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Hybrid Vigor℠

The Hillside Convertible Advisory Letter

Volume 4 Issue 7

When the Levee Breaks

Inside

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As we go to press information is coming out, via Donald Trump Jr., about emails from Russia. Will the market care for more than a few minutes? In other words, is the possibility of malfeasance in the President's immediate family enough to make corporate executives uneasy about decision making—or at least is it enough to make investors nervous about such decisions?

As Chairman Mao might have said, it is too soon to say.

The market's resilience amidst slings and arrows such as these has been remarkable. The main logic is, noise is noise, but where is the money going to go? With the Fed in a gradual tightening pattern, the question is, whom or what do you choose not to fight, the Fed or the tape? Last week's employment report seemed both strong and benign—lots of jobs, no wage pressures—giving the Fed plenty of latitude for its current program. But how much of this good news is already priced in?

Whenever situations like this arise, as in all the time, the benefits of convertibles become more evident. New issuance has slowed this year but is still at least somewhat encouraging. If it keeps on rainin', as the song goes, levee's goin' to break. Best to have a defensive place to stay when the lead balloon crashes. We don't count CWB, an equity fund in drag. Neither should anyone else.

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HILLSIDE ADVISORS LLC

July 11, 2017

Momentum Inflection?

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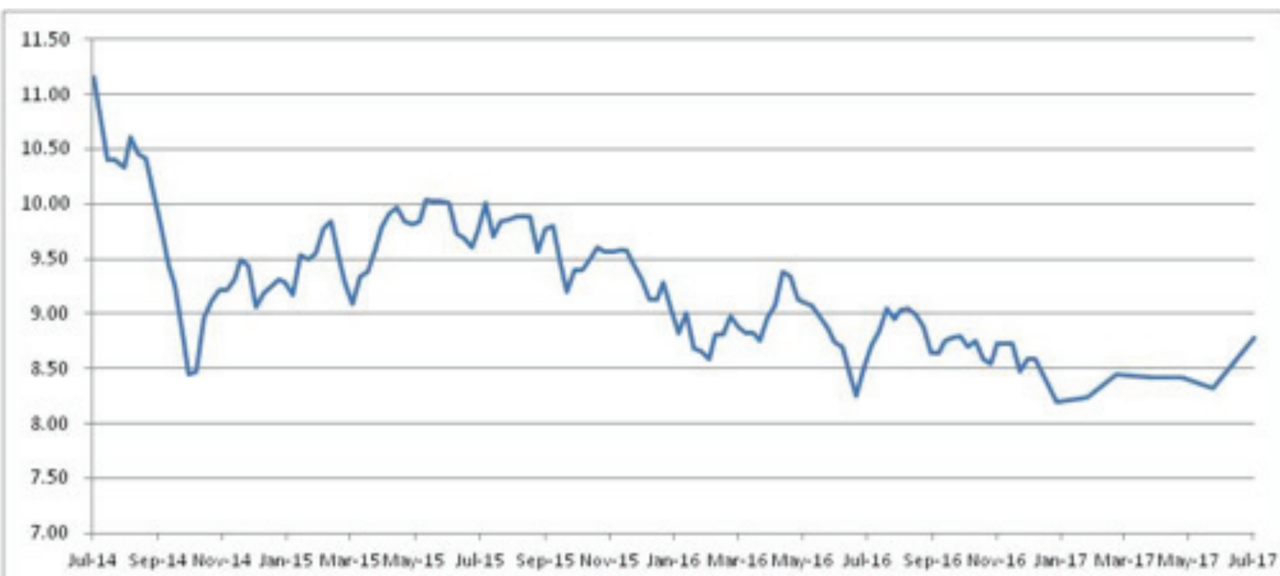
A quick refresher. HARP, or Hillside Adjusted Risk Points, is best thought of as a warning measure for bonds exposed to a blend of absolute price decline and premium decay. The higher the HARP, the more dangerous the bond. HARP tends to be highest for bonds in the 120-130 "death trap" range.

Since we last spoke, it seems that the continuously ever downward trend in HARP has been broken. Average HARP was up by a massive 0.42 HARP, while the underlying bonds gained less than a ½ point in price on average and were unchanged in underlying stock price. As you can see from the graph below, there has been a downward pressure in HARP since about two years ago – yes it wasn't exactly a straight line, but it definitely was a trend from about 10 HARP to 8.50 HARP. Why the trend? Well, there is no one answer since every bond in the Ugly 20 has its own particular story. But if there is one common theme to all, it is that rising stock prices tend to ultimately lead to lower levels of HARP. And since we last spoke, that engine has gone into reverse for a significant subset of bonds.



The largest HARP gainer of the period was Finisar 0.5% of 2033 with a 1.68 HARP move upward, taking the bond from 40th to 19th on the Ugly 20. What was all the fuss about? Well, let's start with last month's bond price, 109¼. Yes, that's a rather innocuous position on the price/risk curve – with par close enough that after coupons are counted, the deadfall loss is about eight points. Fast forward one month, and the stock has put in a 9% move to the upside, to which the bond added five points in price. Now, a 114¼ priced bond has much greater distance to par, and unless parity has moved in between par and bond price, there ain't much support. And what do you know, parity is 90½, far from where it could be of assistance. So why didn't those additional five points of bond price convert directly into five points of HARP, instead of 1.68 points of HARP? Volatility. With a stock volatility near 50% and about 2¼ years of call protection remaining, those additional points of price probably have enough time to be burned off.

Landing at the top of the mountain this period was Priceline 0.9% of 2021 with an 11.28 HARP, a 1.66 HARP move upward from fourth to first. How did this happen? It's the same story as Finisar, just a bit more extreme. The bond started the month at 113¼, with parity far below par – for a bond with one year of call protection left, that's 12¼ points of deadfall risk which needs to overcome by a low-20s stock volatility. All very unlikely, and hence the already high HARP. But along comes optimism, with the stock up 4.33% and the bond up 2¼ points in price. Parity is still not at factor, now at 93½. And so it all adds up to 14½ points of deadfall risk with a paltry stock volatility and a very short time clock. Top of the charts.

Lest you think that all the HARP gains this period were from increasing stock prices, let's turn to a counter-example – Teradyne 1.25% of 2023. Last period the bond was priced at 123 with a HARP score of 9.82 (3rd on the charts). With a 1.03 HARP gain, the bond is now at 2nd place with a HARP of 10.85. What happened? When the bond was priced at 123, parity was significantly above par and HARP was in decline with any upward movement in the stock. So it stands to reason that if the stock fell (it did, 4.88%), that HARP would increase (it did, 1.03). It's all about location, location on the price/risk curve. In this case, the bond fell backwards up the risk curve. Parity is now 101¾, very close to par. So while the bond peeled off 2 ¼ points in price, it wasn't enough to offset the naturally occurring gain in expansion in premium.

A further example of the falling-backwards-up-the-risk-curve situation was J2 3.25% of 2029. Starting the period with a price of 137, a 3.0% stock decline pushed up a 2¼ bond price decline. Doesn't sound too bad, does it? It depends. The bond was clearly on the downward slope of the risk curve, so this sort of price move (not wildly off delta neutral) is going to increase HARP. But by how much? Let's just toss in that stock volatility is a low 20s, and call protection is slightly more than 15 months. And parity, it's at 121½. For those with good mental calculation skills, that's slightly more than nine points of deadfall risk after coupons. It all made for a 1.34 gain in HARP, moving the bond from 34th to 17th on the Ugly 20.

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Hillside Ugly 20 List (Prices as of July 7, 2017)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	PRICELINE 0.900% 2021-09-15	115.50	1921.82	23.5%	22.00	11.28
2	TERADYNE 1.250% 2023-12-15	120.75	32.38	18.7%	19.04	10.85
3	SQUARE 0.375% 2022-03-01	124.50	23.94	19.3%	20.18	10.27
4	RPM 2.250% 2020-12-15	119.25	55.35	13.1%	13.81	10.25
5	AK 5.000% 2019-11-15	140.00	6.00	26.0%	28.89	9.75
6	PROOFPOINT 0.750% 2020-06-15	124.25	84.47	19.5%	20.26	9.72
7	CYPRESS 4.500% 2022-01-15	123.50	13.71	21.5%	21.86	9.41
8	WEBMD 1.500% 2020-12-01	128.50	59.37	13.5%	15.28	9.26
9	BIOMARIN 1.500% 2020-10-15	118.75	89.80	24.5%	23.37	9.26
10	INTERDIGITAL 1.500% 2020-03-01	121.75	77.35	13.5%	14.49	8.95
11	CTRIP.COM 1.000% 2020-07-01	116.00	54.30	16.2%	16.15	8.32
12	NXP 1.000% 2019-12-01	119.25	109.32	12.2%	12.95	8.23
13	INPHI 1.125% 2020-12-01	116.25	36.49	28.0%	25.39	7.92
14	DYCOM 0.750% 2021-09-15	117.75	91.58	24.6%	23.23	7.72
15	TRINITY 3.875% 2036-06-01	125.75	27.70	10.9%	12.38	7.67
16	VIAVI 0.625% 2033-08-15	112.50	10.89	16.6%	15.99	7.59
17	J2 3.250% 2029-06-15	134.75	83.49	11.0%	13.35	7.49
18	CITRIX 0.500% 2019-04-15	120.75	79.93	8.6%	9.60	7.35
19	FINISAR 0.500% 2033-12-15	114.25	27.29	26.4%	23.84	7.25
20	BROADSOFT 1.000% 2022-09-01	123.50	42.10	13.6%	14.78	7.13

Sources: Bloomberg, Kynex

HILLSIDE ADVISORS LLC

July 11, 2017

HOCS™ 20 Review

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Call it, if you like, the law of unintended consequences.

We designed our HOCS rating methodology to capture both things often discussed in evaluating convertibles and those that sometimes get overlooked. We use some traditional credit and growth metrics, but we also put a lot of emphasis on the relationship between market capitalization and debt. Some investors, we think, put too much emphasis on accounting measures when evaluating staying power. We'd rather see an equity price that can take a pounding and still provide a big refinancing cushion.

So it goes with Tesla. It's been at the vanguard of our HOCS lists for most of the time we've been producing them. Part of that is its remarkable market capitalization, to go with its volatility and growth potential. It's a good mix for convertibles, and we agree with the investor who shocked a recent investment conference by bringing up the notion of this odd creature, the convertible bond, as a better way to play Tesla.

For June, Tesla's repeat-offending presence helped the HOCS 100 outperform its rival CWB, though both had good months. The scores for June were 1.59% to 1.31% in HOCS' favor. At the year's halfway point, HOCS 100 was up 8.03%, still well behind the equity-ish CWB, which returned 10.08%. So far in July, though, as Tesla shares have dropped sharply, CWB has continued to rise. Through Monday, July 10, it was up 10.85% for the year, while HOCS 100 slipped to 7.68%. The group of actively managed funds we track is up just under 7% on the year.

Tesla's recent swoon brings its latest issue back into range for our main HOCS 20 lists. The dollar price had risen too high—that's the beauty of countercylicality in a smaller group. Hear that, cap-weighted index fans? Anyway, the new primary HOCS 20 list comes in with an average score of 65.6, still on the low side, still suggesting caution. We prefer to see it in the high 60's or, ideally, above 70, but that's not today's world. It might be tomorrow's. The list has a sweet price point, though, of 99.66, with a profile of 2.22% up 57%. We can't say we're in love with that, but we're reminded, even as rates try to push higher in a new Fed regime, that straight corporates have low yields and infinite conversion premia. The China-free version of HOCS 20 is nearly identical, with a 99.48 price point, a HOCS of 65.2 and a 2.32% up 53.8% profile. So you're not missing much these days if you avoid Chinese convertibles, at least not according to the averages. There is still, however, a meaningful cost for liquidity. The Over $300 million version takes you down to a HOCS of 63.4 and costs you more than 100 basis points of yield while keeping you in the mid-50's premium territory.

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Hillside HOCS 20 List

	Description	Convert	Stock	HOCS Overall	HOCS Growth	HOCS Safety	Yield	Premium
1	AMAG 3.250% 2022-06-01	99.00	19.35	72.5	82.6	52.4	3.47%	40.0%
2	SUCAMPO 3.250% 2021-12-15	98.25	10.75	71.9	81.0	53.6	3.68%	51.7%
3	DEPOMED 2.500% 2021-09-01	88.00	10.66	71.6	79.1	56.6	5.81%	58.8%
4	RH 0.00% 2019-06-15	90.50	60.63	70.7	60.5	91.2	5.26%	73.3%
5	INPHI 0.750% 2021-09-01	99.25	36.49	69.4	68.7	70.8	0.94%	53.2%
6	RESTORATION 0% 2020-07-15	85.00	60.63	67.8	63.6	76.2	5.48%	65.6%
7	VIPSHOP 1.500% 2019-03-15	98.50	10.06	67.2	56.0	89.6	2.42%	97.0%
8	IONIS 1.000% 2021-11-15	107.00	51.50	66.9	67.4	66.0	-0.59%	38.8%
9	ENVESTNET 1.750% 2019-12-15	97.50	37.95	66.7	58.4	83.1	2.82%	61.6%
10	SILVER 2.875% 2033-02-01	96.75	9.29	66.4	63.4	72.3	4.23%	108.3%
11	INTERCEPT 3.250% 2023-07-01	98.00	121.03	65.8	79.9	37.6	3.63%	60.8%
12	DEXCOM 0.750% 2022-05-15	101.00	70.96	65.3	73.6	48.6	0.54%	41.0%
13	WEB.COM 1.000% 2018-08-15	100.00	24.30	64.5	53.2	87.0	1.00%	44.0%
14	ILLUMINA 0.000% 2019-06-15	100.75	169.00	63.4	49.8	90.4	-0.39%	51.6%
15	TESLA 2.375% 2022-03-15	115.50	316.05	61.3	70.9	42.1	-0.87%	19.7%
16	SCORPIO 2.375% 2019-07-01	88.75	3.78	61.2	65.8	52.0	8.72%	139.2%
17	SYNAPTICS 0.500% 2022-06-15	102.50	52.50	61.1	72.2	39.0	-0.01%	42.6%
18	GOPRO 3.500% 2022-04-15	99.25	7.96	60.3	71.8	37.2	3.67%	32.6%
19	SINA 1.000% 2018-12-01	105.00	86.89	59.4	47.7	82.8	-2.53%	40.0%
20	LUMENTUM 0.250% 2024-03-15	122.75	61.60	59.3	72.1	33.8	-2.82%	20.8%

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	AMAG 3.250% 2022-06-01	99.00	19.35	72.5	82.6	52.4	3.47%	40.0%
2	SUCAMPO 3.250% 2021-12-15	98.25	10.75	71.9	81.0	53.6	3.68%	51.7%
3	DEPOMED 2.500% 2021-09-01	88.00	10.66	71.6	79.1	56.6	5.81%	58.8%
4	RH 0.00% 2019-06-15	90.50	60.63	70.7	60.5	91.2	5.26%	73.3%
5	INPHI 0.750% 2021-09-01	99.25	36.49	69.4	68.7	70.8	0.94%	53.2%
6	RESTORATION 0% 2020-07-15	85.00	60.63	67.8	63.6	76.2	5.48%	65.6%
7	IONIS 1.000% 2021-11-15	107.00	51.50	66.9	67.4	66.0	-0.59%	38.8%
8	ENVESTNET 1.750% 2019-12-15	97.50	37.95	66.7	58.4	83.1	2.82%	61.6%
9	SILVER 2.875% 2033-02-01	96.75	9.29	66.4	63.4	72.3	4.23%	108.3%
10	INTERCEPT 3.250% 2023-07-01	98.00	121.03	65.8	79.9	37.6	3.63%	60.8%
11	DEXCOM 0.750% 2022-05-15	101.00	70.96	65.3	73.6	48.6	0.54%	41.0%
12	WEB.COM 1.000% 2018-08-15	100.00	24.30	64.5	53.2	87.0	1.00%	44.0%
13	ILLUMINA 0.000% 2019-06-15	100.75	169.00	63.4	49.8	90.4	-0.39%	51.6%
14	TESLA 2.375% 2022-03-15	115.50	316.05	61.3	70.9	42.1	-0.87%	19.7%
15	SCORPIO 2.375% 2019-07-01	88.75	3.78	61.2	65.8	52.0	8.72%	139.2%
16	SYNAPTICS 0.500% 2022-06-15	102.50	52.50	61.1	72.2	39.0	-0.01%	42.6%
17	GOPRO 3.500% 2022-04-15	99.25	7.96	60.3	71.8	37.2	3.67%	32.6%
18	LUMENTUM 0.250% 2024-03-15	122.75	61.60	59.3	72.1	33.8	-2.82%	20.8%
19	CALATLANTIC 1.250% 2032-08-01	100.25	36.31	59.2	65.7	46.2	1.20%	10.8%
20	FINISAR 0.500% 2036-12-15	99.50	27.29	59.2	52.1	73.2	0.61%	61.1%

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	AMAG 3.250% 2022-06-01	99.00	19.35	72.5	82.6	52.4	3.47%	40.0%
2	SUCAMPO 3.250% 2021-12-15	98.25	10.75	71.9	81.0	53.6	3.68%	51.7%
3	DEPOMED 2.500% 2021-09-01	88.00	10.66	71.6	79.1	56.6	5.81%	58.8%
4	RH 0.00% 2019-06-15	90.50	60.63	70.7	60.5	91.2	5.26%	73.3%
5	RESTORATION 0% 2020-07-15	85.00	60.63	67.8	63.6	76.2	5.48%	65.6%
6	IONIS 1.000% 2021-11-15	107.00	51.50	66.9	67.4	66.0	-0.59%	38.8%
7	INTERCEPT 3.250% 2023-07-01	98.00	121.03	65.8	79.9	37.6	3.63%	60.8%
8	DEXCOM 0.750% 2022-05-15	101.00	70.96	65.3	73.6	48.6	0.54%	41.0%
9	ILLUMINA 0.000% 2019-06-15	100.75	169.00	63.4	49.8	90.4	-0.39%	51.6%
10	TESLA 2.375% 2022-03-15	115.50	316.05	61.3	70.9	42.1	-0.87%	19.7%
11	SCORPIO 2.375% 2019-07-01	88.75	3.78	61.2	65.8	52.0	8.72%	139.2%
12	SYNAPTICS 0.500% 2022-06-15	102.50	52.50	61.1	72.2	39.0	-0.01%	42.6%
13	LUMENTUM 0.250% 2024-03-15	122.75	61.60	59.3	72.1	33.8	-2.82%	20.8%
14	FINISAR 0.500% 2036-12-15	99.50	27.29	59.2	52.1	73.2	0.61%	61.1%
15	HUBSPOT 0.250% 2022-06-01	97.75	66.00	58.8	69.2	37.9	0.72%	40.4%
16	PANDORA 1.750% 2020-12-01	95.00	8.75	58.7	61.2	53.7	3.32%	78.3%
17	TESLA 1.250% 2021-03-01	107.50	316.05	58.4	58.4	58.4	-0.78%	22.4%
18	MOLINA 1.625% 2044-08-15	128.75	69.91	58.3	62.8	49.4	-20.34%	7.0%
19	GOGO 3.750% 2020-03-01	90.75	11.24	58.3	57.5	60.0	7.69%	92.6%
20	AKAMAI 0.000% 2019-02-15	98.00	49.65	57.3	40.1	91.7	1.28%	76.8%

Sources: Bloomberg, Kynex

The Month That Was: June 2017

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New issuance lightened up this month with five issuers bringing $1.1 billion of new paper to the market. With earnings season now upon us, we don't expect a pick-up in the near-term. Kicking off issuance in June was **Invacare** (IVC) on June 7 with a $100 million deal that was upsized to $105 million. IVC is a manufacturer of medical equipment used in non-acute care settings. The company's products provide medical device solutions for congenital, acquired, and degenerative ailments. The issue was priced at 4.5% up 32.5% with a five-year maturity. The initial HOCS slash line was 48 Overall / 61 Growth / 22 Safety. That is quite an unattractive score for a new issue. The company plans to use the proceeds from the deal for a convertible notes hedge transaction, working capital, and general corporate purposes. As of last night's closing, the bonds are trading at 106.25 versus $12.85 giving it a current HOCS slash line of 45/60/14.

On June 15, **PROS Holdings** (PRO), a repeat offender, announced a $106.25 million deal that priced at 2% up 75% with a thirty-year maturity. PRO is a cloud software company focused on commerce. The company plans to use the proceeds for general corporate purposes including acquisitions or other strategic transaction, working capital, and capital expenditures, and possible debt repayments. For the record, the converts received an initial par-based, HOCS slash line of 39 Overall / 39 Growth / Safety 38, though of course they were reoffered substantially lower. While the score is balanced, there isn't anything else good to say about it. The bonds are now trading at 92.5 versus $28.61 and have a HOCS slash line of 45/47/39.

On June 20, **Synaptics** (SYNA) announced a $500 million deal that was upsized from $450 million. The Company plans to use $123.8 million of the proceeds to repay its term loan facility and terminate it, repurchase $94 million of stock, and fund a portion of the cash price for its Conexant System acquisition and the multimedia solutions business of Marvell Technology Group. SYNA has a portfolio of touch, display, and biometric products providing solutions to the mobile, PC, and automotive industries. The deal priced 0.5% up 32.5% with a five-year maturity. The initial HOCS slash line was 72 Overall / 80 Growth / 57 Safety, finally a score to get excited about. As of last night, the bonds are trading at 102.5 versus $52.50 and now have a HOCS slash line of 61/72/39, good enough to make the HOCS 20.

Also on June 20, **Teladoc** (TDOC) announced a $200 million deal that was upsized to $240 million. The deal priced at 3% up 30% with a five-year maturity. The initial HOCS slash line was 70 Overall / 84 Growth / 41 Safety. That is another good score, though the safety score is a bit worrisome. TDOC has the largest tele-health platform in the US, offering a portfolio of virtual care delivery solutions. The company plans to use the proceeds to finance a portion of the cash consideration for its acquisitions of Best Doctors and refinance existing indebtedness, as well as general corporate purposes. The bonds are now trading at 107 versus $35.00 with a HOCS slash line of 63/84/22. The safety score keeps this one out of HOCS 20 at this point.

Finally on June 27, **EZCORP** (EZPW), another repeat offender, announced a $125 million deal that priced at 2.875% up 30% with a seven-year maturity. EZPW is a leading provider of pawn loans in the US and Mexico. The company plans to use the proceeds to repay borrowings under its senior secured credit facility, which will be terminated, and for general corporate purposes, including repurchasing $35 million of its outstanding 2.125% convertible notes due 2019, and to acquire complimentary businesses. The company has entered into a non-binding letter of intent to acquire pawnshops in Latin America. The deal received an initial HOCS slash line of 59 Overall / 66 Growth / Safety 46, a rather ho-hum score. The bonds are now trading at 102 versus $7.75 giving them a HOCS slash line of 57/64/43.

In other news, **Air Lease** (AL) sold $600 million of 2.625% of 2022 senior notes for 99.553. Proceeds will be used for general corporate purposes including the purchase of commercial aircraft and repayment of existing debt……… **Clovis Oncology** (CLVS) announced positive results from its Phase 3 ARIEL3 maintenance trial of Rubraca, its recently launched ovarian cancer treatment. Based upon the results, the company plans to file a supplemental new drug application (sNDA) within the next four months. The stock was up nearly 50% on the news. The company wasted no time in taking advantage of the higher stock price by offering $250 million of common stock, which was upsized to $300 million. CLVS plans to use the proceeds for general corporate purposes including sales and marketing expenses for Rubraca……… **Cal Atlantic Group** (CAA) announced an offering of $300 million of senior notes, which was upsized to $350 million. The notes will pay a rate of 5% and mature in 2027. The company plans to use the proceeds for general corporate purposes including the acquisition of land and companies, land development, home construction, stock repurchases, and repayment of debt including the company's 1.25% senior convertible notes due 2032……… **Echo Global Logistics** (ECHO) approved a repurchase program for up to $50 million aggregate of its common stock and 2.5% convertible senior notes due 2020. The program expires on April 30, 2019…… **EnerNOC** (ENOC) has entered into an agreement to be acquired by Enel Group for $7.67 per share in cash. Including debt, the transaction is valued at over $300 million. The deal is expected to close in the third quarter…… **Hornbeck Offshore Services** (HOS) has refinanced its $200 million senior secured revolving credit facility. The new facility provides a first-lien delayed-draw term loan of up to $300 million. The new facility matures in June 2023, an extension of over three years. The rate on the new facility varies from L+600 to L+750 for year-one through year-five respectively……… **j2Global** (JCOM) has sold $650 million of 6% senior notes, upsized from $550 million. The notes will mature in 2025. JCOM plans to use the proceeds to redeem all of its outstanding 8% senior notes due 2020, to repay all amounts outstanding under its existing credit facility, and for general corporate purposes……… **Meritage Home Corp** (MTH) sold $300 million of 5.125% senior notes due 2027. ……… **Molina Healthcare** (MOH) has sold $330 million of 4.875% senior notes due 2025. The company plans to use the proceeds to retire its 1.625% of 2044 convertible notes……… **Pattern Energy** (PEGI) announced it has attained up to $1 billion in new capital commitments from Pattern Development, Riverstone, and the **Public Sector Pension Investment Board** (PSP). The initiative will support Pattern's goal of doubling its renewable energy portfolio to five gigawatts by 2020……… **Repligen Corp** (RGEN) has entered into an agreement to buy privately-held Spectrum for $359 million comprised of $120 million cash and 6.154 million shares of stock. The transaction is expected to close during the third quarter. The company subsequently sold $120 million of common stock. …….. **Spectranetics** (SPNC) announced it is being acquired for $38.50 per share in cash by Royal Philips. The total value of the transaction is EUR 1.9 billion including debt. The transaction is expected to close in the third quarter. Philips plans to finance the transaction with cash on hand and the issuance of debt……… **VeriSign** (VRSN) sold $550 million of 4.75% senior notes due 2027. The deal was upsized from $450 million. VRSN plans to use the proceeds for general corporate purposes including share repurchases……… **Weatherford** (WFT) has sold $250 million of 9.875% senior notes due 2024. The notes were issued to repay amounts outstanding under the company's revolving credit facility, provide additional liquidity, and provide assurance the company will remain in compliance with financial covenants under its revolving and term loan credit facilities.

That's all for now. We'll be back in August. Stay cool!

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New Issue: EZCORP, Inc. (EZPW)

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Hillside has always been a fan of the publicly traded pawn shop brokers First Cash Financial Services (FCFS) and EZCORP. When run efficiently, pawn shops generate predictable cash flow, and at least in the case of FCFS, can pay down debt, finance share buybacks and pay dividends. Not only that, pawn shops tend to be countercyclical, adding diversification.

EZCORP has had a more difficult time over the last six years than FCFS. Back then its shares peaked at just over $38. However, over time, EZCORP lost its way, diversifying into payday lending and other related businesses. These investments ultimately failed for a variety of reasons and took their toll on the stock price. However, we turned positive on the 2019 convertible bonds two years ago and since then, the 2019 bond price has returned over 30% since we wrote our first article urging investors to consider the bonds in August 2015.

At the time, we liked new EZXCORP management and its strategic plan to close all the tangential businesses to focus on the core pawns shops in the United States and Mexico, a fast-growing market. This "Back to the Future" strategy made sense to us given the economics of a well-run pawn shop and the fact that the pawn industry, particularly in Latin America, remains fragmented providing both EZCORP and FCFS opportunity to continue their roll-up strategy of smaller pawn shops.

EZCORP recently issued a $143.75 million dollar, seven-year convertible note. Pricing for the bond was 2.875% up 30%. With the proceeds, EZCORP paid down the entire $51.6 million outstanding on its senior credit facility and $35 million face value of its outstanding 2.125%, 2019 senor convertible notes, leaving $195 million of the old 2019 convertible notes outstanding.

The new issue is trading around 102 versus $7.75 on the stock. That's a 2.56% yield and a 33% premium--very attractive optics in this market with a competitive yield and a premium allowing plenty of equity participation, though tempered somewhat by the seven-year maturity.

Despite our enthusiasm for EZCORP's future, HOCS scores are middling. The new 2024 bond clocks in with a slash line of 57 overall/64 growth/43 safety. The 2019 bond is at 51 overall/41 growth/70 safety. We look for these scores to improve along with future EZCORP financial results.

Leverage

After paying down debt, new-issue proceeds should leave EZCORP with about $174 million in cash. Given the positive cash flow realized by the business, that gives EZCORP ample liquidity to meet the $195 million obligation under the old 2019 convertible bond and have the necessary cash to acquire additional pawn shops for growth.

Business Summary

The company operates 517 pawn shops in the United States, 240 pawn shops in Mexico and 27 other international stores. Revenue is generated through pawn service charges and merchandise sales. In the US, EZCORP has successfully increased year over year same store increases in pawn loan origination for the past six quarters and same-store pawn service charges were up 5% last quarter versus the same period in the previous year. In Mexico, on a constant currency basis, pawn loan origination increased 12% last quarter and pawn services charges increased 11% over the same quarter last year compared to the same period in the previous year. We believe that the improving results bear witness to new management's ability to run the business efficiently and profitably.

Opportunity for Growth

From our point of view, buy-and-hold convertible investors should be able to enjoy the upside from a move in the stock sooner rather than later. Just prior to the convertible bond announcement, EZPW stock was trading at $9.10 per share, dropping to yesterday's closing price of $7.75 per share after the bond was priced. Though the convertible bond issue represents potential dilution of just over 25%, we think the stock price could reach the $10 per share conversion rate over the next twelve months based on the following factors:

- EZPW has begun to invest in its long-neglected pawn stores, and that could significantly increase operating income margins going forward. For example, the company expects to mine significant customer data with the new point-of-sale system that should be rolled out company-wide by the end of the calendar year. This will allow management to drill down to the customer level to increase efficiency and revenue. For example, armed with data on specific customers, EZPW could increase credit limits for those clients which have developed a history of paying back their pawn loans on time.

  Efforts like these should allow EZPW to close the operating margin gap with FCFS, which currently generates operating income margins 300 basis points higher than EZPW. Even closing the gap by 50% would be a significant boost to EBITDA for EZPW.

- EZPW has stated its intentions to use a portion of the cash raised from the 2024 convertible bond to make additional acquisitions. The company mentioned in its press release that it has signed a letter of intent to purchase pawn shops in Latin America and is in various stages of discussion to purchase additional pawn shops in the US, Canada and Mexico.

- The new convertible bond has significantly lowered EZCORP's interest expense. EZCORP was paying a stiff LIBOR + 750 bp on the outstanding portion of the old credit facility plus a 2.75% per annum fee on the unused portion of the old credit facility.

- The potential to realize significant cash associated with EZCORP's previous sale of Grupo Finmart. Under terms of the deal completed last year, EZCORP is slated to receive $10 million for the remainder of fiscal 2017, a further $26 million in fiscal 2018 and another $18 million in fiscal 2019. These cash proceeds, if paid on time, will further strengthen EZCORP's balance sheet and raise the company's enterprise value.

With the strong cash flow generated by its pawn shops plus the opportunity for additional growth through acquisition, we believe that the new EZPW 2024 convertible bonds present investors with an opportunity for appreciation. Add the 2.875% coupon, and buy and hold investors are paid handsomely to wait for a higher stock price.

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