

Following strong performance of convertible bonds over the last several years, savvy investors are beginning to take notice of the attractive characteristics of this unique asset class. The hybrid construction of convertibles can offer a compelling way to participate in risk on markets while offering some downside support during market pullbacks. Pier 88's Investment Team posits that convertibles are a defensive way to gain exposure to growth stocks with less volatility. We believe the case study of pet medication and wellness company PetIQ, Inc. ("PETQ") is demonstrative.

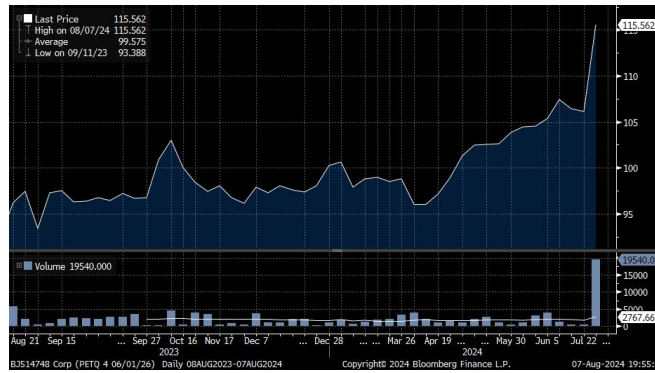
PETQ operates as a pet medication, health and wellness company headquartered in Eagle, Idaho. The company's mission is to deliver a smarter way for pet parents to help their pets live their best lives through convenient access to affordable veterinary products and service. Pier 88 was attracted to the company for its innovative approach to capturing the secular wave of families investing in the wellness of their pets. The broad product offering and multi-tiered distribution model proved quite effective and the company experienced strong growth. From 2017-2023, the company delivered a net annual sales CAGR of approximately 27% with adjusted EBITDA CAGR of approximately 29%.

Innovative companies like PETQ tend to be attracted to the convertible bond market as it allows them to raise capital at lower interest rates in a manner that is less dilutive than straight equity. Investors are attracted to convertibles from companies like PETQ as the risk of default is generally low (especially for technology and healthcare companies) and provides the investor with a call option on the company's future growth. Further, there is a potential benefit of M&A optionality.

Through Pier 88's investment process focusing on disruptive innovators, we identified PETQ as a company that we believed would likely be deemed strategic to a larger industry player or private equity. And it was. On August 7th, 2024, it was announced that consumer-focused private investment firm Bansk Group entered into a definitive agreement to acquire all of the outstanding shares of PETQ's common stock for \$31.00 per share¹, in an all-cash transaction valued at approximately \$1.5 billion. The deal price represented a premium of approximately 41% to the 30-day volume-weighted average stock price as of August 6, 2024, the last trading day prior to announcement of the transaction.

The stock jumped on the news of transaction and the convertible bond had a sharp positive move as well as indicated below:

¹ Not all acquisitions are profitable. The positions can be acquired at a price that is less than the price at which the Firm purchased its interest for its clients. The information is being shown to reflect the Firm's ability to select investments that are likely to be acquisition targets and not to reflect any positive investment experience. The holdings identified do not represent all of the securities purchased, sold, or recommended for Pier 88's clients. It should not be assumed that investments made in the future will be profitable or will equal the performance of the securities in this list. Additional information, including (i) the calculation methodology; and (ii) a list showing the contribution of each holding to the account's performance during the period will be provided upon request. Past performance is not indicative of future results.



Source: Bloomberg August 2024

Bondholders were rewarded as the market price for the convertible bond played offense following the equity move up and jumped from approximately \$106.12 to \$115.56 (+9% one day move). Although the almost double digit one day return is nice, Pier 88 submits that it was the defensive attributes of the PETQ convertible which showcase the potential benefits of owning small and mid-cap growth companies via a convertible bond.

Like many small and mid-cap growth equities, PETQ’s equity experienced volatility in the Fall of 2023 as investors eschewed small and mid-cap stocks and crowded into a select handful of mega cap tech stocks. From October 1, 2023 to March 18, 2024, PETQ’s equity declined over 28% underperforming the major indices. Interestingly, during that same period, the convertible bond only declined approximately 2% as there really were no credit issues facing the company. The following comparison of equity to convertible is telling:



Source: Bloomberg August 2024

The downturn in small and mid-cap growth equities has significantly impacted convertible bonds issued by growth-focused companies. As these equities have declined, the associated convertibles have fallen below par value, creating an intriguing investment opportunity. Despite their current under-par pricing, we believe the inherent structure of convertible bonds enables substantial upside potential if equities rebound, potentially surpassing par value. This distinctive asymmetrical risk-reward appeal has attracted investors aiming to benefit from potential gains while safeguarding against downside risk in the current market climate. Moreover, the prospect of convertibles accreting to par upon maturity, irrespective of market conditions, adds another layer of security, with the potential for an immediate jump to par upon acquisition or take private scenarios.

Pier 88’s Investment Team believes the sharp pullback in small and midcap growth stocks will be a catalyst for more corporate M&A and private equity transactions. We view the convertible bond asset class as providing an

interesting opportunity for the savvy investor to generate better returns from his or her fixed income investments without taking on excessive credit or duration risks. PETQ's convertible makes the point. We believe getting access to great secular growth companies through investing higher in the cap table seems to be a creative and more defensive way to own growth stocks.

Respectfully,

Frank Timons

Disclosures

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