

Debate

The Hedge Fund Battle over Herbalife's Direct Selling Business Model

ISSUE: Is Herbalife operating a pyramid scheme?

A pyramid scheme is a non-sustainable business model in which participants are promised payment or services, primarily for enrolling other people into the scheme, rather than supplying any real products to the public. A pyramid scheme works in the following way: a company hires representatives to “sell” products. In reality, the representative makes money not by selling a product to the public but by recruiting and selling products to other representatives. (In direct selling, representatives must often purchase product packages from the company or another representative for use in demonstrations.) The recruiting representative keeps part of the revenue and gives the rest to the company. This cycle continues until the scheme implodes. When this happens, those recruited later lose their investment while the company and those recruited early can walk away with substantial sums of money. Pyramid schemes are therefore illegal in the United States because of their damaging nature.

While pyramid schemes are an unsustainable business activity, multilevel marketing is both a legal and sustainable direct selling technique. In multilevel marketing, a representative gets paid by the products they sell *as well as* for recruiting and selling to other sales representatives. Because multilevel marketing provides representatives with a sustainable way to earn revenue (by selling products to customers), this is a legitimate way for direct selling. However, multilevel marketing has also garnered suspicion, and not without reason: pyramid schemes have been known to pose as multilevel marketing business models. In fact, China has banned the use of multilevel marketing due to its perceived closeness to pyramid schemes. However, in the United States many of the top direct sellers engage in multilevel marketing. One potential issue is that while the government recognizes multilevel marketing as legitimate, the line between the number of products the firm needs to sell to consumers and the amount they should be selling to new recruits remains undefined.

Herbalife, founded in 1980, is a direct seller of sells nutritional supplements and weight-management and personal-care products. It is the third largest direct selling firm in the world with \$3.5 billion in revenue and distributors in 88 countries. While Herbalife would seem to be a textbook example of a multilevel marketing model, not everyone agrees that its business model is legitimate. Last year two analysts wrote a report claiming that Herbalife's distributors buy company products to earn higher commissions rather than actually sell them to final consumers. Hedge fund manager William Ackman agrees and is so sure that Herbalife is a pyramid scheme that he is betting large sums of money against the company.

William Ackman has become by far the most vocal critic of Herbalife, stating that the majority of distributors end up losing their investments due to the inability to recruit enough to new distributors to make any money. He believes Herbalife has harmed innocent consumer throughout the world. He points to statistics to back up his claims; some statistics say that more than 90 percent of distributors in multilevel marketing will not last more than a year. Ackman has developed a website factsaboutherbalife.com to discuss why his company Pershing Square

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believes that Herbalife is operating a pyramid scheme. Among numerous allegations Pershing Square claims that Herbalife pays its distributors 10 times more for recruiting other distributors than selling products, encouraging distributors to recruit aggressively rather than focus on selling products to consumers; the top 1 percent of distributors earn the majority of money; Herbalife materials are deceptive, and lawsuits have been filed in the past accusing Herbalife of being a pyramid scheme. The website also alleges that Herbalife has a significantly higher failure rate for distributors than other multilevel marketing companies and that it exhibits more of a pyramid structure than its contemporaries in the industry.

On the other hand, Herbalife CEO Michael Johnson adamantly defends Herbalife's business model. He points to the fact that Herbalife sells a legitimate product meant to improve people's lives. In fact, in an interview with *CNBC*, Johnson stated that quality products are the focus of the company, not the direct selling distribution system. Johnson states that 90 percent of Herbalife distributors purchase and use the products. In fact, some consumers become retail distributors in order to buy the product at a lower price. Johnson also says that direct selling is a legitimate business model and his company has been in business for more than three decades and continues to grow rapidly. If Herbalife is a pyramid scheme, why does it continue to grow without any signs of collapsing? Another hedge fund manager David Loeb discredits Ackman's claims and has announced that it is betting long on Herbalife's stock with an 8.2 percent ownership stake in Herbalife amounting to \$350 million. TheStreet, a stock rating service, made Herbalife its featured healthcare winner on January 11. The stock rebounded to \$40 a share after selling as low as \$25 a share in December after Ackman made his accusations. TheStreet reported that eight analysts rate Herbalife as a buy and no analysts rate it as a sell.

Ackman has bet against Herbalife by \$1 billion. Ackman has engaged in short selling, which occurs when an investor sells borrowed stock and then buys the stock back at a later date and "returns" them to the lender. If an investor is able to sell the shares at a higher price and buy them back at a lower price (should the value of the share decrease in that time), the investor can keep the extra money and make a substantial profit. However, if the shares increase in value, the investor can lose significantly. Because Ackman has shorted Herbalife's stock, some believe he has a conflict of interest. Ackerman claims that he will donate any profits he makes from the short to charity, but CEO Michael Johnson has disputed this claim and states that Ackman is waging a "malicious attack" against Herbalife for his own gain? Is Ackerman trying to manipulate the market? Or does he have legitimate reasons to believe Herbalife's stock will decrease due to unethical activities.

There are two sides to every issue:

1. Herbalife is employing a legitimate direct selling business model.
 2. Herbalife is generating revenue illegally through a pyramid scheme.
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