

Foundation Medicine, Inc.

Increased Ordering From Clinical Oncologists and Pharma Customers Drive Upside; Guidance Now Appears Conservative

- On Tuesday, August 12, Foundation Medicine reported second-quarter results that were above expectations, driven by better-than-expected biopharmaceutical revenue (drove \$1 million of beat versus our model) and repeat orders from community oncologists. Management reiterated full-year guidance suggesting a sequential slowdown in the back half of the year. With the beat in the quarter, there appears to be some level of conservatism built into guidance, given current run-rates; management attributed this to the early stage of commercialization and potential for seasonal effects through the year. Revenue of \$14.5 million was above our \$13.2 million estimate and Street consensus at \$13.4 million. Net loss per share was \$0.49 slightly more than our and Street estimate for a \$0.48 loss.
- There was no update on reimbursement; the company continues to submit Medicare claims, despite not being reimbursed. CMS is working to implement 27 new next-generation sequencing-based codes (referred to as genomic sequencing procedures, or GSPs) including codes for somatic tumor panels (categorized as panels with between 5 and 50 genes and panels with 51 or greater genes). It is not clear whether CMS will choose to establish pricing via the gap-fill process (which requires local Medicare Contractor involvement in the pricing process), by applying cross-walking (which leverages existing codes to build out reimbursement), or opt to delay pricing of these codes all together. While we are incrementally comfortable that in the case of coverage, pricing could be in line with to above expectations, we also see an increased risk that Medicare reimbursement could come in phases (e.g., by indication), versus what could be market expectations of an all-or-nothing reimbursement decision.
- Guidance.** Management left guidance unchanged with revenue of \$52 million to \$58 million, clinical tests in the range of 22,000 to 25,000 tests, gross margin between 55% and 65%, and operating expenses between \$85 million and \$92 million. Clinical volume grew 25% sequentially in the first and second quarters and would have to slow to 14% sequentially in the back half of the year to stay within the high end of full-year guidance. If the company continued sequential clinical test growth at 25%, this would imply full-year clinical test volume closer to 27,185 tests and revenue of \$61.5 million. That said, we estimate full year 2014 revenue of \$58.1 million and clinical volume of 25,189.

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

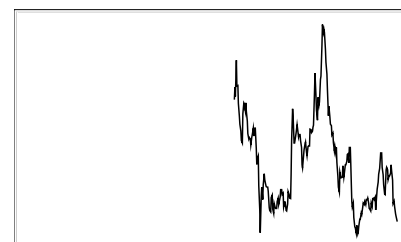
Symbol: FMI (NASDAQ)
Price: \$25.65 (52-Wk.: \$20-\$45)
Market Value (mil.): \$685
Fiscal Year End: December
Long-Term EPS Growth Rate:
Dividend/Yield: None

	2013A	2014E	2015E
Estimates			
EPS FY	\$-1.57	\$-2.04	\$-1.54
CY		\$-2.04	\$-1.54
Sales (mil.)	29	58	106
Valuation			
FY P/E	NM	NM	NM
CY P/E		NM	NM

Trading Data (FactSet)	
Shares Outstanding (mil.)	28
Float (mil.)	16
Average Daily Volume	334,637

Financial Data (FactSet)	
Long-Term Debt/Total Capital (MRQ)	0.0
Book Value Per Share (MRQ)	4.3
Return on Equity (TTM)	-32.2

Two-Year Price Performance Chart



Sources: FactSet, William Blair & Company estimates

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- **Revenue Detail.** The company reported revenue of \$14.5 million with \$9.4 million coming from clinical testing (versus our estimate of \$9.0 million) and \$5.1 million from biopharmaceutical customers (versus our estimate of \$4.2 million).
 - Clinical testing revenue grew 233% year-over-year and roughly 32% sequentially, driven by strong volume growth. Clinical testing volume was 5,908 tests, with 4,960 FoundationOne tests (versus our estimate of 4,585) and 948 FoundationOne Heme tests (versus our estimate of 930 tests). Management indicated that volume growth was driven by more repeat ordering more so than penetration of new physicians. That said, 60% of tests reported were to community oncologists, up from 54% in the first quarter (suggests increasing penetration in mainstream medicine)
 - Biopharmaceutical revenue grew an impressive 65% year-over-year and 17% sequentially, driven by deepening relationships within the pharmaceutical customers by expanding Foundation's role in the drug development process (Foundation recently signed contracts with Addario Lung Cancer Medical Institute and for the Lung-MAP trial). Biopharmaceutical test volume was 1,261 tests, up 104% year-over-year and above our 1,051 tests estimate. We view continued adoption of biopharmaceutical customers as a positive long-term sign, given that they are usually more-sophisticated customers and it also diversifies Foundation Medicine's revenue stream.
- **Margin Detail.** Gross margin was 54.3%, below our estimate of 59.0% yet up from the first quarter at 53.8%. Gross margin continues to be weighed down by Medicare test volume, which is not currently getting paid, though COGS are being recognized. Sales-and-marketing expense was \$7.2 million slightly above our \$7.1 million estimate. General-and-administrative expense was \$5.8 million, \$0.9 million below our \$6.7 million estimate. Lower-than-expected general-and-administrative expense was offset by higher R&D spend at \$8.6 million, versus our \$7.4 million estimate. Net loss was \$13.8 million, versus our \$13.4 million estimate, as a result of lower gross margin and higher R&D spend than we forecast.
- **Stock Thoughts and Valuation.** We continue to believe that Foundation Medicine's investments in workflow and bioinformatics provide a meaningful competitive advantage, and we anticipate increased likelihood that solid tumor panels could be priced at reasonable levels by CMS. Also, in our opinion guidance seems conservative, given the strong second quarter, setting the company up for a potential beat and raise in the third quarter. Still, with the stock trading at 5.9 times on an EV-to-2015-sales basis, expectations seem to incorporate a decent amount of market share gains and some revenue benefit from potential Medicare (or private payer) coverage. While we are incrementally comfortable that in the case of coverage, pricing could be in line with to above expectations, we also see an increased risk that reimbursement could come in phases (e.g., by indication), versus what could be market expectations of an all-or-nothing reimbursement decision. Thus, for now, we maintain our Market Perform rating.
- **Model Update.** For 2014, we now model revenue of \$58.1 million (101% growth), up from our prior estimate of \$57.3 million (98% growth), as a result of a strong second-quarter result (biopharmaceutical drove majority of upside). We lowered our gross margin assumption to 55% from 60%, given the second-quarter gross margin run-rate. We estimate total operating expenses to be \$89.2 million, up from \$87.4 million previously, as the company continues to spend for commercial expansion and fund the R&D pipeline for future growth. We expect a net loss per share of \$2.04, up from our prior estimate of \$1.92 as a result of lower gross margin and increased operating expenses. For 2015, we model revenue of \$105.7 million and net loss per share of \$1.54, compared to our prior estimate of \$105.3 million and \$1.53, respectively.

Foundation Medicine, Inc. Second-Quarter Variance Analysis (\$ in thousands, Fiscal year ends December)						
	2Q 2014 Actual	2Q 2013 Actual	Year/Year %Change	2Q 2014 Estimate	Year/Year %Change	Actual-Est.
Net Sales	\$14,496	\$5,920	144.9%	\$13,154	122.2%	\$1,342.1
Cost of Sales	\$6,619	\$2,219	198.3%	\$5,393	143.0%	\$1,225.9
Gross Profit	\$7,877	\$3,701	112.8%	\$7,761	109.7%	\$116.2
Sales & Marketing	\$7,170	\$2,875	149.4%	\$7,103	147.1%	\$66.9
General & Administrative	\$5,825	\$4,755	22.5%	\$6,708	41.1%	-\$883.5
Research & Development	\$8,645	\$6,097	41.8%	\$7,366	20.8%	\$1,278.8
Operating Income	-\$13,763	-\$10,026	37.3%	-\$13,417	33.8%	-\$346.0
Interest & Other	-\$16	-\$161	-90.1%	-\$27	-83.0%	\$11.3
Net Income/Loss	-\$13,779	-\$10,187	35.3%	-\$13,444	32.0%	-\$334.7
Convertible Preferred Stock	\$0	\$42	-100.0%	\$0	-100.0%	\$0.0
Net Income Common Shareholders	-\$13,779	-\$10,229	34.7%	-\$13,444	31.4%	-\$334.7
W. Avg. Shares (Diluted)	27,877	3,066	809.3%	27,784	806.2%	93
EPS	-\$0.49	-\$3.34	-85.2%	-\$0.48	-85.5%	-\$0.01
Margin Analysis						<i>BPS</i>
Gross Margin	54.3%	62.5%	-8.2%	59.0%	-3.5%	-466
Sales & Marketing	49.5%	48.6%	0.9%	54.0%	5.4%	-454
General & Administrative	40.2%	80.3%	-40.1%	51.0%	-29.3%	-1082
Research & Development	59.6%	103.0%	-43.4%	56.0%	-47.0%	364
Operating Income	-94.9%	-169.4%	74.4%	-102.0%	67.4%	706
Taxes	0.0%	-0.4%	0.4%	0.0%	0.4%	0
Net Income	-95.1%	-172.8%	77.7%	-102.2%	70.6%	715
Clinical Revenue	\$9,400	\$2,820	233.3%	\$8,991	218.8%	\$409
Clinical Tests	5,908	1,626	263.3%	5,515	239.2%	393
Revenue/Tests	\$1,591	\$1,734	-8.3%	\$1,630	-6.0%	-\$39

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

Foundation Medicine, Inc. 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 Q2'14	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	\$14,496	\$15,344	\$16,850	\$58,146	\$105,747	\$191,582	\$278,820
Cost of Goods Sold	\$258	\$5,681	\$2,378	\$2,219	\$2,858	\$4,204	\$11,659	\$5,291	\$6,619	\$6,751	\$7,246	\$25,907	\$34,795	\$51,146	\$63,309
Gross Profit	\$1,799	\$4,964	\$2,822	\$3,701	\$5,350	\$5,458	\$17,331	\$6,164	\$7,877	\$8,593	\$9,605	\$32,238	\$70,952	\$140,435	\$215,511
Operating Expenses															
Sales & Marketing	\$1,555	\$3,454	\$1,811	\$2,875	\$3,038	\$4,602	\$12,326	\$5,690	\$7,170	\$8,132	\$8,594	\$29,586	\$38,980	\$51,832	\$65,346
General and Administrative	\$6,992	\$8,644	\$3,150	\$4,755	\$6,448	\$7,512	\$21,865	\$5,700	\$5,825	\$6,291	\$6,909	\$24,725	\$37,101	\$45,399	\$54,830
Research & Development	\$9,023	\$14,777	\$4,982	\$6,097	\$6,988	\$6,834	\$24,901	\$6,915	\$8,645	\$9,206	\$10,110	\$34,877	\$38,474	\$48,390	\$62,558
Total Operating Expenses	\$17,570	\$26,875	\$9,943	\$13,727	\$16,474	\$18,948	\$59,092	\$18,305	\$21,640	\$23,630	\$25,613	\$89,188	\$114,555	\$145,621	\$182,735
Operating Income	-\$15,771	-\$21,911	-\$7,121	-\$10,026	-\$11,124	-\$13,490	-\$41,761	-\$12,141	-\$13,763	-\$15,037	-\$16,008	-\$56,949	-\$43,604	-\$5,185	\$32,776
Interest Expense	\$421	\$421	\$76	\$65	\$61	\$33	\$235	\$25	\$16	\$10	\$2	\$53	\$53	\$36	\$63
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	-\$13,779	-\$15,047	-\$16,010	-\$57,002	-\$43,657	-\$5,222	\$32,713
Taxes	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$785	\$6,543
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	-\$13,779	-\$15,047	-\$16,010	-\$57,002	-\$43,657	-\$6,007	\$26,170
Basic & Diluted EPS	-\$0.62	-\$0.83	-\$0.27	-\$0.37	-\$0.46	-\$0.48	-\$1.57	-\$0.44	-\$0.49	-\$0.54	-\$0.57	-\$2.04	-\$1.54	-\$0.21	\$0.91
Weighted Avg. Shares - Basic & Diluted	28,138	27,230	27,355	27,405	27,455	27,505	27,430	27,734	27,877	27,977	28,077	27,916	28,264	28,564	28,864
<i>Margin Analysis:</i>															
Gross Margin	87%	47%	54%	63%	65%	56%	60%	53.8%	54%	56%	57%	55%	67%	73%	77%
Sales & Marketing	76%	32%	35%	49%	37%	48%	43%	50%	49%	53%	51%	51%	37%	27%	23%
General and Administrative	340%	81%	61%	80%	79%	78%	75%	50%	40%	41%	41%	43%	35%	24%	20%
Research & Development	439%	139%	96%	103%	85%	71%	86%	60%	60%	60%	60%	60%	36%	25%	22%
Interest Expense	7%	0.8%	0.6%	0.6%	0.7%	0.1%	0.5%	0.1%	0.1%	0.0%	0.0%	0.0%	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%	145%	87%	74%	101%	82%	81%	46%
Cost of Goods Sold	NM	2102%	235%	98%	60%	104%	105%	122%	198%	136%	72%	122%	34%	47%	24%
Gross Profit	NM	176%	-3009%	432%	329%	75%	249%	118%	113%	61%	76%	86%	120%	98%	53%
Sales & Marketing	NM	222%	360%	341%	358%	366%	357%	314%	249%	268%	187%	240%	132%	133%	126%
General and Administrative	NM	124%	188%	235%	302%	267%	253%	181%	123%	98%	92%	113%	150%	122%	121%
Research & Development	NM	164%	165%	169%	196%	149%	169%	139%	142%	132%	148%	140%	110%	126%	129%
Operating Income	NM	39%	35%	73%	110%	144%	91%	70%	37%	35%	19%	36%	-23%	-88%	-732%
Net Income/Loss	NM	31%	32%	73%	127%	135%	92%	69%	35%	21%	22%	33%	-23%	-88%	-726%
EPS	NM	35%	30%	70%	123%	132%	89%	65%	32%	18%	20%	30%	-24%	-86%	-531%

IMPORTANT DISCLOSURES

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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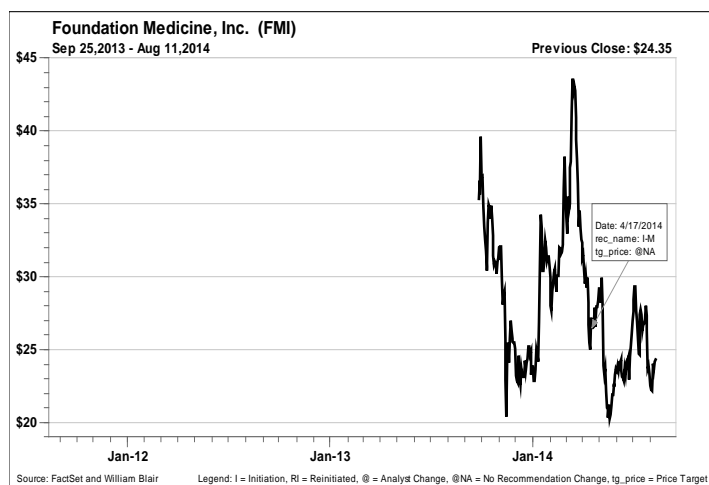
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DOW JONES: 16,569.98

S&P 500: 1,936.92

NASDAQ: 4,401.33



Current Rating Distribution (as of 07/31/14)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	66	Outperform (Buy)	16
Market Perform (Hold)	31	Market Perform (Hold)	3
Underperform (Sell)	1	Underperform (Sell)	0

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