hardman&co

FTSE sector: Financials

Source: Eikon Thomas Reuters

Market data

EPIC/TKR	BUR
Price (p)	389.0
12m High (p)	397.0
12m Low (p)	162.0
Shares (m)	204.5
Mkt Cap (£m)	795.7
Total Assets ($m)	540.6
Free Float*	87%
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, insurance, law firm lending, corporate intelligence and judgement enforcement, bankruptcy litigation funding, advisory and professional services, and a wide range of professional activities.

Company information

CEO	Christopher Bogart
CIO	Jonathan Molot
Chairman	Sir Peter Middleton

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

Key shareholders

Directors	13%
Invesco Perpetual	29.9%
Woodford Investments	10.1%
Fidelity Worldwide	9.5%
Aberdeen Asset	6.0%
Reservoir Capital	5.6%

Next event

28 Oct 2016	Interim dividend paid
March 2017	Full year results

Analysts

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Burford Capital

Guilty of delivering another set of superb results

Burford's interim results for 2016H1 produced another set of outstanding figures. The core litigation finance business was the driving force helping overall revenue grow to $76.2m, up from the $40.6m last year (which we considered then to be an exceptional result). Operating profit more than doubled to $61.7m despite investment in growing the capacity of the business. The new initiatives businesses also performed well, moving to a first profit of $2.9m after tax. Insurance has been closed to new business and delivered a profit of $3.4m after tax, though this was the only part of the business to perform below our expectations.

- **Currency**: With 94% of Burford's assets denominated in USD and all its debt in GBP, it has been a significant beneficiary of the exchange rate moves post Brexit. Even without continuing volatility there will be further benefits due to coupon payments being $2-3m lower than previously.
- **Balance sheet:** During the first half Burford made some significant changes to its balance sheet. The second retail bond issue was discussed in earlier reports. In June the company bought back its preference shares for a total cost of $0.11. This will save $1.2m of annual costs.
- **Valuation:** With performance exceeding expectations and helpful currency moves, Burford's rating remains good value despite the strong share price performance. The prospective P/E for 2018E is only 10.2 times, while a 17% RoE with strong growth suggests strong metrics all round.
- **Risks:** The investment portfolio is fairly focused with some very large investments, which means revenue may be volatile. As the company matures we would expect that to decrease, but not to disappear. As expected, revenue from the insurance business is declining post the adoption of the Jackson reforms.
- **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, the litigation investment business will continue to produce strong earnings growth.

Financial summary and valuation

Year end Dec ($m)	2013	2014	2015	2016E	2017E	2018E
Revenue	60.7	82.0	103.0	126.3	146.3	164.9
Operating Profit	42.5	60.7	77.2	96.5	112.2	125.6
Reported net income	2.6	45.4	64.5	76.1	89.1	101.9
Underlying net income	40.1	53.0	64.5	76.1	89.1	101.9
Underlying Return on Equity	11.7%	12.1%	16.3%	16.6%	17.0%	16.7%
Underlying EPS ($)	0.20	0.26	0.32	0.37	0.44	0.50
Statutory EPS ($)	0.01	0.22	0.32	0.37	0.44	0.50
Dividend per share ($)	0.05	0.07	0.08	0.09	0.11	0.12
Yield	1.0%	1.4%	1.6%	1.8%	2.1%	2.4%
NAV per share ($)	1.72	1.87	2.12	2.42	2.76	3.27
P/E (x) (underlying)	26.0	19.7	16.2	13.7	11.7	10.2
Price/NAV (x)	3.0	2.7	2.4	2.1	1.8	1.6

Source: Hardman & Co Research

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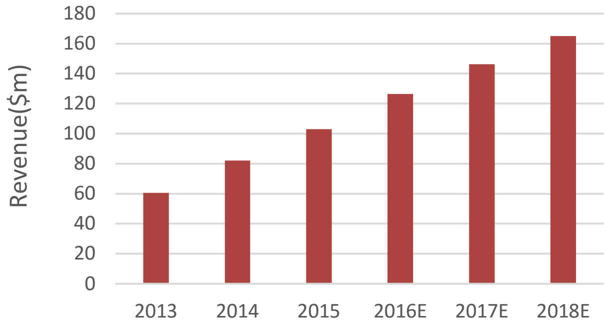
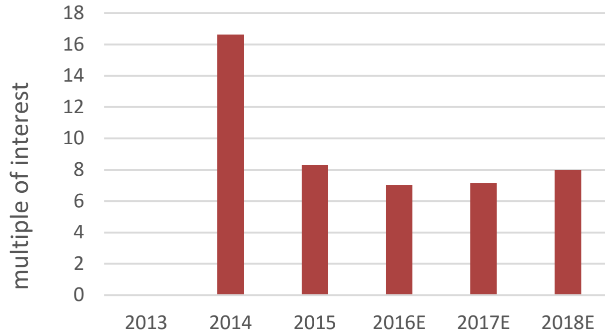
Revenue



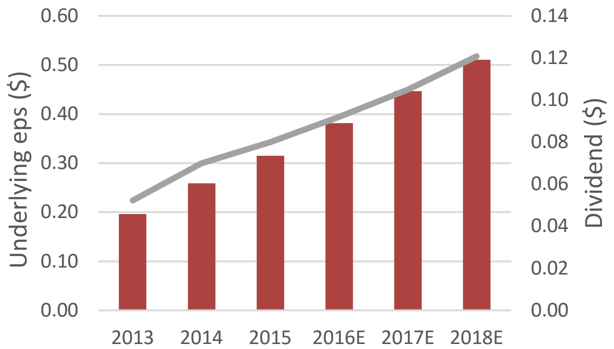
- Growth depends on pace of investment and conclusions
- Accelerated investment in 2016 will boost 2017 and 2018 revenue
- Continued investment in the business underpins the growth

Interest Cover



- No debt prior to 2014
- Retail bond issues in 2014 and 2016
- 2014 issue was mid-year so only partial accrual of coupon

Eps and dividend



- Full effect of large single $100m investment coming through properly in late 2016 and into 2017
- 2015 boosted by large single gain
- 2016 results to date showing benefits of a wide range of investments
- Some large single claims may introduce volatility in the future

Source: Company data; Hardman & Co Research

Results Summary

By Division

Litigation Finance

Litigation Finance	2013	2014	2015	1H16
Income	38.85	47.85	86.90	64.44
Expenses	9.01	10.42	13.95	8.64
PBT	29.84	37.43	72.95	55.80
Tax	0.56	0.61	-2.23	-2.90
PAT	**30.41**	**38.04**	**70.73**	**52.90**
Op Mgn	77%	78%	84%	87%

Source: Burford Capital, Hardman & Co Research

Litigation finance continues to be the driving force behind Burford's growth. Revenue grew from $30.6m in 2015H1 to $64.4m in this half. Positively, this year's returns came from a broad spread of investments, whereas last year's had a single result that contributed significantly.

We monitor various metrics about the pace of conclusions and how the fair value of the book is developing and all of them continue to show improvement. Realisations were 16% of the year end fair value, lower than in 2015 but comfortably ahead of the rate in 2013 and 2014. Fair value as a proportion of invested capital has steadily increased and over the half moved up from 134% at the year end to 135%.

The reasons behind these moves are complex and, probably difficult for Burford to quantify. We can identify two factors that we can have confidence in about why things are improving, though they are not a complete explanation. We also add a partial excuse as to why our estimates have fallen short.

- Secondary market: To date there has been no meaningful secondary market in litigation investments. Attempts to create one have been ongoing, and Burford completed a transaction in the first half. We don't intend to read too much into a single transaction, but the price was above Burford's fair value and helps to confirm that their valuations are conservative.
- Maturing book: Burford started its book from scratch and, as we have noted before, we are relying on censored data. We have also noted that longer standing claims can produce a wider range of results in financial terms, which may be working in Burford's favour.
- Return on Invested Capital: In our initiation report we estimated this at 60%, noting that the historic figure moved around as more results came in. We felt we were being slightly conservative at the time. Although Burford have not supplied an updated figure with these results, the evidence would suggest this estimate was rather more than 'slightly'.

As previously signalled, the costs in this area continue to grow as Burford invests in increasing its capacity. These are 15% more than the last half and 34% than the corresponding period last year, though the income growth means operating margins still improved to 87% (from 81% in 2015).

Insurance

Insurance	2013	2014	2015	1H16
Income	20.91	24.34	12.76	5.11
Expenses	6.78	5.40	2.58	0.83
PBT	12.96	18.94	10.19	4.28
Tax	-2.84	-3.86	-1.19	-0.86
PAT	**10.12**	**15.08**	**9.00**	**3.43**
Restructuring	-1.17	0.00	0.00	0.00

Source: Burford Capital, Hardman & Co Research

The insurance business continued its expected revenue decline, albeit at a slightly faster rate than we expected. There was an update on new business. Munich Re, who are the insurer of this business, are changing their internal systems. Burford would have incurred significant costs to interface with these if they wished to continue writing new business. Burford have decided this investment is not worthwhile and have ceased to write new business. This underpins much of the cost reduction in this half. In the long run this will most likely give a slightly faster revenue decline than previously anticipated, though short term the removal of cost will improve the profits.

As the whole of this business is in the UK, exchange rate effects mean the value of profits in US Dollars is reduced going forward.

New Initiatives

New Initiatives	2013	2014	2015	1H16
Income		0.22	3.48	6.14
Expenses		1.56	4.50	2.63
PBT		-1.34	-1.01	3.51
Tax		0.47	0.00	-0.64
PAT		**-0.87**	**-1.01**	**2.87**

Source: Burford Capital, Hardman & Co Research

The new initiatives showed their first profit, with judgement enforcement in particular having its first significant contingent claim giving a profit of $4m. Burford continue to invest in this business and we expect it to be more significant than the insurance business in the very near future.

The credit lending also had its best half of income generated. Going forward Burford has decided that this business fits better within the litigation financing operations and it will be merged into that area going forward.

Burford made a small investment in Apperio, a technology firm that analyses law firm billing and allows clients to monitor their expenses on a real-time basis. As a significant payer of fees to lawyers, albeit mostly indirectly, the rationale for the investment is pretty clear.

Investing

As usual, Burford has continued to grow its litigation investment portfolio. The cash additions were $158m, including the $100m portfolio announced with the full year results. Overall $193m of new commitments were added and invested capital increased to $358m from $239m at the year end with another $239m of contingent commitments.

Cash generation this half was exceptionally strong with litigation finance returning $84m. A significant part of this was a $33m return from a long standing claim where the payment after the trial in 2010 had been made in Arizona real estate rather than cash. Burford agreed, in return for a fee of course, to allow the recipient to hold the land rather than selling when the market was bombed out. This has been finalised, with a 47% IRR or 415% return on invested capital. Given this large single return we would expect future cash generation to return to being somewhat lower than the accounting return, the effect of a growing portfolio and lags in cash on successes being paid.

With Burford continuing to increase its operational capacity for new business and maintaining a very healthy cash position, we expect the litigation investment portfolio to continue to grow strongly.

Capital

As we have previously reported on, in April Burford raised £100m through a retail bond issue.

In June they followed this up by repurchasing the contingent preference shares. These had been issued in 2013 for a nominal sum, but allowed Burford to call $40m of capital on demand. Since then Burford has both improved its credibility through improving operating results and twice raised much larger sums through the retail bond market. The management felt that there was a reduced need for the contingent capital, and not worth paying $1.2m a year to have. The shares were redeemed on 30 June for a total cost of $0.11 (that is genuinely the total).

Bondholders may note that this will have a small effect on the security of their covenants, though with debt having reduced to 51% of equity the change is unlikely to be significant.

The interim dividend has been raised from ¢2.33 per share to ¢2.67, an increase of almost 15%. Movements in exchange rates mean that UK shareholders will probably see a much larger increase in sterling terms.

Financials and Forecast

The uncertainty of when cases will conclude and what they will bring financially means that producing forecasts for Burford will always be a challenge for analysts. One consequence of this is that existing forecasts can be subject to big revisions, and we are aware our new figures will most likely see future significant revisions. With those thoughts in mind, we have increased our 2016E eps by 42% and 2017E eps by 7%. We have also introduced new estimates for 2018.

The main factors we have adjusted are as follows:

- Much better returns in 2016 from litigation investment – we were probably wrong to assume a delay in the effect the large new investments at the year end would have on earnings.
- Greater cost growth in the litigation investment business – we have raised that to 30% this year and 20% beyond. We have also increased our assumption for new business to reflect the increased capacity.
- For the insurance business a slightly faster decline in revenues, but a much faster reduction in 2016 costs to reflect the stopping of new business.
- Faster progress in the judgement enforcement business.
- Exchange rate effects with the sharp fall in sterling versus the US Dollar. The single biggest effect of this on profits is to reduce coupon payments by $2-3m per annum. Within the business lines the whole insurance business and a minority of the litigation finance area are sterling denominated, offsetting some of that benefit. The balance sheet sees significant effects too, with debt denominated in sterling. For UK investors net assets are boosted in sterling terms as well.

Summary financials

Year end Dec ($m)	2013	2014	2015	2016E	2017E	2018E
Revenue	60.7	82.0	103.0	126.3	146.3	164.9
Expenses	18.1	21.3	25.8	29.8	34.1	39.3
Operating Profit	**42.5**	**60.7**	**77.2**	**96.5**	**112.2**	**125.6**
Finance cost	0.0	3.7	9.3	13.7	15.7	15.7
Exceptional items	-40.4	-9.7	0.0	0.0	0.0	0.0
Reported pre-tax	**2.1**	**47.3**	**67.9**	**82.8**	**96.5**	**109.9**
Reported taxation	0.5	-0.7	-2.2	-5.5	-6.2	-6.9
Minorities	0.1	1.2	1.2	1.2	1.2	1.2
Underlying net income	**40.1**	**53.0**	**64.5**	**76.1**	**89.1**	**101.9**
Statutory net income	2.6	45.4	64.5	76.1	89.1	101.9
Underlying Basic EPS ($)	**0.20**	**0.26**	**0.32**	**0.37**	**0.44**	**0.50**
Statutory Basic EPS ($)	0.01	0.22	0.32	0.37	0.44	0.50
Dividend ($)	0.05	0.07	0.08	0.09	0.11	0.12
Balance sheet						
Total equity	351.5	382.7	434.3	494.5	565.1	669.3
Invested Capital	173.6	207.0	239.0	421.4	491.8	565.0
Fair Value Balance	214.9	266.3	319.6	574.4	722.2	881.7
Total Assets	**376.1**	**533.2**	**594.1**	**744.5**	**815.1**	**918.2**
NAV Per share ($)	1.72	1.87	2.12	2.42	2.76	3.27
Return on Equity	**0.8%**	**12.4%**	**16.1%**	**16.6%**	**17.0%**	**16.7%**

Source: Hardman & Co, £1=$1.31

Valuation

Although the Burford share price has appreciated considerably since the last results, the combination of improved results and advantageous exchange rate movements that has led to estimate upgrades means the rating has risen much less. The prospective P/E for 2017E has risen to 11.7 times, and that for 2018E is only 10.2 times. For a business that we forecast to maintain a return on equity around 17% while sustaining mid to high teen growth rates that seems very good value.

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