NARROW ROAD CAPITAL

When the Truth is this Crazy, Who Needs Conspiracy Theories?

I've often found that people in financial markets are more open to so-called "conspiracy theories" than the average man on the street. When you see the crazy things that happen in financial markets on a regular basis it becomes a lot easier to believe that crazy things can happen elsewhere. The insolvency of German payment giant Wirecard this week is the climax to one such story. It's a gripping tale involving short sellers, margin calls, financial regulators attacking whistleblowers and €1.9 billion of missing cash. It's a classic reminder to always remain sceptical when investing.

The FT has provided an excellent timeline of the history of Wirecard which I've summarised here. Wirecard started in 1999 as a venture capital backed, payment company during the late stages of the tech boom. CEO Markus Braun took the reins in 2002 and listed the company on the Frankfurt stock exchange in 2005. The first short seller attack occurred in 2008 but nothing much came of it. In 2015 Dan McCrum at the FT started on the case highlighting inconsistencies and strange transactions. Around the same time research firm, J Capital, published a report that the company's operations in Asia were vastly overstated. Neither report had much of an impact.

By mid-2018 the shares peaked at €192 giving the company a market capitalisation of €24 billion. It gained entry into the DAX 30 joining German blue chips such as Allianz, BMW, Bayer, Deutsche Bank, SAP and Siemens. The share price then began a downward trend with a mini collapse in early 2019 after the FT published allegations of forged contracts and fraudulent cashflows in Wirecard's Singapore office. Singapore regulators raided the company's offices, but the German regulators responded by banning short selling of Wirecard's shares and starting an investigation into the FT for market manipulation. Wirecard sued the FT and the Singaporean regulators.

Despite the allegations surrounding the company, it secured a €900 million investment from Softbank (WeWork anyone?) and an investment grade credit rating from Moody's in mid-2019. Wirecard leveraged the credit rating to raise €500 million in bonds and €1.75 billion in bank facilities. A crucial source of comfort for the lenders was the company's claimed cash hoard of €2.7 billion at the end of 2018, signed off by the long term auditor EY.

Over the course of 2019 and 2020 further allegations arose, the most perilous being that the company had overstated its cash balances. KPMG was hired to refute these allegations, but the investigation concluded with KPMG saying that it could not verify the profits or the cash balances as the company had failed to provide sufficient evidence. Just over a month later German police raided the company's offices, but the share price held up with the market capitalisation at around €12 billion. The knockout punch landed in mid-June when the company announced that €1.9 billion of cash was missing. A week later, Wirecard filed for insolvency with the company's bonds trading at 11% of their face value.

In some ways the most bizarre part of this story is how long Wirecard was able to keep the charade going. Short sellers had been on the case for twelve years before the collapse, with the company able to continue fooling almost everyone. The chief fool is EY, who apparently never undertook a thorough confirmation of the cash balances. The similarities between Wirecard and Enron, which brought down Arthur Anderson, are striking.

The German financial regulator also has egg on its face for initially protecting Wirecard when evidence was mounting that the company was a Ponzi. The CEO was on paper a billionaire for several years but ended up with a margin call on a €150 million loan secured by his company stock and is facing criminal charges. Lastly, the lenders also look profoundly foolish for funding a company that had been facing credible allegations of financial shenanigans for years.

The winners include Dan McCrum and the FT who stared down the legal action and regulatory investigations and continued to publish as new evidence emerged. The short sellers who stayed the course have done well, both those shorting the shares and the credit default swaps. No doubt there will be several books and a movie to tell the full story.

If we bring this back to our day to day investment activities, it's a great reminder to always retain a healthy degree of scepticism. There are almost always warning signs when a story is too good to be true, with recent Australia examples including Blue Sky, Big Un and IPO Wealth. The AFR was on the case of each of these well before their demise.

Over a decade ago I remember meeting with Eddy Groves of ABC Learning when the company was selling ASX listed notes. Eddy gave a fantastic presentation and answered our questions directly and with detail, but the numbers he gave simply didn't add up, so we didn't invest. A year later the company was insolvent and $600 million of noteholders funds evaporated. I've had many similar experiences since, though most of the time the charlatans aren't as smooth as Eddy and they get angry when questions highlight the problems they are hoping to gloss over.

For those who have interest in a little more of the true "conspiracy theory" genre, it's a good time to start following the case of Witness K and Bernard Collaery. This story includes the Australian government spying on East Timor, a shonky gas deal, raiding homes and offices to disrupt an international trial and chasing a whistleblower and their lawyer through the courts for daring to question the morality of these shenanigans. Get up to speed with the Four Corners episode from 2019 and follow the Guardian and the ABC's coverage of the current trial. This is one story the Australian Government definitely doesn't want you to follow.

Written by Jonathan Rochford for Narrow Road Capital on 27 June 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure