FT Alphaville Volkswagen AG

The day Volkswagen briefly conquered the world

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In midst of the great financial crisis, something odd happened. Volkswagen, the German carmaker, became the biggest company in the world. For one, brief day.

Looking back a decade, as many have recently, you'd be forgiven for thinking the worst asset to own was a US investment bank or mortgage originator. But it was nothing compared to being short the Wolfsburg-based business.

Exactly 10 years (and 48 hours) later, here's how it happened.

A tale of two families

The story revolves around two of Germany's most famous automakers — Porsche and Volkswagen — whose interlocking history rivals the great family sagas of German literature, such as Thomas Mann's Buddenbrooks.

We begin in 1931, when Ferdinand Porsche founded an automotive consultancy. One of his first major projects, at Hitler's behest, was to design Volkswagen's iconic Beetle, which was designed in 1934. The founding of the carmaking arm, Porsche AG, followed in 1948, with the Porsche family remaining in control of the company through the next half century.

A long history of collaboration followed, with Porsche outsourcing much of its manufacturing to Volkswagen. But the ties ran deeper than a business relationship.

Ferdinand Porsche's grandson, Ferdinand Piëch, became the chief executive and chairman of Volkswagen Group in 1993, after thirty years at Audi. He took the position in the midst of troubling times — the company had just recorded a $1.1bn loss, its largest ever — but he turned the company around, before retiring to become chairman in 2002.

Despite running another carmaker, Piëch and his wider family still retained 50 per cent of the voting rights in Porsche stock, with the other half held by the Porsche side. (Porsche AG was listed in 1984, but the public could only buy non-voting preference shares).

According to Handelsblatt, the German business paper, Piëch did not always see eye-to-eye with his cousins:

> [By the time he joined Volkswagen], Mr. Piëch's rivalry with the Porsches was out in the open. That the self-styled Crown Prince Ferdinand [Piëch] openly had a relationship with his sister-in-law Marlene Porsche, which resulted in two children, didn't exactly help to minimise tensions. Mr. Piëch made no bones about how he felt about his cousin Wolfgang "Wopo" Porsche, who headed the clan. For the private school warrior, Wolfgang the Waldorf school grad was soft and weak.

This mesh of family and business relationships formed the backdrop for one of the decade's most memorable takeover attempts. As Porsche — run by former Volkswagen board member and Piëch's choice for the job Wendelin Wiedeking — sought to swallow the Wolfsburg-based car giant whole.

An extended courtship

Wiedeking's Porsche had long courted Volkswagen, seeing a takeover as a means to not only secure access to Volkswagen's manufacturing expertise for Porsche but, due to the overlapping interests between the companies, to buffer the company against a hostile takeover. He referred to it, perhaps unadvisedly, as a "German solution".

Piëch was open to the merger, according to Fortune, as it would have cemented his control of Volkswagen (via his own Porsche stake), and allow him to realise his ambition to "lead a bigger company than my grandfather".

Porsche played the long game. The first move came in 2005, when it announced it had taken a 20 per cent voting stake in Volkswagen. Over the next two years it slowly accumulated more shares, eventually passing the 30 per cent threshold where it would have to make a mandatory offer for the company in early 2007. The bid failed, but in October 2007 Wiedeking was given fresh hope by an unlikely source: the European Court of Justice.

The court, in a case brought by the European Commission, overturned the "Volkswagen Act", an esoteric German law from 1960 that required a party to own 80 per cent of Volkswagen's voting shares before it could formally control the company (versus the 75 per cent normally required). As the state of Lower Saxony owned 20.1 per cent of Volkswagen, the legislation protected the business (and its workers) from the vagaries of international capital.

With the Act now in question (although Germany would go on to fight the ruling), the door opened wider for Wiedeking and Porsche. In March 2008, he was given the all-clear by Porsche's supervisory board to increase the holding to 50 per cent. By September 16, its stake had reached 35 per cent, with Wiedeking declaring:

> Our goal continues to be to increase our stake in Volkswagen to more than 50 per cent. Today's step is a further milestone along this road.

And then, everything went quiet.

A tempting trade

Around the same time that Wiedeking was building the Volkswagen stake, a hedge fund strategy was gaining popularity on Wall Street: event-driven investing.

Pioneered, according to Sebastian Mallaby, by investing legend Tom Steyer at the West Coast hedge fund Farallon, the strategy expresses itself in a number of ways, but what matters for this story is one particular strain: capital structure arbitrage.

It works something like this: an investor finds two securities which should have a relationship to each other — such as the shares and bonds issued by a company. The price of both should reflect assumptions about the company's future, so if they get out of whack it can present an opportunity. The investor sells short the security it believes to be overpriced, and buys the one it thinks is underpriced, with the idea that prices will converge when Mr Market comes to its senses.

In Germany, this tactic gained traction thanks to the Teutonic tradition of dual-share classes. According to a paper by Katie Bentel and Gabriel Walter, the practice dates back to the 1980s, where preference shares — which carry no voting rights but a fixed dividend — became popular as to protect German companies from both hostile takeovers and foreign influence. The outside investors got their dividends, and local owners kept control through the ordinary shares. Everyone was happy.

By 2003, 28 of the DAX-100 (Germany's largest listed corporations) had both ordinary and preference shares, according to data cited by Bentel and Walter.

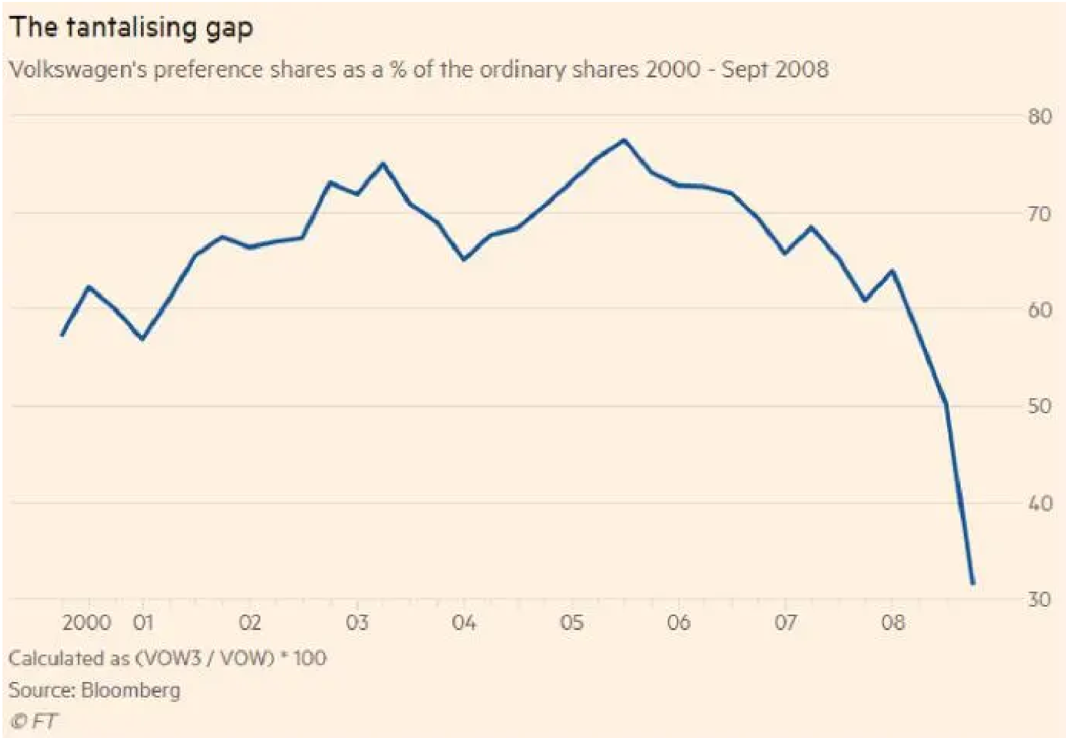
If not for SAP, it may have been 29. The enterprise software group chose to retire its preference shares in February 2001, swapping them for ordinary shares. The idea was a clearer capital structure would attract more investors.

SAP's preference shares were trading at a 20 per cent premium to the ordinaries, due to the ordinaries low liquidity. Therefore investors who owned the ordinary shares, and had sold the preference shares short, made a profit as the two securities converged in price.

According to a friend of Alphaville (who goes by BrokenBanker on Twitter and helped to flesh out the details in this story) who was working in equity sales in Frankfurt at the time, SAP's switch made several event driven hedge funds handsome returns.

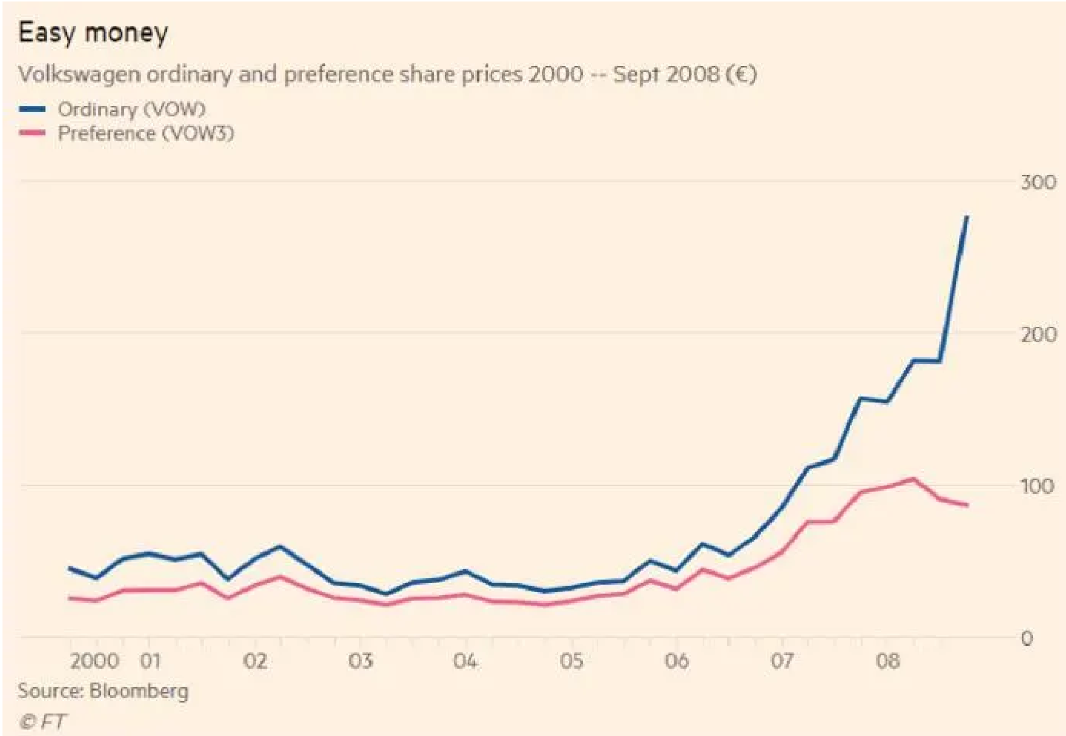
With such (relatively) riskless profits on offer, investors began scouring Germany for similar situations. Attention quickly turned to Volkswagen, where the preference shares traded at a significant discount to the ordinaries, in part because Porsche's takeover demand would target the latter rather than the former.

Here's the chart, from 2000 to September 2008, showing the discount between the two share classes, expressed as the preference shares value relative to the ordinary shares:



As you can see, the discount undulated throughout the noughties, providing plenty of volatility for nimble funds, before falling below 50 per cent as Porsche began to buy up the voting shares from 2006 onwards in its takeover bid.

This created a bizarre split in the two share classes, particularly as the preference shares began to fall as the financial crisis began in mid-2008:



Analysts were perplexed by the divergence, particularly as Porsche did not disclose buying more shares after a previous announcement that it had acquired 35 per cent of them on September 16.

In mid-October, Sanford Bernstein's Max Warburton put forward one explanation: Porsche could be buying cash-settled options on Volkswagen's stock, which — as the stock is only owned once the option is settled — would allow it to accumulate a large stake without disclosing it to the market.

Porsche did have a reputation for financial wizardry — €3.6bn of its €5.86bn pre-tax profits in 2007 were from options used to hedge against a rise in Volkswagen's stock — but the evidence that autumn was circumstantial at best. Porsche described Warburton's thesis as a "fantasy".

With little news to go on and the spread widening to improbable levels, it was hard for investors to resist the arbitrage trade — particularly as other carmakers shares were stalling and Volkswagen wasn't following suit.

Funds like Albert Bridge Capital piled in. Here's how they described the trade:

> By late August, the prefs [preference shares] were trading at €100 per share, but the ords [ordinary shares] were twice the price at €200. Consequently, nearly everyone and their brother were short the ords and long the prefs, in what some viewed as a riskless trade. We, however, were not short. It felt like such a consensus trade and

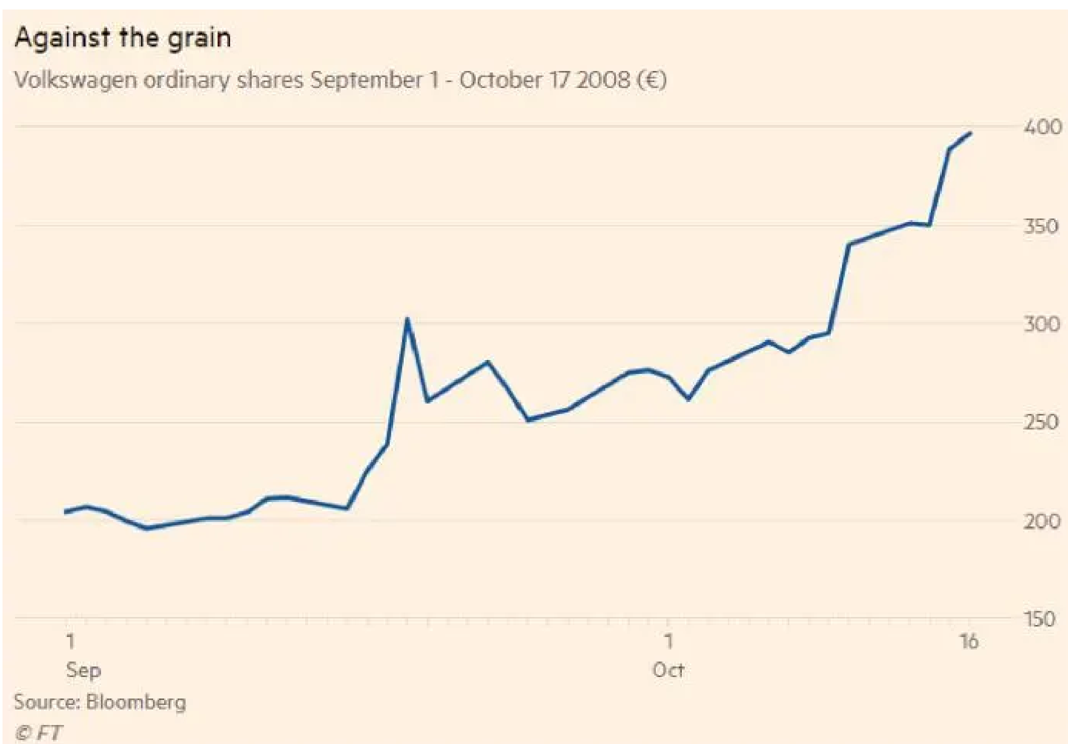
> we knew that Porsche were suspiciously adept at playing the markets (and playing market participants).
>
> But then, just three weeks later, the premium was over 3x (the prefs were at €90 and the ords at €270). That was enough for us to eliminate our "be anti-consensus" requirement, and we threw in the towel and got short in late September in two tranches at €261 and €278 — with the underlying value (represented by the prefs) nearly 70 per cent lower.

Little did any of the funds realise what Wiedeking, and Porsche, were up to.

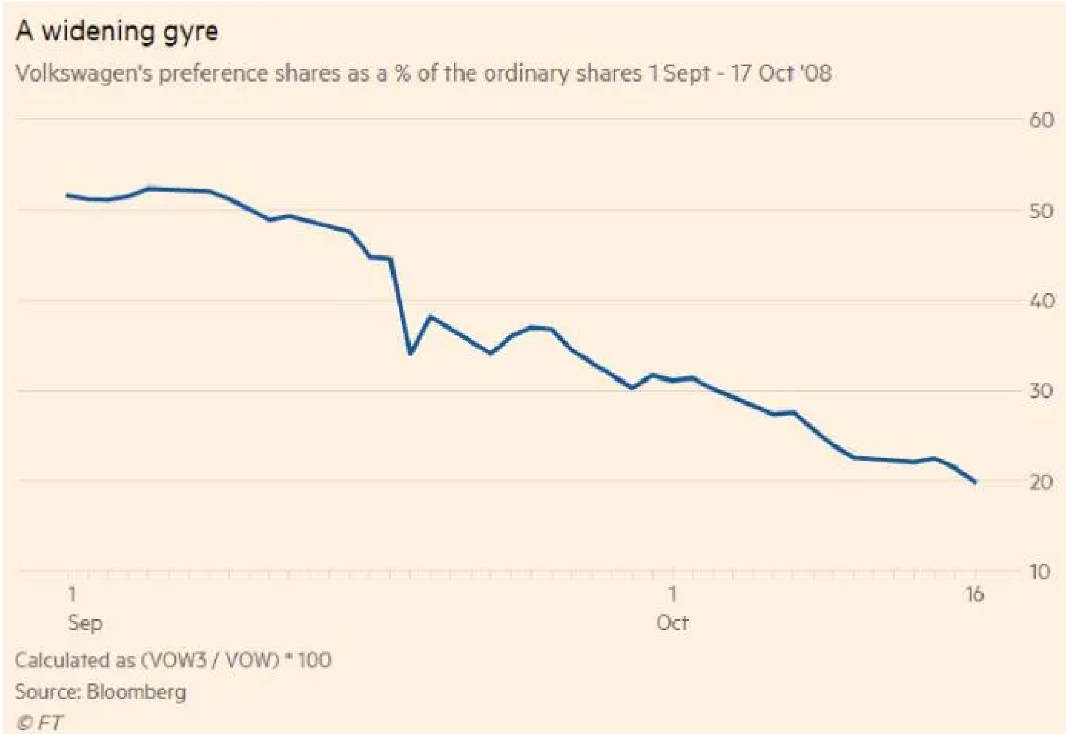
Red October

October 2008 was a pretty good month to be a short-seller. Equity markets were in turmoil following the collapse of Lehman Brothers and the panic of bankers throughout the global financial system.

Yet, for some reason, Volkswagen's ordinary shares continued to ignore the doom and gloom of world markets, doubling over two months:



This pushed the spread out to 80 per cent, as the price of the preference shares headed south:



However, over the week starting October 20, it seemed as if the fundamentals had caught up. Volkswagen's ordinary shares fell from €275 to €210. Here's Albert Bridge Capital again:

> Then the ords finally started to break, and just a week later, the spread was collapsing . . . so on that Friday (the 24th), we felt like this madness was on its way out, and we would soon return to normalcy. We thus concluded it was safe to size up, and we tripled our size and shorted two more tranches, one at €233 and one at €206.

They weren't the only ones. By the end of the week, the 24th, according to Markit Data, 12 per cent of all shares were sold short, around $10bn worth.

But then on Sunday afternoon, while most were away from their Bloomberg Terminals, an explosive Porsche press release hit the news wires:

> Due to the dramatic distortions on the financial markets Porsche Automobil Holding SE, Stuttgart, has decided over the weekend to disclose its holdings in shares and hedging positions related to the takeover of Volkswagen AG, Wolfsburg. At the end of last week Porsche SE held 42.6 per cent of the Volkswagen ordinary shares and in addition 31.5 per cent in so called cash settled options

> relating to Volkswagen ordinary shares to hedge against price risks, representing a total of 74.1 per cent.
>
> Upon settlement of these options Porsche will receive in cash the difference between the then actual Volkswagen share price and the underlying strike price in cash. The Volkswagen shares will be bought in each case at market price.

Combined with Lower Saxony's 20 per cent holding, the shares available to buy on the open market had suddenly dropped to just under 6 per cent.

This was a terrifying prospect for the shorts. To short a share an investor must borrow it, eventually returning it to the lender. They sell the stock in the expectation the price will drop, and the mechanism requires each share be bought back to close a trade. With 12 per cent of the shares outstanding sold short, it was mathematically impossible for every short-seller to buy a share, and therefore close their position.

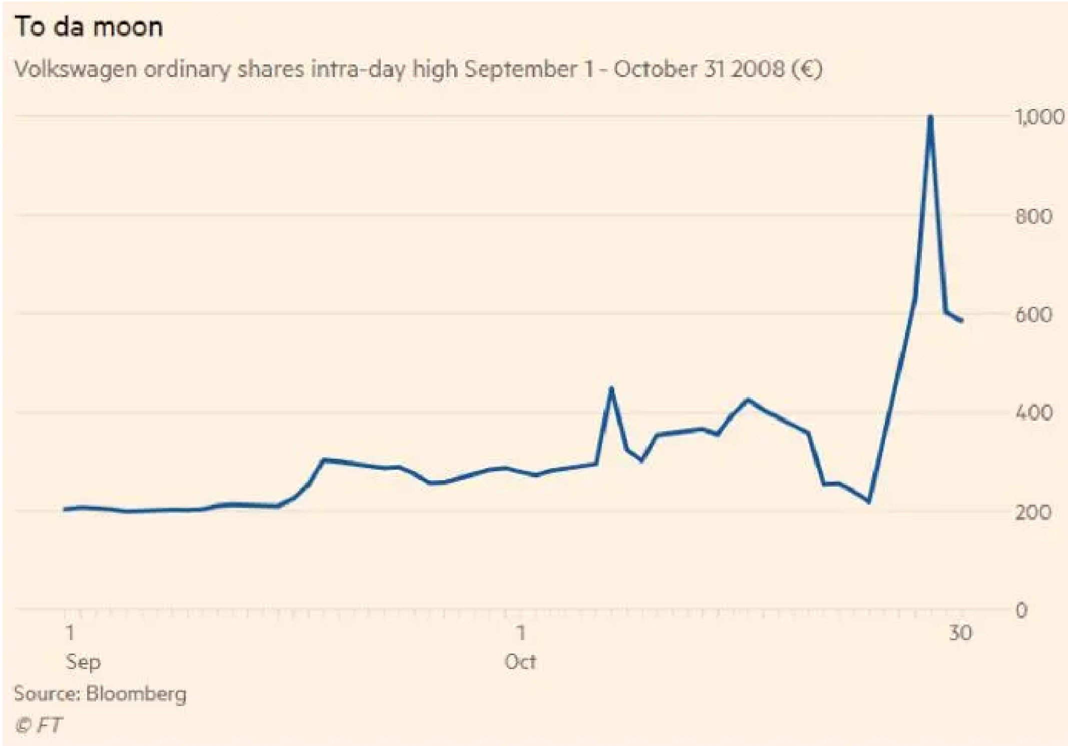
In other words, half the room were going to be left in a burning building with no way out. A panicked dash for the exit began.

On Monday morning Volkswagen's ordinary shares opened at €348, up 66 per cent from Friday's close, and kept rising. The shares closed at €517: a 149 per cent gain in the space of one day's trading.

For those who had not squeezed out the fire escape, the worst was yet to come.

The first tick on Tuesday was a touch lower — €497 — before the shares took off again, rocketing to an intraday high of €999, before easing off to €940 at close. For those who sold a share short on the Friday, the losses were brutal. If they had borrowed €100m of stock, it would have cost them €450m to buy it back. (This calculation has been updated since publication to clarify the cost of buying back the stock.)

This chart does a pretty good job of capturing the madness:



Market participants do not remember the time fondly.

“It was one of the most painful days in my career”, Arndt Ellinghorst, now a Senior Managing Director at Evercore ISI, but then at Credit Suisse, told us. “The pain among investors was unparalleled versus any other market scenario I have encountered”, he added.

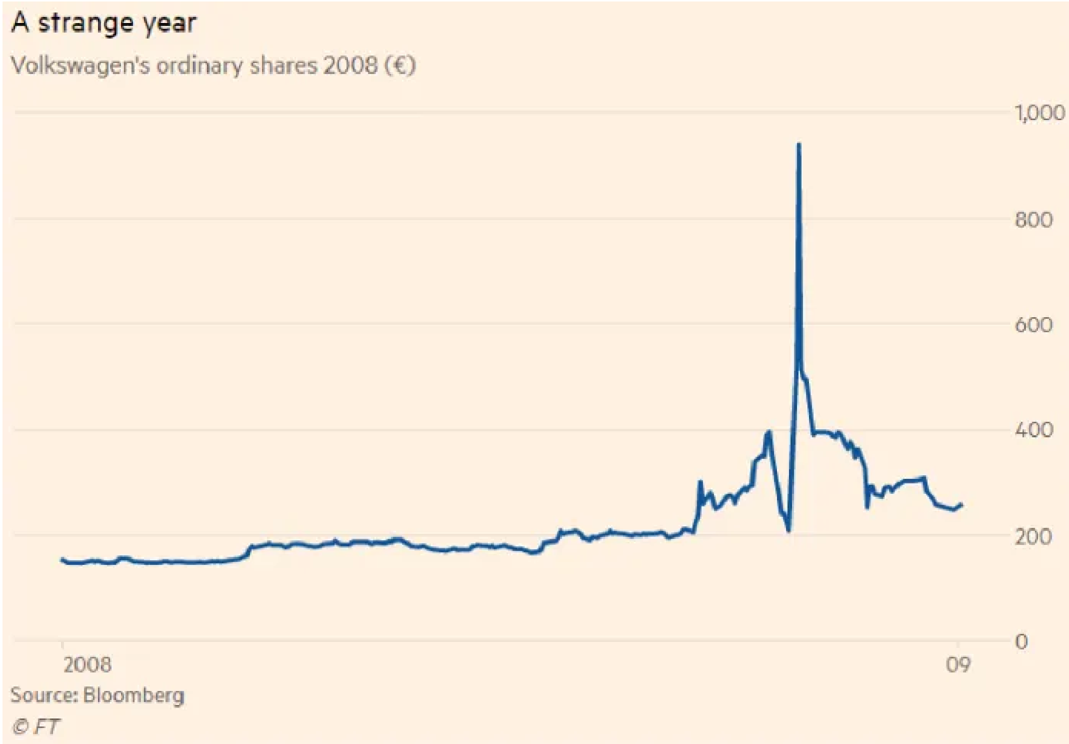
Our equity salesman friend, who had put on the trade for several of his hedge fund clients reminisced, “it remains the single biggest money losing situation I can remember for funds caught short — and a lot of them were”.

It also proved to be a historical moment in markets. At €999, Volkswagen briefly became the largest company by market capitalisation in the world, with a value of $420bn, eclipsing Exxon Mobil, Petro China and Microsoft.

It didn't last long.

On Wednesday 29, Porsche, perhaps realising their actions had caused *some* damage, generously provided an extra 5 per cent of the shares to the stricken shorts. By Friday, Volkswagen's ordinaries closed at €497, down 50 per cent from the Tuesday highs as the squeeze loosened.

By December, Volkswagen's ordinaries were all the way back in the mid-200s. Calm had been restored.



But that's not quite the end of the saga.

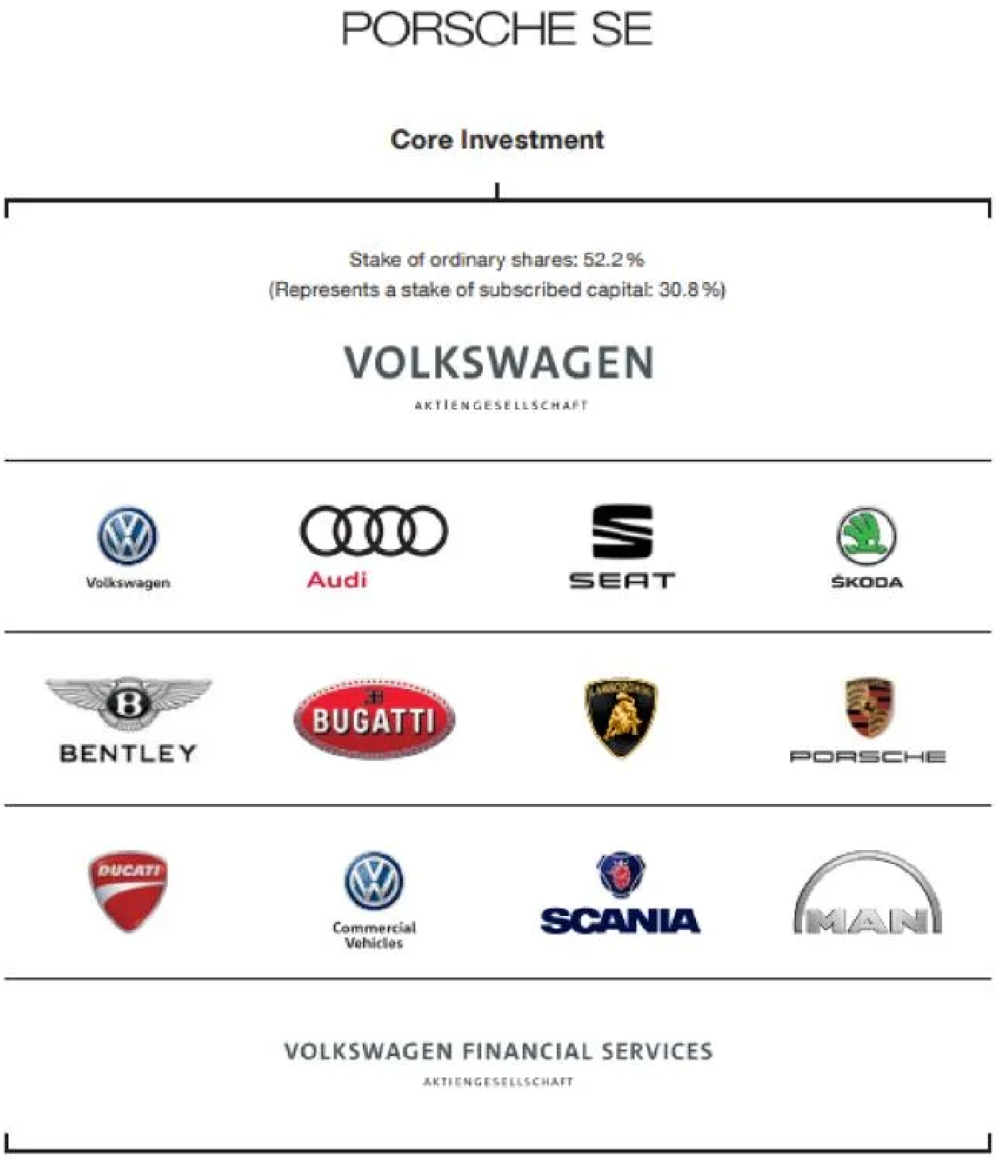
Fallout

Indeed, it was the beginning of the end for Wiedeking and Porsche.

Despite lifting its stake to past the 50 per cent mark, Porsche was short of the cash required to take delivery of the shares it had committed to buying via the options, so as to pass the crucial 75 per cent mark. To add to the pain, Porsche had taken on €15bn of debt, in part to build the position, according to Der Spiegel, and €10bn was coming due in March 2009 just as global car sales were falling off a cliff. With banks wary of lending, Porsche faced bankruptcy.

In a twist that can only be described as ironic, Volkswagen bailed out Porsche AG (the car company) in July 2009. Later in August Porsche SE (the holding company) tapped financing from the Emirate of Qatar, selling a 10 per cent stake and 17 per cent of its cash-settled options in Volkswagen for €7bn.

Under this arrangement, Porsche SE retained its voting stake in Volkswagen (which today stands at 30.8 per cent of shares outstanding or 52.2 per cent of the voting shares), which would own the Porsche AG car company. Sound confusing? Here's a graphic of the structure from Porsche SE's last annual report to help:



Wiedeking was turfed out but, for the trouble of taking the company to the brink, he received a golden parachute of €50m. He now runs a chain of pizza restaurants.

Piëch, as the merger allowed him to retain control of Volkswagen via his stake in Porsche SE, could not hide his delight at the deal:

> Together, Volkswagen and Porsche have all it takes to occupy a leading position in the international automotive industry

The transaction was completed in July 2012, with the price Volkswagen paid for Porsche AG coming to €8.4bn, not including assumed debt.

For the hedge funds nursing an estimated €20bn of losses, however, this was not the end of the story. Yet, so far, their anger has fallen on deaf ears.

Wiedeking and former Porsche chief financial officer Holger Härter were acquitted of market manipulation charges in March 2016. Then in December of that year, 19 hedge funds — including David Einhorn's Greenlight Capital — had a €1.2bn civil claim against Porsche SE for damages dismissed by Germany's federal court of justice. Several other lawsuits are still moving through the German courts, according to the New York Times.

Some have tried other ways to claw back losses. For instance a firm backed by Elliot Management, who were also caught in the short-squeeze, are financing litigation by a group of shareholders over the Volkswagen emissions scandal. In return for paying the upfront costs, they will collect up to 30 per cent of any of the winnings from the lawsuit. While not directly related to 2008, many have suggested it is in part a means for Elliot to settle old scores. Elliot declined to comment.

Teasing lessons out of such an anomalous market event is hard. It's not as if squeezes from stealth takeovers using options are an everyday occurrence. Indeed, one investor we spoke to, Drew Dickson, chief investment officer and managing partner of Albert Bridge Capital, was philosophical. “The thing to learn [from the short-squeeze] is that, it's such a rare experience and special case, we should not overreact. It's very easy to dislike Porsche after that but that should not stop you buying their shares in the future”.

Perhaps another lesson is that panic runs both ways. Often we associate a ruinous market event with things collapsing, such as Carillion last year, but the Volkswagen short-squeeze shows fear can propel securities upwards as well, and far beyond the 100 per cent downside on “long” investments.

It took a particular market era, particular legislation and particular actors for Volkswagen to briefly sit on top of the world. The question is not so much whether history will repeat itself, but when it does again, what form will it take?