



IMF Bentham – value trap or opportunity?

by Roger Montgomery

Key points

- *IMF Bentham (ASX: IMF) has fallen over 30% since its record high in March 2015.*
- *IMF has a very successful track record of funding class actions, generating an historical internal rate of return exceeding 40%.*
- *The company has recently announced the settlement of its sixth class action in the US and is funding four new cases in this market. Management is also pursuing a higher volume of smaller cases that may smooth the company's earnings profile. These initiatives should help grow the claims book above \$2 billion.*

The share price of IMF Bentham (ASX: IMF) has fallen over 30% since its record high in March 2015, and shareholders (including Montgomery Funds) must inevitably ask – is this a value trap or an opportunity?

A temporary weakness

A value trap is when a company is perceived to be good value, though its share price continues to decline. We must assess if the company's fundamentals have deteriorated, or whether the weakness is temporary.

IMF has a very successful track record of funding class actions, generating an historical internal rate of return exceeding 40%. However, while management is very experienced at allocating resources to maximise payoffs for clients, it is difficult to accurately predict when a case will conclude.

A lumpy earning's profile makes it harder to determine IMF's 'normal' level of earnings and whether, for example, short term underperformance reflects longer term deterioration. For instance, after modest returns in fiscal 2013 and 2014, IMF was well

on track for a bumper fiscal 2015. In the December 2014 half-year it settled \$460 million of claims and recognised \$23 million in earnings. But shortly after this impressive result, the company made a string of unfavourable announcements in quick succession.

First, there was the successful appeal of a case that IMF had initially fought and won in 2012. Then came the loss of a small case in the USA. And finally, the Full Court of Australia ruled in favour of ANZ in IMF's class action against the banks to recover credit card fees. While IMF will pursue the matter to the High Court of Australia for final resolution, the high-profile case did certain harm to the company's share price.

Finding intrinsic value

When you are holding an investment in a company with a falling share price, it is helpful to consider the wisdom of Howard Marks from Oaktree Capital. In order to profit in a declining market, you must have a view on intrinsic value and hold that view strongly enough to be able to hang in. Oh, and you must be right.

So let's first explore our view on IMF's intrinsic value. The company is in a very strong cash position, with \$134 million in cash, \$48 million in debt, and \$65 million in current trade receivables, which are not subject to appeal at 31 December 2014.

IMF Bentham also had \$79 million of intangible assets, which comprises the company's investment in current cases. This is a sunk cost, so provided that IMF Bentham maintains its historical returns we believe its liquidation value is similar to its current \$280 million market capitalisation.

A company that is trading close to its liquidation value generally goes a long way in providing an attractive margin of safety for investment. Yet the conviction of our view must also consider the company's



prospects – and IMF appears to have many growth opportunities on the horizon.

The company has recently announced the settlement of its sixth class action in the US and is funding four new cases in this market. IMF also reached agreement with its European joint venture partner to co-fund its first European case, which will attempt to recover damages from S&P and ABN Amro for investors who purchased Constant Proportion Debt Obligations.

Management is also pursuing a higher volume of smaller cases that may smooth the company's earnings profile. These initiatives should help grow the claims book above \$2 billion.

Long-term hold

Our investment thesis depends on the company maintaining its rigorous risk assessment when funding cases, and despite the recent spate of unfavourable rulings, we consider that it is business as usual for IMF Bentham.

It's important to understand that the legal system is adversarial, which means there will always be a winner and a loser. While IMF's track record is impressive, it does not mitigate the risk of future losses. On balance though, we consider that a sufficient margin of safety exists and are comfortable with IMF's long-term prospects.

IMF Bentham



Source: Yahoo!7 Finance, 2 July 2015

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