

March 31, 2014

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Foundation Medicine (FMI - OUTPERFORM): Recap Post Conversations with Academic Med Centers - Positive FMI Feedback Overall - Competitive Efforts by Academics Moving Slowly - Reaffirm OP

Price: \$32.52

12-Month Price Target: \$50

- **Checks with academia in the last few weeks have been favorable towards FMI and further support our view on the competitive landscape.** In the last few weeks, we have spoken with a number of genomics labs affiliated with large academic medical centers. The majority of labs we have spoken with outsource some deep-tumor profiling to FMI and were complimentary about the company's service. None of the labs we spoke with are using competitors to FMI. We spoke with one UC lab (UCSD) that works with FMI in addition to offering some targeted tumor profiling in-house.
- **Some academics talk about developing FMI-like offerings, but it still appears early days, and widespread push into community oncology setting to compete with FMI appears unlikely.** Almost all of the labs we have spoken with believe they will offer an in-house version of deep-tumor profiling in the long term. That said, the motivation appears to be the benefit to academic research from having full access to the sequencing data (i.e., FMI only sends the final report/interpretation). None of the labs looking to develop tumor profiling appear to have the resources or motivation to compete commercially with FMI in the broader community-based oncology setting (~85% of market). Additionally, some institutions are looking to develop more specific versions of tumor profiling for extremely rare cancers and cancers with very low tumor cellularity (<5%) for which there is a smaller market and where FoundationOne may not be applicable.
- **UC discussing a system-wide tumor sequencing initiative. Very early stage and likely to be internally focused.** Sources within the University of California system, which comprises five large cancer centers, say that there has been some discussion of an initiative to sequence all tumors within the network. It appears that the program is still in its infancy and none of the key UC labs have embarked on standardizing the testing process and technology. Even if this program comes to fruition in the next few years, we believe it would likely remain an internal product geared for research-oriented oncology as opposed to widespread community adoption.
- **Reaffirming OUTPERFORM.** We believe the IPO lockup on 3/24, potential financing (\$150 MM S-1 filed on 3/20, mix of primary vs secondary unknown) & Aetna policy bulletin have combined to drive the 24% sell-off in FMI shares over the last two weeks (versus an 8% decline in the BTK index and flat S&P 500). We arrive at our \$50 price target through EV/sales valuation framework, assuming a ~9x 2016E EV/sales multiple with \$31 MM in net cash and 29 MM shares outstanding, discounted back at 15%. This multiple is justified to us given our view of FMI's growth profile (~89% 3-year CAGR, +70% in 2016), cancer focus and very early penetration story (~10% share in 2016). On a 2015E EV/sales multiple basis, shares of FMI are trading a premium to the current group median (7.8x vs 4.2x).

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Risks

Risks to attainment of our price target include a fiercely competitive diagnostics and lab service market. Additionally, clinical adoption for new paradigms of testing in diagnostics is difficult to predict and private payor as well as Medicare reimbursement for *FoundationOne* and *FoundationOne Heme* could prove to be more challenging than expected.

FMI is dependent on Illumina (ILMN, NEUTRAL) for equipment and other materials related to next-generation sequencing. If ILMN were to stop supplying the material or were to enter the space as a competitor, it could lead to an interruption in FMI's ability to perform its menu of tests. The near-term risk of this has been mitigated through a five-year supply agreement FMI signed with ILMN in July 2013.

The company operates a CLIA certified lab at their Cambridge, MA headquarters where they conduct *FoundationOne*. Operating as a CLIA lab allows the company to avoid the FDA regulatory 510(k)/PMA pathway for diagnostic devices. The FDA could more tightly regulate CLIA lab-based tests as medical devices, which would likely cause significant disruption to the business.

Figure 1: Potential Catalysts

Catalyst	Timing
Earnings	May-14
ASCO publications	Jun-14
Clinical decisions studies	3Q14
Additional product launches/enhancements	2014
CMS coverage decision	??

Source: Company data, Wedbush Securities, Inc.

Figure 2: Income Statement

	2011	2012	1Q13	2Q13	3Q13	4Q13	2013	1Q14E	2Q14E	3Q14E	4Q14E	2014E	2015E	2016E
Product Revenue	2,057	10,645	5,200	5,920	8,208	9,662	28,990	11,021	13,599	16,421	19,547	60,589	115,838	197,057
Total Revenues	2,057	10,645	5,200	5,920	8,208	9,662	28,990	11,021	13,599	16,421	19,547	60,589	115,838	197,057
Cost of revenues	258	5,681	2,378	2,219	2,858	4,204	11,659	4,298	5,032	5,747	5,864	20,942	34,284	56,478
COGS as % of sales			46%	37%	35%	44%	36%							
Gross profit	1,799	4,964	2,822	3,701	5,350	5,458	17,331	6,723	8,568	10,673	13,683	39,647	81,554	140,580
Gross Margins	87.5%	46.6%	54.3%	62.5%	65.2%	56.5%	59.8%	61.0%	63.0%	65.0%	70.0%	65.4%	70.4%	71.3%
Selling and Marketing	1,555	3,454	1,811	3,057	3,038	4,602	12,508	5,511	6,120	6,897	7,819	26,346	41,254	60,887
General and administrative	6,992	8,644	3,150	4,755	6,448	7,512	21,865	7,700	7,900	8,200	8,500	32,300	34,950	35,200
Research and development	9,023	14,777	4,982	6,097	6,988	6,834	24,901	7,100	7,300	7,600	8,000	30,000	35,000	35,900
Total operating expenses	17,570	26,875	9,944	13,910	16,475	18,948	59,275	20,311	21,320	22,697	24,319	88,646	111,204	131,987
Operating Income	(15,771)	(21,911)	(7,122)	(10,209)	(11,125)	(13,490)	(41,944)	(13,588)	(12,752)	(12,023)	(10,636)	(48,999)	(29,650)	8,593
Interest income	(421)	(421)	(76)	(65)	(1,278)	(33)	(1,452)	311	286	251	216	1,064	570	272
Other	(845)	(61)	(6)	(96)	(61)	432	269	0	0	0	0	0	0	0
Income before taxes	(17,037)	(22,393)	(7,204)	(10,370)	(12,464)	(13,091)	(43,127)	(13,277)	(12,466)	(11,773)	(10,420)	(47,935)	(29,080)	8,865
Provision for income taxes	0	0	0	0	0	0	-	0	0	0	0	0	0	576
Tax Rate														0
Net income	(17,037)	(22,393)	(7,204)	(10,370)	(12,464)	(13,091)	(43,129)	(13,277)	(12,466)	(11,773)	(10,420)	(47,935)	(29,080)	8,288
Accretion of convertible preferred stock	(296)	(286)	(50)	(42)	(47)	0	(139)	0	0	0	0	0	0	0
Net Income	(17,333)	(22,679)	(7,254)	(10,412)	(12,511)	(13,091)	(43,268)	(13,277)	(12,466)	(11,773)	(10,420)	(47,935)	(29,080)	8,288
GAAP EPS -Basic	(\$3.52)	(\$0.41)	(\$0.64)	(\$0.52)	(\$0.46)	(\$0.48)	(\$2.09)	(\$0.48)	(\$0.45)	(\$0.43)	(\$0.38)	(\$1.74)	(\$1.05)	\$0.30
GAAP EPS -Diluted	(\$3.52)	(\$0.41)	(\$0.64)	(\$0.52)	(\$0.44)	(\$0.48)	(\$2.08)	(\$0.48)	(\$0.45)	(\$0.43)	(\$0.38)	(\$1.74)	(\$1.05)	\$0.30
Non-GAAP EPS -Diluted	(\$3.52)	(\$0.41)	(\$0.64)	(\$0.52)	(\$0.44)	(\$0.48)	(\$2.08)	(\$0.48)	(\$0.45)	(\$0.43)	(\$0.38)	(\$1.74)	(\$1.05)	\$0.30
Weighted average shares - basic	4,930	55,642	11,339	20,129	27,336	27,505	21,577	27,560	27,601	27,643	27,684	27,622	27,864	28,046
Weighted average shares - diluted	4,930	55,642	11,339	20,129	28,138	27,505	21,778	27,560	27,601	27,643	27,684	27,622	27,864	28,046
	proforma													
Cash and Equivalents	10,852	54,838	45,832	35,965	138,088	124,293	124,293	114,507	100,283	86,413	70,422	70,422	28,964	17,789
Net Cash	10,852	54,838	45,832	35,965	138,088	124,293	124,293	114,507	100,283	86,413	70,422	70,422	28,964	17,789
Net Cash/share			4	2	5	5	5	4	4	3	3	3	1	1
NOLs					(39,900)	(52,991)	(52,991)	(66,268)	(78,734)	(90,506)	(100,926)	(100,926)	(130,006)	(121,718)
% of Sales	2011	2012	1Q13	2Q13	3Q13	4Q13	2013	1Q14E	2Q14E	3Q14E	4Q14E	2014E	2015E	2016E
Gross Margins	87%	47%	54%	63%	65%	56%	60%	61%	63%	65%	70%	65%	70%	71%
Sales and Marketing	76%	32%	35%	52%	37%	48%	43%	50%	45%	42%	40%	43%	36%	31%
General and administrative	340%	81%	61%	80%	79%	78%	75%	70%	58%	50%	43%	53%	30%	18%
Research and development	439%	139%	96%	103%	85%	71%	86%	64%	54%	46%	41%	50%	30%	18%
Total operating expenses	854%	252%	191%	235%	201%	196%	204%	184%	157%	138%	124%	146%	96%	67%
EBIT	-767%	-206%	-137%	-172%	-136%	-140%	-145%	-123%	-94%	-73%	-54%	-81%	-26%	4%
Tax rate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	7%
Net income	-843%	-213%	-139%	-176%	-152%	-135%	-149%	-120%	-92%	-72%	-53%	-79%	-25%	4%
Free Cash Flow	-1015%	-199%	0%	0%	-89%	-95%	-122%	-77%	-93%	-73%	-71%	-78%	-27%	2%
y/y Δ	2011	2012	1Q13	2Q13	3Q13	4Q13	2013	1Q14E	2Q14E	3Q14E	4Q14E	2014E	2015E	2016E
Total Revenues	NA	418%	750%	226%	170%	87%	172%	112%	130%	100%	102%	109%	91%	70%
Cost of revenues	NA	2102%	235%	98%	60%	104%	105%	81%	127%	101%	39%	80%	64%	65%
Gross Margins	NA	-47%	-442%	63%	59%	-6%	28%	12%	1%	0%	24%	9%	8%	1%
Sales and Marketing	NA	122%	260%	262%	258%	266%	262%	204%	100%	127%	70%	111%	57%	48%
General and administrative	NA	24%	88%	135%	202%	167%	153%	144%	66%	27%	13%	48%	8%	1%
Research and development	NA	64%	65%	69%	96%	49%	69%	43%	20%	9%	17%	20%	17%	3%
Total operating expenses	NA	53%	92%	115%	152%	119%	121%	104%	53%	38%	28%	50%	25%	19%
EBIT	NA	39%	35%	77%	110%	144%	91%	91%	25%	8%	-21%	17%	-39%	-129%
Tax rate	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Net income	NA	31%	31%	74%	125%	134%	91%	83%	20%	-6%	-20%	11%	-39%	-129%

Source: Company data, Wedbush Securities, Inc.

Figure 3: Balance Sheet

	2011	2012	2013E	2014E	2015E	2016E
Current assets:						
Total Cash and Cash Equivalents	10852	54,838	124,293	74,859	37,883	31,232
Accounts Receivable	278	2,195	6,262	9,774	17,852	29,623
Inventory	318	803	1,763	1,629	2,975	4,937
Prepaid expenses and other Current Assets	313	550	992	992	992	992
Total current assets	11,761	58,386	133,310	87,254	59,702	66,785
Property, Plant and Equipment	7,902	12,154	22,104	25,133	30,925	40,778
Accumulated Depreciation	(1,796)	(4,689)		(4,613)	(10,018)	(16,853)
Restricted cash and other non-current assets	198	188	1,854	1,854	1,854	1,854
Total assets	18,065	66,039	157,268	109,629	82,464	92,563
LIABILITIES AND STOCKHOLDERS' EQUITY						
Current liabilities:						
Accounts Payable and accrued expenses	2,408	5,072	7,007	7,286	9,140	10,848
Deferred revenue and Other Current Liabilities	1,832	3,458	8,752	8,752	8,752	8,752
Total current liabilities	4,240	8,530	15,759	16,038	17,892	19,600
Long-term liabilities:						
Long Term Debt	3,041	1,441	0	0	0	0
Other long term liabilities	632	807	9,798	9,798	9,798	9,798
Total liabilities	7,913	10,778	25,557	25,836	27,690	29,398
Stockholders' equity:						
Preferred Stock	32,455	98,658	0	0	0	0
Common Stock, APIC, RE	(22,303)	(43,397)	131,711	83,793	54,774	63,165
Total liabilities and stockholders' equity	18,065	66,039	157,268	109,629	82,464	92,563

Source: Company data, Wedbush Securities, Inc.

Figure 4: Cash Flow Statement

	2011	2012	2013E	2014E	2015E	2016E
Cash Flows from Operating Activities:						
Net (loss) income	(17,037)	(22,393)	(42,944)	(47,918)	(29,019)	8,391
Depreciation	1,520	2,894	4,525	4,613	5,405	6,836
change in FV of investor rights obligation	1,067	0	0	0	0	0
change in FV of warrant liability	34	131	1,380	0	0	0
Stock-based compensation expense	73	1,535	4,980	0	0	0
common stock issued for services	0	0	4	0	0	0
non-cash interest expense	111	104	57	0	0	0
Change in working capital	99	480	1,244	(3,099)	(7,570)	(12,025)
Net cash provided by operating activities	(14,133)	(17,249)	(30,754)	(46,405)	(31,184)	3,202
Cash Flows from Investing Activities:						
Purchase of property and equipment	(5,410)	(3,183)	1,433	(3,029)	(5,792)	(9,853)
increase in restricted cash	0		(1,725)	0	0	0
Net cash used in investing activities	(5,410)	(3,183)	(292)	(3,029)	(5,792)	(9,853)
Cash Flows from Financing Activities:						
Proceeds from Issuance of Restricted Stock	114	70	30	0	0	0
proceeds from issuance of preferred stock	26,338	65,917	(10)	0	0	0
proceeds from issuance of common stock	0	0	110,596	0	0	0
change in notes payable	2,534	(1,569)	(1,265)	0	0	0
Net cash provided by financing activities	28,986	64,418	109,351	0	0	0
Net increase (decrease) in cash and cash equivalents	9,443	43,986	78,305	(49,434)	(36,976)	(6,651)
Cash and cash equivalents, beginning of period	10,852	54,838	133,143	74,859	37,883	31,232
Cash and cash equivalents, end of period	10,852	54,838	133,143	74,859	37,883	31,232

Source: Company data, Wedbush Securities, Inc.

Company	Ticker	Rating	Price Target	Current Price
Illumina	ILMN	NEUTRAL	\$140	\$142

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Company	Disclosure
Foundation Medicine	1
Illumina	1

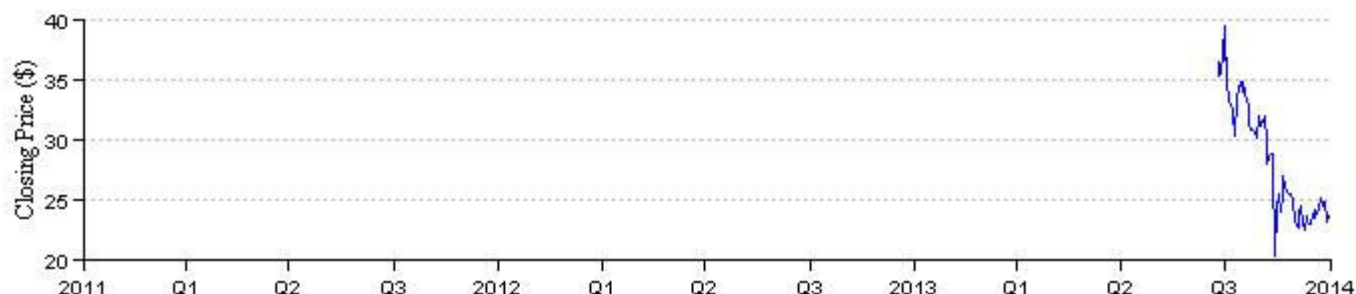
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FMI



ILMN

1) 02/04/11	2) 04/27/11	3) 07/27/11	4) 10/07/11	5) 01/25/12	6) 02/08/12
OUTPERFORM \$75	OUTPERFORM \$80	OUTPERFORM \$78	OUTPERFORM \$35	OUTPERFORM \$50	OUTPERFORM \$65
7) 04/24/12	8) 01/04/13	9) 04/23/13	10) 07/24/13	11) 10/15/13	12) 10/22/13
OUTPERFORM \$52	NEUTRAL \$52	NEUTRAL \$55	NEUTRAL \$60	NEUTRAL \$65	NEUTRAL \$72



* WS changed its rating system from (Strong Buy/Buy/Hold/Sell) to (Outperform/ Neutral/Underperform) on July 14, 2009. Please access the attached hyperlink for WS' Coverage Universe: <http://www.wedbush.com/services/cmg/equities-division/research/equity-research>. Applicable disclosure information is also available upon request by contacting Ellen Kang in the Research Department at (213) 688-4529, by email to ellen.kang@wedbush.com, or the Business Conduct Department at (213) 688-8090. You may also submit a written request to the following: Business Conduct Department, 1000 Wilshire Blvd., Los Angeles, CA 90017.

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