

Reason for report:

COMPANY UPDATE

CELLULAR DYNAMICS INTERNATIONAL

Long-Term Growth Outlook for Stem Cell Technology Promising

• **Bottom Line:** Our attendance at the Society of Toxicology (SOT) annual meeting reinforced our long-term growth outlook for the use of induced pluripotent stem cells (iPSCs). ICEL is the clear market leader. However, we believe a more gradual adoption curve is likely, and we have modestly lowered our 2014 estimates accordingly. We maintain our Market Perform rating and our \$17 price target.

• **Increased interest in stem cells at SOT 2014.** SOT 2014 included 19 sessions and 32 posters addressing stem cell tech versus only 1 session and 19 posters during SOT 2013. The breadth of content expanded, with discussions on drug discovery, toxicity, and potential clinical applications. Overall, we found that the stem cell sessions were well attended and more populated than concurrent sessions in the immediate vicinity.

• **Emerging applications and customers on the horizon.** We encountered two large biopharmas that use stem cells for drug discovery, e.g., one for 131 compounds in clinical development. We also learned that biopharma is using ICEL's iPSCs to discover candidates for infectious disease and glucose-related conditions. Academic institutions are also using the technology for drug development. One is working with various biopharma companies to augment their development efforts, though acknowledged that biopharma does not have as much experience with stem cells as the academic community. Another researcher is using ICEL's cells for the development of a miRNA-based therapeutic to counter cardiomyopathy. Separately, we also met a multi-national company that is exploring the use of ICEL's iPSCs for its flavor division. We believe this and the Nestle deal validate the opportunity for iPSCs beyond traditional biomedical research and pharma customers.

• **ICEL is winning in the market.** Our discussions with attendees cited ICEL consistently as the market leader in iPSCs. Other companies mentioned included Axigenesis, Collectis, ReproCELL, and GE (licenses from ICEL) to a lesser extent. We also believe that ICEL is having greater success at penetrating the biopharma customer market globally, and is the leading supplier of iPSCs in Japan per our recent diligence.

• **Change in guidelines would accelerate iPSC adoption.** Regulators' proposal to change the clinical guidelines to assess proarrhythmic risk was also discussed widely at SOT ([see our 8/19/13 note](#) for further discussion).

• **Still some more work to do.** Researchers thematically cited improvements needed before widespread adoption, including: batch consistency, sensitivity, and reproducibility.

• **Reducing forecasts.** We lowered our 2014 estimates to assume a more conservative 1H14 customer ramp.

Dec Yr	1Q	2Q	3Q	4Q	FY Rev	1Q	2Q	3Q	4Q	FY EPS	P/E
2013A	\$2.4	\$2.8	\$2.5	\$4.2	\$11.9	(\$3.28)	(\$2.92)	(\$0.62)	(\$0.43)	(\$3.19)	NM
2014E - New	\$4.7	\$5.4	\$5.4	\$6.3	\$21.8	(\$0.36)	(\$0.37)	(\$0.34)	(\$0.42)	(\$1.48)	NM
2014E - Old	\$5.3	\$5.7	\$5.4	\$6.5	\$22.8	(\$0.33)	(\$0.36)	(\$0.34)	(\$0.41)	(\$1.44)	NM
2015E	--	--	--	--	\$47.8	--	--	--	--	(\$0.75)	NM
2016E	--	--	--	--	\$71.0	--	--	--	--	(\$0.04)	NM

Source: Company Information and Leerink Partners LLC Research
Revenues in millions.
GAAP EPS.

Key Stats:

(NASDAQ:ICEL)

S&P 600 Health Care Index:	1,249.14
Price:	\$14.45
Price Target:	\$17.00
Methodology:	~6x EV/2015E revs for tools and \$2 for Rx
52 Week High:	\$24.11
52 Week Low:	\$9.50
Shares Outstanding (mil):	15.8
Market Capitalization (mil):	\$228.3
Book Value/Share:	\$5.28
Cash Per Share:	\$3.94
Dividend (ann):	\$0.00
Dividend Yield:	0.0%



INVESTMENT THESIS

ICEL is well positioned as the leading commercial supplier of differentiated human cells derived from induced pluripotent stem cells (iPSCs). We believe cells derived from iPSCs will become increasingly utilized for compound screening and toxicity testing in the biopharmaceutical industry, among other applications. Several signposts suggest the iPSC industry is poised for rapid growth. Our Market Perform rating reflects a view that risks are balanced with rewards absent greater visibility on the revenue ramp.

VALUATION

Our \$17 price target assumes an enterprise value (using projected levels of debt and cash) that is ~6x our revenue forecast for the twelve months ended Dec-2015, including ~\$0.30/share of value for the CIRM contract, which we value separately due to its fixed term. This multiple is a premium to the median Life Science Tools & Diagnostics median forward twelve month revenue multiple of 4x, which we believe appropriate given ICEL's strong growth prospects. We additionally consider ICEL's Rx opportunity worth ~\$2/share based on the median of comparable stem cell technology companies.

RISKS TO VALUATION

Risks to our price target for ICEL include, but are not limited to: the pace of adoption of its iCell products among biopharmaceutical customers, nature and timing of FDA guidance/regulations, competitive pressures from in-house and commercial producers of iPSC lines, policy decisions, and market extension into therapeutic applications.

Cellular Dynamics (ICEL)

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Income Statement

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	2011	2012	Mar-13	Jun-13	Sep-13	Dec-13	2013	Mar-14e	Jun-14e	Sep-14e	Dec-14e	2014e	2015e	2016e
Revenue														
Product	\$1,460	\$5,178	\$1,754	\$1,969	\$1,793	\$2,482	\$7,998	\$2,193	\$2,855	\$2,869	\$3,847	\$11,763	\$30,564	\$45,152
Collabs, partnerships, other	<u>1,137</u>	<u>1,404</u>	<u>636</u>	<u>843</u>	<u>730</u>	<u>1,677</u>	<u>3,886</u>	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	<u>10,000</u>	<u>17,200</u>	<u>25,800</u>
Total revenue	2,597	6,582	2,390	2,812	2,523	4,159	11,884	4,693	5,355	5,369	6,347	21,763	47,764	70,952
COGS	<u>727</u>	<u>2,089</u>	<u>577</u>	<u>676</u>	<u>371</u>	<u>678</u>	<u>2,302</u>	<u>702</u>	<u>914</u>	<u>918</u>	<u>1,231</u>	<u>3,764</u>	<u>9,780</u>	<u>14,449</u>
Gross profit	1,870	4,493	1,813	2,136	2,152	3,481	9,582	3,991	4,441	4,451	5,116	17,999	37,983	56,504
SG&A	9,513	12,422	3,636	3,282	5,406	4,949	17,273	4,670	4,972	4,725	5,695	20,062	26,270	31,929
R&D	<u>13,660</u>	<u>14,301</u>	<u>3,856</u>	<u>3,911</u>	<u>3,906</u>	<u>4,899</u>	<u>16,572</u>	<u>4,723</u>	<u>5,029</u>	<u>4,778</u>	<u>5,759</u>	<u>20,289</u>	<u>22,449</u>	<u>24,124</u>
Operating income (loss)	(21,303)	(22,230)	(5,679)	(5,057)	(7,160)	(6,367)	(24,263)	(5,402)	(5,560)	(5,052)	(6,338)	(22,352)	(10,736)	451
Interest expense (income)	44	34	7	4	358	347	716	261	265	268	272	1,066	1,116	1,139
Other expense, net	<u>(3)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(20)</u>	<u>(1)</u>	<u>(21)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Pretax income	(21,344)	(22,264)	(5,686)	(5,061)	(7,498)	(6,713)	(24,958)	(5,663)	(5,825)	(5,320)	(6,610)	(23,418)	(11,852)	(688)
Taxes	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Net income	(\$21,344)	(\$22,264)	(\$5,686)	(\$5,061)	(\$7,498)	(\$6,713)	(\$24,958)	(\$5,663)	(\$5,825)	(\$5,320)	(\$6,610)	(\$23,418)	(\$11,852)	(\$688)
Basic shares outstanding	1,734	1,734	1,734	1,734	12,087	15,756	7,828	15,766	15,776	15,786	15,796	15,781	15,821	15,861
Diluted shares outstanding	1,734	1,734	1,734	1,734	12,087	15,756	7,828	15,766	15,776	15,786	15,796	15,781	15,821	15,991
EPS diluted	(\$12.31)	(\$12.84)	(\$3.28)	(\$2.92)	(\$0.62)	(\$0.43)	(\$3.19)	(\$0.36)	(\$0.37)	(\$0.34)	(\$0.42)	(\$1.48)	(\$0.75)	(\$0.04)
<i>EPS growth</i>														
Sales growth		153.4%	108.6%	123.2%	104.6%	41.3%	80.6%	96.3%	90.4%	112.8%	52.6%	83.1%	119.5%	48.5%
Product gross margin	50.2%	59.7%	67.1%	65.7%	79.3%	72.7%	71.2%	68.0%	68.0%	68.0%	68.0%	68.0%	68.0%	68.0%
SG&A % of revenue	366.3%	188.7%	152.1%	116.7%	214.3%	119.0%	145.3%	99.5%	92.8%	88.0%	89.7%	92.2%	55.0%	45.0%
R&D % of revenue	526.0%	217.3%	161.3%	139.1%	154.8%	117.8%	139.4%	100.6%	93.9%	89.0%	90.7%	93.2%	47.0%	34.0%
Operating margin	(820.3%)	(337.7%)	(237.6%)	(179.8%)	(283.8%)	(153.1%)	(204.2%)	(115.1%)	(103.8%)	(94.1%)	(99.9%)	(102.7%)	(22.5%)	0.6%
Tax rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
D&A	\$1,366	\$1,433	\$341	\$338	\$322	\$321	\$1,322					\$1,407	\$2,172	\$2,435
EBITDA	(\$19,937)	(\$20,797)	(\$5,338)	(\$4,719)	(\$6,838)	(\$6,046)	(\$22,941)					(\$20,945)	(\$8,564)	\$2,886
Free cash flow														
Operarating cash flow	(\$19,232)	(\$21,004)	(\$4,829)	(\$4,624)	(\$6,940)	(\$4,907)	(\$21,300)					(\$22,269)	(\$12,606)	\$727
CapX	<u>(558)</u>	<u>(132)</u>	<u>(120)</u>	<u>(173)</u>	<u>(353)</u>	<u>(1,171)</u>	<u>(1,817)</u>					<u>(1,877)</u>	<u>(4,175)</u>	<u>(3,949)</u>
Free cash flow	(\$19,790)	(\$21,136)	(\$4,949)	(\$4,797)	(\$7,293)	(\$6,078)	(\$23,117)					(\$24,146)	(\$16,781)	(\$3,223)

Notes:

Source: Company reports and Leerink Partners estimates

Cellular Dynamics (ICEL)

Balance Sheet (\$ thousands)	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14e	Jun-14e	Sep-14e	Dec-14e
Assets								
Cash, equivalents, and short-term investments	\$28,488	\$33,539	\$68,575	\$62,029	\$53,782	\$50,085	\$44,185	\$38,145
Accounts receivable	1,898	2,153	1,908	3,318	1,922	2,503	2,515	3,373
Inventory	2,483	2,643	3,507	3,884	2,691	3,504	3,521	4,722
Other	<u>1,544</u>	<u>2,288</u>	<u>1,092</u>	<u>964</u>	<u>1,052</u>	<u>1,370</u>	<u>1,377</u>	<u>1,847</u>
Total current assets	34,413	40,623	75,082	70,195	59,448	57,463	51,598	48,086
Property and equipment, net	777	738	901	2,052	2,235	2,550	2,557	3,022
Goodwill	6,817	6,817	6,817	6,817	6,817	6,817	6,817	6,817
Other intangibles	4,270	4,178	4,142	4,122	3,997	3,872	3,747	3,622
Other	<u>10</u>	<u>232</u>	<u>221</u>	<u>209</u>	<u>209</u>	<u>209</u>	<u>209</u>	<u>209</u>
Total assets	\$46,287	\$52,588	\$87,163	\$83,395	\$72,706	\$70,911	\$64,928	\$61,757
Liabilities and shareholders' equity								
Notes payable and current maturities of long-term debt	\$338	\$18	\$18	\$18	\$595	\$595	\$595	\$595
Accounts payable	1,754	1,685	1,246	1,811	(673)	2,366	1,281	3,331
Accruals and other	<u>2,049</u>	<u>2,230</u>	<u>3,231</u>	<u>4,800</u>	<u>1,929</u>	<u>2,512</u>	<u>2,525</u>	<u>3,385</u>
Total current liabilities	4,141	3,933	4,495	6,629	1,851	5,473	4,400	7,312
Long-term debt	636	11,736	11,808	11,879	11,302	11,302	11,302	11,302
Other	<u>0</u>	<u>261</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total liabilities	\$4,777	\$15,930	\$16,303	\$18,508	\$13,153	\$16,775	\$15,702	\$18,614
Shareholders' equity	\$41,510	\$36,658	\$70,860	\$64,887	\$59,552	\$54,136	\$49,225	\$43,143
Total liabilities, shareholders' equity, and minority interest	\$46,287	\$52,588	\$87,163	\$83,395	\$72,706	\$70,911	\$64,928	\$61,757

Notes:

Source: Company reports and Leerink Partners estimates

Disclosures Appendix

Analyst Certification

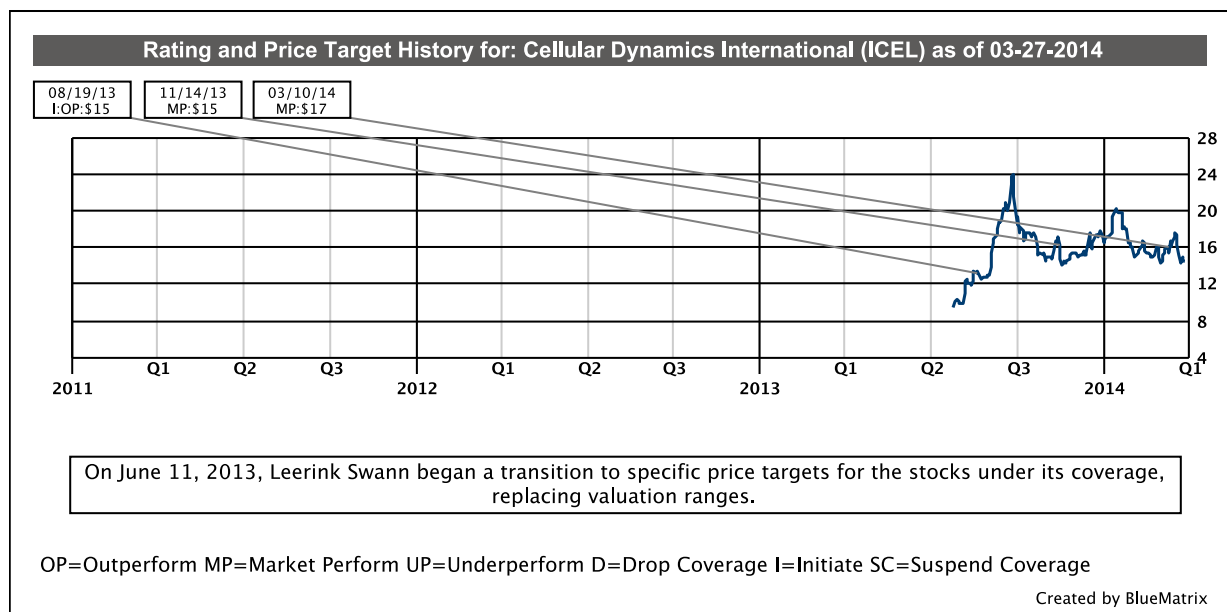
I, Dan Leonard, certify that the views expressed in this report accurately reflect my views and that no part of my compensation was, is, or will be directly related to the specific recommendation or views contained in this report.

Valuation

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Distribution of Ratings/Investment Banking Services (IB) as of 12/31/13				
Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [OP]	118	64.50	30	25.00
HOLD [MP]	65	35.50	2	3.00
SELL [UP]	0	0.00	0	0.00

Explanation of Ratings

Outperform (Buy): We expect this stock to outperform its benchmark over the next 12 months.

Market Perform (Hold/Neutral): We expect this stock to perform in line with its benchmark over the next 12 months.

Underperform (Sell): We expect this stock to underperform its benchmark over the next 12 months. The degree of outperformance or underperformance required to warrant an Outperform or an Underperform rating should be commensurate with the risk profile of the company.

For the purposes of these definitions the relevant benchmark will be the S&P 600® Health Care Index for issuers with a market capitalization of less than \$2 billion and the S&P 500® Health Care Index for issuers with a market capitalization over \$2 billion.

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