

Reason for report:

**EARNINGS****VERACYTE, INC.****Strong Collections Offset Tough Weather; Catalysts Imminent**

• **Bottom Line:** We see several catalysts in 2014 and highlight Outperform-rated VCYT as one of our top small-cap picks. We maintain our PT at \$23, which represents 83% upside from today's close.

• **Strong collections offset tough weather.** VCYT reported 1Q14 revenue of \$7.5M, which exceeded our estimate of \$7.2M. The top-line beat versus our model was driven by a higher GEC (Gene Expression Classifier) ratio as well as strong collections. Volume of 14.4k thyroid nodule fine needle aspirate (FNA) samples fell shy of our 15.4k forecast due to inclement weather, which the company estimates might have dampened volume by 8% - 10%. GM of 51.8% was higher than our model while opex was lower.

• **First Blues payer contracted; first international market entered.** VCYT gained positive coverage decisions with a number of commercial health plans during the quarter, including its first Blues plan, Premera (1.6M covered lives). This and other decisions follow a positive coverage decision by EmblemHealth (3.4M covered lives) in Feb 2014. VCYT's Afirma thyroid test has now been deemed medically necessary by plans covering >125M lives. VCYT also announced the entry into its first international market, Brazil, through a partnership with Fleury (NR), and we anticipate further international expansion later this year.

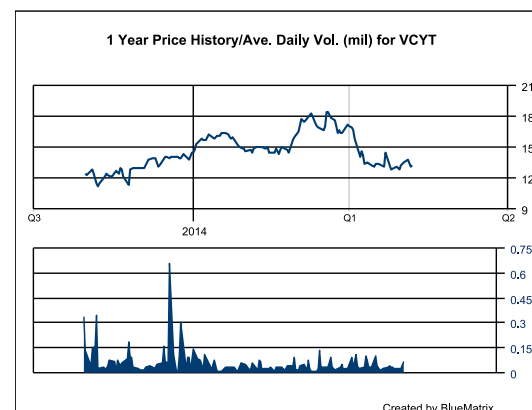
• **Afirma Malignant Classifier launch imminent.** Four presentations supporting the use of the Afirma Malignant Classifier will be presented at the upcoming American Association of Clinical Endocrinologists (AACE) Congress from May 14 – 18. This enhancement to the Afirma assay enables a practitioner to request to test for the presence of medullary thyroid cancer and BRAF mutational status; the additional data points could influence the physician's ultimate treatment strategy.

• **Key catalysts at upcoming conferences.** We see a number of potential catalysts at upcoming American Thoracic Society (ATS) and the Endocrine Society (ICE/ENDO) annual meetings. The ATS has accepted VCYT's abstract to present proof of concept data for its lung program. Also, the American Thyroid Association (ATA) will be reviewing clinical practice guidelines at the ICE/ENDO meeting. Inclusion of Afirma would clearly be positive for test adoption and reimbursement though this is already factored into company guidance.

• **Estimates little changed following quarter.**

**Key Stats:****(NASDAQ:VCYT)**

<b>S&amp;P 600 Health Care Index:</b>	<b>1,199.05</b>
<b>Price:</b>	<b>\$12.58</b>
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):	\$265.4
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 - New	<b>\$7.5A</b>	<b>\$9.1</b>	<b>\$10.2</b>	<b>\$13.0</b>	<b>\$39.7</b>	<b>(\$0.32)A</b>	<b>(\$0.38)</b>	<b>(\$0.38)</b>	<b>(\$0.33)</b>	<b>(\$1.41)</b>	<b>NM</b>
2014E - Old	\$7.2	\$9.5	\$9.9	\$12.9	\$39.5	(\$0.35)	(\$0.34)	(\$0.34)	(\$0.27)	(\$1.31)	NM
2015E - New	--	--	--	--	<b>\$75.7</b>	--	--	--	--	<b>(\$0.94)</b>	<b>NM</b>
2015E - Old	--	--	--	--	\$75.2	--	--	--	--	(\$0.93)	NM
2016E - New	--	--	--	--	<b>\$111.6</b>	--	--	--	--	<b>(\$0.12)</b>	<b>NM</b>
2016E - Old	--	--	--	--	\$110.3	--	--	--	--	(\$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	483	529	540
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)	(2,772)
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)	(\$2,772)
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)				(\$36,836)	(\$11,141)	\$3,099
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)				(\$40,237)	(\$17,713)	(\$4,609)

## Guidance

FNAs

Revenue

76k - 83k

\$38M - \$43M

## Notes:

Source: Company reports and Leerink Partners estimates

## Disclosures Appendix

### Analyst Certification

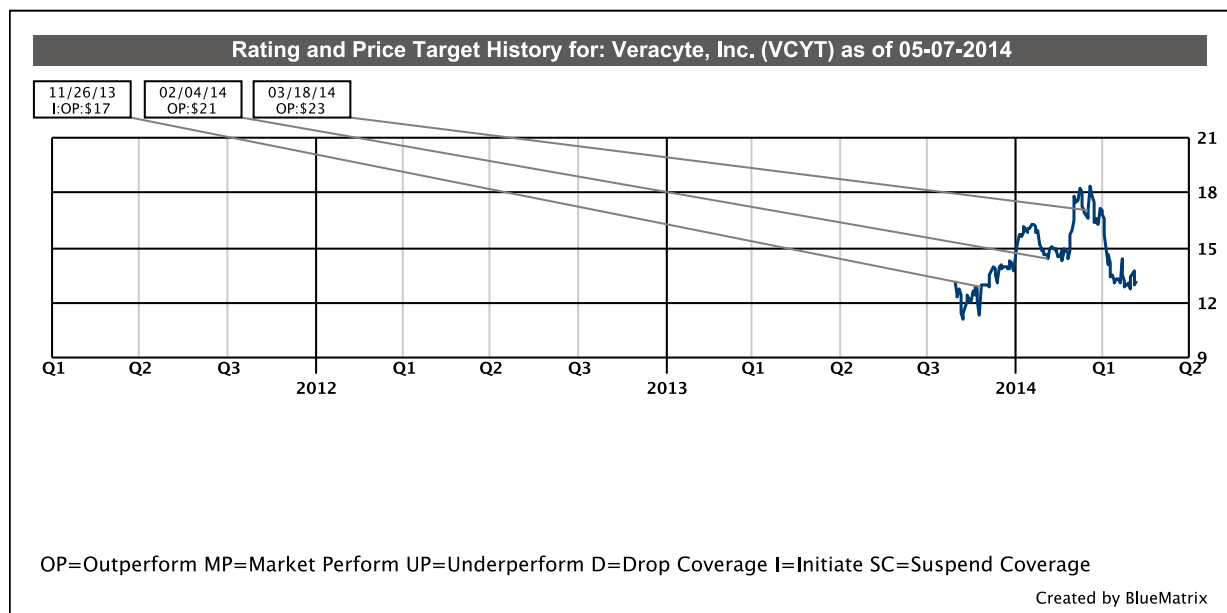
I, Dan Leonard, certify that the views expressed in this report accurately reflect my views and that no part of my compensation was, is, or will be directly related to the specific recommendation or views contained in this report.

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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.

## Important Disclosures

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**In the past 12 months, the Firm has received compensation for providing investment banking services to Veracyte, Inc. .**

**Leerink Partners LLC makes a market in Veracyte, Inc.**

**Leerink Partners LLC has acted as the manager for a public offering of Veracyte, Inc. in the past 12 months.**

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