HILLSIDE ADVISORS LLC

December 22, 2014

Hybrid Vigor℠

The Hillside Convertible Advisory Letter

Volume 1 Issue 31

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Inside

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Dear Friends,

As we prepare for the holidays, I take a moment to introduce the 31st, and final 2014, edition of ***Hybrid Vigor***. We will not be publishing next week, as virtually the entire staff at Hillside Advisors will be enjoying the season with our families.

We will be back with our first issue of 2015 on Monday, January 5th. In 2015 we look forward to continuing to serve as the voice of the convertible market, delivering proprietary analysis and commentary to help experienced and new market participants. We hope to supplement our convertible coverage next year with ongoing insights about the two asset classes most closely linked to the converts market—high-yield bonds and small-cap stocks.

As we've mentioned in recent issues, we are going to a subscription-based model next month. We haven't determined logistically yet whether today's issue or the January 5th one will be the final ***Hybrid Vigor*** to go to non-paying readers, but either way, the day of reckoning is near. We hope those of you who have enjoyed ***Hybrid Vigor*** and have not yet subscribed will speak with John Anderson, our head of business development, at janderson@hillsideadvisors.com or (646) 665-4025 to discuss options.

Starting Hillside Advisors and ***Hybrid Vigor*** this year has been one of the great experiences of my life. Building an exceptionally talented and magnanimous team of colleagues, receiving feedback from readers (many old friends), and getting recognition in the media—all part of the unique process of starting a new business. I'm happy to say that 2014 has exceeded our expectations. We look forward to broadening our client base and range of services in 2015. Thanks, and happy holidays, to all of you.

Bill

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The next issue will be published on January 5, 2015.

HILLSIDE ADVISORS LLC

December 22, 2014

Festive Visits

Bill Feingold and Curt Peters

With the stock market rally of the past week, it's been a season of festive drop-in visits to the Ugly 20. The week prior we had three names fall from grace with collapsing stock prices to land in the multi-dimensional risk zone of high HARP and Ugly 20 fame. This past week, with an average 4.5% increase in Ugly 20 stock prices, the prior week's three visitors (AL, TRN, GPRE) are near the exits or through the door. With someone leaving, that means someone new must have arrived, or else it couldn't be called the Ugly 20. And as astute readers may expect, yes with a sizable equity rally the average HARP score increased – by 0.24 to 9.19 as more bonds came off of ground effect into the danger zone of the 110-130's.

The biggest surprise visitor came through the door with a BUMP - all the way from 37th to 3rd! And how that bump made us jump. We looked and we saw him step onto the mat, and there he stood the cat in a Red Hat. Red Hat 0.25% of 2019 scored the largest HARP increase from 6.46 to 10.74 (4.28 increase) in the history of the Ugly 20 in a single week. Driven by much better than expected Q3 revenue growth, the stock increased 17.6%, while the bond participated about 46% of that to climb from 107½ to 116¼. Exactly what a dollar nuke model would have predicted.

Sitting directly above Red Hat is Omnicare 3.25% of 2035 at 2nd, though in HARP terms basically tied with Red Hat. Two bonds with exactly the same price (116¼), 4 point spread in premium, 3 point spread in coupon, 3 months difference in call protection, 3 points difference in parity, and a difference in dividend yield of 1.2 points. Why the nearly identical HARP? The answer is that all the benefits Omnicare provides in terms of lower premium and higher adjusted yield, are offset by the much higher volatility of Red Hat (and his pals Thing One and Thing Two). That is, there is a much greater probability of Red Hat escaping the premium burn zone than disaster striking and being left to eat coupons.

Moving up the ranks to illuminate our screens this week are two Ugly 20 bottom dwellers now firmly ensconced in the rarified air of the top half. Illumina tranche B 0.5% of 2021 settled in at 6th with a 9.76 HARP and a price of 115. NVIDIA 1% of 2018 established a solid hold on 7th with a 9.39 HARP and a price of 115¾. Similar rankings and similar prices for two bright shining stars. What is not similar are their premiums. Illumina's premium is nearly 4 times the size of NVIDIA's (53.9% vs 14.3%). NVIDIA offers a pretty ugly combination of a 1% coupon and a 1.7% dividend yield. Illumina at least keeps its 0.5% coupon free of dividends. With about a half year of difference between them in terms of call protection, NVIDIA's yield advantage doesn't make up for the massive premium difference. To make up for Illumina's parity nearly 25 points beneath NVIDIA's, something has to be better doesn't it? Yep something is. Just like the Red Hat / Omnicare duel but on a much larger scale, Illumina has a volatility of 1.7 times that of NVIDIA (40% vs 25%).

The Salesforce is back! Let the sales begin. Like a phoenix Salesforce.com 0.25% of 2018 rose from 30th to 14th. CRM equity increased 8.7% based on Q3 good news from rival Oracle – the size of the pie grows and we all get more argument. Bond price was up from 110 to 114, which for a 60 delta fits with what a model would predict. With parity at 90, a puny coupon, and about 3.3 years till call protection ends, the bond is at a painful price point to buy in at. Many things could go wrong. That's why we call this part of the convertible price profile, the multi-dimensional risk zone. The 34% volatility is supposed to make us feel better. Not entirely, and hence why the bond is on the Ugly 20.

With Green Plains Renewables off the list from 19th to 26th, there was room for someone else to squeak on. Wright Med Group 2% of 2017 moved incrementally from 21st to 19th with a 0.3 increase in HARP. Which is what happens when bond price falls back (124¾ to 120½) into the heart of the risk zone. Escaping is a game of two steps forward, one step back. And if you are fast enough, you can make through before the clock runs out. With about a 26 vol, parity of 109½, and little more than 2½ years till maturity, Wright Med Group's 13.8% premium is starting to catch in the throat.

Disclosure: A principal of Hillside Advisors has a position in securites of Salesforce.com.

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Hillside Ugly 20 List (Prices as of December 19, 2014)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	RPM International 2.25% 2020-12-15	115.25	50.83	20.1	19.29	11.28
2	Omnicare (Exchange) 3.25% 2035-12-15	116.25	73.59	21.7	20.73	10.83
3	Red Hat 0.25% 2019-10-01	116.25	68.04	25.6	23.69	10.74
4	Lam Research 1.25% 2018-05-15	142.00	80.50	10.5	13.49	10.40
5	SanDisk 0.5% 2020-10-15	122.00	99.99	12.4	13.46	10.25
6	Illumina 0.5% 2021-06-15	115.00	189.97	53.9	40.28	9.76
7	NVIDIA 1% 2018-12-01	115.75	20.42	14.3	14.48	9.39
8	BioMarin Pharma 0.75% 2018-10-15	120.50	93.84	21.0	20.91	9.15
9	On Semiconductor 2.625% 2026-12-15	118.25	10.08	23.3	22.35	9.10
10	BioMarin Pharma 1.5% 2020-10-15	124.25	93.84	24.6	24.53	9.10
11	Palo Alto Networks 0% 2019-07-01	129.00	124.36	14.4	16.24	8.95
12	Ryland Group 1.625% 2018-05-15	132.75	37.51	13.4	15.69	8.82
13	CSG Systems 3% 2017-03-01	120.25	25.42	10.9	11.82	8.61
14	Salesforce.com 0.25% 2018-04-01	114.00	59.86	26.7	24.02	8.60
15	Standard Pacific 1.25% 2032-08-01	112.00	7.19	26.0	23.11	8.51
16	Workday 0.75% 2018-07-15	122.00	85.45	18.8	19.31	8.17
17	Air Lease 3.875% 2018-12-01	137.00	34.38	19.7	22.55	8.14
18	Trinity Industries 3.875% 2036-06-01	131.75	27.92	18.9	20.94	8.12
19	Wright Med Group 2% 2017-08-15	124.50	27.85	13.8	15.10	7.99
20	Priceline.com 0.35% 2020-06-15	110.50	1109.45	30.9	26.08	7.96

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HOCS℠ 20

Bill Feingold

We got the right-hand side of another V-shaped recovery last week, and the HOCS 20 went along for the ride. The underlying shares rose 4.38%, roughly in line with the broad averages, while the convertibles returned 1.60% for an adequate participation of 36.5%. You hope for better longer-term, of course, and you usually get it. But in the short term, these bonds did about what the back-of-the-envelope math predicts.

The constituents of the HOCS 20 have been varying a bit from week to week, of course. But they've been zeroing in on an average bond price in the low-to-mid-90's (last week's was 93.73, this week's is 93.94). The change in composition this week actually helped the yield/premium mix, bringing the former up from an even (or odd, depending on how you look at it) 3% to 3.23% and the premium down a handful of percentage points to just over 46%.

Part of the reason? The re-entry of small cybersecurity software maker KEYW. You can probably thank Sony's fiasco with the ill-conceived movie "The Interview" and the subsequent hacking. KEYW had dropped off the HOCS 20 for (somewhat ironically) safety concerns, as its market capitalization had become too small to provide the necessary support. With last week's rally it just made the cut. One of our long-standing precepts is that a company's market capitalization is a far better predictor of safety for a convertible issuer than accounting profits. Markets may not be totally efficient (we don't think they are by any stretch), but they're generally way ahead of the guys in the green eyeshades.

The HOCS 20 said goodbye, at least for now, to a couple of last week's better performers, Synchronoss 0.75% and NetSuite 0.25%, along with Priceline 0.9's, which were flattish but fell just off in favor of returnees 51job 3.25% and SunPower 0.875%. Envestnet, one of our favorite recent issues, slipped from second to seventh on the list as its price marched higher. It's still an appealing name, even with the overall HOCS coming down from 77 to 69. LinkedIn 0.50%, our highest-scoring new issue since we began this little exercise, has now dropped to tenth on the list at 68. Still good—just not as good.

All right, we can't help it. Happy HOC-lidays!

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Hillside HOCS 20 List

	Description	Convert	Stock	HOCS Overall	Growth	Safety	Yield	Premium
1	Tesla Motors 1.25% 2021-03-01	90.00	219.29	77	84	62	3.04%	47.70%
2	Solar City 1.625% 2019-11-01	92.00	54.80	72	83	52	3.43%	40.23%
3	Web.com 1% 2018-08-15	92.50	19.76	72	77	62	3.20%	63.84%
4	Renewable Energy 2.75% 2019-06-15	97.50	10.00	72	81	54	3.36%	29.32%
5	Qihoo 1.75% 2021-08-15	84.25	58.86	71	81	51	5.66%	72.87%
6	Invensense 1.75% 2018-11-01	97.13	15.32	70	81	47	3.50%	33.95%
7	Envestnet 1.75% 2019-12-15	104.75	50.42	69	77	55	0.77%	30.65%
8	Allscripts 1.25% 2020-07-01	99.00	12.74	69	71	66	1.44%	33.55%
9	Shutterfly 0.25% 2018-05-15	95.50	42.46	68	69	65	1.62%	44.32%
10	LinkedIn 0.5% 2019-11-01	106.25	234.61	68	67	70	-0.76%	33.39%
11	Cornerstone OnDemand 1.5% 2018-07-01	98.50	36.82	68	80	44	1.94%	44.57%
12	Twitter 1% 2021-09-15	88.25	37.08	67	74	55	2.94%	84.79%
13	KEYW 2.5% 2019-07-15	91.00	10.41	67	83	35	4.72%	29.68%
14	Herbalife 2% 2019-08-15	74.00	37.96	66	71	58	8.97%	68.19%
15	Trina Solar 4% 2019-10-15	82.75	8.12	65	65	65	11.41%	49.68%
16	Ligand 0.75% 2019-08-15	99.00	52.32	65	78	38	0.97%	42.00%
17	Finisar 0.5% 2033-12-15	96.00	19.73	63	58	73	1.54%	46.87%
18	51job 3.25% 2019-04-15	105.50	35.85	62	70	46	0.84%	25.79%
19	SunPower 0.875% 2021-06-01	90.50	25.75	62	57	73	2.48%	71.38%
20	EZPW 2.125% 2019-06-15	94.50	11.90	62	67	52	3.46%	27.58%

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Crunch Time for Navistar

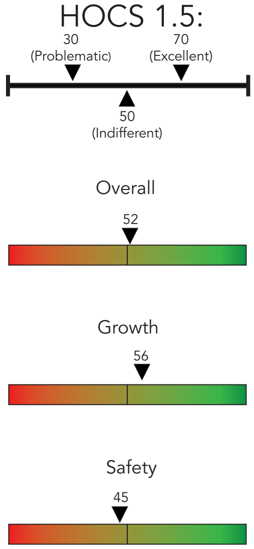
Jeffrey Alton, CFA

NAV

4.50%, 2018/10/15
Price (Bond): 94.00
Stock: $32.87
YTM: 6.30%
Premium: 67.0%
HOCS-Overall: 52
HOCS-Growth: 56
HOCS-Safety: 45

As of December 19, 2014

HOCS 1.5:



You know how you feel when you are waiting for someone that is running late? You start out a little annoyed and as the minutes pass you begin to worry that maybe they won't show up as promised. Well, Navistar is running late.

In fact, given Navistar's checkered history and **HOCS slash lines of 52 overall/56 growth/45 safety for the 4.50% 10/2018 bonds and 53 overall/59 growth/43 safety for the 4.75% 4/2019 bonds,** many would be tempted to move on to considering other convertible opportunities. However, we think the emerging Navistar story deserves a close look, or at least adding the bonds to your monitor list.

The heavy-duty truck maker is in the middle of a three-year turnaround after suffering a punch to the gut with its failed engine design. New management has worked tirelessly to introduce a different engine technology, clean up a huge warranty overhang for the failed engines and reduce bloated manufacturing costs. They have largely been successful in step 1 or "out with the old". Now it is time for the next step, "in with the new".

Because NAV has been so effective in cleaning up the mess, expectations are high for this next phase. Consensus earnings per share are $0.91/share in fiscal 2015 and $3.40/share in fiscal 2016 following a loss of ($7.60)/share this year, highlighting Navistar's potential for improved financial performance. Now that all the write-downs have been taken and the business has been cleaned-up, NAV is back to a simpler story in its quest to hit those numbers: selling more trucks.

In this regard, management has laid out a few major goals for fiscal 2015 to judge their progress. The first is adjusted EBITDA margin of 8 – 10% exiting 2015. The 2014 adjusted EBITDA margin was 3.9%. Another goal is achieving 22 – 24% market share in the company's important class 6 – 8 truck & bus segment. The 2014 market share stood at 17.5%, below NAV's internal goal for the year.

Unfortunately, investors were disappointed with the company's most recent earnings report and first quarter guidance. While barely missing revenue estimates of $3.02 billion, the company whiffed on earnings expectations, reporting a loss of ($0.88) versus consensus estimates of a $0.15 profit. More importantly, NAV failed to achieve its class 6-8 market share goal for the year. Market share actually decreased slightly from the previous year. Finally, NAV guided lower for the first quarter 2015 to an adjusted EBITDA of $50 million. That prompted analysts to lower first quarter estimates from $0.43/share to a loss of ($0.02)/share.

After the earnings release, the stock fell from $35 prior to earnings to $29 the next day. The concurrent fall in bond and convertible bond prices offers an attractive entry point for investors.

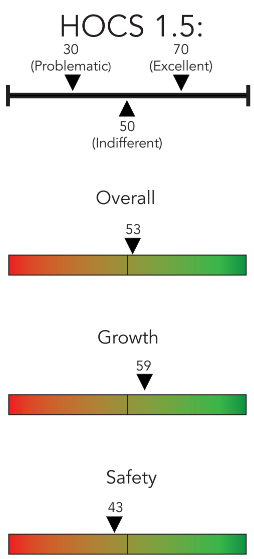
The earnings scorecard summary is:

	Actual 9-31-14	Consensus Estimated 9-30-14	Percent Difference Act. V. Est.	Previous Year Actual 9-30-13	Percent Change Y-O-Y
Revenue	$3,008	$3,020	(0.40%)	$2,751	9.30%
Adjusted EPS	($0.88)	$0.15	(587%)	($1.91)	53.9%

NAV

4.75%, 2019/04/15
Price (Bond): 95.00
Stock: $32.87
YTM: 6.09%
Premium: 56.3%
HOCS-Overall: 53
HOCS-Growth: 59
HOCS-Safety: 43

As of December 19, 2014



Negatives during the quarter included a $29 million write down in inventory for the company's Brazilian operation which continues to be a drag on growth. With Latin America's economy slowing, the Brazil business does not look set to rebound anytime soon. Lower military sales and Blue Diamond part sales also hurt growth. Blue Diamond is Navistar's joint venture with Ford, which Ford is terminating next year.

Market share remains a sticking point. Navistar's current 17.5% market share in medium and heavy duty trucks is slightly lower than in 2013 and heavily trails the company's internal goal of 21% for 2014. Since its engine problems, Navistar has fallen to fourth in market share behind Volvo AB, Paccar (Peterbilt and Kenworth) and Dailmer AG (Freightliner). The truck market is in an upcycle with economic growth beginning to accelerate in the United States and the other truck makers are taking advantage of the environment as well. In the third quarter, Paccar's (PCAR) revenue growth totaled 15.5%, well ahead of Navistar. Navistar faces larger and better financed competition.

Still, there were some positives for Navistar during the quarter. Despite missing internal annual goals for increasing market share during 2014, Navistar did increase revenue 9% to $3 billion for the fourth quarter based on strong domestic sales. Navistar rolled out new engines across more models during the year and truck revenue was up 16% for the quarter versus Q4 2013.

On the cost containment side, where Navistar has been particularly successful, warranty expense dropped from 9% in Q4 last year to 3.7% in the final quarter of 2014. Navistar also reduced structural manufacturing costs to 11.4% of revenue from 15% in Q4 2013. With the stock still trading at rich near-term multiples despite the recent drop, investors can turn to the company's debt securities for value. The senior subordinated convertible bonds trade around 95, with yield to maturity of 6.00%. That's down from a high of 107 for the 4.75% 4/2019 and 103 for the 4.50% 11/2018 bonds hit last July. For comparison, the CCC– rated 8.25% senior unsecured notes due 2021 are currently trading at 97.75, offering 8.69% yield to maturity. All of these bonds are callable, but it is unlikely that Navistar will have that luxury in the near future.

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To achieve its 8 – 10% adjusted EBITDA goal by the end of 2015. Navistar continues to introduce the SCR (selective catalytic reduction) engines across additional models which should boost sales and market share in 2015. SCR engines are the current standard in the industry. Adding SAR engines should be particularly meaningful in the severe truck line which includes dump truck, garbage trucks and other construction trucks. Navistar has lost 5% of the severe truck market share over the past year, but just added the SAR engine in July which should be a catalyst to regaining market share in that category.

On the cost reduction side, NAV's goal is to reduce material costs by 5% and sees room to take out $1,400 of cost in its 13 Liter SCR engine on its way to reducing total structural costs to less than 10% of revenue. Meeting the reduced structural cost goal alone would boost adjusted EBITDA by about $140 million.

To be sure the convertible bond HOCS scores are not breathtaking, but as we have discussed Navistar is a work in progress. The somewhat low HOCS growth scores are a result of the bond's structure as much as Navistar's financial performance. The recent drop in the stock price make the convertible securities trade more like bonds and the conversion premiums blew out to 67.0% for the 4.5% bond and 56.3% for the 4.75% bond, lowering the HOCS growth score. As financial performance improves and the stock price appreciates, the HOCS growth scores will also improve.

Navistar International Corp			
	Fiscal Years Ended		
(Dollars in Millions)	31-Oct-12	31-Oct-13	31-Oct-14
Revenues	12,695	10,775	10,806
Y / Y Change	---	-15.1%	0.3%
Gross Profit	1,294	1,014	1,272
Operating Profit	(866)	(707)	(245)
EBITDA	(820)	(572)	(18)
EBITDA (Adj.)	154	89	294
Interest Expense	259	321	314
Income Tax Benefit (Expense)	(1,780)	171	(26)
Capital Expenditures	309	167	88
% Revenues	2.4%	1.5%	0.8%
Free Cash Flow	301	(67)	(424)
Total Debt	4,771	5,085	5,224
% Total Debt	6.3%	-1.3%	-8.1%
Gross Margin	10.2%	9.4%	11.8%
Operating Margin	-6.8%	-6.6%	-2.3%
EBITDA Margin	-6.5%	-5.3%	-0.2%
EBITDA (Adj.) Margin	1.2%	0.8%	2.7%
EBITDA (Adj.) / Interest	0.6x	0.3x	0.9x
EBITDA (Adj.) - Capex / Interest	NM	NM	0.7x

Navistar's HOCS safety scores under 50 also raise eyebrows. Despite trading in the mid-90s HOCS sweet spot, Navistar's highly leveraged balance sheet brings the safety score down. However, as a CCC– credit, Navistar has plenty of room to improve its balance sheet if it can continue to improve operations. With negative shareholder equity of $4.6 billion and current net manufacturing debt to adjusted EBITDA of 18.0x, Navistar remains highly leveraged. Reaching its 8 to 10% adjusted EBITDA margin goal would raise adjusted EBITDA from the current $294 million to $864 million to $1.07 billion annually beginning in 2016.

That translates into a net debt to adjusted EBITDA ratio of 5.3x to 4.4x, still to the high side, but significantly improving the company's credit standing. The better credit profile should reward NAV convertible bond holders as rating agencies reward Navistar debt with a higher credit rating.

On a segmented basis, Navistar does have some momentum in market share. School bus market share increased to 39% in Q4 2014 from 31% in Q3 2014. Class 8 heavy truck market share also increased a percentage point quarter over quarter. As mentioned, management expects class 8 severe service market share to begin to increase with the addition of the SAR engine.

Navistar could also be acquired. One such rumor had Volkswagen group taking out Paccar or Navistar. While Volkswagen vehemently denied the rumors, an improving Navistar would make an enticing target for an overseas truck manufacturer looking to enter the US market.

Navistar faces a tough fight ahead, but we think management has brought the company a long way. The recent price drop in the convertible securities offers an entry point for investors. Patience will be necessary to allow management to successfully turn the playbook from defense to offense, but we think that the convertible bond investor will be rewarded over time. Give Navistar a little more time to show up.

Navistar Capital Structure (Dollars in Millions)	31-Oct-14	Total Debt (Cum. Bal.)	Adj. EBITDA Multiple	Net Debt (Cum. Bal.)	Adj. EBITDA Multiple
Current Share Price	$32.21				
Shares Out. (Millions)	81.4				
Latest Twelve Months:					
EBITDA	(18)				
EBITDA (Adj.)	294				
Free Cash Flow	(424)				
Cash & Cash Equivalents	537				
Secured debt					
Senior Secured Term Loan Credit Facility due 2017	694				
Financed Lease Obligations	184				
Financing Arrangements & Capital Lease Obligations	54				
Debt of Majority Owned Dealerships	69				
Secured debt at the Financial Services subsidiary	2,192				
Total secured debt	3,193	3,193	10.9x	2,656	9.0x
Unsecured Debt					
8.25% Senior Notes due 2021	1,180				
6.5% Tax Exempt Bonds due 2040 (Loan Agreement)	225				
Unsecured debt at the Financial Services subsidiary	74				
Total Sr. unsec'd debt	1,479	4,672	15.9x	4,135	14.1x
Subordinated Debt					
4.50% Senior Subordinated Convertible Notes due 2018	200				
4.75% Senior Subordinated Convertible Notes due 2019	411				
Total sub unsec'd debt	611	5,283	18.0x	4,746	16.1x
Total Debt	5,283	5,283	18.0x	4,746	16.1x
Equity Market Cap.	2,622	---	---	---	---
Enterprise Value	7,368	---	---	---	25.1x

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Cliffs Natural Resources (CLF) – The Clock is Ticking!

George Lynch and Kathy Schick

CLF issued $731.3 million of Series A 7% Mandatory Convertible Preferred Stock in February 2013. The preferred stock will automatically convert to common equity in February 2016. Based upon the current stock price of $6.67, the mandatory would convert into 0.8621 shares of common stock, which equates to $5.75. The Mandatory Convertible Preferred shares are actually trading at $6.11, or $0.36 above the equivalent common price. Management has already declared a dividend for the February 2015 payment date on the Mandatory Convertible Preferred shares, which equates to $0.4375 per preferred share.

We are amazed that CLF has not terminated the common dividend quite some time ago given the company's rapidly deteriorating liquidity situation. Our reading of the current situation and prices is that the common dividend is done and the preferred dividend will not be paid again after the upcoming February payment. In a worst case scenario, the preferred stock does rank ahead of the common equity, but overall enterprise asset coverage at the senior debt level points to a sizeable coverage deficiency. Hence, we do not expect to see holders of the preferred stock to fare much better than common shareholders.

Cliffs Natural Resources (Dollars in Millions)	30-Sep-14	Total Debt (Cum. Bal.)	Adj. EBITDA Multiple	Net Debt (Cum. Bal.)	Adj. EBITDA Multiple
Current Share Price	$6.41				
Shares Out. (Millions)	153.2				
Latest Twelve Months:					
EBITDA	554				
EBITDA (Adj.)	1,030				
Free Cash Flow	211				
Cash & Cash Equivalents	244				
Senior Secured Debt					
Equipment Loans	146				
Short-Term Borrowings	213				
Revolving Credit Agreement	0				
Total Secured Debt	359	359	0.3x	115	0.1x
Senior Unsecured Debt					
4.875% of 2021 Senior Notes	700				
4.8% of 2020 Senior Notes	500				
6.25% of 2040 Senior Notes	800				
5.9% of 2020 Senior Notes	400				
3.95% of 2018 Senior Notes	500				
Total Unsecured Debt	2,900	3,259	3.2x	3,015	2.9
Total Debt	3,259	3,259	3.2x	3,015	2.9
Equity Market Cap.	982	---	---	---	---
Enterprise Value	3,997	---	---	---	3.9x

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CLF is a leading mining and natural resources company. Specifically, the company is a major iron ore producer in the Great Lakes region and a significant producer of high and low-volatile metallurgical coal in the U.S. In addition, CLF operates iron ore mines in Eastern Canada and an iron mining complex in Western Australia. Both minerals mined by the company have come under tremendous supply/demand pressure over the past handful of years. Moreover, underlying prices have come under similar pressure during the same time frame. It also doesn't help that the company fails to compare well on the global cost curve for both minerals.

As a result, CLF's revenues, earnings, and cash flow have suffered inordinate pressure. Likewise, liquidity has come under tremendous strain as well. The company has taken drastic steps to enhance earnings and cash flow, preserve liquidity, and strengthen its balance sheet. Most notably, the company has endeavored to sell a variety of assets, idled others, and most recently, attempted to complete an exchange offer for certain of its senior unsecured notes; representing $600 million of the $2,900 million outstanding. (While the company attributed the failure of the exchange offer to adverse market conditions, it probably had more to do with the offer being poorly structured and viewed as highly coercive.)

The company appears to have enough liquidity, consisting of balance sheet cash ($244 million as of September 30) plus availability under its $1,125 million secured revolving credit facility (no borrowings outstanding), to allow it to muddle along the next one to two years. However, a wholesale turnaround in the iron ore and coal markets will probably be necessary if the company is to survive over the long haul.

Frankly, a near term recovery in these two challenged markets appears unlikely, in our opinion.

Central to CLF's iron ore challenges are weakening Chinese demand driven by declining (and extremely opaque) Chinese GDP growth and the resultant drop-off in steel demand. Exacerbating matters for the company is the recent surge in low-cost iron ore supply (flowing from Brazil and Australia). Unfortunately, these challenges are likely to remain with us for the foreseeable future.

Despite the aforementioned challenges, CLF does boast a highly enthusiastic CEO. Lourenco Goncalves joined CLF earlier in the year. We have known Mr. Goncalves for quite some time and appreciate the work he did while at the helm of California Steel Industries (steel mini-mill), and more recently Metals USA (steel service center). While neither company was a global mining concern, we will award Mr. Goncalves the benefit of the doubt vis-à-vis his abilities to wrap his arms around CLF's many issues and challenges, at least for the time being.

While we have not done substantial valuation work of our own, the general consensus seems to point to a very low recovery for the company's senior unsecured notes, especially given currently low iron ore and coal prices. The picture is even bleaker for holders of the company's common equity and the Mandatory Convertible Preferred Stock.

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Over the long haul, considerable skill, adroit execution, and a fair amount of luck are all required if management is to execute upon its turnaround initiative. In the meantime, it must confront each of the many challenges while facing a very tight liquidity situation. That is why we are convinced that the common dividend must cease to be paid and we are soon to see the last Mandatory Convertible Preferred dividend payout.

Cliffs Natural Resources						
	Fiscal Years Ended			9 Mos Ended		LTM
(Dollars in Millions)	31-Dec-11	31-Dec-12	31-Dec-13	30-Sep-13	30-Sep-14	30-Sep-14
Revenues	6,564	5,873	5,691	4,176	3,339	4,854
Y / Y Change		-10.5%	-3.1%	----	-20.0%	----
Gross Profit						
Operating Profit	2,297	(309)	671	424	(40)	207
EBITDA	2,724	(149)	1,189	1,018	(7,390)	(7,219)
EBITDA (Adj.)	2,724	1,017	1,492	1,045	583	1,030
Interest Expense	206	196	179	135	135	179
Income Tax Expense						
Capital Expenditures	881	1,128	862	742	233	353
% Revenues	13.4%	19.2%	15.1%	17.8%	7.0%	7.3%
Free Cash Flow	1,408	(613)	284	(56)	(129)	211
% Total Debt	38.2%	NM	9.3%	----	NM	6.5%
Gross Margin	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Operating Margin	35.0%	-5.3%	11.8%	10.2%	-1.2%	4.3%
EBITDA Margin	41.5%	-2.5%	20.9%	24.4%	-221.3%	-148.7%
EBITDA (Adj.) Margin	41.5%	17.3%	26.2%	25.0%	17.5%	21.2%
EBITDA (Adj.) / Interest	13.2x	5.2x	8.3x	NM	4.3x	5.8x
EBITDA (Adj.) - Capex / Interest	8.9x	NM	3.5x	2.2x	2.6x	3.8x

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The On-Deck Circle
Super Micro Computer: A Path to Super-Charged Growth

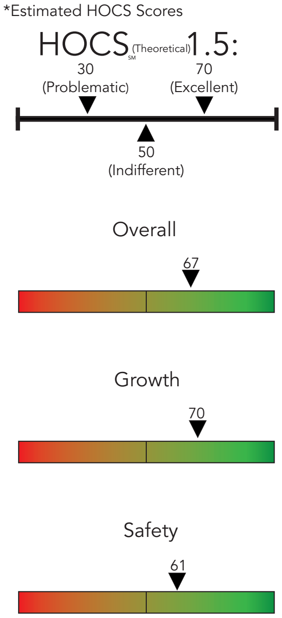
Hillside Staff

Theoretical Bond Pricing

SMCI

1.25% 2019/12/22
Price (Bond): 100.0
Stock: $34.93
Premium: 35.0%
HOCS-Overall: 67*
HOCS-Growth: 70*
HOCS-Safety: 61*

Stock Price as of December 19, 2014
*Estimated HOCS Scores



Each week, we feature a company that we think would be a great convertible issuer. We hope to persuade you and perhaps ultimately the company itself.

Our ideal candidate is trading within 20% of (and preferably much closer to) its 52 week high, has a low debt-to-capital ratio, and has a compelling usage for new capital. Generally, these companies will be convert rookies. Feel free to let us know if you want to nominate a particular company. If we agree with you and publish your nomination, you will receive an honorable mention in the newsletter!

This week for the On-Deck Circle, we are looking at a technology company: Super Micro Computer (SMCI). SMCI fits our target profile very well, with strong sales growth, a stock price that has run up and is within 10% of the all-time high, and a small debt/equity ratio of 7.5%. And of course, we feel the company has a compelling use for the proceeds.

SMCI is a global leader in high performance, high-efficiency server technology. The company serves data centers, cloud computing, Enterprise IT, big data, and embedded systems worldwide. The company released first quarter 2015 results for the period ended September 30, 2014 in late October. SMCI reported EPS and revenue above consensus estimates for the quarter causing the stock to surge to an all-time high of $34.95 in mid-November. Since then the stock has fallen back a bit, but was on a tear this week and closed at $34.93, just below the all time high. The stock is up over 100% for 2014.

For the quarter, revenue increased to $443 million from $309 million in the year earlier quarter, a 43.5% increase. The growth was driven by increased demand from data centers, internet companies, and other cloud computing applications. Management also increased the guidance for second quarter 2015 for both revenue and EPS. The rapid growth has led to negative free cash flow of $(26) million over the last twelve months.

SMCI has only $37.5 million of debt. It has $6 million of secured term loans that mature in September 2016. The company has $10 million drawn on a $40 million revolver with Bank of America. A second revolver with CTBC has $22 million drawn. Both of the revolvers matured in November. Management stated it was working on extending both lines in the 10Q. We are sure it was successful, but wouldn't it be great for this company to have some permanent financing on very attractive terms? A convertible bond issue seems to be just the answer.

SMCI is a good credit and has unused debt capacity. EBITDA for the last twelve months was $107 million. We estimate the company could issue a $250 million five-year convertible bond to pay down the revolvers and retire the term debt. This would still leave it with over $200 million of proceeds to fund future growth initiatives.

Assuming a $250mm convertible senior notes offering, SMCI's financial vital statistics would look like this:

Pro Forma Cash:	$324 million
Pro Forma Debt:	$250 million
Last 12 month EBITDA:	$107 million
Last 12 month FCF:	$(26) million
Leverage	2.3x
Mkt Cap	$1,610 million

Using a credit spread of 400 basis points and a volatility of 40%, we estimate that the convertible bond would look like this:

Issue Price	100.0
Issue Size	$250 million
Maturity	5 years
Coupon	1.25%
Premium	35%
Call	Non-callable
YTM	1.25%

This theoretical convertible bond receives a **HOCS (Hillside Overall Convertible Score) slash line of 67 Overall / 70 Growth / 61 Safety** - a very nice score for a new issue.

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This piece originally appeared as Hillside Alerts (HA!) last week on Hillsideadvisors.com.

Hedging Your Trade on ARCP

Jeffrey Alton, CFA

Shares of American Realty Capital Properties (ARCP) have fallen over 6% since last Friday's close after the Chairman, CEO and President resigned from the company. If you are wondering why the CFO is not on the list – he was already fired after first admitting to accounting irregularities. There was no official reason given for the executive departures, but no doubt they are tied to the investigation. In fact, the investigation looks like so much fun, the FBI and the SEC are looking into the situation with the FBI considering filing criminal charges.

When the ARCP accounting story first broke, we penned an article, "A House Divided". In our piece, we argued that the convertible may be the better way to play any rebound over common shares given the ongoing headline risk. Now a ***Hybrid Vigor*** friend and reader on a major New York trading desk has come up with a pretty slick way to hedge the convertible trade given that things have gotten even uglier.

His idea is to short the 6.70% $25 par preferred shares against the 3.75% 12/15/2020 senior unsecured convertible note. He reckons that if things get worse, the spread between the two securities should blow out as the convertible is senior to the preferred stock in the debt stack. A home run would be bankruptcy as the company has hard assets to back the converts in recovery whereas the preferred equity would be largely wiped out. Right now the spread between the convertible note and the preferred stock in bond terms is less than one point with the ask on the bond at 86.5 and the preferred trading at $21.50, or 86% of par.

Here are scenarios with a convert to preferred hedge ratio of 1 to 0.75:

	Convertible Bond		Preferred Equity			Profit & Loss	
				Par:	25		
	Bond	Price	Pref	% of Par	Price		Total P&L in
Initial Position	1000	86.5	-30200	86%	$ 21.50	Total P&L $	Bond Points
Scenarios......	P&L		P&L				
	$135,000	100	($83,050)	97%	$ 24.25	$51,950	5.20
	$115,000	98	($67,950)	95%	$ 23.75	$47,050	4.71
	$85,000	95	($45,300)	92%	$ 23.00	$39,700	3.97
	$35,000	90	($22,650)	89%	$ 22.25	$12,350	1.24
	($365,000)	50	$460,550	25%	$ 6.25	$95,550	9.56
	($465,000)	40	$536,050	15%	$ 3.75	$71,050	7.11
	($565,000)	30	$611,550	5%	$ 1.25	$46,550	4.66
	($365,000)	50	$498,300	20%	$ 5.00	$133,300	13.33
	($465,000)	40	$573,800	10%	$ 2.50	$108,800	10.88
	($565,000)	30	$611,550	5%	$ 1.25	$46,550	4.66
	($465,000)	40	$649,300	0%	$ -	$184,300	18.43
	($565,000)	30	$649,300	0%	$ -	$84,300	8.43

If the storm passes for ARCP, which seems unlikely at this point, the converts should appreciate at least as quickly as the preferred equity, which is callable at par beginning in October, 2018. With the convertible, investors get a six year maturity and a call option on the stock while the preferred equity offers only a coupon in perpetuity. On the downside, which seems like a possibility, the bond features of the convertible note trump the preferred equity. If ARCP gets taken out, the convertible security also has a change of control put at par.

In fact, it seems like the market does not have a good handle on where the convertible security lies in ARCP's capital structure. We suspect the reason is higher retail demand for the preferred stock versus demand for the more institutionally traded bonds.

Our reader notes that the ARCP's 3% February 2019 straight debt is trading at a stiff 6 point premium to the 2020 converts. It is true that the bonds have a shorter maturity and are structurally superior to the converts because the straight debt has subsidiary guarantees while the convertible bonds are holding company debt. However, the convertible security has the call option embedded in the convertible which maintains value despite the drop in the stock price. That six points to pay up for the straight debt seems even more out of whack when the market is only demanding less than a point to make a greater leap in the debt stack from preferred equity to the convertible.

Another point to consider; while the cost of carry is about 3%, the bond's accretion can help cover the cost.

It is pretty obvious our friend has done his homework here.

The thing we like about the trade, other than the potential monetary rewards, is it highlights how smart our readers are………

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