

Veracyte, Inc. (VCYT)

Overweight

2Q14 Preview, Modeling In-Line Results; No Additional BCBS Coverage; Remain OW

CONCLUSION

We are conducting our first preview after initiating coverage on Veracyte, with our expectations largely in-line with consensus. We are modeling an 86.2% revenue increase to \$9.4M (Street: \$9.4M), reflecting 17,850 FNAs received (+43.7% yoy, 24.2% qoq) and a 20.8% GEC test rate. Additionally, we expect modest revenue contribution (\$161K) from malignancy classifiers and Afirma OUS (Brazil), with these two line items reflecting a point of upside to our estimates. Since initiating coverage, shares have remained essentially flat, while receiving both inclusion within preliminary American Thyroid Association guidelines and positive coverage decisions from Highmark and Horizon (both BCBS). While we do not anticipate additional coverage decisions in the quarter, we expect a beat and raise will drive shares higher. We remain Overweight with a \$21 PT.

- **Anticipate In-Line 2Q14:** We are modeling an 86.2% revenue increase to \$9.4M, in-line with Street expectations, with Afirma U.S. increasing 83.3% to \$9.3M as FNAs received grows 43.7% yoy (24.2% qoq) to 17,850. Additionally we forecast a 20.8% GEC test rate, in-line with management's 20%-22% guidance. We expect a \$12K and \$149K contribution from malignancy classifiers and Afirma OUS (Brazil) in the quarter, respectively, with our modest estimate reflecting a potential point of upside. We are forecasting a 1,460 bpts yoy GM improvement, as increased FNA and GEC volumes lead to lab efficiencies. Additionally, we anticipate opex as a % of revenue to decline to 126% (2Q13: 143%), as an increase in S&M is offset by R&D and G&A. All-in, our (\$0.33) estimate is in-line with the Street ((\$0.33)).
- **Key Items During The Quarter:** During the quarter, Veracyte announced inclusion within preliminary American Thyroid Association guidelines for using molecular testing to reduce unnecessary thyroid surgery (see our note [here](#)). Additionally, two Blue Cross Blue Shield payers (Highmark and Horizon) announced positive coverage decisions for Afirma (see our note [here](#)), with total BCBS payers increasing to four. We believe the guideline inclusion and additional BCBS coverage will lead to further conversion in the near-to-mid term. While our diligence did not uncover any unannounced BCBS coverage decisions, we expect management will update on the 2Q14 call. Additionally, BCBS North Carolina's medical policies are up for review 8/2014 (~2.9M covered) and we expect a majority of BCBS payers will review coverage 1H15.
- **2Q14 Conference Call:** Veracyte will release its 2Q14 results on 8/13/2014 after the market close, with a conference call scheduled to begin at 5:00PM EST (dial-in: 855-541-0980; passcode: 79445857).

RISKS TO ACHIEVEMENT OF PRICE TARGET

Veracyte risks include GEC adoption, private payer coverage and competition.

COMPANY DESCRIPTION

Veracyte develops molecular cytology tests; initially focusing on the thyroid FNA market.

YEAR	REVENUE (US\$ m)						EARNINGS PER SHARE (US\$)					
	Mar	Jun	Sep	Dec	FY	FY RM	Mar	Jun	Sep	Dec	FY	FY P/E
2014E	7.5A	9.4	10.5	13.5	40.9	7.8x	(0.32)A	(0.33)	(0.33)	(0.32)	(1.30)	NM
2015E	16.0	18.3	19.9	22.9	77.1	4.1x	(0.28)	(0.26)	(0.23)	(0.20)	(0.97)	NM
2016E	—	—	—	—	117.4	2.7x	—	—	—	—	(0.30)	NM

PRICE: US\$14.77

TARGET: US\$21.00

4.6x F2016 EV/Rev (net cash/share: \$1.82, s/o: 27.5M)

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Changes	Previous	Current
Rating	—	Overweight
Price Tgt	—	US\$21.00
FY15E Rev (mil)	—	US\$77.1
FY16E Rev (mil)	—	US\$117.4
FY15E EPS	—	US\$(0.97)
FY16E EPS	—	US\$(0.30)
52-Week High / Low	US\$19.00 / US\$10.88	
Shares Out (mil)	21.6	
Market Cap. (mil)	US\$319.0	
Avg Daily Vol (ooo)	83	
Book Value/Share	US\$2.38	
Net Cash Per Share	US\$2.81	
Debt to Total Capital	9%	
Div (ann)	US\$0.00	
Fiscal Year End	Dec	

Price Performance - 1 Year



Source: Bloomberg

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Veracyte

Income Statement

Fiscal Year End: December 31

(\$ in Thousands)

Updated as of 6/18/2014

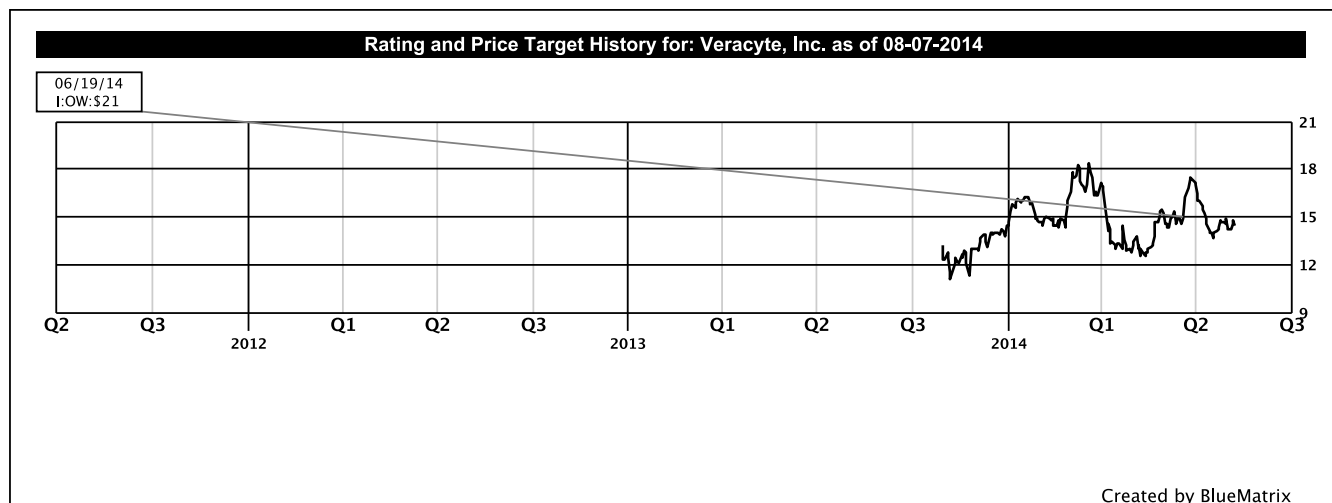
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	2013A				2014E				2015E				Annual				
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	2012A	2013A	2014E	2015E	2016E
	Qtr 1 A	Qtr 2 A	Qtr 3 A	Qtr 4 A	Qtr 1 A	Qtr 2 E	Qtr 3 E	Qtr 4 E	Qtr 1 E	Qtr 2 E	Qtr 3 E	Qtr 4 E					
Product Revenue	4,384	5,068	5,594	6,838	7,476	9,438	10,506	13,470	16,033	18,292	19,873	22,913	11,628	21,884	40,889	77,111	117,415
Total Revenue	4,384	5,068	5,594	6,838	7,476	9,438	10,506	13,470	16,033	18,292	19,873	22,913	11,628	21,884	40,889	77,111	117,415
Cost of Goods Sold	2,773	3,231	3,132	3,471	3,607	4,635	5,206	6,654	7,815	8,689	9,038	9,916	7,584	12,607	20,102	35,459	47,622
COGS - Product	2,773	3,231	3,132	3,471	3,607	4,635	5,206	6,654	7,815	8,689	9,038	9,916	7,584	12,607	20,102	35,459	35,180
Gross Profit	1,611	1,837	2,462	3,367	3,869	4,803	5,300	6,815	8,218	9,603	10,835	12,997	4,044	9,277	20,787	41,652	69,793
Operating Expenses:																	
Research & Development	2,010	1,902	2,028	1,870	2,126	2,265	2,311	2,425	2,565	2,744	2,782	2,864	6,608	7,810	9,127	10,955	13,156
Sales & Marketing	2,703	2,615	3,291	3,931	4,336	5,474	6,022	7,376	8,094	9,037	9,597	10,839	8,447	12,540	23,208	37,568	47,274
General & Administrative	2,791	2,737	3,244	3,328	3,982	4,153	4,097	4,041	4,249	4,390	4,372	4,468	7,918	12,100	16,273	17,479	16,875
Total Operating Expense	7,504	7,254	8,563	9,129	10,444	11,892	12,431	13,842	14,908	16,171	16,751	18,171	22,973	32,450	48,608	66,002	77,305
Operating Income (Loss)	(5,893)	(5,417)	(6,101)	(5,762)	(6,575)	(7,088)	(7,131)	(7,027)	(6,691)	(6,569)	(5,916)	(5,174)	(18,929)	(23,173)	(27,821)	(24,350)	(7,512)
Interest Income (Expense)	0	(5)	(126)	(97)	(111)	(138)	(157)	(174)	(190)	(117)	(130)	(145)	2	(228)	(581)	(581)	(670)
Other Income (Expense)	(1,002)	(1,068)	(76)	(33)	12	0	0	0	0	0	0	0	278	(2,179)	12	0	0
Pretax Income (Loss)	(6,895)	(6,490)	(6,303)	(5,892)	(6,674)	(7,226)	(7,288)	(7,201)	(6,880)	(6,686)	(6,046)	(5,319)	(18,649)	(25,580)	(28,390)	(24,931)	(8,182)
Provision for Income Taxes	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net Income (Loss) - Reported	(6,895)	(6,490)	(6,303)	(5,892)	(6,674)	(7,226)	(7,288)	(7,201)	(6,880)	(6,686)	(6,046)	(5,319)	(18,649)	(25,580)	(28,390)	(24,931)	(8,182)
Non-Reoccurring Items	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net Income (Loss) - Ongoing	(6,895)	(6,490)	(6,303)	(5,892)	(6,674)	(7,226)	(7,288)	(7,201)	(6,880)	(6,686)	(6,046)	(5,319)	(18,649)	(25,580)	(28,390)	(24,931)	(8,182)
Diluted EPS (Reported)	(\$9.04)	(\$7.53)	(\$6.59)	(\$0.42)	(\$0.32)	(\$0.33)	(\$0.33)	(\$0.32)	(\$0.28)	(\$0.26)	(\$0.23)	(\$0.20)	(\$28.66)	(\$6.19)	(\$1.30)	(\$0.97)	(\$0.30)
Diluted EPS (Ongoing, Inc. SBC)	(\$9.04)	(\$7.53)	(\$6.59)	(\$0.42)	(\$0.32)	(\$0.33)	(\$0.33)	(\$0.32)	(\$0.28)	(\$0.26)	(\$0.23)	(\$0.20)	(\$28.66)	(\$6.19)	(\$1.30)	(\$0.97)	(\$0.30)
Avg. Share Outstanding, Diluted	763	862	956	13,944	21,148	21,648	22,148	22,648	24,837	25,337	25,837	26,337	650	4,131	21,898	25,587	27,512
Expense Variables:																	
Cost of Goods Sold (Product)	63.3%	63.7%	56.0%	50.8%	48.3%	49.1%	49.6%	49.4%	48.7%	47.5%	45.5%	43.3%	65.2%	57.6%	49.2%	46.0%	40.6%
Cost of Goods Sold (Royalties/License)	NM	NM	NM	NM	NM	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	NM	NM	NM	NM	NM
Research & Development	45.8%	37.5%	36.3%	27.3%	28.4%	24.0%	22.0%	18.0%	16.0%	15.0%	14.0%	12.5%	56.8%	35.7%	22.3%	14.2%	11.2%
Sales & Marketing	61.7%	51.6%	58.8%	57.5%	58.0%	58.0%	57.3%	54.8%	50.5%	49.4%	48.3%	47.3%	NM	35.7%	22.3%	14.2%	11.2%
General & Administrative	63.7%	54.0%	58.0%	48.7%	53.3%	44.0%	39.0%	30.0%	26.5%	24.0%	22.0%	19.5%	68.1%	55.3%	39.8%	22.7%	14.4%
Total Operating Expenses	171.2%	143.1%	153.1%	133.5%	139.7%	126.0%	118.3%	102.8%	93.0%	88.4%	84.3%	79.3%	197.6%	148.3%	118.9%	85.6%	65.8%
Effective Interest Rate, Debt	0.0%	0.0%	0.0%	0.0%	2.2%	6.1%	6.1%	6.1%	6.1%	6.1%	6.1%	6.1%	0.0%	0.3%	1.3%	1.0%	1.2%
Ongoing 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%	0.0%	0.0%	0.0%
Margin Analysis:																	
Gross Margin (Product Sales)	36.7%	36.3%	44.0%	49.2%	51.7%	50.9%	50.4%	50.6%	51.3%	52.5%	54.5%	56.7%	34.8%	42.4%	50.8%	54.0%	59.4%
Operating Margin	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
Pretax Margin	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
Net Income Margin	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM
YoY Growth Rates:																	
Product Revenue	298.6%	204.5%	173.5%	153.4%	170.5%	186.2%	187.8%	197.0%	214.5%	193.8%	189.2%	170.1%	NM	88.2%	86.8%	88.6%	52.3%
Net Income (Ongoing)	62.3%	40.3%	27.6%	21.8%	-3.2%	11.4%	15.6%	22.2%	3.1%	-7.5%	-17.0%	-26.1%	NM	37.2%	11.0%	-12.2%	-67.2%
EPS (Ongoing)	32.6%	6.3%	-12.0%	-94.2%	-96.5%	-95.6%	-95.0%	-24.8%	-12.2%	-21.0%	-28.9%	-36.5%	NM	-78.4%	-79.1%	-24.8%	-69.5%
Other Data:																	
Days Sales Outstanding	NM	71.4	46.6	61.0	58.2	56.2	60.8	52.1	52.1	45.6	42.4	42.9	NM	19.1	18.4	13.4	12.9
EBITDA Per Share	(\$7.34)	(\$5.99)	(\$6.01)	(\$0.40)	(\$0.30)	(\$0.31)	(\$0.31)	(\$0.30)	(\$0.26)	(\$0.25)	(\$0.22)	(\$0.19)	(\$27.68)	(\$5.34)	(\$1.22)	(\$0.91)	(\$0.24)
Free Cash Flow Per Share	(\$8.09)	(\$3.85)	(\$5.39)	(\$0.25)	(\$0.32)	(\$0.35)	(\$0.32)	(\$0.28)	(\$0.32)	(\$0.21)	(\$0.23)	(\$0.22)	(\$29.05)	(\$4.92)	(\$1.28)	(\$0.98)	(\$0.10)
Net Debt (Cash) Per Share	(\$9.42)	(\$18.54)	(\$11.17)	(\$4.76)	(\$2.81)	(\$2.40)	(\$2.04)	(\$1.72)	(\$2.74)	(\$2.48)	(\$2.20)	(\$1.95)	(\$21.72)	(\$16.12)	(\$1.78)	(\$2.01)	(\$1.82)
S&M Expenses																	
% of Revenue Shared With Genzyme	40%	40%	40%	40%	37%	32%	32%	32%	32%	32%	32%	32%	50%	40%	32%	30%	30%
Genzyme Promotion Expense	1,754	2,027	2,238	2,735	2,791	2,973	3,291	4,144	4,888	5,562	6,020	6,944	5,814	8,754	13,198	23,413	35,051
Genzyme Fee Amortized	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)	(625)					
Core S&M Expense	1,574	1,213	1,678	1,821	2,170	2,501	2,732	3,233	3,207	3,475	3,577	3,895	5,133	6,286	10,636	14,154	12,223
Total S&M Expense	2,703	2,615	3,291	3,931	4,336	5,474	6,022	7,376	8,094	9,037	9,597	10,839	8,447	12,540	23,208	37,568	47,274
Core S&M Expense % of Revenue	36%	24%	30%	27%	29%	27%	26%	24%	20%	19%	18%	17%	44%	29%	26%	18%	10%

Current disclosure information for this company is located at

IMPORTANT RESEARCH DISCLOSURES



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R: Resuming Coverage
T: Transferring Coverage
D: Discontinuing Coverage
S: Suspending Coverage
OW: Overweight
N: Neutral
UW: Underweight
NA: Not Available
UR: Under Review

Distribution of Ratings/IB Services Piper Jaffray				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OW]	359	61.68	94	26.18
HOLD [N]	212	36.43	23	10.85
SELL [UW]	11	1.89	0	0.00

Note: Distribution of Ratings/IB Services shows the number of companies currently in each rating category from which Piper Jaffray and its affiliates received compensation for investment banking services within the past 12 months. FINRA rules require disclosure of which ratings most closely correspond with "buy," "hold," and "sell" recommendations. Piper Jaffray ratings are not the equivalent of buy, hold or sell, but instead represent recommended relative weightings. Nevertheless, Overweight corresponds most closely with buy, Neutral with hold and Underweight with sell. See Stock Rating definitions below.

Analyst Certification — William R. Quirk, CFA, Sr Research Analyst — David C. Clair, CFA, Research Analyst

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