

Reason for report:

COMPANY UPDATE

VERACYTE, INC.

Positive Blue Decision; Payer Catalysts On Deck

• **Bottom Line:** VCYT's Afirma test has received a positive coverage decision from another Blues plan (Horizon Blue Cross Blue Shield of New Jersey [Horizon]). With several sentiment catalysts now behind the company, we believe incremental payer decisions (with a focus on Blues) as well as quarterly execution will be key catalysts for VCYT going forward. We continue to rate VCYT Outperform with a \$23 target.

• **Another Blues Plan Issues a Positive Coverage Decision for VCYT's Afirma.** Horizon recently revised its medical policy on molecular markers in fine needle aspirates of the thyroid. In this policy revision, which will take effect on 7/26/2014, Horizon deemed Afirma medically necessary in the evaluation of fine needle aspirate (FNA) samples that are indeterminate. Horizon notes that 20% - 30% of FNAs are indeterminate, which would yield a \$500M U.S. market opportunity for Afirma. We consider this coverage revision a positive win for VCYT.

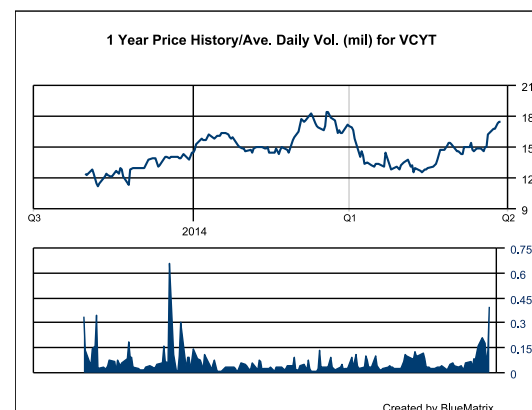
• **Blues to be a focus in 2014.** While VCYT ended 2013 with positive coverage decisions from plans representing >115M lives, the company did not have any positive coverage decisions from any of the Blues, which we believe collectively represent ~30% of the patient load for Afirma. VCYT announced its first positive coverage decision from a Blue (Premera) on its Q1 conference call, and we believe the Blues in aggregate represent a primary focus for VCYT's payer team in 2014. Thus, the Horizon revision represents positive progress towards the objective of increasing the number of Blues with positive coverage policies for Afirma, and we believe further such revisions represent a primary sentiment catalyst through the balance of the year for VCYT.

• **Several catalysts recently realized.** VCYT has successfully executed upon or recently realized several sentiment catalysts. It launched its Afirma Malignancy Classifiers in May, presented proof-of-concept data for a molecular classifier to differentiate interstitial lung diseases, and received a positive preliminary guideline update from the American Thyroid Association (ATA).

Key Stats:

(NASDAQ:VCYT)

S&P 600 Health Care Index:	1,315.45
Price:	\$17.40
Price Target:	\$23.00
Methodology:	~7.0x EV/2015E revenues
52 Week High:	\$19.00
52 Week Low:	\$10.88
Shares Outstanding (mil):	21.1
Market Capitalization (mil):	\$367.1
Book Value/Share:	\$2.38
Cash Per Share:	\$3.04
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	\$7.5A	\$9.1	\$10.2	\$13.0	\$39.7	(\$0.32)A	(\$0.38)	(\$0.38)	(\$0.33)	(\$1.41)	NM
2015E	--	--	--	--	\$75.7	--	--	--	--	(\$0.94)	NM
2016E	--	--	--	--	\$111.6	--	--	--	--	(\$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 Gene Expression Classifier (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 (VCYT)

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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-14	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	\$7,476	\$9,081	\$10,171	\$13,001	\$39,730	\$75,746	\$111,598
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	7,476	9,081	10,171	13,001	39,730	75,746	111,598
Cost of service	2,925	7,584	2,773	3,231	3,132	3,471	12,607	3,607	4,904	5,289	6,241	20,041	33,328	44,639
Gross profit	(281)	4,044	1,611	1,836	2,462	3,367	9,277	3,869	4,177	4,882	6,761	19,689	42,417	66,959
SG&A	8,305	16,365	5,494	5,352	6,535	7,259	24,640	8,318	9,535	10,171	11,051	39,076	49,235	51,335
R&D	6,680	6,608	2,010	1,902	2,028	1,870	7,810	2,126	2,543	2,848	2,860	10,377	13,634	17,856
Operating income (loss)	(15,265)	(18,929)	(5,893)	(5,418)	(6,101)	(5,762)	(23,173)	(6,575)	(7,901)	(8,137)	(7,151)	(29,763)	(20,451)	(2,232)
Interest expense (income) and other, net	(820)	(280)	1,002	1,073	202	130	2,407	99	127	128	130	484	529	539
Pretax income	(14,445)	(18,649)	(6,895)	(6,491)	(6,303)	(5,892)	(25,580)	(6,674)	(8,028)	(8,265)	(7,280)	(30,247)	(20,981)	(2,771)
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)	(\$6,674)	(\$8,028)	(\$8,265)	(\$7,280)	(\$30,247)	(\$20,981)	(\$2,771)
Basic shares outstanding	580	650	813	813	956	13,944	4,131	21,148	21,348	21,548	21,748	21,448	22,248	23,048
Diluted shares outstanding	580	650	813	813	956	13,944	4,131	21,148	21,348	21,548	21,748	21,448	22,248	23,048
EPS diluted	(\$24.90)	(\$28.68)	(\$8.48)	(\$7.99)	(\$6.59)	(\$0.42)	(\$6.19)	(\$0.32)	(\$0.38)	(\$0.38)	(\$0.33)	(\$1.41)	(\$0.94)	(\$0.12)
EPS growth														
Testing service revenue growth		339.7%	198.8%	104.4%	73.5%	53.4%	88.2%	70.5%	79.2%	81.8%	90.1%	81.5%	90.7%	47.3%
FNA volume	6,402	25,890	10,757	12,424	12,417	14,059	49,657	14,373	18,015	19,495	24,181	76,064	108,599	141,179
Gross margin	(10.6%)	34.8%	36.7%	36.2%	44.0%	49.2%	42.4%	51.8%	46.0%	48.0%	52.0%	49.6%	56.0%	60.0%
SG&A % of revenue	314.0%	140.7%	125.3%	105.6%	116.8%	106.2%	112.6%	111.3%	105.0%	100.0%	85.0%	98.4%	65.0%	46.0%
R&D % of revenue	252.6%	56.8%	45.8%	37.5%	36.3%	27.3%	35.7%	28.4%	28.0%	28.0%	22.0%	26.1%	18.0%	16.0%
Operating margin	(577.2%)	(162.8%)	(134.4%)	(106.9%)	(109.1%)	(84.3%)	(105.9%)	(87.9%)	(87.0%)	(80.0%)	(55.0%)	(74.9%)	(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	\$282	\$999	\$290	\$272	\$305	\$390	\$1,258	\$2,272	\$3,348
EBITDA	(\$14,654)	(\$18,222)	(\$5,696)	(\$5,187)	(\$5,812)	(\$5,480)	(\$22,174)	(\$6,285)	(\$7,628)	(\$7,832)	(\$6,761)	(\$28,506)	(\$18,179)	\$1,116
Free cash flow														
Operating cash flow	(\$13,524)	(\$7,167)	(\$6,649)	(\$3,974)	(\$5,238)	(\$3,298)	(\$19,159)	(\$6,674)				(\$36,688)	(\$10,995)	\$3,172
CapX	(276)	(1,462)	(577)	(364)	(120)	(271)	(1,332)	(260)				(3,400)	(6,572)	(7,708)
Free cash flow	(\$13,800)	(\$8,629)	(\$7,226)	(\$4,338)	(\$5,358)	(\$3,569)	(\$20,491)	(\$6,934)				(\$40,088)	(\$17,567)	(\$4,536)

Guidance
FNAs
Revenue

76k - 83k
\$38M - \$43M

Notes:

Source: Company reports and Leerink Partners estimates

Disclosures Appendix

Analyst Certification

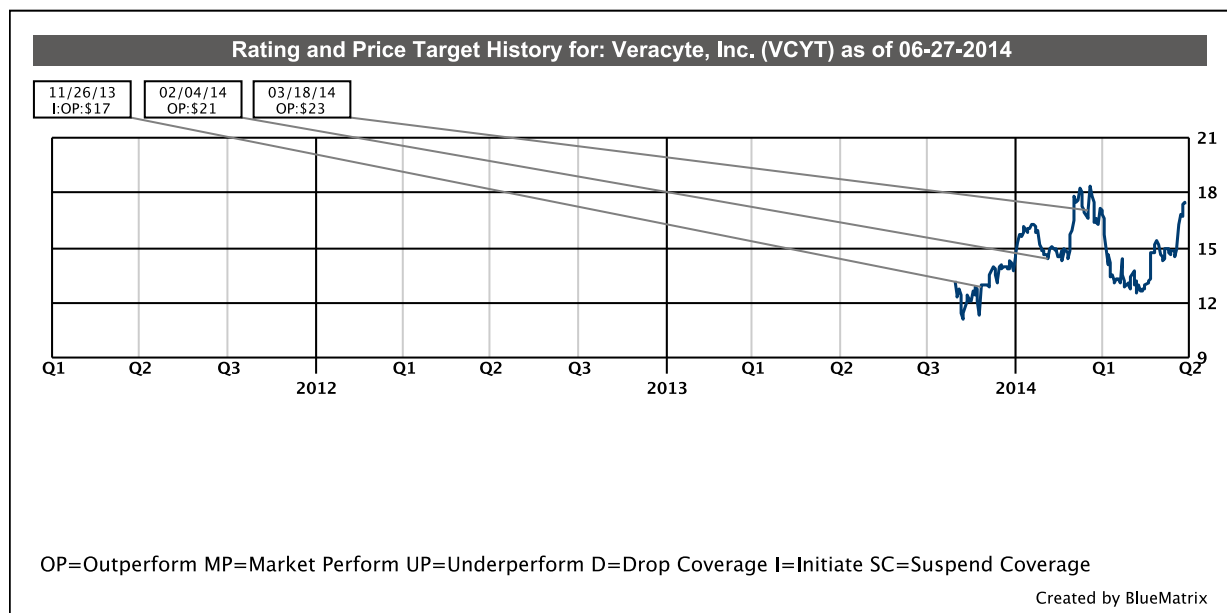
I, Dan Leonard, certify that the views expressed in this report accurately reflect my views and that no part of my compensation was, is, or will be directly related to the specific recommendation or views contained in this report.

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Distribution of Ratings/Investment Banking Services (IB) as of 03/31/14				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OP]	131	68.23	46	35.11
HOLD [MP]	61	31.77	3	4.92
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 has acted as the manager for a public offering of Veracyte, Inc. in the past 12 months.

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