REFINITIV STREETEVENTS

EDITED TRANSCRIPT

DMTK.OQ - Q3 2021 DermTech Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 09, 2021 / 9:30PM GMT

REFINITIV

CORPORATE PARTICIPANTS

John D. Dobak *DermTech, Inc. - President, CEO & Director*

Kevin Sun *DermTech, Inc. - CFO, Treasurer & Secretary*

CONFERENCE CALL PARTICIPANTS

Alexander David Nowak *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Brian David Weinstein *William Blair & Company L.L.C., Research Division - Partner, Group Head of Life Sciences & Healthcare Analyst*

Max Masucci *Cowen and Company, LLC, Research Division - Senior Analyst*

Sung Ji Nam *BTIG, LLC, Research Division - MD and Life Science & Diagnostic Tools Analyst*

Thomas Flaten *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Caroline V. Corner *Westwicke Partners, LLC - MD*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the DermTech's Third Quarter 2021 Earnings Conference Call. (Operator Instructions) As a reminder, this call may be recorded.

I would now like to hand the conference over to your first speaker for today, that is Caroline Corner, Investor Relations. Please go ahead.

Caroline V. Corner - *Westwicke Partners, LLC - MD*

Thank you, operator. Welcome to DermTech's third quarter 2021 earnings call. Joining me on today's call are Dr. John Dobak, President and Chief Executive Officer; and Kevin Sun, Chief Financial Officer.

This call will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements made on this call that do not relate to matters of historical fact are considered forward-looking statements. Forward-looking statements made during this call, including projections of future performance, are based on management's expectations as of today, November 9, 2021, and are subject to various factors, assumptions, risks and uncertainties, which change over time. Actual results could differ materially from those described in such statements. Several factors that may contribute to or cause such differences are described in today's press release and DermTech's most recent filings with the SEC, including DermTech's annual report on Form 10-K for the year ended December 31, 2020, and quarterly report on Form 10-Q for the quarter ended September 30, 2021.

DermTech undertakes no obligation to update these statements, except as required by applicable law. DermTech's press release for third quarter 2021 results is available under the Investor Relations section of the DermTech website, www.dermtech.com and includes additional details about DermTech's financial results. Also available on the DermTech website or DermTech latest SEC filings, which you are encouraged to review. A recording of today's call will be available on the DermTech website by 5:00 p.m. Pacific Time today.

Now I'd like to turn the call over to John.

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Thank you, Caroline, and thank you, everyone, for joining us today. A few weeks ago, we attended the Fall Clinical Dermatology Conference in Las Vegas. This is the second largest dermatology conference behind the American Academy of Dermatology's Annual Meeting in the spring. Not only

did DermTech have a tremendous presence at the conference and our technology was showcased in a large plenary session, but in general, the potential genomics and the inroads it is making into dermatologic care was visible at a level that I have not seen before. As I walk the halls of the conference, I overheard numerous dermatologists and industry people, having discussions about genomic applications in dermatology, which again is a first for me, and it signals growing enthusiasm among the dermatology community about how genomics can improve patient care.

With that, I will share with you an anecdote about how our DermTech melanoma test or DMT dramatically improves patient care. This particular story involves a dermatology physician-assistant who had a history of atypical molds and concerns about melanoma. She was a bit skeptical about our DMT and wanted to try it on several lesions on her own body before offering it to her patients. One of the lesions tested turned out to be double gene positive and was subsequently diagnosed as an early-stage melanoma in situ. She even retested one of the negative lesions 6 months later over some lingering concerns about it, and it remained negative, giving her significant peace of mind. She has become a real believer and regular user of the DermTech test and continues to use it for her own skin checks. This case study highlights how our melanoma test enables early melanoma detection while avoiding unnecessary surgical procedures.

Many companies experienced softness in the third quarter and DermTech was no different. Our growth challenges for the most part were external and included the delta variant wave of the pandemic and pent-up vacation demand by both clinicians and patients. Sales rep access to physician offices declined again to less than 50% of prepandemic levels and patient traffic for medical dermatology was soft, so this number is harder to quantitate. We also were impacted by Hurricane Ida, which disrupted the Southeast in one of our fastest-growing territories, Louisiana, but also had an impact on our more mature territories in the Northeast due to extensive flooding as the storm moved across the country. We estimate that Hurricane Ida alone impacted our overall test volume by at least 5% in Q3 and continues to impact one of our larger customers in Louisiana that had their practice destroyed.

Despite experience in this trifecta of challenging external factors, we continue to execute against our core business drivers. Our year-over-year quarterly assay growth was healthy and increased 140% from $1.2 million to $3 million, with sample volumes growing from approximately 6,700 to approximately 11,720. For the year through the third quarter, we have performed almost 33,000 melanoma tests versus almost 16,000 for the same period last year despite operating in a difficult environment with a suboptimally sized commercial team. Our Q3 assay revenue was essentially flat sequentially at $3 million with a slight increase in ASP to $252 per sample.

We also increased our Medicare proportion to record levels as we continue to penetrate this ideal patient population for our noninvasive melanoma test. We did see a healthy increase in unique ordering clinicians, which grew by 11% sequentially or about 160 clinicians to approximately 1,590. The modest assay revenue growth despite the increase in unique ordering clinicians underpins the macro environmental headwinds that kept sample volume and consequently assay revenue relatively flat over Q2. The most significant development of the quarter was the completion of our sales force expansion and our effort to build a world-class dermatology sales organization, which we have been delaying for the past 18 months due to the pandemic.

We now have 72 sales reps, 9 regional directors and 2 area directors to address a larger number of approximately 9,000 to 10,000 professional dermatology target clinicians. This team has an average of 13 years sales experience with an on average 7 years in dermatology sales, along with 76 President Clubs winners and all of them with new product launch experience. These reps are currently undergoing classroom and field training, and we are taking the time to be thoughtful as we split territories and onboard the new reps. We now have the core infrastructure to drive future growth and provide a buffer against regional external factors that can hamper this growth. We expect contributions from the new hires to kick in during Q1 2022 and beyond. We expect to approximately double our sample volume this year over last year, and we are optimistic a similar trend will continue and/or accelerate through 2022.

Now that we have reached full commercial scale and the worst of the pandemic is hopefully behind us. Another positive recent development is the completion of our first pilot with an integrated primary care network in Florida. Due to the success of this pilot, we are now approved to commence sales of our melanoma test to their 78 clinics and approximately 300 providers. Through the remainder of this quarter, we will work to train and educate the providers in the network that have interest in accessing the technology. We currently plan to deploy our Florida sales team and medical science liaison team against this account to pull through potential adopters. The success of the pilot was due to the enthusiastic reception from the primary care physicians who participated in the effort and word-of-mouth interest from other network physicians that wanted access to our melanoma test.

We also recently expanded the pilot with another large primary care network in the Midwest and are hoping to complete this pilot in the next 1 to 2 quarters. We have begun investing in the selling infrastructure to primary care networks, which consists of dedicated personnel and marketing initiatives to develop a robust pipeline of network opportunities. We have previously discussed various strategies to sell into the primary care channel, and we currently believe the most efficient strategy is to dedicate focused teams of sales reps against the networks after we have secured a commitment to introduce our melanoma test throughout the entire network. Through this effort, we will build our initial foundation in primary care selling, which we expect to develop further as the carcinoma product for non-melanoma skin cancer becomes commercially available.

Our telemedicine in market beta test continues to progress nicely in Florida. We are pleased with the volume of app downloads, which indicates interest in the offering. As expected, acquisition costs per tele consult and per test order were initially high. However, these costs will decrease as we become more efficient with our digital marketing and social media targeting and after we optimize price and the customer experience. We are encouraged by these initial results and are working to expand the number of states where this solution is available. With further expansion, we will gain synergies with our find-a-doctor marketing effort by providing the telehealth option to patients that visit or find a doctor page.

We are also developing channel partners to both leverage our technology solution and/or offer our remote clinician-guided sample collection service. We recently established a contract with dermatologists on call, a leading dermatology telehealth provider in the U.S. Dermatologists on call will provide teledermatology services as a covered benefit for 20 million lives in 2022. Under this agreement, a Board-certified dermatologist will review a picture of a suspicion lesion submitted through the dermatologist on call technology platform and order a DermTech melanoma test, if warranted. Dermatologists on call will provide supervised remote collection of a skin sample using our smart to sticker and the sample will be sent to our gene lab to run the test.

An important part of our telehealth strategy will be to further expand partnerships with virtual care providers and develop our customer ecosystem beyond the brick-and-mortar. Building this customer ecosystem positions us to address an unmet need for access to dermatologic care and helps keep virtual visits as virtual as possible, which is especially attracted to other online health care platforms, including health insurers and employers. Our activity with regional and national payer groups remains robust and is our second core business driver. We recently signed agreements with a fairly large multistate Blues plan with approximately 2 million covered lives with effective dates within Q3 of this year. This plan covers new territories that were created with our recent sales expansion, so there will not be an immediate impact on revenue. However, we are optimistic it will facilitate adoption and awareness in the new territories.

We are also pleased with the progress with several other important payers, and we're optimistic we will announce additional successful contracts in the coming quarters. The trust study has been published, and we are educating payers that requested to see the data published about the importance of the results. We are also working to publish the results of the Optum economic study, which is another data set that payers have requested to see in peer-reviewed published form. We expect to have this paper submitted for peer review before the year-end. We estimate we now have approximately 90 million covered under our contracted lives in the U.S. for our melanoma test.

Turning now to our third business driver, new product development. There are supply chain constraints across our development programs related to sequencing flow cells. We are not certain when this issue will resolve or if it will worsen in the coming months, Luminate development has been modestly affected. We still expect to have the validation complete and the product available for introduction in Q1. We originally planned for an introduction of Luminate in late Q4 with a broader marketing push in Q1 after the December holiday rush. So this delay does not materially affect our plans for a broader DTC effort in Q1 and throughout next year. We are currently pleased with the performance of the product and its ability to assess ultraviolet damage to key driver genes associated with skin cancer and photo aging.

We also plan to pilot a direct selling effort to dermatologists. In this model, a dermatologist would acquire Luminate and sell it to patients to guide treatment decisions. There are several variables we need to understand about this model that need to be resolved in the pilot program before rolling this out more broadly into our commercial team. Carcinoma classifier verification is progressing as planned, and we have completed enrollment in the validation of that cohort. We have been able to manage the supply chain impact to this program thus far. And as soon as the verification effort is complete, which is targeted by year-end, we will look to validate the classifier with expected completion by mid-2022, pending any changes to the supply chain issue.

Lastly, our effort in precision therapy for atopic dermatitis continues to scale up, and we expect to have all 24 sites enrolling in the study by year-end. We had a modest increase in our enrollment percentage, which was affected by various COVID factors already discussed, and we expect enrollment will accelerate as more sites come on board. Our contract revenue was light again this quarter due to the slowdown in activity for inflammatory drug trials related to COVID. Recently, we have had more engagement from companies looking to deploy our platform into their development programs, and we expect to have some new contracts before the end of the year.

While the third quarter presented ongoing challenges related to the pandemic, we believe the table is set to support the long-term growth of DermTech, reaching full commercial scale with sales reach across the entire U.S. is an important milestone for us and one that has been delayed for many quarters. Our vision is to lead the genomic revolution in dermatology and skin health, and we now have the infrastructure to make this reality.

Now I'd like to turn the call over to Kevin to go over our financial results.

Kevin Sun - *DermTech, Inc. - CFO, Treasurer & Secretary*

Thanks, John. Total revenues for Q3 of 2021 increased 122% to $3.0 million compared to $1.4 million for the same period in 2020. Assay revenue for the third quarter of 2021 increased 140% to $3.0 million compared to $1.2 million for the same period of 2020. We continue to see improvements to our ASP in Q3 but a potential assay revenue that could be recognized from having broader payer coverage is still meaningfully higher than the actual reported revenue. Billable samples for the quarter were approximately 11,720 compared to approximately 6,700 for the third quarter of 2020 or a 75% increase and was sequentially flat compared to the second quarter of 2021.

Medicare samples represented about 22% of our billable samples in Q3 of 2021 compared to approximately 17% in the same period of the prior year and 19% in Q2 of 2021. Our Medicare proportion of samples is now recovering from the pandemic low point. However, additional growth in our Medicare proportion could be impacted by future pandemic conditions. With approximately 2,400 unique ordering clinicians during the last 12 months, we penetrated 48% of our initial target market of approximately 5,000 dermatology clinicians who account for a high concentration of the total annual surgical procedures to diagnose melanoma. This translates into a 25% penetration of our expanded initial target market of 9,000 to 10,000 dermatology clinicians and penetration of about 18% of the 13,000 total practicing dermatology clinicians.

We had approximately 1,590 unique ordering clinicians in Q3 of 2021 compared to approximately 950 in Q3 of 2020 or a 67% increase and compared to approximately 1,430 in Q2 of 2021 or an 11% sequential increase. Our average quarterly utilization or average number of tests ordered per unique ordering clinician remained strong and was 7.4 billable samples in Q3 compared to 8.2% in Q1 and 7.8% in Q1 of 2021 and 7.0 in Q3 of 2020. As expected, overall utilization did vary and declined slightly as we added more new accounts since new users typically order less per month when they first start using our melanoma test. We still expect our total billable sample volumes to increase as potential lower utilization rates are offset with a higher number of overall ordering clinicians.

Contract revenue decreased 41% to $76,000 for the third quarter of 2021 compared to $129,000 for the same period of 2020. As of September 30, 2021, we had a maximum of $4.2 million in potential remaining contract revenue related to our current agreements. Gross margin for Q3 of 2021 was 4% compared to negative 18% for the same period of 2020. The increase in gross margin was largely driven by higher billable samples and assay revenue during Q3 of 2021. Asset gross margin for Q3 of 2021 was 3% compared to negative 29% for the same period of 2020 and 11% for Q2 of 2021. Sales and marketing expense increased 114% to $9.8 million for the third quarter of 2021 compared to $4.6 million for the same period of 2020, primarily due to additional head count for the commercial teams and additional marketing investment, including digital media, direct-to-consumer advertising and professional promotion.

We expect sales and marketing expense to continue to increase as we recognize the fully burdened cost of our expanded sales force for the full reporting periods and due to increases in our marketing initiatives to raise awareness of our technology. Research and development expense increased 173% to $4.4 million for the third quarter of 2021 compared to $1.6 million for the same period of 2020. The increase was primarily due to higher compensation-related costs, increased clinical trial costs and additional lab supplies. We expect R&D expense to continue to increase as we ramp up our pipeline development efforts.

General and administrative expense increased 111% to $6.2 million for the third quarter of 2021 compared to $2.9 million for the same period of 2020. The increase was primarily due to higher payroll-related costs and higher stock-based compensation and higher audit and legal costs. We expect our general and administrative expense to continue to increase as we implement systems and infrastructure to support our direct-to-consumer efforts and overall growth. Net loss for the third quarter of 2021 was $20.1 million, which included $3.7 million of noncash stock-based compensation, offset by $0.2 million of benefit related to a noncash change in fair value of the warrant liability compared to a net loss of $9.3 million for the same period of 2020, which included $1.4 million of noncash stock-based compensation, offset by $0.1 million of benefit related to a noncash change in fair value of the warrant liability.

At the end of the third quarter, our cash, cash equivalents, restricted cash and marketable securities totaled $252.5 million. We are revising our full year 2021 assay revenue guidance to be between 10.5 and $12 million, mainly due to the impact of the delta variant and Hurricane Ida. We still saw some softness in October, and while the first week of November has picked up nicely, we have some lingering concerns about physician access and the holiday season with continued pent-up travel demand. If early November trends are sustained, we could still fall within the lower end of our prior guidance range.

Our revised guidance still represents solid growth of 148% to 183% over 2020. And as John mentioned, we believe we can continue the similar trajectory in 2022. We are excited about our sales force expansion, the progress of our integrated primary care network pilots and the expansion of our telemedicine efforts beyond Florida and with partnerships, and we believe we have built the appropriate infrastructure to drive growth in 2022 and beyond.

Now I'll turn the call back to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Now our first question is coming from Brian Weinstein of William Blair.

Brian David Weinstein - *William Blair & Company L.L.C., Research Division - Partner, Group Head of Life Sciences & Healthcare Analyst*

So I thought we'd just start out kind of following up on Kevin's closing comments there and some of the stuff you were talking about, John, in your prepared remarks. As we think about '22 because I think at this point in the earnings season, everybody should be well aware of all of the trends that were going on in Q3 and how that's impacting Q4 across the board. But as we try and keep a forward focus here and we think about 2022, maybe you could just go back over some of the key drivers that are really going to drive this because I thought I heard you say that you expected a doubling of volume this year and that you expected that similar trend to continue into next year. So I want to make sure I heard you say that is sort of the trajectory we should be thinking about and things that, I guess, have you the most excited about 2022 and the growth opportunity?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Yes, that's exactly it. I mean, as I said, we will approximately double this year, and we expect that trend to continue next year. And I believe that it will accelerate. I'm extremely positive about 2022 because we finally achieved that scale up of our sales team. I think that's going to be the biggest driver of the progress of the witness is our effort within that dermatology sales channel. We just got a fantastic sales force that we've put together. They all just have terrific pedigrees and terrific success as sales reps. So we're very optimistic about what they're going to do.

We're also making progress as we talked about against the primary care networks. And while at this point, we don't quite know what the utilization rate is within the primary care channel. And we don't quite know how many reps we need to call on a certain number of primary care docs to generate that utilization. We do think there's a big opportunity there, and we'll continue to push on that. And I think that represents further upside over what we think we'll do within that dermatology professional channel.

Brian David Weinstein - *William Blair & Company L.L.C., Research Division - Partner, Group Head of Life Sciences & Healthcare Analyst*

Great. And just to kind of follow up on that primary care opportunity. Can you just talk about the process to get involved? Or you talked about the one in Florida. There's one, it sounds like in my neck of the woods here in the Midwest. But what does that process look like? And what are they looking for in order to sort of endorse bringing on the technology and then to have your sales force go on and then trying to sell it?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

It really starts out as an executive level sale. So you really kind of go in at the top, and you need to get some buy in at the executive level, which is typically the issue we've talked about where these primary care networks have a real pain point associated with outside referrals to dermatologists that cost them money and there's not a lot of access. So if we get in buying from the executive level, then it goes to a clinical review and they review all of our data. And if that looks good, they then ask to do a pilot. And those pilots, they typically want to understand that this test doesn't really interfere with the overall patient flow and traffic and ability of the primary care doctors to see the patients that they need to see every day. And they also obviously look for the feedback from the primary care physicians about how they feel about the product.

And if that's successful, then it moves to a stage where we can -- since you get what we call sort of a license to hunt, which means we can go and offer the test to all of the -- or some number of the physicians within that network. And then the technology integrations will occur as that process is occurring. These folks all like to live off their electronic medical records. And so we then will proceed with that technology integration, and that's the process we've gone through with that Florida network and the others were in discussions with.

Brian David Weinstein - *William Blair & Company L.L.C., Research Division - Partner, Group Head of Life Sciences & Healthcare Analyst*

Yes. And there are several that you're talking to there, correct?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

We're developing a very nice pipeline of those opportunities. We do have somebody who is focused solely on identifying those opportunities and initiating the discussions at that executive level, and she is developing a very nice, robust pipeline of those opportunities.

Brian David Weinstein - *William Blair & Company L.L.C., Research Division - Partner, Group Head of Life Sciences & Healthcare Analyst*

Okay. Then last one for me, if I can just squeeze one in here on the sales force, it sounds like you have finally kind of the numbers that you're looking for in a high-quality sales force. How do you manage kind of splitting of territories that's going to be going on and just sort of manage the rollout here of these new reps and ensure that you get sort of maximum productivity when they really start hitting the road here in the first quarter?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Yes. As you're aware of, any time you're doubling the sales team and splitting territories, there's a lot of distraction associated with that effort, the hiring and the training and then as territories get split, that means the rep in the existing territory is focusing on a smaller subset of the doctors. We feel like we can manage that, but obviously that is a factor that we have to take into account and things -- how things are going. And we will manage it effectively. The big thing we're doing right now is training those sales reps up and they're getting toured by the other sales reps.

And that's really the best way to get them trained up. And that's why when we really look to their contribution going to occur in starting in Q1, but they're going to spend this whole quarter. They really just started in October. So it's going to occur in Q1 after they go through this training and mentorship program with the existing reps. And then we'll be through all the distraction and the disruption you're taking about that occurs when you scale up the sales team, that should all be behind us and we'll be hitting the ground running in Q1 of 2022.

Operator

And our next question is from Max Masucci of Cowen and Company.

Max Masucci - *Cowen and Company, LLC, Research Division - Senior Analyst*

So can we start on the trust study, great to see the data published in skin in mid-September. I think we're about at 2 months removed from publication. I'm sure you've only discussed the final results or the fraction of the payers on your radar, but it would be great to hear how the results have been received in some of your early discussions?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

You don't give a lot of feedback from the payers and you provide them this information. But I think we've had 1 or 2 payers basically say that they do like the data. They think the data is solid. So we think that's encouraging. And we're hopeful that we'll start to push them over the edge. But as you guys know, the payer process is very opaque. You provide them information. You don't always get a lot of feedback exactly what they're thinking. We do think we're making progress in general with the payers. We do have an audience with them, which is something I couldn't say before, and we are educating with them about the test, and we feel like we're getting some of the clinical teams to understand the problem and get behind the test. And that's why we're optimistic we're going to make more progress with the payers in the coming quarters.

Max Masucci - *Cowen and Company, LLC, Research Division - Senior Analyst*

Great. Maybe 2 quick ones for Kevin. First one, I think it would just be helpful to understand a breakout in terms of the regional impacts that we could see in Q4 from -- that remains from Ida the impact of the delta variant on volumes and any expectations for how the ASPs trend sequentially? Just to get a bit more detail around how we can sort of bridge from the guidance we have today to even the low end of the prior range?

Kevin Sun - *DermTech, Inc. - CFO, Treasurer & Secretary*

Yes. So we previously mentioned that a big concentration of our current sample volume was in the Sunbelt state. So that includes the South, I think Florida, Texas, but as well as states like California and then bigger states like New York. And so those big states with large populations still remain a big state for us in terms of sample volume. What we mentioned before in the call was that Louisiana was literally one of our fastest-growing territories. We hired a really good sales rep there who had some good relationships and was able to really draw up the interest and find a model that worth of getting the demand from the various physicians on tap. And so with Ida specifically, that ran right through Louisiana.

And so the example we gave on the prepared remarks was one of our largest customers had their practice destroyed. So that's just one example. There's others within it as well that is the lasting impact. That's why we say it could continue to affect us within Q4 and potentially beyond because it's hard to say how long some of these things can rebuild. That being said, what we do expect though is now that we have a broader sales force that goes -- it essentially covers the entire U.S. these regional type factors will be hopefully less impactful in the future. But for Q4, we would still expect some potential headwinds related to Ida. And again, because I Ida ran up through the northeast and there's the flooding situations, those areas have recovered a little bit better than some of the places in the South.

From an ASP perspective, can we still expect a sequential improvement with ASPs, but it will be lumpy. How much it improve over time. that's one of the hardest things to model. We are focused on the key drivers for how we can improve ASP growth, including driving proportion of samples through are covered contracts, both Medicare and the commercial contracts, the worry of coverage. But again, that's the one that's really hard because if we get some other payers on board, that can help. And as we improve the proportions within covered territories that will help. But again, we do expect ASPs to kind of trend up slightly probably within Q4 and then throughout 2020. It's just the rate it's hard to definitively fit.

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Max, I would just add to that. The thing that concerns us about the fourth quarter is we got hit so hard with the vacations through August and September. And we had mentioned that on the par, we weren't sure if there was seasonality, but there was clearly pent-up vacation demand. We're hearing similar things about people wanting to get together for the holiday.

So that's the only thing that gives us some pause about the rest of the fourth quarter, not the only thing, but one of the things that's driving our thinking about for the we don't have to forecast that right now because it was so strong in that August, September time frame, and we're just -- with all these holidays coming up and now kids can be vaccinated people want to take a visit to the relative we're just worried that, that may have an impact. And so that's why we've been conservative about how we look at the rest of this quarter. We just want to lose credibility with you guys by not telling what's really happening on the ground and those are the things that we're thinking about.

Max Masucci - *Cowen and Company, LLC, Research Division - Senior Analyst*

Yes, absolutely makes sense. And then dermatologist on call, when does that officially kick off? Is it Q4? Or does that kick off at the beginning of next year, access to 20 million patients is fantastic. Curious, depending on when that kicks off, if there's anything you can do to hit the ground running and any opportunities for joint marketing maybe with that partner to really drive penetration in that channel?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Yes. We are going live with that dermatologist on call relationship now. We're training up their doctors. It's going to take the rest of the quarter to get through all their 100-or-so dermatologists that are in their network, but we are starting that now. Their covered lives benefit is really kicking in 2021, and that's where we would see that exposure to those 20 million covered lives starting in 2022. Right now because the only way to really assess atypical molds with the surgical biopsy, I would say the proportion of visits for teledermatology force suspicious malls is a lower proportion.

But I think with marketing and now understanding there is a true virtual care option where you can have a test in the home, we're going to work to kind of increase that overall proportion. And that will take some time, but that's something we'll be working on throughout the year with dermatologists on call and getting access to the folks that they will have their serves as a benefit -- And then our own efforts that we'll be doing with our fund to doctor page and offering that telemedicine option to the patients that come to our find-a-doctor page.

Kevin Sun - *DermTech, Inc. - CFO, Treasurer & Secretary*

And we've already gotten our first samples in from that partnership with that relationship actually this week. And so even though as we're going through the training protocols, again, it's live right now, and it's going to help contribute. So it will -- like John said, it will take a little bit of time to ramp up. But again, we're very optimistic in what that relationship can do for us.

Operator

And our next question is from Sung Ji Nam of BTIG.

Sung Ji Nam - *BTIG, LLC, Research Division - MD and Life Science & Diagnostic Tools Analyst*

Maybe one for Kevin. For gross margins, obviously, you guys are seeing improvement there year-over-year and also year-to-date -- year-over-year. I was curious about, sequentially, it's declined, especially for the API gross margin. If there is any onetime impact contributor there? Or what's kind of driving the sequential decline?

Kevin Sun - *DermTech, Inc. - CFO, Treasurer & Secretary*

Yes, yes. So we were staffing up in anticipation of some additional growth. Obviously, delta has impacted that growth. And so I'd say from a fixed COGS perspective, it was relatively flat over Q2. We just had some additional variable costs related to some headcount. So scientists in San Diego, they're high demand because of just the biotech industry within San Diego and so want to find good scientist and lab, people lab team members, but we'll go in and get them because again, we'll know that we'll need their capacity here in the near future. We're also putting in some technology improvements within the lab infrastructure, which had a little bit of impact for the quarter in terms of some variable costs. So that was really the main 2 reasons.

Sung Ji Nam - *BTIG, LLC, Research Division - MD and Life Science & Diagnostic Tools Analyst*

Got you. That's helpful. And then, John, obviously, you guys are making good progress with the Medicare portion of the test volume despite the challenging market environment. So I was curious, is there an incremental effort you're making with that population? Or I'm just trying to figure out if it's just kind of the end market trends that you're essentially experiencing?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Well, we think it's hard to put exactly the reasons behind it. But we think as the Medicare population has gotten more vaccinated and they are more out and about living their lives that, that could be a factor that's contributing to that rising proportion because for so long, they were kind of staying away from places like the dermatologist. So that could be a factor. We are more broadly marketing the test digitally to that patient population, so that could be helping a little bit. It's hard to put an exact number on it, but an exact reason behind it, but we're pleased with it, and we've seen this trend now every quarter going up, and we expect that to continue to make improvements there and it is a key focus for us.

Sung Ji Nam - *BTIG, LLC, Research Division - MD and Life Science & Diagnostic Tools Analyst*

Got you. Great. And then just lastly for me, the first I'm hearing about supply chain constraints on the sequencing flow cells. And so was wondering if you have a sense of when that might be addressed if you're hearing anything from the supplier as far as when that might normalize for you guys?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

That's really been really hard to tell. We just can't get enough. And even when we go into our outside suppliers of these services, our contract providers, the sequencing services, they're having trouble too. And so their lead times are extended for the same reason. We're not quite sure. We know where they come from. They come from overseas. So maybe they're stuck at the Port of Los Angeles or something, but it's hard to say. It's just we've got big orders for those, and we're only getting onesies and twosies right now. They're trying to work with us to get as many as possible that I just -- what they tell is they just don't have the flow cells.

And that's just -- it's just been a hang up that slowed things down a little bit as we validate that Luminate product. But again, right now, not an impact on the carcinoma, and we're hopeful that it will be resolved and we're still optimistic that, that product will also be done by mid-2022 despite that near-term kind of supply chain issue with flow cells. I think the JPMorgan analyst wrote about this a while back ago, Luminate challenged with flow cells, but -- maybe a month ago, and then we started experiencing that.

Operator

(Operator Instructions) And our next question is from Alex Nowak of Craig-Hallum.

Alexander David Nowak - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Is the refined sales approach and the new branding strategy here resonating where you're not trying to fully replace the biopsy anymore? And really teaching the clinicians to think about DMT as more ancillary and an alternative to watch for waiting. Is that helping the conversation at all with either new or the existing clinicians?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Yes, absolutely. I think that we spent a lot of time working on the messaging and refining it, and we've been rolling out that new messaging out with our existing sales reps, and that's obviously going into the hands of the new sales reps. But the general starting message is, hey, we're not here to take away your biopsy. We're here to help you with these lesions that you can't buy obviously for a variety of reasons. And that just sort of takes down the general concern that the doctors may have about that and it opens up the conversation much better. In general, we've had end of all the marketing messaging. We've gone to a consultative selling model with MSL support, et cetera. And so I think all those things are part of just the refinement of our commercial strategies and planning, and we expect those things to pay off as now that we've got a full commercial team.

Alexander David Nowak - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

I'm just hoping to understand more about the inter-center ramp here. So of the unique and clinicians, I mean, can you quantify how many of these are ordering 10 or more samples or whatever you consider to be high-volume users there? And just how quickly does a new clinician go from an initial user to a high-volume customer?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Yes. We haven't disclosed the breakout of this various utilization buckets yet. But as you can imagine, again, as the new clinicians come on board, they start out in those first 2 buckets, which is we call the dabblers 1 to 2 a month and then the mid-tier, which is 3 to 9 months. We've been measuring that, and it's kind of varied, right? So how quickly do they go from the lower tier buckets to the higher to buckets. I'd say it's varied and it's really tied to their experience, right? So if the clinician who's ordering the test, if they start seeing these things where it's really just eye-opening where they didn't think something was super suspicious, but they use our test and lo and behold, things come back as positive, that gets them kind of acknowledging the technology a little bit quicker.

But we don't have a good average type of number for all of the use cases just because the pandemic is clouded some of these things. We haven't had the right access, the right repetition with the ordering clinicians to really make sure that they can ramp up and understand the technology as they're really starting to adopt and use it. It's something that we'll target disclosing a little bit more of the buckets and the timing again through the tiers in the future. We're just trying to get -- make sure that the data we have during this pandemic environment is really clean and understood and that we're not muddying waters by just, again, putting out data that's just muddied by COVID right now.

Alexander David Nowak - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Yes. That makes sense. And then the incoming sales team, would you rather have them go out there and try to new clinicians or do you see it better, maybe near term and maybe even midterm ROI by ramping the existing customers?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Well, we expect them to do both, right? I mean there are going to be -- when you -- in the territory, there's going to be some existing business if that territory was split, so we expect them to go after that existing business, and we also expect them to bring in new customers. I think before our territories were a bit larger, 200 or 250 doctors per territory, which is a pretty heavy number for sales reps to -- for one sales rep to cover with the

right frequency and reach. Now we're down to more like 100 to 125 doctors per territory, which now there's adequate frequency and reach within that group.

So we expect both of them to drive that business with existing customers but bring in new customers. In general, though, our focus is now breadth, right? The pandemic focus to go deep -- We're just trying to drive utilization within existing accounts. Now that we're fully scaled up and the pandemic is starting to wane, we want to go broad and we want to bring on as many users as we can. And then as we get that broad group of users on then drive that utilization over time within that broader group of users.

Kevin Sun - *DermTech, Inc. - CFO, Treasurer & Secretary*

Yes. Half of -- probably about half of the new reps or so, are really getting dropped into brand new territories. So the expectation for them is the majority of what they're doing will be to get a breadth of new customers on board. And then again, we also have some other customers who might have ordered a while ago and just haven't ordered a little bit. It gives us an opportunity to get back in front of them. Because again, we know dermatology is a frequency and repetition type of specialty where if you don't have a frequent site of contact with them, then they might forget about it and just not order as much or even potentially even stop ordering. So we want to kind of have the new reps do all of those efforts.

Alexander David Nowak - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay. Now, that makes sense. And then just lastly, how are you thinking about other dermatology assets that on here and strengthen the infrastructure? Just generally thinking about, for example, MetaOptima's technology that you use in DermTech Connect. Is there anything else that you could add on here to help fully integrate this for clinicians?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

I guess we do have a big push right now to do the electronic medical records integration. We're working with Emma, and that's going very well. We're rolling that out to more and more clinicians every quarter. That's been going on for the last couple of quarters. We think that's another important piece to facilitate and streamline the ordering of the test. So that will continue. We haven't identified any other ancillary technologies in the near term that we want to necessarily own and bring in-house. We think that it's more important just to focus on our platform, and we've got a lot of work to do and a lot of upside from where we are today in penetrating the markets we have. We've got a deep pipeline of products. We just -- we need to get the job done with those before we worry about bringing on a lot of other things that could represent more distraction. So that's really our focus. And we don't have any plans in the near term to bring anything new in.

Kevin Sun - *DermTech, Inc. - CFO, Treasurer & Secretary*

Yes. And in addition to what John mentioned in the prepared remarks, the integrated delivery networks that we have, they can use various types of EMRs. And so even though we're integrating currently with Emma, the other couple of pilots that are going on are using different EMRs. And so we'll have multiple EMRs that will do the integrations for both to facilitate their submissions of test requisitions. But then also the second phase of those integrations will allow us to grab medical records, and that will help with the appeal process that we need to do on the back of the call.

Operator

And our next question is from Thomas Flaten of Lake Street.

Thomas Flaten - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Kevin, I just wanted to revise the guidance for a second. On the low end would imply a pretty substantial downtick in testing volume in the fourth quarter. So it kind of sounded like there was some lingering effects of Ida, maybe some pandemic, maybe some vacations, but the low end would imply kind of an acceleration in the brakes, if I can say it that way, that would shrink the business rather than just keep it flat. Can you just walk me through the conservatism there over what we saw in the third quarter?

Kevin Sun - *DermTech, Inc. - CFO, Treasurer & Secretary*

Yes. So in the third quarter, July was great. We came out of Q2 before Delta came about and everything was really rocking on all cylinders. And then Delta came about, and again, August and September were the tough ones. And so as we start out here in October and November, October was again a little bit choppy. But as we mentioned, November has picked back up. And so to get to a flat Q4 over Q3, we still need some acceleration from where we are now. And so that's why we say because of the uncertainty around the vacation environment coming towards the holidays, we're just not quite sure of how it plays out. In addition to Ida, so Louisiana was the example, right? I mean there's that one practice that we mentioned where who knows how long it takes them for them to rebuild and that was one of the largest customers in that territory for what was our largest and fastest -- excuse me, our fastest-growing territory.

Some of the other packs around the south, whether it's Florida or the other states in the South, they're still dealing with some of that Ida cleanup as well. So again, I think it's just a matter of us being conservative and trying to make sure we capture the low end, even though we might think that we're coming in above that, we just don't want to like Johnson lose the credibility for some reason, things kind of slow down even more with any of those things or potentially even another variant, another wave of the pandemic comes at us. Many people are probably reading about the fifth way of going on in Europe right now. So it's hard to say what the impacts for us will be is winter approaches and people head in doors more. So that's really all it is. It's the low end of the new range. It's just really conservatism for where we think the bottom really is. And again, we do think we'll be ahead of that is just the things that we're unsure of how it plays out.

Thomas Flaten - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Got it. And then looking forward for either of you, John or Kevin, as we think about a doubling of testing volumes in '22 over '21, can I just assume that any Luminate volume is not included in that and that would be upside?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

Correct. Yes. So when we talk about the trajectories for next year, we're talking about DermTech no test. -- exactly.

Thomas Flaten - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

And then just one final one, and I didn't catch it during the prepared remarks. Did you have a timing or thoughts on timing of the Optum publication?

John D. Dobak - *DermTech, Inc. - President, CEO & Director*

It will be submitted before the year. And the one thing we can't control is the peer review process. Sometimes that takes a couple of weeks, sometimes it can take a couple of months. And we just -- we know the publication we're going to submit it to. It should go in here within a few weeks, and then we just have to see what the peer review cycle is. So I suspect it will be out there, if not by the end of the year and the first part of the next year.

Operator

And I'm not showing any further questions. Ladies and gentlemen, thank you for participating in today's conference. And this concludes today's program. You may all disconnect. Everyone, have a great day.