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January 20, 2015

Hybrid Vigor℠

The Hillside Convertible Advisory Letter

Volume 2 Issue 3

Spacing The Needle

Inside

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Dear Friends,

Greetings from Seattle, home of both the best team in the NFL (quiet, Patriots fans—do you know how much it kills me as a 49ers fan to say that?) and the luckiest one. Wow. I was waiting Sunday night at JFK with a bunch of Seahawks fans who were thrilled that our flight was delayed, giving them a chance to witness a comeback from the twilight zone. Or somewhere.

Anyway, I wasn't completely sleepless here last night, despite all the coffee, so I'm awake enough to send you a slew of comments. 2015 is shaping up as a treacherous year, but one likely to be filled with opportunities. We hope as many of you as possible will be making ***Hybrid Vigor*** part of your efforts to keep moving the chains downfield.

If Bill Belichick were a convertible trader, he'd probably be a fan of KEYW. In fact, that suspicious email that just showed up on my computer was probably launched near Boston and sent out here to spy on the Seahawks. Anyway, Kathy Schick has comments today about one of the small-cap stalwarts of the HOCS 20.

Curt Peters continues his revolutionary analysis of the Ugly 20, following some movement at the vanguard of the list as well as some changes further down. Roman Terekhin summarizes last week's wild scene—there is no other way to describe it—at FXCM, and Jeff Alton says he's willing to get a Mohawk if a certain company follows our advice and issues a convertible to finance a new acquisition.

All this and more in this week's ***Hybrid Vigor***! And a not-so-gentle reminder—time's just about up for all you non-subscribers. If that's you, get in touch with John Anderson this week at janderson@hillsideadvisors.com or (646) 665-4025. He'll help you find a plan that fits your desk and your budget. We don't want you to stop hearing the voice of the convertible market.

Bill

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January 20, 2015

Lion of Elba

Bill Feingold and Curt Peters

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.

Last week's revolutionary times put the open source *Bonnet Rouge* Jacobins in the leadership position of the Ugly 20. This week the Red Hat 0.25% of 2019 receded into the background a bit as a name with prior leadership experience vaulted up into 1st place. The details of this power play are fraught with intrigue, which we will ferret out for you. But first, the news. The membership of the corps experienced an average 1% decline in stock prices translating into an average ½ point decline in bond price. In all of the commotion, five dearly departed bonds left us due to stock declines, but were replaced by five new vibrant additions to the corps of the Ugly 20. Average HARP was about 9.20 for our group this week.

Before we get to the leaders, let's bid a tearful but important farewell to SanDisk 0.5%. This bond has been one of the most controversial Ugly 20 members, primarily for its attractive optics (especially the moderate-looking premium) and the market's collective memory of the volatility this name has provided over the years. Well, that memory proved right, as SanDisk warned this week and sent its shares and convertible tumbling. With the bond now tantalizingly close to wearing a par halo, hedge funds were smiling and taking a victory lap, while outrights were kicking themselves for not worrying more about the directional risk in the bond at its price point. It was quite a fall from Ugly 20 grace, with the bond dropping from sixth all the way to 43rd and losing more than four HARP (10.4 to 6.3) in the process. This should serve as a reminder that presence on the list is supposed to mean, above all, "Hey, let's be careful out there."

Now, back to our regularly scheduled programming.

The Red Hats took a tumble with RHT stock down 5.16% for the week, bringing the bond down 3¾ points to 114½. That was more than sufficient for a 1.32 HARP contraction to 10.12 HARPs, and from 1st place to 4th. The bond fell about ¾ of a point further than a dollar neutral model would have predicted, which means some of the heavy investment grade bid behind this bond from previous weeks abated. Or maybe—just maybe—Red Hat's swift ascension to Ugly 20 power spooked some investor-readers.

Contrasting the *Bonnet Rouge* bonds with their Orleans brethren, Jazz Pharmaceuticals 1.875% of 2012, makes for a head-scratching enigma. We liked the JAZZ bonds quite a bit initially and figured it was just a matter of time before they rose enough to make the Ugly 20 cut. JAZZ was one of the new additions this week with a rank of 17th and a HARP of 8.01. To secure such a coveted spot, all JAZZ had to do was have a 2% stock gain and a 1¾ point bond gain to bring the price to 114¼ – nearly identical to RHT (114½). The coupons on these bonds aren't anything to dwell on, nor are the nonexistent dividends. Looking at the premiums, RHT's 28.7% should make more friends than JAZZ's 38.3%. So why the very large difference in HARP (RHT 10.12 vs JAZZ 8.01)? Despite having 1 year less of call protection, JAZZ has volatility much larger than RHT (42% vs 26%). To put it another way, while JAZZ is quite ugly, we can see a lot more routes for JAZZ bondholders, outright and arb alike, to profitability than RHT ones.

Similar to the Little Corporal coming back from what turned out to be a short lived retirement was Lam Research 1.25% of 2018 back into top spot after leaving due to a constitutional coup last year. The nature of the HARP calculation tends to elevate bonds in the 110-130 range to the vanguard while pushing down higher (premium contraction) and lower (par halo) priced ones. Nevertheless, sometimes old veterans just don't do as asked. As such was the case with LCRX's stock decline of 2.7% and bond decline of 2¾ points to 138½, and back into top spot. We've told the story of LCRX many times before, so just to summarize, it's investment grade with not enough volatility to justify the price. As a point of comparison, unrated Palo Alto Networks 0% of 2019 is similar in terms of premium and price location on the curve, but has nearly twice the volatility and thus has a HARP 2¼ points less. Take a position now in LCRX bonds, and you too might meet your Waterloo.

The BioMarin Pharmaceuticals twins performed well this week with a 6% gain in the stock off the back of disclosure of positive Preliminary BMN-190 data. BMRN 0.75% of 2018 was up 5½ to 126¼, while BMRN 1.5% of 2020 was up 5¾ to 129¾. Moving them into 7th and 10th place with HARPs of 9.99 and 9.66, respectively. If the stock were to move up 20% from its current location, both these bonds would be above 140 in price and thus a bit removed from the multi-dimensional risk zone from where they currently reside. The high 30's volatility in the stock makes this a real possibility. In addition to a smaller coupon, the 2018 bond has 2 years less of call protection (3.6 years), so hence the higher HARP. Choose wisely!

The week's biggest HARP gainer was Priceline.com 1% of 2018 moving from 14th to 6th with a 1.29 HARP gain to settle at 9.98 HARP. A stock decline of about 4% left the bond down about 1 point less than a dollar neutral model would have predicted, and as such premium expanded from 13.3% to 16.8%. A premium expansion with a bond price falling only 1½ points means more risk, and in our case more HARP.

Homebuilder Ryland Group's 1.625% of 2018 bond fell back from 20th to 13th with a 0.65 HARP increase to 8.65 HARP. Margin warnings at competitor Lennar drove RYL's stock down 7.42% and the bond down 7½ from 139 ½ to 132. This bond was on the verge of leaving the multi-dimensional risk zone near 140, but now is firmly back in a bad spot.

Of our five new additions to the Ugly 20, one of which we discussed already, three share a common theme. Entering at 15th was Emergent BioSolutions 2.875% of 2021 with a HARP of 8.10 and a price of 114. Healthsouth 2% of 2043 entered at 18th with a HARP of 7.93 and a price of 117. And Griffon 4% of 2017 landed at 20th with a HARP of 7.67 and a price of 113½. The common theme was an increasing stock price in a sea of declines. All three bonds are very typical of why they are on the Ugly 20 – they have passed over the lower bound of the multi-dimensional risk zone. Despite Emergent Biosolutions having a smaller coupon than Gryphon, when the stock dividends are factored in both bonds are the same. Healthsouth is unique in that its coupon is entirely offset by its stock dividend. Having the highest volatility (mid 30's), we'd expect Emergent BioSolutions to be the first to pass through the premium burn zone, but expectations can be deceiving.

Our final new entrant for the week was a name we've seen before, SunPower 0.75% of 2018. Coming from 21st to 16th on a small 0.16 HARP increase to 8.07 HARP, SunPower was powered down by a stock decline of 3.88% into a bond decrease of 2 points. It's a minor HARP move, but attributable to the bond missing its dollar neutral spot by about ½ a point. Keeping this 21% premium bond from being ranked much higher on the Ugly 20 is the mid 40s volatility driving the stock. Remember that volatility is just the standard deviation of stock price irrelevant if that stock price moves up or down, as long as it moves. This is a stock which was up near $40 in September, and now below $25. That's volatility alright, but the wrong kind, unless you're hedging.

Hillside Ugly 20 List (Prices as of January 16, 2015)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	Lam Research 1.25% 2018-05-15	138.50	77.58	12.0	14.84	11.01
2	RPM International 2.25% 2020-12-15	112.50	45.96	29.6	25.69	10.85
3	Omnicare (Exchange) 3.25% 2035-12-15	116.50	74.33	20.8	20.06	10.65
4	Red Hat 0.25% 2019-10-01	114.25	65.19	28.7	25.48	10.12
5	BioMarin Pharma 0.75% 2018-10-15	126.25	99.45	19.5	20.60	9.99
6	Priceline.com 1% 2018-03-15	124.75	1008.22	16.8	17.94	9.98
7	Illumina 0.5% 2021-06-15	114.25	183.82	58.1	41.99	9.74
8	BioMarin Pharma 1.5% 2020-10-15	129.75	99.45	22.9	24.18	9.66
9	On Semiconductor 2.625% 2026-12-15	118.00	9.84	25.9	24.27	9.61
10	NVIDIA 1% 2018-12-01	115.00	19.96	16.2	16.03	9.53
11	Trinity Industries 3.875% 2036-06-01	125.75	25.54	23.8	24.17	9.01
12	Palo Alto Networks 0% 2019-07-01	129.00	125.01	13.8	15.64	8.73
13	Ryland Group 1.625% 2018-05-15	132.00	37.31	13.4	15.60	8.65
14	Salesforce.com 0.25% 2018-04-01	112.50	56.64	32.1	27.34	8.36
15	Emergent BioSolutions 2.875% 2021-01-15	114.00	28.17	31.1	27.04	8.10
16	Sunpower 0.75% 2018-06-01	119.50	24.51	21.6	21.23	8.07
17	Jazz Pharmaceuticals 1.875% 2021-08-15	114.25	164.97	38.3	31.64	8.01
18	Healthsouth (Exchg) 2% 2043-12-01	117.00	41.00	10.8	11.40	7.93
19	CSG Systems 3% 2017-03-01	118.75	25.37	9.8	10.60	7.84
20	Griffon 4% 2017-01-15	113.50	13.50	22.6	20.92	7.67

Sources: Bloomberg, Kynex

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HOCS℠ 20

Bill Feingold

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.

It was an eventful week for the HOCS 20, and not a great one, with leader Tesla taking it on the chin again as Elon Musk predicted unprofitability until 2020. The unhedgeable, unborrowable, unpredictable, trade-by-appointment Invensense also took a hit, dropping a handful of points amidst boardroom shuffling. (Should bonds of hard-to-borrow names be eligible? We think so—after all, outrights have the opportunity to profit).

For the week, the HOCS 20 fell 0.78%, with the underlying shares off a cool 2.72%. So relative performance was pretty good, especially with Twitter, down less than 1% versus a 7% stock decline. But as they say, you can't buy groceries with relative performance, at least if you are an outright investor.

We're going to do something a bit different this week. To this point, when a repeat-offending convertible has multiple issues in the Top 20, we've only used the top-scoring bond. This week we're going to give you all the representation. This means sibling bonds from Tesla, Qihoo, Solar City and Twitter are all making the cut. We thought comparing some of the bonds might help illuminate certain features of HOCS. We've also been improving our data feeds to get you the most up-to-date calculations.

Of the sibling bonds, we note that the HOCS gap between the paired Tesla issues of last year has closed from a handful of points to a single one as the price has declined. We have typically preferred the longer-dated bonds, thinking this is a story that will need time to play out. But both continue to rate well even as the company continues to take the worst of the headlines.

In addition to the sibling bonds, we have a couple of new faces in the HOCS 20. ALJ 3%, once a controversial inclusion in the Ugly 20 when it had some attractive optics but was mired in the 120-130 death trap, now finds itself at a far more appealing price point thanks to energy woes. Repeat offender Insulet (PODD) also makes the list with its 2% convertible after disappointing the street with its projections for sales of its OmniPod insulin pump. HOCS, nothing if not forgiving, gives the bond a favorable rating at its new par-halo price point given past growth rates and the $1.8 billion market cap, nine times the convertible's size even after last week's fall.

With the sibling inclusion, some names had to fall off the list. Call it nepotism. The nearest misses were Synchronoss 0.75%, 51job 3.25%, Cornerstone OnDemand 1.50% and Endologix 2.25%. Oh, and we almost forgot—Herbalife 2.25%. Frankly, we're just as happy to have that one off the list, though its departure hurts the average optics.

You'll notice that just making the cut was one of our favorite recent issues, Envestnet 1.75%, which began life with a cool 77/77/77 HOCS slash line. Now the line is 63/70/50, a product of both a rising stock price and several points of dollar-neutral expansion.

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Hillside HOCS 20 List

					HOCS			
	Description	Convert	Stock	Overall	Growth	Safety	Yield	Premium
1	Qihoo 1.75% 2021-08-15	82.75	56.11	75	80	65	6.14%	78.12%
2	Tesla Motors 1.25% 2021-03-01	85.25	193.07	75	81	62	3.99%	58.90%
3	Qihoo 0.5% 2020-08-15	87.00	56.11	74	76	70	6.04%	94.33%
4	Tesla Motors 0.25% 2019-03-01	88.00	193.07	74	77	68	3.40%	64.03%
5	Qihoo 2.5% 2018-09-15	96.00	56.11	74	74	74	5.05%	89.85%
6	LinkedIn 0.5% 2019-11-01	102.75	214.18	70	68	75	-0.07%	41.30%
7	Renewable Energy 2.75% 2019-06-15	90.50	9.07	70	79	52	5.19%	32.34%
8	ALJ 3% 092018-09-15	98.75	10.92	69	77	53	3.37%	31.23%
9	Solar City 1.625% 2019-11-01	86.00	48.15	69	82	42	4.95%	49.19%
10	Invensense 1.75% 11/01/18	92.75	14.02	69	80	45	3.83%	44.81%
11	Solar City 2.625% 2018-11-01	101.75	48.15	67	81	40	2.26%	30.31%
12	Shutterfly 0.25% 2018-05-15	96.00	43.01	67	69	65	1.49%	43.22%
13	KEYW 2.50% 2019-07-15	90.50	10.25	67	82	35	4.88%	30.98%
14	Web.com 1% 2018-08-15	90.50	17.42	66	73	54	3.88%	81.83%
15	Insulet 2% 2019-06-15	101.25	33.09	66	78	42	1.70%	42.31%
16	Twitter 1% 2021-09-15	90.75	37.31	66	71	55	2.52%	88.86%
17	Allscripts 1.25% 2020-07-01	99.00	12.35	66	69	58	1.44%	37.77%
18	Ligand 0.75% 2019-08-15	99.50	54.38	66	79	38	0.86%	37.31%
19	Twitter 0.25% 2019-09-15	91.00	37.31	64	67	57	2.30%	89.38%
20	Envestnet 1.75% 2019-12-15	107.25	51.64	63	70	50	0.26%	30.60%

Sources: Bloomberg, Kynex

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KEYW: Securing the Future

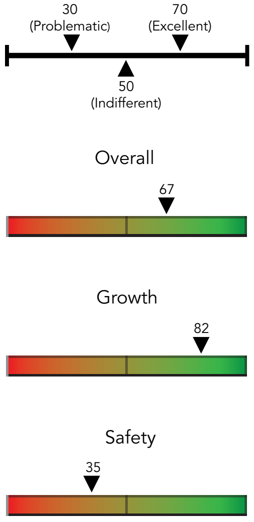
Kathy Schick

KEYW

2.5%, 2019/07/15
Price (Bond): 90.50
Stock: $10.25
YTM: 4.88%
Premium: 31.0%
HOCS-Overall: 67
HOCS-Growth: 82
HOCS-Safety: 35

As of January 16, 2015

HOCS 1.5:



KEYW (KEYW) issued 2.5% convertible notes of 2019 in July 2014. The proceeds from the convertible offering were used to pay down the company's credit facility and for general corporate purposes including acquisitions. The convertible bond has been a regular member of the HOCS 20 with a slash line of 67 Overall / 82 Growth / 35 Safety. The score is heavily weighted toward growth, with safety being penalized for the company's small size and high leverage. The convert is currently priced in the low 90's with a premium of 31%. And with a yield-to-maturity of 4.88%, you do get paid to wait through the 2019 maturity date.

KEYW is a specialized provider of mission-critical cybersecurity, cyber superiority, and geospatial intelligence solutions to US government defense, intelligence, and national security agencies, and commercial enterprises. The company began operations in 2008 when KEYW acquired assets and 60 employees from Northrop Grumman. Those assets and employees had come to Grumman as part of its 2007 acquisition of Essex Corp. KEYW has made numerous acquisitions since then (more than fifteen to date).

Most of KEYW's revenue is derived from US government customers acting as both prime contractors and subcontractors. For fiscal year 2013 93% of revenue was from US government sources: 50% from the National Security Agency; 23% from the Department of Defense; and 20% from other government entities including law enforcement. The other 7% came from commercial enterprises. In 2013 the company launched Hexis Cyber Solutions, a wholly-owned subsidiary, to provide advanced cybersecurity solutions including its Hawkeye G product targeted toward the commercial sector.

Revenue for third quarter 2014 was up 7% year-over-year to $79 million and up $5 million sequentially. The government solutions segment increased 6% year-over-year to $75.9 million and gross margins were 32%. Revenue from the commercial cyber solutions segment was up 51% to $3.0 million. This segment is still in start-up mode and operating margins remain negative as the company continues to invest in product development, marketing, and the sales organization. Within the commercial segment the focus has been on healthcare, energy, high-tech, and finance and there was some interest from retail in the most recent quarter.

Because so much of its business is with governmental security agencies, most of the work requires high-level security clearances. At year-end 2013 80% of employees had US government security clearance, with 74% holding Top Secret or higher clearance. This provides a strong barrier to entry for new entrants. However, KEYW does compete against many larger companies including Lockheed Martin, Boeing, and Northrop Grumman in the defense industry and CACI and Intel Corp within the information technology industry.

KEYW issued the convertible bonds in July 2014. After paying down the prior credit facility, management entered into a new credit agreement, also in July 2014, for a five-year revolver. The line is secured for a maximum of $42.5 million and the rate is L+275. There is currently nothing drawn. It is important to note, that if the convertible bonds are still outstanding 180 days prior to the credit facility's due date, the facility will become due at that time. Hence the banks are guaranteed of being repaid six months ahead of the convertible bonds, if they are not refinanced before then.

The proceeds provided the company with a liquidity boost. In addition to $47 million of cash, the full $42.5 million is available on the revolver. Historically KEYW has made many acquisitions, though nothing significant since early 2013 when IDEAL was acquired for $91 million ($70 million cash plus $21 million common stock). Management has been focused on Hexis Cyber Solutions, its commercial subsidiary, which was launched in July 2013. But we would not be surprised to see acquisition activity resume in the not so distant future.

KEYW is a small company in a competitive industry. The company generates a small amount of free cash flow, which could become more significant if management is successful with growing the Hexis commercial business and turning segment EBITDA positive. The cybersecurity space is in vogue right now and spending is expected to grow driven by private company and government dependency on technology, particularly mobile, cloud computing, and web-centric technologies.

Credit Waterfall

KEYW (Dollars in Millions)	30-Sep-14	Total Debt (Cum. Bal.)	Adj. EBITDA Multiple	Net Debt (Cum. Bal.)	Adj. EBITDA Multiple
Current Share Price	$10.25				
Shares Out. (Millions)	37.5				
Latest Twelve Months:					
EBITDA (Adj.)	14				
Free Cash Flow	2				
Cash & Cash Equivalents	47				
Senior Secured Debt					
Revolver due 2019 (L+275)	0				
Senior Unsecured Debt					
1.00% Senior Cvt. Notes due 2018	150	150	10.7x	103	7.4
Total Debt	150	150	10.7x	103	7.4x
Equity Market Cap.	384				
Enterprise Value	487				34.8x

Sources: Bloomberg, Company Filings

The 2.5% convertible notes of 2019 are the only debt, but the company is highly levered with debt / EBITDA of 10.7 times and net debt / EBITDA of 7.4 times. KEYW is a speculative credit, but for those who like the cybersecurity story there is the potential for good growth if management is successful with the Hexis commercial business. The HOCS slash line reflects this reality: 67 Overall / 82 Growth / 35 Safety. The convertible bonds are now trading at 90.5 with a yield-to-maturity of 4.88% and a relatively low premium of 31%. The convertible bonds are a safer way to play the name and a price in the low 90's presents a good entry point for those looking for some security.

Financial Summary

KEYW	Fiscal Years Ending			Nine Months Ending		LTM
(Dollars in Millions)	31-Dec-11	31-Dec-12	31-Dec-13	30-Sep-13	30-Sep-14	30-Sep-14
Revenues	191	244	299	223	209	286
Y / Y Change		27.7%	22.5%		-6.3%	
Gross Profit	57	84	100	74	72	98
Operating Profit	2	3	(10)	(8)	(7)	(9)
EBITDA (Adj.)	17	29	21	15	7	14
Interest Expense	1	3	3	2	6	7
Income Tax Expense	0	0	(9)	(7)	(6)	(8)
Capital Expenditures	4	9	6	5	6	7
% Revenues	2.1%	3.7%	2.0%	2.2%	2.9%	2.4%
Free Cash Flow	7	5	9	4	7	2
% Total Debt	1.0%	0.7%	1.6%	NM	NM	0.4%
Gross Margin	29.8%	34.4%	33.4%	33.2%	34.4%	34.3%
Operating Margin	1.0%	1.2%	-3.3%	-3.6%	-3.3%	-3.1%
EBITDA (Adj.) Margin	8.9%	11.9%	7.0%	6.7%	3.3%	4.9%
EBITDA (Adj.) / Interest	NM	9.7x	7.0x	7.5x	1.2x	2.0x
EBITDA (Adj.) - Capex / Interest	NM	6.7x	5.0x	5.0x	0.2x	1.0x

Sources: Bloomberg, Company Filings

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FXCM - Déjà Vu All Over Again

Roman Terekhin, CFA

The surprise move by the Swiss National Bank (SNB) on Thursday sent shockwaves through pretty much all markets – from FX to equities. After three years of holding the cap on the CHF/EUR exchange rate at 1.20, SNB threw in the towel after having printed an insane amount of francs. In the process, Switzerland ended up with just too much of FX reserves (most countries wish they had such problem). If it is difficult enough to prop up one's own currency, doing that with someone else's is a gargantuan task. Following the cap's removal, the Swiss Franc appreciated by over 20% to the Euro, which is an unprecedented move for a developed-country currency. It could be very good or very bad depending on what side of the trade one were on.

Of the many FX market players, FXCM apparently took it hardest on the chin. FXCM is a major international FX broker whose retail clients used high (up to 1:50) leverage and traded hundreds of billions of dollars' worth of FX monthly using the firm's platform. Enough of those retail traders were wiped out by the CHF/EUR move to result in FXCM's equity moving into the negative territory. As a result, the company's capital position would not allow it to operate any further. Sometimes there is indeed only one step from the sublime to the ridiculous. Pre-market on Friday, the stock was decimated, declining initially by more than 90%. (Word-origin fans will note that being down 90% is actually the complement of being decimated, which literally means being down 10% and comes from Roman military activity, just in case you were curious).

Also on Friday, Jefferies' parent Leucadia National injected $300 million into FXCM via a two-year senior secured loan at a hefty 10% interest. This allowed the firm to continue "normal operations," whatever that means after such a near-death experience. In either case, that was a major step towards the sublime as the company's stock recovered to close at over $4.

Some of that drama played out in the convertible market as well. FXCM has 2.25% convertible notes due 2018 outstanding. Following the news, the bonds went on a rollercoaster. After closing in the mid 90's on Thursday the bonds fell to as low as 30 on Friday morning. Then, as Jefferies stepped up to the plate, the converts advanced to the mid 40's and ended the day in the high 60's. So the bonds went from pretty much a balanced instrument on Thursday straight to distressed levels. It seems unlikely that anybody was hedged enough to be have adequate downside protection in this situation.

News outlets compare the FXCM situation to that in which Knight Capital found itself a couple of years ago. Although the reason for Knight's demise was not an exogenous event (they forgot to install new software on one of the servers) the resulting effect on the firm's capital was equally dramatic. Back in 2012, Jefferies along with others stepped in to save the troubled trading firm and it turned out to be a very good trade for Jefferies.

Knight Capital had 3.5% converts outstanding at the time which at first declined precipitously but then recovered fully in price providing a great trading opportunity for an adventurous investor. Are there any true parallels here and can the FXCM converts go back into the 90's? We will leave this for the reader to decide. As we develop our research capabilities at Hillside, perhaps one day we will be able to analyze a distressed situation like this swiftly. For now, however, it would require us to undertake a bespoke research project. In the meantime, if we gain any additional insight about this situation we will gladly share it with our readers.

January 20, 2015

Russian Converts Update

Roman Terekhin, CFA

Two weeks ago, we wrote about Russian convertibles (see note titled "Come on, Rachel. Not again…" from January 5 ***Hybrid Vigor)***. Having checked the prices at the end of last week, we could not resist the temptation to pat ourselves on the back – all bonds moved in sync with our analysis' conclusions.

TMK 5.25% is up almost 5 points to 97.75 – not bad at all for such a short time span. There are still over 2 points on the table since the bond matures at par on February 11, 2015. As detailed in our previous note, we believe that the company will redeem the bonds with a very high probability. Still, this is far from being cash alternative and depending on one's entry point though, one may consider trimming the position.

Lukoil 2.625% is up about a point to 96.5-ish with yield to maturity in June of this year down 130 basis points to 11.7%. The mild recovery in the Brent oil prices over the last few days must have helped. Despite the stock being up over 4%, the bond remains very much busted with conversion premium close to 60%. Thus, we would continue to look at it as a pure credit instrument at least at this juncture. As we stated in our earlier analysis, we think that the company has a good chance of redeeming the bond, bar significant deterioration in Russia's political and economical situation over the next few months.

Yandex 1.125% due 2018 is down over 4 points from where we looked at them on January 5th. This is a significant move for a bond with no equity sensitivity – conversion premium is over 120% and parity is a meager 35 points. With the new price at around 78 (down from 82.5) the yield to maturity moved to closer to 8% from just over 6%. Still, we are not convinced that the bonds offer compelling value given the macro economic environment, political risks and the company's credit fundamentals. We must admit though that the instrument has become less unattractive.

Petropavlovsk 4% remained flat as the company tries to complete the refinancing by the newly extended maturity date of March 18, 2015. As we mentioned, we are not close enough to the situation to comment as to which way this will go. However, the fact that the maturity extension was obtained for only one month suggests that there is enough support for the proposed refinancing. In which case, the current stock price way above the 5 pence imputed in the proposed rights issue remains somewhat a mystery to us. Triumph of hope over experience?

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January 20, 2015

The On-Deck Circle
Mohawk Industries: They Have It Covered

Hillside Staff

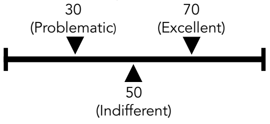
Theoretical Bond Pricing

MHK

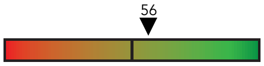
1%, 2020/01/19
Price (Bond): 100.0
Stock: $168.45
Premium: 25.0%
HOCS-Overall: 56*
HOCS-Growth: 57*
HOCS-Safety: 54*

Stock Price as of January 16, 2015
*Estimated HOCS Scores

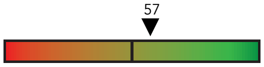
HOCS℠ (Theoretical) 1.5:



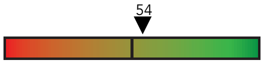
Overall



Growth



Safety



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

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

Mohawk Industries just finished the best quarter in its long history measured by adjusted earnings, reporting third quarter earnings per share of $2.44 excluding extraordinary items. Full year consensus estimates are $8.10 for 2014, rising to $9.35 in 2015, but that estimate could increase further once the company closes its pending IVC Group acquisition announced last week. Mohawk has come a long way from the depths of the Great Recession in 2008 when the company posted a dismal ($21.32)/share loss. The stock has responded in-kind, up over six-fold to $160/share since those dark days.

Mohawk built momentum through acquisitions, expanding beyond its traditional carpet operations to become a global, vertically integrated flooring manufacturer. Operations are divided into the carpet, the ceramic, and the laminate and wood businesses. The company follows a pattern of levering up its balance sheet to complete an acquisition, then integrating the acquisition and paying down debt to get ready to begin the next cycle. However, the company has stated that it intends to protect its investment grade rating through these cycles.

In 2013, the company completed seven acquisitions in three countries. Now that those acquisitions have been digested, last week Mohawk announced a $1.2 billion acquisition of the IVC Group, a Belgium flooring manufacturer. IVC Group manufactures sheet vinyl, luxury vinyl tile, and laminate. Annual sales are about $700 million and the company has operations in the United States and Europe. The acquisition should be accretive to earnings when the deal is closed in the first quarter of 2015.

MHK's financial performance has accelerated over the last two years. When released, 2014 revenue is expected to top $8 billion for the first time, up from $5.8 billion in 2012. Likewise, 2014 adjusted EBITDA is expected to top $1 billion for the second straight year, up from $677 million in 2012.

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With a $1.2 billion acquisition in the works and the need to refinance a $700 million bond with a 6.125% coupon coming due in January, 2016, Mohawk is an ideal candidate to tap the convertible securities market. The stock's momentum plus demand for the investment grade paper that Mohawk has to offer, leads us to believe that a convertible offering as high as $1.5 billion is not out of the question. For "On Deck" though, we are modeling a $1 billion issue.

The following Pro Forma numbers include an assumed $1 billion convertible offering to provide proceeds to fund the LTV acquisition and include company guidance regarding leverage and EBITDA post-acquisition.

Pro Forma Cash:	$105 million
Pro Forma Debt:	$3.4 billion
Last 12 month EBITDA:	$1.1 billion
Pro Forma EBITDA:	$1.3 billion
Last 12 month FCF:	$19 million
Pro Forma Leverage:	2.6x
Mkt Cap	$12 billion

Using a credit spread of 200 basis points and volatility of 23%, we estimate the following:

Issue Price	100.0
Issue Size	$1 billion
Maturity	5 years
Coupon	1.00%
Premium	25%
Non-Call:	3 years
YTM	1.00%

An initial HOCS score for the bond would be 56 overall/57 growth/54 safety. That is not a particularly impressive score for an initial issue. The MHK score is compromised by a lack of volatility as the stock has undertaken a slow steady climb and a higher than average debt load for new convert issuers considering Mohawk's latest acquisition.

But for "On Deck", we put our sell-side hats on, and for a market starved for investment grade convertible paper, a Mohawk issue looks extremely compelling. One only has to look back a few weeks when Brocade, a well-known name rated slightly below investment grade, drew strong demand for its convertible issue.

The savings to Mohawk over straight debt would be substantial. Mohawk five year straight debt would likely come to market at about 2.5% in light of the fact that Mohawk's current outstanding eight year senior notes currently trade in the 3.5% range. Issuing $1 billion of convertible securities at a 1% coupon (or lower) saves the company 1.5% in coupon payments, or $75 million over the life of a five year convertible bond. That is against potential dilution for current Mohawk shareholders if the stock closes over $200 in five years. However, Mohawk's stock is up 35% in three months and 150% over three years. While we expect continued success for Mohawk in the coming years, the coupon savings versus dilution trade-off make sense in the current environment.

When it comes to today's convertible issuance market, we think Mohawk has it covered. For more information regarding Mohawk Industries and a potential convertible issue, please contact John Anderson at 646-665-4025.

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