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2019 Interim Shareholder Letter

Wiedower Capital invests in high-quality companies and CEOs that have industry tailwinds behind them and long runways for growth ahead of them. Research is focused on how an industry may evolve over the next 5-10+ years and if a company's competitive advantage can expand within that evolution. Qualitative factors are emphasized over quantitative, and the portfolio is concentrated with long holding periods. See Appendix 1 for a summary of Wiedower Capital's investment philosophy.

Wiedower Capital made one new investment in the first half of 2019. Burford Capital is the largest legal finance company in the world. In the simplest example, Burford invests in a plaintiff's lawsuit by paying their legal fees. If the case is won, Burford shares in the winnings. If the case is lost, Burford loses their entire investment. While this is the core business that started Burford Capital, it now only accounts for around 50% of investments.

Burford's co-founders, who remain the CEO and CIO today, have expanded their vision from investing in lawsuits to be the go-to capital provider for anything a law firm needs. In addition to funding lawsuits, Burford is now involved in recovering assets to compensate unpaid judgments, insurance, receivable factoring, law firm growth expansion, and they've even started to take ownership of underlying assets that are a part of lawsuits.

"*This continuing evolution in Burford's business requires investors to think of us more broadly as a specialty finance company—an investment bank for law—and not just a litigation funder*."
— Burford Capital 2018 Annual Report

Being new to the litigation finance industry when I discovered Burford, one of the first things I wanted to understand is if they are providing value to their customers. As a relatively nascent industry, the growth runway could be very long if all parties involved are winners. I believe they are.

Industry overview

At a high-level, litigation finance can level the legal playing field. Lawsuits are expensive. Many cases today are determined by which side has the most money to throw at it. And even before that, many legitimate lawsuits are never filed because they can't be funded.

Drilling down to law firms, the biggest benefit is de-risking their business. Litigation funding allows lawyers to take on more expensive and/or riskier cases because they can share the cost with a third-party.

Clients of law firms, whether an individual or a corporation, don't like the traditional hourly billing model. But if a lawyer has a deal with a third-party funder, that law firm has more flexibility in the fee arrangements they can offer, thus improving their own client relationships.

Law firms can get bank loans or lines of credit just like any other business, but there are two issues. First, the most valuable asset a law firm has is their book of cases. However, lenders do not view cases as assets because they have uncertain values. The value of a case is more an estimate of its expected value as opposed to something more concrete like real estate or inventory. Thus, law firms have few assets to offer as collateral in a loan. Because of this, banks systematically undervalue law firms.

Second, using debt to fund litigation is irresponsible because the loan has to be paid back no matter what. However, if a third-party litigation funder pays the expenses, the law firm owes nothing if the case is lost. Of course, Burford charges handsomely for this. Because they lose their entire investment in some cases, those losses have to be made up by charging enough on the cases they do win. Importantly, Burford always takes less than 50% of the award. To date, many lawyers have welcomed this trade off of less upside, less downside, and more flexibility.

In addition to law firms, Burford also works with in-house counsel at large corporations, many of them public. While most of the aforementioned law firm benefits also apply to corporations, there is one additional benefit worth stating. For corporations, legal costs are expensed immediately and usually fall under selling, general, and administrative expenses on the income statement. However, legal awards are counted as other income, which companies don't really get credit for.

Essentially, public companies get penalized for legal expenses but don't get credit for legal awards. Litigation funding allows companies to move legal costs off their financial statements, decrease operating expenses, invest that cash elsewhere, and still benefit in most of the upside.

Finally, Burford has a lot of knowledge that can be valuable to a legal team. Burford has been in business since 2009 and they are currently involved in over 1,100 underlying legal claims. They have been successful by being very picky in the cases that they invest in. If Burford wants to invest, this adds an element of independent validation to a law firm or corporation pursuing a claim. And their chances of winning can increase by having Burford's expertise on their side.

In addition to thinking that litigation finance is a win-win-win for all parties involved (i.e. Burford, law firms and corporations, and law firm clients), I also believe Burford has a strong advantage in this burgeoning industry.

Barriers to entry and barriers to scale

By my estimate, Burford has around 30-40% market share. It's hard to get a more precise number because most competitors are private and, as the industry is relatively young, there isn't much independent third-party data available. Nonetheless, Burford is several times the size of even the second largest litigation funder.

> "*we do more business in a single year than any other player in our industry has done in its entire history, and then some*." — Burford Capital 2018 Annual Report

This scale results in several advantages. First, Burford has little competition in the largest deals. Their market share may be 30-40% of the overall industry, but I suspect as deal size increases, Burford's market share rises to a very large majority. Burford's average investment is over $20 million, and their largest was $200 million. Except at the fringes, a small litigation funder with $300 million in total capital is not competing with Burford.

In addition, the larger the deal, the less price sensitive the customer is and the more pedigree and relationships matter. A lawyer or corporation is not going to default to working with the lowest bidder when the lawsuit is potentially worth tens or hundreds of millions of dollars. I believe Burford has many traits that make them the safest partner for law firms and corporations to work with.

As stated, Burford has by far the most scale and capital in this industry, which means they have the least concentration risk. It is riskier for a law firm to accept $25 million dollars from a $300 million-dollar fund vs Burford that has over $4 billion in total funding. Burford also has audited public financial statements, permanent capital, and major institutional investors.

Having the most scale means Burford has the most experience and data of any litigation funder. This means that Burford is often a strategic partner as opposed to merely a transactional one. This matters the most in the high-end space where Burford dominates. Smaller litigation funders fight over smaller deals with lower quality clients who are more price sensitive.

Decades ago, the saying “nobody gets fired for buying IBM” became popular. This was because IBM had a good reputation in technology and a recognizable brand name. While purchasing technology from a small, unknown competitor may be risky, a purchasing agent at a company knew they wouldn’t be blamed if they bought IBM—even if something went wrong.

In litigation funding, Burford is comparable to IBM. Burford is the largest funder and they are the only one with a recognizable brand name. I realized this when I was researching the industry and noticed how many news stories mention Burford and no other litigation funders. Even competitors cite Burford for industry data!

This brand name recognition has resulted in Burford being the thought-leader in this industry and thus the default option when a legal team is looking for funding. With the market share that Burford has, they have become synonymous with litigation funding—not unlike how Amazon has become synonymous with e-commerce due to their ~50% market share.

The best part is that all of these benefits reinforce each other, which is why scale can be such a powerful advantage. Because Burford is the largest funder, they have become the default choice for litigation finance. This results in them getting far more free marketing than their competitors. Free marketing lowers their customer acquisition cost by attracting customers cheaply—which leads to more scale.

As Burford’s scale increases, so does their reputation and pedigree. This helps them attract the high-quality law firms and Fortune 500 companies that they go after. Finally, the funder with the most scale sees the most deals, funds the most cases, has the most data, is able to most accurately price their investments, and thus is the best partner for law firms and corporations—which leads to more scale.

The future litigation funding industry may be comparable to venture capital. The largest and longest-running venture capitalists have strong advantages over small, lesser known players. Of the top ten venture capitalists, Andreessen Horowitz is the newest firm at ten years old—with all the others being 15+ years old and three over 35 years. Reputation and size matter in these types of industries and being in business a long time helps with both of those. And as I described above, reputation and size reinforce each other. There is some evidence of this in the litigation finance industry as the top firms have been in business the longest.

“*all [of the large] players are at least six years old, and many have been in operation for a decade or more—so it is rather late now to believe that the market will turn into a race to the bottom on pricing*.”
— Burford Capital 2018 Annual Report

It’s difficult for small litigation funders to catch up because there are barriers to scale in this industry. If a lawyer launches a new fund with $300 million and invests it all within one year, it would be another two years before a meaningful portion of those cases have concluded. At that point, three years after launching, there may have enough evidence that he knows what he’s doing and thus is able to raise $600 million more. Three more years and maybe he’s able to raise $1 billion. At that point, his total assets could be $2.5 billion or so.

To put that in comparison, Burford ended 2018 with over $4 billion in available funding. And they would continue to scale as this theoretical new fund launches and grows. So, at a minimum Burford is six years ahead of this new fund even approaching Burford's current scale.

Raising capital, investing that capital, waiting for lawsuits to conclude, and raising more capital takes many years. There's no way around that. Because of this scale advantage, it will be difficult for other litigation funders to catch up with Burford's size.

Customer captivity

In addition to benefitting from the barriers to entry and barriers to scale in this industry, Burford has captive customers. The relationship between Burford and a law firm or corporation is a long one. The average case that Burford invests in takes a little under two years to come to conclusion. But that's just the average. Burford still has open cases from 2010. And it's not uncommon for cases that don't settle to take 5+ years to conclude.

Thus, if Burford invests in a book of cases for a lawyer, they are probably going to work together on a regular basis for many years. If that relationship is comfortable, the lawyer is more likely to stick with Burford for future funding needs. For that lawyer, the process to get more funding with a company they already work with is quicker and simpler than finding a second funder to bring in.

The above is true because there are search costs when it comes to a lawyer finding a funder to work with. Search costs arise when it is difficult to compare offerings between competitors—insurance is a common example. Every insurer has different terms and conditions that can radically change the outcome for customers. Likewise, it's difficult to do an apples-to-apples comparison between different litigation funders as there is an infinite number of ways to structure funding deals.

In addition, this is not an industry that lends itself to open RFPs. A lawyer would be acting recklessly if they put out an RFP that contains intimate details of their case to every third-party funder in the industry. Burford has discussed before how the RFPs they partake in usually only have a couple companies participating. Even better, repeat customers generally come straight back to Burford without doing an RFP.

As evidence of this, 75% of new clients have historically become repeat customers. But I believe Burford's retention rate could actually increase going forward. As I mentioned in the beginning, Burford has recently expanded its business to where core litigation only makes up around 50% of investments.

Burford wants to be the go-to capital provider for anything a law firm needs. And the more services Burford offers, the more ingrained Burford becomes in their customers' businesses. This means stickier relationships and increased switching costs for those clients.

"*Our investment bank approach offers one-stop shopping that augments our value to our clients and stands in contrast with many competitors*." — Burford Capital 2018 Annual Report

This is a common strategy of many successful businesses: create sticky customer relationships and then cross-sell those clients on tangential products or services. This is a very efficient way to increase customer retention and average revenue per user. Customer captivity may also result in pricing power.

Management

I'll end this write-up by discussing Burford's management team, which I am very impressed by. Christopher Bogart and Jonathan Molot co-founded the company in 2009 and continue to run it today as CEO and CIO, respectively. As is usually the case with founder-led companies, they each own meaningful amounts of shares and are thus very aligned with outside shareholders.

The first thing that impressed me about Christopher and Jonathan was how logical they are in their thought processes with respect to capital allocation, debt levels, and sources of capital. They use data and sound reasoning to thoroughly explain their business, how they measure success, and why decisions are made. It is clear that they understand their underlying business better than most executive teams.

"*Burford's investment returns have historically been quite high. Thus, financing Burford's investments with low-cost, on-balance sheet capital has preserved the bulk of Burford's investment returns for its equity investors. The use of leverage has been profit-maximizing and Burford certainly has the capacity to take on more debt—while not wanting to become highly leveraged. However, the availability of multiple capital sources [via debt and investment funds] will permit further expansion of the business and improve capital efficiency, although more of our investment returns will go to the providers of that capital*." — Burford Capital H1 2018 presentation

When I'm researching a company, I'm always looking for signs that a CEO is an independent thinker. This is not being a contrarian—it's just coming to conclusions for oneself, whether others are doing it or not. I believe running a successful business for many years requires the ability to do things differently and risk looking like an idiot. I believe the Burford co-founders fit this bill.

First, they dedicate two pages in their 2018 annual report to explain why they don't give any guidance or do any forecasting. I love it. Refusing to step foot on the Wall Street treadmill of expectations is a great sign. I wish every company in our portfolio would stop giving guidance.

"*as corporate litigators we have spent decades of our professional lives seeing, and dealing with, the misjudgments and other fallacies of corporate executives and market participants… This experience leaves us skeptical about predictions and deeply reluctant to try to make them, particularly in the kind of business we have. Our view is that it is our function as corporate managers to be excellent stewards for shareholders' capital and to provide investors with data and with commentary on the past, and that it is for investors to form their own individual views about what the future holds*." — Burford Capital 2018 Annual Report

The Burford team has also thoroughly thought through how they incentivize themselves and their employees. Many companies have long-term incentive plans that grant stock options if their stock performs well. This isn't as good of an incentive structure as it may appear because it mostly rewards employees for things outside of their control: general stock market and/or industry performance. Burford understands this. Their long-term incentives are based on cash flow growth, investment growth, and shareholder return as compared to similar companies. This way, stock options are only earned if Burford's stock outperforms their peers—as opposed to just rises with the rest of the market.

Finally, Burford has some of the best corporate governance I've seen in a public company. Especially in founder-led companies, it's common to see leaders entrench themselves behind holding both the CEO and Chairman titles and owning super-majority voting shares that give them more control than their actual ownership would dictate. Not the Burford co-founders. In fact, neither of them even sits on the board. All four directors are independent.

"*No members of management sit on the Board… we believe this structure maximizes independent oversight of the business*." — Burford Capital 2018 Annual Report

Travis Wiedower
Managing Director

Appendix 1: Wiedower Capital's Investment Philosophy

1. Long-term focus: I look at companies through a long-term lens. When I invest in a new company, I go in with the mindset that I will own it forever (while recognizing that won't come to fruition very often).

   A company is worth its future free cash flow discounted back to today. A discounted cash flow analysis shows that the majority of a company's intrinsic value comes from the distant future, not near-term results. If how a company will perform over many years is the majority of its worth today, then the durability of their competitive advantage is of paramount importance.

   Because of this, my research is focused on how an industry may evolve over the next 5-10+ years and if a company's competitive advantage can expand within that evolution. This is only possible if the CEO is focused on, and incentivized by, the long-term success of the company. Often, the CEO traits I look for are found in passionate founders who are internally driven to see their own business succeed.

2. I'm very picky: The vast majority of companies are un-investable for me at any price. I have a small circle of competence (that is slowly expanding) and I have zero tolerance for management that isn't aligned with me.

3. Learning mindset: Even more than investing, I love learning. Investing just happens to be a perfect outlet for that—there will always be more companies, industries, and countries to learn about. Beyond that, a lot of outside disciplines indirectly help my investing. Much of what I consume on a weekly basis may not directly benefit my investment results, but I believe there is a lot of value to learning broadly and trying to understand the world better.

4. Alignment of interests: As much emphasis as I put on finding CEOs who are aligned with outside investors, I also want the same alignment between myself and my partners.

   Wiedower Capital is structured to align my own incentives and my partners around a long-term investment strategy. My performance fee is earned over multi-year periods and new partners are subject to a three-year lockup. In addition, performance fees can be clawed back, management fees scale down as assets under management increase, and assets are capped at $100 million.

Appendix 2: Historical Results*

Period	Wiedower Capital	S&P 500
2015	-11.91%	-1.37%
2016	19.19%	11.95%
2017	22.28%	21.82%
2018	-18.61%	-4.39%
2019 1st Half	9.94%	18.54%

Cumulative	14.88%	52.45%
Annualized	3.24%	10.18%

* Started February 24, 2015. Wiedower Capital results are net of fees and are based on a model account that has been active since inception. The model account pays fees as a non-qualified client, which is currently 2% per year. All accounts are managed the same, but individual account results may vary from the above results based on different fee structures and minor position size differences. S&P 500 results are represented by SPX and include dividends.