TEMATICA INVESTING

THEMATIC COMMENTARY, EQUITY RESEARCH & INVESTING STRATEGIES

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Tematica Investing, a weekly publication by Chris Versace, is designed for the experienced or professional investor, providing in-depth information on real-time developing thematic strategies, economic outlook, investment trading ideas, and analysis of the most pressing developments for the market, as well as forces that drive both our thematic perspectives and thematic recommendations.

Brexit Vote, the Fed, Slowing Growth, Trump and Clinton . . . Oh My Says the Stock Market!

Since the last issue of *Tematica Investing*, we've continue to witness a seesawing market attempting to come grips with slowing growth expectations, even though oil prices have continued to inch higher. Looking ahead, there are a growing number of unknowns in the market, ranging from:

- What will be the outcome of the Brexit vote?
- Will the Fed boost rates in June? (We continue think not.)
- Are growth expectations too aggressive in the back half of 2016? (We continue to think yes as recent data discussed in the *Monday Morning Kickoff* confirms that.)
- What about the 2016 presidential election?

Taken alone, any one of these uncertainties is enough to jostle the market around. When combined, they have enough boom to take the wind out of the sails of the recent market rally.

As we know, when uncertainty comes knocking, dividend paying and higher dividend yielding stocks tend to benefit. That has certainly been the case with nearly all of our holdings, save **Disney (DIS)** and **Costco Wholesale (COST)**. As you'll soon read, in our view, Disney delivered a solid quarter last night for its March quarter end results. Moreover, as we learned on the corresponding earnings call, the company continues to make moves that strengthen its position as THE ***Content is King Company***. We're using today's weakness to build out the DIS position size and reduce the average cost basis.

Costco shares have come under pressure too, following what many are calling "disappointing" April same-store-sales comparisons. As we're starting to see, however, COST's April results were head and shoulders above what **Macy's (M)** and **Gap (GAP)** produced.

We continue to see COST as a key player in our ***Cash Strapped Consumer*** investing theme. The April Retail Sales Report, which drops later this week, should bear this out even more. If COST shares dip near $140, we'd be inclined to add to our position size on the ***Tematica Select List***.

Stepping up to the plate with Chipotle Mexican Grill Shares

Following months of a falling share prices due to several E.coli breakouts that had a dramatic impact on its business, we are revisiting Tematica Contender List's Chipotle Mexican Grill (CMG) and finally making a move on the shares.

We first took a look at Chipotle back in December 2015, right after the shares had fallen like an overstuffed lead burrito. The fast-food chain came into focus as part of our ***Foods with Integrity*** theme because of its commitment to non-GMO ingredients, proteins from free-range animals, and vegetables from local farmers.

Back in November, CMG shares peaked at $750. In the ensuing weeks, it bottomed near $400 in January 2016 as the E. coli storm hit the company. As you may recall, lines that once wrapped around the inside of a Chipotle location practically vanished during December and into the March 2016 quarter. During that time Chipotle revamped its food handling procedures. In early February, the CDC declared the company to be E. coli free.

History — in the form of **Jack in Box (JACK)** and others — has shown it takes a while for companies hit with E. Coli breakouts to rebound, both in business and stock price. We saw this confirmed when Chipotle reported its March quarter results. January same store comps fell 34%, but results "improved" to being down 22% by early April. Additional commentary pointed to a spotty recovery with those areas impacted by the outbreaks taking longer to rebound.

To help address this sales drop, as well as the hit to its favorable perception, Chipotle has embarked upon its largest and most aggressive marketing program. It is looking to aggressively win back customers — even though it will likely take a temporary hit to margins — by heavily marketing a free burrito coupon that has had a high (near 70%) redemption rate.

The missing puzzle piece in all of this is the fact that the company opted not to issue guidance for the current quarter. That has led to earnings expectations for 2016 to be drastically cut. Compared to 90 days ago, 2016 EPS expectations now sit at $4.87 vs. $8.89 for 2016, while the consensus EPS forecast for next year (2017) fell to $11.93 from $14.87.

Chipotle Mexican Grill Inc.

NYSE: **CMG**

Theme: ***Foods with Integrity***

Price on 05/03/16: **$455.59**

- Chipotle Mexican Grill, Inc., together with its subsidiaries, develops and operates fast-casual fresh Mexican food restaurants.
- As of December 31, 2015, the company operated 1,971 Chipotle restaurants in the United States; 11 in Canada; 7 in England; 4 in France; and 1 in Germany.
- It also operated 13 ShopHouse Southeast Asian Kitchen restaurants serving fast-casual and Asian-inspired cuisine, as well as owned and operated 3 Pizzeria Locale restaurants that are fast casual pizza concept restaurants.
- The company was founded in 1993 and is based in Denver, Colorado.

Shares Outstanding	29.89M
Avg. Volume	1,252,890
Market Cap	13.30B
EPS: '15 / '16 / '17	$15.10/$4.87/$11.83
Cash (mrq): $US	663.20M
Debt (mrq): $US	0.00
Net Cash (mrq)	663.20M
Revenue (ttm)	4.50B
Enterprise Value to Revenue (ttm)	122.9
Dividend Per Share	--
Dividend Yield	--

In our view, Wall Street has taken those earnings expectations out to the back shed and shot them. In other words, we see those cuts as rather overdone.

Do we expect margins to be impacted near term? Yes. But traffic is rebounding and the company will benefit from lower beef, chicken, rice and cheese prices year over year.

As of the market close on May 10, 2016, CMG shares were trading at $455.29 per share. Based on current Street expectations, it's not difficult to see upside in CMG shares to $550 without hitting the high end of 2017 earnings expectations, with downside to roughly the $420 level. Over the coming quarters, as traffic to locations continues to improve and the impact of the "win-back" marketing fades, we see consensus expectations moving higher. As that happens, there is a high probability that the 23 analysts covering CMG, whom are currently neutral to bearish on the shares, will turn more bullish.

From a fundamentals perspective, we would rather be early than late to the show with CMG. When investor sentiment changes, just like a turning tanker ship, it tends to whip quickly once it's gotten momentum. Our plan would be to use any weakness in the next few months to scale into the position, while lowering our average cost basis.

Bottomline on (CMG)Chipotle Mexican Grill Shares:

- **As of today, we are adding CMG shares, which closed yesterday at $455.29, to the Tematica Select List.**
- **Our price target is $550.**
- **We will look to use any dips in the share price in the next few months to add more CMG shares to lowever our average cost basis.**
- **We recommend a protective stop loss at $390.**

The ***Foods with Integrity*** thematic focuses on the shift in consumer mindset about healthy foods and their willingness to pay more for such foods. This thematic taps into the increasing popularity of foods that claim to boost health or weight loss, as well as those foods that make other claims such as being GMO-free, have no artificial coloring/flavors, are deemed all natural or organic, and in some cases gluten-free.

Companies that fall under this thematic lens include the producers, distributors and sellers of such foods, as well as restaurants. Of course, we leave the science behind the actual health benefits of these products to the experts, but the reality is consumers are demanding more of these foods, and those that are responding are at the tailwinds of the ***Foods with Integrity*** thematic.

Adding to Content is King Position in Disney

Following The Walt Disney Company's (DIS) modest miss in March quarter earnings last night, we are using this morning's weakness in the share price to add to our position and modestly reduce our cost basis in the process.

Disney posted March quarter earnings per share of $1.36 and revenues totaling $13 billion vs. expected earnings of $1.40 per share and revenue of $13.21 billion. As we have come to expect, an earnings miss, and / or weaker than expected guidance, tends to hit a company's shares no matter who they are and no matter how bright the underlying business remains. **In our view, that is what we are seeing this morning with the sell-off in Disney shares and we are using that to our advantage.**

We continue to like the Disney as THE ***Content is King*** play, as it increasingly looks to leverage its robust content library across its various businesses. We're seeing this in the Parks business with the soon to be opened Frozen attractions, as well as the forthcoming Pirates-themed land, Shanghai's Pirates of the Caribbean: Battle for the Sunken Treasure. Other new attractions include TRON Light Cycles and eventually the incorporation of Star Wars and Marvel properties, including the recently announced Guardians of the Galaxy.

The bottom line for Disney is it had a rather good quarter — not a great one. But with expectations running high given the box office performance, there were bound to be some disappointments.

Was the March quarter a perfect one? No. There were some great things, like the strength of the Studio business, which, based on the schedule and charter library should continue to show strength into the back half of 2016 and beyond. In the first half of fiscal 2016 the Studio business generated record operating income of $1.5 billion due the company's strong film slate, and we expect the strength to build with coming Marvel, Pixar and Star Wars properties.

There were some expected issues, like start-up costs for Shanghai Disney that weighed on Parks and Resorts margins during the quarter. There were also some disappointments, such as the impact of currency on Merchandizing in the quarter, (but given the impact of the dollar we've seen, it was hardly shocking.)

ESPN continues to be a drag, but ad sales appear to have turned the corner and Disney/ESPN have settled the skinny bundle issue with **Verizon (VZN),** which places ESPN in the "Sports & More" FiOS bundle. The sports network also appears to be slimming down its overhead with several notable departures from its on-air talent pool. We are also cautiously optimistic with the cross pollination efforts between ESPN and VICE.

There was also the nice surprise that Disney is shuttering its Infinity game, preferring instead to license its characters to other game developers. We applaud that move as it should be very friendly to their operating income and bottom line in the coming quarters.

Exiting the quarter, one unknown remains

Chief Executive Bob Iger has said he does not "currently have any plans" to stay at Disney beyond his contract's expiration in June 2018. Glancing at the calendar, that's still two years off. While the Board continues to search for his successor, we would not be surprised if they ask Iger to stay longer.

Even though we expect 2016 earnings expectations to dip from the $5.84 per share 2016 consensus forecast heading into last night's earnings, we remain comfortable with our $125 price target. Historically DIS shares have peaked at 24x forward earnings, which means earnings expectations would have to fall to $5.20 per share for us re-visit that price target. We continue to suspect there could be upside in the back half of 2016 as foreign currency comparisons ease, startup expenses with Shanghai Disney fall to the wayside and the erosion at ESPN slows. We will remain prudent, and keep our protective stop loss set at $87; we expect to move this higher as DIS shares rebound.

On the housekeeping front, Disney remained active on the share repurchase front, buying back 20.8 million shares for $2 billion, or an average price of $96. We estimate Disney has roughly 290 million shares remaining under its current share repurchase program, which does not have an expiration date. We suspect Disney will continue to actively use this program in the current quarter.

Bottomline on
(DIS) The Walt Disney Co Shares

- **Given today's price drop, we are adding to our position in DIS, modestly reducing our average cost basis in the process.**
- **We remain comfortable with our $125 price target.**
- **Remaining prudent, we will keep our protective stop loss set at $87.**

What We're Enjoying

Captain America Civil War

The summer movie blockbuster season got off to somewhat of an early start this year with the opening of *Captain America Civil War* last Friday. This newest installment in Disney's Marvel franchise had the 5th best opening weekend of all time —$181.7 million in box office receipts — and given our focus on **The Walt Disney Company (DIS)** as part of the ***Content is King*** thematic, we were right there with the masses on opening night.

The modern super-hero genre, whether its the Marvel Avengers franchise or DC Comics' Superman and Batman, come in all shapes and sizes. This latest chapter in Captain America takes on an interesting issue: individuality and personal rights and freedom, versus conformity and support of the greater good of society.

Don't be fooled, the CGI-enhanced action scenes, the comedic banter between the heroes, cool gadgets — they are all there in spectacular fashion. This action-packed superhero movie however goes one step further and reflects the tone and tenor of many of the debates happening in our world today.

It's a great example of whether life is imitating art, or art imitating life. Plus, the kids loved it!

Ask Tematica

In the vein that there is no such thing as a bad question, we encourage subscribers to ask questions about particular investing themes, holdings on the Tematica Select List, the Contender List, or on another topic. It's all good as far as we're concerned. This week's question surrounds the use of stock buyback programs:

> ***It seems that more and more companies are spending cash on repurchasing shares. Is this a good thing, and how do you factor that into valuing the shares?***

Share repurchase programs have become rampant over the last few years, and while they can be accretive to the bottom line (meaning they make EPS comparisons look better) their use also tends to inflate actual net income growth. In some cases, companies have repurchased a hefty amount of stock, which led to a year over year EPS improvement, even though its net income fell year over year.

This reminds us of that old line from the Connect Four board game commercial — "Pretty sneaky, sis!"

The other issues with the near pervasive use of buybacks is there are some programs that are short sighted, funding the program with debt instead of cash flow. In our view, this could be a ticking time bomb down the road. Granted the company may be funding it with cheap debt today. At some point, however, it will have to either pay off that debt or re-finance it. We see debt fueled buyback plans, as well as debt fueled dividend increases, as signaling "low quality" earnings and a management team that is more likely short-sighted.

Another drawback to the buy-back strategy is the shift away from investing in the business, facilities, R&D and new product development in favor of share repurchase plans. If prolonged, this could mean serious catch-up spending later or risk teh company falling behind relative to its peers and competitors.

If you have a question about something you have read as it concerns one of our live positions, a contender, or on one of our investing themes, drop us a line at customerservice@tematicagroup.com

Thematic Signals

We're going to cap this week's edition here. Normally we'd present Thematic Signals, which showcases confirming data points for our thematic investing framework, but given the thousands of companies that have reported earnings over the last two weeks, we're sifting through the mountain of 10-Qs that are starting to be filed with the Securities Exchange Commission. Don't worry, Thematic Signals will return next week.

TEMATICA SELECT LIST PERFORMANCE

as of market close May 10, 2017

(AGNC) AMERICAN CAPITAL AGENCY CORP

DATE ADDED	ADD PRICE	CURRENT PRICE	DIVIDENDS	STOP PRICE	RETURN (%)	TARGET	RATING
7/17/15	$18.98	$19.05	$1.60	$17.00	8.80%	$23.00	(BUY)

(XLY) CONSUMER DISCRETIONARY SPDR (ETF)

Content is King

DATE ADDED	ADD PRICE	CURRENT PRICE	DIVIDENDS	STOP PRICE	RETURN (%)	TARGET	RATING
4/20/16	$79.57	$80.52	--	--	1.19%	--	(BUY)

(COST) COSTCO WHOLESALE CORPORATION

Cashstrapped Consumer

DATE ADDED	ADD PRICE	CURRENT PRICE	DIVIDENDS	STOP PRICE	RETURN (%)	TARGET	RATING
4/13/16	$152.83	$149.56	--	$140.00	-2.14%	$170.00	(BUY)

(DIS) THE WALT DISNEY CO.

Content is King

DATE ADDED	ADD PRICE	CURRENT PRICE	DIVIDENDS	STOP PRICE	RETURN (%)	TARGET	RATING
4/20/16	$102.16	$106.60	--	$87.00	3.34%	$125.00	(BUY)

(DOC) PHYSICIANS REALTY TRUST

Aging of Population

DATE ADDED	ADD PRICE	CURRENT PRICE	DIVIDENDS	STOP PRICE	RETURN (%)	TARGET	RATING
6/27/14	$14.33	$19.40	$1.80	$16.00	47.94%	$18.00	(HOLD)

(SH) PROSHARES SHORT S&P 500 (ETF)

DATE ADDED	ADD PRICE	CURRENT PRICE	DIVIDENDS	STOP PRICE	RETURN (%)	TARGET	RATING
1/14/16	$22.55	$20.12	--	--	-10.77%	$24.00	(BUY)
3/23/16	$20.56	$20.12	--	--	-2.14%	$24.00	(BUY)

(RGC) REGAL ENTERTAINMENT GROUP

Content is King

DATE ADDED	ADD PRICE	CURRENT PRICE	DIVIDENDS	STOP PRICE	RETURN (%)	TARGET	RATING
11/23/15	$18.51	$21.13	$0.44	$19.00	16.53%	$24.00	(BUY)

(T) AT&T, INC.

Connected Society

DATE ADDED	ADD PRICE	CURRENT PRICE	DIVIDENDS	STOP PRICE	RETURN (%)	TARGET	RATING
7/21/15	$34.67	$39.31	$0.95	$36.00	16.12%	$42.00	(BUY)

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 tradeoff to reach more appetizing levels.

AHS	AMN Healthcare Services	*Aging Population / Scarce Resources*
AMZN	Amazon.com	*Connected Society*
CHGG	Chegg Inc.	*Tooling & Retooling*
SCOR	Comscore	*Connected Society*
GLW	Corning Inc.	*Disruptive Technologies*
IMMR	Immersion Corp.	*Disruptive Technologies*
KIM	Kimco Realty	*Rise & Fall of the Middle Class*
LOCK	Lifelock	*Safety & Security*
MKC	McCormick & Co.	*Cashstrapped Consumer / Middle Class*
MRK	Merk & Co.	*Aging of the Population*
NKE	Nike Inc	*Affordable Luxury*
NLSN	Nielson NV	*Connected Society*
PANW	Palo Alto Networks	*Safety & Security*
PETS	PetMed Express, Inc	*Connected Society*
SYNA	Synaptics Inc.	*Disruptive Technologies*
SBUX	Starbucks Inc.	*Rise & Fall the Middle Class*
UNFI	United Natural Foods	*Foods with Integrity*
VZ	Verizon Communications	*Content is King / Connected Society*
XYL	Xylem, Inc	*Scare Resources*

Companies Mentioned

Chipotle Mexican Grill (CMG)
Costco Wholesale Corp (COST)
Jack in Box (JACK)
Gap (GAP)
Macy's (M)
The Walt Disney Co (DIS)

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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