

Foundation Medicine Inc.

Sector: Healthcare/Biotech

Ticker: FMI

Recommendation: Sell

Analyst: Fred Rockwell

Current Price: \$28.22

Target Price: \$20.00

Date: April 26, 2014

Recommendation Summary

Foundation Medicine Inc. (FMI) trades at a premium to other diagnostic companies due to irrational exuberance in the IPO market. It faces the obstacles of third party insurer/Medicare approval, oncologist acceptance, and the recent emerging of a substitute service at a lower cost. The company had an IPO in September 2013 at a share price of \$18, which jumped 78% in the first day. The stock has the characteristics of a trendy IPO including the backing of Google Ventures and other cachet funds, plus offering a first of its kind diagnostic test. Investors are expecting to see fast growth. Current valuations do not make sense as FMI has not yet had profits and will face headwinds growing. I expect a price of \$20 in 1 year as the company fails to achieve the growth baked into price.

Company Overview

FMI provides two types of diagnostic services FoundationOne and FoundationOne Heme. By studying DNA sequencing the company provides information that can be used to custom tailor cancer treatments to patients. Its customers are patients with metastatic cancer (51% of sales) and pharmaceutical companies (49% of sales) optimizing their drugs.

Investment Thesis

There is significant uncertainty around whether FMI's products will be eligible for coverage by commercial third-party insurers and Medicare. If eligible for coverage, it is unclear what reimbursement rates will be. Currently the company is recognizing costs but no revenue from patients covered by Medicare. Tests for patients covered by Medicare represented 30% and 29% of total tests reported to physicians in the U.S. during 2013 and 2012. A judgment by Medicare is expected in mid-2015. Additionally, it would require bringing new drugs to market that require diagnostic screening to support the usefulness of the company's tests. This process will take even longer, giving investors plenty of time to cool off as growth slows. The pharmaceutical company customers pay upfront and represent 49% of sales but they will not be growing quickly. They understand the practicality of DNA sequencing and 18 companies already use FMI services.

CLRX and AFFX formed a partnership this month offering a substitute to FMI services. Additionally, some experts predict a landscape shift in the market over the next 3-5 years obviating the need for FMI services altogether.

FMI missed earnings consensus in 2013 4Q and I see this trend continuing. Diagnostic companies generally trade at a multiple of future year sales. I calculate revenue coming in 10% below expectations and multiple compression bringing FMI's price in-line with peer diagnostic companies, which generally offer low returns.

Key Statistics

Market Cap.	774M
Total Debt	1.5M
52-Week	\$18
Range	\$45
3mo Avg. Vol.	255K
2013 Revenue	29M
2013 EBITDA	(37M)
Cash	124M
EV/2015 Sales Estimate	6x
Consensus 2014 EPS (Operating)	(1.81)
Consensus 2015 EPS (Operating)	(1.35)
Last Reported Quarter	2013 4Q
Consensus	(.43)
Actual	(.48)