EDISON

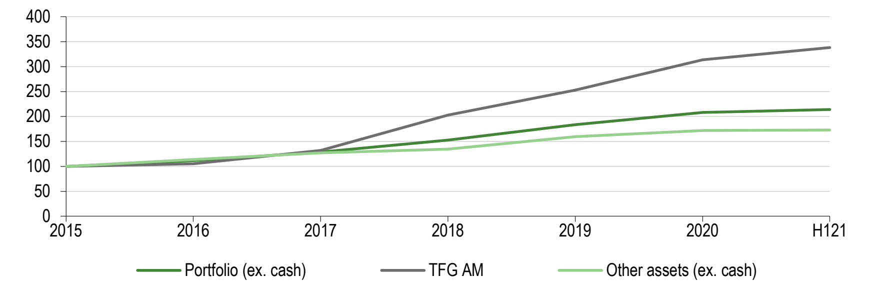
Tetragon Financial Group

Muted performance in H121

Investment companies
Alternative assets

Tetragon Financial Group (Tetragon) reported an H121 NAV total return (TR) of 0% in US dollar terms. Gains on investments in asset managers, bank loans and hedge funds were offset by losses on its listed equities portfolio and private equity (PE). TFG Asset Management (TFG AM) has continued to increase its assets under management (AUM) to US$32.8bn (up 9% in H121) by attracting capital to existing strategies and setting up new managers (eg Contingency Capital active in financing law firms and legal proceedings). Meanwhile, employee ownership of Tetragon increased to 35.0%, further aligning the interests of management and investors.

Cumulative gross returns of Tetragon's portfolio ex. cash (rebased)*



Source: Tetragon, Edison Investment Research. Note: *Not adjusted for investments/disposals during respective years.

Why consider Tetragon Financial Group now?

Tetragon is a one-stop shop for alternative assets with a diversified exposure providing returns that are not correlated with major traditional asset classes. While Tetragon's recent performance was subdued, its long-term returns remain within its target range and visibly outperform the AIC Flexible Investment sector and public equity markets over the last 10 years. Historically, it has traded at a wide discount (10-year average at 44%), with the potential reasons described in our June 2021 note. Currently the discount stands at c 64% to NAV, which provides investors with a certain degree of downside protection.

The analyst's view

Tetragon's H121 return was behind broader equity markets, but we note that this was primarily due to assets that show little to no correlation with equities: two early-stage gold miners in Hawke's Point portfolio were written down by 29% amid a lower gold price (after a +66% return in FY20); Tetragon's listed equity portfolio is concentrated (10 positions) and focused on (bio)technology and financials with value driven by company-specific developments; and Polygon funds (making up 97% of Tetragon's hedge funds exposure) have concentrated portfolios focused on special situations. Meanwhile, the privately valued TFG Asset Management remains the main value driver of NAV returns (see chart above). While Tetragon's historical long-term performance remains intact, the high concentration in some asset buckets, coupled with Tetragon's limited disclosure on individual underlying investments, translates into lower visibility of prospective returns.

NOT INTENDED FOR PERSONS IN THE EEA.

In this report, market data are derived from Refinitiv and company data provided by Tetragon (unless otherwise specified).

1 September 2021

Price	**US$9.40**
Price (TFGS)	**683p**
Market cap	**US$892.1m**
NAV*	**US$2,492m**

NAV per share*	US$26.27
Discount to NAV	64.2%

*At end-July 2021.

Yield		4.3%
Fully diluted shares in issue		94.9m
Code/ISIN		TFG/GG00B1RMC548
Primary exchange		Euronext Amsterdam
Secondary exchange		LSE Specialist Fund Segment
AIC sector		Flexible Investment
52-week high/low*	US$10.60	US$8.44
NAV** high/low	US$26.57	US$23.81

Gearing

Net gearing at 31 July 2021	4.9%

Fund objective

Tetragon Financial Group's objective is to generate distributable income and capital appreciation, aiming to provide stable returns to investors across various credit, equity, interest rate, inflation and real estate cycles. Tetragon's investment portfolio comprises a broad range of assets, including public and private equities and credit, real estate, venture capital, infrastructure, bank loans and a diversified alternative asset management business.

Bull points

- Diversified portfolio with a proven track record.
- Recurring income from asset management. business (TFG Asset Management).
- The wide discount provides investors with some downside protection.

Bear points

- Above-average ongoing charge and performance fees.
- Only non-voting shares available for investors.
- Limited disclosure on underlying assets developments limiting investors' understanding.

Analysts

Milosz Papst	+44 (0)20 3077 5700
Michal Mordel	+44 (0)20 3077 5700

investmenttrusts@edisongroup.com

Edison profile page

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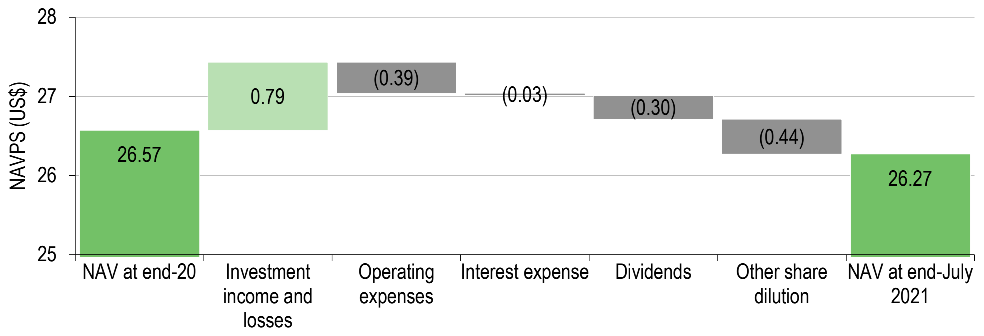
H121 return below broad equity markets and peers

Tetragon posted a flat NAV per share total return in dollar terms (-1.0% in sterling terms) in H121 and -0.1% (-0.7% in sterling) in July 2021. While we acknowledge its aim is to provide uncorrelated returns compared to major traditional asset classes, we note its ytd performance (to end-July) is visibly behind both public (MSCI ACWI TR at 13.4%) and PE markets (LPX 50 NAV at 19%), which continue to rally on the back of expected economic recovery. Tetragon recorded a 3% gross return on its portfolio in H121, which was fully offset by ongoing expenses at 1.70% of average NAV (annualised vs 1.73% in FY20) and a minor incentive fee (US$6m vs US$23.1m pa on average in 2015–20) and share dilution from equity-based compensation and stock dividends (see Exhibit 3). Despite the short-term underperformance (H121 ROE arrived at 1.5%), Tetragon's results in the long run remain within its 10–15% ROE target with an average 11.8% pa since 2017.

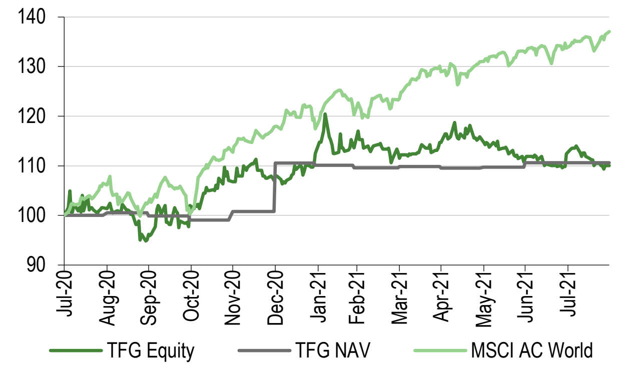
Exhibit 1: Tetragon's NAV per share development in 2021 until end-July (US$)



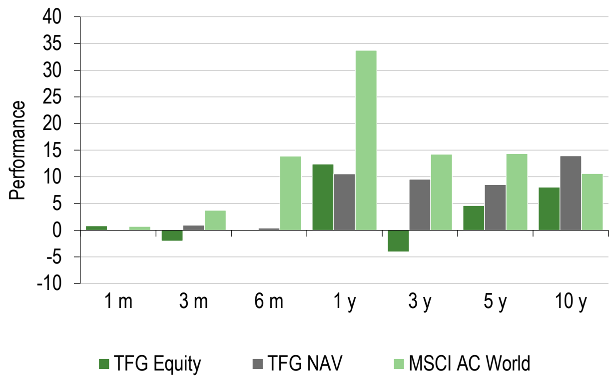
Source: Tetragon, Edison Investment Research

Exhibit 2: Tetragon share price discount to NAV and performance data in US dollar terms

Price, NAV and index one-year total return performance



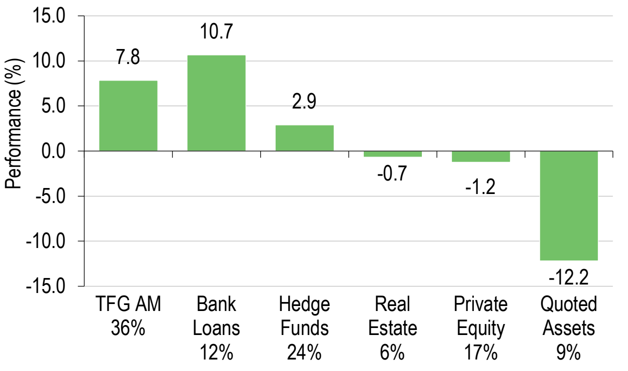
Price, NAV and benchmark total return performance (%)*



Source: Refinitiv, Edison Investment Research. Note: *Performance data to end-July 2021, three-, five-, and 10-year performance annualised.

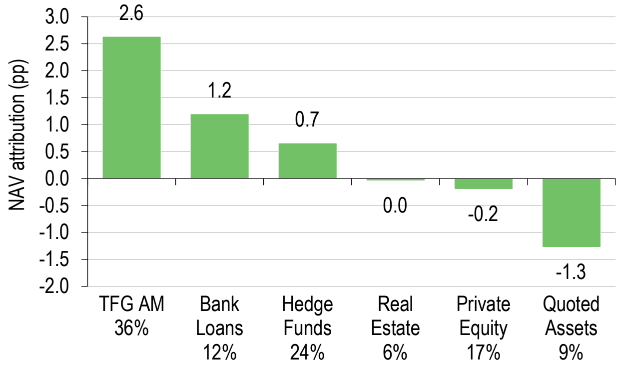
Performance by asset class: TFG AM as key driver

Exhibit 3: H121 performance by asset class (%)



Source: Tetragon Financial Group, Edison Investment Research; Note: Share in Tetragon's total NAV indicated in the data labels.

Exhibit 4: H121 NAV attribution by asset class (pp)



Source: Tetragon Financial Group, Edison Investment Research. Note: Share in Tetragon's total NAV indicated in the data labels.

Tetragon's asset management business continues to drive its NAV TR having delivered a 2.6pp NAV accretion in H121 through a 7.8% revaluation gain driven predominantly by a c 9% increase in combined AUM to US$32.8bn. The value of TFG Asset Management is determined by a third-party valuation specialist using predominantly DCF models based on expected fee income. The main H121 contributor was the infrastructure asset manager Equitix (Tetragon's largest holding making up c 16.9% of its NAV), which added 1.2pp to Tetragon's overall NAV change as Equitix's AUM increased by 6.5% (or c £340m) in H121. On the other hand, the discount rate used to value Equitix was raised by 0.5pp (to 10%) on the back of expected UK corporate tax hike. The revaluation of LCM was assisted by a 0.75pp decrease in discount rate (to 11.25%) and a price to AUM multiple increase to 2.96% (from 2.50%) on the back of a higher valuation of listed peers, likely reflecting the improvement in the fundamentals of the underlying leveraged loan markets. We also note that businesses within TFG Asset Management generate recurring cash from fee income and Equitix distributed £30.4m in dividends in FY20.

Meanwhile, net income of TFG Asset Management decreased 27% y-o-y in H121 to US$27.5m amid a rise in operating expenses (outpacing the c 8% y-o-y top-line growth) due to an increase in headcount (to 420 from 350 a year earlier) and one-time costs associated with setting up Contingency Capital. The cost base was also inflated by the sterling appreciation versus US dollar as most fees are earned in US dollars and costs expensed in sterling.

Exhibit 5: TFG Asset Management pro-forma income statement (US$m)

	H121	H120	y-o-y
Management fee income	68.4	65.4	5%
Performance and success fees	23.6	22.2	6%
Other fee income	11.2	7.7	45%
Distributions from BentallGreenOak	10.7	9.2	16%
Interest income	0.6	1.8	(67%)
Total income	**114.5**	**106.3**	**8%**
Operating, employee and administrative expenses	(75.0)	(61.1)	23%
Minority interest	(12.0)	(7.4)	62%
Net income – 'EBITDA equivalent'	**27.5**	**37.8**	**(27%)**

Source: Tetragon

Bank loans benefitting from benign CLO market

Bank loans were Tetragon's best-performing asset class in H121, increasing in value by 10.7% and contributing 1.2pp to NAV performance (Edison calculations). Tetragon invests in bank loans predominantly through majority stakes in equity tranches of CLO structures. This reflects the positive trends in the broader CLO market, also illustrated by the performance of specialised listed CLO funds (eg CLOs held by Blackstone Loan Financing recorded a c 14% return in the period in euro terms). The equity tranches profit from continuously low default rates, low interest rates (due to usually higher floors on underlying loans than CLO debt tranches) and the ability to reset the structures to lock in the low cost of debt tranches (see our Edison explains note for more details on CLOs). At end-H121, all structures held by Tetragon were compliant with their junior-most overcollateralisation tests. Gains reported by Tetragon were supported by changes in valuation assumptions to reflect the economic recovery and strong underlying loan fundamentals, with future cashflow supported by resets in four structures. Importantly, 74% of Tetragon's CLOs (by original investment size) end their respective reinvestment periods in 2022 or later, allowing managers to rotate the collateral in response to market developments.

Hedge funds: Low correlation to public markets that recently continued to rally

Tetragon invests in hedge funds predominantly through the Polygon-managed European Equity Opportunity Fund (72% of the asset class), while only 3% of the exposure is managed by third-party managers. We calculate that the hedge funds contributed 0.7pp to the NAV by delivering 2.9% return in H121 (the Absolute Return share class delivered a 1.1% return). While the performance was behind Euro STOXX 600 (12%), we highlight that the portfolio has limited correlation to public markets. Polygon focuses on special situations (eg restructurings, M&A deals, market dislocation and corporate activism), which are driven by company-level catalysts and take time to unlock the value. Over the longer term, the strategy has provided solid returns as we estimate that since inception in 2009 the Absolute Return share class has outperformed the index by c 2pp pa (although it slightly underperformed the index since 2017 by 1.7pp pa). Similarly, the Polygon Convertible Opportunity fund (21% of the asset class) is also a highly concentrated, catalyst-driven portfolio that is unlikely to show any meaningful correlation with the broader equity market. This fund delivered an 8.4% return in H121 compared to 3.5% for the HFRX Convertible Arbitrage index.

Quoted assets: Concentrated exposure driven by developments at individual companies

Public investments in equity and credit held on Tetragon's own balance sheet were the worst performing asset class in H121 posting a 12.2% loss and lowering Tetragon's NAV return by 1.3pp, according to our calculations. This exposure is highly concentrated as 91% of its NAV are equity investments in 10 stocks. Here, Tetragon invested primarily in tech, biotech and financial companies and while we see that these sectors performed relatively well in H121, we need to highlight that with such a concentrated portfolio, performance is driven primarily by developments within the underlying companies rather than broader market movements. This is particularly true for biotech stocks whose performance is often dependent on product development progress. We also highlight that Tetragon's quoted assets performed well in H220 (with a 22% return).

PE returns burdened by revaluation of gold mining assets

The PE asset pool recorded a loss of 1.2%, which translated into a 0.2pp decrease in overall NAV (Edison calculations). Funds managed by Banyan Square and third-party managers delivered a healthy 22% return (compared to LPX 50 NAV at 19% in US$ terms). However, they represent only a third of value of Tetragon's exposure to this asset class. The overall decrease was driven by downward revaluation of Hawke's Point investments, which is an early stage (started investing in 2019) manager focused on mining finance. Its two gold mine projects were revalued downwards on the back of a softer gold price (-6.8% in H121), after a 66% value increase in FY20. The largest exposure within the group continues to be the investment in preferred stock of Ripple Labs, which has some characteristics of a debt investment and increases steadily in value through capitalisation of dividends. We note that the SEC case against Ripple, described in detail in our previous note, is still in progress.

Hospitality and commercial real estate still affected by COVID-19

Real estate assets had only a minor effect on NAV development in H121 by decreasing by 0.7% in value. The losses were attributable to US-focused funds (-21% in H121), mostly due to their exposure to hotel and commercial real estate in New York and Los Angeles. Investments in other geographics are more focused on areas less affected by COVID-19 (most notably offices and logistics) but the revaluation gains on Asia-focused focused funds (+8.4%) and Paraguayan farmland (+18%) did not fully offset the losses of US funds.

Fully invested with a partially drawn credit facility

In H121 Tetragon was a net investor, purchasing US$168.7m of assets (US$196.3m including July 2021 investments) and receiving US$136.3m from disposals and distributions (US$149.3m including July). Most notably, US$38.0m was provided to PE, of which US$14.3m was called by third-party PE funds in North America and Europe and US$9.5m by Banyan Square Partners (a further US$19.6m was invested in PE in July). Tetragon also co-invested US$6.0m alongside Hawke's Point and made other undisclosed direct PE investments of US$8.2m. The most cashflow-generative assets were bank loans, with the CLO structures distributing US$35.6m in coupons and amortisation (while Tetragon invested US$18.6m in two new structures set up by LCM). This trend continues, as July 2021 distributions amounted to US$11.5m (we note that most structures distribute cash quarterly and combined May and June distributions amounted to US$6.4m).

These net investments translated into a net gearing at 4.9% of NAV (0.5% at end-FY20) compared to 14% net cash on average in 2015–2019. Tetragon has a US$250m revolving credit facility in place, maturing in 2030. At end-H121 US$100m remained undrawn (US$50m drawn in H121). It has an interest rate at three-month LIBOR+3.25%, which compares with Tetragon's hurdle rate of three-month LIBOR+2.65%. We believe that Tetragon remains flexible in its investment decisions with c US$206m resources at its disposal at end-July (including the undrawn part of the credit line) compared to US$201.1m in commitments reported as at end-H121. The latter are likely to be called gradually over the medium term and include US$76.4m of 'soft' commitments to Banyan Square Partners and Contingency Capital funds.

Peer group comparison

Historically, over the long term Tetragon has outperformed its peers (members of the AIC Flexible Investment sector) with a 10-year NAV TR in sterling terms at 265.0% versus the peer average at 89.4%. In the short term, however, its performance in US dollars paired with sterling appreciation (6% over the last 12 months), has placed its one-year NAV TR on the last spot among peers. While several factors have contributed to the underperformance as described above, we note that Tetragon's limited disclosure on underlying holdings' performance translates into lower visibility of prospective returns in some asset classes. The muted ytd return also affected three- and five-year returns, which are slightly below peer average.

Despite long-term outperformance and above-average dividend yield, Tetragon continues to trade at the widest discount among peers, which has widened since the pandemic outbreak to c 64%

from its 10-year average of 44%. The potential reasons behind the prevailing wide discount in the long term were explored in our June 2020 note.

Exhibit 6: Selected AIC Flexible Investment sector peer group in sterling terms as at 31 August 2021*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Premium/ (discount)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Tetragon Financial Group	**610.5**	**4.4**	**24.0**	**43.7**	**265.0**	**(64.2)**	**1.7**	**Yes**	**105**	**4.3**
Aberdeen Diversified Income & Growth	308.7	7.3	7.3	17.1	42.3	(17.8)	0.6	Yes	100	5.5
Caledonia Investments	1,861.5	30.3	29.9	60.3	153.2	(21.4)	1.0	Yes	100	1.9
Capital Gearing	825.9	13.8	25.9	43.7	86.0	1.9	0.6	Yes	100	0.9
Hansa Trust 'A'	174.4	27.9	12.3	48.8	51.0	(34.6)	1.1	Yes	100	1.5
Personal Assets	1,672.8	11.4	28.0	32.2	74.8	1.2	0.7	Yes	100	1.1
RIT Capital Partners	4,089.2	38.8	47.2	75.8	157.3	(1.8)	0.7	Yes	112	1.3
Ruffer Investment Company	627.1	13.4	24.0	32.7	61.6	3.6	1.1	Yes	100	0.7
UIL	227.7	36.6	32.6	53.5	162.6	(30.3)	2.1	Yes	149	3.0
Average	**1,365.7**	**20.4**	**24.9**	**44.4**	**89.4**	**(9.9)**	**0.8**		**102**	**1.8**
Rank in peer group	**6**	**9**	**6**	**5**	**1**	**9**	**2**		**3**	**2**

Source: Morningstar, Edison Investment Research. Note: *Performance data to 31 July 2021. TR = total return in sterling terms. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

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Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia