

NanoString

3Q13 Review: System Placements Drive Solid Beat-and-Raise; Prosigna On Track For 2014 Ramp

NanoString (NSTG) reported solid F3Q results, with revenues of \$8.4M, +39% y/y, coming in above JPMe (\$7.4M) and consensus (\$7.7M), aided by 50% growth in life science instrument sales (particularly, within APAC), increasing consumable sales to biopharma customers and healthy gross margins (55%). The company also increased 2013 guidance, while reiterating expectations for a 1Q14 U.S. Prosigna launch. We make minor changes to our model and see little to change the investment thesis, as we reiterate our Overweight rating and December 2014 price target of \$14. Please see our [initiation](#) for additional thoughts on the investment thesis, and AACC [recap](#) for thoughts on nCounter Elements.

- 3Q13 revenues and gross margins beat expectations.** Sales of \$8.4M came in above JPMe (\$7.4M) and the Street (\$7.7M), driven by Life Sciences revenues of \$8.1M (aided by strong system placements, particularly in Asia-Pacific and consumable sales to biopharma, which offset academic softness). Gross margins of 54.9% came in ~440 bps above JPMe, driven by increasing scale and consumable manufacturing efficiencies and despite being partially offset by an unfavorable mix shift towards instruments. As a reminder, gross margin expansion driven by consumables and the Prosigna ramp is a key tenet of our thesis, and we were encouraged to see continued outperformance in this metric. On the bottom line, adjusted EPS (-\$0.44) came in better than JPMe (-\$0.63) and consensus (-\$0.67), aided by lower operating expenses.
- Prosigna on track for 1Q14 U.S. launch; encouraging commentary around reimbursement and guidelines.** In light of the FDA approval announced in Sept., management reiterated plans to commercially launch Prosigna in 1Q14 (with launch to higher-volume labs possible in late 2013). The focus now turns to reimbursement (coding and coverage) and treatment guidelines. To that end, NSTG intends to apply for inclusion in CMS's MolDx program, and expects to receive a decision as early as 3Q14 for states covered by Palmetto and Noridian (which include testing sites for the largest U.S. commercial labs), while also planning to submit an application to McKesson for a unique Z-code in early 2014, and pursue conversations with private payors concurrently. Regarding guidelines, NSTG intends to apply for NCCN guideline inclusion in 1H14, while management noted that guidelines are updated annually in July, and the expectation is to be considered by the committee in summer 2014, implying inclusion in 2H14. OUS 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. During 3Q, 4 nCounter systems were placed in Germany, Italy and Turkey, while the system placed in the Middle East last quarter generated its first kit sales.

NanoString Technologies, Inc. (NSTG:NSTG US)

FYE Dec	2013E (Prev)	2013E (Curr)	2014E	2015E
Revenue (\$ mn)				
Q1 (Mar)	6A	6A	10	18
Q2 (Jun)	7A	7A	12	20
Q3 (Sep)	7	8A	14	21
Q4 (Dec)	10	10	21	28
FY	30	31	58	87

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

Overweight

NSTG, NSTG US

Price: \$10.20

Price Target: \$14.00

Life Science Tools & Diagnostics

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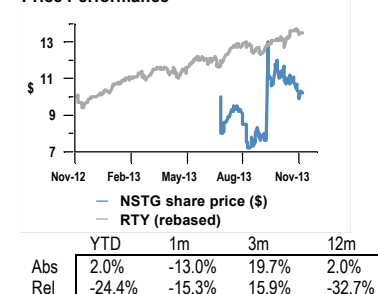
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Price Performance



Company Data

Price (\$)	10.20
Date Of Price	05 Nov 13
52-week Range (\$)	14.10-7.01
Market Cap (\$ mn)	102.00
Fiscal Year End	Dec
Shares O/S (mn)	10
Price Target (\$)	14.00
Price Target End Date	31-Dec-14

See page 8 for analyst certification and important disclosures.

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- **nCounter Elements ramp should drive further system sales to clinical labs.** Management commented on nCounter Elements (a line of general purpose reagents launched at AACC that is designed to enable researchers to develop and translate multiplexed genomic assays into clinical diagnostics offered as lab developed tests), labeling it once again as the “most important product launch in the life sciences business over the past two years,” that should expand access into the clinical lab setting and drive system placements to this untapped customer segment, starting later in 4Q. NSTG noted that 15 customers are already enrolled in the early access program, with continued enrollment ongoing in the fourth quarter. The company will be publicly showcasing the nCounter Dx system for the first time at the Association of Molecular Pathology (AMP) meeting next week. Please see our AACC [recap](#) for thoughts on the nCounter Elements launch. In another pipeline development, management also announced a collaboration agreement with BD Biosciences to jointly develop a single cell isolation and analysis workflow solution.
- **2013 guidance revised upwards.** Management updated their revenue guidance range to \$30-31.5M, from a prior range of \$29.5-\$31.5M (Life Sciences – \$29.0-30.0M, Diagnostics – \$1.0-1.5M). 2013 gross margins are expected to be 50-53% (versus prior expectations of 48-51%), with a reduced net loss ranging from (\$28M) to (\$32M).
- **Modest changes to our estimates; reiterate Overweight rating and December 2014 price target of \$14.** We make modest adjustments to our model for the quarter and updated guidance, and now forecast 2013 sales of \$31M (versus our prior forecast of \$30M). Our DCF-based 2014 price target of \$14 remains unchanged. Reiterate Overweight.

Figure 1: NSTG Variance

	3Q12		3QE				3QA				Variance	
	Actual		JPM Estimate		Consensus		Actual		Change y/y		vs. JPM Est.	
	\$ M	%	\$ M	%	\$ M	%	\$ M	%	Δ \$	Δ margin	\$ M	%
Molecular Diagnostics	0.0		0.4				0.3				(0)	
Life Sciences	6.0		7.0				8.1		34.0%		1	
Total Revenue	6.0		7.4		7.7		8.4		39.0%		1	
Gross Profit	2.9	48.9%	4	50.5%			4.6	54.9%	56.2%	603 bp	1	435 bp
SG&A	(4.2)	69.1%	(9)	121.1%			(8.0)	95.2%	91.6%	2612 bp	1	-2588 bp
R&D	(3.1)	51.1%	(4)	54.1%			(3.8)	45.1%	22.7%	-601 bp	0	-901 bp
Operating Income	(4.3)	-71.4%	(9)	-124.7%			(7.2)	-85.4%	66.4%	-1408 bp	2	3924 bp
EBITDA	(3.8)	-63.2%	(9)	-120.0%			(6.8)	-80.9%	78.1%	-1775 bp	2	3903 bp
Pretax Income	(2.0)		(10)				(6.4)		224.5%		4	
Income Tax	0.0	0.0%	0	0.0%			0.0	0.0%		0 bp	0	0 bp
Adjusted Net Income	(3.9)	-63.9%	(10)	-134.8%			(6.4)	-76.6%	66.5%	-1266 bp	4	5820 bp
Diluted Shares	7.9M		15.7M				14.6M		84.4%		-1.1M	
Adjusted Diluted EPS	\$ (0.49)		(\$0.63)		(\$0.67)		(\$0.44)		-10.2%		\$0.19	

FY13 Guidance

FY2013 revenue guidance: \$30.0-31.5M (prior: \$29.5-31.5M)

- Life Sciences: \$29.0-30.0M (prior: \$28.5-30.0M)
- Diagnostics: \$1.0-1.5M (unchanged)

Gross Margin: 50-53% (prior: 48-51%)

FY2013 Net loss guidance: (\$28M)-(\$32M) (prior: (\$30M)-(\$35M))

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

Other Notes

- Opex of \$44-46M, split 2/3 as SG&A, 1/3 as R&D
- Stock-based compensation expense of \$1.0-1.2M
- Interest expense: \$2M; Capex: < \$1.5M

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 \$14 is derived using a 10-year DCF analysis with a CAPM-derived WACC of 18% and a terminal growth of +1.5% (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; (2) a lack of reimbursement at adequate levels could negatively impact market acceptance of Prosigna; and (3) the company will likely need to raise cash through equity or debt at some point in 2014 which may dilute existing shareholders and/or may be executed on unfavorable terms.

Figure 2: NSTG: Model

Income Statement		1QA	2QA	3QA	4QA		1QA	2QA	3QA	4QE				CAGR
USD \$M	2011A	Mar	Jun	Sep	Dec	2012A	Mar	Jun	Sep	Dec	2013E	2014E	2015E	10-15
Molecular Diagnostics	0	0	0	0	0	0	0	0	0	1	2	17	36	N/A
Life Sciences	18	5	6	6	6	23	6	7	8	9	30	41	51	34.1%
Total Revenue	18	5	6	6	6	23	6	7	8	10	31.1	58	87	49.2%
Gross Profit	8	2	3	3	3	11	3	4	5	5	16	34	57	85.1%
SG&A	(10)	(3)	(3)	(4)	(5)	(15)	(6)	(7)	(8)	(9)	(30)	(38)	(27)	27.6%
R&D	(9)	(2)	(3)	(3)	(3)	(12)	(3)	(4)	(4)	(5)	(15)	(22)	(24)	26.4%
EBITA (Operating Income)	(10)	(4)	(4)	(4)	(5)	(16)	(6)	(7)	(7)	(9)	(29)	(27)	5	N/A
EBITDA	(9)	(3)	(3)	(4)	(5)	(15)	(6)	(6)	(7)	(9)	(28)	(25)	6	N/A
Pre-Tax Income	(11)	(1)	(1)	(2)	(3)	(7)	(3)	(4)	(6)	(10)	(23)	(29)	(0)	
Income Taxes	0	0	0	0	0	0	0	0	0	0	0	0	0	
Adjusted Net Income	(16)	(3)	(3)	(4)	(5)	(14)	(6)	(6)	(6)	(10)	(28)	(29)	(0)	N/A
Diluted Shares Outstanding	10.4	7.9	7.9	7.9	7.9	7.9	9.2	9.2	14.6	14.9	12.0	16.6	19.4	
Adjusted Diluted EPS (incl. ESO)	\$ (1.56)	\$ (0.35)	\$ (0.35)	\$ (0.49)	\$ (0.60)	\$ (1.79)	\$ (0.62)	\$ (0.65)	\$ (0.44)	\$ (0.66)	\$ (2.33)	\$ (1.73)	\$ (0.01)	
Gross Margin	45.1%	41.0%	43.9%	48.9%	50.3%	46.4%	49.2%	51.2%	54.9%	51.0%	51.8%	59.1%	65.2%	8.6%
change in gross margin (y/y, bp)	+2289	-70	-532	+509	+533	+137	+821	+730	+603	+72	+533	+732	+611	
SG&A	53.5%	70.3%	54.7%	69.1%	74.3%	67.1%	107.9%	92.9%	95.2%	94.3%	96.7%	66.1%	31.3%	
R&D	50.5%	48.8%	50.0%	51.1%	53.9%	51.2%	53.9%	61.0%	54.1%	48.9%	49.1%	38.7%	28.1%	
Operating Margin	-59.0%	-78.1%	-60.8%	-71.4%	-77.9%	-71.8%	-112.6%	-92.0%	-85.4%	-92.3%	-94.1%	-46.0%	5.3%	23.2%
change in op margin (y/y, bp)	+5162	-596	-1365	-1253	-1876	-1284	-3447	-3118	-1408	-1435	-2226	+4804	+5136	
EBITDA Margin	-50.8%	-67.4%	-52.5%	-63.2%	-71.4%	-63.6%	-105.4%	-85.9%	-80.9%	-88.5%	-88.9%	-44.0%	6.7%	21.8%
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%	
Profit Margin	-90.9%	-61.3%	-47.0%	-63.9%	-72.8%	-61.5%	-100.4%	-82.4%	-76.6%	-100.2%	-89.7%	-49.8%	-0.2%	29.1%
Reported Revenue Growth y/y	51.7%	3.6%	21.8%	55.0%	38.6%	29.1%	26.1%	21.5%	39.0%	51.2%	35.4%	86.1%	49.9%	

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

Figure 3: NSTG: DCF Analysis

Projected FY Ending Dec	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue (\$M)	31	58	87	122	156	180	201	223	244	266	284	300
growth y/y		86%	50%	40%	28%	16%	12%	11%	10%	9%	7%	6%
EBIT (\$M)	(29)	(27)	5	30	48	63	78	93	110	129	141	153
EBIT margin	-94%	-46%	5%	25%	31%	35%	38%	42%	45%	48%	50%	51%
Tax-affected EBIT (\$M)	(29)	(27)	5	30	48	41	51	61	72	84	92	100
Free Cash Flow	(32)	(34)	3	24	43	38	48	58	69	82	91	98
growth y/y				754%	79%	-11%	26%	21%	20%	17%	11%	8%

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	0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%
16.8%	151	163	168	175	182	189	313	319	326	332	340	2.1x	2.2x	2.2x	2.3x	2.3x
17.3%	146	152	157	163	169	176	298	304	310	316	323	2.0x	2.1x	2.1x	2.2x	2.2x
17.8%	142	142	147	153	158	164	285	290	295	301	307	1.9x	2.0x	2.0x	2.1x	2.1x
18.3%	138	133	138	143	148	153	272	276	281	286	292	1.9x	1.9x	1.9x	2.0x	2.0x
18.8%	134	125	129	134	139	143	260	264	268	273	278	1.8x	1.8x	1.8x	1.9x	1.9x
	Net Debt (Cash) (\$M)	Equity Value (\$M)					Equity Value per Share					Terminal Value as a % of Enterprise Value				
		0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%
	61	252	258	264	271	278	\$15.15	\$15.51	\$15.90	\$16.31	\$16.75	52%	53%	54%	55%	56%
	61	237	243	248	255	261	\$14.27	\$14.60	\$14.94	\$15.32	\$15.71	51%	52%	53%	54%	55%
-	61	223	228	234	239	245	\$13.44	\$13.74	\$14.06	\$14.39	\$14.75	50%	51%	52%	53%	54%
	61	210	215	220	225	230	\$12.66	\$12.94	\$13.23	\$13.54	\$13.86	49%	50%	51%	52%	53%
	61	198	203	207	212	217	\$11.94	\$12.19	\$12.45	\$12.73	\$13.03	48%	49%	50%	51%	52%

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

NanoString: Summary of Financials

Income Statement - Annual	FY12A	FY13E	FY14E	FY15E	Income Statement - Quarterly	1Q13A	2Q13A	3Q13A	4Q13E
Revenues	23	31	58	87	Revenues	6A	7A	8A	10
Cost of products sold	(12)	(15)	(24)	(30)	Cost of products sold	(3)A	(4)A	(4)A	(5)
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(15)	(30)	(38)	(27)	SG&A	(6)A	(7)A	(8)A	(9)
R&D	(12)	(15)	(22)	(24)	R&D	(3)A	(4)A	(4)A	(5)
Operating income	(16)	(29)	(26)	5	Operating income	(6)A	(7)A	(7)A	(9)
EBITDA	(15)	(28)	(25)	6	EBITDA	(6)A	(6)A	(7)A	(9)
Net interest (income) / expense	(1)	(2)	(4)	(7)	Net interest (income) / expense	(0)A	(0)A	(1)A	(0)
Other income / (expense)	-	-	-	-	Other income / (expense)	-	-	-	-
Income taxes	0	0	0	0	Income taxes	0A	0A	0A	0
Net income	(33)	(40)	(29)	(0)	Net income	(12)A	(10)A	(8)A	(10)
Diluted shares outstanding	-	-	-	-	Diluted shares outstanding	-	-	-	-
Diluted EPS	-	-	-	-	Diluted EPS	-	-	-	-
Balance Sheet and Cash Flow Data	FY12A	FY13E	FY14E	FY15E	Ratio Analysis	FY12A	FY13E	FY14E	FY15E
Cash and cash equivalents	22	8		26	Sales growth	29.1%	35.4%	86.1%	49.9%
Accounts receivable	3	6	12	13	EBIT growth	57.2%	77.3%	(9.6%)	(119.2%)
Inventories	5	7	11	13	EPS growth	-	-	-	-
Other current assets	1	3	3	3					
Current assets	32	24	26	55	Gross margin	-	-	-	-
PP&E	-	-	-	-	EBIT margin	(71.8%)	(94.1%)	(46.0%)	5.3%
Total assets	34	28	30	58	EBITDA margin	(63.6%)	(88.9%)	(44.0%)	6.7%
					Tax rate	0.0%	0.0%	0.0%	0.0%
Total debt	13	18	53	88	Net margin	(142.0%)	(127.1%)	(49.7%)	(0.2%)
Total liabilities	24	34	71	108					
Shareholders' equity	13	(19)	(47)	(45)	Net Debt / EBITDA	61.2%	(34.5%)	(207.3%)	1060.4%
					Net Debt / Capital (book)	(200.2%)	(102.0%)	855.1%	373.7%
Net income (including charges)	(18)	(30)	(29)	(1)					
D&A	2	2	1	1	Return on assets (ROA)	(122.8%)	(128.8%)	(99.5%)	(0.5%)
Change in working capital	(0)	(4)	(8)	(1)	Return on equity (ROE)	(262.0%)	1433.9%	87.9%	0.5%
Other	0	(1)	0	0					
Cash flow from operations	(16)	(33)	(36)	(1)	Enterprise value / sales	-	-	-	-
					Enterprise value / EBITDA	-	-	-	-
Capex	(0)	(1)	(1)	(2)	Free cash flow yield	-	-	-	-
Free cash flow	(16)	(35)	(37)	(2)					
Cash flow from investing activities	(0)	(1)	(1)	(2)					
Cash flow from financing activities	26	4	35	35					
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

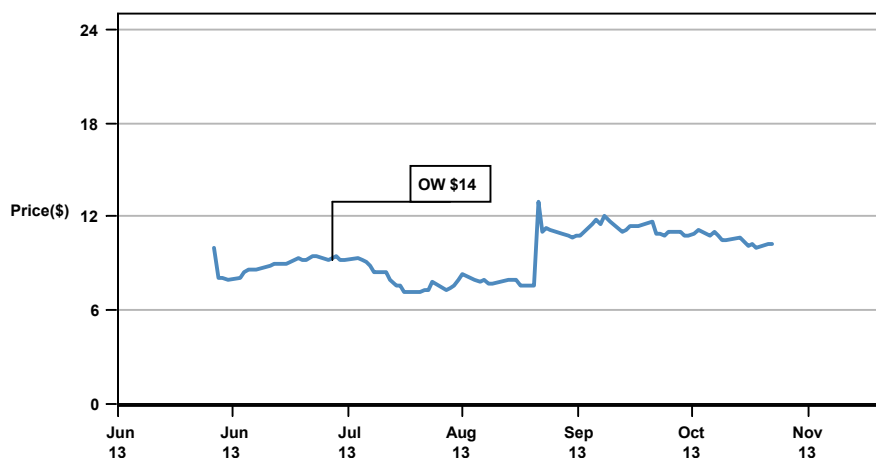
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NanoString (NSTG, NSTG US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
22-Jul-13	OW	9.27	14.00

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

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