

Cellular Dynamics

3Q13 Review: Solid First Quarter Out of the Gate; Increasing December 2014 PT to \$20

Cellular Dynamics (ICEL) reported solid 3Q13 results – its first quarter as a public company – with revenues of \$2.5M (+100% y/y) in line with JPMe and consensus (\$2.9M), driven by improving customer adoption trends among pharmaceutical manufacturers, and record gross margins. No guidance was provided on the call, although management cited expectations on deliveries of MyCell products in 4Q and remains positive on further customer adoption and partnership opportunities in 2014. Our investment thesis on ICEL remains 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 raise our December 2014 price target to \$20. Please see our recent [initiation](#) for more thoughts on our investment thesis.

- **Product sales in line, while gross margins come in significantly higher.** Reported sales of \$2.5M, representing +100% y/y growth, came in slightly below JPMe and consensus of \$2.9M, with growth aided by solid iCell product sales and higher ASPs, offset by a modest miss in Collaboration and Partnership revenues. Total gross margins of 85.3% were well above our estimate of 58% and a company record, driven by favorable product mix and lower than expected COGS associated with Product Sales.
- **Strong customer adoption trends bode well for the future.** Increased customer adoption drove the y/y sales increase in the quarter. Average sales to top-10 customers increased from \$704K for the trailing twelve months ended 3Q13 compared to \$313K in the same period last year. In addition to average sales to its top-10 customers more than doubling y/y, management noted that ICEL sold to 142 customers over the TTM timeframe, compared to 115 customers over the same period last year. Another sign of improving adoption of iCell and MyCell product lines was the 91% y/y increase in attendance at the Annual CDI User Group Meeting. The data points suggest a significant, and broad-based, increase in pharma customer adoption in research programs, while providing further technical validation of ICEL products, a key tenet of our long-term thesis.

Overweight

ICEL, ICEL US

Price: \$17.21 (intraday - 03:01 PM)

▲ **Price Target: \$20.00**
Previous: \$18.00

Life Science Tools & Diagnostics

Tycho W. Peterson ^{AC}

(1-212) 622-6568

tycho.peterson@jpmorgan.com

Bloomberg JPMA PETERSON <GO>

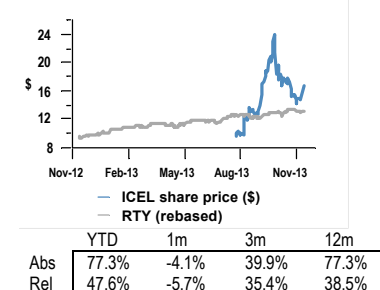
Patrick Donnelly

(1-212) 622-9735

patrick.donnelly@jpmorgan.com

J.P. Morgan Securities LLC

Price Performance



Cellular Dynamics International (ICEL;ICEL US)

FYE Dec	2011A	2012A	2013E (Prev)	2013E (Curr)	2014E (Prev)	2014E (Curr)	2015E
Revenue (\$ mn)							
Q1 (Mar)	1	1	3A	2A	7	7	12
Q2 (Jun)	1	1	3A	3A	7	7	12
Q3 (Sep)	0	1	3	3A	7	7	12
Q4 (Dec)	1	3	4	5	9	9	19
FY	3	7	13	12	31	30	55

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

Company Data

Price (\$)	17.21
Date Of Price	13-Nov-13
52-week Range (\$)	24.11-9.50
Market Cap (\$ mn)	208.95
Fiscal Year End	Dec
Shares O/S (mn)	12
Price Target (\$)	20.00
Price Target End Date	31-Dec-14

See page 8 for analyst certification and important disclosures.

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- **No guidance on the call, but management is optimistic on increasing partnership and MyCell revenues.** Unlike 2Q, the company did not book any MyCell revenue in 3Q, but management noted that there are existing MyCell projects in the pipeline that should be delivered in 4Q. Management also expects to see further growth in its Collaboration and Partnerships segment, specifically noting that ICEL is in position to receive payment from CIRM and to recognize revenue on that contract beginning in 4Q. We see this as positive confirmation that ICEL is implementing its strategy and pushing towards its goal of setting the industrial standard for manufactured human cell products and becoming a dominant player in the \$10B combined market.
- **Modest changes to our estimates; maintain Overweight rating and increasing December 2014 price target to \$20.** We are making modest adjustments to our model based on commentary from the quarter. Our Overweight rating remains unchanged while our DCF-based 2014 price target increases to \$20 (from \$18). With its 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. Please see our [initiation](#) for additional thoughts on our investment thesis.

Figure 1: ICEL Variance

	3Q12		3QE				3QA				Variance	
	Actual		JPM Estimate		Consensus		Actual		Change y/y		vs. JPM Est.	
	\$ M	%	\$ M	%	\$ M	%	\$ M	%	Δ \$	Δ margin	\$ M	%
Product Sales	1.1		1.9				1.8		66.8%		(0.1)	
Collaborations & Partnerships	0.2		1.1				0.7		362.0%		(0.3)	
Total Revenue	1.2		2.9		2.9		2.5		104.6%		(0.4)	
Gross Profit	0.9	76.7%	2.2	58.0%			2.2	85.3%	127.5%	857 bp	(0.0)	2730 bp
SG&A	(2.9)	234.2%	(3.1)	129.0%			(5.4)	214.3%	87.2%	-1996 bp	(2.3)	8527 bp
R&D	(3.5)	286.2%	(2.3)	100.0%			(3.9)	154.8%	10.7%	-13140 bp	(1.6)	5482 bp
Operating Income	(5.5)	-443.7%	(3.3)	-171.0%			(7.2)	-283.8%		15993 bp	(3.9)	-11279 bp
EBITDA	(5.1)	-416.0%	(3.0)	-160.8%			(6.8)	-271.0%		14499 bp	(3.9)	-11024 bp
Pretax Income	(5.5)		(3.3)				(7.2)				(3.9)	
Income Tax	0.0	0.0%	0.0	0.0%			0.0	0.0%		0 bp	0.0	0 bp
Adjusted Net Income	(5.5)	(4.4)	(2.9)		(5.3)		(7.5)				(4.6)	
Diluted Shares	1.7M		15.8M				12.1M		600.0%		-3.7M	
Adjusted Diluted EPS	\$ (3.17)		(\$0.18)		(\$0.39)		\$ (0.62)				\$ (0.44)	

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

Investment Thesis, Valuation, and Risks

Investment thesis

With its first-mover advantage 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 12.3% 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; (4) Uncertainties and exposure to CIRM and other public-funded future customers.

Figure 2: ICEL – Model

Income Statement		1QA	2QA	3QA	4QA		1QA	2QA	3QA	4QE				CAGR
USD \$M	2011A	Mar	Jun	Sep	Dec	2012A	Mar	Jun	Sep	Dec	2013E	2014E	2015E	11-15E
Product Sales	1.5	0.6	1.2	1.1	2.3	5.2	1.8	2.0	1.8	3.5	9.0	21.1	42.3	96.1%
Collaborations, Partnerships & Other	1.1	0.5	0.1	0.2	0.7	1.4	0.6	0.8	0.7	1.1	3.3	8.8	12.9	62.5%
Total Revenue	2.6	1.1	1.3	1.2	2.9	6.6	2.4	2.8	2.5	4.5	12.3	29.9	55.2	84.3%
Cost of Goods Sold	(1)	(0)	(0)	(0)	(1)	(2)	(1)	(1)	(0)	(1)	(3)	(7)	(13)	
Gross Profit	2	1	1	1	2	4	2	2	2	3	10	23	42	
SG&A	(10)	(3)	(3)	(3)	(4)	(12)	(4)	(3)	(5)	(4)	(16)	(23)	(34)	
R&D	(14)	(3)	(4)	(4)	(4)	(14)	(4)	(4)	(4)	(3)	(15)	(18)	(28)	
EBIT (Operating Income)	(21)	(5)	(6)	(5)	(6)	(22)	(6)	(5)	(7)	(4)	(21)	(18)	(19)	
EBITDA	(20)	(4)	(6)	(5)	(5)	(21)	(5)	(5)	(7)	(3)	(20)	(16)	(17)	
Pre-Tax Income	(21)	(5)	(6)	(5)	(6)	(22)	(6)	(5)	(7)	(3)	(21)	(16)	(18)	
Income Taxes	0	0	0	0	0	0	0	0	0	0	0	0	0	
Net Income	(21.3)	(4.8)	(6.2)	(5.5)	(5.8)	(22.3)	(5.7)	(5.1)	(7.5)	(2.8)	(21.0)	(15.6)	(18.0)	
Diluted Shares Outstanding	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	12.1	12.2	12.1	12.5	13.9	
Adjusted Diluted EPS	(\$12.47)	(\$2.80)	(\$3.58)	(\$3.17)	(\$3.36)	(\$12.89)	(\$3.28)	(\$2.92)	(\$0.62)	(\$0.23)	(\$1.73)	(\$1.25)	(\$1.30)	
Product Gross Margin	47%	78%	64%	73%	46%	65%	67%	66%	79%	76%	72%	77%	77%	
Total Gross Margin	70%	88%	67%	77%	58%	72%	76%	76%	85%	75%	78%	76%	77%	
change in gross margin (y/y, bp)	+972	+1191	+1069	+1270	+694	+1032	+867	+1137	+1112	+1303	+1075	+976	+1010	
SG&A	366%	238%	258%	234%	121%	189%	152%	117%	214%	84%	132%	76%	62%	
R&D	526%	267%	299%	286%	134%	217%	161%	139%	155%	70%	121%	60%	50%	
Operating Margin	-820%	-418%	-490%	-444%	-197%	-338%	-238%	-180%	-284%	-79%	-175%	-60%	-38%	
change in op margin (y/y, bp)	+823	+499	+553	+374	+341	+412	+569	+367	+640	+400	+518	+342	+584	
EBITDA Margin	-768%	-382%	-463%	-416%	-185%	-316%	-223%	-168%	-271%	-75%	-165%	-53%	-30%	
Tax Rate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Profit Margin	-822%	-419%	-491%	-444%	-197%	-338%	-238%	-180%	-297%	-61%	-171%	-52%	-33%	
Reported Revenue Growth y/y	26%	92%	106%	160%	222%	153%	109%	123%	105%	54%	86%	144%	85%	

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

Figure 3: ICEL – DCF Analysis

Target Period: **Dec 2014**

Projected FY Ending Dec	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue (\$M)	3	7	12	30	55	89	111	125	140	154	169	187	206	229
growth y/y		153%	86%	144%	85%	61%	25%	13%	12%	10%	10%	10%	11%	11%
EBIT (\$M)	(21)	(22)	(21)	(18)	(19)	(15)	(5)	7	20	33	46	61	68	77
EBIT margin	-820%	-338%	-175%	-60%	-35%	-17%	-4%	5%	14%	22%	27%	33%	33%	34%
Tax-affected EBIT (\$M)	(21)	(22)	(21)	(18)	(19)	(15)	(5)	7	18	30	41	55	62	69
Free Cash Flow to Firm	(25)	(22)	(34)	(27)	(36)	(24)	(12)	1	11	27	39	53	58	64
growth y/y									1101%	147%	44%	36%	9%	10%

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%
11.3%	43	203	214	226	239	254	246	257	269	283	297
11.8%	40	186	195	206	217	230	225	235	245	257	270
12.3%	36	170	178	188	198	209	206	215	224	234	245
12.8%	33	156	163	172	180	190	189	197	205	214	223
13.3%	30	143	150	157	165	173	174	180	187	195	204

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%
(22)	268	279	291	305	320	\$21.54	\$22.41	\$23.38	\$24.44	\$25.63
(22)	248	257	268	279	292	\$19.86	\$20.62	\$21.46	\$22.39	\$23.41
(22)	229	237	246	256	267	\$18.34	\$19.01	\$19.75	\$20.55	\$21.44
(22)	211	219	227	236	245	\$16.96	\$17.55	\$18.20	\$18.91	\$19.68
(22)	196	202	209	217	226	\$15.71	\$16.23	\$16.81	\$17.43	\$18.11

Equivalent Terminal EBITDA Multiple (forward 12 mos)				
0.5%	1.0%	1.5%	2.0%	2.5%
2.6x	2.8x	2.9x	3.0x	3.2x
2.4x	2.5x	2.6x	2.8x	2.9x
2.2x	2.3x	2.4x	2.5x	2.6x
2.0x	2.1x	2.2x	2.3x	2.4x
1.9x	1.9x	2.0x	2.1x	2.2x

Terminal Value as a % of Enterprise Value				
0.5%	1.0%	1.5%	2.0%	2.5%
83%	83%	84%	85%	86%
82%	83%	84%	85%	85%
82%	83%	84%	84%	85%
82%	83%	84%	84%	85%
83%	83%	84%	85%	85%

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

Cellular Dynamics: Summary of Financials

Income Statement - Annual	FY12A	FY13E	FY14E	FY15E	Income Statement - Quarterly	1Q13A	2Q13A	3Q13A	4Q13E
Revenues	7	12	30	55	Revenues	2A	3A	3A	5
Cost of products sold	(2)	(3)	(7)	(13)	Cost of products sold	(1)A	(1)A	(0)A	(1)
Gross profit	-	-	-	-	Gross profit	-	-	-	-
SG&A	(12)	(16)	(23)	(34)	SG&A	(4)A	(3)A	(5)A	(4)
R&D	(14)	(15)	(18)	(28)	R&D	(4)A	(4)A	(4)A	(3)
Operating income	(22)	(21)	(18)	(19)	Operating income	(6)A	(5)A	(7)A	(4)
EBITDA	(21)	(20)	(15)	(16)	EBITDA	(5)A	(5)A	(7)A	(3)
Net interest (income) / expense	(0)	0	2	1	Net interest (income) / expense	(0)A	(0)A	(0)A	1
Other income / (expense)	0	0	0	0	Other income / (expense)	0A	0A	0A	0
Income taxes	0	0	0	0	Income taxes	0A	0A	0A	0
Net income	(22)	(21)	(16)	(19)	Net income	(6)A	(5)A	(7)A	(3)
Diluted shares outstanding	2	12	12	14	Diluted shares outstanding	2A	2A	12A	12
Diluted EPS	(12.89)	(1.73)	(1.25)	(1.30)	Diluted EPS	(3.28)A	(2.92)A	(0.62)A	(0.23)
Balance Sheet and Cash Flow Data	FY12A	FY13E	FY14E	FY15E	Ratio Analysis	FY12A	FY13E	FY14E	FY15E
Cash and cash equivalents	34	54	34	51	Sales growth	153.4%	86.3%	143.9%	84.6%
Accounts receivable	3	3	5	11	EBIT growth	4.4%	(3.4%)	(16.6%)	7.9%
Inventories	2	11	19	32	EPS growth	3.4%	(86.6%)	(25.3%)	3.3%
Other current assets	1	1	1	1					
Current assets	40	69	59	95	Gross margin	-	-	-	-
PP&E	1	5	8	13	EBIT margin	(337.7%)	(175.1%)	(61.5%)	(35.9%)
Total assets	51	85	78	119	EBITDA margin	(315.9%)	(165.4%)	(52.5%)	(29.9%)
					Tax rate	0.0%	0.0%	0.0%	0.0%
Total debt	1	12	12	12	Net margin	(338.2%)	(171.2%)	(53.8%)	(33.5%)
Total liabilities	5	16	20	27					
Shareholders' equity	47	69	59	92	Net Debt / EBITDA	157.9%	209.3%	141.3%	236.6%
					Net Debt / Capital (book)	(231.8%)	(158.0%)	(61.2%)	(73.8%)
Net income (including charges)	(22)	(21)	(16)	(18)					
D&A	1	1	2	3	Return on assets (ROA)	(43.2%)	(30.7%)	(19.7%)	(18.7%)
Change in working capital	(2)	(9)	(6)	(12)	Return on equity (ROE)	(47.4%)	(36.1%)	(25.2%)	(24.6%)
Other	1	1	0	0					
Cash flow from operations	(21)	(28)	(20)	(27)	Enterprise value / sales	-	-	-	-
					Enterprise value / EBITDA	-	-	-	-
Capex	(0)	(5)	(5)	(8)	Free cash flow yield	(71.1%)	(15.6%)	(11.7%)	(14.5%)
Free cash flow	(21)	(33)	(25)	(35)					
Cash flow from investing activities	(3)	(5)	(5)	(8)					
Cash flow from financing activities	(0)	53	5	52					
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

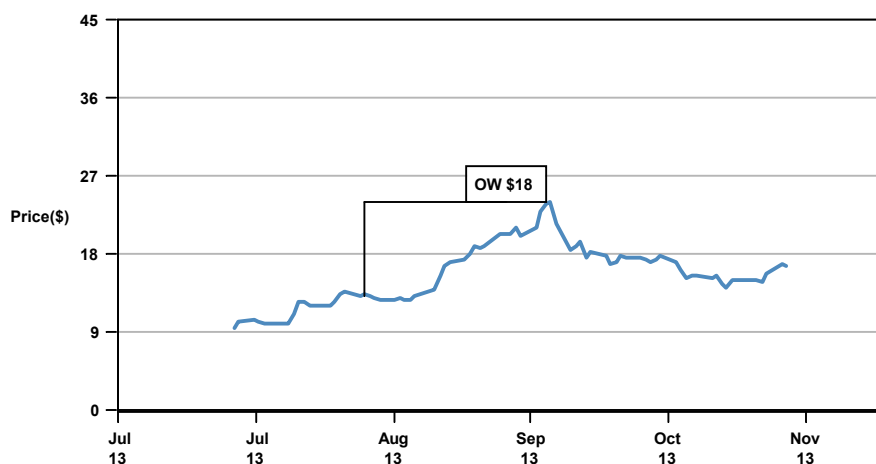
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Cellular Dynamics (ICEL, ICEL US) Price Chart



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

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