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Activist Short Sellers Bring Many a Mighty Down

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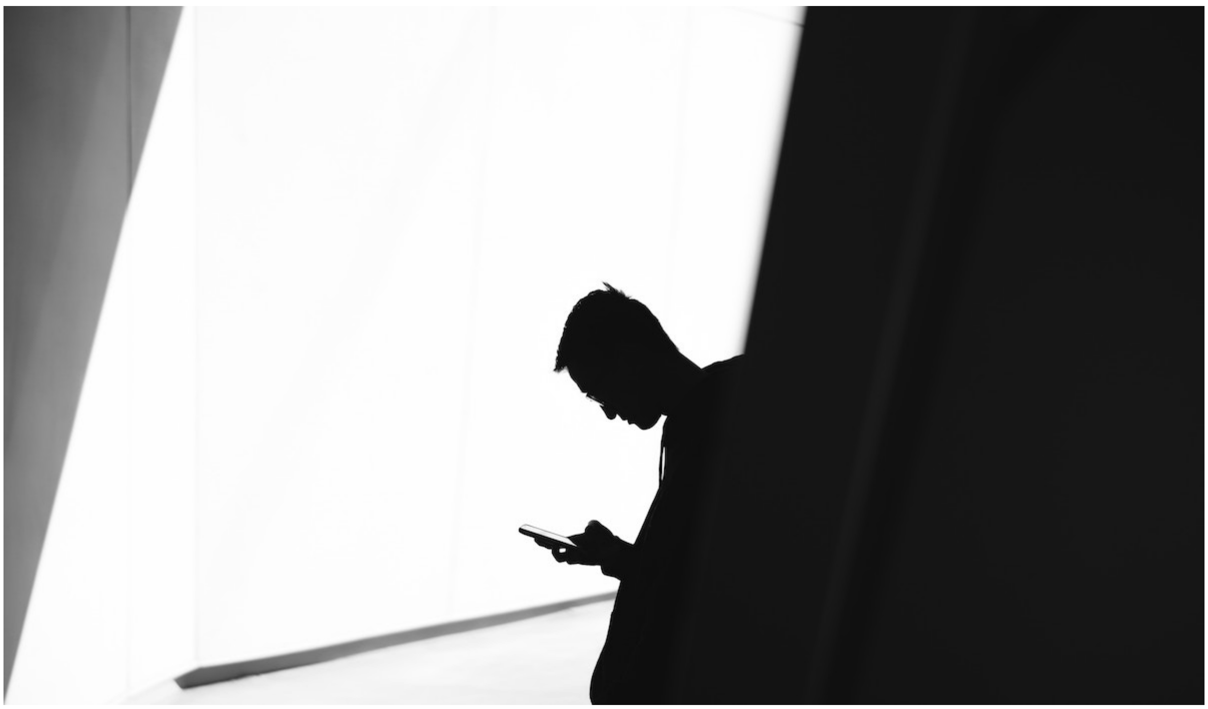

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"Activist short sellers" are mysterious investors who benefit capital markets by correcting overvaluations.

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By March 2023, the net worth of Gautam Adani, a businessman in India, had fallen by about **$80 billion**. Previously, his net worth reached a peak of $150 billion in September, 2022, when he briefly became the **third-richest person in the world** and the richest person in Asia. Also in March 2023, the shareholders of Silicon Valley Bank (SVB) **lost the entire value of their share holding,** when SVB became the second-largest bank failure in United States since the financial crisis of 2007-2008. What do these two events have in common? One group of mysterious investors—the short sellers—made colossal profits despite the large losses suffered by the shareholders of the Adani group and SVB. Much abhorred and ridiculed around the world, **including from an ex-US president**, and even banned from operating in **certain countries**, this group of investors, who technically are not even investors in the firms they target, are undoubtedly some of the smartest players in the capital markets. They make bold moves and make large profits, and often correct misevaluations and uncover accounting frauds while bringing many a might down. However, this profit comes with a high level of risk, as short sellers can suffer astronomical losses, if their bets go wrong and the stock price of the firm they short becomes even more misvalued.

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Historically, short selling has been a clandestine activity. But with the rise of activist short sellers, they have come out in the open, often with fancy names like **Hindenburg Research** that initiated the downfall of Adani group. True to its name, Hindenburg prides itself in **sinking the stock prices of firms it sells short**, similar to the **1937 German flying machine that crashed on earth with catastrophic losses**. **Muddy Waters**, another short seller, identified fraudulent accounting at Lucking Coffee, a Chinese company, which claimed to have become a larger coffee chain **than Starbucks, based on imaginary revenue numbers. Scorpion Capital** aims to publish rigorous due diligence to identify fraud, to bring down overpriced biotechnology stocks.

We explain who these mysterious group of investors are, what they do, why they are abhorred so much, and what their recent, controversial bets are. Finally, what should companies do, when faced with an activist short seller's campaign.

What is Short Selling?

Short selling means selling a security that the investor does not own, with the hope of buying it back later at a lower price. The profit comes from the difference in the stock price at the time of initial sale and the lower price at which that stock will be bought back later. 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, which can occur when the stock price rises unpredictably. A strange risk comes from "short squeeze," a loss caused by the actions of short sellers themselves. This occurs when many short sellers have sold a stock, and the prices starts increasing. They all rush to buy the stock, to cover their short position, causing a sudden spike in the share price. This happened recently in **Gamestop**, a meme stock, that is, stock whose stock price rises meteorically due to heightened social sentiment. Yet another source of risk comes from such severe decline in stock price (a good outcome for short sellers) that the company goes bankrupt and is no longer traded. A short seller can no longer buy shares to deliver on the promised date and must wait for the completion of the bankruptcy process to collect their deposits.

Short selling requires investment of a different kind. A normal investor pays money to buy stocks. In contrast, a short seller must make a margin call to the broker if the stock prices start rising after a short seller sells. The broker demands additional safety deposits, or margin calls, to cover the potential losses. A stock can continue to rise for a long time before it corrects itself, and short sellers must keep making the margin calls during that time. They would lose a lot of money during that period. For example, short sellers of meme stock GameStop lost about **$20 billion** in January of 2021, even when they were right. Some short sellers may not have enough staying power, and may fold up prematurely, suffering massive losses, even though eventually they would have made large profits. For example, short sellers suffered large losses during the dotcom **bubble of the late 1990s**, till the dotcom bust which arrived suddenly in April 2000 and lead to a **sudden**

correction in prices of technology firms. Typically, short sellers are experienced investors with deep pockets, who can handle high risk and have a solid understanding of the market dynamics. Their search for target firms is often the culmination of a significant amount of research and analysis.

Why Does the Society Hate Short Sellers?

Short selling is betting against a company to make profits from its downfall, which is often viewed as **unethical** by certain segments of the society. A sudden decline of a company's stock price often harms the company's employees, suppliers, local governments, creditors, renters, and many other stakeholders. This creates the perception that the short-sellers profit from the misfortunes of the others. They are often referred to as the vultures of the capital markets, preying on the weak.

Short selling can lead to wild swings in stock prices and contribute to market volatility and instability, which can harm investors and the wider economy. Short selling can exacerbate declines in stock prices, leading to panic selling, and further declines, potentially contributing to market crashes and financial crises. That's why, short selling is blamed for **market downturns** and even for the stock market crash of 1929 and the Great Depression that followed.

Despite these problems, why does the society let the short sellers operate, or even encourage their bets? The reason is that the short sellers **contribute as much to the market efficiency**, that is, correction of stock prices based on the available information, as do the investors who buy the stock. In an efficient marketplace, prices should reflect the views of everyone, the optimists as well as the pessimists. Curtailing short selling means that stocks can remain overvalued, as there is no one to uncover fraud or identify overvaluation. If stocks remain overvalued, normal investors would keep throwing good money after bad, harming themselves in the long run. **Studies** show that short sellers improve liquidity of stocks and accelerate discovery of right price levels.

Activist Short Sellers

Before 2000, short sellers acted in the dark alleys of the stock market. That is, they mostly short sold stocks without informing public about their trades. This was unlike buyers, who must file a **Schedule 13D** with the SEC within 10 days of crossing the 5% ownership threshold. As a result, outsiders came to know about the short sellers' trades only after the release of aggregate "short interest" data, collected by **Financial Industry Regulatory Authority** and reported twice a month. The past decade has seen the rise of the "**activist short seller**," those who publicly advertise their short selling activity by providing a detailed report on why they believe that the stock will go down. Activist short sellers aim to build collective momentum by trying to convince the market about their negative sentiment toward the targeted firm. The rise in activist short selling has coincided with the rise of social media, which can be used to quickly and cheaply to publicize research.

But in their aim, short sellers could spread exaggerated negative news, which could even be false rumors and unsubstantiated doubts. They could do so anonymously using false identities, called **pseudonymity**. This can harm the company's reputation and lead to a decline in its stock price beyond a firms' fundamental value, a practice known as "**short and distort**," which, at an extreme, could be considered an **act of market manipulation**. This is mirror opposite of a manipulative stock buyer's "**pump and dump**," in which the buyer after purchasing the stock spreads false positive news about the company, to create a buying frenzy, and then dumps their stock holdings at an inflated prices. Similarly, an activist short seller would tend to spread false bad news about the company, after short selling it. If the short seller has an established reputation of correctly identifying overvalued stocks, then their actions and words carry credibility, and can seriously harm the prospects of the company, at least in the short run.

Adani Saga

On January 24, 2023, Connecticut based Hindenburg Research released a report claiming that the stock price of seven key listed companies of the Adani group had spiked an average of 819% in the past three years because of stock manipulation and accounting fraud. Hindenburg claimed to have spoken to numerous individuals, including former senior executives of the Adani Group, reviewed thousands of documents, and conducted diligence site visits in almost half a dozen countries. They alleged that the inflated stock prices should decline by at least 85%, based on the financial performance of those firms. They also alleged that Adani's companies had taken massive debt, by pledging shares of their inflated stock, putting the entire Adani group of companies on precarious financial footing. Most importantly, they alleged poor corporate governance at the Adani Group claiming that it was largely "a family business," with key positions held by relatives of Gautam Adani. The report also described how offshore shell entities in tax-haven jurisdictions had generated forged documentation. In sum, it posed 88 questions and allegations for the Adani group.

Adani group responded with a **413-page report** on January 29, 2023, with a point-by-point response to Hindenburg's allegations. **It claimed** that 68 of the 88 questions referred to matters already disclosed in their financial disclosures by the Group companies, 18 questions pertained to third parties (and not the Adani portfolio companies), while the balance 5 were baseless allegations.

Hindenburg's allegations had an **immediate knock-on effect** on Adani's stock prices, and almost $100 billion was wiped from the group's market value within a matter of days. Adani Group also canceled a $2.5 billion share sale. Credit Suisse and Citigroup stopped accepting Adani bonds as collateral. Other lenders including Barclays and Deutsche Bank asked for a margin call on a $1.1 billion share-backed loan.

Interestingly, and unsuccessfully, Adani group tried to invoke **nationalistic sentiment** to defend itself, arguing that the allegations against the company were a veiled attack on India by foreigners and not just on its companies. It **called** Hindenburg move as a "calculated attack on India, the independence, integrity and quality of Indian institutions, and the growth story and ambition of India." It also questioned the motives, transparency, and legality of Hindenburg's report. Some in media called Hindenburg report as an "**Anglo-American destabilization**" campaign to topple the Indian government, because India stayed neutral in the Ukraine-Russia conflict. What was a purely financial matter became a nationalistic flashpoint, attracting the attentions of **CNN**, **New York Times**, **Washington Post**, **Fox News**, **Wall Street journal** among others.

While the jury is still divided on the merits of Hindenburg's allegations, the market seems to have sided with Hindenburg. The share price of Adani Enterprises, Adani group's flagship company, has fallen from INR 3,442 on Jan 24, 2023, the date of Hindenburg's report, to INR 1,603 on March 28, 2023, a fall of 54%.

SVB

On March 9 and 10, 2023, the stock prices of SVB plunged **by 87%** because of its balance-sheet troubles, potentially destabilizing the entire US banking system. There is little doubt, SVB failure caused anxious moments for its depositors, clients, FDIC, and the capital markets. However, one short seller **William C. Martin**, had warned his **Twitter followers** about SVB's balance-sheet troubles about two months before its collapse. He correctly identified that the SVB was sitting on a mountain of unrealized losses in its fixed-income portfolio. Further, he also realized that SVB had a very high proportion of deposits that were not FDIC insured, making the bank vulnerable to sudden withdrawals from its primary source of deposits – startups which had raised capital. True to the style of an activist short seller, he not only identified a potential money-making opportunity, but also advertised it widely after taking a short position. Bloomberg estimated that SVB's short sellers made about **$500 million** from their trades. SVB was not the only regional bank that suffered sudden decline in stock prices. Short sellers may have pocketed **$2.3 billion** from the rout in regional banks' share prices over the three-day period surrounding SVB's blow up.

What should companies do when attacked by activist short sellers?

Activist short sellers could become a company's worst nightmare. So, what should you do when your firm is targeted by an activist short seller?

First and foremost, evaluate the extent of short interest (percent of outstanding stock that was sold short) and read the short seller's research report. If there is nothing damaging in the report and the short interest is too small, the best action could be to take no action at all. After all, some people shorting the stock and saying bad things about the company is a normal thing. Reacting or overreacting would not be the best strategy in every circumstance.

Second, don't shoot the messenger. Curb the natural tendency to counterattack. The activist short seller may have a credible prior track record of identifying overpriced stocks and/or corporate malfeasance, and counterattacks often only add fuel to the fire. Activist short sellers are often attempting to draw the market and media attention to their reports, and your counterattack would only help the short seller to achieve that purpose.

Third, believe in "sunlight is the best disinfectant." If short seller's report has the potential to damage the company's prospects, provide a point-by-point response to short sellers' allegations. Provide relevant data, information, and easy-to-understand graphics. Grievances must be addressed, not defended using legalese. If an allegation is correct, be honest to admit it. But describe the circumstances in which the company took those actions or how that problem was fixed or may not be material to company's long-term prospects. The company may even thank the short seller for bringing a genuine problem to its attention while providing a plan to fix it. The company should attempt to reinstate market's confidence in the company's values, culture, innate profitability, and the business model.

Fourth, seek help of legal experts. Short sellers' recommendations could constitute an investment advice and could be based on false misrepresentations. Check if the short seller has violated any laws, such as those related to **defamation** or **investment advice**. Initiate legal actions if advised by the expert lawyers, but do not publicize them, as it may be perceived as a counterattack.

Fifth, speed is the key. While the firm must seek advice from experienced legal counsel, financial advisors, public relation firms, social media experts, and specialized data analytics, it must not wait too long. Otherwise, the damage could be quick, deep, and long lasting

Finally, proactively take steps to ensure that your firm does not become the target of short sellers. Research indicates that short sellers target firms that have opaque disclosures, complex ownership structures, and are overvalued with respect to their fundamentals. So, its advisable to providing transparent disclosures consistently to prevent a firm from coming in the crosshairs of short sellers. Also, while overvaluation may have its benefits (e.g. the ability to use one's overvalued stock as currency for transactions like M&A), these benefits tend to be ephemeral. Remember "what goes up must come down" – it's probably better not to have gone up in the first place. In the medium to long run, don't allow your valuation to get out of whack with your fundamentals. In the case of Adani Enterprises, the stock was clearly overvalued, a point made in Hindenburg report. Valuation guru **Aswath Damodaran** had valued the firm at Rs. 945, which was less than a quarter of what it was trading at, prior to the Hindenburg report.

Conclusion

The Adani and SVB sagas show how a new generation of activist short sellers strive to identify lucrative opportunities and uncover price bubbles or overvalued stocks. These activist short sellers use sophisticated research to identify short opportunities, undertake high risks, and are often rewarded with large returns. The recent events have reignited the debates about whether short sellers add to or detract from well functioning capital markets. While academic research shows that short sellers improve liquidity and hasten price discovery, anecdotal evidence also suggests that short sellers sometimes exaggerate their claims bring down a stock. In addition, short sellers' trades can induce undue volatility, and throw gasoline on fire, when the things are really going bad. Occasionally, even sophisticated players like **Morgan Stanley and Goldman Sachs**, who themselves promote short selling, blame the short sellers for their troubles. Such is the love-hate relationship of the society with some of the most sophisticated players in the capital markets, who profit from others' misfortunes. With the rise of **deepfake, AI**, and social media, we anticipate that short sellers' campaigns will get nastier and more frequent in the times ahead. Companies must accept them as a regular part of life, anticipate their campaigns, and must have strategies ready for the times when attacked.

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