13.3%	-36.0%	-66.8%
EPS (Ongoing)	32.6%	6.3%	-12.0%	-94.2%	-96.5%	-95.8%	-94.7%	-12.2%	-18.5%	-31.1%	-50.4%	-59.8%	NM	-78.4%	-78.2%	-41.7%	-69.6%
<b>Other Data:</b>																	
Days Sales Outstanding	NM	71.4	46.6	61.0	58.2	60.2	53.7	46.8	45.6	44.5	42.9	42.4	NM	19.1	16.6	13.7	13.7
EBITDA Per Share	(\$7.34)	(\$5.99)	(\$6.01)	(\$0.40)	(\$0.30)	(\$0.30)	(\$0.34)	(\$0.36)	(\$0.24)	(\$0.20)	(\$0.16)	(\$0.14)	(\$27.68)	(\$5.34)	(\$1.29)	(\$0.74)	(\$0.20)
Free Cash Flow Per Share	(\$8.09)	(\$3.85)	(\$5.39)	(\$0.25)	(\$0.32)	(\$0.30)	(\$0.34)	(\$0.39)	(\$0.24)	(\$0.24)	(\$0.17)	(\$0.18)	(\$29.05)	(\$4.92)	(\$1.39)	(\$0.83)	(\$0.33)
Net Debt (Cash) Per Share	(\$9.42)	(\$18.54)	(\$11.17)	(\$4.76)	(\$2.81)	(\$2.50)	(\$2.13)	(\$1.72)	(\$1.46)	(\$1.21)	(\$2.44)	(\$2.24)	(\$21.72)	(\$16.12)	(\$1.76)	(\$2.37)	(\$1.94)
<b>S&amp;M Expenses</b>																	
% of Revenue Shared With Genzyme	40%	40%	40%	40%	37%	32%	32%	32%	15%	15%	15%	15%	50%	40%	33%	15%	15%
Genzyme Promotion Expense	1,754	2,027	2,238	2,735	2,791	2,729	3,346	4,338	2,355	2,674	2,914	3,304	5,814	8,754	13,204	11,246	16,972
Genzyme Fee Amortized	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)
Core S&M Expense	1,574	1,213	1,678	1,821	2,170	2,372	3,451	4,541	4,710	4,456	4,273	4,625	5,133	6,286	12,534	18,064	17,549
Total S&M Expense	2,703	2,615	3,291	3,931	4,336	5,101	6,797	8,878	7,065	7,130	7,187	7,929	8,447	12,540	25,113	29,310	34,521
Core S&M Expense % of Revenue	36%	24%	30%	27%	29%	27%	33%	34%	30%	25%	22%	21%	44%	29%	31%	24%	15%

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R: Resuming Coverage  
T: Transferring Coverage  
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S: Suspending Coverage  
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N: Neutral  
UW: Underweight  
NA: Not Available  
UR: Under Review

Distribution of Ratings/IB Services Piper Jaffray				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
<b>BUY [OW]</b>	359	61.16	99	27.58
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### Analyst Certification — William R. Quirk, CFA, Sr Research Analyst — David C. Clair, CFA, Research Analyst

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- **Underweight (UW):** Anticipated to underperform relative to the median of the group of stocks covered by the analyst.

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