Tideway

Tideway Asset Management
Guide to Hybrid Capital

2019

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TIDEWAY ASSET MANAGEMENT

Tideway's "2019 Guide to Hybrid Capital" sheds light on a market that is not easily accessed by anyone other than full-time fixed income professionals.

With over $1 Trillion* now outstanding, the global Hybrid Capital market offers plenty of choice for investors across different industries, credit ratings and time horizons.

Successful investing over the long term requires attention to detail and a real appreciation for the risks involved.

In particular, we draw attention to the new environment for bank bonds which require more research than ever given the increased chances of capital write-down under stress and of course to "extension risk" where bonds are not called at the first opportunity by the issuer if coupon resets are relatively low.

On the positive side, with bank and insurance regulatory capital requirements remaining high, a large opportunity set will be available for the foreseeable future.

We hope that you share our enthusiasm for an asset class that has a long history of delivering positive returns after inflation with a high degree of certainty and with limited capital losses.

PETER DOHERTY

MANAGING PARTNER
CHIEF INVESTMENT OFFICER

GUILLAUME DESQUEYROUX, CFA

CREDIT PORTFOLIO MANAGER

** Barclays, Credit Sights data January 2019*

THE BASICS OF HYBRID CAPITAL

WHAT IS HYBRID CAPITAL?

Hybrid Capital is a form of capital that falls between debt and equity. The features of each specific hybrid define where it sits on the debt/equity spectrum.

INSTRUMENT	TYPICAL FEATURES
DEBT	• Mandatory repayment of interest and principal • Non-payment = “event of default” • Dated • Fixed principal value
HYBRID CAPITAL	• Deferral or non-payment of interest is not an “event of default” • Possible write down of principal value or conversion into equity • Dated or undated (perpetual) • Fixed principal value prior to any conversion
EQUITY	• Optional dividends • Undated • Variable capital value

WHY INVEST IN HYBRID CAPITAL?

Hybrid capital offers:

- A higher return than ordinary debt but with more risk and volatility
- Higher cash flow than common equity dividends
- A return typically well ahead of inflation
- Less volatility than equity investing
- More certainty of future capital value than equity but with limited capital upside
- Exposure to large, household name, investment grade companies
- Investment in companies with long track records of meeting all obligations

THE BASICS OF HYBRID CAPITAL

HYBRID TERMS AND CONDITIONS

The lowest risk Hybrids rank just below ordinary Senior debt. Coupons must be paid on time and in full and principal repayment is on a fixed date. However, these bonds rank below Senior debt in liquidation or an "Event of Default", so there is some risk of loss through a lower recovery in the event of bankruptcy. Somewhat higher risk Hybrids provide much more flexibility for the borrower regarding interest payments, although no borrower misses a payment without seriously impacting its viability and considering a lot of other alternatives first.

Redemption – "Dated" or "Callable Perpetual"

Hybrid bonds with a fixed maturity date offer certainty as to when principal will be returned. These are known as "dated" or "bullet" bonds. Non-timely repayment of principal for a dated bond is an "Event of Default".

However, many Hybrids are issued as "Callable Perpetual" bonds. Perpetual means that the bonds have no stated maturity date and could, in theory, remain outstanding forever. Perpetual Hybrids are "Callable" meaning that the issuer has the right to repay the bonds (at 100/nominal value) on a given date or series of dates. The rate of interest paid may change at the first call date and, importantly, the regulatory and rating agency equity capital content may also change (diminish).

Non-payment

Non-payment is almost always a decision made by a borrower in response to financial distress. Missing a payment is usually "optional", but it can occasionally be "mandatory" depending on the terms of the Hybrid. For example, certain Hybrids issued in heavily regulated industries such as Banking and Insurance also have clauses (triggers) which can make non-payment of interest a mandatory event i.e. the regulator can prevent payment even if the company would like to make the payment (again most likely at a time of financial distress). Mandatory triggers are usually based on a specific event (e.g. bank regulatory capital threshold or insurance company solvency ratio) and their inclusion imparts a higher degree of risk on the investor.

Cumulative or Non-Cumulative

"Cumulative" means the issuer has to ultimately repay missed payments, usually at the end of a given period e.g. "5 years" otherwise an "Event of Default" is declared. "Non-cumulative" means the issuer does not have to make up missed payments and there is no technical "Event of Default" on non-payment. Non-cumulative Hybrids rank lower than cumulative ones in the capital structure and have a higher equity component.

Dividend Pusher and Dividend Stopper

If payments are missed, the issuer is usually restricted from making payments on any other equal ranking or more subordinated instruments, including common and preferred stock dividends, and also cannot make repurchases of the same without making good on missed payments.

A "dividend pusher" means the coupon is mandatory if remuneration is given to any other specified security or class of securities with equal or lower seniority within a specified period of time. A "dividend stopper" or "blocker" is a term which states that the issuer will not, within a specified period of time pay a coupon on another security or class of securities of equal or lower seniority if it does not make payment on the security in question. Many securities also contain a "redemption blocker" which states that, following a deferred coupon, the issuer will not redeem (or call) other securities of equal or lower ranking until coupons have been resumed and paid for a certain period of time (usually 12 months) on the security in question.

A notable exception to this capital structure hierarchy is seen in Contingent Convertibles (Cocos), a type of Tier 1 bank capital where coupons can be skipped even if a dividend is paid. Insurance Restricted Tier 1 instruments (RT1s) fall into the same category.

THE BASICS OF HYBRID CAPITAL

Changes to Nominal Value

Some Hybrids have clauses affecting the nominal value such as “Equity Conversion” or “Write down / Write up”. Examples include bank Additional Tier 1 instruments (AT1 also known as CoCos) which are converted to common equity in the event of a bank’s core capital ratio hitting a pre-defined trigger below current levels. A similar situation exists for Insurers with their RT1s hybrids: the conversion/write-down may happen when the Solvency or Minimum Capital Requirements are breached (Solvency II framework). Strictly speaking, the nominal value of equity offered in exchange at the price set in the Hybrid terms and conditions may not constitute a drop in nominal value. However, the value of equity at the time of conversion would represent a significant mark down of capital value (see the section below on Banco Popular for example).

Features affecting principal values are punitive for investors but, initially at least, the trigger events are very remote and have a very low probability of occurring. However, in the event that things do go wrong, the losses imposed on investors are severe and it is for this reason that investors demand high returns to buy Hybrids with these particular features embedded.

In summary, many callable perpetual Hybrids are designed to be called at the first date, at which time the issuer may elect to re-issue a new Hybrid subject to market conditions.

If a callable perpetual remains outstanding after the first call date, there will be an immediate assessment by investors of the implications of the bond not being called. If the coupon rate after the call is at the current market rate, there will be little impact on the bond price. However, if the interest rate changes and is lower than could reasonably be expected to be paid by the issuer, the bond may trade down in price quite materially. Issuers who experience a deterioration in their credit profiles may opt to leave bonds outstanding if the replacement cost is high. This is not the standard practice in Europe, but a risk factor nonetheless.

As ever with bonds, things can be more complicated. Hybrid bonds issued specifically to provide regulatory capital or to obtain “equity credit” from rating agencies may, depending on the Terms and Conditions at the time of issue, be called at 100 in the event that there is a “regulatory change” that disqualifies the notes from counting as capital or a “methodology change” from the rating agencies that removes “equity credit”.

THE BASICS OF HYBRID CAPITAL

HYBRID CAPITAL VERSUS HIGH YIELD BONDS

One alternative investment to Hybrid Capital is traditional "High Yield" debt.

The major differences between High Yield debt and Hybrid Capital are that High Yield issuers themselves normally have leveraged balance sheets, relatively small enterprise values and are generally more exposed to single event risk.

In contrast, Hybrid Capital is issued by relatively large, safe, well capitalised companies with resilient, diversified businesses.

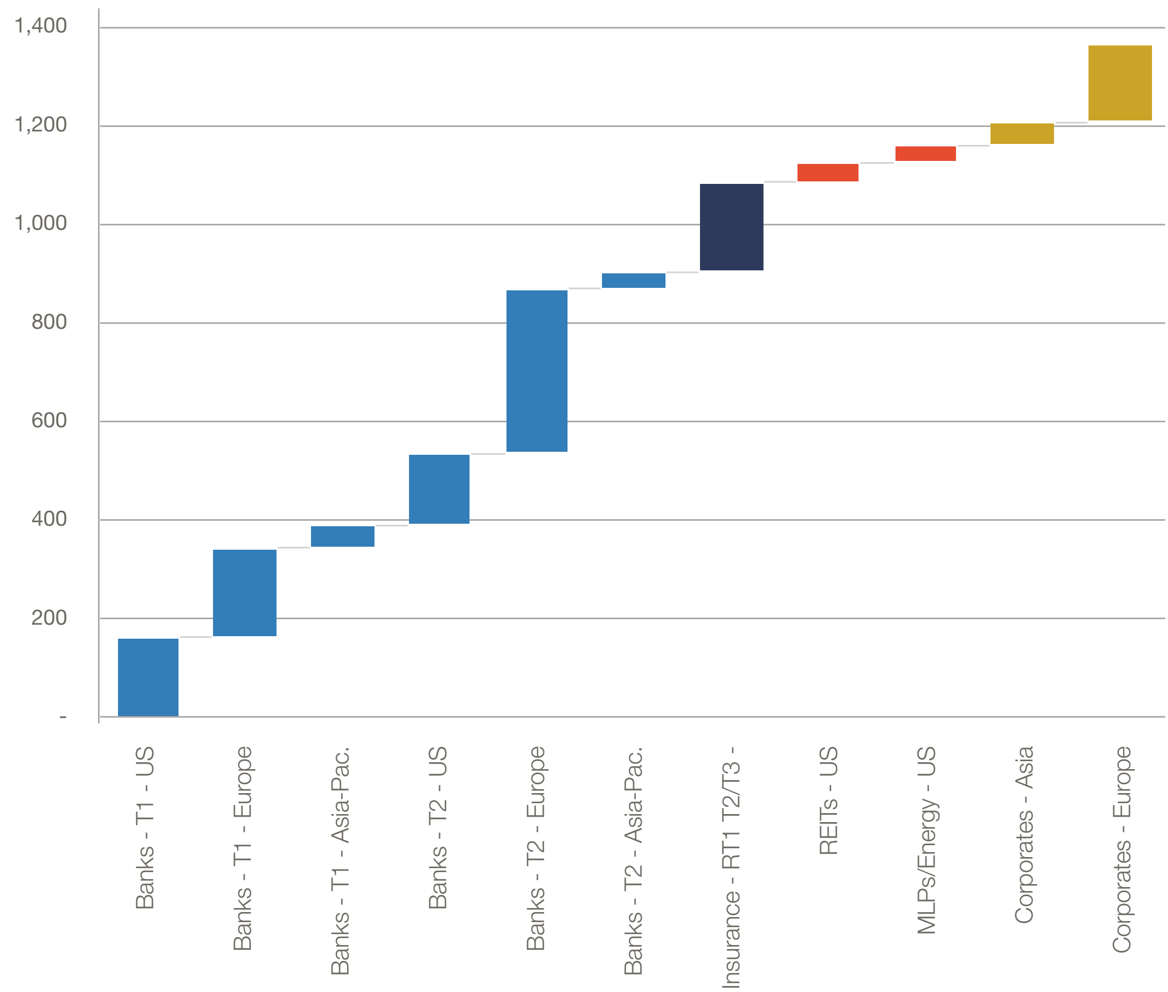
In tough times, the large companies have a pool of resources to call on and are generally respectful of the rights of stakeholders including investors across the capital structure.

In summary, all else being equal, Hybrid Capital may have advantages over High Yield debt including the qualitative benefit of being invested in a large, public company where reputation and brand value are critical.

Finally, in times of financial market stress, Hybrids issued by the bigger household names may be easier to trade than High Yield names with weaker credit profiles.

Specifically, in 2019, Bank of America Merrill Lynch is forecasting defaults of over 5 % in Global High Yield*. In contrast, there is no comparable number for the Global Hybrid Capital market because there is no consensus expectation that Hybrid Issuers will default. This is not to say that losses in Hybrids will be zero - if a major financial institution were to write down bonds that would be headline news – but it is safe to say defaults of 5 % in the $1 Trillion** Global Hybrid Capital Market are extremely unlikely.

OVERVIEW OF THE $1TR+ GLOBAL HYBRID CAPITAL MARKET (IN $BN)



Source: Barclays and Credit Sights, January 2019

** Is this the big one? BAML High Yield Strategy, January 2019*

*** Barclays and Credit Sights data January 2019*

DYNAMICS OF THE HYBRID CAPITAL MARKET

WHO ISSUES HYBRID CAPITAL AND WHY?

Hybrid Capital is issued by the largest Banks, Insurance Companies and Corporations to provide balance sheet flexibility and to allow compliance with regulatory and credit rating agency capital requirements without diluting ordinary shareholders.

Hybrid Capital shares risk with investors primarily through features such as "optional non-payment of interest" or "optional principal write-down" in certain pre-defined circumstances.

These options mean that at different times the Hybrids behave in part like equity and therefore regulators (e.g. Basel Committee, European Central Bank and Bank of England) and credit rating agencies (e.g. Moody's and Standard & Poor's) allocate "equity credit" on the balance sheet of the issuing company. This allows the issuing company to maintain a given credit rating and meet regulatory capital requirements.

To strengthen a balance sheet there is no cleaner solution than issuing more common equity. However, whilst it is true that ordinary equity capital is free from repayment obligations, it also lacks tax advantaged status.

Effectively Hybrid Capital provides an issuer with a lower cost of equity on an after-tax basis.

A couple of bits of news regarding this particular feature shook up the Hybrid Capital market in 2018: Firstly, the Dutch authority has challenged the tax deductibility of bank AT1s in its jurisdiction. Over the summer, it reintroduced the debate on the difference of treatment versus corporate hybrid. The removal of tax deductibility for AT1s could occur in other EU countries. The UK government reacted and took the decision to offer the same treatment to corporate issuers to bridge the gap. However, it also opined on the write-down feature on RT1 and the potential taxed gain implied, contradicting the efforts of the Prudential Regulation Authority (PRA) during the year. All in all, the tax component will remain a political feature which is expected to maintain volatility around the deepest subordinated Hybrid Capital.

Furthermore, "Return on Equity" is a key metric for many investors and if a company has a large common equity base then it may struggle to deliver an adequate return on this capital.

From the borrower's perspective, Hybrids usually have tax deductible interest because as a fixed obligation (in the form of interest and principal owed) most are treated as debt in this regard. A fixed obligation is one with a pre-determined principal value and defined dates for repayment.

On the balance sheet, Hybrids may be accounted for partially as a debt liability and partially as equity. From an accounting perspective, most Hybrids are treated as debt, whereas Preferred Shares count as equity depending on instrument-specific Terms and Conditions.

MARKET OUTLOOK

The Hybrid Capital market has grown substantially since the financial crisis, in no small part because of the dramatic increase in the amount and quality of capital required by banking regulators across the globe. We have introduced a glossary in the appendices as this section introduces most of the technical terms specific to the current Hybrid market in Europe.

For European Banks, most of the Tier 1 and 2 have been issued with the focus on the more senior debt for net issuance in 2019. Still, with c. €450Bn in the market, sizeable volumes will need to be refinanced. In European Insurance, Solvency II came into effect from January 2016 and seems to secure a €140Bn market going forward with further capital optimisation on the roadmap. Finally, corporates will maintain their funding in line with GDP and already offer €140Bn. Overall, Europe should have some €720Bn+ on the table by the end of 2019.

DYNAMICS OF THE HYBRID CAPITAL MARKET

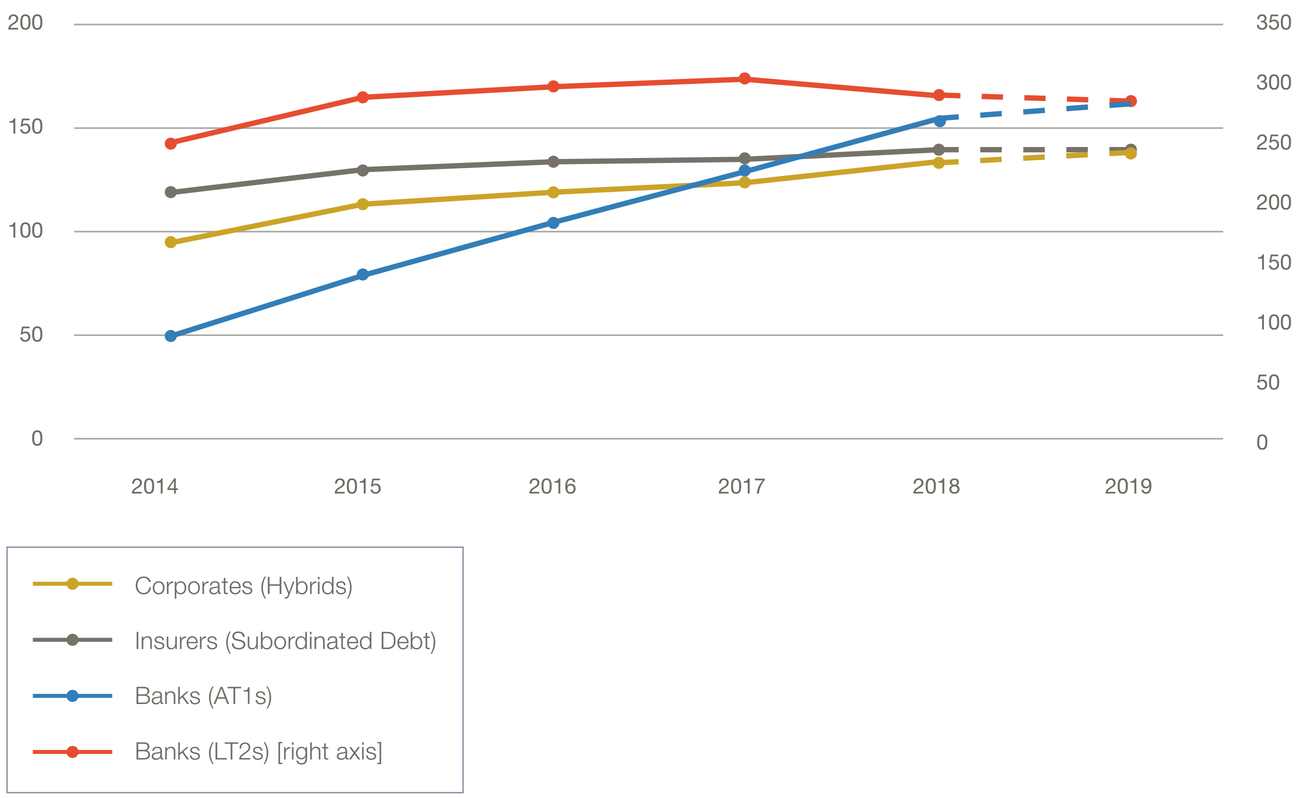
Banks

While the amendments to the Bank Recovery and Resolution Directive and the Capital Requirements Regulation (respectively known as BRRD2 and CRR2) remain to be decided - hopefully - in 2019 by the European institutions, the various central banks involved have made tremendous progress to reinforce the capital structure of their banks over the last five years. In 2017 alone, they clarified the calculation with regards to Pillar 2 capital requirements and specific minimum thresholds for AT1 and Tier 2 (T2) debts. This supported issuance for these two categories whilst positive performance of the sector offered room for further issuance (and for smaller names). In 2018, most banks received more clarity regarding their Minimum Requirement for Own Funds & Eligible Liabilities (MREL). While the requirement hurdle has reduced from conservative/punitive to more attainable levels, the banks have proactively issued lower-risk subordinated debt in anticipation, to complement its capital structure.

What can 2019 offer on the supply side? First, MREL is far from being achieved yet. The primary market should remain buoyant on the less subordinated debt (UK HoldCo Senior are one example). The wider spread should not deter issuers to be active on this side of the debt spectrum. It can potentially bring back some confidence to creditors to the sector.

Regarding the more subordinated debts - AT1 and T2-, as explained, the banks have already done most of the heavy lifting. The primary market has entered its replacement phase for these products. Only smaller issuers could add their initial AT1 (marginal size). Barclays* estimates that € 14Bn of AT1 will need to be redeemed in 2019 but given the recent sell-off in H2 2018, some issuers may decide to extend the existing debt, simply on economic basis. The regulatory pressure to call the old debt (CRR1 grand-fathered bonds) back will also help to maintain a decent turnover. However, the issuers will try to wait as long as possible as Q1 2019 does not look like the perfect window to issue additional paper. The geopolitical risk and the macro pressure need to reduce for the banks to place better coupons.

MARKET SIZE IN €BN EQUIVALENT - EUROPEAN ISSUERS (£, $, € COMBINED)



Source: Barclays and CreditSights, December 2018

** Hybrid supply outlook for 2019 – Barclays Research, December 2018*

DYNAMICS OF THE HYBRID CAPITAL MARKET

Eventually, with the conclusion of CRR2 on the agenda, it is likely to result in non-compliant debt that will need to be replaced over the next few years, supportive to the primary markets (mainly AT1 and T2). Liability-Management Exercise (LME) activity on legacy instruments (Discos and non-capital-compliant bonds) can be an additional reason for further turnover on the T2s. The overall picture for the T2 remains a negative net issuance, given more than € 22Bn of redemption expected by Barclays* during the year and further capital optimisation for MREL.

Insurers

The insurance sector remains very specific on its capital structure. The regulatory pressure has been much lower than on the banks due to less stringent deadlines and a more flexible Solvency II framework.

As a result, the insurers have concentrated their efforts over the last years in issuing T2s, and T3s to a lesser extent. The RT1 market is still young even though some large names like Phoenix have initiated their RT1 programme. It would need other households to bring more volume in this specific instrument. Inevitably, the insurers will consider this option to gradually optimise their capital structure. New accounting rules (IFRS16) may encourage some issuers to be more active to preserve their Solvency II ratio in investor-friendly levels, far away from any trigger. Overall the market size should remain in line with 2018, after a few years of little growth (somewhere between 0% and 4% growth over the last three years) due to very limited pressure to do more.

Corporates

For corporates, the game for issuers does not depend so much on their respective regulator when it comes to their capital; it is all about the rating agencies and their methodologies. When Hybrids were brought to the market -years ago- the rating agencies tried to form an opinion regarding the “equity credit” to allocate to these new products. Each rating agency presented its own criteria for Hybrid to be eligible for equity recognition (effective duration, step-up, etc). Since then, they have come back with updated criteria and methodologies at various points.

As a result, the corporates have been occasionally urged to reissue some of their debt to align their debt stack accordingly. And professional investors have often speculated in anticipation of further changes. The most recent example has been the change in methodology from S&P in early 2018. It relaxed the refinancing guidelines for Hybrid Capital. Issuers took this opportunity to replace some of their existing hybrids ahead of schedule (i.e. call date) without losing the equity content. The objective was both to replace expensive debt with new debt at a much lower coupon and to smooth their refinancing profile. All in all, it seems reasonable to anticipate a net issuance in line with GDP growth and some opportunistic refinancing (3% increase, i.e. €5Bn-10Bn).

WHEN INSURERS TRY TO OPTIMISE THEIR BALANCE SHEETS

Earlier in 2018, Standard Life Aberdeen (SLA) partnered with Phoenix to reorganise its business model. It might have appeared as a surprise to analysts after the recent merger in August 2017 of the two major asset managers: Standard Life and Aberdeen Asset Management have created Europe’s second-biggest fund manager. In fact, people were mainly focused on the painful cost-saving programme which the new entity had to endure at that time. SLA top management decided to make a radical change to its operational tool instead through a partnership with Phoenix (and a 20% capital participation).

Phoenix is the largest back book consolidator in the UK (and Europe) and is gradually capturing the capital-heavy business that SLA underwrites. The remainder is a capital-light and fee-based asset manager with (much) less capital requirement to meet as SLA will move from a Solvency II regulatory framework to a CRD IV framework. In short, it has freed up capital to shareholders with one partnership. Not bad. The interesting piece is that SLA hybrid debt was only Solvency II-compliant. So, the business decision made on one side forced the management to tender most of its debt on the other side.

** Hybrid supply outlook for 2019 – Barclays Research, December 2018*

DYNAMICS OF THE HYBRID CAPITAL MARKET

Another major insurer that has been active in 2018 in considering its capital position is Prudential. With a great and diversified business model in the US / Asia / Europe (mainly UK) and positioned as a UK-based entity, Prudential has historically been regulated under the UK PRA Solvency II framework (so has SLA). They have decided to isolate the UK-based business (UK pension and asset management) into a new entity, M&G Pru, to remain under Solvency II regime. The incumbent entity, Prudential plc (Asian and American businesses) has been moved to Hong-Kong, closer to the key markets… and towards a much more lenient regulator; the Hong-Kong Insurance Authority sticks to the Solvency I regime featuring more simplistic capital requirements.

Prudential plc's business will be monitored at local level only and Hong-Kong will be the overall supervisor. The demerger preparation has been a delicate exercise with debt issued for the new entity, M&G Pru, before its official existence. They clearly stated the intention to supply the same capital buffer and risk management to the two new entities. However, the foggy situation secured a premium, which the historical entity would not have suffered in comparable terms.

Overall, insurers have experimented the new regulatory framework and adjusted their business model. Many other names could be mentioned to illustrate the change. These two are the recent most pertinent examples.

WHAT ARE THE REALISED LOSSES IN HYBRID CAPITAL?

Hybrid Capital prices will always be more volatile than liquid government bonds and senior investment grade bonds of a similar duration. However, over the longer term – ten years or more – it is the lower yielding instruments that are riskier investments because inflation erodes their capital value in real terms.

Price volatility is almost universally used as a proxy for risk but for a buy and hold investor, volatility is far from synonymous with risk. For the great majority of investors who can – and should - invest with a horizon of more than 10 years, market-driven price declines are unimportant. The focus should remain fixed on capturing gains and compounding returns so that the real value of capital increases over the life of the investment. A diversified portfolio of Hybrid Capital, bought over time, will prove far less risky in terms of maintaining real capital value than most traditional fixed income portfolios.

Equally, Hybrid Capital portfolio returns are not likely to be improved by active trading, attempts to time the market, high portfolio concentration or excessive leverage.

Using data from the £ GBP Hybrid Capital market it can be shown that actual losses suffered by investors are small indeed and, unsurprisingly, have been centred around the financial crisis. Aggregate losses from 1997 - 2017 amount to approximately £3 billion in total; over that 20-year period, Hybrids paid out about £3 billion per annum of interest meaning that the realised total losses from a passive portfolio are roughly equal to 1/20th of the total return assuming no disposals at a profit or re-investment at higher rates. This conservative approach estimates total realised losses at about 25 bps p.a. and includes:

- In 2009, Bradford & Bingley suspended coupons on various Hybrid Capital instruments totalling £325 million. When Bradford & Bingley was nationalised in 2008, the Transfer Order modified the rights associated with dated subordinated notes, by stating that "a default in the payment of any principal due in respect of a dated subordinated note shall not constitute an event of default under the note".
- Also in 2009, Northern Rock announced that it was deferring interest payments on its Tier 1 and Upper Tier 2 securities, i.e. where the coupon was discretionary. This affected eight issues: six Upper Tier 2 and two Tier 1 securities. The bank had already stopped paying the coupon on the preference shares that were acquired by the government when Northern Rock was nationalised. The securities included four GBP issues totalling £720 million.
- Again in 2009, RBS and Lloyds announced they would be deferring coupons on a large number of Tier 1 and Upper Tier 2 securities, for a 2-year period from January 2010, as a condition of state aid approval from the European Commission. Lloyds also offered to swap hybrids into ECNs at exchange rates ranging from 68% to 100% of par, while RBS made various cash tender offers ranging from 56% to 100% of par. All deferred coupons will be subsequently repaid.

DYNAMICS OF THE HYBRID CAPITAL MARKET

- In 2013 the Co-Op Bank held a coercive debt swap, with Lower Tier 2 (£907 million) exchanged for shares and new Tier 2 notes, with Upper Tier 2 (£310 million) and Tier 1 (£60 million) notes converted into new instruments at heavy discounts to par.

There are more recent examples of distressed banks and resolution from continental Europe.

In 2017, Banco Popular was taken over by Banco Santander and as part of the rescue cancelled €2Bn+ of bonds (as well as shareholder equity) across AT1, legacy T1 and Tier 2 (see below).

Italian names have also been subject to bail-in, however, the SRB has decided that the case of Banca Popolare di Vicenza S.p.A. and Veneto Banca S.p.A. intervention was not warranted. As a result, the winding up of these banks has taken place under national proceedings launched by the Italian authorities (with a cash injection by the Italian Treasury into Intesa San Paolo, the acquirer of the "good" businesses.)

In 2018, German banks entered the spotlight: It started with HSH Nordbank (HSH) which turned towards private investors in March when The State of Hamburg and Schleswig-Holstein made an eleventh-hour decision to sell its shares to private investors. HSH announcement to skip Tier 1 coupons up to 2024 and the potential need for further credit loss provisions had a material impact to the bond price.

Three other German banks displayed poor relative results under the 2018 ECB stress tests. At the bottom of the list was one of the regional banks, NORDLB with a CET1 ratio of only 7.07% under the 2018 stress test versus an official trigger at 7%. Although anticipated, the management made a clear statement to open its capital structure to external investors away from the State of Lower Saxony, the major shareholder. In reality, the bank has been through several efforts to clean up its loan book in recent years, cancelling various Tier 1 coupons and implementing a partial capital write-down. Bondholders should remain concerned regarding recovery of their initial investment throughout this process.

BANCO POPULAR (SPAIN) – THE FIRST ONE TO BITE THE SINGLE RESOLUTION DUST

This €150Bn-total-assets bank is now famous for being the first resolution case under the BRRD (Bank Recovery and Resolution Directive) framework. On June 7th 2017, its hybrid debt was wiped out overnight as part of the decision from the resolution authorities to use the sale of business tool, which permits the disposal of a bank's assets / liabilities and the transfer to a private purchaser.* A few lessons from this case:

Firstly, it remains challenging to anticipate how the resolution can be triggered (solvency, liquidity, etc): while the bank previously showed some initial signs of stress on its capital position, the European Central Bank contacted the Single Resolution Board (SRB) because of the deteriorating liquidity position of the bank, a point of non-viability (PONV). A distressed entity has multiple fronts to fight at once... so there is nothing as a clear roadmap to "planned" resolution. It also remains a case-by-case situation.

Secondly, the hybrid debt had a few triggers, but none of them got breached by reaching this PONV, it enabled the relevant authorities to exercise its administrative power, which prevails over any "orderly" conversion features of the hybrid debt.

Thirdly, what matters remains the ranking of the security in the capital structure when the entity goes under resolution. But it is by no mean a guarantee of a clear-cut liquidation! If the Senior debt is pari passu with some core business liabilities (depositors, etc), it might suffer a larger loss to better protect the latter. While the Senior Non-Preferred (SNP) layer should build an additional buffer, the Senior debt still needs to be considered under this new normal.

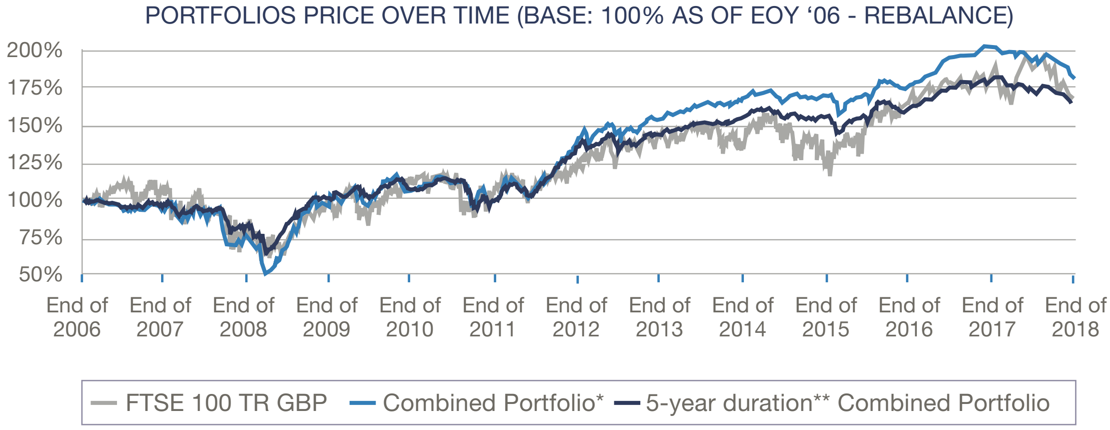
Most of all, if the relevant authority decides to engage with a buyer, the latter has a strong bargaining position to ask for as much debt clearance as possible. For the acquisition of Banco Popular, Santander made a conservative assessment of the reserves and provisions required to act and acquire the bad bank. It also put as a pre-requisite to have the subordinated debt cancelled. The short time frame makes the entire process arbitrary (time pressure to independently value the company, not really to open to competitive bids, etc). The relevant authority focuses on protecting the core activities of the bad bank as soon as possible and preventing any contagion risk.

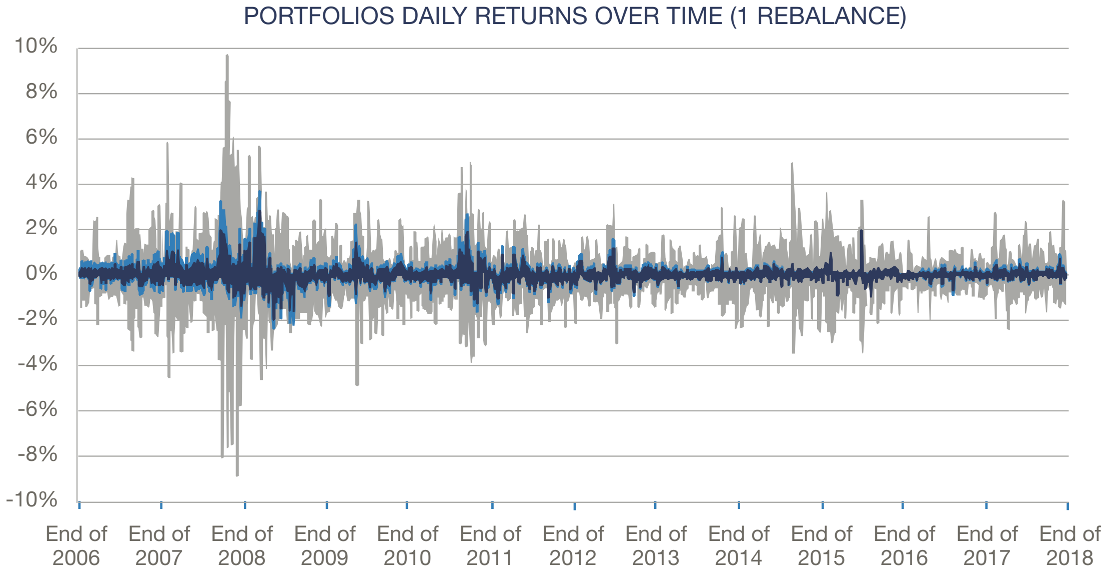
** Euro HY Conference 2017: Banco Popular Resolution, June 2017*

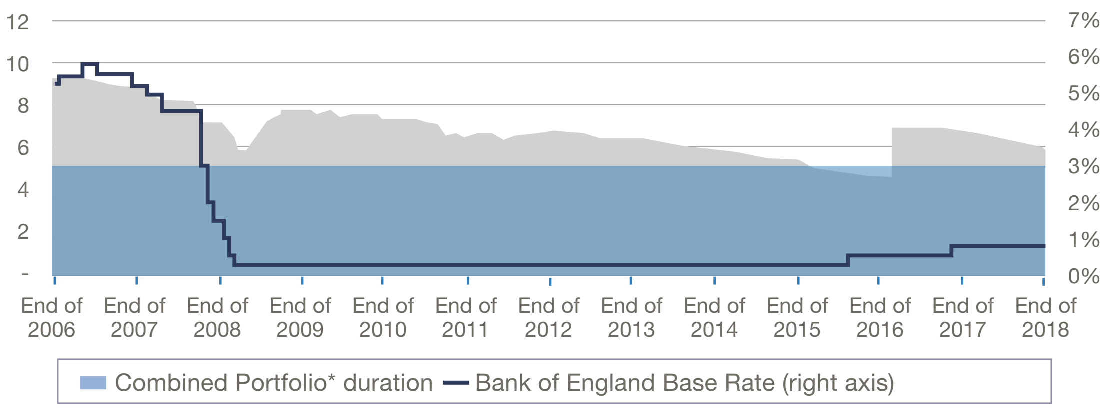
WHAT AN INVESTOR CAN EXPECT FROM HYBRID CAPITAL

HOW DOES HYBRID CAPITAL PERFORM IN PRACTICE?

TOTAL RETURN OVER 12 YEARS







Source: Bloomberg and Bank of England, December 2018

** The Combined Portfolio has been recreated out of 18 equally-weighted securities, which were outstanding in December 2006. One rebalance has been done in February 2017 to bring back the duration of the Combined Portfolio closer to its long-term average (19 securities after this change).*

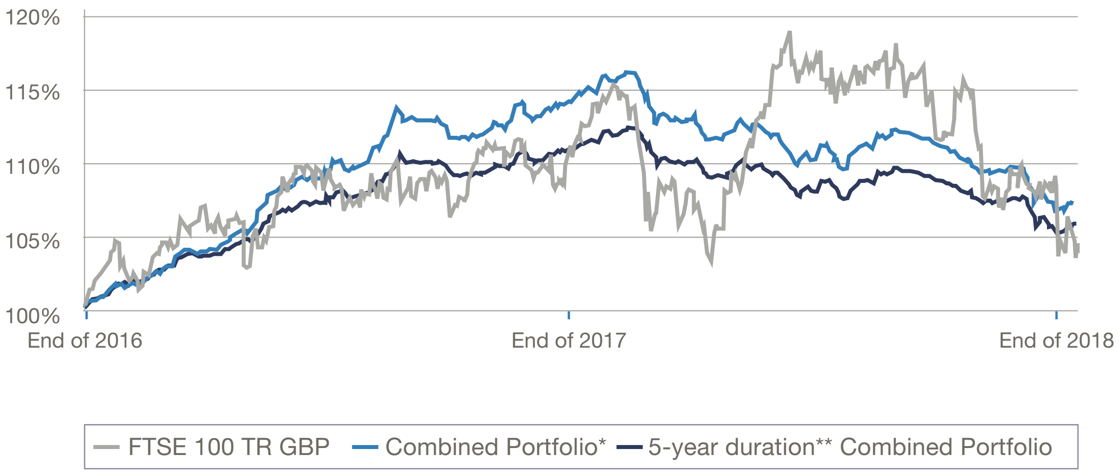
*** The 5-year duration Combined Portfolio has been introduced to reflect the maintenance of the portfolio over time. The duration is mechanically adjusted through the introduction of a cash component.*

WHAT AN INVESTOR CAN EXPECT FROM HYBRID CAPITAL

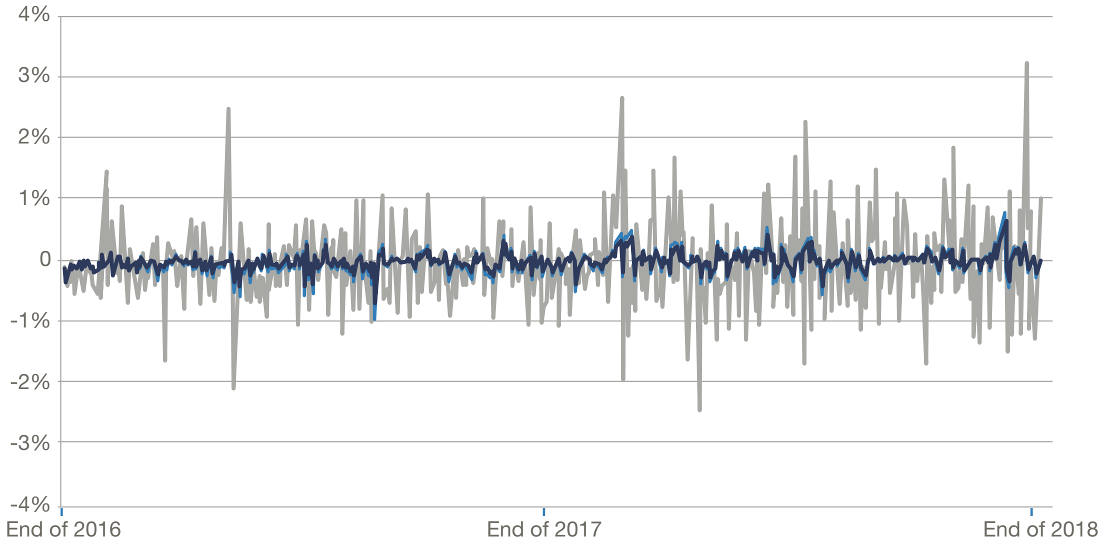
In the above, Hybrid Capital delivers a similar Total Return to Equity, if not slightly higher and certainly with less volatility than the UK equity index. When comparing the two hybrid combined portfolios, the lower duration portfolio performed better through the Financial Crisis, however the higher-duration portfolio (combined Portfolio with no constraint) has subsequently delivered much better.

TOTAL RETURN OVER 2 YEARS

PORTFOLIOS PRICE OVER TIME (BASE: 100% AS OF EOY '16 - REBALANCE)



PORTFOLIOS DAILY RETURNS OVER TIME (1 REBALANCE)



Source: Bloomberg, December 2018

Both Hybrid Capital have achieved a better performance than the Equity Index over the period with a much lower volatility. The duration has once again contributed to the outperformance.

All coupons have been conservatively treated on an annual basis in this section. They are reinvested to match the total return methodology on the equity index (dividend reinvested). The list of securities can be found in the appendices.

** The Combined Portfolio has been recreated out of 18 equally-weighted securities, which were outstanding in December 2006. One rebalance has been done in February 2017 to bring back the duration of the Combined Portfolio closer to its long-term average (19 securities after this change).*

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WHAT AN INVESTOR CAN EXPECT FROM HYBRID CAPITAL

COMPARING HYBRID CAPITAL TO EQUITY – AVIVA PLC

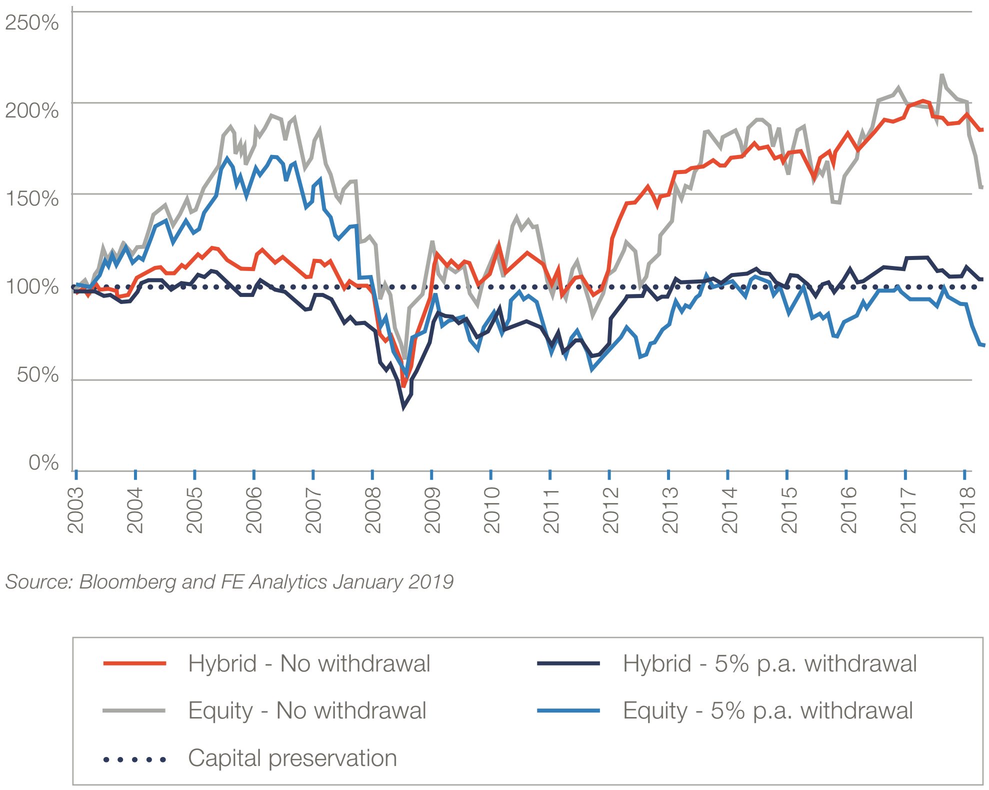
STANDARD DEVIATION* OF TOTAL RETURNS SINCE INCEPTION	
Hybrid	Equity
35%	43%

While considering this UK insurer, its hybrid has outperformed the equity and offered lower volatility along the way. While both securities have suffered from the Financial Crisis, a hybrid investor could have withdrawn 5% of the initial investment annually and preserve 100% of the initial capital. In the meantime, the equity investor would have suffered a 30% loss on the initial capital. Finally, the hybrid investor would have benefited from better legal protection in the meantime, given that the equity remains subordinated to the hybrid debt.

AVIVA PLC £6.125 PERPETUAL

- Issued in September 2003
- Callable at 100 in September 2022
- 5yr gilts + 2.40% if not called

TOTAL RETURN* SINCE HYBRID INCEPTION AVIVA £6.875 VS. AVIVA PLC



Source: Bloomberg and FE Analytics January 2019

**Net of 95 bps p.a. fees*

WHAT AN INVESTOR CAN EXPECT FROM HYBRID CAPITAL

COMPARING HYBRID CAPITAL TO EQUITY – LLOYDS BANKING GROUP

STANDARD DEVIATION* OF TOTAL RETURNS SINCE INCEPTION	
Hybrid	Equity
39%	31%

In this example, we have used two hybrid perpetual bonds issued by Lloyds Bank to reflect the hybrid bond performance and maintain a consistent investment horizon. Bond 1 - issued in 2001 - has been sold and replaced by Bond 2 from March 2014, when the latter was issued.

An equity investor who decided to consistently withdraw 5% of their initial investment in 2001 would have ended up consuming their entire capital stack by 2017. In comparison, a similar strategy through hybrid exposure would have preserved initial capital.

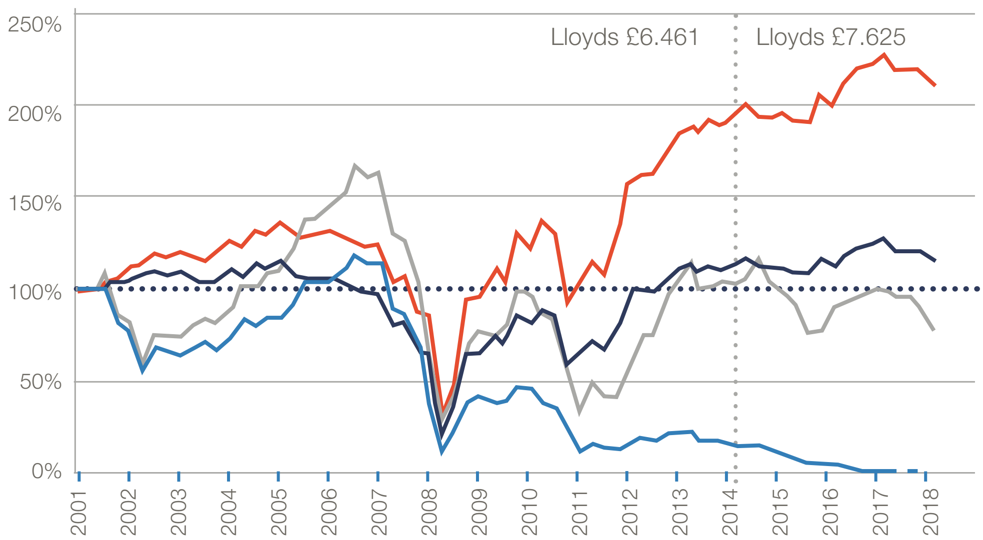
LLOYDS BANK PLC £6.461 PERPETUAL (BOND 1)

- Issued in November 2001
- Callable at 100 in November 2018
- 5yr gilts + 2.85% if not called

LLOYDS BANK PLC £7.625 PERPETUAL (BOND 2)

- Issued in March 2014
- Callable at 100 in June 2023
- CRD IV compliant bond
- 5yr gilts + 5.01% if not called

TOTAL RETURN* SINCE INITIAL HYBRID INCEPTION
LLOYDS £6.461 THEN LLOYDS £7.625 VS. LLOYDS BANK PLC



Source: Bloomberg and FE Analytics January 2019

Hybrid - No withdrawal
Hybrid - 5% p.a. withdrawal
Equity - No withdrawal
Equity - 5% p.a. withdrawal
Capital preservation

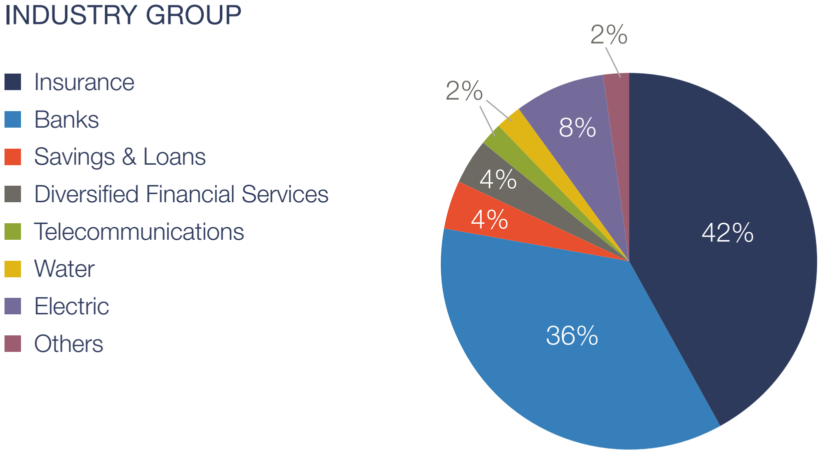
**Net of 95 bps p.a. fees*

WHAT AN INVESTOR CAN EXPECT FROM HYBRID CAPITAL

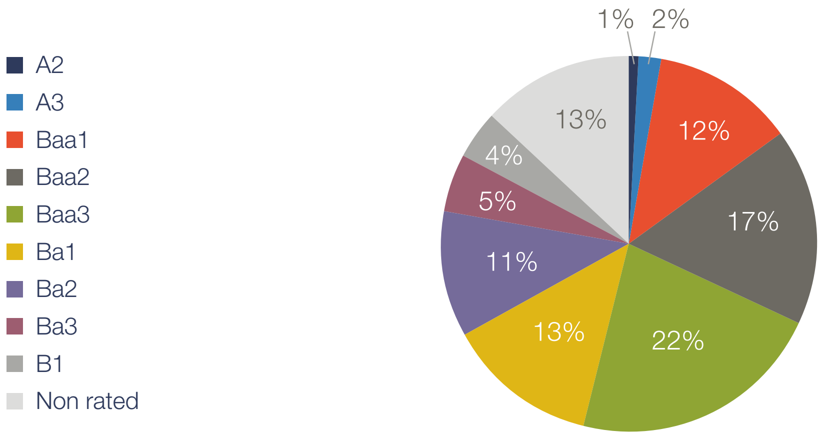
TYPICAL MULTI-CURRENCY HYBRID CAPITAL PORTFOLIO - INDUSTRY AND RATING MIX

We have selected 92 securities that represent the industry split among issuers in the context of the hybrid outlook (see the Dynamics of the Hybrid Capital market section above). Financials are the main contributors (42% for Insurers, 36% for Banks), followed by utilities companies. The portfolio is roughly balanced between high-yield and high-grade bonds. Some issuers decide to issue unrated debt (13%) as the rating agency constraint does not justify the cost implied to maintain the rating.

INDUSTRY GROUP



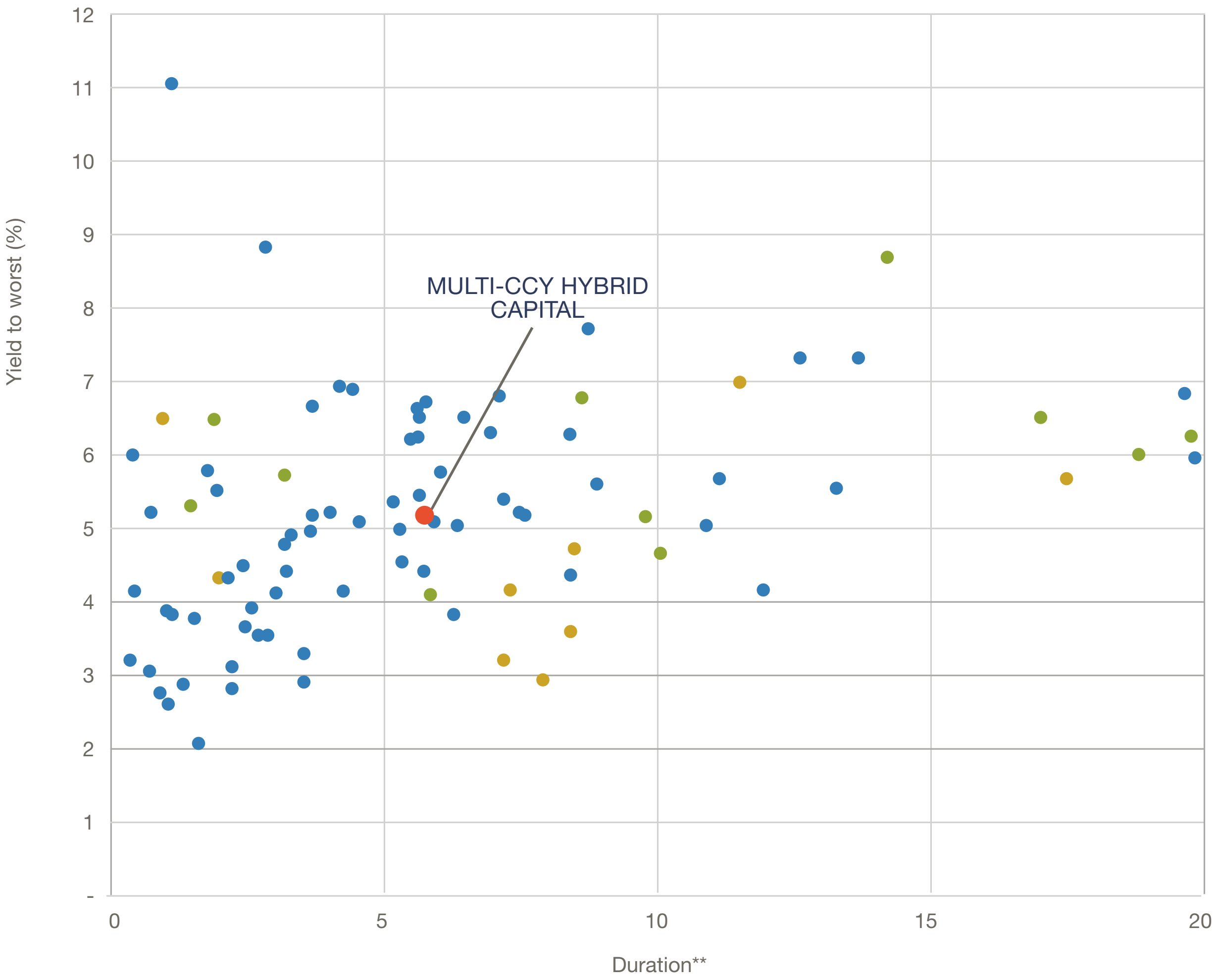
IMPLIED RATING



Source: Bloomberg, January 2019

WHAT AN INVESTOR CAN EXPECT FROM HYBRID CAPITAL

TYPICAL MULTI-CURRENCY HYBRID CAPITAL PORTFOLIO – YIELD VERSUS DURATION



- Equally-weighted multi-currency Hybrid Portfolio (92 securities)
- USD security
- GBP security
- EUR security

Source: Bloomberg, January 2019*

** Securities pricing around and above par have been priced to the first call. Securities at a discount have been priced at Maturity/Perpetuity as appropriate. Securities are the same as the ones used in the previous section to define the typical multi-currency hybrid capital portfolio.*

*** Defined as the sensitivity of a security to a change in interest rate movement. The higher, the more volatile the security is.*

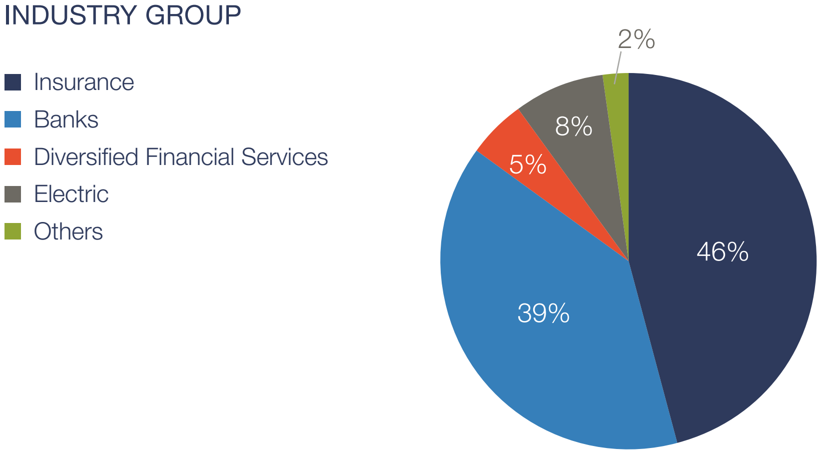
TIDEWAY IN THE GBP HYBRID CAPITAL UNIVERSE

TIDEWAY GBP HYBRID CAPITAL FUND

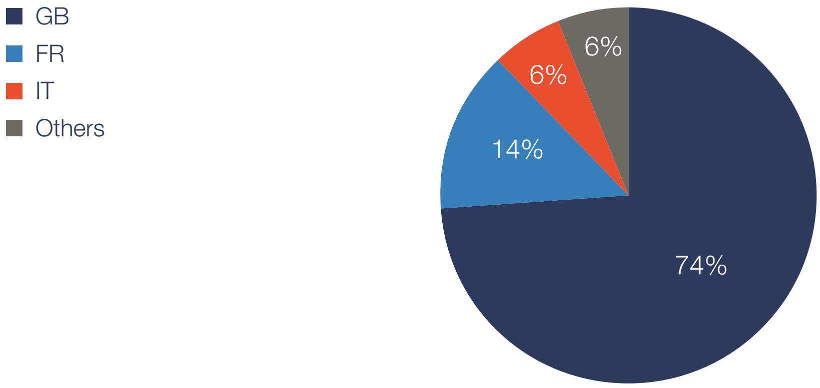
As of 14/01/2019

DURATION	YIELD
7.28	5.66

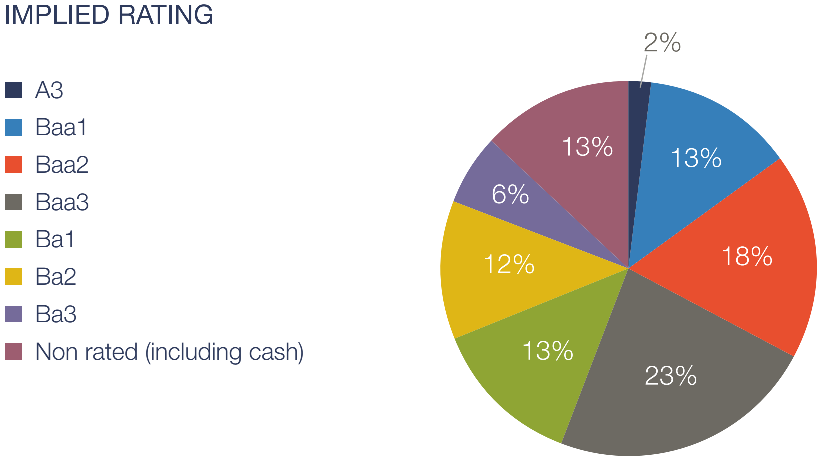
INDUSTRY GROUP



COUNTRY OF RISK



IMPLIED RATING



Source: Bloomberg

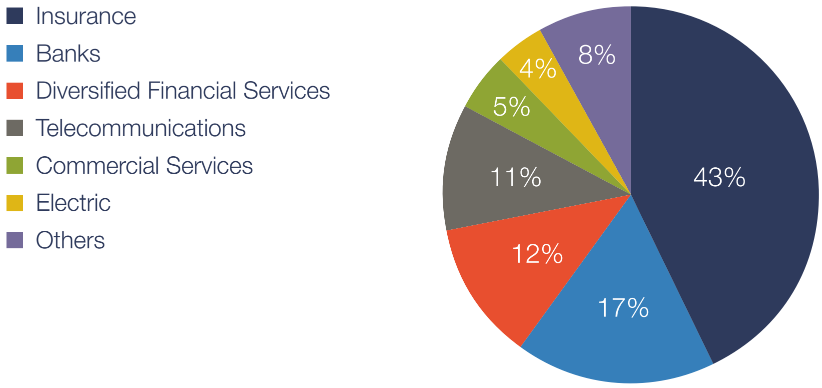
TIDEWAY IN THE GBP HYBRID CAPITAL UNIVERSE

TIDEWAY GBP CREDIT FUND

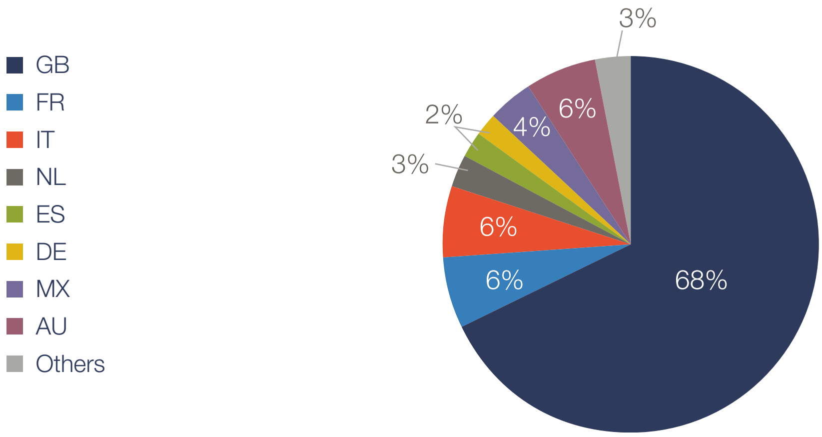
As of 14/01/2019

DURATION	YIELD
3.22	4.60

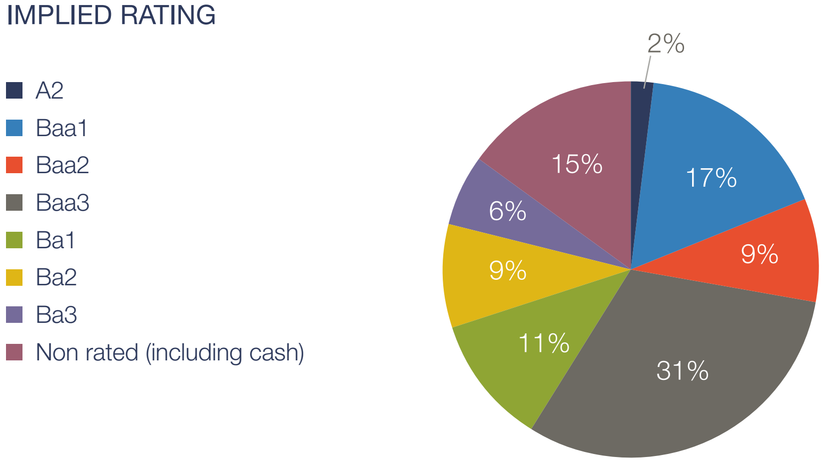
INDUSTRY GROUP



COUNTRY OF RISK



IMPLIED RATING



Source: Bloomberg

APPENDICES

GLOSSARY

AT1 (for Banks only)	Additional Tier 1 that Banks can use in face of their Tier 1 capital requirement. Subordinated to T2, T3 and Senior debt.
Banking Union	This single rulebook gathers initiatives to form a single rulebook for all financial actors in the 28 EU countries. They include stronger prudential requirements for banks, improved protection for depositors, rules for managing failing banks.
BRRD	Bank Recovery and Resolution Directive (Directive 2014/59/EU). It is a common approach within the EU to the recovery and resolution of banks and investment firms that has been transposed in national law. It has introduced the MREL and offers the initial framework for the SRB.
BRRD2	Proposed amendments to BRRD in late 2016. It remains under negotiations between the European Parliament, the European Council and the European Commission. A final agreement is expected in 2019 but cannot be guaranteed given the political agenda (European elections, etc).
CET1	Common Equity Tier 1. Level of capital available to fulfil the Common Equity Tier 1 requirement. Subordinated to AT1, T2, T3 and Senior debt.
CRD IV	Capital Requirements Directive IV (Directive 2013/36/EU). It is an EU legislative package covering prudential rules for banks, building societies and investment firms that has been implemented through national law. It is intended to implement the Basel III agreement in the EU.
CRR	Capital Requirements Regulation (575/2013). It has been directly applied to firms across the EU and is part of CRD IV.
CRR2	Proposed amendments to CRR in late 2016. It remains under negotiations between the European Parliament, the European Council and the European Commission. A final agreement is expected in 2019 but cannot be guaranteed given the political agenda (European elections, etc).
Discos	“Disco bonds” stands for discount bonds. They are bonds which have been issued for less than their par value. They often offer a very low coupon, if any coupon at all.
Equity Credit	Amount of debt that is recognised as equity by a specific rating agency in order to assess the leverage metrics of a company.
EU	The European Union.
HoldCo	Holding Company, as opposed to Operational Company.
LME	Liability-management exercise.
MREL (for Banks only)	Minimum Requirement for Own Funds & Eligible Liabilities. If a bank fails and goes into resolution, the MREL acts as a buffer to absorb losses and to provide new capital to the bank. It will protect further the core activities of the bank for the SRB to find a solution and contain contagion risk.
OpCo	Operational Company, as opposed to Holding Company.
Pillar 2	One of the three elements (with Pillar 1 and the combined buffer requirement) form the overall own funds requirements that a bank must preserve. It also complements any risk missed under the Pillar 1 component.
PONV	Point of non-viability defined in BRRD.

APPENDICES

PRA	The Prudential Regulation Authority is a United Kingdom financial services regulatory body, formed as one of the successors to the Financial Services Authority.
RT1 (for Insurers only)	Restricted Tier 1 that Insurers can use in face of their Tier 1 capital requirement. Subordinated to T2, T3 and Senior debt.
SNP (for Banks only)	Senior Non-Preferred. Debt only subordinated to Senior Preferred debt. In certain jurisdictions like the UK, this asset does not exist as the HoldCo Senior debt is eligible to fulfil the Total Capital requirement instead.
Solvency I	The Solvency I Directive ((Directive 73/239/EEC and Directive 79/267/EEC) has established the initial framework for a common Insurance regulation in the 1970s. It offers a simplistic capital requirement, especially in the perspective of the Solvency II regime decided in the late 2000s.
Solvency II	The Solvency II Directive (2009/138/EC) is a Directive in European Union law that codifies and harmonises the EU insurance regulation. Primarily this concerns the amount of capital that EU insurance companies must hold to reduce the risk of insolvency.
SRB	The Single Resolution Board. The mission of the SRB is to ensure the orderly resolution of failing banks with minimum impact on the real economy and public finances of the participating Member States of the Banking Union in Europe. It works closely with the National Resolution Authorities to implement its decisions.
Tier 1 (for Banks)	Level of capital available to banks to fulfil their Capital Tier 1 requirement. Subordinated to T2, T3 and Senior debt.
Tier 1 (for Insurers)	Level of required capital to insurers to fulfil specific percentages of their Solvency Capital Requirement and Minimum Capital Requirement, as defined under the Solvency II framework. Subordinated to T2, T3 and Senior debt.
Tier 2 / T2 (for Banks)	Additional level of capital required to banks to their Solvency II Capital requirement in Europe. Subordinated to T3 and Senior debt.
Tier 2 / T2 (for Insurers)	Additional level of capital required to Insurers to fulfil their Solvency II Capital requirement in Europe. Subordinated to T3 and Senior debt.
Tier 3 / T3 (for Banks)	Additional level of capital required to banks to fulfil their Total Capital requirement. Subordinated and Senior debt.
Tier 3 / T3 (for Insurers)	Additional level of capital required to Insurers to fulfil their Solvency II Capital requirement in Europe. Subordinated to Senior debt.

APPENDICES

HYBRID CAPITAL EXAMPLES

SBRYLN £ 6.5 Perpetual

TERMS AND CONDITIONS INCLUDE:

- Callable at 100 in July 2020; if not called at 100 coupons change to 5-year £ swap rate + 9.727%
- In the event of non-payment, interest is cumulative, with "interest on interest"
- Dividend Pusher and Dividend Stopper

J Sainsbury operates Sainsbury supermarkets in the UK together with convenience stores, an internet-based home delivery service and Sainsbury Bank. The Bank offers saving accounts, credit cards, mortgages, insurance products, and consumer loans. Its Argos brand sells consumer goods through standalone stores, in Sainsbury's supermarkets, and online. The company was founded 150 years ago and employs 121,000 people across its portfolio of 600 supermarkets and 800 convenience stores. J Sainsbury is a FTSE 100 index constituent and has an enterprise value of £6bn.

LGEN £ 5 3/8 10/27/2045

TERMS AND CONDITIONS INCLUDE:

- Callable at 100 in October 2025; if not called at 100 in 2025, coupons change to 5-year Gilts + 4.58%
- In the event of non-payment, interest is cumulative but no "interest on interest"
- Dividend Pusher and Dividend Stopper

Legal & General – Legal & General Group is one of the UK's biggest life insurers. The holding company operates six divisions, covering annuities, lifetime mortgages, investment activities, savings, and de-risking in the US. The investment management arm generates more than 50% of revenues as the UK's largest pension fund manager, serving institutional and retail investors. Legal & General's risk businesses provide groups and individuals with life insurance, annuities, and homeowners insurance. Personal savings products include unit trusts, investment bonds, and savings accounts. The company employs 7,500 people and is a constituent of the FTSE 100 index, with a market capitalisation of £14bn.

KPN £ 6 7/8 03/14/2073

TERMS AND CONDITIONS INCLUDE:

- Callable at 100 in March 2020; if not called at 100, coupons change to 5-year £ swap rate + 5.505%
- In the event of non-payment, interest is cumulative, with "interest on interest"
- Dividend Pusher and Dividend Stopper

KPN - Koninklijke KPN NV provides telecommunications services throughout the Netherlands, where it has more than 4 million fixed-line phone customers. The company's core business, however, is KPN Mobile, which serves more than 34 million subscribers in the Netherlands, Spain, and France. Through its ownership of several European ISPs, KPN also provides broadband Internet access to 2+ million customers, and it offers business network services and data transport. Subsidiary Getronics provides a wide range of IT services to clients throughout the world. In the US the company operates iBasis, which trades in international voice traffic. The company employs 13,000 people and is listed on the Amsterdam Stock Exchange with an enterprise value of €11bn.

Source: Bond prospectus and Bloomberg. All data as of January 2019

APPENDICES

ORAFP £ 5 7/8 Perpetual

TERMS AND CONDITIONS INCLUDE:

- Callable at 100 in February 2022; if not called at 100 in 2022, coupons change to 5-year £ swap rate + 3.354%
- In the event of non-payment, interest is cumulative with "interest on interest"
- Dividend Pusher and Dividend Stopper

Orange - Orange SA provides telecommunications services to residential, professional, and large business customers primarily in France, Spain and Portugal. The company offers a range of services such as public fixed-line telephone, data transmission, mobile telecommunications, cable television and internet. Orange employs approximately 149,000 people and is listed on the Paris Stock Exchange, with an enterprise value of €38bn.

AVLN £ 6 1/8 09/29/49

TERMS AND CONDITIONS INCLUDE:

- Callable at 100 in September 2022; if not called at 100 in 2022, Coupons change to 5-year Gilts + 2.4%
- In the event of non-payment, interest is non-cumulative
- Dividend Pusher and Dividend Stopper

Aviva - Aviva PLC is an international insurance company that provides general insurance, life assurance and asset management services in the UK, Europe, Asia and Canada. Following the acquisition of the FTSE 100 life insurer Friends Life, Aviva has over 15 million customers in the UK and employs over 30,000 people. The company is a FTSE 100 index constituent and has a market capitalisation of £15bn.

LVFRSC £ 6 1/2 05/22/43

TERMS AND CONDITIONS INCLUDE:

- In the event of non-payment, interest is cumulative but no "interest on interest"
- Callable at 100 in May 2023; if not called at 100 in 2023, coupons change to 5-year Gilts + 5.63%

LV= - Liverpool Victoria Friendly Society Ltd is a UK based insurer that offers car, home, travel, life, and pet insurance. Liverpool also offers income protection, critical illness cover, individual savings accounts, investment funds, multi manager funds, equity funds, and flexible savings plans. Liverpool Victoria was founded in 1843 and employs over 5,000 people. Allianz has decided to gradually acquire LV's general insurance business, which will reinforce its market shares.

Source: Bond prospectus and Bloomberg. All data as of January 2019

APPENDICES

NGGLN £ 5 5/8 06/18/73

nationalgrid

TERMS AND CONDITIONS INCLUDE:

- Callable at 100 in June 2025; if not called at 100 in 2025, Coupons change to 12 year £ swap rate + 3.48%
- the event of non-payment, interest is cumulative, with "interest on interest"
- Dividend Pusher and Dividend Stopper

National Grid - National Grid PLC is an investor-owned utility company that employs some 23,000 people across its network. It serves more than 10 million customers. The company owns and operates the electricity transmission network in England and Wales, the gas transmission network in Great Britain and selected electricity transmission networks in the United States. National Grid is a FTSE 100 index constituent and has an enterprise value of £27bn.

EDF £ 6 PERPETUAL

eDF

TERMS AND CONDITIONS INCLUDE:

- Callable at 100 in January 2026; if not called at 100 in 2025, coupons change to £ 13–year interest rate + 3.958% In the event of non-payment, interest is cumulative with "interest on interest"
- Dividend Pusher and Dividend Stopper

EDF – Electricité de France produces, transmits, distributes, imports and exports electricity. The company, using nuclear power, coal and gas, provides electricity for energy consumers in France, the UK, Italy and other European countries. EDF is involved in supplying energy and services to approximately 38 million customers, of which 28.5 million in France. EDF is listed on the Paris Stock Exchange and is a member of the CAC 40 index, with an enterprise value of €41bn.

Source: Bond prospectus and Bloomberg. All data as of January 2019

APPENDICES

LIST OF SECURITIES FOR THE HISTORICAL ANALYSIS

Please find below the list of securities considered for the historical data (see section How Does Hybrid Capital Perform in Practice?). The objective has been to reflect the sectors of the issuers active in the markets and the targeted duration for investment in Hybrid Capital.

	PERIOD 1	PERIOD 2
start	29/12/2006	09/02/2017
end	09/02/2017	04/01/2019
ASSGEN 6.269 PERP	included	included
AVLN 6 1/8 11/14/36	included	included
AVLN 6 1/8 PERP	included	included
AVLN 6 7/8 PERP	included	
AXASA 6.6862 PERP	included	included
AXASA 7 1/8 12/15/20	included	
BACR 9 1/2 08/07/21	included	included
BRELN 6 5/8 12/09/30	included	
CMZB 6 5/8 08/30/19	included	
CNALN 5 1/4 04/10/75		included
EDF 6 PERP	included	
HSBC 6 1/2 07/07/23	included	included
JUSTLN 9 10/26/26		included
LGEN 5 7/8 PERP	included	
LLOYDS 6.461 PERP	included	
LLOYDS 7 7/8 PERP		included
LLOYDS 9 5/8 04/06/23	included	included
NWIDE 10 1/4 PERP		included
OLDMUT 6.376 PERP	included	
ORAFP 5 7/8 PERP		included
PHNXLN 6 5/8 12/18/25		included
PRUFIN 5 07/20/55		included
PRUFIN 5 07/20/55		included
PRUFIN 6 1/8 12/19/31	included	included
QBEAU 6.115 05/24/42		included
SLLN 6 3/4 PERP	included	
SLLN 6.546 PERP	included	
ZURNVX 6 5/8 PERP	included	included

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- Tideway UCITS Funds ICAV – Irish-domiciled funds
- Specialist Fixed income portfolio management
- Model mixed-asset portfolios in segregated accounts

CONTACT DETAILS

Tideway Asset Management
Thomas House
84 Eccleston Square
London SW1V 1PX

T: +44 (0)20 3143 6100

E: info@tidewayinvestment.co.uk

More information is available via our websites:
www.tidewayassetmanagement.co.uk/p/78/gbp-hybrid-capital-fund

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- The performance of individual client accounts will vary from those quoted due to a range of factors including the timing of when the account was first invested, the size of the account, the underlying asset allocation and the third-party platform used.
- The calculation basis for all the returns quoted can be provided on request.
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info@tidewayinvestment.co.uk
www.tidewayassetmanagement.co.uk