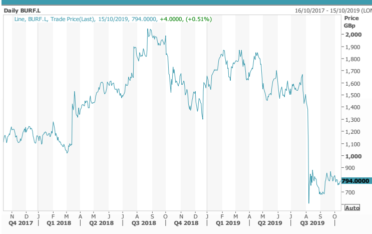
HARDMAN & CO.

17 October 2019

Financials



Source: Refinitiv

Market data

EPIC/TKR	**BUR**
Price (p)	**808.0**
12m High (p)	1,870.0
12m Low (p)	605.0
Shares (m)	218.6
Mkt Cap (£m)	1,767
Total assets ($m)	2,249
Free Float*	90%
Market	AIM

**As defined by AIM Rule 26*

Description

Burford Capital is a leading global finance and professional services firm focusing on law. Its businesses include litigation finance and risk management, asset recovery, and a wide range of legal finance and advisory activities.

Company information

CEO	Christopher Bogart
CIO	Jonathan Molot
CFO	Jim Kilman
Chairman	Sir Peter Middleton

+1 (212) 235-6820
www.burfordcapital.com

Key shareholders

Directors	8.7%
Invesco Perpetual	13.9%
Woodford Inv. Mgt.	<5%

Diary

5 Dec	Interim dividend paid

Analyst

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BURFORD CAPITAL

Strong evidence that fair value is fair

In the aftermath of a dramatic period, Burford has provided additional disclosure that greatly improves understanding of its fair value process and its conservatism. The timing of when fair value adjustments are made has been well explained previously, with clear objective criteria. How the amount of each valuation change is determined has also had some clarification, with an objective core overlaid by adjustments that involve some judgement. Detailed data have also been provided on the 20 concluded cases that have had adjustments of $1m or more. All this adds considerably to the belief that Burford's fair value is prudent.

- **Petersen:** Burford has also provided additional information on the Petersen claim. While the 11 investors who recently bought in appear to be sophisticated, there was some speculation about their potential upside. Burford has shown that this could still be substantial, with all the usual caveats that apply to a single claim.

- **Market manipulation claims:** Burford has published a report by Professor Mitts of Columbia University showing that there were trades on 6 and 7 August that seem to indicate spoofing and layering. It has gone to the High Court to obtain judicial approval for the London Stock Exchange to release identifying data.

- **Risks:** The investment portfolio is highly diversified, with exposure to more than 1,100 claims. However, it retains some very large investments, which means revenue could be volatile, particularly in the smaller divisions. The Petersen case shows that this volatility is not simply a negative.

- **Investment summary:** Burford has already demonstrated an impressive ability to deliver good returns in a growing market, while investing its capital base. As the invested capital continues to grow, we would anticipate that the litigation investment business will continue to produce strong earnings growth.

Financial summary and valuation

Year-end Dec ($m)	2013	2014	2015	2016	2017	2018
Revenue	60.7	82.0	103.0	163.4	341.2	420.7
Operating profit	42.5	60.7	77.2	124.4	285.1	353.0
Reported net income	2.6	45.4	64.5	108.3	249.3	317.4
Underlying net income	40.1	53.0	64.5	114.2	264.8	327.8
Underlying RoE	11.7%	12.1%	16.0%	22.1%	35.9%	30.1%
Underlying EPS ($)	0.20	0.26	0.32	0.55	1.27	1.50
Statutory EPS ($)	0.01	0.22	0.32	0.53	1.20	1.51
DPS ($)	0.05	0.07	0.08	0.09	0.11	0.13
Dividend yield	0.2%	0.3%	0.4%	0.4%	0.5%	0.6%
NAV per share ($)	1.72	1.87	2.12	2.22	3.19	5.50
P/E (underlying, x)	57.6	43.7	35.9	20.6	8.9	7.5
Price/NAV (x)	6.6	6.0	5.3	5.1	3.5	2.1

Source: Hardman & Co Research

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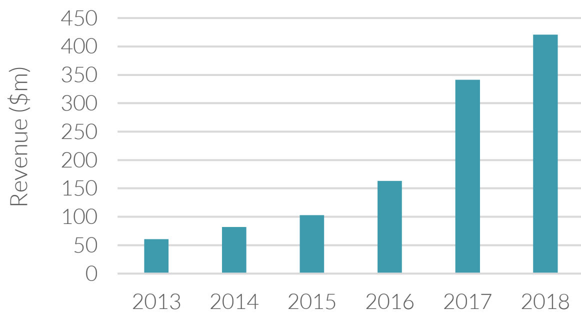
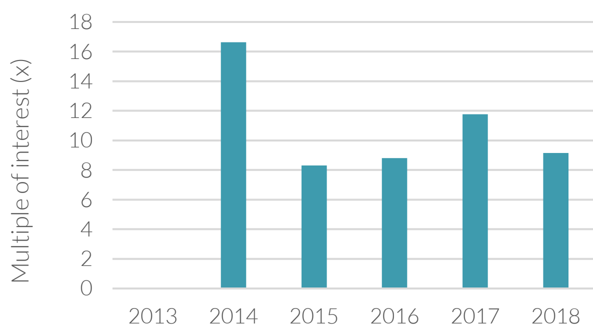
Revenue



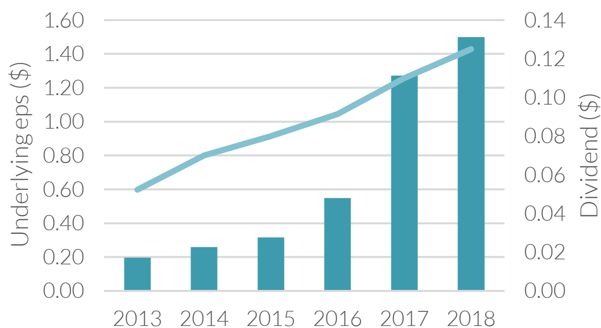
- Long-term growth has correlated strongly with the pace of investment and conclusions
- Accelerated investment from 2017 has boosted revenues
- 2017, 1H'18 and 1H'19 figures were boosted by sales from the Petersen case and the results of the Teinver claim
- New SWF arrangement will deliver a higher proportion of the returns on capital deployed, but has lowered Burford's capital deployment needs

Interest cover



- Retail bond issues in 2014, 2016, 2017 and 2018
- Cash needs and debt issuance are dependent on the rate of investment and the proceeds from realisations
- Interest cover is very strong, and Burford has ample capacity to issue further debt

EPS (bar) and DPS (line)



- 2017, 1H'18 and 1H'19 results were boosted by sales from the Petersen case and the results of the Teinver claim
- Growth in the pace of investment has driven returns
- Some large, single claims have brought volatility, although this has been to the upside, as well as the downside

Source: Company data, Hardman & Co Research

Putting the "fair" into fair value

Although many of the claimed facts, and their interpretation, cited by Muddy Waters in its recent reports are erroneous, they had a dramatic effect. Part of this seems to be because some aspects of Burford's business are not well understood, with its fair value accounting being at the fore. In its reports, Muddy Waters makes it clear that it does not understand, and hence misbelieves, Burford's fair value accounting.

Burford recently published more information on its fair value process, giving a history of marks for each of the 20 concluded cases that had a valuation change of more than $1m. It also gave more information on how these are calculated.

We go into the details below, but Burford highlights some key points:

- Only 26 of the 76 completed cases (34% of the total) had any fair value increase. Another 11 (14%) had fair value decreases – so over half had no fair value movement. Given that the vast majority of cases settle, it is perhaps no surprise that the first significant event in a lot of cases will be the conclusion.
- Burford has reversed $46m of previous write-downs and $25m of write-ups. Although we don't have totals against which to compare these, we know that with an aggregate fair value movement of over $650m, overall fair value write-ups greatly exceed the write-downs. These appear to be a small proportion of the totals. That reversals from previous write-downs are almost double the reversals of previous write-ups supports that the approach is prudent.

The following discussion assumes that readers already have a knowledge of how fair value is processed through the accounts. Readers who are unfamiliar with it may wish to check Appendix 1, which we have reproduced from our initiation note. Appendix 2 gives a cross-collateralisation example (without any fair value marks).

Burford's fair value accounting

Burford accounts for its litigation investments as Financial Instruments. Under IFRS9, this means that they have to be fair-valued as of accounting dates. Given that Burford now has over 1,100 underlying claims, with most in portfolio investments, each of which has to be considered separately, this is not a trivial exercise.

It is worth noting that some other litigation funders use different accounting. Of the two other AIM-listed companies, Manolete Partners also classifies its investments as financial instruments and fair-values them, as we understand several other unquoted US & UK funders also do. Litigation Capital Management (LCM) classifies them as financial contracts, holding them at cost until resolution. It also capitalises its expenses. IMF Bentham, which, like LCM, is an Australian company, also classifies investments as financial contracts and capitalises some costs.

One of the reasons why Australian companies are required to adopt a different classification is that, in Australia, the funder can have some control over the case. Elsewhere, the funder has little control, as the finance is supplied on a non-recourse basis.

Interestingly, LCM, in its recent results call, suggested that it might acquire more insolvency business, which is Manolete's approach, and this may force LCM to adopt a fair value approach in the future. This suggests that, while all of these companies are doing litigation finance, their different approaches may allow different accounting.

It is worth highlighting that, ultimately, all these methods will give the same realised profit for a given investment – the final cashflow and expenses incurred in obtaining them will be the same. Furthermore, both approaches do, for positive progressions, increase the effective carrying value over time, although in very different ways. With $1.16bn of realisations across 76 investments, it is worth noting that Burford now has a substantial track record that it uses to demonstrate its processes.

Although Burford has been attempting to stimulate a secondary market for litigation investments, and has generated some sales, this is not sufficiently developed to be used for valuations. The prices for most transactions are not generally public knowledge. Consequently, these are all classified as "Level 3 assets", where the inputs for the asset or liability are not based on observable market data (unobservable inputs).

Given current litigation requirements, the secondary market is likely to remain limited. The purchaser will want to do diligence on the case, and that means opening all the case information. The need for confidentiality may make this a challenge. Petersen is a notable exception, with most of the details of the case already public.

Determining fair value

The methodology that Burford uses for determining a fair value has two elements.

The first is timing of any changes. At the outset, Burford values an investment using the amount of cash it has invested. This is only adjusted (positively or negatively) when an objective event takes place. This may be progress through the courts, but other events, such as a settlement offer, may also trigger a change. Burford lists possibilities as:

(i) a significant positive ruling or other objective event but where there is not yet a trial court judgement;

(ii) a favourable trial court judgement;

(iii) a favourable judgement on first appeal;

(iv) the exhaustion of as-of-right appeals; and

(v) in arbitration cases, where there are limited opportunities for appeal, issuance of a tribunal award.

Claims will have a different exposure to these, depending on the court or forum at which the case is being heard. Although Burford frames this in terms of favourable results, it states that the same steps apply to negative results too. It seems that this step is almost entirely objective, with little scope for management discretion.

The second part of the methodology is by how much to adjust the valuation. The underlying procedure is simple in concept: the possible number of stages above determines how much the value is moved towards the final award. So if a claim had four steps to conclusion, the default on the first positive judgement would be to move the value a quarter of the way to the ultimate claim value.

In practice, there is a range around that movement in which the value may be adjusted. This reflects the judgement of the Valuation Committee, which consists of the CEO, CIO, CFO and two senior executives. This may reflect the strength of the case, the judgement received, or how successful appeals tend to be in a forum. The expected amount of the claim may be subject to judgement too.

While this stage has more subjectivity, Burford does have a database of historical cases that it can use to inform its decisions. There are also two layers of oversight. Firstly, the entire process is overseen by the Audit Committee of the Board. Secondly, the valuations are subject to audit. Within Ernst & Young, the valuation process is also subject to two opinions, with the audit team being supported by the valuation team.

On the final resolution of Teinver, Burford supplied a good example of how this works in practice for a successful single case – see our report of 9 July 2019, *Petersen appeals to investors*. From 2012 to 2015, there were fair value adjustments that, in aggregate, were slightly under 13% of the ultimate award. The fair value total was 22% of the final award. On the positive judgement, the $69.1m valuation was approximately half the award.

There has been much debate about the prudence of Burford's valuation methodology. Over time, Burford has supplied various items of data that suggest the valuation is not aggressive:

- On average, 33% of income from investments is recognised in the last year before conclusion, with 23% in earlier years. This leaves an average 44% for the final gain (2019 results presentation).
- Only two investments that have been written up (0.2% by dollar value) have turned into a loss (2018 Capital Markets day).
- All secondary market sales have been at a premium to Burford's valuation, although we recognise that this is a very small sample and Burford has discretion on whether to accept a transaction.

Napo example

A further single point is the Napo vs. Glenmark case, which Muddy Waters made such a deal about.

- In 2011, Burford deployed $1.5m, with options for two more investments of $1.5m if Burford so chose. Valuation was at cost.
- In 2012, Burford exercised the options and funded another $3m investment. There was an interim tribunal decision, and Burford adjusted the carrying cost to $9.4m. This is between a quarter and third of the settled amount.
- Under a settlement agreement, Burford's entitlement exceeded $30m. Burford valued this at $15.75m – around half the value of the entitlement reflecting the risk in Napo.
- A restructuring in 2014 led to the liability from Napo being converted to a senior secured debt agreement, with $30m principal and 18% interest maturing in 2017, although Napo had to make a payment in 2016. The senior position gave a stronger position, and the valuation was increased to $21.3m.
- In 2016, Napo did not make the payment, and the face value of the entitlement increased to $51.1m. Burford kept the carrying value at $21.3m.
- The 2017 restructuring saw Burford receive $8m in cash and various tranches of shares. According to market prices, these were worth $40.1m when the merger was agreed, but $24.3m at the effective date of the merger. Burford had some obligations attached to these shares in terms of the minimum price at which it could sell. This led it to value 45% of its holding (Tranche B shares) at zero and use the market price for the Tranche A shareholding. This increased the valuation booked at close by under $0.5m, to $21.7m.

Subsequent movements in the price of the shares held have been noted in the accounts as IFRS requires. Unfortunately, these have been largely adverse.

The key point is that, at each stage, Burford valued the investment at significantly less than the face value of the award. In this case, that prudence was perhaps justified by the movements in share prices after the merger.

We do note that this is one of only three investments where Burford received a non-cash award. Despite Burford following its own methodology in each, all of these formed a prominent part of the initial Muddy Waters report. In the largest of these ("Desert Ridge"), Burford had kept investors informed through its annual reports on an ongoing basis. In the other cases, Burford promptly disclosed the adverse changes when they materialised, although investors may have been unaware of the non-cash nature of the awards. Although it is not frequent, we would suggest that Burford disclose when an award is a non-cash item, and/or add a statement saying there are no non-cash awards as appropriate.

Summary

All the evidence available is that, on average, Burford values its cases prudently. The amount of reversals, both beneficial and adverse, have been small relative to the whole. Investors should bear in mind that all these investments conclude in time, and fair value must converge to this in due course.

Burford management has shown every sign of running the business for the long run, and imprudent fair value calculations would run against this. The statement that bonuses are not linked to fair value movements provides further encouragement. Although some opaqueness remains inevitable, it would seem that investors can have confidence in Burford's accounting.

Petersen

Along with the added disclosure on accounting, Burford has also given some further information on the Petersen case. The last transaction had raised questions about the potential upside. It was for an effective value of $1bn for Burford's share of the claim, which suggests that the investors valued the total recovery at around $1.7bn.

It is well known that Repsol, which had twice the shareholding of Petersen, had settled for $5bn. The crude calculation was that Petersen could thus get $2.5bn, plus interest.

Burford has given some additional information, which makes it clear that the potential return remains significant. Using the formula that is prescribed in YPF's own by-laws, the value would be $9bn, using the date that Argentina notified the public that is was planning to expropriate YPF shares. Even if the defence successfully argues to use the actual date that Argentina took control of the company, the value is still almost $6bn.

The usual caveat remains that this is active litigation and a single case. While Burford believes that the law is in Petersen's favour, nothing is certain. Burford notes that Repsol settled for 50¢ on the dollar. Burford has also observed that, as with any claim, it may fail altogether. Nevertheless, 11 institutional investors have paid an aggregate $100m in the belief that they will receive a good return.

Political uncertainty

The Macri government in Argentina has been significantly more market-friendly than the Kirchner one. News that it may lose power has caused speculation that this would increase the risk of non-payment. Burford has pointed out that the arbitration framework is different from sovereign debt, in that there is a range of enforcement options that may be used. Although countries can default on sovereign debt, there is no mechanism to default on an adverse international litigation or arbitration matter. Burford has also pointed out that even Venezuela has continued to settle international litigation matters while being in default on its sovereign debt.

It is perhaps worth noting that Argentina's strategy is to delay the case as much as it can. The claim may not conclude under the current government, or even the next one.

Valuations and Petersen

There is no doubt that Petersen has been a huge success for Burford, generating $236m of proceeds on an $18m investment, while still retaining 61.25% of its original exposure. It has, however, had a significant, and unquantified effect, on Burford's fair value.

Litigation investments

$m	2016	2017	2018	1H'19
Additions	271.6	414.9	624.6	129.0
Invested capital	394.3	631.4	902.0	849.3
Fair value	559.7	982.2	1,480.2	1,566.3
FV/IC	142%	156%	164%	184%

Source: Company data, Hardman & Co Research

The above table suggests total fair value gains are $717m as of 30 June 2019.

Market manipulation claims

Burford has released a report from Professor Joshua Mitts, an Associate Professor of Law at Columbia University. He has investigated the Burford price movements on 6 and 7 August, and documents evidence of spoofing and layering. If correct, then there appears to be evidence of some attempt to manipulate the Burford share price.

Burford has filed a claim for Norwich Pharmacal relief against the London Stock Exchange (LSE). In essence, this is a request for the release of documentation. In short, while an independent observer can purchase the quantitative data described by Professor Mitts from the LSE, only the exchange knows who actually placed those cancelled orders.

This is the start of a process that, if followed through, will take some time to complete.

Financials

Summary financials						
Year-end Dec ($m)	2013	2014	2015	2016	2017	2018
Revenue	60.7	82.0	103.0	163.4	341.2	420.7
Expenses	18.1	21.3	25.8	39.0	52.3	66.8
Operating profit	**42.5**	**60.7**	**77.2**	**124.4**	**285.1**	**353.0**
Finance cost	0.0	3.7	9.3	14.1	24.3	38.5
Exceptional items	-40.4	-9.7	0.0	-5.9	-3.8	0.0
Reported pre-tax profit	**2.1**	**47.3**	**67.9**	**104.1**	**249.2**	**305.0**
Reported taxation	0.5	-0.7	-2.2	4.8	0.1	12.5
Minorities	0.1	1.2	1.2	0.6	0.0	0.0
Underlying net income	**40.1**	**53.0**	**64.5**	**114.2**	**264.8**	**327.8**
Statutory net income	2.6	45.4	64.5	108.3	249.3	317.4
Underlying basic EPS ($)	**0.20**	**0.26**	**0.32**	**0.55**	**1.27**	**1.50**
Statutory basic EPS ($)	0.01	0.22	0.32	0.53	1.20	1.51
DPS ($)	0.05	0.07	0.08	0.09	0.11	0.13
Balance sheet (@31 Dec)						
Total equity	351.5	382.7	433.1	462.2	664.5	1,202.7
Invested capital	173.6	207.5	252.9	394.3	631.4	902.0
Fair value balance	214.9	266.8	334.2	559.7	982.2	1,480.2
Total assets	**376.1**	**533.2**	**608.7**	**968.2**	**1,318.0**	**2,127.3**
NAV per share ($)	1.72	1.87	2.12	2.22	3.19	5.50
Underlying RoE	**11.7%**	**12.1%**	**16.0%**	**22.1%**	**35.9%**	**30.1%**

Source: Hardman & Co Research
£1=$1.25

Appendix 1

Note: this is reproduced from Hardman & Co's initiation report. The example is now old, but the principles are unchanged.

Burford's requirements under fair value accounting are not difficult to understand, but there are some idiosyncrasies, which we explain in this Appendix. The description is confined to the litigation-related investments and outlines the current application of IFRS. Burford has been cursed over its short history by enforced changes to how it presents it accounts, which have not aided transparency[1].

Balance sheet

Under fair value accounting, the aim is to mark the value of investments to its market price. There is no market in individual investments in litigation. Even if there were such a market, each case on Burford's books is probably distinctive enough that finding a comparable would be difficult. Consequently, the investments are priced on a level 3 basis, i.e. not based on observable market data, and require significant management judgement and estimation. Investments are assessed for both the Interim and Annual results.

The uncertainty inherent in litigation outcomes makes assessing any increases a tricky business. In practice, Burford uses the cash invested as a base value, and only increases the fair value when it has some confidence of a change in outcome. This could, for example, be a settlement offer. This can mean some investments seeing no change until quite close to conclusion. Burford's claims of prudence would seem to be justified – at the end of 1H'15, the fair value was only 20% above the cash invested, compared with an average concluded RoIC of around 60%.

Profit & Loss

The income from litigation-related investments recognised in the Statement of Comprehensive Income is usually derived from two main sources:

- Net gains on realised investments, i.e. total cash expected over the amount invested.
- Fair value movement – the increase or decrease in fair value of the investments on the balance sheet. Previously-recognised gains on investments that are realised are deducted from this figure.

Note that the net effect of combining these two lines is to remove the previously-recognised gains on investments that are realised from being double-counted.

Most of the balance is described as "Interest and other income", and has been a mixture of items. Outstanding settlements and awards can accrue interest if not paid promptly. In rare cases, they can be tied to specific assets, which can lead to larger figures. Burford has also included income from a loan of £30m that it extended in 2011 and was repaid in 2013.

Cashflow

The cashflow from investments is recognised when it is invested (paid out) and when a settlement or award is received. Unfortunately, because of fair value movements between these periods, and cash usually being received after recognition of a

[1] Until 2012, the costs of diligence on investments that were invested in could be capitalised and included in the investment. Since then, they have been expensed immediately.

realisation, the cashflow statement is littered with offsets to non-cash movements elsewhere.

We illustrate all these items using a recent example. In the 1H'15 results, Burford highlighted its largest recovery of $61m in gross proceeds, of which $25m was invested capital, $10m had been previously recognised in fair value gains and $26m was "new" income. For the sake of illustration, three assumptions have been made:

- The investment of $25m was made in a single payment.
- The investment, the fair value gain, the realisation and the payment take place in different accounting periods.
- Interest of 5% accrues on the payment of $61m before payment (not part of Burford's experience, but for illustration.)

Fair value accounting example ($m)

Period	0	1	2	3	4
	Investment	FV Gain	Realisation	Interest	Payment
Financial position (balance sheet)					
Additions	25				
Realisations			-61		
Net realised gain for year			36		
Fair value movement		10	-10		
Balance at fair value	25	35	0	0	0
Due from settlement of litigation-related investments			61	64.05	
Comprehensive income (P&L)					
Interest				3.05	
Litigation investment related income	0	10	26	3.05	0
Cashflows					
Cashflows from operating activities					
Profit before tax		10	26	3.05	
Fair value change on litigation-related investments		-10			
Realised gains on realisation of litigation-related investments			-26		
Interest and other income from litigation-related activities				-3.05	
Net	0	0	0	0	0
Changes in working capital					
Funding of litigation-related investments	-25				
Proceeds from litigation-related investments					64.05
Net cashflow from operating activities	-25	0	0	0	64.05

Source: Hardman & Co Research based on a Burford Capital result

Appendix 2 – portfolio

We consider the following hypothetical example to illustrate a portfolio investment. We ignore any unrealised gains that may occur, as this simplifies the example and makes no difference to the points being made.

Portfolio example

$m	1	2	3	4
Claim 1	-10	4		
Claim 2	-5	-10	30	
Claim 3	-5		-10	30

Source: Hardman & Co Research

The figures represent the cashflow in each year. Consider the values at the end of each year:

- Year 1: $20m has been invested, with no return. The portfolio will not be included in any RoIC calculations.
- Year 2: $30m has been invested, with a $4m return on claim 1. At this point, the RoIC on the concluded investment is -60% (4/10-1).
- Year 3: $40m has been invested, with an additional return of $30m. The RoIC on concluded investments is 36% (34/25-1).
- Year 4: $40m is the total invested, with the final return being $64m. This gives an RoIC of 60%.

This is all completely consistent with the treatment of any other single-case investment. What would clearly be wrong is what has been suggested elsewhere, which is to calculate the RoIC based on the capital invested in the whole portfolio, i.e. including unresolved cases. This would make the RoIC at the end of year 2 -86.7% and year 3 -15%. This would mean that, inconsistently, the $10m invested in year 3 would effectively be written off immediately in the aggregate RoIC calculation. This does not make sense to us, and would contradict usual accounting practices.

There is an additional twist here, though. Suppose the portfolio were cross-collateralised with a minimum return on each claim of the capital invested. To then offset the loss in claim 1, another $6m could be claimed back from claims 2 and 3. In fact, the RoIC after one year would actually be understated, and the final RoIC would be 75%.

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