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2020 Interim Letter

Wiedower Capital is focused on 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.

While the pandemic has obviously been bad for a lot of reasons, speaking strictly about investing, I was excited that the market pull back offered us attractive prices to invest in two companies that have been on my want-to-own list for a while. One of those new investments was Microsoft.

I believe Microsoft is one of the best businesses in the world, thanks in large part to their leadership. I don't think it's an understatement to say that Microsoft's founder, Bill Gates, is one of the most altruistic people in the world today. Through the Bill and Melinda Gates Foundation, Bill and his wife Melinda are spending virtually their entire fortune to improve the world—mainly through causes that focus on global health, education, and gender equality. Every year, I look forward to reading the foundation's annual letter just as much as I look forward to the best investor letters.

While Bill Gates is no longer on the board of Microsoft, he remains the largest shareholder and Technical Advisor to CEO Satya Nadella. Microsoft is one of only two companies we own that is not run by its founder. While my bar for investing in non-founder-led companies is higher, Nadella clears that hurdle with ease.

In 2017, Nadella wrote a book called *Hit Refresh* about what he was trying to accomplish at Microsoft since becoming CEO in 2014. While some books written in this vein are self-aggrandizing marketing tools, I was impressed by how genuine Nadella came across. His obsession with company culture, empathy, and how he talked about his son's cerebral palsy stuck with me long after I was finished reading. That book is what really piqued my interest in Microsoft as a potential investment.

Over the past two years, I have become more purposeful with seeking out good company cultures. The below chart from Investors Management Corporation accurately sums up why.

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). I believe the longer one's investing time horizon is, the more important culture is. Over a long enough timeframe, all employees will eventually turnover, including the founder. But a strong culture that emphasizes customer care, product innovation, and capital allocation can continue to thrive.

From what I can tell, Satya Nadella has significantly improved Microsoft's culture since taking over. Microsoft has become more innovative while also being more collaborative and open with other companies, including competitors. Furthermore, Nadella reorganized the company to focus on cloud computing, which has proven to be quite fruitful.

Earlier I said that reading Nadella's book is what really piqued my interest in Microsoft. But the reason I even read his book in the first place was that Microsoft's cloud computing platform, Azure, made me want to learn more about him.

When it comes to talking about the future, there are very few things I have 100% confidence in. But barring something on the order of a nuclear war, I am confident the following four things will turn out to be true:

1. The world will continue becoming more global.
2. The world will require orders of magnitude more computing power in the future than it does today.
3. For the vast majority of companies, managing servers and data centers will not be a core competency.
4. Because of the upfront costs required and the economies of scale inherent in managing data centers all around the world, the early cloud computing leaders are likely to be the long-term winners in an oligopolistic industry.

Currently, Amazon Web Services (AWS) and Azure are the leaders in cloud computing, and I think that is likely to remain. It is not a coincidence that the cloud leaders (Amazon, Microsoft and Google in the West, and Alibaba in Asia) were already some of the largest companies in the world before they got into cloud computing. Competing in this industry requires spending billions of dollars to build data centers around the world.

If I am correct about those above four points, AWS and Azure are going to benefit from almost every major trend over the coming decades. Below is a handful of trends that are affecting the world today.

- Digital transformation of enterprises
- E-commerce taking share from traditional retail
- Artificial intelligence
- Autonomous driving
- Augmented reality and virtual reality
- Smart homes, buildings, and cities

Each of these requires computing power and—if trends continue—will require significantly more in the future. AWS and Azure are the underlying platforms that power these types of products and services.

A common narrative among investors—and one that I generally agree with—is that it is often better to sell picks and shovels during a gold rush than it is to go digging for gold. It is possible to find gold and get rich, but more often than not, selling products that every person digging for gold needs is going to be more profitable.

Using this analogy, I believe AWS and Azure supply the picks and shovels to companies and government entities that need computing power. Owning AWS and Azure is a way for us to get exposure to entire industries or trends—that may be outside my circle of competence—without me having to pick specific winners within each.

For example, the continued increasing popularity of gaming is a trend I strongly believe in. I have spent many hours searching for a company in the gaming industry that checks all my investment boxes. Unfortunately, I have failed to find one. However, by owning both Amazon and Microsoft, we are getting exposure to the underlying platforms that power most video games. Current and future games will most likely continue to run on AWS and Azure, and thus, we don't care which video games succeed or fail. We benefit as long as gaming overall continues to grow.

Microsoft has a lot of great aspects to their business—not least of which are their monopolies with Windows and Office—but the two things that got me most excited to invest were Satya Nadella and Azure. Likewise, AWS was a large reason as to why we previously invested in Amazon. Now, I am very pleased that we are invested in both of these platforms—and most likely will be for many years.

As excited as I am about our new investments, Burford Capital continues to be by far the largest driver of our recent and future near-term results. While my thesis for investing in Burford has not changed much, the stock price has continued to lag, so I feel a thorough update is needed.

To start, I expect Burford's business to benefit from this global pandemic over the coming years. In the short-term, some courts are closed, and lawsuits may be delayed. However, bad economic periods generally result in bankruptcies, cancelled partnerships, and broken contracts. These types of activities often cause lawsuits. There was an increase in demand for legal services coming out of the financial collapse, and I expect the same coming out of this pandemic.

Burford only reports twice a year, and in April, their results for the second half of 2019 came out. At a cursory glance, it may appear that their business slowed down significantly. In the second half of 2019, Burford's revenue was down 65% year over year. If Amazon's e-commerce business fell 65%, that would be a major cause for concern. That would most likely mean that customers stopped buying from Amazon and moved their e-commerce purchases elsewhere. However, Burford's business is different.

From a high-level, Burford's business is simple: they invest in lawsuits, and then they wait for those lawsuits to conclude. If the lawsuit is victorious, Burford gets their investment back plus a share of the winnings. Importantly, Burford does not control these lawsuits. For example, Burford cannot choose to settle a bunch of lawsuits just to improve short-term results. Because of this, it is inevitable that results will be lumpy. Some periods will have lots of lawsuits come to conclusion and other periods will have very few. The second half of 2019 was a slow period without many of their lawsuits concluding.

What matters more than how many cases conclude during a period is the returns generated from completed cases and how many dollars they commit to new cases. If Burford continues to invest a significant portion of their cash flow into new cases at attractive returns, the company is increasing its value. That's what I care about.

Throughout its history, Burford has generated little free cash flow while earning high returns on their incremental invested capital. If they have the ability to invest all of their cash flow back into more lawsuits at similar returns, it would be illogical not to. This is very similar to what I have discussed with Trupanion investing virtually all of their cash flow back into acquiring new pets. If a company earns high returns on their investments, I want them to invest as much capital as possible (while maintaining a safe balance sheet).

One thing I was worried about last year is that the Muddy Waters short report could have negatively impacted Burford's actual business operations—as opposed to just the perception of their business from investors. Burford got a lot of bad publicity, and it is possible that law firms and corporations would not want to get an investment from Burford because of potential public relations risk.

Burford management had already said the short report did not affect their client relationships, but it was good to see that in the results as well. Burford's commitments to new cases in the second half of 2019 increased meaningfully both year over year and compared to the first half of 2019. Thus, that negative publicity around the short report does not appear to have affected Burford's ability to continue to grow its business.

Second, the returns generated on completed cases gives me a clue as to whether Burford's investment quality has decreased over time. So far, that does not appear to be the case. While the returns generated from completed cases did decrease slightly in the second half of 2019, they were still well within the historical range of what I want to see.

Despite management assuring investors that their hurdle rates have not been lowered, and there being no evidence to the contrary, this is unfortunately a datapoint that is always on a lag. From when Burford first makes a commitment to fund a lawsuit to when they generate a return on that investment averages around two-and-a-half to three years. And given Burford's investment portfolio did not step up in size until 2017, it should be 2020 or 2021 when those results start to really flow through the financial statements. When that happens, I hope the rest of the market starts to agree with my view of the company.

At its current stock price, I believe Burford Capital is the most undervalued company I have ever seen. To demonstrate why, I want to setup an extremely conservative valuation with the following assumptions:

1. The Petersen case, which is by far their most valuable investment that has been valued at over $1.7 billion ($1 billion net to Burford) by independent third-party investors, is worth zero.
2. Their entire fund management business with assets under management of $2.9 billion is shut down and worth zero.
3. Operating expenses are not reduced at all to give credit to their largest case and fund management business no longer existing.
4. The core balance sheet business never raises equity or debt again. Burford's only future investments are made using cash generated from previous investments that come to conclusion and generate cash.
5. Return on invested capital immediately falls 20% below the low-end range of what Burford has historically generated.
6. A 10x multiple is used to reflect a business with poor growth prospects.

The above assumptions get me to a fair value of £9.92 vs its current stock price of £4.55. Using more realistic but still conservative assumptions, I get to a fair value of at least £18. In actuality, I believe the company is worth somewhere in the mid-to-high-£20s. The only way I can realistically imagine a future where Burford is worth anywhere near its current market value is if the company is a fraud.

Starting from a high-level, Burford's employees are mostly lawyers and their business is to provide a service to lawyers. And the lawsuits that Burford invests in go in front of judges. Just those facts alone would make it difficult for Burford management to run a fraudulent business.

Ironically, the Muddy Waters short report also gives me confidence that Burford is not a fraud. The fact that a company spent as much time and effort as Muddy Waters did to try and prove Burford is a fraud—and, in my opinion, failed to do so—makes it more likely that Burford is legit.

But more important than any of the above is that I have not found any evidence that makes me think Burford is anything but above board in their operations.

Ultimately, I can't say with 100% confidence that any public company does not have fraudulent activities. As a small outside investor, I just don't have access to that amount of information. However, I think the chances of any of our portfolio companies having fraudulent activities are very small. This is one of the many reasons that I prefer to invest in passionate founders who view their company as their life's work. In my experience, founder-led businesses are more likely to be conservatively run and optimized for long-term success—because that's what matters to the founder's net worth and reputation.

My favorite CEOs are the ones who continue to impress me the longer I follow them. Several of our previous holdings have been sold because those CEOs were no longer doing that. But I am happy to say that every CEO we're currently invested in—including Chris Bogart at Burford—fits that bill.

Until the 2019 annual report, Burford did not explicitly break out executive compensation as they were not required to. Because of this, Muddy Waters assumed Burford's co-founders were overpaying themselves and milking shareholders. Now, we can see how fair Burford's compensation structure actually is. In 2019, each co-founder was paid a total of just under $4 million, which is very reasonable for the co-founders of a company this size. Plus, each co-founder invested their entire 2019 $2.25 million dollar cash bonus back into Burford shares.

In addition to the absolute dollar amounts, I like Burford's overall compensation philosophy. Importantly, bonus compensation is based on how much cash they generate, not on reported financials. This is important because an unavoidable part of Burford's business is marking investments to their estimated fair value. And while I believe Burford has sufficiently proven that they are conservative in their fair value marks, there is always a risk they use aggressive estimates to boost short-term results. However, it is good to know that management is not incentivized to aggressively markup cases; they are only rewarded for the actual cash generated from investments that have come to conclusion.

In addition to good compensation structures that align incentives and two co-founders who own lots of shares, Burford employees also eat their own cooking. Several directors and "dozens" of employees are invested in Burford's funds. Each co-founder has $2 million invested in the funds as well. Finally, a large majority of employees are Burford shareholders.

Last year, in an effort to get more information on how shareholder friendly Chris Bogart is, I read through all the public filings from his first public company, Churchill Ventures. Churchill Ventures was a blank check company seeking to acquire a business. However, that never happened, and the company was dissolved after two years.

To be clear, blank check companies are about the opposite of what I seek out in a public company. Because of that, I very rarely look at them. Blank check companies can be like the Wild West of the public equity world. Nonetheless, I was happy to see that Churchill Ventures was setup and ran in a shareholder friendly manner. And despite Churchill never doing what it set out to, equity investors still made money.

More recently, Burford's 2019 annual report is the most thorough annual report I have ever read. And that is not an exaggeration. In sometimes excruciating detail, Burford walks through how their entire business model works. Even before this year, Burford already disclosed far more information than legally required—and more than any of their competitors disclose. Finally, Burford is in the process of listing on either NASDAQ or the New York Stock Exchange after being listed on a small London stock exchange since their IPO.

All of that is a longwinded way of saying that, if Burford is running a fraud, they are doing so in a manner opposite of what I would expect. Burford management takes reasonable pay, owns a lot of equity, has purchased millions more in equity over the past year, invests in their own funds, and only receives bonuses if they generate cash. In addition, management keeps releasing more information for outside investors to analyze their company with.

Finally, Burford is voluntarily listing in the United States on one of the two largest stock exchanges in the world. This will almost certainly attract more investors to look at Burford. And to top it off, Burford's CEO previously had a public company that was started, ran, and dissolved in a manner that took care of its outside shareholders and showed no evidence of wrongdoing.

Nonetheless, it is possible I have overlooked something and am wrong about Burford Capital. For the past year, the vast majority of investors have disagreed with my Burford thesis. Mr. Market has made it very clear that he thinks I am wrong. But I have rechecked my thesis many times, and I keep coming to the same conclusion.

First and most importantly, I believe Burford is a high-quality business with a durable competitive advantage in a secular growing industry run by a great management team. Second, I believe it is the most undervalued company I have ever seen. Given that, all I can do is continue to trust myself over Mr. Market.

Travis Wiedower

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	-3.36%	31.48%
H1 2020	-5.38%	-3.18%

Cumulative	-4.45%	63.71%
Annualized	-0.85%	9.65%

* 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 include dividends.