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September 11, 2014

Hybrid Vigor

The Hillside Convertible Advisory Letter

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Remember

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Dear Friends,

Today calls for quiet remembrance.

We also talk about the new Twitter deals and update several names we've discussed previously: Exelixis, Navistar and Restoration Hardware.

We look forward to seeing you at our cocktail party next week. If you still need an invitation, please contact us.

Bill

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9/11 Tribute

Bill Feingold

We join our friends inside and beyond the financial community in remembering those who died 13 years ago.

I lost a number of friends and acquaintances that day. Without intending any disrespect or lack of attention to any 9/11 victims, two that hit me the hardest were Greg Trost and Brad Hoorn. Greg grew up in the Dobbs Ferry house my family has called home for over 17 years—his bedroom belongs now to my older daughter. We had met him when we bought the house in 1997. He was working as an analyst for Keefe, Bruyette and Woods that fateful day. He was a spirited, happy and outgoing young man.

Brad Hoorn's death cut me deep. My friend and former boss Sky Lucas and I taught a seminar at Yale, our alma mater, in the fall of 1999 and 2000. Brad was our student—our best student—in the 2000 edition. He would get perfect scores on assignments and then ask great questions about other ways to approach the problems we assigned. He contributed regularly, quietly but insightfully, to our class discussions. He was a joy to teach.

Brad was working for Fred Alger Management in the North Tower. David Alger, who also died that morning, was the first person ever to offer me a full-time job. I've been filled with a mix of pride that what Brad learned in my class helped him start his career and misplaced guilt that I unwittingly directed him to his death. In any event, Sky and I started a modest teaching foundation in Brad's honor at Yale. It was the very least we could do.

Some of my memories of the day itself: I was working in downtown east. The phone rang that morning. "Bill!," my wife, who was in the Travelers building about nine or ten blocks north of the WTC. "A plane just crashed into the World Trade Center." I yelled it out to everyone on our small trading desk at Clinton Group. We went pretty much silent, dazed and confused. Then a loud boom shook us. We flocked to founder George Hall's office (the only TV at Clinton then) and watched replays. "That," my boss Mike Vacca said, "was not a mistake."

Minutes later we were walking down the stairs. Chris Sferruzzo, my clerk at the time, and I began walking north. He pointed to the burning buildings and we kept walking. We arrived at the corner of Bowery and Park Row and were waiting for the light to change when Chris screamed, "Billy, the building's collapsing." I turned and watched in horror—from that particular spot we had a virtually unobstructed view. We could see the floors disappearing one at a time into a cloud of smoke. "Run, Billy, the smoke is going to kill us," Chris said. In loafers with bad knees, I couldn't run much, but thankfully the smoke turned east and diffused as we headed north.

We reached my grandmother's apartment in Greenwich Village, where we heard people talking about the other crashes. We watched TV there for several hours, the awful burning smell reaching us. My grandmother tried to feed us—that is what Jewish grandmothers do—but we had no appetite. A couple of hours later my wife, who'd been unable to reach me, called my grandmother and I answered the phone. She had just checked our home phone, where we had a message from her doctor. We would have a healthy daughter in five months—February 11, in fact, as it turned out. On that horrible day we got wonderful news, death and birth together.

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September 11, 2014

New Issue Analysis: Twitter (TWTR)

Bill Feingold

We've been pleading all year for high-flying tech companies to tap the convertible market. Maybe somebody retweeted one of our articles to the right place, because Twitter listened.

We don't love the optics of the new Twitter bonds, but now that we've gotten past that, we actually like the bonds quite a bit, especially the longer tranche. On our preliminary HOCS (Hillside Overall Convertible Score) scale, we have scored the 2019 tranche a 65 and the 2021 edition a 70, assuming midpoint pricing. Remember, while the scale is from 0 to 100, 50 is an indifferent score, 60 is pretty good, and 70 is excellent. (It's not like one of those schools—we're not naming any names—where you get a 70 for showing up, an 80 for writing your name on your test, and a 90 for spelling it right).

In the sub-scores, the 2019 tranche gets 62 for Safety and 67 for Growth. The 2021 piece, meanwhile, receives a 59 for Safety and a 76 for Growth.

Some readers are probably scratching their heads how a debt security from a money-burning company can get such respectable safety ratings. There are several reasons, but the biggest by far is simple: market capitalization. Twitter's market cap is over $30 billion, while the convertibles in aggregate will only be about 5% of that. I've long felt that convertibles should be ideally no bigger than 20% of the underlying stock's market cap—that way, even if the stock gets cut in half, there's a reasonable equity valuation to be used as a basis for dilutive financing to get the convert holders paid off.

Needless to say, some people—particularly strict adherents to GAAP accounting—won't touch the Twitter convertibles. They're probably missing out on a good trade. Twitter is exactly the kind of company that should be issuing convertibles in a win-win situation. Good for the company, monetizing its equity valuation and selling extremely low-coupon debt when (because of its accounting losses and cash burn) it probably couldn't tap the straight public debt markets at any decent price. Good for investors because the big market capitalization—which makes buying the stock very risky—actually turns into a key asset.

Twitter figures to be around for a long time—say what you will about the company, it's a game changer. It's not hard to imagine the stock doubling, tripling, quadrupling over time, all of which would lead to a nice payday for convertible holders. It's also not hard to imagine the stock breaking down to a fraction of today's valuation, perhaps leading to an acquisition by a deep-pocketed Internet cousin. As we said, Twitter is a great convertible issuer.

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September 11, 2014

Restoration Hardware (RH): Follow-Up

Bill Feingold

With our regular Restoration Hardware analyst, Jeff Alton, away on family business, we wanted to comment briefly on last night's earnings. With a solid bottom line but disappointing revenues, this momentum-ish name has accelerated its selloff. We liked 97 as an entry point on the bonds and like 94 ½ even more, with the stock trading around $78. In a market filled with high-HARP (Hillside Adjusted Risk Point) bonds subject to a mix of time decay and delta loss, we think this name provides good portfolio balance, along with respectable upside potential in a stock turnaround.

The RH 0% now scores a 64 on our preliminary HOCS (Hillside Overall Convertible Score) scale, where 50 is an indifference point and 70 is an excellent score. The bond now gets 71 for Safety and 60 for Growth. Pre-earnings, we had rated the bond a 65 overall, with sub-ratings of 66 for Safety and 64 for Growth. The lower overall score reflects our reduced growth expectations, while the reduced price point gives a bit more of a safety cushion.

Jeff will have further comments when he returns.

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September 11, 2014

Navistar International, Inc. (NAV)

Jeffrey Alton, CFA, and Kent Bailey, CFA

We wrote favorably about Navistar's turnaround in early July and believe recent third quarter results indicate that progress is still on track.

Earnings Scorecard:

Revenue in $ millions

	Actual 7/31/2014	Consensus Estimate 7/31/2014	Percent Difference Act. V. Est.	Previous Year Actual 7/31/2014	Percent Change Y-O-Y
Revenue	$2,806	$2,950	-4.88%	$2,820	-0.50%
Adjusted EPS	($0.02)	($0.67)	97.00%	($3.06)	99.30%

While Navistar missed revenue estimates by almost 5%, the company reported an impressive two cent loss per share versus estimates of a ($0.67) loss.

Convertible Bond Comments

While we think Navistar's convertibles have a nice blend of income and upside, they don't score especially well on our preliminary HOCS rating mostly because of the company's debt load. The 4.75% bonds get an overall HOCS score of 44, with a Safety score of 27 and Growth of 53. The 4.5% bonds score marginally better, with 45 overall, Safety of 29 and Growth of 53.

Quarterly Earnings Highlights

Overall, Navistar exhibited continued progress in its quest to right the ship after its disastrous quality control problems of the past. Management has persistently improved vehicle and engine quality and reduced operating costs.

The list of positives during the recent quarter was impressive. Navistar reported income from continuing operations before income taxes of $21 million, the first positive number since 2011. EBITDA for Q3 was $133 million, beating guidance of $75 million to $125 million. Warranty expenses continue to fall, down 22% year-over-year in Q3 2014 and down 14% sequentially from Q2. These improvements put the company in a position to meet its long-term goal of 8% to 10% EBITDA margins at the end of 2015.

However, flat quarterly revenue versus Q3 2013 in a domestic market gaining strength does indicate that there is more work to be done. Navistar had forecasted a 21% increase in its run rate by year end, but now expects to be one or two percentage points below that. Executives say Navistar will continue to win back market share over time, but believe customers are taking longer than anticipated to evaluate Navistar's new products before committing a larger part of their fleets.

The company's Brazilian engine unit and its domestic US military business units also continue to be a drag on performance.

Outlook

Category	New Q4 Guidance	Previous Q3 Guidance
Class 8 Industry 2014 Forecast	235,000 – 240,000 units	225,000 – 235,000 units
Structural Cost Savings	$300 million	$250 million
Quarterly EBITDA	$115 to $165 million	$75 to $125 million
Cash & Cash Equivalents	$1.0 to $1.1 billion	$950 million to $1.05 billion

We believe that Navistar will ultimately be successful in reducing costs and right-sizing operations. However, a bigger challenge will be to win back market share in order to significantly improve the bottom line and de-leverage the company over time. Other companies such as Paccar and Daimler are in a better financial situation to compete, making the task more difficult.

Sources & Uses	2014E	2015E	2016E	2017E
Beginning Cash	**1,100**	**584**	**662**	**1,325**
Revenue	*10,850*	*12,480*	*12,854*	*13,240*
EBITDA	**51**	**499**	**1,093**	**1,258**
Cash Interest Expense	-321	-321	-310	-300
Debt Repayment	-166	0	0	0
Capex	-80	-100	-120	-140
Change in Cash	**-516**	**78**	**663**	**818**
Ending Cash	**584**	**662**	**1,325**	**2,143**

Sources: Company Filing; Hillside Estimates

Investors should have a more definitive answer regarding market share gains over the next couple of quarters as Navistar customers move from the evaluating Navistar's redesigned products to increased orders. Navistar won the 2014 Heavy-Duty and Medium-Duty Truck of the Year awards at the American Truck Dealers convention last January, and we think this is indicative of a new emphasis on design that will allow the company to meet market share goals.

Valuation Comments

The stock was up after the earnings report, trading over $40/share for a short period on price-target increases until the market pulled back as a whole. For now though, equity markets appear to have digested the potential of a Navistar turnaround story and are now looking for hard numbers, including increased revenues and market share gains, before rewarding investors with a meaningful higher valuation. That should come in the next few quarters.

Navistar stock has support at the 50-day moving average of $37 and 200-day moving average of $36.30.

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September 11, 2014

More value may be available in the company's bonds. While the bonds are trading at firmer prices than Standard & Poor's CCC- rating on Navistar's debt would indicate, the bonds should have room to appreciate as Navistar's turnaround continues to unfold.

Period	6/30/201	Debt		Net Debt		Interest Expense Analysis	
LTM EBITDA	1,100						
NAV stock price 9/10/14	$39.08		EBITDA	Net	EBITDA		
		Debt	1,100	Debt	1,100		
	Balance	O/S	Multiple	O/S	Multiple	Coupon	Cash Int
Cash/ST Investments	1,165						
Sr Secured Debt							
Senior Secured Term Loan 5/17	693					3.00%	20.8
Financed Lease Obligation Guarantees	195					0.00%	0
Capital Leases	52					0.00%	0
	940	940	0.9	-225	-0.2		
Sr Unsecured							
8.25% Senior Notes 2021	1,200					8.25%	99
Promisory Note	13					3.00%	0.4
6.5% Tax Exempt Bond Notes	225					6.50%	14.6
	1,438	2,378	2.2	1,213	1.1		
Sub Debt							
Other	35					n/a	
Dealership Debt	34					5.50%	1.9
3% Cvt Sub Notes 4/19	166					3.00%	5
4.5% Cvt Sub Notes puttable 5/21/06	200					4.50%	9
4.75% Cvt Sub Notes 4/19, 4/17 call	411					4.75%	19.5
	846	3,224	2.9	2,059	1.9		170.2
Common Stock (Mkt.)	3,181	6,405	5.8	5,240	4.8	Shares O/S	81.4

Sources: Company Filing; Hillside Estimates

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September 11, 2014

Morgan Stanley Healthcare Conference Notes 9/8-9/10/14: Exelixis (EXEL) update

Kent Bailey, CFA

EXEL management presented on Tuesday in their first appearance before investors since the COMET-1 disappointment last week. Not surprisingly, the focus remained on cabozantinib ("cabo"), Exelixis' lead molecule, both in adding color around the prostate trial failure and reiterating the company's focus on the Phase 3 METEOR trial of cabo in renal cell carcinoma (RCC). Regarding COMET-1 in metastatic castrate-resistant prostate cancer (mCRPC), CEO Michael Morrissey confirmed that cabo had performed in-line with expectations on the primary endpoint of overall survival (OS) at 11 months. However, the control arm out-performed expectations, generating over 9 months of OS versus the 7 months Exelixis had modeled. As discussed previously, this surprise may be related to physicians adding therapies (such as recently approved prostate cancer drugs Zytiga and Xtandi) to control patient regimens once they initially progressed.

While some investors believe in the small possibility that cabo will have utility in prostate cancer if the Phase 3 COMET-2 pain palliation trial reads out favorably, the CEO effectively quashed that hope, indicating that a path forward in mCRPC is unfeasible from a regulatory perspective, regardless of the outcome of COMET-2. Instead, EXEL has shifted its focus completely to the METEOR trial, due to read out in sometime in 2015. For a bit of background on METEOR, cabo is being tested in 2nd line RCC, a patient population for which numerous approved drugs are currently used, but none of which offers progression-free survival (PFS) performance better than 5 months. By contrast, cabo showed PFS of 13 months in a Phase 2 trial in 3rd/4th/5th line RCC patients (read: sicker patients). That result comes with considerable caveats, though, as the Phase 2 was an open-label, single-arm trial and many oncology drugs in the past have had trouble translating excellent early stage results to larger, controlled Phase 3 trials. In METEOR, cabo will hit statistical significance if the drug arm reaches 7.5 months PFS vs. 5 months for control, which management hopes will give cabozantanib a substantial performance cushion. Replicating the Phase 2 results would be considered a huge win, although investors remain skeptical that cabo can compete successfully in a crowded RCC marketplace.

The next key piece of news for Exelixis will likely be the announcement of full Phase 3 data from the coBRIM trial (EXEL's Roche-partnered drug cobimetinib ("cobi") in combination with Zelboraf in a subset of melanoma patients) at the European Society of Medical Oncology meeting in late September. Cobi is a key wildcard in the valuation of EXEL stock and converts, given that, in addition to coBRIM, cobi is in early stage combination trials with several other types of oncology drugs and its full market opportunity is not yet known. However, with a dwindling cash balance and a large debt burden, EXEL will likely face solvency issues before the potential of cobimetinib becomes clear. Management thus faces the quandary of selling cobi now to shore up its balance sheet (and possibly selling it too cheaply) or betting the company on the outcome of the METEOR trial and hoping to raise cash following positive results. In response to a direct question, management indicated they will definitely be taking the latter course and will not be monetizing cobi at this time. While cobi value could be more than enough to pay off the converts, the negotiating position of management will be comprised should METEOR fail and the ability to extract that value could be in question.

Finally, it appears very likely the Exelixis will exercise the option to extend the Deerfield debt to 2018. The step-up combined coupon of 15% (7.5% cash + 7.5% pay-in-kind (PIK)) is quite hefty, but what other choice do they have? EXEL must make a decision by March 2015 and it is unlikely positive data from METEOR will read out before then. Perhaps the ESMO cobi data will provide a boost and expand EXEL's financing options, but management body language suggests an aversion to dilution at these levels. The CEO danced around all questions related to debt restructuring, so it's more likely at this point that EXEL is going all-in on the METEOR trial. Good luck and godspeed.

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