

Financial market vigilante

Carson Block, founder of US shortseller Muddy Waters, has zero tolerance for boardroom bullies.

By Andrea Soh



ASK Carson Block, the founder and director of US shortselling research firm Muddy Waters for his namecard, and he will tell you he doesn't carry any.

The company is not in a business where it wants to be easily contacted, he explains. The shroud of secrecy extends to the company's operations. "I'm the only publicly known member of MW. That gives some latitude to people on the team to engage some of the consultants or outside parties we'll be working with on a given project," he tells BT. He is on his first visit to Singapore since he first spoke out against Olam International in an investment conference in London last November.

A week after that event, he published a 133-page report recommending a "strong sell" on the \$3.78 billion large agri-commodities trader, accusing it of, among other things, relying on accounting tricks to boost its bottomline and overspending for low-quality assets.

Olam's shares fell some 20 per cent in the aftermath, but the firm quickly stemmed the barrage on its shares and bonds by unveiling a US\$1.25 billion rights issue sub-underwritten by Temasek Holdings.

Before Olam, Muddy Waters had already made a name for itself in North America for exposing fraud at Chinese forestry giant Sino-Forest in 2011. The Canada-listed group, once valued at more than US\$5 billion, had as its largest shareholder Paulson & Co, run by John Paulson, the hedge fund manager who made more than US\$20 billion betting against subprime mortgages. Sino-Forest has since filed for bankruptcy.

That same year, Mr Block was named by Bloomberg Businessweek as one of the 50 most influential players in the global economy, alongside economist Paul Krugman, US treasury secretary Timothy Geithner and Saudi oil chief Ali Al Naimi.

Mr Block's path to fame - or infamy, depending on the side you take - has been no less than meteoric. The 37-year-old published his first report in 2010.

He had visited Orient Paper at the request of his father, who owns a US small-cap research firm. Hoping to make back some of the US\$15,000 he spent on research, he placed US\$2,000 worth of "put" options on the Hebei-based paper producer with a business partner.

After he emailed the report to some contacts, the firm's shares fell by over 50 per cent.

"When I started this business, I had no business plan... I didn't expect this," he says.

Now, Muddy Waters comprises a motley team of 10 - none of whom carries a card - from backgrounds such as auditing, IT and manufacturing.

The firm also hires local lawyers and field investigators for each field project. "They usually do not know that they're working for MW, because it's obviously very sensitive. If we disclose that we're working on a given company, just that information alone can sometimes create or cause changes in the stock price," Mr Block says.

The same goes for its interactions with the company under research, which Muddy Waters would try to approach under the guise of a potential customer or supplier.

"Our point of view is that several managements - at least the managements that run the companies that we would end up shorting - put a veneer on their businesses, and it's obviously hard when you approach them as an investor to see the things that they're not wanting to show you.

"If you sound like you're the kind of person who might be buying their products, you're told that your factory capacity is far less than what's contained in their financial disclosures."

Master of disguise

The 37-year-old has been known to wear disguises when visiting companies that he is researching, such as in a one-on-one meeting with Sino-Forest's head of investor relations. "I even combed my hair forward for a Dumb and Dumber kind of look. I tried to sound really dumb and speak even slower than usual. I went in with a rumpled appearance. I just tried to seem like an idiot," he told Canadian newspaper The Globe and Mail in an interview in 2011.

In Singapore, Olam's CEO Sunny Verghese accused him of impersonating someone else in a meeting in early November last year, dressed in a T-shirt and jeans with a baseball cap - a charge he doesn't deny.

His penchant for disguise has naturally attracted criticism, but Mr Block points out that companies often complain about not being given a chance to speak to them, until they find out that they have already done so. Then the companies would typically give one of two responses. "Play number one is ad hominem attacks: 'Just shouting fire in a crowded theatre, these are shortsellers, there is a cabal to destroy the stock!'," he says, switching to a high-pitch snivel as he repeats the accusations hurled at him.

The other response is to claim that shortsellers do not understand a particular industry. Muddy Waters had hired consultants "very deep" in the physical commodity trading business when it conducted research on Olam, he says, maintaining that it is "not an issue of not understanding the business".

"We understand bad managements. We understand pathological dysfunctional behaviour with management. We understand businesses' abilities to generate free cash flow. We understand how businesses should have accounting systems and controls in place, and what it looks like when a business does not have those." Recounting his response in an interview after Sino-Forest charged that he did not understand the forestry business, he says: "They're not in the forestry business. They're in the fraud business, and I understand the fraud business very well."

The problems of many of the companies scrutinised by Muddy Waters are not new. Olam, like many others, was brought to his attention by an investor who highlighted it as "really something" he should look at.

"Olam was the most heavily-shortened stock in Asia by the time we wrote on it," he says. "Trust me, a very small percentage of those shorts was us." The way Olam responded reflected their insecurity, he reckons. "What generates insecurity is usually knowledge that there are other problems."

Firms that are listed and tapping public capital markets have to learn to deal with criticism. "If you don't want to deal with criticism, if you don't want to deal with shortselling, then don't ask the public to hand you money," Mr Block says. "Taking money from the public is a privilege and I think a lot of management - especially when they're faced with criticism - really forget that the capital markets create winners and losers.

"And if you build a company where it can be profitable to take a view that you're doing a bad job as a manager, I'm sorry, the person to blame is you, not the shortseller who comes along and says the emperor has no clothes." Indeed, drawing a parallel to the children's tale, one finds that the shortseller relishes speaking truth to power, and fancies himself a financial market vigilante.

There is an illness pervading the global capital markets - fraudulent or badly run companies "preying on the weakest" investors, he says.

"It's one thing if you are looking at an institutional investor. If Temasek or another sophisticated investor does their homework and they want to put their money into XYZ company, fine. That's what makes the market.

"It's another thing when you're hitting up individual investors. They don't really know what they're buying... I don't personally forgive that too easily."

Zero tolerance for cheating

The anger against big bullies comes from his days as a struggling entrepreneur in China, where he says his self-storage business was "near death" four times. There, he faced "business assassins" who were trying to put him out of business by cutting off power to his facility.

Five years on, the emotions still run raw.

"I dealt with a lot of dirtbags," he says, his voice rising for the first time in the 90-minute conversation. "I saw a lot of people who feel that the rules do not or just should not apply to them.

"I get it. You want to be financially successful. (Expletive...) Do it the way the rest of us are trying to do it - by pulling yourself by your bootstraps, by fighting hard to keep your business alive every day. If you don't make it, you don't make it. Accept it. Don't cheat as a result." The battle against fraudulent or fundamentally weak companies is therefore not just a business, but also a personal crusade for him.

And no one else is able to identify these as well or as efficiently as shortsellers, Mr Block argues. "Who else is doing it? I've heard people say it's the media. How many negative articles have you seen written about Olam? Not a lot."

Sell-side analysts, he says, are "a cop-out" who risk antagonising potential clients through their research.

"Goldman Sachs is rarely going to protect you. And just look at the nature of the rating. A 'hold' - that usually means a sell... I can't really think of too many situations when doing nothing is the best decision."

And auditors? They "lack backbone and morals".

"The problem is that auditors are not looking for fraud. They're not looking to be confrontational towards management. Management are the clients of auditors, not shareholders."

In his view, the dynamics at play in the corporate boardroom have their roots in the days of a rough-and-tumble school life. As he sees it, those who go into the auditing profession in the first place tend to be more reserved.

"In American terms, the person who runs a company was captain of the football team, and in high school probably beating up the guy who becomes an accountant.

"So that dynamic persists later in life. A lot of the people who go into auditing just don't feel they have the gravitas to challenge a particularly charismatic manager," says the former high-school baseball and football player.

Investors might be better off altogether if public companies aren't audited, he declares, saying that auditing creates a false sense of security.

"If you talk to investors, so many of them will tell you that they're audited by a Big Four firm, so they must be okay. They're not okay, and that does not make them okay. I think that is probably the single biggest reason why we have a business - it's because auditors don't do the job that investors think they do."

And banks are just as guilty at perpetuating and growing problematic companies, he adds.

"Bankers are happy to make their fees, they're happy to push that crap onto their customers. And the bigger a company gets, the more the fees that are going to be generating, the bigger the banks they're going to be using, and the more the veneer of respectability.

"What if investors don't get the game that's being played? Individual investors are the cannon fodder for banks and management, and if we can remove a capital market parasite, in the future you will have less money lost to that parasite." But it might be getting harder to be rid of the "parasites". A Markit Group report in December last year analysing market reaction to Muddy Waters' allegations against eight of its major targets showed that its reports have had a less debilitating effect on share prices since Sino-Forest.

One month after Muddy Waters released its report, shares for Sino-Forest plunged 85 per cent, while shares for its three targets after that - Focus Media Holding, New Oriental Education and Olam - fell by less than 25 per cent. "Judging by the share price reactions in these companies following the Muddy Waters allegations, the markets have been less willing to jump on Mr Block's bandwagon," said the Markit report, noting that this was in part because it has targeted relatively larger firms since Sino-Forest.

Recent Muddy Waters targets such US cellphone antenna operator American Tower (AMT) have also emerged relatively unscathed.

Shares for AMT, its first American target, fell only 1.1 per cent after the shortselling firm said it had overstated the value of its acquisitions and has poor corporate governance - the smallest ever first-day drop in a stock targeted by Muddy Waters.

Asked about these, Mr Block says that Muddy Waters has been trying to do "harder" things. "We didn't always want to be doing China, we didn't want to be always doing obvious frauds, we wanted to do things that are more nuanced.

"At the end of the day we're responsible to ourselves. Are we enjoying what we're doing? Is it financially sufficient? This is how we look at it. A big part of it is intellectual challenge. You have to test the limits of your business from time to time. So American Towers was us testing those limits."

There are easier ways of making money than tackling an Olam, he admits. "We do choose to do things that are harder and more interesting from time to time."

As the interview winds down, you ask if the criticism is ever troubling, especially for someone who once said he was "number one in class" at school parties. His irreverence for convention - as his lack of namecards shows - rings loud in his reply.

By and large, he doesn't give a hoot what people think, he says. Then he adds: "I have to be accountable to myself, my loved ones, and a very small circle of friends - I do care what they think. But I'm not here to win popularity contests."

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CARSON BLOCK

Founder and Director of Muddy Waters

1976 Born in New York City

1998 Graduated with a business degree from the University of Southern California where he also studied Chinese, and then tried to start a Chinese equity-focused research firm in Shanghai

Jan 1999-Aug 1999: Joined CIBC World Markets (Corporate Finance) in Los Angeles

Aug 1999-2001: Joined his father's firm WAB Capital

2002-2005: Read law at Chicago-Kent College of Law

2005: Moved to Shanghai again to work for law firm Jones Day, where he acted mainly for foreign clients involved in direct investment and M&A in China

2006: Quit to co-author 'Doing Business in China for Dummies' with Robert Collins, and had plans to set up a private banking business in Singapore

2007: Started self-storage business Love Box in Shanghai

June 28, 2010: Published his first research report under Muddy Waters' name while still CEO of Love Box

Nov 26, 2012: Initiated coverage on Olam International, the first non-Chinese firm it has picked