

Reason for report:

COMPANY UPDATE

## VERACYTE, INC.

### Analyst Day Highlights Value Proposition

• **Bottom Line:** We left VCYT's analyst day on 10/9 with a better appreciation of the company's opportunity in pulmonology as well as confirmed the value of its core thyroid testing franchise. We maintain our Outperform rating but have reduced our price target to \$16 from \$20 to reflect a sharp contraction in the multiple for the emerging growth life science tools and diagnostics peer group.

• **Lung cancer test addresses growing unmet need.** We see significant, growing unmet need in the market to diagnose patients with lung cancer less invasively. The US Preventative Services Task Force (USPSTF) recently recommended annual low-dose CT lung cancer screening for high risk individuals between ages 55 and 80. These recommendations should increase the frequency of screening and by corollary the identification of small lung nodules in need of further evaluation. Lung biopsy is invasive and costly. VCYT's 22-gene BronchoGen test (2H 2015 launch) is designed to detect preoperative lung cancer from epithelial cells collected in the airway during a bronchoscopy, thus potentially reducing the number of invasive surgeries. Early clinical validation studies suggest the test performs with an 86% sensitivity and 47% specificity for cancer. We look forward to the publication of these studies in the coming year to better understand the nuances of the data.

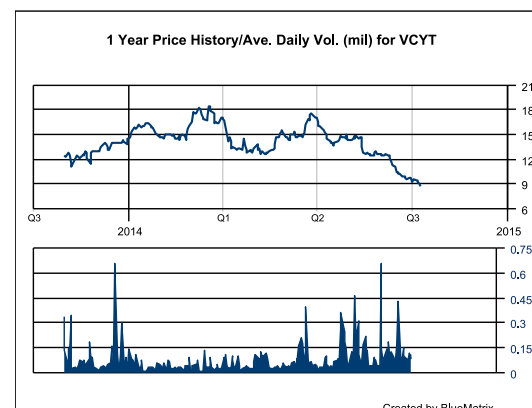
• **Mortality associated with IPF underappreciated; new drugs could enhance value of diagnostic.** The broader category of interstitial lung diseases (ILDs) describes >130 different conditions sharing similar symptoms, physiology, and radiology. However, idiopathic pulmonary fibrosis (IPF) is the worst actor of the bunch, with a five-year survival rate (~24%) worse than most cancers. This situation creates a market need for a better diagnostic test to differentiate IPF from other ILDs. Promising Phase II and III data for pirfenidone and nintedanib suggest pulmonologists may soon have therapeutic options for treating patients with IPF. It remains somewhat unclear whether the new drugs will increase or decrease the need for a better IPF diagnostic, but we tend to think the need will increase, a view supported by one of the key opinion leaders at VCYT's analyst day.

• **Negative predictive value of VCYT's thyroid test is practice changing.** The lead author of VCYT's pivotal clinical validation study (published in the New England Journal of Medicine) for its Afirma thyroid cancer test described how the high negative predictive value (NPV) of this test (~94% - 95%) has changed the management of patients with indeterminate thyroid nodules, reducing the number of invasive thyroid surgeries. While we consider recent literature around this test more mixed, none of the skeptics have challenged the NPV, which is the core value of this test. We're optimistic that VCYT will be able to continue to education the clinical community and drive strong revenue growth.

### Key Stats:

(NASDAQ:VCYT)

<b>S&amp;P 600 Health Care Index:</b>	<b>1,270.00</b>
<b>Price:</b>	<b>\$8.66</b>
Price Target:	\$16.00 from \$20.00
Methodology:	~4x EV/TTM June 2016E revenues
52 Week High:	\$19.00
52 Week Low:	\$8.56
Shares Outstanding (mil):	21.2
Market Capitalization (mil):	\$183.6
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	\$7.5A	\$8.7A	\$10.8	\$12.4	\$39.4	(\$0.32)A	(\$0.31)A	(\$0.34)	(\$0.39)	(\$1.36)	NM
2015E	--	--	--	--	\$70.4	--	--	--	--	(\$0.91)	NM
2016E	--	--	--	--	\$104.2	--	--	--	--	(\$0.16)	NM

Source: Company Information and Leerink Partners LLC Research

Revenues in \$ millions. 2013 quarterly EPS don't total to annual figure due to change in shares outstanding.

## INVESTMENT THESIS

We rate San Francisco, California-based Veracyte (VCYT) Outperform. 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.

## VALUATION

Our \$16 price target reflects an enterprise value (using projected levels of debt and cash) that is ~4x our revenue estimate for the 12-months ended Sept 2016. This multiple is in line with the median emerging growth life science tools and diagnostic company multiple of ~4x forward-twelve month revenue.

## 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-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	\$277	\$324	\$373	\$1,238	\$2,112	\$3,127
EBITDA	(\$14,654)	(\$18,222)	(\$5,696)	(\$5,187)	(\$5,812)	(\$5,480)	(\$22,174)	(\$6,311)	(\$6,284)	(\$6,798)	(\$7,955)	(\$27,348)	(\$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)	(\$5,907)			(\$34,990)	(\$18,470)	\$5,879
CapX	(276)	(1,462)	(577)	(364)	(120)	(271)	(1,332)	(124)	(780)			(3,260)	(5,399)	(7,023)
Free cash flow	(\$13,800)	(\$8,629)	(\$7,226)	(\$4,338)	(\$5,358)	(\$3,569)	(\$20,491)	(\$6,881)	(\$6,687)			(\$38,250)	(\$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
<b>Assets</b>								
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
<b>Liabilities and shareholders' equity</b>								
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

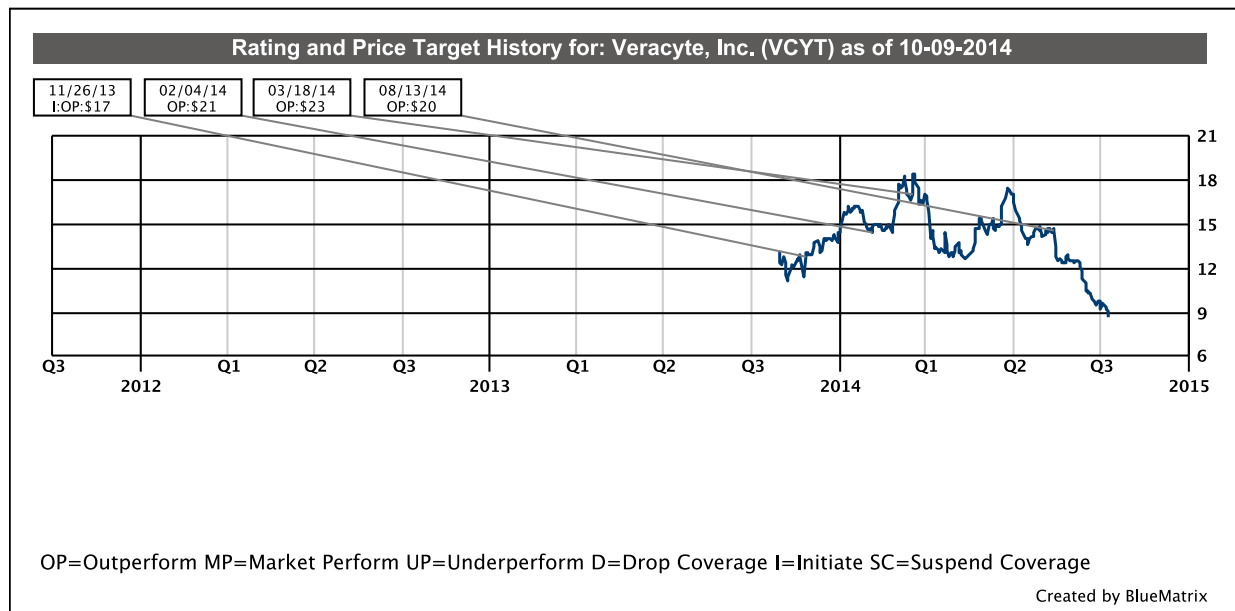
I, Dan Leonard, certify that the views expressed in this report accurately reflect my views and that no part of my compensation was, is, or will be directly related to the specific recommendation or views contained in this report.

### Valuation

Our \$16 price target reflects an enterprise value (using projected levels of debt and cash) that is ~4x our revenue estimate for the 12-months ended Sept 2016. This multiple is in line with the median emerging growth life science tools and diagnostic company multiple of ~4x forward-twelve month revenue.

### 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 09/30/14				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OP]	138	69.30	51	37.00
HOLD [MP]	61	30.70	2	3.30
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

This information (including, but not limited to, prices, quotes and statistics) has been obtained from sources that we believe reliable, but we do not represent that it is accurate or complete and it should not be relied upon as such. All information is subject to change without notice. This is provided for information purposes only and should not be regarded as an offer to sell or as a solicitation of an offer to buy any product to which this information relates. The Firm, its officers, directors, employees, proprietary accounts and affiliates may have a position, long or short, in the securities referred to in this report, and/or other related securities, and from time to time may increase or decrease the position or express a view that is contrary to that contained in this report. The Firm's salespeople, traders and other professionals may provide oral or written market commentary or trading strategies that are contrary to opinions expressed in this report. The Firm's proprietary accounts may make investment decisions that are inconsistent with the opinions expressed in this report. The past performance of securities does not guarantee or predict future performance. Transaction strategies described herein may not be suitable for all investors. Additional information is available upon request by contacting the Editorial Department at One Federal Street, 37th Floor, Boston, MA 02110.

Like all Firm employees, analysts receive compensation that is impacted by, among other factors, overall firm profitability, which includes revenues from, among other business units, Institutional Equities, and Investment Banking. Analysts, however, are not compensated for a specific investment banking services transaction.

MEDACorp is a network of healthcare professionals, attorneys, physicians, key opinion leaders and other specialists accessed by Leerink and it provides information used by its analysts in preparing research.

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

**©2014 Leerink Partners LLC. All rights reserved. This document may not be reproduced or circulated without our written authority.**

## Leerink Partners LLC Equity Research

<b>Director of Equity Research</b>	<b>John L. Sullivan, CFA</b>	(617) 918-4875	john.sullivan@leerink.com
<b>Associate Director of Research</b>	<b>Alice C. Avanian, CFA</b>	(617) 918-4544	alice.avanian@leerink.com
<b>Healthcare Strategy</b>	<b>John L. Sullivan, CFA</b>	(617) 918-4875	john.sullivan@leerink.com
	<b>Alice C. Avanian, CFA</b>	(617) 918-4544	alice.avanian@leerink.com
<b>Biotechnology</b>	<b>Howard Liang, Ph.D.</b>	(617) 918-4857	howard.liang@leerink.com
	<b>Joseph P. Schwartz</b>	(617) 918-4575	joseph.schwartz@leerink.com
	<b>Michael Schmidt, Ph.D.</b>	(617) 918-4588	michael.schmidt@leerink.com
	<b>Gena Wang, Ph.D., CFA</b>	(212) 277-6073	gena.wang@leerink.com
	Jonathan Chang, Ph.D.	(617) 918-4015	jonathan.chang@leerink.com
	Paul Matteis	(617) 918-4585	paul.matteis@leerink.com
	Richard Goss	(617) 918-4059	richard.goss@leerink.com
<b>Life Science Tools and Diagnostics</b>	<b>Dan Leonard</b>	(212) 277-6116	dan.leonard@leerink.com
	Justin Bowers, CFA	(212) 277-6066	justin.bowers@leerink.com
<b>Pharmaceuticals/Major</b>	<b>Seamus Fernandez</b>	(617) 918-4011	seamus.fernandez@leerink.com
	Ario Arabi	(617) 918-4568	ario.arabi@leerink.com
	Aneesh Kapur	(617) 918-4576	aneesh.kapur@leerink.com
<b>Specialty Pharmaceuticals</b>	<b>Jason M. Gerberry, JD</b>	(617) 918-4549	jason.gerberry@leerink.com
<b>Medical Devices, Cardiology &amp; Orthopedics</b>	<b>Danielle Antalffy</b>	(212) 277-6044	danielle.antalffy@leerink.com
	Puneet Souda	(212) 277-6091	puneet.souda@leerink.com
	<b>Richard Newitter</b>	(212) 277-6088	richard.newitter@leerink.com
	Ravi Misra	(212) 277-6049	ravi.misra@leerink.com
<b>Healthcare Services</b>	<b>Ana Gupte, Ph.D.</b>	(212) 277-6040	ana.gupte@leerink.com
<b>Healthcare Technology &amp; Distribution</b>	<b>David Larsen, CFA</b>	(617) 918-4502	david.larsen@leerink.com
	Christopher Abbott	(617) 918-4010	chris.abbott@leerink.com
<b>Sr. Editor/Supervisory Analyst</b>	<b>Mary Ellen Eagan, CFA</b>	(617) 918-4837	maryellen.eagan@leerink.com
<b>Supervisory Analysts</b>	Robert Egan		bob.egan@leerink.com
	Amy N. Sonne		amy.sonne@leerink.com
<b>Editorial</b>	Cristina Diaz-Dickson	(617) 918-4548	cristina.diaz-dickson@leerink.com
<b>Research Assistant</b>	Carmen Augustine	(212) 277-6012	carmen.augustine@leerink.com

**New York**  
299 Park Avenue, 21<sup>st</sup> floor  
New York, NY 10171  
(888) 778-1653

**Boston**  
**One Federal Street, 37<sup>th</sup> Floor**  
**Boston, MA 02110**  
**(800) 808-7525**

**San Francisco**  
201 Spear Street, 16<sup>th</sup> Floor  
San Francisco, CA 94105  
(800) 778-1164