

Jim Chanos Masterclass

The Fundamental Short Seller



INTELLIGENT
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From a \$2,000 nest egg to a US\$9bn bankruptcy

'The New York Stock Exchange suspended trading yesterday in Baldwin-United shares when they were at \$4.50 a share, and the exchange said it was reviewing the eligibility for listing of the company's common and preferred stock, as well as its subordinated debentures. A year ago, the stock sold for more than \$50.'

– The New York Times, 27 September, 1983

In September 1983, Baldwin-United declared bankruptcy. Its stock – one of the most followed on Wall Street – had fallen by 91% from top to bottom ... Except for a wet-behind-the-ears 24-year old working for a nondescript Chicago broker, everyone had missed it.

After seven years on the road as a music teacher, Dwight Hamilton Baldwin had saved an impressive \$2,000. In 1862, he put it to work, investing in a Cincinnati piano shop. Baldwin could not have imagined how a century later this tiny venture would one day cost investors their own nest eggs in a US\$9bn bankruptcy, make fools of Wall Street and crush the career of one man whilst making that of another.

Baldwin's original investment was a good one. The company expanded, eventually making its own pianos. But after Baldwin and his wife died, Lucien Wulsin, a Civil War veteran, and three minority shareholders, took over.

They made a radical change to the business model that was to have echoes almost a century later. After allowing retailers to take stock on consignment and with the help of celebrity endorsements, by 1954 piano sales had reached US\$33m. Then the fun began.

In 1950, aged 19, Morely P. Thompson had joined the company as a travelling piano salesman. Smart and dutiful, the young Thompson could sell anything, even pianos door-to-door in Alaska. By 1961 he was treasurer, making vice-president six years later. In 1970 he became CEO.

It took a further 15 years for Baldwin to become the country's biggest ever bankruptcy, going down with US\$9bn in liabilities. For investors wanting to make money from falling stocks, this was a textbook case. There were more red flags flying over Baldwin-United under Thompson than in a Red Army parade. The issue was that no one *wanted* to see them.

Thompson viewed pianos as a dull and cyclical business but with good cashflow. His plan was to use it to expand into the new growth area of financial services. It wasn't quite as mad as it sounded. Baldwin had long financed its customers' piano purchases. Financial diversification seemed plausible, especially as Thompson had proved adept at moving money between subsidiaries to reduce tax and free up cash flow. If he could continue to do that, the plan might work.

And Thompson gave it a pretty good shake. By the early 1980s, Baldwin controlled more than 200 financial institutions, including savings and loans businesses, investment companies and insurance outfits. Wall Street loved the expansion, the fees it delivered and the man making the charge. As the *Cincinnati* magazine wrote;

'With ingenuity and verve, he'd concoct a new scheme to move money around and around Baldwin subsidiaries, generating profits, dodging taxes and mystifying anybody

trying to critically appraise it. Then he'd hop on a plane and with that broad, open, Great Plains face and Eisenhower grin sell every doubter. Nobody had ever seen the likes of him'.

The company approached its zenith once it began selling single-premium deferred annuities (SPDA), a form of superannuation, except that instead of paying into an account regularly over time, policyholders pay in a one-off lump sum at the start.

The typical Baldwin client deposited about US\$23,000. The annuity interest, accrued at rates of between 7.5% and 14.5%, was sheltered from tax until the client started drawing down funds. It was a nice pitch, especially with the juicy 5% commission paid to brokers. These were typically and purely coincidentally the same firms calling Baldwin a Buy and pushing it to their retail clients. In the first three years of the eighties, Baldwin wrote 165,000 SPDA policies worth over US\$4bn.

But whilst the cash was flooding in, the commission meant the company had to credit the client's account with more than it received. Then it had to pay the interest. Just to stay afloat, Baldwin had to invest the money it received in lump sums at rates far higher than it was paying out in interest, which was proving difficult. Thompson needed cash to keep his uniquely-styled Ponzi scheme ticking along.

Profits were critical. Without them the income tax deductions on which the entire gambit was based were worthless. And so in March 1982, Baldwin-United purchased the highly profitable Mortgage Guaranty Insurance Corp (MGIC), a high quality residential mortgage insurer, for US\$1.2bn.

Whilst the market loved the deal, it was to prove Thompson's and Baldwin's undoing. The first US\$600m payment was funded with short term loans but when MGIC's profits fell more than 20%, in a highly irregular practice money was taken from the insurance subsidiaries to service the debt. Analysts either didn't notice or care but insurance regulators in three states did.

In September 1983, Baldwin-United declared bankruptcy. Its stock – one of the most followed on Wall Street – had fallen by 91% from top to bottom. Slowly, it became apparent that not one analyst had spotted any of the red flags that had been billowing in the wind for years.

Except for a wet-behind-the-ears 24-year old working for a nondescript Chicago broker, everyone had missed it.

Outsider rising

'I don't believe that he deliberately set out to nail Baldwin or send them into bankruptcy, but clearly we threw weight on a sinking ship.'

– H. Robert Holmes, the chairman of Gilford Securities

WHAT IS SHORT SELLING?

A share in Company X currently sells for \$10 a share. Bing Chinos thinks Company X isn't worth anywhere near that amount and there's some dodgy stuff going on. Eventually, although Bing knows not when, he believes the market will realise it.

So Bing borrows 100 shares of Company A from a stock lender, with an obligation to return them at some point and pay dividends and interest costs along the way. He sells the stock and stuffs \$1,000 (less fees) into his pocket. Then he waits to see if he's right. If he is and the stock drops 50% to \$5 a share, Bing can buy 100 shares in Company X for \$500, return them to the lender and walk away with a \$500 profit.

But if the stock price rises 50%, Bing has to find \$1500 to return the stock, meaning he loses \$500, plus expenses.

There was a time when Jim Chanos may not have become the world's most famous short seller. Born in Milwaukee in 1957 to a Jewish-Greek family, Chanos studied political science and economics at Yale but originally wanted to become a doctor. At college he dabbled in options and stock trading but back then, as he told *Value Walk*, 'business was pretty much a four-letter word'.

After graduation in 1980 he read *The Money Masters* by John Train, where he was first introduced to a famous short seller of the 1970s called Robert Wilson, and *Contrarian Investment Strategies* by David Dreman. Forsaking a career wearing a white coat to join one that occasionally enjoys white shoes, he became a junior investment banker in Chicago.

DEFYING THE EXPERTS

It wasn't for him, however. As he told *Value Investor Insight* in 2005, 'It became clear to me after that there had to be something more interesting than making wrong recommendations [to clients] with twisted facts just to generate fees'.

That's how he came to be a junior securities analyst at Gilford Securities in Chicago. Many of Gilford's clients owned MGIC, which at the time was subject to a takeover offer from Baldwin-United. As Chanos told Steven Drobny in *The New House of Money* 'the more I looked at Baldwin, the more I could not figure out how they were making money.'

Chanos felt certain the company was using insurance funds to make acquisitions, faced the threat of regulatory action as a consequence and was heavily indebted and overpriced. As he told *Value Investor Insight*;

'They were issuing annuities at 12–14 %, and I couldn't figure out what they were investing in that was possibly earning that. Other than all their acquisitions, their portfolios were mostly bonds bought years before that were basically underwater.'

In August of 1982 and only a few years into his career, Chanos wrote an eight-page recommendation to sell Baldwin-United short at a price of US\$24. The stock fell at

first but then more than doubled, hitting US\$50. Lawsuits were flying and there was pressure from the New York head office to dump the errant upstart.

Chanos knew he had spotted a fraud and, to wit, a huge mispricing. But no one wanted to know. Then fortune fell his way.

After a story in *Forbes* called Baldwin a 'house of cards' the company's share price collapsed. Incredibly, on the very same day Merrill Lynch refuted major aspects of the story, including parts that even Baldwin-United had publicly admitted, it retained a buy recommendation.

Chanos said of the incident;

'When I saw that go across the tape, it hit me: So many people had bought the stock on this analyst's recommendation and she had not even looked at the Arkansas statements I'd written about months before. It was a real eye opener in how dissenting voices were squashed, how serious facts could be ignored for months on end, and how cozy the banker/analyst/company relationship could be.'

And then the phone started ringing. Suddenly, everyone was interested in what else Chanos didn't like. Swimming with the tide, *The Wall Street Journal*, which two years later was to claim that Chanos 'epitomizes all that is wrong with modern short-sellers', hailed his ability to defy the experts.

VINDICATION

Vindication had taken the reputation of Jim Chanos from zero to hero in a few short months. And that got him thinking; 'If you can be rigorous and do the work in these kinds of situations, and you get your facts right, you might be able to make some serious money taking advantage of how things work.'

And then: 'If nobody wanted to do this type of thing, and I was willing to take the heat, there was a real opportunity to build a business as a young person.'

Enter the cynic

'To their critics, Wall Street's short sellers are worse than ambulance-chasing lawyers. Not only do they seek profit from others' misfortunes, but, the critics say, a new breed of activist short sellers tries to help the bad news happen.'

– *Wall Street Journal*, 5 September, 1985

In a revealing postscript, of the 10 companies that the Wall Street Journal had claimed were being unfairly punished by the evil cabal, nine either entered bankruptcy or were charged with fraud. But the vindication was too late to save his position at Deutsche.

It took Chanos a few more years before he started his own shop. Aged 26 he joined Deutsche Bank in New York where he began what he called his 'next jihad', against [Michael Miliken](#), the 'junk bond king' that headed up Drexel Burnham Lambert.

In 1985 another *Wall Street Journal* article alleged that Chanos and his ilk 'specialize in sinking vulnerable stocks with barrages of bad-mouthing. They use facts when available, but some of them aren't above innuendo, fabrications and deceit to batter down a stock'.

The article named ten stocks that suffered at the hands of what Chanos sarcastically called this 'evil cabal of short sellers'. With his victory at Baldwin-United long forgotten, the criticism proved too much for Deutsche Bank. The bank did not renew his contract.

SOUR VICTORY

In a revealing postscript, of the 10 companies that the *Wall Street Journal* had claimed were being unfairly punished by the evil cabal, nine either entered bankruptcy or were charged with fraud. But the vindication was too late to save his position at Deutsche.

Kynikos Associates ('kynikos' is Greek for 'cynic') came into being when Chanos and his then business partner raised US\$1m from their own funds and US\$15m from a client. But Chanos' timing again lacked prescience. His short portfolio was swept up in the booming mid-80s market.

The strain began to tell on his business partner, who offered to sell his share to Chanos for US\$1. The offer was gratefully accepted and now his ex-partner sleeps with another kind of anxiety; of having missed out on perhaps the best possible investment of his career. Chanos, quoted in *Yale Alumni magazine*, says his ex-partner's wife still wants to 'kill him over it'.

Things went well for a time. The '87 crash proved profitable but as markets boomed in the early '90s

the firm almost went under. In 1990 the company had US\$600m under management. Within four years that number had shrunk to US\$100m and Chanos couldn't find anything to short. Times were tough; at one stage he was paying staff from his own pocket.

The crisis prompted a reorganisation, including the introduction of a performance fee based on an inverse benchmark. If the S&P500 rose by 10%, Kynikos had to lose less than 10% to claim a performance fee. To Kynikos clients using the company to hedge against positions they already held, it made perfect sense. The changes worked and the company's many short positions finally started to pay off.

Within a decade Kynikos had over US\$1bn under management and featured clients like George Soros. By 2007, the year when *Trader Monthly* estimated Chanos' annual pay packet to be about US\$300m, Kynikos had over US\$7bn under management. The current figure is believed to be around US\$4bn, reflecting rises in global markets over the past few years, but with just 30 staff it remains a very profitable business.

NO ACCIDENT

Success of this ilk isn't a quirk of fate. The gods have not indulged Chanos, nor can the sum be explained by what his critics might call the cynical ability to talk down the fortunes of healthy businesses.

In the 30-odd years since its formation, Kynikos has identified and profited from some of the business world's most spectacular failures, including Enron, WorldCom and Eastman Kodak. Locally, Chanos successfully shorted HIH Insurance, Macquarie Bank and Fortescue Metals Group. Let's see how he does it.

Frauds, scams and high prices – The search for value

'Whether you want to short stocks or not, you ought to take valuation into account when you buy something because it will matter at some point.'

– Jim Chanos

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“Instead of seeking out ‘clean’ accounts where every transaction can be traced, they look for dirty, opaque accounts where management employs a great deal of latitude in valuing its own assets.”

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Shorting stocks has its problems, which is why not one *Intelligent Investor Share Advisor* analyst has ever engaged with the practice - something to bear in mind when reading the stocks each would short if forced to do so on [page 14](#).

The reason is simple. For value investors, valuation and how it compares to price, is everything. Once a cheap stock has been purchased one need only wait for the market to catch up. Whether that takes months or years need not matter. With no holding costs, and sometimes a high dividend to grease the wheels, patience doesn't have a price.

Shorting stocks doesn't work like that. There is a cost – the cost of borrowing the stock and the payment of dividends to its owner – plus something potentially more damaging.

ALWAYS INVERT

A shorted stock can only fall to zero (a 100% gain for the shorter and the maximum possible gain) but can rise by thousands of per cent. So getting out of a short position can cost far more than the most you can make from it. In 'long' investing you can only lose the money you've put in. In shorting, you can lose multiples of it.

That's why Chanos says, 'everybody says be careful shorting on valuation and I think that's a good bromide.' That's why Chanos always has reasons in addition to valuation for shorting a stock.

Shorting does have some advantages, though. Fewer people do it, which means it's a less competitive field. And frauds, scams and over-priced stocks are arguably easier to spot than merely cheap companies.

Chanos employs a team of analysts, including former journalists, a profession he values for its inherently sceptical nature, to wade through company accounts, examine management and calculate financial ratios. Most certainly, this is a fundamental approach.

But Chanos and his team use these skills to uncover 'inverse' value. Instead of seeking out 'clean' accounts where every transaction can be traced, they look for dirty, opaque accounts where management employs a great deal of latitude in valuing its own assets.

'Long' investors look for strong, well-managed, stable businesses with predictable futures. Chanos looks for companies under threat, run by blinkered managers that fail to see the elephant in the room.

And whereas every sensible long term value investor tries to avoid bubbles, Chanos loves them, famously shorting in one way or another almost every bubble that has come his way. He categorises his shorts into four areas:

1. DEBT-FUELLED ASSET BUBBLES

Chanos claims that bursting bubbles are the source of his most lucrative shorts, especially those that are debt-financed rather than more conventional valuation bubbles such as the Dotcom era.

Kynikos avoided that debacle, largely due to the absence of debt and the fact that, as Chanos acknowledges, 'we did not know how high those names could go'.

A few years earlier, Kynikos had shorted internet service provider AOL because it was experiencing a high churn rate and was capitalising marketing costs. The stock price flew from US\$10 a share to US\$80 and was eventually purchased by Time Warner, a painful experience that probably influenced Chanos' thinking.

He typically finds the accounting for companies that serially conduct mergers or acquisitions to be extremely murky. When debt is added to the mix, it often signals all is not well – the company may have resorted to chasing new streams of revenue just to maintain the illusion of earnings growth.

2. SUSPECT ACCOUNTING PRACTICES

There are always people willing to fiddle the books. Some might be aware they're breaking the law, others that they're pushing it a little, inhabiting the grey area that what Chanos says 'a rule based system' creates.

In a perfect world a company's accounts should be an accurate reflection of reality, of how it makes and accounts for money. The problem with a rules rather than standards-based system is that, as Chanos told *Value Investor Insight*:

'we want every single possible transaction to have a rule. So you have armies of investment bankers and lawyers who do nothing but think about how to get around the rules. I can't think of one major fraud where the auditors didn't sign off on the statements. In a rules-based system it's easier for unscrupulous people to fix the numbers and get people to sign off on them as proper.'

CASE STUDY: MACQUARIE BANK

Brian Johnson of JPMorgan, at the time Australia's top-rated banking analyst, claimed that Chanos would join the long line of people that had lost money betting against Macquarie. It didn't quite work out like that.

As former research director Greg Hoffman wrote in his [special report on Macquarie Bank](#) in 2002, 'Macquarie manages it [money], borrows it, lends it, advises others about it and, in the process, makes plenty of it for staff and shareholders.'

The so-called Macquarie model generated huge fees and was the source of a successful recommendation for Intelligent Investor members. The company was also an inspiration for copycat investment banks like Babcock & Brown and Allco.

The media lapped up Macquarie's success, with Peter Hartcher of the *Sydney Morning Herald* calling the company's generous staff remuneration 'not a failure of Australian values but a success of Australian internationalisation'.

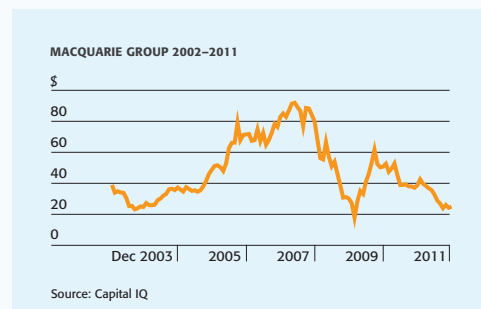
But the model had a flaw and it took an American to spell it out. In May 2007 at a San Francisco investment conference, Chanos was asked to recommend a short. The Macquarie model, he said, was based on the availability of debt, which was used to overpay for assets, which were then constantly re-valued to increase leverage.

Macquarie purchased assets like airports, property and toll roads the world over, often as the highest bidder, taking a fee for sourcing the debt. For another fee, the assets were then flipped into Macquarie satellites. Then Macquarie charged a fee to manage them.

In order to expand its asset base, which delivered ever higher fees, the company constantly re-valued the assets it already owned. Then it went back to its lenders for more based on those revisions.

Chanos called time on the model, arguing that whilst not illegal, it required 'willing lenders, you need a credit environment that looks the other way ... lending on reputation alone.'

That was in 2007, a year before the Global Financial Crisis broke. Brian Johnson of JPMorgan, at the time Australia's top-rated banking analyst, claimed that Chanos would join the long line of people that had lost money betting against Macquarie. It didn't quite work out like that. After reaching \$86 in May 2007, by early 2009 the stock had fallen to under \$17 a share.



The GFC had dried up the sources of cheap funding and Macquarie Bank did indeed change its model, quite successfully as it turned out. But not before the big banks successfully lobbied the Government to temporarily ban short selling of financial stocks. But by then, Chanos had long gone, taking his Macquarie money with him.

Tip: To its credit, Macquarie has retained its May 2007 response to [Chanos' critique](#) on its website. It's a classic of the genre and well worth a read.

CASE STUDY: ABC LEARNING CENTRES

There's no evidence that Chanos shorted ABC Learning Centres, although the fact that many Australian investors were lured by the company's debt-financed aggregation model may have alerted him to it. But as an illustration of the kind of stock Chanos might look for there is no better.

In 2001, ABC listed on the ASX at \$2 a share. By the end of 2006 the share priced had four-bagged and CEO [Eddy Groves](#) was the proud owner of a black Ferrari. It was to last another two years.



A glance at the footnotes in the company's 2005 annual report should have raised eyebrows. But ABC Learning was another Australian success story, conquering the globe with corporatised child care services courtesy of willing lenders and government subsidies.

ABC's largest assets were 'childcare licences'. The footnote revealed that, as was the case with Macquarie, the valuation of these licences was at the discretion of ABC's management. Details were never properly disclosed and Eddy made the most of it. The leverage increased along with the licence valuations. This was the hint, spotted by some three years before the company's eventual collapse, that all was not as it seemed.

At the peak of its popularity ABC was worth \$4.1bn, carrying debt of almost \$1.8bn. Groves backed his own stock through margin loans but when a 42% drop in second half profits was announced to the market in 2007, he got margin called. Then the proverbial hit the fan.

Chanos is fond of saying that once you find one or two accounting irregularities, you'll often find more. That seems to be the case here. ABC mysteriously paid \$100m to Eddy Groves' brother-in-law for 'maintenance services' on ABC's child care centres. For some reason, the services were never put out to tender. A further \$50m went to ABC's broker Austock, partly owned by Eddy Groves. Given that Groves lost his stake in a business that was once valued at \$300m, he could consider himself lucky.

None of that could have happened without freely available debt and a market/media nexus pumping the stock price skyward.

Tip: For a full recount of this appalling episode, read Adam Schwab's account in [Pigs at the Trough: Lessons from Australia's Decade of Corporate Greed](#).

Chanos is fond of saying that once you find one or two accounting irregularities, you'll often find more.

Chanos moves through company accounts exactly as would a traditional value investor; with a sceptical eye looking for something peculiar or unusual. And when he finds it, he likes to let the world know.

HOW TO SPOT A FRAUD

- **ARE THEY USING MARK-TO-MODEL ACCOUNTING?** – When a company can price the value of its assets according to its own criteria, the temptation to start pushing the envelope is hard to resist.
- **HAVE YOU CHECKED THE CASHFLOW QUALITY?** – Is it genuine or is the company finding a source of cash from, say, granting stock options?
- **DO YOU FIND THE ANNUAL REPORT INCOMPREHENSIBLE?** – If after reading the annual report a few times you can't tell how the company makes money, it may be because the company doesn't want you to know.
- **ARE STANDARD RATIOS OFF THE CHARTS?** – If a company sports ratios like return on equity and return on capital way above or below the industry norm, something is often amiss.
- **IS MANAGEMENT PROMOTIONAL?** – If management constantly talks itself up, using words like 'potential' and 'growth' but never addresses problems directly, or it launches legal action and disparages critics, there can be something to hide.
- **HOW HAVE ACQUISITIONS AND MERGERS BEEN ACCOUNTED FOR?** – If the accounts aren't straightforward in how they deal with merger and acquisition activity and you can't quite pinpoint how they were financed, that's another red flag.
- **ARE INSIDERS SELLING OUT?** – People inside the business are usually the first to know something odd is going on so they're usually the first to get out.

“*Our best shorts historically are stocks that have appeared cheap. The businesses were deteriorating faster than the value investors were lowering their numbers. Many of those companies get into financial trouble.*”

So if you can't rely on the accounts to depict reality, what can you use them for? Chanos moves through them as might a traditional value investor, with a sceptical eye looking for something not quite right. And when he finds it, he likes to let the world know.

3. TECHNOLOGICAL OBSOLESCENCE

Some of Chanos' most profitable shorts have been Eastman Kodak, Blockbuster and, more recently, Hewlett-Packard. These companies appeared cheap, often selling for single-digit price-earnings ratios. But all operated in sunset industries, victims of technological change that drove their earnings down each year.

By paying 10 times earnings for a declining business today, investors may actually be paying 20 times near future earnings because profits can quickly halve. These are the classic [value traps](#) into which many investors fall. Chanos actively seeks out such situations as a result.

In Australia Gina Rinehart, Mark Carnegie and John Singleton have all moved into the 'old media' sector

by grabbing fistfuls of apparently cheap stocks like **Ten Network** and **Fairfax Media**. But such businesses are subject to a particularly vicious form of creative destruction where new technology, namely the shift from print and traditional TV to digital, is eating away at the foundations of these businesses.

As Chanos has remarked, 'our best shorts historically are stocks that have appeared cheap. The businesses were deteriorating faster than the value investors were lowering their numbers. Many of those companies get into financial trouble.'

4. FADS – THE ONE TRICK PONY

These are the companies that rely on one factor for their earnings. Perhaps they produce a single product, fleeting in nature. Or perhaps the business benefits from government protections that can be quickly repealed. Or maybe it has struck lucky, as do many mining and biopharmaceutical companies, with a mine or wonder pill.

Chanos has successfully shorted George Foreman Grills and Martha Stewart Living (the products, not the person) plus the company that manufactured Cabbage Patch dolls. Each had a substantial fad element to their success.

Australia, too, has had its fair share of fads, including the management investment scheme companies like Timbercorp and Great Southern Plantations. When the tax laws were changed, preventing investors from claiming a tax deduction in advance, it killed the sector. It turned out that selling tax deductions via financial planners taking 10% commissions was a classic 'one trick pony', as is **McMillan Shakespeare**.

HOW TO SPOT A FAD

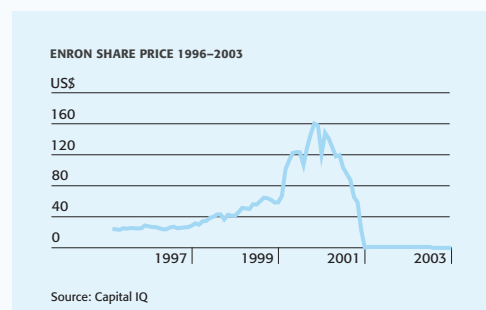
- **IS THE SHARE PRICE GROWTH HUGE?** – Investors need to have something to get excited about and it need not be profitability. Look for a hockey-stick share price chart.
- **IS THERE A COMPETITIVE MOAT?** – A company that sells products or services that are easily replicated won't do well for long – capitalism sees to that. That's why fad stocks don't last.
- **IS THE PRODUCT RANGE LIMITED?** – Fad stocks tend to sell only one product, be it Cabbage Patch Dolls, which sold, err, dolls, and Martha Stewart.
- **IS MANAGEMENT PROMOTIONAL?** – Management that talks of 'changing the world' has usually lost the plot. If you find a 'visionary', you may have also found a potential short.
- **IS THE STOCK TOUTED AS THE NEXT BIG THING?** – A company that becomes the next big thing without making a profit, or offering a product or service protected from competition, but is constantly covered by the media, is often not long for the world.

CASE STUDY: ENRON

If Baldwin-United introduced Jim Chanos to the business of short selling, Enron, a Texas energy company, sealed his reputation as a master practitioner. Enron came from nowhere and eventually returned to capitalism's primordial soup, dragging one of the world's biggest accountants with it, although not before burning through US\$74bn before bankruptcy, most of it due to fraud, and over US\$60bn after it. Baldwin-United? Small change.

The story of the company's rise and fall is best told in *Enron: The smartest guys in the room* (either the [book](#) or the [film](#) cover the material well). Here, we're going to examine how Chanos spotted the fraud and how it played out.

With a stock price that had reached US\$90.75 by the middle of 2000, Enron was the quintessential market darling. In 2000, *Fortune* magazine, which was to play a key part in the breaking of the scandal, had published a list of '10 stocks to last the decade'. Featuring Enron and a host of other overpriced stocks like Nortel and Broadcom, the company didn't last a year, let alone a decade. [*Fortune*, of course, is still going – Ed]



Behind the scenes, Enron was flying just about every red flag Jim Chanos could wish for. Even after multiple readings, the company accounts were bewildering. Special purpose vehicles shielded the company from scrutiny and allowed lots of debt to be moved off-balance sheet.

Enron used mark-to-market accounting, allowing it to recognise revenue from long term contracts that might not appear for years in real life, if at all. Strikingly, it was also the first non-financial company to adopt this practice.

Management was highly promotional, talking the stock up at every opportunity but especially to staff. Not co-incidentally, senior managers constantly awarded themselves generous options. Auditor Arthur Andersen generated US\$27m in consulting fees from a client with an audit fee of US\$25m, making the decision about whether to flag questionable accounting practices easy.

All the signs were of a company heading for a fall. But it didn't come until a Dallas money manager friend faxed Chanos the 'Heard on the Street' column in *The Texas Wall Street Journal*. The column noted that energy merchant banks like Enron had been approved to use mark-to-model accounting for their derivatives books. [It later emerged that Enron was running over 1,200 such books.]

As Chanos told the Committee on Energy and Commerce in the wake of the collapse;

'[mark-to-model accounting] allows a company to estimate the future profitability of a trade made today, and book a profit today based on the present value of those estimated future profits.'

Our interest in Enron and the other energy trading companies was piqued because our experience with companies that have

used this accounting method has been that management's temptation to be overly aggressive in making assumptions about the future was too great for them to ignore... In effect, "earnings" could be created out of thin air if management was willing to "push the envelope" by using highly favorable assumptions.

However, if these future assumptions did not come to pass, previously booked "earnings" would have to be adjusted downward. If this happened, as it often did, companies addicted to the crack cocaine of [mark-to-model] accounting would simply do new and bigger deals (with a larger immediate "earnings" impact) to offset those downward revisions. Once a company got on such an accounting treadmill, it was hard for it to get off.'

As research director Nathan Bell says of the time, 'there were lots of cases where Enron, plenty of banks and many others were valuing all sorts of things however they liked. Two companies would report opposite sides of a trade and both record a profit.' These were halcyon days for the likes of Chanos.

The first Enron document Kynikos examined was its 1999 10-K filing, the company's annual financial statements, which contained an interesting curiosity. Despite the opportunity to effectively create revenue, Enron's return on capital was only 7%. Meanwhile, Chanos estimated the company's cost of capital at closer to 9%. How could Enron report a profit?

There were other issues. Enron employees appeared to be engaged in widespread selling of company stock. And there were a swathe of related party transactions between the parent company and other offshoots, some curiously run by former Enron employees.

Repeated reading of the 10-Qs in 2000, showing the company's quarterly accounts, offered no clarity. As Chanos told the committee, he 'could not decipher what impact they had on Enron's overall financial condition.'

Chanos began shorting Enron in November of 2000. A few months later, when discussing the company with Wall Street associates, most accepted that 'there was no way to analyze Enron' but that it was a "trust me" story. That just about sealed it. All that was needed now was a little publicity.

In March the following year *Fortune* journalist Bethany McLean published [Is Enron overpriced?](#) Chanos had put her on to the story, and a belter it was, too. At the time, the company was trading on a PER of 55. McLean made the Chanos argument, just as she would do years later with Macquarie Bank. Finally, the ball began to roll back down the hill.

As the picture developed over the months that followed, Chanos became more certain. When Enron CEO Jeffrey Skilling resigned in August 2001 for 'personal reasons' he knew he was on a winner. As he told the committee, 'In our experience, there is no louder alarm bell in a controversial company than the unexplained, sudden departure of a chief executive officer no matter what "official" reason is given.'

On 2 December, 2001, Enron filed for bankruptcy. Chanos told *The New House of Money* author Steven Drobny that, 'Enron was one of the easiest shorts we ever did.'

The story has a delicious coda. As Enron was heading towards bankruptcy another energy trader called Dynegy made a takeover offer for it. Dynegy management was asked whether it had taken a look at Enron's books. They had. 'That's the good news,' came the reply, 'Their accounting is exactly the same as ours.' As Chanos told *Yale Alumni* magazine, 'We made as much on Dynegy as we did on Enron.'

Tip: Read the full account of Enron's collapse in the words of Chanos in his [testimony to a US government committee](#).

In the Titanic, the captain went down with the ship. And Enron looks to me like the captain first gave himself and his friends a bonus, then lowered himself and the top folks down the lifeboat and then hollered up and said, 'By the way, everything is going to be just fine'.

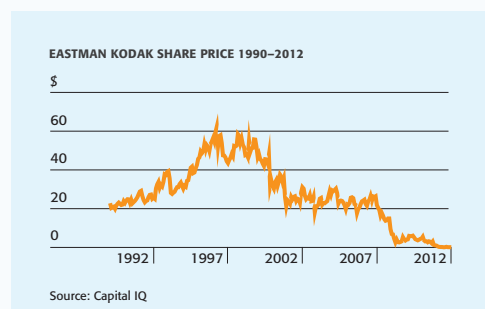
Byron Dorgan, US Senator

One of the differences in the value game now versus, say, 15 or 20 years ago, is that declining businesses, while they often throw off cash early in their decline, find that cash flow actually reaches a tipping point and goes negative much faster than it used to.

Jim Chanos in *Barron's*,
22 December, 2012

CASE STUDY: EASTMAN KODAK

Chanos called this world-renowned photography brand 'the classic value trap'. Whilst music was the first industry to succumb to the digital transition, photography supplies ran it close. For a company that made money selling photographic film, that spelt trouble.



Kodak could have been ahead of the curve. It developed a digital camera in 1975 but dropped the project when it considered the impact its launch may have had on its existing business. That may well have been a smart decision, allowing the company to make healthy profits for another 15 years.

But by the early '90s the company realised it needed to make the switch to digital before it was too late. It produced Apple's QuickTake digital camera in 1994 and launched its own proprietary range two years later. After a few hiccups, by 2005 Kodak was the biggest US player in digital cameras with sales of US\$5.7bn.

But selling digital cameras was a very competitive market, far more so than Kodak's duopoly position in film, which was now in sharp decline. Margins remained extremely high but in 2005 film sales fell 18%. The free cashflow figure revealed the trend. In 2002 it had been about US\$1.5bn. A year later it had fallen by a third and in 2004 was just \$500m.

Management needed to do something, fast. A flurry of activity ensued. A new CEO cut 27,000 employees from the film business; the company started producing ink jet printers and high margin ink; it used patent litigation to generate over US\$800m in new revenue, getting an early start in the [patent wars](#); workflow software and commercial printers hit the market; and the company spent a fortune on acquisitions of unprofitable digital businesses.

In 2005 Chanos said, 'We think Eastman Kodak is going to be a value trap all the way down, just as Polaroid was.' And so it proved. On 19 January, 2012 Kodak filed for Chapter 11 bankruptcy protection. Kodak was unable to replace a highly profitable business in decline with a growing but low margin business.

CASE STUDY: MCMILLAN SHAKESPEARE

The Federal Government broke with all precedent and did do something intelligent, signaling its intention to close the tax loophole on which McMillan's business was based.

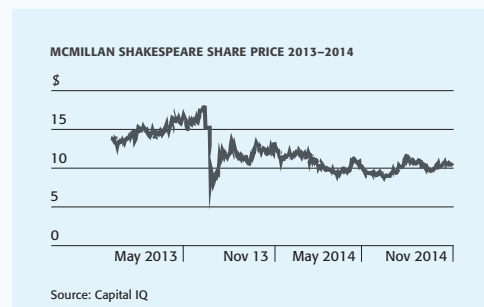
To earn a major part of its revenue salary-packaging company [McMillan Shakespeare](#) relies on a single tax loophole for public health sector employees. As research director Nathan Bell wrote in early 2013, 'Selling on a price to earnings ratio of 20 and more than 40 times operating cash flows, it would take one swipe of the legislative pen for those profits to disappear.'

Former analyst Gareth Brown put it another way; 'While most of us might merely hope they don't do anything else dumb in Canberra, shareholders of McMillan Shakespeare rather hope the Federal Government doesn't do something intelligent.'

In July 2013, the Federal Government broke with all precedent and did do something intelligent, signaling its intention to close the tax loophole on which McMillan's business was based. When the trading halt was lifted the company's shares promptly halved.

The incoming Abbott Government restored the loophole and in so doing confirmed the Australian electorate's long-

standing view of its leaders. But the company's shares have yet to breach \$18, the price at which they traded before Rudd made his announcement. Investors are now well aware that a significant part of this company's business is a one-trick pony.



What makes a good short seller?

'Short selling is un-American. It is done by rogues, thieves, and especially pessimists, who are, or course, the worst of the lot. It is a terrible, terrible thing and must be stopped in our lifetime.'

– Foreword to *Short Selling: Strategies, Risks and Rewards*, by Dr Fabozzi

Most investors aren't cut out for it, a fact soon realised when faced with their first short-squeeze. As a profession, this is a lonely, divisive activity that rankles powerful interests. Some even call it immoral. To do it well requires some formidable skills.

Translated into more than 100 languages, Hans Christian Andersen's [The Emperor's New Clothes](#) tells of a vain emperor who recruits two conniving tailors to make him the finest suit of clothes.

After a few weeks, the tailors are ready for the fitting and the court gathers for the unveiling. Of course, there are no clothes – the tailors fake the fitting to make more money – but the courtiers, in thrall to the emperor and concerned for their court standing, succumb to the pretense. Their compliments encourage the emperor to succumb to vanity. He discards the niggling doubt that all is not well as he bathes in the cooing of the crowd.

A procession through town follows. His subjects, eager to earn favour with the emperor, express their awe. Only when a child shouts, 'The emperor has no clothes' does the self-induced fantasy collapse and bare reality descend.

Rightly or not, no one likes a party pooper. When a company's share price is rising, when brokers, investment bankers and investors are making a killing and the media have plenty to write about, anyone that calls time on the fun is looking for trouble.

Short selling makes trouble, something Jim Chanos knows only too well. Humans are herd animals and short selling, as with value investing, requires not only an exit from the crowd but, in the case of Chanos, a vociferous denouncing of its views.

Most investors aren't cut out for it, a fact soon realised when faced with their first [short-squeeze](#). As a profession, this is a lonely, divisive activity that rankles powerful interests. Some even call it immoral. To do it well requires some formidable skills.

1. GUMSHOE FUNDAMENTAL RESEARCH

Chanos has been called a 'fundamental short seller' with an instinct for bad behavior and a gumshoe attitude towards uncovering it. The process is exactly the same as it is for a value investor looking to go long, except Chanos is looking for the reverse; excessive rather than cheap prices; crooked rather than straight management; ailing rather than sound business models.

In that sense, there is very little difference between the techniques Chanos uses to identify over-priced stocks and those value investors use to find cheap ones. Poring over annual reports and company filings, paying attention to what Phil Fisher calls scuttlebutt and being open to alternative opinions, are the hallmarks of a value investor and fundamental short seller.

2. RESOLUTE, BRAVE INDEPENDENCE

In [The Big Short](#), Michael Lewis depicts the character types that made money from the Global Financial Crisis, shorting the banks and building stocks that had skyrocketed on cheap credit and asset bubbles. They were outsiders with a healthy dose of eccentricity and quirkiness that allowed them to see the world free from received convention.

Chanos may not be the socially awkward, 'on-the-spectrum' archetype but there remains something of the outsider about him, despite his Yale heritage and media omnipresence. Once a member of the Pipefitters and Boilermakers Union, Chanos was perhaps the only Wall Street insider to publicly support the Occupy Wall Street movement.

At the age of 24, inexperienced but resolute in his view, he publicly contradicted Wall Street's received wisdom on Baldwin-United. Two years later and contrary to the wishes of his superiors, he called darling stock Drexel Burnham Lambert a sell. He is regularly attacked in the media and threatened with law suits.

Very few people are willing to take such risks with their career. Chanos has made a career out of it.

3. A MIND OPEN TO BEING WRONG

One of the traps of being an outsider, especially one with opinions that are frequently verified as being correct, is the self-reinforcing nature of being contrary. It is easy to be seduced into the idea that the crowd is frequently wrong and that taking a position contrary to received wisdom is almost always the right one.

Chanos doesn't make that mistake. As friend and *Grant's Interest Rate Observer* publisher James Grant says, 'really successful investors, including Jim, make it a point to be open-minded and seek out opinions, all in the interest of knowing everything they can about a situation.'

Chanos regularly invites other Wall Street analysts to present their views on stocks that may be in conflict to his own (and no doubt also to convince them of his own views if he disagrees with them).

Although comfortable with being an outsider holding opinions not widely shared, he doesn't fall into the trap of thinking conventional wisdom is axiomatically wrong. Genuinely independent thinking should be based on well-reasoned, fact-based research and nothing more. Chanos knows that the popularity of a view, or its opposite, carries little weight.

4. A TOLERANCE FOR FINANCIAL PAIN

One of the reasons why so few investors short sell is the heightened potential for loss. Long investors can only lose the amount initially invested while the potential gain is theoretically limitless. For short sellers the opposite applies. They can make no more than 100%, (assuming they don't use leverage), but potential losses are limitless, especially when the borrowing and dividend costs are included.

Remember how Baldwin-United's stock doubled after Chanos first recommended it as a short sell? Some of his clients probably faced the dreaded short squeeze, where rising prices pressure short sellers to abandon their positions to avoid the prospect of ever-ballooning losses.

The management of companies under attack know this dynamic. They often hire lawyers and run media campaigns of their own to refute the arguments and force a short squeeze. Indeed, in the aftermath of the GFC Macquarie Bank had the ultimate victory and successfully lobbied the government to [temporarily ban short selling altogether](#).

Even if the shorter's view may be eventually vindicated, substantial financial and emotional resources are required to see such a battle through.

To many, this imposes an intolerable psychological and financial burden. To Jim Chanos, it's all part of the game. As he says, 'that's the \$64 million zillion dollar question on the short side. If we could time these things perfectly, there'd be no fun in the process.'

Chanos himself recognises his unusual mindset. 'Good short-sellers have something in the DNA', he says, 'or maybe we were dropped on our heads as babies.'

5. AN ABILITY TO WORK THE MEDIA

If the great threat to a successful short is a rising stock price over the short term, an obvious question arises: Why not do something about it? To reduce the risk of a short squeeze, short sellers will frequently try and talk down a stock's price, a technique for which Chanos has built a deserved reputation.

So-called 'activist short-selling' is a matter of some controversy. For some reason, it's quite acceptable to have entire sectors – including the media, public relations, investment banks and stockbrokers – talk stocks up, but as soon as the case for an over-priced stock is made public there's hell to pay.

A major shareholder in Home Owners for example, a stock once shorted by Chanos, said that 'these people rape the system.' Then there was the *Wall Street Journal* article that called short sellers 'an evil cabal.'

As Chanos said in 1985, 'people think I have two horns and spread syphilis.' He shrugs off the criticism and gets on with the job of cultivating media contacts that are

receptive to his views on a stock. Bethany McLean at Fortune is a case in point. Her story [Is Enron overpriced?](#) was critical to drawing a higher level of scrutiny to the company and its management.

The company would have collapsed at some point but without that article, Enron's stock price may have continued to rise to the point where Chanos was short squeezed. To the activist short seller, getting media coverage isn't just good public relations, it's an essential part of risk management.

There's another aspect to Chanos' famed media persona. The detective work necessary in finding a good short mirrors the work demanded of an investigative reporter. It's possible that people like McLean see something of themselves in Jim Chanos, and vice versa. That makes for an enduring, trusting relationship that Chanos has leveraged to his advantage.

Indeed, James Grant has said that Chanos would have made a good investigative reporter, 'if only journalism paid as little as \$25 million a year.'

6. A TOLERANCE FOR STRESS

From company management and investment bankers, to media commentators and regulators, short sellers upset a lot of powerful, moneyed people. That's a difficult psychological environment in which to make the kinds of decisions required by short selling. In an interview with James Grant, Chanos explains the challenges:

'Most human beings perform best in an environment of positive reinforcement. We like to be told we are smart, we're on the right track, we're doing the right thing, and that the stocks we bought are cheap and are going up and that their earnings are going up as well... almost everything is positive.

'Wall Street is a giant positive reinforcement machine. That's why it exists. If you're a short seller, you're coming in everyday, and out of fifty names in your portfolio, you can count on ten names where there will be some noise. Stocks recommended, re-recommended, earnings estimates raised, CEO on CNBC; whatever it is, you'd be facing that noise. And, a lot of very good value managers completely break down when confronted with the fact they have to invest against the grain in front of all that noise.'

The best short sellers I know have an innate ability to drown out the noise – to not let it affect them. They use the noise to their advantage; they don't let it get to them. I tell managers, find out who you are first and then you'll find out whether or not you'll like the short side. Some of the very best value managers, with terrific long-term records, are the worst short sellers I have ever seen. Again, it comes back to investment psychology.'

“Good short-sellers have something in the DNA”, he says, ‘or maybe we were dropped on our heads as babies.

Sizing up the big shorts of Jim Chanos

'The last command economy that saw this kind of growth was the old Soviet Union and what happened was there was a lot of misallocation of resources. China's heading the same way'

– Chanos on China

In recent years, Jim Chanos has moved from shorting large, well known companies to entire countries. His most commonly known short positions are China and many Brazilian stocks.

Illustrating the difficulty and dangers of shorting, Chanos has been short Chinese banks and property developers from around 2010, claiming on CNBC that, 'bubbles are best identified by credit excesses, not valuation excesses. And there's no bigger credit excess than in China.' With an eye on a media-friendly headline, Chanos warned that the country was on a 'treadmill to hell'.

As it turned out, the China treadmill was moving very slowly. The Chinese sharemarket was down about 40% since 2010 until recently increasing 25%. The path to a successful short can have many bumps along the way.

Now, after four years of banging the drum, vindication beckons. The incredible US\$1 trillion stimulus program that the Chinese embarked upon after the GFC may be the source of the excess credit that Chanos seeks out, but the recent plunge in credit expansion may be the trigger that brings the house down (for the full barrel, 'China's doomed' argument, check out [this Chanos presentation](#)).

There's an acknowledged glut in property with many developers struggling to sell apartments at prices far lower than a few years ago. According to Bloomberg, 'in 20 large Chinese cities, the inventory of unsold new homes was the equivalent of more than 23 months of sales in June [2014]'.

Production is falling, government stimulus is losing traction and the fight against corruption is causing money to flood out of the country, which is why Chanos is short China.

Still, getting direct, short exposure to Chinese stocks is challenging. Foreign investors are forbidden from investing directly in Chinese stocks so Chanos uses the backdoor.

Australia once again is a particular focus. As he told the *Sydney Morning Herald* in May 2014, 'we are long on BHP and Rio because we think they are reasonably managed. They saw this [iron ore over-supply] coming and pulled back a couple of years ago whereas you have companies like Fortescue and Vale that are full speed ahead'.

No doubt Kerry Stokes would be aware of Chanos' short position on Caterpillar, which he called his best investment idea of 2013. The company made huge sums selling mining equipment to companies supplying China's

resources boom. With that boom at an end, Chanos sees stocks like Caterpillar and Fortescue as good China-orientated shorts.

Another way through the back door to a China collapse is the art market. In May of this year Christie's held a contemporary art auction that broke sales records. Chanos took that as a sign. 'Usually, when the art market starts to get silly, it's time to be out of Sotheby's.'

STAY HUMBLE

Despite lightening his position recently in Petrobras, Brasil's national oil company, he's still shorting the company's debt and equity, saying that the 'company exists to serve the state' and remains short 'on a lot of things in Brazil'. He has also recently described national energy companies as 'giant ATM machines' for national governments, which, if you look at local government-owned energy companies, has a ring of truth about it.

Chanos also recently laid a bet against Valeant, Canada's largest pharmaceutical company, which recently failed in its US\$50bn bid to take over Allergan. In May of this year Chanos told *Financial Post* that, 'the only people who are more negative about Valeant than maybe me are Valeant insiders.' Six senior executives had recently left the company, with the executive vice-president of corporate and business development, who also offloaded his stock, the most notable.

More conventionally, Chanos has recently taken long positions in Valero Energy, Dr. Pepper Snapple Group and Palo Alto Networks, all US-listed companies.

Obviously, there's a great deal of skill in first uncovering short-selling opportunities and then seeing them work out. Still, many investors are seduced by their own brilliance when things are going well. Not Chanos, who has said:

'A lot of what happens in your life is merely serendipitous and really just luck. In a lot of ways, that's the lens through which I look at my own career. If the McDonald's share buyback episode hadn't occurred, maybe I wouldn't have left Blyth and I'd probably still be doing deals and be miserable. To join a new firm and to have the first company I look at turn out to be an enormous financial fraud was equally good luck.'

The message, really, is to stay humble. You'll make more and lose less money that way.

According to Bloomberg, 'in 20 large Chinese cities, the inventory of unsold new homes was the equivalent of more than 23 months of sales in June [2014]'.

Analysts' shorts – The top picks

'I'm terrified by the idea of unlimited losses and don't recommend this investment tactic to anyone except the most experienced, sophisticated and wealthy investors.'

– Greg Hoffman, former research director

Research director Nathan Bell set the tone for this exercise, one of fun and interest rather than money-making possibility; 'All the resources (and related) companies have already been pummeled, leaving the cupboard bare. If no one else picks **Fortescue Metals Group** then maybe I can change to that.'

No one did pick Fortescue, a [famed Chanos short](#), but we didn't allow him to go with it anyway. As this special report makes clear, shorting isn't just about valuation. Some of the stock commentary that follows reveals the inherently 'long' nature of those making it. As Nathan says;

The best shorts are based on fashion, fads and frauds, and not, as many think, high valuations. Shorting stocks only because of their high valuations is risky because theoretically there's no limit to how high animal spirits can take a share price.

'The best shorts are based on fashion, fads and frauds, and not, as many think, high valuations. Shorting stocks only because of their high valuations is risky because theoretically there's no limit to how high animal spirits can take a share price. Expensive companies also regularly get taken over at even higher prices.'

Chanos might agree with that. It's also crucial to remember that not one analyst participating in this exercise has ever shorted a stock. This is an intellectual exercise that forces investors forever focused on valuation to do what has never come naturally, purely for the reader's enjoyment. It's cruel, of course, but also makes a point about the difficulty in successfully shorting stocks.

Nathan did suggest [Freelancer](#), a 'business that may not have legs', also suggesting the pool of recent private equity floats might be 'a good place to fish for shorting opportunities'.

James Carlisle's comments were of a similar vein, saying that 'I don't short shares and never would'. His reasons are two-fold. First, over the long-term shares should outperform cash, 'so shorting is a bit like trying to push water uphill'. But secondly, 'the risk asymmetry works against you – your upside is limited but your potential downside is (almost) infinite.'

Nevertheless, he picks **Qantas** as a clear winner, noting [Warren Buffett's view](#) that the airline industry has made net losses since Orville and Wilbur Wright took to the skies over Kitty Hawk in 1903. The reasons – large upfront investments, long investment lead times and a crazily competitive industry – are unlikely to change.

James notes that 'the risk is that Qantas is able to extract the value of its frequent flyer business. That may be worth as much as \$3bn, but it's still comfortably below Qantas's market capitalisation of \$4bn. I wouldn't ascribe much value to the rest of it.'

Graham Witcomb nominates **Unilife**, a U.S.-based but Australian-listed developer of advanced drug delivery

systems. Graham claims 'it has the most promotional management I've ever seen,' which is quite a call.

Management-uttered phrases like 'explosive growth opportunity' followed by 'you can't make this stuff up' had Graham reaching for the smelling salts at a company presentation earlier this year.

Unilife hasn't turned a profit in more than a decade and continuously needs to raise capital. But the real danger Graham sees is net debt, which has grown from US\$5m in 2011 to US\$54m today.

What's more, Unilife has requested that it be allowed to omit certain [covenants on its loans](#) from public filings. This makes it impossible for investors to assess whether the company is approaching default. Maybe that was the point, who knows?

With more liabilities than assets, the stock would be next to worthless in the event of bankruptcy. As Graham says, 'priced at just 24 times *revenue* ... you can't make this stuff up'.

Jonathon Mills nominates a company on which many shorters have been burned – Amazon. He accepts that, too, acknowledging the company 'has been overvalued for about a decade yet anyone shorting it during this period has lost their shirt.'

Has anything changed? Well, yes. David Einhorn, founder of Greenlight Capital, a 'long-short value-orientated hedge fund' and, like Chanos, a great a short seller, has recently hinted he's short Amazon.

The traditional argument proposed by Amazon bulls and CEO Jeff Bezos himself is that profit has been sacrificed for growth. By and large, Wall Street has bought that argument. Einhorn and others are now questioning it.

Since 2009 Amazon has more than tripled revenue yet its operating income (using the last 12 months to 30 Sep 14) is 1/10th of what it was five years ago. Growth has slowed but instead of growing profits, Amazon is now making losses.

Unless Amazon can cut costs, its other option is to raise prices. And yet the company's entire *raison d'être* is to lower the prices of books and electronic goods below that offered by competitors. Price rises will therefore reduce or eliminate its competitive advantage.

Here's Jon on the matter: 'Already down around 20% this year, assuming (very generously) that it can turn things around in 2015 and make \$0.66 per share as it did in 2013, that's still a PER of 479.' Wow, that's some multiple but there's that thing about valuation again.

Former research director Greg Hoffman only focuses on Australian stocks and, like other members of the team, has never shorted a stock. Initially looking at well-known lower quality businesses battling away in areas like commodities, airlines and steelmakers, he settled on a (now) tiny mining services company named **Delta SBD**.

But he clearly struggled with the decision, saying, 'It's not pleasant to pick a company obviously struggling for survival, one which employs hundreds of people that must have a considerable level of stress about their job security.'

The facts are plain enough. The company operates in the coal industry. Its clients are facing enormous pressure from lower prices, pressure that is inevitably passed down the line to suppliers like Delta SBD.

A cash balance of \$5.9m at the start of the financial year had been whittled down to just \$1.0m by 30 June, 2014. That figure was dwarfed by \$15.1m of debt, \$9.7m of which was due in the current financial year. The company is trying to sell off equipment to stay afloat and Greg wishes 'it all the best'. But if I had to be short one stock, 'this would be it.'

The final short pick is a withering, acerbic rave from Gaurav Sodhi. We publish it here in full so you can get the full sense of its fury.

G8 Education is in a fast growing industry with high levels of demand, high levels of regulation and plenty of projected growth. It also has a poor business model and a silly valuation.

G8 owns a collection of almost 300 child care centres and employs an aggregation strategy. It buys independent centres and rolls them into its own network. The stock has enjoyed enormous success over the past three years, having five-bagged. This year alone it has doubled. That should not blind anyone to the nature of this business.

There are few, if any, synergies from owning multiple child care centres. Staff numbers are regulated and centres

themselves aren't scalable. You can't funnel more children in without increasing costs and you can't share costs (apart from head office).

There is no one brand name to build or operating leverage to exploit. G8's entire strategy is to buy unlisted childcare centres at an EBITDA multiple of around five and roll them into one entity that it can sell to shareholders at a far higher multiple.

It creates no value and does little more than engage in 'multiple arbitrage', taking advantage of the fact that listed businesses are valued more highly than unlisted ones. What a cynical, crappy way to make money.

Earnings have been going up, say the bulls. Well, duh! By buying childcare centres G8 has increased its asset base from \$40m in 2009 to almost \$800m today. Of course this will lift earnings.

But look at the rate of return on those assets - just 7%. This figure will surely come under more pressure, too, because this is a model easily replicated. Indeed, ABC Learning Centres used the same strategy. Newly listed peers like Affinity Education Group are now capitalised to compete with G8.

Unfortunately, the entire growth rationale is predicated on continuing the acquisition spree, which means there is a strong incentive to overpay for child care centres. Expect acquisition prices to increase and return on assets to fall.

Over the past five years, G8 has generated about \$120m in operating cash flow and has made acquisitions of almost \$500m, mostly funded with debt.

Investors are currently paying 39 times earnings for a poor quality business facing growing competition and potentially falling returns. This business should not be worth any more than the sum of the acquisitions G8 has made. And yet it trades at almost four times net asset value. I see no reason for the premium. G8 is a poor business at a lousy price and a perfect short candidate.

Investors are currently paying 39 times earnings for a poor quality business facing growing competition and potentially falling returns. This business should not be worth any more than the sum of the acquisitions G8 has made. And yet it trades at almost four times net asset value.

MORE ON JIM CHANOS AND SHORT SELLING

- **John Hempton, Bronte Capital** - Australia has its very own famed short seller, John Hempton of Bronte Capital, who started out on his own after leaving famed local fund **Platinum Asset Management**.

For an anatomy of his short positions, check out his [blog](#), especially for detailed discussions on Herbalife. This stock divides value investors and Hempton has some interesting points to make on it. He also covers Chanos short Valeant, with his most recent post on the stock including the words 'chanelling Jeff Skilling'. That's a name you may remember. You may also want to listen to our [Stocktake interview with John](#).

- **Kerrisdale Capital** - This is a US-based value outfit investing in 'special situations' that often takes short positions. The company doesn't hold back once it's found one. Echoing Graham Witcomb's short pick earlier, Kerrisdale is short local (But US-listed) retractable syringe stock Unilife, believing it to be 75% overvalued, as of December last year. And here's the opening line to their research on Globalstar: 'We are short shares of Globalstar, Inc. (GSAT), a company whose equity value, we believe is worthless, in contrast to their \$4 billion-dollar market capitalization.' Or try this regarding ChinaCast Education: 'We believe that ChinaCast Education Corp. (CAST) is misrepresenting itself in its SEC financial statements. Our 40-page report explaining our short thesis for CAST is [available here](#).' The direct and frank flavour of the commentary is highly refreshing.
- **The New House of Money** - Author Steven Drobny's detailed interview with Jim Chanos from his forthcoming book is available as a preview at [marketfolly.com](#). Worth checking out and quoted extensively in this special report.
- **Riders on the Storm - Short Selling in Contrary Winds** - This 2006 paper by Ben Wakefield, again used in this special report, provides a very useful, evenhanded insight into the minds of short sellers like Jim Chanos. Part four, covering the traits of excellent managers, is especially recommended.



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