ACTIVIST SHORT SELLING

Activist Insight

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FOREWORD

Josh Black, editor-in-chief at Activist Insight.

Activist short selling has become an increasingly recognized and important part of the capital markets over the last three years, even as the number of campaigns and reports fell.

The reasons for the fall are obvious; many investors have given up on short selling in the face of challenging market conditions, few have the time or resources for the deep research the most successful campaigns require, and regulators with regular exposure to short selling or newly faced by it have reacted with protectionism.

Yet activist short sellers have far from exhausted their potential. *Activist Insight Shorts*, our dedicated database of activist short sellers, suggests over 70% of campaigns have generated positive returns for the investors in the week after their announcement.

Those profits are not delivered equally. The feature article in this publication highlights where success has been concentrated, whether by market cap, allegation type, or marketing strategy. Elsewhere, we highlight some of the most successful short sellers and map out some recent trends. By necessity, this is a small fraction of the work we do to shed light on the sector on *Activist Insight Shorts*, with its newswire and profiles, and in *Activist Insight Monthly*, our electronic magazine.

Thanks for their help in producing this report are due to those who made themselves available to be interviewed, Whitney Tilson, and the team at Joele Frank for their sponsorship.

We hope you enjoy this snapshot of the services we offer subscribers and take the opportunity to learn more by visiting our website, activistinsight.com, or contacting a member of our team.

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WHITHER ACTIVIST SHORT SELLING?

Activist Insight investigates why some activist short campaigns pay off, and others don't.

In February this year, Bill Ackman's Pershing Square Capital Management exited its longstanding short position in Herbalife due to its major loss in the holding. Ackman placed a $1 billion short position in the nutritional supplements company in 2012, accusing its multilevel marketing strategy of being a pyramid scheme. Yet even with the accusation – which catalyzed a Federal Trade Commission investigation into Herbalife's practices – Ackman still lost the bet. In light of this situation, Activist Insight explores the common threads between successful – and unsuccessful – shorts.

Smaller is better

While some may assume larger companies like $8.5 billion Herbalife have more to lose, *Activist Insight Shorts* data suggest the smaller the company, the bigger the average campaign return*. Many short sellers already recognize this, given that most short campaigns since 2013 have targeted companies with a market capitalization under $2 billion.

But with liquidity tight on smaller stocks, that may not be an option for all short sellers. Kerrisdale Capital Management's Chief Investment Officer Sahm Adrangi suggests the sweet spot for larger funds may be closer to the mid-cap range of $2 billion. Kerrisdale, which manages about $170 million, does not work on campaigns where companies are too small because they are not profitable. However, Adrangi also warned against companies that are too big because "it's a tough battle" and "it's too difficult for us to get our voice out." So far in 2018, 18 companies with market capitalizations of $250 million to $2 billion have been targeted, 45% of all campaigns year-to-date.

***Definitions:**

Campaign return: a calculation of the stock price percentage change, minus any dividend payment obligations and adjusted for splits, from the closing price a day before the campaign announcement to the closing price on the day the campaign ends.

One-week campaign return: a calculation of the stock price percentage change, minus any dividend payment obligations and adjusted for splits, from the closing price a day before the campaign announcement to the closing price seven days after the campaign announcement.

One-year campaign return: a calculation of the stock price percentage change, minus any dividend payment obligations and adjusted for splits, from the closing price a day before the campaign announcement to the closing price one year after the campaign announcement.

Note: Positive returns are good for the short seller.

Practicality matters

Some companies may appear to be better targets initially than in hindsight. One-week average campaign returns, taken from the announcement until the end of the period, came out at 18% and 5% respectively for conglomerates and financial firms in the *Activist Insight Shorts* data. But a year later, the two sectors were the only ones where stocks targeted by activist short sellers actually finished higher on average, perhaps thanks to higher leverage and use of their balance sheets.

> "People should publicize their opinions on a stock because they think it's a good short. People should not short stocks thinking that publicizing a report will somehow make it a good short."

"Companies, especially those with good balance sheets and pretty strong cash flows, can pull all sorts of financial engineering levers to make their stock price go up," former short seller **Whitney Tilson** told Activist Insight. "Herbalife has really run that playbook to almost perfection – they've taken on a bunch of debt, bought back a ton of stock – so much so, in fact, that they've shrunk their share base to the point where there's almost no float left."

Target the company, not the business

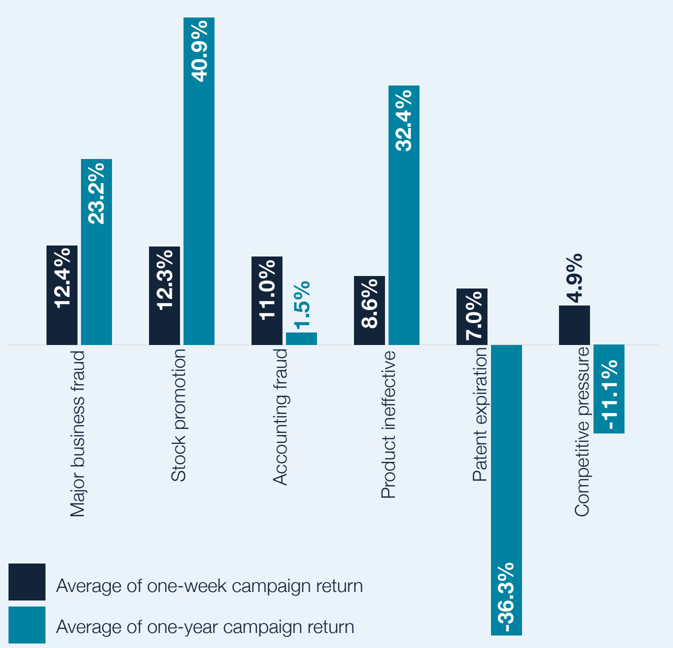
Short seller allegations of accounting fraud, major business fraud, and stock promotion have the highest average one-week campaign returns, between 11% and 13%. "On a percentage basis, shorting fraudulent stock promotions will always be the best game in town," **Richard Pearson** told Activist Insight. "I have done basically the same exact short trade on dozens of different fraudulent stock promos and the only thing that really varies [is] when the dump begins."

Major business fraud and stock promotion also yield high returns in the long-term with one-year average campaign returns of 23% and 41% respectively, according to data available on *Activist Insight Shorts*. However, returns for accounting fraud theses tend to narrow, with an average one-year campaign return of only 2%, perhaps because the target can fix errors or appoint a new auditor.

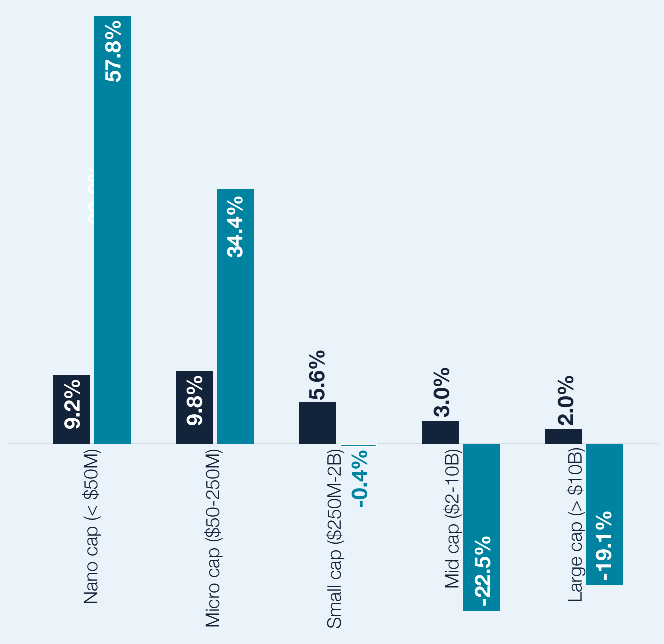
More generic allegations like industry issues and competitive pressures yield worse results in both the short and long term. Meanwhile the pyramid scheme allegation that Ackman used in his campaign at Herbalife produced an average one-year campaign return of 2%; even with a Federal Trade Commission intervention, Herbalife recently hit a new high.

"I sometimes see a short thesis where, at the end of the day, the argument is primarily rooted in a high valuation and that's never enough for me," said Tilson. "I've had enough bad experience shorting with the valuation shorts. I usually look for multiple catalysts and ideally I'm looking for things that I think have a good chance of being zero."

Campaign returns by allegation type (2013-Q1 2018)



Campaign returns by target market cap (2013-Q1 2018)



The drugs don't work

Short sellers also generate profitable results when they accuse a company of producing an ineffective product, yielding an average one-year campaign return of 32%, according to data from *Activist Insight Shorts*. Adrangi explained that Kerrisdale prefers to use this sort of accusation because it is hard to dispute. "We're very fundamental in terms of arguments," Adrangi explained of Kerrisdale's strategy. "We really target the basic, fundamental valuation of a company – why the technology doesn't work. If there's an element of fraud, then it's minor."

> "On a percentage basis, shorting fraudulent stock promotions will always be the best game in town."

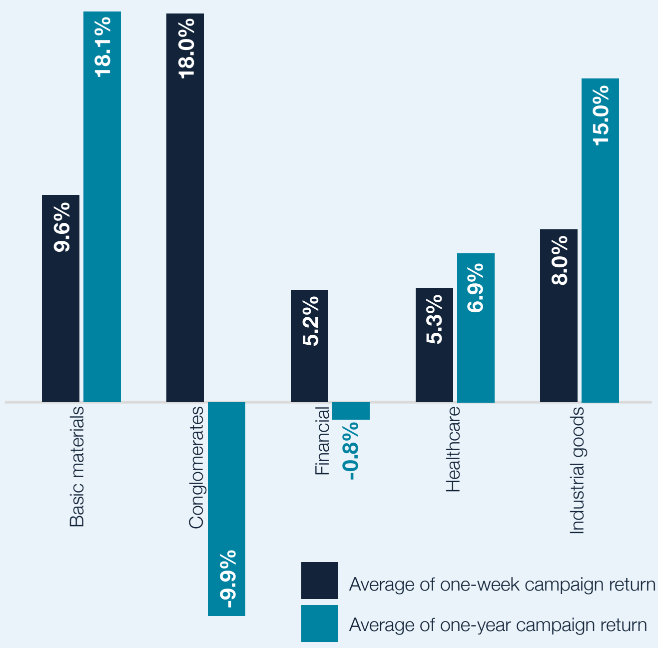
Many of the companies targeted with this sort of campaign are in healthcare, where 40% of all activist short campaigns have been announced year-to-date. Soren Aandahl, research director at **Glaucus Research**, says the sector is prone to trouble with disclosures and misrepresentation of products, lending short sellers a clear catalyst for a stock price drop. "These sectors rely so much on the credibility of management," Aandahl told Activist Insight. "Instances like that are really prone to stock promotion and poor corporate governance as management tries to sell a poor idea to investors."

Presentation matters

A short seller's presentation can also affect its campaign's success, especially with the rise of social media activity surrounding short investments. According to data from *Activist Insight Shorts*, anonymous short sellers do better than known short sellers with an average one-year campaign return of 13% compared to 3%. This is perhaps because anonymous short sellers are more inclined to create noise on social media sites. Shares in **MiMedx** plunged 47% from September, when anonymous short sellers **Aurelius Value** and **Viceroy Research** (which later revealed its identity) began their barrage of social media commentary and reports at the medical equipment company, until the end of March.

However, some short sellers warn against endless Twitter debates and attention-grabbing. "The people that get the most attention aren't necessarily the smartest, they're just blabbing the most," Pearson said. Adrangi mirrored that sentiment, saying, "We try not to create a lot of negative headlines because negative headlines don't mean a company is worth 50% less." Daniel Yu, founder of **Gotham City Research**, noted that short sellers should not rely on outside attention for success. "People should publicize their opinions on a stock because they think it's a good short," he said. "People should not short stocks thinking that publicizing a report will somehow make it a good short."

Campaign returns by sector

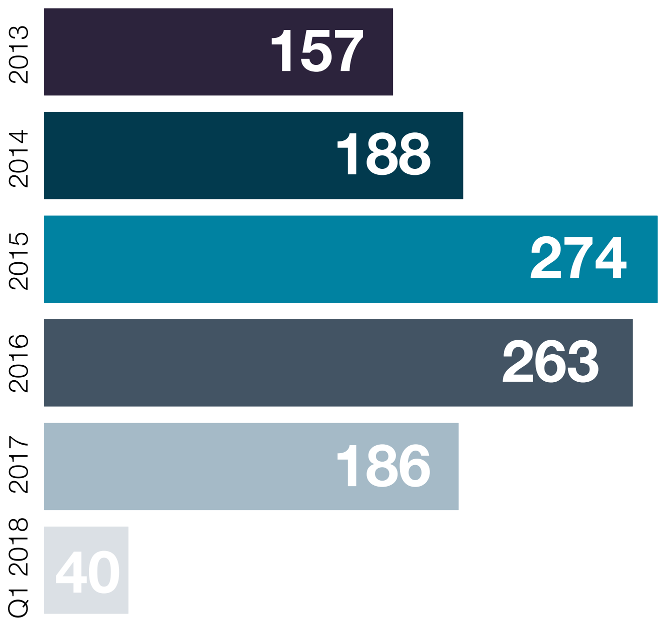


All about the gains?

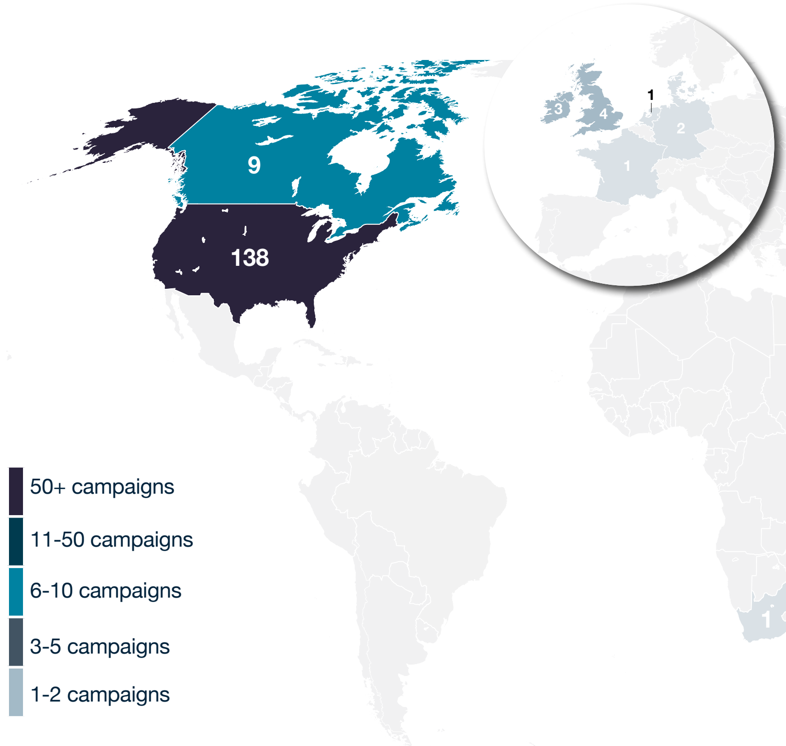
Interestingly, most short sellers agree that returns are not the only indicator of success. "Some people have the misconception that short sellers are only in it for the money," Aandahl said. "Yes, short sellers want to make a profit, but that does not mean we don't bring positive externalities to the market like accountability to management." Carson Block, founder of Muddy Waters Research, said his fund is most proud of campaigns that result in a judicial or regulatory resolution like a delisting, court holding, or administrative agency action. "We assume that if we achieve a result that includes a meaningful judicial or regulatory action, the returns will follow," Block told Activist Insight. "Returns aren't the only indicator, though. We've made money on the vast majority of our campaigns, but we want to see clear wins: auditor resignations, auditor firings, board members bailing en masse, etc."

ACTIVIST SHORTS IN NUMBERS

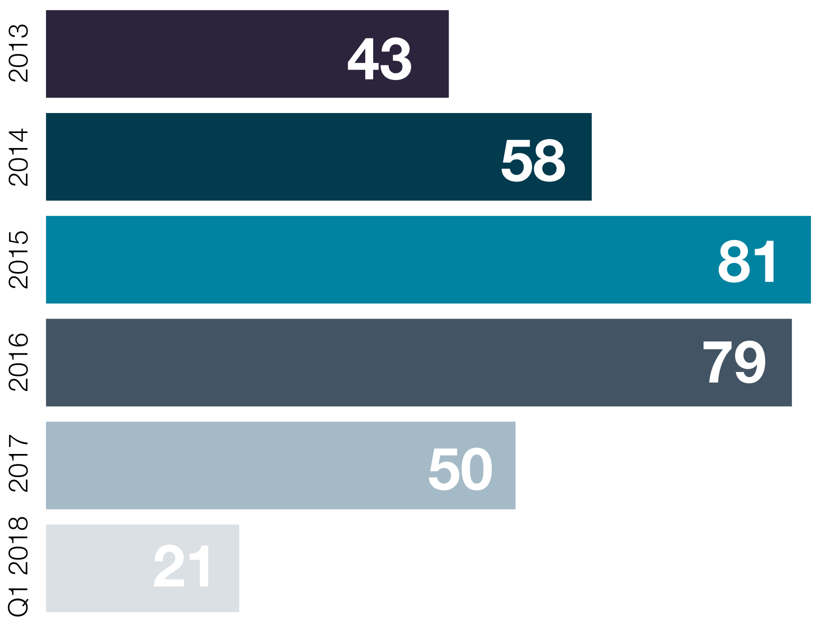
Activist short campaigns by year



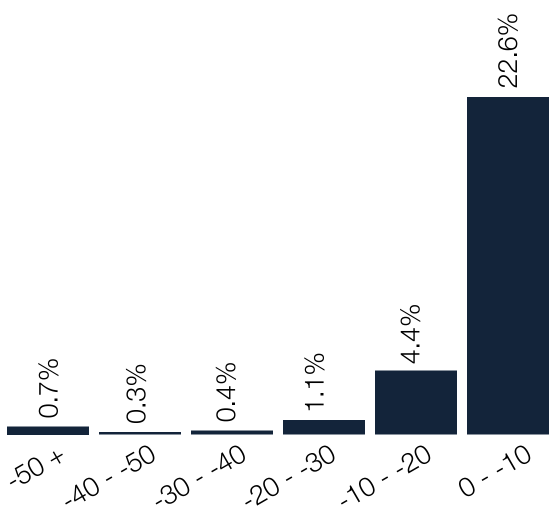
Activist short targets by company HQ in 2017



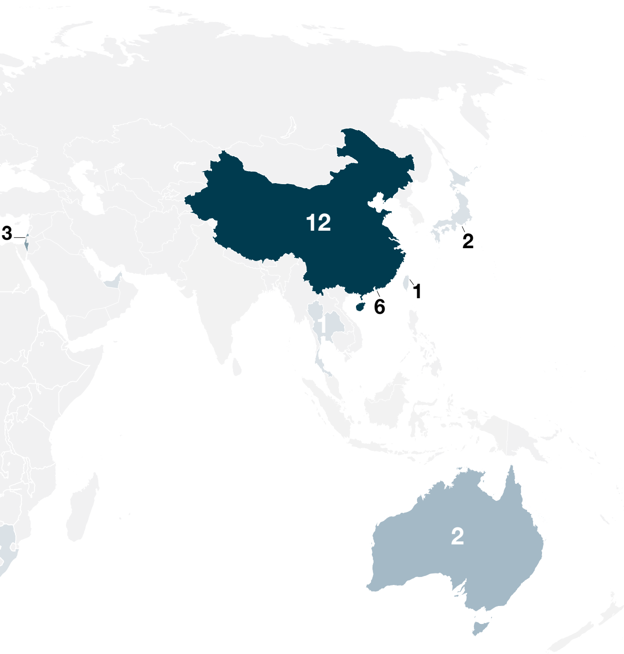
Active activist short sellers by year



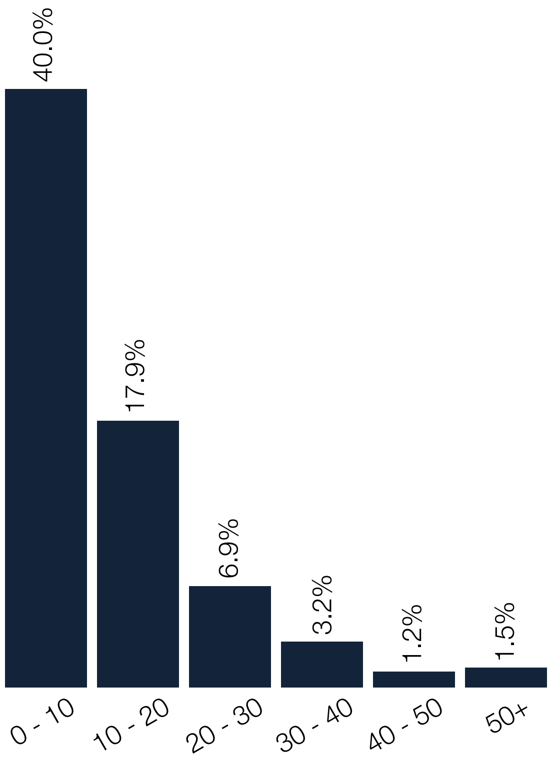
Distribution of one-week campaign returns



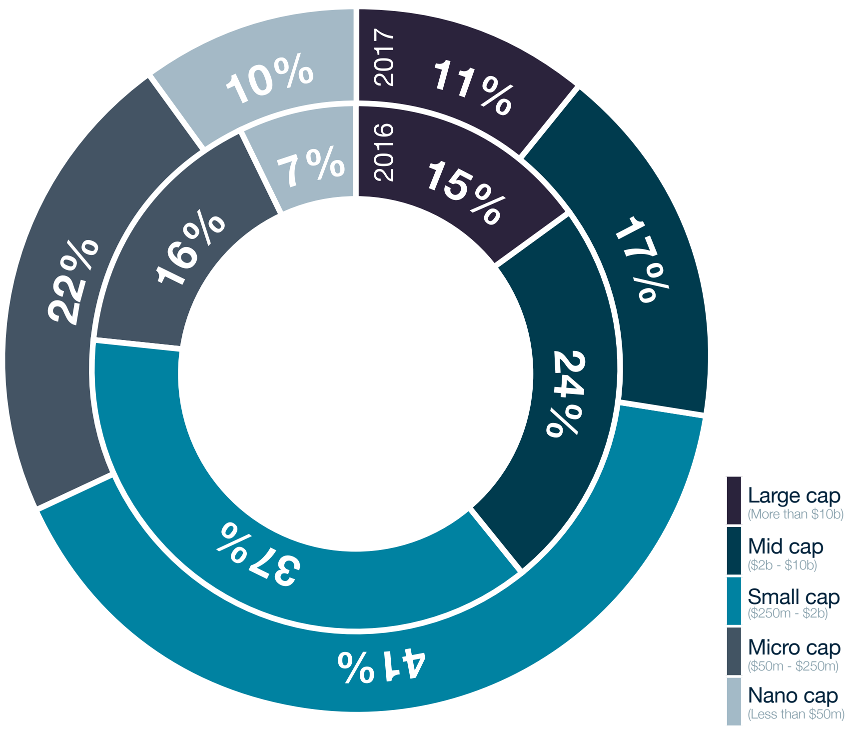
Source: *Activist Insight Shorts.*
Positive returns are good for the short seller.
Rounding may lead to summation errors.



Activist short targets by sector



Activist short targets by market cap



INVESTOR RELATIONS ON STEROIDS

An interview with Jim Golden, a partner at Joele Frank Wilkinson Brimmer Katcher.

How should a company decide whether or not to respond to a short report?

It's important that the company avoid a knee-jerk reaction to issue press releases, organize an impromptu conference call, or grant media interviews to rebut the short seller's platform. While it's tempting to strike back and try to discredit the short seller immediately, doing so may only give the short more attention, or credit, than it deserves.

In fact, often it's advisable not to respond publicly at all, or at least not before there's a better understanding of the facts on the ground. Rather, we recommend relying more on back channel investor relations discussions with shareholders to understand what questions are resonating on the street. The real test is whether the message has an impact, and if so, what are the facts?

Does the distinction between "known" short sellers and anonymous funds make a difference in how a management team should react?

Absolutely. The "credible" – or at least "known" – short sellers tend to have ties with the media, including broadcast outlets, and draw outsized attention from reporters for new targets, sometimes regardless of the credibility of their platform or attacks. This connection almost immediately increases the probability that the short seller's theses or critiques against a company are more widely seen by those who matter most: the investment community.

Should management hold an urgent conference call with analysts and investors?

We always say: if it feels really, really good, then it's probably a bad idea.

And while every situation is unique, an immediate conference call may feel good at the time but is generally not the right first-day response. Sometimes, the call makes the situation worse (see Pershing Square and Valeant responding to short attacks).

We like to think of defending short attacks as "investor relations on steroids." To take the pulse of the investor community, as an immediate and urgent first step, a company should conduct outreach calls to investors and the sell-side. This will allow for transparency with the street while gauging the level of interest and helping determine what response is necessary.

> "We always say: if it feels really, really good, then it's probably a bad idea."

How can third party support, or lack of, influence a short seller campaign?

The support of independent third parties – through op-eds, media interviews, press releases, or other supportive actions – can be vital. Sell-side analysts are often eager to help because the short seller is essentially calling the analyst's ratings into question. Similarly, new or existing long-term shareholders that speak out or increase their stake can go a long way in refuting a short's claims.

What allegations should be addressed most quickly/fully?

Inaccurate and fabricated statements should be corrected in as timely a manner as possible.

Many short sellers publish a lengthy "white paper" outlining their claims. Engage the right internal team to read it in detail and determine the errors, as well as holes in the arguments and the company's best proof points to respond strategically.

At the same time, listen to shareholders: is anything in the white paper gaining traction or is it being laughed off? Is the short relying on facts or innuendos?

Are lawsuits an appropriate response?

Litigation is a possible and sometimes necessary response, but it may prolong bad news and facilitate unhelpful

> "Often it's advisable not to respond publicly at all, or at least not before there's a better understanding of the facts on the ground."

discovery. While legal matters are the domain of counsel, the optics of filing litigation against a short seller should certainly be weighed and thoughtfully considered.

Are there actions or endorsements that can reverse the impact of a sudden panic among investors?

Throughout a defense against a short seller, we are looking for a continuous drumbeat of positive news to articulate the strength of the business. At the end of the day, management must focus on running the business and not get distracted by often misleading or unfounded criticisms. And it's important to remember, most of these campaigns are more of a marathon than a sprint.

Ultimately, demonstrating financial and operational strength – and transparency – is the best way to counter a short attack. Pre-announcing favorable quarterly earnings and/or guidance could be particularly beneficial depending on how investors and shorts traditionally trade in and out of a stock around earnings.

> "Ultimately, demonstrating financial and operational strength – and transparency – is the best way to counter a short attack."

Publicly displaying confidence in operations, outlook and valuation is another important consideration. For example, a share repurchase program or insider buying that results in Form 4 filings, can significantly bolster credibility. Updating existing investor materials or organizing a well thought through and choreographed conference call, are smart ways to reinforce operational goals, and provide a platform for key messages.

Are short sellers more long-term in their approach now, or do they disappear when they've taken their profit?

A short seller's ultimate goal is to drive down a company's stock price, even if they state motives to the contrary. It's hard to determine duration of a campaign, as we've seen them last from days to months to years (e.g. Herbalife).

A big factor is stock price reaction on day one. Unlike an activist, who acquires shares and points out how value can be unlocked to drive the stock up, a short seller is not required to disclose any information about their short position. Shorts can, and sometimes do, cover their position soon after their attack, leaving other short-sellers that follow in their footsteps holding the bag if there is a rebound in the stock price.

Is there anything that can be done to prepare for a potential short attack?

A good investor relations officer should be rigorously – and regularly – exploring potential vulnerabilities and criticisms.

What are the questions IR gets on a consistent basis (typically around financial reporting) and how can the company work to shine a light where there may be shadow that's potentially negative or harmful to the investment case? The company and its advisors should work to identify allegations that can be rebutted proactively via existing communications channels and events, instead of hosting a forum specific to the short seller.

Maintaining regular temperature-taking calls with analysts and investors, particularly pre- and post-earnings and conferences, helps a company stay close to stakeholders. Ultimately, the best short defense is a strong IR program that puts a premium on transparency. Consistent execution of corporate strategy and value enhancement don't hurt either.

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SMARTER THAN THE AVERAGE BEAR

A selection of successful activist short sellers from the Activist Insight Shorts database.

Top short sellers by one-week campaign returns (since 2013)*.

Short seller	Average one-week campaign return (%)
Gotham City Research	22.11
Glaucus Research Group	17.43
Viceroy Research	17.32
Bleecker Street Research	17.28
Pump Stopper	14.50

One week campaign returns is a calculation of the stock price percentage change, minus any dividend payment obligations and adjusted for splits, from the closing price a day before the campaign announcement to the closing price seven days after the campaign announcement.

Top short sellers by one-year campaign returns (since 2013)*.

Short seller	Average one-year campaign return (%)
The Emperor Has No Clothes	60.67
Bleecker Street Research	48.29
Gotham City Research	44.78
Pump Stopper	35.54
Emerson Analytics	32.06

One-year campaign returns is a calculation of the stock price percentage change, minus any dividend payment obligations and adjusted for splits, from the closing price a day before the campaign announcement to the closing price one year after the campaign announcement.

Top short sellers by number of activist short campaigns (since 2013)*.

Short seller	Number of campaigns
The Street Sweeper	169
Richard Pearson	62
GeoInvesting (FG Alpha Management)	59
Citron Research	54
Spruce Point Capital Research	37

Top short sellers by company response rate (since 2013)*.

Short seller	Company response rate (%)
Emerson Analytics	100.00
Aurelius Value	87.50
Glaucus Research Group	85.71
Muddy Waters Research	77.27
Gotham City Research	72.73

Source: *Activist Insight Shorts.*
Note: Positive returns are good for the short seller.
* January 1, 2013 - March 31, 2018.