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Research – Natera Inc. (5/20/19)

Description: Natera, Inc is a diagnostics company that provides preconception and prenatal genetic testing services. The company offers products through its direct sales force, as well as through a network of approximately 100 laboratory and distribution partners in the United States and internationally and was founded in 2003 and is headquartered in San Carlos, California. The company offers the following:

1. **Panorama** - a non-invasive prenatal test that screens for chromosomal abnormalities of a fetus with a blood draw from the mother
2. **Horizon** – a carrier screening to determine carrier status for various genetic diseases that could be passed on to the carrier's children
3. **Vistara** - a single-gene mutations screening test to identify single-gene disorder
4. **Spectrum** – a pre-implantation genetic screening and Spectrum pre-implantation genetic diagnosis to analyze chromosomal anomalies or inherited genetic conditions during an in vitro fertilization cycle.
5. **Anora** products of conception test to analyze fetal chromosomes to understand the cause of miscarriage; and non-invasive paternity testing products to determine paternity by analyzing the fragments of fetal deoxyribonucleic acid in a pregnant mother's blood and a blood sample from the alleged father.
6. **Constellation** - a cloud-based software product that allows laboratory customers to gain access through the cloud to the company's algorithms and bioinformatics in order to validate and launch tests
7. **Evercord** - a cord blood and cord tissue processing and storage service
8. **Signatera** – a circulating tumor DNA technology that analyzes and tracks mutations to an individual's tumor

Ticker: NTRA
Price: $22.54
Market Cap: $1.6B
Performance: +61.5% YTD

Analysis

Natera Inc. is in the genomic testing industry and the demand for such testing is expected to increase at a substantial rate for the next several years. For those not familiar with genomic testing, it is a type of medical test that identifies changes in chromosomes, genes, or proteins. The results of a genetic test can confirm or rule out a suspected genetic condition or help determine a person's chance of developing or passing on a genetic disorder.

The global direct-to-consumer genetic testing market will surpass $2.5B by 2024; according to a new research report by Global Market Insights. More specifically related to NTRA, the global prenatal and newborn genetic testing market size was valued over $3.4B in 2017 and is expected to witness more than 11.9% CAGR from 2018 to 2024 with rising prevalence of genetic disorders and chromosomal abnormalities in the newborns across the globe.

While Natera does have their hands in many different areas as seen above, it appears revenue is mainly coming from Horizon and Panorama at this moment in time.

Below are some stats from their Q1 2019 report that was released less than two weeks ago on May 9th:

The company reported Q1 GAAP EPS of -$0.54 beating estimates by $0.06 on revenue of $66.82M (+7.2% Y/Y) beating by $1.33M.

($ in millions, except for per share data)

P&L	Q1'19	Q1'18	Change
Horizon Revenue	$ 22.7	$ 18.3	$ 4.4
Panorama Revenue	$ 37.2	$ 33.3	$ 3.9
Total Revenue	$ 66.8	$ 62.3	$ 4.5
Gross Margin%[1]	35%	35%	--%
R&D	$ 11.4	$ 14.3	$ (2.9)
SG&A	$ 43.8	$ 37.9	$ 5.9
Net Loss Per Diluted Share	$ (0.54)	$ (0.61)	$ 0.07
Balance Sheet	**Mar 31, 2019**	**Dec 31, 2018**	**Change**
Cash & Investments[2]	$ 128.5	$ 158.5	$ (30.0)
UBS Line of Credit	$ 50.2	$ 50.2	$ --
OrbiMed Debt Facility	$ 73.4	$ 73.4	$ --

- Generated total revenues of $66.8 million in the first quarter of 2019 compared to $62.3 million in the first quarter of 2018, an increase of 7%.
- Processed 200,194 tests in the first quarter of 2019, compared to approximately 164,355 tests processed in the first quarter of 2018, an increase of approximately 22%, and a sequential increase of approximately 15% when compared to 174,200 tests processed in the fourth quarter of 2018.
- Processed approximately 136,500 Panorama tests in the first quarter of 2019, compared to approximately 114,700 Panorama tests processed in the first quarter of 2018, an increase of approximately 19%.
- Accessioned approximately 54,300 Horizon carrier screening (HCS) tests in the first quarter of 2019 compared to approximately 41,500 HCS tests accessioned in the first quarter of 2018, an increase of approximately 31%.

As for potential new streams of revenue, which is something we are very interested in:

- Received a positive draft local coverage decision from Medicare for Prospera in kidney transplant rejection screening.
- Received breakthrough device designation for Signatera from the FDA.

Guidance for the year was left unchanged and the company expects to generate $275-302M in the year. This would imply around 11% growth at the midway point of the guidance from 2018.

As for margins, in 2018 the company averaged gross margins of 35.6% so it looks like there is a good probability that will come in higher this year unless they hit the bottom of their projections.

($ in millions)	
Revenue	$275 – $302
Gross margin % revenue	35% – 41%
SG&A	$180 – $190
R&D	$60 – $65
Cash burn	$80 – $100

Cash burn is something we find pretty concerning which is expected to come in around -$80-100M which is pretty heavy and worse than last year's levered free cash flow of -$75.5M.

When we looked at cash as of March 31st, we were worried that the company wouldn't have enough, or at least very little by year-end, to continue operations. Upon further research, we saw that on April 11th, NTRA did a $100M secondary offering to raise cash which is absolutely necessary for the business at this point in time.

So while the most recent reported quarter does show $128.5M in cash and equivalents on hand the number is closer to $228M now minus whatever cash they've already burned in Q2. Assuming the cash burn is broken down proportionally, we can estimate that cash on hand by end of Q2 will be around $200M give or take.

Right now the prospects for NTRA look promising but given the guidance we think their other business lines are still going to take until 2020, if not longer, to significantly materialize on the financials but this isn't necessarily a bad thing as investors want to ensure the future is solid and has different revenue streams.

When we compare NTRA to its competitors though, the results are mixed. View the table below:

	Natera (NTRA)	Invitae (NTVA)	Guardant Health (GH)	Neogenomics (NEO)	Genomic Health (GHDX)
Forward P/S	5.2x	6.5x	42.8x	5.4x	4.4x
Enterprise Value / Sales	5.3x	5.9x	40.2x	5.7x	4.1x
Gross Margins	35.6%	48.1%	57.1%	47.6%	68.8%
2 YR Rev CAGR	13.2%	126%	89.5%	13%	11.3%
Levered Free Cash Flow (LTM)*	-$63.2M	-$54.7M	-$66.1M	+$17.2M	+$39.9M

*Last Twelve Months

From a fundamental perspective, there's really not too much to get excited about here for these groups of companies. They're all racing for market share right now at the expense of focusing on the bottom line or, for the most part, cash flow generation – which is why NTRA had to raise more capital. This will probably continue into next year as their new revenue streams will most likely require a substantial amount of R&D.

As you can see, one thing that really stands out to us is NTRA's gross margins. They're underperforming their peers in this space by a pretty wide margin and competition is only going increase. If we look at the company's implied revenue per test it has dropped dramatically from >$1100 in 2015 to $333 in Q1 2019 – a plummet of nearly 70%.

Another thing that worries us a bit are the constant lawsuits in this space. Here are some examples:

- A year ago, the gene-testing company Illumina (ILMN) filed a lawsuit against Natera, alleging that the company's non-invasive prenatal testing infringes a patent that Illumina controls and that relies on analysis of cell-free DNA present in maternal blood. That case is still moving toward a trial but it should also be noted that NTRA also utilizes ILMN's technology via a supply agreement that expires in 2026.

- Illumina last year also won a $26.7M jury verdict in a lawsuit accusing a subsidiary of Roche Holdings of using patented prenatal testing technology without authorization.

- There's more. Last year, Natera also agreed to pay $11.4M to settle a lawsuit with the U.S. government, after it alleged that Natera submitted false claims to several government health programs based on tips by two former Natera employees who filed an earlier whistleblower lawsuit against the company.

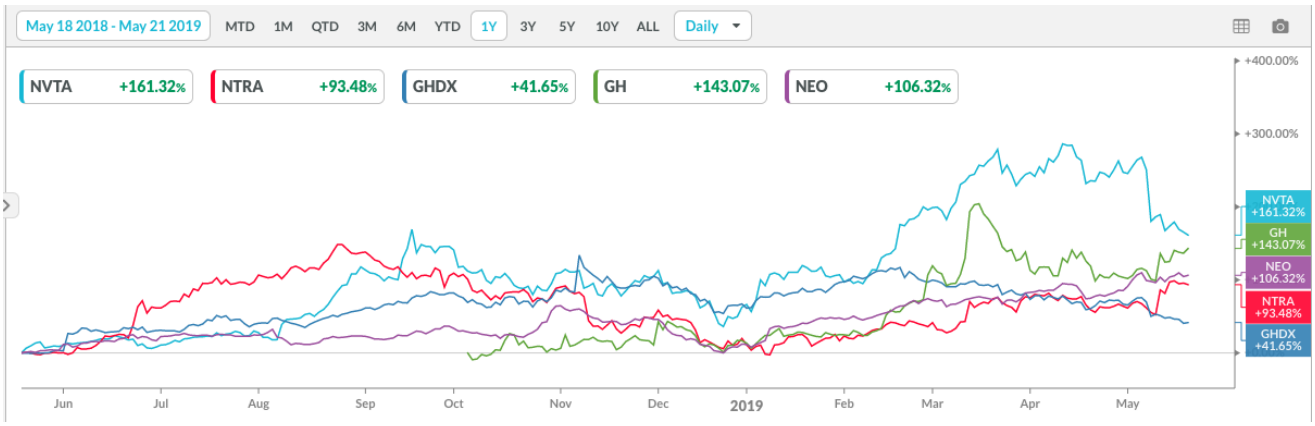
- In 2017, Guardant filed a lawsuit against rival Foundation Medicine, alleging that Foundation's advertising for its own liquid and tissue tests harmed both Guardant and cancer patients by misleading oncologists about the relative accuracy and sensitivity of the competing genomic tests. Foundation later sued Guardant alleging infringement of a patent that covers methods for analyzing a cancer patient's tissue or blood sample to detect multiple classes of genomic alterations. The two companies later settled both without disclosing the terms of their agreement, but Guardant has more recently sued Foundation again. ILMN is also embroiled in an ongoing lawsuit against another rival called Personal Genome Diagnostics over its cell-free DNA technology.

- Most recently on April 10th, CareDx (CDNA) filed a second lawsuit against Natera accusing them of misleading doctors and patients about its kidney transplant technology compared to CDNA's AlloSure via its "false advertising campaign" claiming that its technology is superior to AlloSure.

We spoke about the bad a little bit but it does come with some good being in a space this competitive. Two things that we must say do excite us about this space are:

1. Wall Street tends to place a premium multiple on companies that are heavy in data and that is exactly what all these companies possess in this new space with the hundreds of thousands of tests they've run and hold concrete information on
2. There is significant M&A in the space which can lead to nice returns if you're on the side of the company being acquired
    a. Some examples include LabCorp acquiring Sequenom, Verinata which was acquired by Illumina, Ariosa which was acquired by Roche, and Counsyl which was acquired by Myriad Genetics.

It's pretty apparent Wall Street has been favoring these stocks over the last twelve months:



Over the last year, NVTA leads the pack up 161% (was much higher but has pulled back sharply in last month or so), followed by GH at 143%, NEO at 106%, NTRA at 93% (with a large portion coming over the past month), and GHDX up about 42%.

What's also impressive about these gains is that they are significantly outperforming the IBB (Nasdaq Biotech ETF) which has been struggling this year. The IBB is up only 6.1% YTD, while companies like GH are up triple digits and NTRA is up over 61%.

Technical Analysis

Based on the charts, what we're gather here is that shares are going to want to test their next upward resistance level of $23.68. It tried the first time and was rejected and may want to try again. The only thing is that volume has dried up a bit and it will be a little tough. How we would look at this is the next level of support (not on this screenshot) on the Fibbonaci levels is $21.43. If it holds that there is a good chance it's going to build back up to give the upper bollinger band a crack ($23.68). That's going to be tough to break because the upper resistance fibbonaci level is $23.75. So if it does break passed these two

levels on the way up there's a good chance NTRA is going to want to test its all-time highs of around $29 made back in August of last year.

The stock charts aren't the only ones to look at. We spoke about the fundamentals earlier and we can also use those charts a bit. For example:

NTRA has never in its lifetime as a public company garnered a forward P/S or forward EV/Sales valuation greater than 6.1x and 6.3x, respectively. If NTRA were to get back to those multiples that implies about 17% more upside to hit those levels. At a current price of $22.54, a 17% price jump to a 6.1x P/S multiple would take shares to roughly $26.37, so not quite as high the previous highs made last year.

We believe NTRA will try it given the momentum it has but ultimately we see shares failing to claim new highs as revs were growing at over 20% back then.

All in all, the space is super interesting to us. We did some research on Guardant Health (GH) not too long ago so feel free to check that out as well. We are personally going to watch NTRA from the sidelines as fundamentally the company doesn't meet our investment standards/criteria. If the company were still growing revs at a >20% pace and cash burn was getting closer to zero rather than getting worse than maybe but since they aren't and shares are already up over 60% YTD, we are going to simply stay on the sidelines with this one.