



Herbalife: Why I Made It a 35% Position after the Bill Ackman Bear Raid

Note: Below is the opinion of Chapman Capital L.L.C. and is not a recommendation or an indication of Chapman Capital's current or future intent to buy, sell or otherwise transact in Herbalife common shares. Dated 12/29/2012.

As anyone even remotely connected to the world of multi-level marketing is surely aware, the perpetually sanctimonious Bill Ackman and his extremely successful investment advisory firm, Pershing Square, formally launched a massive bear raid on Herbalife (HLF) on 12/20/2012, orchestrating a 3+ hour, media-packed, web-streamed 300+ PowerPoint slide deck presentation in New York. Of course, none of this occurred until after he sold short 20mm HLF shares for an estimated \$1 billion plus in proceeds. In his presentation and numerous interviews with the business media that day, Ackman declared a target price of zero for HLF's shares. In other words, he claims to be so convinced that Herbalife operates an illegal pyramid scheme, he is certain that government authorities and/or HLF's distributors/salespeople/customers will shortly put the company out of business.

SUMMARY INVESTMENT THESIS. Despite beguiling and specious reasoning, Ackman will fail to influence/cause a material regulatory response or a HLF distributor exodus. Consequently, he will suffer a merciless short squeeze, catalyzed and augmented by a fast and furious combination of HLF share count shrinkage (buyback) and excellent operating performance (beat and raise dynamic).

REGULATORY SUMMARY. FTC has been there, done that.

The Ackman Tell. Many poker games are won and lost upon that infamous turning point when a player properly reads his opponent's "tell." To wit, I am confident that during an [interview with CNBC's Andrew Ross Sorkin on "D-Day"](#) (12/20/2012), Bill Ackman slipped his "tell", confirming my suspicion that he already realized the FTC wasn't going to make his day by shutting down HLF. I strongly recommend all HLF traders/investors read the transcript of this interview, as Sorkin does a masterful job of fighting the media urge to genuflect before Ackman's drawn down zipper, otherwise known as "The Whitney Tilson". Specifically, Sorkin, after hammering Ackman, asked toward the end of this interview, "This is somewhat dependent on the FTC taking action. If they don't, what happens?" Now, remember that Ackman's entire thesis rests on his certitude (so he claims) that HLF is an illegal pyramid scheme, which the FTC has a mandate to shut down. If you were 100% certain (with 20% of HLF shorted in your funds alone) of this claim, wouldn't your answer be, "There is no way the FTC doesn't take action to shut down the illegal pyramid scheme run by Herbalife." Instead, Ackman diffidently responds, "I *think* the FTC is going to take a very hard look. But I think most importantly the new distributor someone is trying to suck into the scheme will be better informed ..."

The moment I read this response, after having researched HLF on/off since 2000 (when Chapman Capital had been an activist in HERBA/HERBB shares during Mark Hughes' LBO efforts), I decided I had to place a monster long bet on HLF. **I believe Ackman already had concluded the FTC wasn't going to assist his crusade. Instead, he realized that he had to focus on existing and prospective HLF distributors, praying the media attention would have a materially deleterious impact on any decision to join or to continue with the HLF team.** Indeed, without the FTC taking injunctive actions against HLF, Ackman's crusade toward "zero" is doomed.

Here are key bullet points on the lack of real regulatory risk to HLF shares:

Internal Consumption Issue Already Clarified/Resolved by FTC in 2004: “the amount of internal consumption in any multi-level compensation business does not determine whether or not the FTC will consider the plan a pyramid scheme” is a quote from an FTC letter dated 01/14/2004. Essentially, the letter states that if a product is marketable, the FTC is OK with the MLM, making Einhorn’s 05/01/2012 call focusing questions on this internal consumption issue far less relevant than was (mis)understood.

FTC Material Adverse Actions Near Zero Probability: during my due diligence, I spoke with the country’s top lawyer specializing in MLM/regulatory dynamics. During our conversation, he offered his legal opinion, pointedly stating that there won’t be any FTC injunction, much less any regulatory action to put HLF out of business (“hell freezes over before this happens”). If there is regulatory action of any kind, it simply will be some type of consent order/settlement addressing better disclosure.

FTC Been There/Done That on Fighting HLF/established MLMs: the FTC already has scrutinized HLF repeatedly with no significant action of note. Now, with only 100 employees, most of who are distracted by much bigger cases against [AAPL](#), [GOOG](#), [MSFT](#), the FTC does not have the time or interest to investigate HLF yet again. Essentially, our legal expert believes the FTC essentially has stopped investigating and that states, taking their cue from the FTC, have follow suit.

Few Consumer Complaints: the FTC has not received many consumer complaints on HLF products – only 37 in 2010, 36 in 2009, and YTD 05/2012 was only 18 (again around 40 annually).

HLF is a Big, Time-Tested Veteran: the FTC can and will shut down companies violating MLM rules, just as it did BurnLounge, the online music retailer, in 03/2012 and in 2000 vs. Equinox Intl. While such action is rare, the FTC will act aggressively to shut down companies when it sees the need. During the 32 years of HLF’s existence, the FTC, despite repeated investigations of the company, has yet to see the need.

HLF Refund Policy Defensible: contrary to fallacious argument, it is actually very easy to return product. Quite simply, Ackman is wrong, right down to the 10% restocking fee, which is an industry norm. HLF responds that it must verify 70% being sold to customers; an MLM law firm delivered to FTC 1,500 affidavits from Amway distributors who said they *perfunctorily* checked the “70% box” and Amway never confirmed but knew it; HLF says to distributors complaining about return policy that those complainers TOLD us this order was for someone else but not true, and thus the distributors’ issue.

Ackman Relied Greatly on Old State Cases: in fact, most of the [post-Einhorn reporting](#) is stale or based on misleading information (see Barron’s article linked above). [Greenberg in 05/2012 essentially conceded the FTC is not going to do anything](#).

No Federal Clarity – Lots of Grey: Unfortunately, there is no “bright line” federal disclosure law against pyramid schemes (MLM’s can rely on safe harbors offered by the FTC). Indeed, even the guy with a jihad against almost all MLMs, [Pyramid Scheme Alert’s](#) Robert FitzPatrick, [conceded that the FTC had decided in September, 2011 that it is too complex to regulate MLM’s](#) and [other anti-MLM consumer protectors have as well](#). My MLM legal expert thinks the DSA *should* actually fight for bright line federal law.

Vast Preponderance of Sales and Growth are International (i.e., Outside Ackman/FTC): 80% of HLF’s business overseas.

The [DSA is an Ultra-Powerful Lobby](#): The DSA lobby killed the 3-10 day cooling off period move in Vermont. It also was behind the effort that led to [17,000 comments sent to the FTC to defeat the 2006-year proposed MLM disclosure \(“business opportunity”\) rule in 2011](#). The DSA is far more powerful than Ackman’s ally, [Pyramid Scheme Alert’s](#) Robert FitzPatrick

DISTRIBUTOR SUMMARY. “Bill who?”

Chapman Capital’s distributor surveys show no meaningful percentage of distributors had even *heard* about Ackman’s circus show. Moreover, their evangelical commitment to HLF and confusion as to what 300+ pages of PowerPoint means seem to be causing an *acceleration* of business growth. Ackman’s payment for Google Ads (pegged to “Herbalife” search) exhibits his desperation to influence distributors, efforts which appear to have negligible effect.

Tailwinds -- Fat tails and business bails. HLF has two secular tailwinds in its favor: lots of fat people (fat “tails”) and no shortage of structurally un/underemployed humans. In fact, one thought for a short in HLF to consider is the following: net/net, does the U.S. government benefit from fewer overweight Americans (lower insurance costs) and fewer people standing in unemployment lines (ever hear of a fiscal cliff problem with U.S. budget)? If the U.S. government benefits from HLF’s impact on the country’s physical and fiscal health, while enduring only 40 complaints/year about HLF, why shut down HLF? Ponder that for a moment.

BACKGROUND: Short seller road kill

HLF shares were trading as high as \$45/share on 12/14/2012, and had been over \$70/share (a high teens P/E multiple) earlier this year before the highly respected investor David Einhorn of Greenlight Capital asked some leading questions on an earnings call that implied he was skeptical that Herbalife was operating within the *Amway* safe harbor guidelines for multi-level marketers. Fear of Einhorn's excellent record of identifying overvalued short sale targets sent HLF shares into the \$40’s in the spring. In contrast, Ackman has been somewhat vague as to when he built the preponderance of his short position (i.e., did he start before Einhorn’s 05/01/2012 questions or was he an unoriginal shadow to Einhorn’s trailblazing?), but I am guessing \$50-55/share is his average short cost basis. There is no evidence Einhorn went short at that time or since, but I would be shocked if Greenlight would maintain HLF short positions anywhere near \$30/share based on HLF’s international value alone.

Open interest on HLF puts accelerated and the stock’s relative weakness worsened in the fall of 2012 as, I suspect – No evidence here. I’ve just been around the block a few times – people “around” Ackman shorted HLF or bought HLF puts ahead of 12/20/2012 presentation. In fact, I have a pet theory that Ackman’s interest in going massively public was heightened (if not driven) by the HLF stock’s reasonably strong response (into mid-\$50/share) attendant with impressive late July and October 2012 financial results. Essentially, my hypothesis is that Ackman, with overall 2012 performance impaired by JCP’s descent into the teens, came to conclude he needed a big winner before year-end 2012.

As word leaked into the market of Ackman’s intention to present publicly the bear case on Herbalife, the stock began a gradual decline, then fell suddenly from ~\$41/share to \$36/share in the closing market hours of 12/19/2012, when a CNBC reporter with big hair reported that market rumors were true. The next morning, as the PT Barnum of the hedge fund industry delivered his presentation in a New York hotel ballroom on 12/20/2012, and especially through the early trading hours of 12/21/2012 (a very illiquid trading day), the shares went into free fall, reaching a nadir of \$24.40/share. My funds made their last purchases at \$25.30/share in a brief but painful period of negative marks. HLF shares have since rebounded to ~\$30/share as traders/investors have taken a closer look at whether the emperor is running around New York denuded (figuratively speaking . . . fortunately).

Ackman’s Timing “of Interest”. Ackman's end-of-same-year-that-Einhorn-showed-up timing was masterful – when it comes to the power of influence, only top hypnotists can compete. A classic bear raid involves creating abject panic in the market. Concurrently using the proximity to Christmas, the December option expiration, and the depth of his presentation, the Ackman impact on the shares was maximized. The last ten days of December are as quiet as it gets on Wall Street, with most decision makers leaving for vacation, drying up market depth and liquidity. Also, at the peak of the panic not many institutional investors felt the urge to have HLF show up in their 12/31/2012 Form 13-F filing. December is also the final month of HLF’s fiscal year, which puts them in a “blackout period,” prohibiting the company and insiders from repurchasing shares under the \$950mm authorized

buyback. Moreover, due to the extensive audit period that attends year-end, it will be several months before year-end 2012 results were reported. This blackout removes HLF's most effective defense to the bear raid: executing a nearly \$1 billion share repurchase authorization. Again, if timing is everything, Ackman is every woman (with a nod to Whitney Houston)

Pied Piper of Hamelin. Ackman received a standing ovation at the conclusion of his 12/20/2012 presentation, which I watched on Bloomberg Live from here in Los Angeles. But rather than impressed, I found myself laughing – there was very little new being reported despite the lugubriously and laboriously presented “facts”. I especially adored the B. Riley analyst (name omitted to protect the feckless) who briefly stood up to the man running the Big Top. Unfortunately, she then killed her Street cred by saying she was a HLF distributor (on the side). She dropped coverage within a few days, right near the lows. My purchases in the mid \$20's owe her some gratitude.

PERSHING SQUARE/ACKMAN RESUME

Let's review some history on Bill Ackman and Pershing Square, some color on the mechanics of short selling, and Herbalife's response to the bear raid to date.

Bill Ackman manages a New York based hedge fund called Pershing Square with exceptionally good long-term results. Ackman is not known as a short seller. His fund is generally a long-biased fund. He achieved some notoriety for predicting that muni-bond insurer MBIA was undercapitalized, which eventually proved true during the financial crisis of 2007-2009. His enormous investment in General Growth Properties (GGP) at less than \$1/share remains one of the most impressive brains/balls combinations I have ever seen. All the while, however, his ego seems boundless.

He is somewhat unusual among usually media averse hedge fund managers in that his strategy involves publicly trumpeting the merits (and genius) of his investments, which he generally holds for a long time. He manages a concentrated portfolio comprised of very few, very large investments. He also is considered an activist investor. He frequently badgers the board and management of the companies in which he invests with what start as suggestions and frequently escalate to demands as to how they should conduct their business, what their capital structure should be, and the composition of its board.

Though he will rarely, if ever, publicly concede, Ackman makes mistakes just like the rest of us, even catastrophic financial ones (e.g., call options on Target). Indeed, Ackman closed down a previous hedge fund advisory entity called Gotham Partners after he [reportedly marooned his investment funds](#) in an illiquid and devastating combination of a closely held REIT (First Union Real Estate) and a portfolio of golf courses (Gotham Golf) for which no exit was possible. So while Ackman is quite good at what he does for a living, his hubris makes him vulnerable to spectacular failure. He has a high financial IQ, but it may be the delusional and narcissistically 15 surplus IQ points he awards himself that have been, and may again be, his undoing. Think of him as the Reggie Jackson (I'm dating myself here) of Wall Street: he swings for the fences, but can cause a lot of pain and break a lot of hearts – or the bank – when he whiffs.

SHORT SELLING PRIMER

A bit more on short selling for those inexperienced in the sport. Short selling is a vital component of the markets. The ability of investors to sell short shares of overvalued companies keeps market valuations in check, and permits investors to hold hedged portfolios that are not dependent on constantly rising indices to make a positive return. There are risks, however, of going short that do not exist on the long side. For instance, if one purchases the shares of Acme Widget at \$10/share, and Acme fails, you know precisely how much you will lose - your \$10/share, and no more. If you were to short Acme Widget at \$10/share and Acme were to discover a vast plutonium mine under their headquarters, those shares that were shorted at \$10/share may have to be repurchased in the market at \$100/share, \$500/share, or even \$1,000/share. The potential loss on a short sale is unlimited. For this reason, most professional long/short investors keep the size of their short positions much smaller than their long positions. For instance, if a core long position is 5% of capital, a core short may be 2%. Last week in Barron's, famed short

seller [Jim Chanos](#) discussed his lessons learned from the 1999-2000 internet bubble when he saw his AOL short go up eight times in value in his face. The lesson he drew was to keep individual shorts small relative to capital. Ackman's \$1 billion short in Herbalife is almost 10% of his reported \$11 billion fund. If he is wrong, he may very well be putting his firm at risk due to the enormity of his short position relative to both Pershing Square's and HLF's size, and the potential difficulty of covering a short position of that magnitude in a "short squeeze". Google the notorious [Volkswagen/Porsche](#) trade to see how dramatically these events can play out at the extremes.

To go short a company's stock, one must borrow the shares to sell from a broker. Shorting without a proper borrow is called "naked shorting", and is illegal. Holders of stock give their broker the right to lend out their shares in exchange for the flexibility of keeping margin accounts, and to participate in a portion of the fees short sellers incur for access to those shares. Short selling is conducted by the investor calling his broker, securing a borrow, and then executing the sale. Most companies have ample shares available to borrow, and this process yields little drama. However, in the case of controversial stocks, the demand to borrow shares may exceed the supply in the brokers "box". If long holders sell shares brokers had out on loan to short sellers, the short seller must replace those borrowed shares he has lost access to with newly sourced shares. Should none be found, he will be forced to cover that portion of his position, and if unwilling to cover, the broker will involuntarily "buy him in". This dynamic is what leads to short squeezes, where heavily shorted issues rapidly appreciate in the absence of any fundamental reason. Just look back to 2008 when the US government suddenly prohibited the shorting of financial stocks to see how painful that result can be for short sellers.

One effective defense for the short seller would be to have his broker contract on his behalf with a lender of shares to provide a quantity of shares for a specific term, at a negotiated payment. This insulates the short seller from buy-in risk for the duration of the contract. However, these contracts are individually negotiated, and somewhat rare. Also, they frequently permit the long holder to regain access to his shares if the company were to, for instance, conduct a self-tender offer for its shares. It is not known if Ackman has such an arrangement.

Ackman's self-reported short position of 20 million HLF shares is over 75% of the reported short interest in Herbalife. At this point, the "borrow is tight" - there appears to be a near zero supply of shares available to sell short. The few brokers that will supply a borrow are charging as much as 20% of the value of the short annually for that access. This is a monster number - between the 20% negative-borrow and HLF's dividend, it would cost nearly 25% each year to stay short HLF, all things remaining constant on those two variables.

HLF's DEFENSE IS COMING

Given the holiday timing, the best defense HLF has been able to muster has been to put a video of CEO Mike Johnson on its IR webpage defending the company broadly, and to schedule an investors' day two weeks later, for 01/10/2013 in New York to address Ackman's accusations in detail. The company has hired an impressive team of advisors. While most would have expected Bank of America/Merrill Lynch to get the assignment given their execution of last spring's \$400mm share repurchase, the task has been given to [Moelis & Company](#), a well regarded, Los Angeles-based boutique investment banking firm. The firm's namesake, Ken Moelis, is a disciple of Mike Milken from the height of Drexel Burnham's power in the mid-1980's. Moelis went on to a successful career at DLJ and UBS, where he became the premier investment banker to the casino gaming world, before launching his own shop.

Additionally, Herbalife has reportedly hired [Boies, Shiller & Flexner](#) the law firm founded by famed litigator David Boies. Consider Boies' HLF team to be the Navy Seals Team 6 of litigation - you really don't want them on the other side of your war. Note, I have no evidence that Bill Ackman is related to Osama bin Laden, and thus worthy of being targeted by DEVGRU (figuratively speaking, of course).

HLF promises a detailed rebuttal of the Ackman allegations on 01/10/2013, and I expect it will blow away the skeptics with a point-by-point dissection of Ackman's claims. I presume Boies was brought on to bring suit against Ackman for some combination of libel, slander, defamation, tortuous interference and other imaginative causes of action. No matter how this turns out, the discovery, depositions and testimony should be highly enlightening and

probably quite entertaining.

HLF's DIRT CHEAP VALUATION

So now, how might one value the shares of HLF in the bull case where Ackman is convincingly discredited by HLF CEO Johnson (a singular American bad-ass, according to my sources who know him personally here in L.A.) on 01/10/2013, and the market no longer ascribes risk to the feared FTC intervention (if I hear "headline risk" one more time ...). EBITDA is a preferred valuation metric for a company like HLF that doesn't have heavy capital expenditure requirements, and converts much of its reported earnings to cash that can be distributed as dividends or used to repurchase shares. Herbalife will produce over \$725mm of earnings before interest, depreciation, and amortization (EBITDA) this year, a growth-stock worthy increase from \$634mm in 2011 and \$480mm in 2010. The few analysts that cover the stock project \$800mm in 2013. Think of HLF's gushing cash flow this way – HLF is printing EBITDA of over \$2mm/day. That's a heck of a lotta cheese with which to fight Ackman, who has and will be spending his own and his investors' money on litigation and other matters (which won't bother his limited partners until the stock is going up on a daily basis). HLF is lightly leveraged, with \$500mm of bank debt, and quite liquid with \$700mm of unused borrowing capacity and \$300mm of cash. HLF currently pays \$1.20/share in dividends annually on its ~108 million shares outstanding.

In the absence of controversy, the market would typically accord a fast growing, capital efficient company such as HLF a premium multiple. Let's just assume the S&P 500 index current multiple of 8x EBITDA. This would yield a total enterprise value of 8x \$725 of EBITDA = \$5.8B. Deducting ~\$500 million of debt, but giving credit for \$150 of the cash (that is excess to the operating needs of the business), would yield a total equity value of \$5.45B, which divided by the 108mm shares works out to \$50.46/share. The current price of ~\$30/share implies an EBITDA multiple of 4.7x. Tupperware, which is a MLM free from controversy, trades at 9.3x EBITDA, and Avon trades slightly higher. At \$50/share, the share still would sport a dividend yield of 2.4%. Herbalife should report net income of about \$4 per share this year and \$4.50 in 2013 (ignoring the massive buyback I see coming). \$30/share implies a 2012 P/E multiple of around 7x. The current S&P multiple is about 13x. For a company growing 15%+, you would expect to see a premium multiple, which is why brokerage firm analysts who cover the stock have target prices from \$65 to \$101. My valuation is lower, but should the Ackman-induced cloud be lifted, I can't say those targets are absurd.

In fact, between the technical short squeeze that is in the making, the massively accretive impact of a \$1B buyback, and the FTC risk fading away, I can't say that I'd be surprised to see HLF trade back to its old highs of \$70/share. If HLF has \$500mm of 2013 net income, and buys back 30mm of around 110mm shares, the ultra-low interest rate environment makes the net income impact from interest expense miniscule (the HLF 13% EPS yield is 3-4x borrowing costs). Getting over \$6/share in EPS is really not that hard to financially engineer, and between the short squeeze, comparable valuations, a below-market 11-12 P/E multiple would take HLF back into the \$70s. Indeed, it could turn out even more financially salubrious than even these scenarios.

Ackman's essentially fired nuclear missiles at HLF's business model and its legality. When (and not "if") HLF's regulators and distributors essentially blow off Ackman's claims as either old or no news, HLF will for all intents/purposes become bulletproof and battle tested. This may/should garner it a higher valuation than before Einhorn or Ackman ever showed up. That "what if" scenario gets you a \$100/share stock price potential (again, only 15x \$6-7/share in EPS gets you there; I'm not talking about a NFLX-level valuation here).

This hypothetical rally toward triple digits is not farfetched. In the event of a self-tender by HLF, or even without one, should the large institutional shareholders proactively remove their shares from the stock loan supply, there is great potential for short sellers being forced to cover as the borrow dries up. A panic to the upside could occur as the shorts are forced to buy in 25 million shares in a market unable to induce that many sellers. I am sure HLF and its capable teams of advisors are looking at the myriad of options to create value out of the chaos caused by this spectacular bear raid. Indeed, it does not take great imagination to see what could make these numbers dance.

In addition, [Ackman has no shortage of enemies](#) from my own polling of the audience. The odds favor Herbalife in this aspect of the battle. Ackman truly went all-in telling the world he has shorted ~20% of a relatively unlevered company trading at ~4x EBITDA.

But what if Ackman is right? His target price of zero implies the company is shut down globally, not just here in the US, which comprises only 20% of HLF's global revenue. Is it possible? I guess so, but in my view no more than a very slim probability. More probable, in the unlikely case the FTC responds to Ackman's presentation and reopens the same issues they have been policing for 32 years in the case of HLF, it is possible that the company could be forced to change some elements of how it conducts business in the US, and maybe elsewhere, leading to lower sales and margins. No doubt this would spook the market with fears that there was even more scrutiny to come, leading the market to value Herbalife at a discounted multiple on reduced earnings.

So let's take a cut at that. Let's say the FTC somehow compels business practice changes that reduce sales by 20% and lead to current pre-tax margins contracting by 25%. This would yield EBITDA of approximately \$450mm, which at 5x would yield a share price of \$17. Personally, I think there is about a 10% chance of this outcome. So weighting a 10% chance of \$17/share, and a 90% chance of \$50/share, I come up with a fair value of \$47/share, which is why I own a boatload of shares purchased into the panic created by the bear raid. In fact, there is far more likelihood of another LBO of HLF (Golden Gate/Whitney stole it the first time around) than any other "headline risk."

Ackman took his shot; now it is HLF's turn.