Financials

Source: Eikon Thomas Reuters

Market data

EPIC/TKR	BUR
Price (p)	564.5
12m High (p)	574.0
12m Low (p)	189.0
Shares (m)	208.2
Mkt Cap (£m)	1175.5
Total Assets ($m)	756.8
Free Float*	86%
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	14%
Invesco Perpetual	27.8%
Woodford Investments	10.0%
Fidelity Worldwide	8.7%
Aberdeen Asset	4.9%

Next event

14 Mar 2017	Full year results

Analysts

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Burford Capital

Acquisition gives greater investment conviction

Burford has completed the acquisition of Gerchen Keller Capital (GKC), a Chicago based asset manager whose funds invest in legal related investments. With $1.3bn of assets and 20 staff, it brings significant additional scale to Burford. GKC has two investment strategies, one of which is new to Burford and expands its range of services. Financially it brings ongoing management fee income, though performance fees will probably be more valuable in the medium term. The headline purchase price is $160m, paid in a mixture of cash, loan notes and equity with an additional payment of 2.5m shares if performance fee targets are met.

- **Earnings:** It is estimated that GKC will have an operating profit of $9.1m for 2016, though with only half a month of the year left and transaction expenses there will be no financial benefit to Burford this year. We have upgraded our earnings for 2017E by 11% and 2018E by 12%.
- **Balance sheet:** Burford will be funding the $93.75m cash payment from its existing resources, citing excellent cash realisation this year, though resources are strong after the spring bond issue. With no associated fundraising, we can infer that 2016 has been another excellent year for Burford.
- **Valuation:** With the deal enhancing earnings, supported by helpful currency moves, Burford's rating remains good value despite the strong share price performance. The prospective P/E for 2018E is only 12.8 times, while an 18% RoE with strong growth suggests excellent 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. The GKC business will add a more predictable revenue stream as well as diversified earnings from a wider, albeit less mature, pool of investments.
- **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.

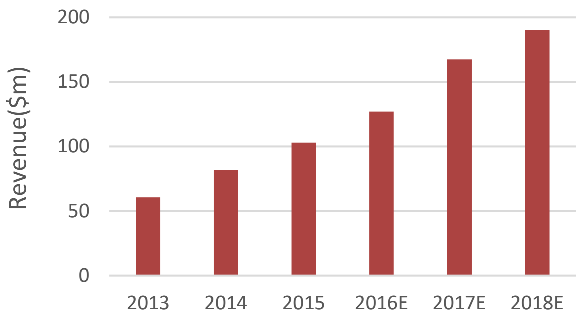
Financial summary and valuation

Year end Dec ($m)	2013	2014	2015	2016E	2017E	2018E
Revenue	60.7	82.0	103.0	127.0	167.3	190.2
Operating Profit	42.5	60.7	77.2	96.9	125.7	141.8
Reported net income	2.6	45.4	64.5	76.8	99.5	114.8
Underlying net income	40.1	53.0	64.5	76.8	99.5	114.8
Underlying Return on Equity	11.7%	12.1%	16.3%	16.7%	18.8%	18.3%
Underlying EPS ($)	0.20	0.26	0.32	0.37	0.48	0.55
Statutory EPS ($)	0.01	0.22	0.32	0.38	0.48	0.55
Dividend per share ($)	0.05	0.07	0.08	0.09	0.11	0.12
Yield	0.7%	1.0%	1.1%	1.3%	1.5%	1.7%
NAV per share ($)	1.72	1.87	2.12	2.38	2.77	3.32
P/E (x) (underlying)	36.1	27.4	22.5	19.2	14.8	12.8
Price/NAV (x)	4.1	3.8	3.3	3.0	2.6	2.1

Source: Hardman & Co Research

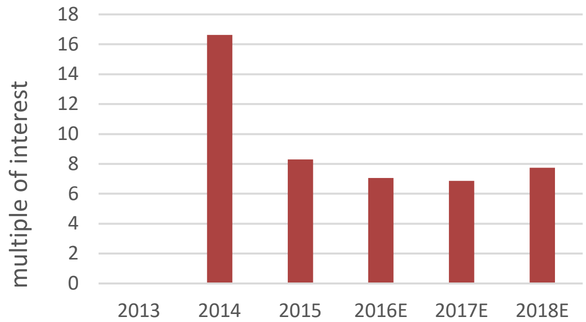
Table of Contents

Revenue



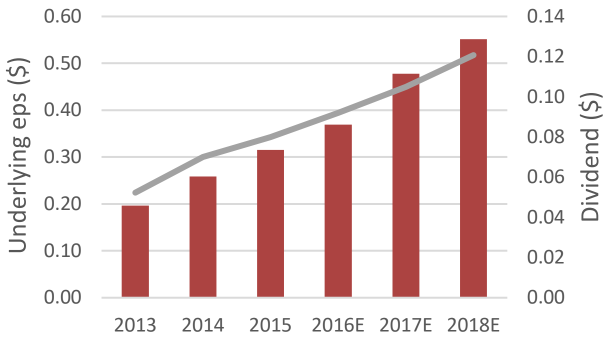
- Growth depends on pace of investment and conclusions
- Accelerated investment in 2016 will boost 2017 and 2018 revenue
- Continued investment in the business underpins the growth
- Acquisition adds revenue from 2017 onwards

Interest Cover



- No debt prior to 2014
- Retail bond issues in 2014 and 2016
- $43.75m loan note issued for acquisition
- 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

Acquisition Details

Burford have agreed to acquire GKC Holdings, LLC, the parent company of Gerchen Keller Capital, for a mixture of shares, cash, loan notes and deferred consideration.

Gerchen Keller Capital

Background

Founded in 2013, Gerchen Keller Capital (GKC) is a Chicago based firm operating in litigation finance. It has adopted a fund management structure for its operations, and currently has four funds with a total of $1,133m in assets plus some smaller SPVs/sidecars taking total funds under management to $1.3bn. It is also currently fundraising for another fund, with a target of $300m.

Current Funds and original funds raised

	Dates started	Funds raised	FUM	Strategy
GKC Partners I	Early 2013	$45m	$305	Pre-settlement
GKC Partners II	Dec 2013	$256m	combined	Pre-settlement
GKC Partners III	Jan 2016	$412m	$412m	Pre-settlement
Credit Opportunities	Oct 2014	$416m	$416m	Post-settlement
Sidecars	NA		~$70m	Pre-settlement
Sidecars	NA	Several hundred $m	~$97m	Post-settlement
Total AUM (current)			$1.3bn	

Source: Burford Capital, SEC, Hardman & Co Research

The funds are set up in a very similar manner to private equity funds, in particular having a limited lifespan with an investment phase followed by a harvesting of returns. Funds I and II have completed their investment phase, which was two years, and have now entered their realisation phase. Fund III has a four-year investment period and also the ability to recycle capital. Its realisation phase will start in 2020, though with timing of cash flows always uncertain will probably mean that in practice some will occur earlier.

The funds are all closed end with heavy penalties for early redemption from investors. Those investors are institutional and include pension funds and endowments.

Strategies

GKC has two investment strategies that it currently uses, though the new fund will add another.

Pre-settlement is the same business as Burford's litigation investment. Unlike Burford's global reach, it has been predominantly focussed on US litigation. Otherwise it has many similarities, in particular being focussed on large corporate litigation rather than personal or small claims and a strong diligence process. GKC considers claims across a wide variety of areas, but has a particular expertise in intellectual property which is an area that Burford has not had the resources to address.

Post-settlement is a new area to Burford, which is described as a sort of law-focussed factoring. For both litigants and legal firms the length of time between the awarding of settlements in courts and payments being made can be substantial. The Credit Opportunities fund can provide funds secured against those expected receipts.

Burford have apparently looked at this business, but felt it was not suitable for funding from its own balance sheet. While with appropriate due diligence it is a low risk business, it is also lower return than litigation financing (GKC have an IRR to date of 12.6%). In addition, there would be tax implications, lowering the potential return further. Using a LP fund, which is tax free for tax-exempt investors, seems like a nice solution.

The sidecars (SPVs) are single case companies that take on larger investments than the funds would deal in. They follow the either the pre- or post-settlement strategies, with more of the latter, though many appear to have been realised.

The new fund will invest in an area that is being called 'complex strategies'. This is described as "other complex and proprietary strategies that are based on assessment of legal risk and the skills both firms have developed in understanding the value of legal assets". In practice this means deals that may not be suitable for on balance sheet investment. This may be due to disclosure requirements that may affect the litigation or something that may suite a different investors profile.

Finances

While the skills involved in running the funds are specialist, from a financial perspective GKC is a simply an asset manager, albeit one with significant performance fees. As such, its income is reasonably transparent and will derive mainly from the fees payable on the funds. Historically there has also been some income from the sidecars and from some consulting.

- **Management fees**: on the pre-settlement side, across the three funds and sidecars the average annual fee is 1.4%. Although in the early funds this was payable on capital deployed, for the third fund this is fixed across the fund size. In Credit Opportunities, the fees are 1.6% of drawn capital.
- **Performance fees**: for the pre-settlement, these are a weighted average of 23% on returns above the return of capital plus fees. For Credit Opportunities, it is 20% after investors receive a 5% preferred return.

Investors should note that the actual amounts paid are subject to the same uncertainties that we have discussed before in reference to Burford's own business. The timing and size of returns on individual cases are essentially unpredictable, which is particularly relevant for performance fees.

A further uncertainty is that behind the average rates given above there is a wide range of rates. For performance fees the range is 15-50%, so the value will also depend on in which vehicle the gain arises. With the first funds having recently started their realisation phase, to date no performance fees have been paid. Burford have acquired all future payments, including those from existing investments.

For the post-settlement fund there is the additional complication that capital is deployed on a revolving basis. Currently the amount deployed is $100m, compared to a current fund size of $416m. This was recently much higher, with several investments maturing in the last couple of months. The average duration of investments in this area is 0.6 months, with the gap to redeploy returns inevitably uncertain. An IRR of 12.6% on investments is attractive, but must be set against the utilisation and the additional 5% hurdle.

A summary of GKC's overall financial results is given below.

GKC Results		
$m	2015	2016E
Income	11.2	15.4
Expenses	3.9	6.3
Operating Profit	7.3	9.1

Source: Burford Capital, Hardman & Co Research
2016E are estimates supplied by Burford Capital and exclude one-time transaction expenses.

Investors should note a couple of things in these figures. Firstly, the agreement with the funds allow certain expenses to be charged to them. Secondly, no performance fees have been paid so far.

GKC's balance sheet appears to be straightforward with less than $1m of assets and no debt. This is net of two existing on-balance sheet litigation investments in which GKC has a minority participation and which Burford has purchased at their original cost of $4.3m.

Effect on Burford

Financial

The initial payment for GKC will be $160m based on the closing share price on 13 December, split as follows:

- $93.75m in cash
- $43.75m in three-year loan notes, with interest of 30-day LIBOR plus 500bps (with a 6% cap)
- 3,692,524 new Burford shares, worth $22.5m at the time of announcement.

In addition, there is a deferred payment of 2,461,682 shares, worth $15m at the time of announcement. This is payable if aggregate performance fees received exceed $100m. The loan notes are repayable at any time without penalty. All bar 177,605 of the shares are subject to a three-year lock-up.

The effect on Burford's earnings in 2016 will be small, with the small accrual of earnings from GKC likely to be exceeded by transaction costs. On a pro-forma basis the operating profits would be about 9% of our estimate for the year, with the number of shares increasing by 1.8% (or 3% if the deferred consideration is paid).

The outlook for earnings from the new fund management business look very good, for two main reasons. The first is the prospect of the new fund, with an additional $300m of assets. A management fee in line with the current average rate would suggest additional fees of over $4m per annum plus eventual performance fees, though there may be additional costs involved in running the fund. Future funds must be under consideration too, though staff capacity may require expansion to allow this.

The second additional source will be performance fees. Although the first two funds have started realising investments, it is clear that the litigation finance (pre-settlement) business is less mature than Burford's. Their realisations to date have averaged 1.0 year duration, with a 52% Return on Invested Capital (RoIC) and 55% IRR. This compare with Burford's figures of 2-year duration, 70% RoIC and 28% IRR. The expectation is that as GKC's book develops the figures will look more like those of Burford, though the inherent uncertainty means that we cannot be sure how close they will ultimately be.

Nevertheless, we can perhaps get a crude idea of the potential range of performance fees from the existing funds. As a lower estimate, we use GKC's RoIC and apply that to the capital in funds I-III plus pre-settlement sidecars. As a higher estimate we use Burford's 70% RoIC. These give aggregate performance fees in the range of $87m to $119m. Results outside this range are possible, but we'd estimate the answer is more likely to be inside it than outside.

Timing, of course, remains uncertain. While funds I and II have started their realisation phase, investors have to receive a return of capital before any performance fee will be payable. While some performance fees may start to arrive in 2017, the bulk will probably come later. Fund III will not start realising until 2020. Sidecars may develop before then, but they are few in number and less significant in value.

For the post-investment fund, similar considerations apply, though with a much shorter duration book the fund should be largely realised within a few months of the start of realisation in 2019. For quantifying the fee there is also the additional complication of capital deployment, as the revolving nature of the book means that utilisation will be significantly less than 100%.

We can again make crude estimates. Using the 12.6% IRR on investments with a 50% utilisation rate would give roughly $4m. Increasing the utilisation to 80% would give $17m. Again, the wide range suggest this is perhaps more an indication of the order of magnitude than a detailed estimate.

Our crude performance fee range from existing funds is then $91m to $136m. This suggests the earnout payment, which is conditional on $100m of performance fees, is more likely to be paid than not though it will probably take a few years for that to be reached.

For our estimates we have assumed very limited performance fees payable in 2017, with greater amounts in 2018. We have assumed that Burford continues to grow its funds and receives increased management fees accordingly, though this slows as Funds I & II are realised. Against that interest on the loan note will be around $2.5m per annum at current LIBOR rates. The net effect is to add $11m (11%) to our 2017E earnings estimates, and $13m (12%) to 2018E. The additional shares mean a slightly lower percentage increment to eps. There can be little doubt that this will be incremental to earnings for Burford shareholders.

Estimates for increment to Burford's earnings

$m	GKC 2015	GKC 2016E	2017E	2018E
Income	11.2	15.4	21.1	25.3
Expenses	3.9	6.3	7.6	9.1
Operating Profit	7.3	9.1	13.5	16.2
Interest on loan notes			2.5	2.5
Tax			0.7	0.8
PAT			**11.3**	**12.9**

Source: Burford Capital, Hardman & Co Research

2016E are estimates supplied by Burford Capital and exclude one-time transaction expenses.

The effect on the balance sheet is straightforward. From the acquired company there are almost di minimis additional assets. On the payment side there is cash to be deducted, and loan notes and additional shares to be added together with additional goodwill.

Burford have stated that they will not raise any finance to fund the deal, citing strong cash realisations from their business in 2016. This implicitly suggests that the second half of the year has been very good for Burford. Without additional detail, we have not adjusted our estimates, though we strongly suspect they will be beaten when the actual results appear in the spring.

Strategic

The acquisition brings several strategic benefits to Burford.

Other than the deal being attractive financially, we see the primary benefit being that of further diversification. The fund management model brings a different revenue stream. Management fee income is somewhat more stable than the other parts of its business, though over time we expect these to significantly exceeded by the performance fees.

There is diversification in its business lines, with the addition of post-settlement finance to Burford's product range and capability in intellectual property. It also adds a presence in Chicago, though both companies appear to operate across the US already.

Management have also cited a scale benefit. The addition of twenty additional staff who are already have appropriate experience is valuable, though we note that they are likely to be very busy ensuring that the available assets continue to be deployed. Hardman is less certain about other scale benefits – both companies have already gained significant traction at their existing size and shown the capability to do large deals.

Ongoing Management

With Fund III currently being actively invested and Burford looking to both utilise both teams flexibly and continue to make on balance sheet investments it has had to address asset allocation for litigation investment. Historically GKC's investments have usually been smaller than Burford's, typically in the \$3-10m range compared with Burford's average of around \$10m. Going forward the first \$15m of any investment will be split equally between Burford's balance sheet and the fund, with the balance remaining on balance sheet.

For judgement enforcement and post-settlement finance each will remain as before.

We note that the three members of the senior management of GKC have been locked in for a minimum of three years and will retain a substantial equity stake in Burford. All three of them will join Burford's investment committee.

Summary

Overall this looks to be a very good acquisition for Burford. It diversifies both its product range and revenue streams. To Hardman, the price paid looks to be on the right side of fair and the deal is clearly earnings enhancing too. The additional staffing capacity is also welcome, but is essential for ensuring that this additional capital is effectively deployed.

Financials and Forecast

Summary financials						
Year end Dec ($m)	**2013**	**2014**	**2015**	**2016E**	**2017E**	**2018E**
Revenue	60.7	82.0	103.0	127.0	167.3	190.2
Expenses	18.1	21.3	25.8	30.1	41.6	48.4
Operating Profit	**42.5**	**60.7**	**77.2**	**96.9**	**125.7**	**141.8**
Finance cost	0.0	3.7	9.3	13.7	18.3	18.3
Exceptional items	-40.4	-9.7	0.0	0.0	0.0	0.0
Reported pre-tax	**2.1**	**47.3**	**67.9**	**83.6**	**107.4**	**123.5**
Reported taxation	0.5	-0.7	-2.2	-5.5	-6.7	-7.5
Minorities	0.1	1.2	1.2	1.2	1.2	1.2
Underlying net income	**40.1**	**53.0**	**64.5**	**76.8**	**99.5**	**114.8**
Statutory net income	2.6	45.4	64.5	76.8	99.5	114.8
Underlying Basic EPS ($)	**0.20**	**0.26**	**0.32**	**0.38**	**0.48**	**0.55**
Statutory Basic EPS ($)	0.01	0.22	0.32	0.38	0.48	0.55
Dividend ($)	0.05	0.07	0.08	0.09	0.11	0.12
Balance sheet						
Total equity	351.5	382.7	434.3	495.2	576.3	692.3
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**	**779.5**	**860.5**	**932.8**
NAV Per share ($)	1.72	1.87	2.12	2.38	2.77	3.32
Return on Equity	**0.8%**	**12.4%**	**16.1%**	**16.7%**	**18.8%**	**18.3%**

Source: Hardman & Co, £1=$1.26

Valuation

There has been some market debate as to how best to value Burford, with an earnings based approach gaining more support than a balance sheet one. The acquisition of a fund management business is likely to further increase support for the former.

Although the Burford share price has appreciated considerably since the interim results, the combination of upgrades for the acquisition and advantageous exchange rate movements means that the rating has risen much less. The prospective P/E for 2017E has risen to 14.8 times, and that for 2018E is only 12.8 times. Our sustainable Return on Equity has also increased a percentage point to over 18%. For a business that we forecast to sustain mid to high teen growth rates that seems to still give good value.

Notes

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(Disclaimer Version 2 – Effective from August 2015)

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