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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the DermTech Third Quarter 2022 Financial Results Call. (Operator Instructions) Please be advised that today's conference call is being recorded.

I would now like to hand the conference over to Steve Kunszabo, Head of Investor Relations. The call is yours.

Steve E. Kunszabo - *DermTech, Inc. - Senior Director of IR*

Thank you, Operator. Welcome to DermTech's third quarter 2022 earnings call. Joining me on today's call are Dr. John Dobak, our President and Chief Executive Officer; and Kevin Sun, our Chief Financial Officer.

Our call today 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 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 these differences are described in today's press release and our most recent filings with the SEC. We undertake no obligation to update these statements except as required by applicable law.

Our third quarter 2022 earnings press release and SEC filings are available on our Investor Relations website. A recording and transcript of today's call will be available on our website later today.

With that, let me turn things over to John.

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

Thank you, Steve, and thank you everyone for joining us. The third quarter of 2022 was positive as it relates to bringing on new payers and increasing covered lives, but was tough in terms of sequential growth. Billable sample volumes did grow 54% year-over-year but were flat sequentially. Payers continue to impact the average selling price or ASP of our DermTech Melanoma Test or DMT which was flat excluding prior period adjustments, but down when including those adjustments, details which Kevin will provide. In addition, we are experiencing some pressure on billable sample growth as payers roll out their typical tactics to impede the adoption momentum we have generated this year. We are addressing this by expanding coverage and using our own tactics to reduce this pressure.

As we discussed on the last call, there was also some pressure on billable sample volumes during the quarter in territories with elevated sales rep turnover. Turnover has stabilized and is back to historical levels and our new reps are ramping up nicely now. We are working to accelerate the historical ramp-up period of new reps to minimize the future potential impact to billable sample volumes. We believe the most (technical difficulty) bring on more commercial payers. It is a critical factor in growing ASP and it removes the barrier to increasing customer usage. To that end, we now have line of sight to adding 30 million to 40 million covered lives by the end of the first quarter of 2023. This total would be more than a 35% increase in our current covered lives in the U.S. and is roughly equivalent to the second largest national payer. These covered lives come from a broad combination of payers, which demonstrate the momentum we have gained to raise awareness of the clinical and economic value proposition of the DMT. We've hit a milestone of more than 150,000 DMTs completed, and we believe these strong volumes are contributing to our progress with payers. We expect approximately half of these covered lives will be effective before the end of the year. In addition, pricing is consistent with our long term targets.

We recently executed an agreement with a large regional payer that covers 6 million lives and completed price negotiations with a national government payer that runs the largest integrated healthcare system in the U.S. We expect to be affected by the year-end. We also received a policy from a large lab benefits manager. The lab benefits manager is a particularly important win because it represents up to 8 million covered lives itself, reaches potentially another 30 million covered lives through its relationships with health plans and it was an independently-developed policy that clearly outlines the value proposition of our test. In addition, national payers are also leaning in more than they ever have and we've been able to leverage educational meetings with medical directors into upcoming scheduled comprehensive reviews. We see these upcoming comprehensive reviews as potential important near term catalysts for our ASP and revenue growth.

Overall, we have more -- had more positive activity with payers now than we've had at any time during the last 2 years, a drought in activity, which was largely driven by the pandemic. We believe we're now in a normalized trajectory to add payers at a similar rate as our more mature diagnostic peers.

It is worth noting that a significant patient need exists in the large addressable market for melanoma skin cancer. There are 4 million biopsies each year to find approximately 200,000 melanoma cases. Annual treatment costs for melanoma are over $3 billion. Early detection matters as melanoma is very treatable when identified early. Overall, it's a $2.5 billion market opportunity.

Along with the nice momentum bringing on payers, we have two initiatives in primary care that can also help strengthen our ASP. First, our agreement with Sonora Quest, which is the largest laboratory testing network in Arizona, establishes a reference testing model where Sonora Quest builds insurance for the samples they generate and pays us a set fee per sample. We have completed systems integration and training of their primary care sales reps is ongoing. We expect this arrangement to begin commercial operations before the end of the year. We're also receiving strong positive feedback regarding the primary (technical difficulty) with an important payer provider and believe this pilot is tracking in the right direction. I also want to emphasize that we further strengthened our operating discipline and are adjusting our operating expenses to be in line with our tempered near term revenue trajectory.

In closing, despite our top line metrics being flat sequentially, long term improvement in ASP and revenue is clearly all about payers. Substantially, all of our capital and energy is focused on 2 important priorities, expanding commercial coverage for our DMT to boost the ASP and alleviating payer friction in our commercial channel. Given the billable samples we've demonstrated we can generate, monetizing this demand at a higher ASP has the potential to exponentially grow assay revenue. I look forward to updating you again in the months ahead.

With that, I'll turn the call over to Kevin for a more detailed financial review.

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

Thanks, John, and good afternoon everyone. I'll begin by summarizing our key operating and financial metrics for the third quarter and then review how we think about our revenue outlook moving forward. I'll wrap up by covering our liquidity profile and cash runway targets.

Assay revenue in the third quarter increased 16% to $3.4 million, largely due to a 54% year-over-year increase in billable samples to approximately 18,080. Contract revenue was flat at $0.1 million during the third quarter. Looking ahead, DermTech Stratum's contract research services continue to show promise as we signed 5 contracts in the last 6 months on the heels of clinical trial activity picking back up in the biopharma space. Total revenue for the third quarter increased 18% to $3.6 million, up from $3.0 million in last year's period, primarily on higher assay revenue.

Drilling down on our main top line drivers. First, ASP was $190 per sample in the third quarter, down 25% year-over-year and 16% on a sequential basis. The second quarter of 2022 had adjustments that netted to a $0.2 million benefit. For the third quarter, we changed collection estimates for tests run in prior periods due to reduced commercial payer payments, which resulted in a $0.5 million downward revenue adjustment. This ASP pressure was partially offset by a modest improvement in Medicare ASP due to the recently-updated code edit. Normalizing for these adjustments in both periods, third quarter ASP would have been $217, which is flat sequentially.

Second, we had approximately 2,410 unique ordering clinicians in the third quarter, up about 1% from roughly 2,390 unique ordering clinicians in the second quarter. With approximately 3,910 unique ordering clinicians during the last 12 months, we penetrated 43% of our current target market of 9,000 dermatology clinicians.

Third, our average quarterly utilization or average number of tests ordered per unique ordering clinician was 7.5 billable samples in the third quarter versus 7.7 in the second quarter and 7.4 in the year-ago period.

Finally, Medicare samples represented about 24% of our billable samples in the third quarter, which was unchanged as a percentage from the second quarter and up modestly from 22% last year. It's important to highlight that Medicare represents half of the total biopsies from melanoma each year and that we continue to try to accelerate penetration of this market segment.

Focusing next on operating expenses. Cost of assay revenue was $3.6 million, a 27% year-over-year increase yielding an assay gross margin of negative 6%. The increase in cost of assay revenue was primarily due to increased billable samples, offset primarily by lower per unit cost from efficiency improvements. The reduction in assay gross margin from 3% in the year-ago period and 22% last quarter was primarily a result of lower ASP and assay revenue.

Sales and marketing expenses were $14.6 million during the third quarter, a 49% increase from the year-ago period, primarily due to higher employee-related costs from increased headcount and marketing expenditures. Research and development expenses were $5.7 million, a 29% year-over-year increase, largely resulting from higher employee-related and lab costs. General and administrative expenses were $8.8 million, 42% higher compared to the third quarter of 2021. The increase was driven by higher employee-related and infrastructure costs. As a result of our continued focus on operational efficiency, we further trimmed all our OpEx line items and now expect total operating expenses to be modestly down in the second half of the year.

Net loss for the third quarter of 2022 was $28.8 million, which included $4.9 million of noncash stock-based compensation compared to a net loss of $20.1 million for the same period of 2021, which included $3.7 million of noncash stock-based compensation.

Moving now to our outlook for full year 2022 assay revenue. Due to the factors we outlined today, we have reduced visibility into the short term path of our assay revenue as we wrap up the year. As a result, we don't believe we'll achieve the low end of our previous guidance range. Due to challenges with commercial payers which affect ASP and the potential for significant additional changes of estimates for anticipated cash collections, it's difficult to provide a revised forecast, but we do anticipate being able to achieve at least $13 million assay revenue for the full year 2022. We expect the factors that have restrained our growth in the second half of 2022 to spill over into 2023. As a result, we've tempered our internal projections for 2023 assay revenue until we have better visibility on ASP growth.

And finally, a review of our liquidity profile and balance sheet. At the end of September, we had a cash, cash equivalents, restricted cash and marketable securities balance of $152.8 million. We believe we have sufficient funds along with the ability to access capital to extend our cash runway multiple quarters beyond our previous target, which was the end of the first quarter of 2024.

In summary, we are making steady progress with payers and much of our effort is focused on closing additional agreements to help accelerate our revenue trajectory. Extending our cash runway is another important priority and we are taking the appropriate steps to do this judiciously. We look forward to updating you again soon.

With that, I'll turn things back to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Andrew Brackmann from William Blair.

Unidentified Analyst

John and Kevin, this is [Dustin] on for Andrew. Just wondering first on the Medicare side. I know last quarter that was a big focus. The code edit expected to come this quarter. Just wanted to ask for more details around that and what the expected tailwind for that can be as we enter this quarter end into 2023?

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

Yes. The code edit was implemented at the beginning of October. It does appear that they backdated the code edit to when the Medicare LCD was first effective, which is January-February of 2020. We did take some benefit of this into the past couple of quarters and it has again some positive impact to ASP. But I'd say it takes a little while to flush it out completely. And it has been netted with any other, say, negative or other prior period adjustments as we've reported in our financial statements.

Unidentified Analyst

Got it. And around the private payer side, I'm wondering if you can give us a sense of how widespread that pay collection issue is. Is it just concentrated to like a couple of payers? Or is it more broader-based than that? And how have things been trending, I guess, where we stand today in the quarter? Has that been getting better you've seen since your tactics that they've been doing -- that you mentioned that you're expecting to overcome?

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

Yes, the payment pressures from [commercial] payers are fairly broad. We believe that it's in response to coming out of the pandemic and they're just tightening up across our industry in general. The tactics we've implemented to counteract that, they do take a little bit of time. Many of those tactics are tied around improving the efficiency of getting medical documentation to help with appeals. And then as we do that, the appeal still takes some time to process through. That's why it's difficult for us to estimate ASP going forward because the appeal process takes a while. And then even as we get medical records, they could still figure ways to still deny claims in the future.

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

We do -- they are addressing some of our customers with what we call redirect letters that sort of -- where they try to discourage use of the product, but we actually turn it down to a positive as an example of what we're doing to counteract that when we bring the doctor into the solution. And have the doctor go to the payer and say, hey, I want this test covered. And so that's one of the other tactics that we do aside from the technology to make the claims efficiency and the medical records burden lessened. But we're hearing about this broadly, as Kevin mentioned, and they're just trying -- the tactics they put in place is to put this administrative burden on our customers. And we can combat it with technology solutions. It's going to take some time but that's the pressure that we're feeling and those are the things we're doing to combat that.

Unidentified Analyst

Got it, okay. And lastly, I know you [turned] the OpEx in this quarter a little bit and expectations to be down in the second half versus the first half. Are there further plans of rationalization in 2023? Or should we think of OpEx being generally flat heading into the first half of '23 and through the rest of the year?

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

No, we think that we can reduce our OpEx even more. We do have discretionary spend. We have spend that's tied to commercializing new products. We had some planned hires that we obviously will not need to go forward until we see some improvement in the ASP and all those things will allow us to achieve the desired savings that we're looking for and help us extend our runway. So we're confident we can do that. We've already shown that we can do that. We made some steps last quarter to do that and we'll continue to do that. And we think it's just prudent until we see those improvements in the ASP that we are optimistic are going to occur in the coming quarters as we get more of these payers wins behind us.

Operator

Our next question comes from the line of Thomas Flaten with Lake Street Capital Markets.

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

Just wanted to make sure I understood the guidance of doing at least $13 million. If I set that as a base based on the first 9 months, that implies the fourth quarter of $1.9 million in assay revenue. Is there a scenario you can envision where you would have that kind of a sequential drop, almost 50%? I'm just trying to put this into context.

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

Yes. The guidance range that we have there, our demand is steady, but the upside has been limited by the commercial payer pressure that we've described. We do expect some seasonal impacts in the fourth quarter due to fewer business days and the holidays, which we've seen often have a greater impact in the dermatology space. The greater challenge right now, it's really estimating the commercial payer collections and the impact of the ASP.

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

So these kind of offensive tactics that they're running with the derms, can you quantify or at least give us some sense of when they started and how significant you think they are in terms of ordering, given that volumes were flat?

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

Yes. So we started seeing some flattening over the summer and we were trying to sort it out because we've seen some flattening for the last couple of summers. We wasn't sure if it was seasonality, we wasn't sure if it was COVID, probably some mix of all those things. We also, as we talked about, did have some sales rep turnover. So we're trying to understand what's causing that flattening. So we went out and did a deep dive with all of our customers and with many of them and talked about what they're seeing. And basically what came to the top is just this payer pressure, whether it was the administrative burden of us having to obtain medical records and actually the payers play this game. They require us to provide more medical records on more and more claims. That's one of the things they do because they know it's creates a burden on our customers and what they know it's going to impact our customers.

And so we started hearing about that and then it just -- it's hard to scale this into practice when you've got that administrative burden. We also -- we heard about the redirection letters. But again, we have ways to combat those and we're working on those things. Again, there are technology solutions where we can lessen that administrative burden and we're using those redirection letters that they like to send. If this is an out-of-network test, we're using that to bring the doctor in to help us demand for coverage of the test and we think that can help us.

So that's really the result of us looking at what was going on with some of the flattening we saw over the quarter. There probably is some seasonality in reality. We know that we heard docs were taking vacations and some of them longer than you can see, but that really didn't account for everything and certainly that we had some of that rep turnover. But as we talked about, that's kind of behind us. And it really started to become clear that these payers are ramping up their game and that's because we are driving a lot of volume. We are squarely on their radar screen. We think it's a typical playbook and we have to fight through it. But I think the fact that we're adding all these covered lives and the progress and the momentum we're seeing with payers are going to ultimately win that battle.

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

Yes, we've also seen a game being played where if a payer who doesn't have a policy or contract with us was previously denying a claim for an experimental or investigational, they've recently switched it to be a denial reason for medical necessity. And so in those cases, that's where we go get the records and try to appeal it, but this is the game that the payers play. They know that they're going to flip back to experimental investigational anyway and so they're just causing us to have some glimmer of hope, have us put more burden on physician customers to get the records, have our staff go through the process of filing the appeals of the claims, and then ultimately land in the same position. So again, this is what we believe is one of the tactics and the games that the payers are playing.

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

We'll get through this.

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

I was just going to ask if you have any thoughts or insights into the kind of stagnant Medicare penetration. I know that's been an issue, kind of, from the get go and it seems to have flatlined here over the last 3 quarters.

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

Yes, we are working on that. We're trying to understand why that's the case. We've looked at some of our peers and we also find against our peers that they don't really penetrate the Medicare proportion to their optimal payer mix either. So we're trying to understand what that is and we -- it is a core focus of ours to try to drive that Medicare proportion. As our volumes do grow and they will grow, we will continue to grow, we are a growth story, but -- and as they do grow, even if the proportion is relatively flat, we are seeing more samples on an absolute value -- an absolute number coming through. But we have yet to -- we have not solved that yet, but we're working like mad to understand what that is and how we can drive that higher utilization in the Medicare population.

Operator

Our next question comes from Max Masucci of Cowen.

Stephanie Yan - *Cowen and Company, LLC, Research Division - Associate*

This is Stephanie on for Max. On the Q3 volume, it came in a little bit weaker versus our expectations. I'm trying to understand why that's the case. Were you impacted by Hurricane Ian, given that Florida is a Medicare-heavy region? And if so, could you give us a sense and quantification, if possible, of the total volumes or was your sales force turnover from Q2 a meaningful driver of the volume weakness this quarter?

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

So in general, Hurricane Ian did have some effects for over a couple of weeks in Florida. I think, in general, the preparation before the hurricane, there was a general slowdown because the whole state was worried about that. And then clearly in the week after it hit, there was obviously a slowdown. It did cut across the state in a particular area, but we don't think there was a major impact from that overall, but it definitely hit us. There's no doubt about it. But we think -- so there are some practices that are offline for a while in those areas where we had -- we were affected. But the bigger issue that we're talking about, this is right now an issue around payers and that's breaking through the payer challenges that we're having, that is the main driver from all the work we did over the last few months that's putting the pressure on the billable sample volumes. And again, we feel confident we can push through it and it's going to take a few quarters, but we're pushing hard to get through that and that's really what we're focused on. It's very clear that that's what the issue is.

Stephanie Yan - *Cowen and Company, LLC, Research Division - Associate*

Got it, that's helpful. And then on the Medicare code edit situation, it's great to hear that that's been implemented. Last quarter, you mentioned that you expect commercial payers to also adopt this change. Do you still hold that expectation? And is there a scenario where they wouldn't choose to adopt the change?

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

We do still expect that. We only had seen just a couple of commercial payers bump back on to that code edit and now that, that code edit does have an effective date all the way back to when the LCD was first effective, it does give us the opportunity to appeal those claims that were previously paid and then retracted because of the code edit. So we are going to appeal them. But with the appeals, like any appeals, we do likely will have to grab some medical records and it will take a little bit of time to work through those appeals. But we do expect that code edit to benefit any payer who's relying on those code edits in terms of how they process claims. We should get paid on the first 2 body sites for pretty much any plan at this point.

Stephanie Yan - *Cowen and Company, LLC, Research Division - Associate*

Got it, that's helpful. And then my last question is on the ramp-up of the new sales force. How has that been going versus your expectations, particularly the ones that you backfilled last quarter? Can you remind us how long it usually takes to ramp up the productivity of the new sales force to the level you expect to see? And are there any metrics you can provide around their productivity or your expectations for their contribution for the rest of the year?

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

So we've talked about in the past that we thought it's somewhere between up to 15 months, maybe between 12 and 18 months for a sales rep to ramp up to productivity. Of course, that was in a COVID period and it was very hard for us to really get a strong handle on that. In the case related to the rep turnover, those were territories that we had a rep in. And so, there was already some seasoning of that territory. So we do expect a better ramp-up period. And as I mentioned on the call, we do feel like they are starting to ramp back up in those territories where we had some rep turnover. We do think it will be shorter than normal, but we still have some time to play up to see them get back up to that full productivity.

We're still trying to get what is that metric, a brand new rep in a fresh territory, what do we expect from a full ramp-up period. Now, because we have broader coverage, we also need to understand that metric if we change out a rep what that ramp-up period has been. And we'll get those metrics over time. It's just that it's been challenging for the last 2 years because of environment we're operating in to have hard metrics today.

Operator

Our next question comes from the line of Francois Brisebois with Oppenheimer.

Unidentified Analyst

This is Dan on for Frank Brisebois. Just a quick one for me, you mentioned the commercial launch of the Sonora Quest agreement later this year. Are you sharing when you expect revenues from this agreement?

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

We haven't done that because we need to see what kind of productivity and utilization they'll get and that -- this has been a key theme that we've talked about. We want to understand the utilization within the primary care space. We know there's utilization there. We've seen our own organic utilization in primary care, but we've never really deployed against it effectively. With the case of Sonora Quest, we will have reps going out directly calling on primary care and we should be able to get a better sense of what that utilization rate is, given a certain call of frequency. So we're excited to get that going and to understand that better. It's something we've been wanting to do.

You may recall, in the past, we were talking about putting our own 10 or 20-person primary care sales force out to get those metrics. We decided to do it instead with this Sonora Quest opportunity that came along because it does include a payment mechanism for us. And they have a meaningful number of reps, therefore we can get some data. Now we will be one of several products that are in their bags, so we're going to have to sort of sort that out. But we're excited about what it means in terms of us understanding the opportunity in primary care. We know there's going to be less utilization per month in primary care, but it's such a vast opportunity that, that is a really meaningful and significant potential market opportunity there. And so, we want to figure out how we can get there in the long-term and understanding those metrics are key to how we plan for that.

Operator

(Operator Instructions) Our next question comes from Mark Massaro from BTIG.

Vidyun Bais - *BTIG, LLC, Research Division - Research Analyst*

This is Vivian on for Mark. And I've been jumping around on calls here, so I apologize if this has been covered already. But you've mentioned in the past that the dermatology [call point] is relatively immune to macroeconomic issues. Is that still your view? And if you could just comment in terms of COVID trends, how clinician access has improved?

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

I'm not sure that we've said that the dermatology community is immune to macroeconomic trends. I don't think we've ever said that and I can't imagine that much different. I'm sure there are issues. Maybe there are some differences in terms of the self-pay cosmetic market that occurs in there that there's some influence of macroeconomic trends there or lack of impact there. But certainly we have not seen or said anything like that as it pertains to macroeconomic trends. And what was the second half of the question?

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

COVID impact.

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

Oh, COVID impact? COVID, yes, yes I don't think we're seeing much in terms of COVID. There is definitely, we see -- if we look at the trends, there are reports about prescribing and tracking the COVID trends and we do see some fluctuations in there. It's sort of in the 5% to 7% range, up and down each month, but I don't think that the COVID is really the issue. Again, I'll just reemphasize this, right now, is a payer game. We are making the progress with payers. That laboratory benefit manager policy is a great win for us, because it's a very nicely-written policy, independent. It allows us to go after a much broader group of potential insurance carriers with it. So this is about payers. We're making the progress with payers. I think all those other things are peripheral right now and that's where our attention is, that's where we're focused. We're very happy with the momentum and the progress we're making with payers. It's been nothing like anything we've seen before and that's all really just occurred in the last quarter.

Operator

Thank you for your participation in today's conference. That does conclude the program. You may now disconnect.