NeoGenomics Q3
2017 Conference Call Script

Opening Remarks

The conference call operator announces the Quarter 3 2017 conference call for NeoGenomics, Inc. and turns it over to Douglas VanOort, the Chairman and Chief Executive Officer of NeoGenomics.

Doug VanOort

Good morning. I'd like to welcome everyone to NeoGenomics' Third Quarter 2017 conference call.

Joining me from our Fort Myers headquarters is Steve Jones, our Executive Vice President, George Cardoza, our Senior Vice President and Chief Financial Officer, Bill Bonello, our Treasurer and Director of Corporate Development, and Jessica King, our Director of External Reporting.

I'd also like to welcome and introduce Kathyrn McKenzie, our Vice President of Finance and Principal Accounting Officer, who is joining us for the first time on this call.

Dr. Maher Albitar, our Senior Vice President, Chief Medical Officer and Director of R&D, Rob Shovlin, President of our Clinical Services Division, and Deena Murphy, our Director of Billing, are joining us from our Aliso Viejo lab in California.

Before we begin our prepared remarks, Steve Jones will read the standard language about Forward-Looking Statements.

Steve Jones

This conference call may contain forward looking statements, which represent our current expectations and beliefs about our operations, performance, financial condition, and growth opportunities. Any statements made on this call that are not statements of historical fact are forward-looking statements. These statements by their nature involve substantial risks and uncertainties, certain of which are beyond our control.

Should one or more of these risks or uncertainties materialize or should the underlying assumptions prove incorrect, actual outcomes and results could differ materially from those indicated in the forward-looking statements. Any forward-looking statement speaks only as of today, and we undertake no obligation to update any such statements to reflect events or circumstances after today.

Before turning it back to Doug, I want to let everyone know that we will be making a copy of our prepared remarks for this morning's call available on the investor relations section of our website shortly after the call is completed. We also want to let everyone know that we are going to limit the number of questions to two per person in order to give more people a chance to ask questions within the one hour that has been allotted for this call.

Doug's Comments

Thanks Steve.

I'll begin my comments this morning by providing some context for the Quarter 3 results we pre-announced two weeks ago. I'll then comment on our guidance for this Quarter 4, and conclude my remarks by describing our analysis of the current environment and our outlook for the longer term.

Quarter 3 Financial Performance

I won't sugarcoat this - We are disappointed with our third Quarter results. We did not deliver what our investors were expecting, and we accept full accountability for that. That said, there are also some very positive trends in the third quarter and we remain very optimistic about our growth prospects.

There are four areas in which our results differed from what the investment community expected. I'll give you a short explanation of each of these. Of course, we will answer any questions you have about any of these during our Question and Answer period.

Hurricanes

The first difference between our results and expectations resulted from Hurricane Irma, and to a lesser extent, Hurricane Harvey. Our Houston and Fort Myers facilities were both directly impacted by these hurricanes. There is not much more we could have done to prepare for these disasters. We executed our Business Continuity plans, and our team did an outstanding job. In fact, in my opinion, it was an A+ performance. Even though we had Lab closures and our people and systems experienced significant disruptions, our clients barely felt any impact at all. I'm extremely proud of the manner in which our teams managed through these natural disasters.

PathLogic

The second difference has to do with our divestiture of PathLogic. This divestiture reduced revenue but had a slightly positive impact on Adjusted EBITDA for the quarter. As you know, we have been attempting to divest PathLogic for awhile because it was no longer strategically or financially additive to our business. We struck a deal which protected as many of PathLogic's clients and employees as possible, and we incurred a loss on the sale. Without PathLogic, our company is now more focused and will be more profitable going forward.

Revenue Adjustment

The third reason we missed investor expectations was because of a $1.3 million revenue adjustment. There is no excuse for this. The adjustment reflected revenue recorded for certain tests where the result was "quantity not sufficient" or "QNS". Although we incurred the full expense of testing these QNS specimens, we do not bill for QNS tests unless partial results are reported out and generally QNS tests result in zero revenue.

We have established enhanced accounting procedures and controls to ensure that this situation does not recur. In addition, we have recently implemented new technologies to allow testing to be

performed using much less tissue sample that should reduce the number of QNS tests. This will improve patient care, and should give a slight boost to revenue and profitability going forward.

Bad Debt

The fourth and final reason we missed Investor expectations was because of higher than expected bad debt expense as a result of changing payer dynamics from Medicare and insurance companies, as well as the performance of our Billing operation during the Clarient Integration.

Unfortunately, despite our best efforts, sometimes Medicare and insurance companies refuse to pay, and increasingly, they are refusing to pay for our higher-value molecular tests. Managed care organizations are more frequently requiring that tests be pre-authorized in advance of an order for the lab to get paid. In many instances, the pre-authorization must be secured by the physician ordering the test rather than by the lab. If the required pre-authorization is not included, payors will often deny the entire claim.

In addition, Medicare and Managed Care Organizations are increasingly denying payment for Next Generation Sequencing-based tests, particularly disease-specific multi-gene molecular panels. Our panels include important biomarkers which guide treatment decisions, and these panels are valued by our clients and our volume in these important tests has grown significantly over the past year. Even though they are important for patient care, Medicare and Managed Care payers sometimes refuse to reimburse us. For context, revenue derived from these disease-specific panels billed to Medicare and Managed Care is approximately 2 % of our total revenue.

Fortunately, nearly 60% of our bills are sent directly to Hospitals under our individual contracts with them. This is a much preferable situation for us, because we directly bill our hospital clients for our services and they pay for what they order.

Also fortunately for us, we have enough scale and expertise to deal with bad debt challenges, and we are adapting to new Medicare and Managed Care rules.

We have enhanced our processes in several ways. We are proactively communicating with payors about typical test algorithms in order to reduce the chance of confusion when pre-authorization requests are submitted. We are educating our clients on new pre-authorization and documentation requirements and establishing systems to ensure that the pre-authorization is secured before the test is sent.

Additionally, we have established a process to identify requisitions that require pre-authorization at the time that they are accessioned in the lab and to secure that approval before the test is even sent to our laboratories.

The Positive Fundamentals

With an understanding of those four Quarter 3 dynamics, let’s turn our attention to some very positive fundamental trends in our business. These fundamentals are what have us excited about our future.

One of the most positive fundamental trends in our business is our ability to continue to gain market share in our core Clinical Services Division. We reported 16.6% volume growth despite

our labs getting hit by those two hurricanes. Moreover, our growth this quarter was more balanced than in the recent past, with continued strength in molecular and histology accompanied by accelerating growth in flow cytometry and FISH. Our sales force is once again focused on winning new business and we are clearly taking share in most segments of the market.

We also reported a record quarter in our Pharma Services Division, with revenue of up 37% year-over-year to $6.9 million. The health of this business is also demonstrated in our record number of new signed contracts, and backlog is up 76% to $58 million. We are watching the momentum build in this business and we remain very excited about its prospects.

We also maintained very strong cost control this past quarter. Cost per test was down 11% year-over-year despite the need to staff-up in California to accommodate samples redirected due to the hurricane. Even with a significant spike in overtime and related expenses, we were able to keep our costs down. Our productivity increased once again, and is up more than 7% year-over-year.

These healthy fundamental trends – continued market share gains in our Clinical business, outstanding growth in our Pharma business, and strong and continuing cost control – are right in line with our expectations and consistent with our long-term goals.

Quarter 4 Guidance

We realize that our Quarter 4 guidance was also a surprise and a disappointment. We are disappointed as well – both by the anticipated revenue and earnings shortfall relative to our initial expectations and by having failed to provide Investors with an accurate assessment of our near-term prospects.

As many of you know, over most of our history as a publicly traded company, NeoGenomics has met and even exceeded expectations. This has not been the case over the past year. We have taken a hard look at our process for forecasting and establishing guidance and have adopted processes which should reduce the chances that we miss again in future quarters.

Our general outlook for Quarter 4 includes an expectation of significant commercial momentum in both our Clinical and Pharma Services divisions, offset by some continued pressures on the reimbursement and collections front.

On the clinical side, our volume growth remains robust. We continue to win new accounts, and our Sales Teams have excellent momentum. We expect continued strength in molecular growth, and also expect improvements in our more traditional, and higher paying, technologies such as FISH and Flow Cytometry. Despite the reimbursement pressure on Next Generation Sequencing tests, we expect greater stability in our mix as we begin to annualize the initial influx of PD-L1 testing which began in Quarter 4 last year.

Our outlook for the Pharma Services Division is very positive in terms of both Quarter 4 revenue and backlog. We are winning new contracts for MultiOmyx, our proprietary testing technology used primarily for immuno-oncology, and for molecular and immunohistochemistry testing. In addition, our Gross Margin in Pharma Services was above 40% this past quarter, and we expect this to continue to improve as the business gains the benefit of more scale.

On the cost side, we expect to see continued reductions in cost-per-test as the result of increased scale and new initiatives implemented over the past several months. We expect that bad debt will remain at elevated levels in Quarter 4 as we continue to adapt to changes in the payer environment.

Overall, we expect these dynamics to result in $65 to $67 million of revenue, and $9 to $10 million of Adjusted EBITDA in the fourth quarter.

Opportunities

I'm now going to transition to talk about our competitive position and longer-term perspective.

Let me start by reminding everyone that we have a pretty successful track record navigating in a challenging environment. Over the years we have faced severe Medicare reimbursement cuts, cumbersome regulatory changes and intense competition. Nevertheless, in the 34 quarters in which I've hosted these Quarterly Investor calls, our volume has grown by over 17 times, our revenue has grown by over 10 times, and our Enterprise value has gone from about $25 million to over $800 million. We do understand challenges, and we know how to manage through them.

Although Medicare and Managed Care reimbursement practices present challenges for us and for our industry in general, we believe NeoGenomics continues to have the capabilities to deal with these and to win. In fact, our competitive position is better than its ever been. We have scale, focus, balance, and the ability to react and respond quickly and effectively.

Every week we hear stories of competitors laying off sales people, cutting back services, or retracting in the market. At the same time, we are focused on patient care, great service and quality, and on relentlessly taking market share. We expect that trend to continue.

We believe NeoGenomics is positioned to continue to gain relative competitive advantage in this environment, and we fully intend to do just that.

Most importantly, the demand for complex oncology testing in this exciting era of Precision Medicine continues to increase. As the market-leading full-service, oncology-focused laboratory, we are uniquely positioned to meet that demand, and we are aggressively pursuing opportunities to accelerate our growth.

Here are just a few of the specific opportunities that we're pursuing:

- We are establishing preferred relationships with more national healthcare organizations. In fact, in the last 2 weeks we finalized a contract with one of the largest Hospital systems in the country giving us the ability to gain a number of new Hospital accounts. We've entered preferred relationships with multiple organizations over the past year, and we are working to add more.

  We are also forming partnerships with large oncology practices. Over the past year, we became the exclusive reference lab for several large oncology practices, and our pipeline includes

dozens of additional practices. These opportunities tend to be even larger than our traditional Pathology accounts.

- We are continuing to cross-sell to capitalize on our comprehensive oncology test menu. We are beginning to see an uptick in FISH, Flow cytometry and molecular work from clients who once used us exclusively for histology. Our sales teams have detailed plans to identify opportunities for cross-selling and they are making progress.

- We are building our Pharma Services business and establishing a global footprint. The grand opening for our new lab near Geneva, Switzerland is scheduled for November 8th. We opened this lab at the request of several customers, and already have projects under contract for this facility. In fact, our contracted backlog is already $1.5 million with several bids in process.

We remain confident in our ability to grow and to build a more profitable business. We continue to drive reductions in cost-per-test through automation, new technology, IT systems enhancements, application of best practices, and by leveraging our increasing scale.

I will reiterate our long-term financial goals of mid-teens volume growth in our Clinical business, 20% plus revenue growth in our Pharma business, and 25% to 35% incremental EBITDA contribution on our new revenue growth.

In summary, while we are working through some inevitable short term challenges, we believe our competitive positioning is excellent, and we remain steadfastly bullish about our future.

Doug transitions to Steve.

Now we're going to turn the floor over to Steve Jones, our Executive Vice President and Director of Investor Relations, to review third quarter results in more detail and lead us through a Q&A Session.

Steve's Comments

Thanks Doug.

Before we open it up for questions, I would like to briefly touch on a few financial highlights from the quarter and briefly describe a new Accounting Standard that will go into effect next year.

Third Quarter Review

Third quarter consolidated revenues were $63.1 million, a 3.8% increase from last year. Clinical genetic testing revenue increased 3.5%, Pharma Services revenue increased 37%, and PathLogic revenue decreased 78% as a result of its divestiture on August 1st. As discussed in the press release, we estimate the two hurricanes depressed volumes by approximately 1.5% and revenue by approximately $1.0 million in the quarter.

Average Revenue per Clinical Genetic Test was $342, an 11.2% reduction from the prior year. The revenue adjustment related to unbilled tests was responsible for approximately $8 of the Revenue per Test decline.

Consolidated gross margin was 45.7%, a 70 basis point increase from the 45.0% reported last year. This improvement was driven by the 11% decrease in Cost per Test as well as a 350 basis point increase in our Pharma Services gross margin from last year. The sale of PathLogic also helped to improve gross margin. We estimate that we incurred approximately $300,000 of overtime and other expenses directly related to the hurricanes, which depressed the Cost per Test improvement by approximately $2 or 1%. Incremental margins in the Pharma Services business continue to be strong with approximately two-thirds of the incremental Pharma Services revenue from Quarter 2 to Quarter 3 falling to gross margin.

Consolidated SG&A expenses increased by 19.9%, or $5.2 million from last year's third quarter, primarily as a result of increases in bad debt and personnel expenses including stock-based compensation. Bad debt expense increased by $2.3 million and personnel expenses increased by $1.9 million from last year.

Doug has already discussed the changing payer dynamics with respect to pre-authorizations and increasing denials for certain molecular tests. In addition, as we discussed on the last two calls, bad debt expense has also been running higher than normal this year as a result of normalizing the reserves for former Clarient clients now that they are on the NeoGenomics billing system. We believe we have now properly reserved for or written off all tests falling into this category. On a year-to-date basis, bad debt expense as a percent of revenue is 6.8% compared to 4.5% for the first nine months of 2016.

Adjusted EBITDA was $6.0 million in the third quarter, a decrease of $3.1 million, or 34%, compared to last year's third quarter, primarily as a result of the impact of Hurricanes, the one-time revenue adjustment, and the increases in bad debt expense.

We expect that higher bad debt expense will continue to somewhat offset lower costs in other parts of our business, and as a result our Quarter 4 Adjusted EBITDA guidance is $9-10 million. As we continue to grow and unlock synergies, and our bad debt expense moderates, we expect Adjusted EBITDA margin to improve considerably next year.

Third Quarter GAAP net loss available to common shareholders was ($7.8) million compared to ($5.6) million in the third quarter of last year, and Diluted loss per share was ($0.10) versus ($0.07) last year. Included in the calculation of GAAP net loss is a $1.1 million loss on the sale of PathLogic.

As disclosed in the press release and in previous earnings calls, we believe that in order to compare the net income related to the true operations of the Company on a more consistent basis across periods, it is appropriate to adjust GAAP net (loss) available to common shareholders to exclude certain non-cash items and, if applicable, one-time costs. We refer to this measure as "Adjusted Net Income" and on a per share basis, "Adjusted Diluted Earnings per Share", and we have included a table with how these are calculated in our earnings release.

In the third quarter, Adjusted Net Income was $474,000 compared to $3.4 million reported in last year's third quarter. And Adjusted Diluted EPS was $0.01 per share compared to $0.04 per share last year.

We finished the third quarter with 977 full-time equivalent employees, contract doctors, and temps, versus 1024 as of June 30. This large sequential decrease was due to the sale of PathLogic.

Before opening it up for questions, I would like briefly discuss Accounting Standards Update No 2014-09, entitled Revenue from Contracts with Customers, which is also commonly referred to as Accounting Standards Codification Topic 606 or ASC 606. In May 2014, FASB and the International Accounting Standards Board collectively issued a new converged standard on revenue recognition, which will go into effect on January 1st, 2018 for most U.S. public companies.

Among other things, we expect this accounting change will eliminate most, if not all of our bad debt expense on a moving forward basis. Instead of bad debt expense being an expense line item in General and Administrative expenses, it will be treated as a contra revenue line item and thus reduce revenue by a corresponding amount. There may also be a timing difference related to the treatment of long-term Pharma Services contracts. We are still determining how to best comply with ASC 606, but we do not expect this accounting change to have any impact on Adjusted EBITDA or Net Income. However, it will reduce revenue, Revenue per Test, and our Gross Margin percentage in 2018. We will quantify the expected reductions in our Quarter 4 earnings call this coming February. We will also provide restated 2017 historical results when we report our 2018 quarterly results.

At this point, we would like to open it up for questions. Incidentally, if you are listening to this conference call via webcast only and would like to submit a question, please feel free to email us at sjones@neogenomics.com during the Q&A session and we will address your questions at the end if the subject matter hasn't already been addressed by our call-in listeners. As mentioned at the beginning of this call, we would like to ask each person to limit their questions to two so that we may hear from everyone and still keep within the hour allotted for this call.

Operator, you may now open up the call for questions.

Question and Answer Session

Closing Remarks

As we end the call, I would like to recognize the approximately 975 NeoGenomics team members around the US for their dedication and commitment to building a world-class cancer-genetics testing company.

On behalf of our NeoGenomics team, I want to thank you for your time in joining us this morning, and let you know that our fourth quarter 2017 earnings call will be on or around February 21, 2018. For those of you listening that are investors or are considering an investment in NeoGenomics, we thank you for your interest in our Company.

Good bye.