

## Cellular Dynamics

### 1Q14 Review: Near-Term Volatility Clouds the Quarter, But LT Thesis Still Intact; Lowering PT to \$17

Cellular Dynamics (ICEL) reported weak 1Q14 results, with revenues below JPMe and consensus due to a drop-off in iCell Cardiomyocyte unit sales and revenue recognition delays in CIRM. Despite a weaker-than-expected top-line result, however, the company showed improving trailing twelve-month customer adoption rates and continued progress on product development, as well as a ~240-bp y/y improvement in gross margin. While no guidance was provided on the call, management expects product sales to return to growth in the coming quarters and remains focused on driving further customer adoption, partnership opportunities, and new product development. Although our investment thesis on ICEL remains unchanged, we are adjusting our model to account for the near-term softness in product sales. As such, we maintain our Overweight rating, but trim our December 2014 price target to \$17.

- **Weak Product Sales more than offset Collaboration revenues.** Revenues of \$2.9M (+23% y/y) came in well below JPMe and consensus (\$5.3M and \$4.7M, respectively), driven by soft Product Sales, which were impacted by a decrease in Cardiomyocyte unit volumes, and which more than offset stronger Collaboration and Partnership revenues (\$1.5M), which came in better than expected due to strength in iCell Hepatocytes, CIRM, and other partnerships. Regarding Cardiomyocyte volumes, management noted that larger customers were able to use cryopreserved inventory purchased in previous quarters to conduct research, thereby leading to inventory drawdown. Nonetheless, customers continue to place orders, and the company expects product sales to return to growth for the remainder of the year. The company also cited a ~9% increase across the iCell line in the quarter as helping offset gross margin headwinds from lower Cardiomyocyte sales. Moving down the P&L, product gross margin of 69% increased ~240 bps y/y due to volume based pricing, while total gross margin of 85% was also above our estimate of 76%.
- **Pharma collaborations set to broaden over time.** On the call, management highlighted the ability to leverage ICEL's broad product portfolio and develop new products to engage large pharma clients in work beyond ADME/Tox. To that end, the company is broadening relationships with pharma customers to include more discovery work, including the iCell Hepatocytes offering, which allows for viral lifecycle testing. During the quarter, the company also recognized initial revenues from iCell DopaNeurons, a new product designed to provide an *in vitro* model to investigate dopaminergic neurons, which are implicated in neurological disorders such as Parkinson's disease and schizophrenia. Management also noted that the company is now growing inventories in anticipation of future sales of these products.

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

FYE Dec	2013A	2014E (Prev)	2014E (Curr)	2015E (Prev)	2015E (Curr)
Revenue (\$ mn)					
Q1 (Mar)	2	5A	3A	9	7
Q2 (Jun)	3	6	5	11	8
Q3 (Sep)	3	6	5	10	10
Q4 (Dec)	4	8	6	16	12
FY	12	25	19	47	36

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

## Overweight

### ICEL, ICEL US

Price: \$11.75 (intraday - 02:15 PM)

▼ **Price Target: \$17.00**  
Previous: \$20.00

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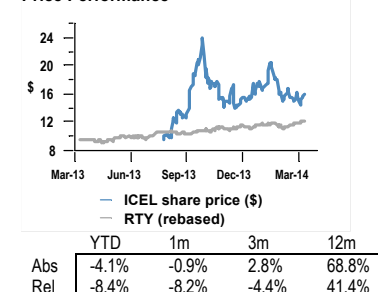
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#### Price Performance



#### Company Data

Price (\$)	11.75
Date Of Price	06-May-14
52-week Range (\$)	24.11-9.50
Market Cap (\$ mn)	91.98
Fiscal Year End	Dec
Shares O/S (mn)	8
Price Target (\$)	17.00
Price Target End Date	31-Dec-14

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

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- **Longer-term customer adoption trends remain healthy.** ICEL continues to see positive customer adoption (which is key to our investment thesis), as evidenced by TTM sales growth of 59% y/y despite lumpiness in 1Q product sales and increasing sales volume to its largest customers. Average TTM sales to the top ten customers increased to \$875K vs. \$516K a year ago, with the company selling to 159 customers vs. 130 customers over the same timeframe last year. Management also gave an update on its recent agreement with Nestle, noting the company is continuing to place significant orders and that ICEL is continuing its business development efforts with similar food, cosmetic, and other non-biopharma customers.
- **Updating estimates, reducing PT to \$17; remain Overweight.** Although we continue to view the company's first mover advantage, validated technology platform, strong competitive advantage due to scale and cost effectiveness, and ability to capture its +\$10B opportunity as viable rationale to own the stock over the long term, we are adjusting our model to account for near-term softness in Cardiomyocyte-related product sales. As such, we are lowering our DCF-based 2014 price target to \$17, while maintaining our Overweight rating.

Figure 1: ICEL 1Q14 Variance

	1Q13A		1Q14E				1Q14A				Variance vs. JPM Est.	
	Actual		JPM Estimate		Consensus		Actual		Change y/y			
	\$ M	%	\$ M	%	\$ M	%	\$ M	%	Δ \$	Δ margin	\$ M	%
Product Sales	1.8		4.2				1.5		-16.6%		(2.7)	
Collaborations & Partnerships	0.6		1.1				1.5		132.2%		0.3	
<b>Total Revenue</b>	<b>2.4</b>		<b>5.3</b>		<b>4.7</b>		<b>2.9</b>		<b>23.0%</b>		<b>(2.4)</b>	
Gross Profit	1.8	75.9%	4.0	76.0%			2.5	84.8%	37.5%	897 bp	(1.6)	886 bp
SG&A	(3.6)	152.1%	(4.6)	87.0%			(5.4)	183.4%	48.2%	3126 bp	(0.8)	9640 bp
R&D	(3.9)	161.3%	(4.0)	75.0%			(4.9)	167.3%	27.5%	593 bp	(0.9)	9227 bp
Operating Income	(5.7)	-237.6%	(4.6)	-86.0%			(7.8)	-265.8%		-2822 bp	(3.2)	-17980 bp
EBITDA	(5.3)	-223.3%	(4.1)	-76.7%			(7.5)	-254.4%		-3109 bp	(3.4)	-17779 bp
Pretax Income	(5.7)		(3.8)				(8.1)				(4.3)	
Income Tax	0.0	0.0%	0.0	0.0%			0.0	0.0%		0 bp	0.0	0 bp
Adjusted Net Income	(6)	-237.9%	(4)	-72.1%			(8)	-276.2%	42.8%	-3827 bp	(4)	-20411 bp
Diluted Shares	1.7M		15.9M				15.8M		809.1%		-0.1M	
<b>Adjusted Diluted EPS</b>	<b>(\$3.28)</b>		<b>(\$0.24)</b>		<b>(\$0.34)</b>		<b>(\$0.52)</b>		<b>-84.1%</b>		<b>(\$0.28)</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

We are decreasing our December 2014 price target from \$20 to \$17, derived from a 10-year DCF analysis with a CAPM-derived WACC discount rate of 10.4% and terminal growth of +3%.

### 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		1QA	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	1.5	3.3	3.7	4.4	12.8	26.5	78.5%
Collaborations, Partnerships & Other	1.1	1.4	0.6	0.8	0.7	1.7	3.9	1.5	1.5	1.4	2.0	6.4	9.4	52.5%
<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>2.9</b>	<b>4.8</b>	<b>5.1</b>	<b>6.4</b>	<b>19.2</b>	<b>35.8</b>	<b>69.0%</b>
Cost of Goods Sold	(1)	(2)	(1)	(1)	(0)	(1)	(2)	(0)	(1)	(1)	(2)	(5)	(9)	
Gross Profit	2	4	2	2	2	3	10	2	4	4	5	15	27	
SG&A	(10)	(12)	(4)	(3)	(5)	(5)	(17)	(5)	(6)	(7)	(7)	(25)	(22)	
R&D	(14)	(14)	(4)	(4)	(4)	(5)	(17)	(5)	(6)	(7)	(7)	(25)	(18)	
EBIT (Operating Income)	(21)	(22)	(6)	(5)	(7)	(6)	(24)	(8)	(8)	(10)	(9)	(35)	(13)	
EBITDA	(20)	(21)	(5)	(5)	(7)	(6)	(23)	(7)	(7)	(8)	(8)	(31)	(10)	
Pre-Tax Income	(21)	(22)	(6)	(5)	(7)	(7)	(25)	(8)	(8)	(9)	(9)	(34)	(12)	
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)	(8.1)	(7.7)	(9.2)	(8.9)	(34.0)	(12.0)	
Diluted Shares Outstanding	1.7	1.7	1.7	1.7	12.1	15.8	7.8	15.8	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>(\$0.52)</b>	<b>(\$0.48)</b>	<b>(\$0.57)</b>	<b>(\$0.55)</b>	<b>(\$2.12)</b>	<b>(\$0.69)</b>	
Product Gross Margin	47%	65%	67%	66%	79%	73%	71%					73%	75%	
Total Gross Margin	70%	72%	76%	76%	85%	84%	81%	69%	72%	74%	77%	76%	75%	
change in gross margin (y/y, bp)	+972	+1032	+867	+1137	+1112	+1447	+1116	+1118	+956	+868	+905	+941	+991	
SG&A	366%	189%	152%	117%	214%	118%	145%	183%	121%	131%	110%	129%	62%	
R&D	526%	217%	161%	139%	155%	119%	140%	167%	125%	135%	110%	134%	50%	
Operating Margin	-820%	-338%	-238%	-180%	-284%	-153%	-204%	-266%	-173%	-192%	-144%	-183%	-38%	
change in op margin (y/y, bp)	+823	+412	+569	+367	+640	+777	+605	+1119	+964	+677	+942	+895	+198	
EBITDA Margin	-768%	-316%	-223%	-168%	-271%	-144%	-193%	-254%	-139%	-168%	-127%	-160%	-27%	
Tax Rate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Profit Margin	-822%	-338%	-238%	-180%	-297%	-161%	-210%	-276%	-160%	-183%	-138%	-177%	-33%	
Reported Revenue Growth y/y	26%	153%	109%	123%	105%	41%	81%	23%	72%	100%	54%	62%	86%	

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

Figure 3: DCF Analysis

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue (\$M)	3	7	12	19	36	56	72	84	93	102	112	123	135	148
growth y/y		153%	81%	62%	86%	57%	28%	17%	11%	10%	9%	10%	10%	10%
EBIT (\$M)	(21)	(22)	(24)	(35)	(13)	(10)	(4)	3	12	20	29	38	42	47
EBIT margin	-820%	-338%	-204%	-183%	-36%	-18%	-6%	4%	12%	20%	25%	31%	31%	32%
Tax-affected EBIT (\$M)	(21)	(22)	(24)	(35)	(13)	(10)	(4)	3	10	18	26	34	38	43
<b>Free Cash Flow to Firm</b>	<b>(25)</b>	<b>(22)</b>	<b>(24)</b>	<b>(44)</b>	<b>(17)</b>	<b>(11)</b>	<b>(6)</b>	<b>2</b>	<b>8</b>	<b>17</b>	<b>24</b>	<b>32</b>	<b>36</b>	<b>41</b>
growth y/y									270%	101%	43%	35%	12%	12%

Discount Rate	Discounted Cash Flows (\$M) 2015-2024	PV of Terminal Value (\$M) at a Perpetual Growth Rate of					Enterprise Value (\$M)				
		2.0%	2.5%	3.0%	3.5%	4.0%	2.0%	2.5%	3.0%	3.5%	4.0%
9.4%	47	229	247	268	292	321	276	294	315	339	368
9.9%	44	205	220	237	257	281	249	264	281	301	325
<b>10.4%</b>	<b>42</b>	<b>184</b>	<b>197</b>	<b>211</b>	<b>228</b>	<b>247</b>	<b>226</b>	<b>239</b>	<b>253</b>	<b>270</b>	<b>289</b>
10.9%	39	166	177	189	203	219	205	216	228	242	258
11.4%	37	150	160	170	182	195	187	197	207	219	232

Net Debt (Cash) (\$M)	Equity Value (\$M)					Equity Value per Share				
	2.0%	2.5%	3.0%	3.5%	4.0%	2.0%	2.5%	3.0%	3.5%	4.0%
(13)	289	307	327	352	380	\$18.04	\$19.16	\$20.46	\$21.98	\$23.78
(13)	262	277	294	314	337	\$16.37	\$17.31	\$18.38	\$19.63	\$21.08
<b>(13)</b>	<b>239</b>	<b>251</b>	<b>266</b>	<b>282</b>	<b>301</b>	<b>\$14.91</b>	<b>\$15.70</b>	<b>\$16.60</b>	<b>\$17.63</b>	<b>\$18.83</b>
(13)	218	229	241	255	271	\$13.63	\$14.30	\$15.06	\$15.93	\$16.92
(13)	200	209	220	231	245	\$12.49	\$13.07	\$13.72	\$14.45	\$15.28

Equivalent Terminal EBITDA Multiple (forward 12 mos)				
2.0%	2.5%	3.0%	3.5%	4.0%
5.1x	5.4x	5.8x	6.3x	6.8x
4.6x	4.9x	5.2x	5.6x	6.0x
4.2x	4.4x	<b>4.7x</b>	5.0x	5.3x
3.8x	4.0x	4.2x	4.5x	4.8x
3.5x	3.6x	3.8x	4.1x	4.3x

Terminal Value as a % of Enterprise Value				
2.0%	2.5%	3.0%	3.5%	4.0%
83%	84%	85%	86%	87%
82%	83%	84%	85%	86%
82%	83%	<b>84%</b>	85%	86%
81%	82%	83%	84%	85%
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	1Q14A	2Q14E	3Q14E	4Q14E
Revenues	12	19	36	56	Revenues	3A	5	5	6
Cost of products sold	(2)	(5)	(9)	(14)	Cost of products sold	(0)A	(1)	(1)	(2)
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(17)	(25)	(22)	(28)	SG&A	(5)A	(6)	(7)	(7)
R&D	(17)	(25)	(18)	(25)	R&D	(5)A	(6)	(7)	(7)
Operating income	(24)	(35)	(13)	(10)	Operating income	(8)A	(8)	(10)	(9)
EBITDA	(23)	(30)	(9)	(6)	EBITDA	(7)A	(7)	(8)	(8)
Net interest (income) / expense	(1)	1	1	3	Net interest (income) / expense	(0)A	1	0	0
Other income / (expense)	0	0	0	0	Other income / (expense)	0A	0	0	0
Income taxes	0	0	0	0	Income taxes	0A	0	0	0
Net income	(25)	(34)	(12)	(8)	Net income	(8)A	(8)	(9)	(9)
Diluted shares outstanding	8	16	17	21	Diluted shares outstanding	16A	16	16	16
Diluted EPS	(3.19)	(2.12)	(0.69)	(0.36)	Diluted EPS	(0.52)A	(0.48)	(0.57)	(0.55)
Balance Sheet and Cash Flow Data	FY13A	FY14E	FY15E	FY16E	Ratio Analysis	FY13A	FY14E	FY15E	FY16E
Cash and cash equivalents	62	25	60	56	Sales growth	80.6%	61.9%	86.2%	57.1%
Accounts receivable	3	4	7	10	EBIT growth	9.1%	44.9%	(63.1%)	(21.2%)
Inventories	4	14	19	22	EPS growth	(75.3%)	(32.8%)	(66.7%)	(46.4%)
Other current assets	1	1	1	1	Gross margin	-	-	-	-
Current assets	70	43	87	88	EBIT margin	(204.2%)	(184.5%)	(37.6%)	(19.0%)
PP&E	2	1	1	1	EBITDA margin	(192.6%)	(160.3%)	(27.5%)	(11.6%)
Total assets	83	55	99	101	Tax rate	0.0%	0.0%	0.0%	0.0%
Total debt	12	12	12	12	Net margin	(210.0%)	(178.3%)	(34.7%)	(14.1%)
Total liabilities	19	20	24	28	Net Debt / EBITDA	219.0%	40.9%	485.6%	670.5%
Shareholders' equity	65	35	75	72	Net Debt / Capital (book)	(339.8%)	(55.5%)	(175.9%)	(154.2%)
Net income (including charges)	(25)	(34)	(12)	(7)	Return on assets (ROA)	(37.0%)	(49.6%)	(16.2%)	(8.0%)
D&A	1	4	3	4	Return on equity (ROE)	(44.6%)	(68.4%)	(22.6%)	(10.8%)
Change in working capital	1	(10)	(5)	(1)	Enterprise value / sales	-	-	-	-
Other	2	1	0	0	Enterprise value / EBITDA	-	-	-	-
Cash flow from operations	(21)	(38)	(14)	(5)	Free cash flow yield	(25.1%)	(21.8%)	(8.0%)	(3.6%)
Capex	(2)	(3)	(3)	(4)					
Free cash flow	(23)	(41)	(16)	(9)					
Cash flow from investing activities	(2)	(3)	(3)	(4)					
Cash flow from financing activities	52	4	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

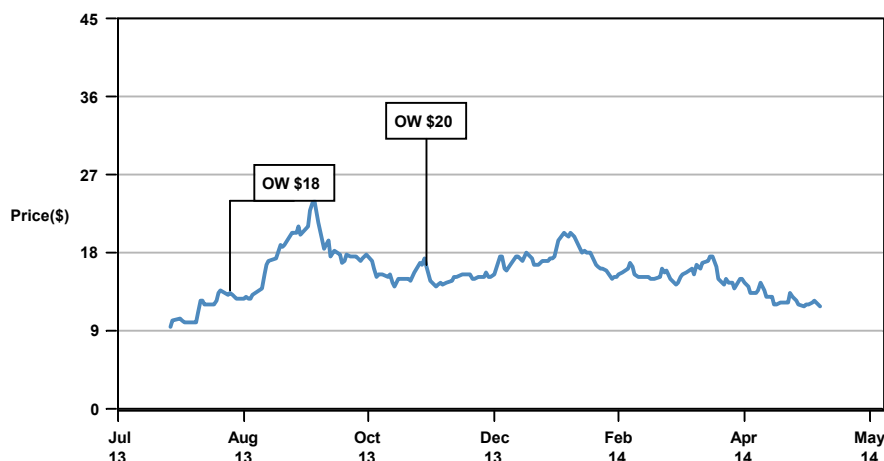
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Cellular Dynamics (ICEL, ICEL US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
19-Aug-13	OW	13.53	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.

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