Veracyte, Inc. 3rd Quarter 2017 Financial Results
Conference Call Script for Monday, November 6; 4:30 p.m. Eastern Time

Veracyte Participants:

Bonnie H. Anderson, Chief Executive Officer and Chairman of the Board
Keith Kennedy, Chief Financial Officer
Chris Hall, President and Chief Operating Officer
Jackie Cossmon, VP of Investor Relations and Corporate Communications

Operator:

Good afternoon, ladies and gentlemen, and welcome to Veracyte's third quarter 2017 financial results conference call. [Operator instructions]. As a reminder, today's conference call is being recorded. I'd now like to turn the conference over to Ms. Jackie Cossmon, Vice President of Investor Relations and Corporate Communications for Veracyte. Ms. Cossmon, you may begin.

Veracyte Prepared Remarks:

[Jackie Cossmon]

Good afternoon, everyone, and thank you for joining us today for our third quarter 2017 financial results conference call. Bonnie Anderson, our Chairman and Chief Executive Officer will be leading the call today and Keith Kennedy, our Chief Financial Officer, will be providing an update on the financial results for the third quarter. Chris Hall, our President and Chief Operating Officer, is also joining us on the call and will be available for questions.

Before we begin, I'd like to remind you that various statements that we may make during this call will include forward-looking statements as defined under applicable securities laws. Forward-looking statements include statements regarding our future plans, prospects and strategy, financial goals and guidance, product attributes and pipeline, drivers of growth, expectations regarding reimbursement and other statements that are not historical fact. Management's assumptions, expectations and opinions reflected in these forward-looking statements are subject to risks and uncertainties that may cause actual results and/or performance to differ materially from any future results,

performance, or achievements discussed in, or implied by, such forward-looking statements, and the company can give no assurance they will prove to be correct. In addition to today's press release, those risks and uncertainties are described in the company's filings with the Securities and Exchange Commission.

Prior to this call, we announced our third quarter 2017 results, which are available on our website, Veracyte.com, by clicking "Menus" on the top-right corner of our website and clicking-through to our "Investors" landing page and then "Press Releases." We also released a financial presentation, which Keith will reference later in the call when he covers our financial results. You may find the financial presentation in the same "Investors" section, under "Events & Presentations." We will also post a transcript of our prepared remarks to our website immediately following this call.

I will now turn the call over to Bonnie.

[Bonnie Anderson]

Thank you, Jackie. And thanks, everyone, for joining us today.

I want to start by saying that this is one of the most challenging quarters I have had to prepare for. On the one hand, we've had one of our most successful quarters in terms of advancing the core foundation of our business, but at the same time, we did not achieve the acceleration of growth in the quarter that we had anticipated and as a result we are adjusting our guidance for the year.

Our revenue for the quarter was $17.5 million compared to $18.6 million for the third quarter of 2016. Accrued revenue, which excludes cash collections for tests performed in prior periods grew 24% and genomic test volume grew 14% over prior year. This was our best growth quarter of the year and in a quarter that is typically flat. We achieved all of this despite the impact of the hurricanes, which we estimate to be $500-$600,000 for the year with the majority of this impacting the third quarter. The result of all of this, combined with slower acceleration of growth from key initiatives, has led us to adjust our 2017 revenue guidance to the range of $71-$72 million.

What I want to describe for you today is why that acceleration was delayed and what we have done to course-correct going forward. We believe the fundamentals of our business are quite strong and we are very optimistic about our strategy and our future. I will explain as I go through our progress in each of our product areas and will then turn the call over to Keith to review our financial results.

I'll start with Afirma.

We have discussed several levers to accelerate Afirma revenue growth. They are:

1. The introduction of our next-generation Afirma Genomic Sequencing Classifier, or GSC, and the transition of our current and new customers to this state-of-the-art test;
2. Our agreement with Quest/Ameripath, which provides expanded access to our Afirma classifier through their physician network;
3. Expansion of our salesforce; and
4. Continued reimbursement success.

Looking at the transition from the Afirma GEC to the Afirma GSC, the demand for our new classifier among physicians is quite strong. We added 100 new accounts during the quarter and continued to convert existing Afirma accounts to the new platform.

Despite that increased demand, our volume growth was slower than we had initially planned. This is due in part to our decision to take a more measured approach to transitioning customers to the GSC than originally anticipated. We did this to optimize workflow complexity in our CLIA lab, given that we are running two full technology platforms – microarray and next-generation sequencing – as we make the transition. The multiple workflow streams, utilization of staff and equipment, and coordination of multiple supplier inventories requires careful coordination to ensure optimal quality. That said, our lab operations ran smoothly without any issues and we delivered hundreds of patient results to physicians as intended. In fact, we have received tremendously positive feedback from the accounts we've converted. We have now hit our stride and, as we have moved into the fourth quarter, we have picked up the pace of transitioning customers. We expect to be fully converted to the new platform by early next year.

In sum, we believe the Afirma GSC is allowing us to gain more business from our clients and are optimistic that it will positively impact our growth rate as we move forward. There is a strong backlog of customer demand for the Afirma GSC, following the impressive data that were unveiled at two major endocrinology conferences in the third quarter.

Researchers shared findings in three oral and three poster presentations from studies at the World Congress on Thyroid Cancer and the American Thyroid Association's annual meeting, which demonstrated the clinical performance of the Afirma GSC. The data reveal that the GSC's unique combination of RNA sequencing and ensemble machine learning algorithms is enabling it to better provide answers to challenging clinical questions – and to significantly improve patient care.

At the World Congress on Thyroid Cancer, researchers showed that the Afirma GSC increases the number of benign patients that can potentially avoid an unnecessary surgery by 30 percent, without compromising the original test's very low false negative

rate. At the ATA meeting a couple of weeks ago, researchers shared data showing the classifiers' ability to distinguish challenging-to-interpret thyroid cancer subtypes. This includes differentiating benign from cancerous Hurthle cells, which until now has largely eluded both traditional and genomic testing techniques. This ability will help many patients avoid surgery, which otherwise would have been a standard next step. We also shared data showing our ability to detect BRAF variants and medullary thyroid cancer with high levels of accuracy, providing physicians with important treatment information when surgery is needed.

In total, these data show that the next-generation Afirma GSC brings to physicians the power to increase the number of benign patients that can avoid surgery and provide better treatment based on key information about the aggressiveness of cancers. It also provides us with an extendable platform for bringing additional answers to market, which could enable physicians to make better clinical-care decisions than ever before for their thyroid nodule patients.

The second lever for accelerating growth is expanded access to Afirma through the Quest/Ameripath relationship. We have built a good working relationship with the Quest/Ameripath team and are encouraged with the traction we're seeing – although, that traction didn't take hold until the last month of the quarter. We know that building a critical mass of users and volume takes time and remain cautiously optimistic about this opportunity and its contribution to accelerated Afirma growth. To that end, we've assigned a single point of contact within our commercial organization to take responsibility for the successful implementation of this relationship.

The third lever is the continued expansion of our salesforce, not only to drive growth of Afirma, but to support the commercial expansion of Percepta and prepare for the launch of Envisia, our third commercial product, which we expect to begin ramping as early as next year.

We've expanded our sales force to 61, as we continue to invest in executing our multiproduct sales strategy. We believe we've lagged in the speed at which we've hired sales associates to backfill for the transition from Genzyme last year. We've corrected this and have added new reps to strengthen regions where needed and have added pulmonary specialists with expertise that will be important for the adoption of both Percepta and Envisia. A group of these reps is recently hired and we expect to get the benefit of them as we move into 2018. We've determined that we'll need additional reps to further support the push into two new indications and we'll continue to hire through the remainder of the year and into early 2018. Our goal is to have a sales force of 85 in place by this time next year.

Our fourth lever is reimbursement expansion, where we are a leader in the industry as one of the few companies with coverage for a genomic test from all major health plans across the country. Now that we've achieved this milestone for Afirma, we're focused on converting these coverage policies into in-network contracts. This will help expand our reimbursement rate; save considerable time and resources in adjudicating claims disputes; and accelerate growth because physicians are more likely to order a genomic test when it's provided by an in-network lab. We made excellent progress on this goal, executing five new contracts during the third quarter, four of which were Blues plans. This brings the total number of contracted lives to 176 million and increases the number of Blues contracted lives by 35% in the quarter, to 45 million.

I want to address one reimbursement headwind that you may have heard about, which is the recently announced programs by UnitedHealthcare and Anthem to require prior authorization for molecular testing. We've been tracking and preparing for such potential requirements and believe we're well positioned to handle them. Afirma and Percepta are both performed in very specific clinical scenarios and the medical necessity for our tests is well defined and documented for each patient sample we receive. In sum, we believe we have good processes in place to address this change in a way that minimizes disruption to our business.

Lastly for Afirma, CMS announced its preliminary rates under the Protecting Access to Medicare Act, or PAMA, and our preliminary Afirma classifier Medicare rate will increase slightly, from $3,220 to $3,600. These new rates are expected to be finalized within the next few weeks and to become effective January 1, 2018. Medicare patients represent approximately 20% of our Afirma test volume.

Now, I'll turn to Percepta.

We're pleased to report that we booked our first Percepta classifier revenue this quarter. This is a really big milestone for our company. We've also expanded the test's adoption to over 70 institutions around the country and, so far, the feedback from customers is terrific. They're using the Percepta classifier as intended and the results are helping to impact their clinical decision-making in lung cancer screening and diagnosis.

We believe our strategy of leveraging existing Afirma relationships to move Percepta into institutions is working well. Our sales reps are able to get access to decision makers, given that Veracyte is already known in the institution as providing well-validated tests that solve important clinical problems.

The sales cycle for Percepta is longer than that of Afirma because the decision-making process at institutions is more complex. We've been pleased with our progress so far but we believe that our sales efforts will further benefit from an important change

in CMS's so-called 14-day rule which has just been released. This change means that we will be able to bill CMS directly for all Percepta Medicare claims, rather than some claims needing to be submitted by the hospital. The change, which is scheduled to go into effect in January 2018, will deliver two benefits for us. First, it will mean that all Medicare recipients will be able to get access to Percepta as a covered test and, secondly, it should help speed up the sales cycle. All of these factors give us confidence that we will be successful in driving adoption of Percepta and creating significant value in the lung cancer space.

With Medicare coverage in place through the MolDx program, we're focusing our efforts on private-payer coverage. We believe that here too we'll be able to leverage our existing relationships through Afirma where we have developed a strong reputation for providing high-quality genomic tests that change patient care and reduce costs.

To that end, we're particularly excited about the real-world clinical utility data for the Percepta classifier, which were presented last week at the CHEST annual meeting. In a podium presentation, a researcher from Johns Hopkins University unveiled new data demonstrating that when the Percepta test classified patients from intermediate to low risk for lung cancer, there was a greater than 50 percent relative reduction in recommendations for risky, costly diagnostic procedures, compared to decisions made without the Percepta test result.

What was equally impressive – and will be especially important to payers – is that this real-world analysis showed that physicians are using the test just as we intended. Our findings show that they elected to use the Percepta classifier 75 percent of the time in patients with the greatest probability to benefit from the test -- those with low to intermediate pre-test risk of cancer.

We believe these data will give physicians further confidence in monitoring patients with CT imaging, rather than directing them to surgery, and suggest that the use of the Percepta classifier can reduce costs in lung cancer screening and diagnosis. All of these findings are powerful and, we believe, have the potential to change guidelines. As we've discussed previously, guideline inclusion of our tests is a key factor in driving test coverage and reimbursement.

I would like to close with an update on the Envisia Genomic Classifier.

We've made great progress in building out the evidence demonstrating the Envisia classifier's effectiveness in improving the diagnosis of idiopathic pulmonary fibrosis, or IPF. In addition to early clinical validation data that were published in late June in the Annals of the American Thoracic Society, which demonstrated the test's performance, later this week, Dr. Neil Barth, our chief medical officer, will present interim clinical utility study findings showing our test's impact in real-world clinical scenarios. These findings

will be shared during the Pulmonary Fibrosis Foundation's bi-annual PFF Summit – and I encourage you to keep your Google news alerts set for Veracyte on Thursday.

We believe we have put together a comprehensive library of evidence that will meet the requirements for a Medicare coverage policy. We continue to believe that a coverage policy by the middle of next year is realistic. That would position us to potentially book our first revenue for the Envisia classifier by the time of our third-quarter call next year. And, more broadly, it would position us as one of the only genomic diagnostics companies to have three tests that are commercialized and covered by Medicare.

With that, I would now like to turn the call over to Keith for our financial results review.

[Keith Kennedy]

Thank you, Bonnie. Good afternoon, everyone. As Jackie mentioned earlier, in addition to our earnings release, you may find our **financial presentation** on our website at www.veracyte.com under "Investors" and then "Events & Presentations." Please review the **Safe Harbor Statement** on page 2 of the presentation.

I plan to speak about our third quarter and year-to-date 2017 results and will reference the relevant pages in the financial presentation as I cover the highlights.

Turning to page 3 of the presentation, this is the first quarter that we accrued substantially all billable tests in the current and prior year quarters, so our accrued revenue is directly comparable.

The **Financial Highlights** for the third quarter 2017, as compared to the third quarter of 2016, are as follows:

- Revenue of $17.5 million declined 6% driven principally by a $4.4 million or 94% decline in cash revenue for tests performed prior to July 1st 2016. Accrued revenue increased 24%, comprised almost equally by volume and rate tailwinds illustrated on the right side of the page.
- Genomic reported volume of 6,533 tests increased 14%;
- Total operating expenses of $23.9 million increased 2%;
- Net loss of $7.0 million increased 25% driven principally by the impact of incremental cash revenue in the prior year. Our cost of revenue increased in-line with volume growth and other operating expenses declined by approximately $0.4 million compared to prior year;
- Net loss per share of 21 cents increased one penny per share;

- Cash burn, defined as net cash used in operating activities and net capital expenditures, of $5.8 million improved 23%; and
- We ended the quarter with $41.2 million in cash.

Turning to page 4 of the presentation, the **Financial Highlights** for the nine-months ended Sept 30, or year-to-date 2017, as compared to the year-to-date 2016, are as follows:

- Revenue of $52.4 million increased 12%;
- Genomic reported volume of 18,873 tests increased 12%;
- Total operating expenses of $72.9 million increased 1%, principally driven by test volume;
- Net loss of $22.6 million improved 16%;
- Net loss per share of 67 cents improved 31%; and
- Cash burn of $19.1 million improved 31%.

Turning to slide 5 and reported Genomic volume. Genomic volume includes reported Afirma GEC, Afirma GSC and Percepta volume, but excludes reported clinical and registry volume. As shown in the chart on the left, specifically the green bars that illustrate 2017 quarterly volume relative to the prior year, continues to improve and grew 9% in the first quarter of 2017, 11% in the second quarter of 2017 and 14% in the third quarter of 2017.

The chart on the right shows sequential change in volume, which gives investors insight into the seasonal impact on our business. In both 2015 and 2016, the fourth quarter was our best quarter with a range of 10 to 11 percent sequential growth over the third quarter. From 2015 to 2017, the change in Genomic volume growth from the second-to-third quarter was plus or minus 300 reported tests and relatively flat the last two years. Since the beginning of 2015, our first quarter has been our slowest volume quarter and sequentially in the range of a zero to ten percent decline relative to the fourth quarter.

Turning to slide 6 and revenue. In the third quarter of 2016—or the prior year quarter—we recognized $3.5 million of incremental revenue upon test delivery that previously would not have been recognized until cash was received. This number is especially important if you are comparing the third quarter of 2016 to any prior quarter, which is why we disclosed it in the third quarter of 2016.

For comparisons of the third quarter of 2016 to any subsequent quarter where we accrue substantially all billable test volume in each quarter, then it is especially important to distinguish between accrued and cash-based revenue, as cash-based

revenue principally reflects the cash we receive for tests performed prior to July 1, 2016 that did not meet our accrual criteria at the time--i.e., in the quarter--of test delivery. As previously mentioned, we received $4.7 million in cash-revenue in the third quarter of 2016 and only $0.3 million in the third quarter of 2017, reflecting the fact that substantially all our test revenue is now recognized on an accrual basis.

Turning to slide 7 and the sequential changes in accrued revenue, the purple bar indicates the change in revenue recognition between the second and third quarter of 2016 that I just mentioned. For the third quarter of 2017, on average, we accrued between $2,400 and $2,500 for the Afirma GEC or Afirma GSC test that met our revenue recognition criteria, which was between 90-95% of the reported Afirma volume. From the third quarter of 2016 to the third quarter of 2017, we accrued between $1.7 and $2.2 million in revenue per quarter from providing cytopathology services associated with our Afirma solution.

We made significant progress this quarter with key physician and institutional partners on the framework for acquiring, processing and reporting Percepta Bronchial Genomic Classifier results. We accrued revenue for a small number of Percepta tests this quarter, but the revenue was immaterial to our results.

Turning to slide 8 and the sequential changes in cash revenue. The chart shows the quarterly trend in cash-revenue that we have collected principally for tests performed prior to July 1st, 2016. Though we continue to appeal older claims, we believe we have substantially completed the cash collection for tests performed prior to July 1st, 2016.

As of September 30, 2017, we had $11.6 million in accounts receivable and our current days sales outstanding, or DSOs, excluding cash revenue, was 65 days.

Now, turning to slide number 9, we generated 59% gross margin in the third quarter 2017. Cost of revenue grew 13%, in-line with our 14% volume growth. Cash revenue as well as adjustments to accrued revenue due to increases in cash collection trends, such as the one million-dollar ($1.0 million) adjustment in the second quarter of 2017, favorably impact our margins.

On slide 10, we further breakdown the components of our operating expenses and show the percentage of revenue for each category. Labor represents approximately 50% of our total cost structure, so while we are investing in our salesforce, we remain focused on getting to cash flow break-even and generating operating leverage across our business.

Slides 11 through 13 cover the trends in our net loss, cash burn and cash position. At September 30th, 2017, we were ahead of plan with $41.2 million in cash on-hand.

Turning to slide 14. On November 3rd, we closed a $35 million senior secured credit facility with Silicon Valley Bank, which includes a $25 million term loan plus a $10 million unfunded asset based revolving credit facility. The facilities mature in five years—in October 2022. As explained on this slide, based on rates at the time of closing the new facility, we estimate that we have reduced the yield-to-maturity from 13.4% to 7.0% and we have added additional borrowing capacity at an even lower rate. Including the $1.5 million make-whole payment we made to refinance our previous credit facility, the adjusted yield-to-maturity and excess liquidity remain very attractive. The new facility is based on a 30-day libor rate and we are looking to hedge at least a portion of the floating-rate risk through an interest rate cap or swap, which we are evaluating now. Our prior facility was priced at a 12% fixed-rate.

Turning to slide 15, in October 2017, we amended and restated our service agreement with TCP. In return for lower fees, we agreed to extend the term for five years and to pay $1.75 million to Pathology Resource Consultants, its previous management company, over eight quarters. Based on current test volume, we expect quarterly savings from the lower rate to exceed cash payments. However, expected savings will vary based on volumes. For GAAP purposes, we currently expect to amortize the upfront payment over the five-year life of the deal.

As Bonnie mentioned, we are updating our revenue guidance to $71 to $72 million and narrowing the range of our cash burn guidance to $25 to $26 million, which excludes the exit fee paid to refinance and significantly lower our borrowing costs.

To achieve our revenue guidance, we must generate $18.6 to $19.6 million in revenue in the fourth quarter of 2017.

To achieve our cash burn guidance, our net cash used in operating activities and net capital expenditures, or cash burn, in the fourth quarter of 2017 must be between $5.9 to $6.9 million dollars.

I will now turn the call back over to Bonnie for closing remarks.

[Bonnie Anderson]

I would like to wrap up today's call with some highlights from the efforts we have underway to build a substantial franchise in the lung cancer space.

Lung cancer is the biggest cancer killer in the United States – more than the next three leading cancers combined. It's even more of an issue on a global scale, where it's responsible for one in five deaths. Now, the movement to reduce lung cancer deaths through increased screening, and advancements in technology that enable earlier

detection and treatment, is gaining significant momentum across the healthcare spectrum.

We are excited to be taking a leadership role in these advances, as Percepta is well positioned to help make lung cancer screening safer and more effective. As we announced earlier in the quarter, we've introduced "Screen Together," a lung cancer awareness and education initiative designed to encourage people at risk for lung cancer to get screened. To make this easier, our campaign encourages people at increased risk to pledge to be screened with a friend or loved one. We are piloting the program in North Carolina in partnership with the Lung Cancer Initiative of North Carolina, where we've also got customers like Duke University and University of North Carolina that can potentially help reach more patients with the program's messages. Pending its success there, we plan to expand the "Screen Together" program to other key markets.

More broadly, we see many opportunities to advance the fight against lung cancer – and see Percepta as just the beginning. The novel "field of injury" technology that powers the Percepta classifier is already gaining significant traction among world-leading lung cancer authorities. Recently, the National Cancer Institute released its 2018 annual budget plan document, which profiled Dr. Avi Spira of Boston University, and how his "field of injury" discovery led to Percepta, which is already providing real benefits to patients. Dr. Spira will also be leading the Stand Up to Cancer organization's recently announced "Dream Team" – comprised of researchers from top institutions including Stanford, Harvard, UCLA and others – to identify and intercept lung cancer at its earliest stages. As an industry advisor to this program, we share in this goal and plan to also focus our R&D efforts on building genomic tests that further leverage the field of injury opportunity. This will include the use of a simple non-invasive nasal swab for early lung cancer detection and screening. We expect to see data beginning to emerge from these efforts next year. It's an exciting time to be in the lung cancer space and we believe our technology positions us well to make significant inroads in the fight against this deadly disease.

So, in conclusion as you can see, the news today is mixed, but, based on the great progress we've made in many foundational aspects of our business, our future is very bright. While we won't provide guidance for 2018 until our Q4 call, we will provide some color as you think about the coming year:

- We expect to achieve a genomic test volume growth around 15 percent next year with a resulting revenue growth of about 20%.
- We continue to target cash flow breakeven by the end of 2018, but expect that this could shift by a quarter or so. We remain fully committed to achieving this important goal for the company – and for our shareholders – but not at the risk of top line growth.

I would now like to ask the operator to open up the call to questions.

Closing Remarks:

I would like to take a moment to thank our employees for their unfailing dedication to delivering high value diagnostic products to market with evidence that is compelling for patients. I also want to thank our stockholders for believing in us and continuing to support our vision of fundamentally changing patient care with diagnostics that deliver value to all stakeholders. We look forward to keeping you up to date on our progress.