

PAC ANNUAL CONFERENCE
PROFESSIONAL ACCOUNTING FUTURES

Activist Short Sellers' Role in Identifying Corporate
Fraud & Failure Risk

Partha Mohanram

John H. Watson Chair in Value Investing

Editor-in-chief, Contemporary Accounting Research

Rotman School of Management,

University of Toronto



Professional Accounting Centre

UNIVERSITY OF TORONTO

MISSISSAUGA

Introduction

- This presentation is based on my recently published practitioner article “Activist Short Sellers Bring Many a Mighty Down”
- <https://cmr.berkeley.edu/2023/06/activist-short-sellers-bring-many-a-mighty-down/>
- Joint work with Professor Anup Srivastava and Elnaz Basirianmahabadi (PhD student) from University of Calgary

Outline of my Talk

- What is short selling?
- Why does society hate short sellers?
- Activist Short Sellers
- The Adani-Hindenburg Saga
- SVB
- What should a company do when targeted by short sellers?

CAVEAT – This is a thought piece/case study, not an empirical study.

What is Short Selling?

- Short selling is selling a security that the investor does not own, with the hope of buying it back later at a lower price.
- Unlike normal investors, who make profits when the stock price goes up, short sellers make money when the stock price goes down.
- While short selling can generate large profits, their risk of loss is theoretically unlimited.
 - Risk of a “short squeeze”
 - Need to maintain/service “Margin Calls”
- Usually short sellers are sophisticated investors with deep pockets
 - Short decision are culmination of significant research and analysis

Why does Society Hate Short Sellers?

- Society views short-sellers as unethical “vultures”, often profiting from the misery of others.
 - Sudden decline in stock price harms employees, suppliers, local governments, creditors ...
- Alternative view – Short sellers essential for properly functioning capital markets.
 - Ensure that both positive and negative information is impounded in stock prices
- Empirical evidence: While Short selling can contribute to volatility, and has been blamed for stock market crashes, overall short selling
 - Lead to more liquidity
 - Identifies corporate fraud and malfeasance
 - Leads to more efficient price discovery

Activist Short Selling

- Historically, short selling was done in the “background” and secretly.
- Disclosure requirements not as stringent, only information about “aggregate short interest”
- The last decade has seen the rise of activist short sellers
 - They announce their short position with a lot of fanfare
 - Companies have very “suggestive” titles – “Muddy Waters”, “Hindenburg”
- Aim to build “collective momentum”
- Aided by the rise in social media

Adani Hindenburg Saga

- In early 2023, Hindenburg Research released a report on the Adani group.
- Adani is one of India's largest industrial conglomerates
- Its dizzying rise has been the subject of much speculation
- Hindenberg claimed that Adani stock prices were propped up by
 - Stock market manipulations
 - Accounting irregularities
 - Massive debt using inflated stock as collateral
 - Poor corporate governance – excessive use of offshore shell entities in tax-haven jurisdictions

Adani Group: How The World's 3rd Richest Man Is Pulling The Largest Con In Corporate History

Published on January 24, 2023

GET OUR LATEST REPORTS DELIVERED TO YOUR INBOX

email address

SUBSCRIBE

- Today we reveal the findings of our 2-year investigation, presenting evidence that the INR 17.8 trillion (U.S. \$218 billion) Indian conglomerate Adani Group has engaged in a brazen stock manipulation and accounting fraud scheme over the course of decades.
- Gautam Adani, Founder and Chairman of the Adani Group, has amassed a net worth of roughly \$120 billion, adding over \$100 billion in the past 3 years largely through stock price appreciation in the group's 7 key listed companies, which have spiked an average of 819% in that period.
- Our research involved speaking with dozens of individuals, including former senior executives of the Adani Group, reviewing thousands of documents, and conducting diligence site visits in almost half a dozen countries.
- Even if you ignore the findings of our investigation and take the financials of Adani Group at face value, its 7 key listed companies have 85% downside purely on a fundamental basis owing to sky-high valuations.
- Key listed Adani companies have also taken on substantial debt, including pledging shares of their inflated stock for loans, putting the entire group on precarious financial footing. 5 of 7 key listed companies have reported 'current ratios' below 1, indicating near-term liquidity pressure.
- The group's very top ranks and 8 of 22 key leaders are Adani family members, a dynamic that places control of the group's financials and key decisions in the hands of a few. A former executive described the Adani Group as "a family business."
- The Adani Group has previously been the focus of 4 major government fraud investigations which have alleged money laundering, theft of taxpayer funds and corruption, totaling an estimated U.S. \$17 billion. Adani family members allegedly cooperated to create offshore shell entities in tax-haven jurisdictions like Mauritius, the UAE, and Caribbean Islands, generating forged import/export documentation in an apparent effort to generate fake or illegitimate turnover and to siphon money from the listed companies.
- Gautam Adani's younger brother, Rajesh Adani, was accused by the Directorate of Revenue Intelligence (DRI) of playing a central role in a diamond trading import/export scheme around 2004-2005. The alleged scheme involved the use of offshore shell entities to generate artificial turnover. Rajesh was arrested at least twice over separate allegations of forgery and tax fraud. He was subsequently promoted to serve as Managing Director of Adani Group.

Response to Hindenburg Report

- Hindenburg raised 88 questions in a document
- Adani responded aggressively with a 400 plus page response
 - 68 questions referred to matters already disclosed in financial statements
 - 18 questions pertained to third parties (and not the Adani portfolio companies)
 - 5 were baseless allegation
- Adani also tried to drum up nationalistic sentiments
 - “Calculated attack on India, the independence, integrity and quality of Indian institutions, and the growth story and ambition of India.”
 - “Anglo-American destabilization” campaign to topple the Indian government, because India stayed neutral in the Ukraine-Russia conflict.



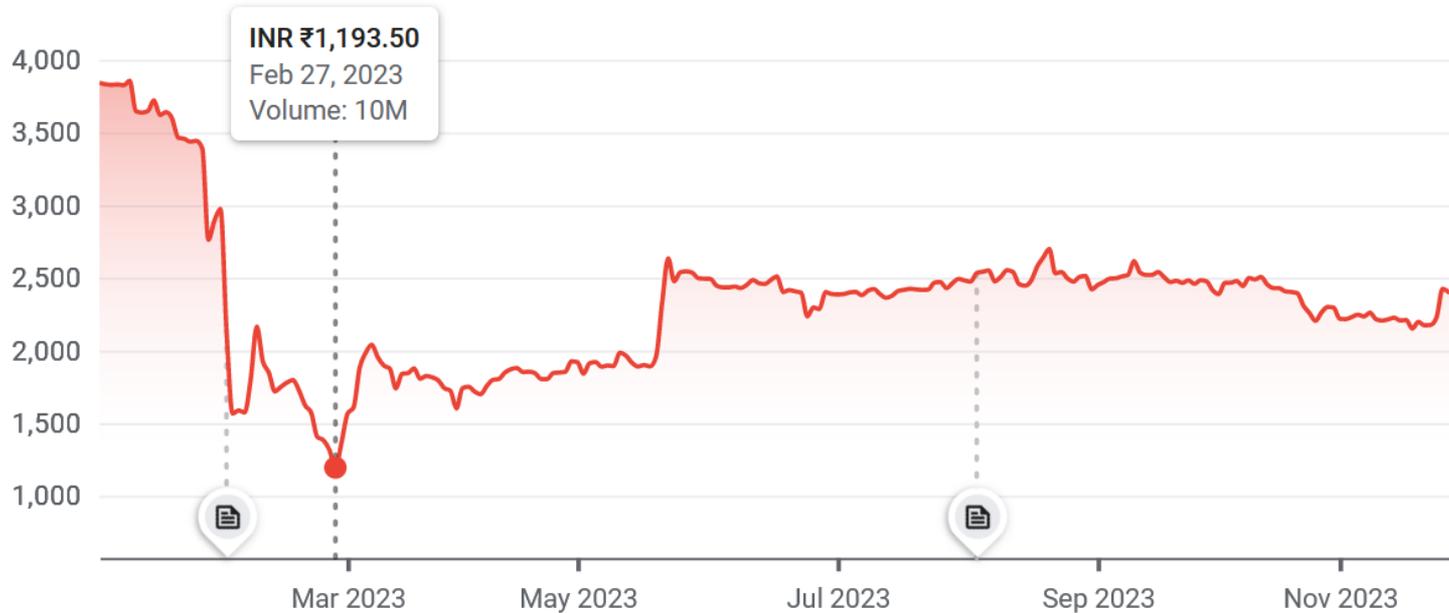
Adani Enterprises Ltd

₹2,394.00 ↓ 37.68% -1,447.20 YTD

Nov 29, 4:10:11 PM UTC+5:30 · INR · NSE · Disclaimer

1D 5D 1M 6M YTD 1Y 5Y MAX

[Key events](#)



Subsequent Developments

- Adani was forced to cancel a secondary equity issuance
- Many cash intensive expansion projects were cancelled
- Some deleveraging – active steps to shore up market confidence
- Many audit changes in Adani group companies – Big 4 replaced by no name auditors
- Market believes that the Indian regulator (SEBI) will give a “clean chit” to Adani because of its political connections
- Stock price is double its annual low, but still down over 40%.



Role of Short Sellers in SVB

- On March 9 and 10, 2023, the stock prices of SVB plunged by 87% because of its balance-sheet troubles.
- Eventually, SVB defaulted and depositors needed to be bailed out.
- Short seller William C. Martin, had warned his Twitter followers about SVB's balance-sheet troubles about two months before its collapse.
 - Identified that SVB was sitting on huge unrealized losses in its fixed-income portfolio.
 - SVB had a very high proportion of non-FDIC insured deposits
 - As an activist short seller, he advertised his position widely after taking a short position.
 - Bloomberg estimated that short sellers made about \$500 million from SVB and \$2.3 billion from shorting regional banks around SVB's blow up.



What if your firm is targeted by Activist Short Sellers?

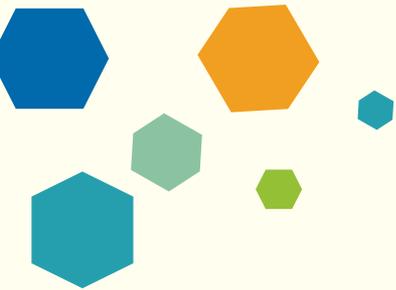
- Evaluate the extent of short position – if small, do not react
- Don't shoot the messenger
 - Activist is looking for attention from media and markets. Don't give them a freebie.
- Sunlight is the best disinfectant
 - Give detailed point by point response
 - Reinstate market's confidence in the company's values, culture, innate profitability, and the business model.
- Seek legal help/redress, especially if the activist campaign is truly motivated by incorrect or malicious information/research.
- Don't allow yourself to become the target of short-sellers



How to “short-proof” your firm?

- Short sellers target firms that have opaque disclosures, complex ownership structures, and are overvalued with respect to their fundamentals.
- Provide transparent disclosures consistently to prevent a firm from coming in the crosshairs of short sellers.
- While overvaluation may have benefits (e.g. the ability to stock as currency for transactions like M&A), these benefits tend to be ephemeral.
- “What goes up must come down” – it’s probably better not to have gone up in the first place. Don’t allow your valuation to get out of whack with your fundamentals.
 - Valuation guru Aswath Damodaran valued Adani enterprises at Rs. 945, less than a quarter of what it was trading at, prior to the Hindenburg report.





Thank you!

