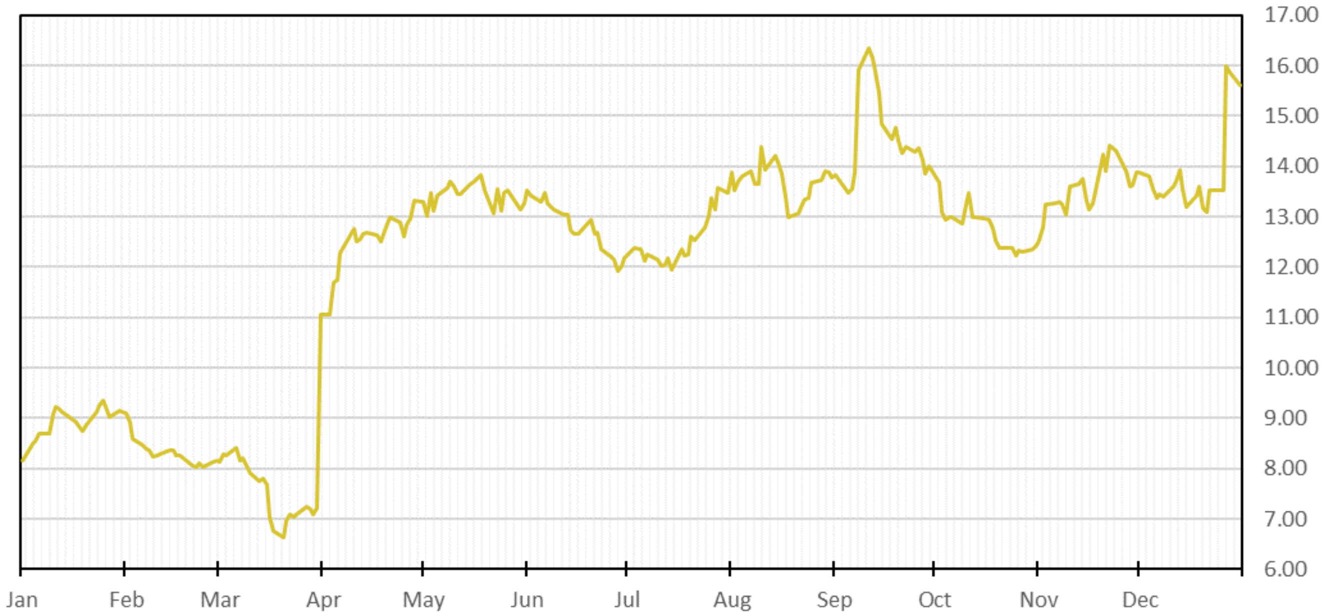


Burford Capital (BUR, BUR:LN)

Price (12/31/23): $15.60 USD   Market Cap (12/31/23): $3.4 billion USD
Stock Gain (2023): +93.3%   Portfolio Weight: 36.6%

Description

Burford is a global litigation finance company, which in essence means that they fund and otherwise monetize commercial lawsuits in exchange for a portion of the proceeds received. Burford trades both on AIM (the junior London stock exchange) in Great British Pounds (GBP) and on the New York Stock Exchange in US Dollars (USD).

2023 — More Business as Usual

Business continues to be conducted as usual, with continued record-high levels of commitments and deployments and continued IRRs approaching 30%. Realizations and realized gains were up significantly for the first 3 quarters of 2023 vs. 2022, up 46% and 92%, respectively. That's purely counting cash gains, not including any fair value adjustments.

We estimate Burford's adjusted NAV (measured using deployed cost and adjusted for 25% IRRs and approximately three-year average elapsed time since deployment, adding in cash, etc., and subtracting debt) to be worth about $2 billion. This net value is compounding at approximately 20-25% for years into the future (using conservative assumptions and net of expenses and debt payments). It is rare to be able to buy a compounding machine like Burford while paying a relatively small premium, and we are thrilled to be able to do so.

And this calculation is for Burford's litigation portfolio alone. It is not assigning any value for the YPF litigation (see below), which has been granted a final ruling from the judge with Burford's share amounting close to twice Burford's present market cap. And it is not assigning any value for Burford's third-party fund business, which is expected to bring in $400 million+ over the next few years. Indeed, in 2022 and 2023, the third-party fund business brought in north of $50 million each year, primarily from the Sovereign Wealth Fund arrangement, which shares gains with Burford on an ongoing basis. The bulk of their third-party fund business has historically run under a European waterfall structure, which heavily tilts Burford's performance compensation to the end of the funds' lives. An annuity of $50 million a year is nothing to sneeze at, but we expect even higher levels of revenue and income when the European-style funds finish running off their portfolios.

We are buying a profitable compounding machine at an excellent price and getting all the rest for free. And what a rest it is!

Accounting Changes

In the first half of the year, there was some brief drama surrounding accounting policies, as Burford delayed the 2022 annual report due to accounting changes being made at the behest of and with the encouragement of the SEC. The stock briefly reacted badly, down at one point as much as 20% pre-market, before quickly recovering. Nothing really changed about the business; the accounting just became more sophisticated and complex, although in some ways also more revealing.

The main accounting change is that the portfolio now takes time value into account, so that portfolio fair value rises as time passes and cases approach closer to resolution, as you would expect in a traditional discounted cashflow model. Unfortunately, this also means that as interest rates change over time, the whole portfolio fair value adjusts with those interest rates changes, which potentially obfuscates what's happening with the underlying business. The risk adjustment changes that come from actual case milestones remain substantially the same.

Although the new accounting regime is arguably more accurate and GAAP-compliant, we continue to advocate that the business is best evaluated on a cash basis, ignoring fair value accounting entirely. As before, all the information needed to evaluate the company on a cash basis is provided, so the new accounting changes simply add more information in a new fashion, instead of subtracting any previously provided information.

Another welcome change is the commencement of quarterly reporting, as opposed to twice a year as they have done in the past. The company voluntarily began reporting quarterly for the first quarter of 2023, in anticipation of eventually becoming a full-fledged US filer when the share of US investors crosses the 50% threshold, which will have probably occurred by the time of the next annual test this coming June.

YPF Litigation — $6 Billion and Counting

Unsurprisingly, given its massive size, the YPF litigation remains of intense interest to investors and the market, with many of the sharp movements in the stock price this year coming from YPF-related news. At the end of March, Judge Preska returned summary judgement in favor of Burford against Argentina (although absolving YPF the company from any responsibility for Argentina's failure to fulfill its obligation to tender for the shares), while still leaving open the exact damages figure and interest rate for further briefing. The final ruling was handed down in September, in which Judge Preska ruled at the higher end of the possible range, finding Argentina liable for $16.1 billion (including the years of accrued interest). Of that figure, about $6.3 billion is Burford's share, and compound interest continues to accrue at 5.42% a year.

This was the absolute best-case scenario. And despite the huge gain in stock price over the year, with the stock almost doubling, there is still plenty of upside remaining. In fact, the sum owed from this case alone is still about twice Burford's entire market cap, presumably because of the market's skepticism as to Argentina actually paying the judgement.

Indeed, as expected, Argentina is appealing the decision, and is continuing to drag their feet in any way they can in the meantime. Argentina refused to post any bond or assets pending the appeal, and Judge Preska has recently allowed Burford to commence any and all enforcement proceedings even while the appeal is underway. Nevertheless, this is only the beginning of the end, and it will still take quite a while for the YPF litigation to come to fruition.

Notwithstanding Argentina's continued delaying tactics, there is a ray of hope from politics. In a November election upset, Argentina has voted in a new libertarian-leaning President, Javier Milei, who has publicly stated that he would like Argentina to pay its legal debts and return into the international finance fold. His rhetoric is positive, and his non-connection to the previous administration which made the whole mess to begin with is welcome. Nevertheless, the fact does remain that Argentina right now couldn't pay the judgement even if they wanted to. So I do expect this to still take quite a bit of time until it reaches final resolution, either through some sort of settlement (possibly involving some sort of delayed payment plan) or through tough enforcement (followed by settlement).

One more point worth underlining is that due to sophisticated corporate structuring, we expect there to be approximately zero taxes owed in any jurisdiction on any monies received from Argentina for the YPF litigation. All money received should essentially fall straight to the bottom line.

YPF — Not a One-Off

Although the market continues to look at the YPF case as an outlier, we firmly believe that YPF and cases like it are inherently part and parcel of the business plan. Despite the difficulty in quantifying the precise quantum or timing of the next YPF-like case, we would nevertheless point to a number of cases, presently in early stages, that have definite potential to result in YPF-like returns.

First, we have the Sundance Resources arbitration against Congo and Cameroon for nakedly confiscating Sundance's iron mine asset and awarding it to Chinese-connected investors, almost certainly due to bribes. Although commercial cases between companies are rarely open-and-shut, as both sides have sophisticated legal advice and tend to act in commercially reasonable manners, the same cannot be said about investor-state disputes. In expropriation cases, governments often act not based on legal advice, and not in any reasonable manner at all, but purely due to political dictates, or, as in the present case, due to bribes. Unsurprisingly, when these matters come before the court or arbitration tribunal, the governments are found liable. This seems to clearly be the case in the Sundance Resources matter, and the damages sought therein are $8.8 billion.

Second, we have the Greenland Minerals case against Greenland and Denmark for $11.5 billion. The case here is murkier than the previous case, and I do not feel that I have enough information to judge who is right and who is wrong over here. I note, however, that this is exactly what Burford excels at doing, and they obviously have plenty of private information that we are missing here.

Third, we have the Sysco matter. Sysco, a large food distributor, was suing the pork, beef, chicken, and now turkey producers for illegal collusion in violation of antitrust laws. The producers have already been found guilty in the corresponding criminal case; now we are discussing the civil damages owed to their customers for the years of higher prices stemming from their illegal collusion. So, the question is not if, but how much. And the final answer is sure to be a very high figure given the multi-year period at question and the vast extent of what is covered. (Note also that antitrust damages are trebled.)

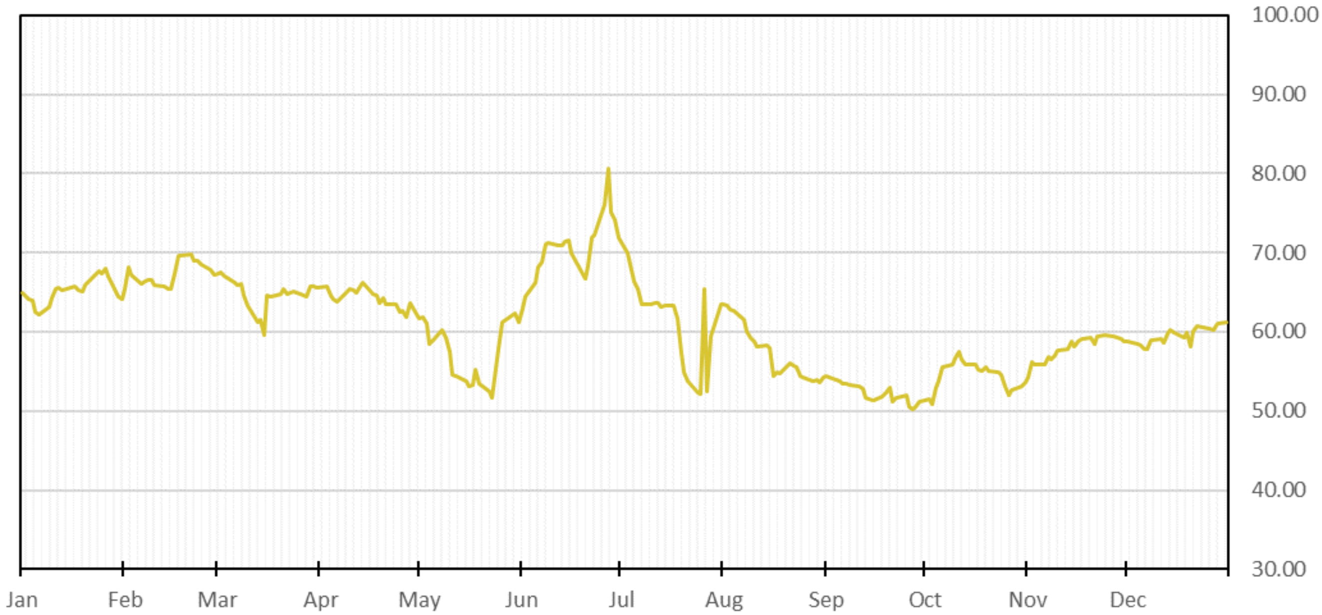
Sysco, itself a large multi-national firm who could easily afford to pursue the case from their own balance sheet, nevertheless sought financing from Burford. The relationship quickly fell apart, however, when Sysco breached their contract with Burford by assigning a significant portion of their entitlement to third parties (their customers), sharply reducing Sysco's skin in the game. Burford protested and the contract was renegotiated to give Burford a right to veto any settlement they considered unreasonable. Sysco then attempted to breach the new contract by settling the case for a relative pittance. Burford sued Sysco, Sysco countersued Burford, and when all the dust settled, the upshot is that Burford now controls the entire litigation with all the upside, with the entire remaining entitlement assigned to Burford.

This litigation has the potential to bring billions of dollars to Burford. Unlike the YPF matter, there is no question whatsoever as to the ability or willingness to pay of the counterparty defendants in this case, as they involve not a third-world country, but major multi-national food producers, such as Tyson Foods. Whatever judgement is ultimately handed down by the court will definitely be paid. There are unquestionably some remaining legal issues to explore, including whether courts will find the ultimate arrangement between Burford and Sysco champertous (a doctrine that does not allow financing litigation under certain specific circumstances, depending on the jurisdiction), voiding the assignment, and how much of the overcharging should have to go to Sysco's own customers who ultimately suffered the higher prices indirectly. So not quite ready to be counted and spent, but still a case with definite potential for YPF-like returns.

Venture Capital with a Twist

We like to analogize Burford as being similar to venture capital, but better. In traditional venture capital, the vast majority of investments fail, but the few home runs more than make up for the failures. In Burford's litigation finance portfolio, the majority of cases are solid singles and doubles, as 84% of cases resolve favorably for Burford. Some of the cases are home runs. And then you have YPF and YPF-like cases — even calling them home runs with all bases loaded hardly does them justice; the potential returns from YPF are simply in a league of its own.

Putting it all together, you have a powerhouse of a company, which, despite the major stock rise in 2023, is still massively underappreciated by the market.



Silicon Motion (SIMO)

Price (12/31/23): $61.27 | Market Cap (12/31/23): $2.1 billion
Stock Loss (2023): -5.7% | Portfolio Weight: 26.7%

Description

Silicon Motion designs and sells controllers which manage the NAND flash memory ubiquitous in modern computing. Wherever there is NAND flash, there must be a controller, often one from Silicon Motion. SIMO is an ADR (American Depository Receipt) trading on the NASDAQ.

2023 — Sharp Decline and Recovery

After the massive growth that Silicon Motion experienced in 2021 and 2022, growth which we have previously characterized as a permanent step-change in revenue and margins for the company, 2023 saw a massive reversal in fortunes. The semiconductor industry as a whole, and the flash memory sector in particular, experienced a massive cyclical decline, with revenue dropping as much as 50% in some quarters. For the full year, Silicon Motion's revenue has dropped by about a third. Unlike in past downturns, gross margins dropped as well, from the previous 50%+ they were enjoying to as low as 40%. Naturally, the double whammy of lower revenues and lower margins decimated the bottom line, although Silicon Motion continued to be profitable throughout the year. We believe this goes to show their strength, that even at the nadir of the cycle, they remain profitable and generate cashflow.

Bad though this all sounds, all signs point to the decline as being strictly temporary, and we are not concerned about the strength and competitive position of the underlying business. First of all, the downturn was industry-wide, not specifically affecting Silicon Motion. The roots of the downturn began with the COVID chip shortage. Customers reacted to the COVID chip shortages by double booking and stockpiling. This caused inventory to build up throughout the supply chain, which led demand to start dropping in the second half of 2022 and then absolutely crater in 2023. Although painful, the downturn is temporary and cyclical, and the downturn does not affect the long-term secular growth of flash memory throughout the computing, data center, auto, industrial, and IotT ecosystems.

Second of all, Silicon Motion actually fared better than competitors such as Phison, whose controller division dropped even further. This indicates that Silicon Motion continued to pick up market share during the downturn.

Third of all, the upwards reversal has already begun. Micron, whose quarters end one month earlier than most companies in the industry, already reported a positive y/y increase for their fourth quarter. Phison's monthly reported numbers also show a sharp increase in recent months. More directly to the point, Silicon Motion themselves recently preannounced fourth quarter earnings as coming in above the high end of guidance on both revenues and gross margins. We believe Silicon Motion is well positioned to have strong growth in 2024, together with the rest of the broader industry.

Merger — Won and Lost

For Silicon Motion, the main drama of 2023 was the merger that was and then wasn't. As a reminder, MaxLinear had previously agreed (in May 2022) to purchase Silicon Motion for a combination of cash and shares, totaling about $104 a share. Given the ongoing tension between China and the US over cutting-edge technology and the semiconductor industry, there was a lot of skepticism in the market as to whether China would approve the merger, and the stock moved up and down based on rumors over China's intentions. In late July, shortly before the August 7th final merger deadline, China approved the transaction. The stock jumped up…and then promptly crashed again upon MaxLinear's announcement that they were terminating the deal.

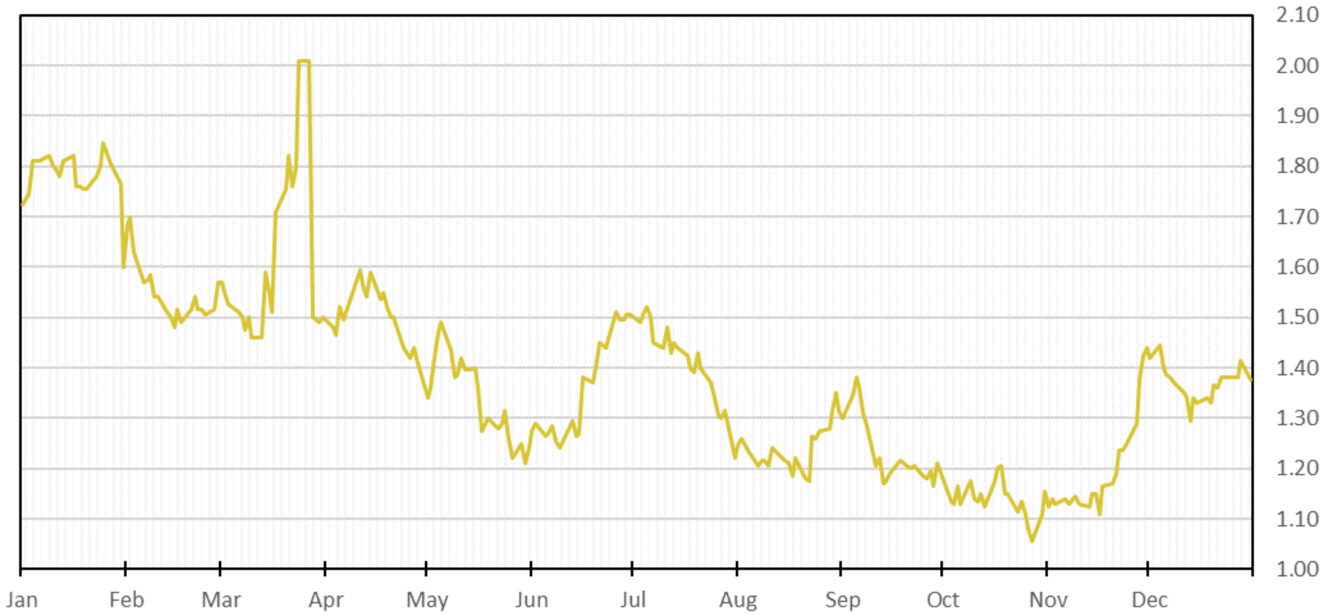
MaxLinear cited a number of generic reasons as giving them the right to back out, including an alleged MAE (Material Adverse Event), breach of contract by Silicon Motion, and conditions to the merger that were incapable of being fulfilled. MaxLinear pointed to nothing specific, because there was nothing to point to. MaxLinear simply no longer wanted to go through with the merger, due no doubt to the worsening economic backdrop in the semiconductor industry as well as the sharp rise in interest rates since the deal was signed, which would make for a very heavy debt load if they indeed were to close. So MaxLinear simply reneged on their contractual obligations.

Silicon Motion sued in Singapore arbitration for damages due to Willful and Material Breach, as provided for in the merger agreement. It is absolutely clear that MaxLinear does not have a leg to stand on, and Silicon Motion will win the arbitration proceedings. Much less clear is the size of the ultimate award. Silicon Motion will certainly be awarded the $160 million break-up fee that MaxLinear definitely owes, as well as ancillary damages, such as legal fees and other fees that Silicon Motion undertook to push the merger forward. Perhaps in the ballpark of $200 million total. In the grand scheme of things, this does not add up to much, about $5-$6 a share.

Far more interesting is the possibility of being awarded expectation damages, the difference between what MaxLinear was supposed to pay for the shares and the price of the shares after they reneged on their obligation, about $1.4 billion. That would be quite significant money, about $40 a share for a stock presently trading around $65. Although it would seem fair to expect MaxLinear to be found liable for the full damages, in our analysis we consider it unlikely, due to the No Third Party Beneficiaries clause included in the merger contract. Past court decisions have found that such clauses preclude being awarded expectation damages, which are really damages to the shareholders, a third party, as the merger parties are the two companies, not their shareholders. Although the precise wording of the clause as written in the present merger can be distinguished from the clauses as written in the precedent court cases, we still think it is unlikely that the Singapore arbitration tribunal will seek to break new legal ground and award a massive award under expectation damages, something which has never previously been awarded in failed public mergers. So, although it would be very nice to be awarded such a massive sum, and in some sense "fair", we are not expecting this to actually occur. If it does, that will be a pleasant surprise.

For anyone further interested in the intricacies of the legal case, we point you to our interview in August where we joined Andrew Walker from Yet Another Value Podcast to discuss the legal case and its implications at length. We encourage anyone interested in the details to watch it on the Research section of our website (focuscapitaladvisers.com/Research).

As we have discussed many times in the past, we are not particularly upset with the merger falling through. From the beginning, we have believed the merger price undervalued Silicon Motion's business and we firmly believe that with the merger in the rearview window, we should do even *better* over the long term.



Kingsgate (KCN:AX)

Price (12/31/23):	$1.375 AUD	Market Cap (12/31/23):	$234 million USD
Stock Loss (2023):	−20.3%	Portfolio Weight:	25.5%

Description

Kingsgate (Sydney: KCN) is an Australian gold mining company with one major asset, the Chatree gold mine in Thailand. Although closed for a number of years due to governmental action, Chatree has already restarted operations and is at the cusp of generating substantial cash flow. Nevertheless, Kingsgate continues to trade at a significant discount to its underlying value. Kingsgate trades in Australia in AUD (Australian dollars), but its business is mostly sensitive to USD (US Dollars). All numbers herein are in USD.

Refurbishment and Commencement

A lot of progress was made over 2023. Plant 2's refurbishment was fully completed and it was brought back online in the first quarter, with the first gold pour near the end of March. Plant operating metrics have been positive, with Plant 2 operating above nameplate capacity and with good uptime. At first, only low-grade stockpile was processed, but mining recommenced in mid-October, and Plant 1 is set to recommence towards the beginning of this year. When brought to full capacity, Kingsgate should be set to produce an annual rate of 100,000–120,000 ounces of gold, according to our own estimates as well as management's guidance. Although the schedule for refurbishment and recommencement was slightly delayed from the most optimistic, aggressive timelines, our estimate last year of being fully online and operating at capacity by mid-2024 remains.

TAFTA

A final resolution to the TAFTA arbitration (over Thailand's illegal closing of the Chatree mine in 2016) has yet to occur, and both parties have again agreed to push off the ruling for another six months (to the end of June) pending a full settlement between the parties. In the meantime, Kingsgate has been awarded tax incentives from Thailand to waive taxes for 8 years (up to a cap of about $90 million), which substantially raises profitability for the medium term. We would hope that in ongoing settlement negotiations, Kingsgate could win a lowering of the very high royalty rates (in which Thailand is very much an outlier compared to global standards), but we stress that even without any further concessions, Kingsgate stands to be very profitable. Kingsgate was very profitable back when the mine was operating in 2016 at gold prices of $1,200 an ounce. Gold prices are much higher now and have continued to increase over 2023, with gold now above $2,000 an ounce, making Kingsgate at full capacity even more profitable. Any further concessions from Thailand, although very much deserved, are icing on the cake.

One major event that has certainly delayed the final resolution of the TAFTA proceedings has been a changing of the guard in the Thai government. Elections were held in May, and pro-liberty, pro-business parties delivered a resounding defeat over the pro-army incumbent parties. Due to the hold that the army continues to hold over the Senate (with 250 unelected seats), the formation of a new government was delayed by a few months until a compromise Prime Minister, Srettha Thavisin, was selected in a coalition of the second biggest party (a pro-liberty, pro-business party) and the more traditional army-aligned parties. Srettha Thavisin is himself a former businessman, and the resulting government formed is substantially more pro-business. The new government is also presumably more predisposed to a favorable resolution for Kingsgate than the prior government, which was responsible for illegally closing Chatree in the first place.

Capital Raise and Expensive Debt

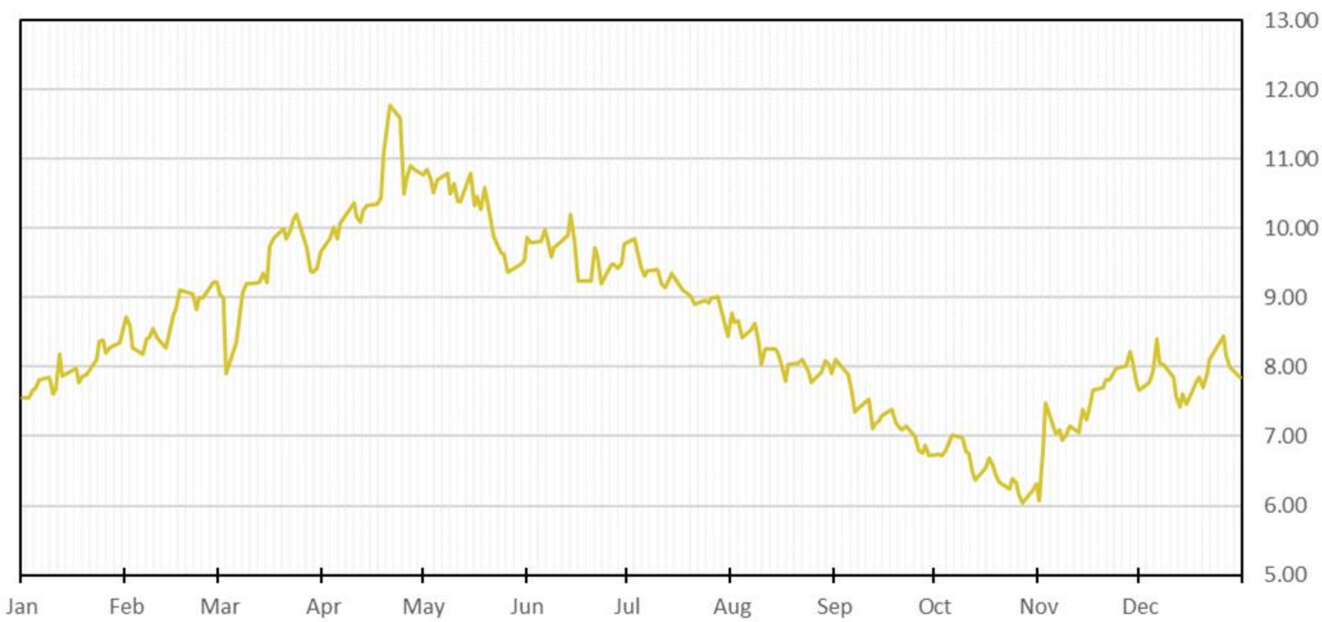
One thing that really hurt the stock price in 2023 has been the need for rather expensive financing to finish the refurbishment and bring the plants back online, partially due to Thai bureaucratic delays. In March, the company sold shares in an institutional placement at a 25% discount, with an accompanying opportunity for retail shareholders to partake as well, which ended up raising $34 million, net of associated expenses. This stock sale hurt the stock price tremendously, from which it has yet to recover.

In addition, Kingsgate borrowed over two occasions a total of $8.4 million from a related party, the owner of their mining contractor (who also has a board seat), paying a 12% interest rate for this debt. And in late December, Kingsgate borrowed $10 million for six months (with an optional 3-month extension) from Nebari Holdings, a third-party lender, at the very high rate of approximately 21% (measured on an annual basis, including all fees, etc.), plus a royalty on gold processed of 0.75% while the loan is outstanding.

All this is definitely very far from an ideal world. But with Kingsgate about to reach full capacity and profitability within a few months, we believe this expensive financing is soon to be a thing of the past.

Outlook

Kingsgate is on the cusp of reaching full capacity using normalized grade ore (as opposed to low-grade stockpile). We will then be producing an annual rate of 100,000–120,000 ounces of gold, with topline revenues of $220–$260 million a year. After subtracting operating costs, royalties (assuming no change in royalty structure), interest, and non-cash depletion charges, we are left with an estimated net income of $60–$95 million, and cash flow of $80–$115 million. Even with absurdly conservative estimates, they should be making at least $50 million net income when operating at full capacity and normalized grade ore, and much more than that in cash flow. With a present market cap of just above $200 million, the company remains absurdly undervalued, as the market remains in show-me mode. We are thrilled to own Kingsgate at these levels, and we have doubled our position size over 2023to take advantage of the drastic, and in our opinion, unwarranted, decline in the stock price. We expect to see great things from our Kingsgate investment.



Viemed Healthcare (VMD, VMD:TO)

Price (12/31/23):	$7.85 USD	Market Cap (12/31/23):	$302 million USD
Stock Gain (2023):	+3.8%*	Portfolio Weight:	0.0%

* Stock gain from beginning of year to our average exit price of $9.65 was +27.6%

Exit

In our previous Portfolio Updates, we highlighted a number of areas of concern, and we indicated that we would likely exit the investment entirely over the year. We indeed exited all our remaining stock by mid-July for an average price of $9.65.

We did extremely well with our investment in Viemed, with an IRR of about 24.7% annually over the approximately 5 years that we were invested in the company. Nevertheless, the issues surrounding the company continued to mount, with no signs of abating, so we have fully exited.

For further details on the history of our investment in Viemed and the reasons for our exit, please see our Postmortems Part 2 from this past July, which can be found on the Research section of our website (focuscapitaladvisers.com/Research).