

## Veracyte, Inc.

### Analyst Day Points to Continued Payer Traction and a Pipeline That Is Getting Closer to Fruition

On Thursday, October 9, we attended Veracyte's investor day in New York. In summary, despite the recent stock weakness, we see no change in fundamentals. The company continues to get payer traction—announcing its first two commercial payer contracts with UnitedHealthcare (UNH \$85.39) and Cigna (CI \$91.31) (effective by the end of 2014 and covering an estimated combined 40 million lives). Conversion of coverage decisions to contracts should drive increased adoption of the Afirma GEC and allow the company to switch to accrual accounting for these lives (driving potentially \$5 million of revenue upside in 2015). The meeting also highlighted Veracyte's pipeline, which continues to come closer to fruition and could more than double the company's total addressable market to \$2 billion.

The stock is trading at an enterprise value of 1.8 times projected 2015 sales and has pulled back 54% from its 52-week high. In our view, the stock valuation does not reflect the broader picture that Veracyte continues to gain meaningful traction with its Afirma assay in thyroid (GEC volume was up 55% in the first half of 2014) and with payers as well as the company's pipeline of pulmonology tests. Over the next year, there is potential for additional guideline inclusion (ATA [already in preliminary guidelines] and AACE) and large payer contract announcements (Aetna [AET \$78.70], Humana [HUM \$126.69], Intermountain), as well as continued positive payer coverage decisions. Veracyte continues to expand its internal salesforce; it now covers 16 territories, up from 8. Thus, we maintain our Outperform rating.

#### Key Conclusions

- UnitedHealthcare and Cigna are the first two commercial payers to go under contract, which took just over a year (currently under contract with Medicare). We would not be surprised to see additional contract announcements by the end of the year (possibly next earnings call) for other payers who made coverage decisions in 2013 like Aetna, Intermountain, and Humana. In our analysis, switching from cash to accrual accounting could pull forward \$5 million to \$10 million in revenue.
- Veracyte plans to launch its first lung cancer test in the second half of 2015 for proper diagnosis of lung nodules. Similar to the Afirma GEC, the test plans to reduce costly invasive procedures following a nondiagnostic bronchoscopy, placing more patients into monitoring. Veracyte obtained this technology/assay through the acquisition of Allegro. Thus far, two prospective multicenter clinical validation studies have been completed (Aegis I and Aegis II) with about a 93% NPV. Veracyte plans to perform clinical utility and cost-effectiveness studies before commercial launch.

*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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October 10, 2014

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

Symbol: VCYT (NASDAQ)  
Price: \$8.69 (52-Wk.: \$9-\$19)  
Market Value (mil.): \$194  
Fiscal Year End: December  
Long-Term EPS Growth Rate:  
Dividend/Yield: None

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

<b>Trading Data (FactSet)</b>	
Shares Outstanding (mil.)	21
Float (mil.)	11
Average Daily Volume	110,741

<b>Financial Data (FactSet)</b>	
Long-Term Debt/Total Capital (MRQ)	0.0
Book Value Per Share (MRQ)	2.1
Return on Equity (TTM)	-83.4

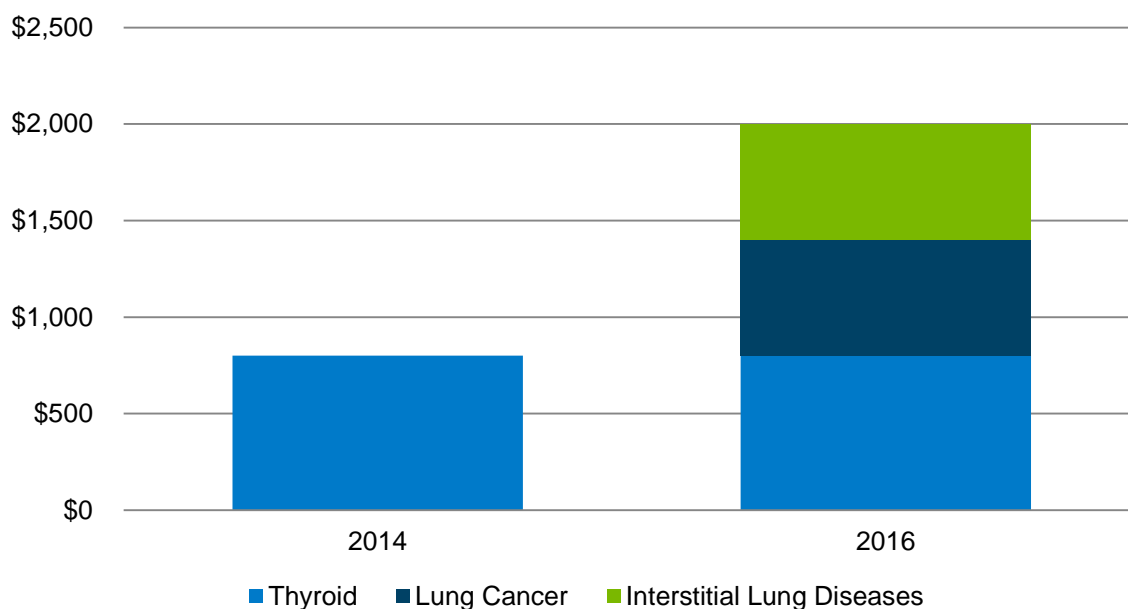
#### Two-Year Price Performance Chart



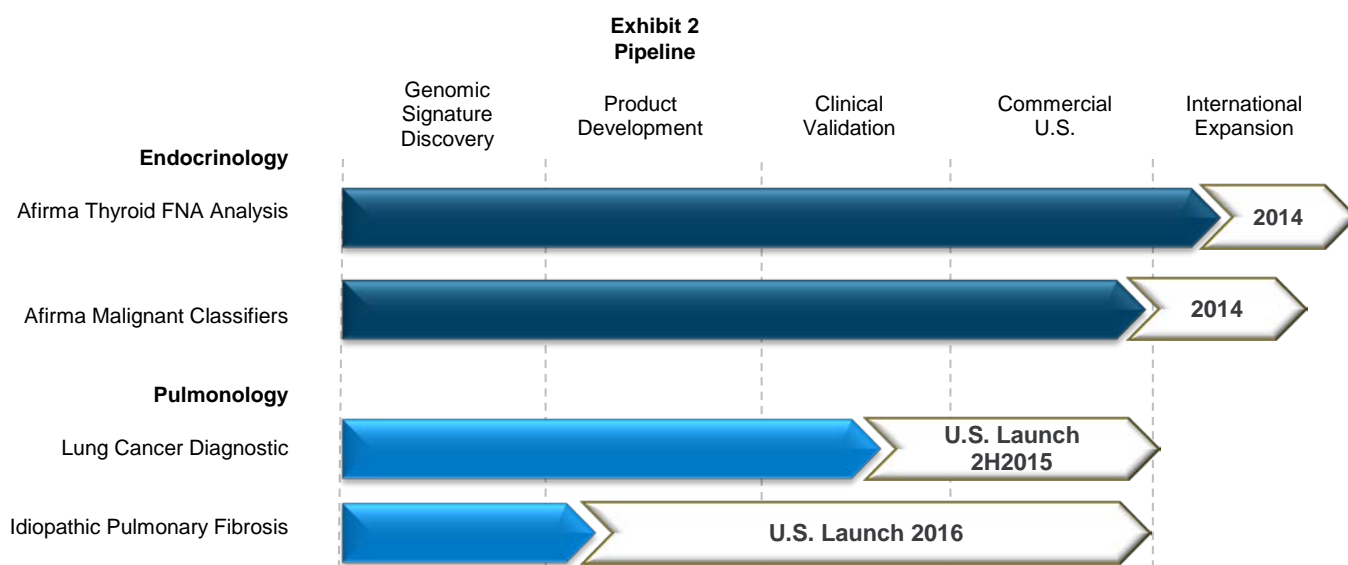
Sources: FactSet, William Blair & Company estimates

- Veracyte's second pulmonology product is for interstitial lung diseases (ILD), specifically to identify those patients with idiopathic pulmonary fibrosis (IPF), which is the deadliest ILD (roughly \$600 million market opportunity). The assay is in the product development phase (though initial findings look promising) with planned commercial launch in 2016 (roughly \$600 million market opportunity). Another interesting potential pipeline product discussed was a potential test that could be used to guide treatment after an assay is developed to identify IPF (there are currently two drugs in the pipeline for IPF, pirfenidone and nintedanib).
- Second-quarter results and FNA guidance reduction (which was driven by relatively higher adoption of Afirma within institutions accounts and academic centers) has caused investors to fear a lack of adoption from community endocrinologists. A couple of explanations were discussed: 1) doctors were hesitant to order a test not contracted as it could push additional cost onto patients; 2) unlike other areas in oncology (breast, colon, prostate), there has not been a lot of innovation in the practice, thus molecular diagnostics is a relatively new topic for some community doctors; and 3) an independent study published by the Moffitt Cancer Center and Mayo Clinic showed less compelling data than the clinical validation study published in the *New England Journal of Medicine* (although there is some debate around the relevancy of the sample population). Continued adoption by payers, however, points to the clinical validity and utility of the Afirma assay, in our view.

**Exhibit 1**  
**New Products to Double Total Addressable Market (\$ millions)**



Source: Company Reports



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

Our model is included on the following page.

# 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
<b>Margin Analysis:</b>														
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%
<b>Growth Metrics:</b>														
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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DOW JONES: 16,659.25

S&P 500: 1,928.21

NASDAQ: 4,378.34



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Coverage Universe	Percent	Inv. Banking Relationships*	Percent
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Market Perform (Hold)	31	Market Perform (Hold)	3
Underperform (Sell)	1	Underperform (Sell)	0

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