HILLSIDE ADVISORS LLC

September 15, 2014

Hybrid Vigor

The Hillside Convertible Advisory Letter

Volume 1 Issue 16

HARP and HOCS: A Convertible Brew

HILLSIDE ADVISORS LLC

September 15, 2014

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Dear Friends,

We hope the first full week back treated you well. The market got a bit choppy last week—we address this in an extended version of our regular Monday Hillside Ugly 20 recap.

We also provide, in response to reader requests, more of an explanation of the similarities and differences between our two proprietary measures to date, HARP (Hillside Adjusted Risk Points) and HOCS (Hillside Overall Convertible Score). We are now providing HOCS data with each name we discuss at length in Hybrid Vigor. Eventually we intend to provide more comprehensive HOCS listings.

In this issue we feature Kent Bailey's update on BioMarin, including some perhaps overlooked reasons to focus on the name right now. We also feature Jeff Alton's comments on UTi Worldwide—Jeff explains why it's not too late to get in despite a recent pop.

We hope to see many of you at our cocktail event this Thursday. We're expecting an excellent turnout, but if you'd like to attend and haven't received an invitation, it's not too late to let us know.

Bill

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September 15, 2014

An Ugly Week for the Ugly 20

Bill Feingold

In reviewing the data for today's installment of the Hillside Ugly 20 we noticed two things.

The first was that RPM International didn't stay out of the top for long. By a very narrow margin--.05—RPM has reclaimed its rightful title as the ugliest bond in the convertible market.

But we also noticed that HARP scores were falling in general. Indeed, the average score on the list fell by more than half a point—indeed, even RPM saw its HARP score decline by .76. It's just that its conqueror, Lam Research 1.25%, took a beating, falling by 1.67. This came after an unusual expansion, on light volume, in LRCX's price the previous week.

We went back to some old-school dollar-neutral analysis and looked at the 17 names that made the list both weeks. The average underlying stock declined 2.38%, and we'd have expected the average bond to fall 1.44%. In fact, the decline was 2.03%. It strikes us that the 15-basis point backup in rates and the 10% gain in volatility (measured by VIX) should have more-or-less offset: if anything, given the average price in the low 120's, we'd have thought volatility picking up should have a greater effect, at least in theory. But for the most part, it didn't.

More likely, outrights didn't like the way the market felt and started selling off names they had bid up to unsustainable premiums. That looks to have been the case not just with Lam but other "darlings" including Helix Energy Solutions and the dotcom siblings, Priceline and Salesforce.

In addition to our regular Ugly 20 chart, we've provided this analysis of the 17 names that carried over and how they did in a fairly poor week for general performance.

We remind readers that HARP is designed to prepare investors for exactly this kind of week—where bonds are likely to perform badly not just in absolute terms but also relative to expectations. Reviewing porfolios to cut back on high-HARP positions is a good way to reduce exposure to drawdowns.

The only name that really bucked the trend, interestingly, was Alon USA Energy, which moved all the way from 17th on the list to 11th. We recently mentioned that a reader wrote in complaining about ALJ's presence on the list, saying he felt the bond looked attractive. We conceded that optically it did, but that the HARP calculation penalized it for its relatively high dividend yield. Be that as it may, ALJ's 3% convertibles—which seem to have a bigger following in the relative-value crowd than most other Ugly 20 bonds, save perhaps Sandisk 0.5%--outperformed their peers in last week's downturn.

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September 15, 2014

Hillside Ugly 20 List (Prices as of September 12, 2014)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	RPM International 2.25% 2020-12-15	115.50	46.64	31.1	27.40	13.80
2	Lam Research 1.25% 2018-05-15	133.75	71.65	17.2	19.63	13.75
3	SanDisk 0.5% 2020-10-15	121.50	98.97	13.2	14.17	10.70
4	Helix Energy 3.25% 2032-03-15	126.50	24.98	26.7	26.66	10.49
5	CSG Systems 3% 2017-03-01	126.50	26.60	12.3	13.86	10.29
6	On Semiconductor 2026-12-15	117.00	9.64	27.4	25.16	10.07
7	Lam Research 0.5% 2016-05-15	125.75	71.65	10.2	11.64	9.61
8	Incyte 0.38% 2018-11-15	120.75	48.72	28.2	26.56	9.53
9	Alon USA Energy 3% 2018-09-15	125.50	15.66	18.5	19.59	9.49
10	Chart Inds 2% 2018-08-01	120.25	64.83	28.1	26.38	9.31
11	Standard Pacific 1.25% 2032-08-01	117.75	8.00	18.9	18.72	9.26
12	Priceline.com 0.35% 2020-06-15	112.75	1163.94	27.4	24.25	9.09
13	Griffon 4% 2017-01-15	113.50	12.30	34.4	29.05	9.01
14	NVIDIA 1% 2018-12-01	112.25	19.12	18.3	17.36	8.98
15	Incyte 1.25% 2020-11-15	122.00	48.72	29.7	27.94	8.89
16	Sunpower 0.88% 2021-06-01	116.25	38.07	48.8	38.13	8.86
17	Salesforce.com 0.25% 2018-04-01	114.25	59.25	28.0	24.99	8.85
18	Workday0.75% 2018-07-15	128.00	91.29	16.8	18.41	8.65
19	Brookdale Senior Living 2.75% 2018-06-15	133.00	33.29	17.1	19.42	8.61
20	Take-Two Interactive 1% 2018-07-01	125.75	23.53	15.1	16.50	8.58

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September 15, 2014

Recapping An Ugly Week

		Previous Week's HARP	Latest Week's HARP	Stock Change	Exp'd CB Chg (%)	Actual CB Chg (%)	Actual - Expected (Pts)	HARP Change	HARP Change %
1	Lam Research 1.25% 2018-05-15	15.42	13.75	-0.44%	-0.31%	-2.19%	-2.58	-1.67	-10.81%
2	RPM Int'l 2.25% 2020-12-15	14.56	13.80	-1.46%	-0.77%	-1.28%	-0.60	-0.76	-5.19%
3	Helix Energy 3.25% 2032-03-15	11.77	10.49	-5.77%	-3.36%	-5.07%	-2.27	-1.28	-10.84%
4	Lam Research 0.5% 2016-05-15	11.02	9.61	-0.44%	-0.36%	-1.95%	-2.04	-1.41	-12.76%
5	SanDisk 0.5% 2020-10-15	11.02	10.70	0.18%	0.14%	-0.41%	-0.67	-0.32	-2.90%
6	Incyte Corp 0.38% 2018-11-15	10.76	9.53	-6.00%	-3.41%	-4.55%	-1.43	-1.23	-11.44%
7	On Semi 2.625% 2026-12-15	10.66	10.07	-2.43%	-1.39%	-1.68%	-0.34	-0.59	-5.55%
8	CSG Systems 3% 2017-03-01	10.31	10.29	-2.96%	-2.33%	-1.94%	0.51	-0.02	-0.15%
9	Priceline.com 0.35% 2020-06-15	10.11	9.09	-2.60%	-1.49%	-2.17%	-0.78	-1.02	-10.08%
10	NVIDIA 1% 2018-12-01	9.95	8.98	-4.26%	-2.99%	-2.60%	0.45	-0.96	-9.68%
11	Standard Pacific 1.25% 2032-08-01	9.72	9.26	-2.20%	-1.51%	-1.88%	-0.44	-0.46	-4.69%
12	Salesforce.com 0.25% 2018-04-01	9.62	8.85	-0.94%	-0.52%	-1.30%	-0.89	-0.78	-8.07%
13	Chart Inds Inc 2% 2018-08-01	9.42	9.31	0.05%	0.03%	-0.21%	-0.28	-0.11	-1.17%
14	Sunpower Corp 0.88% 2021-06-01	9.42	8.86	-2.23%	-0.78%	-1.27%	-0.59	-0.56	-5.92%
15	Incyte Corp 1.25% 2020-11-15	9.35	8.89	-6.00%	-3.32%	-3.94%	-0.78	-0.46	-4.96%
16	Workday 0.75% 2018-07-15	9.04	8.65	1.35%	0.95%	0.20%	-0.97	-0.38	-4.25%
17	Alon USA Energy 3% 2018-09-15	8.91	9.49	-4.40%	-3.09%	-2.33%	0.97	0.57	6.41%
	Averages	10.65	9.98	-2.38%	-1.44%	-2.03%	-0.75	-0.67	-6.00%

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September 15, 2014

HARP vs HOCS—Brewing Our New Convertible Measures

Bill Feingold

We met with a wisecracking reporter for a leading hedge-fund publication last week. "HARP, HOCS, sounds to me like you guys are brewing beer," he said, by way of requesting an explanation of the differences between the two proprietary convertible measures Hillside Advisors has developed thus far.

It's really pretty simple.

HARP

We designed HARP to measure exposure to a blend of premium decay and stock declines. We felt that market conditions—a strong bull market in equities and a convertible market starving for new paper—had led to a large population of convertibles trading well above par but with premiums more appropriate for new issues. In this light, we felt many bonds were prone to underperformance both in absolute terms and relative to the underlying shares.

Bonds with the highest HARP scores tend to fall in the 120's, where there is substantial distance from the "par halo" but premiums are often nearly as high as at issuance. HARP does not focus on credit risk. As such, HARP is not a suitable measure for bonds trading near or below par. But it has already proven its worth for ranking bonds in need of a premium reduction given their price points.

Hedge funds may find attractive candidates for reverse hedges, politically incorrectly known in the business as "Chineses." Of course, some of the bonds may be difficult or prohibitively expensive to borrow. Outright holders should consider reducing their holdings of high-HARP names, swapping into either more attractive substitutes or, if permissible, the underlying shares. Capital-markets professionals can use the list to call issuers of high-HARP bonds to substantiate the market's appetite for new paper from those issuers.

As with many ranking systems, HARP is a part-cardinal, part-ordinal measure that should primarily be viewed relative to itself. A bond scoring 14 is clearly much more exposed to the convertible market's unique blend of time decay and delta loss than one scoring 5. A much higher dollar-priced bond will have a far lower HARP score, but this is because virtually all the exposure is pure equity. A much lower-priced bond will also have a far lower score, but this is because of credit risk, which HARP explicitly does not address. HARP is most useful for bonds trading between 105 and 150—which happens to be a huge chunk of the market.

HOCS

While HARP works best as a negative measure, identifying unattractive bonds, HOCS is more comprehensive and helps investors find good bonds as well as bad ones. HOCS blends traditional modeling inputs with other measures we have found useful over the years in deciding which bonds to buy and which to avoid. Many of these other measures relate to liquidity, both in the short and long term. We try to reward bonds we perceive as having favorable characteristics, both theoretically and optically, as well as bonds we think are likely to benefit from certain longstanding market biases.

HOCS is designed on a 0-100 scale, with 50 intended to be a neutral or indifferent score. HOCS above 60 are quite good and above 70 are excellent, while bonds with HOCS below 40 should generally be avoided.

While a bond's HARP goes into the HOCS calculation, having a low HARP is neither necessary (though it certainly helps) nor sufficient for getting an acceptable HOCS score. For instance, JAZZ Pharmaceuticals makes the HARP Ugly 20 honorable-mention list, scoring just below 8 this week. Yet it gets an entirely acceptable HOCS of 54, with 61 for Growth and 40 for Safety at its recent price of about 115 (versus 169.41).

A couple of other names may help illustrate the distinction. Navistar 4.75% scores a reasonably favorable HARP of just below 6 but a fairly unfavorable HOCS of 44, primarily because of the company's debt load (53 Growth/27 Safety). But investors comfortable with Navistar's financial position can accept the low HOCS and know, from the HARP, that the bond should perform reasonably well if the underlying stock thesis proves accurate.

On the other hand, consider the Integra LifeSciences (IART) 1.625% of 2016. This bond screams "bleeder" and should be avoided anywhere close to its current price around 109 (versus 49.68). It gets 7.78 HARP—slightly below that of JAZZ—but a HOCS of only 25 (16 Growth/44 Safety). The bond's relatively short time to maturity, along with the stock's limited volatility and growth prospects, create a scenario where holders of this bond could easily lose money even if the underlying stock performs reasonably well.

September 15, 2014

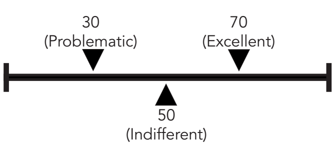
BioMarin Update

Kent Bailey, CFA

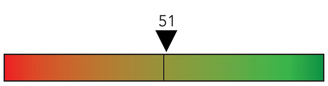
0.75%, 2018/10/15
Price (Bond): $104.75
Stock: $68.00
YTM: -0.43%
Premium: 45.2%
HOCS-Overall: 51
HOCS-Growth: 53
HOCS-Safety: 47
HARP: 3.33

As of September 12, 2014

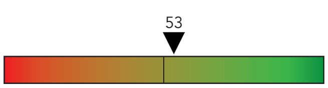
HOCS:



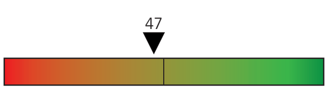
Overall



Growth



Safety



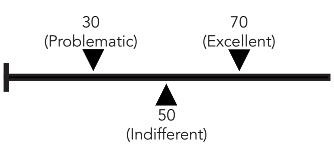
Last week BioMarin CEO J.J. Bienaime updated investors on several key upcoming commercial and clinical catalysts. In response to a question about BioMarin's three-year financial outlook, Bienaime indicated that BMRN would exceed $1 billion in revenue in two to three years on the strength of steady growth from its existing products and an expected robust launch of Vimizim (enzyme replacement therapy for Morquio A Syndrome). Due to large R&D expenditures supporting its orphan drug pipeline, BMRN needs to hit the $1 billion revenue level to reach operating profitability. However, the company does expect 2014 to be the peak year for R&D as a percentage of revenue, though not on an absolute dollar basis.

BioMarin highlighted several of its many clinical programs, including BMN-111 for Achondroplasia, the primary cause of human dwarfism. Currently, a three-cohort dose escalation trial is ongoing, with the goal of improving patient growth velocity by 50% over a 6-month period (although management believes a 100% improvement is possible). Full data from all three cohorts is expected in 2Q15. In terms of safety, the Phase 1 trial in healthy volunteers showed some cases of hypotension, but BioMarin believes this is manageable through altered dosing schedules. Another key pipeline product is BMN-190 for Batten's Disease, a devastating childhood illness which appears around age three or four with seizures and leads to death by age 12 or 13. Because of the disease severity, management is confident in enrolling 22 patients in the Phase 1/2 trial by 4Q14 and may have data by 2H15. While BMN-190 was able to double the life expectancy of dogs in preclinical studies, management cautions that these results may not translate to humans. The trial will be considered positive if the drug can stabilize the disease in at least 50% of patients. European regulators have made it clear that only one positive study will be needed for approval, and the company expects the FDA to follow suit. The exciting aspect of both programs is that although they are among the earliest-stage clinical assets in BioMarin's pipeline, they could demonstrate highly valuable proof-of-concept data during 2015. As these programs are generally not being valued in analyst models, success in these trials could be an important source of upside for BMRN stock in 2015.

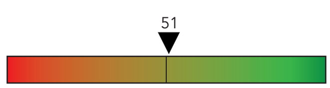
1.5%, 2020/10/15
Price (Bond): $108.00
Stock: $68.00
YTM: 0.16%
Premium: 49.7%
HOCS-Overall: 51
HOCS-Growth: 50
HOCS-Safety: 52
HARP: 6.32

As of September 12, 2014

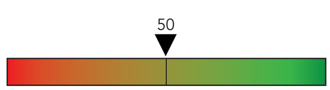
HOCS:



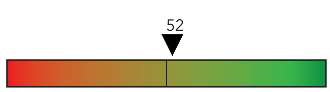
Overall



Growth



Safety



BMN-673 for genetically-defined cancers is a key late-stage clinical program for BioMarin, currently in a Phase 3 trial for breast cancer. In its drug class of PARP inhibitors, BioMarin admits that BMN-673 may not be the first drug to market, but, owing to its much greater potency than other PARPs, management does expect it to be the best. The Phase 3 trial is powered to show 22 weeks of survival, but because the ongoing Phase 2 survival data is now past 35 weeks, management is confident in a positive Phase 3 result. While the initial focus is on breast cancer, BMN-673 will be investigated in other solid tumors as well.

As for Vimizim, the launch is going well, with 1,600 patients already identified out of an estimated 3,000 worldwide. BioMarin believes it can eventually put 2,000 patients on drug. At $400,000 per patient per year, the drug has enormous revenue potential. With the Vimizim launch ongoing and at least five clinical programs reading out proof-of-concept or pivotal trial data, 2015 is set to be a catalyst-rich year for BioMarin.

Convertible View

Both liquid Biomarin convertible deals get average and balanced marks on our proprietary Hillside Overall Convertible Score (HOCS) rating system. Each gets a 51 overall rating, with the longer-dated, higher-delta 1.50% of 2020 scoring 53 for Growth and 47 for Safety, while the 0.75% of 2018 scores 50 Growth and 52 Safety. We note that these ratings take into account the roughly 3.25 point spread between the two bonds, suggesting that the market has been right in favoring the longer-dated bond over the past year. We suggest that because of the bonds' premiums in the 45-50% range, aggressive BMRN investors should add to their convertible holdings with equity as permissible by their mandates and risk tolerance.

September 15, 2014

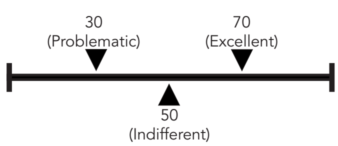
UTi Worldwide Inc.: The Bottom is In

Jeffrey Alton, CFA

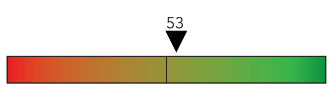
4.5%, 2019/03/01
Price (Bond): $111.00
Stock: $11.34
YTM: 1.93%
Premium: 41.8%
HOCS-Overall: 53
HOCS-Growth: 62
HOCS-Safety: 34
HARP: 5.16

As of September 12, 2014

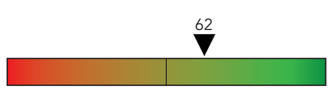
HOCS:



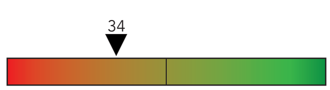
Overall



Growth



Safety



Company Overview

UTi Worldwide, Inc. (UTIW) may finally be ready for a rebound. Before the financial crisis, when international trade was increasing better than 5% annually, the opportunities seemed unlimited for supply chain and freight forwarding companies like UTi. UTi's total net revenue almost tripled between 2005 and 2008, and the company's earnings peaked at $1.04 per share in 2007.

Post-crisis, the road has been more difficult. World merchandise trade has grown at a rate about half that of the boom years, and UTi was offering clients an outdated data system. After peaking at around $36 per share in 2006, the stock fell to under $9 during the crisis. The stock rebounded to over $22 per share in 2011, but revisited $9 in May of this year as trade growth slowed in 2012 and 2013. We think that marks a double bottom for the stock over a period of years that will hold. Even better for shareholders, the company has taken steps to improve its competitive position that should soon begin paying off.

UTi serves clients throughout the globe, providing them with freight forwarding, logistics and supply chain services. The company operates 310 offices and 230 logistics centers in 59 countries. UTi is in the final stages of implementing its 1View system to provide better shipment visibility, inventory optimization functions, data analysis and additional features. It is one of only three globally integrated IT systems in the forwarding industry and UTi management believes it a significant competitive advantage.

The 1View system can also be leveraged to reduce internal costs. Management estimates that as more countries join the system, UTi will realize $65 to $70 million in savings during the current fiscal 2015 year and up to a full $95 million in fiscal 2016 when the system is complete. Based on these cost savings, UTi expects to generate $200 EBITDA in 2016.

Another benefit of the system is a better window for UTi into client profitability. The company is using the system to cull less profitable clients and eliminate the clients who demand payment terms in excess of 90 days. That has led to a reduction in working capital as receivables decreased by $38 million in the most recent quarter.

Trade could also be poised to return to more robust growth. The World Trade Organization expects worldwide trade growth to recover to 5% in calendar 2014 and 2015. UTi is already starting to benefit as net revenue increased to $401 million in Q2 2015 from $385 million one year earlier. Full year consensus total revenue estimates are $4.41 billion in fiscal 2015 and $4.56 billion in fiscal 2016 versus $4.44 billion in fiscal 2014.

While UTi has missed estimates in eight of the last nine quarters, the market showed faith after the latest earnings results were released on September 4. Although shares rose to over $11 from $9, we think investors still have a reasonable entry point along with favorable momentum. The company currently has an EV/ EBITDA ratio of 8.6 times versus 14.5 for industry leader CH Robinson Worldwide, whose market cap is nearly 10 times greater. Increasing EBITDA to management's goal of $200 million from $51 million over the last 12 months should give the shares a further boost.

Convertible View

While more aggressive UTIW investors will clearly prefer common shares (UTIW options are extremely illiquid), the 4.50% convertible bonds provide a fairly attractive way to buy the name. The favorably structured security still yields nearly 2% to the March 2019 maturity with a manageable conversion premium of just above 40%. The bonds score 53 on the HOCS (Hillside Overall Convertible Score) scale. Not surprisingly this rating is strongly biased toward Growth (62) over Safety (34), given the company's small market capitalization and relatively large debt (primarily the convertible).

Meet the Pros

Since we are trying to build a convertible community, we have decided to create a "Meet the Pros" section. We hope to feature one convertible pro in every issue. The person can be from either the sell side or buy side. We welcome any VALID nominations!

Today we are featuring Roman Terekhin, a good friend of Hillside and frequent contributor to ***Hybrid Vigor***. Roman has authored several well-received articles and is always happy to share interesting ideas. We are very lucky to count him as a friend of Hillside!

Name: Roman Terekhin, CFA

Title / Job Function: Independent consultant

Years in converts: 14

What do you find interesting about the product:

It may sound as a cliché but I really like the fact that the instrument offers a whole range of investment strategies. Those range from arbitrage and outright trades to a large spectrum of event driven approaches. It is never boring.

Worst trade in convertibles you have ever done:

In the late 90's I worked as an analyst at a convert arb fund and we were approached by a pay-phone start-up. They wanted to scoop up the unwanted equipment as the majors were getting out of that business - it was the dawn of the wireless phone era (at least on the East coast). I recommended investing in the bonds – the asset coverage looked good and the management had a ton of experience. Within a few quarters after we made the investment, the company went south and filed. The equity hedge we had on did not help much. The key lesson I learned was this: never underestimate the power of disruptive technologies.

Favorite author:

Charles Kindleberger, Andy Kessler

Who should we interview / profile next?

Ro Bawa, Head of Convertible Sales at Deutsche Bank

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