

Reason for report:
PROPRIETARY INSIGHTS

VERACYTE, INC.

Catalysts On Tap; Raising Price Target

• **Bottom Line:** We believe VCYT's stock is well positioned in 2014 with a number of catalysts on deck. We have increased our price target to \$21 from \$17 and maintain our Outperform rating, highlighting VCYT as one of our top small-cap picks.

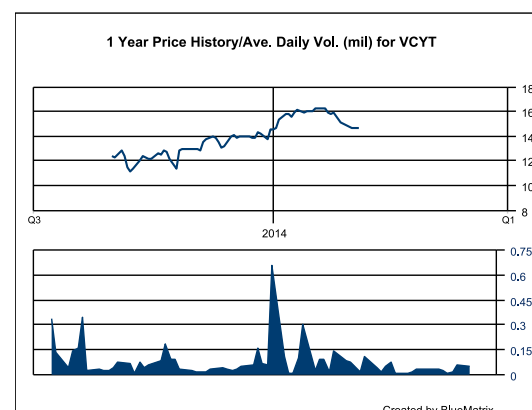
• **Several catalysts on tap for 2014.** We believe VCYT has several sentiment catalysts on deck for 2014 outside of quarterly results. These catalysts include: 1) Additional positive coverage decisions from third-party payers. Following the positive coverage decision by Cigna (OP) in mid-Dec., VCYT's Afirma thyroid test has now been deemed medically necessary by plans covering >115M lives. We believe investors will respond positively to further coverage decisions in 2014, and note that VCYT's stock has outperformed the Russell 2000 index by 5% since the Cigna decision in December (albeit on thin volume). 2) Launch of the Afirma malignant test. This test offers an incremental revenue opportunity for Afirma by itself (~5% of thyroid cytology samples are malignant) and also offers the company an opportunity to reintroduce the entirety of the Afirma brand to physicians. We expect that the company will launch this test at the American Association of Clinical Endocrinologists (AACE) annual meeting, which begins on May 14. 3) Potential inclusion of Afirma thyroid in society guidelines (AACE and American Thyroid Association [ATA]). 4) Presentation of lung data at an industry conference (discussed below). 5) Launch of Afirma thyroid into international markets.

• **Unmet need in lung further confirmed by MEDACorp diligence.** Recall that VCYT is developing a product intended to improve the accuracy of diagnosis of idiopathic pulmonary fibrosis (IPF) by analyzing cells from a bronchoscopy sample. While our early diligence suggests variable usage of bronchoscopy (two doc's use it, one doesn't) and opinions differed on the potential impact of effective therapeutics on the need for accurate diagnosis, doctors were in agreement that diagnostic computed tomography (CT) scans are often ambiguous. In fact, physicians in our small sample estimated that diagnostic CT scans were ambiguous anywhere from 25% to 50% of the time. To us, this signifies a meaningful unmet need. VCYT's initial biomarker discovery for an IPF diagnostic has yielded promising results, with the area under a receiver operator characteristic (ROC) curve of 0.95, a signal that the test effectively separates the group being tested into those with and without disease. We believe VCYT will present its early biomarker discovery findings at a lung meeting in 2014, perhaps as early as the American Thoracic Society's annual meeting, which begins on May 16. We expect that the product will launch commercially in 2016.

• **Our higher valuation on VCYT reflects roll forward to 2015 estimates and confidence in execution.**

Key Stats: (NASDAQ:VCYT)

S&P 600 Health Care Index:	1,241.11
Price:	\$14.67
Price Target:	\$21.00 from \$17.00
Methodology:	6.5x EV/2015E revenues
52 Week High:	\$16.68
52 Week Low:	\$10.88
Shares Outstanding (mil):	21.0
Market Capitalization (mil):	\$308.1
Book Value/Share:	\$2.70
Cash Per Share:	\$3.27
Dividend (ann):	\$0.00
Dividend Yield:	0.0%



Dec Yr	1Q	2Q	3Q	4Q	FY Rev	1Q	2Q	3Q	4Q	FY EPS	P/E
2012A	\$1.5	\$2.5	\$3.2	\$4.5	\$11.6	(\$6.53)	(\$7.11)	(\$7.59)	(\$7.44)	(\$28.68)	NM
2013E	\$4.4A	\$5.1A	\$5.6A	\$6.2	\$21.3	(\$8.48)A	(\$7.99)A	(\$6.59)A	(\$0.45)	(\$6.19)	NM
2014E	--	--	--	--	\$39.6	--	--	--	--	(\$1.28)	NM
2015E	--	--	--	--	\$73.4	--	--	--	--	(\$0.98)	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 \$21 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 \$21 price target reflects an enterprise value (using projected levels of debt and cash) that is ~6.5x 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	Mar-12	Jun-12	Sep-12	Dec-12	2012	Mar-13	Jun-13	Sep-13	Dec-13e	2013e	2014e	2015e
Revenues													
Testing service revenue	\$2,645	\$1,468	\$2,480	\$3,224	\$4,457	\$11,628	\$4,385	\$5,067	\$5,594	\$6,219	\$21,265	\$39,550	\$73,429
Other	0	0	0	0	0	0	0	0	0	0	0	0	0
Total revenues	2,645	1,468	2,480	3,224	4,457	11,628	4,385	5,067	5,594	6,219	21,265	39,550	73,429
Cost of service	2,925	1,254	1,746	1,984	2,600	7,584	2,773	3,231	3,132	3,420	12,557	20,961	32,309
Gross profit	(281)	214	734	1,240	1,857	4,044	1,611	1,836	2,462	2,798	8,708	18,588	41,120
SG&A	8,305	2,982	3,683	4,449	5,252	16,365	5,494	5,352	6,535	6,716	24,097	33,212	47,729
R&D	6,680	1,481	1,677	1,729	1,721	6,608	2,010	1,902	2,028	2,456	8,396	12,458	14,686
Operating income (loss)	(15,265)	(4,248)	(4,626)	(4,938)	(5,116)	(18,929)	(5,893)	(5,418)	(6,101)	(6,374)	(23,785)	(27,081)	(21,294)
Interest expense (income) and other, net	(820)	(0)	(0)	(0)	(279)	(280)	1,002	1,073	202	120	2,397	495	517
Pretax income	(14,445)	(4,248)	(4,625)	(4,938)	(4,837)	(18,649)	(6,895)	(6,491)	(6,303)	(6,494)	(26,182)	(27,577)	(21,812)
Taxes	0	0	0	0	0	0	0	0	0	0	0	0	0
Net income	(\$14,445)	(\$4,248)	(\$4,625)	(\$4,938)	(\$4,837)	(\$18,649)	(\$6,895)	(\$6,491)	(\$6,303)	(\$6,494)	(\$26,182)	(\$27,577)	(\$21,812)
Basic shares outstanding	580	650	650	650	650	650	813	813	956	14,342	4,231	21,535	22,335
Diluted shares outstanding	580	650	650	650	650	650	813	813	956	14,342	4,231	21,535	22,335
EPS diluted	(\$24.90)	(\$6.53)	(\$7.11)	(\$7.59)	(\$7.44)	(\$28.68)	(\$8.48)	(\$7.99)	(\$6.59)	(\$0.45)	(\$6.19)	(\$1.28)	(\$0.98)
EPS growth													
Testing service revenue growth						339.7%	198.8%	104.4%	73.5%	39.5%	82.9%	86.0%	85.7%
FNA volume	6,402	3,925	5,610	7,052	9,303	25,890	10,757	12,424	12,417	13,489	49,087	73,443	102,820
Gross margin	(10.6%)	14.6%	29.6%	38.4%	41.7%	34.8%	36.7%	36.2%	44.0%	45.0%	41.0%	47.0%	56.0%
SG&A % of revenue	314.0%	203.2%	148.5%	138.0%	117.8%	140.7%	125.3%	105.6%	116.8%	108.0%	113.3%	84.0%	65.0%
R&D % of revenue	252.6%	100.9%	67.6%	53.6%	38.6%	56.8%	45.8%	37.5%	36.3%	39.5%	39.5%	31.5%	20.0%
Operating margin	(577.2%)	(289.5%)	(186.6%)	(153.2%)	(114.8%)	(162.8%)	(134.4%)	(106.9%)	(109.1%)	(102.5%)	(111.9%)	(68.5%)	(29.0%)
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%
D&A expense	\$611	\$172	\$177	\$177	\$181	\$706	\$197	\$231	\$289	\$233	\$950	\$1,186	\$2,203
EBITDA	(\$14,654)	(\$4,076)	(\$4,449)	(\$4,762)	(\$4,935)	(\$18,222)	(\$5,696)	(\$5,187)	(\$5,812)	(\$6,141)	(\$22,835)	(\$25,895)	(\$19,092)
Free cash flow													
Operating cash flow	(\$13,524)	\$6,007	(\$4,021)	(\$5,127)	(\$4,025)	(\$7,167)	(\$6,649)	(\$3,974)	(\$5,238)	(\$6,624)	(\$22,485)	(\$30,221)	(\$12,509)
CapX	(276)	(94)	(549)	(406)	(413)	(1,462)	(577)	(364)	(120)	(516)	(1,577)	(2,528)	(6,003)
Free cash flow	(\$13,800)	\$5,913	(\$4,570)	(\$5,534)	(\$4,438)	(\$8,629)	(\$7,226)	(\$4,338)	(\$5,358)	(\$7,141)	(\$24,063)	(\$32,750)	(\$18,512)

Notes:

Source: Company reports and Leerink Partners estimates

Veracyte (VCYT)**Balance sheet**

Period Ended (\$ thousands)	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13e
Assets								
Cash, equivalents, ST investments, restricted cash	\$13,539	\$8,975	\$3,441	\$14,002	\$7,072	\$20,683	\$15,426	\$68,735
Accounts receivable	549	580	567	569	464	991	714	681
Inventory	295	726	767	1,050	737	770	1,392	937
Prepaid expenses and other current assets	<u>435</u>	<u>587</u>	<u>806</u>	<u>760</u>	<u>854</u>	<u>1,398</u>	<u>2,938</u>	<u>1,368</u>
Total current assets	14,818	10,869	5,582	16,381	9,127	23,841	20,470	71,722
Property and equipment, net	1,608	1,895	2,210	2,446	2,826	3,025	2,826	3,109
Restricted cash / LT investments	168	168	168	118	118	118	118	118
Other assets	<u>29</u>	<u>27</u>	<u>61</u>	<u>122</u>	<u>108</u>	<u>175</u>	<u>157</u>	<u>157</u>
Total assets	\$16,623	\$12,958	\$8,021	\$19,067	\$12,179	\$27,159	\$23,571	\$75,106
Liabilities and shareholders' equity								
Notes payable - current portion	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Accounts payable	884	1,217	1,434	1,888	1,651	1,906	5,604	1,949
Accruals	1,605	2,672	2,859	4,021	3,168	5,387	4,416	5,472
Other liabilities	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	<u>3,083</u>	<u>4,085</u>	<u>2,500</u>	<u>2,500</u>	<u>2,960</u>
Total current liabilities	4,989	6,390	6,793	8,992	8,903	9,793	12,520	10,382
Notes payable - long-term portion	0	0	0	0	0	4,826	4,863	4,863
Deferred revenues - long-term portion	0	0	0	0	0	0	0	0
Deferred Genzyme co-promotion fee	6,989	6,364	5,739	5,114	4,489	3,864	3,239	2,614
Other liabilities	<u>0</u>	<u>0</u>	<u>54</u>	<u>61</u>	<u>71</u>	<u>439</u>	<u>502</u>	<u>502</u>
Total liabilities	\$11,978	\$12,754	\$12,586	\$14,167	\$13,463	\$18,922	\$21,124	\$18,361
Convertible preferred stock	\$49,297	\$49,297	\$49,297	\$63,372	\$63,372	\$79,025	\$79,022	\$0
Shareholders' equity	(\$44,652)	(\$49,092)	(\$53,862)	(\$58,472)	(\$64,656)	(\$70,789)	(\$76,575)	\$56,745
Total liabilities and shareholders' equity	\$16,623	\$12,958	\$8,021	\$19,067	\$12,179	\$27,159	\$23,571	\$75,106

Source: Company reports and Leerink Partners estimates

Disclosures Appendix

Analyst Certification

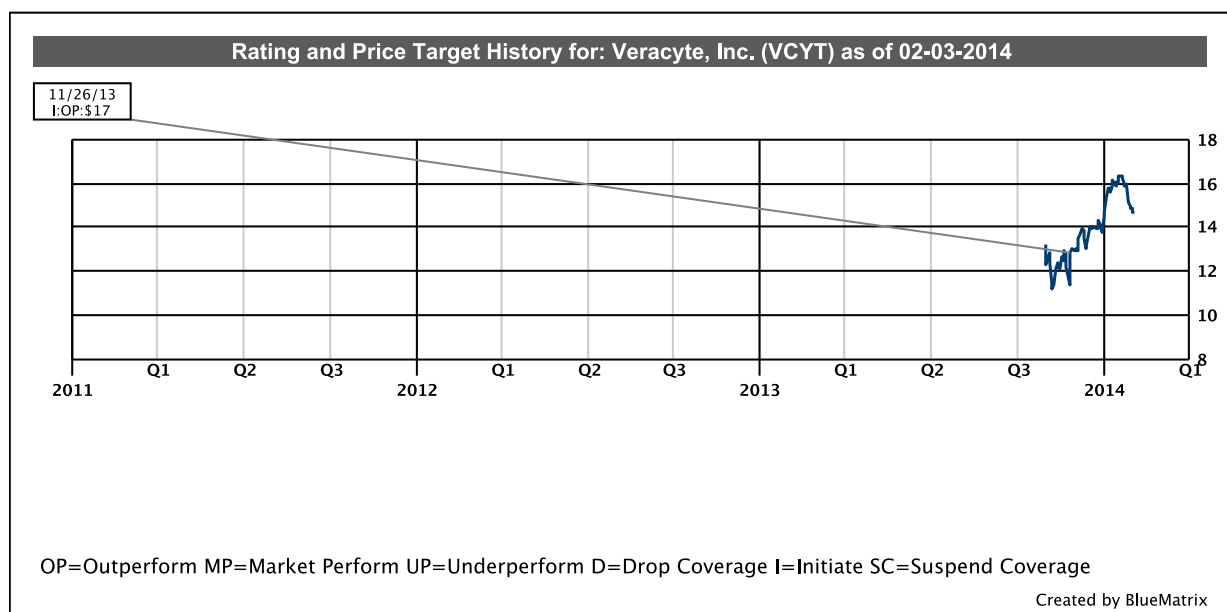
I, Dan Leonard, certify that the views expressed in this report accurately reflect my views and that no part of my compensation was, is, or will be directly related to the specific recommendation or views contained in this report.

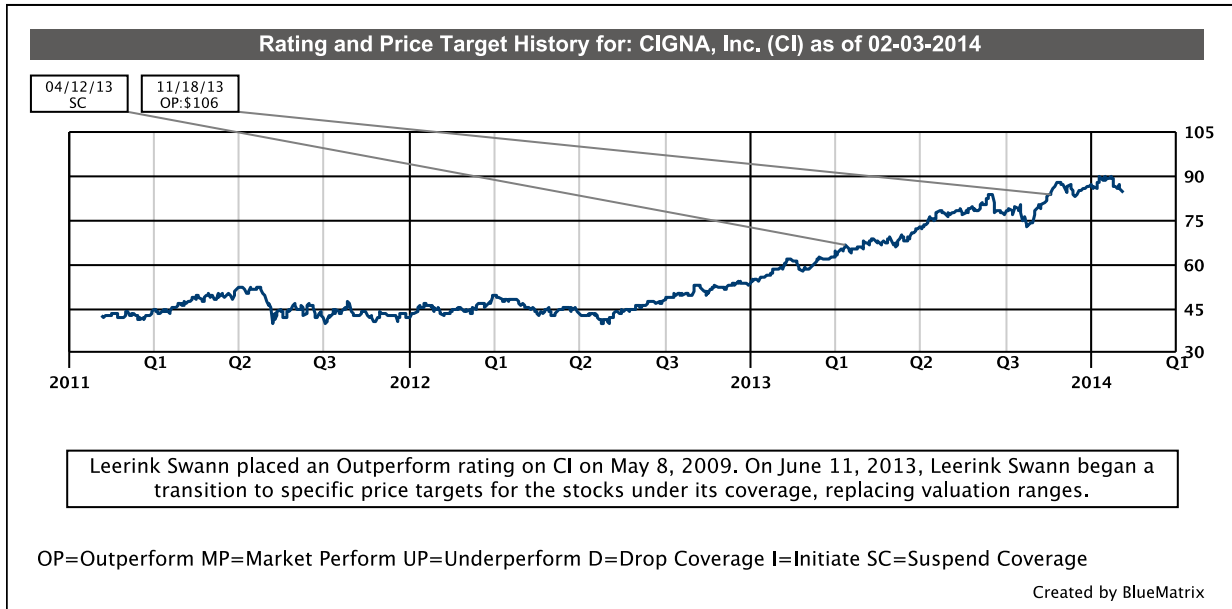
Valuation

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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.

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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. 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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