GameStop Short Squeeze

Before I start this analysis, I want to make a few points clear:

1. I am a fundamental analyst and don't know much about technical analysis. If you're a technical analyst, I would love to hear your opinion on what I'm going to talk about today
2. I didn't invest in GameStop because of this. This is only a recent discovery that I made and if I'm right, the possible returns on GameStop might be higher than I am currently expecting. This analysis, however, doesn't change my initial thesis on GameStop at all.

As you know, I've been buying shares of GameStop since September 2019 because I believe that GameStop is underpriced and that the stock price can outperform the market by quite a high margin when the new consoles come out in November.

This is something that happened in the past.

Today, we are going to look at another thing that may happen to GameStop, a short squeeze.

What's a short squeeze?

Shorting means betting against. If you are shorting a stock, it means you are expecting the shares of that stock to go down and make money on the process.

Right now, the shares of GameStop are $4. Let's say you expect the shares to fall to $3. If you're going to short the shares of GameStop, your gross profits on that investment would be about 25%. It's not bad. What you're going to do is borrow some shares from someone else. There are many institutions holding GameStop would gladly loan you some shares. Let's you borrow 1000 shares for $4000. You are then going to sell those shares in the open market. After one month, the shares fall to $3 and you buy them back. You buy 1000 shares for $3000 and return them to the actual owner of those shares. You pay them an interest on the loan, and you keep the profits. Let's say the interest was 10% on that $4000. You get to keep $600. That's a net profit of 15%.

Shorting is something common but when there are more shares being shorted than actually being bought, this can lead to a short squeeze.

Let's look at a hypothetical company that makes aircraft. The company has 10 000 shares outstanding. This year, 5 aircraft made by that particular company crashed and nobody wants to buy their planes anymore. The stock price is crashing. And more and more people are shorting the stock. Out of the 10 000 shares, 3 000 are being shorted, that is, 30%.

The company misses some earnings and is losing a lot of money. The shares continue to fall, and more and more people are now shorting it. The short ratio is now 60%. Some people have even taken loans to short the company. They believe that it can only go down. It will most certainly go bankrupt.

A few month later, a great news for the company. They just got a big order from an airline. The stock moves up by 10%.

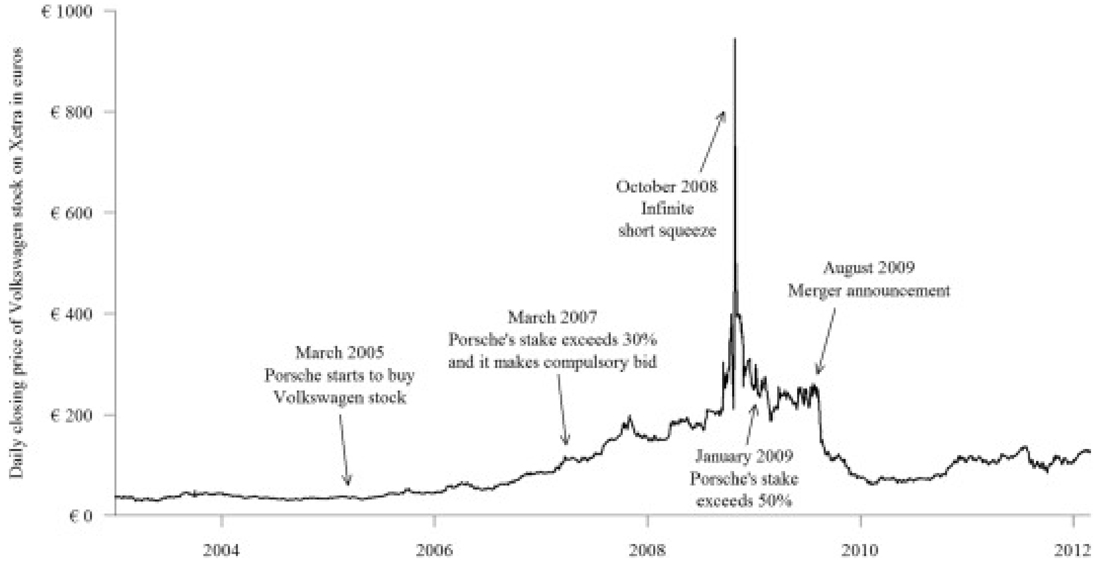
Some of the short sellers of the company are now losing money. They have to buy some of the shares to cover their positions. Remember, when you're shorting a stock, you don't own it, you have to return it to the owner. Since the price is going up, they want to buy as soon as possible. Buy buying the stocks, the price goes higher since there is now more demand to buy the stocks.

More buying trigger more buying, and more short sellers have to buy to cover their positions. In the next days the stock gains 200%. That's a short squeeze.

If you were long on this company, congratulations, you just made a lot of money.

Date	**price**	**Shares**	**short**	**short ratio**
Feb-20	$ 200.00	10000	3000	30%
May-20	$ 100.00	10000	6000	60%
Sep-20	$ 40.00	10000	8000	80%
GREAT NEWS	$ 44.00	10000	7500	75%
Oct-20	$ 132.00	10000	4000	40%

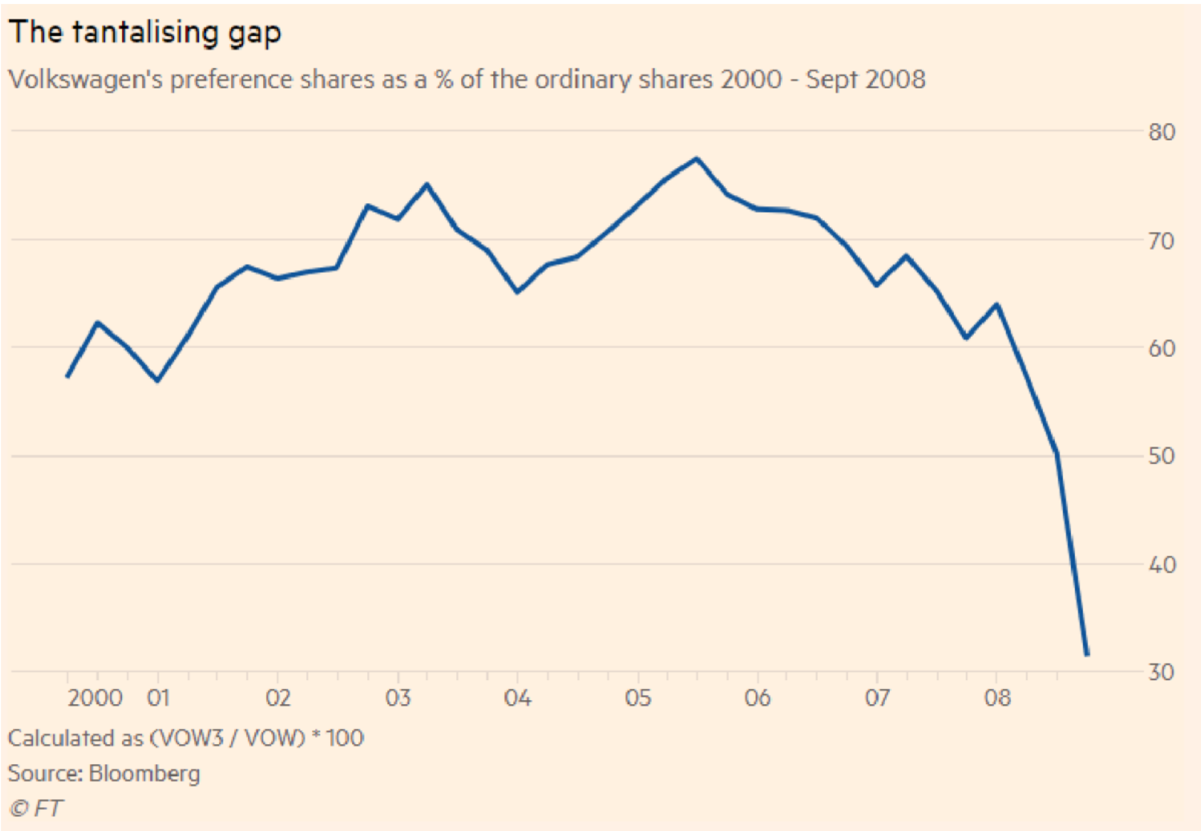
Let's look at a concrete example of a short squeeze, Volkswagen Group in 2008.

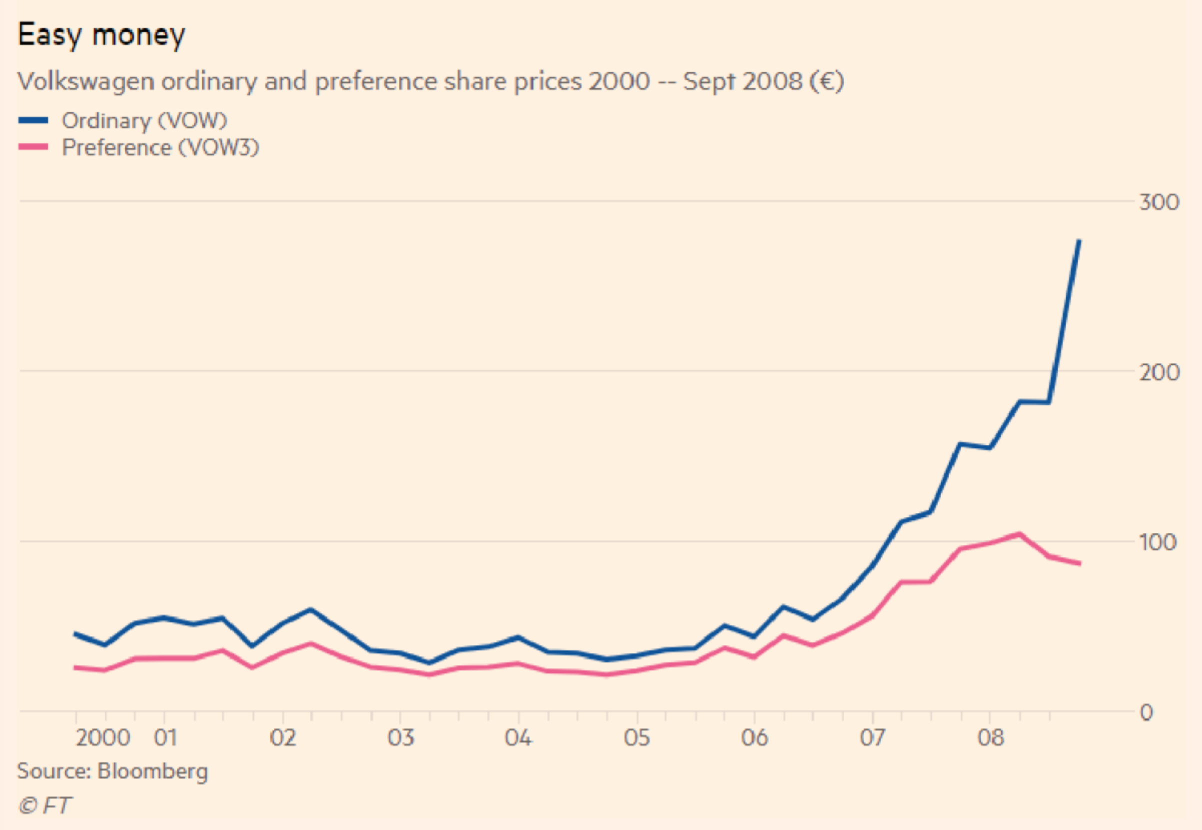


In March 2005, Porsche started buying ordinary shares of Volkswagen Group.

You can read the whole story here, but I'll just give you the main points.

Porsche was trying to have a majority control of Volkswagen Group by buying the ordinary shares. This sent the ordinary shares up as expected. However, the preferred shares were going down since there was a financial crisis. Short sellers saw this discrepancy and started shorting ordinary shares. They expected that sooner or later the ordinary shares would fall back to normal levels.

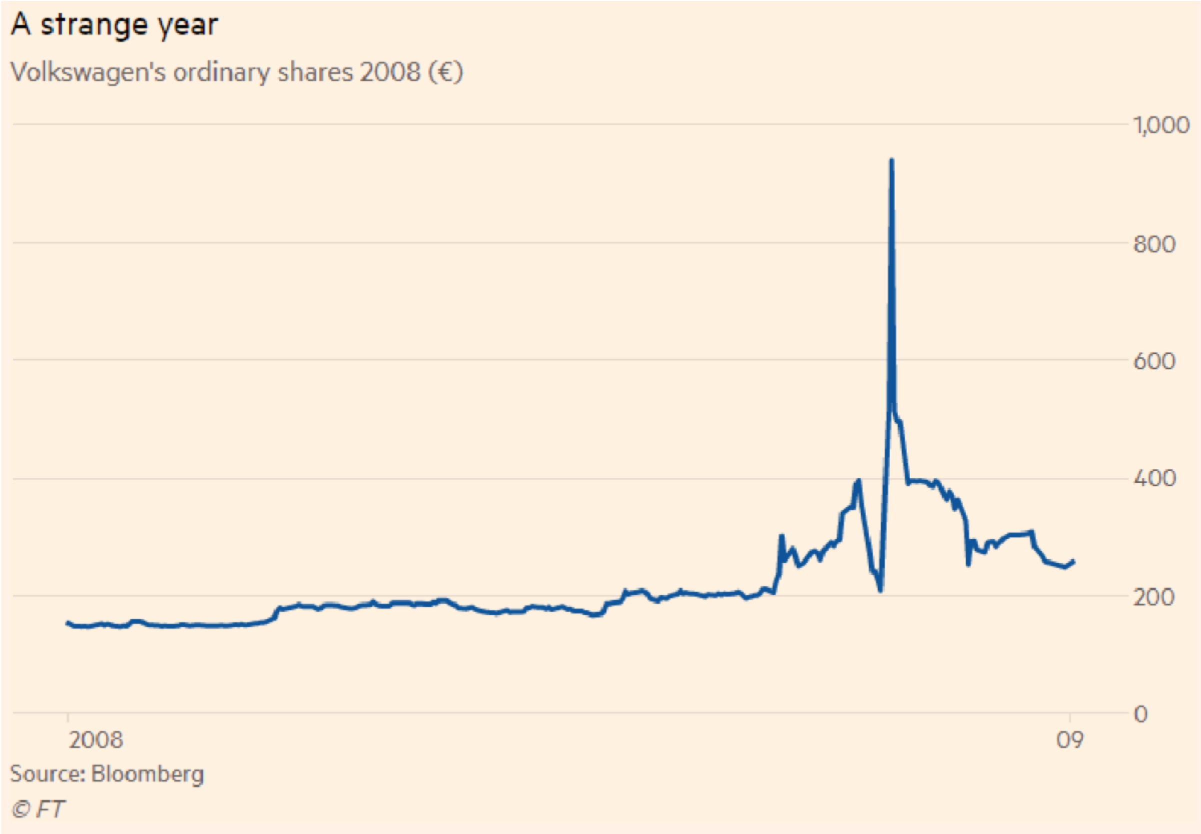




The short ratio was about 10%. And it was assumed that Porsche owned about 50% with other institutional investors owning 20%. There was 20% of shares in the open market, enough to cover the shorts.

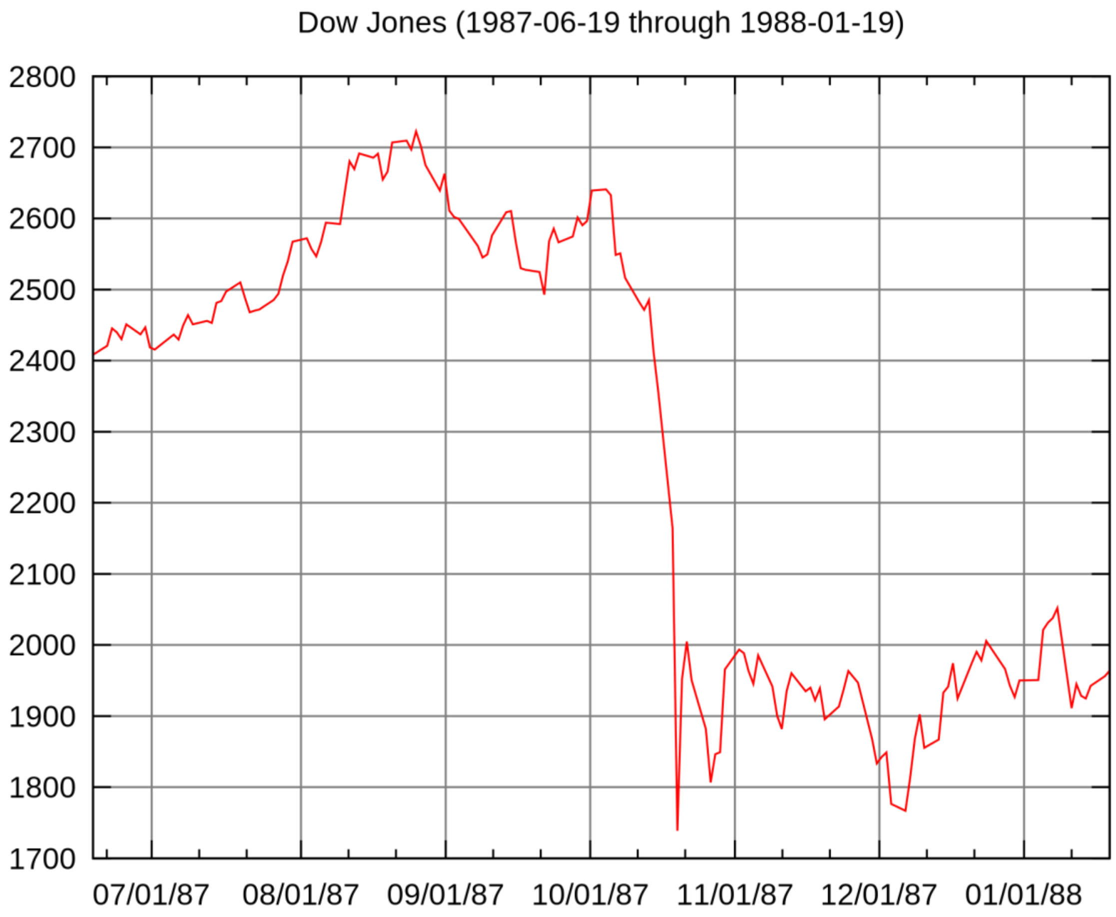
Then, on Sunday 26th of October, Porsche announces that they have been buying more Volkswagen shares and now they own 74% of the company. This would mean that only 6% of the shares were now available to cover the 10% shorts.

On the next day, Monday 27th of October 2008, short sellers had to buy shares to cover their positions and a short squeeze was created and the stock skyrocketed by over 400% that day. Volkswagen briefly became the largest company on Earth.



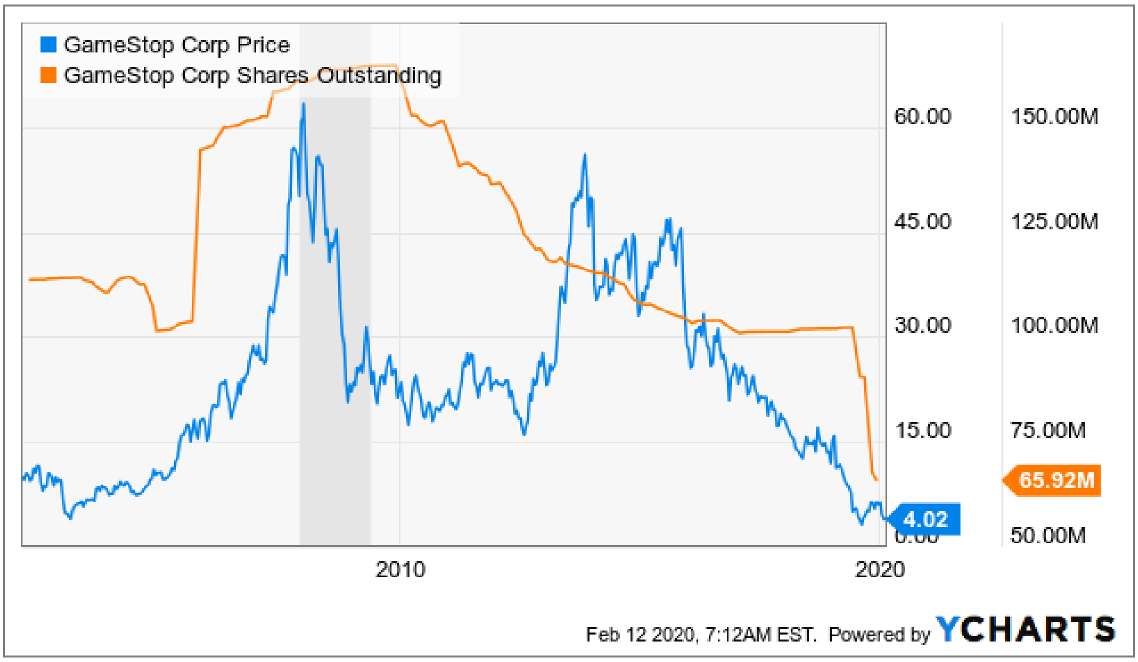
German investor, Adolf Merckle, who was at the time the 94th richest man in the world lost a lot of money on that trade. He was shorting shares of Volkswagen. He ultimately committed suicide.

Another example of a short squeeze was in the whole US stock market in October 1987. The famous Black Monday when the Dow lost 22%, that was a short squeeze. Paul Tudor Jones was able to see that and made a fortune.



My hypothesis is that there is the possibility of a short squeeze happening with GameStop.

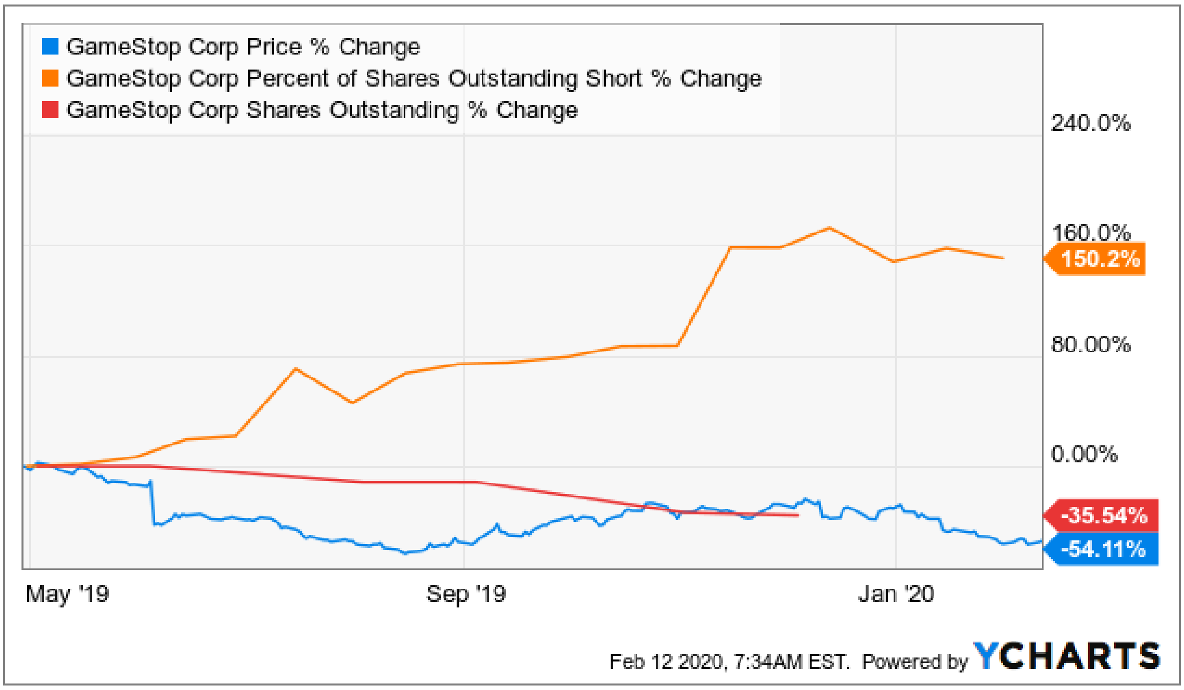
As I mentioned, GameStop is expected to have larger sales next year than this year because of the new consoles. GameStop is a dying business, but it is not going to die anytime soon. The company has a great balance sheet and they are even buying back their shares. Last quarter alone, they bought back 35% of the company and they can still buy 40% with the current repurchase program.



There are currently 66 million shares of GameStop, how many of those do you think are being shorted? Half? Two-thirds?

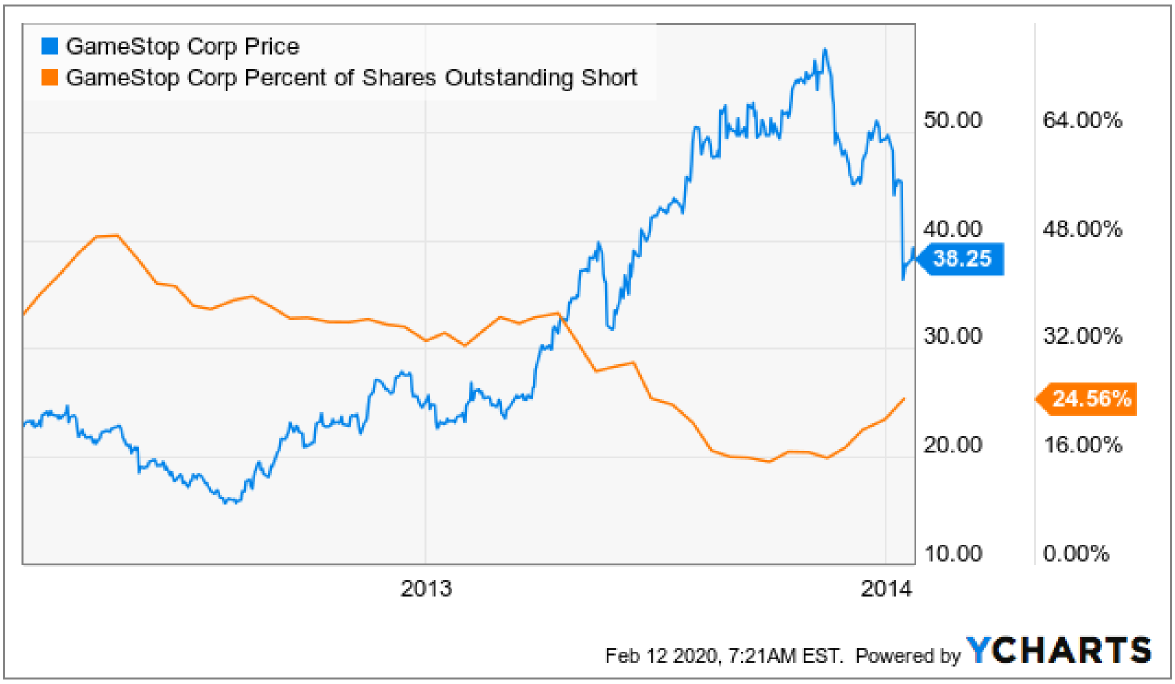
96%.

Here's what's happening. The shares are going down because of the failing business and short sellers expect this to continue. They are selling more and more shares while GameStop is buying more and more shares. At the current rate at which the stocks are being traded, it will take 16 days to cover the shorts. That's not good and can eventually lead to a short squeeze.



In the last twelve months, the stock price of GameStop fell by 54% and Wall Street expects this to continue. GameStop has been taking advantage of that to buy more shares. They bought back 35% of the company. Short sellers seeing the price falling have increased their positions by 150%. That doesn't look stable at all to me.

Just the good news that GameStop is selling more consoles than expected can trigger a short squeeze. Actually, a short squeeze happened in 2013.



The short ratio went from 50% to 16% in less than a year while the shares gained over 300%.

This was not really a big short squeeze as we saw with Volkswagen and the conditions of GameStop today are not similar with GameStop 7 years ago but if we have a short squeeze this time, it can be larger than in 2013.

There is also the possibility that the short sellers choose to take the company private to avoid the short squeeze. This would mean they will need a premium on the current price and if you’re holding on GameStop right now, this might be good.

But if this doesn’t happen and GameStop continues to buy back their shares and the company reports positive earnings as the new consoles are launched, there’s a high probability of a short squeeze happening. The stock can gain 500% or even more in just a couple of days or hours.

Shorting GameStop right now is quite dangerous as you could lose more money that you own.

Could it be that Big Short Investor Michael Burry is buying GameStop because he sees a short squeeze coming? Maybe.

As for me, I will hold on GameStop. If I’m wrong, I lose about 7% of my portfolio. If I’m right I can make 35% of my portfolio in a couple of days. I’m ready to take that risk.

12th of February 2020