FCL Capital

Short Sellers

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On december 20th 2012, the mega investor Bill Ackman was about to give a dramatic presentation in Midtown Manhattan about Herbalife, the famous supplier of weight loss products. With such a high profile investor and being such an important presentation, the company's stock price movements and its trading acquired totally atypical patterns. In fact, it was all that was talked about that week in Wall Street and the financial world, with its CNBCs, Bloomberg terminals and chit chats. Would it be good? Would it be bad? Bill Ackman was just about to claim, in a three hour and 350-slide presentation that Herbalife was, basically, a massive fraud.

A heavy campaign from Persing Square, Ackman's firm, followed the presentation. A website, called www.factsaboutherbalife.com went online, backing the company's vision that Herbalife was a giant pyramid scheme, where sellers should recruits new sellers who should recruit new sellers and there was no final demand for its products. In other words, a scheme that could keep on going for decades, like it did, but that would ultimately crumble. Basically, an equivalent to the dietary industry of what Bernie Madoff did to finance.

The company's misfortune with financial wizards started in May 2012, when the also-mega investor David Einhorn made some tough questions in a quarterly earnings call.

Below is the transcript:

"Q – David Einhorn): I got a couple of questions for you. First is, how much of the sales that you'd make in terms of final sales are sold outside the network and how much are consumed within the distributor base?

(A - Herbalife): So, David, we have a 70% custom rule which is basically says that 70% of all products sold to consumers or actually consume my distributors for their own personal use. So obviously what we've seen with nutrition clubs is that we now have visibility for the first time to our customers. We know that we reported on this call for the first time the number of commercial clubs around the world, which is in excessive of 30,000, so that has given us feasibility to the tremendous amount of products that are being sold directly to the consumers and we see that as a growing trend in our business.

(Q – David Einhorn): So, what is the percentage that actually sold to consumers that are not distributors?

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(A - HLF): So, we don't have an exact percentage David because we don't have visibility to that level of detail.

(Q – David Einhorn): Do you have an approximation?

(A - HLF): So well again going back to our 70%, where we believe is that it is that 70% or potentially in excess of that.

(Q – David Einhorn): Okay. What is the incentive for supervisor to sign somebody up to become a distributor as opposed to – if they're just going to consume for themselves as opposed to just selling them the product for the markup. How does the distributor – how does the supervisor come out better?

(A - HLF): Sure.

(A - HLF): So, I think there are two reasons for that. So, we know from our business today that many of our future supervisors and business builders come in as customers and then they become distributors. So, the benefit from a supervisor is the ability for greater retention of that customer/distributor because they are now earning a 25% discount. The second issue is that it preserves linage. ***So obviously, if I sign you up David as a distributor, my hope and my expectation is that based on the tremendous product result that you're going to achieve that you'll have friends and families go to you and say, gosh David you look great, what do you want. You're going to respond to them, I'm on Herbalife, and that will encourage you to say, wow maybe this is a business opportunity I could be interested in.*** *So, the benefit for me as your supervisor is one, the discount that you would get and that for my greater likelihood of retaining, it was a permanent customer and secondly, the hope that at some stage, you will decide to do the business and therefore that you are already in my lineage and is part of my group.*

(Q – David Einhorn): Right. But just trying to understand this clearly, if I sell to a customer, I bought it – I'm a supervisor, I buy at a 50% discount, I sell to a customer, I make 50 points, if he pays the full price. If he signs up with a distributor and buys it himself, he gets a 25% discount and I get seven points as a royalty. Is that how it works?

(A - HLF): No, you would get the other 25%.

(Q – David Einhorn): I will get 20% plus the 7%.

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(A - HLF): So, unless you're are on royalty you would simply are in the difference. So, you are in a 50% discount, you are selling at a 25% discount, and so the difference between the two is your profit on that sale.

(Q – David Einhorn): Right. So if he signs up with a distributor and buys it for himself from Herbalife, I still get the 25%.

(A - HLF): That is correct.

(Q – David Einhorn): Okay. Good. One last question, when you had your previous 10-K, you disclosed three groups of distributors at the low-end. You called 29% self consumers, 57% small retailers, and 14% potential sales leaders and then that disclosure did not repeat in the subsequent 10-K. So, I got two questions, first of all how do you track that and how do you characterize and know which ones are which? And second, why did you stop disclosing that in the last 10-K? Is that something that you stopped tracking or just stopped disclosing?

(A – John Desimone): David, hi, this is John. The criteria for grouping distributors into different classes was based off of their volume purchases and we are making assumptions that people below of certain volume. While doing the business, they were buying soft consumption and I don't remember the exact amounts, but I can get it to you after the call, as how we delineated between the three classes.

And one the reason that we took out of the 10k is a change in CFO from which to me ***I didn't view it is valuable information to the business or to the investors.*** *However, we can easily provide the exact same breakout going forward if you would like [indiscernible] into our investors. Again, I don't remember the exact delineation between the three classes, but I can certainly get it to you. Our objective is to be completely transparent, so.*

(Q – David Einhorn): Thanks [indiscernible], I appreciate that sort of follow up, that will be helpful.

(A - HLF): Thanks.

(Q – David Einhorn): Thank you so much guys."

The stock ended the day down 20%.

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Then in December came Persing Square and their effort, unprecedented in many ways: it is rare, even in the mature US market, to see such a high profile attack. The website filled with presentations, testimonials from former Herbalife distributors and so on- all claiming or supporting the claim that the company was a fraud. The interviews and everything else makes one thing clear: It is not any exaggeration to say that Ackman is putting (since this story is still ongoing) his entire 10-billion dollar firm's reputation on the line, with such a high profile attack.

Of course, both Eirnhorn and Ackman are not doing this for altruistic reasons. They are not interested in discovering the truth or protecting the world from evil intentions. They just want to make money. They are both among the world's most famous short sellers. In the following days, it was disclosed that Persing Square´s short position in Herbalife amounted to more than U$ 1 billion dollars and he said he wouldn´t stop until the stock reached the price of exactly zero.

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In finance, short selling (also known as shorting or going short) is the practice of selling securities or other financial instruments that are not currently owned, with the intention of subsequently repurchasing them ("covering") at a lower price. Over time, this definition started to mean any position where an investor would profit from the decline in price of an underlying security.

Many people claim that short selling was invented by the Dutch merchant Isaac Le Maire in the XVII century, speculating against the Dutch East India Company, which was his competitor. Over the course of history, short selling has always attracted a good deal of polemic. Some see as immoral to profit from other people's misfortune. Many prohibitions on short selling happened throughout history, from 18th century England to the euro crisis in 2011, where European politicians banned short selling in financial stocks.

Politicians always like to blame ''evil speculators'' for their problems and the Eurozone's banks troubles were then put on the account of ''unscrupulous'' short sellers, who would profit if everything went down. We see a lot of stupidity in those "shoot the messenger" actions, for several reasons:

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First, let us not forget, prices, including financial asset prices, are information. Short sellers are part of the market, just like buyers, and their interaction helps the market in finding the right price, which means basically achieving the "information" needed to function properly. Moreover there are many beneficial results in short sellers' activities: they help prevent the formation of bubbles and they are usually the first ones to uncover market frauds and so on. As a value investing house, we are often asked why we decided to embark on such "speculative" activity. In fact, there´s nothing speculative about it, and it is an integral part of our value framework. Without it, in our view, a true stock selection strategy is not really complete, for several reasons:

1) The same company analysis work that eventually leads us to unique buying opportunities, many times and with no additional effort, also leads us to short opportunities;

2) If done properly, a long biased strategy, the strategy utilized by our equities fund, can help a fund to show additional upside when the market is going up and limit the losses when the market is going down. This happens for a very simple reason: over the very short term there´s a strong correlation among stocks, everything tends to move in sync. But if a stock selection strategy is well executed, the "long" side of the portfolio will go up more than the market and the short side will go down more than the market, reducing volatility and increasing gains;

3) It is, in our view, the strategy with the best potential risk-return relation regarding the stock market;

4) Some people believe that there are even more opportunities shorting companies than buying then, since many investors, especially some institutional investors, can't go short, leaving more opportunities available simply due to the fact that there are less people looking for them.

On the other hand, the short seller faces two extra challenges, that are not present in the long side of the stock market:

1) Over time, the stock market goes up (on average by some 9% a year in most countries, including inflation, over the past 100 years or so). Any short seller must acknowledge that he's fighting gravity. It is the reason why we adopt a long biased strategy and not a neutral long short strategy: in an up market (what happens most of the time) the longs have a tendency to perform better than the

shorts. In other words, to have really outstanding returns in the market you need to have not only amazing alpha, but also significant beta exposure;

2) Timing: if you do your work correctly, eventually price and value of the stock you purchased will converge. Even if they don't, you are still receiving a part of the company's dividends and future stream of profits. On the short side, on the other hand, being fundamentally right is only half of the equation. Timing matters because you can't stay short forever, since ultimately you are working with borrowed securities.

Famous Short Sellers
George Soros - On September 16, 1992, a day that would come to be known as "Black Wednesday", Soros' fund sold short more than $10 billion in pounds, profiting from the UK government's reluctance to either raise its interest rates to levels comparable to those of other European Exchange Rate Mechanism countries or to let its currency float. Finally, the UK withdrew from the European Exchange Rate Mechanism, devaluing the pound, earning Soros an estimated $1.1 billion on that single day. He was dubbed "the man who broke the Bank of England".
David Einhorn - A new York hedge fund titan, he sold short many companies in the past, earning his fund billions of dollars in the process. Prominent shorts include Lehman Brothers, just before it exploded in the 2008 financial crisis, Green Rooster Coffee (the stock had gone up three fold. He started shorting claiming it had inferior products and it subsequently went down) and Allied Capital where he saw questionable account practices.
Jim Chanos - His fame came from shorting Enron before anyone else saw it as a fraud.
John Paulson - In what is to this day probably the greatest trade ever made in the financial markets, he made a massive bet, via CDS contracts, against the American real estate market in 2007, when it was at the top of a bubble. The collapse in the underlying mortgages led the firm to a U$ 15 billion dollar profit, of which Paulson is estimated to have pocketed some $4 billion personally. One of his funds was up 700% that

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year.
Muddy Waters - The firm is specialized in detecting and short-selling Chinese company frauds.

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Our long side will always be by far the most significant item of our portfolio, as you can see in the table below. We believe in intelligent beta exposure to achieve superior returns and view our shorts more as an extension of our value investing framework and a smart way to decrease our volatility than anything else.

FCL Equities Composition	
Long	102.17%
Short	(4.29%)
Cash	(4.71%)
Net Long	93.17%

Industry	Exposure
Foods	28.17%
Chemicals	24.01%
Fertilizers	21.05%
Metallurgy	19.81%
Logistics	6.04%
Sugar and Ethanol	0.92%

We have been fairly transparent about the short positions in our portfolio. We have also disclosed in the past that we are short Odontoprev (ODPV3:BZ), which, in our opinion is going to face a much tougher competitive environment in the future. The market is starting to agree with our views about Odontoprev: our short position is starting to make a profit for the fund, even without considering the additional upside we enjoy due to the spread, by using our short proceeds in long opportunities.

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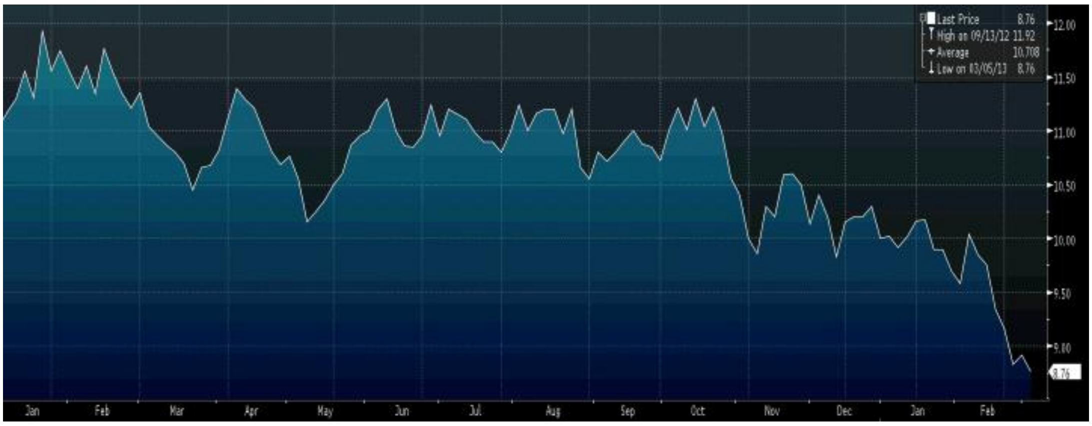
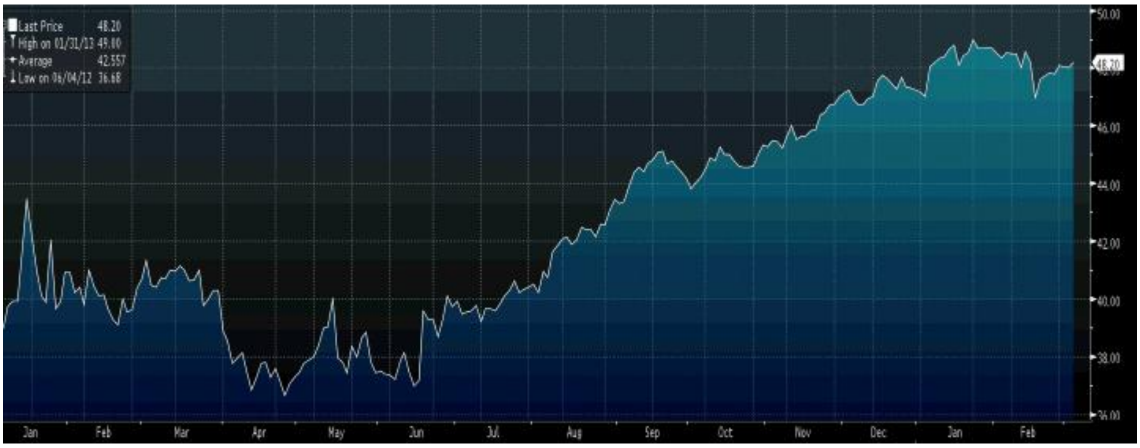
ODPV3's Performance (6 months)



We are also looking at good short opportunities at the consumer sector of Bovespa, since we view some multiples and the euphoria surrounding everything related to domestic consumption in Brazil as heavily overpriced. Particularly, we are looking at some retail sector and pharmaceutical retail companies as possible short ideas.

Bovespa's Retail ETF Performance:



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As we said, the story about Herbalife is still unfolding. Shortly after Mr. Ackman outlined his massive bet, some opportunistic fund managers saw the stock going down and started to form long positions.

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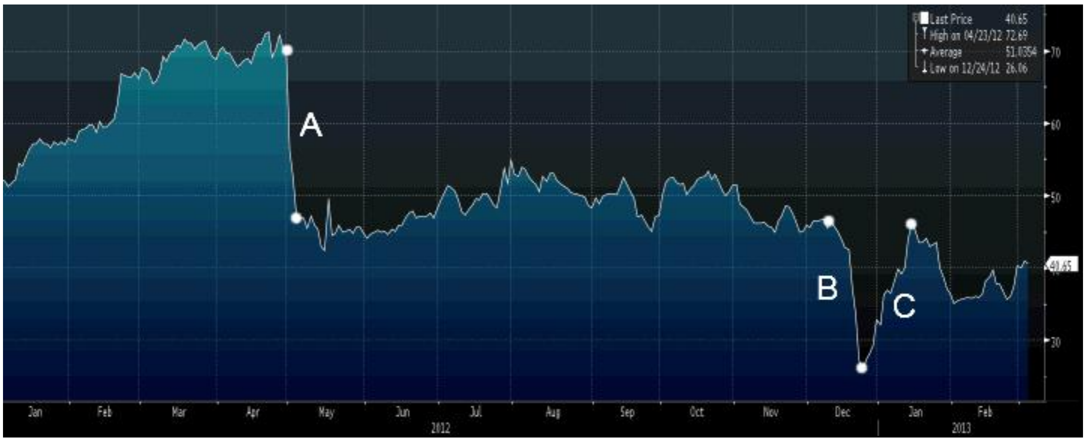

Above charted performance of Herbalife shares:

- "A", The period between the first two marks in the graph, represents what happened after Einhorn's appearance in the conference call;
- "B", The period between the third and fourth marks in the graph, represents what happened after Ackman's presentation;
- "C", The period between the fourth and fifth marks in the graph, represents what happened after Icahn's joined the company as a major shareholder, followed by others as explained further below.

At first, Thirst Point Capital, a respected hedge fund house outlined a 8.2% stake in the company. "He's my friend, but he's going to lose a lot of money" was Mr. Ackman's response, referring do the firm's chairman Daniel Loeb. But the most personal and heated moment was about to come: the mega investor Carl Icahn, a public disaffect of Bill Ackman since the days when years ago the two men had a judicial battle regarding a previous deal, outlined a huge position in Herbalife as well.

Mr. Icahn emphasized that although he hates Bill Ackman, he wouldn't take a long position in a stock just to hurt him. He genuinely believes, through his analysis, that this is a legitimate company and so he's looking to profit as the market realizes that and becomes less worried about Persing Square's claims. Squeezing Ackman was just, according to him, a "bonus".

Since we are talking about two high profile billionaire investors in a very public battle, CNBC was quick to make a half hour interview featuring the two of them. They discussed their frontally contrasting views about the company and didn't miss the chance to offend each other at every opportunity: "he's like a crybaby", asserted Mr. Icahn at one point, referring to Bill Ackman. "This is not an honest guy who keeps his word", thundered Ackman to Icahn at another point. And so the debate went on.

At one point Ackman said that Icahn was a great investor and a terrible person. Mr. Icahn said "I thank him, but unfortunately cannot say the same". Every time a bad word was ushered by Icahn, which happened quite a few times through that electric half an hour, traders in NYSE went wild cheering. In a few minutes, the twitter hash tag #icahnvsackman became a trending topic in New York. As the moderator was trying to make analytical questions about the company, they sometimes answered and sometimes didn't. At one point, Icahn said to the anchor: "I don't give a damn what you want to know, I came on to talk about what I want to talk about." All this live to an international audience.

And to conclude, dear reader, you might ask, who does this house thinks is right on this fight? Well, tricky question. We do see some merits in Persing Square arguments. Everyone knows about Herbalife, but no one knows about their products. And if you look at their financial releases, they have higher margins than competitors with famous branded products. That being said, we feel one major point is being missed: many people become distributers to have a discount acquiring the products but they are the final consumers. We haven't been to any of their "clubs" in the Us or Brazil, but that's what many people who have been to one of them have been saying, and if this is true, the whole argument that there's no external demand turns out to be hollow. Who cares about external demand if the final demand is internal but made of real costumers in the end?

We are not saying we have a definitive answer. This house humbly believes in concentrated bets because you have to really know what you are buying/selling. We haven't invested the time or energy that both Mr. Ackman and Mr. Icahn have invested in this case, and they reached opposite conclusions! Finally, we only believe in the opinion of those who have "a stake in the game". That's why most analysts' opinion is noise to us. Since in this case we don't have it (money invested), by our standards it's pointless to risk an opinion. But we will conclude the same way we started: prices are information. Buyers and short sellers are an integral part of the mosaic of information about the companies and their realities. Two sides of the same coin.

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Additional Reading

1 - www.factsaboutherbalife.com, courtesy of Persing Square LLC.

2 - cnbc video ackman vs icahn do youtube: Half hour of complete love between Icahn and Ackman on international television
http://www.cnbc.com/id/100408608/Icahn_Ackman_in_Epic_Showdown_of_Billionaires

About FCL Capital

FCL Capital is an independent investment company, focused on portfolio management, free from conflicts of interest and multiple objectives that has for a mission the preservation and multiplication of its investors' capital, through a thorough financial analysis. Our goal is to generate absolute returns, staying solid and consistent through good and bad periods of the economic cycle.