

Veracyte, Inc.

Allegro Deal Points to Veracyte's Intent to Build Broader Diagnostic Franchise

- On Thursday, September 4, Veracyte announced the acquisition of Allegro Diagnostics for \$21 million (\$7.8 million in cash and \$13.2 million in common stock). The company did not provide much guidance about the financial impact other than to say the Allegro franchise is not expected to contribute meaningful revenue until 2017 (the Allegro test will be launched commercially in the second half of 2015). The deal is expected to close in the next few weeks. We estimate the transaction would reduce 2015 EPS by \$0.08 and 2016 by \$0.26 (assuming some level of SG&A and R&D expense ramp-up for Allegro) and push profitability into late 2017. We view the deal as a long-term positive for the company as it expands Veracyte's addressable market, diversifies the company's future revenue stream, and strategically aligns Veracyte into its next vertical, pulmonology.
- The stock has been weak in recent trading, we suspect as a result of the revenue miss in the second quarter (which was driven by a higher mix of Afirma tests as a percentage of the total relative to what was anticipated). In our view, the stock valuation does not take into account the broader picture that Veracyte continues to gain meaningful traction with its Afirma assay in thyroid (GEC volume was up 50%, total revenue was up 71% in the most recent quarter) as well as with payers. The overall Afirma market is roughly \$400 million in the United States, suggesting the company has 15% penetration of the U.S. market; given the company's positioning (payer support, guideline support), we see no reason the company cannot drive this north of 50% as others have done in the space. In terms of valuation, including roughly \$11 million in 2017 from Allegro, a 3.5 times revenue-to-sales multiple, and a 20% discount rate, we calculate an enterprise valuation of \$400 million, which implies a stock price close to \$21.
- Allegro was founded in 2006 based on IP generated at Boston University. Allegro has developed a proprietary molecular testing platform based on the field of injury principle, which suggests that inhaled substances (e.g., cigarette smoke) cause a field of injury in the lungs/airways and that gene expression of cells in normal airway epithelial cells can reflect biologic events occurring in the distal lung.
- The company has a 22-gene expression assay in development, which is based on the field of injury concept using Affymetrix (AFFX \$8.51) arrays and is designed to help identify patients who have a nondiagnostic bronchoscopy but are at a low risk for cancer and so can be monitored via CT scans instead of undergoing additional invasive procedures. Thus the Allegro test carries similar cost savings opportunities to the system as Afirma. The idea is that Veracyte can leverage its expertise in building out a diagnostic franchise (including diagnostic workflow, reimbursement relationships, ability to drive appropriate clinical data) to commercialize the Allegro product.

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.

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September 05, 2014

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

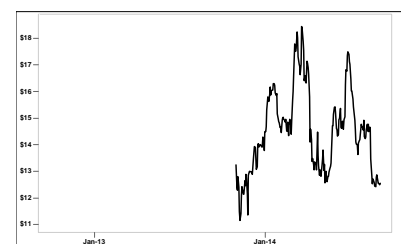
Symbol: VCYT (NASDAQ)
Price: \$12.42 (52-Wk: \$11-\$19)
Market Value (mil.): \$267
Fiscal Year End: December
Long-Term EPS Growth Rate:
Dividend/Yield: None

	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	88,565

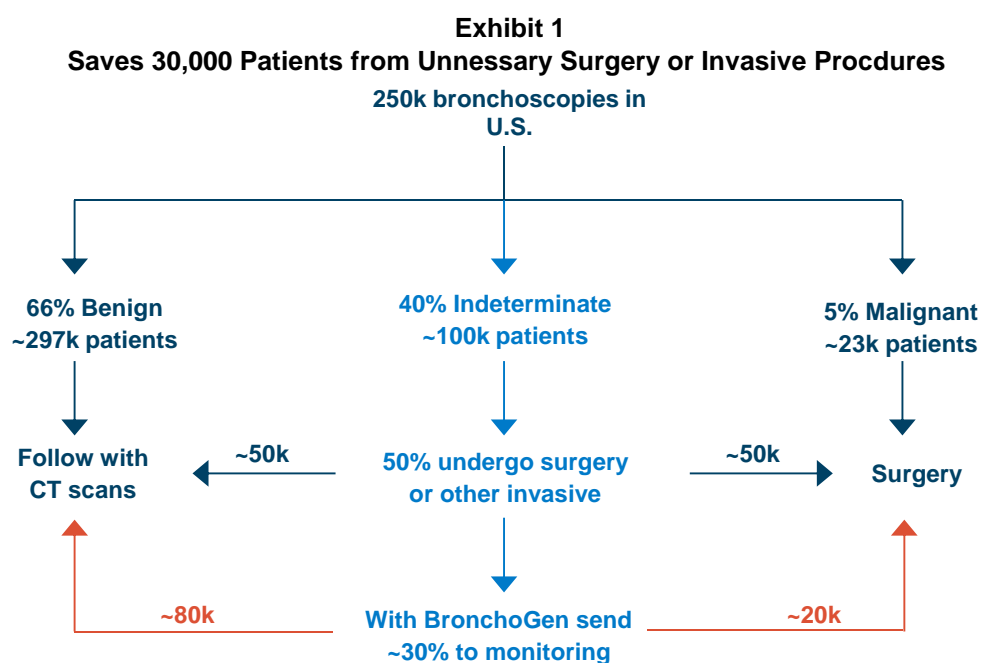
Financial Data (FactSet)	
Long-Term Debt/Total Capital (MRQ)	0.1
Book Value Per Share (MRQ)	2.1
Return on Equity (TTM)	-83.4

Two-Year Price Performance Chart



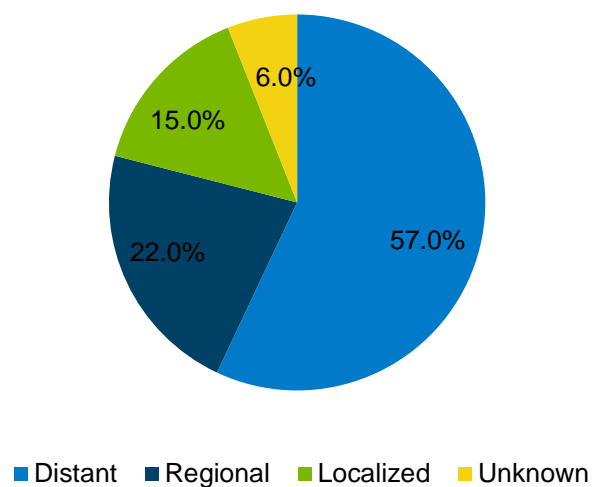
Sources: FactSet, William Blair & Company estimates

- There are roughly 250,000 bronchoscopies performed each year in the United States, of which 40% provide nondiagnostic results (or are indeterminate). Via the Allegro assay, Veracyte believes 30% to 40% of those indeterminate results could be reclassified to low risk. Given that the standard of care for these patients is currently not well defined, roughly half go on to have surgery or some other invasive procedures, suggesting a meaningful cost savings (and underserved opportunity); this suggests a market opportunity of roughly \$300 million, assuming an ASP of \$3,000 in the United States alone.
- The Allegro assay has been validated in two prospective, multicenter clinical validation studies, involving 25 centers and nearly 1,000 patients. Top-line results were recently reported from the Airway Epithelium Gene Expression in the Diagnosis of Lung Cancer (AEGIS-1 and AEGIS-2) trials at the American Thoracic Society (ATS) International Conference in May and have been submitted for publication. Essentially, the AEGIS-2 trial met its primary endpoint suggesting that the company's BronchoGen genomic test improves the accuracy of lung cancer diagnosis when used in combination with bronchoscopy based on endpoints of sensitivity, specificity, and negative predictive value. Final results of the AEGIS-1 clinical validation study were also accepted as a late-breaking abstract at the recent ATS conference; results showed significantly higher sensitivity and negative predictive value in lung cancer diagnoses using BronchoGen in combination with bronchoscopy than by bronchoscopy alone.



Sources: William Blair & Company, L.L.C. estimates

Exhibit 2
Catching Lung Cancer Late



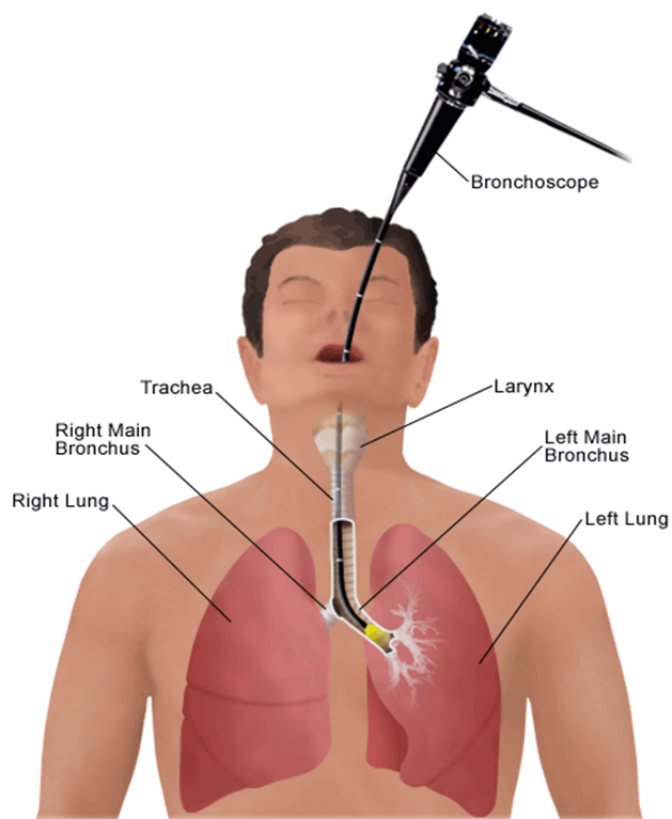
Sources: American Cancer Society, National Cancer Institute, and William Blair & Company L.L.C. estimates

Exhibit 3
Estimated Number of New Cancer Cases and Deaths, U.S, 2014

	Estimated New Cases				Estimated Deaths		
	% Total	Both Sexes	Male	Female	Both Sexes	Male	Female
All Sites	100%	1,665,540	855,220	810,320	585,720	310,010	275,710
Oral cavity & pharynx	2.5%	42,440	30,220	12,220	8,390	5,730	2,660
Tongue	0.8%	13,590	9,720	3,870	2,150	1,450	700
Mouth	0.7%	11,920	7,150	4,770	2,070	1,130	940
Pharynx	0.9%	14,410	11,550	2,860	2,540	1,900	640
Other oral cavity	0.2%	2,520	1,800	720	1,630	1,250	380
Digestive system	17.4%	289,610	162,730	126,880	147,260	84,970	62,290
Esophagus	1.1%	18,170	14,660	3,510	15,450	12,450	3,000
Stomach	1.3%	22,220	13,730	8,490	10,990	6,720	4,270
Small intestine	0.5%	9,160	4,880	4,280	1,210	640	570
Colon	5.8%	96,830	48,450	48,380	50,310	26,270	24,040
Rectum	2.4%	40,000	23,380	16,620	NM	NM	NM
Anus, anal canal, & anorectum	0.4%	7,210	2,660	4,550	950	370	580
Liver & intrahepatic bile duct	2.0%	33,190	24,600	8,590	23,000	15,870	7,130
Gallbladder & other biliary	0.6%	10,650	4,960	5,690	3,630	1,610	2,020
Pancreas	2.8%	46,420	23,530	22,890	39,590	20,170	19,420
Other digestive organs	0.3%	5,760	1,880	3,880	2,130	870	1,260
Respiratory system	14.6%	242,550	130,000	112,550	163,660	90,280	73,380
Larynx	0.8%	12,630	10,000	2,630	3,610	2,870	740
Lung & bronchus	13.5%	224,210	116,000	108,210	159,260	86,930	72,330
Other respiratory organs	0.3%	5,710	4,000	1,710	790	480	310
Bones & joints	0.2%	3,020	1,680	1,340	1,460	830	630
Soft tissue (including heart)	0.7%	12,020	6,550	5,470	4,740	2,550	2,190
Skin (excluding basal & squamous)	4.9%	81,220	46,630	34,590	12,980	8,840	4,140
Melanoma-skin	4.6%	76,100	43,890	32,210	9,710	6,470	3,240
Other nonepithelial skin	0.3%	5,120	2,740	2,380	3,270	2,370	900
Breast	14.1%	235,030	2,360	232,670	40,430	430	40,000
Genital system	20.3%	338,450	243,460	94,990	58,970	30,180	28,790
Uterine cervix	0.7%	12,360	NM	12,360	4,020	NM	4,020
Uterine corpus	3.2%	52,630	NM	52,630	8,590	NM	8,590
Ovary	1.3%	21,980	NM	21,980	14,270	NM	14,270
Vulva	0.3%	4,850	NM	4,850	1,030	NM	1,030
Vagina & other genital, female	0.2%	3,170	NM	3,170	880	NM	880
Prostate	14.0%	233,000	233,000	NM	29,480	29,480	NM
Testis	0.5%	8,820	8,820	NM	380	380	NM
Penis & other genital, male	0.1%	1,640	1,640	NM	320	320	NM
Urinary system	8.5%	141,610	97,420	44,190	30,350	20,610	9,740
Urinary bladder	4.5%	74,690	56,390	18,300	15,580	11,170	4,410
Kidney & renal pelvis	3.8%	63,920	39,140	24,780	13,860	8,900	4,960
Ureter & other urinaryorgans	0.2%	3,000	1,890	1,110	910	540	370
Eye & orbit	0.2%	2,730	1,440	1,290	310	130	180
Brain & other nervous system	1.4%	23,380	12,820	10,560	14,320	8,090	6,230
Endocrine system	3.9%	65,630	16,600	49,030	2,820	1,300	1,520
Thyroid	3.8%	62,980	15,190	47,790	1,890	830	1,060
Other endocrine	0.2%	2,650	1,410	1,240	930	470	460
Lymphoma	4.8%	79,990	43,340	36,650	20,170	11,140	9,030
Hodgkin lymphoma	0.6%	9,190	5,070	4,120	1,180	670	510
Non-Hodgkin lymphoma	4.3%	70,800	38,270	32,530	18,990	10,470	8,520
Myeloma	1.4%	24,050	13,500	10,550	11,090	6,110	4,980
Leukemia	3.1%	52,380	30,100	22,280	24,090	14,040	10,050
Acute lymphocytic leukemia	0.4%	6,020	3,140	2,880	1,440	810	630
Chronic lymphocytic leukemia	0.9%	15,720	9,100	6,620	4,600	2,800	1,800
Acute myeloid leukemia	1.1%	18,860	11,530	7,330	10,460	6,010	4,450
Chronic myeloid leukemia	0.4%	5,980	3,130	2,850	810	550	260
Other leukemia	0.3%	5,800	3,200	2,600	6,780	3,870	2,910
Other & unspecified primary sites	1.9%	31,430	16,370	15,060	44,680	24,780	19,900

Sources: American Cancer Society, National Cancer Institute, and William Blair & Company L.L.C. estimates

Exhibit 4 Lung Bronchoscopy



Source: Johns Hopkins Medicine

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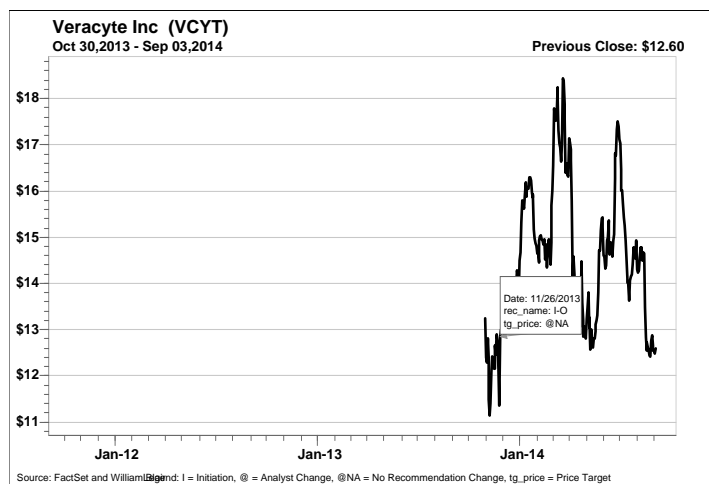
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DOW JONES: 17,069.58

S&P 500: 1,997.65

NASDAQ: 4,562.29



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Coverage Universe	Percent	Inv. Banking Relationships*	Percent
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Market Perform (Hold)	31	Market Perform (Hold)	3
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