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Hybrid Vigor

The Hillside Convertible Advisory Letter

Volume 1 Issue 14

Introducing HOCS:
The Hillside Overall Convertible Score

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Dear Friends,

Welcome to the first full week of unofficial fall. This is a big week for us at Hillside and Hybrid Vigor. Not only are we back on our regular twice-a-week publishing schedule, but we're introducing our comprehensive rating system, the Hillside Overall Convertible Score (HOCS). With HOCS we build on what we started with Hillside Adjusted Risk Points (HARP), developing new measures of risk and opportunity in the convertible market.

We've been thrilled with the market's acceptance of HARP as a means of identifying precarious bonds, but with HOCS we've embarked on a more ambitious project—a single number to rate a convertible's attractiveness. Risk, reward, relative performance, liquidity, market biases—we've tried to build them all, and more, into this number. As such, we expect to be refining the measure over time. We look forward to doing it with your help. Inside we provide HOCS ratings for last week's new issues and several other bonds.

You'll also find our regular Monday HARP Ugly 20 list, which contains a surprising development. In addition, Kent Bailey discusses the prospects of on one of last week's new deals, and Jeff Alton updates his June thesis on a convertible with an attractive entry point.

Meanwhile, our September 18 New York cocktail event approaches. Please advise us as soon as you can if you'll be attending or would like to attend. The party's designed to break up shortly after 8pm, just in time for Thursday night football. We look forward to seeing you next week!

Bill

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Nothing Lasts Forever But The Earth And Sky

Bill Feingold

Some records, they say, will never be broken. They, whoever they are, talk about Joe DiMaggio's 56 straight games with at least one hit, about trainer Woody Stephens' five consecutive Belmont Stakes, about Phil Jackson's 11 NBA coaching titles. Maybe even Bryan Cranston's four dramatic Emmys for being Walter White. You're g-----n right.

There was a quiet buzz in the convertible market that RPM International's 2.25% bonds would establish an unbreakable record for consecutive weeks atop our Ugly 20 list. But that buzz is dying down. The one main challenger to RPM, Lam Research's 1.25% "B" bonds of 2018, appeared to richen by a point and change last week on light volume, even as LRCX's volatility continued its long-term decline. Yes, sports fans, the impossible has happened--RPM is no longer the ugliest bond in the market, at least in the world according to HARP.

We mentioned in last week's issue that Citrix Systems' 0.5% convertibles, the multi-point beneficiary of an unsolicited investment-grade rating, would not only be on the list but near the top if not for a smoothing adjustment in our volatility inputs. Intrigued, we analyzed the spread between long and medium-range volatility in our universe. Unsurprisingly, Citrix had by far the biggest spread--an ominous hint for owners of long-term Citrix optionality. We'll be surprised if the Citrix 0.5% aren't among the leaders of the Ugly 20 next year. Citrix's current HARP score of 8.48 is only good enough for honorable mention.

Based on that analysis, here are five other names whose current pricing may not be capturing negative volatility trends--in other words, future candidates for the Ugly 20 list. Several of these names have already appeared on the list.

- PFPT 1.25% of 2018 (Current HARP 8.46)
- SPNC 2.625% of 2034 (8.38)
- CNQR 0.5% of 2018 (8.12, discussed by Roman Terekhin recently in Hybrid Vigor)
- MDCO 1.375% of 2017 (7.89)
- NUVA 2.75% of 2017 (7.81)

Anyway, congratulations—if that is the right word—to owners of Lam Research's 1.25% for taking the top spot this week. If the stock delivers a few more years of strong growth, the bonds' excess premium will be forgotten. In any other scenario, the bonds will be sorely disappointing—especially if the stock falls by about 12% between now and maturity, bringing parity down to par. That would be a 27% decline for the bonds. Ouch. Potential underperformance like that for bonds well above par, but still loaded with premium, is why we created HARP.

A final note. Two seemingly attractive names on this week's list, SanDisk 0.5% and Alon USA Energy 3%, are on the list because of their dividends—something easily underrated and occasionally forgotten when it comes to optics. SanDisk, after falling off the list, has climbed its way all the way to the Top 5. Without its dividend—which is three times the bond's current yield—SanDisk would be just an honorable mention, a bit behind Citrix. Alon USA, meanwhile, would be one of the most attractive bonds in the universe. Just saying…

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Hillside Ugly 20 List (Prices as of September 5, 2014)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	Lam Research 1.25% 2018-05-15	136.75	71.97	19.4	22.22	15.42
2	RPM International Inc. 2.25% 2020-12-15	117.00	47.33	30.8	27.55	14.56
3	Helix Energy Solutions 3.25% 2032-03-15	133.25	26.51	25.9	27.41	11.77
4	Lam Research Tranche A 0.5% 2016-05-15	128.25	71.97	12.0	13.74	11.02
5	SanDisk Corp 0.5% 2020-10-15	122.00	98.79	13.9	14.89	11.02
6	Incyte Corp Tranche 1 0.38% 2018-11-15	126.50	51.83	26.3	26.34	10.76
7	On Semiconductor Corp 2026-12-15	119.00	9.88	26.6	25.00	10.66
8	CSG Systems 3% 2017-03-01	129.00	27.41	11.8	13.62	10.31
9	Priceline.com 0.35% 2020-06-15	115.25	1195.02	26.7	24.29	10.11
10	NVIDIA Corp 1% 2018-12-01	115.25	19.97	16.4	16.24	9.95
11	Standard Pacific Corp 1.25% 2032-08-01	120.00	8.18	18.5	18.73	9.72
12	Salesforce.com 0.25% 2018-04-01	115.75	59.81	28.7	25.81	9.62
13	Chart Inds 2% 2018-08-01	120.50	64.80	28.4	26.65	9.42
14	Sunpower Corp 0.88% 2021-06-01	117.75	38.94	47.5	37.92	9.42
15	Incyte Corp 1.25% 2020-11-15	127.00	51.83	26.7	26.76	9.35
16	Workday Inc 0.75% 2018-07-15	127.75	90.07	18.1	19.58	9.04
17	Alon USA Energy Inc 3% 2018-09-15	128.50	16.38	16.0	17.72	8.91
18	Altra Holdings Inc 2.75% 2031-03-01	134.00	33.20	8.8	10.84	8.86
19	Healthsouth Corp 2% 2043-12-01	113.75	39.05	14.4	14.32	8.82
20	Ryland Group Inc 1.63% 2018-05-15	131.25	36.55	15.0	17.12	8.67

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Looking For Attractive Convertibles? Get Into HOCS!

Bill Feingold

We designed our first proprietary measure, HARP (Hillside Adjusted Risk Points), to highlight the risks of a soaring and supply-constrained market. We wanted to find a way to capture the sneaky danger of bonds trading well above par with premiums more typically associated with far lower prices. With HARP, we tried to blend theory and practice, acknowledging that bonds can trade well above theoretical valuations, and focusing on the price points where this richness can endanger investors.

The response has exceeded our expectations. Readers have generally "agreed" with most of the constituents of our Ugly 20 list, while challenging some of the names. This is exactly as it should be.

Ultimately, though, they call it the "buy side" for a reason. It's not enough to identify rich bonds—you have to find places to put money to work. We know that, of course, having done it ourselves for many years. We've been working on a comprehensive rating system for convertibles for the better part of this year, and while we still have work to do—both with the system itself and our ability to generate rankings more expeditiously—we thought we were close enough to start sharing our work. We especially wanted to do this now, while we still have some time in our "beta" production period, and as the market seems likely to get a lot of new issuance.

Please say hello to version 1.0 of the Hillside Overall Convertible Score ratings, or HOCS. We'll try to provide HOCS scores for selected bonds and most new issues as we work on refining the measure and our process. You'll see several references to HOCS sprinkled throughout this issue. HOCS, like HARP, tries to blend theory and practice. A bond that models rich but trades near par will likely score better than a more theoretically attractive bond at a less desirable price point. We've tried to combine most of the ingredients that go into traditional models with some of our own ways of quantifying some of the "soft" attributes that can help or hurt convertible performance.

We've designed HOCS on a 0-100 scoring system. But this isn't the Series 7. With HOCS, 70 is an outstanding score, while 50 is supposed to be roughly average. Of the bonds we've evaluated so far, Tesla's two new issues rank among the highest—recent scores were 70 for the 0.25% and 74 for the 1.25%. We expect the least attractive bonds to score in the 20s and 30s—our old friend RPM International checks in with a 21. Even though Lam Research's 1.25% eclipsed RPM on the Ugly 20 scale this week, it gets a much better—though still quite poor—HOCS of 31 mostly because of its superior upside. In the kingdom of the blind, as they say.

Looking at last week's new issues, Depomed scored the best with an excellent 67 as priced, while Clovis was right behind with a 66. Electronics for Imagining and Huron each checked in with a marginally positive 53. The recent Priceline deal got a 49 at par and a 51 as reoffered.

We look forward to developing HOCS further with your thoughts, questions and suggestions, and we hope they become a useful resource for you. More to come.

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Restoration Hardware Gets Hammered, but Investors May Not Get Screwed

Jeffrey Alton, CFA

If you are a value investor, stop reading this immediately because Restoration Hardware (RH) is not for you – even after the recent price decline. It just doesn't fit in your portfolio, and we bet even the tagline "Restoration Hardware is a curator of design, taste and style in the luxury lifestyle market" leaves you rolling your eyes. Everyone else please continue because Restoration Hardware is the kind of quality company that you want to own. Iit is just a matter of the price one is willing to pay.

The market seems to be having that very price debate with itself. After beating earnings estimates by a significant margin in the first quarter, Restoration Hardware stock leaped from $70 on June 11 to a high of $94.50 per share three weeks later. Since then the market has begun to reconsider the valuation. Last week competitor Williams-Sonoma guided below 2014 estimates and management commented on a highly promotional environment in the second quarter which they expect to continue. That loss of momentum was enough for RH investors who saw guilt by association, and RH blew through its 50-day moving average of $85.44, dropping 7% to $81.50. The 200-day moving average of about $71 provides support.

The price of the convertible security has also fallen along with the stock. After nearing 104 on June 30, the convert stands around 96 1/2 today. That gives this zero-coupon bond a yield-to-maturity of 76 basis points, so the buy-and-hold investor is still relying on stock appreciation for any meaningful return. Shorter-term traders will be focused on Restoration Hardware's Wednesday, September 10 second quarter earnings report.

Even factoring in the most recent price decline, Restoration Hardware's stock price is not cheap. Consensus estimates for fiscal 2015 of $2.31 and for fiscal 2016 of $2.91 result in P/E ratios of 35.4 and 28.08 respectively. Enterprise value to trailing EBITDA is 21.73. Continued sales momentum is necessary to support that type of valuation.

However, management believes its long-range targeted annual revenues of $4.5 billion to $5 billion can be achieved under its current business plan, up from about $1.55 billion last year. If the company can continue its 20% annually growth rate, that goal could be realized sometime just around the time that the convertible bond matures.

Restoration Hardware's strategy clearly cuts against the grain, building out much larger stores and mailing out thick catalogues totaling 3,300 pages across 13 Source Books sent each year. This old-school approach seems to be working; Q1 revenues were up 22% year-over-year on top of 30% revenue growth in 2013.

Given the company's success, the recent pullback in price provides an entry point for the buy and hold investor. As for this week's earnings report, Williams-Sonoma's guidance seems to have shaken out most of the recent froth in Restoration Hardware, so any upside surprise could be a catalyst for a return to recent share price highs.

Convertible Score and Evaluation

Despite its lack of current income, Restoration Hardware gets a 65, one of the higher grades in our preliminary Hillside Overall Convertible Score (HOCS) ratings. HOCS are calibrated so that 50 should be considered a point of indifference on the bond. While scores can theoretically approach 100, in practice the most attractive bonds will probably score in the 70s and 80s, while convertibles screaming "avoid me" usually fall in the 20s and 30s.

The RH zeros get a balanced rating--66 for safety and 64 for growth--adding to their appeal.

Please remember that our first proprietary measure, HARP, is designed primarily as a warning signal for identifying bonds susceptible to loss from falling stock prices and time decay. HOCS, by contrast, is a more comprehensive measure that should help find attractive convertibles. We will be putting the finishing touches on HOCS over the next two months (of course, we will always be looking to improve our measures), but we thought the time was right to begin sharing the ratings with you now.

Further Comments on New Depomed Issue

Kent Bailey, CFA

Last week we had quick summary comments on the new Depomed issue. Today we provide further insight from Kent Bailey, who runs our credit research and specializes in health-care names. We note that Depomed scored a very healthy 67 on our preliminary Hillside Overall Convertible Score (HOCS) rating as originally priced, and still scores 65 (the scale is designed for 50 to be average) after its initial appreciation.

Depomed is a specialty pharmaceutical company focused in the central nervous system (CNS) and pain management spaces. The company's strategy is to acquire underpromoted or undervalued niche products and leverage their existing 155-person sales force. Management has repeatedly highlighted Depomed's aggressive posture towards business development in recent quarters, so it is highly likely that one or more transactions will be completed this year. Combined with $224 million of cash at the end of 2Q14, the proceeds from the upsized $300 million convertible senior notes offering last week form a substantial acquisition war chest for Depomed. With the stock bouncing back sharply following a much-improved 2Q earnings report relative to 1Q, the timing of the deal makes sense.

Depomed's product lineup consists of Gralise for postherpetic neuralgia (after-shingles pain), Zipsor, a prescription non-steroidal anti-inflammatory drug (NSAID) for acute pain, Cambia for migraines, and Lazanda, a fentanyl nasal spray for breakthrough cancer pain. Weakness in the first quarter of this year in Gralise and Zipsor related to poor weather and wholesaler inventory destocking. However, results improved substantially in the second quarter, giving investors confidence that each product continues to grow solidly. Depomed's strategy is reminiscent of Cephalon, a serial convertible issuer of days past, in that both aimed to create value by increasing the number of sales reps detailing acquired products, taking price increases where possible, and strengthening IP.

Management guided to $115-125 million in product sales for 2014, but indicated that cash flow will likely be only slightly better than breakeven. Given this model, Depomed should be able to substantially leverage its SG&A expense through existing product growth and new acquisitions. Assuming a 3x sales multiple for future transactions, Depomed's cash hoard can easily finance a doubling of the company's revenue base. Since Depomed maintained a sizable cash balance and no debt prior to the convertible deal, the offering may indicate that management is considering multiple product acquisitions or one transaction larger than the company has done historically. Owning the Depomed convertible outright is a bet on management's ability to execute accretive deals and grow the acquired products, but investors should be comforted that many spec pharma companies have successfully followed this model in the past, including many top performing convertible issuers of recent years.

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