

VERACYTE, INC.  
Form 10-Q  
November 25, 2013  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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(Mark One)

- ☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2013

OR

- ☐ **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

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## VERACYTE, INC.

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**20-5455398**  
(I.R.S. Employer  
Identification No.)

**7000 Shoreline Court, Suite 250**

**South San Francisco, California 94080**

(Address of principal executive offices, zip code)

**(650) 243-6300**

(Registrant's telephone number, including area code)

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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 ☐ No ☒

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 ☒ No ☐

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒  
(Do not check if a  
smaller reporting company)

Smaller reporting company ☐

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

As of November 15, 2013, there were 21,035,046 shares of common stock, par value \$0.001 per share, outstanding.

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Table of Contents

	<b>Page No.</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<u>Item 1. Condensed Unaudited Financial Statements</u>	
<u>Condensed Balance Sheets as of September 30, 2013 and December 31, 2012 (Unaudited)</u>	1
<u>Condensed Statements of Operations and Comprehensive Loss for the Three and Nine Month Periods Ended September 30, 2013 and 2012 (Unaudited)</u>	2
<u>Condensed Statements of Cash Flows for the Nine Month Periods Ended September 30, 2013 and 2012 (Unaudited)</u>	3
<u>Notes to the Condensed Financial Statements (Unaudited)</u>	4
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	38
<u>Item 4. Controls and Procedures</u>	38
<b><u>PART II. OTHER INFORMATION</u></b>	39
<u>Item 1A. Risk Factors</u>	39
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	65
<u>Item 6. Exhibits</u>	66
<u>SIGNATURE</u>	67
<u>EXHIBIT INDEX</u>	68

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Condensed Financial Statements****VERACYTE, INC.****CONDENSED BALANCE SHEETS****(Unaudited)****(In thousands, except share and per share amounts)**

	<b>September 30, 2013</b>	<b>December 31, 2012</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 15,426	\$ 14,002
Accounts receivable, net of allowance of \$364 and \$222 as of September 30, 2013 and December 31, 2012	714	569
Supplies inventory	1,392	1,050
Prepaid expenses and other current assets	2,938	710
Restricted cash		50
Total current assets	20,470	16,381
Property and equipment, net	2,826	2,446
Restricted cash	118	118
Other assets	157	122
Total assets	\$ 23,571	\$ 19,067
<b>Liabilities, Convertible Preferred Stock, and Stockholders (Deficit) Equity</b>		
Current liabilities:		
Accounts payable	\$ 5,604	\$ 1,888
Accrued liabilities	4,416	4,020
Deferred Genzyme co-promotion fee	2,500	2,500
Preferred stock liability		583
Total current liabilities	12,520	8,991
Long-term debt, net of discount	4,863	
Deferred rent, net of current portion	250	61
Preferred stock warrant liability	252	
Deferred Genzyme co-promotion fee, net of current portion	3,239	5,114
Total liabilities	21,124	14,166
Commitments and contingencies		
Convertible preferred stock; \$0.001 par value, 60,187,700 and 59,147,999 shares authorized at September 30, 2013 (unaudited) and December 31, 2012, respectively; 59,989,268 and	79,022	63,372

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53,084,507 shares issued and outstanding at September 30, 2013 (unaudited) and December 31, 2012, respectively

Stockholders' (deficit) equity:

Common stock, \$0.001 par value; 77,000,000 shares authorized; 992,578 and 667,684 shares issued and outstanding at September 30, 2013 (unaudited) and December 31, 2012, respectively

	1	1
Additional paid-in capital	3,181	1,597
Accumulated deficit	(79,757)	(60,069)
Total stockholders' (deficit) equity	(76,575)	(58,471)
Total liabilities, convertible preferred stock, and stockholders' (deficit) equity	\$ 23,571	\$ 19,067

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

Table of Contents

VERACYTE, INC.

CONDENSED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(Unaudited)

(In thousands, except share and per share amounts)

	Three Months Ended		September 30,		September 30,		September 30,	
	September 30,		September 30,		September 30,		September 30,	
	2013		2012		2013		2012	
Revenue	\$	5,594	\$	3,224	\$	15,046	\$	7,171
Operating expenses:								
Cost of revenue		3,132		1,984		9,136		4,984
Research and development		2,028		1,729		5,940		4,887
Selling and marketing		3,291		2,347		8,609		5,392
General and administrative		3,244		2,103		8,772		5,721
Total operating expenses		11,695		8,163		32,457		20,984
Loss from operations		(6,101)		(4,939)		(17,411)		(13,813)
Interest expense		(126)				(131)		
Other income (expense), net		(76)		1		(2,146)		1
Net loss and comprehensive loss	\$	(6,303)	\$	(4,938)	\$	(19,688)	\$	(13,812)
Net loss per common share, basic and diluted	\$	(6.59)	\$	(7.49)	\$	(22.87)	\$	(21.40)
Shares used to compute net loss per common share, basic and diluted		955,890		659,129		860,957		645,306

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

Table of Contents

## VERACYTE, INC.

## CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Nine Months Ended	
	September 30,	September 30,
	2013	2012
<b>Operating activities</b>		
Net loss	\$ (19,688)	\$ (13,812)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	717	526
Bad debt expense	184	144
Genzyme co-promotion fee amortization	(1,875)	(1,761)
Stock-based compensation	851	458
Equity-based compensation		203
Amortization of debt discount and issuance costs	28	
Interest on debt balloon payment	21	
Change in value of preferred stock liability	2,070	
Change in value of preferred stock warrant liability	77	
Changes in operating assets and liabilities:		
Accounts receivables	(329)	(482)
Supplies inventory	(342)	(488)
Prepaid expenses and current other assets	(2,183)	(287)
Other assets	32	(58)
Accounts payable	3,813	747
Accrued liabilities and deferred rent	763	1,531
Deferred Genzyme co-promotion fee		10,000
Net cash used in operating activities	(15,861)	(3,279)
<b>Investing activities</b>		
Purchases of property and equipment	(1,061)	(912)
Change in restricted cash	50	
Net cash used in investing activities	(1,011)	(912)
<b>Financing activities</b>		
Proceeds from the issuance of long-term debt, net of debt issuance costs	4,877	
Proceeds from issuance of redeemable convertible preferred stock, net of issuance costs	12,945	
Proceeds from the exercise of common stock options	474	66
Net cash provided by financing activities	18,296	66
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>1,424</b>	<b>(4,125)</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>14,002</b>	<b>7,566</b>
<b>Cash and cash equivalents at end of period</b>	<b>\$ 15,426</b>	<b>\$ 3,441</b>



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

Table of Contents

**VERACYTE, INC**

**Notes to Condensed Financial Statements**

**1. Organization and Summary of Significant Accounting Policies**

Veracyte, Inc. (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. Veracyte is a diagnostics company pioneering the field of molecular cytology to improve patient outcomes and lower healthcare costs. The Company specifically targets diseases that often require invasive procedures for an accurate diagnosis—diseases where many healthy patients undergo costly interventions that ultimately prove unnecessary. The Company improves the accuracy of diagnosis at an earlier stage of patient care by deriving clinically actionable genomic information from cytology samples collected in an outpatient setting. The Company's first commercial solution, the Afirma Thyroid FNA Analysis, includes as its centerpiece the Gene Expression Classifier ("GEC"). The GEC helps physicians reduce the number of unnecessary surgeries by employing a proprietary 142-gene signature to preoperatively determine whether thyroid nodules previously classified by cytopathology as indeterminate can be reclassified as benign. The Company's operations are based in South San Francisco, California and Austin, Texas, and it operates in one segment.

***Initial Public Offering***

On November 4, 2013, the Company completed an initial public offering ("IPO") of its common stock. In connection with its IPO, the Company issued and sold 5,000,000 shares of its common stock at a price to the public of \$13.00 per share. As a result of the IPO, the Company received approximately \$57.9 million in net proceeds, after deducting underwriting discounts and commissions of \$4.6 million and estimated offering expenses of \$2.5 million payable by the Company. The condensed financial statements, including share and per share amounts, do not give effect to the IPO.

***Reverse Stock Split***

On October 9, 2013, the Company filed a Certificate of Amendment to its Fourth Amended and Restated Certificate of Incorporation to effect a four-for-one reverse stock split of its outstanding common stock. The par value per share and the authorized number of shares of common stock and preferred stock were not adjusted as a result of the reverse stock split. All issued and outstanding shares of common stock, options to purchase common stock and related per share amounts contained in the unaudited interim condensed financial statements have been retroactively adjusted to reflect the reverse stock split for all periods presented. A proportional adjustment to the conversion ratio for each series of convertible preferred stock was also effected in connection with the reverse stock split. The unaudited interim condensed financial statements have not been retroactively adjusted to give effect to the conversion of the preferred stock into 0.25 of a share of common stock upon the closing of the IPO.

***Basis of Presentation***

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The accompanying unaudited interim condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information in accordance with Securities and Exchange Commissions ( SEC ) instructions for interim financial reporting and assume the Company will continue as a going concern.

Table of Contents

Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. The financial information for the three and nine months ended September 30, 2013 and 2012 is unaudited but includes all adjustments (consisting of only normal recurring adjustments), which the Company considers necessary for a fair presentation of the results of operations for those periods. Interim results are not necessarily indicative of results for the full fiscal year.

The unaudited interim condensed financial statements and related financial information should be read in conjunction with the audited financial statements and the related notes thereto for the year ended December 31, 2012 included in the Registration Statement on Form S-1 (No. 333-191282) filed by the Company with the SEC on September 20, 2013, as amended.

*Use of Estimates*

The preparation of unaudited interim condensed financial statements in conformity with U.S. 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; allowance for doubtful accounts; the useful lives of property and equipment; the recoverability of long-lived assets; the determination of fair value of the Company's common stock, stock options, and preferred stock liability; 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 Company's cash and cash equivalents are deposited with two major financial institutions in the United States of America. Deposits in these institutions 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 Afirma, 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 of Afirma. The Company generally does not perform evaluations of customers' financial condition and generally does not require collateral. All of the Company's accounts receivables are derived from sales of Afirma in the United States.

As of September 30, 2013 and 2012, all of the Company's revenue is derived from the sale of Afirma. To date, Afirma has been available only to physicians in the United States. The Company's significant third-party payers and their related revenue as a percentage of revenue were as

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follows:

	Nine Months Ended September 30,	
	2013	2012
Medicare	33%	35%
Aetna	8%	13%
United Healthcare	17%	12%
	58%	60%

Table of Contents

Accounts receivable from Medicare amounted to 79% and 87% of gross receivables as of September 30, 2013 and December 31, 2012, respectively. No other third-party payer represented more than 10% of the Company's revenues or accounts receivable balances for these periods.

***Cash and Cash Equivalents***

Cash and cash equivalents consist of all highly liquid investments with original maturities of three months or less from the date of purchase. Cash equivalents consist primarily of amounts invested in money market accounts.

***Restricted Cash***

At September 30, 2013 and December 31, 2012, deposits of \$118,000 and \$168,000 were restricted from withdrawal and held by a bank in the form of certificates of deposit and collateral for letters of credit. The balances at September 30, 2013 and December 31, 2012 consisted of a \$118,000 letter of credit related to security for the lease of office space. In addition, the balances at December 31, 2012 also included a certificate of deposit of \$50,000 held as collateral for payment of the Company's credit cards.

***Allowance for Doubtful Accounts***

The Company accrues an allowance for doubtful accounts against its accounts receivable based on estimates consistent with historical collection experience in relation to amounts billed. Bad debt expense is included in general and administrative expense on the Company's statements of operations and comprehensive loss. Accounts receivable are written off against the allowance when the claims appeals process is exhausted or when there is other substantive evidence that the account will not be paid. The Company's allowance for doubtful accounts as of September 30, 2013 and December 31, 2012 was \$364,000 and \$222,000, respectively. The provision for bad debt expense was \$66,000 and \$58,000 for the three months ended September 30, 2013 and 2012, respectively, and \$184,000 and \$144,000 for the nine months ended September 30, 2013 and 2012, respectively. There were \$34,000 in write-offs for doubtful accounts against the allowance during the nine months ended September 30, 2013.

***Supplies Inventory***

Supplies inventory consists of test reagents and other consumables used in the sample collection kits and in the performance of testing services for cytopathology and for the GEC. Supplies inventory is valued at the lower of cost or market value. Cost is determined using actual costs on a first-in, first-out basis.

Table of Contents

***Internal-use Software***

Capitalized software costs consist of third-party costs incurred in the application development stage to design and implement the software that is used in the GEC. Costs incurred in the development of software are capitalized and amortized over an estimated useful life of three years on a straight line basis. During the nine months ended September 30, 2013 and 2012, the Company capitalized \$211,000 and \$173,000 of software development costs, respectively. Capitalized software is classified as part of property and equipment, and had a net book value of \$321,000 and \$184,000 as of September 30, 2013 and December 31, 2012, respectively.

***Bonus Accruals***

The Company accrues for liabilities under discretionary employee and executive bonus plans. These estimated compensation liabilities are based on progress against corporate objectives approved by the Board of Directors, compensation levels of eligible individuals, and target bonus percentage levels. The Board of Directors and the Compensation Committee of the Board of Directors review and evaluate the performance against these objectives and ultimately determine what discretionary payments are made. At September 30, 2013 and December 31, 2012, the Company accrued \$639,000 and \$671,000, respectively, for liabilities associated with these employee and executive bonus plans.

***Revenue Recognition***

The Company's revenue is generated from the provision of diagnostic services using its Afirma solution. Service is completed upon the delivery of test results to the prescribing physician which triggers the billing for the service. The Company recognizes revenue related to billings for commercial carriers or governmental programs subject to contractual arrangements and when there is a predictable pattern of collectability on an accrual basis, net of contractual adjustments. These contractual adjustments represent the difference between the list price (the billing rate) and the reimbursement rate set by commercial or governmental payers. Until a contract has been negotiated with a commercial carrier or governmental program, the Afirma solution may or may not be covered by these entities' existing reimbursement policies. In addition, patients do not enter into direct agreements with us that commit them to pay any portion of the cost of the tests in the event that their insurance declines to reimburse the Company. In the absence of an agreement or other clearly enforceable legal right to demand payment, when test services are provided to patients with non-contracted insurance carriers or no insurance, the related revenue is only recognized upon the earlier of payment notification, if applicable, or cash receipt.

For all services performed, the Company considers whether or not the following revenue recognition criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured.

Persuasive evidence of an arrangement exists and delivery is deemed to have occurred upon delivery of a patient report to the prescribing physician. The assessment of the fixed or determinable nature of the fees charged for testing performed and the collectability of those fees require significant judgment by management. Management believes that these two criteria have been met when there is contracted reimbursement coverage and/or a predictable pattern of collectability with individual third-party payers and accordingly, recognizes revenue upon delivery of the patient report. Some patients have out-of-pocket costs for amounts not covered by their insurance carrier, and the Company may bill the patient directly for these amounts in the form of co-payments and co-insurance in





Table of Contents

accordance with their insurance carrier and health plans. Some payers may not cover the GEC as ordered by the prescribing physician under their reimbursement policies. The Company pursues reimbursement from such patients on a case-by-case basis. In the absence of contracted reimbursement coverage or a predictable pattern and history of collectability, the Company believes that the fee is fixed or determinable and collectability is reasonably assured only upon receipt of third-party payer notification of payment or when cash is received and accordingly, recognizes revenue at that time.

***Net Loss per Common Share***

Basic net loss per common share is calculated by dividing net loss for the period 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 the loss for the period by the weighted-average number of common share equivalents outstanding for the period determined using the treasury stock method. Potentially dilutive securities consisting of convertible preferred stock and options to purchase common stock are considered to be common stock equivalents and were excluded from the calculation of diluted net loss per common share because their effect would be antidilutive for all periods presented.

***Recent Accounting Pronouncements***

In February 2013, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. This ASU requires reporting and disclosure about changes in accumulated other comprehensive income balances and reclassifications out of accumulated other comprehensive income. The Company adopted this guidance as of January 1, 2013 on a prospective basis and the adoption did not have a material effect on the Company's financial statements as the Company does not have comprehensive income (loss).

In June 2011, the FASB issued authoritative guidance requiring companies to present items of net income, items of other comprehensive income and total comprehensive income in one continuous statement or two consecutive statements. This guidance eliminates the option for companies to present other comprehensive income in the statement of stockholders' equity. The Company adopted this guidance as of January 1, 2012. As this guidance provides only presentation requirements, the adoption of this guidance did not impact the Company's financial condition or results of operations.

In May 2011, the FASB issued authoritative guidance to achieve common fair value measurement and disclosure requirements between U.S. GAAP and International Financial Reporting Standards. This new literature amends current fair value measurement and disclosure guidance to include increased transparency around valuation inputs and investment categorization. The guidance is effective for fiscal years and interim periods beginning after December 15, 2011. The Company adopted this standard as of January 1, 2012, as reflected in Note 3 to the unaudited interim condensed financial statements.

Table of Contents**2. Accrued Liabilities**

Accrued liabilities consist of the following (in thousands):

	September 30, 2013		December 31, 2012
Accrued compensation expenses	\$ 1,248	\$	1,360
Accrued consulting fees	42		28
Accrued legal and professional fees	294		84
Accrued Genzyme co-promotion fees	2,322		2,175
Accrued other	510		373
Accrued liabilities	\$ 4,416	\$	4,020

**3. Fair Value Measurements**

The Company records 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 long-term debt approximates its fair value because the interest rate approximates market rates that the Company could obtain for debt with similar terms. 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.

Table of Contents

The Company's financial assets and liabilities subject to fair value measurements on a recurring basis and the level of inputs used in such measurements were as follows (in thousands):

	September 30, 2013			
	Level I	Level II	Level III	Total
<b>Financial Assets:</b>				
Money market funds	\$ 15,078	\$	\$	\$ 15,078
Total financial assets	\$ 15,078	\$	\$	\$ 15,078
<b>Financial Liabilities:</b>				
Preferred stock warrant liability	\$	\$	\$ 252	\$ 252
Total financial liabilities	\$	\$	\$ 252	\$ 252

	December 31, 2012			
	Level I	Level II	Level III	Total
<b>Financial Assets:</b>				
Money market funds	\$ 12,830	\$	\$	\$ 12,830
Total financial assets	\$ 12,830	\$	\$	\$ 12,830
<b>Financial Liabilities:</b>				
Preferred stock liability	\$	\$	\$ 583	\$ 583
Total financial liabilities	\$	\$	\$ 583	\$ 583

The Company's Level III liabilities consist of a preferred stock liability and a preferred stock warrant liability (see Note 5). The following table sets forth a summary of the changes in the fair value of the Company's Level III financial liabilities, which are measured on a recurring basis (in thousands):

Balance as of December 31, 2012	\$ 583
Change in fair value of preferred stock liability recorded in other income (expense), net	2,070
Settlement of preferred stock liability	(2,653)
Fair value of preferred stock warrant liability	175
Change in fair value of preferred stock warrant liability recorded in other income (expense), net	77
Balance as of September 30, 2013	\$ 252

In November 2012, the Company recorded a preferred stock liability as investors received the right to purchase from the Company, on the same terms, additional shares of Series C convertible preferred stock, in a second tranche. As the investors hold a majority of the board seats, the decision to complete the second tranche was deemed to be outside the control of the Company. The preferred stock liability was valued using the option-pricing method, which resulted in an initial fair value of \$0.9 million for the Company's obligation to sell the convertible preferred stock. In June 2013, the Company settled the preferred stock liability upon completion of the sale of the second tranche of Series C convertible preferred stock. Immediately prior to settlement, the Company revalued the preferred stock liability to \$2.7 million and recorded other expense of \$2.1 million related to the change in value of the liability through that date. The preferred stock liability was valued using the option-pricing method with the following assumptions: 100% probability of success of the second tranche, fair value of Series C preferred stock of \$2.39, a term of 0.003 years and expected volatility of 36.4%.

Table of Contents

**4. Debt**

In June 2013, the Company entered into a loan and security agreement with a financial institution to fund its working capital and other general corporate needs. The agreement provided for term loans of up to \$10.0 million in aggregate. The Company drew down \$5.0 million in funds under the agreement in June 2013. The Company is required to repay the outstanding principal in 30 equal installments beginning 18 months after the date of the borrowing. The loan bears interest at a rate of 6.06% per annum. The loan carries prepayment penalties of 2.25% and 1.5% for prepayment within one and two years, respectively, of the loan origination and 0.75% thereafter.

Upon execution of the loan and security agreement, the Company issued the financial institution a warrant to purchase shares of Series C convertible preferred stock at \$1.89 per share (See Note 5). At the time of issuance, the aggregate fair value of the warrant for the 99,206 shares exercisable under the warrant was \$175,000. The fair value of the warrant was carved out from total proceeds, resulting in a debt discount to be amortized to interest expense over 48 months, through the maturity date of the initial loan, using the effective interest rate method, and was recorded as a preferred stock warrant liability. The end of term payment of \$223,000 representing 4.45% of the total outstanding principal balance will be accreted over the life of the loan as interest expense. As a result of the debt discount and the end of term payment, the effective interest rate for the loan differs from the contractual rate. Interest expense related to the amortization of the debt discount and accretion of the end of term payment was \$36,000 and \$38,000 for the three and nine months ended September 30, 2013, respectively.

The Company may request a second term loan of up to \$5.0 million on or prior to March 31, 2014. The Company's obligations under the loan and security agreement are secured by a security interest on substantially all of its assets, excluding its intellectual property and certain other assets. The loan and security agreement contains customary conditions related to borrowing, events of default, and covenants, including covenants limiting the Company's ability to dispose of assets, undergo a change in control, merge with or acquire other entities, incur debt, incur liens, pay dividends or other distributions to holders of its capital stock, repurchase stock and make investments, in each case subject to certain exceptions. The agreement also allows the lender to call the debt in the event there is a material adverse change in the Company's business or financial condition. The loan and security agreement does not require that the Company comply with any financial covenants.

**5. Convertible Preferred Stock Warrants**

In June 2013, in conjunction with the execution of the loan and security agreement (Note 4), the Company issued to the lender a warrant to purchase up to 198,412 shares of Series C convertible preferred stock with an exercise price of \$1.89 per share. Upon the draw down of the \$5.0 million term loan, the warrant became exercisable for 99,206 shares. If the Company draws the second term loan, the remaining 99,206 shares will become exercisable under the warrant. The warrant expires at the earlier of (i) June 26, 2023 or (ii) the seventh anniversary of the Company's initial public offering. The warrant is exercisable in cash or through a cashless exercise provision. Under the cashless exercise provision, the holder may, in lieu of payment of the exercise price in cash, surrender the warrant and receive a net amount of shares based on the fair market value of the Company's Series C convertible preferred stock at the time of exercise of the warrant after deducting the aggregate exercise price. In the event that all outstanding shares of the Series C convertible preferred stock are converted into common stock, the warrant will be exercisable for 24,801 shares of common stock (or 49,602 shares in the aggregate if the Company draws down the second term loan), at an exercise price of \$7.56 per share. The fair value of

Table of Contents

the currently exercisable portion of the warrant in the amount of \$175,000 was recorded as a preferred stock warrant liability upon issuance and is subject to remeasurement at each reporting period up to the closing date of the IPO when the Series C preferred is converted into common stock. The fair value of the warrant upon issuance was calculated using the Black-Scholes option-pricing valuation model with the following assumptions: Series C preferred stock value of \$2.40 per share, contractual term of 7.3 years, risk-free interest rate of 2.1%, expected volatility of 73.7%, and expected dividend yield of 0%. At September 30, 2013, the fair value of the warrant was approximately \$252,000, and was calculated using the Black-Scholes option-pricing valuation model with the following assumptions: Series C preferred stock value of \$3.25 per share, contractual term of 7.083 years, risk-free interest rate of 2.02%, expected volatility of 75.63%, and expected dividend yield of 0%. The change in the fair value of approximately \$77,000 was reported as an expense for the three and nine months ended September 30, 2013 and is included in other income (expense), net in the unaudited interim condensed statements of operations.

**6. Convertible Preferred Stock**

In June 2013, the Company amended its Amended and Restated Certificate of Incorporation to increase the number of authorized shares of Series C convertible preferred stock from 14,000,000 to 14,852,001 and amended the Series C stock purchase agreement to increase the number of shares that may be sold in additional closings from 26,455 to a total of 1,640,212. The Company completed the second closing and two additional closings under the agreement, and received gross proceeds of \$13.0 million for the issuance of an aggregate of 6,904,761 shares of Series C convertible preferred stock.

**7. Stock Incentive Plan**

The following table summarizes activity under the Company's 2008 Stock Plan, including grants to non-employees and restricted stock issued (in thousands, except per share amounts):

	Shares Available for Grant	Options Outstanding	Weighted Average Exercise Price per Share	Aggregate Intrinsic Value
Balances at December 31, 2012	347,386	2,227,669	\$ 2.06	\$ 4,311
Additional options authorized	250,000			
Options granted	(636,654)	636,654	4.70	
Options exercised		(324,892)	1.46	
Options forfeited	183,852	(183,852)	2.69	
Balances at September 30, 2013	144,584	2,355,579	\$ 2.81	\$ 21,928
Vested September 30, 2013		1,217,163	\$ 2.02	\$ 12,290
Expected to vest September 30, 2013		2,234,726	\$ 2.77	\$ 20,904

The aggregate intrinsic value was calculated as the difference between the exercise price of the options to purchase common stock and the estimated fair value of the Company's common stock of \$12.12 per share as of September 30, 2013.

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### Table of Contents

Outstanding and exercisable stock options at September 30, 2013 are summarized as follows:

Exercise Price	Options Outstanding		Options Vested and Exercisable	
	Number	Weighted-Average Remaining Contractual Life (in Years)	Number	Weighted-Average Remaining Contractual Life (in Years)
\$0.08	177,750	4.89	177,750	4.89
\$0.80	196,194	6.40	178,718	6.39
\$2.36	430,134	7.06	328,880	7.06
\$2.40	216,875	7.94	141,416	7.95
\$2.68	653,952	8.53	282,438	8.51
\$4.00	473,299	9.33	107,961	9.32
\$6.04	198,375	9.72		
\$7.92	9,000	9.94		
\$0.08-7.92	2,355,579	8.02	1,217,163	7.28

The weighted average fair value of stock options granted was \$3.73 and \$1.88 per share in the nine months ended September 30, 2013 and 2012, respectively.

The weighted average fair value of stock options vested was \$2.24 and \$1.38 per share in the nine months ended September 30, 2013 and 2012, respectively.

The weighted average fair value of stock options exercised was \$0.98 and \$0.92 per share in the nine months ended September 30, 2013 and 2012, respectively. The intrinsic value of stock options exercised was \$3,463,000 and \$112,000 in the nine months ended September 30, 2013 and 2012, respectively.

On October 2, 2013, the Board of Directors adopted the 2013 Stock Incentive Plan which became effective immediately prior to the closing of the IPO. To the extent that any awards outstanding under the 2008 Stock Plan are subsequently forfeited or terminated for any reason before being exercised or settled, or which are subject to vesting restrictions under the 2008 Stock Plan and are subsequently forfeited, the shares of common stock reserved for issuance pursuant to such awards as of the closing of the IPO will become available for issuance under the 2013 Stock Incentive Plan. No options will be granted in the future under the 2008 Stock Plan.

### ***Stock-based Compensation***

Stock-based compensation expense recognized was as follows (in thousands):

**Three Months  
Ended**

**Nine Months  
Ended**

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	September 30,		September 30,	
	2013	2012	2013	2012
Cost of revenue	\$ 10	\$ 5	\$ 23	\$ 21
Research and development	67	38	170	86
Selling and marketing	46	29	123	81
General and administrative	238	96	535	270
Total	\$ 361	\$ 168	\$ 851	\$ 458

Table of Contents

As of September 30, 2013, the Company had \$2.5&