

Veracyte, Inc. (VCYT)

Overweight

2Q14 Revenue Miss, New Genzyme Deal Accretive, Maintaining OW

CONCLUSION

Veracyte reported a 71.2% yoy revenue increase to \$8.7M, below our in-line \$9.4M estimate. VCYT received 16,458 FNAs (+32.5% yoy, 14.5% qoq), below our 17,850 estimate, reflecting faster institutional-based adoption. GEC test rate of >22% was above our 20.8% estimate. LPS of (\$0.31) was favorable to our in-line (\$0.33) estimate. Management changed F2014 guidance, maintaining revenues of \$38M-\$43M, but lowering FNA volume to 66K-73K (was 76K-83K). The important delta here is a higher rate of GEC's which should offset the lower FNAs. We remain Overweight with a \$22 price target (was \$21) based on 4.6x F2015 EV/Rev (unchanged).

- 2Q14 Mixed:** Veracyte reported a 71.2% yoy revenue increase to \$8.7M, below our in-line \$9.4M estimate (Street: \$9.4M). Veracyte received 16,458 FNAs in the quarter, an increase of 32.5% yoy, but below our 17,850 estimate. Product gross margin increased 1800 bpts yoy to 54.3%, above our 50.9% estimate, reflecting a continued higher GEC % of FNAs (>22% vs our 20.8% estimate). Operating expenses increased 45.3% yoy, reflecting incremental leverage. LPS of (\$0.31) was favorable to both our (\$0.33) and consensus' (\$0.33) estimates.
- Genzyme Deal:** Management renegotiated their Genzyme co-promotion agreement effective 1/1/15 with Veracyte leading the new-account sales generation. Genzyme will continue providing account maintenance. As a result, the % of revenue to Genzyme will drop from 32% currently to 15%. The agreement also provides for additional Veracyte flexibility OUS. Veracyte will add ~10 additional sales/marketing people, which combined with the reduced revenue share, suggests ~\$10M accretion in 2015.
- Business Update:** Covered lives increased 10M during 2Q14 to 135M. Conversations continue with BCBS payers, with the recent addition of Highmark BC/BS, Horizon BC/BS and Wellmark BC/BS increasing coverage within this organization to 10M (~10% penetrated). We anticipate preliminary ATA as well as the potential inclusion in AACE guidelines (2H14) to generate additional private payer coverage momentum. We continue to view our modest OUS expectations as a source of potential upside.
- F2014 Guidance:** Management maintained their revenue guidance at \$38M-\$43M, but lowered their FNA estimate to 66K-73K (was 76K-83K). Bridging these disparate numbers is a raised GEC test rate/FNA to ~22% from 20%-22%. In other words, rather than booking ~4,000 GEC's in 2014, the higher rate suggests closer to ~5,000 or ~\$3.5M, offsetting the lower priced FNAs (10K fewer at ~\$200/FNA or \$2M). Longer-term, we think the accelerated institutional adoption should be accretive to revenue.

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.

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	7.7x	(0.32)A	(0.31)A	(0.35)	(0.37)	(1.35)	NM
2015E	15.7	17.8	19.4	22.0	75.0	4.1x	(0.26)	(0.22)	(0.17)	(0.15)	(0.79)	NM
2016E	—	—	—	—	114.5	2.7x	—	—	—	—	(0.24)	NM

PRICE: US\$14.65

TARGET: US\$22.00

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

William R. Quirk, CFA

Sr Research Analyst, Piper Jaffray & Co.
612 303-6858, william.r.quirk@pjc.com

David C. Clair, CFA

Research Analyst, Piper Jaffray & Co.
612 303-6747, david.c.clair@pjc.com

Changes	Previous	Current
Rating	—	Overweight
Price Tgt	US\$21.00	US\$22.00
FY15E Rev (mil)	US\$77.1	US\$75.0
FY16E Rev (mil)	US\$117.4	US\$114.5
FY15E EPS	US\$(0.97)	US\$(0.79)
FY16E EPS	US\$(0.30)	US\$(0.24)

52-Week High / Low	US\$19.00 / US\$10.88
Shares Out (mil)	21.2
Market Cap. (mil)	US\$310.6
Avg Daily Vol (ooo)	82
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

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Veracyte
Income Statement

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

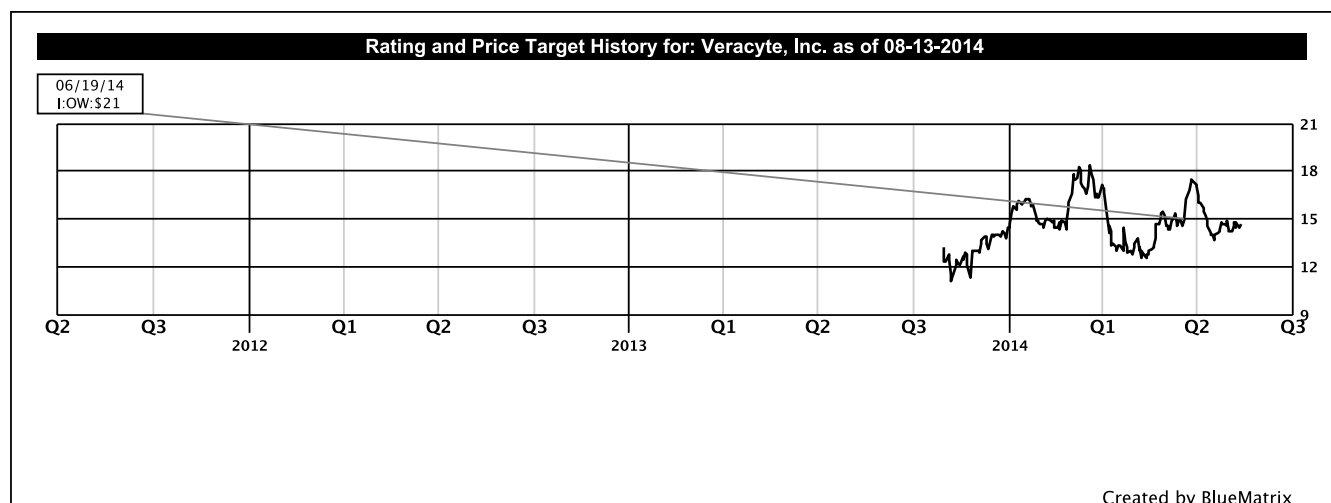
Updated as of 8/13/2014

William Quirk 612-303-6858
Piper Jaffray & Co.

	2013A				2014E				2015E				Annual				
	Mar Qtr 1 A	Jun Qtr 2 A	Sep Qtr 3 A	Dec Qtr 4 A	Mar Qtr 1 A	Jun Qtr 2 A	Sep Qtr 3 E	Dec Qtr 4 E	Mar Qtr 1 E	Jun Qtr 2 E	Sep Qtr 3 E	Dec Qtr 4 E	2012A	2013A	2014E	2015E	2016E
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
Total 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
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
Gross Profit	1,611	1,837	2,462	3,367	3,869	4,711	5,698	7,539	8,441	9,613	10,395	11,714	4,044	9,277	21,816	40,162	63,556
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
Operating Income (Loss)	(5,893)	(5,417)	(6,101)	(5,762)	(6,575)	(6,561)	(7,583)	(8,117)	(5,689)	(4,825)	(4,251)	(3,770)	(18,929)	(23,173)	(28,837)	(18,535)	(6,272)
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
Pretax Income (Loss)	(6,895)	(6,490)	(6,303)	(5,892)	(6,674)	(6,655)	(7,551)	(8,103)	(5,696)	(4,845)	(4,284)	(3,720)	(18,649)	(25,580)	(28,984)	(18,545)	(6,160)
Provision for Income Taxes	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net Income (Loss) - Reported	(6,895)	(6,490)	(6,303)	(5,892)	(6,674)	(6,655)	(7,551)	(8,103)	(5,696)	(4,845)	(4,284)	(3,720)	(18,649)	(25,580)	(28,984)	(18,545)	(6,160)
Non-Recurring Items	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net Income (Loss) - Ongoing	(6,895)	(6,490)	(6,303)	(5,892)	(6,674)	(6,655)	(7,551)	(8,103)	(5,696)	(4,845)	(4,284)	(3,720)	(18,649)	(25,580)	(28,984)	(18,545)	(6,160)
Diluted EPS (Reported)	(\$9.04)	(\$7.53)	(\$6.59)	(\$0.42)	(\$0.32)	(\$0.31)	(\$0.35)	(\$0.37)	(\$0.26)	(\$0.22)	(\$0.17)	(\$0.15)	(\$28.66)	(\$6.19)	(\$1.35)	(\$0.79)	(\$0.24)
Diluted EPS (Ongoing, Inc. SBC)	(\$9.04)	(\$7.53)	(\$6.59)	(\$0.42)	(\$0.32)	(\$0.31)	(\$0.35)	(\$0.37)	(\$0.26)	(\$0.22)	(\$0.17)	(\$0.15)	(\$28.66)	(\$6.19)	(\$1.35)	(\$0.79)	(\$0.24)
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
Expense Variables:																	
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%
Margin Analysis:																	
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
YoY Growth Rates:																	
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%
Other Data:																	
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)
S&M Expenses																	
% 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
D: Discontinuing Coverage
S: Suspending Coverage
OW: Overweight
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
BUY [OW]	362	61.56	94	25.97
HOLD [N]	215	36.56	22	10.23
SELL [UW]	11	1.87	0	0.00

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Analyst Certification — William R. Quirk, CFA, Sr Research Analyst — David C. Clair, CFA, Research Analyst

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