

Get on the case

What do you get when you join a group of lawyers and bankers together to form and run a company? Well surely there is a joke about that, but hey this a PG rated publication. In this case it is a new company that we introduce to the Australian equities Fat Prophets portfolio, IMF Australia.

IMF has its strength in merging expertise in law and finance and is operating in the field of litigation funding or third party funding, as it is sometimes known. This is an emerging and growing asset class that should generally have a low correlation with the broader equity markets, as companies fortunes are much more tightly linked purely to their success in settling and winning cases.

IMF is a leader in the field of litigation funding, although this breed of company is rarely listed so we don't see many in the wild. **Litigation funding is a high-stakes game and companies need a blend of skills to come out on top often enough to deliver returns to shareholders.**

We believe that IMF has these in spades. **IMF is well funded, has a team with a great track record and deep expertise, solid portfolio of cases and good deal flow.**

Litigation funding looks to be forming a wave

As a bit of background, we will spend some time to briefly outline the sandbox in which IMF operates, and it is not one for the faint hearted. High-stakes litigation is often a nasty dogfight, brutish and long lasting and also somewhat controversial.

Litigation funding or third party funding has in some form been around for a long time often associated with wrongful dismissals or a worker injured during the course of work due to a shoddy working environment and the larger class action lawsuits intended to bring compensation to large groups of people negatively influenced by a companies actions or defective products. Think of the early 80's Gene Hackman movie titled "Class Action" or the more recent Julia Robert's "Erin Brokovich" for some examples. For a light read, consider "The King of Torts" by John Grisham.

The twist here, which is part of the reason for the controversy, is that it is becoming more accessible for private investors to get a slice of the potential recovery from a successful settlement and the funds or companies are generally targeting high-stakes commercial litigation.

Critics stress that there will be an increase in the number of frivolous lawsuits and pressure on defendants to handle. Proponents say litigation funding will assist in increasing the number of legitimate claims. **Often this is the so-called "David and Goliath" cases, where small companies can seek to level the playing fields against much larger opponents who often can smother the smaller company in legal costs.**

In addition there are a growing number of publicly listed companies, including those who count themselves amongst the largest looking at using third-party funding as a way to keep a lid on legal costs. An article in the Wall Street Journal quoted the general counsel of chemical manufacturer DuPont, Tom Sager as saying "We have and will continue to entertain the use of third-party funding under the appropriate circumstances."

Whatever our personal view of the debate on which way the legal system should go, changes in the legal framework in recent years, particularly in the main countries for litigation funding (the US, Australia and the UK) have favoured the rise of litigation and third party funding.

More companies are dipping their toes in this particular pond, but we think you should go with one of the best, which just happens to be based on our fair shores. The potential rewards are significant, with a rule of thumb being a targeted three to four times return on initial investment. This return will generally be watered down to some extent by cases lost or discontinued.

Under the hood of IMF

IMF is the gorilla in the Australian litigation funding market with an estimated 80%+ of market share and actively markets its services in other jurisdictions, including the United States, Canada, the United Kingdom, South Africa, New Zealand and Asia. The company opened an office in New York, called Bentham Capital in October 2011 to further develop its presence in the American marketplace, which will greatly expand the company's addressable market.

The company chose the name Bentham Capital for the US business in honor of Jeremy Bentham, an English philosopher and reformer over 200 years ago against Champerty. A lesser known tidbit is that the practice we call third party funding now, was referred to Champerty previously in England and was illegal. Bentham believed this skewed the legal system in favor of the wealthy.

IMF was the first litigation funder to list on the Australian Stock Exchange and has been for over 10 years now. The company focuses on funding large-scale litigation for plaintiffs who may not be able, or would otherwise choose not to pursue legal claims against defendants. Often terms are kept confidential but IMF earns approximately 30% of the settlement value as a fee in addition to the recovery of its legal expenses.

IMF provides funding for the case and investigations preliminary to litigation, strategic planning and management of the process and also generally indemnifies its clients against adverse legal costs. As a leader in its field and its own experienced internal team the company **has close relationships with legal firms and other independent contractors and experts that give it an edge on assessing cases and managing costs**. The company will only take on cases with a minimum claim size of AUD\$5 million.

A litigation funder must not only have a range of lawyers skills, with access to a range of experts but also combine this with an investors understanding of risk and reward and allocate funds accordingly. IMF has proved themselves adept at this to date, with significant returns on investments and high success rate. The following table from the company's annual report summarises the major cases finalised in 2012.

Date commenced	Litigation contract's matter name	Claim value included in investment portfolio report at 30 June 2011	Total litigation contracts' income	Total litigation contracts' expenses (including capitalised overheads)	Net gain/(loss) on disposal of intangible asset
		\$	\$	\$	\$
May-08	Centro	200,000,000	61,976,563	(20,197,283)	41,779,280
Jan-09	National Potato*	70,000,000	14,506,945	(4,799,000)	9,707,945
Sep-09	Transpacific Industries	65,000,000	13,004,397	(2,548,979)	10,455,418
Mar-10	Uniloc**	150,000,000	7,295,922	(3,647,961)	3,647,961
Aug-10	Babcock & Brown	50,000,000	7,265,000	(1,409,396)	5,855,604
Jun-11	Thomson Playford	10,000,000	4,593,529	(1,314,899)	3,278,630
Jul-08	Credit Corp	15,000,000	4,354,813	(2,928,186)	1,426,627
Jul-10	Centrex Limited	5,000,000	1,937,788	(499,870)	1,437,918
Sep-10	Collyer Bristow	60,000,000	-	(4,946,215)	(4,946,215)
		625,000,000	114,934,957	(42,291,789)	72,643,168
	Sons of Gwalia***	-	1,050,774	-	1,050,774
	Other matters	-	1,821,634	(4,948,530)	(3,126,896)
		625,000,000	117,807,365	(47,240,319)	70,567,046

Hugh McLernon, a true litigation veteran and a pioneer in developing the modern litigation funding industry, skips the ship at IMF and is supported by a team of similarly experienced colleagues and contacts. Senior management own significant stakes in the company so have skin in the game the same as their investors.

The company looks to build a portfolio of cases to litigate, much the same as a venture capital or private equity firm looks to build a portfolio of different investments. Although the outcome of each case can end in a variety of ways, if chosen well and managed well the company should be able to improve its return on investment. In this sense IMF is well positioned because as a leader in the field it gets good deal flow, thus being able to cherry pick its cases, which is a virtuous cycle.

For example, to date the company has tended to take on about 3% to 4% of the deals that they see. According to the company they have reviewed several thousand cases over the past decade and taken over one hundred case investments through to completion.

As of 30 June 2012, IMF had a case portfolio of approximately \$1.2 billion in value distributed as per the table below. Readers will see that IMF is migrating towards more sizable deals. The portfolio does not include the Wivenhoe Dam case in Queensland or the credit derivative cases in Europe, Australia and New Zealand at present. We believe these and others could see the case portfolio approach \$2 billion in value during the next financial year.

Portfolio report at 30 June 2012 where the budgeted fee per case to IMF is greater than \$500,000 ('major cases')

	Number of claims	Claim value	Percentage of claims >\$500,000
Claims <\$10m	2	\$10,000,000	1%
Claims \$10M - \$50m	13	\$288,000,000	23%
Claims >\$50m	10	\$935,000,000	76%
Total claims where IMF's budgeted fee is more than \$500,000	25	\$1,233,000,000	100%

IMF's revenues and earnings are lumpy from year to year and very difficult to forecast, due to the nature of litigation, although as the book grows in size then so long as the business model is working we would expect an increase when smoothed over a few periods.

For example, to date the company reports that they have finalised 137 investments since listing, with an average investment period of just 2.3 years. They have generated a gross return on every dollar invested of 3.10 times, excluding overheads, which is a handy run rate. They set target parameters of completing cases within 2.5 years and to generate a gross return on every dollar invested of 3 times, excluding overheads.

The following pie chart delineates the number of results that have dropped into each category. Including wins and settlements the company is hovering around a 76% success rate.

IMF'S TRACK RECORD 137 CASES COMPLETED



The company expects 48% of the investment portfolio to finalise over the next 12 months, which compares favorably last year, when 36% of the portfolio finalised. Therefore the company expects another strong year of profits this upcoming period.

The company is coming off a record year in 2012, with net profit after tax of \$43.0 million almost doubling from the prior years \$22.9 million. Big wins in the year came from Centro netting them \$41.8 million and a return of approximately 207% and Transpacific netting \$10.5 million and return of 410%. The company also has a good track record of distributing dividends, this year declaring a 10.0 cent fully franked dividend. Although the company has not declared a dividend policy, as a rule of thumb they intend to distribute surplus funds in excess of between \$70 to \$75 million, depending on the claim value of the portfolio and where the Directors do not form the view that there is a better use for IMF's cash.

After trading in overbought territory since July, as highlighted by the yellow ellipse on the RSI, prices have retraced quite aggressively. The confluence of support is located at the 61.8% Fibonacci retracement and technically important 200 day moving average at the \$1.40 region in the near term should weakness continue in the shorter term time frame.



With reference to the weekly chart, a decisive break above the downtrend line of \$1.60, would likely lead to higher levels to come over the broader term.



Our view

Litigation funding seems to be gaining traction, probably due to its lowly correlated returns. IMF has a leadership position in the space, which should lead to them continuing to see good deal flow and combined with their experience this should enable them to continue to generate good returns on investment barring major changes in regulation.

With a healthy balance sheet we don't believe the market is attributing enough value to their case portfolio, especially given the \$66 million already assigned to cases, which in the past has netted them a 3x return.

Combine this with likely growth in the book and a start-up in the US and the company has the makings of an interesting speculative investment.

Therefore, we recommend IMF Australia as a buy to Fat Prophets members.

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Snapshot IMF

IMF Australia

Latest Closing Price: \$1.43

Bentham IMF is an Australia-based litigation funder. The Company is engaged in the investigation, management and funding of litigation. The operations of the Company are divided into three areas of business: insolvency claims, commercial claims involving single plaintiffs and commercial group actions. IMF's services include funding for litigation and investigations preliminary to litigation; payment of adverse costs orders; strategic planning, monitoring and managing of litigation; factual investigation, including asset tracing, and assistance in facilitating settlements and maximizing the value of each claim. Financial Redress Pty Ltd is the subsidiary of the Company. The Company has operations in Australia, the United States, Canada, the United Kingdom, South Africa, New Zealand and Asia. In October 2011, it incorporated a new wholly owned subsidiary, Bentham Capital LLC, which was established in the United States of America.

Market Capitalisation: \$184m

	FY1	FY2
Price to Earnings	8.4	10.0
Dividend Yield (%)	6.7	6.7
Price to Book	1.6	1.4
Return on Equity (%)	22.5	17.1

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