Wirecard Demonstrates the Critical Role Played by Activist Short Sellers

Gabriel Grego, Quintessential Capital Management, ggrego@qcmfunds.com

On October 23, 2015, Dan McCrum published an article in the Financial Times about Globo Plc, a fraudulent company listed in London that our research helped to expose and which collapsed soon after. I was impressed by Dan's work and made it a point thereafter to continue reading his articles as a source of ideas and information about other companies with potential red flags. It didn't take me long to notice that a few months earlier McCrum had published a series of critical articles with a very promising name: The House of Wirecard.

The more I read through his articles detailing the many red flags and questions about the German payment processor, the more intrigued I became. From the perspective of an activist short seller like me, Wirecard was an ideal candidate for a deeper look. Its heavy debt load and the many red flags detailed in the FT articles raised the possibility that it was a total fraud. In addition, its large market cap and ample trading liquidity meant that we would be able to act in size if our deep dive uncovered what I thought it might.

We began further investigations immediately, beginning with channel checks in which we contacted Wirecard's major suppliers and business partners. From this initial work, we uncovered credible data suggesting that the company's actual transaction volume may have been as little as 10% of what Wirecard claimed.

In addition, we delved into the details of Wirecard's largest acquisition, the purchase of a little-know Indian company called GI Retail in late 2015 for hundreds of millions of dollars. One of the FT articles flagged some glaring accounting irregularities with GI Retail. Based on the pattern of these red flags, we suspected that Wirecard may have intentionally overpaid by a large amount.

We followed up with some on-the-ground research. I traveled to Zurich in early 2016 for a meeting with Wirecard's former CFO, which proved unfruitful. We had better luck when we followed the trail to Mumbai and interviewed sources who were close to the transaction between Wirecard and GI Retail. These sources included the sellers of GI Retail, the Ramasamy brothers. Finally, we identified and reviewed the activities of the entities that acted as the intermediaries to the acquisition, the infamous Emerging India Investment Fund 1A and India Infoline.

By the end of our trip, I had uncovered compelling evidence that the Indian company was sold for a small fraction of the price supposedly paid by Wirecard. This had significant implications for Wirecard's financial condition and operations. It goes without saying that legitimate companies don't deliberately overpay for assets. If Wirecard did so, the most likely explanation was it needed to mask embezzlement of funds or hide non-existent profitability in its core payment processing business. In either case, the company was committing serious fraud and its stock would be destined for a fall if this fact became widely known.

As I was wrapping up my research trip in India and preparing to return home with the evidence that we had uncovered, I read an article in the Financial Times, Shares in fintech darling plunge on critical report. An anonymous firm, Zatarra Research and Investigations, had just published a scathing report about Wirecard, causing its share price to drop more than 20%.

I had mixed feelings. On the one hand, we had already established a short position in Wirecard in our fund, so the decline in the stock was profitable for us. Still, after spending several months doing meticulous research, I couldn't help but feel like Zatarra had beaten us to the punch.

Upon further review of their report, however, I quickly realized that it focused mainly on the potential money laundering angle and did not include the evidence of the fraudulent activity I had discovered in India. Nevertheless, the cat appeared to be out of the bag so I decided to hold off on publishing our work to see how regulators and other market participants would react to Zatarra's evidence of the company's fraudulent behavior.

I also wanted to get to know the person or people behind the Zatarra report. Fortunately, soon after I returned from India, I met and developed a friendly relationship with its authors, Matthew Earl and Fraser Perring. For several months thereafter, we regularly exchanged information and ideas for how to proceed with the Wirecard research. As we uncovered more and more evidence of enormous fraud, we believed that the end was near for the crooked company. (Keep in mind that this was in 2016.)

How wrong we were! We never could have imagined that this house of cards would continue to grow for four more years, destroying more capital and harming more investors in the process.

To our surprise, Wirecard's stock price began to recover, aided by the company's vigorous denials of wrongdoing and by the sizeable, leveraged stock purchases by CEO Markus Braun. The German financial press and sell-side analysts covering the stock also came to the company's defense, apparently without investigating any of the allegations contained in the Zatarra report or McCrum's FT articles.

The most disturbing event occurred when an anonymous report with the ominous title "R.I.P. Zatarra" appeared on Twitter in late 2016. The document turned out to contain mostly fabricated allegations against Zatarra and other Wirecard critics and included clandestine photographs of the two Zatarra authors as well as the contents of hacked private emails between them and others with whom they'd communicated.

While the report contained no evidence that the Zatarra researchers had done anything wrong and was largely comprised of innuendo and almost laughably unrealistic conspiracy theories, it was nevertheless unsettling. (I made a small appearance in the document, though I was described as "Gabe" and inaccurately portrayed as being in charge of "media relations.")

I was clear that Wirecard would stop at nothing to attack its critics, including hiring thugs to surveil them and hack their email accounts. The message was clear: we are watching you and can get close enough to take your picture. This warning proved to be only the beginning – for some time thereafter, there were reports of Wirecard conducting surveillance, breaking and entering homes, stealing tech equipment, and engaging in hacking campaigns against its critics (I was on the receiving end of a couple of these attempts).

Though I was concerned by Wirecard's intimidation efforts, they didn't deter me from continuing my research into the company's fraudulent activities.

What did deter me, however, was when Germany's financial market regulator, known as BaFin, stepped in to protect Wirecard from its critics. It was clear from a Reuters article in February 2017, Germany's Bafin asks prosecutors to investigate Wirecard share movements, that the German financial watchdogs, rather than investigating the company, were instead "going to investigate possible market manipulation" by critics like Zatarra.

I knew from my experience in exposing other frauds in various markets around the world that regulators play a critical role in validating a short seller's evidence. Conversely, if regulators are determined to protect a company and go after its critics, it's a bad business decision and legally very risky to attempt to fight the regulators, no matter how strong the evidence is.

So we backed off our active work on Wirecard and moved on to other things (though we continued disseminating information to other critics). Sadly, my judgement turned out to be correct, as my friends at Zatarra suffered from persistent legal and regulatory harassment and eventually were fined by German regulators – before being 100% vindicated.

History is always the final judge, and it won't be kind to Wirecard or those responsible for perpetuating the fraud. The story ended as we expected – it just took four years longer than we thought.

The FT published another set of articles, this time with the help of a well-informed and credible whistleblower. And while the FT was itself subject to lawsuits, criminal probes and surveillance, the paper fought on and eventually the monster was slain. Today the fraud has been exposed for all to see.

So, who bears responsibility for this financial catastrophe (other than Wirecard's management) and how can we reduce the frequency of such events? Let's start with Wirecard's auditors, EY, which signed off on Wirecard's financial reports for the years 2016, 2017 and 2018 with unqualified opinions. EY ignored the many obvious red flags until the last possible moment, despite persuasive evidence published by the FT and others. In my experience with numerous fraudulent companies, auditors all too often seem to either look the other way or are the last ones to know what is going on. This obliviousness makes me question both the purpose of auditors for publicly listed companies and the soundness of the system through which auditors are selected and compensated by the companies they are auditing – an obvious conflict, made worse by their large businesses providing "consulting" services to the very same companies. It is clear that auditors need to change how they operate and perhaps how they are paid. It's worth noting that EY was the auditor of a number of other proven, multibillion dollar frauds in the last year, including Luckin Coffee, NMC Health, and Bio-on.

Second, BaFin absolutely disgraced itself, refusing to take seriously the many credible allegations against Wirecard over the years, and instead actively seeking to punish any and all critics. BaFin even resorted to the unprecedented step of prohibiting the short sale of Wirecard stock for over two months in 2019 after the most damaging of the FT articles was published.

I applaud the recent initiatives to conduct an internal review of BaFin's handling of this case in order to understand how an agency whose job it is to preserve the integrity of the market ended up protecting a fraudulent company. I will also point out that by implicitly providing its seal of approval in favor of Wirecard by enforcing its short sale ban, BaFin enabled the company to raise billions of dollars of additional capital from investors, most of which has now gone up in smoke.

In contrast, when I presented Italian authorities in 2019 with compelling evidence that a local company, Bio-on, was committing fraud, they moved quickly to investigate and ended up shutting down the company in record time before more damage could be done.

Third, the sell side "analysts" at German banks almost universally supported Wirecard right up to the bitter end. Rather than do actual research, they casually dismissed the short sellers and belittled the evidence presented in the FT articles, issuing enthusiastic "buy" ratings all the while. Heike Pauls, an analyst from Commerzbank, was typical: he characterized the FT's reporting as "fake news" and a "buying opportunity" as he blithely issued a €230 price target for Wirecard's stock.

Similarly, with some notable exceptions (for example, the Sueddeutsche Zeitung), the German press was hesitant to publish critical articles about Wirecard and failed to do any investigative work whatsoever. This underscores the importance of good investigative journalism to the healthy function of the capital markets.

Lastly, while I acknowledge that it's in my personal interest to say so, activist short sellers deserve as much credit as Dan McCrum and the FT in uncovering the Wirecard fraud long ago and persisting despite the many obstacles thrown at them. In this case, as in so many others, activist short sellers and short research providers proved themselves to be more effective in policing the market than auditors, regulators, sell side analysts, rating firms, and the press.

This underscores the valuable role that activist short sellers play in making the capital markets safer for all investors, and the need to improve a regulatory system that is too often hostile toward them.