

Hybrid Vigor

The Hillside Convertible Advisory Letter

Volume 1 Issue 13

Getting Back to Business

Dear Friends,

Welcome to the third and final week of our abbreviated late-summer once-a-week issues. Beginning next week we return to our regular Monday/Thursday publishing schedule.

We're very encouraged to see a flurry of new issuance welcoming market participants upon their return from summer vacation. The new deals—all discussed here—speak to the bread and butter of convertibles, smallish companies looking for growth capital, raising several hundred million dollars. Big enough deals for most investors to take reasonably meaningful positions, but small enough to make the bonds interesting to trade and susceptible to value-added research.

We also discuss several names in the news this week. Kent Bailey evaluates Exelixis' chances for survival after this week's devastating news, while Roman Terekhin discusses the two software companies that put themselves in play, Concur and Tibco.

As always, we update our trademark Hillside Ugly 20, as measured by our proprietary Hillside Adjusted Risk Points (HARP). HARP is primarily a warning measure, best suited for convertibles that have appreciated since issue but that still retain a significant amount of premium.

Readers have thanked us for creating HARP—it's become a conversation piece, with every Ugly 20 containing some bonds that market participants find attractive. We don't necessarily disagree—any good new statistical measure should generate discussion mixing some "ah-hah" with a little "get out of here."

But since the overarching theme of the Ugly 20 is caution, we've also been asked to provide recommendations. While we've talked about names we like—including names with relatively low HARP scores—readers have told us they want to see more regular lists. We're glad to tell you that we are continuing to refine a convertible rating system that we plan to start publishing later this year, around the time we go to a subscription-based model. We have been using the system internally to evaluate new and existing convertibles and have been pleased with the results. More to follow soon.

A final note—readers in the New York area should have received this week invitations to our September 18 cocktail event. We ask that you RSVP as soon as possible. If you did not receive one and would like to attend, please contact us.

We thank you, as always, for your interest and support.

Bill

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Let The Sun Shine On The Ugly 20

Bill Feingold

There wasn't a lot of motion on the Ugly 20 list, befitting the slow end to a relatively slow summer. RPM International 2.25% continues to "lead" the pack, projecting our top historical bleeder to be our number one future bleeder as well. RPM's lack of volatility would make many broad-based indices jealous.

The spread between the two Lam Research HARP scores continues to narrow. While we can't in good conscience recommend any strategy involving buying the Lam 1.25%, we do note that Lam's 0.50% bond is the only convertible in the ugly 20 maturing in under two years. For those who need investment-grade paper, was that a shout of "reverse inquiry" we just heard?

Priceline's 0.35% issue continues to slip, as investors seeing shares well off their high keep swapping into the lower-delta new bond. Honorable mention- ugly Citrix Systems 0.50% has come off the list because of a tweak in our volatility inputs, but don't let that fool you. If Citrix's recent extreme inertia continues, the bond will not only return to the list but have a big shot at cracking the Top 5. Citrix's fellow recipient of an unsolicited investment-grade rating, Illumina, has further to go to make the Ugly 20, since it hasn't been experiencing single-digit volatility like Citrix and RPM. The higher-priced Illumina "B" tranche is still a handful of points in absolute price from making the cut.

One newcomer to this week's list deserves mention. Say hello to our not-so-little friend, SunPower 0.875% of 2021. A bond with SunPower's underlying volatility needs some extra help to make the Ugly 20. In SPWR's case, that help came in two forms—a levitating stock price and the implicit AA credit support of majority-owner Total. SunPower has been threatening to make the list for a while but it took the move into the high-teens (and proximity to the "land of leakage", the 120's) to get it there.

Indeed, it would make a lot of sense for more investment-grade companies to employ the old Thermo Electron model or some variation, using the parent's credit rating and the subsidiary's volatility to extract more value from convertible issues. Of course, investment-grade issuers can write their own tickets these days anyway.

Hillside Ugly 20 List (Prices as of August 29, 2014)

	<u>Convertible</u>	<u>Price</u>	<u>Stock</u>	<u>Premium (%)</u>	<u>Premium (pts)</u>	<u>HARP's</u>
1	RPM International Inc. 2.25% 2020-12-15	116.75	47.13	31.2	27.76	14.49
2	Lam Research 1.25% 2018-05-15	135.25	71.91	18.2	20.83	14.38
3	Helix Energy 3.25% 2032-03-15	135.50	27.32	24.0	26.23	11.41
4	Lam Research 0.5% 2016-05-15	128.75	71.91	12.5	14.31	11.21
5	Incyte Corp 0.38% 2018-11-15	129.75	54.20	24.0	25.11	11.06
6	SanDisk Corp 0.5% 2020-10-15	121.50	97.96	14.4	15.29	11.05
7	Priceline.com 0.35% 2020-06-15	117.50	1244.31	24.2	22.89	10.70
8	On Semiconductor 2.63% 2026-12-15	118.25	9.76	27.2	25.29	10.45
9	Standard Pacific Corp 1.25% 2032-08-01	122.25	8.37	18.0	18.65	10.15
10	CSG Systems 3% 2017-03-01	130.00	27.72	11.3	13.20	10.13
11	Hornbeck Offshore 1.5% 2019-09-01	114.75	43.66	41.5	33.65	10.10
12	Salesforce.com 0.25% 2018-04-01	115.75	59.09	30.1	26.78	9.72
13	NVIDIA Corp 1% 2018-12-01	114.00	19.45	18.1	17.47	9.70
14	Incyte Corp 1.25% 2020-11-15	130.50	54.20	24.6	25.76	9.52
15	Chart Inds Inc 2% 2018-08-01	122.50	66.89	26.4	25.59	9.51
16	Workday Inc 0.75% 2018-07-15	128.75	91.07	17.8	19.45	9.12
17	SunPower Corp 0.88% 2021-06-01	116.50	38.22	48.6	38.10	8.96
18	Altra Holdings Inc 2.75% 2031-03-01	134.50	33.26	8.9	10.99	8.96
19	Wright Med Group 2% 2017-08-15	133.00	29.84	13.4	15.72	8.89
20	Healthsouth Corp 2% 2043-12-01	114.25	39.39	13.8	13.85	8.82

New Issue: Clovis Oncology (CLVS) \$200 million 2.50% of 9/15/2021

Kent Bailey, CFA and Bill Feingold

Convertible Overview

As mentioned below, one of the best attributes of this deal is the \$1.6 equity market capitalization. This should help with liquidity, both in trading the new convertible and in supporting the bond down the road if and when additional financing becomes necessary. As with most biotechs, modeling is far more art than science. But the overall profile looks attractive, and the conversion price is still well below the price reached in February. Unlike the new EFII issue, this is the kind of bond that can help make your year, even if you tread lightly.

Company Overview

Clovis Oncology (CLVS) is a biotechnology company that develops drugs to target specific subsets of cancer. Like many other biotech stocks, CLVS skyrocketed early in 2014, touching \$80 in February before retracing to the current \$48 level. Despite the drop, Clovis maintains a healthy \$1.6 billion market cap, which reflects its ownership of global rights of three compelling drug candidates. To support development of its pipeline, Clovis is raising \$200 million in convertible notes, at attractive terms for the company. Clovis previously guided to a year-end 2014 cash balance of \$200 million, which appears on target given the 2Q-end cash level of \$273 million and a \$30 million quarterly burn rate. Extending the cash runway by another year and a half or so makes sense, given that Clovis' most advanced molecule, rociletinib for non-small cell lung cancer (NSCLC), is likely two years away from approval. Clovis also needs to fund potential milestones due to Celgene for rociletinib and Pfizer for another drug, rucaparib.

While rociletinib (also known as CO-1686) has shown compelling efficacy in a subset of NSCLC patients with the T790M mutation, there is also concern about toxicity in the form of hyperglycemia (high blood sugar). Rucaparib, currently in Phase 3 for ovarian cancer and Phase 2 for pancreatic cancer, faces a highly competitive landscape in the PARP inhibitor space (the drugs inhibit an enzyme on which some tumors are dependent). However, Clovis hopes that using biomarker data to identify the patients most likely to benefit from rucaparib will be a differentiator. Clovis will report key data on both molecules in mid-November at the EORTC conference in Barcelona. Because the data will be crucial to the medium-term outlook for Clovis, convertible investors need to be comfortable with what will be presented and the potential downside before loading up on this new deal.

New Issue: Electronics for Imaging (EFII) \$300 million 0.75% of 9/1/2019

Jeffrey Alton, CFA

Convertible Overview

It was going to be a stretch to get comfortable with this deal on the original terms, and even the reduced premium doesn't make this bond particularly attractive to model-driven investors because of the stock's fairly anemic volatility. That said, with a 22.5% premium, the optics are pretty good. This bond probably won't make anybody's year, but the low premium should allow investors some time to wait for the next leg higher in the stock. We would buy it as priced.

Company Overview

Products & Markets

Electronics for Imaging, Inc. (EFII) manufactures commercial digital printers & inks and develops printing efficiency & networking software. The company's strategy is to grow revenue through product innovation and selective acquisition of technology to expand its addressable markets and market share.

Current product introductions include a high-volume, near-offset-quality printer which also has the ability to be used in the corrugated-packing segment, a new market for the company. Other new products include an entry-level LED cured printer, a high-resolution technology that does not slow down print speed and 3D ceramic tile printing technology. EFII also recently introduced its fastest printer networking software.

Acquisitions have been mainly software technology businesses or companies that allow further penetration into foreign markets, including printing software in local languages. Executives commented during the most recent quarterly conference call that the company's M&A pipeline was full with deals larger than in the past. Some of the convertible proceeds are likely earmarked for one or more of those deals.

Financial Performance

Management has a history of solid execution. Through 2015, the company should produce steady single-digit revenue growth and double digit net profit growth. Total revenue in 2013 was \$727.7 million and the company's current market cap is approximately \$2 billion.

Revenue (\$ millions) by segment for the second quarter 2014 was:

	<u>Q2 2014</u>	<u>Q2 2013</u>	<u>% Change</u>
Industrial Inkjet	\$93.90	\$88.00	7%
Productivity Software	30.8	28.5	8%
Fiery Networking Software	<u>68.3</u>	<u>63.8</u>	<u>7%</u>
Total	193	\$180.30	7%

Geographic distribution of revenues is 52% in the Americas, 35% in Europe & the Middle East (EMEA) and 13% in Asia Pacific (APAC). Revenue in the Americas increased 1% during the quarter compared to Q2 2013, EMEA revenue increased 34% and APAC revenue decreased 22%. The European region growth was based on continued investment in the region, an increased headcount and new product introductions. Weakness in China was a result of sluggishness in the company's Cretaprint product for printing ceramic tiles. The company believes that Chinese customers are reducing investment as concern over grows a slow-down in construction spending.

Cash flow from operations in Q2 2014 was \$27.5 million, up 44% over the Q2 2013. Cash flow over the latest 12 months was \$81 million, up 6% year-over-year.

For Q3 2014, the company is guiding revenue to \$193 to 196 million, which would be an increase of 8 – 10% year-over-year. Growth should be led by the productivity software segment in the mid-teens as some large purchases were pushed back to this quarter from Q2. The company is guiding non-GAAP EPS in the \$0.43 - \$0.45 per share range, slightly higher than consensus estimates of \$0.43 at the time guidance was announced and 10-15% higher than Q3 2013.

Valuation

At over 23 times 2014 net income per share consensus estimate of \$1.84 and over 20 times 2015 net income per share consensus estimate of \$2.12, the company's common equity appears fairly, if not fully, valued. Enterprise Value to EBITDA over the last 12 months is 15.7 times.

Shares currently trade at about \$43.50, off a recent high of \$47 during earnings season. Resistance is at the 50 day moving average of \$44.48 and support is at the 200 day moving average of \$41.60. The stock is up from a low of \$37 per share last April during the tech/small cap correction.

While EFII is a solid company, we think the stock is consolidating as earnings and cash flow catch up to the stock price. It will take top- and bottom-line results ahead of expectations or a significant acquisition to move the stock meaningfully in the near term.

Leverage

With no current debt on its balance sheet, the timing seems right for EFII to tap a convertible securities market hungry for quality offerings. The company's balance sheet can easily handle the \$300 million convertible securities, with the June 30, 2014 cash & cash equivalents balance over \$324 million.

Quick Comments on This Week's Other Deals

Hillside Team

Depomed's (DEPO) upsized \$300 million convertible of 2021 looks appealing to us from an arb perspective despite the company's smallish market cap. The stock is volatile, trades well and is easily borrowable. With five years of hard call protection and decent coupon, we find the bonds interesting even at 102 vs. \$14. We also like the space the company is in as the diseases of central nervous system and pain management in particular are, unfortunately, widespread and here to stay. Depomed is generating revenues and although the balance sheet is small, pro-forma cash of \$0.5 billion gives us reasonable comfort.

Huron (HURN) is a consulting company that grows through an aggressive acquisition strategy. The new \$225 million five-year bullet is being priced to account for the low volatility of the stock and decent credit quality. We find the volatility of the underlying to be too low for the bond to be particularly attractive to the arbs. At the same time, a company with good cash flow generation capacity should be attractive to long-only investors. While we don't necessarily love businesses in which, as the cliché goes, the assets get on the elevator every night, we imagine there's room in many outright portfolios for a few deals like this, and with the stock well off its 2014 highs, this appears to be a decent entry spot.

Exelixis: COMET-1 Flameout. Will METEOR Crash to Earth?

Kent Bailey, CFA

Exelixis (EXEL) is a biotechnology company focused on developing small molecule drugs for oncology indications. On Monday evening, EXEL announced negative results from its highly anticipated COMET-1 trial of lead molecule cabozantinib ("cabo") in metastatic castrate-resistant prostate cancer (mCRPC), one of several indications in which it's being tested. The trial studied patients who had progressed following treatment with other prostate cancer drugs, and the cabo trial arm failed to show a statistically significant benefit in overall survival vs. the control arm. With a high cash burn rate and a debt-heavy capital structure, the failure casts serious doubt on Exelixis' survival. The sharp price drop of the 4.25% convertible bonds reinforces this concern.

Period	FY2015	Debt		Net Debt		Interest Expense Analysis	
FY2015E EBITDA	-120						
EXEL Stock Price 09/2/14	\$1.85		EBITDA	Net	EBITDA		
	Balance	Debt	-120	Debt	-120		
		O/S	Multiple	O/S	Multiple	Coupon	Cash Int
Cash/ST Investments	352						
Sr Secured Debt (sec'd by cash)							
Silicon Valley Bank TL due 5/31/17	80					0.00%	0
Silicon Valley Bank R/C due 5/31/17	1					0.00%	0
	81	81	-0.7	-271	2.3		
Secured Debt (sec'd by cabo IP)							
Deerfield Sec Cvt Nts due 7/1/15 (2018)	104					0.00%	6
	104	185	-1.5	-167	1.4		
Sr Subordinated							
4.25% Cvt Sr Sub Nts due 8/15/19	288					4.25%	12.2
	288	473	-3.9	121	-1	Total	18.2
Common Stock (Mkt.)	361	833	-6.9	377	-3.1	Shares O/S	194.9

Unlike most biotech convertible names, Exelixis has a complicated capital structure, with two main pieces of debt in front of the publicly-traded 4.25% converts. At the top of the food chain is the Silicon Valley Bank (SVB) Term Loan due 2017 (plus a small line of credit). This is effectively the most senior piece of debt because it must be secured by 100% of the principal amount of the loan on deposit with SVB at all times or the debt becomes immediately due and payable. Given that stipulation, the existence of this debt is baffling. What's the point? Also ahead of the 4.25% notes is the Deerfield convertible note secured by 100% of the cabozantinib IP and 50% of the value of all other IP. Since neither of those debt instruments is freely traded, we'll assume both are worth par, and thus the 4.25% convert level of 60 implies roughly \$360 million of value through the debt. If we want to justify holding the convert at this point, can we make a case that Exelixis is worth at least \$400 million?

Let's consider the assets. EXEL holds \$352 million of cash as of 2Q14. Earlier this year, EXEL management guided to a \$200 million cash balance by year-end 2014. However, EXEL announced a 70% workforce reduction along with the trial results, which will slow the cash outflows considerably. Even with the reduced burn, the existing cash (excluding the cash required to secure the SVB loan) will likely only last through 2015.

Sources & Uses	3Q14E	4Q14E	2015E	2016E	2017E	2018E	2019E
Beginning Cash	352	281	237	195	192	166	145
EBITDA	-59	-40	-120	-80	-20	25	75
Cash Interest Expense	-3	-3	-20	-21	-22	-18	-6
Debt/restructuring pmts	-8	0	0	0	-82	-127	-288
New Financing	0	0	100	100	100	100	200
Capex	-1	-1	-2	-2	-2	-2	-2
Change in Cash	-71	-44	-42	-3	-26	-22	-21

Secondly, it's often overlooked that cabo, branded name COMETRIQ, is already approved for the small indication (\$100 million peak) of metastatic medullary thyroid cancer (MTC) and generated \$6.6 million of sales in 2Q14. Assuming continued modest growth, the MTC indication might reach a \$40 million run rate next year, which translates to \$120 million in value at a 3x multiple.

Exelixis also has cobimetinib ("cobi") another drug in clinical trials for melanoma. Partner Roche recently announced positive data for cobimetinib in combination with its own drug, Zelboraf, and analysts generally assign a high probability of success for the program. While EXEL will have to split profits on cobimetinib, the opportunity could reach \$150 million in the US and potentially more longer term if the combination works in expanded indications, underscoring cobimetinib's significant strategic value to Roche.

Without prostate cancer, Exelixis has one major source of upside optionality, and perhaps only one chance for survival. This is the potential positive readout from the METEOR Phase 3 trial of cabo in renal cell carcinoma (RCC) sometime in 2015. EXEL management tailored its restructuring to conserve cash to reach this data. What are the chances for success? Some analysts have claimed that RCC is more likely to succeed from a scientific standpoint. Also, consider the difference in primary endpoints between the METEOR and COMET-1 trials. COMET-1 failed to show a difference in the primary endpoint of overall survival (OS), but did show a statistically significant benefit in progression-free survival (PFS), a key secondary endpoint. One theory is that doctors added other therapies to patients in the control group once they progressed, which helped them live longer and did not allow cabo to show an OS advantage. For METEOR, PFS is the primary endpoint. Whether or not the PFS success in mCRPC will translate to RCC is the key question, one that will have to wait until next year for an answer. One other trial with cabozantinib, a Phase 3 in hepatocellular carcinoma (HCC) is also enrolling, but results will not be available until 2017.

The above sources-and-uses table takes the optimistic view that METEOR succeeds, but if we consider the alternative scenario that METEOR fails in late 2015, then EXEL would likely find itself in a liquidation or distressed sale scenario. If we assume SVB takes the remaining cash to repay the term loan in full, EXEL will be left with very little cash. The debt at that point would consist of the \$104 million Deerfield notes and the \$288 million 4.25% converts (which the market is currently valuing at ~\$175 million).

Would COMETRIQ sales in MTC, cobimetinib, and a partially-enrolled HCC trial be worth enough to provide excess value above the market price to the convert holders? Possibly, but the converts appear to be fairly valued to us right now given the uncertainty. The price could fluctuate based on how much optionality value investors are willing to assign to the RCC trial and the possibility of monetizing the remaining market cap in a distressed capital raise.

Concur Technologies (CNQR) In Play – We Prefer the 0.5%

Roman Terekhin, CFA

When on Wednesday Bloomberg reported that Concur Technologies (CNQR) is in talks with SAP regarding a potential sale, CNQR stock rallied 10%. According to Bloomberg, CNQR had shopped itself around for some time and after approaching several industry majors settled on SAP as a potential suitor.

CNQR has two convertibles outstanding – the 2.5% senior notes due 2015 and 0.5% senior notes due 2018. The 2.5s are deep in the money and traded with around three points premium prior to the Bloomberg story. For arb accounts who had these set up on 100% hedge the total potential loss is therefore around three points. We would not blame investors for thinking of the 2.5% as a cheap put as the underlying credit is solid, there is call protection for life and the stock can be borrowed at top rate. Perhaps it was worth the takeover risk which is now being realized. Not pleasant but manageable. Moreover, in reality, the bonds came in less than a point, at least so far. We discuss why that might be later in the note.

The 0.5s, on the other hand, did not hurt hedged investors at all if they were on 65% hedge. Although the bond's point premium shrank, the gain on the bond and loss on the stock canceled each other out almost perfectly. In our calculations, we used bond prices of 115.25 vs. \$100.38 pre-announcement announcement and 121.50 vs. \$110 post (an extended-hours quote).

As mentioned earlier, the underlying went up around 10% on the news. If this is where the investors thought the deal would happen, the 0.5s were supposed to come in by 2.5 points on a 65% hedge. Instead, the current bond prices imply that market participants think that the company is in play and that the deal will happen at no less than a 30% premium. This means the takeover price will be at least \$130 or around eight times Bloomberg consensus revenue estimates for 2015. Not cheap but not an unheard-of valuation in the sector. Again, a takeover premium of 30% or more will make a 65% hedged position deliver a positive P/L. The bonds' takeover protection is therefore adequate in our opinion.

There is of course a chance that no deal will happen. In this case the bonds should go back to levels similar to those prior to September 3 (with an added benefit of an increased realized volatility of the underlying). This is perhaps what the holders of the 2.5s are betting on. The stock market is not convinced of a deal either. Otherwise, the stock would probably be up much more than 10%.

At the same time, if a deal were indeed to happen, a chance of an all-cash takeover is high. With potential price tag of under \$7bn, it is very much within the reach of an industry major. SAP, for instance has an equivalent of \$4bn in cash sitting on its balance sheet and easy access to capital markets. Also important is SAP's history of cash acquisitions, as well as the buzz that SAP is looking to expand its cloud presence.

We cannot predict if and at what price a deal might happen. However, a 30% premium and cash consideration sound plausible to us. Given this and the lower takeover risk in 0.5% we prefer these bonds to the 2.5%.

Tibco Software (TIBX) In Play: Bonds Probably Won't Care

Roman Terekhin, CFA

Continuing with the takeover theme, Tibco Software (TIBX) announced that it formed a board committee to explore strategic and financial alternatives. The market immediately assumed that those include a sale of the company and the stock subsequently advanced as much as 9%. We consider the potential sale scenario in this short note.

The 2.25% senior convertible notes due 2023 that the company has outstanding are currently trading just above par with parity in the mid 40's. The close-to-par price makes the yield to maturity and the current yield to be around 2%. We can see how investors might think this a good cash alternative: there is a par put in May of 2017 and the hard call protection extends to the same date making it at least theoretically possible for the stock to recover and deliver equity upside. The sale speculation makes the equity kicker scenario highly unlikely in case of an all-cash transaction. The latter in our view is entirely possible as TIBX's market cap is under \$4 billion.

The 2.25s indenture has a standard par put language in case of a fundamental change. This means that in case TIBX does find an interested buyer par will form the floor for the bonds. At the same time, no relevant amount of takeover protection will push parity over par. We therefore see no equity upside unless the buyer pays a most egregious premium. There may be a very little (emphasis on little) amount of upside if the credit of a combined entity is better than that of standalone TIBX. But with 2% YTM how much upside is really there?

Another scenario to consider is if the company fails to find a buyer. It may actually send a negative signal about the business to the market. It's hard to say how the stock or the bonds might react, but we doubt the reaction would be positive. At the same time, if the bonds remain outstanding, the almost two years of remaining call protection would—again, in theory—give renewed hope of equity upside to the holder.

Beside the outright sale of the company there of course can be other strategic steps that the company may take. Those may affect the credit positively (unlikely, if the objective is boosting the stock) as well as negatively but none of them is likely to deliver any meaningful upside for the bonds. With essentially no upside and potentially multiple points of (admittedly low probability) downside we do not find the bonds attractive at current levels.

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