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As Giant Rivals Stall, Porsche Engineers a Financial Windfall

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(*See Correction & Amplification below*.)

FRANKFURT -- Porsche is proving you can still make lots of money in the car business, especially if you know how to wield derivatives.

The German sports-car maker said Friday that its pretax profit in the fiscal year ended July 31 soared 46% to €8.57 billion euros, or about $10.9 billion. Eighty percent of that came not from making cars but from sophisticated financial instruments connected to a protracted takeover bid Porsche Automobil Holding SE has been pursuing for a company many times its size, Volkswagen AG.

Porsche's profits on those trades totaled more than the current combined market values of beaten-down General Motors Corp. and Ford Motor Co. The outsize gains were scored by a potato-loving chief executive and his Kafka-reading chief financial officer. They teamed up with the offspring of the Beetle creator to engineer an audacious takeover bid -- and outfox hedge funds at their own game.

Porsche is raking in money through a form of options that helped it build up a huge stake in VW since 2005, while keeping other market participants in the dark. The strategy led late last month to a soaring price for VW shares after a Porsche disclosure showed the company, had, in effect, cornered the market on most VW shares.

That put investors who had bet against VW stock in the classic bind called a short squeeze. This one was acute: VW's stock spiked so high that VW briefly was the most valuable public corporation in the world.

Hedge funds that had shorted VW shares -- borrowing them and selling them, hoping to replace them later with cheaper shares -- lost billions over a few frantic hours last week as they wrestled each other to buy the few remaining shares available and unwind their bets. Funds affected, according to people familiar with them, include Greenlight Capital, SAC Capital, Glenview Capital, Marshall Wace, Tiger Asia, Perry Capital and Highside Capital.

Porsche's earnings report provided the latest evidence that the old-economy manufacturer has been taking a page from hedge funds' playbooks, and seemingly beating them at their own game. Thanks to its trading gains, Porsche's net profit for the year rose 51%, to €6.39 billion, at a time when many auto makers are churning out profit warnings, or worse. And those results don't reflect a potentially massive windfall from its trading activity last month.

The final chapter of the drama hasn't been written. German regulators have launched an investigation into whether there was manipulation of VW shares, after some investors accused Porsche of misleading markets. Porsche says that it hasn't done anything wrong and that the fault for the VW share gyrations lies with short sellers. Porsche, meanwhile, faces other obstacles as it tries to clinch control of VW, a company that boasts 15 times as much revenue and builds 60 times as many cars.

WENDELIN WIEDEKING

Porsche's moves point to the resilience of Deutschland AG, the decades-old network of elaborate cross-holdings that kept companies in domestic hands but had been unraveling. Porsche's VW chase is a kind of corporate German reunification drama: Wolfgang Porsche and Ferdinand Piëch, the board chairmen of Porsche and VW, respectively, are grandsons of Ferdinand Porsche, who created the VW Beetle and founded Porsche before World War II.

The affair traces back to 2005, a time of concern in Germany that VW could be a takeover target of non-German investors and broken up. Private-equity firms, many from the U.S. or U.K., had snapped up more than 5,000 German companies since the late 1990s. Adding to the nervousness, the European Union was trying to strike down a decades-old "VW Law" that capped any single shareholder's voting rights at 20%.

'Swarms of Locusts'

In April 2005, Franz Müntefering, the chairman of the then-ruling Social Democratic Party, called non-German financial investors "swarms of locusts" that land on companies and "strip them bare." Wendelin Wiedeking, Porsche's combative CEO, chimed in, telling a newspaper that Germany needed to stick to a "social market" economy that avoided putting shareholders' interests before those of customers, employees, and suppliers.

Mr. Wiedeking had helped steer Porsche out of trouble after taking the wheel in 2003 and pushed profit margins to industry highs. He slashed about a fifth of the work force and imported Japanese-style lean-inventory methods. Once, to drive home the point, he strode across a factory floor and smashed shelves bulging with spare parts.

Mr. Wiedeking cultivates a populist persona, even as Porsche sells pricey cars such as the 911. The 56-year-old executive owns a working-class tavern and a small farm, where he harvests potatoes with the help of an old Porsche tractor, distributing sacks of potatoes to employees.

In September 2005 Porsche surprised investors by announcing it would buy a 20% stake in VW, becoming its biggest shareholder in a "German solution" that would avoid any foreign takeover. VW and its home state of Lower Saxony, which held a bit under 20%, welcomed the move by Porsche -- which, significantly, didn't signal that it was interested in a majority stake.

Behind the scenes, Porsche Chief Financial Officer Holger Härter was crunching numbers. An economist, Mr. Härter had joined the company in the 1990s after Mr. Wiedeking recruited him from a floor-products firm in a town where they both lived.

Mr. Härter is known as a fan of Franz Kafka and Ludwig II, the 19th-century Bavarian king whose fanciful castles inspired Walt Disney. He also is the chairman of Stuttgart's derivatives exchange, and in the 1990s he developed sophisticated models to hedge Porsche's foreign-exchange exposure. Now he is being credited with drafting the financial road map that put Porsche, which makes 100,000 cars a year, in position to take over VW, which makes six million.

'Cash-Settled Options'

The vehicle: "cash-settled options." The buyer of regular stock options gets the right to buy or sell stock at a certain price by a certain date. But in cash-settled options, as the name implies, the buyer gets the right not to stock but the cash difference between the options' "strike price" and the market price of the shares when the options are exercised.

Porsche began buying cash-settled options tied to VW stock in 2005, when VW's share price was below €100. If the price rose, Porsche could exercise the options and receive the difference between the lower strike price and the higher market price. It could then use the money to buy VW shares.

In Germany, an investor needn't disclose ownership of any size holding of options if they are the type settled in cash instead of shares. That allowed Porsche to build a large stake in VW while keeping the rest of the market unaware of its activity.

Such options have one other important twist: Banks that underwrite them typically hedge their exposure by holding actual shares. That takes these shares out of circulation.

By March 2007, Porsche had boosted its stake in VW to 30%. That triggered a German rule requiring it to make a full tender offer for VW shares. The company said it wasn't interested in a takeover of VW. Forced to make a tender offer, Porsche offered the legal minimum price the law let it offer, which was €100.92 for each voting share. Only 0.6% of the remaining VW shares were tendered.

That November, Porsche announced that for the fiscal year ended July 31, 2007, it had booked a pretax profit of €5.86 billion, including €3.59 billion from "the very positive effects" of VW options. Compensation for Porsche's six-person management board more than doubled, to €112.7 million. Mr. Wiedeking pocketed more than half of that.

Green Light

This past March, Porsche's supervisory board gave the green light to take the VW stake above 50%, and this goal was announced. For the six months ended Jan. 31, Porsche disclosed a pretax profit that included €850 million from "hedging transactions in connection with the acquisition of the VW stake." But Porsche denied growing talk that it was gunning for 75% of VW. In a news release, the company said the possibility of that was "very small indeed" and dismissed it as "speculative mind games of analysts and investors."

In mid-September, Porsche disclosed it had raised its VW stake to just above 35%. At the Paris Auto Show in early October, Mr. Wiedeking told reporters a 75% stake was a "purely theoretical option." On Oct. 24, a Friday, VW's share price closed at €210.85 on Frankfurt's stock exchange.

That Sunday, Porsche dropped a bombshell: In a news release, the company disclosed that it owned 42.6% of VW's shares as well as cash-settled options linked to an additional 31.5% of the shares. Porsche also said that it planned to acquire a 75% stake in VW.

Trouble for the 'Shorts'

When financial markets opened Monday Oct. 27, all hell broke loose. Funds that had borrowed VW shares and sold them, expecting no takeover offer and betting the stock would decline, raced to purchase shares to unwind the bets.

There weren't enough to go around. Part of the reason is that underwriters of cash-settled options typically hedge their risk by owning the shares of the company involved. The shares they owned, combined with those Porsche had acquired, added up to 74.1%, and Lower Saxony state owned 20.1%

The result was that while some 12.8% of VW shares were on loan, mostly to short sellers, those that for practical purposes were in circulation amounted to only 6% of VW shares.

As hedge funds fought for the remaining VW shares, they drove the stock's price ever higher -- deepening their losses. At the height of the short squeeze on Oct. 28, VW stock briefly topped €1,000, nearly five times as high as on Oct. 24, making VW the biggest company by stock-market value for a few hours.

VW's share price, more recently, has been returning to earth. It ended at €398.21 in Frankfurt Friday, less than half its record high but still nearly twice as high as on Oct. 24.

Analyst's Speculation

Theories abound about how much money Porsche has made in the process -- and whether its strategy might have gone beyond exercising options when the share price rose. Max Warburton, a senior analyst in London at Bernstein Research, has speculated on a multipart strategy Porsche may have executed, given the company's huge derivatives profits and the way VW's share price has continued to rise in recent months, in contrast to the rest of the auto sector.

Mr. Warburton speculated that Porsche may have lent VW shares it owned to short sellers who were borrowing in order to sell; that when they sold, Porsche may have been the buyer; that when the "shorts" desperately needed to buy shares to close their bets, Porsche may have been a seller at the elevated price; and finally, confident the price wouldn't fall, Porsche may have profited by safely selling put options that convey the right to sell at a set price.

A Porsche spokesman said such theories were "not true" because they suggested Porsche broke laws or manipulated markets, and that it didn't. Porsche addressed some specifics of Mr. Warburton's speculation, but not others; it said that the company didn't lend shares -- that, in fact, it considers doing so to constitute market manipulation.

Porsche's CEO, Mr. Wiedeking, has been quiet of late, but a remark that he made in January suggests he isn't likely to get sentimental about hedge-fund losses. "This world is not a playground where children at play are pampered by friendly nannies," he told the company's annual shareholder meeting.

Earlier this summer, German auto-parts supplier Schaeffler Group did something similar, secretly cornering about a third of the shares of larger rival Continental AG. Some investors complain that Porsche and Schaeffler have crossed the line of fair play, taking advantage of disclosure rules that are too loose and regulators that are too tentative.

"We need a different approach, with efficient supervision,'' says Christian Strenger, a board member at DWS, the asset management arm of Deutsche Bank AG, Germany's biggest financial group.

Bafin's Stance

But Bafin, Germany's securities regulator, the body investigating Porsche's actions, already has given Schaeffler's conduct a clean bill of health. The German finance ministry says it is considering proposing legislation that would force disclosure in the future of cash-settled options. Any such law could take several months to go into effect.

Finance Minister Peer Steinbrück last month reiterated long-standing calls by the German government for increased international regulation of hedge funds. He also has suggested that "detrimental" short-selling be banned. He has shied away from commenting on the VW case.

Some 80% of Germans disapproved of hedge funds in 2005, and that hasn't changed, according to Manfred Güllner, head of Forsa, a polling firm. He also reckons that many Germans like the idea of VW and Porsche, which worked closely together in the 1930s but went their separate ways after WW II, joining forces. "It's history coming together again," he says. "It fits together."

-- Christoph Rauwald contributed to this article.

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Correction & Amplification

Wendelin Wiedeking became chief executive of Porsche in 1993, not 2003 as is incorrectly stated in this article.

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