HILLSIDE ADVISORS LLC

June 1, 2015

Hybrid Vigor℠

The Hillside Convertible Advisory Letter

Volume 2 Issue 22

Will He Or Won't He?

Inside

Our Team

Bill Feingold
Managing Principal

George Chuang
Managing Principal

Jeffrey Alton, CFA
Head of Equity Research

Kathy Schick
Head of Credit Research

George Lynch
Senior Analyst

Roman Terekhin, CFA
Senior Analyst

Curt Peters
Senior Analyst

John Anderson
Director of Business Development

Sue Wu
Associate

You would think, as the publisher of the preeminent convertible newsletter, I would be inundated with requests to name my favorite bonds. You'd think I'd be surrounded the way people used to surround E.F. Hutton.

Strangely, that doesn't appear to be the case. What people do want to know, though, is whether American Pharoah will break the 37-year Triple Crown drought. As I said a couple of weeks ago, for what it's worth: we'll probably know in the first 200 yards or so. If he manages to get an easy lead, he'll be very tough to catch. Otherwise, he will have a difficult time. Remember, win or lose, he'll be a bad bet. This is because many people will buy $2 souvenir tickets on him, not intending to cash them. You can root for American Pharoah—I certainly will, though I'm not going to be there. Too old for those crazy crowds. But please, please, please don't bet on him.

If you do bet: trainer Todd Pletcher is often maligned for his poor Kentucky Derby record, but he's won a couple of Belmonts, and of the three horses he's sending out on Saturday two have an excellent shot at beating American Pharoah. Materiality has the raw talent and Carpe Diem has plenty of top-level experience. Also, if the other jockeys ride to beat American Pharoah the way they rode to beat Smarty Jones 11 years ago (and Pharoah reminds me of Smarty, in running style if not appearance), Carpe Diem may be the prime beneficiary. Carpe Diem was my third choice in the Derby, and he disappointed, but there's a rich history of horses disappointing in the Derby and running big in the Belmont.

Since this is, after all, a convertible newsletter, let's finish this Triple Crown discussion by asserting that convertibles, done right, win the Triple Crown of investing. As we never get tired of saying, you really only look for three things from an investment: income, upside, and capital preservation. It's hard to find single assets offering all three, but convertibles do, at least if you buy them right. It's important to keep that faith amidst a richly valued market at a tricky time. Seize the day.

Bill
bill@hillsideadvisors.com

Hillside Advisors, LLC
400 Columbus Ave., Suite 240E
Valhalla, NY 10595
+ 1 (646) 712-9289
www.hillsideadvisors.com

Contact us:
info@hillsideadvisors.com

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June 1, 2015

Double Shift

Bill Feingold
bill@hillsideadvisors.com

Curt Peters
curtp@hillsideadvisors.com

A quick refresher. HARP, or Hillside Adjusted Risk Points, is best thought of as a warning measure for bonds exposed to a blend of absolute price decline and premium decay. The higher the HARP, the more dangerous the bond. HARP tends to be highest for bonds in the 120-130 "death trap" range.

Double double. A two one-hundredths of a HARP move. That's all the Ugly 20 average could muster this week, closing at an average of 10.02 HARP for the week. After an exciting previous week, are we back to glacial speeds again? It would seem so. And not only did the average barely ping, but the rank order is a near facsimile of the prior week. Only a well trained eye could pick out the few rank swaps in the bottom half of the Ugly 20. As for new entrants, those with double vision wouldn't even notice the single new entrant at the bottom. It was slow – perhaps the slowest week on record, which might surprise some with average bonds down ¾ a point and average stocks down 1.1%. Especially if you use those average price changes to back into an average delta in the low 70's, while we know the actual average delta is in the low 60's. To be precise, it looks like the average bond price fell further than dollar neutral – so why didn't HARP give up a few as well? Because averages conceal the details. For the statistically fluent, the fact that median HARP increased by 0.19 only adds to the conundrum.

Ugly 20 Average HARP

Illumina B 0.5% of 2021 maintained the pole position after last week's overtake, even adding to its lead with a 0.27 HARP increase. And teammate Illumina A 0% of 2019 matched that with a 0.30 HARP increase and a solid lock on 6th place. Both bonds powered up in price with a ½ point increase off of a 0.53% stock increase. That's a bit of overshoot for bonds with a high 40's and low 40's delta, respectively. Toss in that both bonds have parity below par – way below – and the risk just keeps coming. Take your foot off the accelerator boys, speed kills. Especially in the corners.

One of Hybrid Vigor's most dedicated readers called us last week after reading about Illumina's achievement of the top Ugly 20 ranking. This reader noted that outright—we repeat, outright—holders would lose money with a cash takeover at a premium as high as 23% above the current price. We checked, and give or take a few pennies, we agreed. And that's if the takeout happens in just a few months. The longer it takes, the worse it gets.

Contrastingly, NVIDIA 1% of 2018 had a very real stock and bond bounce of 6.09% and four points, but avoided any HARP increase. Such smooth shifting, no? It just took a dollar neutral move (which the bond had) combined with parity above par. Premium burns down from 14.10% to 11.20%. Textbook. Nevertheless while on a relative basis much better than Illumina, on an absolute basis not so good. The NVIDIA bond remains elevated in risk. Its 12¼ points of premium get knocked back a bit with the 1% coupon, to 8¾ points. But then there is the dividend of 1.8% yield – nearly double the coupon. So that pumps up our risk to 15 points. Toss in the not-strong-enough mid 20's volatility and you can see why the NVIDIA bond gets a HARP of 9.78 and 8th place on the Ugly 20. We can understand why some people like this bond because the optics and credit are good, but to HARP aficionados, it's a "meh" at best.

The week's biggest HARP mover was Alon USA Energy 3% of 2018 with a 0.49 HARP decline. This is what a slow week bring us to – getting excited over a snail race. A few weeks ago we spoke of HARP moves in full points, sometime even three full points. But for this week Alon is the star. A 4.57% stock increase powered a 4 point bond increase – a tad more than dollar neutral, but premium contracted from 11.50% to 10.00%. That put the bond at a price of 133½ and a HARP of 8.75 – good enough for a drop from 11th to 15th. How does a bond overshoot dollar neutral and still get a HARP reduction? In this case, it's in the tangent of the price curve. At 133½, Alon has broken into the realm of rapidly decreasing gamma which means that parity and price are converging at an increasing rate. Or to put in HARP-speak, Alon is near the outer limits of the multi-dimensional risk zone. And what risk does remain? That 3% coupon for a little over three years sure does make up for a lot of the 12¼ points of premium. So much so, that you might think your loss was limited to just 2¼ points! But wait, there is that pesky dividend – all 3.4% of it. That's just enough to reverse the coupon reduction and kick in an extra 1¼ points for good measure, setting potential loss at a grand total of 13½ points. Holding it all together and keeping it from getting worse is the high 30's volatility.

And finally, our new entrant. Settling in at 19th, up from 22nd, with a HARP of 8.39 is Workday. No, not the 0.75% of 2018 – that's 20th. The 19th spot holds the 1.5% of 2020 AKA Tranche 2. So there you have it, Tranche 2 resides directly on top of Tranche 1. Double Workday. How did this familial convergence happen? The stars did most certainly line up. The week prior, Tranche 2 was priced at 131¾ which put it heading near the exits of the multi-dimensional risk zone, and hence a lower HARP than the 126¾ priced Tranche 1. Disappointing 1Q numbers on Wednesday hit the stock with a 14.38% weekly decline and the Tranches gave up 11 and 12 points respectively as a result. Those declines put both bonds back in the center of the risk zone with prices of 115¾ and 119¾, respectively, though for Tranche 1, the magnitude of the risk change wasn't as large as for Tranche 2. In HARP terms, now only 0.20 separates the two bonds. So essentially the bonds are nearly equal in poison, but leave you the investor to choose how you like it mixed – longer dated or shorter dated.

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June 1, 2015

Hillside Ugly 20 List (Prices as of May 29, 2015)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	Illumina Tranche B 0.5% 2021-06-15	121.00	206.08	49.4	40.01	13.76
2	RPM International 2.25% 2020-12-15	117.00	50.03	23.7	22.42	12.81
3	Red Hat 0.25% 2019-10-01	125.75	77.27	19.5	20.52	12.65
4	Lam Research Tranche B 1.25% 2018-05-15	145.00	82.25	10.0	13.18	11.91
5	Emergent BioSolutions 2.875% 2021-01-15	123.00	31.86	24.9	24.52	11.31
6	Illumina Tranche A 0% 2019-06-15	115.50	206.08	42.6	34.50	11.00
7	Jazz Pharmaceuticals 1.875% 2021-08-15	119.25	179.35	32.9	29.52	10.40
8	NVIDIA 1% 2018-12-01	122.00	22.13	11.2	12.29	9.78
9	Priceline.com 0.35% 2020-06-15	113.50	1172.04	27.5	24.48	9.74
10	Salesforce.com 0.25% 2018-04-01	125.50	72.75	14.7	16.08	9.59
11	Medidata Solutions 1% 2018-08-01	122.75	58.01	22.7	22.71	9.44
12	BioMarin Pharma 0.75% 2018-10-15	147.50	125.57	10.6	14.14	8.98
13	Array Biopharma 3% 2020-06-01	131.50	7.65	21.1	22.91	8.93
14	US Steel 2.75% 2019-04-01	121.75	24.40	26.1	25.20	8.80
15	Alon USA Energy 3% 2018-09-15	133.50	17.63	10.0	12.14	8.75
16	Akamai Technologies 0% 2019-02-15	110.25	76.27	29.6	25.18	8.73
17	ServiceNow 0% 2018-11-01	120.50	76.61	16.2	16.80	8.72
18	Ctrip.com International 1.25% 2018-10-15	124.00	79.87	21.6	22.03	8.55
19	Workday Tranche 2 1.5% 2020-07-15	119.75	78.92	24.0	23.18	8.39
20	Workday Tranche 1 0.75% 2018-07-15	115.75	78.92	22.0	20.87	8.19

Sources: Bloomberg, Kynex

HOCS℠ 20

Bill Feingold
bill@hillsideadvisors.com

A quick refresher. HOCS, or Hillside Overall Convertible Score, measures the attractiveness of a bond, taking into account both upside potential and downside protection. HOCS is not a theoretical model but a rating system that assigns points to a number of different characteristics of each convertible. HOCS can theoretically lie anywhere from 0 to 100. In practice the average score for a broad group of convertibles is typically around 50. 60 is a good score, 70 is excellent, and 80 is exceptional.

Both flavors of HOCS—the 20 top scorers and the broader index of 100—took it gently on the chin last week. HOCS 20 dropped 24 basis points, while HOCS 100 got hit somewhat harder, losing 53 basis points. We'll explain the main culprit shortly. Meanwhile, despite a generally negative week for stocks, the equity-sensitive CWB ETF managed a 35-basis point gain. We were a bit perplexed over that one as well, so we took a quick look.

Several of CWB's biggest holdings, the Actavis 5.5% mandatory convertible and the two long-dated Intel convertibles, benefited from strong underlying performance last week. We give credit where it's due. Anyway, for the first time since we started tracking, CWB has moved ahead of the HOCS 100 for year-to-date performance, 5.65% to 5.10%. It will be interesting to follow the two as the year plays out.

Why did the HOCS 100 underperform the 20? The general answer is that the HOCS 20 is somewhat more defensive than the 100, so it tends to do better in down markets. Specifically, though, the fault lies not in our stars, but in our workdays. Workday convertibles, that is. Both issues, as Curt Peters mentions this week, fall into the Ugly 20, though near the bottom. Still, they have enough overall merit to make the top 100 ("like it's hard," as Reese Witherspoon famously said about getting into Harvard Law School in *Legally Blonde*). Remember that the HOCS 100 excludes financial convertibles, all non-bond structures, long-dated bonds, and certain other high-yielding names. It also excludes bonds that fail to get a minimum safety score of at least 25—not a particularly onerous requirement, but one that excludes highly appreciated bonds as well as distressed ones.

So Workday bonds, both falling on the order of 8-9%, took down the 100 last week. It's that "death trap" of 120-130 again—that range where bonds are susceptible to a toxic mix of absolute decline and premium compression.

This week's HOCS 20 has a couple of new Chinese names that had slipped through the cracks before. Say hello to E-House 2.75% and Soufun 2%. If you're looking for some yield and are willing to take the plunge into Chinese names, these could work for you. Keep in mind that our HOCS scoring system explicitly penalizes Chinese names because of the lack of transparency and checkered past. That said, the bonds often have attractive yields and favorable structures, leading to good safety ratings even with the caveats above. The inclusion of these names gives the HOCS 20 the most defensive posture it's had in a while, with a 3.25% yield and a 61.8% premium.

Invensense 1.75% continues to top the list, followed by two of the three Qihoo issues. The longest-dated Qihoo 1.75% has slipped to sixth, behind CalAmp and ANI Pharma. Please be sure to read Kathy Schick's commentary on ANI elsewhere in this issue.

Interestingly, the two balanced Tesla convertibles continue to slide down the HOCS 20, with the 0.25% now hanging on by a thread in 20th place. The controversial electric car maker's recent run has brought the bonds back near par, lessening the overall attraction both issues had in the 80's and low 90's. That said, we continue to think both of these issues are the right ways to play this name.

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June 1, 2015

Hillside HOCS 20 List

	Description	Convert	Stock	HOCS Overall	HOCS Growth	HOCS Safety	Yield	Premium
1	INVENSENSE 1.75% 2018-11-01	94.50	14.16	80.2	79.7	81.2	3.47%	46.1%
2	QIHOO 0.50% 2020-08-15	88.25	52.05	75.9	69.9	87.8	6.31%	112.5%
3	QIHOO 2.50% 2018-09-15	96.25	52.05	74.0	67.4	87.3	5.57%	105.2%
4	CALAMP 1.625% 2020-05-15	100.50	19.74	73.8	79.3	63.0	1.52%	40.5%
5	ANI 3.00% 2019-12-01	103.75	50.38	72.2	81.7	53.2	2.12%	43.1%
6	QIHOO 1.75% 2021-08-15	82.75	52.05	72.1	74.4	67.5	6.51%	92.0%
7	IGI 3.50% 2019-12-15	92.25	6.50	71.5	79.5	55.4	5.45%	60.2%
8	WEB.COM 1.00% 2018-08-15	98.50	22.67	71.4	74.4	65.4	1.48%	52.1%
9	ENVESTNET 1.75% 2019-12-15	101.00	43.81	71.4	69.2	75.7	1.52%	45.0%
10	LINKEDIN 0.50% 2019-11-01	99.50	194.93	70.6	64.9	82.1	0.62%	50.3%
11	E-HOUSE 2.75% 2018-12-15	92.25	5.56	70.0	60.5	89.1	8.24%	150.0%
12	HERBALIFE 2.00% 2019-08-15	88.25	52.03	69.7	70.8	67.6	5.15%	46.3%
13	RENEWABLE 2.75% 2019-06-15	100.75	10.63	69.3	73.9	60.2	2.55%	25.7%
14	TESLA 1.25% 2021-03-01	96.25	250.80	68.8	74.5	57.2	1.94%	38.1%
15	SOLARCITY 1.63% 2019-11-01	98.00	60.12	68.3	81.0	43.0	2.10%	36.2%
16	FIREEYE 1.625% 2035-06-01	104.75	46.57	68.3	78.8	47.1	0.92%	36.7%
17	51JOB 3.25% 2019-04-15	100.25	31.04	67.9	59.1	85.7	3.11%	38.0%
18	SOUFUN 2.00% 2018-12-15	94.25	7.43	66.0	55.5	87.0	5.99%	148.9%
19	RESTORATION 0.00% 2019-06-15	102.00	90.96	65.9	60.7	76.4	-0.49%	30.2%
20	TESLA 0.25% 2019-03-01	97.50	250.80	65.6	67.9	61.0	0.93%	39.9%

Sources: Bloomberg, Kynex

HILLSIDE ADVISORS LLC

June 1, 2015

Euro Gang of 20

Roman Terekhin, CFA
roman@hillsideadvisors.com

Over the past week, as the June 5th deadline for Greece's repayment of €1.5 billion to the IMF loomed, the country's officials dispatched conflicting information on whether the payment will indeed be made. News of the critically low level of deposits at the Greek banks and the continued impasse in negotiations regarding the next tranche from the bail-out fund did not help either. On Thursday, putting a cherry on this news-pie, Madame Lagarde spoke of Greece exiting the Euro zone as "a possibility".

Not surprisingly, given the news flow over the past week, European equity markets declined almost in unison with DAX, CAC 40 and most other major indices dropping around 3%. It was not a pretty picture for the underlyings of the sub-set of the European convertible universe that we track either. The average stock declined 2.8% and the average bond declined 0.7 points.

One of the stocks that traded down in sentiment with the overall market was Deutsche Post declining 5% for the week. As the stock traced the DAX index down, premium on the 0.6% convertible due 2019 expanded over 4 points from 0.3 to 4.5. With the bond trading around 137.7, the HARP score shot up to 10.5 from last week's 6.9 thus propelling the bond to the 17th place on the Euro Gang of 20 list. Why such high HARP when the premium sounds pretty reasonable given over 2.5 years remaining of hard call protection? It is mainly the price point that makes the score high, but also the low coupon coupled with a high dividend and lowish volatility of the underlying stock. Over the past week, the bond traded down on a 36% delta, which at this price point should have been higher, the bond's investment-grade rating notwithstanding. Should the decline in the underlying price continue, we would expect further premium expansion and, as long as the bond remains within the price danger zone, the HARP score could go even higher.

The Deutsche Post convertible was the only new entrant into the top 20 European HARP names. The rest of the list remains almost intact in terms of its composition and rankings, despite some significant stock moves. The first five positions are exactly the same as last week with the Drillisch AG 0.75% of 2018 remaining the unchallenged leader. In fact, the bond saw its HARP score increase by over a point further cementing its position.

Perhaps as a sign of things to come, Suez Environnement 0% of 2020, although remaining in its third place on the HARP pedestal, saw its risk score decline by a point. While the stock went down by 3%, the bond experienced virtually no premium expansion having traded down on a 95% delta. As the bond's price declined from 124.2 to 121.5 over the week, it remains squarely in the danger zone.

We'll see what the coming week brings as the current part of the Greek drama culminates on June 5th. For history buffs, we would like to point out that since we started tracking HARP for the US universe, the greatest cheapening occurred last fall as the US market sold off. The names that graced the Ugly 20 prior to the sell-off did significantly worse than the universe overall. Even if history does not repeat itself this time, we can hear the rhyming already.

HILLSIDE ADVISORS LLC

June 1, 2015

Euro HARP 20 (Prices as of May 29, 2015)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	Drillisch AG 0.75% 2018	202.49	42.20	5.5	10.47	18.03
2	Alcatel-Lucent 4.25% 2018	4.33	3.64	12.2	0.47	15.83
3	Suez Environnement 0% 2020	22.31	17.56	27.1	4.75	14.34
4	Rag-Stiftung 0% 2021	116.96	33.80	27.5	25.20	14.08
5	Cap Gemini Sogeti 0% 2019	90.77	79.02	14.9	11.75	14.07
6	Fresenius Se & Co KGAA 0% 2019	130.07	58.11	11.2	13.05	13.05
7	Nexity SA 0.625% 2020	49.87	36.68	29.1	11.25	12.69
8	Fresenius Medical Care A 1.125% 2020	123.53	77.85	16.8	17.80	12.60
9	Adidas AG 0.25% 2019	116.90	71.30	35.3	30.47	11.90
10	ACS Actividades Fin 2 1.625% 2019	115.05	6.30	17.3	16.96	11.62
11	Parpublica 5.25% 2017	115.75	10.72	63.0	44.76	11.56
12	ACS Actividades Finance 2.625% 2018	123.17	6.30	11.4	12.60	11.29
13	Buzzi Unicem SPA 1.375% 2019	118.22	13.93	35.7	31.08	11.16
14	Rag-Stiftung 0% 2018	113.18	33.80	26.4	23.61	11.13
15	SAF-Holland Group 1% 2020	127.12	13.88	12.9	14.54	11.07
16	Alcatel-Lucent 0.125% 2020	4.86	3.64	33.4	1.22	10.55
17	Deutsche Post AG 0.6% 2019	137.68	27.48	3.4	4.53	10.53
18	Acciona S.A. 3% 2019	125.90	69.81	13.7	15.13	9.74
19	NH Hotel Group SA 4% 2018	126.06	5.19	19.5	20.55	9.64
20	Alcatel-Lucent 0% 2019	4.85	3.64	33.1	1.21	9.56

Sources: Bloomberg

HILLSIDE ADVISORS LLC

June 1, 2015

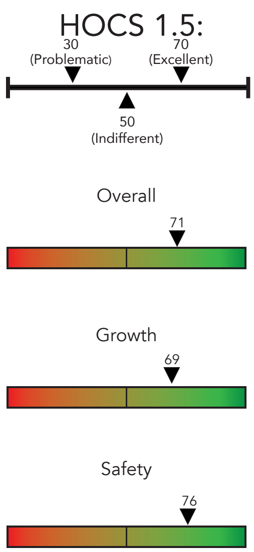
Envestnet Inc (ENV): Value in the Wealth Creation Chain

George Lynch
glynch@hillsideadvisors.com

ENV

1.75% 2019/12/15
Price (Bond) = 101.00
Stock = $43.81
YTM = 1.52%
Premium = 45.0%
HOCS-Overall = 71
HOCS-Growth = 69
HOCS-Safety = 76

As of May 29, 2015



Introduction

Several months ago, Envestnet, Inc. brought its inaugural convertible bond to market. Almost immediately, the issue skyrocketed, ultimately grinding as high as 113.00. The stock traded appreciably higher as well. However, within a few months the bonds and stock began to trade lower on company-specific growth concerns. The breakdown was gradual at first. However, both tumbled following the release of Q1 2015 earnings. As a result, ENV's bonds closed last week at 101 while the shares now trade toward the lower end of their 52-week trading range ($37.76-58.21), closing the week at $43.81. Frankly, we weren't at all concerned by the company's recent results. They were "in line" from our vantage point. However, momentum investors obviously took the news differently.

ENV's flexible and fully customizable cloud-based wealth management platform supports a large and growing network of over 41,000 financial advisors, nearly three-million investor accounts, and approximately $750 billion in total assets. The company's integrated software and services suite is known for its breadth and depth. This has resulted in the creation of formidable barriers to entry and ensures the company's high client retention rates.

Ultimately, we remain bullish on ENV's near-term prospects. The company boasts a leading market position, consistent revenue growth, strong EBITDA generation and a solid balance sheet. In turn, our HOCS slash line measures an impressive 71 Overall / 69 Growth / 76 Safety. ENV definitely deserves a fresh look.

A Large and Growing Opportunity

In the world of technology, there's often no better advantage than being a "first mover". That early advantage frequently carries over for many years. As a result of ENV's first-mover status, the company has been able to grow revenues at an impressive 37% compounded annual rate the past five years. While organic growth has been central to this top line improvement, acquisitions have also played a pivotal role. Specifically, several acquisitions completed in the past few years have succeeded in either expanding the company's customer base or enhancing its investment and technology solutions.

ENV's revenue model is relatively transparent and predictable. Asset-based revenues, which total approximately 85%, are derived from the company's assets under management/administration (AUM/A). Related revenues are billed quarterly in advance, based on invested assets at the end of the previous calendar quarter. Revenues are highly predictable, being affected by two factors: net flows in the previous quarter and quarter-over-quarter market fluctuations. Software and services related revenues, essentially licensing and professional services revenues, account for the roughly 15% balance. The company typically earns such revenues as part of multi-year agreements with large enterprise clients. Fees are based on the level and types of investment solutions and services provided. Moreover, this revenue category is not subject to asset or account volatility.

Ultimately, ENV enjoys several clear competitive advantages. Most importantly, ENV's large and growing network of advisors has proven to be extremely loyal, the result of an easy-to-use, integrated, and feature-rich platform. In addition, the company's end-to-end solutions provide pricing stability and pave the way for significant cross-selling opportunities.

Credit Waterfall

Total Debt (2) (Dollars in Millions)	31-Mar-15	Total Debt (Cum. Bal.)	Adj. EBITDA Multiple	Net Debt (Cum. Bal.)	Adj. EBITDA Multiple
Current Share Price	$43.81				
Shares Out. (Millions)	35.3				
Latest Twelve Months:					
EBITDA	43.4				
EBITDA (Adj.)	61.0				
Free Cash Flow (1)	38.4				
Cash & Cash Equivalents	209.9				
Senior Secured Debt					
Bank Debt (Rev. Commit. = $100mm / 08-Dec-17 Expiry)	0.0				
Other Secured Debt	0.0				
Total Secured Debt	0.0	0.0	0.0x	(209.9)	-3.4x
Senior Unsecured Debt					
1.75% Cvt. Senior Notes due 2019 (2)	175.0				
Total Unsecured Debt	175.0	175.0	2.9x	(34.9)	-0.6x
Total Debt (2)	175.0	175.0	2.9x	(34.9)	-0.6x
Equity Market Cap.	1,546.1	---	---	---	---
Enterprise Value	1,511.2	---	---	---	24.8x

(1) Adjusts free cash flow to reflect interest expense as if current debt had been outstanding for the latest twelve months.
(2) Reflects principal amount of convertible securities outstanding (i.e., unadjusted for unamortized debt discount).
Sources: Company Filings, Bloomberg LLC, and Hillside Advisors LLC

Finally, central to ENV's historical revenue growth has been the addition of advisors, a steady increase in accounts per advisor, and the addition of products as well as advisor relationships. Cerulli Associates, a research firm, specializing in global asset management and distribution analytics, recently published several studies which we believe support our general conclusions. One study highlights the proportion of domestic households investing in the markets and working with financial advisors as having increased from 50% in 2008 to 86% by the end of 2013. Another references the continued increase in registered investment advisors (RIAs). Specifically, the number of RIAs have reportedly increased from 42,200 at the end of 2008, to 57,100 by the end of 2014. Yet another estimates that fee-based AUM/A have grown from $2.7 trillion at the end of 2008, to $6.4 trillion by the end of 2014. A final study suggests that wealth management entities continue to allocate resources to technology. It is estimated that approximately 76% of such entities have shifted to cloud-based or outsourced solutions and 51% have embraced mobile technologies. In combination, all of these developments and resultant data points seem to point towards further company-specific revenue, earnings, and cash flow gains over the foreseeable future.

Recent Results

Q1 2015 revenues totaled $96.5 million, a 23% increase in the year-over-year comparison. The increase was driven by a 21% gain in revenues from AUM/A, the result of a 31% increase in total AUM/A. In turn, EBITDA improved to $16.8 million in the most recent quarter, in contrast to last year's $11.8 million. In addition, EPS came in at $0.22, up from last year's $0.17. Despite the above top- and bottom-line gains, Q1 2015 results were just in line with the $97 million revenue and $0.22 per share estimates, respectively. Again, perhaps the aforementioned results were a disappointment to momentum types. We see it differently.

Financial Summary

Envestnet, Inc.	Fiscal Years Ended			3 Mos. Ended		LTM (1)
(Dollars in Millions)	31-Dec-12	31-Dec-13	31-Dec-14	31-Mar-14	31-Mar-15	31-Mar-15
Revenues						
Assets Under Mgt. or Admin. (AUM/AUA)	127.2	200.6	294.2	67.1	81.1	308.2
Y / Y Change	----	57.7%	46.7%	----	20.9%	----
Licensing & Professional Services	30.1	42.0	54.5	11.5	15.4	58.4
Y / Y Change	----	39.6%	29.9%	----	34.2%	
Total Revenues	157.3	242.5	348.7	78.5	96.5	366.7
Y / Y Change	----	54.2%	43.8%	----	22.8%	----
Cost of Revenues	56.1	99.0	150.1	34.4	38.7	154.3
Compensation & Benefits	55.0	77.4	104.5	23.5	31.5	112.5
General & Administration	30.6	44.8	54.3	12.2	14.2	56.4
Operating Profit	3.0	5.5	21.3	4.1	6.7	23.9
Interest Expense (1)	0.0	0.0	0.6	0.0	0.8	3.1
EBITDA	15.6	21.3	39.9	8.5	12.0	43.4
EBITDA (Adj.)	24.0	38.6	55.9	11.8	16.8	61.0
Cash Interest (1)	0.0	0.0	0.0	0.0	(0.8)	(3.1)
Cash Taxes	(2.5)	(4.6)	(13.2)	(1.3)	(0.1)	(12.0)
Capital Expenditures	(4.8)	(6.1)	(6.2)	(2.0)	(2.1)	(6.2)
Capitalized Software Dev.	(2.4)	(3.1)	(3.4)	(0.9)	(1.1)	(3.7)
Free Cash Flow (1)	14.3	24.7	33.2	7.6	12.8	38.4
Total Debt (2)	0.0	0.0	145.2	0.0	146.4	146.4
FCF % Total Debt	NM	NM	22.9%	----	----	26.2%
Gross Margin	64.3%	59.2%	57.0%	56.2%	59.9%	57.9%
Operating Margin	1.9%	2.3%	6.1%	5.2%	6.9%	6.5%
EBITDA Margin	9.9%	8.8%	11.4%	10.8%	12.5%	11.8%
EBITDA (Adj.) Margin	15.3%	15.9%	16.0%	15.0%	17.4%	16.6%
EBITDA (Adj.) / Cash Interest	NM	NM	NM	NM	22.0x	19.9x
EBITDA (Adj.) - Capex / Cash Interest	NM	NM	NM	NM	19.3x	17.9x

(1) Adjusts interest expense, cash interest, and free cash flow to reflect charges as if current debt had been outstanding for the latest twelve months.
(2) Reflects carrying amount of convertible securities outstanding (i.e., principal amount net of unamortized debt discount).
Sources: Company Filings, Bloomberg LLC, and Hillside Advisors LLC

Acquisition Track Record

ENV has an established track record of having strengthened its platform and grown its business, both organically and via acquisition. The company has proven disciplined when it comes to sourcing, evaluating, and completing transactions. Since 2011, ENV has spent approximately $200 million (plus earn-outs) on a combination of consolidation or strategic focused deals. The company's consolidation transactions have proven to be highly accretive and have resulted in the addition of advisors and assets. The company's strategic acquisitions have enhanced or expanded the company's platform or resulted in the addition of new capabilities. The acquisition of WMS (2013) is the only transaction to have gone less smoothly than originally hoped. However, the kinks were eventually worked out. Given this positive track record, investors should expect the company to continue to pursue strategic transactions and other relationships.

Beware the Robo Advisor

Targeting relatively young investors with limited investable assets, so-called robo advisors are attempting to transform the world of financial advice by introducing websites supported by asset allocation software. Website users are asked a limited number of questions concerning their financial goals, risk tolerance, and investment time horizon. From there, investors are presented with a recommended asset allocation. Once the account is funded, client assets are automatically invested in several exchange-traded funds. It's a quick, easy, and low-cost way of investing.

Might the robo investors eventually encroach on the more traditional advisors' territory? We don't think so. Frankly, as investable assets grow and financial needs increase in complexity, investors still seem to value the "high touch" approach of more traditional advisors. As a result, while we see a real need and growing role for robo advisors, traditional financial advisors are not likely to be displaced.

Business Description

ENV's centrally hosted technology platforms provide advisors with access to a series of integrated services. These services include risk assessment and selection of investment strategies and solutions, asset allocation models, research and due diligence, portfolio construction, proposal generation and paperwork preparation, model management and account rebalancing, account monitoring, tax management, and other features. ENV believes that these attributes empower advisors to manage better client outcomes and strengthen their overall advisory business.

Asset Analysis

Envestnet, Inc.

	For the Period Ended					
	31-Dec-13	31-Mar-14	30-Jun-14	30-Sep-14	31-Dec-14	31-Mar-15
Platform Assets (Dollars in Millions)						
Assets Under Management (AUM)	$45,706	$49,383	$53,063	$54,935	$72,120	$74,643
Assets Undr Administration (AUA)	132,215	146,748	156,723	164,639	174,249	181,239
Subtotal AUM/A	177,921	196,131	209,786	219,574	246,369	255,882
Licensing	358,919	376,341	412,141	448,169	466,982	493,284
Total Platform Assets	$536,840	$572,472	$621,927	$667,743	$713,351	$749,166
Platform Accounts						
AUM	211,039	226,452	239,367	255,359	310,351	319,896
AUA	524,806	566,139	596,886	642,192	667,274	679,753
Subtotal AUM/A	735,845	792,591	836,253	897,551	977,625	999,649
Licensing	1,508,254	1,559,188	1,659,313	1,830,678	1,881,352	1,982,773
Total Platform Accounts	2,244,099	2,351,779	2,495,566	2,728,229	2,858,977	2,982,422
Number of Advisors						
AUM/A	22,838	24,369	24,945	24,887	28,605	29,023
Licensing	7,794	8,025	8,583	11,266	11,632	12,306
Total Advisors	30,632	32,394	33,528	36,153	40,237	41,329
Average Account Size						
AUM	$216,576	$218,073	$221,681	$215,129	$232,382	$233,335
AUA	251,931	259,208	262,568	256,370	261,136	266,625
Subtotal AUM/A	241,791	247,455	250,864	244,637	252,008	255,972
Licensing	237,970	241,370	248,381	244,810	248,216	248,785
Total Platform Assets	$239,223	$243,421	$249,213	$244,753	$249,513	$251,194
Accounts per Advisor						
AUM/A	32	33	34	36	34	34
Licensing	194	194	193	162	162	161
Total Platform Assets	73	73	74	75	71	72

Sources: Company Filings, Bloomberg LLC, and Hillside Advisors LLC

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June 1, 2015

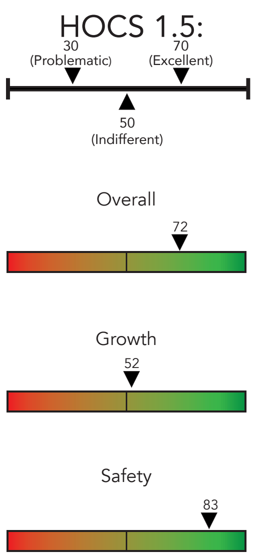
ANI Pharmaceuticals (ANIP): Small Acquisitions are Paying Off

Kathy Schick
kathy@hillsideadvisors.com

ANIP

3% 2019/12/01
Price (Bond) = 103.75
Stock = $50.38
YTM = 2.12%
Premium = 43.1%
HOCS-Overall = 72
HOCS-Growth = 82
HOCS-Safety = 53

As of May 29, 2015



ANI Pharmaceuticals (ANIP) has rejoined the HOCS 20 over the last few weeks as the stock and convertible bond prices fell following the first quarter 2015 earnings announcement on May 5. While bottom line results exceeded expectations the top line fell short. The real concern, though, appears to be that full year guidance was simply reaffirmed and not increased. The stock has fallen 18.5% since the earnings announcement with the bond following it down by 9.0% for just under 50% participation. The HOCS slash line is now 72 Overall / 82 Growth / 53 Safety. Investors have a chance to get in now at these lower levels where downside is limited and upside participation should be good. Plus you get a yield of 2.12%.

Overview

ANIP is a small specialty pharmaceutical company with a line of branded and generic prescription products. The company is focused on pain (narcotics), anti-cancer (oncolytics), women's health (hormones and steroids), and complex formulations including extended release and combination products. As of March 2015, the company had four branded products and eight generic products, two of which were launched in March, on the market.

ANIP as it currently exists came about through a merger with publicly-traded Bio-Sante in an all-stock deal in July 2013. This allowed the company to become public and provided it with some development projects. Since then the focus has been on acquiring mature products in the branded and generic prescription space in order to grow the business. To facilitate the growth initiative the company did a secondary stock offering in March 2014 raising net proceeds of $46.8 million. The $143.8 million 3% convertible senior notes were issued last December providing additional cash to fund future acquisitions.

Over the last year and a half ANIP has made several acquisitions beginning with the Teva product transaction in early 2014. The company acquired 31 previously marketed generic products from Teva for $12.5 million and a percentage of future gross profits. Since then three of those products have been launched by ANIP.

In July 2014 it acquired Lithobid (bipolar disorder treatment) for $12 million. In August Vancocin (diarrhea treatment) came on board for $11 million. Earlier this year, the approved ANDA (abbreviated new drug application) for Flecainide tablets and the approved NDA (new drug application) for Testosterone Gel were acquired, both from Teva.

The company has two manufacturing facilities that allow it to produce complex products, including oral solids, liquids and topical ointments; narcotics; and potent products that must be manufactured in a fully-contained environment. These capabilities create higher barriers to entry than those surrounding the average pharmaceutical company. They also allow the company to perform contract manufacturing, though that is a small part of the business.

The company's strategy of focusing on mature drugs allows it to operate with a small national sales force and limits research and development spending. As a result margins are quite high. For the last twelve months ending Mach 31, the gross margin was 81.8% and for the most recent quarter it was 85.4%. Operating margins were 40.8% and 50.9% respectively.

First Quarter 2015 Results

ANIP reported first quarter 2015 results in early May with adjusted EPS of $0.57 exceeding the consensus estimate by $0.02. However, revenue came in at $18.8 million, short of the $19.9 million consensus estimate. Adjusted EBITDA was $11.5 million for the quarter up $7.3 million from the prior year quarter.

Revenue was up 72% from the prior year quarter driven by a 52% increase in generics and a 452% increase in branded pharmaceuticals. Contract manufacturing was down from a small base due to the timing of customer orders.

Within the generics pharmaceutical business sales growth was driven by Methazolamide and Etodolac, launched in the fourth quarter of 2014 and first quarter of 2015 respectively, and increased sales of EEMT (Esterified Estrogen with Methyltestosterone).

EEMT, a treatment for certain menopause symptoms, remains the company's largest revenue contributor, accounting for 42% of 2014 sales, up from 33% in 2013. The company did not release details for the first quarter, but did acknowledge that EEMT accounts for 45% to 50% of full-year sales guidance. The concentration is trending up as competitors exit. ANIP announced it was awarded two new contracts for EEMT. The first was effective April 1. The company believes Amneal was previously filling those orders and has exited the market. The second contract, which was previously filled by Seton, begins in July. It is possible Seton may be exhausting its inventory and leaving the market as well, though management cannot confirm that. If this is the case the company could be in line for more new business as Walgreens and AmerisourceBergen are both customers of Seton currently. Management acknowledged on the first quarter conference call that its market share for EEMT could be 80% to 85% by the end of the year up from 50% at the beginning of this year. While it is great to pick up market share, it is quite risky to have one product account for a significant share of total revenue.

For branded products, the sales growth was driven by Lithobid and Vancocin, both acquired in the third quarter of 2014. However, Vancocin sales lagged behind management expectations. It is unclear what is causing the weakness and whether it will continue. Average selling price and volume were both down for the first quarter. Management has adjusted down revenue expectations for Vancocin as a result of the weak first quarter, but that weakness was offset by EEMT and recently launched products - Methazolamide tablets (treatment of certain eye conditions), Etodolac capsules (arthritis and acute pain), and Propafenone (irregular heart rhythm).

As a result of the give-and-take between the various products, management reaffirmed its 2015 revenue and adjusted EBITDA guidance of $80 million to $88 million and $48.8 million to $53.1 million respectively. Adjusted EPS guidance, though, was reduced to a range of $2.44 to $2.67 from $2.48 to $2.72 due to a higher tax rate and an increased share count. The market was not expecting that and reacted accordingly.

The company has 47 products in development with a total combined current market of $3.3 billion. The testosterone gel acquired from Teva in May has an approved NDA and the company expects to launch that in early 2016. The company's oral anti-cancer product has an expedited FDA review and is expected to be the only generic product available once on the market. ANIP has an exclusive source for the active ingredient, providing some barrier to entry by competitors. ANIP also has partnered programs with Dexcel and Sofgen Pharmaceuticals that are pending FDA approval. The timing of these product launches is uncertain due to the FDA's timeline, but will provide a boost to revenue once on the market. None of these is included in the company's current guidance.

Table 1: Revenue Summary

Net Sales (in millions)	Q1 2015	Q1 2014	% Chg	FY 2014	FY 2013	% Chg
Generic Products	$12.3	$8.1	52.2%	$35.9	$19.3	85.9%
Branded Products	4.3	0.8	451.9%	11.0	3.4	226.7%
Contract Manufacturing	1.2	1.6	-25.6%	5.9	6.0	-1.4%
Contract Services and Other	1.1	0.5	135.8%	3.2	1.4	124.8%
Total Net Sales	$18.8	$10.9	72.5%	$56.0	$30.1	86.1%

Sources: Company Filings

Liquidity

ANIP has a very nice cash cushion of $166 million, exceeding the $143.8 million of converts, which are the only debt. The company has also begun to generate some modest free cash flow in recent quarters as sales have ramped up. For first quarter 2015 free cash flow was $1 million and for the last twelve months it was $16.9 million. The company's R&D "lite" business model and the limited national sales force allow it to generate high margins which can lead to positive cash generation much quicker than a traditional pharmaceutical or biotechnology company.

The company has been using some cash to make acquisitions. ANIP made three product acquisitions in 2014 with total cash consideration of $36 million. So far in 2015, two acquisitions have been made. Terms were not released, but the upfront cash consideration was not significant.

Management continues to stress the cash is for acquisitions. These may include not only the smaller product acquisitions done to date but also a transformative deal of up to $300 million. We would prefer to see more of the smaller product acquisitions allowing the company time to generate more substantial cash flow while keeping a large cash cushion in place. Large acquisitions always come with large risks.

The 3.0% Convert

The 3.0% senior convertible notes due 2019 receive a HOCS slash line of 72 Overall / 82 Growth / 53 Safety. The safety score is on the low side due to the small market cap and the modest free cash flow, but overall this is a very good score especially for a seasoned deal As we mentioned above, the biggest risk is the company undertaking a large transformative acquisition. But with the converts now trading close to par, the bond offers a good entry point where downside should be limited and upside should be significant.

Credit Waterfall

ANI Pharmaceuticals (ANIP) (Dollars in Millions)	31-Mar-15	Total Debt (Cum. Bal.)	Adj. EBITDA Multiple	Net Debt (Cum. Bal.)	Adj. EBITDA Multiple
Current Share Price	$50.38				
Shares Out. (Millions)	11.4				
Latest Twelve Months:					
EBITDA (Adj.)	31				
Free Cash Flow	17				
Cash & Cash Equivalents	166				
Senior Unsecured Debt					
3.00% Senior Cvt. Notes due 2019 (1)	144	144	4.7x	(22)	NA
Total Debt	144	144	4.7x	(22)	NA
Equity Market Cap.	576	---	---	---	---
Enterprise Value	554	---	---	---	18.1x

(1) Reflects principal amount of convertible securities outstanding, unadjusted for unamortized debt discount.

Sources: Bloomberg, Company Filings

HILLSIDE ADVISORS LLC

June 1, 2015

Financial Summary

ANI Pharmaceuticals (ANIP) (Dollars in Millions)	Fiscal Years Ended			LTM		Quarter Ended	
	31-Dec-12	31-Dec-13	31-Dec-14	31-Mar-14	31-Mar-15	31-Mar-14	31-Mar-15
Revenues	20	30	56	35	64	11	19
Y / Y Change	----	47.7%	86.1%	----	80.3%	----	72.5%
Gross Profit	11	20	44	25	52	8	16
Operating Profit	(0)	1	20	4	26	3	10
EBITDA	1	2	24	6	31	4	11
EBITDA (Adj.)	1	8	27	11	34	4	11
Interest Expense	1	0	1	0	4	0	3
Income Tax Expense	(0)	0	(9)	0	(7)	0	3
Capital Expenditures	(0)	(0)	(1)	(3)	(1)	(0)	(0)
% Revenues	-1.4%	-0.6%	-2.0%	-9.1%	-1.7%	-1.1%	-0.6%
Free Cash Flow	(0)	(6)	21	(3)	17	5	1
Total Debt (1)	4	0	111	0	112	0	112
% Total Debt			18.9%		7.6%		0.9%
Gross Margin	55.0%	66.8%	79.5%	71.7%	81.8%	75.9%	85.4%
Operating Margin		3.0%	35.7%	11.3%	40.8%	32.1%	50.9%
EBITDA (Adj.) Margin	2.6%	6.7%	42.7%	16.0%	47.9%	38.5%	61.0%
EBITDA (Adj.) / Interest	0.4x	4.3x	30.3x	15.1x	8.7x		4.0x
EBITDA (Adj.) - Capex / Interest	0.6x	4.7x	31.8x	23.7x	9.0x		4.0x

(1) Reflects carrying amount of convertible securities outstanding, net of unamortized debt discount.

Sources: Bloomberg, Company Filings

June 1, 2015

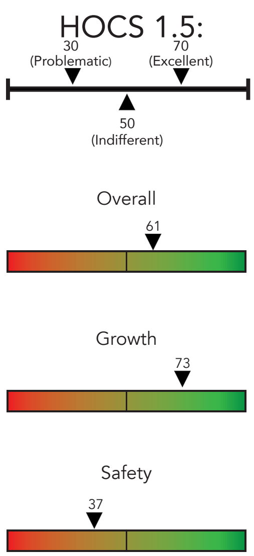
Molina, Where You Going To?

Bill Feingold
bill@hillsideadvisors.com

MOH

1.625% 2044/08/15
Price (Bond) = 135.75
Stock = $72.56
YTP = -7.94%
Premium = 8.7%
HOCS-Overall = 61
HOCS-Growth = 73
HOCS-Safety = 37

As of June 1, 2015



We've made no secret in this space of how much we like Molina Healthcare. We've recommended the company's convertibles for outright investors and urged hedgers to lean long (Hybrid Vigor, January 12, 2015). With last Friday's news about suitors approaching Humana, we find today's announcement of a secondary stock offering by Molina to be especially intriguing.

Analysts have listed Molina, which focuses on Medicaid and is one of the smaller publicly traded names in managed care, as a top takeover candidate. We suspect Humana's is not the only management team in the industry to be fielding inquiries these days. It's hard to blame Molina for monetizing the past year's (and month's) gains in its stock price, but even with these gains the company seems to embody growth at a reasonable price, especially in an in-demand "space." We wonder if today's announcement was in part an attempt to send a message to prospective buyers that Molina wants to keep growing on its own. Either way, things are going to be quite interesting in this area in the weeks and months to come.

Premiums are small enough in both Molina convertibles, which have become highly equity sensitive with the gains in the stock, that delta-neutral hedgers should be fine in the event of a takeout. That said, we still encourage those willing to take a bit of a view to give themselves room to profit from substantial further gains, with or without a takeout.

The Molina 1.625% (CUSIP 60855RAD2) are probably more palatable as an outright buy than the 1.125% simply because they're nearly 50 points lower, while still having a low enough premium to ensure high upside participation. For their price point (135.75 vs 72.56 as we go to press), these bonds have a surprisingly good HOCS slash line: 61 Overall/73 Growth/37 Safety.

Disclosure: A Hillside principal owns Molina securities.

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June 1, 2015

Renewable Energy Group, Inc. (REGI): EPA Finally Steps Up

Jeffrey Alton, CFA
jeff@hillsideadvisors.com

Perennial HOCS 20 member Renewable Energy Group, Inc. is surging today as the EPA finally presented new biofuel blending standards for renewable fuel through 2017. The EPA has failed to issue standards for the last two years, so this is catch-up. Both the REGI stock and convertible security have languished over the last year as the EPA silence has left investors skittish toward biofuel names such as REGI.

For a full account of REGI's biodiesel business, please refer to the January 12, 2015 edition of Hybrid Vigor, where we wrote a bullish account of REGI's potential once the EPA acted. We also wrote about REGI last summer in one of our inaugural Hillside research pieces.
While the EPA's announcement is just a first step toward the final blending requirements, the proposal signifies that the EPA is behind increasing the requirements over time. Of particular concern for REGI, biomass-based diesel requirements would increase from 1.63 billion gallons in 2014 to 1.9 billion in 2017.

As the low-cost producer in the industry, REGI is in a particularly good position to benefit from the proposal. While patient investors have finally been rewarded, we think there is additional room to run as REGI margins expand as RIN (renewable identification number) prices also increase.

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June 1, 2015

Taxing Convertibles For Phantom Dividends: An Introduction

Bill Feingold
bill@hillsideadvisors.com

Over the past 18 months or so two parts of the Internal Revenue Code—one proposed but apparently now put aside, one on the books since the 1960's—have shaken up the convertible market. Those who see convertibles as key instruments for capital formation, especially for companies in the midst of growth or restructuring, have become understandably concerned. The concern is even greater given the increasing number of traditional fixed-income investors who have discovered convertibles in recent years and for whom the convertible asset class provides an ideal solution for minimizing duration risk while increasing upside potential. The new, or newly interpreted, regulations would appear to have the potential to undermine at least some of the convertible issuance and investment process.

Section 871(m): Deemed Dividends, Seven Deadly Sins and a .70 Delta

First there was proposed rule 871(m). Briefly, this rule, as conceived, is designed to identify financial contracts with substantial equity sensitivity and charge them as being effective economic recipients of dividends paid to common stockholders. It came rather as a shock to convertible traders, who are accustomed to being harmed by common dividend payments (though most of the harm has been ameliorated by protective clauses beginning around 2003-2004).

Rule 871(m) as initially conceived had a number of tests, known semi-officially as the "seven deadly sins," designed to show reason to believe a financial holding—usually an equity swap contract—has been created to sidestep dividend tax withholding. One of the "sins," for example, was evidence that the long party to a swap actually controlled the short party's trading of its hedges. Another was that the swap had duration of less than 90 days, presumably showing that the trade was targeted at a single event in the quarterly dividend cycle.

Subsequently, the IRS and Treasury revised their approach, seemingly trying to make it simpler by reducing the "seven deadly sins" to a "simple" delta test. Essentially, any contract with delta of 0.7 or greater would be considered as having sufficient equity content to be a deemed recipient of any dividends paid to the underlying common shares.

Those in the convertible community who took this seriously cried foul for a variety of reasons including the potential for disagreements over what constituted the "right" delta, the burden of substantially increased recordkeeping, the high incidence of convertibles with deltas of .7 or more that were still likely not to be converted, and above all the fact that the convertible contract involves obtaining certain economic benefits in exchange for forgoing other related ones, including stock dividends. Another problem was inconsistency in treatment—the idea was that delta would be determined based on the time of purchase, not subsequent economic reality, so that two different investors owning the same convertible could receive entirely different tax treatment.

The IRS and Treasury argued in response that since convertible holders often receive considerations when common dividends are increased, those considerations must have value and therefore should be subject to withholding tax. Countering this argument was that these considerations only restored convertible holders to the same relative position they had before the dividend increases.

Hillside Gets Involved

Hillside Advisors met in the spring of 2014 with the IRS and Treasury, providing market background while pleading the case of the convertible investor (and issuer). Eventually, as we understand it, the government first moved to a higher delta threshold of .9 and said that the test would only be applied at a security's issuance, thus removing virtually all convertibles (especially those on dividend-paying issuers) from consideration. We have also been informed that current plans are to exclude convertibles from 871 (m) withholdings altogether, although we cannot make any assurances to this effect.

305(c): Old Rule, New Interpretation

Unfortunately, the story does not end here. The IRS is considering a new interpretation of Section 305(c) of the code in a manner deleterious to convertible holders. Section 305(c) was written in the 1960's to prevent "backdoor" dividends through artifice such as the creation of different classes of shares with favorable convertibility features. It came four decades before investors got crushed when Mandalay Bay introduced a 3% dividend just months after issuing a convertible bond, leading to the institution of standard dividend fair-value adjustments in new convertible issues. These have typically come in the form of conversion-ratio enhancements, as a matter of course. Indeed, it was written when few, if any, were probably talking about dividend protection for convertibles.

Now, apparently, the agency wants to start using this rule to tax conversion ratio adjustments, calling them dividend equivalents. There are several clear problems with this, including driving away issuers because of added complexity to an asset class many find daunting as it is. Another is the potential for this "new-old" tax to be applied retroactively.

Let's continue with that one. In theory, you'd have to go back and track the holders of all bonds that received conversion ratio increases over who-knows-how-many years. It seems neither practical nor fair. It also may be making new buyers of these bonds concerned that they may become the payers of these "overdue" taxes simply because they are the easiest holders to identify.

Continuing our exploration of 305(c), economic logic, which can be a dangerous thing in tax-related matters, argues against taxing conversion adjustments on several fronts. First, and most importantly, conversion adjustments play a substantially different role in providing value for convertible holders than do dividends for common shareholders. Convertible investors make an up-front choice to accept a combination of income, capital preservation and upside—the latter past a certain fixed point in the underlying shares—in exchange for giving up the first layer of the shares' upside and the current income the shares provide at the time of the convertible's issuance.

Meanwhile, stockholders buy their shares for a blend of unlimited upside from the time of purchase and all future dividends. Thus, it seems reasonably clear that an increase in the common dividend benefits stockholders, who get the incremental amount in the form of an earlier cash dividend rather than a later capital gain. But it harms convertible holders, for whom all that matters is the projected share price at (in most cases) the bonds' maturity or call date. Today's dividend increase does not flow through to them, but it reduces the potential value of the shares at the bonds' terminal date—the extreme example of liquidation proves this.

Moreover, it's often the case that the bond is relatively unlikely to be converted, in which case a ratio adjustment is nearly worthless. Therefore, it makes no sense to tax a conversion ratio increase until the actual conversion takes place and the acquired shares are sold. Anything else is speculation. Yet that appears to be exactly what the new application of 305-(c) proposes to do.

Ambiguity in the Code Itself

Perhaps most notably, the IRS code contains two consecutive sentences that appear to be largely contradictors. Read this passage from IRS section 305-7 first:

For purposes of applying section 305(c) *in conjunction with section 305(b),* ***a change in the conversion ratio*** *or conversion price of convertible preferred stock (or securities), or in the exercise price of rights or warrants,* ***made pursuant to a bona fide, reasonable, adjustment formula*** *(including, but not limited to, either the so-called "market price" or "conversion price" type of formulas)* ***which has the effect of preventing dilution of the interest of the holders*** *of such stock (or securities)* ***will not be considered to result in a deemed distribution of stock.***

Sounds like a conversion ratio adjustment designed to make holders whole after a common dividend is not considered a taxable event, right? But read the following (!) sentence.

An adjustment in the conversion ratio *or price* ***to compensate for cash or property distributions*** *to other shareholders that are taxable under section 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b), or 857(b)* ***will not be considered as made pursuant to a bona fide adjustment formula.***

So, is a conversion ratio adjustment taxable, or isn't it? Extensive arguments about what constitutes a bona fide adjustment seem nearly certain if 305(c) is interpreted to the detriment of the convertible market. It's beyond the scope of this discussion to examine each of the cases listed, but the clearest thing is how unclear 305(c) is.

Is That All There Is?

Another issue is efficacy, or, rather, the lack thereof. It has been estimated that the application of 305-(c) to convertibles will raise between $10 million and $30 million for the Treasury. Don't get us wrong—we could all use another $10-$30 million. But in the context of jeopardizing a vital capital-raising instrument and treating a large body of investors with a mix of uncertainty and unfairness, it hardly seems like worthwhile policy.

Here's the back-of-the-envelope math we did with another convertible veteran to confirm the estimate.

A: $240 billion: Approximate size of US convertible market

B: $80 billion: Estimated amount of convertibles issued by dividend payers: approximately one-third of convertible issuers pay dividends (A*1/3)

C: $2 billion: Estimated amount of annual dividends paid by convertible issuers (B*2.5%)

D: $200 million: Estimated annual dividend increase (C*10%, a big number)

E: $30 million: (D*15% dividend tax rate)

F: $10 million: Assuming two-thirds of holders not taxable, a lower bound estimate (E*1/3)

Thus somewhere between $10 million and $30 million annually sounds like a reasonable guesstimate of the bounty for the Treasury. It doesn't seem that big. Nevertheless, for any given portfolio manager, this could be a significant problem—especially because of the potential for retroactive enforcement. For investors, issuers, and market-makers, the likely additional reporting requirements could severely damage an asset class that punches far above its own weight. Remember, Apple might have gone bankrupt without its 1996 convertible issue.

Questions? Call us. We're here to help.

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