

# Tetragon Financial Group

Positive returns from all asset classes in Q316

Tetragon Financial Group (TFG) reported fair value earnings of US\$49.7m for the third quarter of 2016, with positive contributions made by all asset classes. NAV total return was 1.3% for the quarter and 7.8% for the nine months to 30 September 2016. Having completed a US\$100m tender offer in June 2016, TFG commenced a US\$50m tender offer on 9 November 2016, which should be meaningfully accretive to NAV per share given the current wide share price discount to NAV. Consistent with previous years, the third interim dividend was held in line with the second interim, confirming TFG's 5.9% yield.

12 months ending	Share price (%)	NAV (%)	MSCI AC World (%)	FTSE All-Share (%)	US 10y Govt Bond index (%)
31/10/12	45.4	25.9	9.2	9.6	7.7
31/10/13	15.7	8.6	24.0	22.4	(4.5)
31/10/14	11.3	11.2	8.3	0.6	5.2
31/10/15	(2.5)	14.5	0.5	(0.6)	3.9
31/10/16	26.4	10.2	2.6	(11.3)	4.6

Source: Thomson Datastream, Bloomberg, Edison Investment Research. Note: 12-month rolling discrete US dollar-adjusted total return performance up to last reported NAV.

## Positive Q316 and 9M16 performance

Positive contributions were made by all assets classes for both Q316 and 9M16 with notable contributions from US CLO 1.0 investments, equities (European event-driven and mining strategies) and distressed credit in the third quarter. While investment performance was positive over the nine months, the NAV uplift from the June 2016 US\$100m tender offer made a significant 5.0% contribution to TFG's 7.8% NAV total return. Offsetting this was a -3.3% effect from the rise in TFG's fully-diluted share count over the period. TFG Asset Management's AUM increased by US\$0.8bn to US\$18.6bn during the quarter.

## Outlook: Returns consistent with low-Libor backdrop

TFG management sees investment returns at the lower end of their 10-15% ROE target range as consistent with the current low-Libor environment. There have been no major changes to asset allocations. CLO equity exposure has declined to 24.2%, with US 1.0 and European CLOs continuing to amortise. However, TFG has outstanding commitments of US\$62m to the TCI II fund which is intended to be the main vehicle for future CLO activity. Real estate exposure is expected to increase through the drawdown of US\$25-75m of commitments and there is potential for new investments to be made in TFG Asset Management and mining finance. The November US\$50m tender offer will be value accretive, adding up to 2.3% to TFG's NAV total return in the fourth quarter.

## Valuation: Above-average discount and yield

Since February 2016, TFG's share price discount to NAV has narrowed from 56.3% to 43.1%. While below its 12-month average of 47.9%, the discount is significantly wider than its three-year low of 30.3%, leaving scope for further narrowing of the discount to strengthen future shareholder returns. TFG's 5.9% dividend yield ranks as one of the highest in the Flexible Investment sector peer group.

## Investment companies

28 November 2016

**Price** US\$11.19  
**Market cap** US\$1,096m  
**NAV\*** US\$1,925m

NAV per share\* US\$19.66

Discount to NAV 43.1%

\* As at 31 October 2016

Yield 5.9%

Fully-diluted shares in issue 97.9m

Code TFG

Primary exchange Euronext Amsterdam

Secondary exchange LSE Specialist Fund Segment

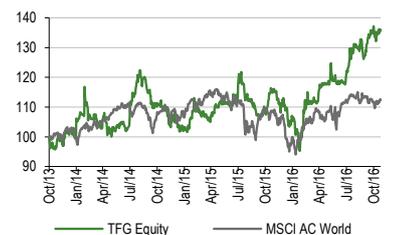
AIC sector Flexible Investment

Benchmark N/A

## Share price/discount performance



## Three-year performance vs index



52-week high/low US\$11.30 US\$8.35

NAV high/low US\$20.06 US\$18.41

## Gearing

Gross borrowings\* 2.0%

Net cash\* 21.7%

\*As at 30 September 2016

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### Exhibit 1: Company at a glance

#### Investment objective and fund background

TFG's investment 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. TFG's investment portfolio comprises a broad range of assets, including a diversified alternative asset management business, TFG Asset Management, and covers bank loans, real estate, equities, credit, convertible bonds and infrastructure.

#### Recent developments

- 9 November 2016: US\$50m tender offer commenced; expiry on 8 Dec 2016; pricing on 13 December 2016, followed promptly by settlement.
- 31 October 2016: Quarterly results to 30 September 2016 – NAV total return +1.3% vs FTSE All-Share -4.7%, both in US dollar terms.
- 28 October 2016: US\$0.1675 Q316 dividend declared vs US\$0.1625 in Q315.
- 28 September 2016: TFG joined Association of Investment Companies (AIC).

#### Forthcoming

Investor day	8 March 2017
Final results	2 March 2017
Year end	31 December
Dividend paid	May, Aug, Nov, Mar
Launch date	Aug 2005 (listed 19 April 2007)
Continuation vote	N/A

#### Capital structure

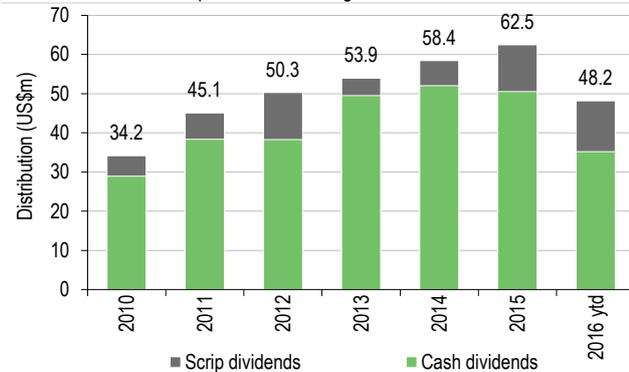
Ongoing charges	1.75%
Net cash	21.7%
Annual mgmt fee	1.5% of net assets
Performance fee	25% over hurdle
Company life	Indefinite
Loan facilities	US\$150m rolling credit facility

#### Fund details

Group	Tetragon Financial Group
Manager	Tetragon Financial Management
Address	1st Floor Dorey Court, Admiral Park St. Peter Port, Guernsey GY1 6HJ
Phone	+44 20 7901 8328
Website	<a href="http://www.tetragoninv.com">www.tetragoninv.com</a>

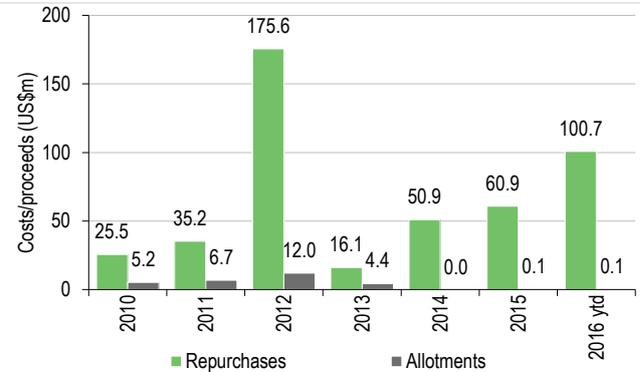
#### Dividend policy and history

TFG pursues a progressive dividend policy with a target payout ratio of 30-50% of normalised earnings. Dividends are paid quarterly. Since launch, TFG has distributed cash and scrip dividends totalling US\$474.4m.

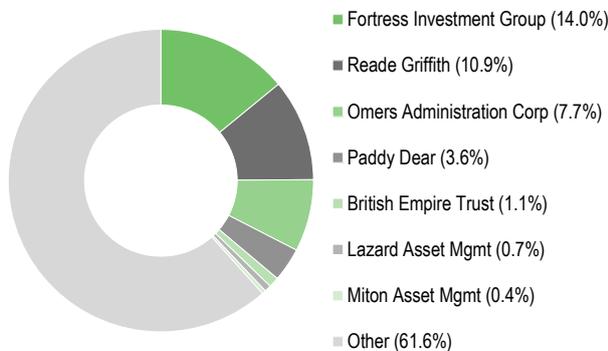


#### Share buyback policy and history

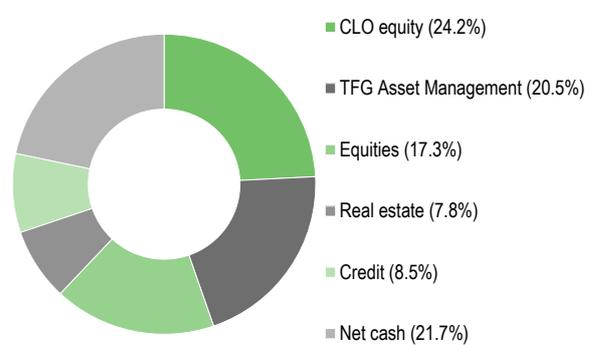
Since launch, TFG has repurchased 57.1m shares at a cost of US\$486.2m. US\$60m and US\$100m tender offers were completed in December 2015 and June 2016. A US\$50m tender offer was launched on 9 November 2016.



#### Shareholder base (as at 13 November 2016)



#### Portfolio exposure by asset class (as at 30 September 2016)



#### Top 10 holdings (as at 30 September 2016)

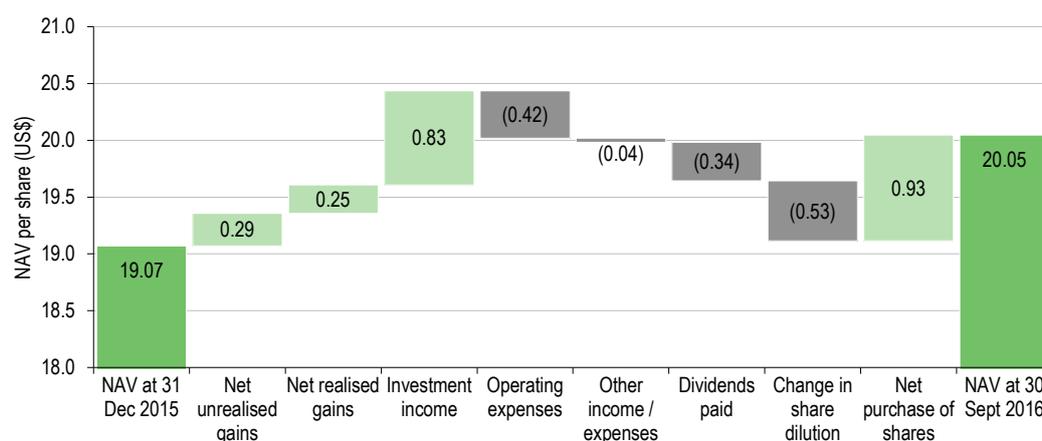
Holding	Investment type	Description	% of fair value NAV	
			30 September 2016	31 December 2015**
Equitix*	Asset Manager	£2.0bn UK infrastructure fund asset manager	8.5	8.7
Polygon European Equity Opp. Fund	Equities	European event driven equity hedge fund	8.4	7.0
Polygon Distressed Opp. Fund	Credit	Distressed opportunities hedge fund	5.4	4.8
LCM*	Asset Manager	US\$6.2bn CLO manager	5.3	5.5
GreenOak Real Estate*	Asset Manager	US\$7.1bn global real estate asset manager	3.4	3.5
Polygon*	Asset Manager	US\$1.6bn hedge fund manager	3.1	3.4
Polygon Convertible Opp. Fund	Credit	Event-driven credit hedge fund	2.5	2.2
Polygon Mining Opp. Fund	Equities	Mining related equity hedge fund	2.3	1.9
GreenOak US II Fund	Real Estate	US real estate fund	1.8	N/A
LCM XIX LP	CLO Equity	US broadly syndicated corporate loans (CLO)	1.7	1.6
<b>Top 10</b>			<b>42.4</b>	<b>40.3</b>

Source: Tetragon Financial Group, Morningstar, Thomson, Bloomberg, Edison Investment Research. Note: \*Part of TFG Asset Management. \*\*N/A where not in December 2015 top 10.

## Positive Q316 performance across asset classes

TFG generated fair value earnings of US\$49.7m in Q316, bringing net income for the first nine months of 2016 (9M16) to US\$94.8m, equating to an annualised return on equity (ROE) of 6.4%. Fully-diluted NAV per share increased from US\$19.96 to US\$20.05 during the third quarter. Taking into account payment of the US\$0.1675 second interim dividend, this equated to a 1.3% return for the quarter, bringing TFG's NAV total return to 7.8% for the nine months to 30 September 2016. Exhibit 2 illustrates the contributors to the US\$0.98 rise in TFG's NAV per share during the nine months, highlighting the uplift from the US\$100m tender offer in June 2016 and the dilutive effect of the rise in TFG's share price, which increased the number of in-the-money issued share options.

**Exhibit 2: TFG's fully-diluted NAV per share progression in 9M16**



Source: Tetragon Financial Group, Edison Investment Research

During Q316, all asset classes made a positive contribution to TFG's US\$70.9m gross investment returns (comprising investment income, realised and unrealised gains). Noteworthy contributions included US\$20.6m from US CLO 1.0 investments, US\$20.3m from equities (European event-driven and mining strategies) and US\$9.9m from distressed credit. This brought TFG's gross investment returns for the nine months to US\$140.0m.

Operating expenses increased in Q316, primarily due to management and performance fees rising to US\$18.4m for the quarter from US\$10.5m in Q216 and US\$8.8m in Q116. The fee increase principally comprises a higher performance fee accrual during the quarter, reflecting the strong underlying performance.

TFG declared a dividend of US\$0.1675 per share for Q316, which was 3.1% higher than Q315, giving a rolling 12-month dividend growth of 3.9%. Following a similar pattern to previous years, the Q316 dividend was in line with the Q216 dividend, which was 1.5% higher than the US\$0.1650 dividends paid for Q116 and Q415.

TFG's fully-diluted share count decreased from 104.2m to 97.1m over the nine months to 30 September 2016. The main element of this change was the 10.0m share repurchase under the June 2016 US\$100m tender offer. Other factors include the issue of shares to satisfy stock dividends, an increase in the number of in-the-money options due to the rise in TFG's share price over the period, and the implementation of equity-based compensation plans for certain senior employees of TFG Asset Management, under which 5.1m shares were awarded, which vest over a period of up to eight years. TFG's fully diluted share count rose to 97.9m at end-October 2016, primarily due to the 6.1% rise in TFG's share price during the month, increasing the intrinsic value of in-the-money options.

## **New investments and commitments**

During the third quarter, TFG made a US\$12.0m additional capital commitment to the TCI II CLO Equity fund, bringing TFG's total capital commitments to US\$62.0m, with no capital yet called as at end-September 2016. Also in the third quarter, TFG made some additional capital contributions to existing GreenOak-managed real estate investment programmes across Europe, the US and Asia. In September 2016, an additional US\$7.0m subscription was made into the Polygon European Equity Fund. A £3.0m direct loan was made to GreenOak in connection with its acquisition of UK property adviser, Grafton Advisors.

## **Asset sales and redemptions**

TFG sold one US CLO 1.0 equity investment during the third quarter, realising gross proceeds of US\$33.0m. In the same period, TFG realised US\$20.4m in capital and income through distributions from a number of GreenOak-managed real estate investment programmes, across Europe, the US and Asia. Shortly after the quarter end, TFG initiated an optional early redemption of another US CLO 1.0 transaction.

## **November 2016 US\$50m tender offer**

TFG commenced a US\$50m tender offer on 9 November 2016 which is scheduled to expire on 8 December 2016, with pricing on 13 December 2016, followed promptly by settlement. This offer follows TFG's US\$100m tender offer in June 2016 under which 10m TFG non-voting shares were repurchased. While the repurchase of shares through the tender offer will reduce TFG's net assets, with the tender offer price range of US\$10.80 to US\$12.00 at a substantial discount to NAV, the repurchase will be meaningfully accretive to NAV per share. Based on TFG's US\$20.05 fair value NAV per share and 97.1m fully diluted shares at 30 September 2016, repurchasing the maximum 4.6m shares at US\$10.80 per share would increase NAV per share by an estimated 2.3% to US\$20.51. The effect of this uplift would be to increase TFG's NAV total return from 7.8% for the first nine months of 2016 to 10.3%.

In addition to the tender offer, TFG agreed to repurchase 0.6m TFG shares held by Michael Humphries, a manager of certain Polygon funds, at the volume-weighted average price (VWAP) per share for the first 10 trading days in November 2016. Based on a VWAP of US\$11.00, this share repurchase would increase NAV per share by a further 0.3% or US\$0.06.

## **Cash and borrowings**

TFG continues to maintain a significant cash holding to cover future commitments and to enable it to capitalise on opportunistic investments. During the third quarter, TFG's net cash position increased from US\$382.0m to US\$423.7m, representing 21.7% of TFG's fair value net assets at 30 September 2016. Operating and investment net cash inflow of US\$52.2m more than covered the US\$10.2m dividend payment during the quarter. Management sees the net cash position as close to the optimum level on a 12-month view given TFG's current commitments, with prospective investments of US\$100m in CLOs, US\$75m in real estate and US\$100m via Hawke's Point as well as the latest US\$50m tender offer and annual dividend payments of c US\$70m.

In April 2016, TFG arranged a US\$75m three-year revolving credit facility, which was increased to US\$150m in August 2016. This facility provides TFG with flexibility to make opportunistic investments; there is no intention to introduce structural leverage at the corporate level. US\$38.0m was drawn against this facility at 30 September 2016.

## Valuation

As illustrated in Exhibit 3, having followed a widening trend from September 2014 to February 2016, TFG's share price discount to NAV has narrowed over the last nine months. The current 43.1% discount is only marginally wider than its 42.8% three-year average but is still significantly wider than its three-year low of 30.3%, leaving considerable scope for further narrowing of the discount to strengthen future shareholder returns. The current US\$50m tender offer is likely to provide near-term support to the share price and hence the discount.

**Exhibit 3: Share price discount to NAV over three years (%)**



Source: Thomson Datastream, Edison Investment Research

## Peer group comparison

Exhibit 4 shows a comparison of TFG with the other constituents of the AIC Flexible Investment sector, which comprises companies with a diverse range of investment strategies; and selected other investment companies focused on CLO securities. Although no longer its primary focus, CLO securities represent TFG's largest portfolio exposure. Blackstone/GSO Loan Financing, Carador Income Fund and Fair Oaks Income Fund are all constituents of the AIC Sector Specialist: Debt sector.

TFG's NAV total return has significantly outperformed the Flexible Investment sector average over one, three and five years, ranking at the top of the sector in all three periods. In comparison with the other selected peers, TFG's NAV total return is similar over one and five years, and significantly ahead over three years. Although it has been narrowing recently, TFG's share price discount to NAV remains the widest across both peer groups, suggesting that factors including lack of investor awareness and perceived lack of share liquidity may be weighing on the share price. While TFG's ongoing charge is the highest in the Flexible Investment sector, it is similar to Carador Income Fund among the selected peers. TFG's structural cash position means that it has no net gearing, similar to the majority of peers. TFG's 5.9% dividend yield is one of the highest in the Flexible Investment sector, significantly ahead of the 2.3% average yield of the nine dividend-paying funds, although lower than the other selected peers investing primarily in CLOs.

**Exhibit 4: Flexible investment and specialist debt peer group as at 24 November 2016**

% unless stated	Market cap US\$m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Tetragon Financial	1,095.5	10.2	40.3	91.9	(43.1)	1.75	Yes	100	5.9
BACIT	630.6	(13.8)	(8.6)		1.7	1.27	No	100	1.7
BlackRock Income Strategies	344.5	(24.6)	(26.1)	(2.3)	(15.1)	0.69	No	112	6.3
Capital Gearing	180.4	(10.2)	(9.0)	1.5	1.6	1.03	No	100	0.5
Henderson Alternative Strategies	140.8	(7.2)	(16.9)	(24.9)	(15.0)	0.97	Yes	100	1.3
Invesco Perp Select Balanced	11.3	(12.5)	(13.0)		(0.4)	1.20	No	100	0.0
Miton Global Opportunities	66.3	2.4	1.8	22.9	(5.5)	1.16	No	103	0.0
New Star Investment Trust	86.8	(1.6)	(1.1)	5.8	(28.7)	0.92	Yes	100	0.3
Personal Assets	906.0	(9.6)	(8.4)	(0.8)	1.5	0.95	No	100	1.5
RIT Capital Partners	3,532.3	(9.7)	2.7	23.8	8.7	1.34	Yes	103	1.7
Ruffer Investment Company	457.0	(13.2)	(15.0)	(2.7)	3.7	1.17	No	100	1.5
<b>Flexible Investment sector average</b>	<b>677.4</b>	<b>(8.2)</b>	<b>(4.9)</b>	<b>12.8</b>	<b>(8.2)</b>	<b>1.13</b>		<b>102</b>	<b>1.9</b>
<b>TFG's rank in sector</b>	<b>2</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>11</b>	<b>1</b>		<b>4</b>	<b>2</b>
<b>Other selected peers</b>									
Blackstone/GSO Loan Financing	334.3	6.0			(1.9)	0.45	No	100	10.3
Carador Income Fund	381.6	9.4	12.6	95.4	(6.3)	1.86	Yes	100	12.8
Fair Oaks Income Fund	304.2	14.9			(2.5)	0.60	No	100	10.3
<b>Selected peer average</b>	<b>340.0</b>	<b>10.1</b>	<b>12.6</b>	<b>95.4</b>	<b>(3.6)</b>	<b>0.97</b>		<b>100</b>	<b>11.1</b>

Source: Morningstar, Edison Investment Research. Note: Performance data to end-October 2016. TR = total return in US\$ terms. Net gearing is total assets less cash and equivalents as a percentage of net assets.

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