

## Cellular Dynamics

### 4Q13 Review: Strong Customer Adoption Trends Continue; Maintain Overweight

Cellular Dynamics (ICEL) reported 4Q13 results, with revenues slightly below JPMe and consensus, but overall performance notable for improving customer adoption and better than expected product and total gross margins. No guidance was provided on the call, although management remains positive on further customer adoption and partnership opportunities in 2014. Our investment thesis on ICEL is unchanged; with first mover advantage in industrial stem cell manufacturing, a focused pipeline and leading industry position, we see increasing customer adoption, revenue ramp, and margin expansion in the future. We maintain our Overweight rating and our December 2014 price target of \$20, while making modest adjustments to our model.

- Lighter than expected product sales offset by higher collaboration revenues.** Revenues of \$4.2M (+100% y/y) came in slightly below both JPMe and consensus (\$4.5M and 4.3M, respectively), driven by unit sales growth of iCell products. Along with continued strength in customer adoption, growth in the quarter was also attributable to better than expected collaboration and partnership sales (\$1.7M), with over \$2M in revenue for the year from the Eli Lilly partnership and products sold under the supply agreement with Nestle S.A., while the company also recognized initial revenues under the CIRM contract. Moving down the P&L, product and total gross margins of 73% and 84%, respectively, were well above our estimates of 68% and 75%, as cost of product sales as a percentage of product sales declined from 54% in 4Q12 to 27% in 4Q13, while higher than expected SG&A and R&D expenses (primarily, due to sales staffing and IPO expenses) drove softer than expected operating and net income.
- Customer adoption trends remain strong, boding well for future growth.** Increased customer adoption drove the y/y sales increase in the quarter, with average sales to top ten customers increasing to \$830K for the trailing twelve month period, compared to \$445K in the prior year, signifying growing customer adoption. In addition to average sales to the top ten customers nearly doubling y/y, management noted that ICEL sold to 150 customers in 2013, compared to 128 in 2012. Uptake for MyCell products also continued in the quarter, with sales of ~\$50K and positive initial reception from customers. For the year, MyCell accounted for ~\$220K in revenue, with management expecting a significant uptick in 2014. Management also highlighted the recent agreement with Nestle, noting that the nutritional research end market presents a significant opportunity and this agreement could be viewed as validation of the technology in the market.

#### Cellular Dynamics International (ICEL;ICEL US)

FYE Dec	2013A	2014E (Prev)	2014E (Curr)	2015E (Prev)	2015E (Curr)
Revenue (\$ mn)					
Q1 (Mar)	2	7	5	12	9
Q2 (Jun)	3	7	6	12	11
Q3 (Sep)	3	7	6	12	10
Q4 (Dec)	4	9	8	19	16
FY	12	30	25	55	47

Source: Company data, Bloomberg, J.P. Morgan estimates.

#### See page 8 for analyst certification and important disclosures.

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## Overweight

ICEL, ICEL US

Price: \$16.38 (intraday - 02:15 PM)

Price Target: \$20.00

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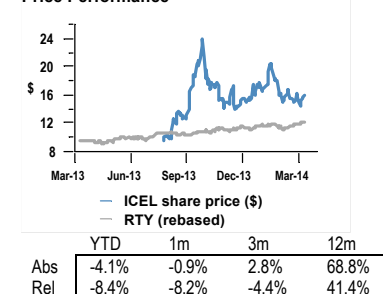
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#### Price Performance



#### Company Data

Price (\$)	16.38
Date Of Price	11-Mar-14
52-week Range (\$)	24.11-9.50
Market Cap (\$ mn)	128.22
Fiscal Year End	Dec
Shares O/S (mn)	8
Price Target (\$)	20.00
Price Target End Date	31-Dec-14

- **No 2014 guidance provided.** Due to the current lack of visibility in the near term business, management chose not to provide 2014 guidance. We are adjusting our estimates slightly lower, as we were previously anticipating more revenue from collaboration and partnership sales in 2014 than will be recognized, although our long-term outlook on the market, and the potential for ICEL within, is unchanged.
- **Maintain Overweight rating.** We reiterate our Overweight rating and DCF-based 2014 price target of \$20. With first mover advantage in the industrialized stem cell manufacturing market (which we believe has high growth potential), coupled with a focused pipeline, increasingly validated technology platform, and strong competitive advantage due to scale and cost effectiveness, we see significant increases in customer adoption, revenue ramp, and margin expansion ahead for ICEL.

Figure 1: ICEL 4Q Variance

	4Q12A		4Q13E				4Q13A				Variance vs. JPM Est.	
	Actual		JPM Estimate		Consensus		Actual		Change y/y			
	\$ M	%	\$ M	%	\$ M	%	\$ M	%	Δ \$	Δ margin	\$ M	%
Product Sales	2.3		3.5				2.5		8.6%		(1.0)	
Collaborations & Partnerships	0.7		1.1				1.7		155.3%		0.6	
<b>Total Revenue</b>	<b>2.9</b>		<b>4.5</b>		<b>4.3</b>		<b>4.2</b>		<b>41.3%</b>		<b>(0.4)</b>	
Gross Profit	1.7	57.8%	3.4	75.4%			3.5	83.7%	104.5%	2587 bp	0.1	832 bp
SG&A	(3.6)	120.6%	(3.8)	84.1%			(4.9)	117.8%	38.0%	-283 bp	(1.1)	3365 bp
R&D	(3.9)	134.1%	(3.2)	70.0%			(4.9)	119.0%	25.4%	-1515 bp	(1.8)	4899 bp
Operating Income	(5.8)	-196.9%	(3.6)	-78.8%			(6.4)	-153.1%		4385 bp	(2.8)	-7433 bp
EBITDA	(5.4)	-185.1%	(3.4)	-74.6%			(6.0)	-144.2%		4093 bp	(2.6)	-6960 bp
Pretax Income	(5.8)		(2.8)				(6.7)				(4.0)	
Income Tax	0.0	0.0%	0.0	0.0%			0.0	0.0%		0 bp	0.0	0 bp
Adjusted Net Income	(6)	-197.2%	(3)	-60.6%			(7)	-161.4%	15.7%	3580 bp	(4)	-10078 bp
Diluted Shares	1.7M		12.2M				15.8M		812.5%		3.6M	
<b>Adjusted Diluted EPS</b>	<b>(\$3.36)</b>		<b>(\$0.23)</b>		<b>(\$0.30)</b>		<b>(\$0.43)</b>		<b>-87.2%</b>		<b>(\$0.20)</b>	

Source: J.P. Morgan estimates, Company data.

## Investment Thesis, Valuation, and Risks

### Investment thesis

With its first-mover advantage in and leading industry position in industrialized stem cell manufacturing, focused pipeline, increasingly validated technology platform, and strong competitive advantage due to scale and cost effectiveness, we see significant revenue ramp and margin expansion ahead for ICEL. We see higher adoption rates for ICEL from biopharmaceutical companies as well as growth in the stem cell banking market and ultimately, the emergence of cellular therapeutics in the future. Maintain Overweight.

### Valuation

Our December 2014 price target of \$20 is derived from a 10-year DCF analysis, with a CAPM-derived WACC discount rate of 10.4% and terminal growth of 1.5%.

### Risks to rating and price target

Downside risks to our rating and price target include: (1) lumpiness and lack of visibility around revenue ramp with pharma customers; (2) regulatory risk for future therapeutics products; (3) potential pricing pressure from competitors; and (4) longer-term uncertainties and exposure to CIRM and other public-funded future customers.

Figure 2: ICEL Model

Income Statement			1QA	2QA	3QA	4QA		1QE	2QE	3QE	4QE			CAGR
USD \$M	2011A	2012A	Mar	Jun	Sep	Dec	2013A	Mar	Jun	Sep	Dec	2014E	2015E	11-15E
Product Sales	1.5	5.2	1.8	2.0	1.8	2.5	8.0	4.2	4.4	4.2	4.8	17.6	36.3	90.2%
Collaborations, Partnerships & Other	1.1	1.4	0.6	0.8	0.7	1.7	3.9	1.1	1.5	1.3	3.0	7.0	10.3	55.3%
<b>Total Revenue</b>	<b>2.6</b>	<b>6.6</b>	<b>2.4</b>	<b>2.8</b>	<b>2.5</b>	<b>4.2</b>	<b>11.9</b>	<b>5.3</b>	<b>5.9</b>	<b>5.5</b>	<b>7.8</b>	<b>24.6</b>	<b>46.6</b>	<b>78.1%</b>
Cost of Goods Sold	(1)	(2)	(1)	(1)	(0)	(1)	(2)	(1)	(1)	(1)	(2)	(6)	(11)	
Gross Profit	2	4	2	2	2	3	10	4	4	4	6	19	36	
SG&A	(10)	(12)	(4)	(3)	(5)	(5)	(17)	(5)	(5)	(5)	(7)	(21)	(29)	
R&D	(14)	(14)	(4)	(4)	(4)	(5)	(17)	(4)	(4)	(4)	(6)	(18)	(23)	
EBIT (Operating Income)	(21)	(22)	(6)	(5)	(7)	(6)	(24)	(5)	(5)	(5)	(7)	(21)	(16)	
EBITDA	(20)	(21)	(5)	(5)	(7)	(6)	(23)	(4)	(5)	(4)	(6)	(19)	(13)	
Pre-Tax Income	(21)	(22)	(6)	(5)	(7)	(7)	(25)	(4)	(4)	(4)	(6)	(18)	(15)	
Income Taxes	0	0	0	0	0	0	0	0	0	0	0	0	0	
Net Income	(21.3)	(22.3)	(5.7)	(5.1)	(7.5)	(6.7)	(25.0)	(3.8)	(4.4)	(4.2)	(6.0)	(18.4)	(14.9)	
Diluted Shares Outstanding	1.7	1.7	1.7	1.7	12.1	15.8	7.8	15.9	16.0	16.1	16.2	16.0	17.4	
<b>Adjusted Diluted EPS</b>	<b>(\$12.47)</b>	<b>(\$12.89)</b>	<b>(\$3.28)</b>	<b>(\$2.92)</b>	<b>(\$0.62)</b>	<b>(\$0.43)</b>	<b>(\$3.19)</b>	<b>(\$0.24)</b>	<b>(\$0.28)</b>	<b>(\$0.26)</b>	<b>(\$0.37)</b>	<b>(\$1.15)</b>	<b>(\$0.86)</b>	
Product Gross Margin	47%	65%	67%	66%	79%	73%	71%					77%	77%	
Total Gross Margin	70%	72%	76%	76%	85%	84%	81%	77%	77%	77%	77%	76%	77%	
change in gross margin (y/y, bp)	+972	+1032	+867	+1137	+1112	+1447	+1116	+1001	+999	+890	+902	+940	+1010	
SG&A	366%	189%	152%	117%	214%	118%	145%	87%	86%	86%	84%	86%	62%	
R&D	526%	217%	161%	139%	155%	119%	140%	75%	75%	75%	75%	75%	50%	
Operating Margin	-820%	-338%	-238%	-180%	-284%	-153%	-204%	-86%	-85%	-85%	-83%	-85%	-37%	
change in op margin (y/y, bp)	+823	+412	+569	+367	+640	+777	+605	+362	+473	+300	+545	+415	+412	
EBITDA Margin	-768%	-316%	-223%	-168%	-271%	-144%	-193%	-77%	-77%	-74%	-76%	-76%	-29%	
Tax Rate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Profit Margin	-822%	-338%	-238%	-180%	-297%	-161%	-210%	-72%	-75%	-75%	-77%	-75%	-32%	
Reported Revenue Growth y/y	26%	153%	109%	123%	105%	41%	81%	123%	111%	120%	88%	107%	89%	

Source: J.P. Morgan estimates, Company data.

Figure 3: DCF Analysis

Projected FY Ending Dec	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue (\$M)	3	7	12	25	47	76	97	109	122	134	147	162	178	197
growth y/y		153%	81%	107%	89%	64%	26%	13%	11%	10%	10%	10%	10%	10%
EBIT (\$M)	(21)	(22)	(24)	(21)	(16)	(13)	(4)	6	17	29	40	53	59	66
EBIT margin	-820%	-338%	-204%	-85%	-35%	-17%	-4%	5%	14%	22%	27%	33%	33%	34%
Tax-affected EBIT (\$M)	(21)	(22)	(24)	(21)	(16)	(13)	(4)	6	15	26	36	47	53	60
<b>Free Cash Flow to Firm</b>	<b>(25)</b>	<b>(22)</b>	<b>(24)</b>	<b>(37)</b>	<b>(31)</b>	<b>(20)</b>	<b>(9)</b>	<b>2</b>	<b>11</b>	<b>26</b>	<b>36</b>	<b>48</b>	<b>53</b>	<b>57</b>
growth y/y									409%	135%	42%	34%	9%	9%

Discount Rate	Discounted Cash Flows (\$M)	PV of Terminal Value (\$M) at a Perpetual Growth Rate of					Enterprise Value (\$M)				
	2015-2024	0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%
9.4%	59	265	283	302	324	350	324	341	361	383	408
9.9%	55	240	255	271	290	311	295	310	326	345	366
<b>10.4%</b>	<b>51</b>	<b>218</b>	<b>231</b>	<b>245</b>	<b>261</b>	<b>279</b>	<b>269</b>	<b>282</b>	<b>296</b>	<b>312</b>	<b>330</b>
10.9%	48	198	209	221	235	250	246	257	269	283	298
11.4%	44	181	190	201	213	226	225	235	245	257	270

Net Debt (Cash) (\$M)	Equity Value (\$M)					Equity Value per Share				
	0.5%	1.0%	1.5%	2.0%	2.5%	0.5%	1.0%	1.5%	2.0%	2.5%
(20)	344	361	381	403	428	\$21.47	\$22.55	\$23.76	\$25.14	\$26.72
(20)	315	330	346	365	386	\$19.65	\$20.57	\$21.61	\$22.77	\$24.09
<b>(20)</b>	<b>289</b>	<b>302</b>	<b>316</b>	<b>332</b>	<b>350</b>	<b>\$18.04</b>	<b>\$18.83</b>	<b>\$19.72</b>	<b>\$20.71</b>	<b>\$21.83</b>
(20)	266	277	289	303	318	\$16.59	\$17.28	\$18.05	\$18.90	\$19.85
(20)	245	255	265	277	290	\$15.30	\$15.90	\$16.56	\$17.30	\$18.11

Equivalent Terminal EBITDA Multiple (forward 12 mos)				
0.5%	1.0%	1.5%	2.0%	2.5%
3.9x	4.1x	4.4x	4.7x	5.0x
3.6x	3.8x	4.0x	4.2x	4.5x
3.3x	3.4x	<b>3.6x</b>	3.8x	4.0x
3.0x	3.1x	3.3x	3.4x	3.6x
2.7x	2.9x	3.0x	3.1x	3.3x

Terminal Value as a % of Enterprise Value				
0.5%	1.0%	1.5%	2.0%	2.5%
82%	83%	84%	85%	86%
81%	82%	83%	84%	85%
81%	82%	<b>83%</b>	84%	84%
81%	81%	82%	83%	84%
80%	81%	82%	83%	84%

Source: J.P. Morgan estimates, Company data.

## Cellular Dynamics: Summary of Financials

Income Statement - Annual	FY13A	FY14E	FY15E	FY16E	Income Statement - Quarterly	1Q14E	2Q14E	3Q14E	4Q14E
Revenues	12	25	47	76	Revenues	5	6	6	8
Cost of products sold	(2)	(6)	(11)	(17)	Cost of products sold	(1)	(1)	(1)	(2)
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(17)	(21)	(29)	(37)	SG&A	(5)	(5)	(5)	(7)
R&D	(17)	(18)	(23)	(34)	R&D	(4)	(4)	(4)	(6)
Operating income	(24)	(21)	(16)	(13)	Operating income	(5)	(5)	(5)	(7)
EBITDA	(23)	(18)	(13)	(9)	EBITDA	(4)	(5)	(4)	(6)
Net interest (income) / expense	(1)	2	1	2	Net interest (income) / expense	1	1	1	1
Other income / (expense)	0	0	0	0	Other income / (expense)	0	0	0	0
Income taxes	0	0	0	0	Income taxes	0	0	0	0
Net income	(25)	(19)	(15)	(11)	Net income	(4)	(4)	(4)	(6)
Diluted shares outstanding	8	16	17	21	Diluted shares outstanding	16	16	16	16
Diluted EPS	(3.19)	(1.15)	(0.86)	(0.49)	Diluted EPS	(0.24)	(0.28)	(0.26)	(0.37)
Balance Sheet and Cash Flow Data	FY13A	FY14E	FY15E	FY16E	Ratio Analysis	FY13A	FY14E	FY15E	FY16E
Cash and cash equivalents	62	32	54	41	Sales growth	80.6%	107.3%	89.1%	63.8%
Accounts receivable	3	5	10	14	EBIT growth	9.1%	(13.9%)	(22.1%)	(21.6%)
Inventories	4	17	27	32	EPS growth	(75.3%)	(62.9%)	(25.1%)	(41.5%)
Other current assets	1	1	1	1	Gross margin	-	-	-	-
Current assets	70	54	92	89	EBIT margin	(204.2%)	(86.8%)	(36.0%)	(17.4%)
PP&E	2	4	8	12	EBITDA margin	(192.6%)	(75.9%)	(28.9%)	(12.0%)
Total assets	83	70	111	111	Tax rate	0.0%	0.0%	0.0%	0.0%
Total debt	12	12	12	12	Net margin	(210.0%)	(76.9%)	(33.1%)	(14.1%)
Total liabilities	19	18	24	29	Net Debt / EBITDA	219.0%	106.9%	312.0%	322.8%
Shareholders' equity	65	51	88	82	Net Debt / Capital (book)	(339.8%)	(63.9%)	(91.6%)	(55.9%)
Net income (including charges)	(25)	(18)	(15)	(10)	Return on assets (ROA)	(37.0%)	(24.7%)	(17.0%)	(9.7%)
D&A	1	2	3	4	Return on equity (ROE)	(44.6%)	(32.6%)	(22.2%)	(12.6%)
Change in working capital	1	(14)	(11)	(4)	Enterprise value / sales	-	-	-	-
Other	2	0	0	0	Enterprise value / EBITDA	-	-	-	-
Cash flow from operations	(21)	(30)	(23)	(10)	Free cash flow yield	(18.0%)	(13.3%)	(10.4%)	(5.1%)
Capex	(2)	(4)	(7)	(7)					
Free cash flow	(23)	(35)	(30)	(17)					
Cash flow from investing activities	(2)	(4)	(7)	(7)					
Cash flow from financing activities	52	5	52	5					
Dividends	0	0	0	0					
Dividend yield	-	-	-	-					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec

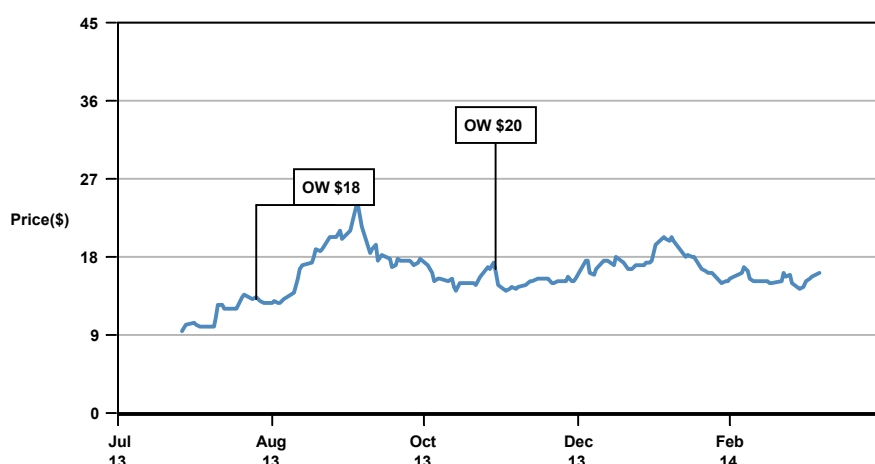
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Cellular Dynamics (ICEL, ICEL US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
19-Aug-13	OW	13.13	18.00
13-Nov-13	OW	16.54	20.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.  
Initiated coverage Aug 19, 2013.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.

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