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Thank you, Batman!

Until a few months ago I had never heard of Gotham City Research (GCR) or Gowex. It was only after I had read about how GCR had published a research report on Gowex, which led to its founder admitting fraud, that I thought it might be worth reading up on GCR. I went to the website to discover the 93 page report that had outlined why they thought that this Spanish company (with a €1.4bn market capitalisation at the time of the original report) was actually worth absolutely nothing. I had a quick read of the report and the thing that jumped out at me was the realisation that they had just done what you think a really good analyst should do. They had used the publicly available information to put their case together and they had done a better job than any other analyst or regulator.

I highly recommend the full report (<http://gothamcityresearch.com/>) because reading it gives a sense of all the publicly available information that is out there if you have the time and resources to find it. Here is a small section that I think is a good example of the simple detective work they did in relation to the core business of Gowex – providing Wi-Fi hotspots:

Gowex Hotspots – the True Count

Given that one can count the number of Gowex Hotspots through its hotspot maps, we struggle to find a good reason why Gowex and CEO Garcia refuse to publicly disclose its hotspot count. We actually counted all the hotspots as disclosed on their map (both on website and app). The number is closer to 5,000 as of April 2014, not 100,000 or 200,000.

Ultimately the evidence compiled by GCR from this publicly available information proved them right; Gowex was worth nothing.

For me, however, reading about Gowex brought back memories going back to 2000 when a similar fraud occurred at a Belgian technology company, Lernout & Hauspie (LH). At the time I was in charge of managing global technology sector investments and one of my main stockbroking relationships was with a niche US investment bank. While conducting research on the company I was in regular contact with one of their analysts – I shall give him the pseudonym “Bob Rock.”

I have to admit that I got caught up in the euphoria of the time because I was excited by the possibility that voice recognition technology was going to revolutionise the world and Lernout & Hauspie was supposedly one of the market leaders. They appeared as if they were growing so fast that I could pay a very high price and still make a decent return. In doing my research for this article I came across a Wall Street Journal Article from 2000 that reminded me of the type of growth that Bob Rock was talking about:



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“Rock boosted his figures for 2001 by 15 cents to \$2.45, representing 50 percent growth. Revenues, he says, should grow 102 percent this year to \$607 million and by 53 percent to \$1.1 billion next. His price target on the stock is \$75 to \$80.”

I remember the first time I felt something was wrong was after one particular earnings release. The share price fell because the market was worried about the fact that sales were only growing because of massive growth out of their Korean subsidiary. I spoke to Bob Rock and he told me categorically that he had been to Korea, he had met the customers and he had seen the translation software in action at those customers. He even offered to arrange a trip to Belgium to meet the company (in the end the fraud emerged before I ever got to travel).

At the time I wasn't cynical enough about the fact that the investment bank was also an adviser to LH but to this day I do not know exactly what Bob Rock did or didn't know. I do know however that my decision to hold on to LH shares was very painful and contributed to some problematic discussions with my boss!

The best summary of the whole story was captured in another Wall Street Journal Article that can be read at: <http://online.wsj.com/articles/SB976143929804554337>. However, to give a sense of the type of thing that was going on, here is a section from the SEC case against the company:

“Between 1996 and 1999, Lernout & Hauspie improperly recorded over \$60 million in revenue from transactions with two Belgian entities: Dictation Consortium, N.V. and Brussels Translation Group N.V. These entities were formed for the specific purpose of engaging in transactions to allow Lernout & Hauspie to claim revenue from its own research and development activities.”

The parallels with Gowex are extensive and I'm afraid that there might be a few fund managers today having similar conversations to the ones I had back in 2000, explaining to their boss how they got excited by the rapid growth of Wi-Fi hotspots and the potential to invest in the market leader. However, for every fund manager in that position there are probably dozens of others thankful that GCR found the fraud before Gowex became so large that they would have been forced to take a closer look (not that this is a justifiable reason!).

For anyone that reads the full LH story they will see that there were hedge funds short at the time and there were negative stories around (the main short appears to have been Marc Cohodes at Roker Partners LP) but unfortunately none of them published a 90 page report setting out exactly why they were short. At the time I did not know if the short sellers were good guys or if they were one of those horrible types vilified by some sections of the media for spreading malicious rumours. I therefore ignored what I thought was just gossip and stuck with the position.

By publishing its research, GCR provides clarity around the accusations and as they say themselves on their website:

“A short seller is only as good as his/her analysis. In fact, the markets are swift and unforgiving when short sellers are wrong. The markets also very quickly punish short sellers who engage in deceitful practices.”

As I mentioned at the beginning, it was the coverage given to the collapse of Gowex that made me have a look at GCR and the first thing I looked at was that 93 page Gowex report, but I also had a quick look at their four other published research notes. None of those other reports are about companies with which I am familiar and I have not come to any opinion on the conclusions reached. As I do not engage in shorting I do not intend to do any further research into these companies but I have to make readers aware that legal action is being taken against GCR. I hope that it doesn't emerge that GCR has done things they shouldn't have done because I genuinely hope that they are as good as they appear to be from their Gowex work.

I also have to acknowledge that it is a bit unusual not to find on the website details of the people working for the firm, but acknowledge there is nothing illegal in that. I therefore have to accept the newspaper reports that state that Daniel Yu is the man behind GCR. Here is what UK newspaper *The Telegraph* states:

American-born but of Chinese or Korean descent, Yu is a maths and science geek who grew up in New York City before studying at the Massachusetts Institute of Technology, one of the most esteemed universities in the United States.

“He’s one of those people that you can tell is super smart as soon as you meet them,” one associate said. Like many of the brightest graduates of the top American colleges, Yu sought a lucrative career in the financial services industry after finishing his studies. He worked for a large asset management firm on “the buy side” – Wall Street parlance for a trader.

However, at some point, he appears to have become disillusioned with capitalism, gaining a belief that those in powerful corporate roles who commit wrongdoing are able to escape justice by an indifferent regulatory regime.

“Daniel has a strong moral core. He hates the inequality in American civic and business life where executives who destroy capital, enterprises and lives can still reap handsome rewards,” one friend said.

After losing some of his own money investing in companies that committed fraud, Yu set up Gotham City two years ago and began searching for other culprits to target.

If this is an accurate reflection of Daniel Yu and his philosophy, it appears to be similar to that espoused by Charlie Munger and Warren Buffett. The members of the *Value Investment Institute* will always be happy to back people similar to Charlie and Warren!

Talking about Warren reminds me of one of my favorite quotes of his:

“We like a business with enduring competitive advantages that is run by able and owner-oriented people. When these attributes exist, and when we can make purchases at sensible prices, it is hard to go wrong” (Chairman’s Letter 1994).

I think GCR could rewrite this quote along the following lines:

“We like a business with no competitive advantage that is run by incompetent and greedy people. When these attributes exist, and when we can make shorts at sensible prices, it is hard to go wrong.”

With this philosophy, Gotham City Research / Daniel Yu might join the ranks of famous value investors. We wish him luck.

Conclusion

The Lernout & Hauspie story is one of those lessons in life that has hopefully made me a better investor. The pain of losing money taught me to avoid lottery ticket-type, over-hyped companies and also taught me to be more careful about doing my own primary due diligence rather than depending on broker research. The Gowex story, thanks to GCR / Batman/ Daniel Yu, is a reminder to never forget what I learned back then.

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