Burford

BURFORD CAPITAL CHRONOLOGY OF NAPO INVESTMENT

2 September 2019

Burford has received a number of investor inquiries about the Napo investment after it was highlighted – inaccurately and misleadingly – in recent commentary. We thus provide here a detailed chronology of events.

As an overarching matter, it is worth bearing in mind that Napo represents 0.35% of Burford's litigation finance commitments to date, 0.8% of its recoveries (at its current carrying value) and 1.9% of its recoveries (at its maximum carrying value). The only thing notable about Napo is that it is one of a handful of Burford investments where Burford obtained a non-cash recovery, and the only investment where the recovery included public equity securities as well as cash – not that it is material.

In summary:

- Burford's entitlements in the Napo investment were created by its detailed and complex investment agreement, which set out various events that could ground a recovery for Burford; an outright win in a litigation matter was not required
- In 2012, an interim arbitral decision granting rights to Napo caused Burford to increase the fair value of the investment
- In 2013, that decision became final and triggered an unconditional entitlement for Burford (agreed by Napo) and the matter became a receivable, which Burford booked at a 50% discount to its entitlement
- In 2014, Burford and Napo restructured Napo's obligations to Burford in the form of a senior secured debt obligation which Burford booked at a 30% discount to its entitlement
- Burford did not increase its carrying value in 2015 or 2016 despite being entitled to a running 18% interest rate on its entitlement and Napo settling the Salix litigation (which would have separately triggered Burford's entitlement)
- In 2017, Napo and Jaguar merged and Burford received $8 million in cash against its $7.4 million investment (in addition to prior cash receipts of more than $500,000) and also received $24 million in stock, only slightly more than half of which it booked
- Burford marked to market the portion of the stock it booked each period for its IFRS accounts
- Burford does not mark its concluded investment table to market and did not do so here (and also did not include the positive impact of a 2018 sale of Napo shares on that table, which would have increased its reported ROIC to 27%)
- Had Burford marked the concluded investment table to market, the impact on its reported returns would have been negligible

Napo background

Napo Pharmaceuticals, a small botanical-focused pharmaceutical company, was engaged in the development of a drug called crofelemer, which had desirable gastrointestinal properties. In 2011, when Burford first encountered Napo, crofelemer was soon to be submitted for FDA approval.

Napo had previously entered into an agreement with a larger pharmaceutical firm, Salix Pharmaceuticals, a gastrointestinal specialist, to develop and manufacture crofelemer for Napo, obtain regulatory approval for the sale of the drug and commercialize it for the benefit of both parties.

Napo believed that Salix was in breach of its agreement with Napo in several respects and had filed a lawsuit against Salix in New York state court. Napo lacked the resources to litigate that case effectively and was in search of litigation finance.

Burford's introduction to Napo

Burford was introduced to Napo by a litigation partner at a major US law firm with which Burford had a relationship, although that firm was not representing Napo in its litigation.

Napo was not referred to Burford by Invesco. Invesco's interest in Napo was held in a different fund with a different fund manager than Invesco's interest in Burford, and at the time Burford did not even know the fund manager who held the Napo interest.

Napo met the classic profile of some of Burford's clients – a smaller business with potentially valuable intellectual property or other rights arguably being taken advantage of by a larger company. Burford regularly provides capital to such clients to level the playing field and permit the smaller business to retain top-flight counsel and match litigation resources with the larger firm.

However, structuring such financing arrangements can present challenges as the smaller company is often cash-poor and the litigation may resolve on desirable commercial but non-cash terms. Thus, Burford focuses on crafting financing agreements that protect Burford and its investors' capital in such instances and do not leave Burford exposed to the vagaries of non-cash settlements; as a result, our agreements often extend well beyond the proceeds from a single piece of litigation. Moreover, Burford's arrangements with such companies may change and evolve over time consistent with their business needs and development.

The 2011 financing agreement

Burford entered into a financing agreement with Napo on 9 December 2011 that provided for $1.5 million of financing and two further $1.5 million options at Burford's election.

The core economics of the Napo financing provided for Burford to receive the greater of two potential streams of payments upon any "litigation resolution". To summarize the complex agreement, one stream was a multiple of Burford's invested capital and the other stream was a share of the monetary proceeds paid by a litigation defendant. In short, if a "litigation resolution" occurred, Burford would immediately become entitled to a significant payment under the first stream even if Napo did not receive any proceeds in the litigation. This approach is an effort to solve for the issue identified earlier of companies settling litigation without cash being paid.

What, then, is a "litigation resolution"? Again, the short answer is a settlement or final resolution of some or all of a piece of litigation encompassed by Burford's agreement. To be clear, Napo did not need to win a case for Burford's entitlement to vest; a number of other outcomes could also cause that vesting. Litigation isn't always just about winning; it can simply be about improving one's position. In this instance, Burford used broad definitions of both the relevant litigation and its resolution, to encompass more than just the Napo/Salix dispute but also to sweep an ongoing dispute between Napo and Glenmark Pharmaceuticals along with other related claims.

With the 2011 agreement in place, Burford began funding Napo, and by the end of 2011 had deployed $1.5 million. In 2011, Burford carried those deployments at cost on its balance sheet consistent with its valuation policy and obviously did not treat Napo as a concluded investment.

<u>2012 – more funding and a favourable interim result</u>

During 2012, both the Salix and the Glenmark litigation continued, and Burford funded another $3 million in the first half of 2012 through the exercise of the two options in the 2011 agreement. At 30 June 2012, Burford continued to carry those deployments on its balance sheet at cost.

In the second half of 2012, the Glenmark arbitral tribunal issued an interim decision granting Napo significant rights. If that interim decision were to form part of the tribunal's final decision (as would be likely), that would constitute a litigation resolution under Burford's agreement with Napo, entitling Burford to a substantial recovery of a multiple of its invested amount. That interim decision was an objective event in the underlying case, and thus pursuant to Burford's valuation policy Burford increased the carrying value of the investment at 31 December 2012 to $9.4 million (representing $4.5 million of deployed cost and $4.9 million of unrealized gain) – well below Burford's entitlement should the interim decision be made final. Because litigation risk remained in the matter, however, it was not treated as a concluded investment in 2012 and the fair value increase was not included in Burford's reported investment returns.

At the same time, the FDA approved crofelemer in late 2012, increasing Napo's expectancy value considerably and suggesting that Burford's future interest here could be quite valuable.

<u>2013 – further financing and a litigation resolution</u>

In 2013, Napo sought incremental financing and thus Burford and Napo entered into an agreement on 1 April 2013 that provided for further capital availability, expanded the scope for Burford's returns and increased those returns on the basis of the incremental capital. In short, Burford could now look to all of Napo's revenues for its returns in exchange for this incremental financing as opposed to being limited to litigation proceeds (with the multiple of capital return remaining available should it prove to be the larger return).

Following that agreement, Burford funded a further $2.9 million in the first half of 2013 which was added to the investment's carrying value at cost at 30 June 2013.

In September 2013, the tribunal in the Glenmark arbitration issued a final order that included the provisions of its previous interim order. While Napo lost pieces of the Glenmark arbitration, its success on certain points was sufficient to count as a litigation resolution under Burford's funding agreements and to trigger Burford's entitlement. Napo agreed. Napo and Glenmark went on to settle the case and agree on its final outcome.

Thus, by the end of 2013, Burford had become entitled to payment under its funding agreements and no litigation risk remained as to that entitlement. Under Burford's longstanding policies, that represented a concluded investment and the balance sheet investment became a receivable. For example, on page 7 of our 2013 annual report, with Napo in contemplation, we made it clear that "one must look at several different strands of recovery to understand our total return from a matter, including both cash receipts and receivable creation".

However, Burford was mindful of the risk associated with Napo's ability to execute on its business plan, despite having a valuable FDA-approved drug, and even though Burford's entitlement had become unconditional Burford nonetheless discounted substantially both the receivable value and the concluded case value as at 31 December 2013, to 50% of Burford's minimum entitlement. Thus, even though Burford's entitlement was more than $30 million, Burford booked the concluded case receivable at $15.75 million and included the same amount on its concluded investment table.

2014 restructuring

As 2014 progressed, a number of developments were affecting Napo having nothing to do with Burford, which was sitting comfortably with its first priority entitlement that was growing over time at a meaningful interest rate:

- After what was widely viewed by the lawyers as an erroneous jury instruction, Napo lost to Salix in its jury trial, but had a strong argument on appeal
- Napo was increasingly interested in the animal potential of crofelemer and was contemplating separating its animal and human businesses
- Salix was in acquisition discussions with Valeant

Ultimately, to crystallize Burford's entitlement and clean up Napo's capital structure, Burford and Napo agreed to an October 2014 restructuring which terminated Burford's litigation funding agreements and replaced them with a traditional senior secured debt instrument with a $30 million principal balance and 18% interest, compounding monthly, with a 1 January 2017 maturity.

Given the greater certainty of this new instrument, Burford accordingly adjusted its carrying value on both the balance sheet and the concluded investment table to $21.3 million, but still retained a 30% discount from its entitlement for conservatism given the risk associated with Napo's business plan despite now being a senior secured creditor.

2015 – Jaguar IPO

In 2015, Napo split its business into two – the human uses of crofelemer remained in Napo (along with its dispute with Salix, which had by this time been acquired by Valeant) and the animal uses of crofelemer were put into Jaguar Health. Jaguar would then be taken public, although Napo would remain a substantial owner of Jaguar, meaning that Burford, by virtue of its senior secured position in Napo, would benefit from the success of both companies. Burford did not at this point obtain any equity in Jaguar.

Burford did not make any change to its carrying value of Napo on either the balance sheet or the concluded investment table in 2015 (including not giving effect to the running 18% interest rate).

2016 – Salix settlement

In March 2016, Salix/Valeant and Napo entered into a settlement of their litigation. The turmoil at Valeant no longer made the partnership viable and the settlement returned the rights to crofelemer's marketing and development to Napo, enhancing Napo's theoretical value considerably. (Had the earlier Glenmark win not already triggered Burford's entitlement under its funding agreement, this settlement would have done so.)

Under the terms of the 2014 debt agreement, if Napo did not prepay some of the outstanding debt in the first half of 2016, the principal balance of the senior secured debt would increase. Napo did not make such a payment and thus the term loan's balance increased by $7.5 million. Despite Burford now being entitled to a greater recovery and Napo having regained full control of crofelemer, Burford did not increase its carrying value because of the execution risk it perceived.

Thus, both the balance sheet carrying value and the concluded investment table continued to reflect the same value as in 2014, again also without giving effect to the running interest or the principal addition. At 31 December 2016, Burford was carrying the Napo investment at $21.3 million against an actual entitlement of $51.1 million.

2017 and beyond – Napo/Jaguar merger and its aftermath

In 2017, Napo merged into Jaguar. Napo's efforts to develop crofelemer on its own, without a larger and better-financed partner like Salix, were challenging and it believed that a single enterprise with some incremental capital invested in it and continuing access to the public markets would maximize the prospects for crofelemer. We consulted with industry experts about the position.

Given the size of Burford's entitlement, it was clear that we represented too much of an overhang to enable the merger to proceed if we remained as a senior secured creditor. We engaged in a period of difficult negotiations with Napo and Jaguar (our negotiations were with the companies, not with Invesco, and we did not coordinate our negotiations with Invesco), and ultimately reached an agreement that saw Burford receive $8 million in cash – our entire investment back plus a modest profit – and a substantial equity interest in the merged entity.

Our equity interest came in several tranches[1]:

- 18,479,826 shares of convertible non-voting common stock (the "Tranche A" shares)
- 19,700,625 shares of non-voting common stock (the "Tranche B" shares)
- 4,884,245 shares of voting common stock (the "Tranche C" shares)
- 270,270 shares of convertible non-voting common stock (the "Expense Reimbursement" shares)

At the share price associated with the capital infusion as part of the merger (92.5¢ per share) that equity was worth $40.1 million, and at the closing price on the effective date of the merger (56¢ per share) that equity was worth $24.3 million.

[1] Share figures are the original share issuances, without adjustment for later reverse stock splits.

Thus, we had turned a \$7.4 million litigation finance investment into \$8.6 million of cash proceeds[2] and a large equity stake in a pharmaceutical company with an FDA-approved drug. Despite the continuing execution risk, this felt like a pretty good deal, and the presence of sophisticated pharma investors on the shareholder register of the merged company gave us comfort as well.

This was, however, uncharted territory for Burford. We had never before turned a litigation funding investment into a public equity position, and haven't since.[3] To provide oversight of our interests, we appointed Marshall Heinberg, the former head of investment banking at Oppenheimer and US Head of Investment Banking at CIBC, to be our observer at the Jaguar board and to be actively engaged in evaluating our investment.

Valuation and accounting

The question then was how to reflect the value of the Napo equity we received.

Part of our agreement with Jaguar obliged it to endeavor to sell or redeem our Tranche A shares for a minimum price that rose over time, from \$20 million in the first twelve months following the merger to \$45 million if the sale or redemption took more than thirty months. Should Jaguar not be able to do so, our Tranche B shares would vest. In other words, we would either receive a substantial amount of cash from the sale of our Tranche A shares, or we would own many more shares.

Nonetheless, we decided that the right approach was to disregard the Tranche B shares – representing 45% of our holding – entirely as opposed either to putting them on our balance sheet or looking to the minimum price for the sale of the Tranche A shares. We booked the remainder of the shares at the 56¢ closing price on 31 July 2017, the effective date of the merger, which was well below the 92.5¢ "merger price", and included the matter in the concluded case table at the same value (along with the \$8.6 million in cash payments). That represented a small (less than \$500,000) increase from the prior carrying value.

It is worth reflecting on how conservative that approach was, and how conservative Burford's entire approach to valuing the Napo investment was. Had our objective been to maximize income and valuation, we could have taken a much lower discount on the original receivable, increased the annual value to reflect the 18% interest and considered the entire equity position instead of just 55% of it. We did none of those things. Burford's valuation of the Napo entitlement until the merger in 2017 was a traditional, conservative and appropriate litigation finance valuation, and after the merger was a mark-to-market approach on the balance sheet for only part of our equity interest.

What happened next was out of Burford's hands. The market was not impressed by the Jaguar/Napo merger, and the share price started to fall. That set off a vicious cycle affecting Jaguar's access to capital, which constrained its drug development activities, and the stock has fallen sharply. Burford was able to sell about \$625,000 of shares in 2018 and we continue to hold the remainder of our interest.

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[2] In addition to the \$8 million as part of the 2017 arrangement, Burford had also previously received more than \$500,000 in prior cash payments from Napo at various times under its prior agreements.

[3] Occasionally, we receive non-cash assets as part of resolutions, the most notable example being the Gray case in Arizona where we converted our litigation finance entitlement into a mortgage and ultimately sold the mortgage, turning a \$7 million investment into \$38 million of proceeds.

As an IFRS valuation matter, we have marked the stock to market in each accounting period, including the second half of 2017, as we discussed in the 2017 annual report. Indeed, we discussed Jaguar specifically and at length at pages 23-24 of the 2017 annual report.

The concluded investment table, however, is not a mark-to-market document and Napo is the only instance in which we have received public equity. Our general approach with that table is to keep investments at their initial concluded value and not necessarily adjust them for incremental changes on a period-by-period basis but true them up at the end of their life. It is worth noting that most of our investments are more straightforward – they resolve and pay at the same time and there is no issue about any residual collection. We intend to expand our concluded investment table disclosure to separate cash receipts and receivables to show investors how small the latter category is.

Thus, just as we did not adjust the Napo investment on the concluded investment table in 2015 and 2016 to reflect the 18% running interest on our entitlement, we similarly did not adjust it every six months for fluctuations in Jaguar's equity value. However, by the first half of 2019, when it had become clear to us that a rebound in the share price was unlikely in the near term, we did make an adjustment. In fact, showing how public equity does not fit neatly into the concluded investment table, we also did not adjust the table to include the proceeds of our sale of some Jaguar stock in 2018, so the returns currently published in fact understate our actual investment performance considerably. Including the 2018 sale, we have generated a 27% ROIC to date, not 18% as currently shown.

It is important to note that this is a largely theoretical discussion. If we had adjusted our concluded investment table every period and used the same mark-to-market values as on the balance sheet, there would have been no meaningful difference in our reported returns:

	ROIC as reported	ROIC with Jaguar marked to market
31 December 2017	76%	75%
31 December 2018	85%	83%
30 June 2019	98%	98%

So, after seven pages of detailed explanation, we trust the answer is now clear: we accounted for Napo appropriately and conservatively; we made no effort to inflate its value; Invesco had nothing to do with our position; and even if one thinks we should have adjusted the concluded investment table earlier, there was no meaningful impact from not doing so.

What Napo is more than anything else is a good example of how doggedly and diligently we work investments for the benefit of our investors. Our focus on principal protection and risk led to a funding contract that produced a return despite uneven litigation outcomes and subsequent cashless settlements for Napo. Multiple restructurings allowed us to improve our position still further. While the equity performance has been disappointing, we nonetheless turned a healthy cash profit of 27% ROIC and own shares that may one day recover some value.