

Veracyte, Inc.

Genzyme Renegotiation a Positive Step to Profitability; Increased Coverage and Guideline Inclusions Drive Adoption

- We recently hosted an investor meeting at Veracyte; presenting for the company were Chief Executive Officer Bonnie Anderson and Chief Commercial Officer Chris Hall.
- The most important recent event for Veracyte was the company's renegotiation of its sales-and-marketing contract with Genzyme. While investors seem to struggle with the impetus for the renegotiation—both sides can terminate the agreement at any time with six months' prior notice—we view the new contract terms as positive for the company. Under the new terms, Veracyte will pay Genzyme 15% of Afirma revenue generated in the United States (down from 32%) beginning January 1, 2015, and for the life of the contract to 2027. It is not unusual for smaller labs to leverage a larger player for sales-and-marketing support (in advance of meaningful capital generation) with the intention of transitioning to a direct salesforce model. Although Veracyte will spend more on sales and marketing in the near term (the company will add 10 sales-and-marketing reps), the amendment is positive for longer-term growth/sustainability and we estimate will pull forward positive cash flow generation by a couple of quarters (into 2016 from 2017).
- The company also continues to gain traction with payers (recently obtaining positive coverage decisions from Blue Cross Blue Shield affiliated plans with the additions of Highmark Inc. and Horizon Blue Cross Blue Shield of New Jersey) and now has 135 million lives under coverage, up from 125 million in the prior quarter and roughly 100 million a year ago. In our view, the rapid coverage decisions continue to highlight the clinical utility and overall cost savings to the system from the Afirma GEC. The next step will be to convert to contracts, which will facilitate quicker payments, higher success rate with appeals, as well as eventually the ability to convert to accrual accounting for that payer. We model commercial contracts beginning in 2015 (boost to realized ASP and gross margin).
- There was some discussion about the company's recent quarter; while growth continues to impress, revenue was weaker than expected as the company had more traction with institutional accounts (which tend to perform the FNA cytology in-house and send samples to Veracyte only to perform the Afirma assay). While this led to lower FNA volumes, Veracyte is seeing a higher percentage of GECs as a percentage of total volume, which has positive implications from both an ASP and margin perspective. Ultimately, management reiterated 2014 revenue guidance of \$38 million to \$43 million, although generated via a different mix (a higher GEC-only rate of 7% and a lower contribution from FNA samples—66,000 to 73,000 samples from 76,000 to 83,000 samples), but expects a larger contribution from higher-margin GECs.

Veracyte is a diagnostics company that specializes in the field of molecular cytology transforming patient care and aims to save the healthcare system unnecessary costs from overtreatment of diseases.

Amanda Murphy, CFA
+1 312 364 8951
amurphy@williamblair.com

JP McKim
+1 312 364 8991
jpmckim@williamblair.com

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September 03, 2014

Stock Rating: **Outperform**
Company Profile: **Aggressive Growth**

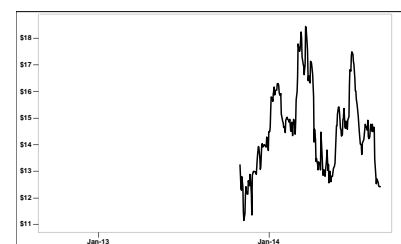
Symbol: VCYT (NASDAQ)
Price: \$12.49 (52-Wk.: \$11-\$19)
Market Value (mil.): \$268
Fiscal Year End: December
Long-Term EPS Growth Rate:
Dividend/Yield: None

	2013A	2014E	2015E
Estimates			
EPS FY	\$-1.22	\$-1.35	\$-0.89
CY		\$-1.35	\$-0.89
Sales (mil.)	22	39	71
Valuation			
FY P/E	NM	NM	NM
CY P/E		NM	NM

Trading Data (FactSet)	
Shares Outstanding (mil.)	21
Float (mil.)	10
Average Daily Volume	87,325

Financial Data (FactSet)	
Long-Term Debt/Total Capital (MRQ)	0.1
Book Value Per Share (MRQ)	2.1
Return on Equity (TTM)	-83.4

Two-Year Price Performance Chart



Sources: FactSet, William Blair & Company estimates

- Stock thoughts and valuation.** The stock is trading at an enterprise value of 3 times projected 2015 sales and has pulled back 34% from its 52-week high. The company continues to gain rapid payer coverage and now has more than 135 million lives under coverage, and we expect to hear contract announcements on a future earnings call (we hope in 2014). We expect further market penetration to be driven by increased payer coverage as well as positive changes to NCCN and ATA guidelines; we assume the company has roughly 15% market penetration in the United States (about 7% worldwide), rising to 35% in 2016 (17% worldwide). While the Genzyme contract may carry some short-term risk in terms of impact to revenue, we believe that the amended agreement brings not only forward profitability for the company, but also additional sales reps in house (more feet on the street) to penetrate complex accounts with a more-specialized/-focused rep. We maintain our Outperform rating.

Veracyte, Inc. Projected Income Statement (2011 to 2016E)

	FY 2011	FY 2012	Q1'13	2013 Q2'13	Q3'13	Q4'13	FY 2013	Q1'14	2014 Q2'14	Q3'14E	Q4'14E	FY 2014E	FY 2015E	FY 2016E
Revenue:	\$2,645	\$11,628	\$4,385	\$5,067	\$5,594	\$6,838	\$21,884	\$7,476	\$8,677	\$9,532	\$13,349	\$39,034	\$71,107	\$115,511
Cost of Services:	\$2,925	\$7,584	\$2,773	\$3,231	\$3,132	\$3,471	\$12,607	\$3,607	\$3,966	\$4,385	\$6,140	\$18,098	\$27,013	\$38,119
Gross Profit	-\$281	\$4,044	\$1,611	\$1,836	\$2,462	\$3,367	\$9,277	\$3,869	\$4,711	\$5,147	\$7,208	\$20,936	\$44,094	\$77,393
Operating expenses:														
Research and development	\$6,680	\$6,608	\$2,010	\$1,902	\$2,028	\$1,870	\$7,810	\$2,126	\$2,243	\$2,478	\$2,803	\$9,651	\$14,933	\$18,895
Total Selling & Marketing	\$2,934	\$8,447	\$2,703	\$2,512	\$3,291	\$3,931	\$12,437	\$4,336	\$5,101	\$6,086	\$8,020	\$23,542	\$29,523	\$42,136
General & Administrative	\$5,371	\$7,918	\$2,791	\$2,737	\$3,244	\$3,328	\$12,100	\$3,982	\$3,928	\$4,099	\$4,138	\$16,147	\$18,704	\$21,120
Total Operating Expenses	\$14,985	\$22,973	\$7,504	\$7,151	\$8,563	\$9,129	\$32,347	\$10,444	\$11,272	\$12,663	\$14,961	\$49,340	\$63,160	\$82,151
Operating Income	-\$15,265	-\$18,929	-\$5,893	-\$5,315	-\$6,101	-\$5,762	-\$23,070	-\$6,575	-\$6,561	-\$7,515	-\$7,753	-\$28,404	-\$19,066	-\$4,759
Interest Income (Expense)	\$2	\$2	\$1	-\$5	-\$126	-\$97	-\$228	-\$111	-\$113	-\$114	-\$115	-\$453	-\$388	-\$196
Other Expense	\$819	\$278	-\$1,003	-\$1,068	-\$76	-\$33	-\$2,180	\$12	\$19	\$0	\$0	\$31	\$0	\$0
Pretax Income	-\$14,445	-\$18,649	-\$6,895	-\$6,388	-\$6,303	-\$5,892	-\$25,477	-\$6,674	-\$6,655	-\$7,630	-\$7,868	-\$28,827	-\$19,454	-\$4,955
Taxes														
Net Income/Loss	-\$14,445	-\$18,649	-\$6,895	-\$6,388	-\$6,303	-\$5,892	-\$25,477	-\$6,674	-\$6,655	-\$7,630	-\$7,868	-\$28,827	-\$19,454	-\$5,160
EPS basic	-\$6.23	-\$7.17	-\$0.33	-\$0.31	-\$0.30	-\$0.28	-\$1.23	-\$0.32	-\$0.31	-\$0.36	-\$0.37	-\$1.35	-\$0.89	-\$0.23
EPS fully diluted	-\$0.72	-\$0.89	-\$0.33	-\$0.31	-\$0.30	-\$0.28	-\$1.21	-\$0.32	-\$0.31	-\$0.36	-\$0.37	-\$1.35	-\$0.89	-\$0.23
W.Avg Shares Outstanding basic	2,320	2,601	20,690	20,690	20,690	20,897	20,742	21,148	21,237	21,343	21,450	21,295	21,992	22,885
W.Avg Shares Outstanding diluted	19,992	20,841	20,843	20,943	21,043	21,143	20,993	21,148	21,237	21,343	21,450	21,295	21,992	22,885
Margin Analysis:														
Gross Margin	-11%	35%	37%	36%	44%	49%	42%	52%	54%	54%	54%	54%	62%	67%
Total Operating Expenses	-567%	-198%	-171%	-141%	-153%	-134%	-150%	-140%	-130%	-133%	-112%	-129%	-89%	-72%
Research and development	253%	57%	46%	38%	36%	27%	37%	28%	26%	26%	21%	25%	21%	17%
Selling & Marketing	111%	73%	62%	50%	59%	57%	57%	58%	59%	64%	60%	60%	42%	37%
General & Administrative	203%	68%	64%	54%	58%	49%	56%	53%	45%	43%	31%	43%	27%	19%
EBIT	-577%	-163%	-134%	-105%	-109%	-84%	-108%	-88%	-76%	-79%	-58%	-75%	-28%	-5%
Tax Rate	NM													
Net Income/Loss	-546%	-160%	-157%	-126%	-113%	-86%	-121%	-89%	-77%	-80%	-59%	-76%	-28%	-5%
Growth Metrics:														
Total Revenue Growth	NM	340%	199%	104%	74%	53%	88%	71%	71%	70%	95%	78%	82%	62%
Gross Profit	NM	-1541%	653%	150%	99%	81%	129%	140%	157%	109%	114%	126%	111%	76%
Total Operating Expenses	NM	53%	68%	33%	39%	31%	41%	39%	58%	48%	64%	53%	28%	30%
Research and development	NM	NM	36%	13%	17%	9%	18%	6%	18%	22%	50%	24%	55%	27%
Selling & Marketing	NM	NM	122%	37%	40%	29%	47%	60%	103%	85%	104%	89%	25%	43%
General & Administrative	NM	NM	58%	48%	54%	52%	53%	43%	44%	26%	24%	33%	16%	13%
EBIT	NM	-24%	-39%	-15%	-24%	-13%	-22%	-12%	-23%	-23%	-35%	-23%	33%	75%
Net Income/Loss	NM	-29%	-62%	-38%	-28%	-22%	-37%	3%	-4%	-21%	-34%	-13%	33%	73%
EPS	NM	86%	81%	84%	84%	85%	-36%	5%	-1%	-17%	-30%	-11%	35%	74%
Shares Outstanding	NM	4%	0%	0%	0%	0%	697%	0%	0%	1%	1%	3%	3%	4%

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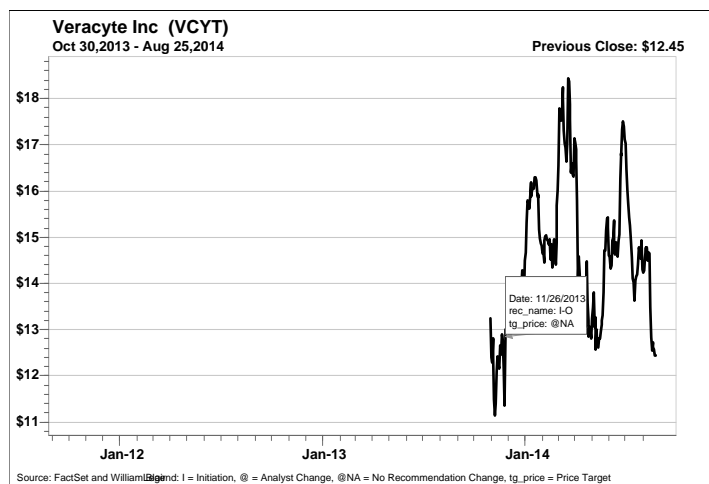
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DOW JONES: 17,067.56

S&P 500: 2,002.28

NASDAQ: 4,598.19



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