HILLSIDE ADVISORS LLC

September 21, 2015

Hybrid Vigor℠

The Hillside Convertible Advisory Letter

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We Understand, But….

Inside

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On the surface we can understand why the Fed didn't act on Thursday. All the standard evidence says deflation is a bigger worry than inflation. Even a small step is arguably a step in the wrong direction. China is slowing. We get it.

We've long believed that the Internet and its associated applications collectively represent one of the most deflationary forces in history. Driving home from a Georgetown finance conference on Friday, we heard Jim Cramer—whom we like and respect even with his antics—talking about this. With a mix of matter-of-factness and sadness he talked about how the main purpose of all the innovations going on at the convention he attended were designed to fire people.

This is, of course, a very slippery slope. Progress cannot be stopped. But there are times when you have to wonder if it contains some of the seeds of its own destruction. The income-inequality issue has become a political dividing line, but it really shouldn't be one. When too much income goes in too few bank accounts, the economy's wheels turn slower and slower. Even the people who dispute this probably end up worse off. But again, progress cannot be stopped.

At the Georgetown event, which examined market structure, a related point kept coming up. Are we putting too much emphasis on speed, at the cost of doing things right? The early trading period on Monday, August 24th was front and center.

Another question, one we have pondered and written about, relates to ETF's and passive investing more generally. What concessions have become necessary? Participants recognized that you can't trade ETF's properly if the underlying components are not active. Some wanted ETF users to ease up their demands for liquidity, particularly the industrial-strength users. Others would have none of it. The tail has clearly started to wag the dog.

All these forces mean rates should be low. Should they be this low? Is there a nagging sense that things would be better if they felt less artificial? Are they perhaps less artificial than they feel.

Lots of questions. We're just the humble convertible bond market

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HILLSIDE ADVISORS LLC

September 21, 2015

The Long Run

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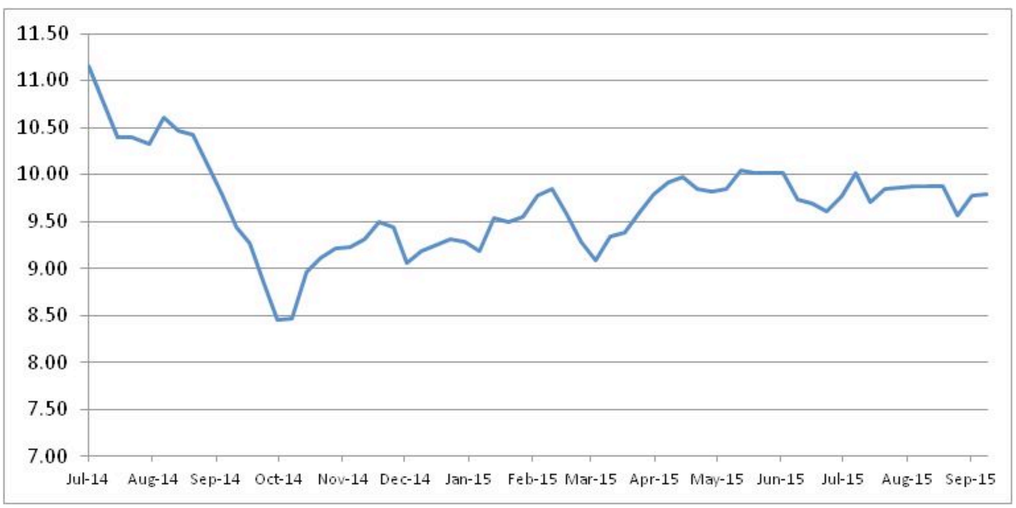
A quick refresher. HARP, or Hillside Adjusted Risk Points, is best thought of as a warning measure for bonds exposed to a blend of absolute price decline and premium decay. The higher the HARP, the more dangerous the bond. HARP tends to be highest for bonds in the 120-130 "death trap" range.

Keyboards were clacking and pens were scribbling all manner of FOMC tea-leaf reading this week, but the Ugly 20 took it all in stride. A non-event at the FOMC that was a huge event, and a non-event at the Ugly 20. Scanning though the top ten of the Ugly 20, not a single bond changed its position from the prior week. This speaks to the lack of net change during the week, even though the markets took the scenic route to get there. Aside from one particular permanently volatile name, the rest of the top ten couldn't even generate an average change above 0.10 HARP. The bottom half of the Ugly 20 was only slightly more active with a grand total of two names generating enough action to make it to publicity this week. Last week we hinted that the low volatility of the HARP average might be an idea for a financial product. If you must know, we've yet to receive a royalty check.



As the graph indicates, average HARP for the past week was ever so slightly up (0.02) to 9.79 HARP. And as suspected, the price drivers weren't so volatile either – the average stock was down 0.8% and average bond was down one point. Don't read too much into that delta, it's an average after all.

As is the tradition of the Ugly 20, we start things off with a damnation of the Dear Leader. Some have wondered if the Dear Leader's rise to the top is a result of being born a Beta as opposed to his brother the Alpha – the competitive spirit and all. Nevertheless, both the Illuminated ones (B's and As') are astride the Ugly 20 with a 1-3 punch, respectively. And not only do they each retain their podium positions, the B's (0.5% of 2021) put in a 0.74 HARP gain. While the underlying stock was up 1.2%, the B bonds ratcheted up a 1½ point gain. To put it in slightly more ominous terms, given the increase in the stock, the B bond would only have had to risen by a ¼ point to maintain the same risk HARP-wise as the week prior. That's rather remarkable for a bond with a 50 delta.

On the other hand, the A bonds behaved a lot more sensibly with only a ¼ point gain, and hence nearly nothing to report on the HARP side of things.

Air Lease 3.875% of 2018 was the second of the three outliers this week – outliers in terms of having at least some detectable HARP. Contrastingly to the Illumina B bonds, Air Lease drove the opposite direction with a 1.73% gain in the stock and a ¾ point pop in the bond leading to a HARP decline. The newly 129 priced bond dropped 0.68 HARP to end at 9.38, enough to drop one rank to 12th. Why did two bonds have price gains, yet one gains in HARP while the other loses? It's all in the positioning. While Illumina B's are less than six bond points away from Air Lease, the issue is that the Illumina B's are on the increasing side of gamma, while Air Lease is on the decreasing side of peak gamma. Or to put it in less Greek-speak, Illumina B's are entering the multi-dimensional risk zone of the price curve, while Air Lease is leaving the zone. All else being equal, leaving the zone is certain to give you better sleeps.

The third noise maker this week was the Idaho chip maker – not of the potato variety, but rather the silicon variety. Micron Technology 3.125% of 2032 popped up from 26th to 18th on the Ugly 20 with a bit of loss on both the stock and bond fronts. The stock's drop of 7.74% translated into an 11¼ point loss in the bond. It's been a rough year for MU investors, the stock and bond both down nearly 50% this year alone. For a high delta high dollar price bond like the MU 3.135% of 2032, those stock drops hit especially hard. And to add insult to injury, despite laying claim to a 171½ bond price, the bond has now gotten enough risk on it to enter onto the Ugly 20 with an 8.21 HARP - a full 1 HARP increase. It's all premium expansion at this price level, a near 25% increase since the week prior to not put too fine a point on it. David Einhorn didn't specify when the MU undervaluation was supposed to end, though many MU investors are hoping that David's 'long run' isn't Keynesian.

Hillside Ugly 20 List (Prices as of September 18, 2015)

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	Illumina Tranche B 0.5% 2021-06-15	123.25	208.88	49.90	41.03	14.96
2	Lam Research Tranche B 1.25% 2018-05-15	132.00	71.22	14.90	17.12	12.17
3	Illumina Tranche A 0% 2019-06-15	117.25	208.88	42.70	35.08	12.00
4	Priceline.com 0.35% 2020-06-15	121.25	1294.47	23.10	22.75	11.63
5	RPM International 2.25% 2020-12-15	113.50	44.45	35.10	29.49	11.53
6	Red Hat 0.25% 2019-10-01	118.75	71.06	22.70	21.97	10.97
7	Emergent BioSolutions 2.875% 2021-01-15	121.50	32.17	22.20	22.07	10.33
8	Salesforce.com 0.25% 2018-04-01	124.75	71.40	16.10	17.30	9.90
9	SanDisk 1.5% 2017-08-15	123.00	52.69	18.80	19.46	9.61
10	Euronet Worldwide 1.5% 2044-10-01	117.75	68.76	23.60	22.48	9.20
11	NVIDIA 1% 2018-12-01	126.75	23.29	9.80	11.31	9.14
12	Air Lease 3.875% 2018-12-01	129.00	32.27	20.10	21.59	8.70
13	Brookdale Senior Living 2.75% 2018-06-15	114.50	27.16	23.70	21.94	8.53
14	Jazz Pharmaceuticals 1.875% 2021-08-15	112.00	160.01	39.80	31.89	8.53
15	Workday Tranche 2 1.5% 2020-07-15	115.50	73.49	28.50	25.62	8.29
16	ServiceNow 0% 2018-11-01	117.50	74.36	16.70	16.81	8.29
17	Trinity Industries 3.875% 2036-06-01	127.50	26.50	20.30	21.51	8.23
18	Micron Tranch 3.125% 2032-05-01	171.50	15.50	10.40	16.16	8.21
19	Rambus 1.125% 2018-08-15	116.25	11.64	20.70	19.94	7.88
20	BioMarin Pharma 0.75% 2018-10-15	151.00	130.65	8.90	12.34	7.80

HILLSIDE ADVISORS LLC

September 21, 2015

HOCS$_{SM}$ 20: Changing of the Guard

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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.

We've quietly seen a new group of names find their way into the HOCS 20 in recent weeks, thanks to some market action and new issuance. We've also seen some reshuffling of the standbys—some names that have frequently led the pack have slipped, with others gaining ground.

First things first. Despite Friday's nasty—and frankly unsurprising—selloff in response to Fed inaction, the HOCS indices put in successful weeks. The broad HOCS 100 returned 31 basis points on the week even with a 42 basis-point Friday giveback. This was marginally better than the antagonist, the CWB, which returned 17 basis points. We note that the IWM, the Russell 2000 ETF that's often associated with convertible performance, made 47 basis points on the week, while the SPY was slightly in the red at 13 basis points and the DIA slightly more at 31. If anything, one might have expected even more of a bias toward better small-cap performance given the Fed's concerns about the international economy.

In a week that saw resurgent biotech performance, especially in small caps, it should be no surprise that the HOCS 20 got its superior weekly performance (100 basis points China-free and 94 original recipe) in large part from a biotech member. The wheeling and dealing Horizon Pharmaceuticals' well-received presentation at a conference jacked the stock nearly 10% on Thursday and took the equity-sensitive 2.50% along for almost 70% of the ride. Without Horizon, the HOCS 20 would have been up about 50 basis points (original recipe) and 60 (China-free). Still pretty good.

Now, back to the composition. We actually overlooked it last week—even the great ones slip up now and then—but Ctrip 1.99% took over the top spot from long-time multiple leader Qihoo 360 in the original HOCS 20. The stock's resurgence brought the profile to an even more balanced look –the premium in the low 40's contributes to a growth score that none of the Qihoo bonds can match. Contrarian investors looking for more long directional exposure to China are taking note.

Joining the fray of late were new issues Broadsoft 1% and Dycom 0.75%. Dycom's gains last week helped the HOCS 20 beat up on its 100-name cousin but also pushed the bond off the original-recipe list for this week. (It's still in the China-free group, but barely). HOCS is nothing if not mean-reverting. Dycom's absolute gain cost it about 4 ½ HOCS points—the bond is still very attractive, though, with an overall score of 66.3. Broadsoft was essentially unchanged in HOCS land, dropping just from 72.4 to 72.2 overall. It remains at number 6 China-free and moves up a notch from tenth to ninth overall. Interestingly, its big brother just makes the China-free cut this week. Unsurprisingly, the short-dated 1.50% outranks the new bond for safety but trails substantially for growth. (Not to mention liquidity).

Deserving mention here is last week's inclusion of Mercadolibre's 2.25%. Given increasing emerging-market worries, it was just a matter of time before this bond reached an acceptable price point to make the HOCS 20. It just made the China-free list last week, coming in at 19th. But after Friday's stock pounding (Latin America took the Fed's warnings harshly), the Argentine online business site has gotten interesting indeed. It's now 15th on the original HOCS list and ninth China-free. You won't find a much better balance—the overall HOCS comes in at 70.7 safety, with 69.7 growth and 72.6 overall.

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September 21, 2015

Hillside HOCS 20 List

	Description	Convert	Stock	HOCS Overall	HOCS Growth	HOCS Safety	Yield	Premium
1	CTRIP.COM INTER LTD. 1.99% 2025-07-01	91.50	68.34	78.8	90.7	55.0	3.96%	43.1%
2	QIHOO 0.50% 2020-08-15	86.00	45.59	77.7	71.9	89.3	8.66%	136.4%
3	ENVESTNET 1.75% 2019-12-15	89.75	32.20	77.1	76.7	77.9	4.43%	75.3%
4	QIHOO 2.50% 2018-09-15	95.25	45.59	75.5	68.3	90.1	7.62%	131.8%
5	IGI 3.50% 2019-12-15	98.50	8.63	74.6	82.1	59.7	3.89%	28.9%
6	WEB.COM 1.00% 2018-08-15	95.50	22.09	74.2	78.5	65.7	2.62%	51.3%
7	ISIS PHARMACEUTICALS INC 1.00% 2021-11-15	106.50	54.56	74.1	78.8	64.8	-0.06%	30.4%
8	FIREEYE 1.63% 2035-06-01	96.00	37.81	73.3	82.9	54.0	2.27%	54.3%
9	BROADSOFT 1.00% 2022-09-01	98.25	30.19	72.2	80.4	55.7	1.26%	26.0%
10	CTRIP.COM INTER LTD. 1.00% 2020-07-01	93.00	68.34	72.2	81.0	54.4	3.68%	48.0%
11	QIHOO 1.75% 2021-08-15	81.75	45.59	72.0	74.7	66.7	7.20%	116.6%
12	RESTORATION 0.00% 2020-07-15	101.50	100.11	72.0	68.9	78.1	-0.31%	19.8%
13	HERBALIFE 2.00% 2019-08-15	90.00	56.79	70.7	71.6	69.0	4.85%	36.7%
14	E-HOUSE 2.75% 2018-12-15	92.75	5.66	70.7	61.4	89.4	9.10%	140.4%
15	MERCADOLIBRE 2.25% 2019-07-01	102.75	99.64	70.7	69.7	72.6	1.50%	30.0%
16	TESLA 1.25% 2021-03-01	97.00	260.62	70.6	78.1	55.7	1.83%	33.9%
17	ANI 3.00% 2019-12-01	106.50	53.07	70.5	81.0	49.5	1.40%	39.4%
18	LINKEDIN 0.50% 2019-11-01	101.00	202.98	70.3	64.3	82.2	0.26%	46.6%
19	CALAMP 1.63% 2020-05-15	93.00	17.09	70.2	74.9	60.9	3.26%	50.2%
20	FIREEYE 1.00% 2035-06-01	97.00	37.81	69.3	76.0	56.0	1.67%	55.9%

Sources: Bloomberg, Kynex

Hillside HOCS 20 List ex China

	Description	Convert	Stock	HOCS Overall	HOCS Growth	HOCS Safety	Yield	Premium
1	ENVESTNET 1.75% 2019-12-15	89.75	32.20	77.1	76.7	77.9	4.43%	75.3%
2	IGI 3.50% 2019-12-15	98.50	8.63	74.6	82.1	59.7	3.89%	28.9%
3	WEB.COM 1.00% 2018-08-15	95.50	22.09	74.2	78.5	65.7	2.62%	51.3%
4	ISIS PHARMACEUTICALS INC 1.00% 2021-11-15	106.50	54.56	74.1	78.8	64.8	-0.06%	30.4%
5	FIREEYE 1.63% 2035-06-01	96.00	37.81	73.3	82.9	54.0	2.27%	54.3%
6	BROADSOFT 1.00% 2022-09-01	98.25	30.19	72.2	80.4	55.7	1.26%	26.0%
7	RESTORATION 0.00% 2020-07-15	101.50	100.11	72.0	68.9	78.1	-0.31%	19.8%
8	HERBALIFE 2.00% 2019-08-15	90.00	56.79	70.7	71.6	69.0	4.85%	36.7%
9	MERCADOLIBRE 2.25% 2019-07-01	102.75	99.64	70.7	69.7	72.6	1.50%	30.0%
10	TESLA 1.25% 2021-03-01	97.00	260.62	70.6	78.1	55.7	1.83%	33.9%
11	ANI 3.00% 2019-12-01	106.50	53.07	70.5	81.0	49.5	1.40%	39.4%
12	LINKEDIN 0.50% 2019-11-01	101.00	202.98	70.3	64.3	82.2	0.26%	46.6%
13	CALAMP 1.63% 2020-05-15	93.00	17.09	70.2	74.9	60.9	3.26%	50.2%
14	FIREEYE 1.00% 2035-06-01	97.00	37.81	69.3	76.0	56.0	1.67%	55.9%
15	HORIZON PHARMA INV LTD 2.50% 2022-03-15	131.50	31.92	68.7	87.6	31.0	-2.02%	18.0%
16	INVENSENSE 1.75% 2018-11-01	91.75	9.68	68.6	62.3	81.3	4.63%	107.5%
17	ECHO 2.50% 2020-05-01	94.00	22.49	67.5	71.5	59.7	3.94%	63.6%
18	TESLA 0.25% 2019-03-01	98.50	260.62	67.0	70.9	59.1	0.69%	36.0%
19	DYCOM INDUSTRIES INC 0.75% 2021-09-15	103.75	77.69	66.3	76.5	45.8	0.12%	29.4%
20	BROADSOFT 1.50% 2018-07-01	102.25	30.19	65.2	60.5	74.7	0.68%	42.2%

Sources: Bloomberg, Kynex

HILLSIDE ADVISORS LLC

September 21, 2015

Euro Gang of 20

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Roman Terekhin is away on client assignment this week. Our European HARP analysis will return in full force next week.

	Convertible	Price	Stock	Premium (%)	Premium (pts)	HARP
1	Fresenius Medical Care A 1.125% 2020	120.87	70.28	26.64	25.43	13.62
2	Cap Gemini Sogeti 0% 2019	90.56	79.99	13.21	10.57	12.65
3	Suez Environnement 0% 2020	21.45	16.29	31.74	5.17	11.79
4	Buzzi Unicem SPA 1.375% 2019	123.24	15.57	26.53	25.84	11.21
5	Nexity SA 0.625% 2020	49.64	38.86	21.31	8.72	11.04
6	Adidas AG 0.25% 2019	113.96	70.23	33.07	28.32	10.98
7	Deutsche Post AG 0.6% 2019	124.01	23.80	7.52	8.67	10.96
8	Rag-Stiftung 0% 2021	111.52	30.21	35.96	29.50	10.33
9	Fresenius Se & Co KGAA 0% 2019	137.68	63.92	6.98	8.98	10.19
10	SAF-Holland Group 1% 2020	120.44	12.75	16.43	16.99	10.17
11	OCI NV 3.875% 2018	118.03	25.47	31.96	28.58	9.48
12	NH Hotel Group SA 4% 2018	121.46	4.96	20.45	20.62	9.34
13	ACS Actividades Finance 2.625% 2018	116.61	5.92	10.82	11.38	8.67
14	Acciona S.A. 3% 2019	122.20	66.87	11.85	12.95	8.33
15	ACS Actividades Fin 2 1.625% 2019	109.69	5.92	17.56	16.38	8.07
16	Rag-Stiftung 0% 2018	107.89	30.21	34.77	27.83	7.35
17	Prysmian SPA 1.25% 2018	109.06	19.15	27.08	23.24	6.62
18	Societa Iniz Autostradal 2.625% 2017	107.56	9.28	21.70	19.18	5.79
19	Parpublica 5.25% 2017	106.97	9.14	76.68	46.43	5.61
20	Nexans SA 2.5% 2019	76.76	32.65	109.02	40.04	4.51

HILLSIDE ADVISORS LLC

September 21, 2015

Web.com (WWWW): Who's Your Daddy?

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Introduction

We are always hearing how essential scale and scope are when it comes to a company's ability to compete in any given industry. We won't be reviewing Michael Porter's (Harvard) competitive analysis or "five forces' analytical framework in today's class. That probably comes as a relief to our readers. However, few would deny that scale and scope are essential if a company hopes to create superior value for its customers and superior profits for itself, and in turn, build a competitive advantage over its rivals.

Web.com provides a full range of Internet services to small businesses to help them compete and succeed online. Today, the company ranks as one of the "web services" industry's leading players, having built an enterprise noted for its scale and scope as well as the ability to deliver results based on operational efficiency. However, the web services space is both highly competitive and evolving.

GoDaddy leads the pack when it comes to installed base and brand recognition. It's the Wal-Mart of the space, if you will. And, if that weren't troubling enough, there are few if any meaningful barriers to entry. Hence, there's little to prevent any company, existing or startup, from offering a new or improved service o product capable of harming the industry's leaders.

That's not to suggest that Web.com is struggling or facing imminent pressure. To the contrary. The company continues to grow its top line at a reasonable pace. The company's margins remain extremely strong. Moreover, free cash flow generation is solid, especially relative to outstanding indebtedness. Still, several recent challenges need to be quickly addressed if the company's convertible bond as well as stock are to perform as we expect.

Investment Recommendation

Web.com appears to be in good shape from a fundamental standpoint, at least for the foreseeable future. Longer term, competitive threats and challenges may heat up. However, near-term results should continue to benefit from the company's strong market position, favorable demand/pricing expectations, sanguine revenue expectations, and likely robust margins. In turn, investors should expect EBITDA and cash flow generation to chug along nicely for the foreseeable future. And there's more. The HOCS slash line for the company's 1.00% Convertible Senior Notes due 2018 measures an impressive 74 Overall / 78 Growth / 66 Safety (based on bond and stock prices of 95.50 and $22.09, respectively). While the company's market capitalization is on the low side ($1.13 billion) and debt leverage is aggressive, the bond's relatively short maturity (within three years to final), below par dollar price, and 2.63% yield-to-maturity boost its attractiveness. Worth a look.

Business Description

Web.com meets the needs of small businesses anywhere along their lifecycle with affordable, subscription-based solutions including domains, hosting, website design and management, search engine optimization, online marketing campaigns, local sales leads, social media, mobile products, and e-commerce solutions. The company currently serves approximately 3.3 million customers, overwhelmingly in North America. Ideally, customers aim to one-stop shopping for an array of effective, affordable online products and services that will help drive their businesses. The company positions itself as a partner to these small

businesses across all phases of their adoption of Internet marketing, from their initial entry onto the web to more advanced online marketing solutions. As a global domain registrar, it enables client businesses to establish an online presence by buying a domain name.
The company's basic services are the entry point to greater value-added offerings. They span the range of customer budgets and expertise, from inexpensive "Do-It-Yourself" websites and e-mail hosting for the technically-savvy to "Do-It-For-Me" custom website design services, online marketing, social media and ecommerce solutions for those needing full service. The company is the technology enabler between small businesses and Internet innovators such as Google and Facebook, allowing the small business customer to take advantage of today's online and social media outreach.

In combining proprietary software, automated workflow processes, and specialized workforce development and management techniques, the company achieves production efficiencies that enable it to offer sophisticated web services at affordable, monthly subscription rates.

CREDIT WATERFALL

Web.com Group, Inc. (Dollars in Millions)	30-Jun-15	Total Debt (Cum. Bal.)	Adj. EBITDA Multiple	Net Debt (Cum. Bal.)	Adj. EBITDA Multiple
Current Share Price	$22.40				
Shares Out. (Millions)	51.2				
Latest Twelve Months:					
EBITDA (Adj.)	153.6				
Free Cash Flow (1)	125.0				
Cash & Cash Equivalents	15.9				
Senior Secured Debt					
Rev. Credit Fac. (Commit: $150mm / Mat: 15-Sep-19)	47.6				
Term Loan (Mat: 15-Sep-19)	194.8				
Other Secured Debt	0.0				
Total Secured Debt	242.3	242	1.6x	226	1.5x
Senior Unsecured Debt					
1.00% Senior Cvt. Notes due 2018 (2)	258.8				
Total Unsecured Debt	258.8	501	3.3x	485	3.2x
Total Debt (2)	501.1	501	3.3x	485	3.2x
Equity Market Cap.	1,147.1	---	---	---	---
Enterprise Value	1,632.3	---	---	---	10.6x

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

Recent Results

Q2 2015 results "beat" consensus revenues and earnings expectations despite some year-over-year slippage. Revenues totaled $135.7 million in the quarter, down slightly from the $138.2 million generated in the year-ago quarter. Similarly, adjusted EBITDA slipped somewhat as well, totaling $38.4 million in the most recent quarter, as compared to $41.8 million in the year-ago quarter. Despite the

year-over-year declines, it now appears that Web.com has begun to turn the corner. Specifically, the company added 21,000 net new subscribers in the quarter, modestly ahead of the 10,000-15,000 target. In addition, ARPU improved to $13.91, an approximately $0.08 gain as a result of growth on the premium domain sales front.
While debt leverage stands at greater than 3.0 times adjusted EBITDA, the company's indebtedness appears manageable. Furthermore, cash and equivalents rarely grow beyond modest levels. However, that' not a knock. It suggests prudent cash management.

Web.com has averaged better than $100 million in free cash flow generation in each of the past three years Expect no less for the foreseeable future. Importantly, the company has been actively reducing debt (to include buying back its sole convertible bond), repurchasing stock, and tackling the occasional acquisition the past few years. Moreover, the company paid down an additional $30 million in debt and bought back $14 million in stock in the most recent quarter. By our reckoning, Web.com has $59 million remaining unde its current stock buyback authorization. We're not going out on a limb in suggesting that further buybacks are likely.

Recent Data Breach

In August, the company announced that a cybersecurity breach had compromised more than 90,000 customer accounts. The breach was quickly contained. However, it will take some time before the revenue and operating expense impact can be determined. Once the news broke, the company's stock traded dow several points. Nothing earth shattering. And since then, it has been creeping back. The good news is the damage appears minimal. Moreover, the company quickly did what it needed to do, to include bringing in an independent firm to conduct necessary forensics and strengthen any system weaknesses. It could have been worse. Fortunately it wasn't.

Market Opportunity – Large & Growing

According to the U.S. Census Bureau, there are more than 28 million small businesses in the United States with fewer than 500 employees. Web.com is focused on helping small businesses succeed online. Small business owners, including sole proprietors, have limited support staff and must devote most of their time to running the daily operations of their businesses. In addition, they often have limited knowledge of how t build a web presence and limited time to acquire the skills to do so. At the same time, there is growing acceptance among these small business owners that an effective Internet presence is critical to their marketing efforts and there is evidence that these businesses are shifting their marketing budgets from traditional media to online channels. This is where Web.com comes in.

Competitive Landscape

As we have begun to describe, the web services market is competitive. Moreover, barriers to entry appear to be few. While most competitors offer a limited number of specialized solutions and services, many provide a more comprehensive set of services in the future. GoDaddy, Wix.co, Web.com and Endurance International rank among the largest of the large in this highly competitive space. However, other competitors include website designers, domain name registrars, Internet service providers, Internet search engine providers, local business directory providers, ecommerce service providers, lead generation companies and hosting companies. The list of actual or potential competitors is long and the threats many. While we like where Web.com currently stands, we will be keeping close tabs on this very real threat.

HILLSIDE ADVISORS LLC

September 21, 2015

ANI Pharmaceuticals (ANIP) – Deja Vu

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ANI Pharmaceuticals (ANIP) seems to be on a recurring loop between the first and second quarter results. The company rejoined the HOCS 20 over the last few weeks as the stock and convertible bond prices fell following the second quarter 2015 earnings announcement on August 4 (similar results following first quarter - check). While bottom line results exceeded expectations the top line fell short (check). The real concern, though, appears to be that full year guidance was reduced (check, almost - in the first quarter it was reaffirmed). The stock has fallen 28% since July 30 when it hit a 52-week high. The bonds have fallen 15% since then, for about 54% participation. The HOCS slash line is now 70 Overall / 81 Growth / 49 Safety with the convertible bond at 106.5 versus $53.07 for the stock. While the stock and convert are both a few points higher than when we originally wrote on the name in early June, this is a good entry point for those who didn't get in previously.

ANIP, this morning, announced it was acquiring the NDAs for purified corticotropin gel and corticotropin-zinc hydroxide from Merck for $75 million in cash and a percent of future sales. The company estimates the US annual sales for these products to be approximately $1 billion based upon products already on the market today. These products are approved for numerous uses including multiple sclerosis, rheumatic disorders, dermatologic diseases, as well as allergic and edematous states. ANIP is planning to form a foreign subsidiary to handle acquisitions as well as future manufacturing and/or other ancillary services. The Merck transaction is expected to be handled through this new subsidiary. The company expects to achieve a lower overall tax rate as a result. Management is hosting a conference call today to discuss the transaction further, but on the surface it appears to be in line with the company's strategy of doing smaller acquisitions and keeping R&D spending on the light side.

Second Quarter 2015 Results

ANIP reported second quarter 2015 results in early August with adjusted EPS of $0.55 exceeding the consensus estimate by $0.01. However, revenue came in at $19.5 million, short of the $20.3 million consensus estimate. Adjusted EBITDA was $10.9 million for the quarter up from $0.3 million from the prior year quarter.

Revenue was $19.5 million for the quarter compared to $6.6 million in the prior year quarter for a 194% increase. Generic pharmaceutical sales increased 185% for the quarter to $13.8 million driven by increased sales of EEMT, and recently launched products Methazolamide (4Q14), Etodolac (1Q15), and Propafenone (1Q15). Revenue from branded products increased 275% to $2.1 million as a result of sales of Lithobid and Vancocin, both acquired in the third quarter. Contract manufacturing revenue fell about 5% to $1.1 million. Contract services revenue increased to $2.5 million from $0.1 million as a result of royalties received on the sales of the authorized generic of Vancocin. ANIP received a non-recurring $1.4 million royalty payment during the quarter. In the fourth quarter the company expects to launch its own authorized generic for Vancocin under its own label, replacing the authorized generic on the market.

Table 1: Revenue Summary

Net Sales (in millions)	Q2 2015	Q2 2014	% Chg	FY 2014	FY 2013	% Chg
Generic Products	$13.8	$4.8	184.6%	$35.9	$19.3	85.9%
Branded Products	2.1	0.6	275.4%	11.0	3.4	226.7%
Contract Manufacturing	1.1	1.2	-5.3%	5.9	6.0	-1.4%
Contract Services and Other	2.5	0.1	2705.6%	3.2	1.4	124.8%
Total Net Sales	$19.5	$6.6	193.6%	$56.0	$30.1	86.1%

Sources: Company Filings

EEMT, a treatment for certain menopause symptoms, continues to be the company's top selling drug. In 2013 methyltestosterone, an active ingredient in EEMT, was classified as a Class III restricted drug by the DEA. The classification required new protocols for reporting sales and movement of the drug, which has led to difficulties in obtaining it. Companies appear to be exiting the EEMT market as existing supplies of methyltestosterone are exhausted. This has benefitted ANIP who has a supply source and has been able to pick up contracts as others have exited the market. Sales of EEMT increased from $8.9 million in the first quarter to $9.8 million in the second. ANIP was awarded a new contract in the second quarter, which contributed to the increase and had another new contract take effect early in the third quarter, which will increase sales further. Management has not provided specific revenue guidance for EEMT, but it has stated that market share was about 50% at the start of the year and is expected to be about 80% by the end of this year. While this is great and will help drive additional revenue gains, it is also a concern when one product accounts for 50% plus of total revenue.

Some of the risk is mitigated by the company's large pipeline – 67 products with a total annual market size of about $4 billion. Management anticipates launching eleven additional products by the end of 2016. Two of these have already been approved and ANIP expects to launch both by December. Seven do not require formal FDA approval, as they were all previously released drugs that ANIP acquired. The other two require ANDAs (abbreviated new drug application), but management feels confident in receiving approval and having both on market by year-end 2016. Details are included in table below.

Table 2: Anticipated Product Launches thru Year-end 2016

Product	**Total Annual Market Size (a)**	**Estimated Launch**	**FDA Approvals Required**
Oxydodone HCI oral solution	$30M	Q4 2015	Approved
Nimodipine capsules (Sofgen partner)	$25M	Q4 2015	Approved
Flecainide tablets	$67M	Q1 2016	CBE-30
Dexcel product	$53M	Q1 2016	ANDA
Anti-cancer drug, (TAD 2/26/2016) (b)	Undisclosed	Q1 2016	ANDA
Five ANDAs acquired in July (TEVA)	$253M	Q1 2016	CBE-30
Testosterone 1% gel	$300M	Q1 2016	PAS

(a) Per IMS Health
(b) FDA's Target Action Date

Sources: Company Filings

Management also updated full year 2015 guidance. Revenue should be in a range of $82 to $84 million versus prior guidance of $80 to $88 million. Adjusted non-GAAP EBITDA should be $48 to $50 million versus earlier guidance of $48.8 to $53.1 million. And adjusted non-GAAP EPS should be $2.44 to $2.50 compared to prior guidance of $2.44 to $2.67. With the midpoint of guidance for all three lowered, the stock retreated on the slower than expected growth.

Liquidity

ANIP continues to manage its cash well. Total cash increased slightly from the first quarter to $167 million at June 30, leaving the company in a net cash position with the $143.8 million of convertible bonds the only debt. Free cash flow remains modestly positive with $1 million generated for the quarter and $16 million over the last twelve months. We continue to like the company's R&D "lite" business model and the limited national sales force, which both contribute to high margins and positive free cash flow.

The company continues to use cash for smallish acquisitions. In July a portfolio of 22 previously marketed generic drugs was acquired from Teva for $25 million in cash. Management plans to launch five of the 22 drugs by the end of 2016 (included in table 2 above). Management reiterated on the conference call that small acquisitions would continue to be the focus. A large transformative transaction has not been ruled out, but doesn't appear likely since those deals are quite expensive currently and management is having success finding smaller acquisitions to expand the portfolio. As we mentioned in our prior note, we much prefer the smaller transactions as they come with much lower risk. The Merck transaction announced today was larger than those announced previously, but still on the smaller side and looks to be manageable for a company this size.

The 3.0% Convert

The 3.0% senior convertible notes due 2019 receive a HOCS slash line of 70 Overall / 81 Growth / 49 Safety. The safety score is on the low side due to the small market cap and the modest free cash flow, but overall this is an excellent score. We understand that the equity market has been disappointed with the rate of growth, but growth is still quite good and with the convert you get to pick up a coupon while you wait. With the converts having retreated from a high of 125.5 at the end of July, investors who missed the boat following the first quarter results have another good entry point. What's more, the convertibles appear to lend themselves to a trading range that investors can use while leaning on the convertible's intrinsically favorable risk/reward profile

Company Overview

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

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

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

In July 2014 it acquired Lithobid (bipolar disorder treatment) for $12 million. In August Vancocin (diarrhea treatment) came on board for $11 million. Earlier this year, the approved ANDA (abbreviated new drug application) for Flecainide tablets and the approved NDA (new drug application) for Testosterone Gel were acquired, both from Teva. In July 22 previously marketed generic drug products were acquired from Teva for $25 million plus a percent of future profits.

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

The company's strategy of focusing on mature drugs allows it to operate with a small national sales force and limits research and development spending. As a result margins are quite high. For the last twelve months ending June 30, the gross margin was 83.5% and for the most recent quarter it was 83.9%. Operating margins were 48.2% and 43.1% respectively.

Table 3: Credit Waterfall

ANI Pharmaceuticals (ANIP) (Dollars in Millions)	**31-Mar-15**	**Total Debt (Cum. Bal.)**	**Adj. EBITDA Multiple**	**Net Debt (Cum. Bal.)**	**Adj. EBITDA Multiple**
Current Share Price	$53.07				
Shares Out. (Millions)	11.5				
Latest Twelve Months:					
EBITDA (Adj.)	45				
Free Cash Flow	16				
Cash & Cash Equivalents	167				
Senior Unsecured Debt					
3.00% Senior Cvt. Notes due 2019 (1)	144	144	3.2x	-23	NA
Total Debt	144	144	3.2x	-23	NA
Equity Market Cap.	608	---	---	---	---
Enterprise Value	585	---	---	---	13.0x

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

Sources: Bloomberg, Company Filings

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September 21, 2015

Table 4: Financial Summary

ANI Pharmaceuticals (ANIP)	**Fiscal Years Ended**			**LTM**		**Quarter Ended**	
(Dollars in Millions)	**31-Dec-12**	**31-Dec-13**	**31-Dec-14**	**30-Jun-14**	**30-Jun-15**	**30-Jun-14**	**30-Jun-15**
Revenues	20	30	56	36	77	7	20
Y / Y Change	----	47.7%	86.1%	----	113.7%	----	193.6%
Gross Profit	11	20	44	26	64	5	16
Operating Profit	-0	1	20	5	37	-3	8
EBITDA (Adj.)	1	8	27	12	45	0	11
Interest Expense	1	0	1	0	6	0	2
Income Tax Expense	0	0	9	0	-5	-0	4
Capital Expenditures	0	0	1	2	1	0	0
% Revenues	1.4%	0.6%	2.0%	6.5%	1.4%	3.8%	1.0%
Free Cash Flow	-0	-6	21	-4	16	2	1
Total Debt (1)	4	0	111	0	114	0	114
% Total Debt			18.9%		14.2%		0.9%
Gross Margin	55.0%	66.8%	79.5%	72.0%	83.5%	68.2%	83.9%
Operating Margin		3.0%	35.7%	14.8%	48.2%	-37.0%	43.1%
EBITDA (Adj.) Margin	2.6%	6.7%	42.7%	21.0%	54.9%	-26.4%	50.4%
EBITDA (Adj.) / Interest	0.4x	4.3x	30.3x		6.7x		3.6x
EBITDA (Adj.) - Capex / Interest	0.6x	4.7x	31.8x		6.5x		3.5x

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

Sources: Bloomberg, Company Filings

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