

Foundation Medicine, Inc.

Solid Heme Volume and Salesforce Expansion Position the Company Well for Future Growth

- On Wednesday, May 7, Foundation Medicine announced first-quarter results that were in line with expectations, though uptake of the FoundationOne Heme assay was notably strong. Revenue of \$11.5 million was essentially in line with our estimate of \$11.6 million and slightly above Street consensus at \$11.3 million. Net loss per share was \$0.44, above our and the Street estimate of a \$0.49 loss. The company reiterated 2014 guidance of 22,000 to 25,000 clinical tests and revenue of \$52 million to \$58 million, which compares with consensus of \$58.6 million.
- During the quarter, the company reported 4,702 clinical tests (above our 4,560 estimate and representing sequential growth of 25%), suggesting the company continues to get meaningful traction. We were surprised by the adoption of the Heme test out of the gate; the company performed 715 Heme tests and 3,987 solid tumor tests (17% sequential growth). Roughly 350 of the clinical cases performed in the fourth quarter were driven by the soft launch of FoundationOne Heme and thus saw 100% sequential growth in the first quarter. On the other hand, some of those doctors ordering Heme may have otherwise ordered solid tumor, perhaps suggesting (especially for peds and sarcoma) some “cannibalization.”
- The company continues to struggle with obtaining payment from its Medicare MAC, NGS; the company started submitting claims to Medicare at the end of 2013 and to date has not received payment on any of those claims. The AMA MoPath committee recently published the next-generation sequencing codes that it will introduce in 2015; the committed opted to create two categories of solid tumor somatic NGS panels (50 genes and below and above 50 genes). While there is still a lot of uncertainty about how these codes will ultimately be priced via the gap-fill process, we view it as an encouraging sign that the AMA recognizes the varying complexity of solid tumor alteration panels. We continue to assume the company starts to be paid for Medicare claims beginning in mid-2015.
- We note that the largest barrier to adoption continues to be education (educating payers and physicians about FoundationOne and its benefits), not competitive hotspot panels. Since the IPO, the company has more than doubled its salesforce from 18 reps to 43 reps. Thus, we expect further adoption from community practices (54% of tests ordered were from community practices and 46% from academic centers) as the new sales reps climb the learning curve and get out into the field.
- Stock Thoughts and Valuation.** The stock is trading at 6.3 times enterprise-value-to-2015-sales estimates, below its average of 6.7 times since the IPO. Also, the stock is now 38% of its 52-week high and 40% above its 52-week low. We are encouraged by the rapid growth in FoundationOne Heme assay and continued growth (albeit slower) of the solid tumor assay. Still, we believe valuation already incorporates robust expectations for market share and reimbursement and therefore maintain our Market Perform rating.

Foundation Medicine is a CLIA-certified lab that generates revenue from its molecular information platform. Foundation leverages next-generation sequencing technology to provide genomic profiles of cancer, offering physicians individualized information about actionable alterations specific to each patient's tumor, enabling optimization of treatment.

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May 08, 2014

Stock Rating: **Market Perform**
Company Profile: **Aggressive Growth**

Symbol: FMI (NASDAQ)
Price: \$27.99 (52-Wk.: \$20-\$45)
Market Value (mil.): \$787
Fiscal Year End: December
Long-Term EPS Growth Rate:
Dividend/Yield: None

	2013A	2014E	2015E
Estimates			
EPS FY	\$-1.57	\$-1.92	\$-1.53
CY		\$-1.92	\$-1.53
Sales (mil.)	29	57	105
Valuation			
FY P/E	NM	NM	NM
CY P/E		NM	NM

Trading Data (FactSet)	
Shares Outstanding (mil.)	28
Float (mil.)	12
Average Daily Volume	266,946

Financial Data (FactSet)	
Long-Term Debt/Total Capital (MRQ)	0.0
Book Value Per Share (MRQ)	4.8
Return on Equity (TTM)	-32.2

Two-Year Price Performance Chart



Sources: FactSet, William Blair & Company estimates

- Revenue Detail.** Reported revenue was \$11.45 million, of which \$7.1 million came from clinical testing (below our estimate of \$7.8 million) and \$4.3 million from biopharmaceutical customers (above our estimate of \$3.8 million). Total volume was 5,553 tests, including 4,702 clinical tests and 851 tests to biopharmaceutical customers. Realized average revenue per clinical test was \$1,510 compared with our estimate of \$1,705 driven by strong uptake from the Heme assay given dynamics of cash accounting (the company is recognizing expenses for the new Heme, while revenue will be recognized upon cash receipt in later quarters). Average revenue per clinical test recognized in the quarter was \$3,400, in line with our estimate of \$3,479.
- Margin Detail.** Gross margin was 54%, below our estimate of 57% and slightly below the guided range of 55% to 65%, driven by Foundation Heme tests that were performed for which revenue has not been collected. Sales and marketing expense was \$5.7 million compared with our estimate of \$5.3 million as a result of increased rep count. General and administrative expense was \$1.7 million below our estimate of \$7.4 million at \$5.7 million. Research and development expense was \$6.9 million, below our estimate of \$7.5 million.
- Model Update.** For 2014, we now model revenue of \$57.3 million, down from \$57.7 million as a result of lower first-quarter results and realized ASP. Our gross margin estimate remains unchanged at 60%. Within operating expenses, we increased sales and marketing expense by \$3.5 million, to \$29.4 million from \$25.9 million. Given lower-than-expected general and administrative expenses in the first quarter, we lower our full-year estimate to \$27 million, down from \$31 million. Also, we lowered our estimate for research and development expense to \$31 million from \$33 million. Our 2014 net loss per share of \$1.92 is up from our prior estimate of a \$1.96 loss. For 2015, we model revenue of \$105 million and net loss per share of \$1.53 compared with our prior estimates of \$105 million and \$1.66, respectively.

Foundation Medicine, Inc. First-Quarter Variance Analysis						
(\$ in thousands, Fiscal year ends December)						
	1Q 2014 Actual	1Q 2013 Actual	Year/Year %Change	1Q 2014 Estimate	Year/Year %Change	Actual-Est.
Net Sales	\$11,455	\$5,200	120.3%	\$11,619	-55.2%	-\$164.4
Cost of Sales	\$5,291	\$2,378	122.5%	\$4,996	-52.4%	\$294.7
Gross Profit	\$6,164	\$2,822	118.4%	\$6,623	-57.4%	-\$459.1
Sales & Marketing	\$5,690	\$1,811	214.2%	\$5,229	-65.4%	\$461.3
General & Administrative	\$5,700	\$3,150	81.0%	\$7,436	-57.6%	-\$1,736.4
Research & Development	\$6,915	\$4,982	38.8%	\$7,553	-34.0%	-\$637.6
Operating Income	-\$12,141	-\$7,121	70.5%	-\$13,595	-47.6%	\$1,453.7
Interest & Other	-\$25	-\$82	-69.5%	-\$31	167.1%	\$5.7
Net Income/Loss	-\$12,166	-\$7,203	68.9%	-\$13,625	-47.1%	\$1,459.4
Convertible Preferred Stock	\$0	\$50	-100.0%	\$0	NM	\$0.0
Net Income Common Shareh	-\$12,166	-\$7,253	67.7%	-\$13,625	-46.8%	\$1,459.4
W. Avg. Shares (Diluted)	27,734	27,355	1.4%	28,005	-2.3%	-271
EPS	-\$0.44	-\$0.27	65.4%	-\$0.49	-45.5%	\$0.05
Margin Analysis						<i>BPS</i>
Gross Margin	53.8%	54.3%	-0.5%	57.0%	-2.7%	-319
Sales & Marketing	49.7%	34.8%	14.8%	45.0%	-10.2%	467
General & Administrative	49.8%	60.6%	-10.8%	64.0%	-3.4%	-1424
Research & Development	60.4%	95.8%	-35.4%	65.0%	30.8%	-463
Operating Income	-106.0%	-136.9%	31.0%	-117.0%	-19.9%	1101
Taxes	0.0%	-0.7%	0.7%	0.0%	-0.7%	0
Net Income	-106.2%	-139.5%	33.3%	-117.3%	-22.2%	1106
Clinical Revenue	\$7,100	\$2,300	208.7%	\$7,774	238.0%	-\$674
Clinical Tests	4,702	1,140	312.5%	4,560	300.0%	142
Revenue/Tests	\$1,510	\$2,018	-25.2%	\$1,705	-15.5%	-\$195

Source: Company Reports and William Blair & Company L.L.C. estimates

Foundation Medicine Projected Income Statement (2011 to 2017E)

	FY 2011	FY 2012	2013 Q1'13	2013 Q2'13	2013 Q3'13	2013 Q4'13	FY 2013	2014 Q1'14	2014 Q2'14E	2014 Q3'14E	2014 Q4'14E	FY 2014E	FY 2015E	FY 2016E	FY 2017E
Revenues	\$2,057	\$10,645	\$5,200	\$5,920	\$8,208	\$9,662	\$28,990	\$11,455	\$13,154	\$15,265	\$17,396	\$57,270	\$105,327	\$191,612	\$278,879
Cost of Goods Sold	\$258	\$5,681	\$2,378	\$2,219	\$2,858	\$4,204	\$11,659	\$5,291	\$5,393	\$5,953	\$6,436	\$23,074	\$34,611	\$51,052	\$63,281
Gross Profit	\$1,799	\$4,964	\$2,822	\$3,701	\$5,350	\$5,458	\$17,331	\$6,164	\$7,761	\$9,312	\$10,959	\$34,196	\$70,715	\$140,560	\$215,597
Operating Expenses															
Sales & Marketing	\$1,555	\$3,454	\$1,811	\$2,875	\$3,038	\$4,602	\$12,326	\$5,690	\$7,103	\$7,938	\$8,698	\$29,429	\$38,683	\$51,767	\$65,289
General and Administrative	\$6,992	\$8,644	\$3,150	\$4,755	\$6,448	\$7,512	\$21,865	\$5,700	\$6,708	\$7,175	\$7,654	\$27,237	\$36,795	\$45,303	\$54,770
Research & Development	\$9,023	\$14,777	\$4,982	\$6,097	\$6,988	\$6,834	\$24,901	\$6,915	\$7,366	\$7,938	\$8,524	\$30,743	\$38,133	\$48,324	\$62,500
Total Operating Expenses	\$17,570	\$26,875	\$9,943	\$13,727	\$16,474	\$18,948	\$59,092	\$18,305	\$21,178	\$23,050	\$24,876	\$87,409	\$113,611	\$145,394	\$182,559
Operating Income	-\$15,771	-\$21,911	-\$7,121	-\$10,026	-\$11,124	-\$13,490	-\$41,761	-\$12,141	-\$13,417	-\$13,739	-\$13,916	-\$53,213	-\$42,896	-\$4,834	\$33,038
Interest Expense	\$421	\$421	\$76	\$65	\$61	\$33	\$235	\$25	\$27	\$26	\$23	\$101	\$65	\$50	\$76
Other Non-Operating Expenses	\$845	\$61	\$6	\$96	\$1,278	-\$432	\$948	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Net Income/Loss	-\$17,037	-\$22,393	-\$7,203	-\$10,187	-\$12,463	-\$13,091	-\$42,944	-\$12,166	-\$13,444	-\$13,764	-\$13,939	-\$53,314	-\$42,961	-\$4,883	\$32,962
Taxes	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$816	\$6,592
Convertible Preferred Stock	\$296	\$286	\$50	\$42	\$47	\$0	\$139	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Net Income Common Shareholders	-\$17,333	-\$22,679	-\$7,253	-\$10,229	-\$12,510	-\$13,091	-\$43,083	-\$12,166	-\$13,444	-\$13,764	-\$13,939	-\$53,314	-\$42,961	-\$5,699	\$26,370
Basic & Diluted EPS	-\$0.62	-\$0.83	-\$0.27	-\$0.37	-\$0.46	-\$0.48	-\$1.57	-\$0.44	-\$0.48	-\$0.49	-\$0.50	-\$1.92	-\$1.53	-\$0.20	\$0.92
Weighted Avg. Shares - Basic & Diluted	28,138	27,230	27,355	27,405	27,455	27,505	27,430	27,734	27,784	27,834	27,884	27,809	28,071	28,371	28,671
<i>Margin Analysis:</i>															
Gross Margin	87%	47%	54%	63%	65%	56%	60%	54%	59%	61%	63%	60%	67%	73%	77%
Sales & Marketing	76%	32%	35%	49%	37%	48%	43%	50%	54%	52%	50%	51%	37%	27%	23%
General and Administrative	340%	81%	61%	80%	79%	78%	75%	50%	51%	47%	44%	48%	35%	24%	20%
Research & Development	439%	139%	96%	103%	85%	71%	86%	60%	56%	52%	49%	54%	36%	25%	22%
Interest Expense	7%	0.8%	0.6%	0.6%	0.7%	0.1%	0.5%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Operating Income	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	12%
Taxes	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	20%
Net Income/Loss	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	NM	13%
<i>Growth Metrics:</i>															
Revenue	NM	418%	750%	226%	170%	87%	172%	120%	122%	86%	80%	98%	84%	82%	46%
Cost of Goods Sold	NM	2102%	235%	98%	60%	104%	105%	122%	143%	108%	53%	98%	50%	47%	24%
Gross Profit	NM	176%	-3009%	432%	329%	75%	249%	118%	110%	74%	101%	97%	107%	99%	53%
Sales & Marketing	NM	222%	360%	341%	358%	366%	357%	314%	247%	261%	189%	239%	131%	134%	126%
General and Administrative	NM	124%	188%	235%	302%	267%	253%	181%	141%	111%	102%	125%	135%	123%	121%
Research & Development	NM	164%	165%	169%	196%	149%	169%	139%	121%	114%	125%	123%	124%	127%	129%
Operating Income	NM	39%	35%	73%	110%	144%	91%	70%	34%	24%	3%	27%	-19%	-89%	-784%
Net Income/Loss	NM	31%	32%	73%	127%	135%	92%	69%	32%	10%	6%	24%	-19%	-89%	-775%
EPS	NM	35%	30%	70%	123%	132%	89%	65%	30%	9%	5%	22%	-20%	-87%	-558%

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William Blair is a market maker in the security of Foundation Medicine, Inc. and may have a long or short position.

William Blair intends to seek investment banking compensation in the next three months from Foundation Medicine, Inc.

Additional information is available upon request.

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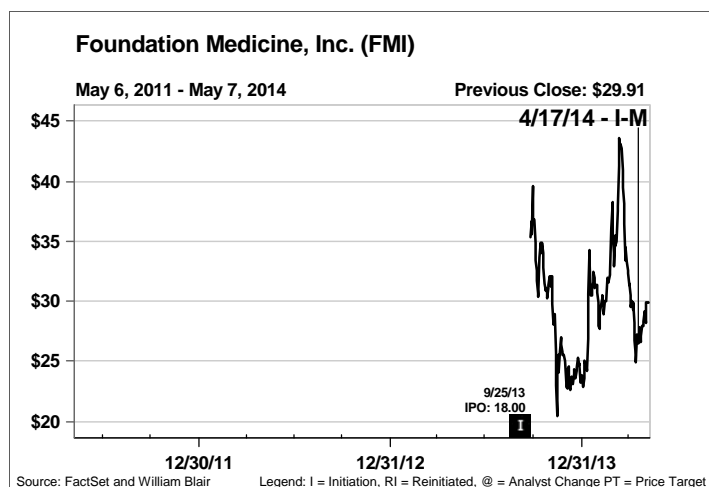
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DOW JONES: 16,518.54

S&P 500: 1,878.21

NASDAQ: 4,067.67



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Coverage Universe	Percent	Inv. Banking Relationships*	Percent
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Market Perform (Hold)	31	Market Perform (Hold)	2
Underperform (Sell)	1	Underperform (Sell)	0

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