

NanoString

2Q13 Review: Few Surprises Out of the Gate, Prosigna On Track for 1Q14; Reiterate Overweight

NanoString (NSTG) reported solid F2Q results – its first quarter as a public company – with revenues of \$7.2M, +21%, coming in above JPMe (\$6.7M) and consensus (\$6.8M), aided by 41% growth in consumables, continued expansion of the nCounter installed base (now >140 systems) and healthy gross margins (51%). The company also provided 2013 guidance that was largely in-line versus our prior forecast, 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; 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 the nCounter Elements launch.

- 2Q13 revenues and gross margins beat expectations.** NanoString reported sales of \$7.2M, which came in above JPMe (\$6.7M) and the Street (\$6.8M), with strength driven by Life Sciences revenues of \$7.0M (driven by strong biopharma system placements and consumable sales), coupled with a better-than-modeled Diagnostics contribution of \$200K off Prosigna sales driven by the sale of one Prosigna-capable nCounter system in the Middle East. Gross margins of 51.2% came in ~440 bps above our forecast, driven by favorable product mix (higher contribution of consumables) and increasing scale and utilization of consumable manufacturing capacity. As a reminder, gross margin expansion driven by growing sales of consumables and the Prosigna ramp is a key tenet of our long-term thesis on the company, and we were encouraged to see the outperformance in this metric relative to our forecast in the quarter. On the bottom line, adjusted EPS (-\$0.65) came in slightly lower than our estimate (-\$0.60), but was significantly better than consensus (-\$0.76).

Overweight

NSTG, NSTG US

Price: \$8.00

Price Target: \$14.00

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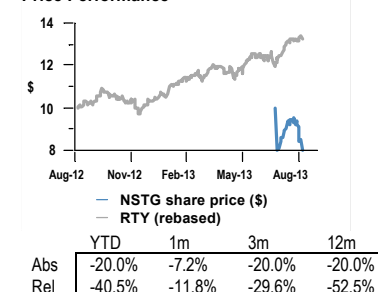
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Price Performance



NanoString Technologies, Inc. (NSTG;NSTG US)

FYE Dec	2013E (Prev)	2013E (Curr)	2014E	2015E
Revenue (\$ mn)				
Q1 (Mar)	6A	6A	10	18
Q2 (Jun)	7	7A	12	20
Q3 (Sep)	7	7	14	21
Q4 (Dec)	10	10	21	28
FY	29	30	58	87

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

Company Data

Price (\$)	8.00
Date Of Price	06 Aug 13
52-week Range (\$)	10.00-7.81
Market Cap (\$ mn)	80.00
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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- **Prosigna remains on track for 1Q14 U.S. launch; encouraging commentary around nCounter Elements.** Management reiterated expectations for a 1Q14 U.S. launch for the Prosigna assay, and stated that the company continues to have an “interactive and constructive” dialog with FDA. International rollout of the test also continues to progress well, via a direct sales model in Europe, coupled with distribution agreements in the Middle East and Asia. During the quarter, three nCounter systems were placed with leading medical centers in Europe, while an additional Prosigna-capable system was placed in the Middle East. Management also 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 the “most important product launch in the NanoString life sciences business over the past two years.” Please see our AACC [recap](#) for thoughts on the nCounter Elements launch. As for the nCounter Gen3 system, NanoString remains on track for a 2014 launch.
- **2013 guidance in line with our forecast.** Management issued revenue guidance of \$29.5-\$31.5M (Life Sciences – \$28.5-30.0M, Diagnostics – \$1.0-1.5M), while 2013 gross margins are expected to be 48-51%, with a net loss ranging from (\$30M) to (\$35M).
- **Modest changes to our estimates; reiterate Overweight rating and December 2014 price target of \$14.** We are making modest adjustments to our model for the quarter and updated guidance, and now forecast 2013 sales of \$30.1M (versus our prior forecast of \$29M). Our DCF-based 2014 price target of \$14 remains unchanged. Reiterate Overweight.

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 anticipated FDA approval of the Prosigna Breast Cancer assay in 1Q14 (JPMe), 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 10.6% and a terminal growth of +1.5% (see Figure 3).

Risks to Rating and Price Target

Downside risks include: (1) FDA approval for the Prosigna breast cancer assay is pushed out beyond early 2014 or not obtained; (2) market share gains for Prosigna in the diagnostics market are slower than anticipated; (3) a lack of reimbursement at adequate levels could negatively impact market acceptance of Prosigna; and (4) 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 1: NSTG: 2Q13 Variance

	2Q12		2QE				2QA				Variance	
	Actual		JPM Estimate		Consensus		Actual		Change y/y		vs. JPM Est.	
	\$ M	%	\$ M	%	\$ M	%	\$ M	%	Δ \$	Δ margin	\$ M	%
Molecular Diagnostics	0.0		0.0				0.2				0	
Life Sciences	5.9		6.7				7.0		18.1%		0	
Total Revenue	5.9		6.7		6.8		7.2		21.5%		0	
Gross Profit	2.6	43.9%	3	46.8%			3.7	51.2%	41.6%	730 bp	1	437 bp
SG&A	(3.3)	54.7%	(7)	103.7%			(6.7)	92.9%	106.3%	3823 bp	0	-1077 bp
R&D	(3.0)	50.0%	(4)	61.0%			(3.6)	50.2%	22.0%	24 bp	0	-1076 bp
Operating Income	(3.6)	-60.8%	(8)	-117.9%			(6.6)	-92.0%	83.7%	-3118 bp	1	2589 bp
EBITDA	(3.1)	-52.5%	(8)	-112.3%			(6.3)	-86.8%	100.6%	-3423 bp	1	2553 bp
Pretax Income	(1.0)		(9)				(3.6)		282.8%		5	
Income Tax	0.0	0.0%	0	0.0%			0.0	0.0%		0 bp	0	0 bp
Adjusted Net Income	(2.8)	-47.0%	(10)	-141.8%			(6.0)	-82.4%	112.9%	-3541 bp	4	5939 bp
Diluted Shares	7.9M		15.9M				9.2M		16.4%		-6.7M	
Adjusted Diluted EPS	(\$0.35)		(\$0.60)		(\$0.76)		\$(0.65)		85.7%		-\$0.05	
FY13 Guidance							Other Notes					
FY2013 revenue guidance: \$29.5-31.5M - Life Sciences: \$28.5-30.0M - Diagnostics: \$1.0-1.5M Gross Margin: 48-51% FY2013 Net loss guidance: (\$30M)-(\$35M)							- Opex of \$45-49M, split 2/3 as SG&A, 1/3 as R&D - Stock-based compensation expense of \$1.0-1.4M - Interest expense: \$2M; Capex: \$1.5-2.0M					

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

Figure 2: NSTG Model

Income Statement		1QA	2QA	3QA	4QA		1QA	2QA	3QE	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	7	9	29	41	51	34.1%
Total Revenue	18	5	6	6	6	23	6	7	7	10	30	58	87	49.2%
Gross Profit	8	2	3	3	3	11	3	4	4	5	15	34	57	85.2%
SG&A	(10)	(3)	(3)	(4)	(5)	(15)	(6)	(7)	(9)	(12)	(34)	(54)	(49)	43.8%
R&D	(9)	(2)	(3)	(3)	(3)	(12)	(3)	(4)	(4)	(6)	(16)	(23)	(23)	25.1%
EBITA (Operating Income)	(10)	(4)	(4)	(4)	(5)	(16)	(6)	(7)	(9)	(13)	(35)	(42)	(16)	N/A
EBITDA	(9)	(3)	(3)	(4)	(5)	(15)	(6)	(6)	(9)	(13)	(34)	(41)	(15)	N/A
Pre-Tax Income	(11)	(1)	(1)	(2)	(3)	(6)	(3)	(4)	(10)	(13)	(30)	(43)	(20)	
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)	(10)	(13)	(35)	(43)	(20)	N/A
Diluted Shares Outstanding	10.4	7.9	7.9	7.9	7.9	7.9	9.2	9.2	15.7	16.3	12.6	18.0	20.8	
Adjusted Diluted EPS (incl. ESO)	\$ (1.56)	\$ (0.35)	\$ (0.35)	\$ (0.45)	\$ (0.60)	\$ (1.75)	\$ (0.62)	\$ (0.65)	\$ (0.63)	\$ (0.83)	\$ (2.78)	\$ (2.40)	\$ (0.97)	
Gross Margin	45.1%	41.0%	43.9%	48.9%	50.3%	46.4%	49.2%	51.2%	50.5%	50.5%	50.4%	59.4%	65.4%	8.6%
change in gross margin (y/y, bp)	+2289	-70	-532	+509	+533	+137	+821	+730	+168	+26	+401	+894	+601	
SG&A	53.5%	70.3%	54.7%	69.1%	74.3%	67.1%	107.9%	92.9%	121.1%	124.3%	112.9%	92.7%	57.0%	
R&D	50.5%	48.8%	50.0%	51.1%	53.9%	51.2%	53.9%	61.0%	54.1%	58.9%	54.7%	39.1%	26.7%	
Operating Margin	-59.0%	-78.1%	-60.8%	-71.4%	-77.9%	-71.8%	-112.6%	-92.0%	-124.7%	-132.7%	-117.2%	-72.7%	-18.8%	18.4%
change in op margin (y/y, bp)	+5162	-596	-1365	-1253	-1876	-1284	-3447	-3118	-5332	-5481	-4538	+4450	+5388	
EBITDA Margin	-50.8%	-67.4%	-52.5%	-63.2%	-71.4%	-63.6%	-105.4%	-86.8%	-119.9%	-129.6%	-112.4%	-71.0%	-17.7%	16.9%
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%	-58.7%	-72.8%	-60.2%	-100.4%	-82.4%	-133.2%	-137.1%	-116.1%	-74.5%	-23.3%	24.5%
Reported Revenue Growth y/y	51.7%	3.6%	21.8%	55.0%	38.6%	29.1%	26.1%	21.5%	22.4%	51.2%	31.0%	92.3%	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)	30	58	87	122	156	180	201	223	244	266	284	300
growth y/y		92%	50%	40%	28%	16%	12%	11%	10%	9%	7%	6%
EBIT (\$M)	(35)	(42)	(16)	1	10	20	29	40	52	65	74	81
EBIT margin	-117%	-73%	-19%	1%	7%	11%	15%	18%	21%	25%	26%	27%
Tax-affected EBIT (\$M)	(35)	(42)	(16)	1	10	13	19	26	34	43	48	53
Free Cash Flow	(39)	(50)	(18)	(6)	5	10	17	23	31	40	47	52
growth y/y						91%	66%	40%	36%	28%	15%	11%

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%
9.6%	41	261	278	296	317	341	302	319	338	359	382	3.8x	4.0x	4.3x	4.5x	4.8x
10.1%	39	238	253	269	286	307	277	291	307	325	345	3.5x	3.7x	3.9x	4.1x	4.4x
10.6%	36	218	230	244	260	277	254	266	280	296	313	3.2x	3.4x	3.6x	3.7x	4.0x
11.1%	33	200	211	223	236	251	233	244	256	270	285	3.0x	3.1x	3.2x	3.4x	3.6x
11.6%	31	184	193	204	216	228	215	224	235	247	260	2.7x	2.8x	3.0x	3.1x	3.3x
	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%
	23	279	296	314	335	359	\$15.54	\$16.46	\$17.50	\$18.67	\$20.00	86%	87%	88%	88%	89%
	23	253	268	284	302	322	\$14.11	\$14.91	\$15.80	\$16.80	\$17.93	86%	87%	87%	88%	89%
-	23	230	243	257	272	290	\$12.84	\$13.53	\$14.30	\$15.16	\$16.13	86%	87%	87%	88%	89%
	23	210	221	233	246	261	\$11.69	\$12.30	\$12.97	\$13.72	\$14.55	86%	86%	87%	88%	88%
	23	191	201	212	223	236	\$10.66	\$11.20	\$11.78	\$12.43	\$13.15	86%	86%	87%	87%	88%

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

NanoString: Summary of Financials

Income Statement - Annual	FY12A	FY13E	FY14E	FY15E	Income Statement - Quarterly	1Q13A	2Q13A	3Q13E	4Q13E
Revenues	23	30	58	87	Revenues	6A	7A	7	10
Cost of products sold	(12)	(15)	(24)	(30)	Cost of products sold	(3)A	(4)A	(4)	(5)
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(15)	(34)	(54)	(49)	SG&A	(6)A	(7)A	(9)	(12)
R&D	(12)	(16)	(23)	(23)	R&D	(3)A	(4)A	(4)	(6)
Operating income	(16)	(35)	(42)	(16)	Operating income	(6)A	(7)A	(9)	(13)
EBITDA	(15)	(34)	(41)	(15)	EBITDA	(6)A	(6)A	(9)	(13)
Net interest (income) / expense	(1)	(1)	(3)	(6)	Net interest (income) / expense	(0)A	(0)A	(0)	(0)
Other income / (expense)	-	-	-	-	Other income / (expense)	-	-	-	-
Income taxes	0	0	0	0	Income taxes	0A	0A	0	0
Net income	(33)	(45)	(43)	(20)	Net income	(8)A	(10)A	(9)	(12)
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	39	24	38	Sales growth	29.1%	31.0%	92.3%	49.9%
Accounts receivable	3	6	12	13	EBIT growth	57.2%	113.8%	18.7%	(62.1%)
Inventories	5	7	11	13	EPS growth	-	-	-	-
Other current assets	1	2	2	2	Gross margin	-	-	-	-
Current assets	32	55	50	67	EBIT margin	(71.8%)	(117.2%)	(72.7%)	(18.8%)
PP&E	-	-	-	-	EBITDA margin	(63.6%)	(112.4%)	(71.0%)	(17.7%)
Total assets	34	57	53	70	Tax rate	0.0%	0.0%	0.0%	0.0%
Total debt	13	13	48	83	Net margin	(142.0%)	(150.7%)	(74.5%)	(23.3%)
Total liabilities	24	28	66	102	Net Debt / EBITDA	61.2%	78.5%	(56.8%)	(289.3%)
Shareholders' equity	13	32	(10)	(29)	Net Debt / Capital (book)	(200.2%)	(509.7%)	177.5%	291.0%
Net income (including charges)	(18)	(36)	(43)	(21)	Return on assets (ROA)	(122.8%)	(99.6%)	(78.0%)	(33.0%)
D&A	2	2	1	1	Return on equity (ROE)	(262.0%)	(201.0%)	(399.9%)	102.9%
Change in working capital	(0)	(5)	(8)	(1)	Enterprise value / sales	-	-	-	-
Other	0	1	0	0	Enterprise value / EBITDA	-	-	-	-
Cash flow from operations	(16)	(39)	(50)	(21)	Free cash flow yield	-	-	-	-
Capex	(0)	(1)	(1)	(2)					
Free cash flow	(16)	(39)	(51)	(23)					
Cash flow from investing activities	(0)	(1)	(1)	(2)					
Cash flow from financing activities	26	56	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

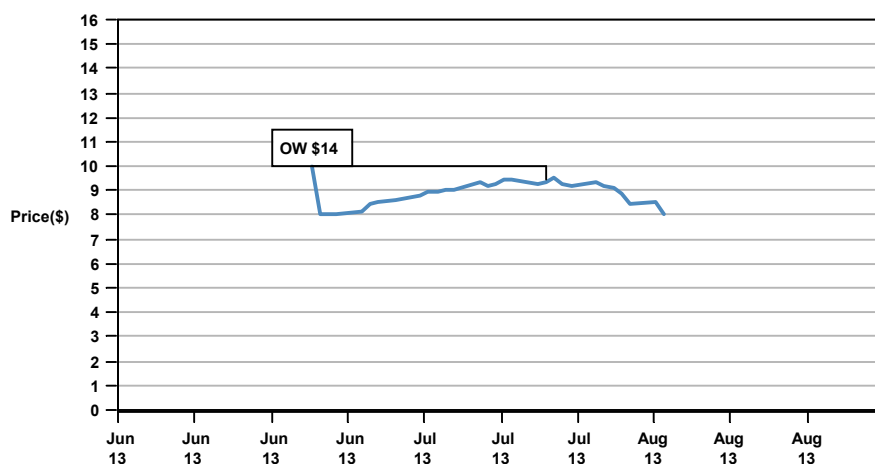
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NanoString (NSTG, NSTG US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
22-Jul-13	OW	9.44	14.00

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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IB clients*	56%	50%	40%
JPMS Equity Research Coverage	42%	50%	8%
IB clients*	76%	66%	55%

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