Hedge-fund activism and the fight over Herbalife

This IESE case examines how Herbalife is being fought over by three of the most successful activist shareholders: Bill Ackman, Carl Icahn and Daniel Loeb.

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Its name and three-leafed logo can be found on the jerseys of mega sports stars like Lionel Messi and David Beckham. Its network of distributors reaches north of three million people. Yet Herbalife may be more famous, in certain circles at least, for its stock market gyrations.

On December 20, 2012, Bill Ackman, CEO of Pershing Square Capital Management, attacked Herbalife's business model during a three-hour investment presentation, claiming it is an illegal pyramid scheme while explaining why he had decided to short 20 million Herbalife (HLF) shares, worth over $1 billion.

In the days following Ackman's presentations, HLF's share price fell dramatically on the New York Stock Exchange. After closing at $42.50 on December 18, the shares closed at $26.06 on December 24. Rival, disagreeing hedge-fund activists sprang to the company's defense, setting off a battle over Herbalife's business model, its legality and, ultimately, its market value.

This dramatic showdown is featured in the case study "Who Wants to Be a Millionaire? Bill Ackman's Big Short of Herbalife." IESE's Tom Vandebroek, Fabrizio Ferraro and Jan Simon use the story to examine such topics as hedge-fund activism, short selling, responsible investing and a CEO's possible responses to such market machinations.

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Starting with a success story

Founded in 1980 in Los Angeles, California, Herbalife grew to be a global company, operating in 88 countries, selling nutrition products through a network of about 3.2 million independent distributors.

Herbalife offers both products -- e.g., weight-management shakes, vitamins and energy supplements -- as well as the opportunity to sell these products as an independent distributor.

Becoming an independent distributor involves a minimal investment in a starting kit. The distributors then receive a deep discount on Herbalife products. Distributors also gain financially by recruiting other distributors.

Herbalife's most significant period of growth was overseen by current CEO Michael Johnson, formerly president of Disney. The company's sales went from $1.2 billion in 2003 to over $4 billion in 2012.

In 2004 Herbalife went public on the NYSE. Between 2005 and 2012, the HLF share price increased 1,000 percent.

The accusation: Selling dreams not products

On December 20, 2012, Bill Ackman, the legendary CEO of Pershing Square Capital Management, explained why he had decided to short Herbalife shares.

In a three-hour presentation, Ackman provided a detailed account of why he is convinced that Herbalife's business model is inherently unsustainable. While Herbalife considers itself a multilevel marketing company and a product company, Ackman said it is a well-disguised pyramid scheme -- and therefore illegal.

Ackman claimed that Herbalife "is all about the business opportunity" because independent distributors primarily get their revenue from recruiting other distributors.

Legally speaking, being primarily a "business opportunity company" is considered illegal, the case points out. Ackman explained that his own research showed that, after due adjustments, the ratio between Herbalife distributors' income stemming from recruiting and their income from direct sales stood at about 10 to 1.

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Ackman also claimed that Herbalife products, which allegedly were essentially commodities, were cheaper to buy from competitors or online. He said the majority of distributors lose money.

In this very open attack against Herbalife, made public through a website (www.factsaboutherbalife.com) and via the media, Ackman said he was pursuing the truth and not profit. He declared that 100 percent of his personal profits from shorting Herbalife shares would go to charity.

The reaction

In the days following Ackman's attack, Herbalife shares lost about a third of their value, closing as low as $26.06 on Christmas Eve. Ackman told the media he would be happy when the shares hit zero.

On January 9, 2013, fellow hedge-fund titan, Daniel S. Loeb, revealed in filings with the U.S. Securities and Exchange Commission (SEC) that he had acquired an 8.2 percent stake (8.9 million shares) of Herbalife. The same day he also wrote to his shareholders that he rejected Ackman's arguments. Shares promptly soared 10 percent that day.

Another renowned hedge-fund activist, Carl Icahn, also reported he was long Herbalife and hinted of a "short-squeeze," which could force Ackman to buy shares at a far higher price than he had initially hoped for. This was January 16, 2013, by which time HLF's share price was back in the mid-$40s.

On February 14, 2013, Icahn notified the SEC in a filing that he had a 13 percent stake in Herbalife. The filing also noted his intentions to have discussions with Herbalife management "regarding the business and strategic alternatives to enhance shareholder value, such as a recapitalization or a going-private transaction."

The battle continues

Icahn's announcement pushed Herbalife's volatile stock up 20 percent in heavy trading on February 15. Despite mounting losses due to these price increases, Ackman persisted in his position, intensifying his lobbying activity, and regularly presenting new evidence supporting his claims.

Over a year later, on March 12, 2014, Herbalife confirmed that the Federal Trade Commission had opened an official investigation of its business practices. News of the investigation

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pushed share prices down. It will take months, perhaps years, to reach a verdict on the legality of Herbalife's practices.

In the meantime, this case study opens a debate on the wider business implications of hedge-fund activism and its potential role in shedding light on dubious business practices. The case also questions what, if anything, Herbalife's CEO might do.

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