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Hybrid Vigor

The Hillside Convertible Advisory Letter

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Introduction

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Greetings from Saratoga, and welcome to the first of three abbreviated weeks of **Hybrid Vigor**. As we enter the final weeks of summer, we, like most others, are working with a smaller crew. We also continue to tweak our product as we get ready for moving to a subscription-based model later this year.

With our production limitations, this week's Ugly 20 list is based on prices from Friday's close. While we believe HARP is a more useful tool for identifying precarious bonds than for finding cheap ones, we do continue to point out individual low-HARP bonds we consider attractive. Readers continue to ask us for a list of low-HARP bonds. Since HARP depends heavily on price point, many low-HARP bonds trade at 105 or lower. But we do provide a list of 10 lower-HARP bonds in the same 110-140 price range as their Ugly 20 cousins.

In addition, Kent Bailey evaluated TTM Technologies' turnaround effort. Roman Terekhin and Jeffrey Alton collaborated on a report evaluating the prospect of Titan Machinery. Finally, Jeffrey Alton and Sue Wu provided some earnings analysis on 51Jobs, a Chinese Internet Recruiting firm.

A reminder: we'll have information for you in the next couple of weeks about our September cocktail event in New York. We also look forward to meeting readers in several other cities in October to discuss **Hybrid Vigor**.

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The Ugly 20

Bill Feingold

While there isn't a great deal of change on this week's Ugly 20 list, as measured by Hillside Adjusted Risk Points (HARP), several points deserve mention.

One is the reappearance of the SanDisk 0.5%. You may recall that a number of readers were surprised to see this bond on our original list, feeling that the mix of relatively low premium, good credit and history of volatility created a reasonably attractive trade in a rich market. We acknowledged all of the above but cautioned that the bond's price point in the midst of the 120/130 "death trap" put it in danger of loss both from a sharp stock decline as well as premium contraction. HARP is ultimately a measure best used for absolute performance, but we suggest that arbitrageurs pay attention to it for better looks into how outright investors are likely to behave.

SanDisk dropped off the HARP list after a disappointing earnings report, as the bonds fell into the low-to-mid-teens, but as they claw their way back with the stock, they get closer to the feared 120. Closing last week at 118, SanDisk 0.5% are not a bad play for holders expecting significant further moves. But the entry point is far from ideal.

Last week's Priceline deal also showed the value of using HARP as a canary in the convertible coal mine. A number of savvy market participants expressed surprise—some in language better suited to a bar than a newsletter, though we still wish we could repeat it here—that other investors would trade out of a bond (the 0.35%) that's been painfully bled of premium over the past 15 months in favor of the new deal. Again, it's price point: even when a bond in the 120's appears to have a reasonable enough premium, it's still probably going to be sold when the new deal comes. Price point by itself won't get a bond on the list, but treading lightly between the high teens and the low-mid 130's is almost always going to be good policy.

More than a few readers have speculated that the recent Macquarie Infrastructure (MIC) convertible would find a home on the uglies list. As the list is currently built, the bond is not eligible, because the stock's dividend is too high. One reader asked the rationale for excluding high-dividend names, arguing correctly that all other things equal, high dividends are worse for convertibles than low ones. This, by the way, is exactly what we've said to Treasury regarding its plans to assess "deemed dividend" taxes on convertible holders in Section 871(m).

So why are we excluding high-dividend names? Because we will be providing a separate analytic framework that we think is more appropriate for convertibles on such names. In most cases, these names are low-premium REIT or BDC names for which the HARP analysis would yield misleading results. But, now and then, you come across a name like MIC. For the record, if not for our high-dividend screen-out, MIC would have been a top-five HARP name, even at a relatively low price point around 112. It expanded four points right out of the gate and has opened up several more since.

The investment-grade bid is a powerful force indeed, like it or not. We recently spoke with one convertible vet who relayed a story of a manager taking on a new client insisting on at least 25% investment-grade for a big separate account. The manager indicated it would be a challenge getting invested in any kind of reasonable paper. The client's response, essentially, was: I want investment grade, not excuses.

This brings us back to Priceline. Has any other American company come close to using the post-crisis convertible market as effectively as Priceline has? It sure doesn't seem like it. There are plenty of investment-grade credits out there, and precious few willing to embrace the bounty convertible investors are trying to give them. Say what you will—you have to give Priceline credit for seizing this opportunity ignored by so many others.

Hillside Ugly 20 List (Prices as of August 15, 2014)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP's
1	RPM International 2.25% 2020-12-15	115.75	45.82	33.9	29.33	14.70
2	Lam Research 1.25% 2018-05-15	133.00	69.65	20.0	22.17	14.28
3	Helix Energy 3.25% 2032-03-15	131.50	25.66	28.3	29.02	12.14
4	Hornbeck Offshore 1.5% 2019-09-01	116.25	43.51	43.9	35.47	10.98
5	Lam Research 0.5% 2016-05-15	126.00	69.65	13.6	15.08	10.91
6	Priceline.com 0.35% 2020-06-15	118.75	1270.12	23.0	22.22	10.77
7	Incyte Corp 0.38% 2018-11-15	126.00	51.36	26.9	26.69	10.68
8	Standard Pacific 1.25% 2032-08-01	118.5.0	7.94	20.6	20.25	10.45
9	Lions Gate 1.25% 2018-04-15	130.00	32.74	18.5	20.30	10.44
10	CSG Systems 3% 2017-03-01	129.00	27.39	11.7	13.50	10.23
11	Chart Inds Inc 2% 2018-08-01	127.50	71.53	23.0	23.83	10.12
12	Ryland Group Inc 1.63% 2018-05-15	127.00	34.70	17.2	18.63	10.04
13	Citrix Systems Inc. 0.5% 2019-04-15	110.75	68.95	44.4	34.02	9.98
14	Incyte Corp 1.25% 2020-11-15	127.25	51.36	28.1	27.89	9.68
15	Jarden Corp 1.5% 2019-06-15	117.25	57.22	19.7	19.29	9.61
16	On Semi Corp 2.63% 2026-12-15	114.00	8.81	35.8	30.03	9.56
17	Alon USA Energy Inc 3% 2018-09-15	124.50	15.54	18.4	19.33	9.56
18	SanDisk Corp 0.5% 2020-10-15	118.00	94.03	15.7	16.01	9.55
19	Altra Holdings Inc 2.75% 2031-03-01	132.50	32.66	9.2	11.16	9.32
20	Healthsouth Corp 2% 2043-12-01	115.25	39.52	14.4	14.50	9.09

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On the Brighter Side

Two recent deals that continue to have some appeal amidst a rich market are QIHU 1.75% and JAZZ 1.875%, both of 2021. Both come in with modest HARP scores, with QIHU at around 3 and JAZZ at around 4. Neither is too far above par and both offer solid equity upside. Obviously QIHU requires willingness to buy Chinese deals, but investors with this willingness get an attractive bond. When we initially reviewed the JAZZ convertible we thought it would be welcomed somewhat more enthusiastically than it was—but this is good news. The cheap-end pricing means there is still value for investors late to the party.

10 Low-HARP Names Between 110 and 140

Bill Feingold

As promised, here is a list of 10 lower-HARP bonds trading between 110 and 140. You've seen a number of these on our previous low-HARP list. We've discussed some of the other bonds from that list as being among our favorites, such as AUXL 1.5% and JOBS 3.25%, both of which are at a lower price point. Again, low-HARP bonds tend to congregate around and below par (as well as deep in the money) because of the nature of the calculation.

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP's
1	OPKO Health Inc 3% 2033-02-01	137.75	9.08	7.2	9.25	1.70
2	Iconix Brand Group Inc 2.5% 2016-06-01	139.00	40.93	4.5	5.99	1.89
3	Iconix Brand Group Inc 1.5% 2018-03-15	140.00	40.93	5.5	7.29	2.38
4	NRG Yield Inc 3.5% 2019-02-01	122.25	53.34	6.7	7.68	3.81
5	InvenSense Inc 1.75% 2018-11-01	127.00	24.99	11.1	12.68	3.99
6	WebMD Health Corp 1.5% 2020-12-01	110.50	47.55	22.6	20.35	4.90
7	Renewable Energy Group 2.75% 2019-06-15	111.25	11.64	26.7	23.43	4.92
8	Kaman Corp 3.25% 2017-11-15	130.00	40.48	8.3	9.96	5.33
9	Healthways Inc 1.5% 2018-07-01	110.50	17.65	21.7	19.69	5.46
10	Jarden Corp 1.88% 2018-09-15	133.75	57.22	10.4	12.60	5.78

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TTM Technologies: Should We Expect a Quick Turn?

Kent Bailey, CFA

TTM Technologies (TTMI) is the largest printed circuit board (PCB) manufacturer in North America and the eighth largest globally. PCBs, the green boards imprinted with circuitry that form the backbone of nearly every electronic device, are a $55 billion market worldwide and growing in the low-to-mid-single digit range. The market is segmented into low and high margin products. High volume "commodity" boards that represent the mass production phase of many electronics generate lower margins, while quick turn/prototyping (used in the R&D phase of product development) and more complex "advanced technology" boards command higher margins. Historically, the higher margin business was focused in North America, while volume production was centered in Asia. Those lines have blurred in recent years due to consolidation and the steady improvement in the technological capabilities of the Asian PCB makers.

Longtime convertible investors will remember TTMI as the class of North American PCB manufacturers, consistently generating positive earnings and free cash flow despite the wild cyclical swings faced by the industry. In 2010, however, TTMI's ill-timed entry into the Asian market through the acquisition of high-volume manufacturer Meadville created significant challenges for the company's business model and severely pressured results. In 2011, the Chinese government raised the minimum wage, which led to a drastic reduction in gross margins. Years later, TTMI's margin profile and stock price have yet to recover. In the first half of 2014, worse than normal seasonality due to weakness in the mobile phone and tablet markets has further dampened results.

However, there are several reasons for optimism heading into the second half, including a strong balance sheet, reasonable equity valuation, improving fundamentals, and a new management team with clear margin goals. TTMI remains a solid credit, with excellent liquidity and modest net leverage. Management is focused on further debt reduction to maintain flexibility in the advent of attractive acquisition opportunities.

Period	FY2015	Debt		Net Debt		Internet Expense Analysis	
FY2015E EBITDA	193						
TTMI Stock Price 08/15/14	$7.46		EBITDA		EBITDA		
			193		193		
	Balance	Debt O/S	Multiple	Net Debt O/S	Multiple	Coupon	Cash Int
Cash/ST Investments	282						
Sr Secured Debt							
Term Loan due 09/14/16 (sec'd by APAC)	322					2.50%	8.1
$90m R/C due 09/14/16	0					2.50%	0
	322	322	1.7	40	0.2		
Sr Unsecured							
3.25% Cvt Sr Nts due 5/15/15	32					3.25%	1
1.75% Cvt Sr Nts due 12/15/20	250					1.75%	4.4
	282	604	3.1	322	1.7	Total	13.5
Common Stock (Mkt.)	621	1,225	6.3	943	4.9	Shares O/S	83.3

Excluding the amortization of the term loan, TTMI should generate positive free cash flow going forward, keeping in mind that the revenue trajectory of such a cyclical company is likely to be less than linear. With an unused $90 million revolving credit line available in addition to its cash balance, TTMI will maintain a comfortable liquidity cushion even in the event of a further downturn.

Sources & Uses	3Q14E	4Q14E	2015E	2016E	2017E	2018E
Beginning Cash	282	261	250	184	306	361
Revenue	325	400	1,350	1,391	1,432	1,475
Gross Profit	49	68	216	229	243	251
SG&A	(31)	(38)	(128)	(132)	(136)	(140)
D&A	25	26	105	106	107	108
EBITDA	43	56	193	203	214	219
Cash Interest Expense	(3)	(3)	(12)	(11)	(10)	(10)
Term Loan amortization	(32)	(32)	(120)	(140)	(15)	(15)
Cash Taxes	(5)	(9)	(27)	(30)	(34)	(35)
New Financing	0	0	0	200	0	0
Capex	(23)	(23)	(100)	(100)	(100)	(100)
Change in Cash	(21)	(12)	(66)	122	55	58
Ending Cash	261	250	184	306	361	420

TTMI stock trades at ~9.5x the 2015 consensus EPS estimate of $.79 and just under 5x enterprise value-to-2015 expected EBITDA, roughly in-line with historical averages. Given that management missed estimates and guided down in each of the past two quarters, we believe that expectations are modest heading into next year.

There are also several potential fundamental catalysts that could provide upside to current consensus numbers. TTMI's highly volatile mobility segment is expected to rebound from a dismal first half, and the company will benefit significantly if (Top 5 customer) Apple's next product launch is a success. Last year, TTMI's new management team, led by CEO Tom Edman, closed one unprofitable factory and sold another, boosting margins by 100 basis points. With overall utilization weak, TTMI could further reduce its footprint. Also, management will use its balance sheet strength to continue to look for accretive acquisitions.
Upon taking over at the beginning of this year, new management set long-term operating goals of gross margins of 19% and operating margins of 9%. This compares with expectations of 15% and 6%, respectively, for 2014. Management will need to further rationalize capacity and shift the business mix toward advanced technologies to achieve these targets.

Trading at 103, the TTMI 1.75% convertible bonds due 2020 will provide decent exposure to the upside stock thesis, although the 32% premium is higher than we would like to see. With the stock trading near multi-year lows, outright investors should consider adding a portion of stock to their bond position to boost the participation rate.

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Titan (TITN): Sky is Not Falling

Roman Terekhin, CFA, Jeffrey Alton, CFA, and Bill Feingold

The weakness of the farm economy is showing as agriculture-related companies announce second quarter earnings. Last week, Deere & Company reported earnings down almost 15% compared to the same quarter in 2013 with equipment sales in the US & Canada down 8 percent. Earlier in the year, the US Department of Agriculture predicted that 2014 net farm income will be $95.8 billion, down 26.6% from 2013 and the lowest since 2010.

One company that may be particularly affected by the slowing farm economy is Titan Machinery Inc. (TITN) of Fargo, North Dakota. Through its stores in the United States and Europe, Titan is the largest Case IH agricultural retail dealer in the world, the largest retailer dealer of Case construction equipment in North America and a major dealer of New Holland farm and construction equipment in the US. Titan is heavily leveraged to the farm economy. In fiscal 2014 ended January 31, Titan had $1.77 billion in agricultural equipment sales accounting for 76.2% of revenue. Construction equipment was $405.8 million and international sales were $145.9 million.

Just as the farm economy has been weakening, Titan has been increasing its inventories. They reached $1.12 billion as of April 30, 2014, a 12% increase from the previous year. As the company has increased inventory, net income and leverage covenants in its credit facilities have been tightened. The combination of those two factors have put the company at heightened risk of a covenant violation and its consequences.

Over the past month or so, the company's 3.75% senior unsecured convertible notes due 2019 have declined from the high to low 80's. In all likelihood, the selloff was fueled by the concerns of the secured-debt covenant violation. As troublesome as things are, we doubt that the banks are ready to put the company into bankruptcy. A forced liquidation of over $1 billion in inventory would hurt a market for new agricultural equipment already in pretty bad shape. We simply do not see such scenario occurring and believe that there is more value in keeping the company afloat.

Besides, of the $847 million in secured debt, $500 million is in the form of vendor financing and the entire amount is backed by inventory. Vendors will probably oppose any forced inventory reductions as it would diminish the value of their collateral. A more likely scenario is that the company will get covenant waivers in exchange for some concessions and continue as a going concern. This is not to say that operationally the company is in good shape or that there will be no further pain for stock or convertible investors.

The weakness in farm equipment sales has been fueled by low demand from the agricultural sector weakened by falling commodity prices. All the major equipment manufacturers have announced lowered revenue guidance for 2014 and 2015. That includes CNH, for which TITN is the largest dealer, and whose shares have been declining almost in unison with those of TITN (or is it the other way around?). TITN shareholders may also have to wait for the company to start growing again as its strategy included acquisitions and those seem unlikely in the foreseeable future.

For the convertible, we ran some back–of-the-envelope recovery numbers in a hypothetical bankruptcy scenario. The current price of the convertible implies about an inventory liquidation at about 15% discount to

its book value. The recovery moves to par if one assumes a 12% inventory discount. However, a 20% inventory discount brings the recovery down to only to 44 cents on the dollar. We will not attempt to predict the discount in bankruptcy, however unlikely. Under normal conditions, year-over-year changes in equipment prices are in the single digits. Thus, 15% seems a bit pessimistic to us. Using 81 as the convertible price we get 8.7% yield to maturity and 700 basis points spread over Treasuries. Although parity is only in the low 30's, this is a five-year bond with a theoretical time to recover (in the absence of bankruptcy). In the environment of few high yield opportunities in the marketplace these optics may attract a speculative buyer.

This is a smallish $150 million issue which is mostly owned by a small number of long-term holders. This makes the bond pretty illiquid (the stock is as well) and subject to significant price gyrations. It does not take much to move the market, and the latest sell-off appears to have occurred on a single $1 million bond trade. We do not have access to dealer's trading desks and cannot comment on the continued presence of sellers and their intentions. There is clearly significant further mark-to-market risk to the downside, especially given how thinly the underlying shares trade, even given the high conversion premium. At some point, the bonds may be worth a look for semi-distressed or distressed investors.

Earnings Update

Jeffrey Alton, CFA, Bill Feingold, Sue Wu

Below we review the recent earnings report of 51job, Inc. (JOBS), which has a low-HARP convertible outstanding. Focusing on low-HARP bonds issued by fundamentally sound companies helps find attractive risk/reward situations.

As always, we caution the buyers of Chinese convertibles to be aware of the VIE (Variable Interest Entity) structure common to many Chinese ADS, including 51jobs, Inc. Under this structure, the convertible issuer indirectly owns a call option on equity of the Chinese operating company, but has no direct ownership. The assets owned by the Chinese operating company are held in a local corporation which has only a contractual relationship with a subsidiary of the offshore holding company that issues the convertible security. This structure may limit recourse available to the convertible security holder in the event of default.

51job, Inc. (JOBS)
3.25% 2019-04-15 HARP: 2.25
(Price 104 as of 8/16/2014)

Earnings Scorecard:

Revenue in $ millions

	Actual	Consensus Estimated	Percent Difference	Previous Year Actual	Percent Change
	6/30/2014	6/30/2014	Act. V. Est	6/30/2013	Y-O-Y
Revenue	$73.75	$72.33	1.89%	$65.88	11.90%
Adjusted EPS	$0.89	$0.32	178.10%	$1.42	-37.30%

Convertible Bond Comments

We understand that many investors avoid Chinese convertibles and we understand why. However, this does create seemingly attractive opportunities for those believing not all Chinese companies are created alike and willing to carve out room in their portfolios for certain names.

In that light, we think the JOBS 3.25% of 2019 have much to recommend, with optics out of a bygone convertible market and a five-year maturity plus a three-year put. We'd go so far as to say that if you're willing to consider Chinese convertibles, this one belongs very near the top of your list. A price just a handful of points above par, along with the other structural benefits and a very modest premium for the price point, all point to this as one of the cheapest bonds in the market. Again, it's cheap with one big caveat.

Equity Comments

After the earnings announcement, the ADS dropped as much as 17% from the previous close of $38.25. Investors were disappointed with the slowing revenue growth rate and the lingering worries over China's economic expansion. Currently, the ADS trades at $35.9, at its 200-day moving average. The ADS's 50-day moving average of $34.65 offers support. At 26x 2014 consensus earnings and 21x 2015 earnings, the ADS should be considered in a consolidating period until revenue growth reaccelerates. Over the longer period, China's continued economic expansion and the ability to mine the SME market should offer renewed growth.

Quarterly Earnings Highlights

51job reported a solid second quarter with revenue of RMB457.5 million ($73.75 million), slightly higher than the top end of the company's RMB455 million guidance. Adjusted net income per share was RMB2.75, also beating the top-end of the company's guidance of RMB2.35/share ($0.76 per ADS). Sequentially, year-over-year revenue growth declined from 18.9% in Q4 2013 and 14.9% Q1 2014.

The online recruitment reporting segment grew 15.76% during the quarter to revenues of RMB312 million compared to the second quarter last year. That growth rate is up from 14.28% last year. The Other HR Services reporting segment grew 15.63% to RMB143 million compared to last year. That is slower than the 20.82% rate in the same quarter last year.

The company continues to execute on its strategy of increasing the number of corporate customers, focusing on the small & medium enterprise market (SME) as most large Chinese companies are already using employee and recruitment services. Total unique corporate users increased 21% to over 280,000 during the quarter and the company ended the quarter with 79 million registered users and 70 million resumes. 51job has increased its sales force to over 3.000, up 750 in the last 18 months in order to penetrate the SME market further and new geographic markets in China. As a sales strategy, 51job will offer shorter trial periods with a limited array of services to engage a new client with the goal of up-selling additional products, including additional HR services, at the end of the introductory term.

Outlook

51job, Inc. offered the following guidance for next quarter:

Category	Q3 2014 Guidance
Revenue	RMB455 – 470 million
Non-GAAP EPS	$RMB2.25 – 2.45 ($0.36 - $0.39)

The top end of revenue guidance suggests year-over-year revenue growth of 12% versus Q3 2013, a further deceleration in revenue growth. The slowing growth is both a result of the challenging macro-economic climate in China, the smaller size of new clients and the difficulty in continuing to grow at the current pace as the company's revenue base increases.

With regard to the earnings per share in US dollars, the ratio of 51job, Inc. equity shares per ADS was previously 2:1; however, the ratio was changed after quarter-end to 1:1. Consequently, earnings per ADS should be adjusted accordingly when comparing to prior periods.

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