Lessons From a 15 Years of Short Selling

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12 Reasons Not to Short (1)

(Excerpt from Chapter 11 of More Mortgage Meltdown)

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Shorting looked easy in 2008, but in reality it's a brutally tough business. In many ways, it appears to involve nothing more than applying the same analyses one uses when determining whether to buy a stock: on the long side, investors generally seek companies with good management, strong growth, high margins and returns on capital, little or no debt, clean balance sheets, and sustainable competitive advantages – all at a low price. Conversely, short sellers look for weak or dishonest management, low or negative growth, margins and returns on capital, high and increasing debt, accounts receivable and inventory, and weak competitive advantages – all at a ridiculously high price.

But shorting is not simply the opposite of long investing. It's much harder and more dangerous for a number of reasons:

1. Your upside is capped and your downside is unlimited – precisely the opposite of long positions. When shorting stocks, you could be right 80% of the time, but the losses from the 20% of the time that you're wrong could exceed the accumulated profits. Worse yet, a once-a-century storm such as the internet bubble might wipe you out entirely. If there's even a 1% annual risk of such an event, that tiny risk translates into a 39.5% chance of the freak event occurring over 50 years.
2. To prevent such an occurrence, most short sellers use stop loss limits, meaning they will start covering the short if it runs against them a certain amount. This means short sellers not only have to be right about a stock, but also about the timing. If a stock rises significantly, many short sellers will lock in losses, even if they are later proven correct.
3. In order to short a stock, you first must get the borrow from your broker, who has the power to call in the stock you've borrowed at any time – or, worse yet, buy stock to cover for you. Brokers are most likely to do these things if the stock is rising quickly, and they're probably doing it to other short sellers as well at the same time, so all of this buying pressure can cause a stock to rise even further, triggering even more covering. This vicious cycle is called a "short squeeze" and it isn't pretty – we can show you the scars on our backs.
4. Shorting has gotten much more competitive. There are now a few thousand hedge funds (and who knows how many individual investors) looking for the same handful of good shorts, in contrast to a few dozen a couple of decades ago. This results in "crowded" shorts, increasing the odds of a short squeeze.

12 Reasons Not to Short (2)

(Excerpt from Chapter 11 of More Mortgage Meltdown)

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5. A short squeeze can also be created if the "float" – the number of shares that trade freely – is suddenly reduced. Such a case occurred in October 2008 when Porsche, which owned 35% of Volkswagen, unexpectedly disclosed that it had raised its stake in Volkswagen to 74.1% through the use of derivatives. The German state of Lower Saxony, where Volkswagen is based, owns 20%, so that left a float of only about 5% of VW shares on the market. Three popular hedge fund trades had been to short VW based on weakening car demand, go long Porsche and short out its ownership of VW to "create" only Porsche, or go long VW preferred stock and short the common stock, betting on relative underperformance of the common. In any case, for whatever reason, nearly 13% of all VW common shares were short, so moments after Porsche announced its higher stake, the mother of all short squeezes ensued and the stock instantly quintupled from $200 to over $1,000, momentarily making VW the most valuable company in the world. This was extraordinarily painful for many shorts.
6. Short sellers used to earn interest on the cash they held while they were short a stock, but this has all but disappeared due to low interest rates – and brokers even charge "negative rebates" on hard-to-borrow stocks, meaning that short sellers have to pay 5%, 10%, 15% or more in annual interest to get the borrow.
7. The long-term upward trend of the market works against you (yes, believe it or not, markets used to go up most of the time).
8. Gains are taxed at the highest, short-term rate.
9. It generally requires many more investment decisions, thereby increasing the chances of making a serious mistake.
10. It's a short-term, high-stress, trading-oriented style of investing that requires constant oversight.
11. Mistakes hurt your portfolio more as they compound. If you make a mistake with a long position, it becomes a smaller percentage of your portfolio as it drops. A mistaken short, however, grows larger as it appreciates.
12. If you go public with your short thesis, a company can attack you in many ways: file a lawsuit (Fairfax), complain to regulators (who occasionally investigate) (MBIA, Farmer Mac), tap your phone (Allied Capital), etc. Also, expect to get flamed on message boards and in the media. Many people view short selling as evil and un-American.

Conclusion (in 3/09): "we'll again repeat that, especially in this environment, **for most people, we think shorting stocks is a very bad idea**."

Carnage in the Short Sector in 2013

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- Viewing shorting as insurance is fine – as long as it's cheap
- But at times it's not cheap – in general, there's been carnage in the short sector since the market bottom March 9, 2009
    - 2013 was especially bad – a once-every-10-to-20-year storm
- Some short-only funds have closed
- Some hedge funds have launched long-only funds
- Many hedge funds have reduced their short exposure, often substantially (myself included)

What Short Sellers Were Saying During the Melt-Up of 2013

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- "Being bearish in the bull market has been, thus far, a mug's game and a hedge against profits." – Doug Kass
- "We've also taken our lumps this year on the short side (and since March 9, 2009) so we know how you feel. For what it's worth, we agree that this is the best environment to find shorts and we are seeing some incredible opportunities. We haven't seen a variance like this between our longs and shorts since early 2008. So, while I feel like I'm covered in battle wounds and have blood dripping out of my eye balls at the end of each day, I am confident we will be rewarded for staying the course." – A friend
- "I don't have the antidote to your pain. We've been bludgeoned by this melt-up as well. It's unbelievably unpleasant. I've never seen such widespread capitulation among seasoned short sellers. Many are out of business. This stretch is worse than the internet bubble for me. It's constant pain across my entire short book, whereas the internet was isolated to one industry – and then you got relief when the bubble burst." – Another friend

Nine Reasons to Short (1)

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1. If you're *very* good at it, you can make money over time.
2. Having a short book allows me to invest more aggressively on the long side, both in terms of overall portfolio positioning, individual position sizes, and willingness to take risks in certain stocks. Here are some examples:
   - I wouldn't be comfortable taking my fund's long exposure up to 100% at times without meaningful short exposure;
   - I wouldn't have held onto my position in Netflix as it rose from just above $7 to over $60 in less than two years from late 2012 to late 2014 (it's now approaching $150) if my fund hadn't been short a number of similarly volatile, speculative stocks;
   - I would feel less comfortable owning economically sensitive stocks today like CSX (railroad), Howard Hughes (housing/real estate), Platform Specialty Products (chemicals), and Spirit Airlines if my fund weren't short many stocks that I expect would do very poorly if the economy weakens.

Nine Reasons to Short (2)

3. A short book typically pays off just when you need it most, during severe market declines, providing cash – and the psychological boost – to invest aggressively on the long side when it's most attractive. It also stems investor redemptions, which is effectively another source of cash.
   - This is exactly what happened to me in 2008 and early 2009. After inflicting losses as the market rose from early 2003 through October 2007 (the same length of time as the current bull market), my substantial short book cushioned the downturn – my fund was down approximately half the market in 2008 – and allowed me to invest aggressively on the long side, which translated into big gains after the market bottomed in March 2009.
4. I sleep better at night with insurance. At the beginning of every year, I write a check for homeowner's insurance and at the end of the year, when my apartment hasn't suffered from a flood or fire, my insurance expires worthless and I have to buy it again. Is it a mistake to buy insurance that turns out to be worthless almost every year? Of course not.

Nine Reasons to Short (3)

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5. The psychic rewards are enormous:
   - Shorting is much more contrarian than buying an out-of-favor stock
   - It's incredibly interesting and entertaining thanks to the preposterous lies and incredible cast of characters you encounter – shysters, crooks, charlatans, promoters, etc.
   - It feels good to bet against these cretins
   - For all these reasons, making $1 on the short side is much more gratifying than making $1 on the long side
6. Developing the mindset of a short seller has been very valuable: extreme skepticism, knowing where to look for bombs on a balance sheet, etc.
7. It puts me in the flow of short ideas, so I often hear/read about problems with companies whose stocks I'm long (or considering going long), which has saved me from some blowups/value traps.
8. It keeps me occupied so I'm less likely to do stupid things with my long book like sell a winner or get impatient and sell a stock right before it jumps.
9. Most investors expect hedge funds to have a short book.

In Late 2014, I Had Conflicting Thoughts on Shorting

I had two strong feelings about shorting in late 2014:

1. It's a horrible business, it had cost me (and my investors) a fortune over the previous 5½ years, I wished I'd never heard of it, and every bone in my body wanted to cover every stock I was short and never short another stock again; and
2. In my 15+ years of professional investing, the only other times that had been as target-rich in terms of juicy, obvious shorts were late 1999/early 2000, late 2007/early 2008 (and we all know how those ended…). My bottoms-up research was, on average, uncovering a great new short idea every *day*, but only one great new long idea every *month*

So which feeling did I follow? I wasn't sure, but this I knew: the only other time I'd felt like covering every short and becoming a long-only manager was October 2007. At that time, I went through my short book, stock by stock, and said, "OK, am I willing to cover MBIA at $70? Hell no, not a single share! Allied Capital at $30? Hell no, not a single share! Farmer Mac at $30? Hell no, not a single share!" And on it went… I couldn't bring myself to cover a single share of any stock I was short – they were all "trembling-with-greed" shorts.

And that's exactly how I was feeling then. I looked at the stocks I was short – all of which I thought were absurdly overvalued and sure to collapse – and felt strongly that covering them would be the most boneheaded capitulation trade of all time.

That said, unlike in 2007, I didn't have the same foreboding feeling that there was a good chance that the world would fall apart in the next year or two, which made being short that much harder…

I Eventually Decided to Cover 80% of My Short Book

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- Over the 13 months from Q4 2013 through October 2014, though the market was up 22.6%, my short book generated nearly four percentage points of return
- But as a one-person operation (I don't have even one analyst), managing 50+ short positions it was sucking up a large amount of my time – and time is my most precious commodity
- Investing on the long side is fundamentally a much, much better business than shorting, and historically I have made nearly all of my profits here, so I came to the conclusion that I should focus the vast majority of my energies going forward on finding a small number of great long ideas that will drive superior returns over time
- I was looking for an opportune time to execute on this plan and fortunately the market cooperated: I took advantage of the turmoil in late September and early October 2014 to shrink my short book to only eight active positions (now 10) and 17% exposure (now 19%)
- This was not a short-term market call. While there will likely always be room in the portfolio for a handful of my highest-conviction short ideas, I anticipate that fewer than a dozen positions and less than 30% exposure on the short side will be a permanent state of affairs
- This means I will have to pick even safer, higher-return stocks on the long side – but that's a challenge I willingly accept
- While there will no doubt be times of market turmoil when I'll miss having a big short book, I'm certain that this strategy will pay off in the long run

What's Happened Since Then?

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- I have had my best year ever on the short side in 2015, with the exception of 2008, despite having low short exposure
  - I made ~9 percentage points of return in a up market (+1.4% for the S&P), led by Lumber Liquidators, but also with major contributions from Exact Sciences, World Acceptance, Unilife and a levered biotech ETF
  - I would have made even more money had I not covered 40+ short positions in 2014
- So did I make a mistake?
- No. The reasons behind my decision were sound and things have played out as I expected them to (except for my long book doing so poorly!)
- I lost ~5 percentage points of return on the short side in 2016 (in a +12% market)

Sources of Good Short Ideas

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- Other short sellers
  - Build relationships and networks, and swap ideas
- Attend investing conferences
  - Robin Hood Investors Conference
  - Ira Sohn Conference
  - Value Investing Seminar (in Italy every July)
- Value Investor Insight
  - Go to www.valueinvestorinsight.com/freetrial for a free trial
- ValueInvestorsClub.com
  - Can access ideas as a guest with a 30-day delay
- Activist Shorts Research (www.activistshorts.com)
- Seeking Alpha
- SumZero
- Citronresearch.com
- Stock screens
- Newspapers, magazines, business television

Try to Match Long and Short Positions

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- If you're going to run a big short book (50%+ exposure), try to match long and short positions
  - There's a serious mismatch between a long book focused on large-cap blue-chips like Berkshire Hathaway, AIG, Procter & Gamble, Microsoft, and ExxonMobil, and a short book focused on smaller, more volatile, heavily shorted and/or battleground stocks
  - These stocks tend to be the most overvalued and have the potential to fall the furthest – often 100% – but they can also rise the most during periods of excess liquidity and complacency (like today)
  - Owning riskier/volatile/heavily shorted stocks like Netflix, Sodastream and Deckers can balance the pain on the short side
  - If you have a large-cap, low-beta long book, look for large-cap, low-beta shorts (e.g., IBM)

Stocks Usually Follow Earnings

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- Even the most well-publicized, airtight case that a company is, for example, committing blatant accounting fraud, bilking its customers, is dangerously underreserved and overlevered, etc. is usually not enough to cause the stock to decline materially
- As long as a company continues to report growing earnings, it's generally safe to assume that its stock will continue to rise as well
- Historical Examples: Allied Capital (David Einhorn) and MBIA (Bill Ackman)
  - Bill Ackman published a devastating 66-page report on 12/9/02 entitled *Is MBIA Triple A?* and in subsequent years he continued to warn investors, ratings agencies and regulators about the company and the danger it was causing to the financial system
  - But nobody cared as long as the company continued to report strong earnings, so the stock doubled – until the financial system collapsed, as did MBIA's earnings and stock price

Beware of the "Beat N' Raise" Game

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- Be careful of companies successfully playing the "beat n' raise game"
  - Every quarter they beat their earnings estimates and raise guidance
  - There is no price a stock can't soar to, especially if it's a high-quality business
  - Conversely, for a company missing and lowering, there's no price the stock can't drop

Be Patient

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- Be patient
  - I've been reasonably successful over the years in being able to identify hugely overvalued stocks, but have been less successful in getting the timing right
  - In such cases, I correctly foresee what's going to happen in a year or two, but highly promotional management, as always cheered on by Wall St., dupes investors into ignoring huge red flags – and the stocks run up a lot in the short term
  - I've certainly gained a greater appreciation for the power of short-term stock price momentum so I make an effort to be patient, stay out of the way of freight trains on the way up, and do what the best short sellers do: make money by adding to shorts that are working on the way down
  - Examples:
    - Lehman Brothers
    - Crocs

Look for "Titanics"

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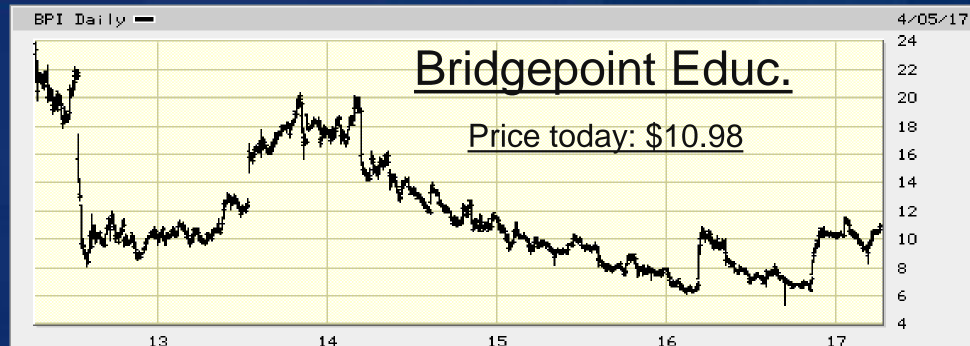
- "Titanics" are stocks that suffered major wounds, but the market didn't fully appreciated the implications for some time, so there was plenty of time to short before the collapse



Look for Obvious Bubbles (1)
Examples: 3D Printing

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- There's always room for obvious bubbles
  - But size them small!

Look for Obvious Bubbles (2)
Examples: Alternative Power Promotions

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Look for Obvious Bubbles (3)
Examples: SaaS/Internet

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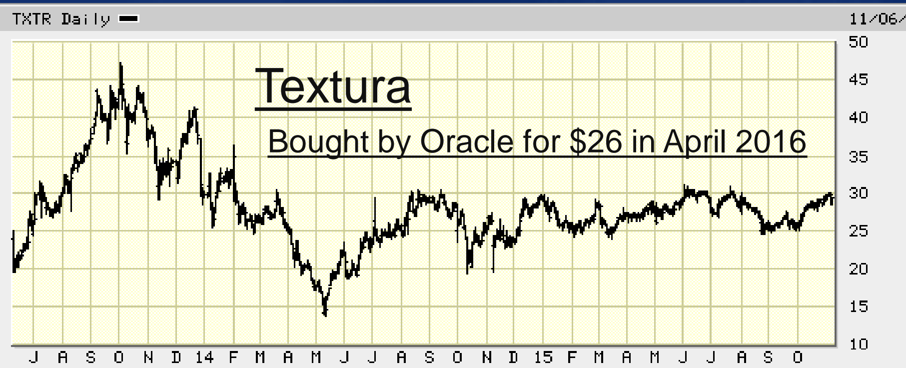
- Look for third-tier, me-too players



Look for Obvious Bubbles (4)
Examples: Biotech/Pharma

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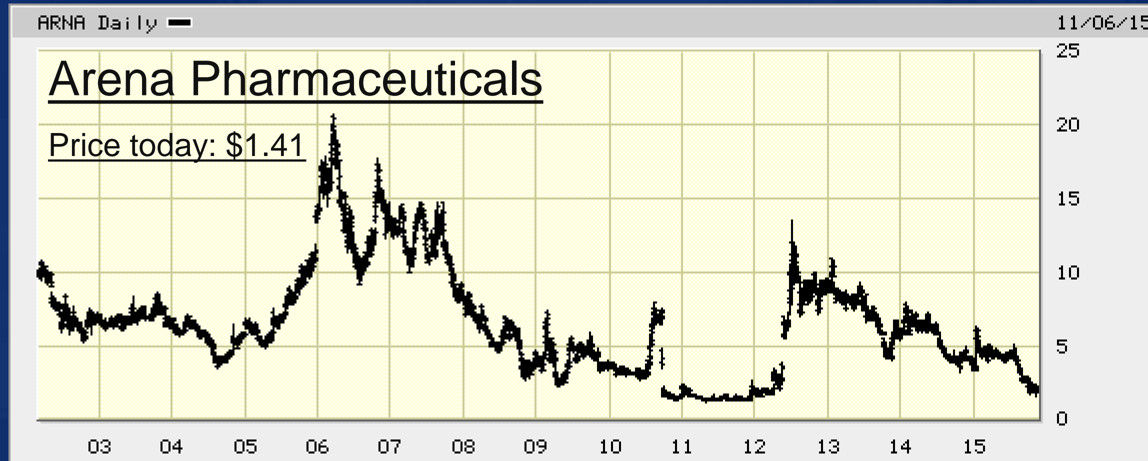
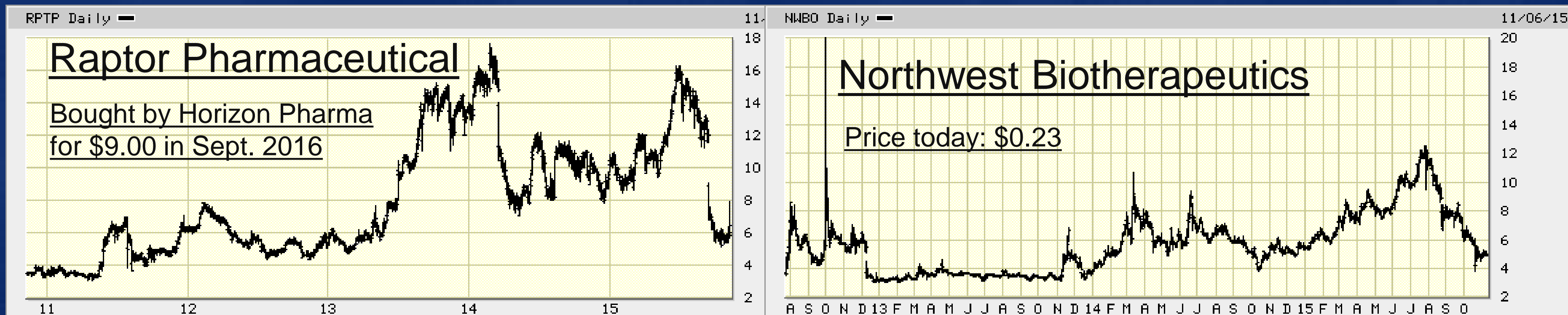
- Look for third-tier, me-too players





An Obvious Bubble in Mid-2015: Biotech

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- I prefer to just short an ETF like IBB or, better yet, a 3x-leveraged ETF like UBIO

Conclusion

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- Shorting is a *very* difficult business
- Size positions small
- Balance long and short book
- Be patient
  - Stocks tend to follow earnings not analysis or headlines
  - Often there is time to get into a short *after* the writing is on the wall
  - Short stock rather than use options
- Look for multiple ways to win
  - Very high valuation – far above historical and peer averages
  - Very high margins – far above historical and peer averages, and what common sense says is possible
  - A fad coming to an end
  - Market under-reacts to an earnings miss/guide down, regulatory action, etc.
  - Impact of new competitors
  - Regulatory problems

My Largest Short Position Today (3.1%): Wingstop

Overview

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- Wingstop is in the chicken wing restaurant franchise business
- Founded in 1994, it began franchising in 1997
- There are just over 1,000 Wingstop restaurants in 40 states (93% of units) and 6 countries, of which 98% are franchised
- 75% of revenues are take-away (vs. 16% at Buffalo Wild Wings)
- Like most franchise businesses, Wingstop has high margins and low capex, thus generating healthy free cash flow
- Market cap (at $27.78): $802m; cash: $4m; debt: $151m; EV: $943m

Wingstop Is Growing Rapidly

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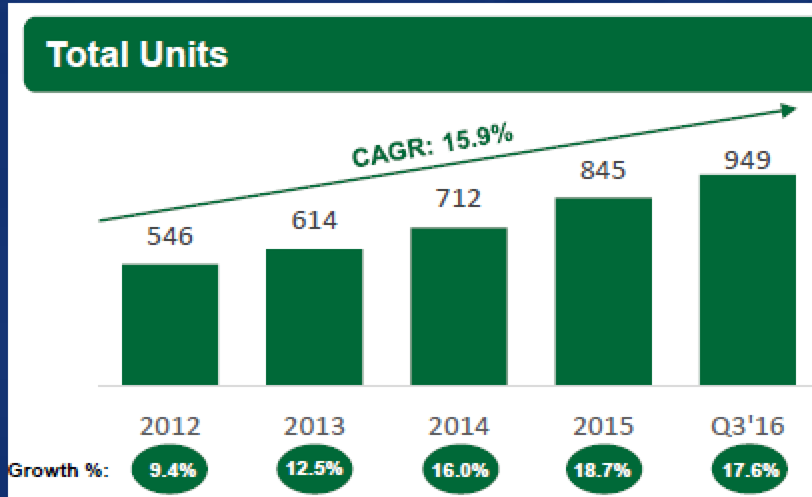

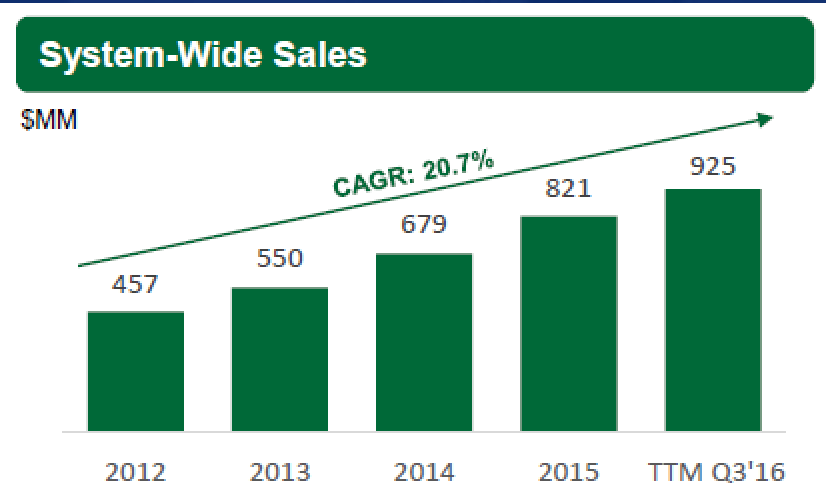

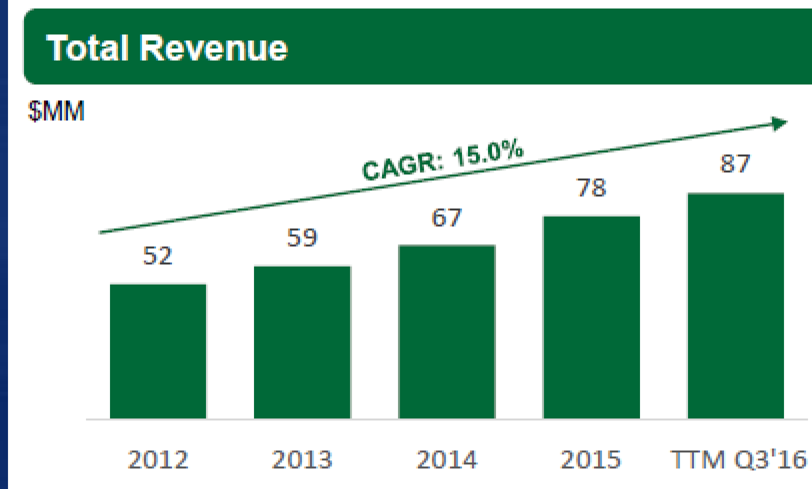

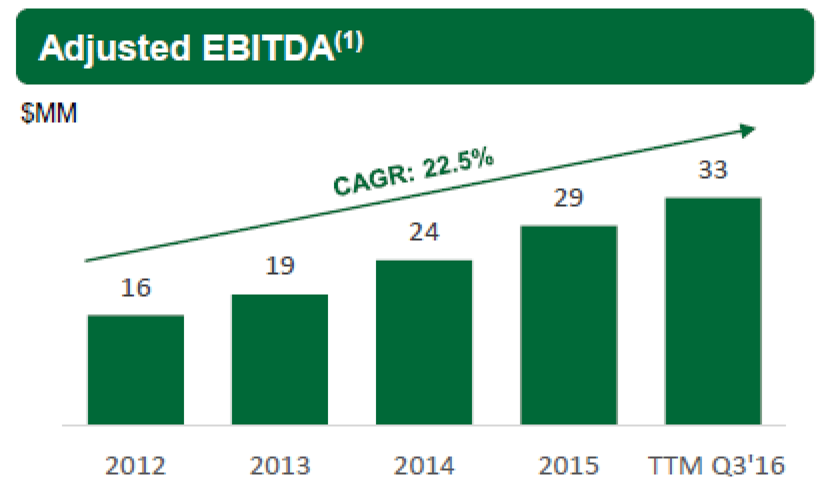

Source: Wingstop investor presentation, 11/16.

Wingstop's Stock Is Down Slightly Since Its First Day Close After Its IPO in June 2015

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Why Am I Short the Stock?

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1) The valuation is absurd: 52x trailing EPS (43x NTM), 29x trailing EBITDA (24x NTM), and 11x trailing revenues (10x NTM)
2) Same store sales growth is decelerating
   - An estimated half of same store sales growth in recent years has been driven by price increases, which is likely unsustainable
3) There is little that is proprietary or unique about this business – these are chicken wing restaurants!
   - There are plenty of competitors, many much larger, with deeper pockets and better technology: head-to-head (BWW, Wing Street), other fast food chains (KFC, Domino's, Pizza Hut, Popeyes, Papa John's), and indirect (supermarkets selling ready-to-eat wings)
4) I doubt whether Wingstop can nearly triple the number of units in the U.S. to management's stated goal of 2,500
   - The market is much more competitive and may be becoming saturated
     - Roughly half of all chicken wing restaurants in the U.S. have been opened the last five years, a quarter in the last two years
   - Nearly 2/3 of Wingstops today are in two states, Texas (nearly 10% in Dallas alone) and California, so the business and brand are largely unproven elsewhere
5) After 22 years (including a dozen owned by two respected private equity firms) and growth to over 1,000 units, the company generated a mere $91 million in revenues and $15 million in net income in 2016

Wingstop's Investor Presentation Boasts of Phenomenal Same Store Sales Growth

But Note the Slowing Growth

AND INDUSTRY LEADING SSS

2012 – YTD Q3 2016 Stacked Same Store Sales

Legend: YTD Q3 2016, 2015, 2014, 2013, 2012

Company	Stacked SSS
Wingstop (1)	48.0% (2012: 13.8%; 2013: 9.9%; 2014: 12.5%; 2015: 7.9%; YTD Q3 2016: 3.9%)
Zoës Kitchen (2)	38.2%
Domino's (1)	37.7%
Shake Shack (2)	35.7%
The Habit Burger Grill (2)	26.2%
Popeyes Louisiana Kitchen (1)	24.0%
Pollo Tropical (3)	23.6%
Buffalo Wild Wings (4)	16.0%
Panera Bread (5)	13.9%
Dunkin' Donuts (6)	12.0%
Noodles & Company (2)	8.1%
Papa Murphy's (1)	8.0%

Source: Wingstop investor presentation, 1/17.

In Reality, Wingstop's Same Store Sales Growth Has Decelerated Significantly

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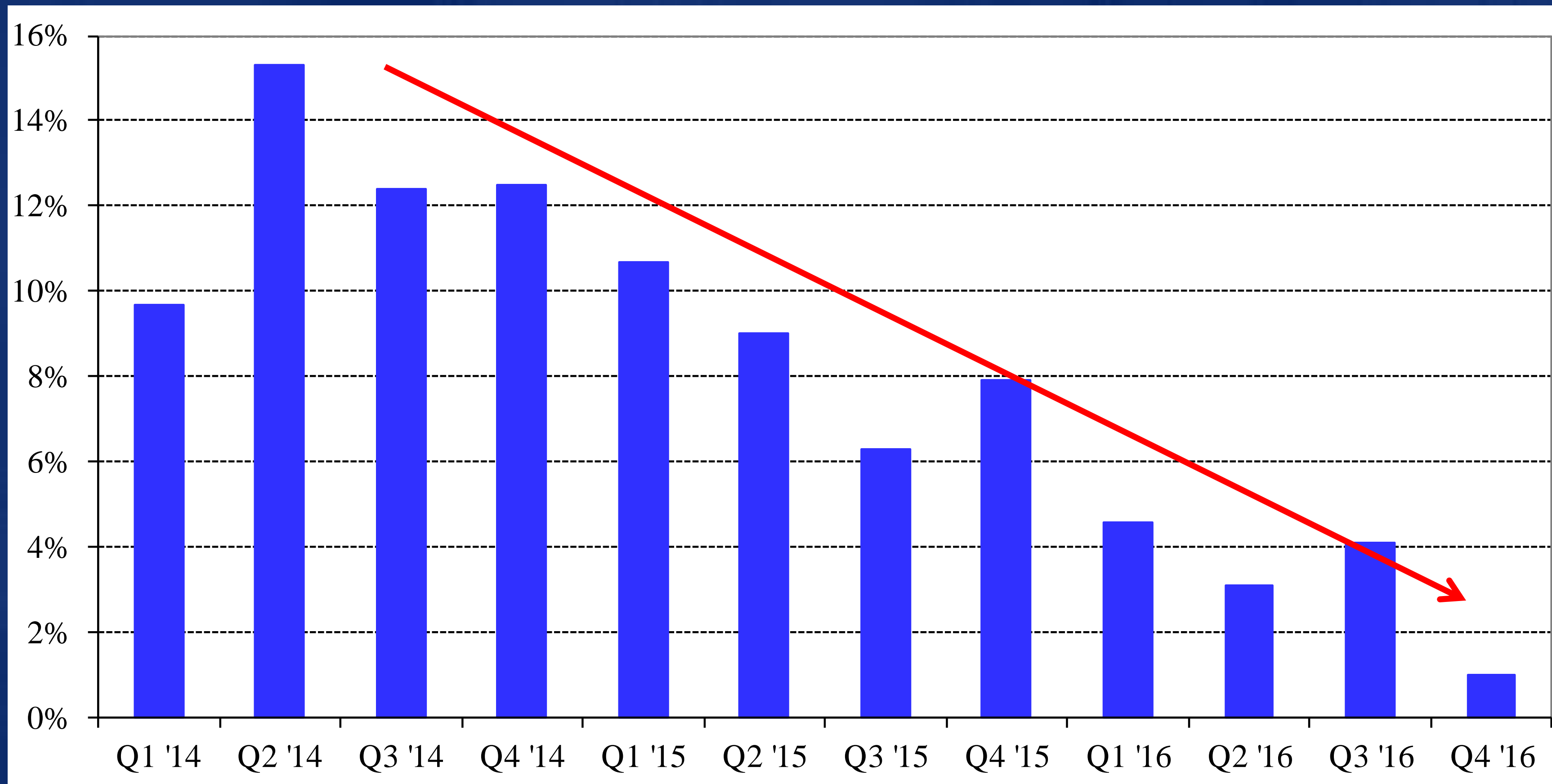
Despite Increasing the Pace of New Unit Growth



The Gross Margin of Wingstop's Company-Owned Stores Has Also Declined Significantly

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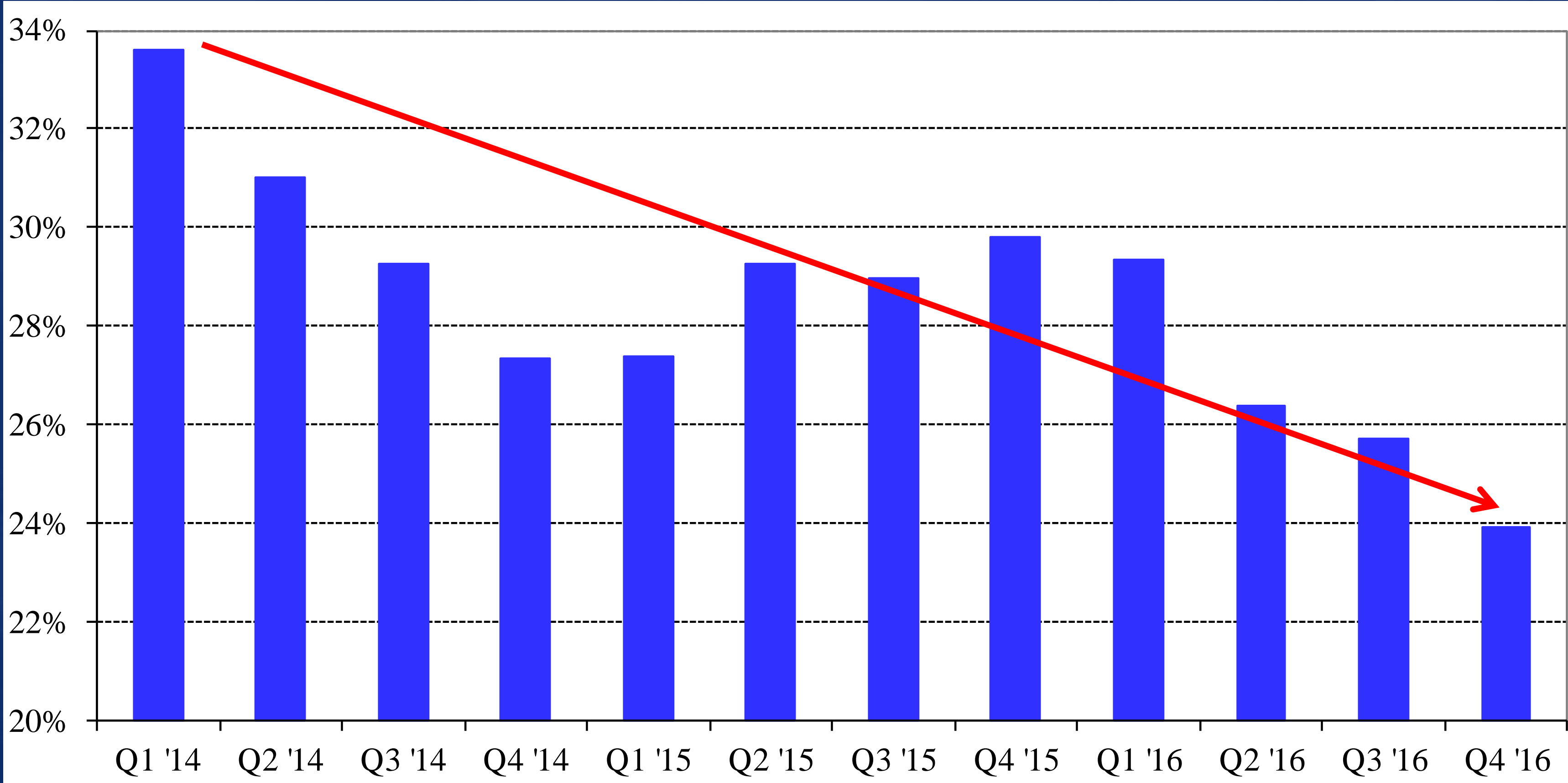
Gross Margin of Company-Owned Stores



Note: Gross margin calculated as total cost of sales divided by company-owned restaurant sales

Wingstop's 2017 Guidance Indicates a Very Disappointing Year

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- On the Q4 '16 conference call in early March, management said Q1 '17 comps are *negative* 2.6% so far *plus* the cost of wings are 10% higher YoY – meaning Wingstop could report unexpectedly weak sales, margins and profits in Q1
- Wingstop has issued the following guidance for 2017:
  - System wide unit growth of approximately 13% to 15%
  - Low single digit domestic same store sales growth
  - SG&A expenses of between $34 million and $35 million
  - Net income between $18.5 million and $18.8 million
  - Fully diluted EPS growth of 8% - 10%
  - Adjusted EBITDA growth of 13% - 15%
- This guidance implies *another ~300bps of margin decline*
- Summary: negative comps and plunging margins are totally inconsistent with a stock trading at such a rich valuation, so something have to give: either Wingstop's business metrics start to improve dramatically or the stock is likely to get cut in half (or more)
- I'm betting on the latter – and so was Roark Capital (see next slide)

Public Shareholders Are Wingstop's 4th Owners – and the Prior Owner Has Already Cashed Out Entirely

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- Founded in 1994
- Acquired by Gemini Group in 2003
- Acquired by Roark Capital in 2010
- Taken public in 2015

Roark Capital specializes in franchise businesses and currently owns 16 quick/limited/full service restaurants chains. It typically holds for a decade or more.

But in the case of Wingstop, it rushed to dump its entire stake:

- Jun 2015 – IPO – 3.2m shares sold at $19;
- Mar 2016 – Secondary – 6.3m shares sold at $24;
- July 2016 – Special dividend of $2.90/share, bringing debt to EBITDA to 5.2x;
- Aug 2016 – Secondary – 6m shares sold at $29.25;
- Nov 2016 – Secondary – all of remaining 6.8m shares sold at $26.28

Why the rush? My guess is that Roark saw a possible fad, oversaturation, and the signs of slowing growth, so wisely took the opportunity to cash out at an absurd valuation

Summary and Price Target

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- Wingstop is an OK business at best – and there are major signs of deterioration (primarily weakening margins and SSS growth)
- Its business is largely undifferentiated and faces ferocious competition from all sides
- It has only proved that its business and brand work in two states, yet its valuation assumes that it can scale rapidly across the U.S. and abroad – a highly questionable proposition
- Given that the stock is currently priced for perfection, if I'm wrong, it has little upside – and if I'm right, look out below!
  - For example, look at Papa Murphy's (FRSH), a fresh pizza (take-away to cook at home) franchising business with 1,570 stores in 38 states and abroad: the stock went public ~$10, soon soared to $20+ -- and has now crashed to ~$5
- A discounted cash flow analysis, even assuming favorable growth and margin increases for the next decade, yields a share price roughly half today's level
  - Even at that price, the stock would still be richly priced at more than 25x trailing EPS
- This is my largest short position at 3.1%
- There is plenty of borrow at negligible cost