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Burford: Husbanding Liquidity, Wife-ing Financials

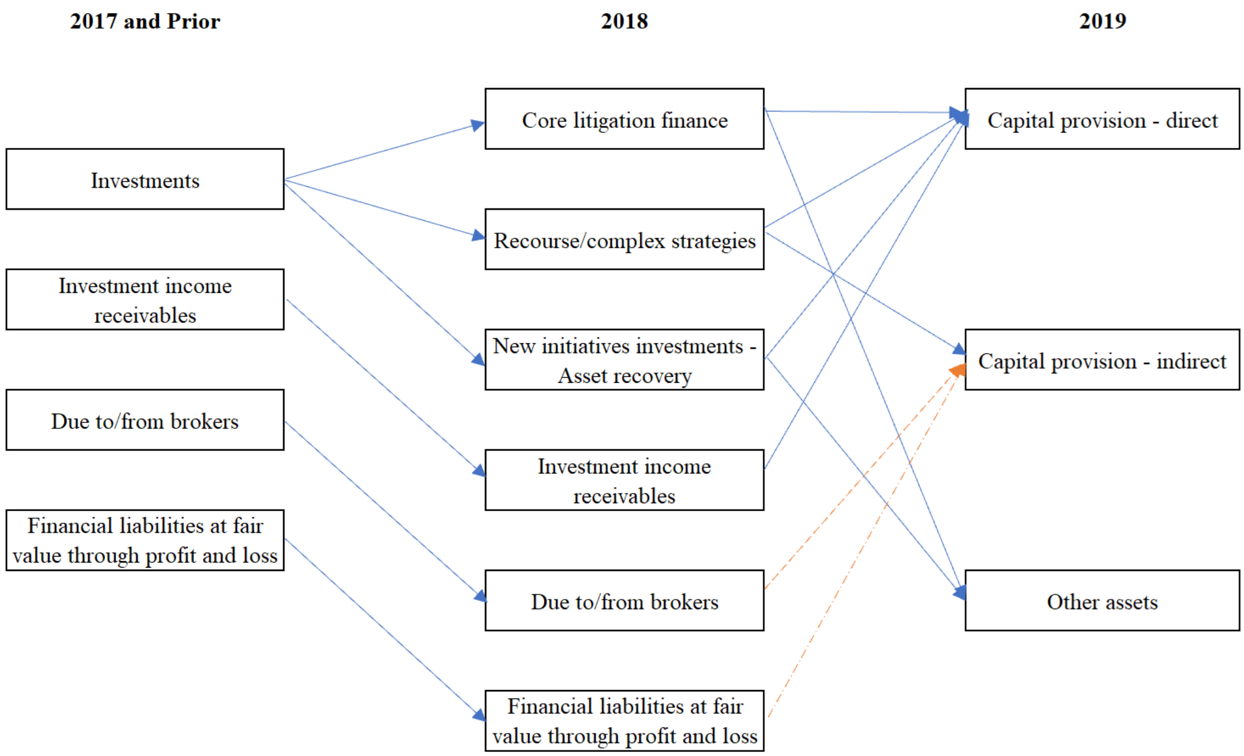
Burford's 2019 financials use reclassification, redefinition to inflate cash receipts, operating profit, and to otherwise present a misleading picture of the business. Cutting through the new bullshit, we adjust Burford's cash receipts to show a YoY decline of -11.8%. We also adjust reported 2019 operating profit lower by approximately -8%. Burford manipulated its 2019 vintage "Direct" return recoveries up 13x by reclassifying a complex strategy case into Direct – *after the end of the fiscal year*. In 2019, Burford changed its definitions of deployments and realizations by including hedging in them for the first time. Removing this misleading padding (i.e., using the previous definition), balance sheet deployments actually declined in 2019 by -35.5%, rather than the claimed -30.6%. Realizations, as previously defined, show a decrease -22.9%, versus the reported -14.2%.

We wonder whether all this goalpost movement was the real reason Burford delayed releasing its 2019 accounts.

New Reclassifications Inflate Cash Metrics and 2019 Vintage Recoveries

Our adjustments show that Burford's cash receipts declined in 2019 by -11.8%. Burford uses changed segment reporting to obscure that in 2019, its cash returns were poor, while it also reclassified certain investments to provide the appearance of growth in a stagnant portfolio. By constantly changing its segment reporting, Burford is hiding the ball from investors and making it difficult to do true apples-to-apples comparisons between periods. Over the past three years, Burford's investment-related balance sheet line items have gone from four to six to three, bringing with them numerous adjustments:

Burford's Changing Classifications Continue to Enable Deception



Related cash flows were added to deployments and realizations at the Burford-only level

Sources: Burford Capital annual reports

The 2019 changes put lipstick on the pig by appearing to pad cash flows and Direct segment recoveries. (This is the first year Burford has added cash from hedging / margin to cash receipts.)

Changing Definition Masks a Significant Drop in Cash Receipts

Burford tried to spin its awful 2019 by focusing on "cash receipts", presumably because it was one of the few operating metrics that did not decline YoY. However, Burford changed the definition of cash receipts in 2019 in order to manipulate the metric higher. Without this definition change, cash receipts would have dropped -11.8% YoY. We almost have to admire the brazenness of this management in doing something so deceptive despite all its protestations of being "transparent" and "conservative".

The company asserts that 2019 balance sheet-only cash receipts were "over $500 million for [the] second year in a row", but this is greatly misleading using Burford's 2018 definition of "cash receipts".[1] For 2019, Burford makes two add-backs it did not make the previous year in calculating cash receipts from operations. One is for "cash from margin/hedging", which has

[1] BUR 2019 Annual Report, p. 32

nothing to do with case success, as detailed below, and is thus not relevant to operating cash receipts. The other is a line item for refinancing proceeds, which we believe should be treated as a financing cash inflow. As a result, not only did Burford's cash receipts decline by -11.8% YoY, but Burford overstated its 2019 cash receipts by 14.5% by changing their definition.

2019 Operating Cash Receipts, Adjusted for Inappropriate Reporting	
($millions)	
Operating Cash Receipts, As Stated	517.8
Less Cash from Margin/Hedging	(56.2)
Less Refinancing Proceeds	(9.2)
Operating Cash Receipts, As Adjusted	**452.4**
Degree of BUR Overstatement	**14.5%**
2018 Operating Cash Receipts, As Stated in 2018	513.0
YoY Decline in Cash Receipts	**(11.8%)**
Sources: Burford Capital 2019 Annual Report, p. 34; 2018 AR, p. 4	

Cash Receipts Ignore Reality: Burford Burns Cash

We believe that Burford chose to discuss cash receipts because it allows the company to avoid factoring in ongoing expenditures necessary to sustain its business. Under a section header titled "Cash Generation", Burford launches into a discussion of cash receipts.[2] We find this characterization laughable. Cash receipts are not cash generation: they do not account for any form of costs or expenditures necessary to stay in business. Indeed, in a business such as Burford's, where cash outflows consistently outpace cash in the door, we see how the company can trot out cash receipts to mask core business declines.

To that end, Burford's balance sheet business consumed significant capital in 2019, with cash balances falling to $206 million from $277 million, a -26% decline YoY. The company likes to protest this reality by noting the obvious, that the bulk of cash outflows are new capital deployments. But, of course, deploying cash is not an elective activity for Burford. If the company were to decline to fund a raft of new cases each year, realizations would dry up.

Operating cash flows do a better job of reflecting Burford's consolidated cash generation, and they are consistently negative. Burford's 2019 stated operating cash outflow is, at first glance, a nearly breakeven -$8.3 million.[3] However, as shown in the below reconciliation, nonroutine cash flow events provided $114.7 million of cash inflows in the period.[4] Excluding these to isolate ongoing Burford operations yields operating cash burn of -$123.0 million:

[2] BUR 2019 Annual Report, p. 32
[3] BUR 2019 Annual Report, p. 105
[4] Such items accounted for -$12.0 million of cash outflows in 2018.

2019 Operating Cash Outflows Balloon After Excluding Nonroutine Items	
($millions)	
Operating Cash Outflow, As Stated	**(8.3)**
Adjusted For:	
Net Proceeds From Third-Party Interests in Consolidated Entities	(83.4)
Net Proceeds From Brokers	(73.4)
Net Funding of Financial Liabilities At Fair Value Through P&L	42.2
Total Nonroutine Cash Inflows, Reversed	**(114.7)**
Underlying Operating Cash Outflow	**(123.0)**
Source: Burford Capital 2019 Annual Report, p. 105	

Burford just does not make money on a cash basis, no matter which adjusted metrics management tries to conjure up in a given year.

Unexplained Operating Profit of $20.6 million

We also adjust 2019 operating profit lower by approximately -8%, or $20.6 million, which we suspect are dubious fair value gains. Burford's disclosures do not explain the source of this $20.6 million income, which is in "Indirect" investments. We therefore suspect that it consists of fair value gains taken on its complex strategies (appraisal rights) book, which would seem to be highly aggressive. Burford discloses that its unrealized gains for its balance sheet Capital provision – indirect were only $4 million.[5] Burford should explain the source of this $20.6 million income.

The unexplained income appears to be from fair value gains in complex strategies. Burford states that when it takes long positions in equities as part of its appraisal rights strategy, it hedges the positions.[6] Once litigation begins, Burford transfers the long side of the investment to a Level 3 asset.[7] In this way, the company books movements in the hedges as Net Realized Gains even as gains or losses on the long side remain unrealized. Such practices allow Burford to inflate fair value gains by booking gains or losses for short-side hedging even while the long side of the investment can be marked up significantly higher than its original cost.

Though Burford claims that "netting is not permitted" in its hedges, we believe the company is intentionally missing the point in its commentary. Hedge accounting principles were created to reduce the accounting mismatch of the hedging instrument and the hedged item, not to increase it.[8] As shown infra, Burford appears to have booked $20.6 million of income unattributable to cash proceeds as operating income in 2019. To the extent Burford is reporting operating income from fair value gains on hedging assets, we question why the company does not net the short and

[5] BUR 2019 Annual Report, p. 62
[6] BUR 2019 Annual Report, p. 48
[7] Ibid.
[8] https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-9/achieving-hedge-accounting-in-practice-under-ifrs-9.pdf, p. 11

long legs of the investment.

Burford reports $51.4 million in 2019 income from equity securities related to its capital provision – indirect investments, as emphasized in red below.[9]

21. Fair value of assets and liabilities continued

Movements in Level 3 fair value assets and liabilities

The table below provides analysis of the movements in the level 3 financial assets and liabilities.

	At 1 January 2019 \$'000	Transfers into level 3 \$'000	Additions \$'000	Realisations \$'000	Income for the year \$'000	Foreign exchange losses \$'000	Transfer to capital provision asset sub-participation \$'000	At 31 December 2019 \$'000
Single case	217,703	–	179,727	(37,078)	97,787	201	–	458,340
Portfolio	1,058,979	–	116,232	(152,377)	209,265	(1,693)	10,700	1,241,106
Legal risk management	3,086	–	–	(1,762)	190	105	–	1,619
Asset recovery	42,217	–	30,439	(1,438)	13,485	1,425	–	86,128
Indirect – equity securities	108,549	210,501	149,152	(327,274)	51,428	–	–	192,356
Derivative financial assets	4,154	–	–	–	(4,154)	–	–	–
Total level 3 assets	1,434,688	210,501	475,550	(519,929)	368,001	38	10,700	1,979,549
Capital provision asset subparticipations	(3,244)	–	–	–	–	–	(10,700)	(13,944)
Derivative financial liabilities	(7,000)	–	–	–	7,000	–	–	–
Third-party interests in consolidated entities	(136,959)	–	(167,685)	84,242	(15,318)	–	–	(235,720)
Total level 3 liabilities	(147,203)	–	(167,685)	84,242	(8,318)	–	(10,700)	(249,664)

We calculate the likely impact of unexplained fair value gains as follows. In 2018, Burford stated proceeds of \$16.1 million across the concluded cases in the complex strategies portfolio.[10] In 2019, however, the company reported that total proceeds stood at \$46.9 million.[11] The \$30.8 million in realizations on concluded cases falling in 2019 leaves 40% of that year's income from capital provision – indirect still unexplained:

Unexplained Income Within Capital Provision – Indirect

Vintage	Deployed (\$mn)	Recovered	Total Return
2017	362.1	387.3	25.2
2018	130.2	149.1	18.9
2019	65.4	68.2	2.8
Total	557.7	604.6	**46.9**
Less Total Return Reported through Dec. 31, 2018			(16.1)
2019 Derived Capital Provision – Indirect Income			**30.8**
Indirect – Equity Securities Income, As Stated			51.4
Less 2019 Derived Capital Provision – Indirect Income			(30.8)
Unexplained Income			**20.6**

Sources: BUR 2019 Annual Report, pp. 47, 138; 2018 Annual Report, p. 29

[9] BUR 2019 Annual Report, p. 138
[10] BUR 2018 Annual Report, p. 29
[11] BUR 2019 Annual Report, p. 47

Accordingly, we believe that the $20.6 million of unattributable Indirect income comes from fair value gains, including gains taken on hedges. After adjusting for our estimate of aggressively booked segment income, we find that Burford's combined 2019 operating profit is overstated by approximately 8.0%:

Unexplained Capital Provision – Indirect Income Inflates 2019 Profit	
2019 Operating Profit, As Stated*	279.3
Less Unexplained Income	(20.6)
2019 Operating Profit, As Adjusted	**258.7**
Degree of BUR Overstatement	**8.0%**

Source: BUR 2019 Annual Report, p. 90
**Excludes amortization of intangibles and one-time expenses*

As much as Burford may try to muddle its year-on-year reporting, it is necessary to understand the impact of Burford's methodological changes to establish the degree to which the company may have distorted its 2019 income statement. <u>Accordingly, we call on Burford to disclose how much income or loss the company recognized from hedging activities in 2019, and to reconcile the $20.6 million income discrepancy in Indirect with the portfolio's cash performance in the concluded investment tables.</u>

Exaggerating 2019 Vintage Recoveries by Moving Assets

Burford reclassified $34.3 million of complex strategies investments to Direct without substantive explanation. One of these reclassifications of 2019 segment gains or losses occurred well *after the end of the fiscal year*. This particular reclassification boosted the vintage's recovered proceeds by 13x.

Burford reported a 16% ROIC on complex strategies in 2018, excluding fees and carry.[12] As of the 2019 annual report, however, Burford's ROIC on the nearly analogous capital provision – indirect investments had shrunk to just 8%, excluding fees. This depressed return rate is partially due to Burford's inclusion of deployments for hedges. However, the ROIC also dropped because the company reclassified $34.3 million of complex strategies investments to capital provision – direct without substantive explanation.[13] The company did not disclose the net impact of such investment reclassifications on 2019 segment gains or losses, nor their effect on the balance sheet.

In fact, in one instance more than a month after the end of the financial year, and after reporting preliminary results on February 3, 2020, Burford reclassified Case 170718, an $11.9 million complex strategies investment with $11.9 million of recoveries, into Direct.[14] We believe this change, which was made management's discretion, was used to pad recoveries in the 2019

[12] BUR 2018 Annual Report, p. 29
[13] BUR 2019 Annual Report, p. 52
[14] BUR 2019 Annual Report, p. 32

vintage, which only has $1.0 million in partially concluded proceeds outside of the transferred case:[15]

Capital provision-direct assets
Burford balance sheet only continued

($ in millions)	Number of assets	Commitment amount	Deployed costs	Recovered proceeds	ROIC	IRR	WAL – D	WAL – R
Concluded	1	11.9	11.9	11.9	8%	19%	0.3	0.3
Partial realised – concluded	2	0.2	0.2	1.0				
Partial realised – ongoing		22.3	5.0	–				
Ongoing	45	381.3	143.2	–				
2019 Total	**48**	**415.7**	**160.3**	**12.9**				

Burford Also Exaggerates Deployments and Realizations

In another example of Burford's putting lipstick on the pig by moving the goalposts, Burford began including "hedging-related assets" in calculating deployments and realizations in 2019. The company asserts that "such inclusions more accurately represent the cash flows in that strategy", but this seems a thinly-disguised excuse for blatantly misleading and attempting to distract from a dismal year's performance.[16]

Burford claimed "another year of deployments above $1 billion Group-wide" in 2019. Hedging-related deployments, however, rose +70% YoY to $92 million across Burford and its funds, while hedging-related realizations more than quadrupled to $97 million. Eliminating the impact of hedging assets yields deployments that were $982 million, for a -9% decline YoY.[17] We suspect this inflation of deployments came from a need to hit a round number—in this case, $1 billion—by manipulating the numbers to fit the narrative.

Similarly, Burford claims 22% realizations growth across the portfolio in 2019. However, after excluding realizations from hedging assets, which quadrupled YoY, realizations across Burford's own capital and that of its funds were only up 14%. Burford's balance sheet-only deployments and realizations, which already showed double-digit YoY percentage declines, plummet further when restated under this more appropriate treatment.

[15] BUR 2019 Annual Report, p. 43
[16] BUR 2019 Annual Report, p. 50
[17] Ibid.

Burford Uses Hedging Assets to Inflate Deployments and Realizations

Burford Balance Sheet Only

Deployments	**2018**	**2019**	**YoY**
As Presented in 2019	670	465	-30.6%
Excluding Hedging Assets (Follows 2018 Methodology)	637	411	**-35.5%**
Realizations	**2018**	**2019**	**YoY**
As Presented in 2019	537	461	-14.2%
Excluding Hedging Assets (Follows 2018 Methodology)	525	405	**-22.9%**

Total ($millions)

Deployments	**2018**	**2019**	**YoY**
As Presented in 2019	1,133	1,074	-5.2%
Excluding Hedging Assets (Follows 2018 Methodology)	1,080	982	**-9.1%**
Realizations	**2018**	**2019**	**YoY**
As Presented in 2019	841	1,028	22.2%
Excluding Hedging Assets (Follows 2018 Methodology)	817	931	**14.0%**

Source: Burford Capital 2019 Annual Report, Muddy Waters estimates

Petersen Appears to be Egregiously Mis-Marked

In our view, Burford's strained attempts to justify the bloated Petersen valuation are chief among the company's attempts at misdirection. In the 2019 annual, Burford finally disclosed that it carries Petersen and the related Eton Park claim at a combined $773 million. As we discussed in our initial report, we had suspected Petersen was "likely marked very close to its latest sale value".[18] We were right, and even a bit conservative in our estimate. After refusing to disclose the valuation and hiding behind asinine excuses for over eight months, on April 28, Burford finally admitted that it marks Petersen at the June 2019 transaction price.[19]

There are multiple serious flaws in the prospects for Petersen that, in our view, should give investors misgivings not only about the effect of that asset's valuation Burford's balance sheet, but about the way that management conducts business in the rest of the portfolio.

Argentina's precarious financial position is no secret. Argentine 100-year sovereign debt issue currently trades at 28 cents on the dollar.[20] If Petersen prevails in court, it is logical to expect at least a similar haircut applied to any eventual payout. Burford, for its part, implies that a legal judgment against Argentina would somehow sit above the sovereign debt.[21] We find it laughable that a litigation finance outfit would be paid par while bondholders accept a fraction of their principal. That said, we suspect that Burford can't backtrack on its astronomical Petersen

[18] Muddy Waters is Short BUR Capital, p. 21
[19] BUR 2019 Annual Report, p. 123.
[20] Bloomberg data
[21] "When you invest in a suit like this, you're not betting on sovereign debt." Source: BUR FY2019 Earnings Call Transcript

valuation, as it would only further confirm that Burford's marks are misleading; and, that rather than being the smart money at the table, it is actually the sucker.

As we noted in our February 2020 report, we believe there is a strong possibility a Petersen judgment would be paid in Argentine pesos (or in dollars equal to the depreciated peso).[22] Burford tries to point to Section 7 of the YPF bylaws to bolster its case for dollar-denominated payment but did not cite any explicit support from the document in question.[23] We agree with a recent *Financial Times* assessment of Petersen, which noted that Section 7 of the YPF bylaws refers to shares traded on the Buenos Aires stock exchange, denominated in pesos.[24] There exists no reference to shares traded on the New York Stock Exchange in Section 7. Therefore, we see that Burford faces a strong possibility of getting at best roughly six cents on the dollar for any judgment in its favor. Again, we find this inconvenient to the $773 million YPF-related carrying value, and in our view, we are not surprised that Burford tries to cloud the narrative here.

Burford also makes much of its ability to enforce and recover such a judgment. But, Burford's asset recovery arm appears to us to be more a bungling band of thugs and sex tape blackmailers than a highly skilled set of operators.[25] If there was any doubt as to Burford's inability to perform, its failure to seize oligarch Farkhad Akhmedov's yacht this February confirms that its capacity to make good on a judgment would be stunted, at best.[26]

We note that Burford threw up lame excuses for not disclosing Petersen's value for months before finally coming up with the justification that the "size of this latest sale", coupled with third-party transactions amounting to less than half of Burford's sale, allow for disclosure of the mark.[27,28] The most recent Petersen disposal occurred in H1 2019, and we do not view that transaction as arm's-length. Secondary market sales were thin enough that Burford apparently sold 30% of the claim to one of the funds it manages.[29] Such a related-party sale could well be viewed as "painting the tape". (Investors would do well to remember how entangled Neil Woodford has been with Burford.)

[22] "Horrible Second-Half Results Validate Our Thesis", p. 4
[23] https://www.sec.gov/Archives/edgar/data/904851/000119312506147059/dex12.htm
[24] https://www.ft.com/content/33963a6e-60f1-4dde-b5b0-49f840d8799b
[25] https://www.ft.com/content/a0519614-c431-11e9-a8e9-296ca66511c9
[26] https://www.ft.com/content/3d4056c6-4cdc-11ea-95a0-43d18ec715f5
[27] "Horrible Second-Half Results Validate Our Thesis", p. 5
[28] Burford 2019 Annual Report, p. 61
[29] Ibid., see footnote phrased as a hypothetical