

TEMATICA INVESTING

THEMATIC COMMENTARY, EQUITY RESEARCH & INVESTING STRATEGIES

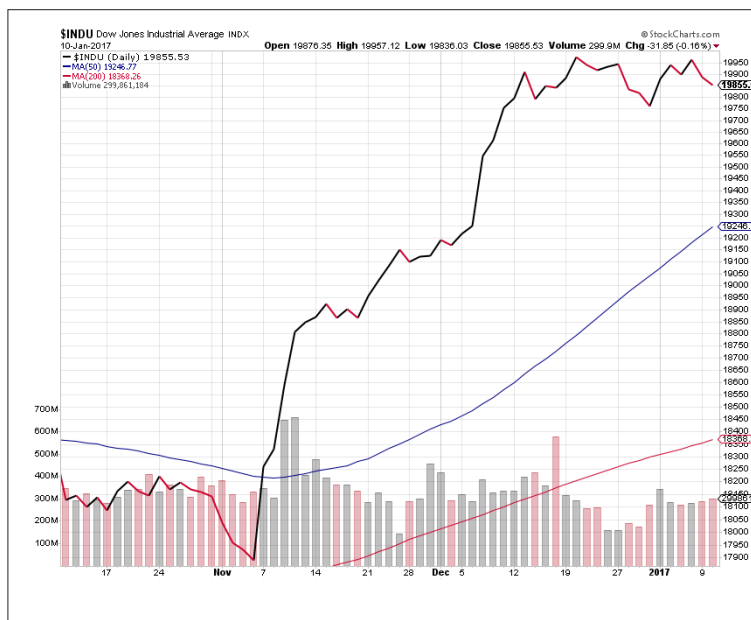


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Making a Nuanced Move With The Tematica Select Investment List



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Over the last week, while many have been watching the Dow Jones Industrial Average flirt with 20,000, the Nasdaq Composite Index continued to climb higher. That led our **Connected Society** investment theme positions in **Facebook (FB)**, **Alphabet (GOOGL)** and **Amazon (AMZN)** higher over the last week.

- **Even so, we still have ample room to our respective price targets for each of those positions and our buy rating on all three remains.**

Over the last few months, we’ve been talking about the impact of food deflation, which has been confirmed by our **Cash-strapped Consumer** play that is **Costco Wholesale (COST)** as well as grocery chain **Kroger (KR)** and others.

We’ve also called out the inability of restaurants to harness that deflation for their own margins given minimum wage increases and other cost drivers. The



latest findings from Fitch Ratings sees restaurant sales slowing this year, and the NPD Group expects traffic will be flat this year, with a 2 percent decline at dine-in restaurants offsetting a 1% increase at quick-service concepts. We expect confirmation to be had this coming earnings season, and if **Kona Grill's (KONA)** 4 percent decline in same-store sales for the December quarter is any indication it's not going to be pretty.

Still, we know that people need to eat and are continuing to shift toward organic and natural foods and other products, which bodes well for our **McCormick & Co. (MKC)** and **United Natural Foods (UNFI)** shares. Recent findings from a new poll conducted by Pew Research Center underscore our bullish position. According to the Pew poll, 55 percent of Americans believe that "organic food, particularly organically grown fruits and vegetables, are healthier than conventional." The same poll also showed a growing distrust of GMO foods and concern over pesticide use.

A different study conducted by the European Parliament's Independent Research Service, titled "Human health implications of organic food and organic agriculture," concluded that eating organic food improves early development, reduces pesticide exposure, strengthens the nutritional value of food, and mitigates disease risks.

We do not see this as a short-term fad and point to a recent report from Research and Markets that forecasts the global market for organic food to grow at "a CAGR of over 14 percent during 2016-2021, on account of high demand for organic food."

- **Both MKC and UNFI remain Buys at current levels.**

On the continued strength of *Rouge One* at the box office and the news that **Content is King** investment theme company **Walt Disney Co. (DIS)** is firming up plans for a streaming ESPN service, our Disney shares moved higher over the last several days.

The same can be said with our **CalAmp (CAMP)** shares following management's presentation at the annual Needham Growth Conference that focused on its expanding market opportunities across fleet management, Connected Car and enterprise asset tracking markets.



Adding Nuance Communications to the Tematica Select List as Voice Goes Big

Last week was the tech world descended upon Las Vegas for CES 2017. The annual trade show kicks off the new year and introduces a number of new consumer gadgets that we're likely to see — some this year and others in the coming ones.

Among the sea of announcements, there were a number that focused on one aspect of our **Disruptive Technology** investing theme and that is the area of voice recognition technology. Over the years we've seen various incarnations of this technology, most recently with Siri from **Apple (AAPL)**, Cortana from **Microsoft (MSFT)**, Google Assistant from **Alphabet (GOOGL)** and Alexa from **Amazon (AMZN)**. Each of these has come to the forefront like in products like Amazon Echo and Google Home that house these virtual digital assistants (VDAs), but for now one of the largest consumer facing markets for voice interface technology has been the smartphone. Coming in 2016, Parks Associates found that nearly 40 percent of all smartphone owners use some sort of voice recognition software such as Siri or Google Now.

In 2016, the up and comer was Amazon as sales of its Echo devices were up 9x year over year this past holiday season and "millions of Alexa devices sold worldwide this year." If you're a user of Amazon Echo like we are, then you know that each week more capabilities are being added to the Alexa app such as ordering a pizza from **Dominos (DPZ)**, calling for an Uber, checking sports scores and weather to getting holiday cocktail recipes.

As we entered 2017, Amazon announced that Prime members can voice-order their next meal through Amazon Restaurants on their Alexa-enabled devices including the Amazon Echo and Echo Dot. Once an order is placed, Amazon delivery partners deliver the food in one hour or less. Pretty cool so long as you have Amazon Restaurants operating in and around where you live.

Virtual digital assistants cut across more than just smartphones and devices like Amazon Echo and the recently announced Google Home. According to a new report from Tractica, while smartphone-based consumer



Generally speaking, Disruptive Technologies takes the form of devices, but it can be found in other forms of innovation, even entire industries. One of the best examples is how Apple Inc. has continually disrupted industry after industry over the last few years. With its iPod, iPad, iPhone, Apple TV and, most importantly, iTunes products, Apple has changed the way people buy and consume content, such as music, TV shows, movies, books, textbooks and magazines, software, games and more. As one would expect given Apple's installation base, this growth has had a ripple effect in a bad way across those aforementioned industries and the companies that serve them.

Past industry leaders, like mobile-phone leader Nokia Corp. and email-device manufacturer Research in Motion Ltd. (of BlackBerry fame), have been dethroned. The music industry has struggled to find its way since hit singles were decoupled from full CDs. The shift to tablet computing that has gone mainstream thanks to Apple's iPad, dealt another blow to struggling PC manufacturers Dell Inc. and Hewlett-Packard Corp. Another example can be found in Apple's new Passbook wallet solution, which has the potential to disrupt couponing, ticketing, mobile payments and more.

Investors need to understand the impact of these innovations and assess the impact their disruptive wave will have on their investment holdings.

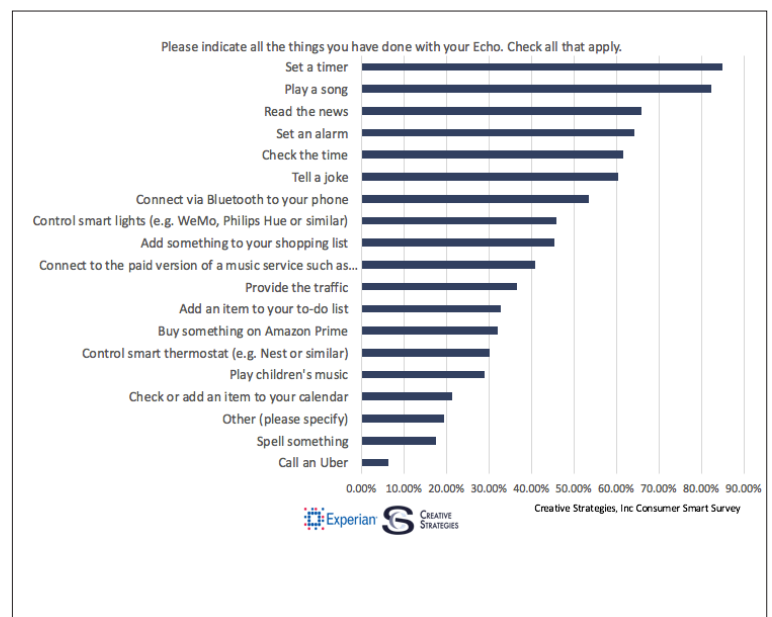
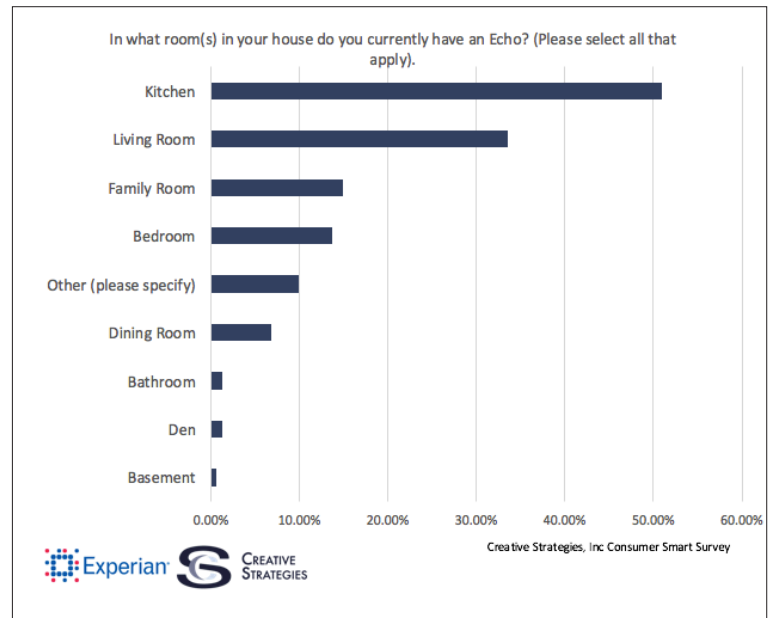
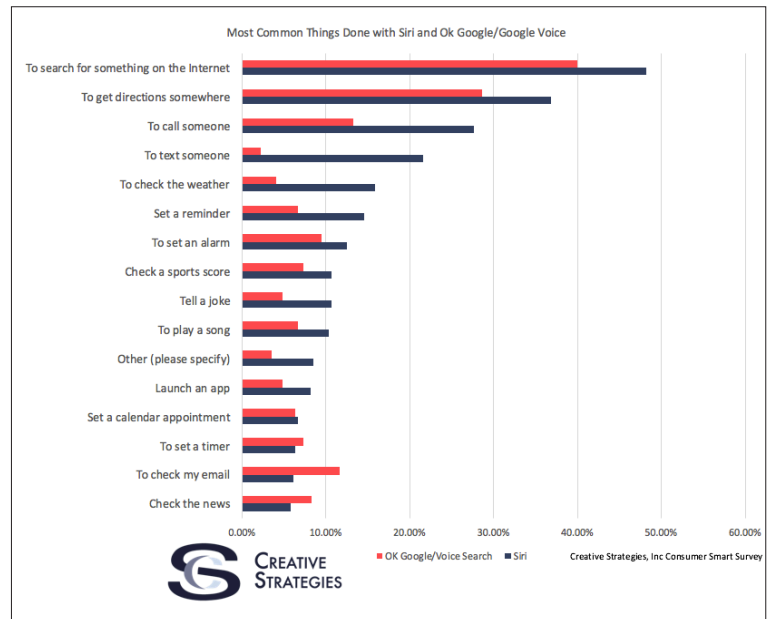
VDA's are currently the best-known offerings, virtual assistant technologies are also beginning to penetrate other device types including smart watches, fitness trackers, PCs, smart home systems, and automobiles.

We saw just that at CES 2017 with some landscaping changing announcements for VDA's. Alphabet had several announcements surrounding its Google Home product at CES 2017, including integration into upcoming Hyundai and Chrysler models; and acquiring Limes Audio, which focuses on voice communication systems, and will likely be additive to the company's Google Home, Hangouts and other products. Microsoft also scored a win for Cortana with Nissan.

While those wins were impressive, the big VDA winner at CES was Amazon as it significantly expanded its Alexa footprint on deals with LG, **Dish Network (DISH)**, **Whirlpool (WHR)**, Huawei and **Ford (F)**. In doing so Amazon has outflanked Alphabet, Microsoft and even Apple in the digital assistant market. To us, that's another leg to the Amazon stool that offers more support to the share alongside the digital shopping/services, content, and Amazon Web Services businesses. You don't need to read between the lines to think that we still see big upside to our \$975 Amazon price target.

To be fair, Apple originally did not license out its Siri technology and only in June 2016 did it announce that it would open the code behind Siri to third-party developers through an API, giving outside apps the ability to activate from Siri's voice commands, and potentially endowing Siri with a wide range of new skills and datasets.

Tractica forecasts that unique active consumer VDA users will grow from 390 million in 2015 to 1.8 billion worldwide by the end of 2021. During the same period, unique active enterprise VDA users will rise from 155 million in 2015 to 843



million by 2021. The market intelligence firm forecasts that total VDA revenue will grow from \$1.6 billion in 2015 to \$15.8 billion in 2021.

An Overlooked Player in the VDA Segment

The one drawback when it comes to the VDA market is the players mentioned above have large existing businesses, which means their respective VDA businesses, at least in the next few years, will have at best modest influence on their overall financial picture. In keeping with our “buy the bullets not the guns,” coming out of CES 2017 we find ourselves looking at speech technology and voice recognition company **Nuance Communications (NUAN)**.

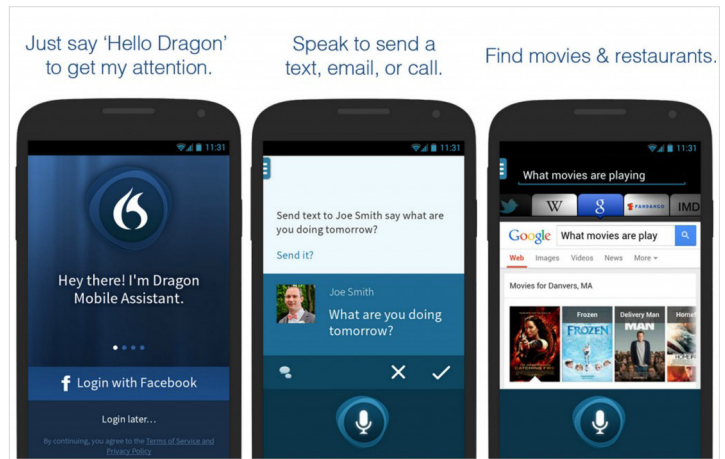


Nuance’s voice solutions compete in four markets:

- Healthcare (49 percent of revenue):** In this business, Nuance supports clinical documentation workflows and electronic medical record (EMR) adoption through flexible offerings, including transcription services, dictation software for the EMR, diagnostics workflow, and mobile applications. Recently Nuance released Dragon Medical Advisor, an AI Assistant for doctors. More than 500,000 clinicians and 10,000 healthcare facilities worldwide use Nuance’s healthcare solutions, which are sold through customers that include Cerner (CERN), Epic, McKesson (MCK), UPMC, Cleveland Clinic, Siemens, and the Mayo Clinic. Over the last few quarters, Nuance has been transitioning this business from a perpetual license business to a software as a service (SAAS) one, but with that shift expected to be largely completed by the second half of 2017 that revenue drag should be eliminated.
- Enterprise (20 percent of revenue):** This business segment offers automated intelligent self-service solutions that include speech and artificial intelligence (AI) technologies that reduce or replace human contact center agents with conversational systems, across voice, mobile, web and messaging channels. Think of when you call your bank, broker or even consider using the phone to call for a pizza from Dominos (candidly we’re not sure why you would call given the ease of the Domino’s app that can be used on either your smartphone, Apple TV, or Amazon’s Alexa, but hey that’s us). Representative customers include Avaya, BT, Cisco, DiData, Genesys, Huawei, MoshiMoshi, NICE, Telstra, and Verint. Our customers include, American Airlines, Amtrak, Bank of America, Barclays, Dominos, Delta, Deutsche Telekom, e*trade, ING Bank, Lloyds Banking Group, T-Mobile, Telefonica, Telstra, and Vodafone.
- Mobile (19 percent of revenue):** Here Nuance offers a portfolio of specialized virtual assistants and connected services built on voice recognition, text-to-speech, natural language understanding, dialog, and text input technologies across automotive, device and mobile operator solutions. With regard to automotive in particular, Nuance has announced Daimler, Ford and BMW as customers, and as evidenced at both CES 2017 and the 2017 North American International Auto Show we are nearing the tipping point for the Connected Car, which should bode well for this business segment.
- Imaging (12 percent of revenue):** In this division, segment Nuance provides software solutions and expertise that help professionals and organizations to gain optimal control of their document and information processes. Customers and partners include Ricoh, Xerox, HP, Canon, and Samsung. This

business has been bumping along at around 11 to 12 percent of revenue the last few years as Nuance has reorganized itself over the last several quarters.

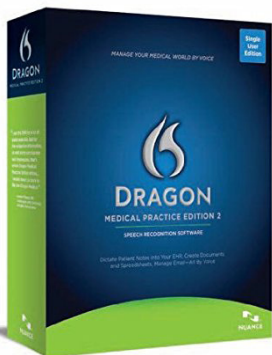
When we step back from Nuance’s business segments and look at the overall market growth for voice recognition technologies, BCC Research sees it growing to \$184.9 billion in 2021, up from \$90.3 billion in 2015. Breaking these two markets down into Consumer and Enterprise markets, BCC expects the Consumer market to grow to \$95.9 billion in 2021 from \$54.4 billion in 2016 and the Enterprise market to reach \$79.0 billion by 2021 up from \$44.0 billion in 2016. Viewed against that larger market, we see ample room for Nuance to expand beyond the \$1.9 billion in revenue it generated in 2016.



Over the last few years, after delivering significant revenue growth during 2010-2014, the pace of revenue growth, while positive, has dipped. Part of that is due in part to erosion for the transcription business in the company’s Healthcare business, as well as the shift from a contract business model to a Cloud based one that offers integrated solutions. In 2016, roughly 70 percent of the company’s revenue stream was recurring in nature, up from 65 percent or so in 2015.

What this tells us is the bulk of the revenue shift is largely behind the company. Like a turning tanker, these changes take time, but once they catch momentum they tend to pick up speed and Nuance should see its recurring revenue growth to 70-75 percent of overall revenue during 2017. As investors, we like the nature of a recurring revenue model, given that it affords far greater visibility and shares tend to be rewarded with better multiples given that predictability.

We’ve seen the power of this business shift already at **Adobe Systems (ADBE)**, which now has more than 70 percent of its revenue recurring in nature, up from 19 percent in 2011, and its shares that have climbed to just over \$108 from \$28 at the end of 2011.



Looking Ahead to 2017 for Nuance

The growth businesses at Nuance include its automotive, voice biometrics, omni-channel customer care, unified print and scan solutions, Dragon Medical, CDI and diagnostics. Paving the way is the company’s most recent quarterly bookings, which were up 45 percent year on year. Longer-term we expect more applications across the consumer electronics market to develop. As noted above, Whirlpool is working with Amazon and odds are that means before too long we’ll see VDAs built into various appliances across the kitchen and laundry rooms. In our view, that’s just scratching at the surface.

The big question circling Nuance is the competitive landscape, particularly the move by Amazon, Alphabet and Apple to open up their application programming interface (API) to third-parties. Just like **Rackspace (RACK)** specializes in Cloud computing, but thus far has remained unharmed by Amazon’s AWS, Nuance

specializes in selling to global brands, health care, and large corporations, which are not likely to utilize Google’s free API for its business needs. As you’ve probably notice with Android, one of the issues with a free API is malware and cyber hacking.

It’s also not lost on us that Alphabet recently acquired Limes Audio to improve its voice recognition capabilities. As anyone who has used Apple’s Siri knows, it’s far from perfect in voice recognition and voice to text. In our view, this means Nuance could be an attractive candidate for a larger player that needs to improve its technology positioning.

What are NUAN shares worth?

In looking over historic multiples, including P/E and Enterprise Value to Revenue, and applying them to consensus 2017 earnings expectations that call for EPS of \$1.59 on revenue of just over \$2 billion, we see upside to \$21 and downside to just under \$15.

At the current share price — \$15.45 as of market close on 1/10/17 — NUAN shares are trading at under 10x expected 2017 earnings of \$1.59 per share. We certainly like that risk-to-reward tradeoff in NUAN shares at a time when voice technology is expanding its market size across the device, automotive and Internet of Things markets.

Bottomline on NUANCE COMMUNICATIONS (NUAN):

- **We’re adding NUAN shares to the Tematica Select list with a price target of \$21.**
- **Because this is a new position, we are holding off with a stop loss recommendation at this time, preferring to use near-term weakness to scale into the position and improve the cost basis.**



NUANCE

NUANCE COMMUNICATIONS, INC.

NASDAQ: **NUAN**

Theme: **Connected Society**

Price on 01/10/17: **\$15.45**

- Nuance Communications, Inc. provides voice recognition and natural language understanding solutions worldwide.
- It operates four segments: Healthcare, Mobile, Enterprise, and Imaging. The Healthcare segment offers transcription solutions. The Mobile segment provides a portfolio of virtual assistants and connected services. The Enterprise segment offers automated customer service solutions. The Imaging segment provides MFP Scan automation solutions to offer scanning and document management solutions.
- The company was formerly known as ScanSoft, Inc. and changed its name to Nuance Communications, Inc. in October 2005.
- Nuance Communications, Inc. was founded in 1992 and is headquartered in Burlington, Massachusetts.

Shares Outstanding	291.25M
Avg. Volume	2.73M
Market Cap	4.64B
EPS: '15 / '16 / '17	1.52/1.59/1.66
Cash (mrq): \$US	580.46M
Debt (mrq): \$US	2.43B
Net Cash (mrq)	-1.849B
Revenue (ttm)	1.95B
Enterprise Value to Revenue (ttm)	3.32
Annualized Dividend Per Share	--
Dividend Yield	--

TEMATICA SELECT LIST PERFORMANCE

POSITION	DATE ADDED	ADD PRICE	CURRENT PRICE	DIV. PAID	STOP PRICE	RETURN (%)	TARGET	RATING
ALPHABET, INC. (GOOGL) <i>Asset-Lite</i>	6/15/16	\$733.94	\$826.01	--	--	12.54%	\$900.00	(BUY)
AMAZON.COM (AMZN) <i>Connected Society</i>	5/24/16	\$709.53	\$795.90	--	--	12.17%	\$950.00	(BUY)
	10/28/16	\$781.59	\$795.90	--	--	1.83%	\$950.00	(BUY)
AMN HEALTHCARE SERV. (AMN) <i>Scarce Res. / Aging of Population</i>	8/17/16	\$33.80	\$37.70	--	--	11.54%	\$47.00	(BUY)
	10/5/16	\$31.18	\$37.70	--	--	20.91%	\$47.00	(BUY)
AT&T (T) <i>Connected Society</i>	10/12/16	\$39.29	\$40.82	--	\$31.00	4.16%	\$45.00	(HOLD)
	11/21/16	\$37.63	\$40.82	--	\$31.00	8.48%	\$45.00	(HOLD)
CALAMP CORP (CAMP) <i>Connected Society</i>	8/09/16	\$15.37	\$14.87	--	--	-3.25%	\$21.00	(BUY)
	10/05/16	\$13.70	\$14.87	--	--	8.54%	\$21.00	(BUY)
COSTCO WHOLESALE (COST) <i>Cash-strapped Consumer</i>	9/28/16	\$149.67	\$161.60	--	--	8.27%	\$170.00	(HOLD)
WALT DISNEY CO. (DIS) <i>Content is King</i>	4/20/16	\$102.16	\$108.35	\$1.49	\$87.00	7.92%	\$125.00	(BUY)
	5/11/16	\$101.78	\$108.35	\$1.49	\$87.00	7.52%	\$125.00	(BUY)
DYCOM INDUSTRIES (DY) <i>Connected Society</i>	9/14/16	\$80.47	\$78.60	--	--	-2.32%	\$115.00	(BUY)
	10/27/16	\$72.89	\$78.60	--	--	7.83%	\$115.00	(BUY)
FACEBOOK (FB) <i>Connected Society</i>	11/30/16	\$116.86	\$119.07	--	--	4.68%	\$150.00	(BUY)
INTER. FLAVORS & FRAGRANCES (IFF) <i>Rise & Fall of the Middle Class</i>	10/19/16	\$129.23	\$115.43	--	\$105	-10.18%	\$145.00	(BUY)
	11/21/16	\$120.06	\$115.43	--	\$105	-3.32%	\$145.00	(BUY)
MCCORMICK & CO. <i>Cash-strapped Consumer</i>	11/21/16	\$91.80	\$89.76	--	--	-2.22%	\$170.00	(BUY)
PROSHARES SHORT S&P 500 (SH)	1/14/16	\$45.10	\$36.08	--	--	-20.00%	\$24.00	(BUY)
	3/23/16	\$41.12	\$36.08	--	--	-12.26%	\$24.00	(BUY)
POWERSHARES INTERNET PORTFOLIO (PNQI) <i>Connected Society</i>	11/16/16	\$83.68	\$87.61	--	--	4.70%	\$90.00	(BUY)
STARBUCKS (SBUX) <i>Guilty Pleasures</i>	6/01/16	\$54.90	\$57.88	\$0.20	--	6.26%	\$74.00	(BUY)
UNDER ARMOUR (UAA) <i>Rise & Fall of Middle Class</i>	7/27/16	\$39.26	\$30.70	--	\$25.00	-21.80%	\$55.00	(BUY)
	11/2/16	\$30.74	\$30.70	--	\$25.00	-0.13%	\$55.00	(BUY)
UNITED NATURAL FOODS (UNFI) <i>Foods with Integrity</i>	8/31/16	\$47.00	\$49.09	--	--	4.45%	\$232.00	(BUY)
	9/14/16	\$38.91	\$49.09	--	--	26.16%	\$232.00	(BUY)
UNIVERSAL DISPLAY (OLED) <i>Disruptive Technology / Connected Society</i>	10/5/16	\$53.09	\$57.80	--	--	8.87%	\$68.00	(BUY)

as of market close January 10, 2017

Tematica Contenders

As we roll up our sleeves each week we add companies and discard others to our list of **Tematica Select Contenders**. These are companies that we're doing more work on and in some cases we're waiting for the risk to reward trade-off to reach more appetizing levels.

AWK	American Water Works	Scarce Resources
WTR	Aqua America	Scarce Resources
CHGG	Chegg Inc.	Tooling & Retooling
CMG	Chipotle Mexican Grill	Foods with Integrity
GLW	Corning Inc.	Disruptive Technologies
KIM	Kimco Realty	Rise & Fall of the Middle Class
MRK	Merk & Co.	Aging of the Population
NLSN	Nielson NV	Connected Society
OME	Omega Protein Corp.	Fountain of Youth
PANW	Palo Alto Networks	Safety & Security
SYNA	Synaptics Inc.	Disruptive Technologies
XYL	Xylem, Inc	Scarce Resources

STOCKS / FUNDS MENTIONED

Adobe Systems (ADBE)
Alphabet (GOOGL)
Alphabet (GOOGL)
Amazon (AMZN)
Apple (AAPL)
CalAmp (CAMP)
Cerner (CERN)
Costco Wholesale (COST)
Dish Network (DISH)
Dominos (DPZ)
Facebook (FB)
Ford (F)
Kona Grill (KONA)
Kroger (KR)
McCormick & Co. (MKC)
McKesson (MCK)
Microsoft (MSFT)
Nuance Communications (NUAN)
Rackspace (RACK)
The Walt Disney Co. (DIS)
United Natural Foods (UNFI)
Whirlpool (WHR)

ANALYST POSITIONS

At the time of publication, Mr. Versace, Chief Investment Officer of Tematica Research had no positions in the shares of companies mentioned in this issue.

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