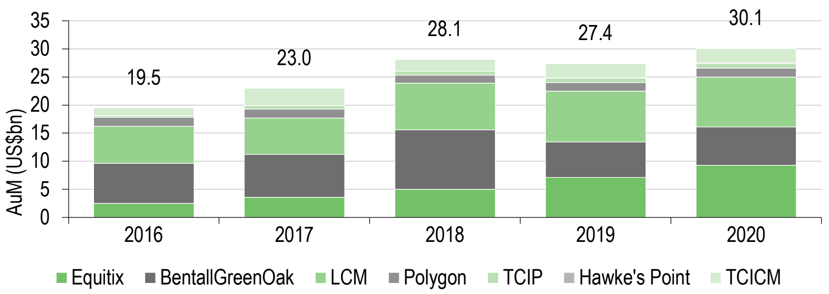
Tetragon Financial Group

TFG Asset Management grows in AUM and value

Investment companies
Alternative assets

Tetragon Financial Group (Tetragon) reported a 9.5% NAV TR in FY20 in US dollar terms. Its main value driver remains TFG Asset Management, which delivered a 24% return in FY20 as it continues to expand its assets under management (AUM, up by 10% in FY20 mainly assisted by Equitix). In contrast, Tetragon's CLO and real estate investments were a drag on FY20 performance. Moreover, Polygon funds (the majority of Tetragon's exposure to hedge funds) delivered positive returns, but below broader equity markets. As a result, Tetragon posted a 7.6% return on equity, below its long-term target of 10–15%. Still, its long-term performance remains intact with an average 13.7% NAV TR pa over the last 10 years.

Assets under management in TFG Asset Management (US$bn)



Source: Tetragon, Edison Investment Research

Why invest in Tetragon Financial Group now?

While equity markets are close to all-time highs, the economic outlook remains uncertain. Progress in COVID-19 vaccinations varies greatly across the globe, new virus variants are being discovered and lockdowns have been reintroduced in several countries. At the same time, inflation expectations are on the rise. In these conditions, Tetragon's alternative assets portfolio (part of which generates recurring income) could appeal to investors searching for uncorrelated returns.

The analyst's view

Despite the long-term NAV returns Tetragon demonstrated, its shares continue to trade at a wide discount of 63%, which is ahead of the already wide 10-year average of 43% and visibly higher than its peers. This may at least partly come from its incentive fee structure (which also dampened the NAV TR in FY20), only non-voting shares being available to investors (which means Tetragon cannot enter LSE's premium segment) and TFG Asset Management's carrying value being based on private valuation. The recent enforcement action of the US Securities and Exchange Commission (SEC) against Ripple Labs (7.3% of Tetragon's NAV) may add to this. Nevertheless, the current discount offers considerable downside protection to investors, who are also rewarded through dividends (4.1% yield on a last 12 months basis) and NAV-accretive share buybacks. Tetragon sees room for further growth in AUM of TFG Asset Management and does not expect to float the business in the near term (which, however, remains its long-term intention).

27 April 2021

Price	**US$9.82**
Price (TFGS)	**712p**
Market cap	**US$917.2m**
NAV*	**US$2,450m**

NAV per share*		US$26.23
Discount to NAV		62.6%

*As at end-January 2021.

Yield		4.1%
Fully diluted shares in issue		93.4m
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$7.88
NAV high/low	US$26.57	US$22.69
Gross gearing*		4.0%
Net gearing*		0.5%

*As at end-December 2020.

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.
- Ongoing Ripple Labs case.

Analysts

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

investmenttrusts@edisongroup.com

Edison profile page

Tetragon Financial Group is a research client of Edison Investment Research Limited

Market outlook: Low interest rates keep valuations high

The financial markets rebounded quickly after the coronavirus-induced broad sell-off in March 2020 with the help of record-high monetary stimulus and unprecedently low interest rates. Meanwhile, the western world economy has avoided a major crisis so far and corporate default rates remain relatively low, supported by various governmental initiatives and access to private debt financing, which has developed visibly after the Global Financial Crisis (GFC). The prevalence of covenant-lite loans also played an important role in averting a sudden spike in defaults in the initial phase of the crisis. Nevertheless, we see that the valuations rally of H220 was not uniform (both in public and private equity markets) and was fuelled by sectors that have proven resilient to lockdowns.

The competition for quality assets among private equity (PE) managers remains high, as PE funds have considerable dry powder at their disposal (€294bn in European funds and more than US$550bn in the US at end-2020, according to PitchBook Data). After an M&A standstill in early 2020, when earnings prospects were difficult to gauge and companies focused on securing liquidity, deal activity rebounded in the H220 pushing up valuations in certain sectors (eg tech, healthcare), which now leads some PE managers to cautiously assume multiples contraction going forward.

The default rate is so far lower than during the GFC, which supports collateralised loan obligation (CLO) structures and most of them continue to distribute income to equity tranches. However, rating agencies swiftly downgraded the ratings of a number of loans constituting CLO collateral, which in turn led to test breaches in a number of structures (24% of US CLOs failed their interest diversion tests as at end-July 2020, according to Volta Finance citing findings of Wells Fargo). Moreover, while markets avoided a rapid spike in defaults, these are likely to occur eventually and may be spread over time as highlighted by Fitch Ratings expecting a cumulative three-year default rate at a similar level to that of the GFC (17–20% for US leveraged loans compared to 15% in 2008–10). Having said that, CLO equity tranches, which are still in reinvestment phase are well positioned for a recovery scenario, as these can currently reinvest capital in leveraged loans at discounted prices. We also note that new CLO structures can lock in cheap cost of funding (ie spreads on CLO debt tranches) to the benefit of equity tranches. Moreover, Libor floors are also often set at a higher level for underlying loans than CLO debt tranches, which amid the current historically low Libor levels supports cashflow to equity tranche holders. Finally, given that leveraged loans are normally floating rate, CLOs offer upside in a scenario where inflation picks up and triggers a monetary policy tightening.

The economic recovery path remains uncertain and may prove both protracted and volatile. This is illustrated by IMF forecasts from April 2021 for the eurozone to have had a 6.6% decline in GDP in 2020 followed by 4.4% and 3.8% growth in 2021 and 2022 respectively. Several countries reported delays in the vaccination process due to slower than expected vaccine deliveries, as well as internal bottlenecks. Moreover, scientists report new coronavirus variants emerging in various regions of the world (eg UK, Brazil, South Africa), which become an additional risk factor.

Consequently, given the combination of continued high macro uncertainty coupled with rising inflation expectations and elevated valuations in public equity markets, Tetragon's diversified alternative portfolio, aimed at providing returns that are uncorrelated to the broader macro environment, may appeal to some investors, especially given the proportion of income-generating assets (including the asset management business and real estate). Moreover, Tetragon's asset management business may be further assisted by investor demand for infrastructure assets (assisting growth in Equitix's AUM). Still, some of Tetragon's asset classes may suffer in case of a financial market downturn (hedge funds, bank loans and quoted assets in particular).

EDISON

The fund manager: Tetragon Financial Management

Tetragon is managed by Tetragon Financial Management (TFM). TFM was founded and is owned by the co-founders of Tetragon (Reade Griffith and Paddy Dear), who also launched Polygon, currently wholly owned by Tetragon. While Tetragon pays management fees to TFM, in terms of decision making it can be viewed as a self-managed entity.

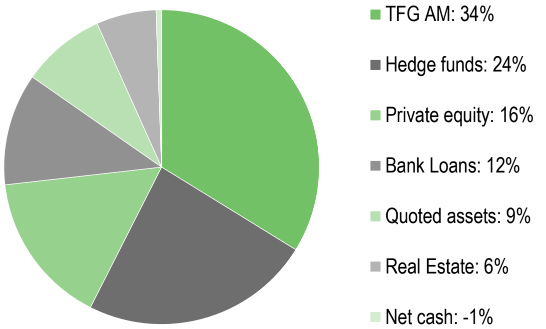
The manager's view: Relying on multiple return drivers

TFM aims to manage a diversified portfolio with limited correlation to broader macro factors rather than actively positioning the portfolio in anticipation of a given scenario materialising in financial markets. It expects to continue to allocate capital especially to its newly founded asset managers within TFG Asset Management (Contingency Capital, Hawke's Point, Banyan Square Partners), while keeping the allocation in existing assets broadly stable. Additionally, Tetragon expects to invest in new asset classes and hedge funds (beyond the current exposure to Polygon's funds). Direct public market investments remain opportunistic and Tetragon does not provide any guidance on its prospective allocation. Tetragon acknowledges that macroeconomic and pandemic-related externalities will likely continue to be important drivers across markets in 2021. It believes that the global economy shall experience economic expansion on the back of pent-up demand once life returns to normal (most likely in the second half of 2021 according to Tetragon), which will be further assisted by continued accommodative monetary policy globally. On the other hand, the manager expects prospective returns closer to the lower end of its 10–15% return on equity (ROE) target due to the current low interest rates and high asset valuations.

Asset allocation

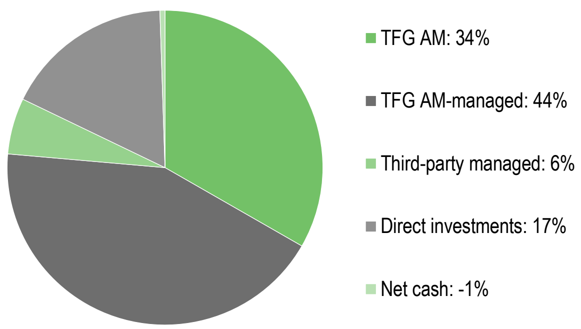
As at end-2020, Tetragon had a net asset value (NAV) of US$2.5bn derived from a diversified portfolio of alternative investments. Its largest investment is TFG Asset Management (34% of the NAV), which is a wholly owned subsidiary holding (mostly) majority stakes in alternative asset management companies generating stable fee income from assets under management (AUM) of over US$30bn in infrastructure, real estate, CLOs, private equity as well as hedge funds. Tetragon's remaining portfolio represents investments in the above asset classes through funds managed within the TFG Asset Management group (44% of total portfolio) and external managers (6%), but also direct investments (17%).

Exhibit 1: Portfolio by asset class (February 2021)



Source: Tetragon Financial Group, Edison Investment Research

Exhibit 2: Portfolio exposure by manager (end-2020)



Source: Tetragon Financial Group, Edison Investment Research

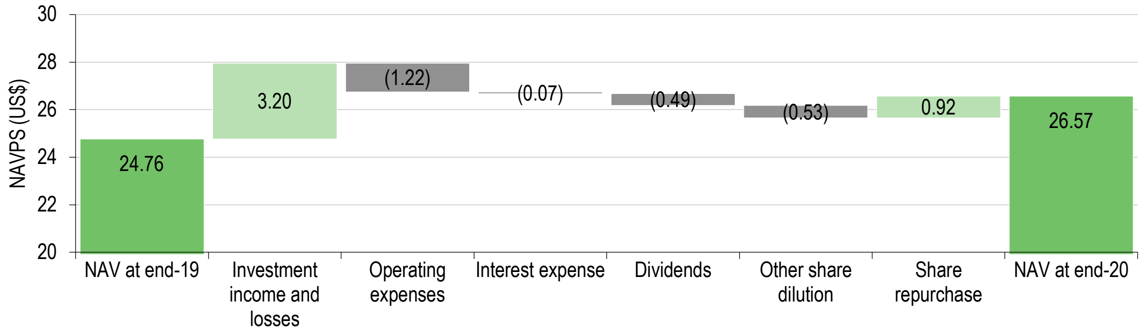
Performance

Tetragon posted a 9.5% NAV per share total return (TR) in dollar terms (6.1% in sterling terms) in FY20, which is somewhat below public equity markets, which experienced a significant price rally in H220 on the back of emergency approvals of COVID-19 vaccines, as well as continued fiscal and monetary stimulus (eg MSCI ACWI was up 16.8% in dollar terms). Moreover, 2020 performance was behind Tetragon's long-term returns, with a 7.6% ROE compared to the five-year average of 12.1% and its 10–15% pa long-term target. The main value driver was TFG Asset Management (especially Equitix), whose value is based on a private valuation. Excluding TFG Asset Management, the change in value of Tetragon's remaining portfolio's NAV was 7.7% y-o-y (excluding ongoing charges and fees).

The best performing single assets in the portfolio were Equitix (an infrastructure asset manager that is rapidly expanding its AUM), which added 7.0pp to Tetragon's NAV performance in US dollar terms (on the back of its 55% y-o-y increase) and Hawke's Point Fund 1 (whose gold mine projects were revalued with 66% y-o-y growth), which added 2.2pp. Tetragon's trading in public equities on its own book (26% gain) added another 2.0pp to the performance.

Tetragon's ongoing charge ratio decreased slightly to 1.70% from 1.73%, however the total fees were higher year-on-year as Tetragon paid 3.05% of its opening NAV in incentive fees in FY20 compared to 2.90% in 2019. This may seem counterintuitive given Tetragon's lower NAV TR (9.5% vs 13.6% in 2019) and comes from the fact that its high-water mark is set based on the preceding two quarters only (see below for details). Having said that, given that Tetragon's NAV TR is now above its last peak, the above should not influence Tetragon's near-term performance. As at end-February 2021 Tetragon's NAV/share stands at US$26.23, 0.9% lower than end-2020 on the back of the performance of public assets held directly by Tetragon.

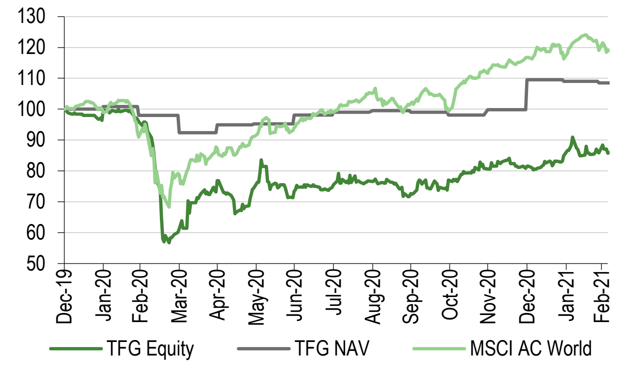
Exhibit 3: Tetragon's NAV per share development in FY20 (US$)



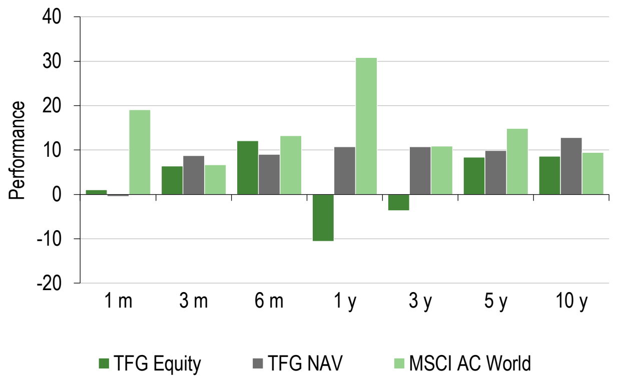
Source: Refinitiv, Edison Investment Research

Exhibit 4: Tetragon share price discount to NAV and performance data in US dollar terms

Price, NAV and index total return performance, rebased to end-2019



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



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

TFG Asset Management continues to grow its AUM

The wholly owned TFG Asset Management was the main NAV TR driver with a 24% increase in value in FY20 (see Exhibit 6). The eight wholly or majority owned managers within the group generated a combined fee income of US$226m in FY20 (up 27% y-o-y). Moreover, distributions from BentallGreenOak (where Tetragon holds a 13% stake) stood at US$18.1m in 2020 (up 68% y-o-y). Minority interests reflect the 25% share in Equitix owned by Equitix's management, and a controlling stake of Polygon CB LP – a former subsidiary of Polygon managing the Polygon Convertible Opportunity Fund, currently held by its CIO Mike Humphries. The minority interest increased twofold year-on-year reflecting Equitix's growth and Tetragon's reduced economic interest in the company to 75% from 85% following the repayment of a loan to Tetragon. As a result, net income was US$75.2m, 26% higher than in 2019.

We estimate that Tetragon's investments currently make up c 4% of TFG Asset Management's AUM. Tetragon paid US$9.4m in management fees to TFG Asset Management in FY20 (which represent 7.5% of overall management fees earned) and US$12.7m in performance and success fees (15.6% of total). TFG Asset Management provides various operational services to the investment manager (eg marketing, payroll and compliance), which are charged at cost with no effect on TFG Asset Management and are thus earnings neutral. They amounted to US$18.1m in FY20 (FY19: US$19.4m), and for the purpose of presentation Tetragon excludes these fees from the income and expenses of TFG Asset Management.

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

	2019	2020	y-o-y
Management fee income	111.2	125.8	13%
Performance and success fees	51.8	81.6	58%
Other fee income	15.5	18.9	22%
Distributions from BentallGreenOak	10.8	18.1	68%
Interest income	3.8	4.1	8%
Total income	**193.1**	**248.5**	**29%**
Operating, employee and administrative expenses	(124.3)	(145.8)	17%
Minority interest	(9.3)	(27.5)	196%
Net income – 'EBITDA equivalent'	**59.5**	**75.2**	**26%**

Source: Tetragon

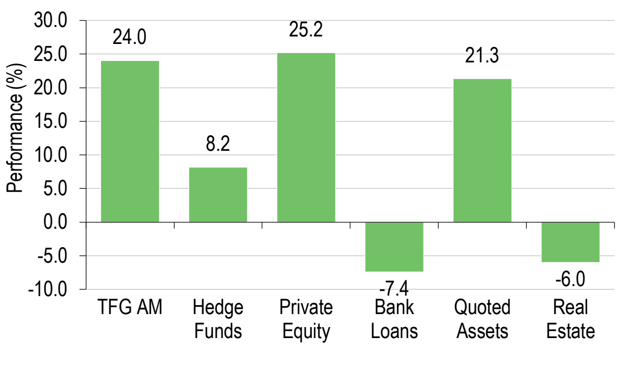
Equitix was the main growth contributor as it continues to raise new capital with its AUM up to US$9.3bn at end-2020 from US$7.1bn a year ago. The manager benefits from increased interest from investors in infrastructure assets (as an income-generating asset and inflation hedge) and expects to raise further capital in the funds that have not reached their final close yet. The increase in expected fees triggered a 28% revaluation to US$386m (46% of TFG Asset Management value at end-2020). Over the year, Equitix distributed US$91m to Tetragon (FY19: US$55m) in the form of dividends (£30.4m) as well as repayment of remaining loan notes (£39.3m), which have been refinanced with new external debt. On the other hand, the carrying value of managers with exposure to CLOs (TCP and LCM) was reduced on the back of expected higher corporate default rates translating into lower projected carry (this had a combined -0.7pp effect on Tetragon's NAV).

Tetragon continues to see room for expansion for TFG Asset Management and does not expect to float the business in the near term (which however remains its long-term intention). During 2020, TFG Asset Management has set up (together with Brandon Baer) a new asset manager Contingency Capital (which will manage litigation finance related investment funds globally), in which it holds a non-controlling stake. Moreover, it has made an S-1 filing to raise up to US$500m in an IPO of a SPAC to acquire an alternative asset manager.

Hedge funds exposure profits from H220 rally

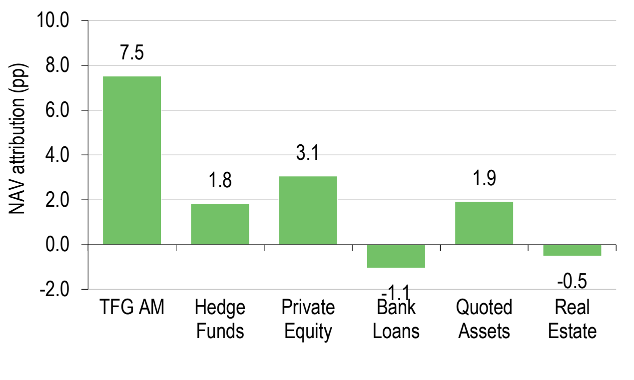
The hedge funds are the second largest asset class in Tetragon's portfolio (making up 23% of its NAV at end-2020) and delivered an 8.2% return in FY20 (1.8pp attribution to Tetragon's NAV) on the back of the H220 rally. Here, Tetragon invests predominantly in Polygon-managed funds (99.5% of hedge funds exposure) and allocated additional capital to them in March and June 2020, which allowed it to achieve a higher return than the underlying funds. Polygon European Equity Opportunity Fund (78% of Tetragon's exposure) posted a 7.3% return for its absolute return class and 3.7% for long-bias share class. The asset pool generated US$61m distributions, mainly due to the final exit from Credit Suisse's QT Fund (US$45m).

Exhibit 6: FY20 performance by asset class (%)



Source: Tetragon Financial Group, Edison Investment Research

Exhibit 7: FY20 NAV attribution by asset class (pp)



Source: Tetragon Financial Group, Edison Investment Research

Private Equity

In the private equity and venture capital asset class (16% of portfolio value), Tetragon reported a 25% value increase in FY20, which contributed 3.1pp to total NAV return in FY20. The main growth contributor was Hawke's Point Fund 1 with a 66% value increase, fuelled by the development of its two gold mine projects, supported by higher gold prices.

The largest exposure within the asset pool (making up 7.3% of Tetragon's NAV at end-February 2021) remains its only direct PE investment in the preferred stock investment of Ripple Labs. The company operates a real-time global payments network developed in 2012 that is based on the XRP cryptocurrency, with its development largely financed through the ongoing sale of XRP held in treasury. Ripple Labs, as well as its CEO and chairman of the board, currently face a lawsuit filed by the US SEC, which claims that it violated federal securities laws by offering XRP without reporting it as a security. SEC also indicts the CEO and chairman of using information asymmetry for personal gains estimated at US$600m (see the complaint filed by the SEC for details).

Tetragon had anticipated that Ripple Labs could be subject to such a regulatory action and negotiated a provision in the investment agreement that gives it an option to redeem its investment in the event the SEC determines that XRP is a security on a current and going forward basis. In January 2021, it filed a complaint under seal in the Delaware Chancery Court, seeking to enforce this contractual right. In the filing, Tetragon disclosed that that it has unsuccessfully tried to execute its right to redeem the shares back in October 2020. The court concluded that the SEC's recent enforcement action alone does not determine XRP as a security and consequently does not trigger a securities default.

We note that Tetragon invested US$150m in the preferred shares, which were valued at US$179.0m as at end-February 2021. The gradual increase in value reflects income accruals and Tetragon has not performed any write-downs of the investment at this stage.

Other asset classes

Tetragon's trading in **public assets** on its own balance sheet delivered a 21.3% return in FY20, which translated into 1.9pp NAV accretion on the total portfolio. Similarly to Tetragon's investments in hedge funds, returns were supported by H220 performance and Tetragon's additional investments in March, July and August. **Real estate** investments decreased in value by 6.0%, yet they continue to deliver steady cashflow – US$65m in 2020, though 22% lower year-on-year. The decrease was fuelled by revaluations of US-based funds, which have exposure to office, multi-family, retail and hotel properties. The investments in **bank loans** were the worst performing asset pool, posting a 7.4% loss, which translated into a 1.1pp NAV decrease. CLO investments suffered from erosion of certain CLO test cushions and loan collateral quality as well as a recalibration of certain model assumptions and discount rates used to value the positions. Tetragon continues to perceive CLOs as an attractive asset class.

Peer group comparison

In Exhibit 8 we present a sterling-based comparison of Tetragon with eight members of the AIC Flexible Investment sector. We note that the Flexible Investment sector varies widely in investment strategies and mandates, and Tetragon's investment approach is very diversified, which renders none of the companies a perfect direct comparator. Having said that, Tetragon clearly outperforms peers on a NAV basis over three-, five-, and 10-year periods, with the one-year performance slightly above the sector average. While Tetragon's discount is currently high, we note that it has traded at a c 40% discount for the last 10 years, and the 10-year price TR is clearly above peers as well.

Despite Tetragon's long-term outperformance and above average dividend yield, it trades at the widest discount in the peer group. We described possible reasons behind the prevailing wide discount in our June 2020 note, and these include above-average fees and only non-voting shares available for investors.

Exhibit 8: Selected AIC Flexible Investment sector peer group in sterling terms as at 20 April 2021*

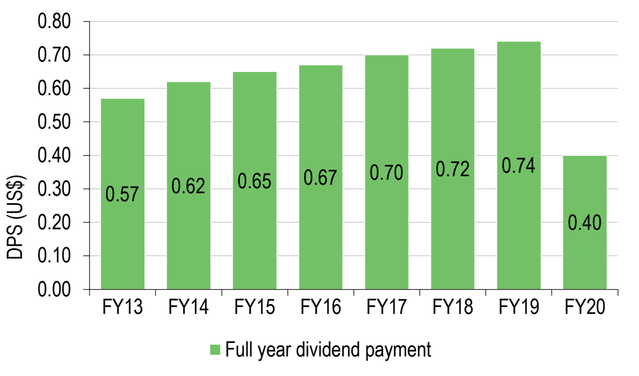
% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Premium/ (discount)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Tetragon Financial Group	**634.0**	**10.7**	**35.7**	**60.1**	**265.3**	**(62.6)**	**1.7**	**Yes**	**100**	**4.1**
Aberdeen Diversified Income & Growth	298.2	(4.1)	0.0	9.4	30.7	(16.6)	0.6	Yes	101	5.7
Caledonia Investments	1,606.7	(2.9)	10.2	38.8	103.3	(26.5)	0.9	Yes	100	2.1
Capital Gearing	683.6	7.3	21.3	39.2	83.7	1.9	0.7	Yes	100	0.9
Hansa Trust 'A'	170.4	12.2	14.2	53.3	46.4	(33.1)	0.3	Yes	100	1.5
Personal Assets	1,512.5	6.0	15.7	29.3	68.3	0.9	0.9	Yes	100	1.2
RIT Capital Partners	3,831.4	22.2	32.1	63.6	121.6	(3.9)	0.7	Yes	115	1.4
Ruffer Investment Company	562.8	24.2	22.7	41.7	58.6	2.1	1.1	Yes	100	0.7
UIL	198.4	19.9	43.2	132.3	144.2	(30.6)	2.1	Yes	165	3.3
Average	**1,237.9**	**9.3**	**16.6**	**39.3**	**73.2**	**(10.8)**	**0.7**		**102**	**1.9**
Rank in peer group	**5**	**5**	**2**	**3**	**1**	**9**	**2**		**5**	**2**

Source: Morningstar, Edison Investment Research. Note: *Performance data to 28 February 2021. TR = total return in sterling terms. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

Dividends and share repurchases

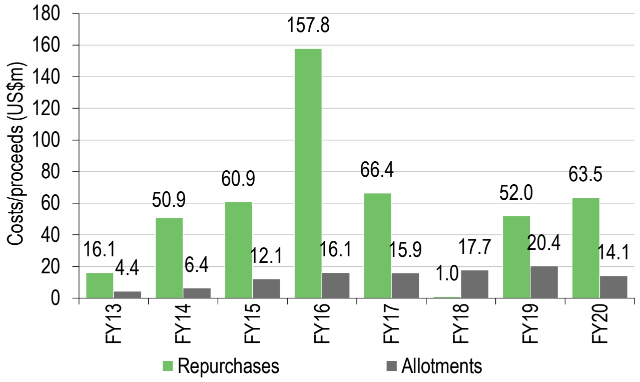
After modifying its dividend policy in H120 Tetragon does not target any specific dividend payout ratio at present (formerly 30–50% of normalised earnings). The change in policy was followed by a sharp decrease in DPS after gradual growth since 2009. The FY20 dividends were 46% lower year-on-year, back at the 2011 level. Dividends continue to be paid quarterly in May, August, November and March each year, with the 2020 dividends (US$0.10 each quarter) implying an above-average 4.1% yield on the current share price. Tetragon also takes advantage of its wide discount and regularly performs share repurchases, which are conducted through a Dutch auction at a price close to the market price of the shares, resulting in significant NAV accretion. During 2020, Tetragon used US$50.2m for share repurchases (FY19: US$50.3m). Shareholders have an option to receive dividends in the form of shares and in FY20 US$14.1m (FY19: US$20.4m) out of US$44.8m gross dividend (FY19: US$65.2m) has been taken in shares by investors.

Exhibit 9: Dividend paid from period earnings (US$)



Source: Tetragon Financial Group, Edison Investment Research

Exhibit 10: Repurchases and allotments (US$m)

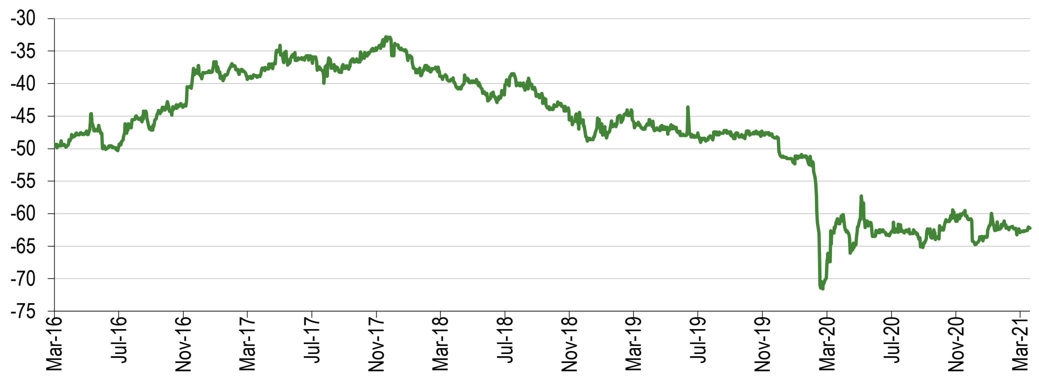


Source: Tetragon Financial Group, Edison Investment Research

Discount

Tetragon shares trade at a wide discount of 63%, ahead of the 10-year average of 43%. After the initial sell-off in March 2020 the share price did not fully rebound despite resilient and growing NAV. Currently investors may apply an additional discount due to ongoing litigation at Ripple Labs, which makes up c 7% of Tetragon's NAV. We also see several other factors that may at least partially explain the historically high discount. As explained in Fees and charges section on page 10, Tetragon's fees are relatively high compared to peers (see Exhibit 8); nevertheless, Tetragon's solid long-term NAV TR is calculated post fees. We also understand that investors may be wary of the fact that all outstanding shares are non-voting, which prevents Tetragon from entering the LSE's premium segment. On the other hand, we note that the record-high discount provides considerable downside protection for investors.

Exhibit 11: Share price discount to NAV over five years (%)



Source: Refinitiv

Fund profile: A broadly diversified portfolio

Tetragon Financial Group is a closed-ended investment company traded on the London Stock Exchange (LSE) and Euronext Amsterdam. It invests in a broad variety of asset classes with exposure to public and private equities and credit (including distressed securities and structured credit), convertible bonds, real estate, venture capital, infrastructure, bank loans and TFG Asset Management, a diversified alternative asset manager. The company is domiciled in Guernsey and was founded in August 2005. Before 2018 Tetragon invested through the Tetragon Master Fund, which was amalgamated with Tetragon that year to simplify the structure and reporting. Tetragon's shares were admitted to trading on Euronext Amsterdam in April 2007 and listed on the Specialist Fund Segment of the LSE in November 2015 (ticker: TFG). In April 2018, an additional sterling LSE market quote was introduced under the ticker TFGS and cash dividends may be elected by investors to be paid in sterling, instead of the company's base operating and reporting currency (US dollars). The quoted shares available to investors on the listed exchanges do not hold any voting rights.

Tetragon is ultimately controlled by its co-founders Reade Griffith and Paddy Dear. They control the voting shares of the company, as well as Tetragon's investment manager – Tetragon Financial Management (TFM). They co-founded Polygon, which is wholly owned by TFG Asset Management, in 2002. TFM's investment committee, which determines Tetragon's investment strategy and approves every major investment, comprises Griffith and Dear as voting members, and Stephen Prince (Head of TFG Asset Management), who all have experience in alternative investments. Tetragon and Polygon employees cumulatively held 32.7% of outstanding non-voting shares of Tetragon at end-February 2021.

Investment process: Targeting risk-adjusted returns

The investment manager focuses on alternative asset classes that it believes offer 'intrinsic alpha' (excess returns relative to their assessed investment risk) and aims to diversify its portfolio of assets that are uncorrelated with broader financial markets. New investments analyses include evaluations of risk/reward, correlation, duration and liquidity characteristics. Tetragon searches for managers they believe to be high-quality specialists with successful track records and aims to invest not only into managed funds, but into the manager as well to supplement its returns with stable fee income and capital appreciation from growing third-party capital.

When assessing acquiring a stake in a new asset manager, TFM takes into consideration performance track record, reputation, regulatory requirements, infrastructure needs and asset-gathering capacity. To mitigate potential correlated risks across asset managers, Tetragon seeks to diversify exposure across asset classes, investment vehicles, durations and investor types.

Tetragon's approach to ESG

Tetragon acknowledges the importance of environmental, social, and corporate governance (ESG) factors in sustainable investing and sees evidence demonstrating a link between ESG performance and financial performance. In the investment process, the investment manager integrates ESG factors as supplementary information to investment decisions to help identify drivers of risk and return. It has also adopted a Statement on the UK Modern Slavery Act in its operations.

Having said that, we understand that Tetragon's ESG approach is still evolving and believe its investment manager (Tetragon Financial Management) could enhance its ESG profile, for instance by introducing and disclosing ESG-related targets for its own operations. Additionally, Tetragon may consider assigning voting rights to shares held by investors other than the co-founders. Moreover, while we understand that the level of disclosure provided by alternative funds on the underlying holdings has traditionally been more limited compared to listed equity funds, we still would like to see more disclosures on Tetragon's direct investments. Neither Tetragon nor Tetragon Financial Management has been assigned any external ESG rating at present.

Gearing: Fully invested with available capital

Tetragon's net debt as at end-February 2021 stands at a minor 0.6% (FY19: 2.3% net cash) compared to a significant cash reserve kept historically to maintain flexibility for opportunistic investments (2015–18 average net cash at 18% at year-end). In July 2020, Tetragon entered into a 10-year US$250m revolving credit facility (of which US$100m was drawn at end-December 2021), which replaced the former US$150m facility. The current allocation should limit the portfolio's cash drag, while available credit leaves Tetragon with ample dry powder to pursue new opportunities; we calculate that Tetragon has c US$250m (or 10% of its NAV) available to invest.

The facility has an interest rate at three-month US Libor+3.25%, compared to one-month US Libor+4.00% in the case of the previous facility. Additionally, Tetragon is obliged to pay a servicing fee of 0.015% of the total amount (nil previously) and non-usage fee of 0.5% on the undrawn amount (1% previously). The total costs Tetragon bore in FY20 associated with the facility stood at US$6.2m (FY19: US$3.5m).

Fees and charges

Tetragon pays a 1.5% pa management fee to TFM based on its net assets calculated monthly. TFM is also eligible to receive a quarterly incentive fee at a rate of 25% on the increase in NAV above a hurdle. The latter is calculated as the higher of the two prior quarter-end NAVs (adjusted for dividends and capital adjustments) plus a hurdle rate, which is equal to three-month US dollar Libor plus 2.65% per year (currently c 2.89% for Q120). If the hurdle is not met in any calculation period, the shortfall is not carried forward to future periods, which effectively means the high-water mark applies only to the two prior quarters. While the fees may seem relatively high, Tetragon's healthy historical performance (eg in terms of NAV returns) is stated net of all fees.

The board of directors is entitled to a fixed fee of US$0.4m pa (US$125k each member; Dear and Griffith waived their fee), which can be realised in the form of shares. Additionally, some senior employees of the structure are eligible to equity-based compensation. The shares are bought from the market and held in an escrow account until they are vested upon fulfilment of certain targets. During FY20 Tetragon released 1.7m shares from escrow and 1.5m from treasury shares as stock dividends and equity-based compensation. On the other hand, 6.6m has been bought back from the market.

Reade Griffith and Paddy Dear are owners of TFM. Mr Griffith is also employed by TFG Asset Management and is the chief investment officer of Polygon's event-driven European equity strategies. His current contract has been in place since July 2019 and includes US$9.5m paid in cash upon signing, US$3.75m paid in 2020 and up to 5.6m shares to be granted over seven years depending on performance, which are held in escrow. The employment replaces an earlier agreement, which included US$0.1m annual salary.

Capital structure

Tetragon's issued share capital consists of 10 voting shares and 139.7m non-voting shares. The voting shares are owned by the co-founders and are not entitled to any distributions; however, the co-founders also hold large stakes in Tetragon's non-voting shares. At end-2020, 88.8m shares were outstanding (93.1m on a fully diluted basis). Tetragon holds 40.0m shares in treasury (45% of the shares issued) and another 10.9m are held in escrow to fulfil future expected equity-based awards. Co-founders and employees held a total stake of 32.7% in Tetragon at end-February 2021. Tetragon uses gearing only to provide additional flexibility to the manager to take advantage of investment opportunities and temporarily bridge the gap between new investments and realisations.

The board

Tetragon's board comprises five directors, three of whom are independent. Each board member stands for re-election by Tetragon's voting shareholders each year at the AGM, with the voting shares controlled by Reade Griffith and Paddy Dear, the non-independent board directors appointed in 2007 and 2005, respectively. Both are co-founders of Tetragon, Polygon and TFM and are employed at various levels of the structure, including TFG Asset Management and Polygon.

Deron Haley, Steven Hart and David O'Leary were appointed independent directors in December 2018. Deron Haley is a founding partner and chief operating officer at the New York-based private equity firm Durational Capital Management. Steven Hart serves as president of Hart Capital, which he founded in 1998 as a family office to invest in a diversified portfolio of assets. David O'Leary retired from State Street Corporation in 2012, having served latterly as chief administrative officer.

General disclaimer and copyright

This report has been commissioned by Tetragon Financial Group and prepared and issued by Edison, in consideration of a fee payable by Tetragon Financial Group. Edison Investment Research standard fees are £49,500 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.