

Foundation Medicine (FMI)

2Q14 Preview - Expecting Good Results with Solid Volumes & Stable Reimbursement - Color on Large Payor Discussions is Key - Reaffirm OUTPERFORM

- **Expecting solid 2Q14 results.** We forecast sales of \$13.5 MM and an EPS loss of (\$0.46) when FMI reports 2Q14 financial results (after the market close) on Tuesday August 12, 2014. Wall Street consensus estimates are for sales of \$13.4 MM and an EPS loss of (\$0.48). FMI is hosting a conference call at 4:30 p.m. EST (dial-in: 885-420-0652, passcode: 68469471, investors.foundationmedicine.com).
- **Clinical test volumes remain the key metric. Expecting solid volumes driven by better market awareness and the heme product.** We are forecasting 2Q14 clinical test volume of 6,079 (up 30% q/q), helping drive the company to outstrip its 2014 guidance for 22,000-25,000 tests.
- **Mid-quarter 2Q14 checks on competition were consistent with our view that there is little head-to-head competition.** Checks continue to suggest that there is little competition commercially and that there is minimal threat from the academic medical centers which continue to be relatively slow moving and inwardly focused.
- **Encouraged by the directionality and frequency of the large payor discussions following early July management meetings.** We feel that given the improving tone of large payor discussions and greater frequency, reimbursement from the large payors is likely to hold up and there is a higher likelihood of the company inking an in-network contract in the next 12 months.
- **Encouraged by the May clinical outcomes data and recent Palmetto documents.** We were encouraged following three key new abstracts published in May (in front of ASCO) that showed better accuracy and a high rate (~28%) of FoundationOne to change practice. Additionally Palmetto's recent sequencing related documents were an interesting 1st step in the convoluted Medicare story.
- **Maintaining OUTPERFORM.** We arrive at our \$50 price target through an EV/sales valuation framework, assuming a ~9x 2016E EV/sales multiple with no net cash and 29 MM shares outstanding, discounted back at 15%. This multiple is justified to us given FMI's hyper growth profile (~83% 3-year CAGR, +60% in 2016), cancer focus and the very early stages of adoption (~10% share in 2016). On a 2015E EV/sales multiple basis, shares of FMI are trading at a premium to the current group median (5.7x vs 3.7x).

August 7, 2014

Price
\$23.56

Rating
OUTPERFORM

12-Month Price Target
\$50

Zarak Khurshid
(415) 274-6823
zarak.khurshid@wedbush.com

Company Information

Shares Outst (M)	28
Market Cap (M)	\$664
52-Wk Range	\$19.51 - \$45
Cash/sh	4
Enterprise Value	553
LT Debt/Cap	0
2015 EV/Sales	6 x
Book Value/sh	4.6

Company Description

Foundation Medicine is the leading provider of test services to oncologists for the deep analysis of genetic alterations in cancer. These test results provide clinically actionable information for rare, recurring & stubborn solid tumors and hematologic cancers.

FYE Dec	2013A	2014E			2015E		
REV (M)	ACTUAL	CURR.	PREV.	CONS.	CURR.	PREV.	CONS.
Q1 Mar	\$5.2A	\$11.5A		\$11.5A	\$22.1E		\$21.8E
Q2 Jun	\$5.9A	\$13.5E		\$13.4E	\$25.7E		\$23.6E
Q3 Sep	\$8.2A	\$16.2E		\$15.5E	\$29.7E		\$27.9E
Q4 Dec	\$9.7A	\$19.0E		\$17.8E	\$33.5E		\$30.9E
Year*	\$29.0A	\$60.1E		\$58.0E	\$110.9E		\$108.6E
Change	172%	107%			84%		
	2013A	2014E			2015E		
EPS	ACTUAL	CURR.	PREV.	CONS.	CURR.	PREV.	CONS.
Q1 Mar	(\$0.64)A	(\$0.44)A		(\$0.44)A	(\$0.40)E		(\$0.42)E
Q2 Jun	(\$0.52)A	(\$0.46)E		(\$0.48)E	(\$0.37)E		(\$0.37)E
Q3 Sep	(\$0.44)A	(\$0.44)E		(\$0.45)E	(\$0.31)E		(\$0.30)E
Q4 Dec	(\$0.48)A	(\$0.44)E		(\$0.46)E	(\$0.29)E		(\$0.29)E
Year*	(\$2.08)A	(\$1.77)E		(\$1.82)E	(\$1.37)E		(\$1.37)E
P/E	NM	NM			NM		
Change	410%	-15%			-23%		

Consensus estimates are from Thomson First Call.

* Numbers may not add up due to rounding.



Source: Thomson Reuters

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Investment Thesis

FMI is a lab services company whose test menu is focused on the genetic analysis of rare, recurring and aggressive tumors. FMI's testing platform leverages next-generation sequencing (NGS) to identify clinically actionable genetic mutations within tumor cells. The company's two tests are FoundationOne, a pan-cancer panel for solid tumors, and FoundationOne Heme, a panel for hematological malignancies (i.e., leukemia, lymphoma & myeloma). These tests are targeted for use by academic and community-based oncologists, as well as biopharmaceutical companies for use in cancer therapeutic R&D. We believe FMI's FoundationOne test represents the first mover and highest-quality test commercially available for detailed genomic workup of tumors. We estimate the company's test volumes and sales will grow above an 85% CAGR for the next three years and we believe FMI has many years of significant growth potential ahead as the opportunity in solid tumors, blood-based cancers and future cancer monitoring products is largely untapped. We believe investors are overly concerned about potential competitive threats and potential challenges to reimbursement near term which are overhangs on the shares currently. We believe continued strong execution by the company, lack of viable competition and continued reimbursement progress with large payors will drive solid financials, thus inspiring confidence and meaningful share price appreciation in the near term. We believe the late 2013 addition of high-quality sales reps, improving sales force efficiency and recent menu expansion, combined with growing physician awareness tees up a strong case for test volume outperformance in the near term. Additionally, we believe sentiment on shares is medium-low and based primarily on reimbursement concerns. Based on the slightly earlier clinical outcomes data from US oncology and better traction with the higher priced FoundationOne heme test recently, we believe average reimbursement is likely to get easier, representing near term validation for our long term thesis.

Estimates

Figure 1: 2Q14 Estimates

	2Q14			
	REV (m)	EPS	Volumes*	Reimbursement**
Wedbush	13.5	(\$0.46)	6,079	\$3,400
Consensus	13.4	(\$0.48)	NA	NA

*clinical only

**reimbursement per clinical sample (when paid)

Source: Company data, Wedbush Securities, Inc.

Valuation

We arrive at our 12-month \$50 price target through EV/sales valuation framework where we assume a 9x 2016E EV/sales multiple with \$31 MM in net cash and roughly 29 MM shares outstanding discounted back at 15%. This multiple is justified to us given the 2016 growth profile (~70% y/y), cancer focus and very early penetration story (~10% share in 2016). On a 2015E EV/sales basis, shares of FMI are trading at 5.7x representing a premium to the current group median multiple of 3.7x. Versus the molecular diagnostics lab service growth comps, FMI is trading at a premium on a 2015 EV/sales multiple basis (5.7x vs. 3.3x median).

Figure 2: Potential Catalysts

Catalyst	Timing
Earnings	Aug-14
ASCO publications	2H14/2015
FoundationOne Solid enhancements	2H14
Additional product launches/enhancements	2015
In-Network Contracts with Large Payors	??
CMS coverage decision	??

Source: Company data, Wedbush Securities, Inc.

Figure 3: Potential Competitors

Company/Group	Product	Genomic Coverage	# of genes	Platform	DNA sample	Turnaround Time	Launch	Price
Foundation Medicine (FMI)	FoundationOne	~590x	236	HiSeq	50-200 ng	14-17 days	Jun-12	\$5,800
OncoDNA (Private, Belgium)	OncoDEEP Dx	~1000x	40	IonTorrent	10 ng	5-10 days	??	TBD
LabCorp (LH)	IntelliGEN	TBD	50 (2600 mutations)	HiSeq or MiSeq?	TBD	TBD	??	\$3,200-\$4,000
University of Washington	OncoPlex	>500x	194	HiSeq	5000 ng	8 weeks	??	\$2,400
Memorial Sloan Kettering	MSK-IMPACT	>500x	340	HiSeq	??	??	May-14	??
Quest Diagnostics	OncoAdvantage	??	34	HiSeq	??	??	Jun-14	??
Molecular Health	TreatmentMAP	??	??	HiSeq		7-14 days	4/1/2014?	??
ParadigmMdx	PCDx	>5000x	114	HiSeq	??	4-5 days	Apr-14	??

Source: Company data, Wedbush Securities, Inc.

Risks

Risks to attainment of our price target include a fiercely competitive diagnostics and lab service market. Additionally, clinical adoption for new paradigms of testing in diagnostics is difficult to predict and private payor as well as Medicare reimbursement for *FoundationOne* and *FoundationOne Heme* could prove to be more challenging than expected.

FMI is dependent on Illumina (ILMN, NEUTRAL) for equipment and other materials related to next-generation sequencing. If ILMN were to stop supplying the material or were to enter the space as a competitor, it could lead to an interruption in FMI's ability to perform its menu of tests. The near-term risk of this has been mitigated through a five-year supply agreement FMI signed with ILMN in July 2013.

The company operates a CLIA certified lab at their Cambridge, MA headquarters where they conduct *FoundationOne*. Operating as a CLIA lab allows the company to avoid the FDA regulatory 510(k)/PMA pathway for diagnostic devices. The FDA could more tightly regulate CLIA lab-based tests as medical devices, which would likely cause significant disruption to the business.

Figure 4: Income Statement

	2011	2012	2013	1Q14	2Q14E	3Q14E	4Q14E	2014E	1Q15E	2Q15E	3Q15E	4Q15E	2015E	2016E
Product Revenue	2,057	10,645	28,990	11,455	13,534	16,099	19,000	60,088	21,772	25,760	29,807	33,692	111,032	178,510
Total Revenues	2,057	10,645	28,990	11,455	13,534	16,099	19,000	60,088	21,772	25,760	29,807	33,692	111,032	178,510
Cost of revenues	258	5,681	11,659	5,291	6,090	7,244	8,550	27,176	8,709	10,304	11,923	13,477	44,413	66,647
COGS as % of sales			36%											
Gross profit	1,799	4,964	17,331	6,164	7,444	8,854	10,450	32,912	13,063	15,456	17,884	20,215	66,619	111,862
Gross Margins	87.5%	46.6%	59.8%	53.8%	55.0%	55.0%	55.0%	54.8%	60.0%	60.0%	60.0%	60.0%	60.0%	62.7%
Selling and Marketing	1,555	3,454	12,508	5,690	7,308	7,244	7,600	27,843	8,491	9,789	9,836	11,455	39,572	55,172
General and administrative	6,992	8,644	21,865	5,700	6,000	6,400	7,500	25,600	7,600	7,700	7,800	7,850	30,950	35,200
Research and development	9,023	14,777	24,901	6,915	7,300	7,600	7,700	29,515	8,300	8,600	8,900	9,200	35,000	36,000
Total operating expenses	17,570	26,875	59,275	18,305	20,608	21,244	22,800	82,958	24,391	26,089	26,536	28,505	105,522	126,372
Operating Income	(15,771)	(21,911)	(41,944)	(12,141)	(13,165)	(12,390)	(12,350)	(50,046)	(11,328)	(10,633)	(8,652)	(8,290)	(38,903)	(14,509)
Interest income	(421)	(421)	(1,452)	(25)	280	257	225	737	183	166	135	108	593	209
Other	(845)	(61)	269	0	0	0	0	0	0	0	0	0	0	0
Income before taxes	(17,037)	(22,393)	(43,127)	(12,166)	(12,885)	(12,133)	(12,125)	(49,308)	(11,144)	(10,467)	(8,517)	(8,182)	(38,310)	(14,300)
Provision for income taxes	0	0	-	0	0	0	0	0	0	0	0	0	0	10
Tax Rate														(0)
Net income	(17,037)	(22,393)	(43,129)	(12,166)	(12,885)	(12,133)	(12,125)	(49,308)	(11,144)	(10,467)	(8,517)	(8,182)	(38,310)	(14,310)
Accretion of convertible preferred stock	(296)	(286)	(139)	0	0	0	0	0	0	0	0	0	0	0
Net Income	(17,333)	(22,679)	(43,268)	(12,166)	(12,885)	(12,133)	(12,125)	(49,308)	(11,144)	(10,467)	(8,517)	(8,182)	(38,310)	(14,310)
GAAP EPS -Basic	(\$3.52)	(\$0.41)	(\$2.09)	(\$0.44)	(\$0.46)	(\$0.44)	(\$0.44)	(\$1.77)	(\$0.40)	(\$0.37)	(\$0.30)	(\$0.29)	(\$1.37)	(\$0.51)
GAAP EPS -Diluted	(\$3.52)	(\$0.41)	(\$2.08)	(\$0.44)	(\$0.46)	(\$0.44)	(\$0.44)	(\$1.77)	(\$0.40)	(\$0.37)	(\$0.30)	(\$0.29)	(\$1.37)	(\$0.51)
Non-GAAP EPS -Diluted	(\$3.52)	(\$0.41)	(\$2.08)	(\$0.44)	(\$0.46)	(\$0.44)	(\$0.44)	(\$1.77)	(\$0.40)	(\$0.37)	(\$0.30)	(\$0.29)	(\$1.37)	(\$0.51)
Weighted average shares - basic	4,930	55,642	21,577	27,734	27,775	27,817	27,859	27,796	27,914	27,956	27,998	28,040	28,040	28,223
Weighted average shares - diluted	4,930	55,642	21,778	27,734	27,775	27,817	27,859	27,796	27,914	27,956	27,998	28,040	28,040	28,223
		proforma												
Cash and Equivalents	10,852	54,838	124,293	112,000	102,983	89,905	73,348	73,348	66,378	54,005	43,318	28,159	28,159	2,204
Net Cash	10,852	54,838	124,293	112,000	102,983	89,905	73,348	73,348	66,378	54,005	43,318	28,159	28,159	2,204
Net Cash/share			5	4	4	3	3	3	2.38	1.93	1.55	1.00	1	0
NOLs			(52,991)	(65,157)	(78,042)	(90,174)	(102,299)	(102,299)	(113,444)	(123,911)	(132,428)	(140,609)	(140,609)	(154,920)
% of Sales	2011	2012	2013	1Q14	2Q14E	3Q14E	4Q14E	2014E	1Q15E	2Q15E	3Q15E	4Q15E	2015E	2016E
Gross Margins	87%	47%	60%	54%	55%	55%	55%	55%	60%	60%	60%	60%	60%	63%
Selling and Marketing	76%	32%	43%	50%	54%	45%	40%	46%	39%	38%	33%	34%	36%	31%
General and administrative	340%	81%	75%	50%	44%	40%	39%	43%	35%	30%	26%	23%	28%	20%
Research and development	439%	139%	86%	60%	54%	47%	41%	49%	38%	33%	30%	27%	32%	20%
Total operating expenses	854%	252%	204%	160%	152%	132%	120%	138%	112%	101%	89%	85%	95%	71%
EBIT	-767%	-206%	-145%	-106%	-97%	-77%	-65%	-83%	-52%	-41%	-29%	-25%	-35%	-8%
Tax rate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Net income	-843%	-213%	-149%	-106%	-95%	-75%	-64%	-82%	-51%	-41%	-29%	-24%	-35%	-8%
Free Cash Flow	-1015%	-199%	-132%	-59%	-86%	-70%	-77%	-74%	-22%	-39%	-27%	-37%	-32%	-7%
y/y Δ	2011	2012	2013	1Q14	2Q14E	3Q14E	4Q14E	2014E	1Q15E	2Q15E	3Q15E	4Q15E	2015E	2016E
Total Revenues	NA	418%	172%	120%	129%	96%	97%	107%	90%	90%	85%	77%	85%	61%
Cost of revenues	NA	2102%	105%	122%	174%	153%	103%	133%	65%	69%	65%	58%	63%	50%
Gross Margins	NA	-47%	28%	-1%	-12%	-16%	-3%	-8%	12%	9%	9%	9%	10%	4%
Selling and Marketing	NA	122%	262%	214%	139%	138%	65%	123%	49%	34%	36%	51%	42%	39%
General and administrative	NA	24%	153%	81%	26%	-1%	0%	17%	33%	28%	22%	5%	21%	14%
Research and development	NA	64%	69%	39%	20%	9%	13%	19%	20%	18%	17%	19%	19%	3%
Total operating expenses	NA	53%	121%	84%	48%	29%	20%	40%	33%	27%	25%	25%	27%	20%
EBIT	NA	39%	91%	70%	29%	11%	-8%	19%	-7%	-19%	-30%	-33%	-22%	-63%
Tax rate	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Net income	NA	31%	91%	68%	24%	-3%	-7%	14%	-8%	-19%	-30%	-33%	-22%	-63%

Source: Company data, Wedbush Securities, Inc.

Figure 5: Balance Sheet

	2011	2012	2013E	2014E	2015E	2016E
Current assets:						
Total Cash and Cash Equivalents	10852	54,838	124,293	73,348	28,159	2,204
Accounts Receivable	278	2,195	6,262	9,500	16,846	26,412
Inventory	318	803	1,763	1,583	2,808	4,402
Prepaid expenses and other Current Assets	313	550	992	992	992	992
Total current assets	11,761	58,386	133,310	85,423	48,805	34,010
Property, Plant and Equipment	7,902	12,154	22,104	25,108	30,660	39,586
Accumulated Depreciation	(1,796)	(4,689)		(4,615)	(10,003)	(16,731)
Restricted cash and other non-current assets	198	188	1,854	1,854	1,854	1,854
Total assets	18,065	66,039	157,268	107,771	71,316	58,719
LIABILITIES AND STOCKHOLDERS' EQUITY						
Current liabilities:						
Accounts Payable and accrued expenses	2,408	5,072	7,007	6,818	8,673	10,387
Deferred revenue and Other Current Liabilities	1,832	3,458	8,752	8,752	8,752	8,752
Total current liabilities	4,240	8,530	15,759	15,570	17,425	19,139
Long-term liabilities:						
Long Term Debt	3,041	1,441	0	0	0	0
Other long term liabilities	632	807	9,798	9,798	9,798	9,798
Total liabilities	7,913	10,778	25,557	25,368	27,223	28,937
Stockholders' equity:						
Preferred Stock	32,455	98,658	0	0	0	0
Common Stock, APIC, RE	(22,303)	(43,397)	131,711	82,403	44,093	29,782
Total liabilities and stockholders' equity	18,065	66,039	157,268	107,771	71,316	58,719

Source: Company data, Wedbush Securities, Inc.

Figure 6: Cash Flow Statement

	2011	2012	2013	2014E	2015E	2016E
Cash Flows from Operating Activities:						
Net (loss) income	(17,037)	(22,393)	(42,944)	(49,308)	(38,310)	(14,310)
Depreciation	1,520	2,894	5,006	4,615	5,388	6,728
change in FV of investor rights obligation	1,067	0	0	0	0	0
change in FV of warrant liability	34	131	1,380	0	0	0
Stock-based compensation expense	73	1,535	7,316	0	0	0
common stock issued for services	0	0	4	0	0	0
non-cash interest expense/impairment	111	104	497	0	0	0
Change in working capital	99	480	(2,025)	(3,247)	(6,716)	(9,447)
Net cash provided by operating activities	(14,133)	(17,249)	(30,766)	(47,941)	(39,637)	(17,030)
Cash Flows from Investing Activities:						
Purchase of property and equipment	(5,410)	(3,183)	(6,930)	(3,004)	(5,552)	(8,925)
increase in restricted cash	0		(1,564)	0	0	0
Net cash used in investing activities	(5,410)	(3,183)	(8,494)	(3,004)	(5,552)	(8,925)
Cash Flows from Financing Activities:						
Proceeds from Issuance of Restricted Stock	114	70	49	0	0	0
proceeds from issuance of preferred stock	26,338	65,917	(10)	0	0	0
proceeds from issuance of common stock	0	0	110,381	0	0	0
change in notes payable	2,534	(1,569)	(1,705)	0	0	0
Net cash provided by financing activities	28,986	64,418	108,715	0	0	0
Net increase (decrease) in cash and cash equivalents	9,443	43,986	69,455	(50,945)	(45,189)	(25,955)
Cash and cash equivalents, beginning of period	10,852	54,838	124,293	73,348	28,159	2,204
Cash and cash equivalents, end of period	10,852	54,838	124,293	73,348	28,159	2,204

Source: Company data, Wedbush Securities, Inc.

Company	Ticker	Rating	Price Target	Current Price
Illumina	ILMN	NEUTRAL	\$165	\$160

Analyst Biography

Zarak Khurshid is a senior equity research analyst covering the Medical Diagnostics and Life Science Tools sectors. Prior to joining Wedbush in January 2010, Mr. Khurshid was Vice President and senior equity research analyst with Caris & Company where he covered the Medical diagnostics and Life Sciences Tools sectors from 2006 to 2010. Mr. Khurshid's aggressive risk/reward focused investment style is supported by data points from a diverse network of contacts from industry, hospitals, clinical labs, and academia. Mr. Khurshid was ranked #1 in the Life Science Tools and Services sectors and #4 on Wall Street for earnings accuracy in 2012 by *Starmine*. Prior to his start on Wall Street with *Pacific Growth Equities* in 2004, Mr. Khurshid was a Research Associate with *Cytokinetics* and an Associate Bioengineer with *Aurora Biosciences*. Mr. Khurshid received a BS in Bioengineering and a BA in Economics from the University of California, San Diego.

Analyst Certification

I, Zarak Khurshid, certify that the views expressed in this report accurately reflect my personal opinion and that I have not and will not, directly or indirectly, receive compensation or other payments in connection with my specific recommendations or views contained in this report.

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Neutral: Expect the total return of the stock to perform in-line with the median total return of the analyst's (or the analyst's team) coverage universe over the next 6-12 months.

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The Investment Ratings are based on the expected performance of a stock (based on anticipated total return to price target) relative to the other stocks in the analyst's coverage universe (or the analyst's team coverage).*

Rating Distribution (as of July 30, 2014)	Investment Banking Relationships (as of June 30, 2014)
Outperform: 54%	Outperform: 25%
Neutral: 42%	Neutral: 1%
Underperform: 4%	Underperform: 0%

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Wedbush Equity Research Disclosures as of August 7, 2014

Company	Disclosure
Foundation Medicine	1
Illumina	1

Research Disclosure Legend

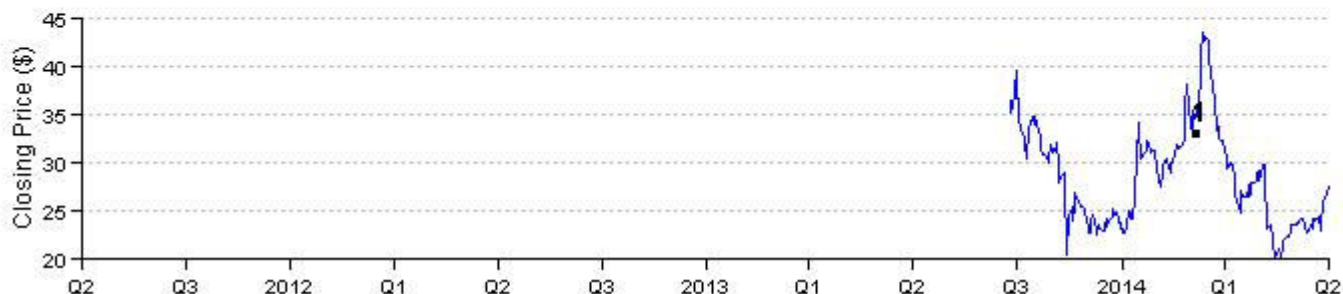
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2. WS managed a public offering of securities within the last 12 months.
3. WS co-managed a public offering of securities within the last 12 months.
4. WS has received compensation for investment banking services within the last 12 months.
5. WS provided investment banking services within the last 12 months.
6. WS is acting as financial advisor.
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11. WS or one of its affiliates beneficially own 1% or more of the common equity securities.
12. The analyst maintains Contingent Value Rights that enables him/her to receive payments of cash upon the company's meeting certain clinical and regulatory milestones.

Price Charts

Wedbush disclosure price charts are updated within the first fifteen days of each new calendar quarter per FINRA regulations. Price charts for companies initiated upon in the current quarter, and rating and target price changes occurring in the current quarter, will not be displayed until the following quarter. Additional information on recommended securities is available on request.

FMI

1) 03/04/14
OUTPERFORM \$50



ILMN

1) 07/27/11 OUTPERFORM \$78	2) 10/07/11 OUTPERFORM \$35	3) 01/25/12 OUTPERFORM \$50	4) 02/08/12 OUTPERFORM \$65	5) 04/24/12 OUTPERFORM \$52	6) 01/04/13 NEUTRAL \$52	7) 04/23/13 NEUTRAL \$55
8) 07/24/13 NEUTRAL \$60	9) 10/15/13 NEUTRAL \$65	10) 10/22/13 NEUTRAL \$72	11) 01/23/14 NEUTRAL \$130	12) 01/29/14 NEUTRAL \$140	13) 04/23/14 NEUTRAL \$155	



* WS changed its rating system from (Strong Buy/Buy/Hold/Sell) to (Outperform/ Neutral/Underperform) on July 14, 2009.

Please access the attached hyperlink for WS' Coverage Universe: <http://www.wedbush.com/services/cm/g/equities-division/research/equity-research> Applicable disclosure information is also available upon request by contacting Ellen Kang in the Research Department at (213) 688-4529, by email to ellen.kang@wedbush.com, or the Business Conduct Department at (213) 688-8090. You may also submit a written request to the following: Business Conduct Department, 1000 Wilshire Blvd., Los Angeles, CA 90017.

OTHER DISCLOSURES

RESEARCH DEPT. * (213) 688-4505 * www.wedbush.com

EQUITY TRADING Los Angeles (213) 688-4470 / (800) 421-0178 * EQUITY SALES Los Angeles (800) 444-8076

CORPORATE HEADQUARTERS (213) 688-8000

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WEDBUSH

EQUITY RESEARCH DEPARTMENT

(213) 688-4529

DIRECTOR OF RESEARCH

Mark D. Benson (213) 688-4435

MANAGER, RESEARCH OPERATIONS

Ellen Kang (213) 688-4529

RETAIL AND CONSUMER

Consumer Products

Rommel T. Dionisio (212) 938-9934
Alicia Reese (212) 938-9927

Footwear, Apparel and Accessories

Corinna Freedman (212) 688-9876

Healthy Lifestyles

Kurt M. Frederick, CFA CPA (415) 274-6822
Alicia Reese (212) 938-9927

Restaurants

Nick Setyan (213) 688-4519
Colin Radke (213) 688-6624

Specialty Retail: Hardlines

Joan L. Storms, CFA (213) 688-4537
John Garrett, CFA (213) 688-4523

Seth Basham, CFA (212) 938-9954

Specialty Retail: Softlines

Morry Brown (213) 688-4311
Taryn Kuida (213) 688-4505

INDUSTRIAL GROWTH TECHNOLOGY

Clean Technology

Craig Irwin (212) 938-9926

Environmental Services / Building Products

Al Kaschalk (213) 688-4539

Water and Renewable Energy Solutions

David Rose, CFA (213) 688-4319
James Kim (213) 688-4380

TECHNOLOGY, INTERNET, MEDIA & SOCIAL MEDIA

Communications and Application Software

Shyam Patil, CFA (213) 688-8062
Andy Cheng (213) 688-4548

Computer Services: Financial Technology

Gil B. Luria (213) 688-4501
Aaron Turner (213) 688-4429

Enterprise Software

Steve Koenig (415) 274-6801
Kevin Ikeda (213) 688-4423

Entertainment: Retail

Michael Pachter (213) 688-4474
Nick McKay (213) 688-4343
Nick Citrin (213) 688-4495

Entertainment: Software

Michael Pachter (213) 688-4474
Nick McKay (213) 688-4343
Nick Citrin (213) 688-4495

Internet: Media and Gaming

Michael Pachter (213) 688-4474
Nick McKay (213) 688-4343
Nick Citrin (213) 688-4495

Internet: Social Media, Advertising & Technology

Shyam Patil, CFA (213) 688-8062
Andy Cheng (213) 688-4548

Media

James Dix, CFA (213) 688-4315

Movies and Entertainment

Michael Pachter (213) 688-4474
Nick McKay (213) 688-4343
Nick Citrin (213) 688-4495

Semiconductors

Betsy Van Hees (415) 274-6869
Ryan Jue, CFA (415) 263-6669

LIFE SCIENCES AND HEALTH CARE

Biotechnology/Biopharmaceuticals/BioDefense

David M. Nierengarten, Ph.D. (415) 274-6862
Dilip Joseph (415) 273-7308

Emerging Pharmaceuticals

Liana Moussatos, Ph.D. (415) 263-6626

Healthcare Services - Managed Care

Sarah James (213) 688-4503

Medical Devices

Tao Levy (212) 938-9948

Medical Diagnostics and Life Sciences Tools

Zarak Khurshid (415) 274-6823

EQUITY SALES

Los Angeles (213) 688-4470 / (800) 444-8076
San Francisco (415) 274-6800
New York (212) 938-9931
Boston (617) 832-3700
Minneapolis (213) 688-6671
Chicago (213) 688-4418

EQUITY TRADING

Los Angeles (213) 688-4470 / (800) 421-0178
San Francisco (415) 274-6811
New York (212) 344-2382
Boston (617) 832-3700
Milwaukee (213) 688-4475

CORPORATE HEADQUARTERS

1000 Wilshire Blvd., Los Angeles, CA 90017-2465

Tel: (213) 688-8000 www.wedbush.com
