Burford Capital

Another positive verdict

Burford's results for 2016 produced another outstanding set of figures. Revenue grew by 60% to $163.4m with strong growth in the litigation finance business and an additional boost from a secondary sale in the Petersen case. On an underlying basis net income grew to $114m, a 75% increase despite the investment in growing capacity which increased costs. A combination of ongoing investment and gains and increases on valuation saw the fair value of the litigation assets increase 67% to $559m, underpinned by a growth in invested capital to $394m. With the results statement there was an announcement of a further sale of 9% of the Petersen case at a valuation of 20 times the cost of investment.

- **Other businesses**: Insurance had a very good result in 2016H2 and its earnings grew 7% over 2015. Judgement enforcement had a weaker second half, but still gave a first positive annual result of $3.1m. Gerchen Keller, with only two weeks within Burford in 2016, made a minimal operational contribution.

- **Balance sheet:** By Burford's standards this has been a busy year. The main second half item was the purchase of GKC. Burford currently has ample cash for its needs, but as it continues to grow will probably need more funds later this year. This will most likely be a debt raising.

- **Valuation:** With performance again exceeding expectations Burford's rating remains good value despite the strong share price performance. The prospective P/E for 2019E is only 13.1 times, while a prospective 18% RoE with strong growth suggests strong metrics all round.

- **Risks:** The investment portfolio is now quite diversified, but still has some very large investments, which means revenue may be volatile. The Petersen case provides a concrete example of this. As the company matures we would expect that to decrease, but not to disappear.

- **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 ($m)	2014	2015	2016	2017E	2018E	2019E
Revenue	82.0	103.0	163.4	233.1	211.5	259.2
Operating Profit	60.7	77.2	124.4	181.0	150.8	188.8
Reported net income	45.4	64.5	108.3	157.2	121.3	158.1
Underlying net income	53.0	64.5	114.2	157.2	121.3	158.1
Underlying Return on Equity	12.1%	16.0%	22.2%	24.3%	16.0%	17.6%
Underlying EPS ($)	0.26	0.32	0.55	0.75	0.58	0.76
Statutory EPS ($)	0.22	0.32	0.53	0.75	0.58	0.76
Dividend per share ($)	0.07	0.08	0.09	0.11	0.12	0.14
Yield	0.7%	0.8%	0.9%	1.0%	1.1%	1.3%
NAV per share ($)	1.87	2.12	2.22	2.71	3.29	4.05
P/E (x) (underlying)	40.6	33.4	19.2	13.9	18.1	13.9
Price/NAV (x)	5.6	5.0	4.7	3.9	3.2	2.6

Source: Hardman & Co Research

Financials

Source: Eikon Thomas Reuters

Market data

EPIC/TKR	BUR
Price (p)	835.0
12m High (p)	835.0
12m Low (p)	226.0
Shares (m)	208.2
Mkt Cap (£m)	1,738.8
Total Assets ($m)	968.2
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

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Key shareholders

Directors & Management	14%
Invesco Perpetual	25.9%
Woodford Investments	10.0%
Fidelity Worldwide	8.7%
Aberdeen Asset	4.9%

Next event

16 May 2017	AGM
16 June 2017	Final dividend paid

Analysts

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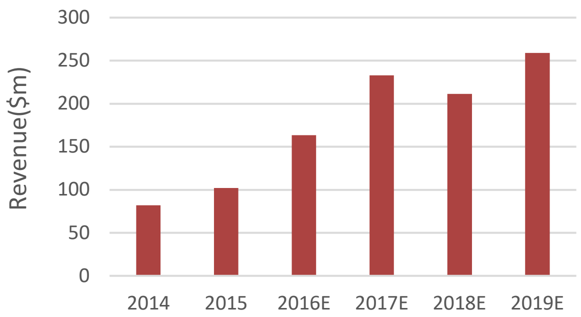
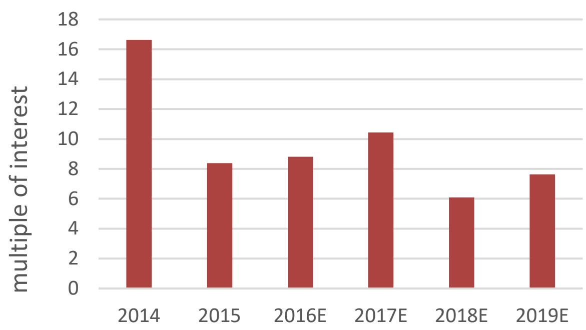
Revenue



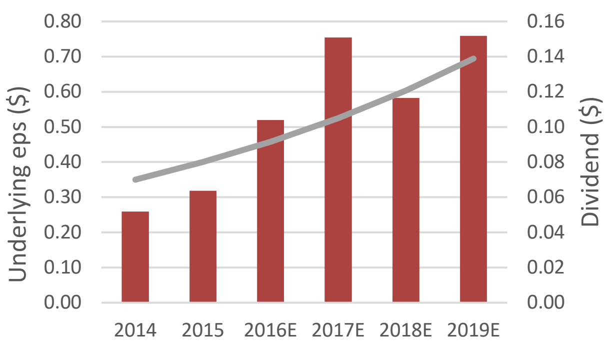
- Growth depends on pace of investment and conclusions
- Accelerated investment in 2016 will boost 2017 and 2018 revenue
- 2016 and 2017E boosted by movements in Petersen case
- Continued investment in the business underpins the growth

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
- Assumed another £100m debt issue from start of 2018

Eps and dividend



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

Source: Company data; Hardman & Co Research

Results Summary

As is now a good habit, Burford produced an outstanding set of results for FY2016. Total income grew 59% to $163.4m, again driven by the core litigation business which grew its income by 60%. On an underlying basis (excluding amortisation and acquisition costs) earnings also grew 75%.

The final dividend was increase to ¢6.48, giving a full year total of ¢9.15 which is a 14% increase in dollar terms. UK investors see a much larger increase of 38% at current exchange rates due to the depreciation of sterling over the year.

By Division

Litigation Finance

Litigation Finance

	2013	2014	2015	2016
Income	38.85	47.85	87.88	140.19
Expenses	9.01	10.42	15.65	26.02
PBT	29.84	37.43	72.22	114.17
Tax	0.56	0.61	-2.23	4.72
PAT	**30.41**	**38.04**	**70.00**	**118.89**
Op Mgn	77%	78%	82%	81%

Source: Burford Capital, Hardman & Co Research

As noted above, the core litigation finance business continues to drive revenues and profits forward. Hardman & Co noted at the time of the FY2015 results that the significant increase in litigation investments on Burford's balance sheet would drive a significant increase in profitability. At the time we expected the primary benefit to come in 2017, but this has come sooner. Although Burford will not comment on specific investments, we believe that the $100m announced a year ago has slightly different characteristics from its earlier investment. We note in particular the full investment at outset with no contingent commitments, and believe that the cases in this investment have been maturing a bit quicker than the other investments.

There is also a boost from a secondary sale in the Petersen case, which is discussed in detail below.

Costs also grew significantly in this area, with an increase of 66% over 2015. Burford had previously indicated that they believed that they had underinvested in growing capacity in 2015 and intended to rectify that in 2016. This has led to a slight decrease in the operating margin compared to FY2015, though it is still better than prior years. Management have indicated that they will continue to invest in growing the capacity in 2017. Given the apparent market potential, Hardman & Co believe they should continue to do so.

It should be noted that law firm lending is now included with the litigation finance segment, though the overall numbers are small relative to the existing business.

Investment Management

Last year Burford purchased Gerchen Keller, a litigation investment business that managed funds. With the acquisition taking place in mid-December 2016, there is little in Burford's profit and loss from operations, with $647,000 of revenue and

$379,000 of operating profit. With the comprehensive disclosure at the time of the acquisition, there is also little in the way of incremental news.

There has been a bigger effect on the balance sheet, with $133.9m of goodwill and $39.4m of intangible assets representing the value of existing accounts. Acquisition costs are $5.9m, with the bulk of these and a substantial part of the cash payment as unpaid liabilities at the year end.

Insurance

Insurance

	2013	2014	2015	2016
Income	20.91	24.34	12.76	12.92
Expenses	6.78	5.40	2.58	1.70
PBT	12.96	18.94	10.19	11.23
Tax	-2.84	-3.86	-1.19	-1.61
PAT	**10.12**	**15.08**	**9.00**	**9.62**
Restructuring	-1.17	0.00	0.00	0.00

Source: Burford Capital, Hardman & Co Research

The insurance business had a very positive result in the second half of 2016, reversing a weaker first half and for the year revenue grew by 1.2% in dollar terms. Exchange rate moves disguise that in sterling terms operating profit increased by 25%. As indicated at the half year results, new business is no longer being written as of 31 December 2016 and the book is now in run-off.

Burford have managed the costs down in this business, and there remains a substantial book to be run-off. Nevertheless, though it has been a very profitable investment for Burford, profits from the existing business will decline over the next few years.

It is clear that Burford is not the only one who has pulled back from the UK litigation insurance market over the last few years, and it observes that there are some issues now related to a lack of capacity. It would seem that Burford see a potential opportunity and are looking at solutions, which may include a creating captive insurer.

New Initiatives

New Initiatives

	2013	2014	2015	2016
Income		0.22	2.51	8.85
Expenses		1.56	2.80	4.90
PBT		-1.34	-0.29	3.95
Tax		0.47	0.00	-0.82
PAT		**-0.87**	**-0.29**	**3.14**

Source: Burford Capital, Hardman & Co Research

The New Initiatives segment now contains only judgment enforcement, with law firm lending being moved to the litigation finance section. The 2015 figures have been restated to reflect that.

The first half of FY2016 was very good for the business, with its first significant contingent return in the first half of the year. With no repeat of that in the second half, profitability declined to $0.4m in 2016H2. Management described this business as a mini-Burford, particularly as it seems likely to have volatility in revenues depending on when contingent claims come in. It may take some time for the book to build up and for revenues to become more stable. Having said that, almost half the costs were covered by fees so there appears to be some underpinning already.

This business will shortly be renamed "asset recovery".

Corporate

There were two significant changes to the income statement from the corporate centre. Firstly the issue of a new retail bond (£100m at 6.125%) increased interest costs. In 2017 this cost will increase further, with a full year of the bond and the addition of the loan note for the GKC acquisition, though there will be some offset from the beneficial exchange rate movements.

The second large item is something of a one-off, with a currency gain of $34.9m. Most of this reflects the change in the value of the debt. In the absence of further large currency movements this line is expected to return to more normal levels in 2017.

Investments

While there has been much discussion of some individual investments (more on that below), it is the diverse portfolio of investments that remains Burford's biggest attraction. FY2016 as a whole showed improvement in returns over the previous year with $177m of gross realisations ($139m in FY2015), $47m of realised gains ($60m in FY2015) and $203m of cash flow ($140m in FY2015).

Cumulative returns (percent)

	2012	2013	2014	2015	2016
RoIC	57%	62%	60%	70%	60%
IRR	22%	26%	24%	28%	27%

Source: Burford Capital, Hardman & Co Research

For FY2016 Hardman & Co is changing its analysis of investments. When Burford started investing, each investment represented a single case. As the business has progressed its investments have increasingly been in multiple cases, meaning the methods we used before no longer give the same insight. Ultimately this is good for the business, as the portfolio investments now have over 500 individual cases underlying them, even if it means using simpler statistics than before.

The cumulative Return on Invested Capital (RoIC) declined to 60%, from 70% the year before while the IRR only reduced slightly. The former probably reflects the shorter duration of some of the 2016 investments, with $42.7m from one investment producing $61.1m of return. We believe this is from the large investment of $100m that we discussed earlier. The RoIC on realisations in 2016 from that investment was 44%, but with an overall IRR of 60% this has been a great investment so far.

We note the weighted average duration on concluded investments declined to 1.6 years from 1.9 years in 2015. We attribute much of this decline to the early resolutions within the $100m investment and expect a return to more normal levels of around 2 years going forward.

Petersen case

Alongside the results, Burford announced the further sale of part of their investment in the Petersen case. They sold another 9% of their exposure at the same valuation as last time, 20 times their investment, for a cash amount of $36m, implying a total value for the case of $400m. Burford retains 90% of their exposure to the case, but have already recovered their investment so far with a profit too.

This is being read by many investors as significant, but the exact effect is rather opaque. We would make the following points, some of which we discussed in our previous note:

- This is a single case and the outcome is binary – either there will be a win/settlement or the case will be lost. The price may be regarded as an expected value of that, but will either be too low or too high depending on the outcome. The amounts either way could be significant for the company as a whole.
- Timing of any resolution remains uncertain.
- We do not know the valuation of the case prior to the sale.
- We do not know the valuation of the case in the 2016 accounts. The total fair value movement for the year was $87.8m. Previous years have had figures of $18-24m on much smaller books of investments. This suggests the uplift was perhaps around 10-15% of the then ~99% retention of $400m that applying the price to the full investment would imply.
- The sale at the end of 2016 represented less than 1% of the value of the case and, given the almost complete absence of any other secondary market activity, was insufficient establish a proper market price. We believe that 10% will give more confidence, but will not clearly set a price for the whole case.

What we do know is that, from the data so far, that Burford will register another gain this year of $36m less 9% of the current valuation, which is still likely to be significant. There will also probably also be a significant valuation uplift. We have included a total of $72m for the gain and valuation uplift in our estimates, though we have no insight as to whether this fits with management and auditor thoughts. Frankly, the potential range is roughly $40m to $300m. We know Burford tend to be prudent, so a figure in the lower half of the range seems more likely, but without further information we cannot be more precise.

We also note that the Petersen case is not the only case that can significantly influence results by itself. We believe any of the outstanding 2010 cases could do so, but timing, as always, remains unclear.

New Investments

Having expanded its staffing capacity, Burford managed to grow its book of investments significantly again in 2016. As well as the $100m portfolio announced at the start of the year, Burford committed to funding another $50m portfolio and overall made 21 new investments in 2016. These took $203.9m of investment with another $163.9m of contingent commitments, both of which would be new highs for the company even without the large portfolio.

Litigation investments				
	2013	**2014**	**2015**	**2016**
Additions during year	62.4	77.4	124.2	271.6
Invested capital at y/e	173.6	207.5	252.9	394.3
Fair value at y/e	214.9	266.8	334.2	559.7
Fair value/ invested capital	124%	129%	132%	142%

Source: Burford Capital, Hardman & Co Research

As a consequence of this activity the end of the year saw Burford with a significantly larger book of investments than at the start of the year. The fair value balance grew 67% to $559.7 and invested capital by 56% to $394.3m.

Balance Sheet

By Burford's standards this was an exceptionally busy year. As well as the strong growth in litigation investments it issued a £100m retail bond, retired its preference shares and purchased Gerchen Keller. Only the preference share retiral can be said to have not had a significant effect.

Key balance sheet figures				
	2013	**2014**	**2015**	**2016**
Litigation investments	214.9	266.3	334.2	559.7
Cash investments and equiv.	83.8	189.6	185.6	169.5
Due from litigation investments	50.9	63.51	61.61	40.1
Goodwill and intangible asset				173.33
Total assets	**376.1**	**533.2**	**608.7**	**968.2**
Debt	0.0	138.1	131.3	274.0
Shareholders equity	351.5	382.7	434.2	596.2
Gearing	0%	36%	30%	46%

Source: Burford Capital, Hardman & Co Research

Burford finished the year with a cash and equivalents balance (net of the outstanding payments for GKC) of $105.7m. The latest Petersen sale adds $36m to that. Litigation payments due at the year end were $40.1m, $20.5m lower than at the end of 2015. Net investment (growth in invested capital) in the litigation investment book last year was $141.4m, with contingent commitments 39% higher at $297m.

All this tells us that if Burford continue to invest at their current rate then they will need an influx of capital before the year end. Although last year's single $100m investment may not be repeated, the ongoing investment in capacity suggests that there will not be any slow down in growth. We note some of that will go to filling the funds brought by the GKC acquisition which does give a bit more uncertainty about the on balance sheet requirements going forward, though there will continue to be a balanced approach.

Given their statement about the "remarkably low level of leverage" and that returns on capital are much higher than the coupon rate on their existing debt, Hardman & Co would expect that there will be a further raising of debt later this year. If another large portfolio opportunity comes along then that may settle the timing, though this will also depend on the flow of resolutions too.

Financials and Forecast

In this year's annual report Burford spent several pages discussing the market and their growth opportunity. It seems pretty clear that there is still a big market opportunity for Burford and, for the moment, the only real restraint is their capacity to process the opportunities.

As always, 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. This year the Petersen sale complicates that even further. With those thoughts in mind, we have increased our 2017E eps by 57% and 2018E eps by 6%. We have also introduced new estimates for 2019 with an eps of ¢76.

The main factors we have adjusted are as follows:

- Addition of $72m for the Petersen case in 2017E.
- Faster growth for new business reflecting the increased investment in capacity, offset by some business maturing quicker than expected in 2016. This has led to a smaller upgrade for 2018E, but our 2019E have the benefit of that investment.
- Further Increased investment in capacity for the litigation finance business.
- An additional £100m of debt with a 6% coupon from the start of 2018, which has also reduced the 2018E upgrade.

Adjustments to insurance, fund management and judgment enforcement forecasts have been minor.

Summary financials

Year end Dec ($m)	2014	2015	2016E	2017E	2018E	2019E
Revenue	82.0	102.0	163.4	233.1	211.5	259.2
Expenses	21.3	24.1	39.0	52.0	60.7	70.4
Operating Profit	**60.7**	**77.9**	**124.4**	**181.0**	**150.8**	**188.8**
Finance cost	3.7	9.3	14.1	17.4	24.7	24.7
Exceptional items	-9.7	0.0	-5.9	0.0	0.0	0.0
Reported pre-tax	**47.3**	**68.6**	**104.1**	**163.4**	**125.8**	**163.8**
Reported taxation	-0.7	-2.2	4.8	-6.2	-4.5	-5.6
Minorities	1.2	1.2	0.6	0.0	0.0	0.0
Underlying net income	**53.0**	**65.2**	**114.2**	**157.2**	**121.3**	**158.1**
Statutory net income	45.4	65.2	108.3	157.2	121.3	158.1
Underlying Basic EPS ($)	**0.26**	**0.32**	**0.56**	**0.75**	**0.58**	**0.76**
Statutory Basic EPS ($)	0.22	0.32	0.53	0.75	0.58	0.76
Dividend ($)	0.07	0.08	0.09	0.11	0.12	0.14
Balance sheet						
Total equity	382.7	433.1	462.2	564.0	685.2	843.3
Invested Capital	207.5	252.9	394.3	561.6	708.8	880.8
Fair Value Balance	266.8	334.2	559.7	833.7	1,078.7	1,372.1
Total Assets	**533.2**	**608.7**	**826.4**	**931.6**	**1,175.9**	**1,334.0**
NAV Per share ($)	1.87	2.12	2.22	2.71	3.29	4.05
Return on Equity	**12.4%**	**15.8%**	**21.0%**	**24.3%**	**16.0%**	**17.6%**

Source: Hardman & Co, £1=$1.23

Valuation

The Burford share price has continued to appreciate strongly, though much of this reflects the underlying performance of the business. The Petersen transaction means earnings are likely to be somewhat volatile over the next couple of years. The prospective P/E is 17.1 times for 2018E and 13.1 times for 2019E. We are estimating 31% growth in invested capital over this period, something that should ultimately be reflected in earnings – Burford remains very much a growth business.

Our return on equity forecast for 2019 is now 17.6%. With additional gearing Burford can grow this further, justifying a premium valuation.

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