



This new section of eurofenix will bring you the most relevant news in the field of insolvency tech and digital assets.

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Wirecard – Serial fraud or an exceptionally pathological case?

The Insolvency Tech & Digital Assets Wing in association with the INSOL Europe Anti-Fraud Forum write on this very recent and very important case of the collapse of Wirecard.

The first collapse in June 2020 of a Dax30 company, Wirecard, which was also the first fintech listed in the Dax 30-index, has made a lot of noise inside and outside the financial sector. Will this particular case affect the credibility of the whole fintech sector, which included 29 unicorns worldwide, with a cumulative valuation estimated at \$84.4 billion in 2018?

Wirecard is a German payment processor and financial services provider which started out as an internet payment provider in the early 2000's and experienced a steep and rapid growth. It was listed on the German stock exchange and, in 2018, included in the Dax30-index. Wirecard was one of the few German fintech stars. In 2018, Wirecard shares reached their peak with a company value of €24 billion.

Its international operations reached to East Asia and had global coverage. In its most recent form, its range of products and services included general banking services, credit cards, prepayment cards, mobile payment

applications, virtual payment card, etc. and facilitated the trade in cryptocurrency (e.g. Bitcoin).

In April 2020, questionable accounting practices were revealed through the publication of an audit report prepared by KPMG following Wirecard's appointment of KPMG to investigate irregularities. In this report, KPMG questioned the willingness of Wirecard's staff to cooperate. As a result of the investigation process, the publication of the annual accounts was postponed several times.

In a press release dated 22 June 2020, Wirecard revealed that €1.9 billion was "missing". Two banks in the Philippines who were allegedly holding the money claimed that they did not have these funds and that they never did. The share value decreased and the CEO and majority shareholder, Markus Braun, resigned.

Criminal investigations were initiated and on 22 June 2020 Markus Braun was arrested. Soon thereafter, an additional two board members and other executives were also arrested. Wirecard's COO, Jan Marsalek, also in charge of Asian operations,

was subject to an arrest warrant and was last reported to have fled to Belarus or Moscow.

On 25 June 2020, the German holding Wirecard AG filed for insolvency in Germany. In the meantime, Wirecard's UK activities were temporarily frozen by local authorities.

Extent of alleged fraud

At present, it may still be too early to determine the nature and extent of the offences or frauds that seem to have been committed. We may however anticipate that at least the following points will be closely investigated in Germany and abroad.

Wirecard's former management

The first questions will of course be regarding the potential actions and/or omissions of Wirecard's former management. Who set up the fraud scheme? When, how and why was it developed? Who knew that the €1.9 billion was fake? Apart from administrator liability in general, it seems that charges regarding falsification, market manipulation, money laundering, theft, among others, could be reviewed.



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EY's role

EY was Wirecard's auditor for over 10 years. Although the first major rumors concerning Wirecard's financial standing started in 2015 with the publication of a series of Financial Times articles raising questions about potential accounting irregularities, as early as 2008 a German shareholder association made an accusation against Wirecard which resulted in the appointment of EY as the group's auditor. It seems that the "missing" Asian funds had been in the books for years. Certain shareholders will question why it took EY so long to discover irregularities. The Financial Times alleged that EY had not requested account information from any bank in Singapore for more than three years while at the same time Wirecard claimed to hold €1 billion in cash for third party acquisitions. EY will certainly provide its own version of the events.

National and European authorities

The German financial regulator BaFin is accused of failing to correctly follow up on Wirecard and even prohibiting short-selling on its shares. The ESMA, upon the EU Commission's request, opened an investigation to find out if BaFin broke EU rules on financial reporting especially the Transparency Directive and the Guidelines of the Enforcement of Financial Information.

Third parties

In order to set up a fraud scheme of this magnitude, the support and collaboration of "third parties" is necessary. Fake bank documents seem to have been created and people both in the EU and in the Philippines are accused of having played an essential role in supporting and furthering the fraud scheme. However, the Central Bank of the Philippines already stated that Wirecard's missing cash balances did not appear to have been recorded in the Philippine financial system.

The Wirecard case also raises

various questions related to the valuation of listed companies, especially in the field of fintech.

Valuing a fintech

In essence, the valuation of fintech companies is inherently difficult. Fintech companies have very few physical assets. Given the dematerialised nature of the technological and financial activities, the organisation itself is frequently complex, legally and otherwise, usually with international aspects. Growth is frequently achieved by acquiring other companies rather than from existing activities. This volatility is reinforced when the company is listed.

Correctly valuing the activities of fintech companies is challenging, despite these companies being under (i) the strong supervision of regulators as listed companies involved in regulated financial sectors and (ii) the control of statutory auditors.

Wirecard seems to perfectly encapsulate these difficulties which *prima facie* may be seen as high risk for investors if not for the economy:

Quick listing

After its founding in 1999, Wirecard was quickly listed on the Frankfurt Stock Exchange in 2006 by taking over the listing of a defunct call centre group. Retrospectively, this may be seen as a way to circumvent the scrutiny on valuation at the stage of the initial public offering.

Initial share value

Wirecard's share value then experienced remarkable growth, coinciding with the decline of traditional banks, Deutsche Bank in particular. Business and technological achievements as reported by Wirecard contributed to this increase in share value. The share was valued at €6 in 2006 and reached approximately €40 in 2016. Initially focused on guaranteeing payments for pornographic and gambling sites, the company was among the few which resisted the Internet bubble burst of the early 2000's.

Wirecard then shifted gears to focus on the development of solutions for processing bank and credit card transactions, and was a pioneer in mobile payment in the early 2010's, culminating in a partnership with Orange in 2015.

Rise in share value

As from 2016, the rise in share value was exponential, going from around €40 in 2016 to over €190 in 2018. At this point in time, the Dax30 was the first major European stock exchange to integrate a fintech.

Group performance

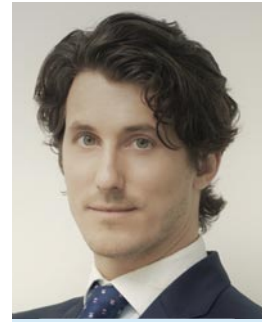
Based on the reported accounts, the performance achieved by the group partly explains this increase. The growth in turnover since 2010 was multiplied by 7.35. The company's net profit was €8 million in 2006, €45 million in 2009, €267 million in 2016, €347 million in 2018.

Other factors contributed to this rise of share value as well. Wirecard made a number of acquisitions, with a significant increase in foreign acquisitions starting precisely in 2015 with the largest buyout of Indian payment companies in a 340 million euro deal. This growth led to a more complex organisation with the creation of several companies, only some of which were regulated. Furthermore, the increased diversity of business sectors where the group was active led to a more complex comparison in terms of value with other fintech companies.

Irrationality

The success story reported by the group led to irrationality on the part of some investors who chose to forego basic analysis.

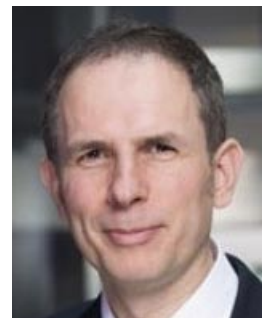
One of the main paradoxes is that the rise in share value was never stronger than when the group was publicly challenged by both the press and the short-sellers. In 2015, the Financial Times began to raise questions about inconsistencies. In 2016, anonymous short-sellers published allegations related to money laundering, which Wirecard denied. Many short-sellers



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considered that there were possible accounting irregularities within the group. The BaFin investigated Zatarra, the publisher, for market manipulation. Short-sellers' campaigns can indeed worsen a company's difficulties. But in 2017, a clean audit from EY renewed investor enthusiasm for Wirecard shares, which more than doubled in price.

The apparent support of BaFin and the auditors seems to have played a fundamental role in this "misunderstanding" from investors.

Transparency

Allegations of breaches of transparency rules and accounting irregularities increased considerably between 2019 and 2020. However, in May, the company announced that its first quarter results increased EBITDA by 26% to restore investor confidence following the opening of regulatory investigations.

Wirecard AG filed for bankruptcy after the share price dropped more than 98% within 15 days in June 2020. Betting on the downfall of the company, short-sellers received a total of at least €2.4 billion.

Lessons learned

Lessons will certainly be learned from the Wirecard case which is still in the early stages in terms of understanding exactly what happened. It is possible that Wirecard's bewildering collapse will come to be seen as the result of fraud and failures combined in an exceptional manner. The lessons taken from this case will not necessarily have to be applied to the whole fintech sector. For various reasons which include the following:

- 1) Fraud and related overestimation of value are not exclusive to the fintech sector. Other similar cases were found in the non-financial technological field (e.g. Enron in the US), or in the more traditional sectors (e.g. Carillon in the UK, William Saurin in France, Parmalat in Italy).
- 2) Even in the case of Wirecard, certain investors had better understood the situation at the early stage, and not only the short-sellers. In particular, investors more sensitive to non-financial factors had limited their risk-taking with the company, such as

Sycomore, a French investment company specialising in responsible investment, which had downgraded the company's value in 2016, particularly in terms of governance criteria and accounting risks.

- 3) Investors seem to continue to weigh market potential and growth for the fintech sector, beyond the COVID-19 context, which has reinforced the potential growth of tech companies in general. In the US, at the end of 2019, fintech companies remained priced at a premium to the broader markets with the S&P 500 priced at ~18.3x estimated forward earnings.

The development of fintech, and more generally, of digital activities, is relatively recent. It is obvious that these activities are different from classical activities, which makes certain traditional regulations, accounting and valuation supervision methods ineffective as applied to fintech companies. Therefore, the market, the authorities and the applicable rules will need to adapt. However, the balance between regulation of, on the one hand, financial and non-financial as well as listed and non-listed companies and, on the other hand, shareholder activism, which is also an equilibrium between regulation, competitiveness and efficiency of financial markets, remains extremely complex to find.

Online conference

On Thursday 29 October, during INSOL Europe's online conference, the Insolvency Tech and Digital Assets Wing will have the pleasure to develop the lessons learned from the failures of the fintech company Wirecard Case thanks to the expertise of the panelists (lawyers, M&A Advisor, IPS, Capital market specialists). We look forward to your questions and participation to this webinar. ■