

Equity Research

September 5, 2014

Price: \$12.42 (09/4/2014)

Price Target: \$22.00

OUTPERFORM (1)

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Key Data

Symbol [NASDAQ: VCYT](#)

Market Cap (MM) [\\$266.9](#)

Company Quick Take

Compelling Rationale For Acquisition Of Allegro Diagnostics

The Cowen Insight

Yesterday after market close, Veracyte announced an agreement to acquire Allegro Diagnostics. We believe this acquisition makes strategic sense as it significantly expands Veracyte's addressable market with a clinically validated test, provides the company access to an interesting technology, and is synergistic with the company's strategy and existing products under development.

Background on Allegro Diagnostics

Allegro Diagnostics is a privately held company focused on developing genomic tests to improve the preoperative diagnosis of lung cancer. The company is currently developing a lung cancer test that is designed to help physicians determine which patients with lung nodules who have had a non-diagnostic bronchoscopy result are at low risk for cancer and can thus be safely monitored with CT scans rather than undergoing invasive procedures.

Financial Details

Veracyte agreed to acquire Allegro Diagnostics for \$21MM, comprised of \$7.8MM in cash and \$13.2MM in stock. We note that Veracyte ended Q2:14 with ~\$60MM in cash and equivalents. Veracyte plans to commercially launch Allegro's lead lung cancer test in H2:2015 with meaningful revenue expected in 2017. Management noted that minimal investments will be needed in 2015; acceleration in spend supporting the commercial launch will occur in 2016 and beyond.

Strategically Sound Acquisition

We believe that the acquisition of Allegro Diagnostics makes strategic sense. Allegro's test is closely aligned with Veracyte's strategy to "focus on diseases in which a large number of patients undergo invasive and costly diagnostic procedures that could be avoided with a more accurate diagnosis from a cytology sample taken preoperatively". Further, Allegro significantly expands Veracyte's addressable market – management estimated that Allegro's market opportunity is similar to that of its GEC test.

There are clear synergies with this acquisition, including synergies with the sales force, as both Allegro's test and Veracyte's internally developed idiopathic pulmonary fibrosis (IPF) test target the same physicians (pulmonologists), and commercialization, as we believe Veracyte can leverage its experience in building a commercial infrastructure, and obtaining guideline recommendation and reimbursement for Afirma GEC to successfully launch and monetize Allegro's test. On the former point, we think that today's announcement can enhance the IPF launch given an accelerated sales force penetration into the pulmonology market.

Management also sounded enthused about certain intellectual property owned by Allegro (which Veracyte will be obtaining), particularly surrounding Allegro's "field

of injury” technology, which can return a correlated gene expression result from a sample that is not directly from the lung nodule; this technology was noted to have the potential to develop new product verticals in the future.

Valuation Methodology And Risks

Valuation Methodology

Life Science & Diagnostic Tools:

Price targets are based on several methodologies which may include: analysis of market risk, growth rate, revenue stream, discounted cash flows (DCF), EBITDA, EPS, cash flow (CF), free cash flow (FCF), EV/EBITDA, P/E, PE/growth, P/CF, P/FCF, premium (discount) / average group EV/EBITDA, premium (discount) / average group P/E, sum of the parts, net asset value, dividend returns, and return on equity (ROE) over the next 12 months.

Investment Risks

Life Science & Diagnostic Tools:

Risks to the Medical and Life Science Tools sector may include: reduction or delay in research and development budgets and government funding, reduced or delayed purchasing from health care / hospital customers, increased or extended regulatory hurdles or processes for regulated products, increased dependence on volatile emerging markets for revenues and profitability, and general macroeconomic challenges.

Risks To The Price Target

Risks include but are not limited to: difficulty in expanding payer coverage and entering into payer contracts; reimbursement prices lower than expected; delays or weaker than expected clinical data in support of new products; competition from other potential molecular diagnostic players; weaker than expected uptake in international markets; Genzyme partnership could become "relatively" expensive; and delivering on margin / profitability targets.

Addendum

Stocks Mentioned in Important Disclosures

Ticker	Company Name
VCYT	Veracyte

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Cowen and Company Rating System effective May 25, 2013

Outperform (1): The stock is expected to achieve a total positive return of at least 15% over the next 12 months

Market Perform (2): The stock is expected to have a total return that falls between the parameters of an Outperform and Underperform over the next 12 months

Underperform (3): Stock is expected to achieve a total negative return of at least 10% over the next 12 months

Assumption: The expected total return calculation includes anticipated dividend yield

Cowen and Company Rating System until May 25, 2013

Outperform (1): Stock expected to outperform the S&P 500

Neutral (2): Stock expected to perform in line with the S&P 500

Underperform (3): Stock expected to underperform the S&P 500

Assumptions: Time horizon is 12 months; S&P 500 is flat over forecast period

Cowen Securities, formerly known as Dahlgren Rose & Company, Rating System until May 25, 2013

Buy – The fundamentals/valuations of the subject company are improving and the investment return is expected to be 5 to 15 percentage points higher than the general market return

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Cowen And Company Rating Definitions

Distribution of Ratings/Investment Banking Services (IB) as of 06/30/14

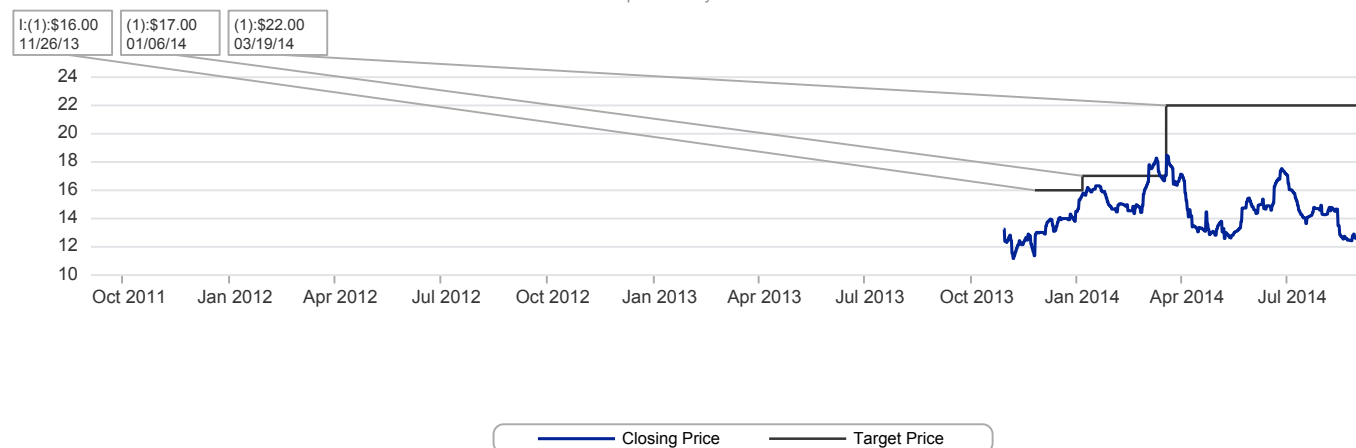
Rating	Count	Ratings Distribution	Count	IB Services/Past 12 Months
Buy (a)	417	58.57%	94	22.54%
Hold (b)	279	39.19%	7	2.51%
Sell (c)	16	2.25%	0	0.00%

(a) Corresponds to "Outperform" rated stocks as defined in Cowen and Company, LLC's rating definitions. (b) Corresponds to "Market Perform" as defined in Cowen and Company, LLC's ratings definitions. (c) Corresponds to "Underperform" as defined in Cowen and Company, LLC's ratings definitions.

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Veracyte Rating History as of 09/04/2014

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Legend for Price Chart:

I = Initiation | 1 = Outperform | 2 = Market Perform | 3 = Underperform | UR = Price Target Under Review | T = Terminated Coverage | \$xx = Price Target | NA = Not Available | S=Suspended

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