IDIOSYNCRATIC RISK

Volume 1 / Issue 4 (July 2020)

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Idiosyncratic Risk is a monthly investment ideas newsletter published by Antrim Investment Research, LLC.

"These new regulations will fundamentally change the way we get around them."

New Yorker cartoon, March 9, 2009

AUDITS AND PLAUDITS

ON JUNE 18TH 2020, WIRECARD AG ANNOUNCED THAT IT COULD NOT VERIFY THE SUPPOSED EXISTENCE OF €1.9B CASH

I have a story to tell. A decade ago (or thereabouts), a good buddy of mine worked as a bank teller at a local credit union. The buddy and the credit union will remain nameless (though I know he's reading this) because I'm not writing it to embarrass anybody. I'm writing it to make a point.

My buddy ended one otherwise forgettable shift and turned his cash drawer in to discover that it was, as they say, "light." He was missing a full $2,000. That is to say: in the morning, the credit union had counted out his bank, twice, and handed him a cash drawer. He'd recorded all of the cash deposits and withdrawals he'd received and disbursed over the course of the day and credited the deposits to his ledger, debited the withdrawals. And at the end of the day, while his cash drawer had $X in it, his ledger read, "$X + $2,000."

What happened next was, the credit union filed a police report and the police conducted a criminal investigation. Spoiler alert: my buddy had not taken $2,000 of the credit union's money. Nevertheless, the credit union cared very much that $2,000 of their money was unaccounted for, and they felt that such an amount fell outside of the bounds that could reasonably be attributed to sticky bills, fat fingered data-entry, or otherwise "human" error. My buddy was fired.

My buddy was fired, and then he was investigated. It took a couple of months and several thousand dollars more before the bank identified the actual culprit, a different employee, who was also fired and ultimately prosecuted for embezzling (actually I don't know if it was considered embezzlement or straight up larceny) company funds. My buddy's old boss sent him an email to apologize for having suspected him in conjunction with the incident. That email did not offer my buddy his job back.

Everybody was satisfied with that. My buddy was satisfied with that, my friends and I were satisfied with that, and the credit union was satisfied, but understaffed. My friends and I talked about this a lot when it happened, and we all understood a couple of things that seemed pretty obvious to us, even at first glance. We didn't really think my buddy was a thief, we thought he was a terrible bank teller. We didn't really know where the money went, but we knew it was his responsibility to account for it, and he had failed. It made sense, therefore, that he had been fired. There was no discussion as to whether or not he had been "wrongfully terminated." The onus of proving theft was not placed on the credit union, the branch manager was not investigated or maligned. Everyone did their job, (or didn't) and reaped just rewards (or consequences) for their actions.

On June 18th, 2020, a large German payments processing and financial technology company, Wirecard AG, announced the departure of its CEO Markus Braun and COO Jan Marsalek, in conjunction with the disclosure that it would not be filing audited financial statements for the previous fiscal year (2019), and the admission that neither Wirecard nor its auditors could verify the existence of €1.9B, cash, that it had supposedly held in the bank. It had been dutifully recorded in its ledger, and on the "balance sheet" value investors so routinely rely on. Markus Braun would later be arrested. Jan Marsalek fled to the Phillipines (or so it's been reported). Wirecard, a company that had a €10B market cap only one week before, filed for insolvency protection with the German financial authority on June 25th. Its stock traded hands on Monday morning at a price of €3.26, roughly 100% higher than what it's worth, but 97% lower than €104.50, where it had closed on June 17th. And nobody was satisfied with that.

Where there is money to be made, fraud runs rampant.

German pensioners lost billions. The German finance minister Olaf Scholz reportedly called the scandal, "extremely worrying," and suggested that the country would have to act quickly to improve oversight of companies such as Wirecard. The only people who profited from the company's demise were short sellers (like Antrim, which was short shares of WDI in its portfolio), and even they weren't really "satisfied." Short sellers and whistleblowers had been harassed and maligned for years by Wirecard and its allies in the German regulatory regime. BaFin, the German Federal Financial Supervisory Authority, had banned short sales in Wirecard shares – literally banned short selling a single company's shares – for 2 months in 2019 amidst mounting criticism. The regulator had launched a criminal investigation into the Financial Times, despite its august reputation, for its reporting on the allegations against Wirecard. Wirecard itself had hired an Israeli security consultant to funnel payment to an Indian Hacker-for-Hire firm tasked with investigating and harassing short sellers, whistleblowers, and journalists.

This is a tale as old as time. Where there is money to be made, fraud runs rampant. Whistleblowers are maligned. Short sellers are misrepresented and disregarded. Journalists are (perjoratively) called critics and muckrakers. The frauds persist in plain sight. They grow, and the prevailing attitude becomes, "it's a $10B company, it couldn't possibly be a multi-national money laundering organization with fake financial statements. The regulators would have discovered it. The auditors signed off!" Well, the regulators are too busy suing the journalists and the short sellers. And the auditors… oh the auditors.

19 years after Arthur Andersen's failure to audit Enron brought the powerhouse auditing and consulting firm to its knees, we have EY Germany, the European hub of the global "big four" auditor Ernst & Young. EY Germany has disclosed that for the **past three years** it had failed to ask Wirecard for the bank statements that confirm its cash accounts. In truth it's a little more complicated than that – Wirecard allegedly held cash in trust accounts with offshore trustees, who couldn't be

reached by EY because the trustees were fake, or had already absconded with the cash – but the point is, EY Germany did not verify Wirecard's cash balances (!) for three years running. And yet they signed their name on Wirecard's public financial statements.

Antrim Investment Research did none of the reporting on Wirecard. That was up to Dan Mccrum at the Financial Times. Roddy Boyd at the Foundation for Financial Journalism, and Zatarra Research. Google Zatarra research, you get a link to their website, and a second link: "Slander, Ghost entity and media collusion: meet Zatarra, the… mysterious organization designed to harm and make a profit." In 2020, evidently that's a synonym for "truth, and fiduciary duty to investors." Antrim sold WDI shares short and made a killing on it in June, only because short sellers like Fraser Perring and Marc Cohodes wouldn't let it go, or be quiet about it.

These things are happening in plain sight. In today's version of the "efficient market hypothesis" the Financial Times can report that a €10B company is a fraud and catch nothing for it but grief and a subpoena. In the U.S., a $100M company can go bankrupt and de-list its equity the morning after ETFs purchased 800,000 of its shares, and they had told you that an index fund was the way to go.

Back to my buddy the bank teller. At the end of the day, when they counted his cash and compared it to his ledger, that's an audit. That's what an auditor does. That's what EY Germany failed to do in the case of Wirecard. In a properly functioning system, if there are questions about the cash drawer or the ledger entries that the teller can't answer, the teller is fired. The onus is on the bank teller to keep an orderly ledger and maintain responsible oversight of the cash drawer. It's not on the branch manager to prove embezzlement, or theft, or fraud. (Incidentally, my buddy is doing great. We're older now, and life is nothing but a never ending coming-of-age story anyway.)

… the Financial Times can report that a €10B company is a fraud and catch nothing for it but grief and a subpoena.

It is the position of your author that the onus is on public company management to keep orderly financial statements and accounting controls. To maintain responsible oversight over cash balances, and fiduciary responsibility over their shareholders' capital. It is the position of your author that there's money to be made – or even alpha to be generated – by selling short companies whose management cannot or will not answer simple questions about their business model and financial statements, and companies who expend an order of magnitude more energy harassing and silencing journalists, critics, and whistleblowers than they do reassuring their own shareholders and actively promoting transparency.

I understand that opinion can be perceived controversially. And I understand that not all of my subscribers sell stocks short, or would if they could. But over the course of the following pages, I intend to describe two short positions Antrim currently maintains in its portfolio, and the excellent reporting that has been done by other journalists, whistleblowers, and yes, short sellers, on those companies. I intend to convince you that these companies' management teams have monumentally failed to respond to legitimate criticisms and simple questions. And if I can't, I intend to challenge you to answer why you believe that the burden of proof in these cases falls with the critics and the whistleblowers? There are thousands of publicly traded companies and investment vehicles. Due diligence is always and everywhere a process of "investment by exclusion," and the burden of proof is always on management to prove that they deserve your investment dollars. Not the other way around.

SHORT TESLA (Nasdaq:TSLA)

GOODWILL, BY ANY OTHER NAME

Tesla came public during 2010, selling shares to the public at a price of $17 to raise $226M, and valuing the company at almost $900M dollars. $1,000 invested in that IPO would be worth $58,000 ten years later. $1,000 thrown at Tesla in the open market, up 41% on its first day of trading would be worth $41,667 ten years later. This is a remarkable feat for a company that has famously never turned an annual profit.

In its time as a public company, Tesla has issued, cumulatively, $3.2B in additional equity. The company has issued (net) $9.6B of additional debt. The company famously received a $750M subsidy from the state of New York to build a manufacturing plant in Buffalo. The company has received, and recorded as revenue, billions of dollars of Zero-Emission Vehicle ("ZEV") credits after California and 9 other U.S. States have started offering them to manufacturers of vehicles that produce zero emissions.

The company has required $14B of capital investment over the past decade to generate $6B of cash flow from operations, cumulatively, and inclusive of subsidies received. Tesla had, as of the end of 2018, $25B of gross property, plant, and equipment on its balance sheet. The company delivered only 367,500 cars during the following year but stated that it was capacity constrained in so doing. In contrast, Ford Motor company, which carries less than 3x as much gross property, plant, and equipment on its balance sheet, delivered 14.7x as many cars, worldwide, during 2019.

These numbers are all audited by Price Waterhouse Coopers ("PwC") and are all generally accepted by Tesla investors and critics alike. They are unremarkable. They describe a niche automobile manufacturer that sells a small number of expensive cars at a curiously low profit margin, which has funded its (heretofore unprofitable) expansion by issuing debt, diluting shareholders, and attracting subsidies. Tesla's share price describes a different company.

> *These numbers ... describe a niche automobile manufacturer that sells a small number of expensive cars at a curiously low profit margin*

In 2018, famed short seller and principal of Kynikos Associates, James Chanos discussed his short Tesla position, which had been on the Kynikos books since at least 2014. He called Tesla's management turnover rate, "stunning," and suggested that Elon Musk "may be misleading investors" by promising a new Tesla Roadster in 2020 and an electric semi-truck which was to have gone into production during 2019. Of course, neither of Musk's promises, as cited in that interview, came to pass. Tesla's stock went to $1,000 a share.

But what of Tesla's management turnover? In 2018, TSLA lost its VP of worldwide service and customer experience, senior VP of engineering, VP of North America and EMEA business development, chief accounting officer, chief people officer (HR), VP of global supply chain management, VP of manufacturing, and head of global security. In 2019, TSLA lost its CFO, and replaced him with a 34-year-old who had worked at McKinsey for a few years before joining the TSLA accounting department. Who else would want to be CFO at the world's largest auto manufacturer?

In 2019, TSLA lost it's general counsel, senior director of engineering, VP of global recruiting, its replacement general counsel, director of global security (again), senior director of global communications, VP of human resources, VP of production, VP of exterior and interior engineering, VP of Tesla Europe, VP of engineering, its senior VP of energy operations, and then, its third (!) general counsel in the same year. Thus far in 2020, Robin Ren, a VP of business development instrumental in getting Tesla's Chinese operations up and running has left, amongst others.

This level of employee turnover is not typical for successful Silicon Valley start-ups. This level of executive turnover is unheard of. It wasn't seen at Apple, which famously bristled under Steve Jobs's exacting and eccentric brand of leadership. It is not, and was not seen at Netflix, despite its famously candid and critical employee assessment process. It's not seen at Amazon, despite... I don't even know what to call it. If you Google "Amazon Culture," the first link that comes up is a NY Times headline: "Inside Amazon: Wrestling Big Ideas in a Bruising Workplace." Evidently, if Amazon is "bruising," Tesla is bareknuckle boxing.

What is more concerning are the roles left vacant by the revolving door to Tesla's executive conference rooms. That the company went through *three*, 3, THREE General Counsel in 2019 is astonishing. It's frankly appalling when one considers that Tesla is due in Delaware Court later this year to answer to not one, but three outstanding shareholder lawsuits. One alleging that Musk misled investors by tweeting, "considering taking Tesla private at $420. Funding secured." (He wasn't, hadn't, and didn't.) Another alleging that his $56B incentive compensation package is excessive. Losing three separate counselors in a single year is appalling when one considers that all of Tesla's directors, except Musk himself, recently entered into a $60M partial settlement to lay to rest claims that the company's 2016 acquisition of SolarCity for $2B amounted to a "bail out" of an insolvent solar panel manufacturer co-founded by Musk and his own cousins.

Perhaps it is that $60M settlement, charged against Tesla Directors' "D&O" (Directors & Officers) Liability Insurance policy that caused D&O carriers to distance themselves from the company, offering Tesla quotes on a renewed policy that Musk decried as usurious. Elon cancelled Tesla Directors' D&O insurance earlier this year and entered into an agreement with the board to personally insure them against liabilities incurred over the course of their duties as directors. Insurance industry observers have noted that, while it is not entirely unprecedented, the arrangement is unusual. The same directors reliant on Musk's financial ability to honor that commitment determine Mr. Musk's pay package. And it must also be pointed out that a D&O policy is likely to pay out at the culmination of a successful shareholder lawsuit, when presumably, Mr. Musk's financial ability to honor that commitment would be approaching its nadir, tied as his finances are, inexorably, to Tesla's stock price. (Mr. Musk owns 20% of Tesla and has pledged half of those shares, or 10% of the company, as collateral against personal loans used to fund his lifestyle)

Tesla is owed over $1 billion by its customers. With customers paying up front, why are the balances so high?

Tesla also lost a Chief Financial Officer and a Chief Accounting Officer in the past 18 months. No doubt this turmoil has hampered the company's ability to respond to investor questions about irregular and unusual accounting practices at the carmaker. I quote a late 2019 "open letter" from David Einhorn (who famously exposed fraud at Allied Capital, and later Lehman Brothers), regarding Tesla's accounts receivable balance:

"Car buyers don't typically drive off the lot without paying for the car. Publicly traded auto dealers have only a couple days of accounts receivable balances. Yet, Tesla is owed over $1 billion by its customers. With customers paying up front, why are the balances so high?"

In 2018, Tesla's answer was that the quarter had ended on a Sunday, and the banks Tesla deals with didn't factor receivables over the weekend (this is rank nonsense). The quarters since have ended during the week, the "receivables," still haven't been received. In 2019, the explanation was that the Model 3 delivery ramp in Europe meant that receivables balances would remain elevated, as a result of the fact that they receive payment from U.S. banks in 3 days, Chinese banks in 7 days, but require 28 days to receive payments from European banks. FT Alphaville has noted that this is unusual, because, well, it doesn't take 28 days to process bank transfers from Europe to the U.S., the receivables balance started ballooning before the Model 3 started ramping, and the receivables balance has not collapsed, despite the collapse of model 3 deliveries in Europe. So, Tesla has offered answers to Mr. Einhorn's question, but none that withstand scrutiny.

Tesla has also faced questions about its accounting for revenues under "Sales Type: Leasing" accounting policies.

Tesla has also faced questions about its accounting for revenues under "Sales Type: Leasing" accounting policies. Such accounting treatment is generally reserved for car dealers and manufacturers who lease their own inventory, like Tesla does (the company does not utilize a network of independent dealers). When Tesla "sells" a car that is actually a customer lease agreement, the revenue recognized is the present value of the lease payments to be made over the life of the lease at the prevailing discount rate (interest rates are currently zero), plus the present value of the "residual value," which is the value that the used inventory will have when it is returned to the manufacturer. In this way, the higher the "residual value" of a used Tesla, the more "revenue" Tesla can actually record, under sales type leasing standards. This is not actually a cash inflow, like you would think, when you think, "revenue." Rather it's a non-cash estimation of the value of a used Tesla returned to the company. But it can be famously difficult to verify just what exactly a "reasonable" assumption about residual values might be. Hertz certainly failed to estimate them accurately before declaring bankruptcy earlier this year.

In Q4 of 2019, Tesla booked $225M of lease type sales on 9,201 deliveries. In Q1 of 2020, they booked $239M of lease type sales on 6,104 units. That's a slight increase in lease type sales on a 1/3 reduction in unit volume. There is a positive ASP mix shift in there, as Model 3 units declined more (2300 units) than Model S/X units (743 units), but that doesn't explain an increase in recorded revenues. Tesla didn't take a price increase for any model in the quarter. So the only explanation is appreciating used car values for Tesla, impacting the present value of the residual estimate calculation.

Used car prices during the majority of Q1 might have been up slightly, sequentially from Q4 of '19 (they cratered in April, according to the Mannheim used vehicle index, not before) but Tesla would need a 2-3x increase in the residual value of their used cars to adequately explain this discrepancy, based on my estimates, which admittedly, I don't understand. What I do know is this. Normally an auditor would look to used car auction values, then Kelley ("Blue Book") values, and maybe then, third party listings to determine whether residual value estimates are reasonable. (h/t to "Abnormal Accrual @bbm010" on twitter for calling this one out – give him a follow) After a national state of emergency was declared in response to the coronavirus, however, the used car auctions were shut down. Kelley's sample size was too small to draw meaningful conclusions, and used car lots were closed, except for … Carvana's online lot, where Tesla fans and skeptics alike started to notice used Teslas listed at prices above where Tesla would sell the identical configuration, new.

Tesla has also drawn criticism for its accounting for property, plant, and equipment depreciation. In particular, it's been noted that Tesla's depreciation expense assumes that the tools it purchased to manufacture the Model S and Model X will remain useful for 325,000 units of production or so, while the tools it purchased to manufacture the Model 3 will last for 1 million units before wearing out. The tools in China are even hardier, as the company has registered nary an increase in depreciation expense despite breaking ground and starting production at a whole new factory there, just this past year. In the opinion of this author, Tesla is getting much better at buying tools.

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And then there's the issue of warranty reserves and releases. On average, Tesla reserves more for warranty expenses than other car manufacturers, despite recognizing less in warranty expenses than those same competitors. This seems positive, and potentially even conservative, until one considers that Tesla is the only company offering warranties on a fleet of purely battery powered, electric vehicles. Batteries are expensive, really expensive, and they don't last that long. They're covered by warranty (8 years or 150,000 miles). This seems conservative until one considers that JD Power ranked Tesla dead last amongst car manufacturers on initial quality in their June 2020 survey, at 250 reported problems per 100 new Teslas sold.

As a result, the bean counters and skeptics took note when insideevs.com reported that customers taking their new Teslas back to service centers for warranty repairs often receive receipts that read, "Pay type: Goodwill – Service," as opposed to "Pay type: Basic vehicle limited warranty." This was reported to insideevs.com by reader, Sergio Rodriguez, in January of this year. When a service center wants to ingratiate themselves to a loyal customer, they'll do a repair for free, even if it's not covered under warranty. If it is under warranty, the pay type should read, "Basic vehicle limited warranty." This ensures that Tesla's accounting systems recognize a warranty expense has been incurred, Tesla's auditors can verify the estimates underpinning Tesla's warranty reserves with real life expenses, and that Tesla has not run afoul of lemon laws or NHTSA quality and safety regulations. What is particularly interesting to note here, is that EVBrite reported in April of 2019 that Tesla had asked its service centers to reduce free, "goodwill" repair work in order to save the company money.

Perhaps these ongoing goodwill repairs do have something to say about Teslas warranty reserves, which have been systematically and inexplicably reduced over time? If indeed Tesla is offering free repairs to customers in lieu of reporting warranty related expenses into the appropriate national database, they might indeed choose to call those repairs, "Goodwill." An outside observer might call that, at best, "misclassification," and at worst, "fraud."

Warranty reserves … have been systematically and inexplicably reduced over time

For those observers wondering what $100M here or there has to do with a company valued at over $180B in market cap, it must be remembered that Tesla bulls are hoping whatever set of non-GAAP assumptions Tesla makes can help the company string together a fourth quarter in a row of non-GAAP profitability, and earn it inclusion in the venerable S&P 500 index.

In June 2019, Aswath Damodaran, who frequently posts DCF valuations of controversial "bubble" stocks to demonstrate to his MBA students that a common sense valuation approach can help moderate stock market controversies and excesses, wondered what TSLA would be worth if it grew to $100B in revenue (almost the size of Ford) and $10B in pre-tax income (over 10x as profitable as Ford) over the next decade. He arrived at a valuation of $190 per share. He sold his TSLA shares in January of this year as TSLA crossed $600.

Tesla's marketing around "autopilot," and the veracity of its autonomous driving claims have come under scrutiny. The company's website states, "Autopilot and Full Self Driving Capability are intended for use with a fully attentive driver, who has their hands on the wheel and is prepared to take over at any moment." On twitter, Musk states that "FSD" (Full Self Driving) is an appreciating investment, that could well be worth $100k per car, by the time Tesla is done with it. The company has already settled one class action lawsuit related to these claims and could well be at risk for more legal liability. On Tuesday, June 30th (yesterday), Nbc10 Boston reported that a Tesla which had hit a state trooper parked on the side of the highway with lights flashing, had been operated under autopilot. The article noted a deadly collision between an "autonomous" Tesla and a tractor trailer in Florida in 2016, a fatal crash into a concrete highway barrier in California in 2018, a Utah driver who rear ended a fire truck at a red light in 2018, and a Connecticut State Trooper who'd also been hit by a Tesla operated under autopilot. A week ago, Burger King realized that Teslas mistake their logo for stop signs, and ran an ad campaign under the tag line, "Smart Cars are Smart Enough to Brake for a Whopper." A UK customer posted a video to YouTube of his car repeatedly trying to drive in the right lane (like it would in the U.S.).

There is a large body of evidence that suggests Tesla, and Musk himself, devotes enormous energy to harassing and silencing critics.

There is a large body of evidence that suggests Tesla, and Musk himself, devotes enormous energy to harassing and silencing critics. In July of 2018, shortly after Musk had called a Thai rescue diver a "pedo guy" on twitter, it was reported that he had "doxxed" an anonymous Seeking Alpha contributor, critical of Tesla under the byline, "Montana Skeptic," and called his place of employment to threaten legal action. "Montana's" boss and another colleague confirmed to the media, on background, that they had spoken with Musk directly. In August of 2018, Martin Tripp was fired from Tesla's Nevada GigaFactory after leaking photos of scrapped car batteries that he claimed were broken or defective cells emblematic of Tesla's manufacturing quality control issues. Tesla's security department reported to local police that they had received an anonymous tip suggesting Mr. Tripp planned a mass shooting at their facility. When the police investigated Mr. Tripp, they found nothing to substantiate this claim. To this day, Martin Tripp is embroiled in a suit-countersuit with Tesla over defamation of character and his whistleblowing activities. In 2019, Karl Hansen filed a civil lawsuit in Nevada against Tesla for violations of the Sarbanes Oxley Act. Court documents related to that proceeding allege that the company has subjected current and former employees to illegal surveillance, improperly interfered with ex employees' efforts to find work, and fired employees for reporting safety violations to company safety officers. In the interest of full disclosure, it must be stated that Mr. Hansen's lawsuit also seems fantastical: it alleges that Mr. Musk and Tesla have ties to known Mexican drug cartels.

Tesla was sued by a former director of Environment, Health, and Safety for being fired after reporting safety violations. Imagine firing a safety officer for reporting a safety violation? An assembly line worker sued after being fired, he alleged, for reporting anti-gay harassment in the workplace. That employee claims that after reporting harassment, HR told him he was injured and took away his badge, stating, "there's no place for handicapped people at Tesla." Another Nevada lawsuit alleges that an employee was terminated after reporting that they had been the victim of a sexual assault in the workplace.

Antrim has little to add to this debate. I'm not reporting anything that hasn't been reported elsewhere, and probably more eloquently. Rather, I am repeating these allegations in the pages of this newsletter because I refuse to be complicit in the acceptance of nonsense, fraud, and chicanery in the financial markets. It may be that it is the normal course of business, but it should not be. To that end, Antrim is short any company, auditor, or investor who actually believes that Accounts Receivable are caused by Sundays.

SHORT GSX TECHEDU (NYSE:GSX)

PRECISE JOINERS, BURST JOINERS, EARLY JOINERS

GSX Techedu is a Chinese provider of for-profit K-12 online education and tutoring programs, brought public via NYSE listing after the company established a Cayman Islands holding company meant to funnel U.S. based investor dollars back to its Chinese "parent" in compliance with PRC regulations restricting foreign ownership of mainland Chinese businesses. The company was founded by Xiangdong "Larry" Chen, in 2014, after he had served four years at the helm of New Oriental Education & Technology Group, Inc. (NYSE:EDU). The company started as an "online to offline" referral service, offering offline teachers a platform to perform online tutoring sessions while simultaneously advertising their services as offline educators in real world, for profit K-12 education centers. Its business model has migrated away from "online to offline" referrals, and today GSX offers a full suite of K-12 courses online, in a live, large-classroom format, which the company states, "is the most effective and scalable model to disseminate scarce, high-quality teaching resources to aspiring students in China." GSX offers these courses under its brand name, Gaotu Class, which the company launched in 2016 after witnessing the success of a competitive large class, live online tutoring platform called, Yuan Fu Dao.

On May 18th, 2020, a registered investment advisory known as "Muddy Waters, LLC," which has previously exposed fraud at NYSE listed Chinese American Depository Receipts: Sino Forest, NQ Mobile, and Luckin Coffee, published a research report critical of GSX. Muddy Waters alleged that they had obtained a data set of 463,217 sign in records for 54,065 unique users on GSX's platform. Analysis of this data showed that 28.2% of GSX's purported "students" shared an IP address with a GSX teacher. GSX responded that they had queried their entire database of users and found 0.78% overlap between "student" and "teacher" IP addresses. It is statistically impossible that both claims are true. Muddy Waters purported to examine 2.9% of GSX's user data and found 28%+ overlap. That would amount to more than 0.78% of GSX's total users, even if no overlap existed outside of the dataset obtained by Muddy Waters.

> *It is often the role of the security analyst to evaluate the veracity of primary research performed by third parties.*

Muddy Waters further alleged that over 80% of the "users" identified in their dataset were highly likely to actually be bots designed to mimic the behavior of real, live students. Over half (52.8%) of the unique users in Muddy Waters' data set conform to a pattern that Muddy Waters calls, "precise joiners," meaning these users join the same class, at the same time (to the second) on different days of at least two different weeks.

Muddy Waters describes an additional pattern it refers to as, "burst joiners." Burst joiners refers to large groups of users, frequently from the same IP address, that all join a class at the same precise second. These bursts often, but do not always come during periods where there is little or no sign in activity outside of the "burst."

Muddy Waters identified that 14% of the unique users in their dataset frequently joined classes early. Implausibly early, according to Muddy Waters, who set the cut-off for "early joiner" identification at more than 30 minutes prior to a class's listed start time. Your author must confess that he's never logged in to a video conference more than 30 minutes ahead of its start.

I am reiterating these claims and attributing them to Muddy Waters for two reasons. First, I do not intend to take credit for work performed by somebody else. And second, I believe that it is important to demonstrate that it is often the role of the security analyst to evaluate the veracity of primary research performed by third parties. In this case, I find Muddy Waters' expertise and track record compelling. In 2016, for example, the company released a report claiming that pacemakers and other implantable medical devices made by St. Jude Medical were highly susceptible to "hacking" or otherwise nefarious exploitations of holes in the devices' security software. St. Jude decried the allegations as false and misleading, and sued Muddy Waters for defamation. In January of 2017 the U.S. Food and Drug Administration together with the Department of Homeland Security released the results of their joint investigation into St. Jude's cybersecurity vulnerabilities and confirmed that all of Muddy Waters' allegations were true.

"Brushing," which is a practice of using bots or otherwise fake accounts to generate fake web traffic and increase reported e-Commerce revenue is commonplace in China. NQ Mobile and Luckin Coffee, both exposed by Muddy Waters, engaged in the tactic. Alibaba (NYSE:BABA) has openly wrestled with brushing on its platform, as third party merchants seek to improve their standing in Alibaba's search algorithms by artificially inflating transaction volumes and satisfied customer counts. Tencent has publicly wrestled with bots on its WeChat (like twitter, Instagram, whatsapp and paypal combined) platform, seeking, unsuccessfully, to confine bot activity to legitimate customer service related chatbots.

No surprise then, that Muddy Waters alleges GSX is operating bot farms on WeChat. What is more surprising is that GSX openly recruits software engineers qualified in the operation and maintenance of bot farms. A second research release by Muddy Waters contained a screenshot obtained from a Chinese internet denizen of a GSX job listing. The listing reads as follows: "Duties: Responsible for maintaining and operating the company's server rooms. 1. Resolving problems occurring with cell phone equipment in the server room. 2. Cell phone bot network equipment, install all types of framework software like Xp and TaiChi, etc."

GSX openly recruits software engineers qualified in the operation and maintenance of bot farms.

Muddy Waters alleges that "Xp" refers to "Xposed," a set of tools that allow individuals to root or jailbreak Android phones, allowing them to perform tasks that the phones cannot perform out of the box. Tai Chi's website indicates that the company's software supports a variety of Xposed modules enabling functions called, "fake device," and "fake location."

In response, GSX stated, "GSX's staff rely heavily on cell phones to communicate daily with students and parents. In line with the rapid growth in students and employees, the company requires enough engineers to conduct daily maintenance of cellphones, to improve communications efficiency and enhance cost control." They did not deny that the listing posted was their own. They did not explain what cell phone equipment was located in the company's server rooms, and they did not respond to allegations concerning the use of Xposed and Tai Chi software tools.

In order to refute Muddy Waters claims about "precise joiners" and "burst joiners" the company posted a screenshot of a "data set" that did not include timestamps. Forgetting for a moment that a screenshot is proof of nothing because, it's a screenshot of text, one must recognize as well that it's inherently impossible to refute allegations regarding the timestamp on user log in activity without including timestamps in the refutation.

A Seeking Alpha contributor named Chen Yang recently reported that the company sends WeChat group messages (from Bots) to users in an attempt to entice them to buy classes, referring to this practice as a highly aggressive and misleading sales tactic that is not employed by larger online tutoring companies with better brand recognition in China, like Yuan Fu Dao and Zuoyebang. Mr. Yang also analyzed Gaotu app reviews on the iOS app store and determined that many were faked reviews, copy and pasted from legitimate reviews of a competitor's app. He posted a screenshot of 11 reviews where the poster carelessly forgot to change the name of the app from "TAL" to "Gaotu." Mr. Yang mentions that fake reviews on Tencent's WeChat platform threaten to run the company afoul of China's Cyberspace Administration's regulations, as well as Tencent's own internal controls over its platform.

One of GSX's six co-founders, Yuxiao Song, who was reportedly, "in charge of finances," left the company mere months before it completed its successful IPO on the NYSE, an occasion that should have represented a large payday for the successful founder of a U.S. listed, Chinese tech start up. The company's actual CFO, Ms. Nan Shen, was formerly CFO of a company called, China Sinoedu Co., which has been accused of operating a scam illegally targeting foreign workers and travelers seeking "English as a Second Language" teaching posts on the mainland.

Many of Muddy Waters' allegations were substantially corroborated by an interview Muddy Waters claimed to have conducted with a former member of GSX middle management. On June 4th, GSX chairman Larry Chen publicly announced that they had listened to Muddy Waters' recording and determined it was fake. Muddy Waters did not release the recording of that interview until June 23rd.

Whether or not my readers find the arguments made by Muddy Waters, Grizzly Research, Scorpio Research, and Citron Research compelling (your author, for instance, has immense respect for the work done by Carson Block at Muddy Waters, and a far greater degree of skepticism reserved for claims made by Andrew Left at Citron, but who's counting?), I question whether a responsible U.S. based investor can credibly claim that they've performed due diligence confirming the veracity of GSX financials.

> *GSX's own annual reports include the risk statement that its financials are subject to audit review by an audit firm not subject to PCAOB oversight.*

It is perhaps for this reason that the U.S. Senate recently passed, UNANIMOUSLY, a bill that would require foreign firms listed on a U.S. exchange to use an auditor subject to oversight by the U.S. Public Company Accounting Oversight Board ("PCAOB"). The bill had been co-sponsored by Senator John Kennedy, a Republican from Louisiana, and Chris Van Hollen, a Democrat from Maryland. A similar bill was advanced in the house, sponsored by California representative Brad Sherman, a Democrat on the House Financial Services Committee. Should this bill ever become law, it would effectively amount to a mandated de-listing of Chinese firms currently trading on U.S. exchanges, as Chinese mainland regulations forbid such firms from using U.S. auditors.

GSX's own annual reports include the risk statement that its financials are subject to audit review by an audit firm not subject to PCAOB oversight. That firm, Deloitte Touche Tohmatsu, also signed off on financials for exposed U.S. listed, Chinese frauds including: Longtop financial, and China Media Express. The Deloitte partner in charge of GSX's account, Li Li Shan, is listed as auditor for only two other companies. Both Chinese online education providers who have sought listing on the NYSE. RYB, which trades at $2.76, down roughly 85% from its IPO price, and NEW, which trades at $5.22, roughly 70% below its IPO price.

Candidly, this article does not contain positive proof of wrongdoing at GSX. It reiterates allegations, deemed credible by your author, that have already been published elsewhere. It is the opinion of your author, furthermore, that the lack of PCAOB oversight for auditors of U.S. listed, publicly traded Chinese firms is absolutely a problem. And it's a problem with a solution that has already passed the Senate with unanimous bipartisan support and been introduced in the House. It's a problem that global "big four" auditors like Deloitte might do well to pay attention to, as they observe their competitors EY Germany and Price Waterhouse Coopers becoming embroiled in accounting scandals and misrepresentations on other continents. And it's one that China's State Administration for Industry Commerce might well pay attention to, as the country seeks to negotiate a trade deal with the United States amidst increasing political tension and incendiary, escalating, international rhetoric.

Antrim is short shares of GSX Techedu, Inc.

LONG AKORN INC. (OTC:AKRXQ)

THE AFTERMATH

On June 23rd, PBS aired a documentary entitled, "Opioids, Inc." which detailed the rise and fall of Dr. John Kapoor, who founded a company called Insys Therapeutics, which sold Subsys, a sublingual "spray" formulation of the powerful opiod, Fentanyl, which could be extracted from the spray container using a spoon and a cigarette lighter, and abused. On May 2nd, 2019, Kapoor was convicted of engaging in a racketeering conspiracy on charges which stemmed from allegations that Kapoor had engineered a scheme to bribe doctors who were high prescribers of the drug Subsys, and defraud insurance companies by either lying or offering misleading information about the Subsys prescriptions for which the patients were seeking reimbursement. Federal juries found four other Insys executives guilty of fraud and racketeering charges, including Sunrise Lee, who had been employed as an adult entertainer at a Florida nightclub before she was named Director of Insys's midwest sales organization and placed in charge of several high prescribing doctors' accounts.

> *AKRX had misrepresented their financial condition and made misleading statements about their business*

In addition to founding Insys, Kapoor has been a high ranking executive at other pharmaceutical companies. Akorn, Inc., for instance, which is engaged in the manufacture, marketing and distribution of brand and generic pharmaceuticals, over the counter ("OTC") private label pharmaceuticals, and animal health products. Under Kapoor's leadership, Akorn was no stranger to controversy. The company nearly went bankrupt during U.S. recessions in 2002 and 2009.

In 2009, Kapoor installed Raj Rai to run the company profitably, which he did, ostensibly by cutting costs (and some corners) out of AKRX's manufacturing processes. Under Rai's leadership, Akorn initially flourished, ultimately acquiring a competitor, Hi-Tech Pharmacal in 2013, and finally, selling the entire company to Fresenius in 2017 for a total consideration of $4.3B.

Shortly thereafter, AKRX lost a key customer and withdrew guidance. They received a form 483 warning letter concerning improper quality control mechanisms and procedures at a key manufacturing facility, and Fresenius walked away from the deal. Akorn, already reeling from the loss of a key customer, started fighting Fresenius in court, alleging that Fresenius had entered into a binding agreement to acquire the company. Fresenius countered that AKRX had misrepresented their financial condition and made misleading statements about their business. Akorn lost, and Raj Rai was ousted.

With Kapoor incarcerated, and Rai gone, the company's board installed a new CEO, Douglas Boothe, formerly CEO of Impax Labs, another publicly traded manufacturer of generic pharmaceuticals, which had been acquired by Amneal Pharmaceuticals in May of 2018. Mr. Booth had successfully navigated IPXL through receipt and resolution of a form 483 warning letter from the FDA, and sold the company. At AKRX, his task was to put a turnaround plan in place, and do the same thing.

The company launched a sale process, which was hopelessly and abruptly impeded by the coronavirus pandemic which swept across the globe early in 2020

In January of this year, the company launched a sale process, which was hopelessly and abruptly impeded by the coronavirus pandemic which swept across the globe early in 2020. The company received a second round, and then a final round of bids during March, which were lowballed and summarily rejected by the company's own creditors, who are owed more money than the acquirers were willing to offer in exchange for AKRX (at least, without being allowed to travel to see AKRX facilities in person). The company filed for Chapter 11 bankruptcy protection, and began the process of selling the company anew, under the Chapter 11 protections, and with its creditors, ultimately, in possession of its assets and, theoretically, the proceeds of any such sale. AKRX was delisted, and now trades OTC, with the five-letter bankruptcy ticker, AKRXQ.

On June 19th, the law offices of Kasowitz, Benson, & Torres filed a letter with the Department of Justice Trustees overseeing the AKRXQ bankruptcy proceedings, asking that the court appoint an "Equity Committee" to represent the interests of AKRX's public equity shareholders. That letter points out that the debt holders' own court filings indicate Mr. Boothe's turnaround plan is bearing fruit, as revenue and EBITDA at AKRX are now growing. The letter mentions several comparable company transactions that have been consummated in recent years, all of which occurred at valuations which would amply compensate AKRX debt holders, and still leave substantial value for equity shareholders.

On June 22nd, M&A attorney Derrick Takeuchi filed a motion to appear in front of the court administering AKRX's bankruptcy proceeding, on behalf of a Japanese Pharmaceutical company, Senju Pharmaceutical, that is not otherwise mentioned as a financial creditor or trade creditor of Akorn.

While it is rare for a company to emerge from bankruptcy proceedings with any value left over for public equity shareholders, it's not unprecedented. Ted Weschler famously led the equity committee for W.R. Grace out of Chapter 11, and scored a 100-fold return on his initial investment. Bill Ackman pounded the table for equity shareholders of General Growth Properties during its bankruptcy proceedings, and was handsomely rewarded.

Antrim does not maintain any particular expertise in bankruptcy proceedings, and has no intention of taking an activist stance in this one. A betting man might reasonably ascertain that the most likely outcome for shareholders of AKRXQ is still a total zero. But a pharmaceutical analyst would be forced to admit that comparable M&A transactions do value AKRXQ at anywhere from 5-10x the price at which it presently exchanges hands. And because this author believes that price does not reflect the meaningful probability that AKRX is, indeed, able to sell itself at a valuation close to those comparable transactions, Antrim has taken a tiny long position in shares of AKRXQ.

PAST PERFORMANCE IS NOT A RELIABLE PREDICTOR OF FUTURE RESULTS

Recommendation	Date	Performance Since Recommendation
Long MIK	June 1st, 2020	+83.2%
Short QSR	June 1st, 2020	+1.1%
Long ZMTP	June 1st, 2020	-7.0%
S&P 500	*June 1st, 2020*	+1.8%
Long NLY	May 1st, 2020	+8.5%
Long AGNC	May 1st, 2020	+5.8%
Short SWKS	May 1st, 2020	+23.1%
S&P 500	*May 1st, 2020*	+6.5%
Long DESP	April 1st, 2020	+26.6%
Short KNSL	April 1st, 2020	+48.5%
S&P 500	*April 1st, 2020*	+20.0%

Antrim
Investment
Research

This coffee has a thought-provoking quality. It is brewed independently, with conscientious diligence and differentiated perceptions.

DISCLOSURES

Antrim Investment Research is long shares of AKRXQ, MIK, ZMTP, NLY, AGNC, and DESP. Antrim is short shares of TSLA, GSX, QSR, SWKS, and KNSL. Neither does Antrim nor do I, personally, have any business relationship, banking, consulting, or otherwise with any company mentioned in this newsletter.

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If you are coming across this, the fourth issue of ***Idiosyncratic Risk***, for the first time, welcome. I would always like to make new friends. If you find my views interesting or helpful, and if you'd be so kind, feel free to forward this newsletter along in your network to those who might also make use of its content.

I sincerely appreciate the friendship, support, mentorship, and camraderie I've experienced during my career in Investment Management and I would like to thank my friends and readers for supporting me, whether by forwarding this email and my contact information along in your network, or merely reading these pages and considering what I have to say.

Feel free to reach out with questions, criticisms, suggestions, and investment ideas if you've got any good ones.

A Publication By:

Antrim Investment Research
Eric S. Jensen, Jr., CFA
ejensen@antrimresearch.com
www.antrimresearch.com

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Research