VERACYTE, INC.
Form 10-Q
July 31, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2017
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number 001-36156

VERACYTE, INC.
(Exact name of registrant as specified in its charter)

Delaware	20-5455398
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6000 Shoreline Court, Suite 300
South San Francisco, California 94080
(Address of principal executive offices, zip code)

(650) 243-6300
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o	Smaller reporting company o
(Do not check if a smaller reporting company)	Emerging growth company x

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).Yes o No ý

As of July 28, 2017, there were 33,893,567 shares of common stock, par value $0.001 per share, outstanding.

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PART I. — FINANCIAL INFORMATION

Item 1. Condensed Financial Statements

VERACYTE, INC.

Condensed Balance Sheets

(In thousands of dollars, except share and per share amounts)

	June 30, 2017 (Unaudited)	December 31, 2016 (See Note 1)
Assets		
Current assets:		
Cash and cash equivalents	$ 46,463	$ 59,219
Accounts receivable	11,027	8,756
Supplies inventory	3,317	3,475
Prepaid expenses and other current assets	1,933	2,057
Restricted cash	120	120
Total current assets	62,860	73,627
Property and equipment, net	10,093	11,480
Finite-lived intangible assets, net	13,600	14,133
Goodwill	1,057	1,057
Restricted cash	603	603
Other assets	134	134
Total assets	$ 88,347	$ 101,034
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,349	$ 2,424
Accrued liabilities	8,450	9,110
Total current liabilities	10,799	11,534
Long-term debt	24,971	24,918
Capital lease liability, net of current portion	456	599
Deferred rent, net of current portion	4,277	4,402
Total liabilities	40,503	41,453
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized, no shares issued and outstanding as of June 30, 2017 and December 31, 2016	—	—
Common stock, $0.001 par value; 125,000,000 shares authorized, 33,891,817 and 33,762,278 shares issued and outstanding as of June 30, 2017 and December 31, 2016, respectively	34	34
Additional paid-in capital	243,409	239,631
Accumulated deficit	(195,599)	(180,084)
Total stockholders' equity	47,844	59,581
Total liabilities and stockholders' equity	$ 88,347	$ 101,034

The accompanying notes are an integral part of these financial statements.

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VERACYTE, INC.

Condensed Statements of Operations and Comprehensive Loss

(Unaudited)

(In thousands of dollars, except share and per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenue	$18,406	$14,675	$34,838	$28,225
Operating expenses:				
Cost of revenue	6,960	6,301	13,257	12,580
Research and development	3,603	4,267	7,633	7,728
Selling and marketing	7,994	8,263	15,330	15,329
General and administrative	6,192	6,071	12,211	12,299
Intangible asset amortization	266	267	533	534
Total operating expenses	25,015	25,169	48,964	48,470
Loss from operations	(6,609)	(10,494)	(14,126)	(20,245)
Interest expense	(808)	(785)	(1,608)	(1,152)
Other income, net	119	36	219	79
Net loss and comprehensive loss	$(7,298)	$(11,243)	$(15,515)	$(21,318)
Net loss per common share, basic and diluted	$(0.22)	$(0.40)	$(0.46)	$(0.77)
Shares used to compute net loss per common share, basic and diluted	33,873,128	27,859,918	33,848,645	27,838,955

The accompanying notes are an integral part of these financial statements.

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VERACYTE, INC.

Condensed Statements of Cash Flows

(Unaudited)

(In thousands of dollars)

	Six Months Ended June 30,	
	2017	2016
Operating activities		
Net loss	$ (15,515)	$ (21,318)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,846	1,703
Bad debt expense	—	68
Loss on disposal of property and equipment	—	12
Genzyme co-promotion fee amortization	—	(721)
Stock-based compensation	3,214	3,173
Conversion of accrued interest on long-term debt	—	192
Amortization and write-off of debt discount and issuance costs	53	119
Interest on debt balloon payment and prepayment penalty	—	206
Changes in operating assets and liabilities:		
Accounts receivable	(2,271)	48
Supplies inventory	158	265
Prepaid expenses and current other assets	25	47
Other assets	—	(13)
Accounts payable	266	(805)
Accrued liabilities and deferred rent	(772)	712
Net cash used in operating activities	(12,996)	(16,312)
Investing activities		
Purchases of property and equipment	(728)	(3,587)

Proceeds from sale of property and equipment	440		—	
Change in restricted cash	—		(2	)
Net cash used in investing activities	(288	)	(3,589	)
Financing activities				
Proceeds from the issuance of long-term debt, net of debt issuance costs	—		24,452	
Payment of long-term debt	—		(5,000	)
Payment of end-of-term debt obligation and prepayment penalty	—		(288	)
Proceeds from the issuance of common stock in a public offering, net of costs	200		—	
Payment of capital lease liability	(135	)	—	
Proceeds from the exercise of common stock options and employee stock purchases	463		646	
Net cash provided by financing activities	528		19,810	
Net decrease in cash and cash equivalents	(12,756	)	(91	)
Cash and cash equivalents at beginning of period	59,219		39,084	
Cash and cash equivalents at end of period	$ 46,463		$ 38,993	
Supplementary cash flow information of non-cash investing and financing activities:				
Purchases of property and equipment included in accounts payable and accrued liabilities	$ —		$ 42	

The accompanying notes are an integral part of these financial statements.

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VERACYTE, INC.

Notes to Financial Statements

1. Organization and Description of Business

Veracyte, Inc. (“Veracyte” or the “Company”) was incorporated in the state of Delaware on August 15, 2006 as Calderome, Inc. Calderome operated as an incubator until early 2008. On March 4, 2008, the Company changed its name to Veracyte, Inc. The Company’s operations are based in South San Francisco, California and Austin, Texas, and it operates in one segment.

Veracyte is a leading genomic diagnostics company that is fundamentally improving patient care by resolving diagnostic uncertainty with evidence that is trustworthy and actionable. The Company's products uniquely combine genomic technology, clinical science and machine learning to provide answers that give physicians and patients a clear path forward without risky, costly surgery that is often unnecessary.

Since the Company's founding in 2008, it has commercialized three genomic tests that it believes are transforming diagnostics:

Afirma Thyroid FNA Analysis - The Afirma genomic classifiers, specifically the Afirma Gene Expression Classifier, or GEC, and the recently commercialized Afirma Genomic Sequencing Classifier, or GSC, employ proprietary gene signatures to determine whether thyroid nodules previously classified by cytopathology as indeterminate can be reclassified as benign, thus enabling the patient to avoid an unnecessary surgery. The new Afirma GSC uniquely combines RNA sequencing and machine learning to leverage more enriched, previously undetectable genomic information. It can identify 30 percent more benign thyroid nodules among those deemed indeterminate following cytopathology.

Percepta Bronchial Genomic Classifier - The 23-gene Percepta classifier improves lung cancer screening and diagnosis by identifying patients at low risk of cancer among those whose lung nodules are not clearly benign or malignant following traditional evaluation. The Percepta classifier analyzes genomic changes that occur in the epithelial cells lining the airways of current or former smokers to assess a patient’s risk of having lung cancer, without the need to test the often-hard-to-reach nodule directly.

Envisia Genomic Classifier - Commercialized in October 2016, the Envisia classifier is designed to improve physicians’ ability to differentiate idiopathic pulmonary fibrosis, or IPF, from other interstitial lung diseases, or ILD, without the need for invasive and potentially risky surgery. The Envisia classifier uses machine learning coupled with powerful, deep RNA sequencing to detect the presence or absence of usual interstitial pneumonia, or UIP, a classic diagnostic pattern whose presence is essential for the diagnosis of IPF.

All of the Company's testing services are made available through its clinical reference laboratories located in South San Francisco, California and Austin, Texas, which are each certified under the Clinical Laboratory Improvement Amendments of 1988, or CLIA.

Basis of Presentation

The Company’s financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”). Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. The condensed balance sheet as of June 30, 2017, the condensed statements of operations and comprehensive loss for the

three and six months ended June 30, 2017 and 2016, and the condensed statements of cash flows for the six months ended June 30, 2017 and 2016 are unaudited, but include all adjustments, consisting only of normal recurring adjustments, which the Company considers necessary for a fair presentation of its financial position, operating results and cash flows for the periods presented. The condensed balance sheet at December 31, 2016 has been derived from audited financial statements. The results for the three and six months ended June 30, 2017 are not necessarily indicative of the results expected for the full year or any other period.

The accompanying interim period condensed financial statements and related financial information included in this Quarterly Report on Form 10-Q should be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

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Use of Estimates

The preparation of unaudited interim financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant items subject to such estimates include: revenue recognition; contractual allowances; the useful lives of property and equipment; the recoverability of long-lived assets; the estimation of the fair value of intangible assets; stock options; income tax uncertainties, including a valuation allowance for deferred tax assets; and contingencies. The Company bases these estimates on historical and anticipated results, trends and various other assumptions that the Company believes are reasonable under the circumstances, including assumptions as to future events. These estimates form the basis for making judgments about the carrying values of assets and liabilities and recorded revenue and expenses that are not readily apparent from other sources. Actual results could differ from those estimates and assumptions.

Concentrations of Credit Risk and Other Risks and Uncertainties

The majority of the Company's cash and cash equivalents are deposited with one major financial institution in the United States. Deposits in this institution may exceed the amount of insurance provided on such deposits. The Company has not experienced any losses on its deposits of cash and cash equivalents.

Several of the components of the Company's sample collection kit and test reagents are obtained from single-source suppliers. If these single-source suppliers fail to satisfy the Company's requirements on a timely basis, it could suffer delays in being able to deliver its diagnostic solutions, a possible loss of revenue, or incur higher costs, any of which could adversely affect its operating results.

The Company is also subject to credit risk from its accounts receivable related to its sales. The Company generally does not perform evaluations of customers' financial condition and generally does not require collateral.

Through June 30, 2017, all of the Company's revenue has been derived from the sale of Afirma. To date, Afirma has been delivered primarily to physicians in the United States. The Company's third-party payers in excess of 10% of revenue and their related revenue as a percentage of total revenue were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Medicare	26%	30%	26%	30%
UnitedHealthcare	15%	13%	14%	12%
	41%	43%	40%	42%

The Company's significant third-party payers and their related accounts receivable balance as a percentage of total accounts receivable were as follows:

	June 30, 2017	December 31, 2016
Medicare	17 %	18 %

No other third-party payer represented more than 10% of the Company's accounts receivable balances as of those dates.

Restricted Cash

The Company had deposits of $120,000 included in current assets as of June 30, 2017 and December 31, 2016, pledged for corporate credit cards. The Company also had deposits of $603,000 included in long-term assets as of June 30, 2017 and December 31, 2016, restricted from withdrawal and held by a bank in the form of collateral for an irrevocable standby letter of credit held as security for the lease of the Company's South San Francisco facility signed in April 2015.

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Fair Value of Financial Instruments

The carrying amounts of certain financial instruments including cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable and accrued liabilities approximate fair value due to their relatively short maturities.

Revenue Recognition

The Company recognizes revenue in accordance with the provision of ASC 954-605, Health Care Entities — Revenue Recognition ("ASC 954"). The Company's revenue is generated from the provision of diagnostic services. The service is completed upon the delivery of test results to the prescribing physician, at which time the Company bills for the service. The Company recognizes revenue related to billings for tests delivered on an accrual basis when amounts that will ultimately be realized can be estimated. The estimates of amounts that will ultimately be realized require significant judgment by management. Until a contract has been negotiated with a commercial payer or governmental program, the Company's tests may or may not be covered by these entities' existing reimbursement policies. In addition, patients do not enter into direct agreements with the Company that commit them to pay any portion of the cost of the tests in the event that their insurance declines to reimburse the Company.

The Company may bill the patient directly for these amounts in the form of co-payments and co-insurance in accordance with their insurance carrier and health plans. In the absence of the ability to estimate the amount that will ultimately be realized for the Company's services, revenue is recognized on the cash basis.

Revenue recognized for the three and six months ended June 30, 2017 and 2016 was as follows (in thousands of dollars):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2017	%	2016	%	2017	%	2016	%
Revenue recognized on the accrual basis	$17,611	96%	$9,349	64%	$32,749	94%	$17,575	62%
Revenue recognized on the cash basis	795	4%	5,326	36%	2,089	6%	10,650	38%
Total	$18,406	100%	$14,675	100%	$34,838	100%	$28,225	100%

Prior to July 1, 2016, the Company accrued less than 50% of the billed Afirma genomic classifier test volume per fiscal period. The Company believed it did not have a consistent enough payment history to accrue the remaining Afirma genomic classifier tests delivered to customers and, as noted above, recognized revenue on the cash basis for such tests. The Company has been analyzing the amounts received for tests performed since commercialization, and during the quarter ended September 30, 2016, sufficient information developed to support a reasonable estimate of the amount of revenue to accrue upon test delivery for a number of payers that had been previously recognized on the cash basis. As a result, starting in the quarter ended September 30, 2016, the Company began accruing substantially all of its billed Afirma genomic classifier test volume. In determining the amount to accrue for a particular test, the Company considered factors such as payer coverage, whether there is a reimbursement contract between the payer and the Company, timeliness of payment, payment as a percentage of agreed upon rate (if applicable), amount paid per test and any current developments or changes that could impact reimbursement. As a result, the Company recognized $3.5 million of incremental revenue during the quarter ended September 30, 2016 upon test delivery that previously would not have been recognized until cash was received. Tests performed prior to July 1, 2016 that did not meet the Company's accrual criteria at the time of delivery will continue to be recognized as revenue on the cash basis. In the quarter ended June 30, 2017, as a result of the related cash collections being higher than previously estimated and cash collection trends, the Company updated its revenue estimates and recognized an additional $1.0 million of revenue for certain tests performed in the six months ended December 31, 2016.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606), to supersede nearly all existing revenue recognition guidance under GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. ASU 2014-09 defines a five-step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than are required under existing GAAP. The Company will adopt the new revenue standard as of January 1, 2018 using the modified retrospective method. The Company has completed its assessment of the first three steps of this ASU, which include identifying the Company’s customers, identifying the Company's performance obligations, and determining transaction prices. The Company

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is currently assessing the remainder of the steps and believes the adoption of this ASU will not have a material impact on either the Company's financial position or results of operations.

In February 2016, the FASB issued ASU No. 2016-2, Leases. This ASU is aimed at making leasing activities more transparent and comparable, and requires substantially all leases be recognized by lessees on their balance sheet as a right-of-us asset and corresponding lease liability, including leases currently accounted for as operating leases. The ASU will be effective for interim and annual periods beginning after December 15, 2018. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. Full retrospective application is prohibited and early adoption is permitted. The Company is currently evaluating the potential effect of this standard on its financial statements.

In March 2016, the FASB issued ASU 2016-9, Compensation - Stock Compensation, related to the tax effects of share-based awards. The ASU requires that all the tax effects of share-based awards be recorded through the income statement, thereby simplifying the current guidance that requires excess tax benefits and certain excess tax deficiencies to be recorded in equity. This ASU also permits an election for the impact of forfeitures on the recognition of expense for share-based payment awards where forfeitures can be estimated or recognized when they occur. This ASU is effective for interim and annual periods beginning after December 15, 2016. The Company adopted this ASU as of January 1, 2017 and elected to continue using its forfeiture estimation method for share-based payment awards. This ASU was adopted prospectively and the impact of adoption on the Company's financial statements was not material.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows - Restricted Cash. This ASU requires that restricted cash and restricted cash equivalents be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The ASU will be effective for interim and annual periods beginning after December 15, 2017. The Company does not anticipate that the adoption of this ASU will have a significant impact on its financial statements.

2. Net Loss Per Common Share

Basic net loss per common share is calculated by dividing net loss attributable to common stockholders by the weighted-average number of common shares outstanding during the period, without consideration of common stock equivalents. Diluted net loss per common share is computed by dividing net loss attributable to common stockholders by the weighted-average number of common share equivalents outstanding for the period determined using the treasury stock method. The following outstanding common stock equivalents have been excluded from diluted net loss per common share because their inclusion would be anti-dilutive:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Shares of common stock subject to outstanding options	6,436,953	5,320,885	6,039,791	4,890,309
Employee stock purchase plan	41,044	47,435	35,229	36,942
Restricted stock units	70,000	—	54,834	—
Total common stock equivalents	6,547,997	5,368,320	6,129,854	4,927,251

3. Accrued Liabilities

Accrued liabilities consisted of the following (in thousands of dollars):

	June 30, 2017	December 31, 2016
Accrued compensation expenses	$ 4,945	$ 6,120
Accrued other	3,505	2,990
Total accrued liabilities	$ 8,450	$ 9,110

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4. Fair Value Measurements

The Company recognizes its financial assets and liabilities at fair value. The carrying amounts of certain financial instruments of the Company, including cash and cash equivalents, prepaid expenses and other current assets, accounts payable and accrued liabilities, approximate fair value due to their relatively short maturities. The carrying value of the Company's debt approximates its fair value because the interest rate approximates market rates that the Company could obtain for debt with similar terms. The estimated fair value of the Company's debt is estimated using the net present value of the payments, discounted at an interest rate that is consistent with market interest rates, which is a Level II input. The accounting guidance for fair value provides a framework for measuring fair value, clarifies the definition of fair value, and expands disclosures regarding fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the reporting date. The accounting guidance establishes a three-tiered hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value as follows:

- Level I: Inputs which include quoted prices in active markets for identical assets and liabilities.

- Level II: Inputs other than Level I that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

- Level III: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The fair value of the Company's financial assets, which consist only of money market funds, was $47.1 million and $58.7 million as of June 30, 2017 and December 31, 2016, respectively, and are Level I assets as described above.

5. Commitments and Contingencies

Operating Leases

The Company leases its headquarters and laboratory facilities in South San Francisco, California under a non-cancelable lease agreement for approximately 59,000 square feet. The lease began in June 2015 and ends in March 2026 and contains extension of lease term and expansion options. In February 2017, the Company relinquished certain expansion rights for a nominal fee. The Company had deposits of $603,000 included in long-term assets as of June 30, 2017 and December 31, 2016, restricted from withdrawal and held by a bank in the form of collateral for an irrevocable standby letter of credit held as security for the lease of the South San Francisco facility.

The Company also leases laboratory and office space in Austin, Texas under a lease that expires on July 31, 2018. The Company provided a cash security deposit of $75,000, which is included in other assets in the Company's condensed balance sheets as of June 30, 2017 and December 31, 2016.

Future minimum lease payments under non-cancelable operating leases as of June 30, 2017 are as follows (in thousands of dollars):

Year Ending December 31,	
2017	$1,079
2018	2,102
2019	2,026
2020	2,082

2021	2,144
Thereafter	9,812
Total minimum lease payments	$19,245

The Company recognizes rent expense on a straight-line basis over the non-cancelable lease period. Rent expense was $455,000 and $457,000 for the three months ended June 30, 2017 and 2016, respectively, and $912,000 and $1.1 million for the six months ended June 30, 2017 and 2016, respectively.

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Contingencies

From time to time, the Company may be involved in legal proceedings arising in the ordinary course of business. The Company believes there is no litigation pending that could have, individually or in the aggregate, a material adverse effect on the Company's financial position, results of operations or cash flows.

6. Debt

Credit Agreement

In March 2016, the Company entered into a credit agreement (the "Credit Agreement") with Visium Healthcare Partners, LP ("Visium"). Under the Credit Agreement, two term loans were available to the Company with an aggregate principal amount of up to $40.0 million. The Company drew down the initial $25.0 million term loan (the "Term Loan") on March 30, 2016, of which $5.0 million was used to pay the outstanding balance of the Company's existing long-term debt, which was cancelled at that date. On or prior to June 30, 2017, the Company was permitted to request a second term loan of up to $15.0 million; however, the Company did not draw down the second term loan and it expired. The Term Loan matures on March 31, 2022.

The Term Loan bears interest at a fixed rate of 12.0% per annum, payable quarterly at the end of each March, June, September and December. No principal payments will be due during an interest-only period, commencing on the funding date for the Term Loan (the "Borrowing Date") and continuing through and including March 31, 2020. The Company is obligated to repay the outstanding principal amount under the Term Loan in eight equal installments during the final two years under the Credit Agreement. For any quarterly interest payment through and including the 16th interest payment date after the Borrowing Date, so long as no event of default has occurred and is then continuing, the Company may elect to pay interest in cash on the outstanding principal amount of the Term Loan at a fixed rate of 9.0%, with the remaining 3.0% of the 12.0% interest paid-in-kind by adding such paid-in-kind interest to the outstanding principal amount of the Term Loan. The Company elected to pay interest in-kind for the quarters ended June 30, 2016 and September 30, 2016 and has recorded a total of $385,000 of paid-in-kind interest through June 30, 2017.

The Company may prepay the outstanding principal amount under the Term Loan subject to a minimum of $5.0 million of principal amount or a whole multiple of $1.0 million in excess thereof plus accrued and unpaid interest and a prepayment premium. The prepayment premium will be assessed on the principal amount repaid and will equal (i) 24.0% less the aggregate amount of all interest payments in cash, if the prepayment is made on or prior to March 31, 2018, (ii) 4.0%, if the prepayment is made after March 31, 2018 and on or prior to March 31, 2019, (iii) 2.0%, if the prepayment is made after March 31, 2019 and on or prior to March 31, 2020, and (iv) 1.0%, if the prepayment is made after March 31, 2020 and on or prior to March 31, 2021. After March 31, 2021 there is no prepayment premium.

The Company's obligations under the Credit Agreement are secured by a security interest in substantially all of its assets. The Credit Agreement contains customary representations, warranties and events of default, as well as affirmative and negative covenants. The negative covenants include, among other provisions, covenants that limit or restrict the Company's ability to incur liens, make investments, incur indebtedness, merge with or acquire other entities, dispose of assets, make dividends or other distributions to holders of its equity interests, engage in any material new line of business or enter into certain transactions with affiliates, in each case subject to certain exceptions. To the extent the Company forms or acquires certain subsidiaries domiciled in the United States, those subsidiaries are required to be guarantors of the Company's obligations under the Credit Agreement. As of June 30, 2017, the Company was in compliance with the loan covenants.

As of June 30, 2017, the net debt obligation for borrowings made under the Credit Agreement was as follows (in thousands of dollars):

	June 30, 2017
Debt principal	$25,385
Unamortized deferred debt issuance costs	(414)
Net debt obligation	$24,971

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Future principal payments under the Credit Agreement are as follows (in thousands of dollars):

Year Ending December 31,	
2020	$9,519
2021	12,693
2022	3,173
Total	$25,385

Loan and Security Agreement

In June 2013, the Company entered into a loan and security agreement as subsequently amended ("2013 Loan Agreement") with a financial institution that provided for borrowings of up to $10.0 million in aggregate. Borrowings under the 2013 Loan Agreement totaled $5.0 million, which was outstanding at January 1, 2016 until March 30, 2016 when it was repaid upon the Company entering into the Credit Agreement discussed above.

Interest Expense

Interest expense was as follows (in thousands of dollars):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Nominal interest	$769	$758	$1,532	$828
Amortization and write-off of debt discount and debt issuance costs	27	27	53	118
Prepayment penalty	—	—	—	50
End-of-term payment interest	—	—	—	156
Interest on capital lease	12	—	23	—
Total	$808	$785	$1,608	$1,152

7. Stockholders' Equity

Common Stock

The Company had reserved shares of common stock for issuance as follows:

	June 30, 2017	December 31, 2016
Stock options and restricted stock units issued and outstanding	6,394,917	5,251,832
Stock options and restricted stock units available for grant under stock option plans	1,048,850	887,724
Common stock available for the Employee Stock Purchase Plan	525,794	609,053
Total	7,969,561	6,748,609

8. Genzyme Co-Promotion Agreement

In January 2012, the Company and Genzyme Corporation ("Genzyme") executed a co-promotion agreement for the co-exclusive rights and license to promote and market the Company's Afirma thyroid diagnostic solution in the United States and in 40 named countries. In exchange, the Company received a $10.0 million upfront co-promotion fee from Genzyme in February 2012 which was deferred and amortized over the life of the agreement until the agreement was

terminated effective September 9, 2016. Under the terms of the agreement, Genzyme received a percentage of U.S. cash receipts that the Company has received related to the Afirma solution as co-promotion fees.

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In February 2015, the Company entered into an ex-U.S. co-promotion agreement with Genzyme for the promotion of the Afirma solution with exclusivity in five countries outside the United States initially and in other countries agreed to from time to time. The agreement commenced on January 1, 2015 and continued until December 31, 2019, with extension of the agreement possible upon agreement of the parties. Pursuant to the agreement, the Company agreed to pay Genzyme 25% of net revenue from the sale of the Afirma solution in Brazil and Singapore over a five-year period commencing January 1, 2015. These payments have been immaterial for all periods presented. Effective July 6, 2017, the agreement was terminated.

The Company incurred $2.1 million and $4.2 million in co-promotion expense, excluding the amortization of the upfront co-promotion fee, in the three and six months ended June 30, 2016, respectively, which is included in selling and marketing expenses in the condensed statements of operations and comprehensive loss. The Company had no outstanding obligations to Genzyme under the U.S. co-promotion agreement as of June 30, 2017 and December 31, 2016.

The Company amortized $290,000 and $721,000 of the $10.0 million upfront co-promotion fee in the three and six months ended June 30, 2016, respectively, which is reflected as a reduction to selling and marketing expenses in the condensed statements of operations and comprehensive loss. No such related costs were incurred during the three and six months ended June 30, 2017.

9. Thyroid Cytopathology Partners

In 2010, the Company entered into an arrangement with Pathology Resource Consultants, P.A. (“PRC”) to set up and manage a specialized pathology practice to provide testing services to the Company. There is no direct monetary compensation from the Company to PRC as a result of this arrangement. The Company’s service agreement is with the specialized pathology practice, Thyroid Cytopathology Partners (“TCP”), and was effective through December 31, 2015, and thereafter automatically renews every year unless either party provides notice of intent not to renew at least 12 months prior to the end of the then-current term. Under the service agreement, the Company pays TCP based on a fixed price per test schedule, which is reviewed periodically for changes in market pricing. Subsequent to December 2012, an amendment to the service agreement allows TCP to sublease a portion of the Company’s facility in Austin, Texas. The Company does not have an ownership interest in or provide any form of financial or other support to TCP.

The Company has concluded that TCP represents a variable interest entity and that the Company is not the primary beneficiary as it does not have the ability to direct the activities that most significantly impact TCP’s economic performance. Therefore, the Company does not consolidate TCP. All amounts paid to TCP under the service agreement are expensed as incurred and included in cost of revenue in the condensed statements of operations and comprehensive loss. The Company incurred $1.2 million and $1.3 million for the three months ended June 30, 2017 and 2016, respectively, and $2.4 million and $2.6 million for the six months ended June 30, 2017 and 2016, respectively, in cytopathology testing and evaluation services expenses with TCP. The Company’s outstanding obligations to TCP for cytopathology testing services were $412,000 and $426,000 as of June 30, 2017 and December 31, 2016, respectively, and are included in accounts payable on the Company’s condensed balance sheets.

TCP reimburses the Company for TCP's proportionate share of the Company’s rent and related operating expenses for the leased facility. TCP’s portion of rent and related operating expenses for the shared space at the Austin, Texas facility was $27,000 and $23,000 for the three months ended June 30, 2017 and 2016, respectively, and $52,000 and $46,000 for the six months ended June 30, 2017 and 2016, respectively, and is included in other income, net in the Company’s condensed statements of operations and comprehensive loss.

10. Income Taxes

The Company did not record a provision or benefit for income taxes during the three and six months ended June 30, 2017 and 2016. The Company continues to maintain a full valuation allowance against its net deferred tax assets.

As of June 30, 2017, the Company had unrecognized tax benefits of $2.4 million, none of which would currently affect the Company's effective tax rate if recognized due to the Company's net deferred tax assets being fully offset by a valuation allowance. The Company does not anticipate that the amount of unrecognized tax benefits relating to tax positions existing at June 30, 2017 will significantly increase or decrease within the next 12 months. There was no interest expense or penalties related to unrecognized tax benefits recorded through June 30, 2017.

A number of years may elapse before an uncertain tax position is audited and finally resolved. While it is often difficult to predict the final outcome or the timing of resolution of any particular uncertain tax position, the Company believes that its reserves for income taxes reflect the most likely outcome. The Company adjusts these reserves, as well as the related interest, in light of changing facts and circumstances. Settlement of any particular position could require the use of cash.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of financial condition and results of operations should be read together with the condensed financial statements and the related notes included in Item 1 of Part I of this Quarterly Report on Form 10-Q, and with our audited financial statements and the related notes included in our Annual Report on Form 10-K for the year ended December 31, 2016.

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. When used in this report, the words "expects," "anticipates," "intends," "estimates," "plans," "believes," "continuing," "ongoing," and similar expressions are intended to identify forward-looking statements. These are statements that relate to future events and include, but are not limited to, the factors that may impact our financial results; our expectations regarding our sources of revenue; our expectations with respect to our future research and development, general and administrative and selling and marketing expenses and our anticipated uses of our funds; our expectations regarding capital expenditures; our anticipated cash needs and our estimates regarding our capital requirements; potential future sources of cash; our business strategy and our ability to execute our strategy; our ability to achieve and maintain reimbursement from third-party payers at acceptable levels and our expectations regarding the timing of reimbursement; the estimated size of the global markets for our tests; the attributes and potential benefits of our tests and any future tests we may develop to patients, physicians and payers; the factors we believe drive demand for and reimbursement of our tests; our ability to sustain or increase demand for our tests; our intent to expand into other clinical areas; our ability to develop new tests, and the timeframes for development or commercialization; our ability to get our data and clinical studies accepted in peer-reviewed publications; our dependence on and the terms of our agreement with TCP, and on other strategic relationships, and the success of those relationships; our beliefs regarding our laboratory capacity; the applicability of clinical results to actual outcomes; our expectations regarding our international expansion; the occurrence, timing, outcome or success of clinical trials or studies; the ability of our tests to impact treatment decisions; our beliefs regarding our competitive position; our compliance with federal, state and international regulations; the potential impact of regulation of our tests by the FDA or other regulatory bodies; the impact of new or changing policies, regulation or legislation, or of judicial decisions, on our business; the impact of seasonal fluctuations and economic conditions on our business; our belief that we have taken reasonable steps to protect our intellectual property; the impact of accounting pronouncements and our critical accounting policies, judgments, estimates, models and assumptions on our financial results; and anticipated trends and challenges in our business and the markets in which we operate.

Forward-looking statements are based on our current plans and expectations and involve risks and uncertainties which could cause actual results to differ materially. These risks and uncertainties include, but are not limited to, those risks discussed in Part II, Item 1A of this report, as well as risks and uncertainties related to: our limited operating history and history of losses since inception; our ability to increase usage of and reimbursement for our tests; our dependence on a limited number of payers for a significant portion of our revenue; the complexity, time and expense associated with billing and collecting for our test; current and future laws, regulations and judicial decisions applicable to our business, including potential regulation by the FDA or by regulatory bodies outside of the United States; changes in legislation related to the U.S. healthcare system; our dependence on strategic relationships and collaborations; unanticipated delays in research and development efforts; our ability to develop and commercialize new products, including our GSC classifier, and the timing of commercialization; our ability to successfully enter new product or geographic markets; our ability to conduct clinical studies and the outcomes of such clinical studies; the applicability of clinical results to actual outcomes; trends and challenges in our business; our ability to compete against other companies, products and technologies; our ability to protect our intellectual property; and our ability to obtain capital when needed. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or undertaking to update any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is

based.

When used in this report, all references to "Veracyte," the "company," "we," "our" and "us" refer to Veracyte, Inc.

Veracyte, Afirma, Percepta, Envisia, the Veracyte logo and the Afirma logo are our trademarks. We also refer to trademarks of other corporations or organizations in this report.

This report contains statistical data and estimates that we obtained from industry publications and reports. These publications typically indicate that they have obtained their information from sources they believe to be reliable, but do not guarantee the accuracy and completeness of their information. Some data contained in this report is also based on our internal estimates.

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Overview

We are a leading genomic diagnostics company that is fundamentally improving patient care by resolving diagnostic uncertainty with evidence that is trustworthy and actionable. Our products uniquely combine genomic technology, clinical science and machine learning to provide answers that give physicians and patients a clear path forward without risky, costly surgery that is often unnecessary.

Our vision is to lead a transformation of diagnostics with a new genomic standard of truth. Our goal is to drive shareholder value by improving patient outcomes and reducing the cost of healthcare.

The role of genomic information in medical practice is evolving rapidly and has affected the diagnosis of disease as well as treatment decisions. Over the past decade, molecular diagnostic tests that analyze genomic material from surgical tissue samples have emerged as an important complement to evaluations performed by pathologists. Information at the molecular level enables one to understand more fully the makeup and specific subtype of disease to improve diagnosis. In many cases, the genomic information derived from these samples can help guide treatment decisions as part of the standard of care.

While genomic and technological advances are fueling the imagination about what is possible in medicine, we remain focused on delivering tests that change clinical decision making and improve patient outcomes.

We deploy machine learning methods and RNA expression to improve diagnostic clarity for cancer and other diseases. In our thyroid and lung cancer indications, diagnosis can be ambiguous in approximately 15-70% of patients undergoing diagnostic evaluation. Our tests provide clarity of diagnosis that can in turn guide treatment decisions in approximately half of those cases, eliminating costly, risky surgeries and other unnecessary medical procedures, improving the lives of patients and saving the healthcare system money.

Since our founding in 2008, we have commercialized three genomic tests that we believe are transforming diagnostics: the Afirma Gene Expression Classifier, or GEC, and its next-generation test, the Afirma Genomic Sequencing Classifier, or GSC, to determine whether thyroid nodules previously classified by cytopathology as indeterminate can be reclassified as benign; the Percepta Bronchial Genomic Classifier to improve lung cancer screening and diagnosis; and the Envisia Genomic Classifier to improve the physician's ability to differentiate idiopathic pulmonary fibrosis, or IPF, from other interstitial lung diseases, or ILD. Collectively, we believe these tests address a $2 billion global market opportunity.

Patients typically access our tests through their physician during the diagnostic process. All of our testing services are made available through our clinical reference laboratories located in South San Francisco, California and Austin, Texas, which are each certified under the Clinical Laboratory Improvement Amendments of 1988, or CLIA.

The published evidence supporting our tests demonstrates the robustness of our science and clinical studies. Patients and physicians can access our full list of publications on our website. Nearly 30 clinical studies covering our products have been published, including two landmark clinical validation papers published in The New England Journal of Medicine. We continue to build upon our extensive library of clinical evidence. We also expect to continue expanding our offerings in thyroid cancer, lung cancer and interstitial lung diseases such as IPF as well as other cancer indications that we believe will benefit from our technology and approach.

We believe our focus on developing clinically useful tests that change patient care is enabling us to set new standards in genomic test reimbursement. Our flagship product, the Afirma classifier, is now covered for more than 269 million people in the U.S. for use in thyroid cancer diagnosis and our second commercial product, the Percepta classifier, is the first genomic test to gain Medicare coverage for improved lung cancer screening and diagnosis.

Second Quarter 2017 Financial Results

For the three-month period ended June 30, 2017, as compared to the three-month period ended 2016:

- Revenue increased 25% to $18.4 million;
- Operating Expenses declined 1% to $25.0 million;
- Net Loss and Comprehensive Loss improved 35% to $7.3 million;
- Cash Burn (which is defined as net cash used in operating activities and net capital expenditures) improved 41% to $5.0 million; and
- Cash and Cash Equivalents was $46.5 million at June 30, 2017.

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Second Quarter 2017 and Recent Business Highlights

Commercial Achievements:

- Grew Afirma genomic classifier volume by 11% in the second quarter of 2017, compared to the second quarter of 2016.
- Initiated the transition to the next-generation Afirma Genomic Sequencing Classifier (GSC) that can save an estimated 70% of benign patients from unnecessary thyroid surgery to rule out thyroid cancer.
- Initiated access to the Afirma genomic classifier through Quest/Ameripath division's extensive network of service providers.
- Accepted our first commercial orders for the Percepta genomic classifier that aids in the screening and diagnosis of lung cancer.

Reimbursement Progress:

- Received Anthem and additional Blues coverage for our Afirma classifier, which is now one of the few genomic assays to attain coverage by virtually all health plans in the U.S.
- Signed five new contracts with Regence Blue Cross and Blue Cross of Kansas, bringing the total contracted lives for our Afirma classifier to approximately 163 million.

Clinical Evidence Development:

- Delivered podium presentation at the World Congress on Thyroid Cancer of pivotal clinical validation data for the next-generation Afirma GSC.
- Published a clinical utility study in the Journal of Thoracic Oncology (JTO), demonstrating that adoption of the Percepta classifier in lung cancer screening and diagnosis can meaningfully reduce invasive procedures and associated costs, and is cost-effective across a range of assumptions.
- Presented pivotal clinical validation data for the Envisia Genomic Classifier at the American Thoracic Society 2017 International Conference, demonstrating the classifier's unique ability to identify patients likely to have idiopathic pulmonary fibrosis (IPF) from a non-invasive sample.
- Initiated the Catalyst Study to evaluate the clinical utility of the Envisia classifier in the diagnosis of IPF.

Factors Affecting Our Performance

Reported Molecular Test Volume

Our performance depends on the number of molecular tests that we perform and report as completed in our CLIA laboratories. Factors impacting the number of tests that we report as completed include, but are not limited to:

- the number of samples that we receive that meet the medical indication for each test performed;
- the quantity and quality of the sample received;
- receipt of the necessary documentation, such as physician order and patient consent, required to perform, bill and collect for our tests;
- the patient's ability to pay or provide necessary insurance coverage for the tests performed;