

Reason for report:

EARNINGS

VERACYTE, INC.

Quarter, Forecast Augments Growth Story; Raising PT

• **Bottom Line:** We see several catalysts in 2014 and highlight Outperform-rated VCYT as one of our top small-cap picks. We increase our PT to \$23 (from \$21) due to the 4Q beat and above-Street guide.

• **Strong finish to 2014.** VCYT reported 4Q13 revenue of \$6.8M, 53% growth versus 4Q12. Versus our model, the top-line beat was driven by higher test volume. The company received 14.1k thyroid nodule fine needle aspiration (FNA) samples during 4Q13, +4% greater than our 13.5k forecast and up 51% y/y. The Afirma GEC (Gene Expression Classifier) test rate also came in higher than our 19% est due to higher submissions from academic medical centers. Gross margin was higher while opex was lower than our model. For 2014, VCYT guided FNA volume of 76k – 83k and revenue of \$38M – \$43M, both of which were above Street consensus.

• **Additional positive coverage decision by payer in early 2014.** Including the positive coverage decision from CIGNA (OP) in Dec, and the Feb 2014 coverage decision by Emblem Health (3.4M covered lives), VCYT's Afirma thyroid test has now been deemed medically necessary by plans covering >120M lives. The company also increased the list price for Afirma by 14% effective 1/1/14. This could motivate payers to contract with VCYT sooner. Contracting is not currently reflected in the company's guidance and thus represents a potential upside lever to 2014 revenue.

• **Commercial expansion tracking ahead of plan.** VCYT is making solid progress in achieving its increased commercial footprint for 2014. As of 3/1/14, the company is more than half way toward its plan to double its sales force by 2014 year-end. We also expect the company will enter international markets this year via its partnership with Genzyme (SNY [MP]). VCYT has completed the required registrations and has obtained a CE mark for the Afirma GEC collection kit, and we should begin to see international revenue accruals once the company finalizes reimbursement decisions across various markets in Europe.

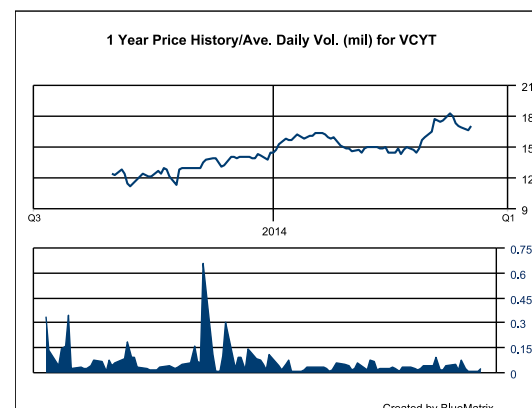
• **Plenty underway in the pipeline.** VCYT remains on track for a 2Q14 launch for the Afirma malignancy test. The new assay will test for medullary thyroid cancer (MTC) and will also provide physicians with the opportunity to elect for BRAF mutation detection. The company recently began to pilot the malignancy test at ~12 clinical sites and will likely launch it in May 2014. VCYT is also in late-stage biomarker discovery for its idiopathic pulmonary fibrosis (IPF) product.

• **Estimates little changed.** We've tweaked our 2014-15 forecasts and introduced 2016 estimates.

Key Stats:

(NASDAQ:VCYT)

S&P 600 Health Care Index:	1,321.83
Price:	\$17.02
Price Target:	\$23.00 from \$21.00
Methodology:	7.0x EV/2015E revenues
52 Week High:	\$18.50
52 Week Low:	\$10.88
Shares Outstanding (mil):	21.2
Market Capitalization (mil):	\$360.8
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 - New	\$7.2	\$9.5	\$9.9	\$12.9	\$39.5	(\$0.35)	(\$0.34)	(\$0.34)	(\$0.27)	(\$1.31)	NM
2014E - Old	--	--	--	--	\$39.6	--	--	--	--	(\$1.28)	NM
2015E - New	--	--	--	--	\$75.2	--	--	--	--	(\$0.93)	NM
2015E - Old	--	--	--	--	\$73.4	--	--	--	--	(\$0.98)	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.

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 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 (VYCT)

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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-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%	174.1%	121.5%	76.1%	51.1%	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%
D&A expense	\$611	\$706	\$197	\$231	\$289	\$256	\$973	\$217	\$286	\$296	\$386	\$1,186	\$2,255	\$3,310
EBITDA	(\$14,654)	(\$18,222)	(\$5,696)	(\$5,187)	(\$5,812)	(\$5,506)	(\$22,200)	(\$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)	(\$5,362)	(\$21,223)					(\$34,244)	(\$11,327)	\$3,123
CapX	(276)	(1,462)	(577)	(364)	(120)	(849)	(1,910)					(3,386)	(6,337)	(7,543)
Free cash flow	(\$13,800)	(\$8,629)	(\$7,226)	(\$4,338)	(\$5,358)	(\$6,211)	(\$23,133)					(\$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

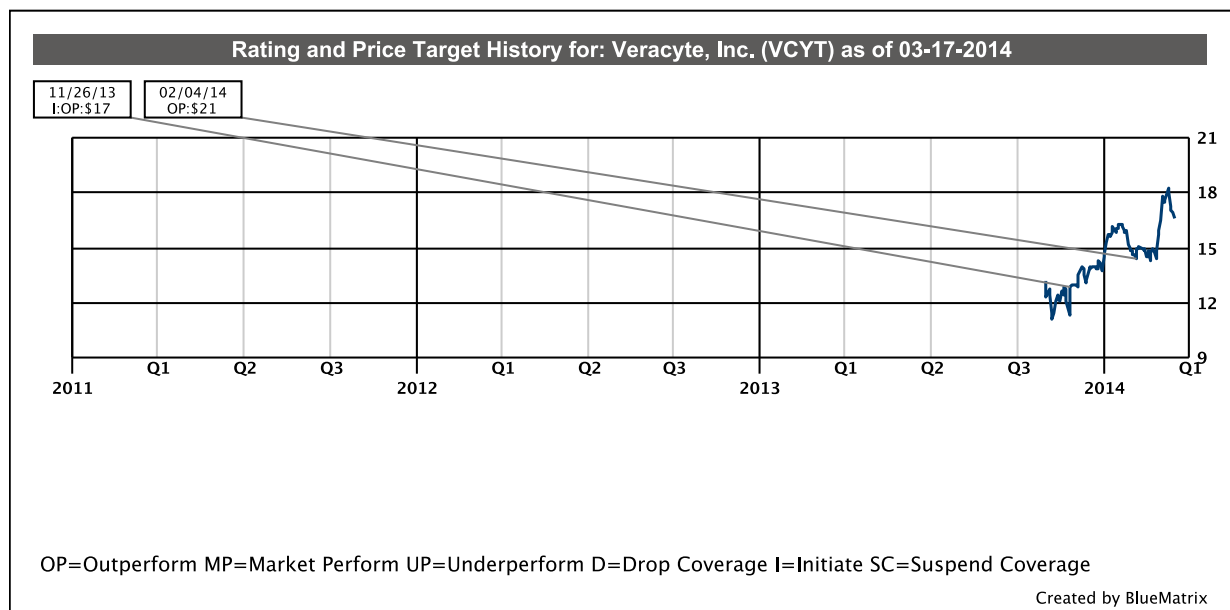
I, Dan Leonard, certify that the views expressed in this report accurately reflect my views and that no part of my compensation was, is, or will be directly related to the specific recommendation or views contained in this report.

Valuation

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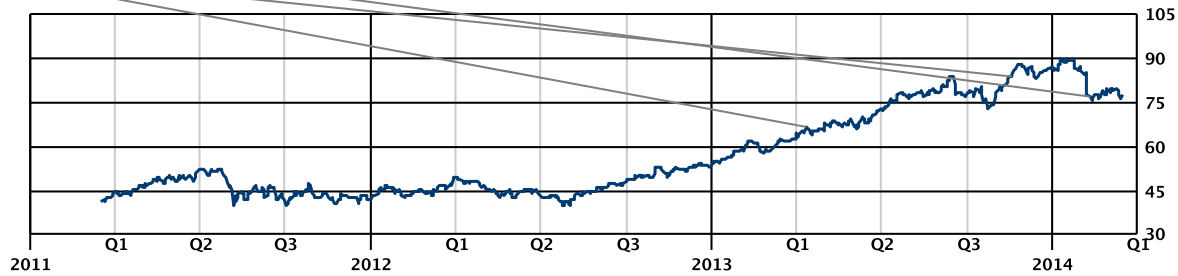


Rating and Price Target History for: CIGNA, Inc. (CI) as of 03-17-2014

04/12/13
SC

11/18/13
OP:\$106

02/10/14
OP:\$96



Leerink Swann placed an Outperform rating on CI on May 8, 2009. 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

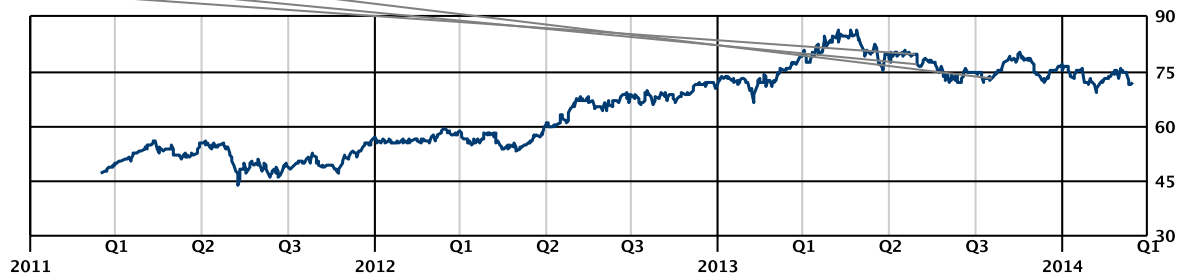
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Rating and Price Target History for: Sanofi (SAN FP) as of 03-17-2014

07/29/13
OP:€89

08/01/13
OP:€83

10/18/13
MP:€80



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 12/31/13				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OP]	118	64.50	30	25.00
HOLD [MP]	65	35.50	2	3.00
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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Leerink Consulting LLC, an affiliate of Leerink Partners, is a provider of evidence-based strategy and consulting to the healthcare industry.

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. and CIGNA, Inc.

Leerink Partners LLC is willing to sell to, or buy from, clients the common stock of CIGNA, Inc. and 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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