HILLSIDE ADVISORS LLC

August 1, 2016

Hybrid Vigor℠

The Hillside Convertible Advisory Letter
Volume 3 Issue 30

A Summer Like No Other

Inside

How does a small-cap company, product of a low-growth economy and political uncertainty, dropped in the middle of a volatile market by Providence, confused so much it hurts, pass up the chance to issue some converts?

We keep wondering. Maybe we need Lin-Manuel Miranda to do a Disney movie about Coupy, the Convertible Bond. Everyone wants to drive her but nobody wants to make her. So she sits there, just kind of an idea, until some great banker stirs things up.

The mismatch between demand—clearly there—and supply—which should be—confounds. One thing we know is that it feeds on itself, with the ranks of convertible bankers and salespeople thinning, seemingly by the day.

We got an email the other day featuring a quasi-advertisement for a trading service with the headline "Convertibles are Back in Style." If only issuers agreed. The deal they're missing out on is nothing short of remarkable. We might even say it's yuge.

Ugh, why did we have to think of him?

To accommodate summer schedules, we will be publishing every other week between now and Labor Day. Our next issue will be on Monday, August 15th. We wish you the best during the rest of this most peculiar of summers.

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HILLSIDE ADVISORS LLC

August 1, 2016

Two Old and Two New

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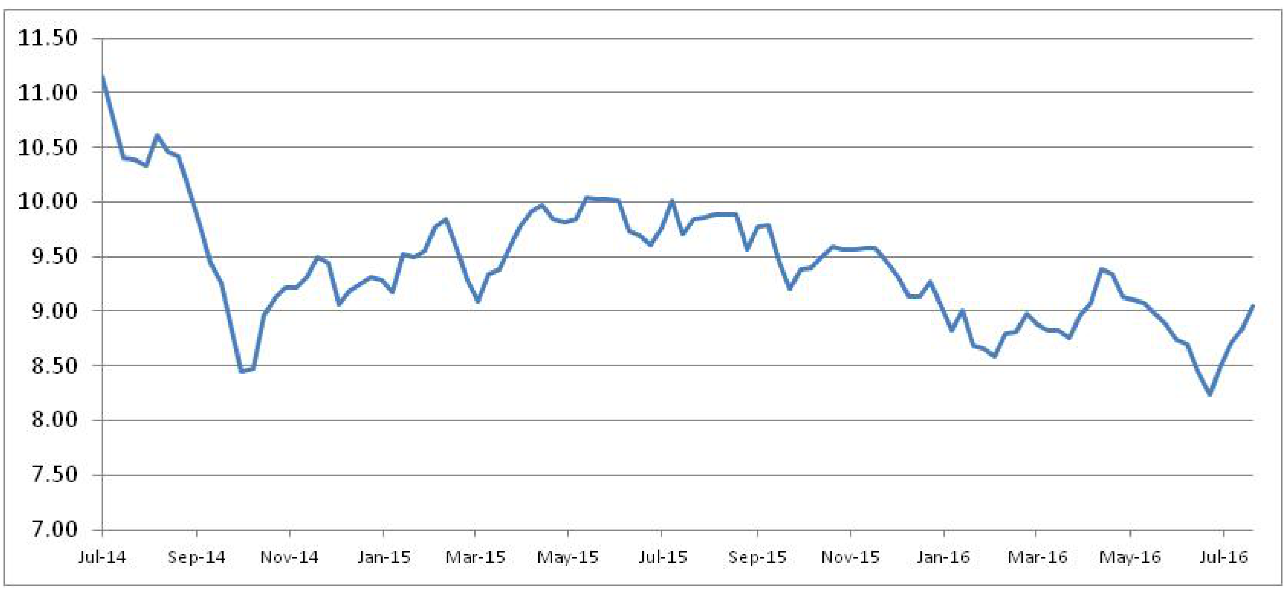
A quick refresher. HARP, or Hillside Adjusted Risk Points, is best thought of as a warning measure for bonds exposed to a blend of absolute price decline and premium decay. The higher the HARP, the more dangerous the bond. HARP tends to be highest for bonds in the 120-130 "death trap" range.

With continued strength post-Brexit, equity markets have powered up the convertible markets for the past few weeks. Some of that strength has translated into HARP gains for the average convertible, moving the needle up by about 0.75 HARP. This past week a gain of 0.21 HARP, to end at 9.05, was powered by a 3.0% gain in equity prices and a 1¾ point gain in bond prices. Don't be fooled that price increases always bring HARP increases – seven of our Ugly 20 had price increases and HARP decreases this week. However, the HARP gains in the other 13 bonds were enough to swing the HARP needle into the positive.



RPM 2.25% of 2020 is back on top of the heap this week with a gain of 0.74 HARP, moving it from second to first with a 12.29 HARP score. Not the all time worst score, but terribly ugly nonetheless. We've mentioned this specimen a number of times, but let's recap the issues. The bond has 1.4 years of call protection and is powered by a low 20's volatility, neither of which leaves much in the hope column. Toss in the 2% dividend offsetting most of the bond's coupon, and that makes it even grimmer. Then a look at the price to see that it sports nearly 19 points of premium – about 5 of which is pure richness over theoretical – and the picture becomes clear. There are folks who are in this bond because of investment grade mandates. We hope that if you are one of them, that you have a keen eye on the risks of this bond. We wonder if your investors would press for investment-grade if they understood what it sometimes gets them.

Down at 16th sits Royal Gold 2.875% of 2019. The stock put in some strength with a 6.58% gain on the week, powering a two-point gain in the bond. Royal Gold is one of those sub-par parity bonds where all price gains translate into HARP gains. In this case the 81¾ parity bond translated those two-points of price gain into a 0.76 HARP gain.

From 27th to 13th rose Proofpoint 0.75% of 2020. The bond is another sub-par parity type, which means much of the price move translates into a HARP move. In this case, the 5.16% equity gain and the five-point bond gain translated into 1.61 in HARP, to end at 8.49. With a 117¾ price, 1.9 years of call protection, and a low 40's volatility, the bond has about 16¼ points of deadfall risk for investors to chew on. With parity at 93½, that still leaves 6½ points of slack until parity starts to become a factor.

BroadSoft 1% of 2022 was the outlier this week. The stock dropped 5.22%, the bond price dropped 4¼, and yet HARP gained 0.81 – to end at 7.45, a gain from 38th to 20th. BroadSoft is a bond on the downward slope of the risk mountain. In other words, it has passed peak risk and now is in the premium burn phase of its price/risk profile. However, this week the premium burn booster rockets deactivated, and equity and bond prices fell backwards – adding premium back to the package. Last week the bond had 10.4% premium, this week it has 12.8%. That's all that changed. And that's all it took to add 0.81 HARP to the tally of the 130¾ priced bond.

Disclosure: An affiliate of Hillside Advisors has a position in Royal Gold securities.

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Hillside Ugly 20 List (Prices as of July 29, 2016)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	RPM International 2.25% 2020-12-15	122.00	54.26	18.40	18.96	12.29
2	Red Hat 0.25% 2019-10-01	123.50	75.29	20.30	20.84	11.69
3	Air Lease 3.875% 2018-12-01	124.75	28.81	28.80	27.89	10.30
4	BioMarin Pharma 1.5% 2020-10-15	132.50	99.42	25.60	27.01	10.30
5	Emergent BioSolutions 2.875% 2021-01-15	125.50	33.39	21.80	22.46	10.23
6	Priceline.com 0.35% 2020-06-15	122.00	1350.81	18.80	19.31	9.85
7	BioMarin Pharma 0.75% 2018-10-15	127.75	99.42	21.00	22.17	9.58
8	Palo Alto Networks 0% 2019-07-01	133.00	130.89	12.10	14.36	8.69
9	Medidata Solutions 1% 2018-08-01	116.75	53.15	27.50	25.18	8.69
10	NuVasive 2.25% 2021-03-15	122.50	62.20	17.80	18.51	8.66
11	Euronet Worldwide 1.5% 2044-10-01	122.50	76.26	16.00	16.90	8.51
12	Trinity Industries 3.875% 2036-06-01	119.75	23.21	27.20	25.61	8.50
13	Proofpoint 0.75% 2020-06-15	117.75	75.87	26.00	24.30	8.49
14	Workday Tranche 2 1.5% 2020-07-15	124.00	83.34	21.60	22.03	8.41
15	Citrix Systems 0.5% 2019-04-15	117.25	89.13	18.50	18.30	8.38
16	Royal Gold 2.875% 2019-06-15	114.25	84.54	40.00	32.64	8.10
17	ServiceNow 0% 2018-11-01	118.50	74.92	17.00	17.22	7.82
18	Workday Tranche 1 0.75% 2018-07-15	118.25	83.34	18.10	18.12	7.57
19	Dycom Inds 0.75% 2021-09-15	118.00	94.05	21.60	20.96	7.56
20	BroadSoft 1% 2022-09-01	130.75	44.83	12.80	14.84	7.45

Sources: Bloomberg, Kynex

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HOCS Time in the Old Town

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Readers of these pages know that the normally reliable HOCS family has had a tough year. But last week offered a sweet little bit of redemption—and not the bad convertible-related kind. The flagship HOCS 100 returned 1.50% for the week, bringing year-to-date performance to an increasingly respectable 2.93%. This is still far behind the rival CWB, whose weekly gain of 22 basis points took 2016's return up to 7.39%. Meanwhile, the group of mutual funds we track rose 58 basis points to get to 4.61% for the year.

The narrower HOCS 20 lists did even better thanks to a few stalwarts. One was Interactive Intelligence 1.25% of 2020. A story that the call-center software company is exploring selling itself broke on Friday and took the stock up nearly 24% with the bonds participating in almost half of that gain. Pandora, profiled last week by Jeff Alton, also shot and scored, rising nearly 11% and bringing the 1.75% convertible up 7% with it. But the big winner was TTMI 1.75%, whose underlying shares jumped 23% on an earnings beat. The convertible jumped almost 15% in sympathy—good old two-thirds of the upside, as the mantra goes.

Adding it all up, original-recipe HOCS 20 returned 2.20% on the week, with China-free doing even better at 2.36% and the relatively stodgy Over $300 Million coming in with 1.52%, similar to the HOCS 100.

This week's HOCS 20 reports in with an average overall score of 67.7, about as low as we've had for the list and reflecting the good recent performance. The price point for the list as originally designed is 96.89, still a good spot, and the profile looks more than ok at 3.26% up 49.2%. China-free is only 0.3 HOCS points lower with a price point of 97.79. Its 2.45% yield costs you a premium of 49.4%. Finally, Over $300 Million is looking kinda ugly. It's got a price point just inches below par—no problem there—but the HOCS score is only 63.1 and the profile is 0.85% up 77.4%. Smaller is looking better.

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Hillside HOCS 20 List

	Description	Convert	Stock	HOCS Overall	HOCS Growth	HOCS Safety	Yield	Premium
1	HORIZON 2.500% 2022-03-15	99.50	19.29	77.7	83.5	66.3	2.60%	47.8%
2	TESLA 1.250% 2021-03-01	88.25	234.79	73.0	81.1	56.8	4.09%	35.3%
3	ECHO 2.500% 2020-05-01	98.00	24.76	71.5	76.0	62.7	3.07%	55.0%
4	TESLA 0.250% 2019-03-01	92.00	234.79	71.5	76.2	62.1	3.52%	41.0%
5	TRINA 4.000% 2019-10-15	87.75	8.25	69.8	76.6	56.1	15.54%	56.2%
6	MERITAGE 1.875% 2032-09-15	99.75	36.39	69.2	63.6	80.6	2.10%	59.4%
7	ACETO 2.000% 2020-11-01	100.75	25.71	68.4	68.1	68.9	1.82%	30.2%
8	ENVESTNET 1.750% 2019-12-15	94.75	38.17	68.3	78.3	48.1	3.41%	56.1%
9	IONIS 1.000% 2021-11-15	78.75	29.19	67.3	77.7	46.7	5.71%	80.2%
10	INFINERA 1.750% 2018-06-01	103.75	8.76	66.8	62.3	75.8	-0.29%	49.0%
11	PAR 5.000% 2021-06-15	100.50	15.00	66.7	65.0	70.2	4.88%	20.6%
12	VITAMIN 2.250% 2020-12-01	97.50	29.26	66.6	65.4	69.0	2.87%	32.4%
13	ILLUMINA 0.000% 2019-06-15	102.00	166.35	66.2	58.2	82.2	-0.69%	56.0%
14	SYNCHRONOSS 0.750% 2019-08-15	104.00	37.34	66.1	64.1	70.0	-0.55%	48.1%
15	FINISAR 0.500% 2033-12-15	98.50	18.76	65.2	55.6	84.3	1.14%	58.5%
16	SPECTRUM 2.750% 2018-12-15	97.75	6.87	64.7	59.1	75.9	3.75%	49.8%
17	TELIGENT 3.500% 2019-12-15	95.75	8.12	64.2	80.1	32.3	4.88%	33.1%
18	BROOKDALE 2.750% 2018-06-15	100.50	18.47	63.7	65.7	59.6	2.47%	59.6%
19	SILVER 2.875% 2033-02-01	100.00	13.94	63.7	76.7	37.8	2.87%	43.5%
20	TOLL 0.500% 2032-09-15	98.00	28.01	63.7	50.8	89.4	1.99%	71.7%

Sources: Bloomberg, Kynex

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Hillside HOCS 20 List ex China

	Description	Convert	Stock	HOCS Overall	HOCS Growth	HOCS Safety	Yield	Premium
1	HORIZON 2.500% 2022-03-15	99.50	19.29	77.7	83.5	66.3	2.60%	47.8%
2	TESLA 1.250% 2021-03-01	88.25	234.79	73.0	81.1	56.8	4.09%	35.3%
3	ECHO 2.500% 2020-05-01	98.00	24.76	71.5	76.0	62.7	3.07%	55.0%
4	TESLA 0.250% 2019-03-01	92.00	234.79	71.5	76.2	62.1	3.52%	41.0%
5	MERITAGE 1.875% 2032-09-15	99.75	36.39	69.2	63.6	80.6	2.10%	59.4%
6	ACETO 2.000% 2020-11-01	100.75	25.71	68.4	68.1	68.9	1.82%	30.2%
7	ENVESTNET 1.750% 2019-12-15	94.75	38.17	68.3	78.3	48.1	3.41%	56.1%
8	IONIS 1.000% 2021-11-15	78.75	29.19	67.3	77.7	46.7	5.71%	80.2%
9	INFINERA 1.750% 2018-06-01	103.75	8.76	66.8	62.3	75.8	-0.29%	49.0%
10	PAR 5.000% 2021-06-15	100.50	15.00	66.7	65.0	70.2	4.88%	20.6%
11	VITAMIN 2.250% 2020-12-01	97.50	29.26	66.6	65.4	69.0	2.87%	32.4%
12	ILLUMINA 0.000% 2019-06-15	102.00	166.35	66.2	58.2	82.2	-0.69%	56.0%
13	SYNCHRONOSS 0.750% 2019-08-15	104.00	37.34	66.1	64.1	70.0	-0.55%	48.1%
14	FINISAR 0.500% 2033-12-15	98.50	18.76	65.2	55.6	84.3	1.14%	58.5%
15	SPECTRUM 2.750% 2018-12-15	97.75	6.87	64.7	59.1	75.9	3.75%	49.8%
16	TELIGENT 3.500% 2019-12-15	95.75	8.12	64.2	80.1	32.3	4.88%	33.1%
17	BROOKDALE 2.750% 2018-06-15	100.50	18.47	63.7	65.7	59.6	2.47%	59.6%
18	SILVER 2.875% 2033-02-01	100.00	13.94	63.7	76.7	37.8	2.87%	43.5%
19	TOLL 0.500% 2032-09-15	98.00	28.01	63.7	50.8	89.4	1.99%	71.7%
20	ILLUMINA 0.500% 2021-06-15	105.75	166.35	63.6	58.5	73.9	-0.66%	61.7%

Sources: Bloomberg, Kynex

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Hillside Advisors HOCS 20 List (Issue Size > $300 Million)

	Description	Convert	Stock	HOCS Overall	HOCS Growth	HOCS Safety	Yield	Premium
1	HORIZON 2.500% 2022-03-15	99.50	19.29	77.7	83.5	66.3	2.60%	47.8%
2	TESLA 1.250% 2021-03-01	88.25	234.79	73.0	81.1	56.8	4.09%	35.3%
3	TESLA 0.250% 2019-03-01	92.00	234.79	71.5	76.2	62.1	3.52%	41.0%
4	IONIS 1.000% 2021-11-15	78.75	29.19	67.3	77.7	46.7	5.71%	80.2%
5	ILLUMINA 0.000% 2019-06-15	102.00	166.35	66.2	58.2	82.2	-0.69%	56.0%
6	BROOKDALE 2.750% 2018-06-15	100.50	18.47	63.7	65.7	59.6	2.47%	59.6%
7	ILLUMINA 0.500% 2021-06-15	105.75	166.35	63.6	58.5	73.9	-0.66%	61.7%
8	PANDORA 1.750% 2020-12-01	108.00	13.60	62.4	74.1	39.2	-0.09%	30.4%
9	ACORDA 1.750% 2021-06-15	87.50	25.28	61.7	71.6	41.9	4.65%	47.3%
10	AKAMAI 0.000% 2019-02-15	97.50	50.53	61.6	49.7	85.4	1.00%	72.8%
11	HERBALIFE 2.000% 2019-08-15	104.00	68.01	61.5	60.5	63.4	0.67%	31.9%
12	INTEGRATED 0.875% 2022-11-15	101.50	21.99	61.4	58.8	66.5	0.63%	54.4%
13	TWITTER 1.000% 2021-09-15	90.25	16.64	59.7	47.1	85.1	3.07%	321.1%
14	PRICELINE 1.000% 2018-03-15	148.25	1350.81	59.4	71.3	35.8	-22.11%	3.7%
15	IMPAX 2.000% 2022-06-15	92.25	31.42	59.2	59.7	58.2	3.47%	86.0%
16	TWITTER 0.250% 2019-09-15	92.25	16.64	59.1	44.1	89.2	2.86%	330.4%
17	GOGO 3.750% 2020-03-01	66.00	8.41	59.0	68.8	39.2	16.75%	87.2%
18	CEPHEID 1.250% 2021-02-01	93.00	35.33	58.7	64.7	46.8	2.92%	71.4%
19	MOLINA 1.625% 2044-08-15	116.75	56.81	58.1	58.7	56.9	-5.95%	19.4%
20	MERCADOLIBRE 2.250% 2019-07-01	134.00	153.08	58.0	70.7	32.5	-7.90%	10.3%

Sources: Bloomberg, Kynex

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Pioneer (PXD) Delivers a Better than Expected Second Quarter

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Pioneer Natural Resources Company (NYSE-PXD) recently released results for the second quarter of 2016 that were better than expected. Production for the quarter was higher than what was guided to earlier in the year. Oil price realizations were significantly higher than those of the first quarter. PXD is highly liquid and modestly leveraged.

For the quarter ended June 30, revenue amounted to $786 million, up 22% from $644 million for the corresponding year earlier period. For the quarter total production amounted to 232,703 barrels of oil equivalent (BOE) per day up 18.3% from 196,626 BOE per day a year earlier. Moreover, second quarter production exceeded the 229,000 BOE guided to earlier in the year. Breaking production down by product reveals that oil production amounted to 134,723 BOE per day versus 100,569 BOE per day a year earlier; natural gas production was 340,542 Mcf (thousand cubic feet) per day 4.5% lower than 356,391 Mcf per day a year earlier, and natural gas liquids (NGL) production was 41,223 barrels per day versus 36,659 barrels per day. Revenue increased thanks to higher production, which offset a lower, but improving price deck versus last year. For the second quarter, realized oil prices were $41.43 per barrel, down from $51.64 per barrel last year but up from $28.09 per barrel for the 2016 first quarter; natural gas price realizations were $1.67 Mcf down from $2.37 Mcf last year and $1.79 Mcf for the 2016 first quarter; and NGL price realizations were $14.21 per barrel versus $14.03 per barrel last year and up significantly from $10.33 per barrel for the first quarter.

EBITDAX for the quarter was $450 million, up from $433 million for the corresponding year-earlier quarter. PXD, like others in the industry has focused on not only higher production but cost reduction and liquidity. During the quarter, Pioneer incurred production costs of $8.36 BOE down from $11.19 BOE for the second quarter of 2015. PXD ended the quarter with $1.8 billion in cash and $1.5 billion of short term investments. At June 30, total debt amounted to $3.7 billion and net total debt was less than $400 million.

Pioneer gave some guidance for the third quarter of 2016. It expects production to amount to between 232,000 BOE per day to 237,000 BOE per day. Production costs are expected to be $8.25 BOE to $10.25 BOE. The company revised its capital program for 2016 upward to $2.1 billion from $2.0 billion. Longer term, management said it expects to deliver compounded annual production growth of 15% and maintain net debt to operating cash flow below 1% through 2020.

HILLSIDE ADVISORS LLC

August 1, 2016

Biotech Mid-Year 2016 Review: A Rocky Beginning

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Now that we are past the mid-way point of the year, we wanted to focus in on what is happening in the biotech space since in addition to accounting for a significant portion of the US convertible bond market, the sector has been especially volatile over the past 12-month period. While the NASDAQ Biotechnology ETF (IBB) has recovered from the lows set in February, it is still down 14% for the year and 26% from its all-time high of last summer. Stocks in the sector continue to gyrate with IBB nearly repeating the February low in late June and while it is on a new upswing currently, it is anyone's guess if it will be sustained.

There are two key trends in the biotech space, which we anticipate will prevail throughout the year. The first is headline risk from political posturing by both presidential candidates. This could be especially active during the fall debates. Remember all the pain inflicted on the sector last fall following Hillary Clinton's famous tweet about taking on price gouging in the drug industry?

With stock prices considerably lower and large pharmaceutical companies under pressure to keep their pipelines relevant, we could see more M&A activity - the second trend. Speaking of M&A, Anacor Pharmaceuticals is a great example. The company brought its second convertible bond in late March. Anacor was not unlike many other biotech convert issuers we have seen over the years. The company had one small product on market, which didn't seem to be living up to expectations, a potential blockbuster product on the horizon, and was burning cash all along the way. The converts received a very attractive HOCS slash line of 74 Overall / 87 Growth / 47 Safety and quickly ran up to 114.75 with the stock up 17% within a month of the new issue date.

Then in mid-May Pfizer announced it was acquiring Anacor for $99.25 per share, which compares to a share price of $53.45 when the convert deal was priced at the end of March, quite the nice return for those who participated. Pfizer cited its strategic focus on inflammation and immunology and the potential for a near-term US product launch as motivation for the deal. We expect to see more deals over the second half of the year and won't be surprised if some targets are issuers of outstanding convertible bonds.

We'd like to update a number of issues we've followed regularly.. These include two HOCS 20 members (Horizon Pharma and Ionis Pharmaceuticals), a prior HOCS 20 member (ANI Pharmaceuticals) that has seen its safety rating recede as the convert has climbed above par, and a cautionary tale (Clovis Oncology) of what can happen to a start-up biotech when a potential blockbuster drug does not get approved.

				HOCS				
	Description	Convert	Stock	Overall	Growth	Safety	Yield	Premium
1	ANIP 3.000% 2022/03/15	115.75	60.60	49	62	23	-1.59%	32.7%
2	CLVS 2.500% 2021/09/15	73.00	14.28	40	43	32	9.24%	216.3%
3	HZNP 2.500% 2022-03-15	99.50	19.29	78	83	66	2.60%	47.8%
4	ICPT 3.255% 2023/07/01	113.00	173.03	59	77	23	1.28%	29.7%
5	IONS 1.000% 2021-11-15	78.75	29.19	67	78	47	5.71%	80.2%

Sources: Bloomberg, Kynex

But before jumping into those names, we first wanted to highlight a recent new issue that we will be digging into over the next few weeks – Intercept Pharmaceuticals (ICPT). The company brought a $460 million (upsized from $400 million) deal in late June. The initial HOCS slash line was 67 Overall / 77 Growth / 48 Safety. That is a good overall score, but as we stressed at the time of issue the modest safety score comes from ICPT's significant cash burn, which is not likely to end anytime soon. The company recently launched its first drug, Ocaliva for PBC (primary biliary cholangitis). PBC is a rare liver disease that can lead to cirrhosis, liver failure, and death. The market is fairly small and probably won't turn the company cash-flow positive even in a best-case scenario, but the company is evaluating the drug for other liver indications. The most promising of those is a treatment for nonalcoholic steatohepatitis (NASH). This is a significantly larger population and a life-threatening disease. With no current FDA-approved product, the potential is in the billions. However, the company is currently enrolling a Phase II and Phase III trial and results are still years away. The converts have moved up to 113.0 since issuance. This has brought the safety score even lower to 23, a level that disqualified the bond from HOCS 20. We do think the name is worth digging into due to the company's significant cash reserves (though it will be gone quicker than you might think), the potential for a blockbuster product on the horizon, and as mentioned before the possibility of M&A activity. So stay tuned for more information on this name.

Horizon Pharma (HZNP): Moving Beyond Specialty

We have written on Horizon Pharma, a regular HOCS 20 member, several times and last did an update in mid-May. At that time the 2.5% of 2022 convertible bond received a HOCS slash line of 73 Overall / 80 Growth / 59 Safety with the bonds at 83.75 versus $14.08. Since then the overall biotech market is up 14% using the IBB (iShares Nasdaq Biotechnology) ETF, which both the stock and convertible bond have outperformed significantly with HZNP stock up 37% to $19.29 and the 2.5% convertible bonds due 2022 up 19% to 99.50. The revised HOCS slash line is 78 / 83 / 66. The underlying story remains pretty much unchanged: the company has excellent growth potential that can be realized via the expansion of the existing portfolio/pipeline and acquisitions. Thus, the growth component figures prominently in the overall score of the convertible. The safety score is adequate, especially in the sector, but we have to caution this is an acquisitive company and management does not hesitate to take on debt.

The biggest catalyst event for 2016 is the release of Actimmune (interferon gamma 1-b) Phase III results for the treatment of Friedreich's Ataxia, a debilitating, life-shortening ultra-orphan disorder for which there is no FDA approved treatment. The company expects results by the end of this year and could file a New Drug Application (NDA) and have approval if all goes well by the third quarter of next year. Management estimates peak sales of $500 million to $1 billion. We want to emphasize the part about all going according to plan.

Management has reiterated that its highest priority for capital allocation remains M&A, which gets us to the other catalyst - an announcement of one or more acquisitions. Since we last wrote on the company, management has signed an agreement to acquire the worldwide rights to interferon gamma 1-b from Boehringer Ingelheim for EUR 25 million. This will afford the company control over its investment in Actimmune, especially with regards to the FA Phase III trial and other ongoing trials for solid tumors. This is of course a relatively small acquisition and aligns with the company's pipeline. A larger acquisition (or two) could introduce more uncertainty, but could also contribute to future growth.

Part of the reason HZNP underperformed earlier in the year was its association with specialty pharmacies. As the company focuses more on the orphan drug segment, that association will continue to weaken. The company expects sales to more than double this year to a range of $1.025 to $1.050 billion from $505 million in 2015. Management has set a target of $2 billion in sales by 2020 with the majority of those sales coming from orphan drugs. The HOCS score reflects the company's significant growth prospects and while the safety score lags, we want to highlight once again that while management will almost definitely be doing additional acquisitions, it has done a good job of keeping leverage at a manageable level.

Ionis Pharmaceuticals (IONS): News Flow is Still King

What follows below is what we had prepared to print for Ionis as of last night. Things have changed with the company's positive news release on Nusinersen this morning. Nusinersen is a treatment for spinal muscular atrophy (SMA), a severe motor-neuron disease that is the leading genetic cause of infant mortality. Biogen Idec is Ionis' partner for this drug. The companies announced this morning that the ENDEAR Phase III trial for infants met the primary endpoint for interim analysis. Biogen is exercising its option to develop and commercialize Nusinersen globally and paid Ionis a $75 million license fee. Biogen will be initiating regulatory filings in the coming months, with a US and EU filing expected by year-end. Ionis is eligible to receive up to $150 million in additional milestone payments and tiered royalties on future sales up to a percentage in the mid-teens. As we are writing, the bonds have traded up to 92 versus $40 on the stock, which compares to 78.75 versus $29.19 at Friday's close. The HOCS slash line is now 71 Overall / 82 Growth / 48 Safety. "News Flow is Still King" turned out to be a very appropriate title.

Our second HOCS 20 member is Ionis Pharmaceuticals, about which we wrote a couple of months ago just after the company reported negative news on one of its Phase III drug trials. The stock and convert both took a beating on the news with the stock down 45% and the converts down 17%. This is a development-stage company, so news flow is particularly important. In this case the news was not good, but as we pointed out previously the company has a large and diverse pipeline with several large pharmaceutical partners, and liquidity is good which is very important when you are burning cash.

The converts currently have a HOCS slash line of 67 Overall / 78 Growth / 47 Safety with the bonds at 78.75 versus $29.19. While there has been no new news, both the stock and bond have begun recovering with the stock up 49% since the news hit and the converts up 6%. Of course the stock is still down 53% from the beginning of the year with the bonds down 30%. The safety score is low for a reason as developmental biotechs always come with significant risks. In this case, though, we think the damage has been overdone.

The company held an R&D day in mid-July and discussed the serious platelet decline issue that has occurred with two of its three high-profile Phase III drug candidates – IONIS-TTR and Volanesorsen. (In case you are wondering, platelets are needed to prevent uncontrolled bleeding.) We should remind everyone that the FDA did not halt any of the ongoing studies for either drug. Management addressed the issue at the meeting and stressed the following points: (1) there have been very few cases of serious platelet declines in the Phase III studies; (2) the patients involved have been responsive to a dose pause or steroid treatment; and (3) there is a misperception that serious platelet declines may have broader implications. Management also highlighted the fact that platelet declines are common with many well-known drugs including acetaminophen and ibuprofen, so this is not an insurmountable problem.

We think investors overreacted to the news. We want to continue to stress that this is a cash-burning biotech, which by default is risky, but that is reflected in the HOCS safety score. The overall HOCS score of 67 is quite good and incorporates the company's broad and diverse pipeline, many large pharma partners, and good liquidity. The company is still expecting to release preliminary Phase III results in mid-2017 for all three of its high profile drugs – IONIS_TTR, Volanesorsen, and Nusinersen. With the bonds at this level you are getting a yield of 5.71%. We think investors are being compensated for the risks.

ANI Pharmaceuticals (ANIP): Moving in the Right Direction

We have written on ANI Pharmaceuticals on several occasions and most recently did an update in late June. No news has surfaced since then, but the biotech market has been recovering ground with IBB up 16% during the post-Brexit period. ANIP has lagged the overall market, but is still up 12%. The convertible bonds receive a HOCS slash line of 49 Overall / 62 Growth / 23 Safety with the bonds at 115.75 versus $60.60. As we have said in the past, the divergence between the growth and safety scores tells the story.

Revenue growth is accelerating driven by the company's large and growing pipeline. The company had plans to launch twelve new drugs this year, with six of those having come to market in the first half of the year. Management has guided for full-year revenue in a range of $119 to $134 million and adjusted EBITDA of $55 to $63 million. At the mid-point of guidance that represents revenue growth of 66% and EBITDA growth of 36%.

The growth from all the new product launches is also helping the company diversify away from its number one drug, EEMT. The drug accounted for nearly half of revenue in the first quarter. Sales should remain fairly level for the year, but the addition of other revenue sources will reduce EEMT's contribution to about one third for the full year, reducing one of the key risks.

Other things driving the low safety score include the company's small size, somewhat constrained liquidity, and the convert price being above par, but ANIP has a lot of things going for it that most small-cap biotechs do not. That list includes positive and growing free cash flow, robust margins, and a diminishing reliance on one product. At this price point we would not jump into the convert, but simply keep your eye on the company.

Clovis Oncology (CLVS): A Cautionary Tale

We have not written much about Clovis. It hit our radar last November when the company released bad news on its top drug candidate Rociletinib, a treatment for non-small cell lung cancer. CLVS was awaiting FDA approval of the drug and the news called into question whether an approval would actually occur. Management felt confident of success at the time and our advice was to wait and see. We reiterated that advice a few weeks later when we included CLVS in our year-end review.

In April, an FDA advisory committee recommended not approving Rociletinib until results from an additional Phase III trial (TIGER-3) were available. That trial was underway, but would not be fully enrolled until late 2018. With limited resources and a competing drug from AstraZeneca (Tagrisso) now on the market, management pulled the plug on Rociletinib.

CLVS did, and still does, have a couple of things still going for it. First, there was a lot of cash on the balance sheet when all this happened. Second the company does have a couple of other drugs in the pipeline. Management is now focusing on Rucaparib, an ovarian cancer treatment, in Phase III trials. The company initiated a rolling NDA and is preparing for a launch later this year or in early 2017. CLVS also has Phase II trials underway for Lucitanib, a breast cancer treatment. Cash burn remains quite high, but the company ended March 31 with cash of $445 million and expects to end 2016 with a cash balance of $220 to $235 million, which should take Clovis into 2018.

The stock has fallen 55% to $14.28 since we wrote on the name in December, after having already fallen nearly 70%. The converts have fallen from 82 to 73 and yield 9.24%. The HOCS slash line is 40 Overall / 43 Growth / 32 Safety. The score screams high risk and we agree. We brought this name up as a cautionary tale on the inherent risk of small, start-up biotechs. Things don't always go according to plan. Still we think converts generally remain a much better choice than the underlying in these types of companies.

Appvion Back-to-Back Solid Quarters on Thermal Papers Strength: We Envision Further Upside in the Bonds

Bhaskar Dutta, CFA

The following article is the opinion of the guest contributor. As such, it should not be construed as investment advice, and the opinions expressed do not necessarily reflect the views of Hillside Advisors LLC.

Type	Coupon	Maturity	Amount ($MM)	Rating	Price	Yield to Maturity	YTM Spread
2nd Lien Sec. Notes	9.000%	6/1/20	250.0	B3/CCC+	60	26.01%	2,500bp

Source: Bloomberg

****We are seeing significant improvement in the thermal papers operating fundamentals due to increased shipments and multiple price hikes in POS receipt paper. Price increases in September 2015 and January 2016 are holding; Appvion sees increased demand and market share for its thermal receipt paper as foreign competition subsides.

****<u>We view Appvion to be a legitimate going concern business</u> and expect that 2016 EBITDA will rise and exceed the level of our normalized EBITDA. We estimate leverage through 2nd lien debt to fall to 5.6x at year-end 2016 and to 4.9 at year-end 2018. In keeping with this view, we believe that the 9% 2nd lien notes due '20, currently trading at 60 (26.01% YTM; +2,500), should see considerable upside. <u>As a going concern, we envision the Appvion bonds to be worth 100 cents on the dollar!</u>

****<u>We believe that the fair value of the 9% 2nd lien notes (B3/CCC+) due '20 is in the 63-89 range (mid-point 76) upon a recapitalization as of today.</u> Our workout analysis, based on a mid-June 2018 (to coincide around the June 28, 2018 expiration date of the revolver), suggests a <u>net present recovery value of 55-76 (mid-point 65)</u>, after factoring in five interim semi-annual coupons (4.5 points each).

Appvion
Capital Structure ($MM)

Category		Amount Outstanding	Gross Leverage Based On		Net Leverage Based On	
			LTM EBITDA	Norm. EBITDA	LTM EBITDA	Norm. EBITDA
LTM EBITDA (Covenant Adjusted)(1)		57.0				
Normailzed EBITDA		73.0				
Cash & Equiivalents		2.3				
1st Lien & Similar Debt						
Bank Revolver (2)	10.5					
Term Loan	158.3					
Secured Ind. Dev. Bond	6.0					
Seniormost Tranche Debt	174.8		3.1x	2.4x	3.1x	2.4x
2nd Lien 9% Notes due '20	250.0					
Debt Thru 2nd Lien Tranche	**424.8**		**7.5x**	**5.8x**	**7.4x**	**5.8x**
State of Ohio Assisance Loan	1.6					
State of Ohio Loan	1.0					
Columbia Co Municipal Loan	0.3					
	2.9					
Total Debt	427.7		7.5x	5.9x	7.5x	5.8x

1. Reflecting $4.3MM adjustment ($2MM Brazilian base stock; Encapsys SG&A $.8MM; other $1.5MM)
2. $75MM notional capacity; $17MM used in LOC; $16.6MM available

Source: Company documents

HILLSIDE ADVISORS LLC

August 1, 2016

Recent Developments: Fundamentals of the thermal POS paper market have improved substantially starting mid-3Q15. Exit of some of the exporters into the North American market increased demand for domestically produced paper and paved the way for price increases. Appvion instituted two price hikes in that category – one in September 2015 (by 5-7%) and another in January 2016 (by 4-6%), both of which were absorbed in the marketplace. As a result, average prices in 1Q16 were about 11% higher than the lows of 2015. Aided by the pricing momentum as well as gain of new accounts in POS paper, Appvion's segment EBITDA grew to $7.2B in 1Q16, compared to $(1.1)MM and $2.8MM in the middle two quarters of 2015.

Appvion
Operating History ($MM)

Period	LTM	FY15	FY14	FY13	1Q16	4Q15	3Q15	2Q15	1Q15	4Q14	3Q14	2Q14	1Q14
Net Sales	696.6	700.0	809.8	807.5	180.5	169.4	180.6	177.9	195.6	197.1	201.0	207.9	203.8
Cost of Sales	569.3	576.4	677.4	567.8	144.3	138.3	147.7	144.1	156.6	203.5	153.6	162.7	157.5
Gross Profit	127.3	123.6	132.4	239.7	36.2	31.1	32.9	33.8	39.0	(6.4)	47.4	45.2	46.3
SG&A Expenses	111.5	113.1	149.1	106.9	26.6	27.6	28.7	31.0	30.2	49.8	33.1	34.5	31.8
Fox River Funding Agrmt	0.0	0.0	24.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	24.0	0.0	0.0
Operating Income	15.8	10.5	(40.7)	132.8	9.6	3.5	4.2	2.8	8.8	(56.2)	(9.7)	10.7	14.5
Other Expense													
Interest, Net	43.4	46.0	49.1	55.5	10.2	9.6	11.1	12.5	12.8	13.0	11.9	11.8	12.3
Foreign Exchange Loss	(0.3)	1.6	2.1	0.1	(0.5)	0.2	3.6	(0.3)	1.4	0.9	1.1	0.0	0.1
Other Expense	0.9	1.0	0.6	0.0	0.2	0.2	0.2	0.3	0.3	0.2	0.3	0.1	0.0
Debt Extingmt/Modif. Exp.	3.6	3.6	0.0	59.7	0.0	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Pretax Income	(31.8)	(41.7)	(92.5)	17.5	(0.3)	(6.5)	(11.0)	(9.7)	(5.7)	(70.3)	(23.0)	(1.2)	2.1
Provision for Income Tax	0.2	0.2	0.3	0.2	0.1	0.0	0.0	0.1	0.1	0.2	0.2	(0.1)	0.1
Income from Cont. Oper.	(32.0)	(41.9)	(92.8)	17.3	(0.4)	(6.5)	(11.0)	(9.8)	(5.8)	(70.5)	(23.2)	(1.1)	2.2
Discontinued Operations													
Income from Disc. Oper.	7.3	11.8	0.0	0.0	0.0	0.0	3.0	0.0	0.0	0.0	0.0	0.0	0.0
Gain on Sale	188.7	188.7	0.0	0.0	0.0	(0.2)	188.9	0.0	0.0	0.0	0.0	0.0	0.0
	196.0	200.5	0.0	0.0	0.0	(0.2)	191.9	0.0	0.0	0.0	0.0	0.0	0.0
Net Income	(32.0)	(41.9)	(92.8)	17.3	(0.4)	(6.7)	180.9	(9.8)	(5.8)	(70.5)	(23.2)	(1.1)	2.0
Cash Flow Analysis													
Operating Income	15.8	10.5	(40.7)	132.8	9.6	3.5	4.2	2.8	8.8	(56.2)	(9.7)	10.7	14.5
Depreciation	23.6	24.5	27.7	27.8	6.0	5.6	6.8	6.8	6.9	7.1	6.8	7.0	6.8
Amortization	2.4	2.3	2.3	2.3	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
EBITDA	41.8	37.3	(10.7)	162.9	16.3	9.7	11.6	10.2	16.3	(48.5)	(2.3)	18.3	21.9
Mark-to-Mkt on Ret. Benefit	2.1	3.5	63.6	(63.0)	0.1	4.6	0.0	0.0	1.5	64.8	1.5	0.0	(2.7)
Severance	2.6	3.1	0.0	0.0	0.1	0.3	0.0	0.0	0.6	0.0	0.0	0.0	0.0
Domtar Transition	0.0	0.0	0.0	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capacity Start-up, Repair etc.	3.7	3.7	0.0	0.4	0.0	1.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fox River, ITC & Other Legal	0.1	0.0	25.9	0.0	0.1	0.0	0.8	0.8	0.0	0.3	24.0	1.3	0.3
ESOP Contributions	3.6	3.8	4.7	5.5	0.5	1.3	1.4	1.4	0.7	1.7	0.5	1.9	0.6
Adjusted EBITDA	53.9	51.4	83.5	107.8	17.1	17.5	13.8	12.4	19.1	18.3	23.7	21.5	20.1
Interest Expense	(43.4)	(46.0)	(49.1)	(55.5)	(10.2)	(9.6)	(11.1)	(12.5)	(12.8)	(13.0)	(11.9)	(11.8)	(12.3)
Cash Taxes	(0.2)	(0.2)	(0.3)	(0.2)	(0.1)	0.0	0.0	(0.1)	(0.1)	(0.2)	(0.2)	0.0	(0.1)
Capital Expenditures	(15.5)	(15.7)	(19.7)	(28.3)	(1.8)	(3.1)	(3.0)	(7.2)	(2.0)	(5.5)	(3.7)	(7.3)	(3.2)
Changes in Working Capital	(23.4)	(14.4)	30.1	(2.8)	(12.6)	(4.0)	(5.0)	7.0	(3.6)	(20.1)	27.3	19.5	3.4
Free Cash Flow	(28.6)	(24.9)	44.5	21.0	(7.6)	0.8	(5.3)	(0.4)	0.6	(20.5)	35.2	21.9	7.9
Margin Analysis													
Gross Margin	18.3%	17.7%	16.3%	29.7%	20.1%	18.4%	18.2%	19.0%	19.9%	-3.2%	23.6%	21.7%	22.7%
SG&A Cost/Sales	16.0%	16.2%	18.4%	13.2%	14.7%	16.3%	15.9%	17.4%	15.4%	25.3%	16.5%	16.6%	15.6%
Adjusted EBITDA Margin	7.7%	7.3%	10.3%	13.3%	9.5%	10.3%	7.6%	7.0%	9.8%	9.3%	11.8%	10.3%	9.9%
Ratio Analysis													
Adjusted EBITDA/Interest	1.2x	1.1x	1.7x	1.9x	1.7x	1.8x	1.2x	1.0x	1.5x	1.4x	2.0x	1.8x	1.6x
Adj. EBITDA-CapEx/Interest	0.9x	0.8x	1.3x	1.4x	1.5x	1.5x	1.0x	0.4x	1.3x	1.0x	1.7x	1.2x	1.4x
Debt/Adjusted EBITDA	7.7x	8.1x	7.0x	5.5x									
Net Debt/Adjusted EBITDA	7.7x	8.0x	7.0x	5.5x									
Balance Sheet													
Cash & Equivalents	2.3	1.8	2.7	1.8									
Inventories	92.9	87.2	92.9	92.3									
Accounts Receivable	46.3	41.6	48.8	75.9									
Accounts Payable	52.2	51.1	55.6	61.4									
Property, Plant & Equipment	211.7	214.9	223.5	245.2									
Long-Term Debt	414.9	413.8	587.4	592.4									

Business
Appvion is an ESOP controlled manufacturer of various kinds of coated and other specialty paper. It began as the supplier of carbonless paper marketed by NCR corp. in 1954. The Company later changed hands multiple times and also entered and exited certain businesses. Today, it has reduced paper manufacturing and increased outsourcing of base stock from suppliers for the purpose of converting. As of 1Q16, its continuing businesses generated roughly $697MM in sales and $53MM in EBITDA in the trailing 12 months.

Source: Company documents

Appvion sold its growing microencapsulation business Encapsys for $208MM or over 12x LTM EBITDA in mid-2015, and cut 1st lien term loan by $170MM with the proceeds from sale. Outstanding debt senior to the 2nd lien bonds currently stands at roughly $175MM, about 3.1x LTM covenant-adjusted EBITDA from the continuing businesses, but only 2.4x estimated "normalized" EBITDA. Leverage through the 2nd lien tranche is 7.5x LTM covenant-adjusted EBITDA and 5.8x estimated normalized EBITDA.

Outlook: At this point, we expect the company to post an EBITDA of $74MM in 2016, aided by at least one more price hike in thermal paper, which should offset the impact of the maintenance related downtime (estimated $4-5MM) at the Roaring Spring, Pennsylvania mill. This would result in an 1.9x (1.6x after CapEx) EBITDA/interest coverage for the full year. Notional leverage would be about 5.7x at year-end 2016, compared to 7.7x at the end of 1Q16 and 8.1x at year-end 2015. For 2017, we forecast $79MM in EBITDA, covering interest expense 2.2x (1.7x after CapEx), and improving leverage to 5.3x. For the following year, we are estimating $85MM in EBITDA, 2.4x (1.9x after CapEx) in interest coverage and 4.9x (4.6x net of cash) in year-end leverage. We consider these estimates conservative as even 2018E EBITDA is below the $96MM achieved in 2013 and that $96MM did not incorporate the benefit of $48MM cost savings recorded in the past five quarters.

Appvion
Recovery Estimates on 2nd Lien Notes

	Estimated Valuation (Cents on the Dollar)	
	Low	High
<u>Scenario 1</u> Recapitalization Now	63	89
<u>Scenario 2</u> Workout in Mid-2018	51	72

Source: Estimates by Bhaskar Dutta, CFA

Valuation: Based on our conviction that the Company has adequate liquidity for the time being and that net leverage by year-end 2016 would improve to 5.6x, we expect the bonds to trade up significantly over the next 12-18 months. Not only that, given our forecast of net leverage falling to 4.6x by 2018, **we see it to be entirely possible for the bonds to trade above par, given its hefty 9% coupon, barring a large adverse movement in treasury rates**. While we do not expect the Company to be a restructuring candidate in the near-term, we still conducted backstop asset valuation exercises under two scenarios: 1. Recapitalization as of today; 2. Chapter 11 restructuring in mid-2018. For the scenario 1, we use normalized EBITDA for the thermal paper business and LQA (last quarter annualized) EBITDA for the carbonless paper business. In scenario 2, we stress tested the balance sheet under the following assumptions: a) thermal paper EBITDA stays at today's normalized level; b) carbonless paper EBITDA undergoes annual declines of 10% or more relative to the LTM level; c) Appvion completely draws down the revolver; d) an ROI of 12% would be required to adjust for the time value of the cash flow stream generated from holding the bonds. We came up with mid-point valuations of **76 cents on the dollar in scenario 1** and **61 cents on the dollar in scenario 2**, for the 9% 2nd lien notes due '20, both at or above the current trading level of 60.

Meet the Pros

Bhaskar Dutta
Contributing Writer

Bhaskar has been involved in financial analysis and securities research in various capacities for the past 24 years, with the lion's share spent in the fixed income space. Most recently he was a managing director of corporate credit research at Raymond James, where he was employed for the past seven years and covered both investment grade and high yield securities. Bhaskar's primary expertise is in the base materials, capital goods and TMT sectors where he has utilized his relative value analysis and asset valuation skills to generate ideas for alpha generation. Prior to Raymond James, Bhaskar worked at Mizuho Securities, Credit Agricole, First Albany and Prudential Securities. Between 2001 and 2005, Bhaskar worked rigorously in distressed credit, especially involving start-up telecommunication services providers. He had worked previously with Price Waterhouse's national practice in business valuation and corporate recovery consulting and participated in a number of high profile capital restructuring scenarios (such as EuroDisney and Four Queens). Bhaskar lives in Bergen County in Northern NJ with his three children.

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