BURFORD CAPITAL (BUR:LN)
MUDDY WATERS DREAMS OF A BLACK CAT THAT IS JUST NOT THERE

EXECUTIVE SUMMARY

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SEPTEMBER 9, 2019
ABOUT CARO-KANN CAPITAL

Caro-Kann Capital LLC is a research-intensive investment firm focused on small cap stocks. The firm was founded in late 2014 and is an exempt reporting advisor under the laws of the State of California.

Caro-Kann's investment philosophy is based on the principles of value investing. We are primarily drawn toward special situations and compounding opportunities.

The “Caro Kann Defense” is a well-regarded chess opening that emphasizes safety and encourages players to establish a defensible position before contemplating an offensive strategy. A strong foundational opening tends to lead players to more positive endgames. These principles guide our firm’s investment strategy.

ABOUT ARTEM FOKIN

Artem Fokin is the founder and portfolio manager of Caro-Kann Capital LLC, a hedge fund based in San Francisco. Caro-Kann Capital invests in special situations and compounding. Artem has won SumZero Top Stocks for 2017, 2018 and 2019 by pioneering new investment theses on CommerceHub, TripAdvisor and Burford Capital.

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EXECUTIVE SUMMARY

“The hardest thing of all is to find a black cat in a dark room, especially if there is no cat.”

This proverb\(^1\) talks about a black cat that was not there. We think the same concept applies to recent attempts by short sellers to find corporate improprieties in Burford Capital (BUR:LN).

We provide a point-by-point rebuttal to the Muddy Waters short thesis over the next 50+ pages. We should note that we purposefully skipped certain points made by Muddy Waters because we felt that Burford’s management has already responded to them in sufficient detail, and there was little value for us to be repetitive on those issues. We encourage everybody to read management’s response and the full write up which follows, but we offer our consolidated perspective in the summary version below to whet your appetite.

You can find a full 70-page rebuttal on our website\(^2\).

Muddy Waters asserted a number of claims throughout its 25-page report that Caro-Kann Capital wishes to take issue with:

**Claim #1: Burford Categorized a Loss as an Investment with Significant Return and Might Have Acted in Concert with Its Own Largest Shareholder to Deceive**

The strongest card in the Muddy Waters hand stems from claims that (1) Burford reported a profitable investment before the resolution of a case; (2) Burford’s client, Napo Pharmaceuticals, subsequently lost the case that Burford funded, and (3) Burford and its largest shareholder, Invesco, who also happened to be an investor in Napo purportedly colluded to design a highly complex corporate restructuring to enable Burford to keep reporting its profitable investment. This was meant to be Muddy Waters’ Mike Tyson uppercut, a good night and good luck to the Longs. Given the market’s knee-jerk reaction to the report, it seemingly was.

But there is no smoking gun. Caro-Kann believes this point to be a *phantom punch*. The more facts and explanations Muddy Waters has demanded on this matter, the more disclosures Burford has provided. Burford has come out better looking as a result.

First, while Muddy Waters asserted that Burford inappropriately recorded Napo as concluded and reported high ROIC on the matter presumably in its attempt to impress investors with its track record, it turned out that Burford’s reporting was in fact *conservative*. Here are a few illustrations:

✓ At the end of 2013 when Burford’s entitlement became unconditional, Burford applied a discount of -50% to the receivable on the balance sheet and the concluded case value in its non-IFRS investment data. To be more specific, the receivable and the concluded case investment were accounted at -$15.75M while Burford was legally entitled to -$30M.
✓ At the end of 2015 Burford did not include the effect of the accruing interest at a rate of 18%.

\(^1\) It appears almost impossible to trace the origins of this proverb.

\(^2\) [http://caro-kann-capital.com/#research](http://caro-kann-capital.com/#research)
At the end of 2016 Burford carried the Napo investment at ~$21.3M while it was legally entitled to ~$51.1M.

Why did Burford apply such a conservative approach? Burford did so because it was not certain about collectability of its entitlement. This shows thoughtfulness and conservatism as opposed to aggressiveness to impress investors with returns as implied by Muddy Waters.

Second, Burford’s explanation of events matches several public documents, including:

✓ Settlement Agreement between Glenmark and Napo
✓ Petition to Confirm Arbitration Award filed by Glenmark with United States District Court for the District of New Jersey – this is the very court document that Muddy Waters included into 2019-08-26 Report “Burford: Was MW Wrong About Napo?” as an exhibit.

Third, Muddy Waters also correctly noted that Nantucket, Burford’s affiliate that held Jaguar Health (e.g., successor to Napo) shares had its address of record listed in 2017 Proxy Statement that was identical to Invesco’s global headquarters address. Muddy Waters did not comment on implications of this, but it would not be unreasonable to think that at least some readers (and probably a lot more than some) viewed this “cozy address sharing” as circumstantial evidence of concerted efforts by Invesco and Burford to orchestrate the entire transaction. The reality appears a lot duller: a careful review of prior and subsequent filings shows that Invesco’s address listed as Nantucket’s address was a result of a clerical error.

**Claim #2: Deemed Recoveries Lead to Increased IRRs**

Another key component of the short thesis relates to Burford's recovery practices. Muddy Waters asserts that Burford unjustifiably reported a higher IRR on an investment where it collected proceeds only a few years later. Muddy Waters cites the *Desert Ridge* case as a telling example of such “abuse”.

We view the Desert Ridge case from a radically different perspective. In our opinion, *Desert Ridge* shows Burford’s outstanding deal making abilities and a general commitment to shareholder communication and transparency.

Thanks to such deal making abilities, Burford turned an initial profit of $17.6M into a $31.1M profit (-76.7% increase) and increased ROIC from 254% to 448%. This occurred at the expense of a slight reduction in IRR from 51% to 47%, from 2010 to 1H 2016. Burford did so by agreeing to wait to collect what it was owed and converting its entitlement which was an unsecured obligation of the client into a first lien mortgage that carried a very attractive rate. A brilliant move in our humble opinion.

In other words, Burford made a lot more money and sacrificed -4 percentage points of IRR on the initial IRR of 51%. We bet that every hedge fund manager out there would take such an IRR reduction in order to gain a higher ROIC. While Muddy Waters correctly pointed out the decrease in the IRR, it neglected to mention a massive increase in profits of 76.7% (from $17.6M to $31.1M) and ROIC increase from 254% to 448% as a result. We find this omission a bit misleading and a bit too convenient.

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3 [https://www.sec.gov/Archives/edgar/data/1585608/000104746917003695/a2232030zex-10_60.htm](https://www.sec.gov/Archives/edgar/data/1585608/000104746917003695/a2232030zex-10_60.htm)

4 [https://www.muddywatersresearch.com/research/bur/was-mw-wrong-about-napo-no/](https://www.muddywatersresearch.com/research/bur/was-mw-wrong-about-napo-no/)
Claim #3: Burford Does Not Reduce ROIC and IRR from Investments that It Acquired by Purchase Price It Paid for Acquired Operating Businesses

Muddy Waters argues that Burford does not allocate the purchase price of operating businesses to the cost basis of acquired investments. Let us explain what Muddy Waters means by that.

In the past, Burford completed few acquisitions of operating businesses because it wanted to bring a particular area of expertise / skillset in-house (e.g., asset recovery) or gain speed to market (e.g., acquisition of asset management business – Gerchen Kellner (GKC)). Muddy Waters asserted that (1) Burford acquired investments as part of those M&A deals and (2) returns (ROIC and IRR) on those investments should be reduced by allocating some purchase price against ROIC and IRR of such investments.

We respectfully disagree with Muddy Waters’ viewpoint in two ways: conceptual and fact specific. Furthermore, examples that Muddy Waters provided to prove that Burford misrepresented IRRs on investments in questions are not persuasive. Burford pointed out multiple factual inaccuracies in Muddy Waters’ examples. Management’s position on the matter is fact based and well supported, and Muddy Waters has yet to challenge those corrections. In fact, a careful review of past disclosures demonstrates that Muddy Waters is mistaken.

For example, Burford previously disclosed that it separately acquired two small investments (~$4.3M) concurrently with the acquisition of the operating business of GKC. We are satisfied with that, and we broadly feel that Muddy Waters has simply gotten this point wrong. More detail follows in the full write-up.

Claim #4: Burford Inappropriately Calculates ROIC of Partial Recoveries

We disagree with Muddy Waters’ approach to critiquing this metric and believe that the cost allocation approach deployed by Burford is conceptually preferred and is an intellectually honest method. That said, Burford provides so much data in its detailed disclosures that one can calculate ROIC any way they want, a practice for which Burford should be credited.

We diverge further from Muddy Waters’ perspective with regard to some of its supporting evidence. Muddy Waters presented factually correct data about the Akhmedov case to support its assertions. However, many of these data points such as the length of prior divorce proceedings are irrelevant to Burford at this point because Burford was never involved in divorce proceedings. Their length, whatever it was, is a matter of the past and is irrelevant to Burford. Burford simply pursues a judgment issued after the divorce proceedings, which is an entirely different legal matter.

Other data points such as public information about Mr. Akhmedov’s lawsuit against Burford are optically sensational and appear damning but lack relevant context. The actions outlined by Muddy Waters are, in fact, typical for high stakes litigation. Outcomes are too early to judge, and the high headline number does not mean much at this stage. Furthermore, the judgment issued by an English court remains outstanding and valid and is enforceable. We believe Muddy Waters has done the market a disservice by not providing the relevant context on this point.

Claim #5: Burford Delayed Recognizing a Trial Loss for Two Years

Muddy Waters relies on Progas, an international investment arbitration case that Burford’s client lost to demonstrate that Burford delays recognition of its losses.

Here is an example in which Muddy Waters needs to mention that Burford also delayed recognition of sizable wins under the very same policy. In our opinion, Progas and Teinver cases show that Burford consistently applies the same reporting policy. In Progas their policy resulted in a “delay” of recognition of a loss. In Teinver the same policy resulted in a “delay” in recognition of a massive win with 700%+ ROIC. Again, we find the claims misleading and questionably selective.

Claim #6: Burford Keeps Trial Loses Out of the “Concluded Investment” Category

Muddy Waters provides three examples of how Burford purportedly kept trial losses out of the “concluded investments” category.

After digging into all three examples provided by Muddy Waters, we do not see any evidence proving that Burford keeps trial losses out of the “Concluded Investment” category. None of Muddy Waters’ examples proves this claim. For example, in RCR Tomilson, a securities class action in Australia, Muddy Waters asserted that prospects to collect any recoveries are remote at best.

We see facts differently. As recently as mid-August 2019 three law firms and three litigation funders were fighting to represent the plaintiffs. Burford and IMF Bentham would be funding the litigation together. The litigation has not even “really” started as the plaintiff’s counsel was just determined. We do not see why this case should be viewed as a “concluded investment”.

In our view, Burford is consistently applying the set of policies that it told investors it would apply.

Claim #7: Burford Failed to Deduct Various Costs and Operating Expenses Against Recoveries

Muddy Waters asserted that shareholders are overpaying management because of an extraordinary high expense ratio of ~9%. To provide more context, Muddy Waters gets to ~9% expense ratio by removing all fair market value gains from the capital base and gets to the Adjusted Capital Base of ~$880M. Given that Muddy Waters has not proven that fair value adjustments are inappropriate, we do not see any reason why one should rely on the Adjusted Capital Base.

We see an expense ratio of ~4.25% and the entire “expense ratio” is lower than what a hedge fund with a 2% and 20% fee structure would charge given the returns Burford has been delivering. We believe these expenses to be reasonable based on the firm’s exceptional creation of value over the past decade.

A good conceptual parallel is a hedge fund manager that charges a management fee and an incentive fee based on the amounts invested by limited partners and unrealized capital gains when investments with such gains are carried into the next year. In our view, investable assets are $2B+ (excluding 3rd party hedge funds where Burford acts as a general partner). As a result, we arrive to ~4.25% expense ratio.
Claim #8: Burford’s ROIC Is Highly Reliant On a Few Outlier Cases

We find this line of argument to be problematic on multiple levels. To start, on what basis is it sensible to discount Burford’s biggest wins? Burford’s business is about both protecting downside and capturing the occasional home run outcome. Sounds familiar, does it not?

The return streams and attribution of highly successful fund managers are not normally distributed – limited number of ideas tend to generate the vast majority of a fund’s alpha. What would venture capital as an asset class look like if you applied the same treatment? Perhaps more telling: What would Muddy Waters’ track record look like if you wipe out its biggest and best calls? Ironically Burford is still a highly profitable enterprise even if one removes its biggest wins measured by ROIC (and even more so when adjusting for errors in Muddy Waters’ adjusted ROIC).

Muddy Waters claims that ROIC without those “outlier” cases is 19%. In reality, it is 30%+. Muddy Waters mismatched IFRS reporting for all cases and non-IRFS investment data that covers only core litigation matters and does not cover complex litigation strategies that have substantially lower ROIC (~15% to -20%) but strong IRR.

Finally, such analysis ignores the fact that such high ROIC comes together with longer duration and while IRRs are still higher than portfolio averages, the difference is a lot less dramatic. For example, Teinver was an unquestionable success and generated 722% ROIC but “only” 39% IRR. Over the same period of time Burford could have invested in several cases with lower ROIC but still an attractive IRR of -30%.

Claim #9: Burford Had Ulterior Motives for GKC Acquisition Such as to Consolidate Assets In Order to Make Debt Load Look Less Ominous

“We cannot help but feel that BUR had ulterior motives for this acquisition, such as to consolidate assets in order to make its debt load look less ominous, or to ensure it is valued as an operating business, rather than as a closed-end fund. BUR has issued $646.9 million of retail bonds, and yet has no credit ratings.”

-Muddy Waters

The core problem with this argument is that GCK as any asset manager was an asset light business. As a result, the lion’s share of the purchase price ($133M or ~80%) was allocated to goodwill.

We do not see how making an acquisition and recording a goodwill of $133M helped Burford boost its balance sheet.

We believe that the acquisition had a genuine and clearly articulated business purpose of entering the asset management business. It was a buy vs. build decision. The rapid growth of Burford’s asset management division shows that it was, in fact, a very good M&A transaction.

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6 This claim was not numbered by Muddy Waters. We will assign “number 8” to it as a matter of convenience.

7 This claim was not numbered by Muddy Waters. We will assign “number 9” to it as a matter of convenience. See page 4 of Muddy Waters 2019-08-07 Report.
Claim #10: Burford Is “Arguably Insolvent”

This is a punchline of Muddy Waters’ report:

“BUR is arguably insolvent. If subtracting BUR’s funded debt balance of $637.8 million from the adjusted capital base, there is only a $243.1 million cushion. However, BUR has future balance sheet litigation commitments of $708.2 million. Historically, approximately 85% of these commitments are eventually deployed, implying that BUR has an off balance sheet liability of $602.0 million. When looking at BUR’s solvency through this methodology, BUR has negative equity of -$358.9 million relative to the adjusted capital base.”

-Muddy Waters

After twenty-three pages of one-sided interpretations, Muddy Waters believes it has finally found a black cat in a dark room – the “insolvency” of Burford.

How did Muddy Waters get to that conclusion? Muddy Waters did the following: (1) reduced book equity by all fair value gains, (2) assumed that all bonds become payable overnight, (3) assumed that funding commitments come due, and (4) gave Burford zero chance to generate any cash inflows from investments that may conclude over coming months.

We find this approach sensational and incorrect.

First, we already discussed why removing all fair value gains is incorrect.

Second, assuming that all debt (~$637.8M) becomes payable overnight is a product of strong imagination given Burford’s thoughtfully created maturity ladder over the next seven years. Why these bonds would become immediately payable is quite unclear and we wish Muddy Waters had explained the rationale in their report.

Third, Muddy Waters’ analysis assumes cash outflows beyond imagination and ignores any potential cash inflows. For example, some of the current investments are very likely to come to conclusion over the coming months and bring cash to Burford.

Fourth, Muddy Waters ignores Burford’s ability to sell some of its investments.

Fifth, Muddy Waters ignores Burford’s ability to syndicate its own deals by partnering up with other litigation finance providers instead of funding its solo. We want to be crystal clear: this is a matter of last resort and we do not envision it happening.

Not surprisingly, we strongly disagree with Muddy Waters’ solvency punchline. There is no cat in the dark room, and with respect to Burford, we feel there is no reason to question its financial durability.

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This claim was not numbered by Muddy Waters. We will assign “number 10” to it as a matter of convenience. See page 24 – 25 of Muddy Waters 2019-08-07 Report.
In Summary, We Do Not Find Muddy Waters’ Claims Persuasive, Let Alone Conclusive of Improper Behavior

We do not find Muddy Waters’ claims persuasive, let alone conclusive of Burford’s improper behavior. Muddy Waters provided many correct facts, but often selectively so. Their interpretations of these facts are, however, unusual and appear to be colored by a strong bias in selection. We find that the rigor of their work on the name to be uncharacteristically short of their generally high standard. To put it simply, we disagree with Muddy Waters.

Ben Graham famously said that in the short run, the market is a voting machine, and the market definitely voted in the weeks after Muddy Waters published its report. But in the long run, the market it is a weighing machine. We strongly believe that the market will weigh Burford properly in the long run.

Below you can read the full analysis.

How to Access Full Rebuttal of Muddy Waters Report

You can download the full, ~70 page rebuttal report “Burford Capital: Muddy Waters Dreams of a Black Cat That Just Is Not There” at http://caro-kann-capital.com/#research

Get in Touch

If you want to discuss Burford Capital, please get in touch with us. You may reach the author of this report at artem.fokin@caro-kann-capital.com or you can visit our website at www.caro-kann-capital.com. Thank you for reading.
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