

NanoString

4Q Review: No Surprises Post Preannouncement; Focus Remains on Prosigna Ramp

NanoString reported 4Q revenues of \$10.1M, in line with the January 13th preannouncement (see our take [here](#)) and consensus expectations at the time. Importantly, the company issued a 2014 outlook with sales of \$45-50M bracketing current sell-side forecasts and pointing to a backend-loaded year, due to the timing of the MolDX reimbursement decision and potential inclusion in NCCN guidelines. We continue to see room for upside as U.S. Prosigna adoption and an expanding base of nCounter systems drive strong growth in 2014, and maintain our Overweight rating, as we believe that NanoString remains well positioned to outgrow peers in its two attractive end markets. We are updating our DCF and revise our December 2014 price target to \$22. Please see our [initiation](#) for additional thoughts on the investment thesis.

- 4Q revenues in line with preannouncement...** 4Q13 revenues of ~\$10.1M were in line with JPMe (\$9.8M), as well as consensus (\$9.6M) at the time of the January 13th preannouncement. The company noted that it was particularly pleased with instrument revenue in the quarter of \$5.3M (+109% y/y), an optimistic leading indicator for future consumables and Prosigna kit sales. During 4Q, NanoString placed 6 Prosigna-capable systems (3 with LabCorp, Quest and ARUP Labs and another 3 with leading cancer centers), while Consumable revenue, including in-vitro diagnostic kits, came in at \$4.4M (+19% y/y). Gross margins of 52% increased ~300 bps vs. last year, driven by manufacturing scale efficiencies, which helped offset a mix shift towards higher instrument revenue. As a reminder, gross margin expansion over time (driven by consumables and the Prosigna ramp) is a key tenet of our thesis, and we were encouraged to see continued strength in this metric. On the bottom line, adjusted EPS (-\$0.51) came in better than JPMe (-\$0.65) and consensus (-\$0.60), due to higher gross margins and lower R&D and SG&A relative to our forecast.
- ...while early commentary on U.S. Prosigna ramp continues to be positive.** Following FDA approval last September and the LabCorp and Quest partnerships announced in December (LH and DGX are both covered by JPM analyst Lisa Gill), management noted that LabCorp launched the Prosigna test in January, and Quest and ARUP are expected to follow suit by the end of 1Q14. While internal validation at all three customers is complete, NanoString is working closely with them on developing commercial materials and refining the reimbursement strategy, following which they will collaborate to drive oncologist adoption in the field.

NanoString Technologies, Inc. (NSTG;NSTG US)

FYE Dec	2013A	2014E (Prev)	2014E (Curr)	2015E (Prev)	2015E (Curr)
Revenue (\$ mn)					
Q1 (Mar)	6	10	8	15	15
Q2 (Jun)	7	11	9	17	17
Q3 (Sep)	8	12	12	18	19
Q4 (Dec)	10	15	16	25	26
FY	31	48	45	76	77

Source: Company data, Bloomberg, J.P. Morgan estimates.

See page 8 for analyst certification and important disclosures.

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Overweight

NSTG, NSTG US

Price: \$18.41

▲ **Price Target: \$22.00**
Previous: \$20.00

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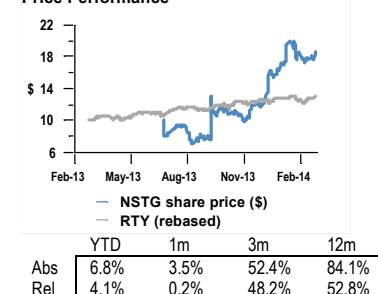
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Price Performance



Company Data

Price (\$)	18.41
Date Of Price	26 Feb 14
52-week Range (\$)	20.79-7.01
Market Cap (\$ mn)	184.10
Fiscal Year End	Dec
Shares O/S (mn)	10
Price Target (\$)	22.00
Price Target End Date	31-Dec-14

- **MolDX reimbursement decision and inclusion in NCCN guidelines in 2H14 remain two key catalysts for Prosigna adoption.** While NanoString received a unique Z-code from the McKesson Diagnostics Exchange in February, the company expects to hear on the MAAA CPT-code application shortly. NSTG is also pursuing discussions with Palmetto for inclusion in CMS's MolDX program and expects to receive a positive coverage decision by 3Q14 for states covered by Palmetto and Noridian (including North Carolina and California, the largest molecular diagnostic testing sites for LabCorp and Quest, respectively). Regarding guidelines, NSTG reiterated that it intends to apply for NCCN guideline inclusion in 1H14. Management noted that guidelines are updated annually around July, and the expectation is to be considered by the committee in summer 2014, implying inclusion in late 2014. Taken together, the timing around these two catalysts suggests a significantly backend-loaded year for U.S. Prosigna revenues. Outside the U.S., the rollout of Prosigna also continues to progress well, driven by a direct sales model in Europe coupled with distribution agreements in the Middle East and Asia. The company announced that it has now completed enrollment in the 200-patient decision impact study in Spain, seen accelerated enrollment in a similar study under way in Germany, and plans to launch a third study in the EU later this year. That said, reimbursement for genetic tests continues to be a gating factor for adoption in Europe and is not expected to come through in 2014.
- **nCounter Elements ramp should drive further system sales to clinical labs, while the new benchtop instrument is expected in late 2014.** NSTG concluded the early access program for nCounter Elements (a line of general purpose reagents designed to enable researchers to develop and translate multiplexed genomic assays into clinical diagnostics offered as lab developed tests) in 2H13, and expected the first commercialized diagnostic tests to emerge over the next couple quarters and accelerate in 2H14. NSTG expects the Elements ramp to first drive accelerated nCounter Dx instrument placements into clinical labs and only later have an impact on consumables revenue. In other pipeline updates, management announced that the company remains on track to launch the benchtop instrument in late 2014 (technical improvements on the platform are now complete and they are currently focused on the engineering aspect). As announced recently at AGBT, NanoString is also developing a new chemistry that could substantially increase the specificity of their probes, improving their ability to detect gene fusions and potentially allowing the nCounter system to detect mutations for the first time.
- **2014 guidance brackets consensus and points to a significantly backend-loaded year.** Management issued 2014 revenue guidance of \$45-50M (+43-59% y/y), which brackets current Street expectations of \$47M, with an expectedly backend-loaded year as a result of the MolDX/guideline decisions in the second half and their implications for the U.S. Prosigna ramp. We note that guidance assumes a positive MolDX coverage decision in the back half of the year. Gross margins are expected to be ~55-58% (once again, increasing sequentially through the year), with operating expenses in the \$70-75M range (front-end loaded as a result of the new hires in 2H13). The company expects a net operating loss of ~\$40-50M in 2014 with capex of ~\$3-4M. For 1Q, management expects revenue of \$8.3-8.8M (with no meaningful contribution from Prosigna due to the early stage of the ramp).
- **Modest changes to our estimates; reiterate Overweight rating and revise December 2014 price target to \$22.** We make modest adjustments to our model for the quarter and updated guidance, and now forecast 2014 sales of \$45M. As a result of our model update, we are increasing our DCF-based 2014 price target to \$22. Reiterate Overweight.

Figure 1: NSTG – 4Q Variance

	4Q12A		4Q13E				4Q13A				Variance vs. JPM Est.		Notes
	Actual		JPM Estimate		Consensus		Actual		Change y/y				
	\$ M	%	\$ M	%	\$ M	%	\$ M	%	Δ \$	Δ margin	\$ M	%	
Molecular Diagnostics	0.0		1.0				0.1				(1)		
Life Sciences	6.5		8.8				10.0				1		
Total Revenue	6.5		9.8		9.6		10.1		55.9%		0		
Gross Profit	3.3	50.3%	5.0	51.0%			5.3	52.4%	62.3%	209 bp	0	137 bp	
SG&A	(4.8)	74.3%	(9.3)	94.3%			(9.1)	89.8%	88.4%	1551 bp	0	-449 bp	
R&D	(3.5)	53.9%	(4.8)	48.9%			(4.5)	44.6%	28.9%	-931 bp	0	-431 bp	
Operating Income	(5.1)	-77.9%	(9.1)	-92.3%			(8.3)	-82.0%	64.1%	-411 bp	1	1024 bp	
EBITDA	(4.6)	-71.4%	(8.7)	-88.7%			(7.9)	-78.5%	71.4%	-711 bp	1	1015 bp	
Pretax Income	(2.7)		(9.6)				(7.9)		191.0%		2		
Income Tax	0.0	0.0%	0.0	0.0%			0.0	0.0%		0 bp	0	0 bp	
Adj. Net Income, excl. ESO	(4.6)	-70.6%	(9.6)	-98.2%			(7.5)	-74.1%	63.7%	-355 bp	2	2411 bp	
Diluted Shares	7.9M		14.7				14.6M		84.9%		-0.1M		
GAAP EPS	(\$0.98)		(\$0.65)				(\$0.60)		-38.8%		\$0.05		
Adjusted Diluted EPS (excl. ESO)	(\$0.58)		(\$0.65)		(\$0.60)		(\$0.51)		-12.1%		\$0.14		

FY14 Guidance

Revenue Guidance: \$45.0-50M

- Gross Margin: 55-58%
- Opex of \$70-75M, split 2/3 as SG&A, 1/3 as R&D
- Interest expense: \$1-3M; SBC: \$3-4M; Capex: \$3-4M

Net loss Guidance: (\$40M)-(\$50M)

- 1Q14 Sales: \$8.3-8.8M

Prosigna Breast Cancer Assay adoption lead US clinical labs and cancer centers
6 nCounter Dx Analysis System with FLEX configuration in the US
Publication of the 2nd clinical validation study for Prosigna

Source: J.P. Morgan estimates, Company data.

Investment Thesis, Valuation, and Risks

Investment Thesis

As a life science company moving into diagnostics, NSTG can leverage several trends, including a migration from analog to digital multiplex analysis, and the need for new clinically relevant content in areas like breast cancer analysis. With steady growth in the life science business today and FDA approval of the Prosigna Breast Cancer assay granted in 3Q13, we expect the company to outgrow peers, aided by an expanding installed base of nCounter systems, increased consumable pull-through and, ultimately, adoption and acceptance of Prosigna and other follow-on tests. Moreover, gross margins are poised to expand as high-margin consumables become a larger part of the Life Sciences revenue mix and Prosigna revenues begin to ramp following FDA approval. Reiterate Overweight.

Valuation

Our December 2014 price target of \$22 is derived using a 10-year DCF with a CAPM-derived WACC of 11.1% and a terminal growth of +2% (see Figure 3).

Risks to Rating and Price Target

Downside risks include: (1) market share gains for Prosigna in the diagnostics market are slower than anticipated; and (2) a lack of reimbursement at adequate levels or inclusion in guidelines which could negatively impact the market acceptance of Prosigna.

Figure 2: NSTG – Model

Income Statement		1QA	2QA	3QA	4QA		1QE	2QE	3QE	4QE			CAGR
USD \$M	2012A	Mar	Jun	Sep	Dec	2013A	Mar	Jun	Sep	Dec	2014E	2015E	10-15
Molecular Diagnostics	0	0	0	0	0	1	0	0	1	2	4	26	N/A
Life Sciences	23	6	7	8	10	31	8	9	11	14	41	51	34.3%
Total Revenue	23	6	7	8	10	31	8	9	12	16	45	77	45.6%
Gross Profit	11	3	4	5	5	16	4	5	7	9	25	50	80.5%
SG&A	(15)	(6)	(7)	(8)	(9)	(30)	(14)	(13)	(12)	(11)	(50)	(48)	43.0%
R&D	(12)	(3)	(4)	(4)	(5)	(15)	(7)	(6)	(6)	(5)	(24)	(32)	33.5%
EBITA (Operating Income)	(16)	(6)	(7)	(7)	(8)	(28)	(16)	(14)	(11)	(7)	(49)	(31)	N/A
EBITDA	(15)	(6)	(6)	(7)	(8)	(27)	(16)	(14)	(11)	(7)	(47)	(28)	N/A
Pre-Tax Income	(7)	(3)	(4)	(6)	(8)	(21)	(16)	(14)	(11)	(7)	(49)	(32)	
Income Taxes	0	0	0	0	0	0	0	0	0	0	0	0	
Adjusted Net Income	(14)	(6)	(6)	(6)	(8)	(26)	(16)	(14)	(11)	(7)	(49)	(32)	N/A
Diluted Shares Outstanding	7.9	9.2	9.2	14.6	14.6	11.9	17.1	19.3	20.0	20.7	19.3	25.2	
Adjusted Diluted EPS (excludes ESO)	\$ (1.70)	\$ (0.60)	\$ (0.62)	\$ (0.42)	\$ (0.51)	\$ (2.08)	\$ (0.92)	\$ (0.69)	\$ (0.53)	\$ (0.30)	\$ (2.38)	\$ (1.22)	
Gross Margin	46.4%	49.2%	51.2%	54.9%	52.4%	52.2%	51.5%	52.9%	55.7%	60.5%	56.0%	65.0%	8.6%
change in gross margin (y/y, bp)	+137	+821	+730	+603	+209	+576	+226	+165	+81	+817	+381	+896	
SG&A	67.1%	107.9%	92.9%	95.2%	89.8%	95.3%	162.9%	142.9%	103.2%	72.3%	111.6%	62.5%	
R&D	51.2%	53.9%	50.2%	45.1%	44.6%	47.7%	83.9%	65.2%	46.1%	32.6%	52.3%	41.7%	
Operating Margin	-71.8%	-112.6%	-92.0%	-85.4%	-82.0%	-90.7%	-195.4%	-155.4%	-93.7%	-44.6%	-108.0%	-39.7%	14.2%
change in op margin (y/y, bp)	-1284	-3447	-3118	-1408	-411	-1894	-8282	-6343	-831	+3742	-1728	+6832	
EBITDA Margin	-63.6%	-105.4%	-85.9%	-81.2%	-78.5%	-85.8%	-190.9%	-150.8%	-91.2%	-42.1%	-104.7%	-37.0%	13.1%
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%	
Profit Margin	-61.5%	-100.4%	-82.4%	-76.6%	-77.8%	-82.6%	-194.9%	-154.8%	-93.7%	-44.8%	-107.9%	-41.9%	20.8%
Reported Revenue Growth y/y	29.1%	26.1%	21.5%	39.0%	55.9%	36.7%	48.5%	25.3%	43.3%	54.8%	43.8%	70.1%	

Source: J.P. Morgan estimates, Company data.

Figure 3: NSTG – DCF Analysis

Target Period: **Dec 2014**

Projected FY Ending Dec	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue (\$M)	31	45	77	114	146	170	190	211	231	251	269	285
growth y/y		44%	70%	48%	29%	16%	12%	11%	10%	9%	7%	6%
EBIT (\$M)	(29)	(49)	(31)	1	21	40	55	70	82	94	105	114
EBIT margin	-91%	-108%	-40%	1%	14%	23%	29%	33%	36%	37%	39%	40%
Tax-affected EBIT (\$M)	(29)	(49)	(31)	1	21	26	36	46	54	62	68	75
Free Cash Flow	(31)	(54)	(36)	(5)	16	23	33	43	51	59	67	73
growth y/y						45%	46%	29%	19%	16%	13%	10%

Discount Rate	Discounted Cash Flows (\$M)	PV of Terminal Value (\$M) at a Perpetual Growth Rate of					Enterprise Value (\$M)					Equivalent Terminal EBITDA Multiple (forward 12 mos)				
	2015-2024	1.0%	1.5%	2.0%	2.5%	3.0%	1.0%	1.5%	2.0%	2.5%	3.0%	1.0%	1.5%	2.0%	2.5%	3.0%
10.1%	84	359	382	408	437	470	444	466	492	521	554	4.0x	4.2x	4.4x	4.6x	4.9x
10.6%	80	327	347	369	394	422	408	427	449	474	502	3.6x	3.8x	4.0x	4.2x	4.5x
11.1%	76	300	317	336	357	381	376	393	412	433	457	3.3x	3.5x	3.7x	3.9x	4.1x
11.6%	72	275	290	306	325	345	347	362	378	397	417	3.1x	3.2x	3.4x	3.5x	3.7x
12.1%	68	253	266	280	296	314	321	334	349	365	382	2.9x	3.0x	3.1x	3.3x	3.4x
	Net Debt (Cash) (\$M)	Equity Value (\$M)					Equity Value per Share					Terminal Value as a % of Enterprise Value				
		1.0%	1.5%	2.0%	2.5%	3.0%	1.0%	1.5%	2.0%	2.5%	3.0%	1.0%	1.5%	2.0%	2.5%	3.0%
	(9)	453	476	501	530	563	\$23.44	\$24.62	\$25.95	\$27.45	\$29.17	81%	82%	83%	84%	85%
	(9)	417	437	459	483	511	\$21.58	\$22.60	\$23.75	\$25.03	\$26.48	80%	81%	82%	83%	84%
	(9)	385	402	421	442	466	\$19.92	\$20.81	\$21.80	\$22.90	\$24.14	80%	81%	82%	82%	83%
	(9)	356	371	388	406	427	\$18.43	\$19.21	\$20.07	\$21.02	\$22.09	79%	80%	81%	82%	83%
	(9)	330	343	358	374	392	\$17.08	\$17.77	\$18.52	\$19.35	\$20.28	79%	80%	80%	81%	82%

Source: J.P. Morgan estimates, Company data.

NanoString: Summary of Financials

Income Statement - Annual	FY13A	FY14E	FY15E	FY16E	Income Statement - Quarterly	1Q14E	2Q14E	3Q14E	4Q14E
Revenues	31	45	77	114	Revenues	8	9	12	16
Cost of products sold	(15)	(20)	(27)	(35)	Cost of products sold	(4)	(4)	(5)	(6)
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(30)	(50)	(48)	(48)	SG&A	(14)	(13)	(12)	(11)
R&D	(15)	(24)	(32)	(28)	R&D	(7)	(6)	(6)	(5)
Operating income	(28)	(49)	(30)	2	Operating income	(16)	(14)	(11)	(7)
EBITDA	(27)	(47)	(28)	5	EBITDA	(16)	(14)	(11)	(7)
Net interest (income) / expense	(2)	(2)	(4)	(6)	Net interest (income) / expense	(0)	(0)	(0)	(1)
Other income / (expense)	-	-	-	-	Other income / (expense)	-	-	-	-
Income taxes	0	0	0	0	Income taxes	0	0	0	0
Net income	(39)	(49)	(33)	(3)	Net income	(16)	(13)	(10)	(5)
Diluted shares outstanding	-	-	-	-	Diluted shares outstanding	-	-	-	-
Diluted EPS	-	-	-	-	Diluted EPS	-	-	-	-
Balance Sheet and Cash Flow Data	FY13A	FY14E	FY15E	FY16E	Ratio Analysis	FY13A	FY14E	FY15E	FY16E
Cash and cash equivalents			45	38	Sales growth	36.7%	43.8%	70.1%	47.7%
Accounts receivable	7	9	13	17	EBIT growth	72.8%	71.0%	(38.1%)	(107.0%)
Inventories	7	8	11	14	EPS growth	-	-	-	-
Other current assets	3	3	3	3	Gross margin	-	-	-	-
Current assets	49	53	104	105	EBIT margin	(90.7%)	(108.0%)	(39.7%)	1.1%
PP&E	-	-	-	-	EBITDA margin	(85.8%)	(104.7%)	(37.0%)	3.7%
Total assets	50	54	105	105	Tax rate	0.0%	0.0%	0.0%	0.0%
Total debt	18	28	63	63	Net margin	(122.9%)	(108.7%)	(42.7%)	(2.3%)
Total liabilities	32	43	80	82	Net Debt / EBITDA	(67.6%)	(59.7%)	(64.7%)	595.7%
Shareholders' equity	31	20	31	30	Net Debt / Capital (book)	36.7%	58.3%	37.5%	45.4%
Net income (including charges)	(29)	(49)	(33)	(3)	Return on assets (ROA)	(92.5%)	(94.8%)	(41.4%)	(2.5%)
D&A	2	1	2	3	Return on equity (ROE)	(172.1%)	(190.3%)	(129.2%)	(8.7%)
Change in working capital	(2)	(3)	(4)	(6)	Enterprise value / sales	-	-	-	-
Other	(1)	0	0	0	Enterprise value / EBITDA	-	-	-	-
Cash flow from operations	(31)	(51)	(35)	(6)	Free cash flow yield	-	-	-	-
Capex	(1)	(3)	(3)	(3)					
Free cash flow	(32)	(54)	(38)	(9)					
Cash flow from investing activities	(1)	(3)	(3)	(3)					
Cash flow from financing activities	53	45	76	0					
Dividends	0	0	0	0					
Dividend yield	-	-	-	-					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec

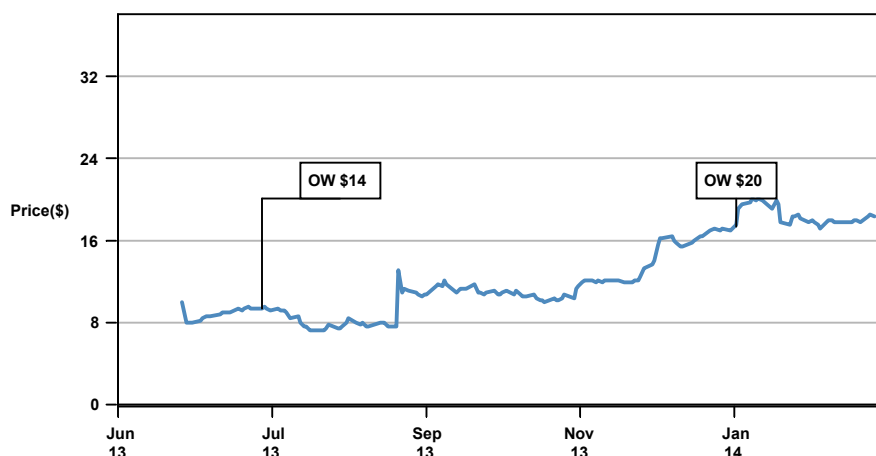
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NanoString (NSTG, NSTG US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
22-Jul-13	OW	9.27	14.00
07-Jan-14	OW	17.32	20.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Jul 22, 2013.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.

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