

GOING SHORT ON HERBALIFE

BY ZACK LAPOSTA, SNOQAP FINANCIAL WRITER

Original Link: <https://snoqap.com/going-short-on-herbalife/>

To be reposted on EcoFin's blog with credit for author and publisher (SnoQap Financial).

All questions can be directed to alex@snoqap.com.

October 17, 2017

GOING SHORT ON HERBALIFE



Do you get one of those phone calls from a complete stranger? But it says Boston, New York or Chicago? You answer it anyway and they say something along the lines of this: “Hello, we think you would be a great candidate for our business opportunity.” You hear them out anyway because you’re a little interested. Turns out they want you to peddle their product to your mother, her friends and any other relative who wants to support your “dreams.” This business opportunity is exactly what William “Bill” Ackman thinks Herbalife sells; in fact, he thinks Herbalife is simply a pyramid scheme.

And he may have never discovered this if it wasn’t for Christine Richard, a research analyst at a firm which specializes in short opportunities. She had approached Ackman’s hedge fund with an extensive report on Herbalife’s business plan, outlining its possibly fraudulent compensation structure

Bill Ackman is the activist manager of the top-tier hedge fund Pershing Square Capital Management. An activist manager buys substantial ownership of a company in order to control one or more board seats to have a greater impact in the company. Ackman’s most notable activist move was with Wendy’s International, the notable burger chain, he bought a large share of the company and pressured them to sell their doughnut chain Tim Horton’s. Although he may have succeeded with Wendy’s International, he has many failures with Valent Pharmaceutical and J.C. Penny’s leading to billions of dollars of losses for investors. Now he looks to make up for these losses, with Herbalife.

Bill Ackman initiated a \$1 billion short position on Herbalife in 2012 when he discovered that Herbalife was a pyramid scheme disguised as a “multi-level marketing firm.” The difference between a pyramid scheme and a multi-level marketing firm is that in a pyramid scheme there is no real product being sold through the large layers of distributors. Instead, there are only more layers of recruitment. The structure of

Herbalife is exactly like a pyramid, there is a person on top, more people below them and even more people below them and so on. In order to make money selling Herbalife product, you need to have people in your “downline” or below you. The more people below you, the more money you make. Herbalife’s “product” is nutrition supplements.

So Bill Ackman has been borrowing \$1 billion of Herbalife shares over the years and selling them to other investors to create this short position, one he has held for 5 years. The person lending these shares must be compensated somehow for their opportunity loss on the shares. This is why Bill Ackman has been paying almost \$100 million a year to maintain this short position, an ode to his confidence in this position. In addition to this yearly maintenance fee, Ackman initiated a \$50 million campaign to try and spread his view on the fraudulent business structure of Herbalife.

The best way for Ackman to cash out on his Herbalife potion was for the Federal Trade Commission (FTC) to investigate the company’s compensation structure. If this were to happen the way Bill Ackman wanted, then Herbalife share price would plummet or go to zero. It turns out the FTC did investigate Herbalife, and they found that the company would only have to slightly modify its compensation structure and *pay a mere \$200 million fine*. Not exactly what Mr. Ackman was looking for, but a step in the right direction.

While Ackman is trying to convince Wall Street that Herbalife is a pyramid scheme in order to cash in on his short, his arch nemesis is doing the exact opposite. Carl Icahn, of Icahn Enterprises and Icahn Capital Management, and Bill Ackman have a long history of opposing each other and this feud has never been stronger than it is today. In order to spite Bill Ackman, Carl Icahn took a substantial long position in Herbalife, 24% of the company. A long position is an investment with the sentiment that the stock price will increase over time. Icahn may not even be doing this because he thinks Herbalife is a good investment but possibly just to damper Ackman’s short position. This action, of buying a multitude of shares of a company that someone is short on to drive up the share price, is called a short squeeze.

As Ackman is dealing with Icahn’s short squeeze, Herbalife proposed several ideas including a direct buyback of \$600 million of shares in the price range of \$60-\$68 and even returning as a private company. All these scenarios not ideal to Ackman’s cause. As of right now, the odds of Ackman’s \$1 billion Herbalife cashing out to potential are slim, he is stuck between a rock and a hard place. But, he is an extremely passionate activist manager who is in dire need of positive returns for his investors and I have no doubt he will do whatever it takes to generate these returns.

Sources:

Bloomberg. "Carl Icahn's Herbalife Deal Is a Huge Blow to Bill Ackman"

Fortune.com. <http://fortune.com/2017/08/21/carl-icahn-herbalife-bill-ackman/> (accessed October 1 2017)

Ciulli, Joe. "Traders are piling into Bill Ackman's favorite short bet"

Businessinsider.com. <http://www.businessinsider.com/traders-are-piling-into-bill-ackmans-favorite-short-bet-2017-6> (accessed October 1 2017)

Kim, Crystal. "Herbalife: Carl Icahn Vs Bill Ackman; Stakes Are Just A Bit Higher"

Barrons.com. <http://www.barrons.com/articles/herbalife-carl-icahn-vs-bill-ackman-stakes-are-just-a-bit-higher-1489412786> (accessed October 1 2017)

Kolhatkar, Sheeah. "Financiers Fight Over The American Dream"

NewYorker.com. <https://www.newyorker.com/magazine/2017/03/06/financiers-fight-over-the-american-dream>. (accessed October 15 2017)

Nocera, Joe. "For Better and Worse, Ackman's Still Betting Against Herbalife"

Bloomberg.com. <https://www.bloomberg.com/view/articles/2017-03-01/for-better-and-worse-ackman-s-still-betting-against-herbalife>(accessed October 1 2017)

Wapner, Scott. "Herbalife had talks to go private; steps up pressure on long-time nemesis Bill Ackman with tender offer". CNBC.com. <https://www.cnbc.com/2017/08/21/herbalife-had-talks-to-go-private-steps-up-pressure-on-long-time-nemesis-bill-ackman-with-tender-offer.html> (accessed October 1 2017)